

ROBERT F. HARTLEY

MARKETING MISTAKES & SUCCESSSES



11th Edition

ELEVENTH EDITION

MARKETING MISTAKES AND SUCCESSSES

30TH ANNIVERSARY

Robert F. Hartley
Cleveland State University



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P R E F A C E

Welcome to the 30th anniversary of *Marketing Mistakes and Successes* with this 11th edition. Who would have thought that interest in mistakes would be so enduring? Many of you are past users, a few even for decades. I hope you will find this new edition a worthy successor to earlier editions.

I think this may even be my best book. The new Google and Starbucks cases should arouse keen student interest, and may even inspire another generation of entrepreneurs. A fair number of the older cases have faced significant changes in the last few years, for better or for worse, and these we have captured to add to learning insights.

After so many years of investigating mistakes, and more recently successes also, it might seem a challenge to keep these new editions fresh and interesting. The joy of the chase has made this an intriguing endeavor through the decades. Still, it is always difficult to abandon interesting cases that have stimulated student discussions and provoked useful insights, but newer case possibilities are ever contesting for inclusion. Examples of good and bad handling of problems and opportunities are forever emerging. But sometimes we bring back an oldie, and with updating, gain a new perspective.

For new users, I hope the book will meet your full expectations and be an effective instructional tool. Although case books abound, you and your students may find this somewhat unique and very readable, a book that can help transform dry and rather remote concepts into practical reality, and lead to lively class discussions, and even debates. In the gentle environment of the classroom, students can hone their analytical skills and also their persuasive skills—not selling products but selling their ideas—and defend them against critical scrutiny. This is great practice for the arena of business to come.

NEW TO THIS EDITION

In contrast to the early editions, which examined only notable mistakes, and based on your favorable comments about recent editions, I have again included some well-known successes. While mistakes provide valuable learning insights, we can also learn from successes and find nuggets by comparing the unsuccessful with the successful.

With the addition of Google and Starbucks, we have moved **Entrepreneurial Adventures** up to the front of the book. We have continued **Marketing Wars**, which many of you recommended, and reinstated **Comebacks** of firms

rising from adversity. I have also brought back **Ethical Mistakes**, because I believe that organizations more than ever need to be responsive to society's best interests. Altogether, this 11th edition brings seven new cases to replace seven that were deleted from the previous edition. Some of the cases are so current we continued updating until the manuscript left for the production process. We have tried to keep all cases as current as possible by using Postscripts, Later Developments, and Updates.

A number of you have asked that I identify which cases would be appropriate for the traditional coverage of topics as organized in typical marketing texts. With most cases it is not possible to truly compartmentalize the mistake or success to merely one topic. The patterns of success or failure tend to be more pervasive. Still, I think you will find the following classification of cases by subject matter to be helpful. I thank those of you who made this and other suggestions.

Classification of Cases by Major Marketing Topics

Topics	Most Relevant Cases
Marketing Research and Consumer Analysis	Coca-Cola, Disney, McDonald's, Google, Starbucks
Product	Starbucks, Nike, Coke/Pepsi, McDonald's, Maytag, Dell, Hewlett-Packard, Newell Rubbermaid, DaimlerChrysler, Kmart/Sears, Harley-Davidson, Boeing/Airbus, Merck, Boston Beer, Firestone/Ford, Southwest, MetLife, Borden, United Way, Vanguard, Continental, Euro Disney
Distribution	Nike, Coke/Pepsi, Newell Rubbermaid, Harley-Davidson, Vanguard, Starbucks, Kmart/Sears, Hewlett-Packard, Dell
Promotion	Nike, Coke/Pepsi, Maytag, Vanguard, Merck, Boston Beer, Kmart/Sears, Harley-Davidson, Borden, MetLife, Hewlett-Packard, Southwest Air, Google, Starbucks
Price	Continental, Southwest, Vanguard, Starbucks, Boston Beer, Dell, Euro Disney, Newell Rubbermaid, Boeing/Airbus, McDonald's
Non-product	Google, United Way, Disney, Southwest, Continental
International	Euro Disney, Boeing/Airbus, Harley-Davidson, Maytag, DaimlerChrysler, Firestone/Ford, Dell, Hewlett-Packard, Nike, Coke/Pepsi, Starbucks, McDonald's
Customer Relations	Newell Rubbermaid, Vanguard, Maytag, Harley, Merck, Firestone/Ford, Starbucks, United Way, Nike, MetLife
Social and Ethical	Starbucks, Merck, Firestone/Ford, United Way, MetLife
Outsourcing	Boeing/Airbus, Maytag, Nike, Dell

TARGETED COURSES

As a supplemental text, this book can be used in a variety of undergraduate and graduate courses. These range from introduction to marketing/marketing principles to courses in marketing management and strategic marketing. It can also be used as a text in international marketing courses. Retailing, entrepreneurship, and ethics courses could use a number of these cases and their learning insights. It can certainly be used in training programs and even appeal to nonprofessionals who are looking for a good read about well-known firms and personalities.

TEACHING AIDS

As in previous editions, you will find a plethora of teaching aids and discussion material within and at the end of each chapter. Some of these will be common to several cases, and illustrate that certain successful and unsuccessful practices are not unique.

Information Boxes and Issue Boxes are included in each chapter to highlight relevant concepts and issues, or related information, and we are even testing Profile Boxes. Learning insights help students see how certain practices—both errors and successes—cross company lines and are prone to be either traps for the unwary or success modes. Discussion Questions and Hands-On Exercises encourage and stimulate student involvement. A recent pedagogical feature is the Team Debate Exercise, in which formal issues and options can be debated for each case. New in some cases are *Devil's Advocate* exercises in which students can argue against a proposed course of action to test its merits. A new pedagogical feature, based on a reviewer's recommendation, appears at the end of the Analysis section: students are asked to make their own analysis, draw their own conclusions, and defend them, thereby having an opportunity to stretch themselves. In some cases where there is considerable updating, a new feature invites students to *Assess the Latest Developments*. Invitation to Research suggestions allow students to take the case a step further, to investigate what has happened since the case was written, both to the company and even to some of the individuals involved. In the final chapter, the various learning insights are summarized and classified into general conclusions.

An Instructor's Manual written by the author accompanies the text to provide suggestions and considerations for the pedagogical material within and at the ends of chapters.

ACKNOWLEDGMENTS

It seems fitting to acknowledge everyone who has provided encouragement, information, advice, and constructive criticism through the years since the first edition of these *Mistakes* books. I hope you all are well and successful, and I truly appreciate your contributions. I apologize if I have missed anybody, and

would be grateful to know such so we can rectify this in future editions. I welcome updates to present affiliations.

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Before coming into academia, he spent thirteen years in retailing with the predecessor of Kmart (S. S. Kresge), JCPenney, and Dayton-Hudson and its Target subsidiary. He held positions in store management, central buying, and merchandise management.

His first textbook, *Marketing: Management and Social Change*, was published in 1972. It was ahead of its time in introducing social and environmental issues to the study of marketing. Other books, *Marketing Fundamentals*, *Retailing*, *Sales Management*, and *Marketing Research*, followed.

In 1976 the first *Marketing Mistakes* book was published and brought a new approach to case studies, making them student-friendly and more relevant to career enhancement than existing books. In 1983, *Management Mistakes* was published. These books are now in the eleventh and ninth editions, respectively, and have been widely translated. In 1992 Professor Hartley wrote *Business Ethics: Violations of the Public Trust*. *Business Ethics Mistakes and Successes* was published in 2005. He is listed in Who's Who in America, and Who's Who in the World.

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Introduction

At this writing, *Marketing Mistakes* has passed its thirtieth anniversary. Who would have thought? The first edition, back in 1976, was 147 pages and included such long-forgotten cases as Korvette, W. T. Grant, Edsel, Corfam, Gilbert, and the Midi.

In this eleventh edition, seven cases from the tenth edition have been dropped, and seven added, several of these being modified from earlier editions. Other cases have been updated, and in some instances reclassified. Two exciting new entrepreneurial cases, Google and Starbucks, are introduced, and the entire Entrepreneurial Adventures moved to the front of the book as Part I. I think your students will find these cases particularly interesting and even inspiring.

The popular “Marketing Wars” is again included, this time as Part II, and it follows major competitors in their furious struggles. Two new parts have been added from older editions: Part III Comebacks, and Part VI Ethical Mistakes. In response to your feedback, the section on notable successes has been continued. Some cases are as recent as today’s headlines; several still have not come to complete resolution. A few older cases have been continued or brought back. For example, Borden last appeared in the ninth edition, but some of you thought the learning insights were important enough to reintroduce the case.

We continue to seek what can be learned—insights that are transferable to other firms, other times, other situations. What key factors brought monumental mistakes to some firms and resounding successes for others? Through such evaluations and studies of contrasts, we may learn to improve batting averages in the intriguing, ever-challenging art of decision making.

We will encounter organizational life cycles, with an organization growing and prospering, then failing (just as humans do), but occasionally resurging. Success rarely lasts forever, but even the most serious mistakes can be (but are not always) overcome.

As in previous editions, a variety of firms, industries, mistakes, and successes are presented. You will be familiar with most of the organizations, although probably not with the details of their situations.

We are always on the lookout for cases that can bring out certain points or caveats in the art of marketing decision making, and that give a balanced view of the spectrum of marketing problems. The goal is to present examples that provide

somewhat different learning experiences, where at least some aspect of the mistake or success is unique. Still, we see similar mistakes occurring time and again. From the prevalence of such mistakes, we have to wonder how much decision making has really progressed over the decades. The challenge is still there to improve it, and with it marketing efficiency and career advancement.

Let us then consider what learning insights we can gain, with the benefit of hindsight, from examining these examples of successful and unsuccessful marketing practices.

LEARNING INSIGHTS

Analyzing Mistakes

In looking at sick companies, or even healthy ones that have experienced difficulties with certain parts of their operations, it is tempting to be overly critical. It is easy to criticize with the benefit of hindsight. Mistakes are inevitable, given the present state of decision making and the dynamic environment facing organizations.

Mistakes can be categorized as errors of omission and of commission. *Mistakes of omission* are those in which no action was taken and the status quo was contentedly embraced amid a changing environment. Such errors, often characteristic of conservative or stodgy management, are not as obvious as the other category of mistakes. They seldom involve tumultuous upheaval; rather, the company's competitive position slowly erodes, until management finally realizes that mistakes having monumental impact have been allowed to happen. The firm's fortunes often never regain their former luster.

Mistakes of commission are more spectacular. They involve hasty decisions often based on faulty research, poor planning, misdirected execution, and the like. Although the costs of eroding competitive position due to errors of omission are difficult to calculate precisely, the costs of errors of commission are often fully evident. For example, with Euro Disney, in 1993 alone the loss was \$960 million from a poorly planned venture; it improved in 1994 with only a \$366 million loss. With Maytag's overseas Hoover Division, the costs of an incredibly bungled sales promotion were more than \$300 million, and still counting. Then there was the monumental acquisition of Chrysler by Germany's Daimler, maker of proud Mercedes, for \$36 billion in 1998. After nine tumultuous years, Daimler gave up and sold Chrysler to a private equity firm in 2007 for only \$7.4 billion.

Although they may make mistakes, organizations with sharp managements follow certain patterns when confronting difficult situations:

1. Looming problems or present mistakes are quickly recognized.
2. The causes of the problem(s) are carefully determined.
3. Alternative corrective actions are evaluated in view of the company's resources and constraints.
4. Corrective action is prompt. Sometimes this requires a ruthless axing of the product, the division, or whatever is at fault.

5. Mistakes provide learning experiences. The same mistakes are not repeated, and future operations are consequently strengthened.

Slowness to recognize emerging problems leads us to think that management is incompetent or that controls have not been established to provide prompt feedback at strategic control points. For example, a declining competitive position in one or a few geographical areas should be a red flag that something is amiss. To wait months before investigating or taking action may mean a permanent loss of business. Admittedly, signals sometimes get mixed, and complete information may be lacking, but procrastination is not easily defended.

Just as problems should be quickly recognized, the causes of these problems—the “why” of the unexpected results—must be determined as quickly as possible. It is premature, and rash, to take action before knowing where the problems really lie. Returning to the previous example, the loss of competitive position in one or a few markets may reflect circumstances beyond the firm’s immediate control, such as an aggressive new competitor who is drastically cutting prices to “buy sales.” In this situation, all competing firms will likely lose market share, and little can be done except to stay as competitive as possible with prices and servicing. However, closer investigation may reveal that the erosion of business was due to unreliable deliveries, poor quality control, noncompetitive prices, or incompetent sales staff.

With the cause(s) of the problem defined, various alternatives for dealing with it should be identified and evaluated. This may require further research, such as obtaining feedback from customers and from field personnel. Finally, the decision to correct the situation should be made as objectively as possible. If drastic action is needed, there usually is little rationale for delaying. Serious problems do not go away by themselves: They tend to fester and become worse.

Finally, some learning experience should result from the misadventure. A vice president of one successful firm told me,

I try to give my subordinates as much decision-making experience as possible. Perhaps I err on the side of delegating too much. In any case, I expect some mistakes to be made, some decisions that were not for the best. I don’t come down too hard usually. This is part of the learning experience. But God help them if they make the same mistake again. There has been no learning experience, and I question their competence for higher executive positions.

Analyzing Successes

Successes deserve as much analysis as mistakes, although admittedly the urgency is less than with an emerging problem that requires quick remedial action. Any analysis of success should seek answers to at least the following questions:

Why Were Such Actions Successful?

- Was it because of the nature of the environment, and if so, how?
- Was it because of particular research, and if so, what and how?

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- Was it because of particular engineering and/or production efforts, and if so, can these be adapted to other operations?
- Was it because of any particular element of the strategy—such as service, promotional activities, or distribution methods—and if so, how, and is it transferable to other operations?
- Was it because of the specific elements of the strategy meshing well together, and if so, how was this achieved?

Was the Situation Unique and Unlikely to Be Encountered Again?

- If the situation was not unique, how can these successful techniques be used in the future and defended against competition?

ORGANIZATION OF THIS BOOK

In this eleventh edition we have modified the classification of cases somewhat from earlier editions. As mentioned before, Part I, *Entrepreneurial Adventures*, describes and analyzes well-known recent endeavors. In Part II, *Marketing Wars*, we examine the actions and countermoves of archrivals in hotly competitive arenas. Part III, *Comebacks*, studies three firms that faced adversity, and came back better than ever. In Part IV, *Marketing Management Mistakes*, we delve into seven firms guilty of a variety of mistakes that offer great learning insights. Part V, *Notable Marketing Successes*, offers paragons of successful marketing strategies and operations. Finally, in Part VI, *Ethical Mistakes*, we examine three firms whose mistakes had major ethical and legal consequences. Let us briefly describe the cases that follow.

Entrepreneurial Adventures

Google is arguably the most outstanding successful new enterprise ever. It was founded by Sergey Brin and Larry Page who dropped out of Stanford's Ph.D program to do so. With its search engine, it raised advertising to a new level: targeted advertising. In so doing, it spawned a host of millionaires from its rising stock prices and stock options and made its two founders some of the richest Americans, just under Bill Gates and Warren Buffett. How did they do it?

Starbucks is also a rapidly growing new firm—not as much as Google, but still great—and a credit to founder Howard Schultz's vision of transforming a prosaic product, coffee, into a gourmet coffee house experience at luxury prices.

Boston Beer burst on the microbrewery scene with Samuel Adams beers, higher priced even than most imports. Notwithstanding this—or maybe because of it—Boston Beer became the largest microbrewer. It proved that a small entrepreneur can compete successfully against the giants in the industry, and do this on a national scale.

Marketing Wars

Pepsi and Coca-Cola for decades competed worldwide. Usually Coca-Cola won out, but it could never let its guard down; however, it recently did so in Europe. Now a

trend toward noncarbonated beverages along with Pepsi's non-drink diversifications is swinging the momentum to Pepsi. But Coca-Cola is trying hard to recover.

Dell long dominated the PC market with lowest-prices, direct-to-consumer marketing. Hewlett-Packard, the world's second biggest computer maker, chose Carly Fiorina, a charismatic visionary, to be its CEO, and she engineered a merger with Compaq. But growth in profitability did not follow, and early in 2005, the board fired Fiorina. Mark Hurd, an operational person, replaced her, and brought the company to PC dominance. But Michael Dell is fighting back.

Boeing long dominated the worldwide commercial aircraft market, with the European Airbus only a minor player. A series of Boeing blunders, however, coupled with an aggressive Airbus, brought market shares close to parity. Both firms are now introducing strikingly new planes, but are finding problems with their outsourcing key components to foreign suppliers.

Comebacks

McDonald's had long dominated the fast food restaurant market. Then it began to falter, and hungry competitors made inroads into its competitive position. As it fought to regain its momentum, it explored diversifications and ever more store openings, while profitability plummeted. Recently, it found a new formula for profitable growth.

In the early 1960s, Harley-Davidson dominated a static motorcycle industry. Suddenly, Honda burst on the scene and Harley's market share dropped from 70 percent to 5 percent in only a few years. It took Harley nearly three decades to revive, but now it has created a mystique for its heavy motorcycles and gained new customers. And its Rallies are something else again.

The comeback of Continental Airlines from extreme adversity and devastated employee morale to become one of the best airlines in the country is an achievement of no small moment. New CEO Gordon Bethune brought marketing and human relations skills to one of the most rapid turnarounds ever, overcoming a decade of raucous adversarial labor relations and a reputation in the pits.

Marketing Management Mistakes

Borden, with its enduring symbol of Elsie the Cow, was the country's largest producer of dairy products. On an acquisitions binge in the 1980s, it became a diversified food processor and marketer—and a \$7 billion company. But Borden allowed consumer acceptance of its many brands to wither through unrealistic pricing, ineffective advertising, and an unwieldy organization.

United Way of America is a nonprofit organization. The man who led it to become the nation's largest charity perceived himself as virtually beyond authority. Exorbitant spending, favoritism, conflicts of interest—these went without criticism until investigative reporters from the *Washington Post* publicized the scandalous conduct. With its public image plummeting, contributions nationwide drastically declined. The real concern was whether United Way could ever regain its former luster.

The merger of Chrysler with Daimler, the huge German firm that makes Mercedes, was supposed to be a merger of equals. But Chrysler's management quickly found otherwise, and the top Chrysler executives were soon replaced by executives from Germany. Assimilation and coordination problems plagued the merger for years. Nine years later, Daimler sold Chrysler to a private equity firm for tens of billions of dollars less than it paid.

Newell, a consumer-products firm, successfully geared its operations to meet the demands of giant retailers, particularly Wal-Mart, whereas Rubbermaid had in recent years been unable to meet those stringent requirements. In 1999, Newell acquired Rubbermaid, confident of turning its operation around, only to find that Rubbermaid's problems were not easily corrected and that they negatively impacted Newell's fortunes as well. What do you do now?

In April 1992, just outside Paris, Disney opened its first theme park in Europe. It had high expectations and supreme self-confidence (critics later called it arrogance). The earlier Disney parks in California, Florida, and more recently Japan were all spectacular successes. But rosy expectations became a delusion as marketing miscues finally showed Disney that Europeans, and particularly the French, were not carbon copies of visitors elsewhere.

The problems of Maytag's Hoover subsidiary in the United Kingdom almost defy reason. The subsidiary planned a promotional campaign so generous that the company was overwhelmed with takers; it could neither supply the products nor grant the prizes. In a miscue of multimillion-dollar consequences, Maytag had to foot the bill while trying to appease irate customers. What can we learn from Maytag's travails?

Two faltering retail chains, Kmart and Sears, merged under the auspices of a hedge fund manager, Edward Lampert. Whether two weaklings could become one strong operation to compete with the likes of Wal-Mart and Target was uncertain, though investors bid both stocks up to extravagant levels in anticipation. The rosy expectations collapsed as we moved into a recession in 2007 and 2008.

Notable Marketing Successes

Southwest Airlines found a strategic window of opportunity as the lowest cost and lowest price carrier between certain cities. And how it milked this opportunity! Now it threatened major airlines in many of their domestic routes. However, by 2008, competitors were beginning to counter Southwest's price advantage.

Nike and Reebok were major competitors in the athletic footwear and apparel market. Nike was overtaken by Reebok in the late 1980s, but then Nike surged far ahead, never to be threatened again. What is the secret of Nike's increasing dominance?

Vanguard has become the largest mutual fund company, charging past Fidelity. Vanguard's strategy is to downplay marketing, shunning the heavy advertising and overhead of its competitors. It provides investors with better returns through far lower expense ratios and relies mostly on word of mouth and unpaid publicity to

gain new customers, while old customers continue to pour in money. Is Vanguard vulnerable to aggressive new competitors?

Ethical Mistakes

Merck, the pharmaceutical giant, learned that its blockbuster arthritis drug, Vioxx, doubled the risk of a heart attack or stroke. Over five years and \$500 million in advertising, it had 20 million users in the United States at the time it recalled the drug September 30, 2004. Critics and tort lawyers assailed the company for waiting so long to recall this drug, since some research studies as early as five years before had raised questions about the safety of Vioxx. What can we learn from Merck's handling of its great profit-making drug now discredited?

The huge insurance firm MetLife, whether through loose controls or tacit approval, permitted an agent to use deceptive selling tactics on a grand scale, in the process enriching himself and the company. Investigations by several state attorneys general brought a crisis situation to the firm that it was slow to react to. Eventually, fines and lawsuits totaled almost \$2 billion.

Product safety lapses that result in injuries and even loss of life are among the worst abuses any company can confront. Worse, however, is when such risks are allowed to continue for years. Ford Explorers equipped with Firestone tires were involved in more than 200 deaths from tire failures and vehicle rollovers. After news of the accidents began surfacing, Ford and Firestone each blamed the other for the deaths. Eventually, inept crisis management brought a host of lawsuits resulting in massive recalls and billions in damages.

GENERAL WRAP-UP

Where possible, the text depicts major personalities involved in these cases. Imagine yourself in their positions, confronting the problems and facing choices at their points of crisis or just-recognized opportunities. What would you have done differently, and why? We invite you to participate in the discussion questions, the hands-on exercises, the debates appearing at the ends of chapters, and the occasional devil's advocate invitation (a devil's advocate is one who argues an opposing viewpoint for the sake of testing the decision). There are also discussion questions for the various boxes within chapters.

While doing these activities, you may feel the excitement and challenge of decision making under conditions of uncertainty. Perhaps you may even become a fast-track executive and make better decisions.

QUESTIONS

1. Do you agree that it is impossible for a firm to avoid mistakes? Why or why not?
2. How can a firm speed up its awareness of emerging problems so that it can take corrective action? Be as specific as you can.

3. Large firms tend to err on the side of conservatism and are slower to take corrective action than smaller ones. Why do you suppose this is?
4. Which is likely to be more costly to a firm, errors of omission or errors of commission? Why?
5. So often we see the successful firm eventually losing its pattern of success. Why is success not more enduring?

**PART
ONE**

**ENTREPRENEURIAL
ADVENTURES**

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Google—An Entrepreneurial Juggernaut

In 1998 Sergey Brin and Larry Page dropped out of the Ph.D program at Stanford to start Google in a friend's garage. Along the way, they discovered a powerful marketing tool that would revolutionize advertising. Six years later, on August 19, 2004, they took this Internet search and advertising firm public at a price of \$85 a share. One year after the initial public offering (IPO), Google stock closed at \$280. By 2007, the stock had gone over \$700, and lots of people had become very rich. But this was to cause some serious concerns for the firm.

Brain Drain

Craig Silverstein, a fellow Stanford Ph.D student, was the first hire of Page and Brin. He helped them move their equipment out of Page's dorm room and into a place with more space and, more importantly, a garage. In early 1999, five months later, the enterprise had grown enough to move into offices on University Avenue in downtown Palo Alto. The firm's fortunes continued to improve, and Craig became director of technology in charge of product development. Before many years, Craig realized he had become very rich indeed.

From the beginning, Google gave its employees stock options in lieu of competitive salaries that in those days it could ill afford. These options gave employees the right to purchase a given number of shares of stock at a certain price, called a vested price, some years in the future. Even before going public in 2004, it had granted two big batches of such options. A 2002 grant that was priced at 30 cents a share vested in 2006. Another, priced at \$4 a share in 2003, also vested in 2006. In May 2008, another round of options would be exercisable at \$35, far more costly than the 30 cent option, but the way the stock was going up since the IPO, this higher price was of little consequence. By 2007, Craig was worth well over \$100 million in Google stock and was becoming richer with every passing day.

He knew that some 700 of his associates were worth at least \$5 million, and he knew that many of them were talking about quitting, with some wanting to start their own businesses. He knew that Bismarck Lepe, for example, who began working

for Google in 2003, had left the firm immediately after his four-year options vested in 2007. He now had a few million dollars that would help him start his own firm—2 million in only four years, wow! Craig couldn't help pondering whether he should do the same. After all, how many hundreds of millions does one man need? But he did not really see himself as an entrepreneur. At his young age, about the same age as Sergey and Larry, he was not ready to retire to some South Sea island and count coconuts. So he stayed, caught up in the challenge of solving tough problems with other smart Googlers.¹

Making the brain drain all the more tempting for many of these employees was Google's hiring of the brightest young people, the very ones most likely to become entrepreneurs, if given the chance. Their ambitions fed on the great example of Google, as well as a plethora of smaller enterprises in this hotbed of innovation that was Silicone Valley with its great research universities such as Stanford.

SERGEY BRIN AND LARRY PAGE AND THE START OF GOOGLE

In 1998 when the venture that was to be Google was only an idea, Sergey and Larry were both 25 years old and were doctoral students at Stanford. Sergey was a math whiz, having completed his undergraduate degree at 19, and aced all ten of the required doctoral exams on his first try, and teamed easily with professors doing research. His parents' backgrounds were rich in science and technology. His mother was a scientist at NASA's Goddard Space Flight Center. His father, Michael, taught math at the University of Maryland. Sergey was born in Moscow, but he and his family left the Soviet Union when he was six, fleeing anti-Semitism and seeking greater opportunity for themselves and their children.

Larry Page grew up in Michigan, also the son of a professor whose Ph.D was computer science, and who taught at Michigan State University where Larry's mother also taught computer programming. He followed in the footsteps of his father and brother by going to the University of Michigan where he studied computer engineering, receiving his undergraduate degree in 1995. At first he had felt uneasy about being one of the select few to be admitted to Stanford's elite Ph.D program.

In those early days, these sons of esteemed professors were focused on pursuing their Ph.Ds, not on getting rich. "In their families, nothing trumped the value of a great education. Neither of them had the slightest idea just how soon their heartfelt commitment to academia would be tested."²

The Beginning

In the mid-1990s, the Internet was just emerging. Millions of people were logging on and communicating through email. But researchers grew frustrated with the clutter of Web sites. Searching it for relevant information often resulted in an abundance of completely meaningless data. Search engines began to organize the Internet, and thus Yahoo and AltaVista among others were born. But they still left a lot to be

¹ Examples can be found in Quentin Hardy, "Close to the Vest," *Forbes*, July 2, 2007, pp. 40–42.

² David A. Vise, *The Google Story*, New York: Delacorte, 2005, p. 31.

desired. The answer to more relevant research seemed to be a better use of links, such as a highlighted word or phrase. In 1996, Page and Brin teamed up to work on downloading and analyzing Web links. In the process they developed a ranking system for searching the Internet that yielded prioritized results based on relevance to the object of the search, and useful answers could be found swiftly.

In 1997, they made the search engine available to students, faculty, and administrators on the Stanford campus, and popularity grew by word of mouth. As the database and number of users burgeoned, more computers were needed. In these early days, Brin and Page were able to scrounge around for unused computers and string together inexpensive PCs. By July 1998, they had an index of 24 million pages, with more coming. But their growth was stymied by lack of capital.

They decided to take a leave of absence from the Ph.D program and start their own firm. This way they could develop a business of their own that would fit their search engine. If it was as good as they thought, and with Internet use growing so rapidly, growth could be virtually unlimited. Rather than selling out to some existing firm, wouldn't they be better off keeping control?

Still, by August they had run out of cash and badly needed an "angel." One of their professors suggested they meet his friend, Andy Bechtolsheim, a legendary investor in a string of successful start-ups. After listening to their presentation, he said, "This is the single best idea I've heard in years. I want to be part of this," and he left them a check for \$100,000 made out to Google Inc.³ It took them two weeks before they could formally incorporate the company, Google Inc., and then open their first bank account. The check sustained the two entrepreneurs at first, and in fall 1998 they moved their computers from a dorm room into a garage and several rooms of a house. They also hired a friend, Craig Silverstein (mentioned earlier), as their first employee.

After five months they outgrew the garage and moved into offices in downtown Palo Alto, barely a mile from the Stanford campus. By now, their search engine was handling 100,000 queries a day, all this through word of mouth, emails, and instant messages. But they were again running out of money, despite the now \$1 million in funding that they had collected from Bechtolsheim and other early investors, and through borrowing on their credit cards. But it was clear that with upward of 500,000 searches per day toward the end of the year, they needed much more money. In the boomtown climate of Silicon Valley in early 1999, a public stock offering was one option, even though Google had no profits. But Brin and Page resisted this option, not wanting to reveal their trade secrets and lose some control. Efforts to license their search technology to other firms wishing to use it for research, found few takers.

Eventually they went the venture capital route. But Brin and Page insisted on keeping control of Google's destiny and remain majority owners, or it was no deal. On June 7, 1999, less than one year after they left Stanford, they issued a press release announcing that two venture capital firms, Kleiner Perkins and Sequoia Capital, were investing \$25 million in Google. On the Stanford campus and around Palo Alto, amazement reigned at the enormity of the sum seemingly without the two giving anything up in return. "The announcement included details of the funding as well as additional information about Google, its impressive list of investors, and its growth

³ Vise, p. 48.

rate of 50 percent per month. All this put the company in the global limelight, giving it the opportunity to grow further through free media publicity.”⁴

But Google still had not earned any appreciable revenue to support its heady growth, and no plan for this was revealed in the press release.

THE EARLY GROWTH YEARS

By the end of 1999, Google was averaging 7 million searches per day, but its revenue from licensing remained small. If the business could not be reasonably profitable, they could hardly maintain their vision of vast information available to users without charge. With licensing its search technology to businesses proving to be such a limited revenue source, they finally were forced to consider allowing advertisers access to their multitude of users. Brin and Page could see a relationship between their search engine and the television networks: those offered entertainment and news for free, while charging millions for the advertising. But the two shuddered at the flashy banner ads that littered the Internet. Still, they belatedly recognized that advertising was where vast sums were being spent, not in licensing.

Creating a Different Advertising Model

They wanted to avoid the clutter of almost out-of-control, irrelevant ads, and they developed strict standards for size and type of ads. They separated the free search results from the ads, which they would label “Sponsored Links.” These “Links,” because of their relevance to the search, would be clicked on more often than if they were labeled simply “Ads.” They decided to display the links in a clearly marked box above the free search results. The ads would be brief and look identical, with just a headline, a short description, and a link to a web page. But these would be *targeted ads*, offering a major advantage for advertisers confronted with the huge wastage of advertising reaching uninterested audiences.

At first Google sold this advertising to large businesses that could afford expensive ad campaigns, but it soon found substantial market potential in letting smaller advertisers easily sign up online with a credit card, and their ads could then be running within minutes. This gave Google an edge over similar providers unable to offer such fast service, and also minimized its own costs of selling advertising.

Shortly after turning to its advertising model, Brin and Page had another innovative idea—they would rank ads based on relevance. And relevance would be determined by how often ads were clicked on by computer users. This would provide valuable feedback to advertisers and influence the selling and pricing of ads.

CHARGING AHEAD

When the Internet stock price bubble burst in 2000, it ravaged the former high-flying entrepreneurial firms of Silicone Valley with major layoffs and bankruptcies. But Google stood poised at the nadir of its great growth to come and was one of

⁴ Vise, p. 69.

the few firms able to hire outstanding software engineers and mathematicians, many holding worthless stock options. This pool of talent stimulated Google's growth as it moved to a large headquarters in Mountain View, named the Googleplex, forty minutes south of San Francisco. There Brin and Page developed a work environment practically unprecedented. See the following Information Box for some examples of this culture that was designed to cultivate strong loyalty and job satisfaction and to foster a creative, playful environment where Google's employees, mostly young and single, would be willing to spend their waking hours.

By early 2001, Google was recording 100 million searches per day. It was also entering the dictionary as a verb, as for example, to "google each other before dates." Now large firms, such as Wal-Mart, the world's biggest retailer, and Acura, a major automobile manufacturer, joined the entourage of firms advertising their wares on Google.

What was the secret behind the rapid growth of Google's advertising program? As we saw before, Google came up with an unique approach to advertising, an

INFORMATION BOX

WORK CLIMATE AT GOOGLE

Employees worked long hours but were treated like family. There was even a gourmet chef, with free meals, healthy drinks and snacks. The chef took pride in providing better meals than found in area restaurants. Given the international mix of employees, the menu was varied to cater to all tastes: Southwestern, classic Italian, French, African, Asian, Indian, etc. The *Wall Street Journal* sent a reporter out to investigate. "Where else but the Plex can you zip around on a bicycle and choose from multicultural comfort food, American regional food, small plates, entrees made with five ingredients or less, and dishes based on raw materials supplied from within 150 miles of Mountain View? Many employees eat three meals a day at the Plex's 17 food venues, open any time day or night. . . . We were told that Messrs. Brin and Page chow down with the troops." (Raymond Sokolov, "Googling Lunch," *Wall Street Journal*, December 1–2, 2007, pp. W1 and W5.)

Also furnished were such conveniences as on-site laundry, hair styling, dental and medical care, a car wash, day care, fitness facilities with personal trainers, and a professional masseuse. Brightly colored medicine balls, lava lamps, assorted gadgets and sports equipment gave the appearance of a college campus. Chartered buses had internet access so that commuters to San Francisco could use their laptops. Social events and entertainment were Friday afternoon and evening features.

As a spur for creativity, a policy was set that software engineers spend at least 20 percent of their time, or one day a week, working on whatever projects interested them.

Do you see any downside to these workplace amenities?

Would these influence your choosing to work for Google despite less money?

Would some of these be appropriate to other firms? If so, what kind of firms?

approach that most advertisers previously could only dream of: i.e., *Targeted Text Ads*. The unobtrusive ads are seen only by potential customers who are searching for information on that specific topic. In one swell swoop this advertising virtually eliminates the great *waste* of most mass media advertising that is viewed by a vast audience who have no interest whatever in the product being advertised despite millions and hundreds of millions of dollars being spent. For an example of the waste of such untargeted ads, consider an airline spending \$1 million or more on a TV ad campaign that gains only 100 new first-class customers as a result.⁵

Furthermore, in Google-placed ads no intrusive banners compete for attention. The text ads (links) and websites are read carefully by users or potential users, and these often find the ads as valuable as the actual search results.

A New CEO

In early January 2001, at the urging of its venture capitalists, Larry and Sergey reluctantly consented to hire a chief executive officer to run operations. Eric Schmidt was highly recommended by one of the venture capitalists. He not only had entrepreneurial experience as founder of Sun Microsystems, and CEO of Novell, but also academic credentials—a Ph.D in computer science from the University of California at Berkeley, and a degree in electrical engineering from Princeton. Then there was research experience at Xerox Palo Alto Research Center and Bell Labs. At 46, he was a seasoned tech executive and brought a needed mature balance to this organization of young people. Besides, he was willing to invest \$1 million of his own money to buy preferred stock in Google, this at a time when the company was running short of cash again. (It would soon never again run short of cash.)

Google entered into pacts with Yahoo, AOL, EarthLink, and Ask Jeeves. This gave it relationships with most of the biggest Internet properties.

By the end of 2002, Google and its venture capitalists could see that the search engine was going to be a huge financial success. For the year, it had recorded \$440 million in sales and an amazing \$100 million in profits. Virtually all of these profits came from people clicking on the text ads that were on the right side of search results pages at Google.com and the pages of its partners and affiliates. But the world did not realize the extent of this profitability since Google was still a private company. This silence about the profitability of the online search and advertising business model undoubtedly kept other firms, especially Microsoft and Yahoo, from investing in or developing search engines of their own—until Google had an almost insurmountable head start.

The advertising industry was being transformed as well, as billions of dollars of advertising was being shifted from television, radio, newspapers, and magazines to the Internet. But the time was nearing for Google to go public, and with this full disclosure would shock the investment community and make Google stock the darling of investors and employees alike.

⁵ Example cited in Seth Godin, “Your Product, Your Customer,” *Forbes*, May 7, 2007, p. 52.

GOING PUBLIC

Finally in early 2004, Larry and Sergey reluctantly started the process of taking Google public. In truth, their decision was practically dictated by federal rules that required public disclosure of financial results by companies with a substantial amount of assets and shareholders, and Google had exceeded these limits with many of the company employees having been given stock in the then-private firm. This move would enable them to convert their holdings to cash. The venture capitalists who had supplied the early crucial funds would also benefit from the liquidity that going public would provide.

For most entrepreneurs, taking their new firm public was the ultimate goal since the IPO (initial public offering) would often make them instant millionaires. But for Brin and Page, the reality of being billionaires was not all that appealing. They both lived relatively modestly, loved the privacy, and cared little for the accumulation of wealth and the accoutrements of wealth—such as grand homes, planes, and yachts to attest to their success. The company was debt free, self-funded, had plenty of cash, and had no need to sell stock to the public to raise money. They were not sure they wanted the immense publicity and what it would entail and affect the freedoms they had enjoyed, and that of their families. For example, would they need bodyguards? How about the paparazzi? And their employees who would become instant millionaires, how would this affect their intensity and focus? And would they even stay with Google, or go out on their own? (We know that many left to start their own enterprises.) In early 2004, the employees were quietly told that the company was going to file a public offering. And thousands of Google employees, spouses, and interested others began an eight-month guessing game of how much the company and themselves would be worth.

The eight months proved to be a stressful time for almost all concerned, but probably most of all for Brin and Page. Their reluctance to disclose much before the public auction did not endear them to the media. Then an ill-advised *Playboy* interview did not go well and even triggered a SEC investigation.

To make matters worse, the stock market was tanking as world oil prices spiked, and many analysts were warning of a global recession. Also, the Athens Olympics were starting amid great fears of terrorism. Google and its bankers realized that the initial price range of \$108–\$135 would probably not be acceptable to the market at this time, and on August 19, Google finally went public at \$85 a share. By the end of the first day, the stock had reached nearly \$100. By the next day it was \$108. It reached \$200 in November and kept climbing from there. *Forbes*, in its listing of the 400 Richest Americans cited Brin and Page's wealth at \$4 billion each at the end of 2004, due to the success of the IPO. Then in 2006, "The Google Guys crack the top 10 of the Forbes 400, each now worth \$18.5 billion." This placed them as the fifth richest Americans, in the company of Bill Gates and Warren Buffett, ahead of Michael Dell of Dell Computer, and way ahead of Donald Trump. And they were both only 34.⁶

⁶ *Forbes*, Forbes 400 The Richest People in America, October 8, 2007, p. 78.

AFTER THE IPO

After the IPO, the pace of innovation at Google got into high gear. New products and innovations were being spawned and made available to millions of customers around the world. Google became the darling of the media; no other firm or individual got the press coverage of Google. The fact that it was now a public company with its financial performance readily available—and as such now well covered by financial analysts who did not cover private firms—made its promising results and potential very visible. It expanded the lead in its core search and advertising business in the United States and much of the world. And with its new cash horde, it eagerly branched out into new areas, even such far out visions as a Green renewable-energy program to find ways to generate electricity more cheaply than by burning coal.⁷

Not surprising, the growth of Google was being compared with that of Microsoft two decades earlier. Google was also becoming a major competitor of Microsoft, not in PCs, but in a later phase of technology that was surpassing the earlier technology, this time by the power of the Internet revolution. But perhaps the real competition was in recruiting and retaining the brightest technology minds in the world. But more about this later. For now, let us compare this early growth of Google with Microsoft in the Information Box beginning on page 19.

Google's Poaching of Talent

As the business burgeoned in the spring and summer of 2005, Google added more than 700 employees in just three months. The total headcount now was 4,183, nearly double the total the previous year. Google was hiring Ph.Ds from the top universities across the country, and even trespassing on Microsoft's own neighborhood, at the University of Washington. It opened a facility in a Seattle suburb just down the road from Microsoft's Redmond plant, and now it was easy for their engineers and scientists to move over to Google. They didn't even have to move to a new city or change their commute.

In these days, Microsoft was viewed as a mature business. It no longer had the sex appeal that Google had grasped. Microsoft was struggling to keep its best people, even offering more money and perks. But the amazing growth and potential of Google brought the lure of great riches as stock options became valuable. As mentioned before, not the least of the perks that Google offered were the free restaurants and other amenities at its Googleplex headquarters in the Silicone Valley 40 minutes south of San Francisco.

The increasing poaching of talent climaxed with Dr. Kai-Fu Lee, a highly regarded scientist, who wanted to leave Microsoft to become president of Google China. Microsoft began an all-out legal assault alleging that Google improperly sought to induce Lee to violate the terms of his employment contract with Microsoft. A temporary triumph over Google raised the specter of litigation for any senior Microsoft employee who left for Google. The wide publicity served to illustrate how seriously Microsoft regarded the threat posed by its smaller rival.⁸

⁷ Rebecca Smith and Kevin J. Delaney, "Google's Electricity Initiative," *Wall Street Journal*, November 28, 2007, p. A16.

⁸ Vise, p. 274.

ANALYSIS

Here we have seen perhaps the greatest growth ever of a new enterprise. In the exuberance of this growth, investors bid up its stock market price to make the company more valuable than such long-established firms as Coca-Cola, Hewlett-Packard, Time Warner, AT&T, Boeing, Disney, McDonald's, and General Motors and Ford.

INFORMATION BOX

COMPARISON OF MICROSOFT AND GOOGLE

TABLE 2.1 Comparison of Microsoft and Google Growth in Revenues from Their Beginnings

	Microsoft		Google	
	Revenues (millions)	Y/Y Growth	Revenues (millions)	Y/Y Growth
Beginning	1975		1996	
Went Public	1986		2004	
Years from Beginning	11 years		8 years	
1986	\$ 197	40.7%		
1987	346	75.1		
1988	591	70.1		
1989	831	36.0		
1990	1,183	47.3		
1991	1,843	55.8		
1992	2,759	49.7		
1996	9,400			
2002	28,365		\$ 439	409%
2003	32,187	13.5	1,466	233.9
2004	36,835	14.4	3,189	117.5
2005	39,735	7.9	6,138	92.5
2006	44,282	11.4	10,605	72.8

Source: Calculated from company annual reports.

Commentary: The much faster start of Google is mind-boggling. The experts thought Microsoft was the model of the most successful entrepreneurial start ever. Bill Gates did not rush to take his venture public, waiting 11 years to do so, at which time revenues were almost \$200 million. Google on the other hand delayed only six years before going public, but its revenues were already over \$3 billion. As we can see, the year-to-year growth rate also strongly favored Google, with around a hundred percent growth since 2004. (The two years before going public showed growth over 400 percent and 200 percent each year.) The comparison between a young growth company and a mature Microsoft is clearly evident.

(continues)

COMPARISON OF MICROSOFT AND GOOGLE (*continued*)**TABLE 2.2 Comparison of Microsoft and Google Net Income from Their Beginnings**

	Microsoft		Google	
	Profit (millions)	Y/Y Growth	Profit (millions)	Y/Y Growth
1986	\$ 39.2	62.9%		
1987	71.9	83.1		
1988	123.9	54.2		
1989	170.5	47.1		
1990	279.2	63.7		
1991	462.7	65.7		
1992	708.1	55.9		
2002	7,829		\$ 100	
2003	9,993	27.0	108	.1 %
2004	8,168	(8.1)	399	269.4
2005	12,254	50.0	1,465	267.2
2006	12,599	2.8	3,077	110.0

Source: Calculated from company annual reports.

Commentary: Table 2.2 shows net income comparisons for Google and Microsoft in same year-to-year growth, and while Microsoft shows erratic growth, Google presents double and triple growth in the years since its IPO.

Not surprisingly, such growth stimulated burgeoning share prices, price valuations that some analysts thought not sustainable, while others saw as indicative of a supreme growth company and not unreasonable. Table 2.3 shows the stock market valuation of Google, Microsoft, and selected other major firms as of the beginning of 2007.

TABLE 2.3 Sales and Stock Market Valuations of Google and Selected U.S. Corporations End of 2006 (\$ millions)

	Sales	Market Value
Wal-Mart	348,650	201,357
ExxonMobil	335,086	410,665
General Electric	163,391	358,984
Hewlett-Packard	94,081	106,265
IBM	91,423	139,924
Procter & Gamble	73,602	200,335
Microsoft	46,057	275,850
Google	10,605	137,602
Coca-Cola	24,088	108,078

Source: Global Super Stars, 2007 Special Edition of *Forbes*, April 15, 2007: "The Top 100," pp. 148ff.

Commentary: In this company of heavyweights, Google was 32nd in Market Value. Despite sales of only \$10 billion, it still had more market value than Hewlett-Packard, and almost as much as IBM. In *Forbes's* listing of the top 50 firms in market value, many well-known firms did not make the list: e.g., Disney, McDonald's, General Motors, Yahoo, Amazon, and Time Warner. Google's high standing, despite its modest relative sales, of course reflects the valuation that investors have placed on the stock in view of its sensational growth in sales and profits, and its promising future. By the latter part of 2007, despite a flaky stock market, Google stock soared to over \$700 a share.

The rise of two young men to become the fifth richest in America—worth \$18.5 billion each in barely ten years after starting from scratch—has to be awesome. How did they do it? What was their secret? Or was it merely a matter of tremendous luck?

How Did They Do It?

Larry and Sergey were innovators. They did not originate searching the Internet, but they got in on the ground floor and ran with their ideas to vastly expand the search process. They were sufficiently creative and technologically adept with computers that they could string together a bunch of unused PCs to make a powerful entity, their search machine.

Their real innovation was how to make money from the searches. They wanted to make an Internet search free to all users—without this freedom to search without costing an arm and a leg, would the popularity of the Internet ever have reached the levels it did?

Probably not. But how do you make money without charging the users? Ah, there was the genius: It was *marketing strategy* at its finest. Advertising was the key, not licensing, which they had tried at first. But not just any advertising.

Firms spend hundreds of billions of dollars for mass media advertising, but most of it is wasted, this despite more than a century of advertising research. For most mass media advertising, advertising research can identify which ad or commercial of several is the most attention-getting, the most memorable, the most humorous, the most likeable. But how this directly translates into concrete demand and sales is more a matter of faith and hope. Mass media advertising can be improved if it can be seen by enough of those likely to be interested in purchasing. Certain media—TV and radio programs, magazines, newspapers, direct mail from carefully selected mailing lists—can help reach these target buyers. But still as we have seen, even for target buyers, many will not be particularly interested, or already have similar products, or just have different priorities for spending their money. The better job a firm can do in reaching a carefully chosen target audience, the more effective the advertising would be, and the more productive the money spent for the ad.

So, how did Larry and Sergey tie the most effective advertising to its Internet search? They did this through *targeted advertising*, that is, providing an arena for ads most likely to be read. Short advertising messages link the search for a particular topic to a Web page for a product or service of most interest to those searching. The advertiser of the short message then pays a small amount to Google based on each hit or click of its website.

At first, Larry and Sergey themselves did not see the great money-making potential of these small ads. Millions of users did not either; they couldn't fathom how Google could make billions of dollars of revenue when they were using it for free. But on the scale at which Google was operating—hundreds of millions of searches each day—even if just a small percentage of these searchers clicked on a ad at only cents per click, the results could be awesome.

The venture capitalists who had invested heavily in the new firm had been pressuring the founders for several years to recruit a strong top executive to handle the operations side of the business. Eric Schmidt proved to be both compatible with Page and Brin, and highly effective in installing good systems, policies, and controls, as well as being a mature interface for Google with government and business. It is doubtful if the time and talents of the founders could have brought Google as far along without him. Schmidt himself benefited well from the association, also becoming one of Forbes 400 Richest People in America, worth \$6.5 billion at the beginning of 2007.

The work environment could hardly have been better. The atmosphere was geared to young, highly educated professionals, many single, many driven and ambitious. Page and Brin were hardly older than most of their employees, and were of the same mode. It was a happy ship. Recruiting was easy. The environment stimulated creativity and innovation, and wealth through stock options was within reach. Microsoft was once this kind of firm, but now it had become mature, and vulnerable to a new over-achieving entity on its periphery.

So was the success of Larry and Sergey mostly due to tremendous luck? What do you think ?

Threats

While Google has been a growth phenomenon, still we can identify certain threats that may be on the horizon.

Litigation

With size and growth, a firm becomes more visible and vulnerable to litigation and regulation, especially from competitors who feel disadvantaged, employees who feel discriminated against, governments federal and otherwise who suspect anti-competitive actions, and from salivating lawyers eager to fan any perceived inequities or grievances. As we saw previously, Microsoft accused Google of inducing a key employee to violate an employment contract. Earlier lawsuits involved American Blinds in a trademark controversy, and also Geico, a major insurance conglomerate owned by Warren Buffett. These were harbingers of threats to come, and would eventually consume more corporate time and expense. Even if Google won most of its cases, the wide publicity could become a public relations nightmare.

Limits to Growth

As a firm becomes larger, statistics put a brake on growth percentages. For example, Google's growth percentages were 409 percent in 2002, 234 percent in 2003, and 118 percent in 2004. Such percentages of year-to-year growth are just not sustainable as a firm grows to a large size.

As a firm becomes larger, and especially if the major characters are young, the climate is ripe for jealousy and envy. This can arise among associates, employees,

governmental agencies, and others that the firm has to deal with. In its early growth stage, Google was the darling of the media. With increasing size, however, the media would likely become just as eager to capitalize on any miscues, with reporting not always objective.

A Climate of Arrogance and Cockiness?

John Battelle, in an insightful book about Google, observed a serious problem developing by late 2002 as the company was racking up massive sales gains. In a section titled “Just Who Did These Kids Think They Were?,” he noted a backlash growing that Google was unresponsive, self-centered, and dangerously cocky. “Google is going to have a major fall in the next couple of years. They’ve pissed off too many people,” a venture capitalist source was quoted. “Some of their hubris is warranted,” a major Wall Street analyst cautioned, “But this cult of genius is going to be difficult to take out of the company.” By mid-2002, Silicon Valley was in its second full year of recession, and tens of thousands of young technology workers were unemployed, and the only firm hiring was Google. Thousands of résumés poured in each week, and most were tossed away without any acknowledgment, and the bad mouthing began.

More than 100,000 advertisers were using its services by 2003, yet its customer service was abysmal. Google preferred to automate customer interactions, and shunned any personal contact. With years of great growth, Google was becoming viewed as the next great monopolist—first IBM, then Microsoft, and now Google. While this was attractive to those wishing to establish lucrative relationships, to many others, a cold and unresponsive great monopolist was hardly a desirable entity.⁹

I do not know whether “insular arrogance,” and the “cult of genius” sentiment still permeates the Google organization, as obviously it did in 2002–2004. I suspect success breeds such an attitude, unless strong efforts are made to minimize the hubris.

Can you identify any other likely threats?

UPDATE—GOING INTO 2008

Philanthropic Efforts

In early January 2008, Google unveiled nearly \$30 million in new grants and investments focusing on a massive philanthropic endeavor. This was the first of planned efforts in five focus areas: (1) to predict and prevent disease pandemics, (2) to empower the poor with information about public services, (3) to create jobs by investing in small- and midsize businesses in the developing world, (4) to accelerate

⁹ Adapted from John Battelle, *The Search, How Google and Its Rivals Rewrote the Rules of Business and Transformed Our Culture*, (New York: Penguin 2005) pp. 146–152.

the commercialization of plug-in cars, and (5) to make renewable energy cheaper than coal. Google had already set aside assets valued at about \$2 billion for this philanthropic arm, Google.org., this being the biggest in-house corporate foundation in the United States. (Some private foundations such as Microsoft's Bill Gates have more assets.) These initiatives were in areas where Google could utilize its engineering and information management prowess.

While this commitment to bettering the environment had to be laudable and concrete evidence of the corporate motto "Don't Be Evil," there were skeptics. Some warned that efforts trying to solve the world's problems have consistently underestimated the complexity of such problems, and fallen short. Critics warned that some of the initiatives would negatively affect the oil and coal industries and result in their business shifting out of Google's core online advertising.¹⁰

Microsoft Bids for Yahoo

At the end of January 2008, Microsoft formally made a hostile bid of \$44.6 billion for Yahoo, this being a 62 percent premium over Yahoo's share price, and an indication of its desire to narrow Google's dominance in the lucrative online search and advertising markets. This would be the largest acquisition in Microsoft's history, far surpassing last year's \$6 billion purchase of online ad service aQuantive. Actually, Microsoft had been after Yahoo for more than a year, but had been rebuffed. Steve Ballmer, Microsoft CEO, in a conference call said, "This is a decision we have—and I have—thought long and hard about. We are confident it is the right path for Microsoft and Yahoo."¹¹ The following statistics show the increasing dominance of Google and the tempting acquisition of Yahoo.

	2005	2006	2007
Google	\$2.41	\$4.10	\$6.12
Yahoo	2.44	3.00	3.33
AOL	.91	1.24	1.42
Microsoft	1.02	1.14	1.41

Source: Bloomberg News, Nielsen Online, eMarketer, as reported in *Cleveland Plain Dealer*, *ibid.*

Yahoo turned down the hostile bid, and Google offered to help Yahoo fight off Microsoft. The issue remains unresolved as we go to press.

The Recession of 2008

By March, with a collapsing stock market and rising unemployment, most experts believed the economy was sliding into a recession. This was triggered initially by a

¹⁰ Kevin J. Delaney, "Google: From 'Don't Be Evil' to How to Do Good," *Wall Street Journal*, January 18, 2008, pp. B1 and B2.

¹¹ "Yahoo in Microsoft's Sights," Associated Press as reported in *Cleveland Plain Dealer*, February 2, 2008, pp. C1 and C2.

bursting of the bubble of real estate prices gone wild, and the consequent hundreds of billions of dollars of write-offs for subprime mortgages. In this deteriorating environment, Google's exuberant share price was savaged, as many investors thought the great growth of the past could not be maintained. Google's share price that had climbed to a historic high of \$747.24 in November 2007, a little over three years after its initial public offering of \$85 a share, closed on March 8, 2008 at \$433.35, a decline of 42 percent. The amount of insider selling and the lack of any open-market purchases by insiders led some analysts to see a strong bear signal of a worsening situation amid concern that an economic slowdown would drastically affect Google's advertising revenues. Many predicted that the share price had much farther to decline.

Google executives downplayed any recession, pointing out a fourth-quarter 2007 addition of 889 jobs, including engineers, in the United States, and also an 85 percent increase in capital outlays from the previous year. *Forbes* magazine noted that adding jobs and capital expenditures characterize expanding firms and cited Google and seven others that fit that criteria. Still, growth was slowing in the industry for online ads.¹²

WHAT WE CAN LEARN

Importance of Innovative Thinking in an Organization

Innovative thinking—the search for new approaches and opportunities—is desirable in any industry and any firm, even a mature one. For a firm on the threshold of a new technology, such as Google was and is, innovative thinking becomes ever more important, lest competitors gain a crucial advantage. The founders of Google were brilliant, highly educated, and very talented Ph.D. students at a hotbed of creativity that was Stanford University, an institution that had spawned other fresh entrepreneurial ventures. Nearby Silicone Valley had attracted venture capitalists eager to invest in new ventures that showed promise. So, in the late decade of the last century the seeds were right: ideas flourished, and funding was readily available for those whose ideas were deemed promising.

For industries more mature, innovation can still mark the more successful firms. *Strategic windows of opportunity* often exist when a traditional way of doing business has prevailed in the industry for a long time—maybe the climate is ripe for a change. Opportunities often are present when existing firms are not entirely satisfying customers' needs. Innovations are not limited to products but can involve customer services as well as such things as methods of distribution. For industries with rapidly changing technologies—usually new industries—heavy research and development expenditures are generally required if a firm is to

¹² Jack Gage, "The Economic Drift," *Forbes*, March 10, 2008, pp. 75, 76; "Online ads top \$21 billion, as growth slows," Associated Press, reported in *Cleveland Plain Dealer*, March 2, 2008, p. C6; and Nicolas Brulliard, "Stock Sales at Google Send Shivers," *Wall Street Journal*, March 5, 2008, p. C3.

avoid falling behind its competitors. But heavy R&D does not guarantee being in the forefront.

How Innovative Thinking Can Be Fostered

Google represents the extreme of innovative thinking as it was poised at the onset of a new technology, the Internet. Top management not only encouraged creativity, but led it. The work force—comprised mostly of young, single, very intelligent geeks—was passionate for creative thinking and only needed the right environment to bring it to full fruition.

And could a workplace ever be more conducive to creative thinking than was that of Google? The technical people were even given 20 percent of their week to work on their own pet projects, and whatever showed potential was readily supported.

Given the fact that Silicon Valley had been a hotbed of entrepreneurial activity before the bust of 2000–2002, the dream of riches just over the horizon was hardly an impossible dream, especially given the great example of Google's leaders.

Most firms can hardly expect innovative thinking on such a scale from their work force. Still, it can be encouraged. What is needed first is a growth-minded top management receptive to new ideas. (But to be useful, we need some specifics on such receptivity. A Hands-On Exercise at the end of the chapter invites such specificity.)

Operational Controls Must Not Be Sacrificed at the Altar of Innovative Thinking

Google came close to this. Page and Brin were innovative geniuses, but deficient in operational skills. Yet they were reluctant to share this responsibility and perhaps diminish their role in running the company. But their venture capital firms pressured them to bring another top executive on board, and Eric Schmidt proved an excellent choice as top operational CEO, bringing maturity and organizational skills to round out the creative dreams of the founders. But he could just as well have been a disaster, if he had not fitted in well with the uniqueness of the young organization.

Beware the Insular Arrogance and Cult of Genius Mindset

Not only Brin and Page, but most of the organization as well, in these years of greatest growth apparently “left non-Googlers with the feeling that Google was unresponsive, self-centered, and dangerously cocky.”¹³ The “cult of genius” sentiment can be dangerous to any organization. Over the long term, it alienates customers, suppliers, the media, local to federal governments, indeed, everyone who has contact with the firm. In the litigious environment of today, it can even

¹³ Bartelle, p. 147.

bring unnecessary litigation. A softer tone needs to come from the top, and work its way down.

CONSIDER

Can you think of additional learning insights?

QUESTIONS

1. What is targeted advertising?
 - a. How is it revolutionizing the advertising industry?
 - b. How is this affecting newspapers and TV?
 - c. Is targeted advertising desirable for all firms?
2. What are the various directions for innovation to take?
Can a mature firm in a stagnant industry pursue innovation? How successful is this likely to be?
3. Would you describe Google as a happy ship? Is a happy ship always the most efficient and innovative? Why or why not?
4. Do you think Google's drive for great growth faces serious obstacles? If so, how might it overcome them?
5. On balance, do you think Google has a serious public relations problem?
6. What is a strategic window of opportunity? What kind of firms are most likely to discover such a window?
7. As a Google stockholder, should you be worried if the Microsoft merger with Yahoo goes through? Why or why not? Is there anything Google can do to prevent it?

HANDS-ON EXERCISE

1. You are a management consultant and have been asked by Messrs. Schmidt, Page, and Brin to investigate the public perception of Google as unresponsive, self-centered, and dangerously cocky. How would you investigate, and what remedies would you suggest? Or is such an attitude, based on great success and growth, anything to be concerned about?
2. Google's customer service has been criticized. How would you improve this situation? Be specific. If you want to make some assumptions, state them clearly and keep them reasonable.
3. In a previous learning insight regarding fostering innovative thinking in an organization, we noted that top management receptivity was needed. Going beyond top management support for innovative thinking, provide specifics for accomplishing this in a medium-size consumer-products manufacturer.

TEAM DEBATE EXERCISE

Google is generating cash at a prodigious rate. Its latest project for spending some of its billions is in philanthropic efforts, one of which is a green-energy program to find ways to generate electricity more cheaply than by burning coal. Stockholders have asked for a debate on this issue: Is this the best use of its billions?

INVITATION TO RESEARCH

How well has Google weathered the 2008 recession? Has its growth slowed? Is it still the darling of Wall Street? Has it branched out to rather different diversifications? How is it handling Microsoft and other competitors?

Starbucks—A Paragon of Growth and Employee Benefits Faces Storm Clouds

Howard Schultz was a dreamer. He saw a great marketing opportunity with a most prosaic product, and he ran with it—despite all the skeptics and naysayers—to lead a venture to become the largest purveyor of coffee in the world, and to lead a fantastic journey for investors. Along the way, his firm became a model of enlightened employee relations and benefits, and of corporate social responsibility.

Starbucks went public in June 1992 at \$17 a share. On the first day of trading, it closed at \$21.50. If you had invested \$10,000 then, your investment eventually would be worth some \$650,000. While many firms offer options to key executives and technicians (as we saw in the Google case), Howard Schultz made them, as well as health benefits, available to everyone working for as few as 20 hours a week, even including those standing behind the counter at local stores. And these stores could be close, even across the street or down the block from each other.

Alas, by 2008 as an economic downturn hit the country, Starbucks's fortunes worsened and its charmed growth path became rocky.

HOWARD SCHULTZ

Howard Schultz rose from humble beginnings in Brooklyn. He was a quarterback at Canarsie High, a school so poor it didn't even have a football field. Northern Michigan University offered him a football scholarship, and he was out of Brooklyn at last. But he couldn't make the team, and resorted to bartending and selling his blood to make ends meet. He majored in communications and public speaking, but didn't know what to do after graduating in 1975, and wound up working at a nearby ski lodge. Eventually, he got a job with Xerox, in the sales training program.

He found selling to be his forte, and by 1981 was vice president of U.S. operations for a Swedish manufacturer of kitchen equipment. Then he noticed that a little retailer in Seattle named Starbucks was placing amazingly large orders for a

certain type of coffeemaker. He went to investigate how this small store could buy more of these than Macy's, and his comfortably complacent life would change forever. He wound up selling himself to the owners as the man they needed to grow their business.

To Get a Piece of the Action

This original Starbucks store was and still is located in the Pike Place Market, a major tourist attraction near the waterfront. It and three sister stores had opened around Seattle and offered a major contrast to the 50-cent cups of black liquid that were usually served with gobs of powdered cream and sugar in self-service convenience stores. These Starbucks stores offered rich, exotic coffee blends at six to eight times the price of ordinary coffee. By the time Starbucks went public, it had 165 stores, but they almost all were clustered around Seattle and neighboring states except for one in Vancouver, Canada. As Schultz contemplated expanding nationwide, eastern skeptics ridiculed the idea of \$3–\$4 coffee as strictly a West Coast yuppie fad.¹

At times, Schultz himself had to doubt that Starbucks would ever reach this threshold of great growth. So many obstacles barred his dream. In the first place, the owners of these four Seattle stores were cool to the growth that Schultz envisioned—they preferred their comfortable status quo. A particular bone of contention was Schultz's desire to emphasize serving coffee and espresso, rather than just the beans that the firm had always sold. "Starbucks is a retailer—not a restaurant or a bar," they argued.²

In late 1985, with the impasse Schultz left to start his own company. He particularly wanted to replicate authentic Italian-style coffee bars, such as he had found so intriguing several years before on a trip to Italy. These were small social gathering places, sometimes two or three to a block, serving richly flavored coffee and espresso. Schultz decided to name his new venture *Il Giornale*, this being the name of the largest newspaper in Italy, and *giornale* means *daily*. The name expressed his hope that people would patronize daily.

Schultz estimated he would need \$400,000 in seed money to make this new venture in Seattle artistically appealing. Then he would need another \$1.25 million to open eight more espresso bars in and around Seattle.

He raised the seed money rather quickly and opened the first store in April, and sales exceeded expectations although it was not yet profitable. He had already signed a lease for a second store, but had trouble raising the \$1.25 million. He realized with some concern that investors could not get over the notion that coffee was only a commodity. Unless he could change such a mindset, this was a major impediment, one that would scuttle his dream. To every one who would listen he repeated his mantra: "We would take something old and tired and common—coffee—and weave a sense of romance and community around it. We would rediscover the mystique

¹ Cora Daniels, "Mr. Coffee: the Man behind the \$4.75 Frappuccino Makes the 500," *Fortune*, April 14, 2003.

² Howard Schultz, *Pour Your Heart Into It*, Hyperion: New York, 1977, p. 55.

and charm that had swirled around coffee throughout the centuries. We would enchant customers with an atmosphere of sophistication and style and knowledge.”³ Eventually he raised \$1.65 million. Those initial investors ended up earning a one hundred-to-one return on their investment.⁴

Within six months, the first Il Giornale store was serving more than 1,000 customers a day. With profound relief, Schultz found that the tiny 700-square-foot store had become a gathering place, just as were those coffee bars in Italy that had so impressed him. He opened two more stores, including one in Vancouver, and by mid-1987 sales were around \$500,000 for each store. Then in August 1987, a major opportunity presented itself.

The owners of Starbucks offered Schultz the chance to buy them out. They now had six stores, the roasting plant, and the name Starbucks. But he had exhausted nearly every resource in raising the previous amounts. Now he needed almost \$4 million more. Still, his persuasive skills enabled him to get this, mostly from present investors who saw the future promise and had confidence in Schultz himself. He was 34 years old and felt himself at the beginning of a great adventure. The name Il Giornale was dropped, and henceforth all stores would be named Starbucks, which seemed a more catchy name and one that matched his robust coffee.

THE GROWTH BEFORE GOING PUBLIC, 1987–1992

Schultz quickly learned that morale at the original Starbucks was not good, and he needed to gain employees’ trust. He wrote, “I wanted people to feel proud of working at Starbucks, to believe in their hearts that management trusted them and treated them with respect. I was convinced that under my leadership, employees would come to realize that I would listen to their concerns. If they had faith in me and my motives, they wouldn’t need a union.”⁵

Without the glaring spotlight of being a public company, Schultz was able to experiment and develop Starbucks while still a private company. He focused on national expansion, employee benefits, investing in the future, and management development.

National Expansion

The Chicago Test

Early on, Schultz had wanted to expand to Chicago, to test whether this center of conservative Midwest culture would be receptive to the stronger, richer, and more robust taste of Starbucks, and also whether the retail stores would morph to become daily gathering places. He feared that Chicago might be the crucial arena that would largely determine Starbucks’s future, whether it could indeed be the national brand he envisioned. Better learn the verdict now, early in the game, he thought. But the

³ *Ibid.*, p. 77.

⁴ *Ibid.*, p. 79.

⁵ *Ibid.*, p. 108.

experts were so negative: 2,000 miles away, they pointed out; hard to supply with a perishable product like fresh-roasted coffee; too much of a cultural shock, this, the heartland of Folger's and Maxwell House coffees.

But he pushed on, opening the first store in the Chicago Loop in October 1987; and it was a disaster. For one thing, it faced the street, and he now learned people did not go outside in the winter unless they had to—he should have had this open into a lobby. Over the next six months, Schultz opened three more stores in the area. But demand was spotty at best, while rents and labor costs were considerably higher than the West Coast. Was Starbucks really a fad? Was the concept transferable? Skepticism made raising money difficult, and while needed money was eventually raised, the price per share was far lower than he had hoped.

In Chicago the corner was turned in 1990—three years it took—with experienced managers and higher prices reflecting the higher costs. Now he saw wonderingly that a groundswell was beginning to emerge as a growing body of loyal customers had learned to love the stronger flavored coffee, and also cappuccinos and *caffè lattes*. Yes, and also the customer service and inviting atmosphere.

Onward to California and Beyond

Schultz decided to enter Los Angeles in 1991. Skeptics, again the skeptics, decried this Southern California decision: people don't walk there, they drive; people don't want to drink hot coffee in a warm climate; etc, etc. But the invasion turned out to be easily done, in contrast to Chicago. The *Los Angeles Times* named Starbucks the best coffee in America, and almost overnight it became chic. San Francisco was next, and then the whole country seemed a viable market.

One problem with widespread distribution that the critics pounced on was shipping fresh-roasted coffee beans without losing freshness. Therefore, they cautioned, you had to have your stores close to a roasting plant. But Schultz and his associates found the solution in FlavorLock bags. This vacuum packaging preserved freshness with the flavor from roasting sealed in before shipping.

Now the road was opened for almost unlimited expansion.

Employee Benefits

“From the beginning of my management of Starbucks, I wanted it to be the employer of choice, the company everybody wanted to work for. By paying more than the going wage in restaurants and retail stores, and by offering benefits that weren't available elsewhere, I hoped that Starbucks would attract people who were well-educated and eager to communicate our passion for coffee.”⁶ These words of Howard Schultz were more than lip service, and propelled Starbucks to become a paragon in employee relations and benefits, and so gain loyal and dedicated employees, all the way down to part-timers. See the following Information Box for the background of a kind and compassionate firm.

⁶ *Ibid.*, p. 125.

INFORMATION BOX

THE MAKING OF A KIND AND COMPASSIONATE FIRM

It began to take shape when Howard Schultz was seven years old. He grew up in Brooklyn in a working-class family. His father was a high school dropout who could only obtain unskilled jobs. One day the boy walked into their apartment after school and found his father sprawled on the couch with a full-leg cast. He had slipped on a patch of ice at work. His job provided no workmen's compensation and no health insurance. The family faced severe financial problems, and his father became a beaten man. He had never attained fulfillment and dignity from work he found meaningful. This made a powerful impression on young Schultz. "As a kid, I never had any idea that I would one day head a company. But I knew in my heart that if I were ever in a position where I could make a difference, I wouldn't leave people behind. I think success is best when it is shared."

There were years when Starbucks actually spent more on health care than on coffee. "Although I didn't consciously plan it that way, Starbucks has become a living legacy of my dad."

Comments?

Adapted from Schultz, pp. 4, 7.

He recommended to the board of directors that health-care coverage include part-timers who worked as little as 20 hours a week. Starbucks began offering health benefits to such part-timers in late 1988, long before it became a public company. The company also covered employees who had terminal illnesses, paying full medical costs until they were covered by government programs.

The company achieved its first profitable year in October 1990. In August 1991, Schultz introduced a stock option plan for everyone, again including part-timers, who had been with the company for six months. Now employees were no longer "employees" but were "partners." And each October, every partner received 14 percent of his or her salary in stock options. When the firm went public a few years later, some of the stock options were rather valuable.

Investing for Further Expansion

In 1987–1989, Schultz began developing a solid leadership base of managers and other personnel for the rapid expansion ahead. He wanted experienced people, and in most cases had no trouble getting them—they were eager to work for a rapidly growing company. Now he had to find the capital to finance the expansion he had in mind. Past performance was key to inspiring investor confidence.

Fortunately, revenues were rising at more than 80 percent a year, and number of stores were nearly doubling each year. Schultz had proven that his business model could work in different cities and geographical areas. Furthermore, there were signs that the specialty coffee business was increasing all over the country, both in supermarkets and stand-alone stores.

Just a year after Schultz had raised \$3.8 million to acquire Starbucks, he had to raise another \$3.9 million to finance growth plans. More money was needed by 1990, and venture capital firms supplied \$13.5 million, and the next year \$15 million. See the following Information Box about venture capitalists.

Schultz could no longer handle such store development from his office, and the challenge was now to find people to provide the expertise needed in the various aspects of what was becoming a very large firm, indeed, en route to a billion dollar company.

INFORMATION BOX

VENTURE CAPITALISTS: AID TO ENTREPRENEURS

The biggest roadblock to entrepreneurship is financing. Banks usually are not receptive to funding unproven new ventures, especially for someone without a track record. Given that most would-be entrepreneurs have limited resources from which to draw, where are they to get the financing needed? Venture capitalists may be the answer.

Venture capitalists are wealthy individuals (or firms) looking for extraordinary returns for their investments. At the same time, they are willing to take substantial risks. Backing nascent entrepreneurs in speculative undertakings can be the route to a far greater return on investment than possible otherwise—provided that the venture capitalist chooses wisely who to stake. This decision is much easier after a fledgling enterprise has a promising start. Then venture capitalists often stand in line for a piece of the action. But until then, the entrepreneur may struggle to get seed money.

For a would-be entrepreneur seeking venture capital, then, the most important step may be in selling yourself, in addition to your idea. Intellectual honesty is sometimes mentioned by venture capitalists as a necessary ingredient. This may be defined as a willingness to face facts rigorously and not be deluded by rosy dreams and unrealistic expectations.

Those who win the early support of venture capitalists will likely have to give away some of the ownership. Should the enterprise prove successful, the venture capitalist will expect to share in the success. Indeed, the funds provided by a venture capitalist may be crucial to even starting, and they may mean the difference in being adequately funded or so poorly funded that failure is almost inevitable.

Selling a definitive business plan to a prospective venture capitalist is usually a requirement for such financing. In the process, of course, you are selling yourself. You may want to do this exercise: Choose a new business idea, develop an initial business plan, and attempt to persuasively present it to your class of would-be investors.

Going Public

At last Schultz realized that they could no longer remain a private company and handle and finance the growth that seemed within their grasp. On June 26, 1992, Starbucks went public with its stock listed on NASDAQ. The initial target range was \$14–\$16 a share. Financial advisers recommended the low end of that range, but Schultz defied conventional wisdom and priced it at \$17 a share. He and his senior management team watched anxiously as at the opening bell the price jumped to \$21. The IPO (initial public offering) raised \$29 million for the company, \$5 million more than expected.

Within three months it was \$33. But Schultz found that the market could be fickle. In early December 1995, stock reached an all-time high. But in early January, it fell and lost \$300 million in market value. Three months later it rose to another all-time high. Schultz realized that being a public company had some downside. But now the company was poised to make a quantum leap in growth.

STARBUCKS BY 2006–2007

By 2006, Starbucks had 12,440 stores. Its net revenue was \$7.8 billion, and net earnings were \$564 million. It had been opening over a thousand stores a year since the millennium, and in 2006 had opened over 2,000. About 85 percent of all stores were company owned, and not franchised. How did it organize to attain such growth? Could there be any limit to its growth?

The strategy of growth was honed in 1992 and 1993. Recruiting and training had to be systematized to provide the capable personnel not only for individual stores but also for supporting and supervising groups of stores. In addition, overseeing the site selection, handling legal matters, as well as physically opening hundreds of stores in new markets every year, was no small matter. High-level executives from Burger King, 7-Eleven, and other retail chains were recruited for this vital aspect of great growth. The strategy was to target a large city to be a hub, and then place teams of professionals to open and support new stores. “We entered large markets quickly, with the goal of rapidly opening 20 or more stores in the first two years. From that core we branched out, entering nearby ‘spoke’ markets, including smaller cities and suburban locations with demographics similar to our typical customer mix.”⁷

Eventually Starbucks would be in office buildings, with kiosks in building lobbies, airport terminals, and supermarkets. Schultz also introduced Frappuccinos and began expanding the food menu.

In 1994, Schultz had seen that his ambitious initial goals were within reach. Now he envisioned a bigger goal: the world market. In truth, the successful business plan was now being copied around the world, as was the logo. He was sure

⁷ Schultz, pp. 194–195.

that only accelerated foreign growth would counter the imitators. In years to come, he had a long-term global target of 40,000 stores.

The following Information Box gives statistics for the years of most rapid growth.

INFORMATION BOX

STARBUCKS'S OPERATING STATISTICS

TABLE 3.1 Starbucks Revenue and Year-to-Year Percentage Gain, 2001–2006

	Revenue (Billions \$)	Percentage from Previous Year
2006	\$7.8	22%
2005	6.4	20
2004	5.3	30
2003	4.1	24
2002	3.3	24
2001	2.6	22

Source: Starbucks 2006 Annual Report.

Commentary: Notable is the consistent year-to-year percentage growth. This is the mark of a successful growth company, attractive enough to support a high price/earnings stock ratio. Now look at Table 3.2 to see if net earnings can match this steady revenue growth.

TABLE 3.2 Net Earnings and Year-to-Year Percentage Gain, 2001–2006

	Net Earnings (Millions \$)	Percentage from Previous Year
2006	\$564	14%
2005	494	27
2004	389	47
2003	265	26
2002	210	17
2001	179	

Source: 2006 Annual Report.

Commentary: The year-to-year growth in net earnings compares favorably with the gains in revenue shown in Table 3.1. The lower percentage gain in 2006 probably reflects opening 2,199 new stores that year. Table 3.3 shows the increase in number of stores opened during this six-year period.

TABLE 3.3 Stores Open at End of Years 2001–2006 and Increase over Previous Year

	Total Stores Open	Increase from Previous Year
2006	12,440 stores	2,199 stores
2005	10,241	1,672
2004	8,569	1,344
2003	7,225	1,339
2002	5,886	1,177
2001	4,709	

Source: Starbucks 2006 Annual Report.

Commentary: This increase in stores is awesome. Every year shows an increase in new stores over the previous year's increase, with the huge jump in 2006. Undoubtedly, such new store openings placed a strain on company resources, as seen in Table 3.2, with the lowest percentage gain in earnings for the 6 years. Could Starbucks be trying to grow too fast?

Threats

By late 2007, the economy was on the cusp of a recession because of the collapsed housing market, the multitude of foreclosures due to unwise and even fraudulent subprime lending, and tightened credit. The stock market reflected these concerns and had dropped from record highs earlier in the year. Starbucks's stock was particularly hard hit, dropping nearly 50 percent from its highs. One analyst said, "The . . . underlying fear is that Starbucks is finally seeing the signs of saturation in the U.S."⁸ Some analysts were saying that the chain had fallen behind in creating enticing new beverages and that its hot egg-and-cheese breakfast sandwiches had created little excitement.⁹

Other analysts cited a subtle change in Starbucks's customer base, that in its rapid increase in stores, it had reached Americans with lower average incomes. These people would more likely cut back luxury spending in more austere economic times—after all, high priced coffee can be an expensive luxury.¹⁰ Or is it? It was but a short step from analysts warning of a changing customer base to critics decrying too many stores.

Not the least of the emerging threats was intensified competition. In the last few years, McDonald's had upgraded its coffee and spent \$60 million advertising this in

⁸ Janet Adamy, "At Starbucks, Too Many, Too Quick?" *Wall Street Journal*, November 15, 2007, pp. B1 and B2.

⁹ Janet Adamy, "Starbucks Chairman Says Trouble May Be Brewing," *Wall Street Journal*, February 24–25, 2007, p. A4.

¹⁰ *Ibid.*

2006. For 2008, it planned to add lattes and cappuccinos to thousands of stores. In test markets, McDonald's priced such drinks near \$3, considerably less than Starbucks. But some analysts did question whether McDonald's could sell a \$3 cappuccino.¹¹

Up until 2007, Starbucks had used no network television and only spent \$37.9 million, largely on magazine and newspaper ads. (This compared with Dunkin' Donuts that spent \$116.2 million on ads in the United States). It had always relied mostly on word-of-mouth and such local marketing efforts as sponsoring a free day at the zoo. The collapsing stock prices now induced the company to shift advertising to national ads. Faced with a declining number of transactions in older U.S. stores for the first time, the company cut its earnings and sales growth projections for 2008.¹²

ANALYSIS

Starbucks today is one of the world's best known brands. It owes it all to a visionary, Howard Schultz. Although not Starbucks' founder, he built the company into a coffee empire. He believed in maximum growth in number of outlets, regardless of their proximity to each other. While many analysts criticized placing stores near each other because of their likelihood of *cannibalizing* (i.e., taking sales away from one another), Schultz maintained that this was desirable to lessen long lines at the bar.

Through the years, Starbucks had been the darling and also the whipping boy of both investors and skeptics, and the stock commanded a high price/earnings ratio. Until the meltdown in stock prices that started in late 2007, Schultz had always proven the skeptics wrong. Still, growth seemed vulnerable if the market was indeed saturated and overstored. Is coffee any different than hamburgers, than running shoes, than bottled water, even than PCs? For decades, McDonald's was confronted with the same skeptics who trumpeted, "How many hamburgers can one person eat?" Sometimes a judicious diversification can start the firm on a growth curve again. More often, however, such diversifications and acquisitions do not live up to expectations.

Is increased competition from powerful firms such as McDonald's going to delimit Starbucks' growth? Perhaps, unless we can envision the total market expanding for richer coffee and the social experience of a coffeehouse. While Starbucks was introducing some food items, management had to worry about being seen as just another fast-food restaurant. It needed to safeguard its image as a coffeehouse.

In the decline of Starbucks' stock value in the recent market retrenchment, much was made over same-store sales not showing the 5–10 percent growth they had in the past. See Table 3.4 for older store sales increases from preceding years 2001–2006.

Investors quickly perceived from lessening same-store sales in 2007–2008 that Starbucks was no longer a growth company, and thus the stock's high multiple was not justified. Was this perception of Starbucks warranted? Perhaps not. Static same-store sales should not rule out overall growth as long as new stores are being opened, and cannibalization may be less a concern than critics maintain.

¹¹ Janet Adamy, "Will Investors Buy Into Iced McMochas?" *Wall Street Journal*, November 13, 2007, p. C1.

¹² Stephanie Kang, Janet Adamy, and Suzanne Vranica, "TV Campaign Is Culture Shift for Starbucks," *Wall Street Journal*, November 17–18, 2007, pp. A1 and A7.

TABLE 3.4 Older Store Sales Growth, 2001–2006

	Percentage Sales Growth from Previous Year
2001	5
2002	6
2003	8
2004	10
2005	8
2006	7

Source: Starbucks 2006 Annual Report.

Commentary: These six years show a very healthy growth pattern. We know that Starbucks had been rapidly opening new stores, but the older stores show sales gains too. Unfortunately, we know that same store sales began declining in 2007 and 2008, aggravated by a worsening economy, but also raising investor fears of cannibalization and market saturation. Investors were losing confidence in the growth prospects of Starbucks, hence a falling stock price.

A recent *Wall Street Journal* article suggested that additional Starbucks, far from cannibalizing, may instead expand the total market for coffee to the entire community so that all benefit. See the following Information Box for more on this.

INFORMATION BOX

STARBUCKS REVERSE JINX

Taylor Clark, a researcher who recently published a book about the chain, surveyed café owners around the country, and found a surprising phenomenon, what he called “Starbucks Reverse Jinx.” The chain’s arrival seemed to stimulate demand for the coffeehouse experience that spilled over to other shops. He saw some of this spillover coming from customers wandering elsewhere to avoid long lines at Starbucks. He speculated that other stores thrived from former Starbucks customers who having cultivated a taste for drinks like cappuccino now sought less-pricey versions. But wouldn’t this be a negative for Starbucks?

Statistics support the anecdotal data of Clark, but not his complete conclusions. Some 57 percent of U.S. coffee shops are independents. Between 2000 and 2005, independents grew from 9,800 to 14,000. But during this same period, Starbucks tripled its number of outlets and still had increasing same-store sales, as shown in Table 3.4.

How enduring do you think this gourmet coffee and coffeehouse experience will be? Do you think lower-price competitors are going to take many customers from Starbucks? Do you agree from the above statistics, admittedly they were only up to 2005, that the growth of independent coffeehouses is not a negative for Starbucks?

Adapted from “‘Starbucks Reverse Jinx’ Aids Some Rivals,” *Wall Street Journal*, December 29–30, 2007, p. A7.

Schultz introduced perhaps the best example of enlightened social responsibility of any firm today by providing complete health care for all employees and their families, even part-timers, as well as a pension plan with stock options for every person, again including part-timers employed at least six months in any capacity. A moving book has even been written about “How Starbucks Saved My Life,” by Michael Gates Gill.

The author describes his unusual journey after losing a senior advertising job along with his marriage. Lonely and unemployed at 63 years old—with no health insurance after being diagnosed with a brain tumor—he landed a job at a Starbucks in Manhattan. His fellow workers and boss were decades younger, mostly African-Americans, with formal educations light years away from his Ivy League degree from Yale. But rather than feeling depressed taking orders for lattes and lugging garbage to the curb, he had found a health provider as well as a refuge, where he felt valued with friends among both colleagues and regular customers.

Gill’s account of his year behind the counter at Starbucks—this is slated to become a movie starring Tom Hanks—can tantalize a reader that being in a community at work can be more rewarding than a big office or title.¹³

The company also participated in various environmental projects, such as improving children’s health in coffee-and- tea-producing regions, addressing the educational needs of indigenous Mayan peoples dependent on coffee production, and promoting coffee quality, environmental sustainability, and natural resources conservation in east Africa. For example, Starbucks paid Ethiopian coffee farmers a 75 percent premium over market prices, believing this was better than passing out the equivalent in welfare.¹⁴

One wonders, however, as sales and profits confront recessionary times, whether it can maintain its social responsibility against pressure from investors and creditors.

UPDATE—GOING INTO 2008

In early January 2008, Schultz, the company’s chairman, again took over the chief executive post as the company reported the worst quarterly same-store sales in its history. Some questioned whether Starbucks could re-energize itself, amid an environment of stiffer competition and rising prices for commodities such as milk and coffee beans, at a time when many consumers were feeling pinched between recession and inflation. The company began experimenting in the Seattle area with a \$1 “short” brew and free refills for traditional-brewed coffee.

Schultz planned to stop selling hot breakfast sandwiches concerned that they created an unpleasant smell—“the scent of the warmed sandwiches interferes with the coffee aroma in our stores”—and made the company too much like a fast-food chain. But could he disregard the \$35,000 a year in sales they added to each store? The growth in new stores would be slowed, although he still planned to add more

¹³ Adapted from Carol Hymowitz, “Some Holiday Books About Inspiration and Delusion at Work,” *Wall Street Journal*, December 24, 2007, p. B1.

¹⁴ M. Todd Henderson and Anup Malani, “Capitalism 2.0,” *Forbes*, March 10, 2008, p. 30.

than 2,000 in 2008, but would close some poor performers. International expansion was deemed crucial in the company's recovery, and China was one of its biggest markets with already more than 420 stores—"the sheer numbers of people make it an enormous opportunity." Despite the cheaper premium coffees that McDonald's and Dunkin' Donuts were adding, Schultz as well as some analysts did not see these as that big a threat since Starbucks had always faced lower-priced competition. "When you succeed at this level for so long . . . you get a little soft," Schultz said. "We have to get back to what made this company great."¹⁵

See the following Profile of the person who became Schultz's right hand in a creative struggle to resurrect Starbucks's growth.

PROFILE

MICHELLE GASS, SENIOR VICE PRESIDENT, GLOBAL STRATEGY, OFFICE OF CEO

Michelle Gass is a 40-year-old chemical engineering graduate who found herself Howard Schultz's right-hand person in shaping a new agenda for Starbucks and reviving the company. "I'm not a traditionally trained strategist," she admits. "I've never worked at McKinsey or Bain." She grew up in Maine, where an analytical bent swayed her to study at Worcester Polytechnic Institute in Massachusetts. She had a summer internship at Procter & Gamble, and this got her interested in consumer research. After moving to Seattle with her husband, she got an MBA from the University of Washington and in 1996 joined Starbucks as the marketing manager for Frappuccino. With customer research, she guided this to become one of Starbucks most successful products. "That's when we discovered we were bringing people into the stores that hadn't had coffee before." She decided there was "something magical about the drink."

She became Schultz's top strategist when he retook the chief executive position in January 2008, and she moved into an office nearby his. She talks to him several times every day and typically puts in 12-hour days. In meetings her chair is directly to his right. She recently led a three-day summit to explain the new agenda to 200 company leaders from as far away as China. The meeting was "very emotional," she said. "Any kind of transformation like this is not only about your tactical plan, but also your recommitment as a leader to be part of the journey."

You may want to keep track of the major changes at Starbucks, since these should reflect Michelle Gass's input and implementation.

Adapted from Janet Adamy, "At Starbucks, Low-Key Vet Plots Course," *Wall Street Journal*, March 18, 2008, pp. B1 and B2.

¹⁵ Compiled from Janet Adamy, "With Starbucks, Investors Need Patience," *Wall Street Journal*, February 2-3, 2008, pp. B1 and B5; and Steve Forbes, "This Move Deserves a Rotten Egg," *Forbes*, March 10, 2008, pp. 19 and 20.

On Tuesday, February 26, 2008, Starbucks closed almost all of its 7,100 domestic stores between 5:30 and 8:30 P.M. for an unprecedented education and training session for its employees, to “signal the company’s focus on transforming the Starbucks experience: for its customers and workers. During the training session, baristas learned updated quality standards for “pulling the perfect espresso shot, skillfully . . . ensuring that every beverage and every experience is right for every customer, every time.” (In a move to take advantage of Starbucks’s three-hour absence from the market, Dunkin’ Donuts promoted 99-cent small lattes, cappuccinos, and espresso drinks during that time).

At the annual shareholder meeting held on March 19, 2008, Schultz announced that the company was buying the maker of a high-end coffee brewing machine and adding new espresso machines that will allow baristas to interact more easily with customers. The company has issued a new loyalty card that will give cardholders added benefits. It has also launched a Web site for customers to offer suggestions and also a social network where users can comment on each others’ ideas. Starbucks also planned to sell energy drinks and create more health-oriented items. The \$1 drip coffee that was being tested in a few stores was dropped because of poor sales. Planned store additions for 2008 were cut to 1,175 from the original plan of 2,000, and 100 underperformers would be closed.¹⁶

Your prognosis, please, for Schultz’s proposals for turning Starbucks around.

WHAT WE CAN LEARN

A Strong Commitment to Corporate Social Responsibility Is Not Incompatible with a Growth Mode

Through the years, Starbucks has shown a steady and rather remarkable growth, while at the same time practicing the best of social responsibility toward employees, suppliers, and the environment. It has also sought to serve its customers well, with friendly and caring service. Is there a cause-and-effect relationship between good and sustainable growth and an unusual degree of social responsibility? Well, we cannot prove this, but it seems reasonable to think so. Now this commitment adds some costs, such as employee health benefits, but who can say how much more dedicated employees can add to customer satisfaction and repeat business?

Market Saturation Is Not the Kiss of Death, and Can Be Changed

Market saturation is perceived to be the limit to growth, a negative for the company and its investors. But I do not believe that market saturation is finite. It can be expanded by better meeting untapped consumer needs, by finding elements of differentiation, perhaps beyond the product to the actual environment where

¹⁶ Janet Adamy, “Starbucks Moves Aim to Revive Brand, Shares,” *Wall Street Journal*, March 20, 2008, p. B5; and Jack Hough, “SmartMoney Stock Screen,” March 20, 2008, p. D2.

buying takes place. Market saturation should not mean a moratorium on new store openings, even if cannibalization is a danger. Weaker stores can be closed and stronger ones and sites take their place.

Actually, cannibalization is not necessarily bad, if it is not extreme. Where a store may initially lose some business with a sister store coming on the scene, total revenues should still be higher. Cannibalization is more of a problem if the stores are franchises rather than company-owned stores, since independent franchisees will fiercely want to protect their turf. Cannibalization is also likely to be a nonfactor if two nearby stores appeal to different customers, such as an airport outlet and a neighborhood store. The negatives are in the extremes, and should be considered on a store-by-store basis. The former Information Box, Starbucks Reverse Jinx, suggested that additional Starbucks increase total demand for this coffee experience, enough to even boost competitors' businesses.

A Visionary Has to Be a Doer to Be Effective

A lot of people have ideas, but few are determined to do something about them now, and fewer have the courage to give up the security of a regular paycheck to do so. Persistence, great self-confidence, an ability to disregard disappointments and skeptics, and keep trying—these are qualities of successful entrepreneurs. Schultz certainly exemplified these traits and pursued almost single-mindedly his dream of making coffee far more than a commodity, to become a pleasant and enduring life experience.

Beware the Reckless Drive for Growth

Great growth needs to be controlled if it is to be successful. The temptation is otherwise in a situation of virtually unlimited potential. Prudent growth most likely will dictate a slower rate of store openings for a retail chain. Care must be exercised in site selection, in developing an organization for supporting the new units while not neglecting older ones, as well as providing the physical facilities, equipment, and inventory needed. Employees need to be recruited and trained, and policies and systems put in place for controlling widespread operations. It helps if stores and operations can be standardized, and budgets and cost controls carefully maintained. The converse of such careful attention to details is growth run amuck, with reckless spending and waste, poorly trained people, and a business plan lacking guidance for far-flung outlets.

Schultz realized that he lacked experience in handling the great growth needed before strong competitors came on the scene. Hence, he reached out to successful executives of other retail chains. He found many were eager to join the fast-growing firm that Starbucks was becoming. Controls were established to contain costs and evaluate performances, and other policies formulated so that an orderly but rapid growth was achieved.

“Success Is Not an Entitlement”

These words of Howard Schultz in a February 14, 2007 memo to the executives of his firm have a strong warning to any firm inclined to rest on its laurels. He

was concerned with “the watering down of the Starbucks experience, and what some might call the commoditization of our brand.”¹⁶ It speaks against the status quo, but not against maintaining a core position. We can pull two concepts from this succinct statement to help guide marketing strategy. The first suggests that the firm should be prepared for adjustments in strategy as conditions warrant. The second suggests that there is a basic core of a firm’s business that should be the final bastion to fall back on for regrouping if necessary.

CONSIDER

Can you add other learning insights?

QUESTIONS

1. Can Schultz’s business model be challenged?
2. How would you prove that happy employees lead to greater sales?
3. Do you frequent Starbucks? If so, what is your opinion of it?
4. If you do not frequent Starbucks, what might induce you to try it?
5. Do you see any limits to Starbucks’s growth?
6. Would drive-through windows make Starbucks more attractive or less attractive? Why?
7. Several recent surveys have found that Starbucks coffee in blind taste tests is not rated any higher by consumers than McDonald’s, Dunkin’ Donuts, and some local coffee houses. Yet Starbucks continues to command a price premium. Discuss.
8. “Starbucks’s unspoken strategy for repeat business is coffee so strong in caffeine that customers become addicted to it like tobacco. Is this a good citizen?” Comment.
9. “[With Frappuccinos] That’s when we discovered we were bringing people into the stores that hadn’t had coffee before.” These words of Michelle Gass have interesting implications. Evaluate them on several dimensions.

HANDS-ON EXERCISES

1. As a Starbucks senior executive, describe how you would defend against McDonald’s.
2. You have been given the assignment by Howard Schultz to reevaluate the growth policy. Present your recommendations and rationale as persuasively as possible.
3. *Be a Devil’s Advocate.* The decision is being considered of going to TV advertising, as well as drive-through windows, thus becoming more like the

¹⁶ Adamy, “Starbucks Chairman Says . . .”

successful fast-food restaurants. What arguments would you array for not doing this? Be as persuasive as you can.

TEAM DEBATE EXERCISES

1. Debate this issue: Starbucks is reaching the limits of its growth without drastic change. (*Note:* The side that espouses drastic change should give some attention to the most likely directions for such change; be prepared to defend these expansion possibilities).
2. Debate the issue of employee benefits during a time of falling profits and stock prices. One group should offer its arguments for dropping some or most of the employee health and profit-sharing benefits, while the other group vigorously defends keeping them.

INVITATION TO RESEARCH

What is the situation with Starbucks now? Has it abandoned or toned down its vigorous expansion policy? Has the more aggressive competition of firms such as McDonald's and Dunkin' Donuts had an impact on Starbucks? Have any other serious competitors emerged for gourmet coffee and for the coffeehouse atmosphere? Is the company still offering the same employee benefits? How about its environmental stance?

Boston Beer—Is Greater Growth Possible?

Jim Koch was obsessed with becoming an entrepreneur. He wasn't quite sure where he should do his entrepreneuring. Maybe the brewing industry? Years before, his great-great-grandfather, Louis Koch, had concocted a recipe at his St. Louis brewery that was heavier, more full-bodied than such beers as Budweiser or Miller. However, it was much more expensive to produce than mass-market beers. It involved a lengthy brewing and fermentation process, as well as such premium ingredients as Bavarian hops that cost many times more than those regularly used by other brewers.

Jim had a well-paying job with the prestigious Boston Consulting Group. He had been with them for six-and-a-half years already, but still he was haunted by that dream of becoming his own man. Of late, the thought pursued him that maybe the brewing industry might be ripe for a new type of product and a new approach, a good-tasting brew something like his ancestor's. He wondered if he might have a strategic window of opportunity in a particular consumer segment: men in their midtwenties and older who were beer aficionados and would be willing to pay a premium for a good-tasting beer. What he couldn't be certain of was how large this segment was, and he knew from his consulting experience that too small a segment doomed a strategy. So, were there enough such sophisticated drinkers to support the new company that he envisioned?

In 1984, he thought he detected a clue that this might indeed be the case: Sales were surging for import beers such as Heineken and Beck's with their different tastes. Didn't this portend that enough Americans would be willing to pay substantially more for a full-bodied flavor?

As he studied this more, Koch also came to believe that these imports were very vulnerable to well-made domestic brews. They faced a major problem in maintaining freshness with a product that goes sour rather quickly. He knew that the foreign brewers, in trying to minimize the destructive influence of the time lag between production and consumption, were adding preservatives and even using cheaper ingredients for the American market.

Some small local brewers offered stronger tastes. But they were having great difficulty producing a lager with consistent quality. And he sensed they were squandering their opportunity. Although they could produce small batches of well-crafted beer, albeit of erratic quality, what they mainly lacked was the ability and resources to aggressively market their products.

He thought now that he had indeed found the right niche, a strategic window of opportunity, for becoming an entrepreneurial success. See the following Information Box for further discussion of a strategic window of opportunity and its desirable accompaniment, a SWOT Analysis.

He decided to take the plunge, and gave up his job.

INFORMATION BOX

STRATEGIC WINDOW OF OPPORTUNITY AND SWOT ANALYSIS

A strategic window is an opportunity in the marketplace, an opportunity that no competitor has yet recognized, and one that fits well with the firm's competencies. Strategic windows often last for only a short time before they are filled by alert competitors, but sometimes they may be more lasting if competitors deem it difficult to enter the particular niche. Potential competitors may pass because of price or image advantages they see the first firm as having, or perhaps because they judge—correctly or incorrectly—that the niche does not have sufficient potential.

SWOT Analysis

Strategic windows may be found by systematically analyzing the environment, examining the opportunities and threats it poses. The firm's competencies, its strengths and weaknesses, should be assessed. These competencies would include its physical and financial resources and, not the least, its people resources—management and employees. The objective is to determine whether the competencies of the firm might be appropriate for a particular course of action.

This then is the SWOT analysis:

Analyzing: Strengths and
 Weaknesses of the firm, and
 Opportunities and
 Threats in the environment

Although SWOT analysis may be a formal part of the planning, it may also be informal and even intuitive. We suspect that Jim Koch, having worked six-and-a-half years with a prestigious consulting firm would have formalized this analysis. In the two previous cases, Schultz of Starbucks and Brin and Page of Google may have been more informal and intuitive in their assessment of entrepreneurial opportunity.

Why do you think all the big brewers overlooked the possibilities of the highest-priced end of the market?

Amassing sufficient capital to start a new venture is the common problem with almost all entrepreneurs, and so it was with Koch. Still, he was better off than most. He had saved \$100,000 from his years with Boston Consulting, and he persuaded family and friends to chip in another \$140,000. But while this might be enough to start a new retail or service venture, it was far less than the estimated \$10 million or more needed to build a state-of-the-art brewery.

Koch got around this major obstacle. Instead of building or buying, he contracted an existing firm, Pittsburgh Brewing Company, to brew his beer. It had good facilities, but more than this, its people had the brewing skills coming from more than 20 years of operation. He would call his new beer Samuel Adams, after a Revolutionary War patriot who was also a brewer.

PROBLEMS

A mighty problem still existed, and the success of the venture hinged on this. Koch would have to sell his great-tasting beer at \$20 a case to break even and make a reasonable profit. But this was 15 percent more than even the premium imports like Heineken. Would anyone buy such an expensive beer, and one that didn't even have the cachet of an import? See the Information Box about competing on price.

It fell to Koch as the fledgling firm's only salesperson to try to acquaint retailers and consumers with his new beer, this unknown brand with the very high price.

INFORMATION BOX

COMPETING ON PRICE: THE PRICE/QUALITY PERCEPTION

Boston Beer was attempting to compete while having some of the highest prices in the industry. Was this the height of foolishness? Why would anyone pay prices higher even than the expensive imported beers just for a different taste?

The highest price can convey an image of the very highest quality. We as consumers have long been conditioned to think this. With cars, we may not be able to afford this highest quality, such as an Infiniti, Lexus, or Mercedes convertible. But with beer, almost anyone can afford to buy the highest-price brew sometimes, maybe to impress guests or to simply enjoy a different taste that we are led to think is better.

Sometimes such a price/quality perception sets us up. It might be or might not be valid. This is especially true where quality is difficult to ascertain, such as with beer and liquor, with bottled water, with perfume, as well as other products with hidden ingredients and complex characteristics.

Have you ever fallen victim to a price/quality misperception? How does one determine quality for an alcoholic beverage such as vodka, gin, and scotch, as well as beer? By the taste? The advertising claims? Anything else?

“I went from bar to bar,” he said. “Sometimes I had to call 15 times before someone would agree to carry it.”¹

He somehow conjured up enough funds for a \$100,000 ad campaign in the local market. Shunning the advertising theme of the big brewers that almost without exception stressed the sociability of the people drinking their brand, Koch’s ads attacked the imports: “Declare your independence from foreign beer,” he urged; and the name Samuel Adams was compatible with this cry for independence. Foreign brews were singled out as not having the premium ingredients and quality brewing of Samuel Adams. Koch appeared on most of his commercials, saying such things as: “Hi, I’m Jim Koch . . . It takes me all year to brew what the largest import makes in just three hours because I take the time to brew Samuel Adams right. I use my great-great-grandfather’s century-old recipe, all malt brewing and rare hops that cost ten times what they use in the mass-produced imports.”²

Gradually his persistence in calling on retailers and his anti-import ads, some of which garnered national attention in such periodicals as *Newsweek* and *USA Today*, induced more and more bartenders and beer drinkers to at least try Samuel Adams. Many liked it, despite the high price (or, perhaps, because of it).

Now his problem became finding distributors, and this proved particularly daunting for a new firm in this industry where major brands often had a lock on existing wholesalers. The situation was so bad in Boston—no wholesaler would carry Samuel Adams, even though it was a local brand—that Boston Beer bought a truck and delivered the cases itself.

At Last, Slow Expansion

Koch slowly expanded his distribution one geographical area at a time, from Boston into Washington, D.C., then to New York, Chicago, and California, taking care that production could match the steady expansion without sacrificing quality. He brought in his secretary at Boston Consulting, Rhonda Kaliman, to assist him in building a sales organization. This grew from less than a dozen sales reps in 1989 to 70 nationwide by 1994, more than any other microbrewer and about the same number as Anheuser-Busch, the giant of the industry. Now, Samuel Adams salespeople could give more personalized and expert attention to customers than competitors whose sales reps often sold many beverage lines.

Sales soared 63 percent in 1992 when the company went national and achieved distribution in bars and restaurants in 48 states. In a continual search for new beer ideas, Boston Beer added a stout, a wheat beer, and even a cranberry lambic, a type of beer flavored with fruit. Adding to the growing popularity were numerous industry awards and citations Samuel Adams had received since 1984. It was not only voted the Best Beer in America four times at the annual Great American Beer Festival, but also received six gold medals in blind tastings.

¹ Jenny McCune, “Brewing Up Profits,” *Management Review*, April 1994, p. 18.

² *Ibid.*, p. 19.

In April 1994, Jim Koch and two of his brewmasters were testing their entry into the Great American Beer Festival: “Triple Bock.” They had not yet tried to market this creation, although their expectations were high. But this was so different. It boasted a 17 percent alcoholic content with no carbonation, and they planned to package it in a cobalt bottle with a cork. It was meant to be sipped as a fine brandy. “It’s a taste that nobody has ever put into a beer,” Koch said.³ Too innovative? Jim and his colleagues pondered this as they sipped on this beautiful spring day.

THE BREWING INDUSTRY IN THE 1990s

In ten years, Boston Beer had forged ahead to become a major contender in its industry and the largest U.S. specialty brewer. But a significant change in consumer preferences was confronting the industry in the 1990s. The big brands that had been so dominant, to the extent that smaller brewers could not compete against their production efficiencies, now were seeing their market shares decline. The brand images they had spent millions trying to establish were in trouble. Many were cutting prices in desperate attempts to keep and lure consumers. For example, special price promotions in some markets were offering 12-packs of Budweiser, Coors, and Miller for just \$1.99.

The shifting consumer preferences, and the severe price competition with their regular brands, were motivating the big brewers to seek the types of beers that would command higher prices. Imports were still strengthening, growing at an 11 percent rate between 1993 and 1994. But microbrews seemed the wave of the future, with prices and profit margins that were mouth-watering to the big barons of the industry.

Consequently, a few major breweries came up with their own craft brands. For example, Icehouse, a name that conveyed a fake microbrewery image to a beer that was actually produced in megabreweries by Miller Brewing. So too, the pseudo-import Killian’s Irish Red was made by Coors in Golden, Colorado. Killian’s, stocked in retailer’s import cases and commanding a high price, muscled its way abreast of Samuel Adams as the largest specialty beer in the United States.

The brewing industry was desperately trying to innovate. But no one saw anything revolutionary on the horizon, not like the 1970s when light beer made a significant breakthrough in the staid industry. Now, “ice” beers became the gimmick. First developed in Canada, these were beers produced at temperatures a little colder than ordinary beer. This gave them a slightly higher alcohol content. Whether because of this or the magic of the name “ice,” these products captured almost 6 percent of total industry sales in 1994, more than all the imports combined. But, still, the potential was limited.

Anheuser-Busch, with a still dominant 44 percent of U.S. beer sales despite its 9 percent sales volume slide in the early 1990s, asserted its reluctance to change: “The breweries that we have are designed to produce big brands. Our competition can’t compete with big brands. That’s why they’ve had to introduce lots

³ McCune, p. 20.

of little brands.”⁴ But even Anheuser, despite its words, was sneaking into microbrewing by buying into Redhook Ale Brewery, A Seattle microbrewery that sold 76,000 barrels of beer in 1993, versus Anheuser’s 90 million. Anheuser’s distributors applauded this move as a badly needed step in giving them higher-profit, prestige brands. When Anheuser tiptoed into this market, other giants began to look for microbreweries to invest in.

This troubled Jim Koch: “I’m afraid of the big guys. They have the power to dominate any segment they want.” Then he expressed his faith and confidence: “Still, my faith is that better beer will win out.”⁵

THE CONTINUING SAGA OF BOSTON BEER

In August 1995, Boston Beer announced an initial public stock offering (IPO) of 5.3 million shares, of which 990,000 shares would be made available directly to the public through a coupon offer. This selling of shares to the general public was unlike any other IPO and, as such, caught the fancy of the national press.

The company put clip-and-mail coupons on Samuel Adams six-packs and other beer packages. These offered customers a chance to buy 33 shares of stock at a maximum price of \$15, or \$495 total. Only one subscription was allowed per customer, and these were honored on a first-come, first-served basis. The success was overwhelming. First distributed in October, by November 1 the offering was oversubscribed. The company expected that the total funds generated from the IPO would be \$75 million.⁶ But when the new stock offering finally came out on November 20, 1995, heavy demand led to it being priced at \$20 a share. Two days later it was selling on the New York Stock Exchange for \$30. Interestingly, its stock symbol is SAM.

Boston Beer was riding high. It reported an impressive 50 percent growth in 1994 over 1993, brewing 700,000 barrels and becoming the largest microbrewery in the country. The entire microbrewing industry was producing more than double the volume in 1990. By now, Boston Beer had 12 different beers including six seasonals, and was distributing in all 50 states through 300 wholesalers. Its newest beer, the 17-percent alcohol content Triple Bock, had been introduced to the market.⁷

Most of Boston Beer’s production continued to be contract brewed. In early 1995, it did encounter difficulties with Pittsburgh Brewing, the first of the three contract breweries it was now using. Because of an alleged overdraft of \$31 million by its owner, Michael Carlow, who was accused of fraud, the brewery was to be auctioned off. Jim Koch stoutly professed having no interest in buying the brewery and that any problems of Pittsburgh Brewing would have no effect on Boston Beer.⁸

⁴ Patricia Sellers, “A Whole New Ballgame in Beer,” *Fortune*, September 19, 1994, p. 86.

⁵ *Ibid.*

⁶ “Boston Beer’s Plan for Offering Stock,” *New York Times—National Edition*, August 26, 1995, p. 20.

⁷ “Little Giants,” *Beverage-World*, December 1994, p. 26.

⁸ “Sam Adams Brewer May Be on Block,” *Boston-Business-Journal*, February 24, 1995, p. 3.

INFORMATION BOX

THE MERITS OF EXPANDING SLOWLY AND KEEPING FIXED COSTS TO A MINIMUM

There is much to be said for any enterprise, new or old, to keep its fixed overhead to a minimum. If it can escape having to commit large sums to physical plant and production facilities, its breakeven point is far less, which means that fewer sales are needed to cover expenses and interest payments, leaving more to go into profits. In the event of adversity, such a firm can retrench much more nimbly than if burdened with heavy overhead. In every such decision of renting or buying, the economics of the particular situation need to be carefully analyzed.

Arguments against such contracting out usually maintain that efficiency will be sacrificed since direct control is lacking. So, this argument would maintain that Pittsburgh Brewing could not do as good a job as Boston Beer could have done itself. Yet the empirical evidence is that Boston's contract brewers were giving it the high standards it wanted. It set the standards and insisted on them being met, or it would find another contract brewery.

Still, the "edifice complex" tantalizes many top executives, as well as hospital and school administrators, who see the stone and mortar of their buildings and factories as conveying tangible evidence of their own importance and accomplishments. They will claim that such is important to the public image of their organization.

Given the approximately \$100 million that Boston Beer received from its IPO, would you predict some of this would go for "stones and mortar"?

See the preceding Information Box for a discussion of contracting out rather than building production facilities.

TOWARD THE MILLENNIUM

By 1998, Samuel Adams had become the seventh-largest brewer overall and was the largest competitor in independent craft brewing—a sector that had grown 39 percent in a five-year period while U.S. beer total shipments remained virtually flat. Samuel Adams Boston Lager, the company's flagship product, grew faster than the overall craft beer sector, and accounted for the majority of Boston Beer's sales in 1997.

For 1997, revenues were \$184 million, down 3.8 percent from the year before, but a major increase from the \$77 million in 1994, the year before Boston went public. Net income at \$7.6 million was a decline of 9.9 percent from the year before, but this compared with \$5.3 million in 1994.

Boston Beer produced more than two dozen styles of beer and was selling in all 50 states and several foreign countries. Its sales force was still the largest of any craft brewer, and one of the largest in the domestic beer industry.

The acute disappointment had to be the stock market valuation of its shares. An exuberant public reaction to the initial stock offering had bid the price up to \$30 a share. Almost immediately, the share price began a slow decline. By late 1998, shares were trading around \$8.

The situation had not improved significantly by the millennium. Indeed, the growth that had so bedazzled Koch and early investors seemed only an illusion. Samuel Adams had been the forefather of microbrews, but this specialty market had now spawned 3,000 microbrews, all competing within the \$3 billion beer market—a market that represented just 3 percent of the U.S. beer market—with a mind-boggling array of ciders, ales, stouts, and so-called better beers. “After people got inundated with so many choices . . . they kind of stepped back,” said one industry analyst.⁹

Koch drastically cut back his assortment of different brews, concentrating only on best sellers: the flagship lager and four seasonal brews. He went through four advertising agencies in six years trying to find the right pitch, but without much success. Experts were wondering if Koch would eventually sell out to a big brewer such as Miller. By mid-2001, the stock price ranged from \$8 to \$10 a share, still a disaster for its IPO investors.

AFTER THE MILLENNIUM

Table 4.1 shows the trend in revenues and net income for 1998 through 2006. Sales and profits show little growth trend during the first five years. The stock price had ranged between \$10 and \$18 a share for 2003. Better results came

TABLE 4.1 Boston Beer Revenue and Net Income, 1998–2005
(in millions)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Revenue	\$183.5	\$176.8	\$190.6	\$186.8	\$215.4	\$238.3	\$239.7	\$263.3	\$315.3
Net Income	7.9	11.1	11.2	7.8	8.6	10.6	12.5	15.6	18.2

Source: Company annual reports.

Commentary: Here we see a company with practically no growth from 1998 through 2003, even though revenue increased slightly during these five years. Net income, however, did not exceed that of 1999 and 2000 until 2004. Then 2005 finally looked like a banner year, giving hope of much better days to come. However, the stock market valuations for 2005 ranged from a low of \$20.71 to \$27.27; 2006 looked like a breakout year, both in revenue and in net income, if the improvement could be continued. In partial 2007 statistics, we know that sales were robustly ahead of 2006, but profit was about the same.

These statistics show a stable company, one comfortably established in its own niche. Unfortunately, this has until very recently been little consolation for those investors who bought at the initial public stock offering (IPO) at \$20 a share in late November 1995, or bought a few days later at \$30 a share, expecting big growth. It would seem the growth was long overdue.

⁹ Hillary Chura, “Boston Beer Crafts Strategy: Slumping Brewer Abandons Some of Its Specialty Beers,” *Advertising Age*, November 8, 1999, p. 20.

in 2005 with the stock price ranging from \$20.71 to \$27.27. Still, for those investors who bought at or near the initial offering in 1995, this was hardly a coup. Then 2006 gave a big boost, which continued into 2007. Record third quarter revenue increased 10.9 percent over the same period in 2006, this being the seventh successive quarter of double digit increases. The company had to feel optimistic, and the stock price reached a high of \$55.30 a share in 2007, although falling to \$38.50 by end of the year. A contingent excise tax liability related to a federal audit impacted on profitability, which was about flat with previous periods. The company also warned of significant cost pressures in 2008 due to barley and hop markets tightening.¹⁰

In August 2002, Koch had led a ten-city “Liquid Lunch” taste-test tour, pitting three Samuel Adams beers and local craft beers from each of the cities against leading international brews, such as Heineken, Corona, and Guinness. The beers were scored according to appearance, aroma, flavor, mouthfeel, and overall impression. The taste-testers included beer enthusiasts, consumers, journalists, and winners from local radio station promotions.

In one-on-one taste tests, Samuel Adams was preferred over the imports in all thirty blind taste-offs. Many of the local brews also bested their foreign competition. Koch’s crusade against imports received a good promotional push. He declared: “These imports have been considered the world standards . . . But I believe when you take away the fancy bottles and marketing mystique of imported beer, you discover that Samuel Adams and other American brewers simply make better tasting beers.”¹¹

In January 2005, Jim Koch announced that he would spend nearly \$7 million modernizing an old brewery in Cincinnati to restore roots deep in Ohio’s German heritage. Koch’s father had once apprenticed in the brewery, and now the expansion would mean that nearly two-thirds of Samuel Adams beer would be produced and bottled in Ohio by the end of 2005. The mayor and other city officials downed bottles of beer with Koch to toast the economic coup of gaining one hundred new jobs.¹² Unfortunately, in fall 2007, the company had to temporarily shut down this now-problem brewery for preventative maintenance and process improvements. It was in the process of buying a brewery in the Lehigh Valley of Pennsylvania, near Philadelphia, with costs likely to impact on profitability in 2008. Boston Beer also invested in an older brewery in Latrobe, Pennsylvania in summer 2007.

The decision of Koch near the millennium to cut back to five kinds of beer had been scrapped. As of 2007, the company now had more than 21 styles of beer. It was still striving to elevate the image of American craft beer by entering festivals

¹⁰ Press release, “Boston Beer Reports Record Third Quarter Volume and Revenue,” Boston Beer, November 6, 2007, reported on the Internet.

¹¹ Boston Beer Company News, August 25, 2000, www.samadams.com.

¹² Bill Sloat, “Samuel Adams Brewer Expanding in Cincinnati,” *Cleveland Plain Dealer*, January 7, 2005, pp. C1 and C3.

and competitions the world over, and in the past five years had won more awards in international beer competitions than any other brewery in the world.¹³

ANALYSIS

Entrepreneurial Character

Although many entrepreneurial opportunities come in the retail and service industries, mostly because these typically require less start-up investment, Jim Koch saw the possibility in beer, even without a huge wallet. He started with \$100,000 of his own money and \$140,000 from friends and relatives. He had the beer recipe and determination. By contracting out the production to an existing brewery with unused production capacity, the bulk of the start-up money could be spent on nonproduction concerns, such as advertising.

His determination to gain acceptance of his beer, despite its high price and lack of foreign cachet, is characteristic of most successful entrepreneurs. They press on, despite obstacles in gaining acceptance. They have confidence that their product or concept is viable. They are not easily discouraged.

At the same time, Koch believed he had something unique, a flavor and quality that neither domestic nor imported brews could deliver. He had the audacity to further make his product unique by charging even higher prices than the imports, thus conveying an image of highest quality.

His search for uniqueness did not end with the product. He developed an advertising theme far different from that of other beers by stressing quality and aggressively attacking the imports: “Declare your independence from foreign beer.” And he was the spokesman on TV and radio commercials, giving a personal and charismatic touch.

As Boston Beer moved out of regional into national distribution, Koch developed a sales force as large as Anheuser-Busch, the giant of the industry. His grasping of uniqueness even went to Boston Beer’s initial public stock offering, in which customers were invited to buy into the company through coupons on six-packs. And it was oversubscribed in only a few weeks.

Controlled Growth (Aggressive Moderation)

The temptation for any firm, but especially for newer, smaller firms, when demand seems to be growing insatiably, is to expand aggressively: “We must not miss this opportunity.” Such optimism can sow the seeds of disaster, when demand suddenly lessens because of a saturated market and/or new competition. And our firm is left with too much plant and other fixed assets, and a burdensome overhead.

Controlled growth—we might also call this “aggressive moderation”—is usually far better. Now our firm is not shunning growth, even vigorous growth, but is controlling it within its present resources, not overextending itself. Boston Beer showed this restraint by expanding within its production capability, adding several

¹³ *Ibid.*, November 6, 2007 press release by Boston Beer.

more contract brewers as needed. It expanded market by market at the beginning, only moving to a new geographical area when it could supply it. First was Boston, then Washington D.C., then New York, Chicago, California, and finally all 50 states.

Besides husbanding resources, both material and personnel, aggressive moderation is compatible with the tightness of controls needed to assure high-quality product and service standards. Even more than this, moderation allows a firm to build the accounting and financial standards and controls needed to prevent the dangerous buildup of inventories and expenses.

Limits on Potential

It is difficult to perceive, in the heady days of growth for a new firm, that the growth potential is sorely limited without drastic and risky changes. Limits on potential usually are due to two factors:

1. Ease of entry into the industry, which encourages a host of competitors. This turned out to be especially true with the influx of microbrewers, to 3,000 in just a few years.
2. Finite potential in demand. (This also affected the high-tech industry and the collapse of the NASDAQ at the turn of the millennium.) Demand for specialty beer, while at first robust and rising, was certainly not going to take over the mainstream beer market.

Given the rush to microbreweries in an environment of limited demand, the aspirations of Jim Koch to be a dominant force in the brewing industry had to be curbed. He could still be a profitable firm and do well in his niche, but he would never be a challenge beyond that. Perhaps that is enough for most entrepreneurs. They can hardly expect to grasp the golden ring of complete market dominance.

Repudiation of Former Strategies with Maturity

Koch seems to have disavowed the former strategies that influenced his early growth. Now he seems motivated to own breweries, rather than to contract out his beer production. Did he find quality control to his standards impossible to maintain? Or is it the allure of an edifice complex? Then there is the reversal of his cutting back on the proliferation of styles of beer. It seems he is more driven by the need to increase sales than the need to be stingy on expenses. But it must give Jim Koch great satisfaction that he has gotten the stock price up beyond what it was at the IPO, and far above the five years after.

Invitation for Your Own Analysis and Conclusions

We welcome your own analysis of Jim Koch and his Boston Beer enterprise. Do you see any business plan that might have made him more successful, a bigger factor in the market?

WHAT WE CAN LEARN

The Price-Quality Perception

We have a curious phenomenon today regarding price. More consumers than ever are shopping at discount stores because they supposedly offer better prices than other retailers. Airlines competing with lowest prices, such as Southwest and JetBlue, have clobbered higher-cost carriers. Yet, for many products, especially those that are complex and have hidden ingredients, a higher price than competitors is the major indicator of higher quality. Boston Beer certainly confirms that a higher price can successfully differentiate a firm. Especially if the taste is robustly different, and if the theme of highest quality is constantly stressed in advertising. The great success of Starbucks in the preceding case certainly attests to this also.

So, we know that both low prices and high prices can be successful. A strategy of lowest prices, however, tends to be vulnerable since competitors can more easily and quickly match these low prices (not always profitably, of course), while a high-price strategy stressing quality tends to attract less competitors. But it may also attract fewer customers.

The Challenge of the Right Approach to Growth

In the analysis section we discussed the desirability of controlled growth or aggressive moderation and noted that Boston Beer practiced this well in its early days. There are some who would challenge such slowness in grabbing opportunities. Exuberant expansion instead is advocated, when and if the golden opportunity is presented (some would call this “running with the ball”). Operations should be expanded as fast as possible in such a situation, they would say. But there are times when caution is advised.

Risks lie on all sides as we reach for these opportunities. When a market begins to boom and a firm is unable to keep up with demand without greatly increasing capacity and resources, it faces a dilemma: Should it stay conservative in the expectation that the burgeoning demand will be short lived, and thereby abdicate some of the growing market to competitors, or should it expand vigorously and take full advantage of the opportunity. If the euphoria is short lived, and demand slows drastically, the eager firm is then left with expanded capacity, more resource commitment than needed, high interest and carrying costs, and perhaps even jeopardized viability because of being overextended. Above all, however, a firm should not expand beyond its ability to maintain organizational and accounting controls over the operation. Not to have such controls is tantamount to letting a sailing ship brave the uncertainties of a storm under full canvas.

Keep the Breakeven Point as Low as Possible, Especially for New Ventures

Fixed investments in plant and equipment raise the breakeven point of sales needed to cover overhead costs and make a profit. Boston Beer kept its breakeven point low by using contract breweries. Now this would have been a mistake if the quality

of production at these breweries was erratic or not up to Boston Beer's expectations. Excellent and dependable quality were indeed vital requirements if it were to succeed in selling its high-priced beer. But by working closely with experienced brewers, quality control apparently was not a serious problem, or was it?

Certainly the lower breakeven point makes for less risk. And the future is always uncertain, despite research and careful planning. Mistakes will be made. The environment is constantly changing as to customer attitudes and preferences, and particularly in actions of competitors.

When a decision involves high stakes and an uncertain future—which translates into high risks—is it not wiser to approach the venture somewhat conservatively, not spurning the opportunity, but also not committing major resources and efforts until success appears more assured?

The Importance of Maintaining Quality

For a high-priced product, a brief letdown in quality control can be disastrous to the image. The story is told of Jim Koch ordering a draft of his own Samuel Adams at a restaurant across from Lincoln Center in New York City. He was horrified at the taste. He called the manager and they went to the basement and looked at the keg. "It was two-and-a-half months past its pull date." The manager quickly changed the keg, which the distributor, intentionally or not, had sold the restaurant.¹⁴ Sometimes a lapse in quality is not the fault of the manufacturer, but of a distributor or dealer. Whoever is at fault, the brand image is tarnished. And it is difficult to resurrect a reputation of poor or uncertain quality.

For Investors, Consider the Risk of Initial Public Offerings (IPOs)

IPOs are often bid up to unreasonable prices in public enthusiasm with new offerings. While Boston Beer did well as a niche brewer, and dominated its niche, it had to be a major disappointment to its investors who bought in at the beginning. Perhaps the better investor strategy is to wait for public enthusiasm to calm down before taking a stake in a new enterprise.

CONSIDER

Can you think of other learning insights?

QUESTIONS

1. Have you ever tried one of the Boston Beer brews? If so, how did you like the taste? Was it worth the higher price?
2. The investment community evidently thought Boston Beer had great growth potential to have bid up the initial price so quickly. Why do you suppose so many fell into this trap? Or was Jim Koch a poor executive in not bringing Boston Beer up to their expectations?

¹⁴ Example related in McCune, p. 16.

3. “The myriad specialty beers are but a fad. People will quickly tire of an expensive, strong-flavored beer. Much of it is just a gimmick.” Discuss.
4. What problems do you see retailers facing with the burgeoning number of different beers today? What might be the implications of this?
5. Playing the *devil’s advocate* (one who takes an opposing view for the sake of argument and deeper analysis), critique the strategy of charging some of the highest prices in the world for your beer.
6. We saw the detection of a problem with the freshness of a beer at a restaurant by Jim Koch himself. How can Boston Beer prevent such incidents from happening again? Can such distributor negligence or shortsighted actions be totally prevented by Boston Beer?
7. Do you think Boston Beer can continue to compete effectively against the giant brewers who are moving with their infinitely greater resources into the specialty beer market with their own microbrews? Why or why not?
8. In 1998, Boston Beer produced more than two dozen styles of beer. Then a few years later it was down to just a few. Now it’s up to more than 21 again. Do you see any problems with this?

HANDS-ON EXERCISES

1. You are Jim Koch. You have just learned that it has taken Howard Schultz of Starbucks ten years from going public to reach \$3.3 billion in revenues. It has taken you ten years to grow Boston Beer to a \$260 million firm. You are depressed at this but determined to greatly increase your company’s growth. How would you go about setting Boston Beer on this great growth path? Be as specific as you can. What dangers do you see ahead?
2. It is 1986, and Boston Beer is beginning its growth after hiring Pittsburgh Brewery to produce its beer. Jim Koch has charged you with coordinating the efforts at Pittsburgh Brewery, paying particular attention to assuring that your quality standards are rigidly maintained. How would you go about doing this?

TEAM DEBATE EXERCISE

Debate how Boston Beer should commit the \$100 million it received in late 1995 from the public stock offering. In particular, debate whether the bulk of the proceeds should go to building its own state-of-the-art brewery, or something else.

INVITATION TO RESEARCH

How is Boston Beer faring today? Has its expansion accelerated or stalled? Is it facing any particular problems? What is the stock price today? Are any merger rumors circulating?

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**PART
TWO**

MARKETING WARS

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Cola Wars: Coca-Cola vs. PepsiCo



Intense competition between Pepsi and Coca-Cola has characterized the soft-drink industry for decades. In this chess game of giant firms, Coca-Cola ruled the soft-drink market throughout the 1950s, 1960s, and early 1970s. It outsold Pepsi by two to one. But this was to change. Then the “war” switched to the international arena, and it became a “world war.”

EARLY BATTLES, LEADING TO NEW COKE FIASCO

Pepsi Inroads, 1970s and 1980s

By the mid-1970s, the Coca-Cola Company was a lumbering giant. Performance reflected this. Between 1976 and 1978, the growth rate of Coca-Cola soft drinks dropped from 13 percent annually to a meager 2 percent. As the giant stumbled, Pepsi Cola was finding heady triumphs. First came the “Pepsi Generation.” This advertising campaign captured the imagination of the baby boomers with its idealism and youth. This association with youth and vitality greatly enhanced the image of Pepsi and firmly associated it with the largest consumer market for soft drinks.

Then came another management coup, the “Pepsi Challenge,” in which comparative taste tests with consumers showed a clear preference for Pepsi. This campaign led to a rapid increase in Pepsi’s market share, from 6 to 14 percent of total U.S. soft-drink sales.

Coca-Cola, in defense, conducted its own taste tests. Alas, these tests had the same result—people liked the taste of Pepsi better, and market share changes reflected this. As Table 5.1 shows, by 1979 Pepsi was closing the gap on Coca-Cola, having 17.9 percent of the soft-drink market, to Coke’s 23.9 percent. By the end of 1984, Coke had only a 2.9 percent lead, while in the grocery store market it was now trailing by 1.7 percent. Further indication of the diminishing position of Coke relative to Pepsi was a study done by Coca-Cola’s own marketing research department. The study showed that in 1972, 18 percent of soft-drink users drank Coke exclusively, while only 4 percent drank only Pepsi. In ten years the picture had changed greatly:

TABLE 5.1 Coke and Pepsi Shares of Total Soft-Drink Market, 1950s–1984

		1975		1979		1984	
Mid-1950s Lead		% of Market	Lead	% of Market	Lead	% of Market	Lead
Coke	Better than 2 to 1	24.2	6.8	23.9	6.0	21.7	2.9
Pepsi		17.4		17.9		18.8	

Source: Thomas Oliver. *The Real Coke. The Real Story* (New York: Random House, 1986), pp. 21, 50; “Two Cokes Really Are Better Than One—For Now,” *Business Week*, 9 September 1985, p. 38.

Only 12 percent now claimed loyalty to Coke, while the number of exclusive Pepsi drinkers almost matched, with 11 percent. Figure 5.1 shows this change graphically.

What made the deteriorating comparative performance of Coke all the more worrisome and frustrating to Coca-Cola was that it was outspending Pepsi in advertising by \$100 million. It had twice as many vending machines, dominated fountains, had more shelf space, and was competitively priced. Why was it losing market share? The advertising undoubtedly was not as effective as that of Pepsi, despite vastly more money spent. And this raises the question: How can we measure the effectiveness of advertising? See the following Information Box for a discussion.

Coca-Cola Tries to Battle Back

The Changing of the Guard at Coke

J. Paul Austin, chairman of Coca-Cola, was nearing retirement in 1980. Donald Keough, president for the American group, was expected to succeed him. But a new name, Roberto Goizueta, suddenly emerged. Goizueta’s background was far different

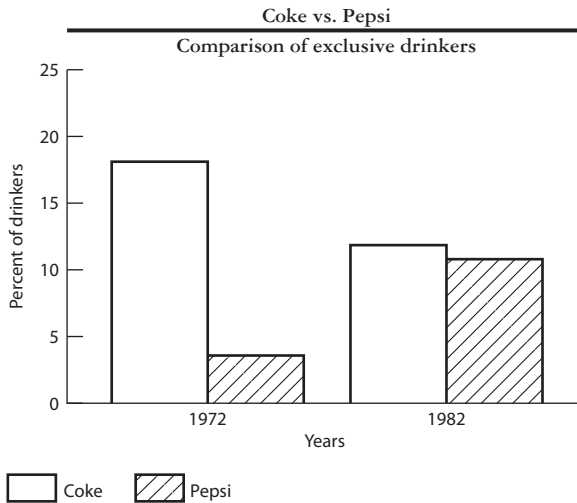


Figure 5.1 Coke versus Pepsi: Comparison of exclusive drinkers, 1972 and 1982.

INFORMATION BOX

HOW DO WE MEASURE THE EFFECTIVENESS OF ADVERTISING?

A firm can spend millions of dollars for advertising, and it is only natural to want some feedback on the results of such an expenditure: To what extent did the advertising really pay off? Yet many problems confront the firm trying to measure this.

Most methods for measuring effectiveness focus not on sales changes but on how well the communication is remembered, recognized, or recalled. Most evaluative methods simply tell which ad is the best among those being appraised. But even though one ad may be found to be more memorable or to create more attention than another, that fact alone gives no assurance of relationship to sales success. A classic example of the dire consequences that can befall advertising people as a result of the inability to directly measure the impact of ads on sales occurred in December 1970.

In 1970, the Doyle Dane Bernbach advertising agency created memorable TV commercials for Alka-Seltzer, such as the “spicy meatball man,” and the “poached oyster bride.” These won professional awards as the best commercials of the year and received high marks for humor and audience recall. But in December, the \$22 million account was abruptly switched to another agency. The reason? Alka-Seltzer’s sales had dropped somewhat. Of course, no one will ever know whether the drop might have been much worse without these notable commercials.

So, how do we measure the value of millions of dollars spent for advertising? Not well. Nor can we determine what is the right amount to spend, what is too much or too little.

Can a business succeed without advertising? Why or why not?

from that of the typical Coca-Cola executive. He was not from Georgia (the company is headquartered in Atlanta), and was not even southern. Rather, he was the son of a wealthy Havana sugar plantation owner. He came to the United States at age sixteen, speaking virtually no English. By using the dictionary and watching movies, he quickly learned the language and graduated from Yale in 1955 with a degree in chemical engineering. Returning to Cuba, he went to work in Coke’s Cuban research lab.

Goizueta’s complacent life was to change in 1959 when Fidel Castro seized power. With his wife and three children, he fled to the United States, arriving with \$20. At Coca-Cola he became known as a brilliant administrator and in 1968 was brought to company headquarters; he became chairman of the board 13 years later, in 1981. Donald Keough had to settle for being president.

In the new era of change, the sacredness of the commitment to the original Coke formula became tenuous and the ground was laid for the first flavor change in ninety-nine years.

Introducing a New Flavor for Coke

With the market-share erosion of the late 1970s and early 1980s, despite strong advertising and superior distribution, the company began to look at the soft-drink product

itself. Taste was suspected as the chief culprit in Coke's decline, and marketing research seemed to confirm this. In September 1984, the technical division developed a sweeter flavor. In perhaps the biggest taste test ever, costing \$4 million, 55 percent of 191,000 people approved it over both Pepsi and the original formula of Coke. Top executives unanimously agreed to change the taste and take the old Coke off the market.

But the results flabbergasted company executives. While some protests were expected, they quickly mushroomed; by mid-May calls were coming in at the rate of 5,000 a day, in addition to a barrage of angry letters. People were speaking of Coke as an American symbol and as a long-time friend who had suddenly betrayed them.

Anger spread across the country, fueled by media publicity. Fiddling with the formula for the 99-year-old beverage became an affront to patriotic pride. Even Goizueta's father spoke out against the switch and jokingly threatened to disown his son. By now the company began to worry about a consumer boycott against the product.

On July 11th company officials capitulated to the outcry. They apologized to the public and brought back the original taste of Coke.

Roger Enrico, president of Pepsi-Cola, USA, gloated, "Clearly this is the Edsel of the '80s. This was a terrible mistake. Coke's got a lemon on its hand and now they're trying to make lemonade." Other critics labeled this the "marketing blunder of the decade."¹

Unfortunately for Pepsi, the euphoria of a major blunder by Coca-Cola was short lived. The two-cola strategy of Coca-Cola—it kept the new flavor in addition to bringing back the old classic—seemed to be stimulating sales far more than ever expected. While Coke Classic was outselling New Coke by better than two to one nationwide, for the full year of 1985, sales from all operations rose 10 percent and profits 9 percent. Coca-Cola's fortunes continued to improve steadily. By 1988 it was producing five of the top-ten selling soft drinks in the country, and now had a total 40 percent of the domestic market to 31 percent for Pepsi.²

BATTLE SHIFTS TO INTERNATIONAL ARENA

Pepsi's Troubles in Brazil

Early in 1994, PepsiCo began an ambitious assault on the soft-drink market in Brazil. Making this invasion even more tempting was the opportunity to combat arch-rival Coca-Cola, already entrenched in this third largest soft-drink market in the world, behind only the United States and Mexico.

The robust market of Brazil had attracted Pepsi before. Its hot weather and a growing teen population positioned Brazil to become one of the world's fastest-growing soft-drink markets, along with China, India, and Southeast Asia. But the potential still had barely been tapped. Brazilian consumers averaged only 264 eight-ounce servings of soft drinks a year, far below the U.S. average of about 800.³

¹ John Greenwald, "Coca-Cola's Big Fizzle," *Time*, July 22, 1985, pp. 48–49.

² "Some Things Don't Go Better with Coke," *Forbes*, March 21, 1988, pp. 34–35.

³ Robert Frank and Jonathan Friedland, "How Pepsi's Charge into Brazil Fell Short of Its Ambitious Goals," *Wall Street Journal*, August 30, 1996, p. A1.

Three times before over the previous 25 years, Pepsi had attempted to enter the Brazilian market with splashy promotional campaigns and different bottlers. Each of these efforts proved disappointing, and Pepsi had quickly dropped them and retreated from the field. In 1994 it planned a much more aggressive and enduring push.

A Super Bottler, Baesa, and Charles Beach

Buenos Aires Embotelladora SA, or Baesa, was to be the key to Pepsi's rejuvenated entry into Brazil. Baesa would be Pepsi's "superbottler," one that would buy small bottlers across Latin America, expand their marketing and distribution, and be the fulcrum in the drive against Coca-Cola. Charles Beach, the CEO of Baesa, was the person around whom Pepsi planned its strategy.

Beach, 61, was a passionate, driven man, a veteran of the cola wars, but his was a checkered past. A Coca-Cola bottler in Virginia, he was indicted by a federal grand jury on charges of price fixing and received a \$100,000 fine and a suspended prison sentence. He then bought Pepsi's small Puerto Rican franchise in 1987. Then, in 1989, Beach acquired the exclusive Pepsi franchise for Buenos Aires, Argentina—one of the most important bottling franchises outside the United States. By discounting and launching new products and packages, he caught Coke by surprise. In only three years he had increased Pepsi's market share in the Buenos Aires metro area from almost zero to 34 percent.⁴

With Pepsi's blessing, Beach expanded vigorously, borrowing heavily to do so. He bought major Pepsi franchises in Chile, Uruguay, and most importantly, Brazil, where he built four giant bottling plants. Pepsi worked closely with Baesa's expansion, providing funds to facilitate it.

However, they underestimated the aggressiveness of Coca-Cola. Their rival spent heavily on marketing and cold-drink equipment for its choice customers. As a result Baesa was shut out of small retail outlets, those most profitable for bottlers. Goizueta, CEO of Coca-Cola, used his Latin American background to influence the Argentine president to reduce an onerous 24 percent tax on cola to 4 percent. This move strengthened Coke's position against Baesa, which in contrast to Coca-Cola was earning most of its profits from non-cola drinks.

By early 1996, Baesa's expansion plans—and Pepsi's dream—were floundering. The new Brazilian plants were running at only a third of capacity. Baesa lost \$300 million for the first half of 1996, and PepsiCo injected another \$40 million into Baesa.

On May 9, Beach was relieved of his position. Allegations now surfaced that Beach might have tampered with Baesa's books.⁵ But PepsiCo's troubles did not end with the debacle in Brazil.

Intrigue in Venezuela

Brazil was only symptomatic of other overseas problems for Pepsi. Roger Enrico, now CEO, had reasons to shake his head and wonder at how the gods seemed

⁴ Patrica Sellers, "How Coke Is Kicking Pepsi's Can," *Fortune*, October 28, 1996, p. 78.

⁵ Sellers, "How Coke is . . ." p. 79.

against him. But it was not the gods, it was Coca-Cola. Enrico had been on Coke's black list since he had gloated a decade before about the New Coke debacle in his memoir, *The Other Guy Blinked: How Pepsi Won the Cola Wars*. Goizueta was soon to gloat, "It appears that the company that claimed to have won the cola wars is now raising the white flag."⁶

The person Enrico thought was his close friend, Oswaldo Cisneros, head of one of Pepsi's oldest and largest foreign bottling franchises, suddenly abandoned Pepsi for Coca-Cola. Essentially, this took Pepsi out of the Venezuela market.

Despite close ties of the Cisneroses with the Enricos, little things led to the chasm. The closeness had developed when Enrico headed the international operations of PepsiCo. After Enrico left this position for higher offices at corporate headquarters, Oswaldo Cisneros felt that Pepsi management paid scant to Venezuela: "That showed I wasn't an important player in their future," he said.⁷ Because Cisneros was growing older, he wanted to sell the bottling operation, but Pepsi was only willing to acquire 10 percent.

Coca-Cola wooed the Cisneroses with red carpet treatment and frequent meetings with its highest executives. Eventually, Coca-Cola agreed to pay an estimated \$500 million to buy 50 percent of the business.

Pepsi's Problems Elsewhere in the International Arena

Pepsi's problems in South America mirrored its problems worldwide. It had lost its initial lead in Russia, Eastern Europe, and parts of Southeast Asia. While it had a head start in India, this was being eroded by a hard-driving Coca-Cola. Even in Mexico its main bottler reported a loss of \$15 million in 1995.

The contrast with Coca-Cola was significant. Pepsi still generated more than 70 percent of its beverage profits from the United States; Coca-Cola got 80 percent from overseas.⁸

Table 5.2 shows the top ten markets for Coke and Pepsi in 1996 in the total world market. Coke had a 49 percent market share while Pepsi's had only 17 percent, despite its investment of more than \$2 billion since 1990 to straighten out its overseas bottling operations and improve its image.⁹ With its careful investment in bottlers and increased financial resources to plow into marketing, Coke continued to gain greater control of the global soft-drink industry.

If there was any consolation for PepsiCo, it was that its overseas business had always been far less important to it than to Coca-Cola, but this was slim comfort in view of the huge potential this market represented. Most of Pepsi's revenues were in the U.S. beverage, snack food, and restaurant businesses, with such well-known brands as Frito-Lay chips and Taco Bell, Pizza Hut and KFC (Kentucky Fried Chicken) restaurants. But as a former Pepsi CEO was fond of stating, "We're

⁶ Sellers, p. 72.

⁷ Sellers, p. 75.

⁸ Frank and Friedland, p. A1.

⁹ Robert Frank, "Pepsi Losing Overseas Fizz to Coca-Cola," *Wall Street Journal*, August 22, 1996, p. C2.

TABLE 5.2 Coke and Pepsi Shares of Total Soft-Drink Sales, Top 10 Markets, 1996

Markets	Market Shares	
	Coke	Pepsi
United States	42%	31%
Mexico	61	21
Japan	34	5
Brazil	51	10
East-Central Europe	40	21
Germany	56	5
Canada	37	34
Middle East	23	38
China	20	10
Britain	32	12

Source: Company annual reports, and Patricia Sellers, "How Coke Is Kicking Pepsi's Can," *Fortune*, 28 October 1996, p. 82.

Commentary: These market share comparisons show the extent of Pepsi's ineptitude in its international markets. In only one of these top 10 overseas markets is it ahead of Coke, and in some, such as Japan, Germany, and Brazil, it is practically a nonplayer.

proud of the U.S. business. But 95 percent of the world doesn't live here."¹⁰ And Pepsi seemed unable to hold its own against Coke in this world market.

COKE TRAVAILS IN EUROPE, 1999

The Trials of Douglas Ivester

In early 1998, Douglas Ivester took over as chairman and chief executive of Coca-Cola. He had a tough act to follow, being the successor to the legendary Goizueta. Things seemed to go downhill from then on, but it was not entirely his fault. The first quarter of 1999 witnessed a sharp slowdown in Coca-Cola's North American business, at least partly due to price increases designed to overcome weakness resulting from overseas economic woes. While most analysts thought the sticker shock of higher prices would be temporary, some thought the company needed to be more innovative and needed to do more than offer super-size drinks.¹¹ Other problems emanated from a racial discrimination lawsuit, as well as Mr. Ivester's "brassy" attempts to make acquisitions such as Orangina and Cadbury Schweppes, angering overseas regulators and perhaps motivating them to make life difficult for Coke.

Such concerns paled before what was to come.

¹⁰ Frank, C2.

¹¹ Nikhil Deogun, "Coke's Slower Sales Are Blamed on Price Increases," *Wall Street Journal*, March 31, 1999, pp. A3 and A4.

Contamination Scares

On June 8th, a few dozen Belgian schoolchildren began throwing up after drinking Cokes. This was to result in one of the most serious crises in Coca-Cola's 113-year history. An early warning had seemingly been ignored when in mid-May the owner of a pub near Antwerp complained of four people becoming sick from drinking bad-smelling Coke. The company claimed to have investigated but found no problems.

The contamination news could not have hit at a worse time. Belgium was still reeling from a dioxin-contamination food scare in Belgian poultry and other foods, and European agencies were coming under fire for a breakdown in their watchdog responsibilities. Officials were inclined to be overzealous in their dealings with this big U.S. firm.

The problems worsened. Coca-Cola officials were meeting with Belgium's health minister, seeking to placate him, telling him that their analyses "show that it is about a deviation in taste and color" that might cause headaches and other symptoms, but "does not threaten the health of your child." In the middle of this meeting, news came that another fifteen students at another school had gotten sick.¹²

It was thought that the contamination came from bottling plants in Antwerp, Ghent, and from the Dunkirk plant that produced cans for the Belgium market. European newspapers were speculating that Coke cans were contaminated with rat poison.

Soon hundreds of sick people in France were blaming their illnesses on Coke, and France banned products from the Dunkirk plant. France and Belgium rebuffed Coca-Cola's urgent efforts to lift the ban, and scolded the company for not supplying enough information as to the cause of the problem. The setback left Coke out of the market in parts of Europe because the company had badly underestimated how much explanation governments would demand before letting it back in business.

Not until June 17 did Belgium and France lift restrictions, and then only on some products; the bans were continued on Coca-Cola's Coke, Sprite, and Fanta. Then the Netherlands, Luxembourg, and Switzerland also imposed selective bans until health risks could be evaluated. Some 14 million cases of Coke products eventually were recalled in the five countries, and estimates were that Coke was losing \$3.4 million per day in revenues. Case volume for the European division was expected to fall 6 to 7 percent from the year earlier.¹³ The peak soft drink summer season had arrived, and the timing of the scare could not have been worse.

The European Union requested further study as the health scare spread. At the same time, Coca-Cola and its local distributors launched an advertising campaign defending the quality of their products. The company blamed defective carbon

¹² "Anatomy of a Recall: How Coke's Controls Fizzled Out in Europe," *Wall Street Journal*, June 29, 1999, p. A6.

¹³ Will Edwards, "Coke Chairman Tries to Assure Europeans," *Cleveland Plain Dealer*, June 19, 1999, pp. 1-C and 3-C; and Nikhil Deogun, "Coke Estimates European Volume Plunged 6% to 7% in 2nd Quarter," *Wall Street Journal*, July 1, 1999, p. A4.

dioxide, used for fizz, for problems at Antwerp. It also said the outsides of cans made in Dunkirk were contaminated with a wood preservative during shipping. One company-commissioned study suggested that health problems were in the victim's heads. Meanwhile, the Ivory Coast seized 50,000 cans of Coke imported from Europe as a precautionary measure, though there was no evidence that anyone in the Ivory Coast had become ill by drinking imported Coke.

Problems continued to spread. All glass bottles of Bonaqua, a bottled water brand of Coca-Cola, were recalled in Poland because about 1,500 bottles were found to contain mold. This recall in Poland soon spread to glass bottles of Coke. Company officials believed the mold was caused by inadequate washing of returnable bottles. Barely a week later, the company recalled 180,000 plastic bottles of Bonaqua after discovering nonhazardous bacteria. Coca-Cola also had to recall some soft drinks in Portugal after small bits of charcoal from a filtration system were found in some cans.

Coca-Cola Finally Acts Aggressively

In the initial contamination episodes, Coca-Cola was accused of dragging its feet. Part of the problem in ameliorating the situation was the absence of an explanation by any top Coca-Cola officials. Ivester was criticized for this delay when he finally made an appearance in Brussels on June 18, ten days after the initial scare. He visited Brussels again four days later, meeting with the prime minister. Strenuous efforts to improve the company's image and public relations then began.

Ivester, in a major advertising campaign, apologized to Belgian consumers and explained "how the company allowed two breakdowns to occur." The ads showed his photograph along with these opening remarks, "My apologies to the consumers of Belgium; I should have spoken with you earlier." Ivester further promised to buy every Belgian household a Coke. A special consumer hotline was established, and fifty officials including several top executives, were temporarily shifted from the Atlanta headquarters to Brussels.

Five thousand delivery people then fanned out across the country offering a free 1.5-liter bottle of Coke's main brands to 4.37 million households. Around Belgium, Coke trucks and displays proclaimed, "Your Coca-Cola is coming back." In newspaper ads, the company explained its problems, noted it was destroying old products and using fresh ingredients for new drinks. A similar marketing strategy was planned for Poland where two million free beverages were distributed to consumers.

Pepsi's Competitive Maneuvers Near the Millennium

Pepsi's Role in Coke's European Problems

Some thought that Coca-Cola's problems should have been Pepsi's gain. Yet, Pepsi did nothing to capitalize on the situation, did not gloat, did not increase advertising for its brand. Worldwide, Pepsi experienced some temporary gains in sales, most surprisingly in countries far removed from the scare—such as China. A Pepsi bottler in Eastern Europe probably expressed the prevailing company attitude

when he observed that people were buying bottled water and juices instead of soda pop: “That’s why we don’t wish this stuff on anyone,” he said, referring to the health scare.¹⁴

But Pepsi was not idle in Europe.

Pepsi’s Antitrust Initiatives against Coca-Cola

In late July 1999, acting upon a complaint by Pepsi, European Union officials raided offices of Coca-Cola and its bottlers in four countries in Europe—Germany, Austria, Denmark and Britain—on suspicions that the company used its dominant market position to shut out competitors. Coming at a time when Coca-Cola was still trying to recover from the contamination problems, this was a cruel blow. All the more so since such alleged noncompetitive activities affected its plans to acquire some additional businesses in Europe.

The raids were expected to lead to a full-blown antitrust action against Coke. The major suspicion was that Coke was illegally using rebates to try to force competitors out of the market. The several types of rebates under investigation were rebates on sales that boosted Coke’s market share at the expense of rivals, as well as rebates given to distributors who agreed to sell the full range of Coke products or to stop buying from competitors.

Coca-Cola’s huge market share in most countries of Europe fed the concern. See Table 5.3 for Coke’s market shares of the total soft-drink market in selected countries in Europe.

Pepsi also filed a complaint with Italian regulators, and they were quicker to act. A preliminary report found that Coca-Cola and its bottlers violated antitrust laws by abusing a dominant market position through practices such as discounts, bonuses, and exclusive deals with wholesalers and retailers. The Italian regulators also said there was evidence that Coke had a “strategic plan” to remove Pepsi from

TABLE 5.3 Coca-Cola’s Market Share of Soft-Drink Market in Selected European Countries, 1998

France	59%
Spain	58
Germany	55
Central Europe	47
Italy	45
Nordic and Northern Eurasia	41
Great Britain	35

Source: Company published reports.

Commentary: The dominance of Coke in almost all countries of Europe, not surprisingly, makes it vulnerable to antitrust scrutiny.

¹⁴ Nikhil Dogun and James R. Hagerty, “Coke Scandal Could Boost Rivals, but Also Could Hurt Soft Drinks,” *Wall Street Journal*, June 23, 1999, p. A4.

the Italian market, one of the biggest in Europe, by paying wholesalers to remove Pepsi fountain equipment and replace it with Coke. At about this time, Australian and Chilean officials also began conducting informal inquiries in their markets.

Coca-Cola officials responded to the Italian report as follows: “We believe this is a baseless allegation by Pepsi and we believe that Pepsi’s poor performance in Italy is due to their lack of commitment and investment there. As a result, they are attempting to compete with us in the courtroom instead of the marketplace.”¹⁵

COKE FINDS TOUGH GOING IN NEW CENTURY WHILE PEPSI SURGES

For decades, Coca-Cola was a premier growth company with some of the best-known brands in the world, and management seemed well positioned to take advantage of the global economy. But we have just seen lapses in the late 1990s, particularly in handling contamination problems in Europe and in dealing with antitrust charges there. Going into the new millennium, problems seemed more subtle but with longer lasting concerns. Not that the old battered company was withering away, but rather that it faced a slowing growth trend. For example, Coke generated average annual earnings growth of 18 percent between 1990 and 1997. In recent years its net income grew at just a 4 percent average. Share prices had fallen hard, in 2004 trading at less than half their 1998 peak. At the same time, PepsiCo, while it never quite caught Coke in the cola wars, outdid its rival in overall business growth. The following comparative statistics show the slipping performance of Coca-Cola to PepsiCo over the five years to 2004.

	Coke	Pepsi
Sales 2003	\$21 billion	\$27 billion
Sales growth (5-year average)	2%	4%
Earnings	\$4.3 billion	\$3.6 billion
Earnings growth (5-year average)	4%	12%
Stock price (5 years ending 12/3/04)	-40%	38%

Source: Bloomberg Financial Markets as reported in Dean Foust, “Gone Flat,” *Business Week*, December 20, 2004, pp. 76ff.

Part of the problem facing Coke was an industry problem, but with its heavy emphasis on carbonated soft drinks it became worse for Coke than for Pepsi. Consumers, more concerned with health and obesity, were seeking new kinds of beverages such as gourmet coffees, New Age teas, sports drinks, and waters. Carbonated beverages were no longer a growth sector of the market. One consultant said, “The carbonated soft-drink model is 30 years old and out of date.”¹⁶ Pepsi had pushed

¹⁵ Betsy McKay, “Coke, Bottlers Violated Antitrust Laws in Italy, a Preliminary Report States,” *Wall Street Journal*, August 13, 1999, p. A4.

¹⁶ Tom Pirko, president of Bev Mark LLC, as quoted in Dean Foust, “Gone Flat,” *Business Week*, December 20, 2004, p. 76.

into the noncarb market with Tropicana juice, Gatorade sports drink, and Aquafina water, and these were billion-dollar beverage brands. Coca-Cola remained fixated on its flagship Coke brand, with sodas accounting for 82 percent of its worldwide beverage sales, far more than Pepsi. On the other hand, Pepsi not only had more strongly diversified into other noncarb beverages, but also had its Frito-Lay Division with snack foods such as Lays, Doritos, and Baked Crunchy Cheetos; and then there was Quaker Oats that it acquired August 2001. (In 1997, PepsiCo had spun off its restaurant operations.) The following shows the breakdown of sales and profits for Pepsi's four major businesses as of 2004:

Percent of Company Sales and Operating Profits		
Frito-Lay	34%	41%
PepsiCo Beverages	29	30
Quaker Foods	5	9
PepsiCo Int'l (snacks and beverages)	32	20

Source: Public information as of 2004.

Coke's Reluctance to Diversify

Critics blamed Coke's stubborn commitment to its four hallowed soda-pop brands—Coca-Cola, Diet Coke, Sprite, and Fanta—as going back to the 16-year reign of Roberto Goizueta, who guided Coke stock to a 3,500 percent gain in those years. Goizueta was the first CEO ever to break the \$1 billion compensation barrier. After he died of lung cancer in 1997, he was almost deified, and his cola-centric philosophy became the gospel of the executives who followed and also of the aging board of directors.

The reluctance to diversify was evident when Coca-Cola decided against acquiring South Beach Beverage Company after negotiating two years. Pepsi made an offer and in two weeks acquired the SoBe brand New Age juice company, which gave Pepsi access to a market completely bypassed by soda pop.

Neville Isdell came out of retirement to head the company in May 2004, after earlier building distribution networks in India, Russia, and Eastern Europe. He showed the same conservative mindset of his predecessors and had passed on the chance to acquire Red Bull, a promising energy drink. Isdell still believed in the growth potential of carbonated soft drinks and their 30 percent profit margins. Because of this conservatism, Coke now lacked a popular entry in the highly profitable energy-drink category to compete with what had become the market leader, Red Bull. Some analysts saw this reluctance to diversify as reflecting a corporate mindset that still saw Coca-Cola as only a soda company, while Pepsi viewed itself as a beverage-and-snack company.¹⁷

¹⁷ Foust, p. 80; Leslie Chang, Chad Terhune and Betsy McKay, "Coke's Big Gamble in Asia," *Wall Street Journal*, August 11, 2004, pp. A1, A6; "Behind Coke's CEO Travails: A Long Struggle Over Strategy," *Wall Street Journal*, May 4, 2004, pp. A1, A10.

Still, Coke had joined Pepsi and other firms in moving into bottled water by 2003 as this became the fastest growing sector of the beverage industry. Pepsi's Aquafina was the leading brand and was enhanced by a multimillion-dollar promotional campaign, while Coke through acquisitions amassed such brands as Dannon, Evian, and Dasani. However, Coke was less aggressive than its competitors in pursuing this market, and problems with Dasani further cooled the enthusiasm.

Other Problems

Ivester, successor to Goizueta in the late '90s, in a desperate effort to try to sustain the profitability of the Goizueta era, had imposed a 7.6 percent price hike on the concentrate it sold its bottlers. For decades Coke had sold its beverage concentrate to U.S. bottlers at a constant price, no matter what price the soft drinks would later command at retail. Not surprisingly, these bottlers were now incensed and complained bitterly to the board and succeeded in pushing the already embattled Ivester to resign in late 1999. His successor, Douglas Daft tried to work with them, but relations steadily deteriorated. Bottlers began fighting back with sharp increases in their retail prices of Coke. These hikes dampened sales of Coke, but increased bottlers' profits. Some also refused to carry the company's new noncarbonated niche offerings, Mad River teas and Planet Java coffee, and these flopped and the company phased them out in 2003. Going into 2005, Isdell faced contentious bottler relations that needed to be addressed.

The C2 Disappointment

In the summer of 2003, Coca-Cola launched C2, a reduced-calorie, reduced-carb cola, with a \$50 million promotional campaign. This was Coke's biggest product introduction since Diet Coke more than twenty years before. The company had expected this new beverage would help win back a critical consumer group—20- to 40-year-olds who were concerned about weight—and priced it at a 15 percent premium in the quest to achieve higher profits on its drinks. But sales of C2 fell nearly 60 percent a few weeks after the product introduction.

Isdell halted the premium pricing strategy to try to salvage the product, but still sales languished. The pricing strategy had been botched, as C2 at times retailed for 50 percent and more than regular Coke, especially on weekends when sodas were often discounted. Adding to the dissatisfaction with the higher prices, many consumers were critical of the taste, either too flat or with an aftertaste.

Advertising Miscues

Spending for advertising had become conservative during the reign of Ivester. He believed that the Coke brand could largely sell itself without a major commitment to advertising. The result of a reduced ad budget was lackluster ads that failed to attract the important youth market. Instead, Ivester shifted resources into more vending machines, refrigerated coolers, and delivery trucks, "growth through distribution." But some of these expanded distribution sites, such as auto part stores, did not pay off.

Global Problems

Even Coke's global strength was becoming tarnished. Ivester's slowness in responding to the contamination scare in Belgium and France in 1999 was but the first misstep. Coke's plans to make Dasani bottled water into a global brand were slowed by an aborted launch in Europe after elevated levels of bromate, a cancer-causing substance, were detected in bottles in Britain. Declining sales in Germany and Mexico, two very important markets, put more pressure on developing such markets as China and India. Yet these looked years away from contributing significantly to Coke's profitability. The distribution and capacity that Isdell built in Eastern Europe in the 1980s and 1990s proved to be extravagant, and write downs eventually exceeded \$1 billion.¹⁸

Meantime, Pepsi was nibbling away at Coke's international markets. Its antitrust case against Coke in the European Union was eventually settled five-years later in October 2004, with Coke having to drop its controversial incentive discounts to retailers, and agreeing to share display space with rivals such as PepsiCo. So, the playing field was more leveled to Pepsi's benefit.

Coke's Board of Directors

Few firms could boast as prestigious a board of directors as Coke. Warren Buffett, one of the world's richest and most influential investors, was a major presence on the board. Ten of the 14 directors dated back to the Goizueta era and still espoused his policies of concentrating on the basic core of carbonated soft drinks with less emphasis on diversifying. Critics of the board accused it of micromanaging and being too conservative, and blamed it for the difficulty in recruiting highly regarded candidates for top management jobs, as well as not retaining the ones it had.¹⁹

The board played a major part in vetoing the acquisition of Quaker Oats, the maker of Gatorade. CEO Douglas Daft had reached an agreement to buy Quaker for \$15.75 billion in stock. But the board overruled him, calling the price too expensive. PepsiCo snapped up the company instead. Daft was left to contemplate his lack of support by the board, and his loss of faith among his peers. His tenure was short lived, and Isdell replaced him.

ANALYSIS

Coke's Outlook at the New Millennium

The situation by 2005 did not come about suddenly. It gradually crept up until a deteriorating stock price confronted investors, managers, and analysts. Yet the company was still healthy and profitable, but somehow the Coke name had lost its cachet and critics abounded. Then there was PepsiCo, becoming more formidable all the time.

Proposals for dealing with the situation went to two extremes: (1) stick with the basics, and simply do things better, or (2) vigorously diversify, even to nondrink areas as Pepsi had seemingly done successfully. The two approaches could be

¹⁸ "Coke's Big Gamble in Asia," p. A6.

¹⁹ For example, see Dean Foust, pp. 76ff; and "Behind Coke's CEO Travails," A1, A6.

categorized as a mission of being a soda company versus an expanded mission of being a beverage-and-snack company. Coke's board, hearkening back to the glory days of Goizueta, was negative toward mergers and strongly favored doing a better job with the basic core, such as with advertising, distribution, and tapping international markets more aggressively. Critics, however, saw Coke as too wedded to the status quo and missing growth opportunities. Of course, there was a third option between the two extremes. This would look for suitable diversifications within the non-cola drink market, and even fortuitous and compatible nondrink additions, but without any mandate to go on a merger binge.

Several factors should affect these decisions. One was the recent trend toward healthy lifestyles, and the foods and drinks that impact this either negatively or positively. Worrisome omens were appearing. Some schools were removing colas from their vending machines and school lunches. Advertisements and other publicity were trumpeting the health risks of fast foods and soft drinks. Was this the wave of the future, or merely a short-term phenomenon?

Then Coke needed to confront whether its days as a growth firm were over and if it was in the mature stage of its life cycle. The long-term consequences of this decision would hardly be inconsequential. Disavowing aggressive growth—recognizing a mature life cycle—can benefit investors, at least in the short run, since more profits would be available for dividends. But the search for breakthrough diversifications should not be abandoned. The right one(s) might put a mature firm on the growth path again.

What Went Wrong with the New Coke Decision?

The most convenient scapegoat was the marketing research that preceded the decision. Yet Coca-Cola spent about \$4 million and devoted two years to the marketing research. About 200,000 consumers were contacted during this time. The error in judgment was surely not from want of trying. But when we dig deeper into the research, some flaws become apparent.

Flawed Marketing Research

The major design of the marketing research involved taste tests by representative consumers. After all, the decision was whether to go with a different flavored Coke, so what could be more logical than to conduct taste tests to determine acceptability of the new flavor, not only versus the old Coke but also versus Pepsi? The results were strongly positive for the new formula, even among Pepsi drinkers. This was a clear “go” signal.

With benefit of hindsight, however, some deficiencies in the research design merited concern. Research participants were not told that by picking one cola, they would lose the other. This proved to be a significant distortion: Any addition to the product line would naturally be far more acceptable than completely eliminating the traditional product would be.

While three to four new tastes were tested with almost 200,000 people, only 30,000 to 40,000 of these testers tried the specific formula for the new Coke. Research was geared more to the idea of a new, sweeter cola than that used in the final formula. In general, a sweeter flavor tends to be preferred in blind taste tests.

This is particularly true with youths, the largest drinkers of sugared colas and the very group drinking more Pepsi in recent years. Interestingly, preference for sweeter-tasting products tends to diminish with use.²⁰

Consumers were asked whether they favored change as a concept, and whether they would likely drink more, less, or the same amount of Coke if there were a change. But such questions could hardly prove the depth of feelings and emotional ties to the product.

Symbolic Value

The symbolic value of Coke was the sleeper. Perhaps this should have been foreseen. Perhaps the marketing research should have considered this possibility and designed the research to map it and determine the strength and durability of these values—that is, would they have a major effect on any substitution of a new flavor?

Admittedly, when we get into symbolic value and emotional involvement, any researcher is dealing with vague attitudes. But various attitudinal measures have been developed that can measure the strength or degree of emotional involvement.

Herd Instinct

Here we see a natural human phenomenon, the herd instinct, the tendency of people to follow an idea, a slogan, a concept, to “jump on the bandwagon.” At first, acceptance of new Coke appeared to be reasonably satisfactory. But as more and more outcries were raised—fanned by the media—about the betrayal of the old tradition (somehow this became identified with motherhood, apple pie, and the flag), public attitudes shifted strongly against the perceived unworthy substitute. The bandwagon syndrome was fully activated. It is doubtful that by July 1985 Coca-Cola could have done anything to reverse the unfavorable tide. To wait for it to die down was fraught with danger—for who would be brave enough to predict the durability and possible heights of such a protest movement?

Could, or should, such a tide have been predicted? Perhaps not, at least regarding the full strength of the movement. Coca-Cola expected some protests. But perhaps it should have been more cautious, by considering a worst-case scenario in addition to what seemed the more probable, and by being better prepared to react to such a contingency.

Pepsi, and Later Coca-Cola's, International Problems

Pepsi's Defeats in South America

With hindsight we can identify many of the mistakes Pepsi made. It tried to expand too quickly in Argentina and Brazil, imprudently putting all its chips on a distributor with a checkered past, instead of building up relationships more slowly and carefully. It did not monitor foreign operations closely enough or soon enough to prevent rash expansion of facilities and burdensome debt accumulations by affiliates. It did not listen closely enough to old distributors and their changing wants, and so

²⁰ “New Cola Wins Round 1, but Can It Go the Distance?” *Business Week*, June 24, 1985, p. 48.

lost Venezuela to Coca-Cola. Pepsi apparently did not learn from its past mistakes: For example, three times before it had tried to enter Brazil and had failed. Why the failures? Why was it not more careful to prevent failure the next time?

Finally, we can speculate that maybe Pepsi was not so bad, but rather that its major competitor was so good. Coca-Cola had slowly built up close relationships with foreign bottlers over decades. It was aggressive in defending its turf. Perhaps not the least of its strengths, at least in the lucrative Latin American markets, was a CEO who was also a Latino, who could speak Spanish and share the concerns and build on the egos of its local bottlers. In selling, this is known as a dyadic relationship, and it is discussed further in the following Information Box. After all, why can't a CEO do a selling job on a distributor and capitalize on a dyadic relationship?

Coca-Cola's Problems in Europe

Could Coca-Cola have handled the Belgian crisis better? With hindsight we see a flawed initial reaction. Still, the first incident of twenty-four schoolchildren getting ill and throwing up after drinking Coke seemed hardly a major crisis at the time. But crises often start slowly with only minor indications, and then mushroom to even catastrophic proportions. Eventually hundreds of people reported real or imagined illnesses from drinking the various Coca-Cola products.

The mistakes of Coca-Cola in handling the situation were: (1) not taking the initial episodes seriously enough; (2) not realizing the intense involvement and skepticism of governmental officials, who demanded complete explanations of the cause(s) and were reluctant to lift bans; and (3) not involving Coke Chairman Douglas Ivester and other high-level executives soon enough. Allowing ten days to go by before his personal intervention was a long time for Ivester to let problems fester. Added to

INFORMATION BOX

THE DYADIC RELATIONSHIP

Sellers are now recognizing the importance of the buyer-seller interaction, a *dyadic relationship*. A transaction, negotiation, or relationship can often be helped by certain characteristics of the buyer and seller in the particular encounter. Research suggests that salespeople tend to be more successful if they have characteristics similar to their customers in age, size, and other demographic, social, and ethnic variables.

Of course, in the selling situation this suggests that selecting and hiring sales applicants most likely to be successful might require careful study of the characteristics of the firm's customers. Turning to the Pepsi/Coke confrontation in Brazil and Venezuela, the same concepts should apply and give a decided advantage to Coca-Cola and Roberto Goizueta in influencing government officials and local distributors. After all, in interacting with customers and affiliates, even a CEO needs to be persuasive in presenting ideas as well as handling problems and objections.

Can you think of any situations where the dyadic theory may not work?

that, the quality-control lapses should not have been allowed to occur in the first place. Eventually, Ivester and Coke acted aggressively in restoring Coca-Cola, but lost revenues could not be fully recovered.

Of interest in this environment of cola wars was Pepsi's restraint in not trying to take advantage of Coke's problems. This was not altruism but fear that the whole soft-drink industry would face decreased demand, so Pepsi did not want to aggravate the situation. Anyway, Pepsi saved its competitive thrusts for antitrust challenges.

With its great size and market-dominance visibility in country after country, Coca-Cola was vulnerable to regulatory scrutiny and antitrust allegations, especially when stimulated by its number one competitor, PepsiCo. Does this mean that it is dangerous for a firm to become too big? In certain environments, such as that facing a foreign competitor in some European countries, this may well be the case. The firm then needs to tread carefully, tone down inclinations toward arrogance, and be subtle and patient in seeking acquisitions on foreign turf.

UPDATE—GOING INTO 2008

In June 2007, Coca-Cola named Muhtar Kent CEO, and Isdell would remain chairman until the annual meeting in April 2009. Muhtar holds dual U.S. and Turkish citizenship, and had been an international trouble shooter for Coke in such markets as Japan and the Phillippines. Early 2007, he had led the largest acquisition in Coke's history, a \$4.1 billion purchase of Energy Brands, maker of Glaceau Vitaminwater. He said he continues to see huge upside in international growth. "About 700 million people by 2015 will be coming into the middle class. That's a huge driver for growth."²¹

The company posted a 13 percent increase in third-quarter profit in 2007, to go along with a 6 percent rise in global sales volume, but U.S. sales remained weak. Demand for the carbonated cola drinks declined 2 percent, but the company's expansion into noncarbonated drinks increased and seemed the wave of the future. The \$4.1 billion purchase of Energy Brands showed the willingness now of Coca-Cola to spend whatever it takes to inch closer to rival PepsiCo in the growing market for noncarbonated drinks. The 2002 deal to purchase Quaker Oats and its Gatorade sports drink that fell through when the board vetoed the purchase as too costly had haunted Coke ever since—especially when Pepsi jumped at the chance to distance itself from Coca-Cola in this growing market.²²

PepsiCo had a 17 percent increase in third-quarter 2007 profit, and an 11.3 percent increase in revenues. Like Coca-Cola, sales of carbonated soft drinks declined to 3 percent, but the Frito-Lay snack division turned in a 7 percent profit growth. PepsiCo had spent about \$1 billion on acquisitions for 2007 up to October.

²¹ Betsy McKay, "Coke Makes It Official, Taps Kent as CEO," *Wall Street Journal*, December 7, 2007, p. A3.

²² Betsy McKay, "Coke Gains Show Pop from Isdell's Strategy," *Wall Street Journal*, October 18, 2007, p. A4.

TABLE 5.4 Comparison of Coke and Pepsi Revenue and Net Income, 1999–2006 (Million \$)

	1999	2000	2001	2002	2003	2004	2005	2006
Revenue								
Coke	19,805	20,458	20,092	19,564	21,044	21,982	23,104	24,088
Pepsi	20,367	20,438	26,935	25,112	26,971	29,261	32,562	35,137
	Coke percentage increase these 8 years					21.6%		
	Pepsi percentage increase					72.5%		
Net Income								
Coke	2,431	2,177	3,979	3,976	4,347	4,847	4,872	5,080
Pepsi	2,050	2,183	2,662	3,313	3,568	4,174	4,078	5,642
	Coke percentage increase these 8 years					108.9%		
	Pepsi percentage increase					175.2%		

Source: Compiled from company public statistics.

Commentary: Here we see that Coca-Cola is being outgunned by Pepsi in these most recent eight years. This was not always the case. As we see in 1999, revenues were about the same, with a slight edge to Pepsi. But in net income, Coke had a nice edge, which continued until 2006. It is interesting to speculate what happened. We know that the most profitable carbonated soft drink market had been slowly declining in recent years, partly due to health concerns. And this is where most of Coke's business has always been. It was slow to diversify beyond this, whereas Pepsi had far more vigorously done so, even beyond noncarb drinks into the snack market with its Frito-Lay division.

This was far less than Coke's acquisition of Glaceau from Energy Brands for its so-called enhanced waters, which contain added vitamins, minerals, and flavorings. PepsiCo Chairman and CEO Indra Nooyi was cautious in October 2007 about the challenges the company will face in 2008, citing commodity-price increases and slower U.S. economic growth. But she noted that Pepsi's broad product portfolio and increasing global footprint would make the company "much more resilient" than some other companies to rising costs and slowdowns in the U.S. economy.²³ See Table 5.4 for a comparison of the growth in revenues and net income of the two rivals from 1999 to 2006.

What Would You Do?

Looking at Table 5.4, which shows Pepsi winning the war with Coca-Cola, at least in market dominance, what would you do to get the company in the growth mode, with the goal of eventually surpassing Pepsi in both revenue and net income?

²³ Betsy McKay, "Pepsi Envisions Challenges Ahead," *Wall Street Journal*, October 12, 2007, p. B4.

WHAT WE CAN LEARN

Consumer Taste Is Fickle

Taste tests are commonly used in marketing research, but I have always been skeptical of their validity. Take beer, for example. I know of few people—despite their strenuous claims—who can in blind taste tests unerringly identify which is which among three or four disguised brands of beer. We know that people tend to favor the sweeter in taste tests. But does this mean that a sweeter flavor will always win out in the marketplace? Hardly. Something else is operating with consumer preference other than the fleeting essence of a taste—unless the flavor difference is extreme.

Brand image usually is a more powerful sales stimulant. Advertisers consistently have been more successful in cultivating a desirable image or personality for their brands or the types of people who use them, than by such vague statements as “better tasting.”

Don't Tamper with Tradition

Not many firms have a hundred-year-old tradition to be concerned with—or even 25 years. Most products have much shorter life cycles. No other product has been so widely used and so deeply entrenched in societal values and culture as Coke.

The psychological components of the great Coke protest make interesting speculation. Perhaps in an era of rapid change, many people wish to hang on to the one symbol of security or constancy in their lives—even if it's only the traditional Coke flavor. Perhaps many people found this protest to be an interesting way to escape the humdrum, by making waves in a rather harmless way, in the process of seeing if a big corporation might be forced to cry “uncle.”

One is left to wonder how many consumers would even have been aware of any change in flavor had the new formula been quietly introduced without fanfare. But, of course, the advertising siren call of “New” would have been muted.

So, do we dare tamper with tradition? In Coke's case the answer is probably not, unless done very quietly, but then Coke is unique.

Don't Try to Fix Something That Isn't Broken

Conventional wisdom may advocate that changes are best made in response to problems, that when things are going smoothly the success pattern or strategy should not be tampered with. Perhaps. But perhaps not.

Actually, things were not going all that well for Coke by early 1985. Market share had steadily been lost to Pepsi for some years. So it was certainly worth considering a change, and the obvious one was a different flavor. I do not subscribe to the philosophy of “don't rock the boat.” But Coke had another option.

Don't Burn Your Bridges

Coke could have introduced the new Coke, but kept the old one. Goizueta was concerned about dealer resentment at having to stock an additional product in the

same limited space. Furthermore, he feared Pepsi emerging as the No. 1 soft drink due to two competing Cokes. This rationale was flawed, as events soon proved.

Consider the Power of the Media

Press and broadcast media are powerful influencers of public opinion. With new Coke, the media exacerbated the herd instinct by publicizing the protests. News seems to be spiciest when someone or something can be criticized or found wanting. We saw this fanning of protests in Coke's contamination problems in Europe, to the extent that some people came up with psychosomatic illnesses after drinking Coca-Cola products. The power of the media should not only be recognized, but should also be a factor in making decisions that may affect an organization's public image.

International Growth Requires Tight Controls

In Pepsi's problems with Baesa we saw the risks of placing too much trust in a distributor. One could question the selection of Charles Beach to spearhead the Pepsi invasion of Coke strongholds in South America. Prudence would dictate close monitoring of plans and performance, with major changes—in expansion planning, marketing strategy, financial commitments—needing approval by corporate headquarters. In international dealings, the tendency is rather to loosen controls due to the distances, different customs and bureaucratic procedures, as well as unfamiliar cultures. We will see an extreme example of this later in the Maytag case.

The Human Factor May Be More Important in International Dealings

Rapport with associates and customers may be even more important in the international environment than domestically. The distances involved usually necessitate more decentralization and therefore more autonomy. If confidence and trust in foreign associates are misplaced, serious problems can result. Customers and affiliates may need a closer relationship with corporate management if they are not to be wooed away. Furthermore, in some countries the political climate is such that the major people in power must be catered to by the large firm wanting to do business in that country.

Sound Crisis Management Requires Prompt Attention by Top Management

The chief executive is both an expeditor and a public relations figure in crises, particularly in foreign environments. Ivester's delay in rushing to Belgium may have held up resolution of the crisis for several weeks, and it cost Coca-Cola millions in lost revenues. No other person is as well suited as the CEO to handle serious crises. Some sensitive foreign officials see an affront to their country without top management involvement and are likely to express their displeasure in regulatory delays, calls for more investigations, and bad publicity toward a

foreign firm. In the case of Coca-Cola, even though Ivester eventually made a conciliatory appearance, by that time some countries were receptive to antitrust allegations made by Pepsi against Coca-Cola.

Beware of High-Margin Insistence to the Neglect of Other Worthy Products

It is natural for executives to want to push the higher margin goods. After all, profitability deserves priority, everything else being equal. But often lower margin goods may yield more total profits because of greater sales volume. Similarly, raising prices will produce higher margin per item, but lower volume may adversely affect total profits. In recent years, Coca-Cola hurt itself by concentrating on the higher margin cola drinks, to the neglect of other growth opportunities, and by injudiciously raising prices of its concentrate to bottlers, thus jeopardizing bottler relations.

CONSIDER

Can you think of other learning insights?

QUESTIONS

1. In the new Coke fiasco, how could Coca-Cola's marketing research have been improved? Be specific.
2. When a firm faces a negative press—as Coca-Cola did with the new Coke, and almost 15 years later in Europe—what recourse does a firm have? Support your conclusions.
3. “If it's not broken, don't fix it.” Evaluate this statement.
4. Do you think Coca-Cola engineered the whole scenario with the new Coke, including fanning initial protests, in order to get a bonanza of free publicity? Defend your position.
5. Critique Pepsi's handling of Baesa. Could it have prevented the South American disaster? If so, how?
6. With hindsight, how might Enrico, CEO of PepsiCo, have kept Cisneros, his principal bottler in Venezuela, in the fold instead of defecting to Coke?
7. How could Coca-Cola have lessened the chances of antitrust and regulatory scrutiny in Europe?
8. Do you think Pepsi can ever make big inroads in Coke's market share in Europe? Why or why not?
9. A big stockholder complains, “All this fuss over a few kids getting sick to their stomach. The media have blown this all out of proportion.” Discuss.
10. Do you think Coca-Cola is still a growth company? Why or why not? Defend your reasoning.

HANDS-ON EXERCISES

1. Assume that you are Robert Goizueta and that you are facing increased pressure in early July 1985 to abandon the new Coke and bring back the old formula. However, your latest marketing research suggests that only a small group of agitators are making all the fuss. Evaluate your options and support your recommendations to the board. (Do not be swayed by what actually happened—maybe the protests could have been contained.)
2. As a market analyst for PepsiCo, you have been asked to present recommendations to CEO Roger Enrico and the executive board, for the invasion of Brazil's soft-drink market. The major bottler, Baesa, is already in place and waiting for Pepsi's final plans and objectives. You are to design a planning blueprint for the "invasion," complete with an estimated timetable.
3. You are a staff assistant to Ivester. It is 1998, and he has just assumed the top executive job with Coca-Cola. One of his first major decisions concerns raising soft-drink prices over 7 percent to improve operating margins and make up for diminished revenues in a depressed European market. He wants you to provide pro and con information on this important decision.

TEAM DEBATE EXERCISES

1. Debate the issue of whether Coke is in a mature stage of the life cycle or whether it is still in a growth stage. In the course of the debate, each side should consider how best to maximize its performance.
2. Debate Ivester's plan to distribute millions of free bottles of Coke products to people in Belgium and Poland. In particular, debate the costs versus benefits of this recovery strategy. Are the benefits likely to be worth the substantial cost?
3. Debate the issue of Coca-Cola diversifying into non-drink products, such as PepsiCo had done quite successfully.

INVITATION TO RESEARCH

What are the newest developments in the Cola wars? Has Coke lost market share in Europe? Has Pepsi been able to make any inroads in Latin America? How do the two firms stack up in profitability? Have there been any innovations in this arena? How has the bottled water battleground gone for the two rivals? How are their stock prices faring?

PC Wars: Hewlett-Packard vs. Dell Computer

In July 1999 Hewlett-Packard, the world's second-biggest computer maker, chose Carly Fiorina to be its CEO. Thus she became the first outsider to take the reins in H-P's 60-year history. Never before had it ever filled a top job with an outsider, and now this. Fiorina at that time became one of only three women to head a Fortune 500 company.

Three years later in May 2002, Fiorina engineered the biggest merger in high-tech history, with Compaq Computer. By August 2003 it looked like the massive merger and the differing cultures were being well assimilated—unlike the problems of many mergers, including several in this book. Then abruptly on February 9, 2005, the board fired her.

Meantime, Michael Dell started in a dorm room in 1984 what was to become the biggest PC maker, and became a multibillionaire in the process. It seemed no other manufacturer of PCs could sell them at as low a price as Dell could, and still make a profit.

HEWLETT-PACKARD

Carly Fiorina

Fiorina earned a BA in medieval history and philosophy from Stanford University in 1976. She received an MBA in marketing from the University of Maryland in 1980, and a MS from MIT's Sloan School. She was 44 years old when chosen for the CEO post at Hewlett-Packard, after nearly twenty years at AT&T and Lucent Technologies. At Lucent, she spearheaded the spin-off from AT&T in 1996, overseeing the company's initial public offering and the marketing campaign that positioned Lucent as an Internet company. In 1998 she became president of Lucent's global service-provider business, a \$19 billion operation that sold equipment to the world's largest telephone companies.

Fiorina was known for having a “silver tongue and an iron will,” being articulate and persuasive. She had a personal touch that inspired intense loyalty. Her coddling of customers at Lucent was legendary, as were her sales and marketing skills.¹

Still, how did a student of philosophy, medieval history, and marketing succeed in being the winning candidate for CEO by H-P’s search committee, selected from 300 potential candidates and the first outsider in the company’s history to be CEO? Indeed no other outsiders had even been high-level executives. What qualities did Carly apparently manifest that swayed the search committee? See the following Issue Box for a discussion of two extremes of leadership: charismatic and visionary versus shunning the limelight and emphasizing execution.

ISSUE BOX

CHARISMATIC VERSUS DOWN-TO-EARTH OPERATIONAL LEADERSHIP

For most leaders, their ability and emphasis would favor one or the other. In Fiorina’s case, her strengths were being a charismatic leader, one who could communicate sweeping strategies, and bring a sense of urgency and vision throughout the organization. Undoubtedly her “silver tongue” and persuasive skills influenced the committee more than any other candidate. As we will see later in the case, she was fired by the board of directors five-and-a-half years later, and an operations man replaced her, and the stock price doubled. This raises several meaty questions: Can a person be too charismatic? Is an organization better served by operational leadership, shunning the spotlight and lofty visions?

What does a charismatic leader bring to an organization? Change. And this can be highly desirable for organizations mired in complacency, bureaucracy, and conservatism. But it can also bring resentment, jealousy, and even fear of positions being eliminated or reduced. A charismatic leader is seldom inclined to give priority to details, and unless this mindset is delegated to competent subordinates, operations may suffer.

The major merger with Compaq Computer that Fiorina instigated and pushed through, despite criticism and serious opposition from Walter Hewlett, a member of the board and of the founding family with 24 percent of the vote, would probably not have been consummated without her charisma and steadfastness. But a charismatic leader can run roughshod over subordinates, and in Carly’s case can be disdainful of the board’s efforts to change her ways. As we shall see in the Update, the Compaq merger turned out to be a triumph, but after her departure.

If Fiorina were a man, do you think he would have been fired as she was?

¹ Peter Burrows, with Peter Elstrom, “H-P’s Carly Fiorina: The Boss,” Business Week Online, August 2, 1999.

BACKGROUND OF THE COMPANY (H-P)

H-P was founded by Stanford University classmates Bill Hewlett and Dave Packard in 1938. They invented their company's first product in a tiny Palo Alto, California garage. It was an audio oscillator, an electronic test instrument used by sound engineers. One of their first customers was Walt Disney Studios, which purchased the oscillators to develop and test an innovative sound system for the movie *Fantasia*. From 1938 to 1978, Bill and Dave built a company that became a model for thousands of subsequent Silicon Valley enterprises. In so doing, they created an informal egalitarian culture where brilliant engineers could flourish. Their emphasis on teamwork and respect for co-workers was dubbed the "H-P Way."

From 1978 to 1992, John Young directed H-P into becoming a major computer company, something AT&T, Honeywell, RCA, and other first-generation electronics companies never were able to do. But Young's efforts to consolidate H-P's independent units bogged the company down in bureaucracy.

From 1992 to 1999, Lew Platt, a well-liked engineer who had joined the firm in 1966, guided H-P for its growth in the mid-1990s, but he encountered difficulties when PC prices and Asian sales plummeted in the late 1990s. By now, H-P had become a staid company, but one with deep engineering roots and old-fashioned dependability.

The Situation When Carly Fiorina Took Over

"Some might say we're stodgy, but no one would say this company doesn't have a shining soul," Fiorina said when she took over.² H-P had had no major breakthrough product since the inkjet printer in 1984. And the H-P Way had evolved into a bureaucratic, consensus-style culture, somehow not conducive to being in the forefront in a time of rapid technological innovations.

A bloated bureaucracy seems a concomitant of many old successful organizations. Examples abounded of the bureaucracy run amok that had developed at H-P. The company had 130 different product groups. When retailer Best Buy wanted to buy some computer products, 50 H-P salespeople showed up to push their units' goods. When a vice president at H-P wanted an operational change, 37 different internal committees had to approve it.³

The dearth of new products went along with the cumbersome bureaucracy and the many different product groups. Managers often were reluctant to invest in new ideas for fear of missing their sales goals. If the proposed new product did not seem assured of healthy profits, or might cannibalize or take away business from existing products, it was not considered further.

The crown jewel of H-P's arsenal of products was its printer business, which it had dominated since the 1980s. Ink and toner refills brought H-P some \$10 billion annually, 15 percent of total revenues. The profitability of these refills enabled the company to sell printers at low prices, much as Gillette sells its razors for bare-bones prices, but makes huge profits on the sales of blades.

² Burrows and Elstrom.

³ Examples cited in Burrows and Elstrom.

In 1998, with revenue growth slowing to the low single-digits, CEO Platt began to act more decisively in combating the malaise. He hired McKinsey & Co. consultants to explore restructuring, which led to the spin off of H-P's \$8 billion test-and-measurement division, which had little relevance to the faster-growing computer and printer businesses. Platt put his own job on the line, suggesting the board hire a new CEO. This led to Fiorina's hiring.

Fiorina's Actions

The Merger with Compaq

Fiorina began searching for a big deal soon after becoming CEO. H-P and Compaq Computer agreed to the rough outline of a merger in June 2001, then spent four months planning it before the formal announcement. But she could hardly have expected the controversy of the ensuing merger battle, in which Walter Hewlett, an H-P board member, first voted in favor of the deal and then waged a bitter and public campaign against it. He voted his family's 24 percent of the ballots against the merger, and it passed by only three percentage points. Not content with this defeat, Hewlett sued, charging that Fiorina and H-P had illegally manipulated the vote, but he was unsuccessful and the merger went ahead.

What might have led to serious divisiveness among the organization and particularly the higher executive staff, and make Fiorina's job difficult at best, had more of the opposite effect. While some had initially resented her as an outsider who didn't understand the H-P Way, now most united behind their controversial new leader. "None of us anticipated the conflict. Carly was characterized as someone who destroyed the soul of H-P, and we were her willing accomplices," Susan Bowick, H-P's personnel chief said.⁴ Still, we would expect that many employees would resist change, knowing that Fiorina's arrival most likely heralded substantial changes and jobs lost.

Early Results

In the first full year after the merger, the results were impressive. Some 3,000 new patents had been racked up and 367 new products introduced. The patents spanned every part of the technology complex, from print technology to molecular computing. H-P gained market share in key categories and won a 10-year, \$3 billion outsourcing deal with Procter & Gamble. Combined sales to Disney more than doubled since 2001. H-P built technology for Walt Disney World's newest ride, Mission: Space, and wireless headsets that explained the theme park in five languages. H-P was claiming one of the fastest and most effective mergers in all of business, and by far the biggest in the computer industry. It saw its adaptive model as a technology and strategy that could be sold to other firms contemplating mergers and strategic changes.

Was the "Successful" Merger Truly So?

Skeptics of the H-P merger with Compaq for a while appeared to be proven wrong. CEO Fiorina impressed analysts with cost cuts faster and deeper than they had

⁴ Quentin Hardy, "We Did It," *Forbes*, August 11, 2003, p. 80.

ever imagined. She unveiled a host of new consumer products and a new vision. Investors were willing to attribute anemic revenue growth to the deep recession in technological spending.

As the economy and stock market began to improve in 2003, H-P stock flirted with a 52-week high of \$24 a share until August 20, the day after H-P announced it had missed its third-quarter earnings expectations. The explanation was slack European markets, which counted for 40 percent of company sales, plus price-cutting in personal computers, and weakness in H-P's enterprise businesses. The stock slid 11 percent on this news.

Dell was the big culprit affecting H-P's computer sales, and it had turned in a strong quarter, by contrast. H-P failed to raise PC prices fast enough to keep pace with such components as computer memory. It also missed the boat in forecasting sales for flat-panel computer screens and had to use expensive airfreight to meet the demand. Then Dell announced it was cutting prices of business computers by 22 percent.⁵

Fiorina planned to excite consumers, who had been steadier customers than corporate clients—consumer-related sales comprised 30 percent of total H-P sales—with 150 new products in time for the back-to-school and Christmas seasons 2003. H-P was also testing a “store-in-store” concept at consumer electronics retailers, such as Circuit City. The H-P area within these larger retailers would emphasize how all the H-P products can work together, with assortments well beyond just PCs and printers, as for example, media-center PCs that link home entertainment and computers together. But adding to H-P's worries, Dell announced that it would also cut prices on its PCs and network servers. Sales for H-P's personal-systems division, which included notebooks and desktops, rose 4.5 percent in the third quarter, but the division remained unprofitable.

Printers and ink refills had long carried H-P, with rising sales and profits. Yet the enterprise-systems group which generated about 20 percent of total revenue remained the last of H-P's four main businesses to still be in the red as fiscal 2003 drew to a close. The turnaround of the systems group, which made server computers, storage devices, and related software used by large corporations and agencies, was plagued by competition from Dell and IBM, and slow tech spending by corporate customers. Unless this could quickly be turned around, it would represent a continuing black mark on the controversial \$19 billion Compaq purchase, which was partly undertaken to repair the enterprise business.⁶

Whether the merger with Compaq was a model of how best to handle mergers remained controversial and questionable.

The Situation in 2005

The situation—and especially the stock price of H-P—had not improved by the beginning of 2005. The closing price by end of January was under \$20 a share,

⁵ Quentin Hardy, “HP Slips Up,” *Forbes*, September 15, 2003, p. 42.

⁶ For more details, see Amy Tsao, “Carly Fiorina’s Next Big Challenge,” Business Week online, August 22, 2003; and Pui-Wing Tam, “Man on the Hot Seat at H-P’s Struggling Enterprise Unit,” *Wall Street Journal*, August 19, 2003, pp. B1 and B5.

which was 15 percent less than when the Compaq deal was announced in September 2001, and 50 percent less than when Fiorina was named CEO in July 1999. (Admittedly, the tech sector had not been robust in the previous four years, but H-P had fallen considerably more than its major competitors, IBM and Dell.) The H-P board began considering a reorganization that would distribute some key day-to-day responsibilities of Fiorina to other executives. “She has tremendous abilities” one person close to the situation said. “But she shouldn’t be running everything every day. She is very hands on, and that slows things down.”⁷

Other criticisms centered on the Compaq merger. This was Fiorina’s “Get-Big” strategy to compete with IBM. But it seemed to have led to complex and myriad problems. H-P’s PC unit was taking a beating from Dell. It found itself faltering against IBM in servicing big corporate clients, and had been unable to come up with any big new consumer gadgets. A controversy brewed over whether H-P would be better off broken into pieces rather than keeping the company whole. The example of IBM was given to support breaking up: “IBM had the courage recently to exit the bleak PC business. By contrast, H-P continued to hold fast.”⁸

H-P’s Board Ousts Fiorina

Abruptly on February 9, 2005, the board fired Fiorina, after she resisted the directors’ plan for her to cede some day-to-day authority to the heads of H-P’s key business units. This was just before she had been scheduled to attend a meeting at the White House with members of the Business Roundtable. Just a few weeks later, H-P reported a 10 percent increase in revenue for its first fiscal quarter, better than expected.

After Carly

Mark Hurd was chosen to succeed Fiorina. He had spent 25 years at electronic cash-register maker NCR, working up from a sales job to CEO. Some critics thought Carly was “full of herself and out of touch,” and Mark Hurd was the anti-Carly, “ignoring all fluff for execution.” He became a star of Wall Street, as manifested by H-P stock rising over 50 percent after he took over. Dell had been almost flat before, while IBM shareholders lost money.

The biggest criticisms levied against Fiorina focused on the 2002 Compaq acquisition. But Hurd saw nothing wrong with this and other elements of her strategy. He did not break up the company along pre-merger lines, as Fiorina’s loudest critics sought. She had planned to cut 10,000-to-12,000 jobs; Hurd cut 15,000. She had predicted that H-P would be the biggest tech company in the world, and its revenue in 2006 was \$87 billion, about even with IBM’s. H-P was number two worldwide in PCs to Dell, number one in Windows, Linux servers, and printers, and number four in tech services. Total operating expenses were 21.5 percent in 2001.

⁷ Pui Wing Tam, “Hewlett-Packard Board Considers a Reorganization,” *Wall Street Journal*, January 24, 2005, pp. A1 and A5.”

⁸ Jesse Eisinger, “Carly Fiorina Fails at Hewlett-Packard After Betting Badly,” *Wall Street Journal*, January 26, 2005, pp. C1 and C2; Also, Ben Elgin, “Carly’s Challenge,” *Business Week*, December 13, 2004, pp. 98–108.

By 2006, they were down to about 16 percent. But all but one percentage point of the decline happened before Hurd's cost-cutting campaign took hold.

Some analysts began asking, Who deserves the credit? Hurd was quick to say that in H-P's PC business, "there has been a prolonged sustained march in performance that, frankly, predates me." One analyst suggested that H-P's directors "in the end, got the best of both worlds—a charismatic CEO who brought about a hotly contested but transformational merger, and a no-nonsense, operations-oriented CEO determined to make the combined company work."⁹

A Scandal

In summer 2006, a nasty scandal wracked H-P. The company began investigating suspected leaks by directors to the *Wall Street Journal*, *Business Week*, and *New York Times* that the board was unhappy with then-CEO Fiorina. The hired investigators used a range of extraordinary tactics, including "pretexting," or the use of deception to obtain phone records of board members and employees, booby-trapped email to invade a reporter's computer, impersonating corporate officials, and physical surveillance of at least one director and a journalist. Criminal investigations were under way by the FBI and California attorney general. In this atmosphere, chairman Patricia Dunn resigned as well as the general counsel and several directors. The U.S. House Energy and Commerce Committee demanded to know how such tawdry tactics could have been used. Pretexting is "an invasion of privacy and probably is illegal," the chairman of the panel said, and wondered why no one "had the good sense and courage to say 'Stop.'" Patricia Dunn and Mark Hurd refused to "accept personal responsibility for what happened." The former general counsel and nine other H-P attorneys and investigators invoked the Fifth Amendment right against self-incrimination, and refused to testify.¹⁰

DELL COMPUTER

The Start

Michael Dell, a tall, curly-haired youth of 19, started Dell Computer in a dorm room at the University of Texas in 1984 with \$1,000. He had an idea that computer systems could be sold directly to customers rather than going through middlemen. He thought the manufacturer could better understand the needs of customers and provide them the most effective computing systems at lower prices. This direct marketing would also do away with retailers and their high margins.

Three years later in 1987, Dell began its international expansion by opening a subsidiary in the United Kingdom. The next year, Dell took his enterprise public

⁹ Alan Murray, "H-P Lost Faith in Carly, but Not in Merger," *Wall Street Journal*, May 24, 2006, p. A2. For a sampling of many articles on this newsworthy story, also see Chana R. Schoenberger, "Carly Resurrected," *Forbes*, July 24, 2006; and Christopher Lawton, "Hewlette-Packard's Net Income Increases 51%," *Wall Street Journal*, May 17, 2006, p. A3.

¹⁰ Marilyn Geewax, Cox News Service, as reported in *Cleveland Plain Dealer*, September 29, 2006, pp. C1 and C5.

with an initial offering of 3.5 million shares at \$8.50 each and became an instant multimillionaire. By 1992 Dell was included in the Fortune roster of largest companies. In 1997 the pre-split price per share of the common stock reached \$1,000, and Michael Dell was a multibillionaire.

With the bruising industry downturn, Dell's stock price fell along with all the rest, its shares by mid-2002 down 55 percent from the early 2001 peak of \$59. Michael Dell bought 8.5 million shares of his company to add to the 300 million he already owned.

Competition in 2002

In this troubled environment, Dell's revenue in 2001 grew 2.6 percent while that of the PC industry fell 14 percent. For the quarter ended May 3, 2002, Dell reported \$457 million in earnings on sales of \$8 billion. These figures were flat from the year-earlier figures, but far better than those of competitors.

Compaq, once the master of the PC business, found its stock collapsing from \$50 to below \$10 and was forced into a merger with Hewlett-Packard since it could not compete profitably with Dell.

Dell's market share inroads

The economic downturn provided Dell a golden opportunity to grab market share. It almost doubled its share of the worldwide PC market, going from 8 percent to 15 percent in just four years. Much of this came when Dell cut prices as the downturn began, thus pressuring rivals with higher cost structures. Wall Street initially criticized this move as bound to destroy Dell's profits. But the consequent boost in market share instead led to increased profits.

When Hewlett-Packard acquired Compaq Computer for 19 billion in May 2002, it leapfrogged Dell to become the biggest PC maker in the world. But the dominance was short-lived. Next quarter, Dell's share of the PC market grew to 14.9 percent from 13.1 percent a year earlier, while H-P's combined share with Compaq fell to 15.5 percent from 18.3 percent before the merger. By fall 2002, Dell regained its No. 1 worldwide ranking, shipping 5.2 million PCs to H-P's 5.0 million.¹¹

Dell was also engaged in a major marketing battle with H-P in the printer arena. H-P had long dominated this market of printers and related gear, and with it the very lucrative ink refills market. These ink and toner refills brought H-P some \$10 billion annually, this being 15 percent of its combined annual revenues.¹² See the Information Box for vulnerability of cash cows. Dell's entry into this market through an alliance with No. 2 printer maker Lexmark showed promise of striking at the vital organs of H-P. If Dell could pressure H-P's highly profitable printer business, H-P would be less able to subsidize its money-losing PC sector, thus adding to Dell's mastery of its core PC operation.

¹¹ Gary McWilliams, "Gateway's Loss Shrinks, but It Sees Gloomy Year," *Wall Street Journal*, October 18, 2002, p. A7.

¹² *Ibid.*, A8.

INFORMATION BOX

VULNERABILITY OF CASH COWS

A cash cow is a product or division that is well entrenched with good profits in a low-growth market. Potential competitors seldom are attracted to such a market or willing to make the investment needed to go against a dominant firm. With no competitive threat, this firm has little incentive to invest more and is content to “milk” the profits of the cash cow, especially if the cow is as essential as ink is to a printer.

However, danger can lurk in this complacent mindset. If the product is profitable enough, and if entry into the industry is not prohibitive, then interlopers may still be attracted, or in Dell’s case, with H-P’s cash cow subsidizing the money-losing PC sector in direct competition with Dell, it seemed worthy of attacking.

Therein lies the danger of being greedy with cash cow profitability. Any attempt to enter the market will bring prices and profits tumbling down. A more defensible strategy for the dominant firm is to be content with more modest profits and minimize competitive threats.

Do you think Dell will be successful in its “invasion” of the printer and ink refill market? What circumstances might affect its successful entry?

Dell pursued a potential vulnerability of the H-P/Compaq merger. Longtime H-P and Compaq customers were justifiably apprehensive about the proposed acquisition and how it would turn out. Dell aggressively wooed these corporate customers, especially those buying PCs and the larger computer systems called servers. Dell believed it could offer them lower prices and better customer service.

Competitive Strength of Dell

Low Cost Structure

Dell depended heavily on technology developed by others. Essentially, Dell had turned low-end computers into a commodity, so that they could supplant high-priced brands. In the process, once high-flying firms such as Digital Equipment, Apollo Computer, and Data General were now in the graveyard. No one seemed able to match Dell’s low prices and still be profitable.

Dell’s operating costs, and this included research and development, were around 10 percent in 2001, compared with 20 percent at Compaq, 21 percent at Gateway, and 22 percent at H-P. Trying to match the costs of Dell was no simple matter. Compaq and H-P in their merger hoped to cut \$2.5 billion from their combined costs. Dell, half the size of the two companies after their merger, actually cut \$1 billion in operating manufacturing costs in 2001, and planned to do so again in 2002.¹³ See the Information Box on Dell’s production efficiencies.

¹³ Daniel Fisher, “Pulled in a New Direction,” *Forbes*, June 10, 2002, p. 104.

INFORMATION BOX

DELL'S PRODUCTION EFFICIENCIES

In 2001 Dell wrung \$1 billion out of its costs, half of that coming from manufacturing. Other areas of cost savings included product design, logistics, and warranty costs. The company vowed to cut another \$1 billion in 2002.

Dell reduced manufacturing costs with a more efficient factory layout, computer-directed conveyor systems, robots, and constant attention to simplifying assembly and reducing the number of people needed to complete a product. Purchasing managers worked with suppliers to watch parts inventories hourly, ensuring there were just enough parts to meet expected demand without excess inventory. Its constant attention to improving efficiency enabled Dell to increase production by a third in two years while cutting manufacturing space in half.

Do you see a downside to constantly trying to improve efficiency and cost-cutting?

Source: Fisher, "Pulled in a New Direction," p. 110.

Dell typically entered a market only after the technology had become standardized and cheap. In the process, it saved on R&D where Dell spent a puny 1.5 percent. This allowed Dell to capitalize on its leaner operations and undercut rivals. Seemingly, the march toward standardization had been unstoppable.

New Horizons for Dell

In late 2002 Dell began opening kiosks in major malls across the country. These booths in heavily trafficked areas gave consumers the chance to touch and play with Dell computers instead of just seeing them in pictures. The rent was far less than for a store in the mall, while visibility was greatly increased.

In 1997 Dell made a strategic decision to expand beyond PCs into the market for servers, those high-end computers with multiple microprocessors to run complex software. By 2002, servers and other so-called enterprise systems accounted for 20 percent of revenues.

Michael Dell's expanded target list began encompassing the entire \$1 trillion information technology (IT) market, going beyond desktop PCs and servers to storage devices, switches, even mainframe-like systems. Estimates were that Dell could double revenues to \$60 billion in four or five years if it could gain a strong foothold in these expanded markets.¹⁴

The problems with these ambitious goals were that Dell would be forced to change from assembling boxes depending on technology developed by others to spending billions developing its own engineering service and support talent. At the least, in such expansion of horizons Dell's puny R&D expenditures would have to be significantly increased.

¹⁴ Fisher, 104ff.

The PC market, though growing only slowly now, still offered Dell great potential as it gained ever more dominance in this market. In an interview with *Money* magazine in November 2002, Michael Dell noted that 30 million computers had been sold in the United States in the previous quarter, most of them upgrades and replacements. He speculated that 180 million computers out there were probably over three years old, and 50 million of those were in large corporations. “A personal computer is like a rubber band. You can stretch it and it works. But eventually you can stretch it too hard and it breaks . . . The ‘maybe we don’t need upgrade’ idea won’t last long.”¹⁵ With just 15 percent of the worldwide PC market, Dell had plenty of market share to grab.

Dell’s fortunes began to change. In late July 2006 its stock plummeted to the lowest level in four and a half years, with earnings per share projected to fall nearly 50 percent. Dell blamed aggressive PC pricing. While it had been the instigator in aggressive PC pricing, in the last few years its cost advantage had lessened and new Far Eastern firms had entered the market as low-price competitors. The company had also been confronted with poor customer service (see the following Information Box about the perils of outsourcing), personnel defections, and the recall of 4.1 million laptop batteries that potentially could overheat and burst into flames. Criticisms

INFORMATION BOX

PERILS OF OUTSOURCING CUSTOMER SERVICE

To save money, Dell had moved toll-free customer service and tech support to India in 2001. Consumers soon started complaining about foreign voices and communication problems. At first, Dell executives ignored the complaints, pointing out that the corporate clients who represented 85 percent of Dell’s business seemed satisfied. Evidently that satisfaction was either misread or had changed, because in 2004 Dell shifted support for business clients, but not for consumers, back to the United States. In a November 2005 semiannual survey of its own employees, the criticism was clear: “They felt we might not have been listening enough and that they didn’t think we were positioning the company for success,” Rollins recalled. “We felt terrible. We thought we could do better.” In late 2005, Dell hired 2,000 people for its U.S. call centers and stepped up training for 5,000 other reps—making a \$150 million commitment to shift customer support back to the United States. The company spent an additional \$100 million in 2006 to improve customer service, and call-wait times were down 50 percent.

Is Dell’s experience with outsourcing customer service the tip of the iceberg? Today, even medical diagnoses are being outsourced despite patient discomfiture. Might we be seeing a reversal of nonmanufacturing outsourcing?

Source: Elizabeth Corcoran, *Forbes*, June 19, 2006, pp. 44–46.

¹⁵ “Muscling into New Markets,” *Money*, November 2002, p. 49.

mounted against Kevin Rollins, who was Michael Dell's handpicked successor as CEO in July 2004, when Dell stepped away from active management.

UPDATE, 2007–2008

H-P and Mark Hurd

Fiorina was fired February 9, 2005. Hurd arrived on April 1. It was a time of the worst and longest slump in tech industry history. In early June 2006, at the end of his first full year at H-P, Hurd could report 12-month revenues of \$89 billion, up 7 percent from 2005. As 2006 ended, H-P emerged as the largest tech company in the world, with almost \$92 billion in sales and eclipsing IBM, which had held the number one spot for four decades. By 2007, it was to break the \$100 billion goal with revenues of \$104 billion. H-P was soon to overtake Dell in PCs, although the advantage was shifting back and forth. See Table 6.1 for comparative revenue, income statistics, and share prices of Dell and H-P from 2000 to 2007. Notice in particular the sharp jump in

TABLE 6.1 Comparison of Hewlett-Packard and Dell Revenue, Income, and Stock Prices, 2000–2007

	2000	2001	2002	2003	2004	2005	2006	2007
Revenue (millions \$)								
H-P	48,782	45,226	58,588	73,061	79,905	86,696	91,658	104,286
Dell	25,265	31,886	31,168	35,404	41,444	48,205	55,908	55,472
	H-P percentage increase these 8 years					113.7%		
	Dell percentage increase					119.1%		
Net Income (millions \$)								
H-P	3,581	624	−923	2,539	3,497	2,398	6,198	7,264
Dell	1,666	2,236	1,246	1,122	2,645	3,043	3,572	2,583
	H-P percentage increase these 8 years					102.8%		
	Dell percentage increase					55.0%		
Share Prices (\$)								
H-P	29–78	13–38	11–24	14–24	16–26	19–30	28–42	38–53
Dell	31–55	16–60	16–31	22–31	23–37	31–43	29–42	22–31

Source: Compiled from company public statistics.

Commentary: Surprisingly, although H-P became a \$100 billion company in 2007, the percentage increase in revenue in these 8 years is slightly below Dell. But net income has almost doubled percentagewise. Note for H-P the huge increase in revenue and income the last two years, reflecting the positive impact that Hurd had on H-P in his few years on the job. Dell's statistics show a steady increase in revenue but a rather erratic net income picture. As for share prices, the long plateau of share prices during the time of Fiorina compares with a slow but steady rise for Dell until 2007. Perhaps most significant is how H-P is forging ahead in total revenues and net profits by 2007, reflecting partly the Compaq merger, but also a much greater growth machine than Dell can muster at this point in time.

revenue and net income in 2006 and 2007 for H-P, as well as the range of per share prices. Now compare these with Dell's figures for the same period.

The See-Saw Battle for PC Dominance

When Hurd joined H-P in 2005, Dell was the top PC maker while H-P's PC operations were barely profitable, morale was in the pits, and pressure was building for H-P to get out of PC's altogether. Hurd hired Todd Bradley to run the company's PC business that same year. Bradley had previously helped lead another technology company out of the doldrums. As CEO of palmOne, he moved the company from its Palm data devices to smart phones just as those sales took off.

Within weeks of joining the firm, Bradley concluded that H-P was concentrating its resources on the wrong battlefield, where Dell was entrenched and strongest: in direct sales over the Internet and phone. He decided H-P should focus on its strengths, which was retail stores, where Dell had no presence at all. Bradley worked hard to build better relations with retailers and fix delivery snafus. Then he turned his attention to developing more attractive products such as touch-screen PCs that would display well and command a premium price, thus making them more profitable for retailers. He helped stores differentiate their H-P computers from those of competitors, by giving them exclusive models, much like fashion designers make exclusive lines of clothing. New PCs were introduced imprinted with fresh designs and decorations. In 2006 H-P spent 55 percent of its U.S. marketing budget on merchandising and store promotions, up from 40 percent in 2005.

Dell hung tough though. As H-P was taking market share from Dell, latest figures for early 2008 showed Dell the No. 1 U.S. seller, with about a 33 percent market share. Worldwide, H-P was No. 1, with 50 million computers shipped to Dell's 40 million.

Michael Dell returned as CEO in January 2007 and moved to rectify the company's lack of retail presence in an environment of changing buying habits. After four months of negotiations in late 2007, Dell and Best Buy agreed to sell PCs in the chain's 900 stores. Dell did not offer the whole line, fearing to siphon off its Web customers who still comprised most of its consumer sales. Dell has also signed deals with Wal-Mart and Staples, as well as several overseas retailers. But the slow pace of expansion into retail firms brought criticisms. One analyst noted that while Dell had entered more than 10,000 retail outlets globally, H-P was already in 110,000 worldwide. Overall, Dell's retail sales were projected to be about 5 percent of its revenue, while 40 to 50 percent of H-P's PC revenue was from retail chains.¹⁶

ANALYSIS

The Merger

Unlike many mergers that quickly sour, H-P's merger with Compaq at first seemed a qualified success, even though the combined company still had profitability problems. After all, despite being larger now, it still faced the formidable competi-

¹⁶ Christopher Lawton, "Dell Treads Carefully into Selling PCs in Stores," *Wall Street Journal*, January 3, 2008, pp. B1 and B2.

tion of IBM and Dell Computer. The boom in corporate high-tech spending had ended and long-term growth prospects for the industry no longer seemed robust, while a number of marginal firms were on the ropes. With the merger, H-P was poised to take advantage of a revival of corporate interest, and perhaps a regeneration of consumer interest from appealing new products. All the while, H-P still dominated the high-profit ink-refill market.

Monday-Morning Quarterbacking after the Ouster

Perhaps Fiorina could have been a better administrator. Heading a \$56 billion firm, perhaps she needed to delegate more. This lack of delegation is not an uncommon fault of executives, but it can limit their effectiveness in higher positions. She resisted the idea of any assistant or vice chairman, and maybe this should have been reconsidered. She was in a difficult situation, with the might of Dell in PC and the powerful IBM at the other extreme of the industry. Add to this a resentful Walter Hewlett who was still influential with the board, and perhaps Fiorina's doom was sealed. (At the end of this section, in *What Do You Think?* What could she have done to save her job?, we invite students to address Fiorina's situation in 2005 before the abrupt termination decision.)

People were quick to judgment in the days following the ouster news. Shareholders blamed her for the sagging stock price. Long-term employees condemned her for upsetting the company's paternalistic culture. Industry analysts faulted her for H-P's sluggish computer business. While Fiorina was a dynamic and charismatic leader who was widely esteemed in the business world, inside H-P her rather autocratic management style stirred deep animosity from some employees, and several high-level executives had quit for other positions. Reports were that reactions to her ouster led to "jubilant" champagne toasts.¹⁷

Fiorina seems to have received little credit for the planning and organization that made the merger with Compaq what now most experts had to concede was a legitimate success. As the CEO and primary mover in this merger, this may have been her finest hour.

Turning around H-P

Hurd did a remarkable job of bringing H-P back to growth and profitability. Does this mean that an operational person is a better CEO than a charismatic leader? I don't think we can accede this; it depends on the environment and the circumstances. Perhaps the board was too impatient with Fiorina. The economy was on the verge of turning around, and in another year Fiorina may have posted splendid results. Maybe. But her public persona inhibited her in the nitty-gritty of important details. And maybe gave her people problems. But she had the vision. Alas, Mark Hurd intoned: "Without execution, vision is just another word for hallucination."¹⁸

¹⁷ Pui-Wing Tam, "Fallen Star: H-P's Board Ousts Fiorina as CEO," *Wall Street Journal*, February 10, 2005, pp. A1 and A8.

¹⁸ Quentin Hardy, "The UnCarly," *Forbes*, March 12, 2007, p. 83.

Dell's Comeuppance and Attempted Comeback

The direct marketing, low-price strategy of Dell blew away its competitors for almost two decades. But then the situation changed as Far East computer makers trumped the low-price strategy. Dell had lost its leadership in PCs to hard-charging H-P and the low-cost competitors. It was late in recognizing a shift in consumer buying patterns for computers. When Michael Dell came back in early 2007, the company began a strong effort to gain a retail store presence in the world market, but H-P was first on the scene, with a presence not easily countered. Had H-P won the war, or was this just a temporary aberration?

What Do You Think?

What could Carly have done to save her position at H-P?

WHAT WE CAN LEARN

The Power of a Charismatic Leader

Carly Fiorina was a charismatic leader. Even though new to the H-P organization, she motivated employees and managers to jump-start the innovation machine, to escape the staid bureaucratic culture that had permeated the organization in recent years. She got key people in both firms to support the Compaq merger and work together to make it work. Mergers can succeed without charisma, but it helps if enthusiasm and commitment can be instilled. Yet, a charismatic leader may not be able to execute particularly well and can make enemies and jealousies that undermine and detract. Could this have been at the root of her abrupt firing?

Survival of the Fittest—Power of Lower Costs

If a firm has managed to reduce its operating costs and overhead significantly below its competitors, and if competitors cannot quickly match these costs, then a price war can be a shrewd marketing strategy. While it may reduce profits somewhat, market-share gains could be significant, and such gains may be lasting. In two later cases, Southwest Airlines and Vanguard, we find similar instances of firms having significantly lower costs than the rest of the industry. Few competitors have been able to cut costs sufficiently to meet their prices and still be profitable. The power of lower costs can make a survival-of-the-fittest environment that results in greater efficiency and price benefits to customers. Still, there is always the danger that a new competitor will emerge who will trump the price advantage, as Far Eastern firms did for Dell. (For a related insight, see “Problems of Competing Entirely on Price” in Chapter 7, Boeing.)

Do Not Be Complacent with a Cash-Cow Strategy

H-P's pricing structure with its industry-leading ink and toner refills contributed \$10 billion and 15 percent of total company revenue, as well as a much higher percentage of total income. Some called these profits obscene. We would think that such a situation would be very attractive to competitors eager for the golden opportunity to gain market share with lower-priced refills. And there has been some nibbling at the edges of this market, with retailers taking trade-ins on new cartridges. At first, we thought Dell was going to be such a factor, but it and other competitors have found the temptation of huge markups to be irresistible, and have not undercut H-P prices. I doubt this pleasant environment will last forever, and a firm should plan in advance what options to pursue when this lovely cash cow is destroyed perhaps by aggressive competitors from the Far East.

Have We Carried Outsourcing too Far?

Early flags that this might be the case were shown in Dell's experience when it moved toll-free customer service and tech support to India. Sure, it saved money, but a horde of customer complaints about foreign voices and communication difficulties forced the company after four years to shift this customer support back to the United States at a cost of \$250 million. In the next case, Boeing, we will see another example of outsourcing causing long delays and quality control problems in assembling the new Dreamliner. Wide publicity of defective and dangerous products, ranging from toys to pet food, coming mainly from China, was another cause for outsourcing concern, especially since 80 percent of all toys purportedly come from China.

CONSIDER

Can you think of other learning insights?

QUESTIONS

1. How do you judge the quality of a product, whether a computer or something else? Is it mostly by price? Discuss your perception of price and quality, as well as any ramifications.
2. "Tradition has no place in corporate thinking today." Discuss this statement.
3. Giant organizations are often plagued with cumbersome bureaucracies. Discuss how this tendency could be prevented as an organization grows to large size over many years.
4. Playing a devil's advocate (one who takes an opposing position for the sake of examining all aspects of a decision), present the case against the Compaq merger. (You may want to research the arguments raised by Walter Hewett in his aggressive campaign against the merger.)
5. "H-P is gouging the consumer in charging such high prices for its ink refill cartridges. Sure, it's a high profit item, but such profits cross the line and are obscene." Discuss.

6. Do you think the 17,000 jobs lost in the merger was laudatory, or should it be condemned? What would swing your opinion?
7. Why do you think Hurd's efforts were so successful and so quickly accomplished? Support your conclusions as persuasively as you can.
8. Why do you think Dell lagged so far behind H-P in tapping into retail markets?

HANDS-ON EXERCISES

1. You have been asked by Carly Fiorina to draw up a rationale for eliminating 17,000 jobs. She wants this to be as tactful and persuasive (to the organization) as possible.
2. Mark Hurd has just assumed the top job at H-P. He has asked you as a staff VP to draw up a course of action to get the ailing PC division up to competitive parity with Dell. If you need to make some assumptions, keep them reasonable.
3. Michael Dell, founder and CEO of Dell Computer, had his sights set on invading H-P's lucrative printer and ink refill business. As an advisor to Carly Fiorina, what action, if any, would you recommend taking to try to thwart Dell's incursion. Be prepared to support your recommendations.
4. Place yourself in the position of Carly Fiorina at the beginning of 2005 facing a critical board, skeptical stockholders, and a negative press. Lay out your strategy to protect your position. Do you think this would have saved her job? Why or why not?

TEAM DEBATE EXERCISES

1. The search committee for a new CEO is seriously considering Carly Fiorina. Based on the information in the case, debate the controversy: should we hire this woman who is an outsider, or look for someone else among our 300 candidates?
2. Michael Dell is seriously considering a change in the PC distribution strategy. Instead of sticking with his founding strategy of going directly to consumers by Internet and telephone, he is thinking of distributing more through retail stores. Debate the pros and cons of such a decision.

INVITATION TO RESEARCH

How has H-P's operating performance fared since 2007?

Has Dell become a bigger factor in this market? Is it solidly in retail stores?

Has price competition become more aggressive in the ink refill market?

Whatever happened to Walter Hewett?

What is Fiorina doing now?

Airliner Wars: Boeing vs. Airbus—And Recent Outsourcing Woes

The commercial jet business had long been subject to booms and busts: major demand for new aircraft and then years of little demand. By the second half of the 1990s, demand burgeoned as never before. Boeing, the world's leading producer of commercial airplanes, seemed in the catbird seat amid the worldwide surge of orders. This was an unexpected windfall, spurred by markets greatly expanding in Asia and Latin America at the same time as domestic demand, helped by deregulation and prosperity, boomed. In the midst of these good times, Boeing in 1997 incurred its first loss in 50 years.

During this same period, Airbus (Airbus Industrie), a European aerospace consortium, an underdog, began climbing toward its long-stated goal of winning 50 percent of the over-100-seat airplane market. The battle was all-out, no-holds-barred, and Boeing was vulnerable. But in this chess game of monolithic firms, Airbus stumbled with its throwing all its resources into the world's biggest passenger jet, and Boeing emerged a winner with its Dreamliner. Then outsourcing woes afflicted them both by 2008.

BOEING

Boeing's is a fabled past. The company was a major factor in the World War II war effort, and in the late 1950s led the way in producing innovative, state-of-the-art commercial aircraft. It introduced the 707, the world's first commercially viable jetliner. In the late 1960s, it almost bankrupted itself to build a jetliner twice the size of any other then in service, while the critics predicted it could never fly profitably. But the 747 dramatically lowered costs and airfares and brought passenger comfort previously undreamed of in flying. In the mid-1990s, Boeing introduced the high technology 777, the first commercial aircraft designed entirely with the use of computers.

In efforts to reduce the feast-or-famine cycles of the commercial aircraft business, Boeing acquired Rockwell International's defense business in 1996, and in 1997 purchased McDonnell Douglas for \$16.3 billion.

In 1997, Boeing's commercial aircraft segment contributed 57 percent of total revenues. This segment ranged from 125-passenger 737s to giant 450-500-seat 747s. In 1997, Boeing delivered 374 aircraft, up from 269 in 1996. The potential seemed enormous: over the next 20 years, air passenger traffic worldwide was projected to rise 4.9 percent a year and airlines were predicted to order 16,160 aircraft to expand their fleets and replace aging planes.¹ As the industry leader, Boeing had 60 percent of this market. At the end of 1997, its order backlog was \$94 billion.

Defense and space operations comprised 41 percent of 1997 revenues. This included airborne warning and control systems (AWACS), helicopters, B-2 bomber subcontract work, and the F-22 fighter, among other products and systems.

Problems with the Commercial Aircraft Business Segment

Production Problems

Boeing proved to be poorly positioned to meet the surge in aircraft orders. Part of this resulted from its drastic layoffs of experienced workers during the industry's last slump, in the early 1990s. Though Boeing hired 32,000 new workers over 18 months starting in 1995, the experience gap upped the risk of costly mistakes. Boeing had also cut back its suppliers in strenuous efforts to slash parts inventories and increase cost efficiency.

But Boeing had other problems. Its production systems were a mess. It had somehow evolved some 400 separate computer systems, and these were not linked. Its design system was labor intensive and paper dependent, and very expensive as it tried to cater to customer choices. A \$1 billion program had been launched in 1996 to modernize and computerize the production process. But this was too late: The onslaught of orders had already started. (It is something of an anomaly that a firm that had the sophistication to design the 777 entirely by computers was so antiquated in its use of computers otherwise.)

Demands for increased production were further aggravated by unreasonable production goals and too many plane models, almost an impossible product line. Problems first hit with the 747 Jumbo, and then with a new version of the top-selling 737, the so-called next-generation 737NG. Before long, every program was affected: also the 757, 767, and 777. While Boeing released over 320 planes to customers in 1997 for a 50 percent increase over 1996, this was far short of the planned completion rate. For example, by early 1998 a dozen 737NGs had been delivered to airlines, but this was less than one-third of the 40 supposed to have been delivered by then. Yet the company maintained through September 1997 that everything was going well, that there was only a month's delay in the delivery of some planes.

Soon it became apparent that problems were much greater. In October, the 747 and 737 assembly lines were shut down for nearly a month to allow workers to

¹ *Boeing 1997 Annual Report.*

TABLE 7.1 Boeing's Trend of Revenues and Income, 1988–1996

	Revenue	Net Income
	(millions)	
1988	\$16,962	\$614
1989	20,276	675
1990	27,595	1,385
1991	29,314	1,567
1992	30,184	1,554
1993	25,438	1,244
1994	21,924	856
1995	19,515	393
1996	22,681	1,095
1997	45,800	(177)
1998	56,100	1,100

Source: Boeing Annual Reports.

Commentary: Note the severity of the decline in revenues and profits during the industry downturn in 1993, 1994, and 1995. It is little wonder that Boeing was so ill-prepared for the deluge of orders starting in 1997. Then, in an unbelievable anomaly, the tremendous increase in revenues in 1997 to the highest ever—partly reflecting the acquisitions—was accompanied by a huge loss.

catch up and ease part shortages. The *Wall Street Journal* reported horror stories of parts being rushed in by taxicab, of executives spending weekends trying to chase down needed parts, of parts needed for new planes being shipped out to replace defective parts on an in-service plane. Overtime pay brought some assembly-line workers incomes over \$100,000, while rookie workers muddled by on the line.²

Despite its huge order backlog, Boeing took a loss for 1997, the first in over 50 years. See Table 7.1 for the trend in revenues and net income from 1988 to 1998.

The loss mostly resulted from two massive write-downs. One, for \$1.4 billion, arose from the McDonnell Douglas acquisition and in particular from its ailing commercial aircraft operation at Long Beach, California. The bigger write-off, \$1.6 billion, reflected production problems, particularly on the new 737NG. Severe price competition with Airbus resulted in not enough profits on existing business to bring the company into the black. Production delays continued, with more write-downs on the horizon.

As Boeing moved into 1998, analysts wondered how much longer it would take to clear up the production snafus. This would be longer than anyone had been led to believe. Unexpectedly, a new problem arose for Boeing. Disastrous economic conditions in Asia now brought major order cancellations.

² Frederic M. Biddle and John Helyar, "Behind Boeing's Woes: Clunky Assembly Line, Price War with Airbus," *Wall Street Journal*, April 24, 1998, p. A16.

Customer Relations

Not surprisingly, Boeing's production problems resulting in delayed shipments had a serious impact on customer relations. For example, Southwest Airlines had to temporarily cancel adding service to another city because the ordered planes were not ready. Boeing paid Southwest millions of dollars of compensation for the delayed deliveries. Continental also had to wait for five overdue 737s.

Other customers switched to Boeing's only major competitor, Airbus Industrie, of Toulouse, France.

AIRBUS INDUSTRIE

Airbus had to salivate at Boeing's troubles. It had been a distant second in market share to the 60 percent of Boeing. Now this was changing and Airbus could see achieving a sustainable 50 percent market share. See the Information Box: Importance of Market Share for a discussion of market share.

Background of Airbus

Airbus was founded in 1970 as a consortium that came to include four countries: British Aerospace, DaimlerChrysler Aerospace (Germany), France's Aerospatiale,

INFORMATION BOX

IMPORTANCE OF MARKET SHARE

The desire to surpass a competitor is a common human tendency, whether in sports or business. A measurement of performance relative to competitors encourages this desire and can be highly motivating for management and employees alike. Furthermore, market share performance is a key indicator in ascertaining how well a firm is doing and in spotting emerging problems, as well as sometimes allaying blame. As an example of the latter, declining sales over the preceding year, along with a constant and improving market share, can suggest that the firm is doing a good job, even though certain factors adversely affected the whole industry.

Market share is usually measured by (1) share of overall sales, and/or (2) share relative to certain competitors, usually the top one or several in the industry. Of particular importance is trend data: Are things getting better or worse? If worse, why is this, and what needs to be done to improve the situation?

Since Boeing and Airbus were the only real competitors in this major industry, relative market shares became critical. The perceived importance of gaining, or not losing, market share led to severe price competition that cut into the profits of both firms, as will be discussed later.

How would you respond to the objection that market share data is not all that useful, since "it doesn't tell us what the problem really is"?

Can emphasizing market share be counterproductive? If so, why?

and Spain's Casa. Each of the partners supplied components such as wings and fuselages; the partners also underwrote the consortium's capital expenses (sometimes with government loans), and were prepared to cover its operating losses.

The organizational structure seemed seriously flawed. It was politicized, with the partners voting on major issues in proportion to their country's ownership stakes. From this fragmented leadership, public squabbles frequently arose, some very serious. For example, plans to produce a new 107-seat A318 were held up by the French, who thought they were not getting their fair share of the production. Finances were also tangled with components supplied by the various countries charged to Airbus at suspiciously high prices.

The result was that in 1998, Boeing made \$1.1 billion on sales of \$56.1 billion, while Airbus was losing \$204 million on sales of \$13.3 billion. Boeing accused Airbus of selling below cost in order to steal business from Boeing, and Airbus blamed Boeing for the low bids.

The competition between the two companies became increasingly bitter after 1996. In that year, Boeing and several Airbus partners discussed a joint development of a superjumbo. The talks ended when they could not agree on a single design. But Airbus suspected Boeing was not sincerely interested in this collaboration, that its main purpose in the talks was to stall Airbus's plans.

Airbus went ahead with its plans, while Boeing pooh-poohed the idea of such a huge plane.

Airbus Chairman Noel Forgeard

A slight Frenchman with a cheery disposition, Noel Forgeard, 52, joined the consortium in 1998 from Matra, a French aerospace manufacturer. He came with several major goals: to centralize decision-making, to impose sensible book-keeping, and to make Airbus consistently profitable. The task was not easy. For example, plans to build the world's largest airplane, code-named A3XX, were even threatened by disagreements over where it would be assembled. Both France and Germany thought it should be produced in their country. Forgeard stated, "The need for a single corporate entity is well recognized. Everybody here is focused on it."³ Still, while the need for reorganizing into something like a modern corporation was evident to most executives, the major partners were divided over how to proceed.

The World's Largest Plane

The A3XX was designed as a double-decker plane that could carry 555 passengers comfortably—137 more than a Boeing 747-400 (it could even carry 750 people on routes around Asia where people did not care as much about seating comfort). It was expected to fly by 2004, with prices starting somewhat over \$200 million. Development costs could reach \$15 billion, so essentially the A3XX was a bet-the-company project with an uncertain outlook, much as was Boeing's 747 thirty years before. To pay for these costs, Airbus expected to get 40 percent from suppliers such as

³ Alex Taylor II, "Blue Skies for Airbus," *Fortune*, August 2, 1999, p. 103.

Sweden's Saab, 30 percent from government loans arranged by its partners, and the rest from its own resources.

The huge financing needed for this venture could hardly be obtained without a corporate reorganization, one that would provide a mechanism for handling internal disputes among the various partner countries, not the least of which was where the plane would be assembled. So, Forgeard had necessity on his side for reorganizing. But the A3XX faced other issues and concerns.

Should a Plane Like the A3XX Even Be Built?

Boeing's publicly expressed opinion was that such a plane would never be profitable. "Let them launch it," said one Boeing official, with a hint of malice.⁴ Boeing took the position that consumers want frequent, nonstop flights, such as Southwest Airlines had brought to prominence with its saturation of city-pair routes with frequent flights. An ultra-large aircraft would mean far less frequency.⁵

Airbus, meantime, surveyed big airlines and discerned enough interest in a superjumbo to proceed. It also consulted with more than 60 airports around the world to determine whether such a big plane would be able to take off and land easily. Weight is critical to these maneuvers, and Airbus pledged that the A3XX would be able to use the same runways as the 747 because of a new lightweight material. Instead of regular aluminum, the planes would use a product called Glare, made of aluminum alloy and glass-fiber tape.

Airbus promised ambitious plans for passenger comfort in this behemoth. It built a full-size 237-foot mockup of the interior to show prospective customers, and enlisted 1,200 frequent flyers to critique the cabin mockup. To reduce claustrophobia, the designers added a wide staircase between upper and lower decks. Early plans also included exercise rooms and sleeping quarters fitted with bunk beds.

Airbus claimed that the 555-seat A3XX would be 15 percent cheaper to operate per seat-mile than Boeing's 747. Boeing maintained this was wildly optimistic. United Airlines Frederick Brace, vice president of finance, also expressed doubts: "The risk for Airbus is whether there's a market for A3XX. The risk for an airline is: Can we fill it up? We have to be prudent in how we purchase it."⁶

Competitive Position of Airbus

Airbus was well positioned to supply planes to airlines whose needs Boeing couldn't meet near term. Some thought it was even producing better planes than Boeing.

United Airlines chose Airbus's A320 twinjets over Boeing's 737s, saying passengers preferred the Airbus product. Several South American carriers also chose A320s over the 737, placing a \$4 billion order with Airbus. For 1997, Airbus hacked out a 45 percent market share, the first time Boeing's 60 percent market share had eroded.

The situation worsened drastically for Boeing in 1998. US Air, which had previously ordered 400 Airbus jets, announced in July that it would buy 30 more. But

⁴ Steve Wilhelm, "Plane Speaking," *Puget Sound Business Journal*, June 18, 1999, p. 112.

⁵ *Ibid.*

⁶ "Blue Skies for Airbus," p. 108.

the biggest defection came in August when British Airlines announced plans to buy 59 Airbus jetliners and take options for 200 more. This broke its long record as a Boeing-loyal customer. The order, worth as much as \$11 billion, would be the biggest victory of Airbus over Boeing.⁷

Beyond the production delays of Boeing, Airbus had other competitive strengths. While it had less total production capability than Boeing (235 planes vs. Boeing's 550), the Airbus production line was efficient and the company had done better in trimming its costs. This meant it could go head-to-head with Boeing on price. And price seemed to be the name of the game in the late 1990s. This contrasted with earlier days when Boeing rose to world leadership with performance, delivery, and technology more important than cost. "They [the customers] do not care what it costs us to make the planes," Boeing Chairman and Chief Executive Philip Condit admitted. With airline design stabilized, he saw the airlines buying planes today as chiefly interested in how much carrying capacity they could buy for a buck.⁸

Increasingly passengers were grouching about the cramped interiors of planes designed for coast-to-coast trips and the dearth of lavatories to accommodate 126 to 189 passengers on long flights. Passenger rage appeared to be cropping up more and more. *Forbes* magazine editorialized that "the first carrier that makes an all-out effort to treat passengers as people rather than oversized sardines will be an immense money-maker."⁹

Boeing's new 737-700s and 737-800s were notorious for giving customer comfort low priority. Airbus differentiated itself from Boeing by designing its A320 150-seat workhorse with a fuselage 7 1/2 inches wider than Boeing's, thus adding an inch to every seat in a typical six-across configuration.

In the first four months of 1999, Airbus won an amazing 78 percent of orders. US Airways Chairman Stephen Wolf, whose airline had ordered 430 Airbus planes since 1996, said, "Airbus aircraft offer greater flexibility for wider seats, more overhead bin space, and more aisle space—all important in a consumer-conscious business."¹⁰

A Donnybrook

An interesting competitive brawl occurred in mid-1999 that was indicative of the intensity of this airliner war. Boeing won a \$1.9 billion order for ten of its 777 jetliners from Singapore Airlines. This in itself would not have raised eyebrows, but there was more to it. As a condition, Boeing agreed to purchase for resale 17 competing Airbus A340-300 jets from Singapore Airlines, which would allow the airline to phase out these Airbus planes.

Airbus officials claimed that Boeing had agreed to unprofitable terms out of desperation to close a 777 sale agreement and that this signaled a new price war

⁷ "British to Order Airbus Airliners," *Cleveland Plain Dealer*, August 25, 1998, p. 6-C.

⁸ Howard Banks, "Slow Learner," *Forbes*, May 4, 1998, p. 54.

⁹ "Plane Discomfort," *Forbes*, September 6, 1999, p. 32.

¹⁰ "Blue Skies for Airbus," p. 104.

involving trade-ins to provide a discount rather than direct price cutting. Boeing crowed that the carrier's decision to eliminate the competing version of the A340 from its fleet was a victory for Boeing.¹¹

A month later, still stung by the sales thrust of Boeing, and in an effort to thwart it, Airbus announced that it would not provide its standard support services for the jets it sold to Singapore Airlines if Boeing buys and resells them. Such a countermove could prove costly to Boeing. On the other hand, Boeing was likely to offer the jets first to airlines with fleets of the same planes, several of whom had already expressed interest. Refusing to provide support service would put Airbus in the position of denying support for a small number of planes within the fleet of a major customer. Move and countermove, this.¹²

WHO CAN WE BLAME FOR BOEING'S TROUBLES?

Was It CEO Philip Condit?

Philip Condit became chief executive in 1996, just in time for the emerging problems. He had hardly assumed office before he was deeply involved in the defense industry's merger mania, first buying Rockwell's aerospace operation and then McDonnell Douglas. Condit later admitted that he probably spent too much time on these acquisitions, and not enough time on watching the commercial part of the operation.¹³

Condit's credentials were good. His association with Boeing began in 1965 when he joined the firm as an aerodynamics engineer. The same year, he obtained a design patent for a flexible wing called the sailwing. Moving through the company's engineering and managerial ranks, he was named CEO in 1996 and chairman in 1997. Along the way, he earned a master's degree in management from the Massachusetts Institute of Technology in 1975, and in 1997 a doctorate in engineering from Science University of Tokyo, where he was the first Westerner to earn such a degree.

Was Condit's pursuit of the Rockwell and McDonnell Douglas mergers a major blunder? While analysts did not agree on this, prevailing opinion was more positive than negative, mostly because these businesses could smooth the cyclical nature of the commercial sector.

Interestingly, in the face of severe adversity, no heads rolled, as they might have in other firms. See the Issue Box: Management Climate during Adversity.

Were the Problems Mostly Due to Internal Factors?

The airlines' unexpected buying binge, which was brought about by worldwide prosperity fueling air travel, maybe should have been anticipated. However, even

¹¹ Jeff Cole, "Airbus Industrie Charges Boeing Is Inciting Price War in Asian Deal," *Wall Street Journal*, June 21, 1999, p. A4.

¹² Daniel Michaels, "Airbus Won't Provide Support Service for Jets It Sold to Singapore Air If Boeing Resells Them," *Wall Street Journal*, July 28, 1999, p. A17.

¹³ Howard Banks, "Slow Learner," *Forbes*, May 4, 1998, p. 56.

ISSUE BOX

MANAGEMENT CLIMATE DURING ADVERSITY: WHAT IS BEST FOR MAXIMUM EFFECTIVENESS?

Management shake-ups during adversity can range from practically none to widespread head-rolling. In the first scenario, a cooperative board is usually necessary, and it helps if the top executive(s) controls a lot of stock. But the company's problems will probably continue. In the second scenario, at the extreme, wielding a mean axe with excessive worker and management layoffs can wreck havoc on a company's morale and longer-term prospects.

In general, neither extreme—complacency or upheaval—is good. A sick company usually needs drastic changes, but not necessarily widespread bloodletting that leaves the entire organization cringing and sending out résumés. But we need to further define sick. At what point is a company so bad off it needs a drastic overhaul? Was Boeing such a sick company? Would a drastic overhaul have quickly changed things? Certainly Boeing management had made some miscalculations, mostly in the area of too much optimism and too much complacency, but these were finally recognized.

Major competitor Airbus was finally aggressively attacking, and that certainly had something to do with Boeing's problems. Major executive changes and resignations might not have helped.

How do you personally feel about the continuity of management at Boeing during these difficult times? Should some heads have rolled? What criteria would you use in your judgment of whether to roll heads or not?

the most prescient decision maker probably would have missed the full extent of this boom. For example, orders jumped from 124 in 1994 to 754 in 1996. With hindsight, we know that Boeing made a grievous management mistake in trying to bite off too much, by promising expanded production and deliveries that were wholly unrealistic. We know what triggered such extravagant promises: trying to keep ahead of arch-rival Airbus.

Huge layoffs in the early 1990s contributed to the problems of gearing up for new business. An early-retirement plan had been taken up by 9,000 of 13,000 eligible people. This was twice as many as Boeing expected, and it removed a core of production-line workers and managers who had kept a dilapidated system working. New people could not be trained or assimilated quickly enough to match those lost.

Boeing had begun switching to the Japanese practice of lean inventory management that delivers parts and tools to workers precisely as needed, so that production costs could be reduced. Partly due to this change, and to the early 1990s downturn, Boeing's supplier base changed significantly. Some suppliers quit the aviation business; others had suffered so badly in the slump that their credit was affected and they were unable to boost capacity for the suddenly increased business. The result was serious parts shortages.

Complicating production problems was Boeing's long-standing practice of customizing. Because it permitted customers to choose from a host of options, Boeing was fine-tuning not only for every airline, but for every order. For example, it offered the 747's customers 38 different pilot clipboards, and 109 shades of the color white.¹⁴ Such tailoring added significantly to costs and production time. This perhaps was acceptable when these costs could be easily passed on to customers in a more leisurely production cycle, but it was far from maximizing efficiency. With deregulation, fare wars made extreme customizing archaic. Boeing apparently got the message with the wide-bodied 777, designed entirely by computers. Here, choices of parts were narrowed to standard options, such as carmakers offer in their transmissions, engines, and comfort packages.

Cut-rate pricing between Boeing and Airbus epitomized the situation by the mid-1990s. Then, costs became critical if a firm was to be profitable. In that climate, Boeing was so obsessed with maintaining its 60 percent market share that it fought for each order with whatever price it took. Commercial airline production had somehow become a commodity business, with neither Boeing nor Airbus having products all that unique to sell. Innovation seemed disregarded, and price was the only factor in getting an order. So, every order became a battleground, and prices might be slashed 20 percent off list in order to grab all the business possible.¹⁵ And Boeing did not have the low-cost advantage over Airbus.

Such price competition worked to the advantage of the airlines, and they grew skillful at gaining big discounts from Boeing and Airbus by holding out huge contracts and negotiating hard.

The cumbersome production systems of Boeing—cost inefficient—became a burden in this cost-conscious environment. While some of the problems could be attributed to computer technology not well applied to the assembly process, others involved organizational myopia regarding even such simple things as a streamlined organization and common parts. For example, before recent changes the commercial group had five wing-design groups, one for each aircraft program. This was reduced to one. Another example cited in *Forbes* tells of different tools needed in the various plane models to open their wing access hatches.¹⁶ Why not use the same tool?

There is a paradox in Boeing's dilemma. Its 777 was the epitome of high technology and computer design, as well as efficient production planning. Yet much of the other production was mired in a morass with supplies, parts management, and production inefficiency.

Harry Stonecipher, former CEO of McDonnell Douglas before the acquisition and then president and chief operating officer of Boeing, cited arrogance as the mindset behind Boeing's problems. He saw this as coming from a belief that the company could do no wrong, that all its problems came from outside, and that business as usual would solve them.¹⁷

¹⁴ John Greenwald, "Is Boeing Out of Its Spin?" *Time*, July 13, 1998, p. 68.

¹⁵ "Behind Boeing's Woes . . ." A1, A16.

¹⁶ Banks, p. 60.

¹⁷ Bill Sweetman, "Stonecipher's Boeing Shakeup," *Interavia Business & Technology*, September 1998, p. 15.

The Role of External Factors

Adding to the production and cost-containment difficulties of Boeing were increased regulatory demands. These came not only from the U.S. Federal Aviation Administration, but also from the European Joint Airworthiness Authority (a loose grouping of regulators from more than 20 European countries). The first major consequence of this increased regulatory climate concerned the new 730NG. Boeing apparently thought it could use the same over-the-wings emergency exits as it had on the older 737. But the European regulators wanted a redesign. They were concerned that the older type of emergency exits would not permit passengers in the larger version of the plane to evacuate quickly enough. So Boeing had to design two new over-the-wing exits on each side. This was no simple modification since it involved rebuilding the most crucial aspect of the plane. The costly refitting accounted for a major part of the \$1.6 billion write-down Boeing took in 1997.

Europe's Airbus Industrie had made no secret of its desire to achieve parity with Boeing and to have 50 percent of the international market for commercial jets. This mindset led to the severe price competition of the latter 1990s as Boeing stubbornly tried to maintain its 60 percent market share even at the expense of profits. While its total production capacity was somewhat below that of Boeing, Airbus had already overhauled its manufacturing process and was better positioned to compete on price. Airbus's competitive advantage seemed stronger with single-aisle planes, those in the 120–200 seat category, mostly 737s of Boeing and A320s of Airbus. But this accounted for 43 percent of the \$40 billion expected to be spent on airliners in 1998.¹⁸

The future was something else. Airbus placed high stakes on a superjumbo successor to the 747, with seating capacity well beyond that of the 747. Such a huge plane would operate from hub airports such as New York City's JFK. Meantime, Boeing staked its future on its own 767s and 777s, which could connect smaller cities around the world without the need for passenger concentration at a few hubs.

Have you ever heard of a firm complaining of too much business? Probably not, but then we're confronted with Boeing's immersion in red ink, caused by trying to cope with too many orders. However, Boeing's feast of too much business abruptly ended. Financial problems in Asia brought cancellations and postponements of orders and deliveries.

In October 1998, Boeing disclosed that 36 completed aircraft were sitting in company storage areas in the desert, largely because of canceled orders. By December 1998, Boeing warned that its operations could be hurt by the Asian situation for as long as five years, and it announced that an additional 20,000 jobs would be eliminated and production cut 25 percent.¹⁹ Of course, it didn't help that Airbus was capitalizing on Boeing's production difficulties by wresting orders from the stable of Boeing's long-term customers, nor that Airbus planned a 30 percent production increase for 1999.

¹⁸ Banks, p. 60.

¹⁹ Frederick M. Biddle and Andy Pasztor, "Boeing May Be Hurt up to 5 Years by Asia," *Wall Street Journal*, December 3, 1998, p. A3.

Competition at the New Millennium

By 2001 the competition between Airbus and Boeing continued unabated. Airbus had gone ahead with its superjumbo, the world's largest passenger jet, now named the A380, with delivery to start in 2006 for a list price of \$239 million. In its standard configuration, it would carry 555 passengers between airport hubs. With delivery still five years away, Airbus already had orders for 72 of the jumbos and expected to reach the 100 milestone early in 2002. It would breakeven with 250 of the wide bodies.

In March 2001, Boeing scrapped plans for an updated but still smaller 747-X project. Instead it announced plans for a revolutionary delta-winged "Sonic Cruiser," carrying 150 to 250 passengers higher and faster than conventional planes. The savings in time would amount to 50 minutes from New York City to London, and almost two hours between Singapore and London. Further time savings would come from the plane flying to point-to-point destinations, bypassing layovers at such congested hubs as London and Hong Kong. Delivery was expected in 2007 or 2008.

Both companies had undergone major organizational changes. As of January 1, 2001, Airbus was no longer a four-nation consortium, but now a unit of European Aeronautic Defence & Space (EADS), an integrated company with centralized purchasing and management systems. Operations were streamlined toward bottom-line responsibilities.

Boeing had previously diversified itself away from so much dependence on commercial aircraft through its acquisitions of Rockwell's aerospace and defense business, McDonnell Douglas, Hughes Space & Communications, and several smaller companies. Boeing expected that within five years more than half its revenues would come from new business lines, including financing aircraft sales, providing high-speed Internet access, and managing air-traffic problems.²⁰

Everything Changed with 9/11

The airline industry's woes that began with 9/11 intensified in 2002. By late that year two major carriers, US Airways and United, were in bankruptcy, and other airlines—with the exception of a few discount carriers, notably Southwest and JetBlue—were experiencing horrific losses. Airlines were placing no new orders and even renegeing on accepting delivery of previously ordered planes. Boeing's jet production fell to half of what it had been a year earlier, and forecasts for 2003 and 2004 were little better.

In this environment the competition between Airbus and Boeing for winning the few customers still buying became even more fierce and was influenced almost entirely by price. The biggest prize was capturing the 120-plane order from British budget carrier, easyJet, and this customer milked its power position to the utmost, repeatedly sending Boeing and Airbus back to improve their offers.

During the aviation slump in the early 1990s, Boeing had beefed up its order backlog by selling at steep discounts—only to find itself in a serious bind in 1997

²⁰ Compiled from such sources as: David J. Lynch, "Airbus Comes of Age with A380," *USA Today* (June 21, 2001), pp. 1B, 2B; J. Lynn Lunsford, Daniel Michaels, and Andy Pasztor, "At Paris Air Show, Boeing-Airbus Duel Has New Twist," *Wall Street Journal* (June 15, 2001), p. B4.

when it could not keep up with the built-up demand, and production costs skyrocketed. Now, Boeing refused to follow Airbus into unprofitable terrain, and Airbus got the easyJet order. Though Airbus claimed it was not selling its planes at a loss, many people in the industry thought otherwise.

In late December 2002, Boeing announced it was shelving the ambitious development program for its high-speed Sonic Cruiser. In talks with potential customers to gauge interest in such a plane in this post-9/11 environment, few expressed any interest; most wanted a replacement plane that would be cheaper to operate than existing ones. So, Boeing began changing its focus to developing a new 250-seat plane that would be 20 percent cheaper to operate than existing jetliners.²¹

Boeing's Continuing Problems

The competition between Boeing and Airbus grew ever more fierce in 2003. This was to prove a watershed year as, for the first time, Airbus delivered more planes than Boeing. By selling fleets of A320 variations to low-cost carriers like JetBlue, Airbus captured 52 percent of the commercial jet market. It already had 95 orders for its A380 superjumbo jet seating 550 passengers that was expected to enter service in 2006, and this was very close to its declared goal of 100. Furthermore Airbus thought it had a chance to sell to the U.S. military. A \$23 billion deal for Boeing to supply the U.S. Air Force with 100 modified 767 jetliners for midair refueling was terminated as the company became immersed in a contract-for-job scandal that cost CEO Philip Condit his job and landed Chief Financial Officer Michael Sears in prison. Further shenanigans involved documents stolen from Lockheed, resulting in the loss of \$1 billion in space-launch contracts.

Meanwhile, Boeing announced that it would stop making its twin-engine 757 because of waning interest. It was in preliminary planning for a new model, called the 7E7, a long-range jet that would seat 200–250 and be 20 percent cheaper to own and operate than other planes. This could enter service around 2008. Boeing had not had a new model since 1995, and badly needed a success with the new plane. The company suffered serious setbacks elsewhere. It had to take write-offs on its slow-selling single-aisle 717, and also had written off \$2.4 billion of its commercial satellite and launch business.

But Boeing achieved profitability by revamping assembly lines, contracting out fabrication of parts, and laying off 32,000 workers since 9/11. Union leaders claimed the result was an aging skilled workforce and rock-bottom morale.²²

²¹ Sources: J. Lynn Lunsford, "Boeing to Drop Sonic Cruiser, Build Plane Cheaper to Operate," *Wall Street Journal*, December 19, 2002, p. B4; Daniel Michaels and J. Lynn Lunsford, "Airbus is Awarded easyJet Order for 120 New Planes Over Boeing," *Wall Street Journal*, October 15, 2002, pp. A3 and A6; and Scott McCartney and J. Lynn Lunsford, "Skies Darken for Boeing, AMR and UAL as Aviation Woes Grow," *Wall Street Journal*, October 17, 2002, pp. A1 and A9.

²² J. Lynn Lunsford, "Boeing, Losing Ground to Airbus, Faces Key Choice," *Wall Street Journal*, April 21, 2003, pp. A1, A8; J. Lynn Lunsford, "Boeing May Risk Building New Jet," *Wall Street Journal*, October 15, 2003, pp. A1, A13; and Daniel Michaels, "Airbus Sees Military-Sales Opening," *Wall Street Journal*, September 15, 2003, p. A8.

In early 2004, Airbus captured a \$7 billion, 110-plane order from Air Berlin, a discount airline that was Germany's No. 2 carrier. What made the situation all the more galling for Boeing was that Air Berlin had always flown Boeing 737s. A debate brewed among executives and customers over why the once dominant Boeing was losing order after order.

Stonecipher blamed the company's sales force for not doing a better job of nurturing relationships. But some in the industry blamed Boeing's failures on poor pricing strategy, an unwillingness to bend, a distorted notion that quality was still more important to airlines than price—all this at a time when airlines were struggling mightily to reduce costs.

Compounding the situation, Boeing was trying to gain commitments for its new 7E7 widebody, soon to be renamed a 787 Dreamliner. Airbus was countering with its A350, which would be derived from its current A330 model. While Japan Airlines late in 2004 agreed to order 30 787s from Boeing and take options for 20 more, this brought total orders and commitments for the plane to 112, but this was still well short of the goal of 200 by the end of 2004.

Boeing continued to attribute Airbus's success in the marketplace as due to billions of dollars of European subsidies that allowed it to underbid Boeing. Airbus maintained its success was planes that could be built more quickly and cheaply than Boeing's.²³

In December 2004, Boeing had one source of satisfaction. Airbus disclosed that its flagship A380 superjumbo jetliner had cost overruns approaching \$2 billion or about 12 percent in excess of the plane's original budget. The first flight of the huge A380 was expected in March 2005. Airbus saw no problem with this budget overage, and said it will have "no impact on the overall profitability of the program."²⁴

Harry Stonecipher had been brought back from retirement at Boeing in early 2004 to try to repair relationships with Washington that were damaged by legal and ethics standards involving some Boeing employees, following a string of scandals at Boeing, mostly involving conflicts of interest on government interactions. For example, Boeing's finance chief improperly engaged in employment talks with an Air Force procurement official while she had authority over billions of dollars worth of Boeing contracts. Stonecipher helped draft a code of conduct that prohibited any behavior that might embarrass the company. Alas, after 15 months, Stonecipher himself was dismissed for unethical conduct after directors learned about an extramarital affair that violated this very code of conduct.²⁵

The Tide Turns for Boeing

In 2005, Jim McNerney, 56 years old, became the third top executive at Boeing in three years. He was the former head of 3M Corp., and General Electric's jet engine

²³ Compiled from J. Lynn Lunsford, "Behind Slide in Boeing Orders: Weak Sales Team or Firm Prices?" *Wall Street Journal*, December 23, 2004, pp. A1 and A6; Daniel Michaels, "Airbus Firms Up Plans for a New Jet," *Wall Street Journal*, September 30, 2004, p. A3.

²⁴ David Gauthier-Villars, Pierre Briancon and Daniel Michaels, "Airbus Discloses Cost Overruns on Big A380 Jet," *Wall Street Journal*, December 16, 2004, pp. A3 and A10.

²⁵ Carol Hymowitz, "The Perils of Picking CEOs," *Wall Street Journal*, March 15, 2005, pp. B1 and B4.

division. While many people expected him to take immediate and drastic actions, he spent months of what he called “deep dives” to learn as much as possible about Boeing’s massive commercial airplanes and defense unit. In January 2006 he presented an agenda to “help Boeing lose the baggage of its rocky past while using its size and intellectual talent to produce better financial results.”²⁶

The year 2006 was to see a monumental swing in the two competitors’ fortunes. Boeing’s new 787 Dreamliner was proving a real winner with orders surging, even though delivery would not be until 2008. This was no ordinary plane. With its plastic fuselage, it was a sleek aircraft that would carry 250 to 330 people, cruise near the speed of sound (650 mph), have a range of over 10,000 miles, and according to Boeing, would cut fuel bills by 20 percent and maintenance costs 30 percent. No one had ever built a commercial airplane with a plastic fuselage (actually, it was carbon fiber embedded in epoxy). As a further production innovation, for the first time Boeing was *outsourcing* more than half the parts of the plane to be manufactured in six different countries. The projected \$130 million cost per plane was modest compared with the alternatives, and especially Airbus’s superjumbo A380, now projected to cost about \$300 million.

Airbus faltered in 2006 as the A380 experienced further delivery delays. These were already costing the company at least \$2.5 billion over the \$12 billion originally planned; the cost of fines, canceled orders, and lost future orders were additional. The blow to prestige might be even greater. Rising fuel prices and a recent trend toward long-haul flights that avoided busy hub airports cast doubt on the whole A380 decision of a huge plane designed to fly between major hub airports. Boeing’s new 787 and 777 models were marketed as more comfortable and more efficient. Shares of Airbus’s parent company, EADS, fell sharply and forced the departure of Noel Forgeard and his colleague, Gustav Humbert, on July 2, 2006. Mr. Forgeard was criticized for selling some of his EADS shares a few months before the profit warning, but denied accusations of insider trading.²⁷

Going into the last quarter of 2006, Airbus’s production problems became a crisis situation, and talk was of shifting more work to other nations as well as other restructuring efforts. Airline executives publicly complained about their inability to plan schedules and related investments due to the uncertainty about A380 delivery. On top of this, European and U.S. aviation regulators determined that the A380’s powerful wake required changes in air-traffic-control rules. These new requirements could increase congestion at some large airports and reduce the attractiveness of operating the A380. The giant plane on which Airbus was staking so much was assuming the stance of an albatross.²⁸

²⁶ J. Lynn Lunsford, “Piloting Boeing’s New Course,” *Wall Street Journal*, June 13, 2006, pp. B1 and B3.

²⁷ Compiled from a number of sources, such as Mark Tatge, “Global Gamble,” *Forbes*, April 17, 2006, pp. 78–82; J. Lynn Lunsford and Daniel Michaels, “Bet on Huge Plane Trips Up Airbus,” *Wall Street Journal*, June 15, 2006, pp. A1 and A11; J. Lynn Lunsford, “Piloting Boeing’s New Course,” *Wall Street Journal*, June 13, 2006, pp. B1 and B3; Daniel Michaels, “Airbus Problems Lead to Ouster of Key Executives,” *Wall Street Journal*, July 3, 2006, pp. A1 and A2.

²⁸ Simon Clow and Daniel Michaels, “Airbus Work May Move Elsewhere as a Broad Revamp Is Considered,” *Wall Street Journal*, September 29, 2006, p. A10.

Problems in 2007—2008

Boeing

On July 9, 2007, the company unveiled its first fully assembled Dreamliner to an audience of thousands. It had rolled out the red carpet and set out 15,000 seats for spectators at one end of the 787 factory north of Seattle. Tom Brokaw served as master of ceremonies, and the premiere was broadcast live on the Internet and on satellite television in nine languages to more than 45 countries. More thousands of employees and retirees watched via satellite at the NFL stadium where the Seattle Seahawks play, and Boeing also hosted viewing parties for customers and suppliers around the world.

The plane was already a huge hit with airlines, with 762 orders from 52 carriers by the end of December 2007. This would sell out delivery positions through 2015. It was the first all-new jet since 1995 and the 777. Made mostly of carbon-fiber composites, it was lighter, more durable, and less prone to corrosion than aluminum. As such, this midsize, long-range jet would burn less fuel, be cheaper to maintain, and offer more passenger comforts than any comparable plane. No wonder carriers were beating down the door to place orders.

Unfortunately, the plane these tens of thousands of people came to see on July 9, this prototype, was missing tens of thousands of parts. As the guests strolled around the plane, few realized that more than 1,000 temporary fasteners were embedded under its shiny coat of Boeing blue and white paint. When boxes and crates for the fuselage section had been opened, workers found them filled with thousands of brackets, clips, wires, and other components that should have been installed. Many of these had no paperwork at all, or had instructions written in Italian. In no way was the Dreamliner going to meet its delivery schedule.

Global Outsourcing

The mess was the result of global outsourcing. It had seemed so cost effective to authorize a team of parts suppliers from around the world to design and build major sections of the plane, and then bring all these disparate sections to the Seattle plant to be snapped together. This would be the extreme use of outsourcing and would represent a manufacturing innovation of no small moment. But many of these carefully selected suppliers, instead of using their own engineers to do the design work, farmed this out to smaller companies. The result was that many of the items failed to conform to a rigid set of engineering tolerances. Efforts to correct the situations were hampered by the distances and language problems. Sometimes suppliers' underlying problems were worse than expected; maybe the schedule was just too ambitious.

As of December 2007, the Dreamliner was at least six months behind schedule, and the goal of delivering 109 planes by the end of 2009 seemed an illusion. Instead of being well into flight tests, Boeing's primary efforts had to be helping suppliers around the world bring their factories up to speed. Delays would be costly, since the company could face millions of dollars in penalty payments to customers. Some of the airlines had counted on using their planes during the 2008 Summer Olympics.

INFORMATION BOX

BOEING IN 2008 LOSES A HUGE AIR FORCE CONTRACT

One of the largest military purchases in history was on the line. The Air Force was seeking bids on a \$40 billion initial contract to build aerial refueling aircraft (tankers). If successful, this contract could grow to \$100 billion, with 179 jets at stake, and eventually replacing the entire fleet of 600 aging tankers over 30 years. Boeing, the pride of American aerospace, was the heavy favorite to win the contract, having built earlier tankers. But the parent of Airbus, EADS, won out. How could this have happened?

Eager to enter the American defense market, Airbus built a \$100 million state-of-the-art refueling boom on spec and tested it to complete satisfaction. It proposed a tanker from a refitted A330 jetliner that could carry more fuel than Boeing's proposal of a modified 767. It also offered more flexibility for carrying cargo, troops, refugees, and providing humanitarian aid.

Boeing did not even build a prototype boom, and offered a plan that would deliver 19 tankers by 2013, compared with 49 by the Airbus team. In addition, rumors surfaced of Boeing's arrogance and unresponsiveness. "Somehow that all eluded senior management. They were not even aware there was a problem."

In an election year, criticism abounded for this Air Force decision. But the debate that too many jobs would be lost overseas was spurious since large manufacturing projects today typically involved worldwide suppliers, as Boeing had led the way with its Dreamliner. Still, Boeing rushed ahead to file a formal protest for a review of the decision.

How could Boeing's loss have been avoided?

Can you raise some other arguments why the Air-Force decision should be reversed?

Sources: Adapted from David Herszenhorn and Jeff Bailey, "In Tanker Bid, It Was Boeing vs. Bold Ideas," *New York Times*, March 10, 2008, pp. A1 and A14.; and August Cole and J. Lynn Lumsford, "Boeing to Protest Air-Force Tanker Award," *Wall Street Journal*, March 11, 2008, p. A3.

Boeing faced a major disappointment in early 2008, as it pursued another Air Force contract for tanker planes (remember, it lost a previous contract because of unethical practices). See the preceding Information Box, Boeing loses a huge contract.

Airbus

On October 15, 2007, Airbus delivered its first A380 jet, the world's biggest passenger jet, to Singapore Airlines. It was almost two years behind schedule and \$6.8 billion over budget. In the process, communication failures and conflicts between the company's French and German operations brought on a full-fledged crisis. As a result, the company sold fewer new planes in 2006 than Boeing for the first time in some years. Problems surfaced in early 2005 as the first A380 began test flights. These trial runs identified needed changes to the design, often requiring wiring alterations. While test flights usually uncover problems needing fine-tuning, these were more complex

What Would You Do?

Since 2005, sales have been robust for both Boeing and Airbus with their various planes. In early January 2008, their combined orders were for nearly 7,000 planes, valued at more than \$750 billion before discounts. As the world moved toward a recession due to the mortgage crisis, they faced several tough questions: Have their customers ordered more planes than they could afford? How many will renege or even go out of business before the planes can be made, perhaps years in the future? (For example, the Dreamliner is booked up until 2014.) How much should production facilities be expanded to handle this increased volume?

The uncertainty was confounded by the credit crunch, record fuel prices, a weak dollar, and an uncertain economy. Adding to the concern was that many of the recent orders were placed by new carriers and leasing companies not even in business a few years before, or else came from countries like China and India where air travel was surging now but where demand might not hold up.

What would you do about production if you were the decision maker at Boeing and Airbus?

Source: J. Lynn Lunsford and Daniel Michaels, "As Orders Soar, Flight Check Begins," *Wall Street Journal*, January 11, 2008, p. A7.

for the A380 than for any plane built before. Some 20 planes that were sitting, almost complete, now had to undergo expensive and time-consuming alterations. The fact that these problems were so prevalent reflected cultural tensions at the company's highest echelons. Top French managers publicly blamed the Germans, while the Germans blamed French managers for the organizational mess.

At last, with the delivery of the first A380 to Singapore Airlines, Airbus planned to deliver 13 more in 2008. Ambitious goals called for delivering almost four each month by 2010. To add further incentive, British Airways ordered 12 A380s.

Airbus was fully aware of Boeing's great success in garnering orders for its 787 Dreamliner, and was working hard to counter this with its A350, a new midsize long-haul jetliner. It had started on the A350 in 2004, but had to send plans back to the drawing board three times. Airlines wanted it to be faster and more fuel efficient. It was now five years behind Boeing's Dreamliner, and had booked only 13 orders compared with Boeing's almost 800 orders. Airbus had planned to use the same model for global outsourcing that Boeing did with the Dreamliner. Lessons that Boeing was learning the hard way could possibly help Airbus.²⁹

²⁹ Compiled from Elizabeth M. Gillespie, "Boeing Rolls Out First 787 Dreamliner," *Cleveland Plain Dealer*, July 9, 2007, p. A8; J. Lynn L. Lunsford, "Boeing Scrambles to Repair Problems with New Plane," *Wall Street Journal*, December 7, 2007, pp. A1 and A13; Daniel Michaels, "Airbus, Amid Turmoil, Revives Troubled Plane," *Wall Street Journal*, October 15, 2007, pp. A1 and A19; Daniel Michaels and J. Lynn Lunsford, "Airbus Faces Wide Gap in A350 Orders," *Wall Street Journal*, June 13, 2007, p. June 13, 2007.

WHAT WE CAN LEARN

Beware the “King-of-the-Hill” Three-Cs Mindset

Firms that have been well entrenched in their industry and that have dominated for years tend to fall into a particular mindset that leaves them vulnerable to aggressive and innovative competitors. These “three Cs” are detrimental to a frontrunner’s continued success:

- Complacency
- Conservatism
- Conceit

Complacency is smugness—a complacent firm is self-satisfied, content with the status quo, no longer hungry and eager for innovative growth. *Conservatism*, when excessive, characterizes a management that is wedded to the past, to the traditional. Conservative managers see no need to change because they believe nothing is different today (e.g., “Our 747 jumbo jet is the largest that can be profitably used”). Finally, *conceit* further reinforces the myopia of the mindset: conceit regarding current and potential competitors. The beliefs that “we are the best” and “no one can touch us” can easily permeate an organization that has dominated its industry for years. Usually the three Cs insidiously move in at the highest levels and readily filter down to the rest of the organization.

Stonecipher, former CEO of McDonnell Douglas and then president of Boeing, admitted to company self-confidence bordering on arrogance. The struggle with Airbus should have destroyed any vestiges of the three Cs mindset.

Arrogance in an Organization Should Not Be Tolerated

We dealt with this first in the Google case. Now we have it again in a mature organization, but one that has had its moments of greatness. Arrogance is a symptom of conceit, but one that is not easily concealed. In at least two instances it was visible enough to be commented on. When Harry Stonecipher, CEO of McDonnell Douglas, came to Boeing, he saw this as the mindset behind Boeing’s problems in the 1990s. And it may have been a major factor in quashing the Air Force decision to give the huge tanker bid to Airbus. This attitude must be curbed, it must not be allowed to surface in the various interactions with employees and the various publics.

Growth Must Be Manageable

Boeing certainly demonstrated the fallacy of attempting growth beyond immediate capabilities in a growth-at-any-cost mindset. The rationale for embracing great growth is that firms “need to run with the ball” if they ever get that rare opportunity to suddenly double or triple sales. But there are times when a slower, more controlled growth is prudent.

Risks lie on both sides as businesses reach for these opportunities. When a market begins to boom and a firm is unable to keep up with demand without greatly increasing capacity and resources, it faces a dilemma: (1) Stay conservative in fear that the opportunity will be short lived, but thereby abdicate some of the growing market to competitors, or (2) Expand vigorously to take full advantage of the opportunity, but risk being overextended and vulnerable should the potential suddenly fade. Regardless of the commitment to great growth, a firm must develop an organization and systems and controls to handle it, or find itself in the same morass as Boeing, with quality control problems, inability to meet production targets, alienated customers, costs far out of line, and not the least, having its stock price savaged by Wall Street investors while its market share tumbles. Growth must not be beyond the firm's ability to manage it.

Downsizing Has Its Perils

Boeing presents a sobering example of the risks of downsizing in this era when downsizing is so much in fashion. With incredibly bad timing, Boeing encouraged many of its most experienced and skilled workers and supervisors to take early retirement, just a few years before the boom began. Boeing found out the hard way that it could replace bodies, but not the skills needed to produce the highly complex planes under severe deadlines for output. The company would have been better off maintaining a core of experienced workers during the downturn rather than lose them forever. It would have been better suffering higher labor costs during the lean times and disregarding management's typical attitude of paring costs to the bone during such times. Yet, when we look at Table 7.1 and see the severe decreases of revenue and income in 1993, 1994, and lasting well into 1995, we can understand the mindset of Boeing's management.

Problems of Competing Entirely on Price

Price competition almost invariably leads to price-cutting and even price wars to win market share. In such an environment, the lowest-cost, most efficient producer wins.

More often, all firms in an industry have rather similar cost structures, and severe price competition hurts the profits of all competitors without bringing much additional business. Any initial pricing advantage is quickly matched by competitors unwilling to lose market share. In this situation, competing on non-price bases has much to recommend it. Nonprice competition emphasizes uniqueness, perhaps in some aspects of product features and quality, perhaps through service and quicker deliveries, or maybe better quality control. A firm's reputation, if good, is a powerful nonprice advantage.

Usually, new and rapidly growing industries face price competition as marginal firms are weeded out and more economies of operation are developed. The more mature an industry, the greater likelihood of nonprice competition since cutthroat pricing causes too much hardship to all competitors.

Certainly the commercial aircraft industry is mature, and much has been made of airlines being chiefly interested in how much passenger-carrying capacity they can buy for the same buck, and of their pitting Airbus and Boeing against each other in bidding wars.³⁰ Nonprice competition badly needed to be reinstated in this industry. At that point, Airbus appeared to be doing a better job of finding uniqueness, with its passenger-friendly planes and its charting new horizons with the superjumbo. But the pendulum of uniqueness had swung to Boeing by 2006.

The Synergy of Mergers and Acquisitions Is Suspect

The concept of synergy says that a new whole is better than the sum of its parts. In other words, a well-planned merger or acquisition should result in a better enterprise than the two separate entities. Theoretically, this seems possible with operations streamlined for more efficiency, and greater management and staff competence is achieved as more financial and other resources are tapped—or in Boeing's case, if the peaks and valleys of commercial demand are countered by defense and space business.

Unfortunately, as we will see in other cases, such synergy often is absent, at least in the short and intermediate term. More often such concentrations incur severe digestive problems—problems with people, systems, and procedures—that take time to resolve. Furthermore, greater size does not always beget economies of scale. The opposite may in fact occur: an unwieldy organization, slow to act, and vulnerable to more aggressive, innovative, and agile smaller competitors. The siren call of synergy is often an illusion.

The assimilation of the McDonnell Douglas and Rockwell acquisitions came at a most troubling time for Boeing. The Long Beach plant of McDonnell Douglas alone led to a massive \$1.4 billion write-off, and contributed significantly to the losses of 1997. Less easily calculated, but certainly a factor, was the management time involved in coping with these new entities.

CONSIDER

Can you think of additional learning insights?

QUESTIONS

1. Do you think Boeing should have anticipated the impact of Asian economic difficulties long before it did?
2. If it had more quickly anticipated the drying up of the Asian market for planes, could Boeing have prevented most of the problems that confronted it? Discuss.

³⁰ e.g., Banks, p. 54.

3. Do you think top management at Boeing should have been fired after the disastrous miscalculations in the late 1990s? Why or why not?
4. A major stockholder grumbles, “Management worries too much about Airbus, and to hell with the stockholders.” Evaluate this statement. Do you think it is valid?
5. Do you think that at this point, 2008, the superjumbo A380 should be abandoned? Defend your recommendation.
6. Do you think Stonecipher should have been fired for having an affair with an employee? Why or why not?
7. Discuss synergy in mergers. Why does synergy so often seem to be lacking despite expectations?
8. You are a skilled machinist for Boeing and have always been quite proud of participating in the building of giant planes. You have just received notice of another lengthy layoff, the second in five years. Discuss your likely attitudes and actions.
9. How wise do you think it was for Airbus to “bet the company” on the super-jumbo A380, the world’s largest jet?
10. Do you think Airbus’s more passenger-friendly planes gave it a significant competitive advantage? Why or why not? Discuss as many aspects of this as you can.
11. How can arrogance in an organization be combatted?

HANDS-ON EXERCISES

Before

1. You are a management consultant advising top management at Boeing. It is 1993 and the airline industry is in a slump, but early indications are that things will improve greatly in a few years. What would you advise that might have prevented the problems Boeing faced a few years later? Be as specific as you can, and support your recommendations as to practicality and probable effectiveness.

After

2. It is late 1998, and Boeing has had to announce drastic cutbacks, with little improvement likely before five years, and Boeing’s stock has collapsed and Airbus is charging ahead. What do you recommend now? (You may need to make some assumptions; if so, state them clearly and keep them reasonable.)
3. It is 2005, and you have been brought in as vice president of sales. What do you propose to counter the aggressive and successful efforts of Airbus to win customers?

4. *Be a Devil's Advocate.* You are a union leader, and the 32,000 layoffs after 9/11 appall you. Array all the arguments you can muster for Boeing to reconsider such massive layoffs. Be as persuasive as you can.

TEAM DEBATE EXERCISES

1. A business columnist writes: Boeing could “have told customers ‘no thanks’ to more orders than its factories could handle . . . [It] could have done itself a huge favor by simply building fewer planes and charging more for them.” (Holman W. Jenkins Jr., “Boeing’s Trouble: Not Enough Monopolistic Arrogance,” *Wall Street Journal*, December 16, 1998, p. A23.) Debate the merits of this suggestion.
2. Debate the controversy of Airbus Chairman Forgeard’s decision to go for broke with the A3XX superjumbo. Is the risk/reward probability worth such a mighty commitment? Debate as many pros and cons as you can, and also consider how much each should be weighted or given priority consideration. (Do not consider what actually happened in 2006. You are not prescient at the time of the decision.)

INVITATION TO RESEARCH

What is the situation with Boeing today? Has it remained profitable? How is the competitive position with Airbus?

What is the situation with the A380 superjumbo of Airbus? Has it been abandoned?

What is the situation with the 787 Dreamliner? Is it meeting all expectations, or have unexpected engineering problems assailed it?

Did Boeing succeed in getting the Air Force tanker contract with Airbus rescinded?

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**PART
THREE**

COMEBACKS

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McDonald's Rebirth Through Moderation

Few business firms anywhere in the world have been able to match the sustained growth of McDonald's. Initially, it grew with one simple product, a hamburger, and while it has broadened its product mix today, it still remains uniquely undiversified. The foundation for the success had always been the most rigid standards and controls to be found anywhere. McDonald's insisted these be adhered to by all outlets, company-owned as well as franchised, and therein was an enduring marketing strategy.

For decades, no competitor could match McDonald's unique standards of quality, service, and cleanliness. In recent years, however, these standards and controls had slipped, while competitors countered its former advantage and became ever more aggressive. The ball game had changed, and McDonald's was struggling to keep the growth mode. One McDonald's CEO went on a new-store binge, but these new stores often cannibalized older outlets to franchisees' consternation; another CEO embarked on a crusade to acquire other fast-food restaurants, but these proved a drain on profits. Then Jim Cantalupo took the company back to basics, and the company's fortunes turned around.

An ill wind now seemed to beset McDonald's. Cantalupo, 60, the savior, died suddenly of a heart attack. His successor was diagnosed with colon cancer shortly after taking office.

THE McDONALD'S GROWTH MACHINE

When Ray Kroc took over the embryonic McDonald's, it took the company only 17 years to reach the billion dollar milestone. It gave him great satisfaction to think that IBM had needed 40 years to do this. He had laid the foundation for great growth; by 1972 the number of outlets had climbed to 2,272 and sales were accelerating beyond \$1 billion.

In its 1995 *Annual Report*, McDonald's management was justifiably proud. Sales and profits had continued the long trend upward, and even seemed to be accelerating. Far from reaching a saturation point, the firm was opening more restaurants than ever, some 2,400 around the world in 1995, up from 1,800 the year

before. "We plan to add between 2,500 and 3,200 restaurants in both 1996 and 1997, with about two thirds outside the United States. In other words, we opened more than six restaurants per day in 1995; over the next two years, we plan to open eight a day."¹ And, "Our growth opportunities remain significant: on any given day, 99 percent of the world's population does not eat at McDonald's . . . yet."²

Company management extolled the power of the McDonald's brand overseas, and how on opening days lines were sometimes "miles" long. "Often our challenge is to keep up with demand. In China, for example, there are only 62 McDonald's to serve a population of 1.2 billion."³ By the end of 1995, the company had 7,012 outlets in 89 countries of the world, with Japan alone having 1,482.

Growth Prospects in the United States

In 1995, with 11,368 of its restaurants in the United States, wasn't McDonald's reaching saturation in its domestic market? Top management vehemently disputed this conclusion. Rather, it offered a startling statistical phenomenon to support accelerating expansion. Called "Greenberg's Law," after newly appointed McDonald's U.S. chairman Jack Greenberg, it maintained that the more stores McDonald's put in a city the more per-capita transactions would result. Thus, with two stores in a city there might be 16 transactions per capita per year. Add two or four more stores and the transactions will not only double, or quadruple, but may even do better than that. The hypothesized explanation for this amazing phenomenon seemingly rested on two factors: convenience and market share. With more outlets, McDonald's increased its convenience to consumers and added to its market share at the expense of competitors; hence, the justification for the expansion binge.

Aiding this domestic expansion, the company had been able to reduce the cost of building a new U.S. traditional restaurant by 26 percent through standardizing building materials and equipment and global sourcing, as well as improving construction methods and building designs. It had also found abundant market opportunities in satellite restaurants. These were smaller, had lower sales volume, and served simplified menus. This format proved cost efficient in such nontraditional places as zoos, hospitals, airports, museums, and military bases as well as in retail stores such as Wal-Mart, The Home Depot, and other major stores. For example, such satellite restaurants were in some 800 Wal-Mart stores by the end of 1995, with more planned. In October 1996 a McDonald's Express opened in an office building in Lansing, Michigan, a harbinger of more such sites to come.

In its eager search for more outlets, McDonald's did something it had never done before. It took over stores from weak competitors. In late summer 1996, it bought 184 company-owned Roy Rogers outlets. "Here was an opportunity that was maybe once in a lifetime," Greenberg stated.⁴ Earlier the same year, it acquired Burghy's,

¹ *McDonald's 1995 Annual Report*, p. 8.

² *Ibid.* p. 7.

³ *Ibid.*

⁴ Gary Samuels, "Golden Arches Galore," *Forbes*, November 4, 1996, p. 48.

an 80-store fast-food chain in Italy. And in New Zealand, it added 17 restaurants from the Georgie Pie chain.

The new stores being opened were seldom like the old ones. The drive-through windows generated 55 percent of U.S. sales and made fewer seats needed inside. This left more space available for indoor playgrounds—"Ronald's Playplaces"—to attract families. McDonald's made joint ventures with Chevron and Amoco to co-develop properties. It also signed an exclusive marketing deal with Disney for promoting each other's brands.

McDonald's had always been a big spender for advertising, and this had been effective. Even back in the 1970s, a survey of school children found 96 percent identifying Ronald McDonald, ranking him second only to Santa Claus.⁵ In 1995, advertising and promotional expenditures totaled \$1.8 billion, or 6 percent of sales.⁶

Factors in the Invincibility of McDonald's

Through the third quarter of 1996, McDonald's could proudly claim 126 consecutive quarters of record earnings. Since its earliest days, the ingredients of success were simple, but few competitors were able to effectively emulate them. The basic aspects were:

- A brief but consistent high-quality menu over thousands of outlets.
- Strictly enforced and rigorous operational standards controlling service, cleanliness, and all other aspects of the operation.
- Friendly employees, despite a high turnover of personnel because of the monotony of automated food handling.
- Heavy mass media advertising directed mostly at families and children.
- Identification of a fertile target market—the family—and directing the marketing strategy to satisfying it with product, price, promotional efforts, and site locations (at least in the early years this meant the suburban locations with their high density of families).

However, by the end of 1996, international operations were the real vehicle of growth, providing 47 percent of the company's sales and 54 percent of profits. Of no small concern, the domestic operation had not blossomed accordingly.

STORM CLOUDS FOR THE DOMESTIC OPERATION

Souring Franchisee Relations

In the market-share game, in which McDonald's dominated all its competitors, corporate management concluded that the firm with the most outlets in a given community wins. But as McDonald's unprecedented expansion continued, many

⁵ "The Burger That Conquered the Country," *Time*, September 17, 1973, pp. 84–92.

⁶ *McDonald's 1995 Annual Report*, p. 9.

franchisees were skeptical of headquarters' claim that no one loses when the company opens more outlets in a community since market share rises proportionately. Still, the franchise holder wondered how much his sales would diminish when another McDonald's opened down the street.

The 7,000-member American Franchisee Association, an organization formed to look after franchisees' rights, claimed that McDonald's operators were joining in record numbers.⁷ Other franchisees formed a clandestine group called the Consortium, representing dissidents who felt present management was unresponsive to their concerns. They remembered a kinder and gentler company. See the following Information Box for contrasting franchisee views on the high-growth market-share policy.

Other concerns of franchisees were a new set of business practices developed by corporate headquarters, known as Franchising 2000. The company claimed it

INFORMATION BOX

THE CONTENTMENT OF TWO McDONALD'S FRANCHISEES

In 1980 Wayne Kilburn and his wife, Mary Jane, took over the only McDonald's in Ridgecrest, California, a town of 26,000. The Kilburns prospered in the years to come. Then McDonald's instituted its "market-share plan" for Ridgecrest. Late in 1995 it put a company-owned restaurant inside the Wal-Mart. A few months later it built another outlet inside the China Lake Naval Weapons Center. A third company-owned store went up just outside the naval base. "Basically, they killed me," *Forbes* reported Kilburn saying. And he claimed his volume dropped 30 percent.⁸

In its 1995 *Annual Report*, corporate headquarters offered another view concerning franchisee contentment. Tom Wolf was a McDonald's franchisee with 15 restaurants in the Huntington, West Virginia and Ashland, Kentucky markets. He opened his first McDonald's in 1974, had eight by the end of 1993, and opened seven more in the next two years, including two McDonald's in Wal-Mart stores and another in an alliance with an oil company; in addition he added indoor Playplaces to two existing restaurants.

Has all this investment in growth made a difference? The *Annual Report* quotes Tom: "I wouldn't change a thing. Sales are up. I'm serving more customers, my market share is up and I'm confident about the future. Customers say that the Playplaces and Wal-Mart units are 'a great idea.' The business is out there. We've got to take these opportunities now, or leave them for someone else to take."⁹

"The high-growth, market-share policy should not bother any franchisee. It simply creates opportunities to invest in more restaurants." Evaluate this statement.

⁸ Samuels, p. 48.

⁹ *McDonald's 1995 Annual Report*, p. 32.

⁷ Richard Gibson, "Some Franchisees Say Moves by McDonald's Hurt Their Operations," *Wall Street Journal*, April 17, 1996, pp. A1 and A8.

instituted this as a way to improve standards for quality, service, cleanliness, and value by giving franchisees better “tools.” But some saw this as a blatant attempt to gain more power over the franchised operations. One provision revived a controversial A, B, C, and F grading system, with only franchisees who received A’s and B’s eligible for more restaurants. Furthermore, McDonald’s began using Franchising 2000 to enforce a single pricing strategy throughout the chain, so that a Big Mac, for example, would cost the same everywhere. The corporation maintained that such uniformity was necessary for the discounting needed to build market share. Those not complying risked losing their franchise. Franchisee relations should not be a matter of small concern to McDonald’s. Some 85 percent of restaurants were franchised as of 2007.

Menu Problems

In 1993 domestic per-store sales were increasing at a 4 percent annual rate. By the third quarter of 1996, sales had slumped to a 3 percent decrease, this being the fifth quarter in a row of declining sales. In part this decline was thought to be attributable to older customers drifting away: “Huge numbers of baby-boomers . . . want less of the cheap, fattening foods at places like McDonald’s. As soon as their kids are old enough, they go elsewhere.”¹⁰

In an attempt to win more business from this customer segment, McDonald’s with a \$200 million promotional blitz launched its first “grownup taste” sandwich, the Arch Deluxe line of beef, fish, and chicken burgers. It forecast that this would become a \$1 billion brand in only its first year. But before long, some were calling this a McFlop. In September 1996, Edward Rensi, head of U.S. operations, tried to minimize the stake in the new sandwich, and sent a memo to 2,700 concerned franchisees, “the Arch Deluxe was never intended to be a silver bullet.”¹¹ On October 8, Rensi was replaced by Jack Greenberg.

McDonald’s domestic troubles were not entirely new. As far back as the late 1980s, competitors, including Pizza Hut and Taco Bell, were nibbling at McDonald’s market share, and Burger King was more than holding its own. Even the great traditional strength of McDonald’s of unsurpassed controlled standards over food, service, and cleanliness seemed to be waning: A 1995 *Restaurants and Institutions Choice in Chains* survey of 2,849 adults gave McDonald’s low marks on food quality, value, service, and cleanliness. Top honors instead went to Wendy’s.¹²

In 1991 McDonald’s reluctantly tried discounting, with “Extra Value Meals,” largely to keep up with Taco Bell’s value pricing. But by 1995, price promotions were no longer attracting customers, and per-store sales began slumping. The new, adult-oriented Deluxe line was not only aimed at older adults, but with its prices 20 percent more than regular items, it had been expected to parry the discounting.

The company previously had problems in expanding its menu beyond the breakfast menu. The McDLT was notably unsuccessful despite heavy promotion. Later, the low-fat McLean, an effort to attract weight-conscious adults, was a complete disaster. In fact, this beef-and-seaweed concoction sold so badly that some

¹⁰ Shelly Branch, “McDonald’s Strikes Out with Grownups,” *Fortune*, November 11, 1996, p. 158.

¹¹ *Ibid.*

¹² *Ibid.*

operators kept only a few frozen patties on hand, while others, as revealed in an embarrassing TV exposé, sold fully fattened burgers in McLean boxes to the few customers asking for them.

Some years before, the company had tried but failed to develop an acceptable pizza product. It also was unable to create a dinner menu that would attract evening-hour traffic. Two other experiments were also abandoned: a 1950s-style café and a family-type concept called Hearth Express that served chicken, ham, and meatloaf.

THE SITUATION IN THE NEW MILLENNIUM

Jack Greenberg was promoted to CEO of McDonald's in August 1998, and then to chairman of the board in May 1999. There was hope that he would improve the alienation felt by many franchisees. He quickly began diversifying within the fast-food industry, buying Donatos Pizza, a Midwestern chain of 143 restaurants, proclaiming: "We would like to make this a growth opportunity for our franchisees."¹³ Imitating some of its competitors, particularly Wendy's, McDonald's also installed a new cooking system to deliver sandwiches to order, "Made for You," which meant fresher with less waste compared with the old system of holding bins. "You don't grow this business by having clean washrooms," Greenberg said. "We will grow this business through food."¹⁴

Despite Greenberg's leadership, McDonald's domestic operations continued to falter. By 2001 it was averaging only 1 percent same-store sales growth, far behind the 4 percent average of Burger King and Wendy. After 44 years as one of America's premier growth companies, market saturation seemed imminent. The main reason was thought to be a stale menu, but this was hardly a new insight.

Of perhaps just as much concern was the deterioration of the stringent controls that for decades had marked McDonald's as the paragon among all firms. A 2001 University of Michigan study on customer satisfaction showed that conditions had worsened from the 1995 survey that had given it low marks on food, service, and cleanliness. This 2001 study also ranked McDonald's among the poorest-performing fast-food chains, with 11 percent of customers dissatisfied because of slow service, wrong orders, dirty stores, and rude and uncaring employees. Estimates were that unhappy customers could mean an average of \$60,000 in lost sales per year per store. In efforts to improve customer satisfaction, "customer recovery teams" were planned, along with better education of store managers and franchisees in handling complaints.¹⁵

Undoubtedly such problems reflected the difficulty many businesses were having in hiring good help in the low unemployment of the late 1990s. But other fast-food chains were doing better in this regard than McDonald's. In recognition of franchisee

¹³ James P. Miller and Richard Gibson, "Did Somebody Say Pizza?" *Wall Street Journal*, May 1, 1999, p. A4.

¹⁴ Kevin Helliker and Richard Gibson, "The New Chief Is Ordering Up Changes at McDonald's," *Wall Street Journal*, August 24, 1998, p. B4.

¹⁵ Richard Gibson, Dow Jones News, as reported in "McDonald's Leaders Finding Rudeness, Slowness Are Costing Company Business," *Cleveland Plain Dealer*, July 16, 2001, p. C6.

complaints, Greenberg threw out the *Franchise 2000* rulebook with its 80 pages of onerous regulations and gave franchisees more say in their local menus.

The frenetic growth in outlets of the mid-1990s was over, as many angry franchisees had seen their sales decline as much as 30 percent due to cannibalization by nearby McDonald's outlets. In 1999 only 150 new restaurants were added, down sharply from the 1,100 of a few years before.

Increasingly, Greenberg turned his attention to food diversification. He planned to grow the 143-store Donatos Pizza regional chain to a national one of a thousand stores. He bought into Chipotle Mexican Grill, a popular Denver-based chain of Mexican restaurants. The purchase of Aroma, a coffee-and-sandwich bar in London, England showed perhaps the most promise. In the UK the cold-sandwich market was almost double the size of the burger market and growing twice as fast, appealing to a mostly single, health-conscious and female customer base that had practically no overlap with the burger crowd—therefore, no cannibalization. Some 150 Aroma stores were planned by 2002. In another major acquisition, McDonald's acquired the faltering Boston Market chain on May 26, 2000. About 100 under-performing Boston Market restaurants were closed, and others were converted to McDonald's, Chipotle Mexican Grill, and Donatos Pizza. This still left more than 750 Boston restaurants that could challenge McDonald's management in achieving profitability. McDonald's finally called "uncle" on Boston Market and announced the sale to Sun Capital Partners in early August 2007. It did not reveal the sales price.¹⁶

In a major menu thrust beyond burgers, more new products were coming out of McDonald's test kitchens than ever before, many of these appealing regionally rather than nationally: for example, the McBrat, a \$1.99 sandwich with sauerkraut and onion on the bratwurst, a big hit in Minnesota and Wisconsin; a McLobster Roll in New England; Homestyle Burger with hot mustard in Texas; the Brutus Buckeye Burger for Ohioans; and even bagel breakfast sandwiches, already doing well in 6,000 stores.¹⁷

Still, U.S. sales grew just 3 percent in 2000, while fourth-quarter net earnings declined 7 percent. McDonald's responded with a "New Tastes Menu," a collection of 44 items to be rotated four at a time. An analyst noted, however, that these were mostly "tired old products with such startling innovations like a strip of bacon or a dollop of ranch dressing."¹⁸

The Situation in the Rest of the World

In Europe, mad-cow hysteria and currency woes were playing havoc, and McDonald's stock was at a two-year low. But non-U.S. restaurants continued to offer the best opportunities, and by the end of 2000, foreign restaurants outnumbered U.S. outlets by 15,900 to 12,408. International business contributed 52 percent of total operating income by 2000.¹⁹

¹⁶ "McDonald's to Sell Boston Market Chain, *Wall Street Journal*, August 7, 2007, p. A2.

¹⁷ Bruce Upbin, "Beyond Burgers," *Forbes*, November 1, 1999, pp. 218–223.

¹⁸ Brandon Copple, "Same Old, Same Old," *Forbes*, February 19, 2001, p. 60.

¹⁹ Company public information.

Japan especially was a lucrative foreign market, and by 2001 the almost 3,600 McDonald's had changed the eating habits of the nation, making fast food a part of everyday life. McDonald's—"Maku" in Japanese shorthand—controlled about 65 percent of the fast-food burger market, serving 1.3 billion customers a year. The mad-cow scare that had so severely affected demand in Europe was at first largely averted in Japan, which used beef from Australia where there had been no disease. Later, the stigma also began to affect Japanese demand.

But Russia had turned out to be one of the gems in McDonald's overseas business. See the following Information Box, Doing Business in Moscow.

INFORMATION BOX

DOING BUSINESS IN MOSCOW

At lunch time on a recent day, Khamzat Khasbulatov was sitting in the world's busiest McDonald's in Pushkin Square in Moscow, and watching the crowd of people lined up at its 26 cash registers. "I have too many customers," he sighs. But company top management has abandoned the wild rush to open new stores of a few years before. McDonald's president, Ralph Alvarez said, "We're going to stay disciplined." And only 12 new stores were opened in Russia in 2007.

On opening day in January 1990, more than 5,000 customers patiently waited for the Pushkin Square McDonald's doors to open. To this day, the crowds have scarcely diminished in this huge restaurant with its 900 seats and free wireless Internet access in 24,000 square feet. It seems the Russians really like burgers and fries.

Although attracting customers was never a problem, just about everything else was difficult for Mr. Khasbulatov. He was named to McDonald's top Russia position in 1999, and then given responsibility for all Eastern European restaurants. A major early problem in Russia was finding reliable suppliers of beef patties, hamburger buns, and other items. Eventually McDonald's had to spend \$45 million to build a facility to produce these items on its own, something it had never done before. And then there was the red tape, often requiring 200 signatures from local officials to open a store. Real-estate prices increased tenfold in a decade. And in Moscow and St. Petersburg, low unemployment rates made it difficult to find qualified personnel. Still, as of late 2007, Russia had 180 restaurants in 40 cities. On average, each location served about 850,000 customers a year, more than twice the store traffic in other markets. Of course, this is a tiny fraction of McDonald's nearly 32,000 restaurants worldwide.

Are you surprised that such an American icon as McDonald's is so successful in Russia?

Do you agree with the very "disciplined" approach to store openings in Russia?

Source: Janet Adamy, "As Burgers Boom in Russia, McDonald's Touts Discipline," *Wall Street Journal*, October 16, 2007, pp. A1 and A17.

LATER DEVELOPMENTS

CEO Jack Greenberg, now 60, stepped down at the end of 2002, well ahead of his planned 2005 retirement. His had been a frustrating four-year effort to reinvent the firm and start it on a new growth pattern.

Greenberg's reinvention efforts included starting a fierce price war by selling two of McDonald's biggest sandwiches for \$1 each, introducing some 40 menu items, and spending \$151 million to overhaul the company's U.S. kitchens in order to make food hotter and fresher, as well as acquiring other restaurant chains. In November 2002, customers were even given the option of paying with credit cards and earning frequent flyer miles. Still, sales had remained lackluster, and profits fell in seven of the past eight quarters, while the stock price had sunk to a seven-year low.

Aside from the acquisitions, customer response to most of these efforts was poor. The price war mostly resulted in all burger chains facing lower profits with little increase in sales. The new "Made for You" kitchens sacrificed speed and service; and Greenberg could never bring customer service up to historic levels, despite sending mystery shoppers to evaluate service. The mad-cow scare in Europe in 2000 dragged down profits as well, but profitability was not regained with the end of mad-cow concerns.²⁰

The foreign markets that had long sustained the growth were also faltering now. Germany was the largest European market, but McDonald's growth there stagnated as competition grew from Burger King, which expanded in Germany from 268 stores in 2000 to 390 in 2002, and from local retailers such as gas-station food marts and traditional mom-and-pop bakeries. In the UK, McDonald's problems with service and cleanliness, as well as changes in consumer tastes, now throttled its expansion efforts. In Japan, long the crown jewel in McDonald's foreign operations, the chain's 3,800 stores faced a saturated market, with its core customers—families with children—shrinking with a declining birthrate, while local competitors became stronger. Same-store sales in Japan fell 12.1 percent in 2002 and were expected to decline an additional 3.5 percent in 2003.

Domestically, even the restaurant chains that Greenberg acquired in his diversification efforts were not producing the expected profits. Boston Market and its partner brands as a group lost \$67 million on sales of \$1.07 billion in 2002. Some of these could face divestiture by a top management less growth minded. As noted earlier, Boston Market was sold in 2007.

James R. Cantalupo

Cantalupo succeeded Greenberg as CEO in January 2003. Recently retired as CEO of McDonald's International, his job now was to restore sales and profit growth company-wide. With his arrival, the company announced its first quarterly loss since going public in 1965, almost 40 years before.

²⁰ Shirley Leung and Ron Lieber, "The New Menu Option at McDonald's: Plastic," *Wall Street Journal*, November 26, 2002, pp. D1-2; and Shirley Leung, "McDonald's Chief Plans to Leave," *Wall Street Journal*, December 6, 2002, pp. A3, A6.

When the board brought him back to replace Greenberg, Cantalupo acted quickly to undo some of the high-profile projects of his predecessor. He killed a \$1 billion technology effort, code-named Innovate, that had been envisioned a global digital network linking 30,000 McDonald's restaurants to headquarters and vendors. "We know we need to make changes," Cantalupo said, but "We don't intend to throw capital at problems."²¹ In his letter to shareholders for the 2002 *McDonald's Annual Report*, Cantalupo announced, "We are targeting a lower earnings growth rate. Given the nature and size of our business, the prior earnings per share growth target in the 10 percent to 15 percent range is no longer realistic . . . in short, McDonald's is in transition from a company that emphasizes "adding restaurants to customers" to one that emphasizes "adding customers to restaurants."²² He made investors happy by slashing capital spending by 40 percent largely through closing poorer-performing restaurants and adding fewer new restaurants. He also raised the dividend 70 percent.

Cantalupo and his team addressed mounting customer complaints about slow drive-through service and surly employees. Efforts were made to improve the taste of burgers and promote salad entrees, while eliminating "super sizes" in french fries and soft drinks—these latter two menu moves were designed to placate critics blaming obese consumers on burger sellers.

The attractiveness of the new low-growth policy of Cantalupo was fully evident in summer and fall 2003 when the stock price rose from \$18 to over \$24 by early October.

On April 19, 2004, a calamity of no small moment occurred. At a global convention of McDonald's franchisees in Orlando, Fla., just before he was to make the opening remarks about his successful 16-month campaign to restore sales and profit growth, Jim Cantalupo collapsed and died of an apparent heart attack. McDonald's board quickly named 43-year-old Charlie Bell to the top job. Bell was an obvious choice, having been president and chief operating officer since late 2002.

Then the company faced an almost unbelievable double whammy when soon after Bell was named CEO he was diagnosed with colon cancer and had to resign in November to focus on battling the disease.

Overcoming Adversity to a Rebirth

Cantalupo started the rebirth, but did not live to see its fruition. Jim Skinner, vice chairman, moved up to CEO after Bell had relinquished that post to fight a losing cancer battle. Skinner continued the new strategy aimed at reversing the company's sliding profit. No more building lots of restaurants, but instead focus would be on improving existing locations. The goals would be faster, friendlier service, tastier food, more appealing ambience, better value, and sharper marketing. In his first two years as CEO, 2004–2006, McDonald's stock climbed 45 percent, same-store sales and profit rose steadily, and "50 million customers walk through McDonald's

²¹ Richard Gibson and Steven Gray, "Death of Chief Leaves McDonald's Facing Challenges," *Wall Street Journal*, April, 20, 2004, p. A16.

²² *McDonald's 2002 Annual Report*, p. 3.

TABLE 8.1 Growth in Sales and Net Income, 1997–2006, and Comparison with Previous Year

	Sales (millions)	Percent Gain	Income (millions)	Percent Gain or (Loss)
1997	11,409		1,643	
1998	12,421	8.9%	1,550	(5.7%)
1999	13,259	6.7	1,948	20.4
2000	14,243	7.4	1,977	1.5
2001	14,870	4.4	1,637	(17.2)
2002	15,406	3.6	992	(39.4)
2003	17,141	11.3	1,508	52.0
2004	19,065	11.2	2,279	51.1
2005	20,460	7.3	2,602	14.5
2006	21,586	5.5	2,873	10.4

Source: Compiled from *McDonald's Annual Reports*.

Commentary: The major strategy of slashing capital spending and initiating a slow-down policy began when James Cantalupo became CEO in January 2003. Looking at the years before 2003, we see a steady but by no means spectacular increase in sales. But the income picture looks bleak indeed, with the two years before showing serious deterioration of net income. But 2003 and 2004 show more than 50 percent gains in net income, and the following years double digit gains. Revenue gains during the years since 2002 also have double digit gains in revenue in 2003 and 2004, something not even achieved in the years of greatest increase in stores. These statistics bear out the rightness of the marketing decision of Cantalupo and his successors.

doors each day, four million more per day than 3½ years ago.”²³ See Table 8.1 for sales and profits before and after the strategy change. Skinner talked to a reporter about how the decision to drastically change the growth strategy came about:

Basically, we sat in this room and talked about how the growth story is problematic. We had contributed \$4 billion or \$5 billion to capital expenditures and building new stores over four years, and yet we didn't have any corresponding incremental operating-income growth. So we decided to focus on our existing restaurants.²⁴

Tastier Food

McDonald's hired an experienced chef, Dan Coudreaut, as director of culinary innovation. He and his helpers came up with 85 different ideas. The breaded chicken snack wrap at \$1.29 became one of the most successful new product launches. He considered adding a shrimp salad to the menu, but couldn't because McDonald's would need to use so much shrimp that it would deplete the nation's shrimp supply.²⁵

New salad offerings, expanded snack wraps, Happy Meals, breakfast items, and coffees began driving up sales. Still, the company was having problems eliminating

²³ Janet Adamy, “How Jim Skinner Flipped McDonald's,” *Wall Street Journal*, January 5, 2007, pp. B1 and B2.

²⁴ *Ibid.*

²⁵ Janet Adamy, “For McDonald's, It's a Wrap,” *Wall Street Journal*, January 30, 2007, pp. B1 and B2.

the trans fat in french fries without hurting the taste, and was blamed for the nation's obesity.

Renovation

By late October 2007 about 6,500 of McDonald's 13,700 U.S. restaurants had been renovated. The giant golden arches were removed and replaced by a modest yellow swoosh. Landscaping was improved, and interiors given muted earth tones instead of blazing reds and yellows, while lighting was more subdued. Oversized chairs replaced molded plastic booths, and dining zones for singles, families, and business meetings were marked off in some restaurants. Many restaurants now could speed drive-through customers with two lanes instead of one. Some have wireless Internet service, digital ordering displays and plasma-screen TVs.

Costs for these renovations were not small. Wilson Rogers who has three restaurants in Cleveland, remodeled his large unit near downtown, with construction costs of more than \$1 million.²⁶

Bearding Starbucks with Upscale Coffee Drinks

Along with the renovations that were greatly improving the ambience of McDonald's restaurants, the company had been gearing up to compete strongly with Starbucks in the total market for upscale coffee drinks. It envisioned that this program and the addition of smoothies and bottled beverages such as energy and sport drinks and tea would add \$1 billion to McDonald's annual sales. In test markets it had determined that the espresso machines should be moved to the front counter from the back so that the "baristas" (a moniker taken from Starbucks) would be facing customers as they made lattes, cappuccinos, mochas, and a Frappe, similar to Starbucks ice-blended Frappuccino. These would also be available at the drive-through windows. Drinks were priced from \$1.99 to \$3.29, and in advertisements, McDonald's told customers these were 60 to 80 cents less than competitors' prices. Should Starbucks be worried?²⁷

ANALYSIS

After decades of uninterrupted growth in sales, profits, and number of stores opened, McDonald's faced diminished prospects both domestic and foreign by the latter 1990s. Though no one wanted to admit it then, the evidence was rather compelling that the company life cycle was reaching maturity unless it could come up with major marketing strategy changes. Pouring more efforts into additional outlets seemed ill-advised, although it took a new CEO to recognize and come to grips with this. But the siren call of growth is difficult to subdue.

Relations with franchisees, formerly best in the industry, had deteriorated as corporate management pursued policies more dictatorial and selfish than ever

²⁶ Zachary Lewis, "McDonald's New Image Is Coming Here," *Cleveland Plain Dealer*, October 20, 2007, pp. C1 and C3.

²⁷ For more specifics, see Janet Adamy, "McDonald's Takes On a Weakened Starbucks," *Wall Street Journal*, January 7, 2008, pp. A1 and A10.

before—policies that signaled the end of the kinder and gentler stance franchisees remembered. In particular, the new expansion policy aimed at increased market share regardless of its effect on established franchisees, portended worsening relations, and the start of an adversarial instead of supportive climate.

The cost/benefit consequences of an aggressive expansion policy were rationalized as in the company's best interest, especially as recent store construction became more cost efficient. If total market share could be substantially increased, despite same-store sales declining, the accounting analyses supported more stores. But how much should the franchisee be considered in this aggressive strategy of McDonald's outlets competing not so much with Wendy's, Burger King, and Taco Bell as with other McDonald's outlets? And, couldn't profitability be improved by more carefully selecting fewer new store sites, and at the same time identifying marginal stores that perhaps should be closed?

A major domestic challenge for the growth-minded McDonald's was the menu: How could it better appeal to adults and thus expand market potential? Could the dinner market be tapped? But the last successful menu expansion had been the breakfast menu, and that was decades ago. Installing a salad bar—would this be the menu breakthrough needed? With a history of past failures, expectations could hardly be robust. Yet McDonald's, as any chain organization whether fast food or otherwise, can test different prices and strategies or different menus and different atmospheres in just a few outlets, and only if results are favorable will it expand further. A few stores thus can provide a powerful research tool.

McDonald's difficulty in enforcing tighter controls over product quality and service needed to be addressed. The rigid standards and controls imposed in the days of Ray Kroc that made McDonald's unique had somehow eroded. Admittedly, as more and more outlets were added, enforcing tight controls became more difficult. Yet competitors meantime were doing a better job of matching, and surpassing, McDonald's former high standards. And the profit picture and shareholder attitudes were ever worsening. The glory days seemed only a pleasant memory.

Into this breach came a white knight. In less than 16 months, Jim Cantalupo, with an espoused low-growth strategy, had turned things around. But then he died suddenly of a heart attack. The new CEO a month after assuming the office was diagnosed with colon cancer and a few months later had to resign.

Still, a turnaround of rather significant proportions came about with such a simple change of course: Do more with what we have, and stop the frantic push for new stores. Put the \$4 to \$5 billion dollars saved by building fewer new stores into programs to enliven existing stores. And somehow, this worked wonders with sales, profits, and stock prices. You may want to review Table 8.1 for sales and profits before and after the change in strategy. So with a total remodeling of thousands of U.S. stores, a spiced-up menu with an experienced head chef, and a \$1 billion invasion of Starbucks turf, the future looked bright for the old dinosaur, McDonald's, but maybe not quite so bright for Starbucks, although that remains to be seen. As the market expands for upscale coffee drinks, both firms may still reap the harvest. What do you think?

WHAT WE CAN LEARN

It Is Possible to Have Strong and Enduring Growth without Diversification

For more than four decades, since 1955, McDonald's had grown continuously and substantially. In all this time, the product was essentially the hamburger in its various trappings and accompaniments. Almost all other firms in their quest for growth have diversified, sometimes wisely and synergistically, at other times imprudently and even recklessly.

For such an undeviating focus, the product should have universal appeal, be frequently consumed, and have almost unlimited potential. The hamburger probably meets these criteria better than practically any other product, along with beer, soft drinks, coffee, and tobacco. And soft drinks, of course, are a natural accompaniment of the hamburger.

Eventually, even the hamburger began to fall short in providing continued strong growth as the international market reached saturation and the domestic market over-saturation. McDonald's may be forced to seek judicious diversifications or lose the growth mode. There is risk: Firms in pursuit of growth often jump into acquisitions far too hastily and are faced with massive debt and overhead. And many of McDonald's past food-service diversifications did not meet their expectations. Will the menu diversification into upscale coffee drinks a la Starbucks meet the optimistic expectations?

Beware the Reckless Drive for Market Share

A firm can usually "buy" market share, if it is willing to sacrifice profits to do so. It can step up advertising and sales promotions. It can reduce prices, assuming that lower prices would bring more demand. It can increase sales staff and motivate them to be more aggressive. Sales and competitive position then will usually rise. But costs may increase disproportionately. In other words, the benefits to be gained may not be worth the costs.

As we saw, McDonald's aggressively increased market share in the mid-1990s by opening thousands of new restaurants. As long as developmental costs could be kept sufficiently low for these new units to be profitable and not cannibalize business from other McDonald's restaurants, then the strategy was defensible. But a hard look at the \$4 to \$5 billion in development costs without any consequent increase in profitability led to scrapping this strategy. And the costs of damaged franchisee relations due to cannibalizing resulted in lowered morale, cooperation, and festering resentments. Interestingly, this market share growth strategy was toned down by early 2000.

The Surprising Power of a Slow-Down Strategy

What a surprise! When McDonald's drastically cut back on opening new stores, profits went up, and in a big way. How can this be? First, the \$4 to \$5 billion

that was spent on opening new stores could now be directed elsewhere—to remodeling existing stores, to prudent food diversification, to refining operations, to making stockholders happy with increased dividends. Fully as important as the saving of expenditures was the freeing up of executive time that was surely diluted by all the details of finding new store sites, overseeing construction, recruiting and training new employees, etc. Now existing operations could be better served.

Maintaining the Highest Standards Requires Constant Monitoring

McDonald's heritage and its competitive advantage had long been associated with the highest standards and controls for cleanliness, fast service, dependable quality of food, and friendly and well-groomed employees. The following Information Box discusses strategy countering by competitors and the great difficulty in matching nonprice strengths.

Alas, in recent years McDonald's let its control of operational standards slip. Surveys of customer satisfaction in 1995 and 2001 gave McDonald's low marks on food quality, value, service, and cleanliness, with its competitors rating considerably better. Why this lapse? Without doubt, maintaining high standards among thousands of units, company-owned as well as franchised, requires constant monitoring and exhortation. But this was successfully done for over four decades. How was this lapse allowed to happen? We can only speculate that such standards became taken for granted, not emphasized as much. Then it became difficult to resurrect them.

INFORMATION BOX

MATCHING A COMPETITOR'S STRATEGY

Some strategies are easily countered or duplicated by competitors. Price cutting is the most easily countered. A price cut can often be matched within minutes. Similarly, a different package or warranty is easily imitated by competitors.

But some strategies are not so easily duplicated. Most of these involve service, a strong and positive company image, or both. A reputation for quality and dependability is not easily countered, at least in the short run. A good company or brand image is hard to match because it usually results from years of good service and satisfied customers. The great controls of McDonald's with its high standards would seem to be easily imitated, but they proved not to be, as no other firm fully matched them until recent years.

The strategies and operations most difficult to imitate often are not the wildly innovative ones, nor the ones that are complex with great research. Rather they seem to be the simple things: doing a better job in servicing and satisfying customers and in performing even mundane operations cheerfully and efficiently.

What explanation can you give for competitors' inability for so long to match the standards of McDonald's?

Controls Can Be too Stringent

In a belated attempt to improve standards and tighten corporate control, McDonald's instituted the controversial Franchising 2000. Among other things this called for grading franchisees, with those receiving the lower grades being penalized. McDonald's also wanted to take away any pricing flexibility for its franchisees: All restaurants now had to charge the same prices, or risk losing their franchise. Not surprising, some franchisees were concerned about this new "get tough" management.

Can controls be too stringent? As with most things, extremes are seldom desirable. All firms need tight controls over far-flung outlets to keep corporate management alert to emerging problems and opportunities and maintain a desired image and standard of performance. In a franchise operation this is all the more necessary since the company is dealing with independent entrepreneurs rather than hired managers. However, controls can be so rigid that no room is left for special circumstances and opportunities. If the enforcement is too punitive, the climate becomes more that of a police state than a team-work relationship with both parties cooperating to their mutual advantages.

This brings us to the next insight for discussion.

There Is Room for a Kinder, Gentler Firm in Today's Hotly Competitive Environment

Many longtime McDonald's franchisees remembered with sadness a kinder, gentler company, an atmosphere nurtured by founder Ray Kroc. To be sure, Kroc insisted that customers be assured of a clean, family atmosphere with quick and cheerful service. To Kroc, this meant strict standards, not only in food preparation but also in care and maintenance of facilities, including toilets. Company auditors closely checked that the standards were adhered to, under Kroc's belief that a weakness in one restaurant could have a detrimental effect on other units in the system. Still, the atmosphere was helpful—the inspectors were "consultants"—rather than adversarial. Kroc was proud that he was responsible for making more than 1,000 millionaires, the franchise holders.

Many franchisees traced the deterioration of franchiser-franchisee relations to the 1992 death of Gerald Newman, McDonald's chief accounting officer. He spent much time interacting with franchisees, sometimes encouraging them—he had a reputation for a sympathetic ear—sometimes even giving them a financial break.²⁸

So, is it possible and desirable to be a kind and gentle company? With franchisees? Employees? Suppliers? Customers? Of course it is. Organizations, and the people who run them, often forget this in the arrogance of power. They excuse a "get tough" mindset on the exigencies of competition and the need to be faithful to their stockholders.

Kind and gentle—is this an anachronism, a throwback to a quieter time, a nostalgia long past its usefulness? Let us hope not.

²⁸ Gibson, p. A8.

Any Firm Needs Contingency Planning, Especially with Regard to Succession

The improbable catastrophe that beset McDonald's—losing two CEOs to death and severe illness in only a few months—graphically shows the need for successor-planning in developing understudies who can step in quickly if necessary to continue the momentum and successful policies. It also should raise a caution: since accidents do happen, company policies should prohibit top executives all flying on the same plane—perhaps a corporate jet—or being in the same car. Insurance policies also can offer some protection against financial loss should major executives be unexpectedly incapacitated.

CONSIDER

Can you add other learning insights?

QUESTIONS

1. How do you account for the reluctance of competitors to imitate the successful efforts of another firm in their industry? Under what circumstances is imitation likely to be embraced?
2. To date McDonald's has shunned diversification into unrelated food operations as well as nonfood options. Discuss the desirability of such diversification efforts.
3. “Eventually—and this may come sooner than most think—there will no longer be any choice locations anywhere in the world for new hamburger outlets. As a McDonald's stockholder, I'm getting worried.” Discuss.
4. Does the size of McDonald's give it a powerful advantage over its competitors? Why or why not?
5. What do you think is McDonald's near-term and long-term potential? What makes you think this?
6. Is it likely that McDonald's will really realize \$1 billion in additional revenues coming from imitating Starbucks?
7. Discuss the importance of market share in the fast-food industry.
8. Discuss the desirability of McDonald's efforts to insist on the same price in all domestic restaurants.

HANDS-ON EXERCISES

1. You have been given the assignment by Edward Rensi in 1993 to instill a recommitment to improved customer service in all domestic operations. Discuss in as much detail as you can how you would go about fostering this among the 13,700 domestic outlets.
2. As a McDonald's senior executive, what long-term expansion mode would you recommend for your company?

3. As a Starbucks senior executive, what strategy would you recommend to combat McDonald's invading your turf?
4. Be a Devil's Advocate (and argue a dissenting view). Develop all the persuasive arguments you can that Cantalupo's limited expansion policies will doom the company's growth and invite competitive inroads.

TEAM DEBATE EXERCISE

1. Debate this issue: McDonald's is reaching the limits of its ability to grow without drastic change. (Note: the side that espouses drastic change should give some attention to the most likely directions for such, and be prepared to defend these expansion possibilities.)
2. Debate the issue of a "get-tough" attitude of corporate management toward franchisees even if it riles some, versus involving them more in future directions of the company. In particular, be prepared to address the challenge of bringing customer satisfaction up to traditional standards.
3. Debate this contention: Market share is overemphasized in this industry. (Both sides in their debate may want to consider whether this assertion may or may not apply to other industries.)

INVITATION TO RESEARCH

How has Skinner's major move into the higher-priced coffees and espressos fared? Has growth in overall profitability continued? How about the company stock market valuation? Has McDonald's made any major acquisitions recently? Has the Russian infatuation with McDonald's continued?

Harley-Davidson—Creating an Enduring Mystique

This century-old firm has exhibited stark contrasts in its history. In its first 60 years it had destroyed all of its U.S. competitors and had a solid 70 percent of the motorcycle market. Then in the early 1960s, its staid and unexciting market was shaken up, was rocked to its core, by the most unlikely invader. This intruder was a smallish Japanese firm that had risen out of the ashes of World War II, and was now trying to encroach on U.S. territory.

Almost inconceivably, in half a decade Harley-Davidson's market share was to fall to 5 percent, and the total market was to expand many times over what it had been for decades. This foreign invader had furnished a textbook example of the awesome effectiveness of a carefully crafted marketing effort. In the process, this confrontation between Honda and Harley-Davidson was a harbinger of the Japanese invasion of the auto industry.

Eventually, by the late 1980s, Harley was to make a comeback. But only after more than two decades of travail and mediocrity. As it surged forward in the last of the old century, it had somehow built up a mystique, a cult following, for its big bikes. In January 7, 2002, *Forbes* declared Harley to be its "Company of the Year," a truly prestigious honor. But let us go back first to the dire days of the Japanese "invasion."

THE INVASION

Sales of motorcycles in the United States were around 50,000 per year during the 1950s, with Harley-Davidson, Britain's Norton and Triumph, and Germany's BMW accounting for most of the market. By the turn of the decade, Honda began to penetrate the U.S. market. In 1960 less than 400,000 motorcycles were registered in the United States. While this was an increase of almost 200,000 from the end of World War II 15 years before, it was far below the increase in other motor vehicles. But by 1964, only four years later, the number had risen to 960,000; two years later it was 1.4 million; by 1971 it was almost 4 million.

In expanding the demand for motorcycles, Honda instituted a distinctly different strategy. The major elements of this strategy were lightweight cycles and an

advertising approach directed toward a new customer. Few firms have ever experienced such a shattering of market share as did Harley-Davidson in the 1960s. (Although its competitive position declined drastically, its total sales remained nearly constant, indicating that it was getting none of the new customers for motorcycles.)

Reaction of Harley-Davidson to the Honda Threat

Faced with an invasion of its static U.S. market, how did Harley react to the intruder? They did not react! At least not until far too late. Harley-Davidson considered themselves the leader in full-size motorcycles. While the company might shudder at the image tied in with their product's usage by the leather jacket types, it took solace in the fact that almost every U.S. police department used its machines. Perhaps this is what led Harley to stand aside and complacently watch Honda make deep inroads into the American motorcycle market. The management saw no threat in Honda's thrust into the market with lightweight machines. The attitude was exemplified in this statement by William H. Davidson, the president of the company and son of the founder:

Basically, we don't believe in the lightweight market. We believe that motorcycles are sport vehicles, not transportation vehicles. Even if a man says he bought a motorcycle for transportation, it's generally for leisure-time use. The lightweight motorcycle is only supplemental. Back around World War I, a number of companies came out with lightweight bikes. We came out with one ourselves. They never got anywhere. We've seen what happens to these small sizes.¹

Eventually, Harley recognized that the Honda phenomenon was not an aberration, and that there was a new factor in the market. The company attempted to fight back by offering an Italian-made lightweight in the mid-1960s. But it was far too late; Honda was firmly entrenched. The Italian bikes were regarded in the industry to be of lower quality than the Japanese. Honda, and toward the end of the 1960s other Japanese manufacturers, continued to dominate what had become a much larger market than ever dreamed.

AFTERMATH OF THE HONDA INVASION: 1965–1981

In 1965, Harley-Davidson made its first public stock offering. Soon after, it faced a struggle for control. The contest was primarily between Bangor Punta, an Asian company, and AMF, an American company with strong interests in recreational equipment including bowling. In a bidding war, Harley-Davidson's stockholders chose AMF over Bangor Punta, even though the bid was \$1 less than Bangor's \$23 a share offer. Stockholders were leery of Bangor's reputation of taking over a company, squeezing it dry, and then scrapping it for the remaining assets. AMF's plans for expansion of Harley-Davidson seemed more compatible.

¹ Tom Rowan, "Harley Sets New Drive to Boost Market Share," *Advertising Age*, January 29, 1973, pp. 34–35.

But the marriage was troubled. Harley-Davidson's old equipment was not capable of the expansion envisioned by AMF. At the very time that Japanese manufacturers—Honda and others—were flooding the market with high-quality motorcycles, Harley was falling down on quality. One company official noted that “quality was going down just as fast as production was going up.”² Indicative of the depths of the problem at a demoralized Harley-Davidson, quality-control inspections failed 50–60 percent of the motorcycles produced. This compared to 5 percent of Japanese motorcycles that failed their quality-control checks.

AMF put up with an average \$4.8 million operating loss for 11 years. Finally, it called it quits and put the division up for sale in 1981. Vaughan Beals, vice president of motorcycle sales, still had faith in the company, and he led a team that used \$81.5 million in financing from Citicorp to complete a leveraged buyout. All ties with AMF were severed.

VAUGHAN BEALS

Beals was a middle-aged Ivy Leaguer, a far cry from what one might think of as being a heavy motorcycle aficionado. He had graduated from MIT's Aeronautical Engineering School, and was considered a production specialist.³ But he was far more than that. His was a true commitment to motorcycles, personally as well as professionally. Deeply concerned with AMF's declining attention to quality, he achieved the buyout from AMF.

The prognosis for the company was bleak. Its market share, which had dominated the industry before the Honda invasion, now was 3 percent. In 1983, Harley-Davidson would celebrate its 80th birthday; some doubted it would still be around by then. Tariff protection seemed Harley's only hope. And massive lobbying paid off. In 1983, Congress passed a huge tariff increase on Japanese motorcycles. Instead of a 4 percent tariff, now Japanese motorcycles would be subject to a 45 percent tariff for the coming five years.

The tariff gave the company new hope, and it slowly began to rebuild market share. Key to this was restoring confidence in the quality of its products. And Beals took a leading role in this. He drove Harley-Davidsons to rallies where he met Harley owners. There he learned of their concerns and their complaints, and he promised changes. At these rallies, a core of loyal Harley-Davidson users, called HOGs (for Harley Owners Group), were to be trailblazers for the successful growth and mystique to come.

Beals had company on his odyssey: Willie G. Davidson, grandson of the company's founder, and the vice president of design. Willie was an interesting contrast to the more urbane Beals. His was the image of a middle-age hippie. He wore a Viking helmet over long, unkempt hair, while a straggly beard hid some of his wind-burned face. An aged leather jacket was compatible. Beals and Davidson fit in nicely at the HOG rallies.

² Peter C. Reid, *Well Made in America—Lessons from Harley Davidson on Being the Best*, New York: McGraw-Hill, 1990, p. 10.

³ Rod Willis, “Harley-Davidson Comes Roaring Back,” *Management Review*, March 1986, pp. 20–27.

THE STRUGGLE BACK

In December 1986 Harley-Davidson asked Congress to remove the tariff barriers, more than a year earlier than originally planned. The confidence of the company had been restored, and it believed it could now compete with the Japanese head to head.⁴

Production Improvements

Shortly after the buyout, Beals and other managers visited Japanese plants both in Japan and Honda's assembly plant in Marysville, Ohio. They were impressed that they were being beaten not by "robotics, or culture, or morning calisthenics and company songs, [but by] professional managers who understood their business and paid attention to detail."⁵ As a result, Japanese production costs were as much as 30 percent lower than Harley's.

Beals and his managers tried to implement some of the Japanese management techniques. Each plant was divided into profit centers, with managers assigned total responsibility within their particular area. Just-in-time (JIT) inventory and a materials-as-needed (MAN) system sought to control and minimize all inventories both inside and outside the plants. Quality circles (QCs) were formed to increase employee involvement in quality goals and to improve communication between management and workers. See the following Information Box for further discussion of quality circles. Another new program called statistical operator control (SOC) gave employees the responsibility for checking the quality of their own work and making proper correcting adjustments. Efforts were made to improve labor relations by more sensitivity to employees and their problems as well as better employee assistance and benefits. Certain product improvements were also introduced, notably a new engine and mountings on rubber to reduce vibration. A well-accepted equipment innovation was to build stereo systems and intercoms into the motorcycle helmets.

The production changes between 1981 and 1988 resulted in:⁶

- Inventory reduced by 67 percent
- Productivity up by 50 percent
- Scrap and rework down two-thirds
- Defects per unit down 70 percent

In the 1970s the joke among industry experts was, "If you're buying a Harley, you'd better buy two—one for spare parts."⁷ Now this had obviously changed, but the change still had to be communicated to consumers, and believed.

Marketing Moves

Despite its bad times and its poor quality, Harley had a cadre of loyal customers almost unparalleled. Company research maintained that 92 percent of its customers

⁴ "Harley Back in High Gear," *Forbes*, April 20, 1987, p. 8.

⁵ Dexter Hutchins, "Having a Hard Time with Just-in-Time," *Fortune*, June 19, 1986, p. 65.

⁶ Hutchins, p. 66.

⁷ *Ibid.*

INFORMATION BOX

QUALITY CIRCLES

Quality circles were adopted by Japan in an effort to rid its industries of poor quality and junkiness after World War II. Quality circles are worker-management committees that meet usually weekly to talk about production problems, plan ways to improve productivity and quality, and resolve job-related gripes on both sides.

At the height of their popularity they were described as “the single most significant reason for the truly outstanding quality of goods and services produced in Japan.”⁸ At one time Mazda had 2,147 circles with more than 16,000 employees involved. They usually consisted of seven or eight volunteers who met on their own time to discuss and solve the issues they were concerned with. In addition to making major contributions to increased productivity and quality, quality circles gave employees an opportunity to participate and gain a sense of accomplishment.⁹

The idea—like so many ideas adopted by the Japanese—did not originate with them: it came from two American personnel consultants. But the Japanese refined the idea and ran with it. In the 1980s, American industry, unable to match the quality of Japanese imports, saw quality circles as the elixir in quality enhancement. Firms also found them a desirable way to promote teamwork, good feelings, and to avoid some of the adversarial relations stemming from collective bargaining and union grievances.

Despite the glowing endorsements for quality circles, in the United States they were more a fad that quickly faded. Workers claimed they smacked of “tokenism,” and were a facade and impractical, with no lasting benefits once the novelty had worn off. Others saw them as time wasted and, unlike Japan, few U.S. workers accepted the idea of participating in quality circles on their own time.

How would you feel about devoting an hour or more to quality circle meetings every week or so, on your own time? If your answer is, “No Way,” do you think this is a fair attitude on your part? Why or why not?

Invitation to Research: Can you find any U.S. firms that are still using quality circles?

⁸ “A Partnership to Build the New Workplace,” *Business Week*, June 30, 1980, p. 101.

⁹ As described in a Mazda ad in *Forbes*, May 24, 1982, p. 5.

remained with Harley.¹⁰ Despite such hard-core loyalists, the company had always had a serious public image problem. It was linked to an image of the pot-smoking, beer-drinking, woman-chasing, tattoo-covered, leather-clad biker: “When your company’s logo is the number one requested in tattoo parlors, it’s time to get a licensing program that will return your reputation to the ranks of baseball, hot dogs, and apple pie.”¹¹

¹⁰ Mark Marvel, “The Gentrified HOG,” *Esquire*, July 1989, p. 25.

¹¹ “Thunder Road,” *Forbes*, July 18, 1983, p. 32.

Part of Harley's problem had been with bootleggers ruining the name by placing it on unlicensed goods of poor quality. Now the company began to use warrants and federal marshals to crack down on unauthorized uses of its logo at motorcycle conventions. And it began licensing its name and logo on a wide variety of products, from leather jackets to cologne to jewelry—even to pajamas, sheets, and towels. Suddenly retailers realized that these licensed goods were popular, and were even being bought by a new type of customer, undreamed of until now: bankers, doctors, lawyers, and entertainers. This new breed soon expanded their horizons to include the Harley Davidson bikes themselves. They joined the HOGs, only now they became known as Rubbies—rich urban bikers. And high prices for bikes did not bother them in the least.

Beals was quick to capitalize on this new market by expanding the product line with expensive heavyweights. In 1989 the largest motorcycle was introduced, the Fat Boy, with 80 cubic inches of V-twin engine and capable of a top speed of 150 mph. By 1991, Harley had 20 models, ranging in price from \$4,500 to \$15,000.

The Rubbies brought Harley back to a leading position in the industry by 1989, with almost 60 percent of the super heavyweight motorcycle market; by the first quarter of 1993, this had become 63 percent. The importance of this customer to Harley could be seen in the demographic statistics supplied by the *Wall Street Journal* in 1990: "One in three of today's Harley-Davidson buyers are professionals or managers. About 60 percent have attended college, up from only 45 percent in 1984. Their median age is 35, and their median household income has risen sharply to \$45,000 from \$36,000 five years earlier."¹²

In 1989 Beals stepped down as CEO, turning the company over to Richard Teerlink, who was chief operating officer of the Motorcycle Division. Beals, however, retained his position as chairman of the board.

SUCCESS

By 1993 Harley-Davidson had a new problem, one born of success. Now it could not even come close to meeting demand. Customers faced empty showrooms, except perhaps for rusty trade-ins or antiques. Waiting time for a new bike could be six months or longer, unless the customer was willing to pay a 10 percent or higher premium to some gray marketer advertising in biker magazines.

Some of the six hundred independent U.S. dealers worried that these empty showrooms and long waiting lists would induce their customers to turn to foreign imports, much as they had several decades before. But other dealers recognized that somehow Beals and company had engendered a brand loyalty unique in this industry, and perhaps in all industries. Assuaging the lack of big bike business, dealers were finding other sources of revenues. Harley's branded line of merchandise, available only at Harley dealers and promoted through glossy catalogs, had really taken off. Harley black leather jackets were bought eagerly at \$500;

¹² Robert L. Rose, "Vrooming Back," *Wall Street Journal*, August 31, 1990, p. 1.

fringed leather bras went for \$65; even shot glasses brought \$12—all it seemed to take was the Harley name and logo. So substantial was this ancillary business, that in 1992 noncycle business generated \$155.7 million in sales, up from \$130.3 million in 1991.

Production

In one sense, Harley's production situation was enviable: it had far more demand than production capability. More than this, it had such a loyal body of customers that delays in product gratification were not likely to turn many away to competitors. The problem, of course, was that full potential was not being realized.

Richard Teerlink, the successor to Beals, expressed the corporate philosophy to expanding quantity to meet the demand: "Quantity isn't the issue, quality is the issue. We learned in the early 1980s you do not solve problems by throwing money at them."¹³

The company increased output slowly. In early 1992 it was making 280 bikes a day; by 1993, this had risen to 345 a day. With increased capital spending, goals were to produce 420 bikes a day, but not until 1996.

Export Potential

Some contrary concerns with the conservative expansion plans of Teerlink surfaced in regard to international operations. The European export market beckoned. Harleys had become very popular in Europe. But the company had promised its domestic dealers that exports would not go beyond 30 percent of total production, until the North American market was fully satisfied. Suddenly the European big-bike market grew by an astounding 33 percent between 1990 and 1992. Yet, because of its production constraints, Harley could only maintain a 9 to 10 percent share of this market. In other words, it was giving away business to foreign competitors.

To enhance its presence in Europe, Harley opened a branch office of its HOG club in Frankfurt, Germany, for its European fans.

Specifics of the Resurgence of Harley-Davidson

Table 9.1 shows the trend in revenues and net income of Harley from 1982 through 1994. The growth in sales and profits did not go unnoticed by the investment community. In 1990 Harley-Davidson stock sold for \$7; in January 1993 it hit \$39. Its market share of heavyweight motorcycles (751 cubic centimeters displacement and larger) had soared from 12.5 percent in 1983 to 63 percent by 1993. Let the Japanese have the lightweight bike market! Harley would dominate the heavyweights.

Harley acquired Holiday Rambler in 1986. As a wholly owned subsidiary, this manufacturer of recreational and commercial vehicles was judged by Harley management to be compatible with the existing motorcycle business as well as moderating some of the seasonality of the motorcycle business. The diversification proved rather mediocre. In 1992 it accounted for 26 percent of total corporate sales, but only 2 percent of profits. (Company annual reports.)

¹³ Gary Slutsker, "Hog Wild," *Forbes*, May 24, 1993, p. 46.

TABLE 9.1 Harley-Davidson's Growth in Revenue and Income (millions of \$), 1983–1994

Year	Revenue	Net Income
1982	\$ 210	def. \$25.1
1983	254	1.0
1984	294	2.9
1985	287	2.6
1986	295	4.3
1987	685	17.7
1988	757	27.2
1989	791	32.6
1990	865	38.3
1991	940	37.0
1992	1,100	54.0
1993	1,210	68.0
1994	1,537	83.0

Source: Company annual reports.

Commentary: The steady climb in sales and profits, except for a pause in 1985, is noteworthy. The total gain in revenues over these years was 631.9%, while income rose more than eightyfold since 1983.

Big motorcycles, made in American by the only U.S. manufacturer, continued to be the rage. Harley's 90th anniversary was celebrated in Milwaukee on June 12, 1993. As many as 100,000 people, including 18,000 HOGS, were there to celebrate. Hotel rooms were sold out for a 60-mile radius. Harley-Davidson was up and doing real well.

Toward the Millennium and Beyond

The 1990s continued to be kind to Harley. Demand grew with the mystique as strong as ever. The company significantly increased its motorcycle-production capacity with a new engine plant in Milwaukee completed in 1997 and a new assembly plant in Kansas City in 1998. It expected that demand in the United States would still exceed the supply of Harley bikes.

The following numbers show how motorcycle shipments (domestic and export) increased from 1993 to 1997 (in thousands of units):

	United States	Exports
1997	96.2	36.1
1993	57.2	24.5

Despite continuous increases in production, U.S. consumers still had to wait to purchase a new Harley Davidson bike, but the wait only added to the mystique.

The following shows the growth in revenues and income from 1993 to 1997:

	Revenues (\$M)	Net Income (\$M)
1997	1,763	174.0
1993	1,217	18.4

Indicative of the popularity of the Harley-Davidson logo, Wolverine World Wide, original maker of Hush Puppies but now the largest manufacturer of footwear in the United States, entered a licensing agreement with Harley to use its “sexy” name for a line of boots and fashion shoes to come out in late 1998.¹⁴

In its January 7, 2002 issue, *Forbes* declared Harley to be its “Company of the Year,” a truly prestigious honor. In supporting its decision, *Forbes* noted that:

In a disastrous year for hundreds of companies, Harley’s estimated 2001 sales grew 15 percent to \$3.3 billion and earnings grew 26 percent to \$435 million. Its shares were up 40 percent in 2001, while the S&P stock averages dropped 15 percent. Since Harley went public in 1986, its shares have risen an incredible 15,000 percent. Since 1986, GE, generally considered the paragon of American business, had risen only 1,050 percent.

Jeffrey Bleustein, a 26-year company veteran and the current Harley CEO, was diversifying into small, cheaper bikes to attract younger riders as well as women who had shunned the big lumbering machines and who represented only 9 percent of Harley riders. The cult image was stronger than ever. Half the company’s 8,000 employees rode Harleys, and many of them appeared at rallies around the country for pleasure and to promote the company. In 2002, there were 640,000 owners, the parts-and-accessories catalog numbered 720 pages, and the Harley Davidson name was on everything from blue jeans to pickup trucks. Harley would celebrate its 100th birthday in 2002, and some 250,000 riders were expected at this rally in Milwaukee, up from 100,000 for the 90th birthday.¹⁵

By 2005, a rental program, which started in 1999 as a tool for Harley-Davidson to hook customers on riding and thereby entice them to buy, had ballooned from six participating dealers to 250, including 52 in such countries as Canada, Mexico, Costa Rica, Australia, France, and Italy. The number of days the motorcycles were rented zoomed from 401 in 1999 to 224,134 in 2004. Harley found that 32 percent of rental customers bought a bike after renting, and another 37 percent planned to buy one within a year. About half of the renters spent more than \$100 on Harley accessories such as T-shirts and gloves.¹⁶

By 2006, the popularity of Rallies and the eagerness of many communities to welcome these bikers seemed insatiable. The following Information Box describes this phenomenon.

¹⁴ Carleen Hawn, “What’s in a Name? Whatever You Make It,” *Forbes*, July 27, 1998, p. 88.

¹⁵ Jonathan Fahey, “Love Into Money,” *Forbes*, January 7, 2002, pp. 60–65.

¹⁶ Ryan Nakashima, Associated Press, as published in “Harley Rents Bikes to Boost Sales,” *Cleveland Plain Dealer*, July 5, 2005, p. C2.

INFORMATION BOX**THE BOOM IN HARLEY RALLIES**

Imagine this: It is an early week in August 2006, and your town of Sturgis, with all of 6,500 people, situated on the rolling Dakota plains nestled against the Black Hills, is playing host to half a million bikers from around the world for the 66th Sturgis Motorcycle Rally. For weeks motorcycles have been roaring around Sturgis, clogging the main streets and nearly doubling the state's population. The blaring of classic rock and country music almost drowns out the sounds of the revving engines. All available rooms have long been filled and biker tents are pitched on every available space, while shops and saloons are open from dawn to midnight and beyond. Still, you wonder how the town can accommodate such a horde.

Your neighbors couldn't be happier. "We do like to see them come. They're fun, good people," says the executive director of the chamber of commerce.

Why? You wonder. But then you know. These rallies are great for business. With the average Harley owner making about \$75,000 a year, they are free spenders, "and good tippers." A one-week event can bring several hundred million dollars to the local economy, and to the state in sales taxes.

Sturgis is not alone in attracting bikers. Laconia, New Hampshire, and Daytona Beach, Florida also host hundreds of thousands of bikers, while hundreds of smaller events appear across the country every year. Johnstown, Pennsylvania, is one of the fastest growing rallies, starting in 1998 with 3,500 bikers, and by 2006 drawing 200,000. The social calendar for motorcyclists has been rapidly filling up in recent years, as communities offer such popular activities as vintage bike shows, parades, stunt shows, races, scenic rides, and live music. "The residents come down, bring their kids. You'll see people here who don't even own motorcycles dressed like bikers." The old Viking and Hells Angel image of outlaws, barbarians, and wild men seems no more.¹⁷

How do you personally feel about motorcycles? Do you have one? Would you rent one? Would a rally attract you?

¹⁷ Adapted from Peter Schroeder, "Their Economic Engines Are Harleys," *Wall Street Journal*, August 24, 2006, p. D8.

ANALYSIS

One of Vaughan Beal's first moves after the 1981 leveraged buyout was to improve production efficiency and quality control. This became the foundation for the strategic-regeneration moves to come. In this quest, he borrowed heavily from the Japanese, in particular in cultivating employee involvement.

The cultivation of a new customer segment for the big bikes had to be a major factor in the company's resurgence. To some, discovering that more affluent consumers embraced the big, flashy Harley motorcycles was a surprise of no small moment. After all, how could you have two more incompatible groups than the stereotyped black-jacketed cyclists, and the Rubbies? Perhaps the change was due

in part to high-profile people such as Beals and some of his executives frequently participating at motorcycle rallies and charity rides. Technological and comfort improvements in motorcycles and their equipment added to the new attractiveness. Dealers were coaxed to make their stores more inviting.

Along with this, expanding the product mix not only made such Harley-branded merchandise a windfall for company and dealers alike, but also piqued the interest of upscale customers in motorcycles themselves. The company was commendably aggressive in running with the growing popularity of the ancillary merchandise and making this well over a \$100 million revenue booster.

Questions remained. How durable was this popularity, both of the big bikes and the complementary merchandise, with this affluent customer segment? Would it prove to be only a passing fad? If so, then Harley needed to seek diversifications as quickly as possible, even though the Holiday Rambler Corporation had brought no notable success by 1992. Diversifications often bring earnings disappointments compared with a firm's core business.

Another question concerned Harley's slowness in expanding production capability. Faced with a burgeoning demand, was it better to go slowly, to be carefully protective of quality, and to refrain from heavy debt commitments? This had been Harley's most recent strategy, but it raised the risk of permitting competitors to gain market share in the United States and especially in Europe. The following Issue Box discusses aggressive versus conservative planning.

ISSUE BOX

SHOULD WE BE AGGRESSIVE OR CONSERVATIVE IN OUR PLANNING?

The sales forecast—the estimate of sales for the periods ahead—serves a crucial role because it is the starting point for all detailed planning and budgeting. A volatile situation presents some high-risk alternatives: Should we be optimistic or conservative?

On one hand, with conservative planning in a growing market, a firm risks underestimating demand and being unable to expand its resources sufficiently to handle the potential. It may lack the manufacturing capability and sales staff to handle growth potential, and it may have to abdicate a good share of the growing business to competitors who are willing and able to expand their capability to meet the demands of the market.

On the other hand, a firm facing burgeoning demand should consider whether the growth is likely to be a short-term fad or a more permanent situation. A firm can easily become overextended in the buoyancy of booming business, only to see the collapse of such business jeopardizing its viability.

Harley's conservative decision was undoubtedly influenced by concerns about expanding beyond the limits of good quality control. The decision was also influenced by management's belief that Harley-Davidson had a loyal body of customers who would not switch despite the wait.

Do you think Harley-Davidson made the right decision by expanding conservatively? Why or why not? Defend your position.

Invitation to Make Your Own Analysis and Conclusions

Do you think Beal's rejuvenation efforts could have been better handled? Support your conclusions.

WHAT WE CAN LEARN

A Firm Can Come Back from Adversity

The resurrection of Harley-Davidson almost from the point of extinction proves that adversity can be overcome. It need not be fatal or forever. This should be encouraging to all firms facing difficulties, and to their investors. Harley, however, is noteworthy in the time it took to grasp opportunities and counter competitors—it was decades before a Vaughan Beals came on the scene as change maker.

What does a turnaround require? Above all, it takes a leader who has the vision and confidence that things can be changed for the better. The change may not necessitate anything particularly innovative. It may involve only a rededication to basics, such as better quality control or an improved commitment to customer service brought about by a new, positive attitude of employees. But such a return to basics requires that a demoralized or apathetic organization be rejuvenated and remotivated. This calls for leadership of a high order. If the core business has still been maintained, it at least provides a base to work from.

Preserve the Core Business at All Costs

Every viable firm has a basic core or distinctive position—sometimes called an ecological niche—in its business environment. This unique position may be due to its particular location or to a certain product. It may come from somewhat different operating methods, from the customers served, or from whatever makes a firm better than its competitors. This stronghold is the basic core of a company's survival. Though it may diversify and expand far beyond this area, the firm should not abandon its main bastion of strength.

Harley almost did this. Its core and, indeed, only business was its heavy-weight bikes sold to a limited and loyal, though not at the time particularly savory, customer segment. Harley almost lost this core business by abandoning reasonable quality control to the point that its motorcycles became the butt of jokes. To his credit, upon assuming leadership Beals acted quickly to correct the production and employee-motivation problems. By preserving the core, Beals was able to pursue other avenues of expansion.

The Power of a Mystique

Few products have been able to gain a mystique or cult following. Coors beer did for a few years in the 1960s and early 1970s, when it became the brew of

celebrities and the emblem of the purity and freshness of the West. In the cigarette industry, Marlboro rose to become the top seller from a somewhat similar advertising and image thrust: the Marlboro man. The Ford Mustang had a mystique at one time. Somehow the big bikes of Harley-Davidson developed a more enduring mystique as they appealed to two disparate customer segments: the HOGS and the Rubbies. Different they might be, but both were loyal to their Harleys. The mystique led to “logo magic”: Simply put the Harley-Davidson name and logo on all kinds of merchandise, and watch the sales take off.

How does a firm develop (or acquire) a mystique? There is no simple answer, no guarantee. Certainly a product has to be unique, but though most firms strive for this differentiation, few achieve a mystique. Image-building advertising, focusing on the target buyer, may help. Perhaps even better is image-building advertising that highlights the people customers might wish to emulate. But what about the black-leather-jacketed, perhaps bearded, cyclist?

Perhaps, in the final analysis, acquiring a mystique is more accidental and fortuitous than something that can be deliberately orchestrated. Two lessons, however, can be learned about mystiques: First, they do not last forever. Second, firms should run with them as long as possible and try to expand the reach of the name or logo to other goods, even unrelated ones, through licensing.

CONSIDER

What additional learning insights can you see coming from this Harley-Davidson resurgence?

QUESTIONS

1. Do you see any limitations to the viability and growth of Harley in the future? Discuss how these might be countered.
2. How durable do you think the Rubbies’ infatuation with the heavyweight Harleys will be? What leads you to this conclusion?
3. A Harley-Davidson stockholder criticizes present management: “It is a mistake of the greatest magnitude that we abdicate a decent share of the European motorcycle market to foreign competitors simply because we do not gear up our production to meet the demand.” Discuss.
4. Given the resurgence of Harley-Davidson in the 1990s, would you invest money now in the company? Discuss, considering as many factors bearing on this decision as you can.
5. “Harley-Davidson’s resurgence is only the purest luck. Who could have predicted, or influenced, the new popularity of big bikes with the affluent?” Discuss.
6. “The tariff increase on Japanese motorcycles in 1983 gave Harley-Davidson badly needed breathing room. In the final analysis, politics is more

important than management in competing with foreign firms.” What are your thoughts?

HANDS-ON EXERCISES

1. Be a Devil’s Advocate (One who opposes a position to establish its merits and validity). Your mutual fund has a major investment in Harley-Davidson, and you are concerned with Vaughn Beals’s presence at motorcycle rallies hobnobbing with black-jacketed motorcycle gangs. He maintains this is the way to cultivate a loyal core of customers. Argue against Beals.
2. As a vice president at Harley-Davidson in the 1990s, you believe the recovery efforts should have gone well beyond the heavyweight bikes into lightweights. What arguments would you present for this change in strategy, and what specific recommendations would you make for such a new course of action? What contrary arguments would you expect? How would you counter them?
3. As a staff assistant to Vaughn Beals when he first took over, you have been charged to design a strategy to bring a mystique to the Harley-Davidson name. How would you propose to do this? Be as specific as you can, and defend your reasoning.

YOUR PROGNOSIS FROM THE LATEST DEVELOPMENTS

Do you think the public’s willingness to promote biker rallies is reaching a saturation point? Why or why not? How does your prediction impact on Harley?

TEAM DEBATE EXERCISE

A major schism has developed in the executive ranks of Harley-Davidson. Many executives believe a monumental mistake is being made not to gear up production to meet the burgeoning worldwide demand for Harleys. Others see the present go-slow approach to increasing production as more prudent. Persuasively support your position and attack the other side.

INVITATION TO RESEARCH

What is the situation with Harley-Davidson today? Has the cult following remained as strong as ever? How are the new lightweight bikes faring? Are many women being attracted to Harleys? Have any new competitors emerged? Has Harley diversified beyond bikes? Are Rallies still drawing hundreds of thousands of bikers?

Continental Airlines: Salvaging from the Ashes

Massive marketing and management blunders almost destroyed Continental Airlines, but in only a few years, with a remarkable turnaround by new management, Continental became a star of the airline industry. The changemaker, CEO Gordon Bethune, wrote a best-selling book on how he turned around the moribund company, titled *From Worst to First*. In this chapter we will look at the scenario leading to Continental's difficulties, and then examine the ingredients of the great comeback.

THE FRANK LORENZO ERA

Lorenzo was a consummate manipulator, parlaying borrowed funds and little of his own money to build an airline empire. By the end of 1986, he controlled the largest airline network in the non-Communist world: only Aeroflot, the Soviet airline, was larger. Lorenzo's network was a leveraged amalgam of Continental, People Express, Frontier, and Eastern, with \$8.6 billion in sales—all this from a small investment in Texas International Airlines in 1971. In the process of building his network, Lorenzo defeated unions and shrewdly used the bankruptcy courts to further his ends. When he eventually departed, his empire was swimming in red ink, had a terrible reputation, and was burdened with colossal debt and aging planes.

The Start

After getting an MBA from Harvard, Lorenzo's first job was as a financial analyst at Trans World Airlines. In 1966 he and Robert Carney, a buddy from Harvard, formed an airline consulting firm; in 1969, the two put together \$35,000 to form an investment firm, Jet Capital. Through a public stock offering they were able to raise an additional \$1.15 million. In 1971 Jet Capital was called in to fix ailing Texas International and wound up buying it for \$1.5 million, and Lorenzo became CEO. He restructured the debt as well as the airline's routes, found funds to upgrade the almost obsolete planes, and brought Texas International to profitability.

In 1978, acquisition-minded Lorenzo lost out to Pan Am in a bidding war for National Airlines, but he made \$40 million on the National stock he had acquired.

In 1980, he created nonunion New York Air and formed Texas Air as a holding company. In 1982 Texas Air bought Continental for \$154 million.

Lorenzo's Treatment of Continental

In 1983, Lorenzo took Continental into bankruptcy court, filing for Chapter 11. This permitted the corporation to continue operating but spared its obligation to meet heavy interest payments and certain other contracts while it reorganized as a more viable enterprise. The process nullified the previous union contracts, and this prompted a walkout by many union workers.

Lorenzo earned the lasting enmity of organized labor and the reputation of union-buster as he replaced strikers with nonunion workers at much lower wages. (A few years later, he reinforced this reputation when he used the same tactics with Eastern Airlines.)

In a 1986 acquisition achievement that was to backfire a few years later, Lorenzo struck deals for a weak Eastern Airlines and a failing People Express/Frontier Airlines. That same year, Continental emerged out of bankruptcy. Now Continental, with its nonunion workforce making it a low-cost operator, was Lorenzo's shining jewel. The low bid accepted for Eastern reinforced Lorenzo's reputation as a visionary builder.

What kind of executive was Lorenzo? Although he was variously described as a master financier and visionary, his handling of day-to-day problems bordered on the inept.¹ One former executive was quoted as saying, "If he agreed with one thing at 12:15, it would be different by the afternoon."² Inconsistent planning and poor execution characterized his lack of good operational strength. Furthermore, his domineering and erratic style alienated talented executives. From 1983 to 1993, nine presidents left Continental.

But Lorenzo's treatment of his unions brought the most controversy. He became the central figure of confrontational labor-management relations to a degree perhaps unmatched by any other person in recent years. Although he won the battle with Continental's unions and later with Eastern's, he was burdened with costly strikes and the residue of ill feeling that impeded any profitable recovery during his time at the helm.

The Demise of Eastern Airlines

In an environment of heavy losses and its own militant unions, Eastern in 1986, accepted the low offer of Lorenzo. With tough contract demands and the stockpiling of \$1 billion in cash as strike insurance, Lorenzo seemed eager to precipitate and then crush a strike. He instituted a program of severe downsizing and in 1989, after 15 months of fruitless talks, some 8,500 machinists and 3,800 pilots went on strike. Lorenzo countered the strike at Eastern by filing for

¹ See for example, Todd Vogel, Gail DeGeorge, Pete Engardio, and Aaron Bernstein, "Texas Air Empire in Jeopardy," *Business Week*, March 27, 1989, p. 30.

² Mark Ivey and Gail DeGeorge, "Lorenzo May Land a Little Short of the Runway," *Business Week*, February 5, 1990, p. 48.

Chapter 11 bankruptcy, and replaced many of the striking pilots and machinists within months.

At first, Eastern appeared to be successfully weathering the strike, while Continental benefited with increased business. But soon revenue dropped drastically with Eastern planes flying less than half full amid rising fuel costs. Fares were slashed in order to regain business, and a liquidity crisis loomed. Then, on January 16, 1990, an Eastern jet sheared the top off a private plane in Atlanta. Even though the accident was attributed to air controller error, Eastern's name received the publicity.

Eastern creditors, now despairing of Lorenzo's ability to pay them back in full, pushed for a merger with Continental, which would expose it to the bankruptcy process. On December 3, 1990, Continental again tumbled into bankruptcy, burdened with overwhelming debt. In January 1991, Eastern finally went out of business.

CONTINENTAL'S EMERGENCE FROM BANKRUPTCY, AGAIN

Lorenzo was gone. The legacy of Eastern remained, however. Creditors claimed more than \$400 million in asset transfers between Eastern and Continental, and Eastern still had \$680 million in unfunded pension liabilities. The board brought in Robert Ferguson, veteran of Braniff and Eastern bankruptcies, to make changes. On April 16, 1993, the court approved a reorganization plan for Continental to emerge from bankruptcy, the first airline to have survived two bankruptcies. However, creditors got only pennies on the dollar.³

Despite its long history of travail and a terrible profit picture, Continental in 1992 was still the nation's fifth largest airline, behind American, United, Delta, and Northwest, and it served 193 airports. Table 10.1 shows the revenues and net profits (or losses) of Continental and its major competitors from 1987 through 1991.

Lorenzo's Legacy

Continental was savaged in its long tenure as a pawn in Lorenzo's dynasty-building efforts. He had saddled it with huge debts, brought it into bankruptcy twice, left it with aging equipment. Perhaps a greater detriment was a ravished corporate culture. The following Information Box discusses corporate culture and its relationship to public image or reputation.

A devastated reputation proved to be a major impediment. The reputation of a surly labor force had repercussions far beyond the organization itself. For years Continental had a problem wooing the better-paying business travelers. Being on expense accounts, they wanted quality service rather than cut-rate prices. A reputation for good service is not easily or quickly achieved, especially when the opposite reputation is well entrenched.

On another dimension, Continental's reputation also hindered competitive parity. Surviving two bankruptcies does not engender confidence among investors, creditors, or even travel agents.

³ Bridget O'Brian, "Judge Backs Continental Airlines Plan to Regroup, Emerge from Chapter 11," *Wall Street Journal*, April 19, 1993, p. A4.

TABLE 10.1 Performance Statistics, Major Airlines, 1987–1991

	1987	1988	1989	1990	1991	Percent 5-Year Gain
<i>Revenues: (millions \$)</i>						
American	6,368	7,548	8,670	9,203	9,309	46.0
Delta	5,638	6,684	7,780	7,697	8,268	46.6
United	6,500	7,006	7,463	7,946	7,850	20.8
Northwest	3,328	3,395	3,944	4,298	4,330	30.1
Continental	3,404	3,682	3,896	4,036	4,031	18.4
<i>Income (millions \$)</i>						
American	225	450	412	(40)	(253)	
Delta	201	286	467	(119)	(216)	
United	22	426	246	73	(175)	
Continental	(304)	(310)	(56)	(1,218)	(1,550)	

Source: Company annual reports.

Commentary: Note the operating performance of Continental relative to its major competitors during this period. It ranks last in sales gain. It far and away has the worst profit performance, having had massive losses in each of the years in contrast to its competitors, who, while incurring some losses, had neither the constancy nor the magnitude of losses of Continental. And the relative losses of Continental are even worse than they at first appear: Continental is the smallest of these major airlines.

A Sick Airline Industry

Domestic airlines lost a staggering \$8 billion in the years 1990 through 1992. Fare wars and excess planes proved to be albatrosses. Even when planes were filled, discount prices often did not cover overhead.

A lengthy recession drove both firms and individuals to fly more sparingly. Business firms found teleconferencing a viable substitute for business travel, and consumers, facing diminished discretionary income as well as the threat of eventual layoffs or forced retirements, were hardly optimistic. The airlines suffered.

Part of the blame for the red ink lay directly with the airlines—and especially their reckless expansion efforts—yet they did not deserve total blame. In the late 1980s, passenger traffic climbed 10 percent per year, and in response the airlines ordered hundreds of jetliners.⁴ The recession arrived just as new planes were being delivered. The airlines greatly increased their debt in these expansion efforts. The big three, for example—American, United, and Delta—doubled their leverage in the four years after 1989, with debt by 1993 at 80 percent of capitalization.⁵

In such a climate, cost-cutting efforts prevailed. But how much can be cut without jeopardizing service and even safety? Some airlines found that hubs, heralded as the great strategy of the 1980s, were not as cost-effective as expected. With hub cities, passengers were gathered from outlying “spokes” and then

⁴ Andrea Rothman, “Airlines: Still No Wind at Their Backs,” *Business Week*, January 11, 1993, p. 96.

⁵ *Ibid.*

INFORMATION BOX

IMPORTANCE OF CORPORATE CULTURE

A corporate or organizational culture can be defined as the system of shared beliefs and values that develops within an organization and guides the behavior of its members.⁶ Such a culture can be a powerful influence on performance and customer satisfaction:

If employees know what their company stands for, if they know what standards they are to uphold, then they are much more likely to make decisions that will support those standards. They are also more likely to feel as if they are an important part of the organization. They are motivated because life in the company has meaning for them.

Lorenzo had destroyed the former organizational climate as he beat down the unions. Replacement employees had little reason to develop a positive culture or esprit de corps given the many top management changes, the low pay relative to other airline employees, and the continuous possibility of corporate bankruptcy. Employees had little to be proud of, and this impacted on the service and consequent reputation among the traveling public.

But this was to change abruptly under new management.

Can a corporate climate be too upbeat? Discuss.

Source: Terrence E. Deal and Alan A. Kennedy, *Corporate Cultures: The Rites and Rituals of Corporate Life*, Reading, MA: Addison-Wesley, 1982, p. 22.

⁶ Edgar H. Schein, "Organizational Culture," *American Psychologist*, vol. 45 (1990), pp. 109–119.

flown to final destinations. Maintaining too many hubs, however, brought costly overheads. While the concept was good, some retrenchment seemed necessary to be cost effective.

Airlines such as Continental with heavy debt and limited liquidity had two major concerns: first, how fast the country could emerge from recession; second, the risk of fuel price escalation in the coming years. Despite Continental's low operating costs, external conditions impossible to predict or control could affect viability.

THE GREAT COMEBACK UNDER GORDON BETHUNE

In February 1994 Gordon Bethune left Boeing and took the job of president and chief operating officer of Continental. He faced a daunting challenge. While it was the fifth largest airline, Continental was by far the worst among the nation's ten biggest according to these quality indicators by the Department of Transportation:

- On-time percentage (the percentage of flights that land within 15 minutes of their scheduled arrival).
- Number of mishandled-baggage reports filed per 1,000 passengers.

- Number of complaints per 100,000 passengers.
- Involuntarily denied boarding, i.e., passengers with tickets who are not allowed to board because of overbooking or other problems.⁷

In late October Bethune became chief executive officer. Now he was sitting in the pilot's seat.

He made dramatic changes. In 1995, through a "renewed focus on flight schedules and incentive pay," he greatly improved on-time performance, along with lost-baggage claims and customer complaints. Now instead of being dead last in these quality indicators of the Department of Transportation, Continental by 1996 was third best or better in all four categories.

Customers began returning, especially the higher-fare business travelers, climbing from 32.2 percent in 1994 to 42.8 percent of all customers by 1996. In May 1996, based on customer surveys Continental was awarded the J.D. Power Award as the best airline for customer satisfaction on flights of 500 miles or more. It also received the award in 1997, the first airline to win two years in a row. Other honors followed. In January 1997 it was named "Airline of the Year" by *Air Transport World*, the leading industry monthly. In January 1997, *Business Week* magazine named Bethune one of its top managers of 1996.

Bethune had transformed the workforce into a happy one, as measured by these statistics:

- Wages up an average of 25 percent.
- Sick leave down more than 29 percent.
- Personnel turnover down 45 percent.
- Workers compensation claims down 51 percent.
- On-the-job injuries down 54 percent.⁸

Perhaps nothing illustrates the improvement in employee morale as much as this: In 1995, not all that long after he became top executive, employees were so happy with their new boss's performance that they chipped in to buy him a \$22,000 Harley-Davidson.⁹

Naturally these improvement in employee relations and customer service had major impact on revenues and profitability. See Table 10.2 for the 3 years before and after Bethune.

Gordon Bethune

Bethune's father was a crop duster, and as a teenager Gordon helped him one summer and learned first hand the challenges of responsibility: in this case, preparing a crude landing strip for nighttime landings, with any negligence disastrous. He joined the Navy at 17, before finishing high school. He graduated second in his class at the

⁷ Gordon Bethune, *From Worst to First*, New York: Wiley, 1998, p. 4.

⁸ *Ibid.*, pp. 7–8.

⁹ *Ibid.*, frontpiece.

TABLE 10.2 Continental Sales and Profits, Before and After Bethune, 1992–1997

	Before Bethune			After Bethune		
	1992	1993	1994	1995	1996	1997
Revenues (millions \$)	5,494	3,907	5,670	5,825	6,360	7,213
Net income (millions \$)	–110	–39	–612	224	325	389
Earnings per share (\$)		–1.17	–11.88	3.60	4.25	5.03

Source: Company annual reports.

Commentary: While the revenue statistics do not show a striking improvement, the net income certainly does. Most important to investors, the earnings per share show a major improvement.

These statistics suggest the fallacy of a low-price strategy at the expense of profitability in the 1992–1994 era. At the same time, we have to realize that the early 1990s were recession years, particularly for the airline industry.

Naval Technical School to become an aviation electronics technician, and over 19 years worked his way up to lieutenant. After leaving the Navy he joined Braniff, then Western, and later Piedmont Airlines as senior vice president of Operations. He finally left Piedmont for Boeing as VP/General Manager of Customer Service. There he became licensed as a 757 and 767 pilot: “An amazing thing happened. All the Boeing pilots suddenly thought I was a great guy,” he writes. “I hope I hadn’t given them any reason to think otherwise of me before that, but this really got their attention.”¹⁰

HOW DID HE DO IT?

Bethune stressed the human element in guiding the comeback of a lethargic, even bitter, organization by doing the simple things: “On October 24, 1994, I did a very significant thing in the executive suite of Continental Airlines . . . I opened the doors. . . [Before this] The doors to the executive suite were locked, and you needed an ID to get through. Security cameras added to the feeling of relaxed charm. . . So the day I began running the company, I opened the doors. I wasn’t afraid of my employees, and I wanted everybody to know it.”¹¹ Still, he had to entice employees to the twentieth floor of headquarters, and he did this with open houses, supplying food and drink, and personal tours and chat sessions. “I’d take a group of employees into my office, open up the closet, and say, ‘You see? Frank’s not here.’ Frank Lorenzo had left Continental years before; the legacy of cost cutting and infighting of that era was finally gone, and I wanted them to know it.”¹²

Of course, the improved employee relations needed tangible elements to cement and sustain it, and to improve the morale. Bethune worked hard to instill a spirit of teamwork. He did this by giving on-time bonuses to all employees, not just pilots. He burned the employee procedure manual that bound them to rigid policies instead of being able to use their best judgment. He even gave the planes a new paint job

¹⁰ *Ibid.*, p. 268.

¹¹ *Ibid.*, p. 14.

¹² *Ibid.*, p. 32.

to provide tangible evidence of a disavowal of the old and an embracing of new policies and practices. This new image impressed both employees and customers.

Better communications was also a key element in improving employee relationships and the spirit of teamwork. Information was shared with employees through newsletters, updates on bulletin boards, e-mail, voice-mail, and electronic signs over worldwide workplaces. To Bethune it was a cardinal sin for any organization if employees first heard of something affecting them through the newspaper or other media. The following Information Box contrasts the classic Theory X and Theory Y managers. Bethune was certainly a Theory Y manager and Lorenzo Theory X.

INFORMATION BOX

THE THEORY X AND THEORY Y MANAGER

Douglas McGregor, in his famous book, *The Human Side of Enterprise*, advanced the thesis of two different types of managers, the traditional Theory X manager with rather low opinion of subordinates, and his new Theory Y manager, whom we might call a human-relations type of manager.

Schermerhorn contrasts the two styles as follows:

Theory X views subordinates as:

- Disliking work
- Lacking in ambition
- Irresponsible
- Resistant to change
- Preferring to be led than to lead

Theory Y sees subordinates this way:

- Willing to work
- Willing to accept responsibility
- Capable of self-direction
- Capable of self-control
- Capable of imagination, ingenuity, creativity

Which is better? With the success of Bethune in motivating his employees for strong positive change in the organization, one would think Theory Y is the only way to go. McGregor certainly thought so and predicted that giving workers more participation, freedom, and responsibility would result in high productivity.

So, is there any room for a Theory X manager today? If so, under what circumstances?

Sources: Douglas McGregor, *The Human Side of Enterprise*, New York: McGraw-Hill, 1960; John R. Schermerhorn, Jr., *Management, 6th ed.*, New York: Wiley 1999, p. 79.

Now Continental had to win back customers. Instead of the company's old focus on cost savings, efforts were directed to putting out a better product through better service. This meant emphasis on on-time flights, better baggage handling, and the like. By giving employees bonuses for meeting these standards, the incentive was created.

Bethune sought to do a better job of designing routes with good demand, to "fly places people wanted to go." This meant, for example, cutting back on six flights a day between Greensboro, North Carolina and Greenville, South Carolina. It meant not trying to compete with Southwest's Friends Fly Free Fares, which "essentially allowed passengers to fly anywhere within the state of Florida for \$24.50.¹³ The frequent flyer program was reinstated. Going a step further, the company apologized to travel agents, business partners, and customers and showed them how it planned to do better and earn their business back.

Continental queried travel agents about their biggest clients, the major firms that did the most traveling, asking how could it better serve their customers. As a result, more first-class seats were added, certain destinations were given more attention, volume discounts were instituted. Travel agents were made members of the team and given special incentives beyond normal airline commissions.

This still left financial considerations. Bethune was aggressive in renegotiating loans and poor airplane lease agreements, and in getting supplier financial cooperation. Controls were set up to monitor cash flow and stop waste. Tables 10.3 and 10.4 show the results of Bethune's efforts from the dark days of 1992–94, and how the competitive position of Continental changed. Remember, Bethune

TABLE 10.3 Competitive Position of Continental Before and After Bethune, 1992–1997

	Before Bethune			After Bethune		
	1992	1993	1994	1995	1996	1997
<i>Revenues (millions \$):</i>						
AMR (American)	14,396	15,701	16,137	16,910	17,753	18,570
UAR (United)	12,890	14,511	13,950	14,943	16,362	17,378
Delta	10,837	11,997	12,359	12,194	12,455	13,590
Northwest	NA	8,649	9,143	9,085	9,881	10,226
Continental	5,494	3,907	5,670	5,825	6,360	7,213
Continental's Market Share (percent of total sales of Big Five Airlines):		7.1%	9.9%	9.9%	10.1%	10.8%

Sources: Company annual reports.

NA = Information not available.

Commentary: Most significant is the gradual increase in Continental's market share over its four major rivals. This is an improving competitive position.

¹³ *Ibid.*, pp. 51–52.

TABLE 10.4 Profitability Comparison of Big Five Airlines, 1992–1997

	Before Bethune			After Bethune		
	1992	1993	1994	1995	1996	1997
<i>Net Income (millions \$):</i>						
AMR	-474	-96	228	196	1,105	985
UAL	-416	-31	77	378	600	958
Delta	-505	-414	-408	294	156	854
Northwest	NA	-114	296	342	536	606
Continental	-110	-39	-696	224	325	389

Source: Company annual reports.

NA = Information not available.

Commentary: Of interest is how the good and bad times for the airlines seem to move in lockstep. Still, the smallest of the Big Five, Continental incurred the biggest loss of any airline in 1994. Under Bethune, it has seen a steady increase in profitability, but so have the other airlines, although AMR and Delta have been more erratic.

joined the firm in February 1994 and did not become the top executive until late October of that year.

UPDATE

As the airline industry moved into the new millennium, external circumstances impacted negatively on the whole industry. The 9/11 disaster of 2001 had a profound effect, all the more because passenger planes were the instruments of destruction by the terrorists. Passenger traffic was down, restrictions and inconveniences were the order of the day. Then surging oil prices were the double whammy. U.S. airlines posted losses of some \$8 billion in 2002, after 2001's record loss of \$7.7 billion. The loss in the more profitable business travel was particularly acute. High-cost airlines faced enormous pressure from low-fare carriers, most notably Southwest and JetBlue Airways. United Airlines and US Airways fell into bankruptcy in late 2002, and were joined by Northwest and Delta in 2005, leaving only AMR and Continental of the six major carriers to escape bankruptcy. Airlines needed to slash billions in operating costs, notably through labor givebacks of extravagant union contracts, and restructuring was the order of the day. In this climate, Continental's revenue rose, although red ink prevailed most years, Table 10.5 compares Continental's operating results for 2002 through 2005, with those of American Airlines (now AMR) and Southwest Airlines, the only carrier to make a profit every year.

Gordon Bethune retired at the end of 2004 after a distinguished career. He joined the lecture circuit, and his speaker's fees ranged from \$30,000 to \$50,000. In 2006 he became CEO of Aloha Airlines.

Bethune's Legacy While Bethune was gone by mid-decade, his fine-tuning of Continental lived on. In 2006 awards continued to be showered on the airline. A survey of business travelers by *Conde Nast Traveler* found Continental running the best business class of any U.S. airline on foreign routes, and the best premium

TABLE 10.5 Comparison of Continental with Its Two Major Competitors Not in Bankruptcy, 2002–2005 (millions of \$)

	2002	2003	2004	2005
<i>Revenues:</i>				
AMR (American)	17,299	17,440	18,645	20,712
Southwest	5,522	5,937	6,530	7,584
Continental	8,402	8,870	9,744	11,208
Continental's market share (Continental's sales divided by total sales of these three airlines)	26.9%	27.5%	27.9%	28.4%
<i>Net Income:</i>				
AMR	-2,523	-1,228	-761	-861
Southwest	241	442	313	548
Continental	-451	38	-363	-68

Source: Company annual reports.

Commentary: Of particular interest is how Continental has improved its market share relative to these two competitors each year since 2002. Of course, it had other competitors—Northwest, United, Delta, and US Air—who were in bankruptcy with operating statistics not available. In the income comparisons, AMR shows up by far the worst, while Southwest alone of all the airlines was profitable every year. Continental's three years of losses, while erratic, show an improving picture.

service on domestic routes. Earlier in the year, it was ranked first in a poll by J. D. Power & Associates. While only the fourth-largest U. S. carrier, Continental flew to more international destinations than any other U.S. airline. It catered to business travelers, who paid the highest fares and flew most frequently, with more comfortable seats, special waiting areas, and bags tagged for first unloading. At a time when most airlines were drastically cutting back on amenities in coach, Continental still provided free blankets, pillows, and hot meals.

Continuing with the Bethune legacy, the airline valued employees. After the 9/11 attacks hurt air travel, Continental's executives gave up their pay for the rest of the year. They later squeezed more than \$1 billion out of operations before turning to employees for \$500 million in pay cuts when fuel costs soared. The result was peaceful labor relations, higher morale, and better service.¹⁴

Invitation to Make Your Own Analysis and Conclusions

Gordon Bethune's approach to salvaging Continental seems almost too good to be true. Surely he has shown some management flaws or missteps? What could he have done better? Your recommendations please.

¹⁴ Jane Engle, "Continental Could Be the Airline of the Future," *Los Angeles Times*, as reported in *Cleveland Plain Dealer*, October 22, 2006, p. G1.

WHAT WE CAN LEARN

It Is Possible to Quickly Turn Around an Organization

This idea flies in the face of conventional wisdom. How can a firm's bad reputation with employees, customers, creditors, stockholders, and suppliers be overcome without years of trying to prove that it has changed for the better? This conventional wisdom is usually correct: a great comeback does not often occur easily or quickly. But it sometimes does, with a streetwise leader, and a bit of luck perhaps. Gordon Bethune is proof that negative attitudes can be turned around quickly.

This possibility of a quick turnaround should be inspiring to other organizations mired in adversity.

Still, reputation should be carefully guarded. In most cases, a poor image is difficult to overcome, with trust built up only over time. The prudent firm is careful to safeguard its reputation.

Give Employees a Sense of Pride and a Caring Management

Bethune proved a master at changing employees' attitudes and their sense of pride. Few top executives ever faced such a negative workforce, reflecting the Lorenzo years. But Bethune changed all this, and in such a short time. His open-door policy and open houses to encourage employees to interact with him and other top executives was a simple gesture, but so effective, as was his opening wide the channels of communication about company plans. The incentive plans for improving performance, and the freeing up of employee initiatives by abolishing the rigidity of formal policies, were further positives. He engendered an atmosphere of teamwork and a personal image of an appreciative CEO. What is truly remarkable is how quickly such simple actions could turn around the attitudes of a workforce from adversarial, with morale in the pits, to pride and an eagerness to build an airline.

Contradictory and Inconsistent Strategies Are Vulnerable

Lorenzo was often described as mercurial and subject to knee-jerk planning, and poor execution. (For example, Ivey and DeGeorge, p. 48.) Clearly focused objectives and strategies mark effective firms. They bring stability to an organization and give customers, employees, and investors confidence in undeviating commitments. Admittedly, some objectives and strategies may have to be modified occasionally to meet changing environmental and competitive conditions, but the spirit of the organization should be resolute, provided it is a positive influence and not a negative one.

Try to Avoid an Adversarial Approach to Employee Relations

Lorenzo used a confrontational and adversarial approach to his organization and the unions. He was seemingly successful in destroying the unions and hiring

nonunion replacements at lower pay scales. This resulted in Continental's becoming the lowest-cost operator of the major carriers, but there were negatives: service problems, questionable morale, diminished reputation, and devastated profitability.

Bethune used the opposite tack. It is hard to argue against nurturing and supporting an existing organization, thereby avoiding the adversarial mindset of "them or us." Admittedly this may sometimes be difficult—sometimes impossible, at least in the short-run—but it is worth trying. It should result in better morale, motivation, and commitment to the company's best interest.

The Dangers of Competing Mostly on Low Price

Bethune inherited one of the lowest-cost air carriers, and it was doing badly. He says, "You can make an airline so cheap nobody wants to fly it, [just as] you can make a pizza so cheap nobody wants to eat it. Trust me on this—we did it . . . In fact, it was making us lousy, and people didn't want to buy what we offered."¹⁵

We might add here that competing strictly on a price basis usually leaves a firm vulnerable. Low prices can often (though not always) be matched or countered by competitors if such low prices are attracting enough customers. On the other hand, competition based on nonprice factors like better service, quality of product, a good public image or reputation are not so easily matched, and can be more attractive to many customers.

In three other cases in this book, we see firms competing successfully with a low-price strategy. Vanguard, Dell, and Southwest Air have for decades had operational efficiencies unmatched in their industries, but Dell and Southwest are now seeing their advantage eroding somewhat.

CONSIDER

Can you add any other learning insights?

QUESTIONS

1. Could Lorenzo's confrontation with Continental's unions have been more constructively handled? How?
2. Compare Bethune's handling of employees with that of Kelleher of Southwest Airlines in Chapter 18. Are there commonalities? Contrasts?
3. Compare Bethune's management style with Lorenzo's. What conclusions can you draw?
4. Bethune gave great credit to his open-door policy when he became CEO. Do you think this was a major factor in the turnaround? How about changing the paint of the planes?

¹⁵ Bethune, p. 50.

5. How do you motivate employees to give a high priority to customer service?
6. Evaluate the causes and the consequences of frequent top executive changes such as Continental experienced in the days of Lorenzo?
7. How can replacement workers—in this case, pilots and skilled maintenance people hired at substantially lower salaries than their unionized peers at other airlines—be sufficiently motivated to provide top-notch service and a constructive esprit de corps?

HANDS-ON EXERCISES

1. It is 1994 and Bethune has just taken over. He has asked you as his staff adviser to prepare a report on improving customer service as quickly as possible. He has also asked you to design a program to inform potential business and nonbusiness customers of this new commitment. Be as specific as possible in your recommendations.
2. You are the leader of the machinists' union at Eastern. It is 1986 and Lorenzo has just acquired your airline. You know full well how he broke the union at Continental, and rumors are flying that he has similar plans for Eastern. Describe your tactics under two scenarios:
 - a. You decide to take a conciliatory stance.
 - b. You plan to fight him every step of the way.

How successful do you think you will be in saving your union?

TEAM DEBATE EXERCISE

Bethune was quoted as saying, "You can make an airline so cheap nobody wants to fly it." Debate this issue, and the related issue of how can an airline make itself sufficiently unique so that it can command higher prices than competitors.

INVITATION TO RESEARCH

What is Continental's current situation? Have all the major airlines emerged from bankruptcy? Is the U.S. airline industry healthy now? Whatever happened to Lorenzo? How is Bethune doing with Aloha Airlines?

**PART
FOUR**

**MARKETING
MANAGEMENT
MISTAKES**

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Borden: Letting Brands Wither

Elsie the cow had long been the symbol of Borden, the largest producer of dairy products. But Borden grew well beyond dairy products to become a diversified food processor and marketer. Decades of children cherished its Cracker Jacks candied popcorn with a gift in every box; its Creamette pasta was the leading national brand, and it had strong regional brands as well. Lady Borden ice cream, milk, and frozen yogurt were well known, as were other dairy brands, national and regional. Even Elmer's glue belonged to the Borden family. With its well-known brands, Borden experienced solid growth in sales and profits for years and became a \$7 billion company. Then in 1991, fortunes took a turn for the worse, and dark days were upon Borden. Top management had somehow allowed its brand franchises—the public recognition and acceptance of its brands—to deteriorate. Regaining lost ground was to prove no easy matter.

PRELUDE TO THE DARK DAYS

Borden was founded in 1857 by Gail Borden Jr., a former Texas newspaperman. It sold condensed milk during the Civil War and later diversified into chemicals. In the 1960s Borden acquired such food brands as Cracker Jack and ReaLemon. Because of the wide earnings swings of cyclical chemical prices, Eugene J. Sullivan, the CEO, intensified the shift into consumer products in the 1970s.

In November 1991 Anthony S. D'Amato took the helm at Borden. He succeeded Romeo J. Ventres, a good friend, who when he retired in 1991 convinced the board that his protege, D'Amato, was the ideal successor. The two men, however, had sharply different management styles. Ventres was more an idea man who had great faith in his top managers and gave them free rein. D'Amato was blunt, profane, and believed in personally becoming deeply involved in operations. D'Amato's different management approach was not well received by some Borden top managers. And the company went downhill fast under D'Amato's chairmanship.

But the seeds of Borden's problems were sowed before D'Amato took the helm. Ventres had dreamed of transforming Borden from a rather unexciting conglomerate into a major food marketer. Between 1986 and 1991, Ventres spent nearly \$2 billion on 91 acquisitions. "We were hurriedly buying companies for the sake of

buying companies,” said one Borden executive. The company in its rush to move quickly on its acquisition program sometimes spent as little as two weeks researching an acquisition candidate before making a decision.¹

Some acquisitions turned out to be real losers. For example, in 1987 Borden purchased Laura Scudder potato chips for nearly \$100 million. Unfortunately, major union problems led to Borden’s closing all of Laura Scudder’s California plants only a year after the purchase. Borden then shifted production to a plant in Salt Lake City, only to encounter high costs and quality-control problems it could not correct. In 1993 it sold Laura Scudder for less than \$20 million. All told, this fiasco cost Borden nearly \$150 million.

Most acquisitions were small- and medium-size regional food and industrial companies. Ventres’ strategy was to obtain growth by marketing these regional brands beyond their regular market areas. By consolidating manufacturing and distribution, he thought Borden could become the low-cost producer of a variety of product lines, thereby gaining more clout in the marketplace.

In the late 1980s this strategy seemed to work well. With its acquisitions, company sales grew 54 percent between 1985 and 1988. Earnings climbed even sharper to 61 percent, the most rapid growth in the company’s history (see Table 11.1). Regional marketing and tailoring products to local tastes seemed a potent strategy.

In 1987 *Fortune* magazine featured Borden as a model of corporate performance. It termed the company “a consumer products brute,” and extolled “some 40 acquisitions over two years that have made Borden, already the world’s largest dairy company, the nationwide king of pasta and the second-largest seller of snack foods behind PepsiCo’s Frito-Lay.” The regional brand strategy was praised as motivating regionals to create new products as well as borrow from one another. For example, in just six weeks, Snacktime, one of Borden’s new regional brands, developed Krunchers!, a kettle-cooked

TABLE 11.1 Revenues and Net Income, 1983–1989

	Revenues (million \$)	% Change	Net Income (million \$)	% Change
1989	7,593	4.8	(61)	
1988	7,244	11.2	312	16.9
1987	6,514	30.2	267	19.7
1986	5,002	6.1	223	14.9
1985	4,716	3.2	194	1.5
1984	4,568	7.1	191	1.1
1983	4,265		189	

Source: Company reports.

Commentary: Growth was steady during most of these years, but really accelerated in 1987 and 1988. No wonder the 1987 *Fortune* article spoke in glowing terms about Borden.

¹ Kathleen Deveny and Suein L. Hwang, “A Defective Strategy of Acquisitions Spoils Borden Name,” *Wall Street Journal*, January 18, 1984, p. A4.

potato chip differentiated from those made the conventional way through continuous frying. The chip became an instant success, generating \$17 million in annual sales.²

In 1987 the milk business was among the most profitable in the industry. Borden, with its Elsie the cow symbol, was able to charge more than competitors could, this being surprising for a commodity such as milk, which is virtually the same product whatever cow it comes from. The company insisted that its high quality and service standards made the “Borden Difference.” But when asked exactly what that difference was, a veteran dairyman in a succinct quote said, “About a buck a gallon.”³ Perhaps this was a portent of what was to come.

Premonitions

Flaws in the execution of the strategy were beginning to emerge by end of the 1980s. In the race to expand the food portfolio, the company ignored some of the well-known and successful brands it already had. For example, it had sold ice cream under the Lady Borden label for decades, but ignored the golden opportunity in the 1980s to extend the line into super-premium ice cream, which was becoming highly popular. Borden showed the same negligence in not aggressively developing new products for many of its other strongest brand names. (See the Information Box: Brand Extension for a discussion of the effective brand extension strategy.) And one could wonder how much longer the price premium charged for milk and Lady Borden ice cream could hold up as the company moved into the skeptical 1990s.

Borden was now finding difficulty in digesting its hodgepodge of acquisitions. (Table 11.2 shows the broad range of food and nonfood products and the business

INFORMATION BOX

BRAND EXTENSION

Brand extension can be a particularly effective use of branding. It is a strategy of applying an established brand name to new products. As a result, customer acceptance of the new products is more likely because of their familiarity and satisfaction with the existing products bearing the same name. This reduces the risk of new-product failure. Today about one-half of new consumer products use some form of brand extension, such as the same product in a different form, a companion product, or a different product for the same target market.

The more highly regarded a brand is by customers the better candidate it is for brand extension—provided that a new product will not hurt its reputation and has some relevance to it. The strong favorable image of the Lady Borden brand made it ideal for such brand extension. A favorable image should be zealously protected from being cheapened or having its perception of good value undermined.

Discuss why brand extension may not always work.

² Bill Saporito, “How Borden Milks Packaged Goods,” *Fortune*, December 21, 1987, pp. 139–144.

³ *Ibid.*, p. 142.

TABLE 11.2 Business Segment Contributions to Total Company Sales and Earnings, 1992

	Sales	Operating Profits
	(percent of total)	
Grocery	26%	42%
Snacks and International Consumer	26	18
Dairy	20	5
Packaging and Industrial	28	35

Grocery products include North American pasta and sauces (Creamette, Prince, Dutch Maid, Goodman's, Classico, Aunt Millie's); niche grocery products (Eagle-brand condensed milk, Campfire marshmallows, Cracker Jack candied popcorn); refrigerated products (Borden cheese); and food service operations.

Snacks & International Consumer products include Borden's worldwide sweet and salty snacks (Borden, Wise, Snack Time!); other food products outside the United States and Canada (Weber sweet snacks, KLIM milk powder, Lady Borden ice cream); and films and adhesives in the Far East.

Dairy products, including milk, ice cream, and frozen yogurt, sold under national and branded labels, which include Borden, Lady Borden, Meadow Gold, Viva, and Eagle.

Packaging & Industrial products include consumer adhesives (Elmer's glue); wall-coverings, plastic films, and packaging products (Proponite food packaging film, Resinite, and Sealwrap vinyl food-wrap films); and foundry, industrial, and specialty resins.

Source: Company public information.

segment contributions to total sales and profits as of 1992.) It continued to operate as a bunch of nonintegrated businesses and thereby proved to be neither as efficient as major competitors nor as able to amass marketing clout.

By the time D'Amato took over, the company was clearly ailing. By the end of 1991, sales had declined 5 percent from the previous year, and net income had fallen 19 percent. D'Amato quickly tried to consolidate the loosely structured organization, but all his efforts seemed to only make matters worse.

D'AMATO'S FUTILITY

Shortly after becoming CEO, D'Amato tried to better integrate the morass of consumer food businesses. He wanted to tighten up and centralize the widely decentralized company with its "dozens of independent fiefdoms." Even corporate offices were scattered between New York City and the hub of the company's operations in Columbus, Ohio. Such geographical distance suited the hands-off management style of Ventres, who rarely got involved in day-to-day operations and spent most of his time at Borden's small Park Avenue offices in New York. D'Amato moved to centralize far-flung operations in Columbus. There he involved himself deeply in day-to-day operations. He increasingly saw the need to eliminate or sell many of Borden's small regional businesses while focusing most efforts on building national brands. A reversal of the strategy of Ventres, this.

Analysts initially applauded D'Amato's strategy for turning Borden around, but the praise was short-lived as results failed to meet expectations and even brought new problems.

D'Amato was especially wedded to the notion that the brand recognition of certain of its brands should allow the company to charge a premium price. For example, Borden's own research had shown that 97 percent of consumers recognized Borden as a leading milk brand.⁴ D'Amato saw this as supporting such a premium price. Then in early 1992, raw-milk prices dropped by about one-third. Borden doggedly held its prices, while competitors lowered theirs to reflect the drop in commodity prices. Before long, Borden began losing customers who were realizing that milk is milk. Good brand recognition did not insulate a national brand from lower priced competition of other national brands and private brands. See the Information Box: The Battle of the Brands.

INFORMATION BOX

THE BATTLE OF THE BRANDS: PRIVATE VERSUS NATIONAL

Wholesalers and retailers often use their own brands—commonly referred to as private brands—in place of or in addition to the national brands of manufacturers. Private brands usually are offered at lower selling prices than nationally advertised brands, yet they typically give dealers better per-unit profit since they can be bought on more favorable terms, partly reflecting the promotional savings involved. Some firms, such as Sears and Penney, used to stock mostly their own brands. Thus, they had better control over repeat business since satisfied customers could repurchase the brand only through the particular store or chain.

With private brands directly competing with manufacturers brands, often at a more attractive price, you may ask why manufacturers sell some of their output to retailers under a private brand? A major reason is to minimize idle plant capacity. Manufacturers can always rationalize that if they refuse private-label business, someone else will not, and competition with private brands will continue. Other manufacturers welcome private-brand business because they lack the resources and know-how to enter the marketplace effectively with their own brands.

By the 1990s, more knowledgeable and frugal consumers were realizing that private brands often offered the best value. National consumer brands were being hurt. Recognizing this new intense competition, some manufacturers of branded goods, led by makers of cigarettes and disposable diapers, in 1993 rolled back the price differentials over private brands of their national labels. Borden management had difficulty accepting the idea that the price premiums of its national brands were no longer sustainable if market share was not to be lost.

How do you personally feel about private brands?

⁴ Elizabeth Lesly, "Why Things Are So Sour at Borden," *Business Week*, November 1993, p. 82.

D'Amato opted to tough out the loss of market share, expecting that higher profit margins would offset somewhat lower sales. Only after almost a year of steadily declining sales did he abandon the premium-pricing policy. By then sales had fallen so drastically that the milk division was operating at a loss.

Another marketing mistake involved misuse of advertising. D'Amato, in his strategy to build up Borden's major brands, had boosted marketing efforts for Creamette, the leading national pasta brand. With the sizable promotional expenditures, the brand's sales rose 1.6 percent in 1992. This may have seemed a significant increase but for the fact that, nationally, pasta sales rose 5.5 percent.

How could the promotional efforts have been so ineffective? Unbelievably, most of the advertising featured recipes aimed at increasing pasta consumption, rather than at building *selective demand* for the Creamette brand.

Making the marketing efforts for Creamette even more misguided, Borden neglected its regional pasta brands, such as Anthony's in the West and Prince in the Northeast. These sales slumped, so that total division sales were down \$600 million in the first nine months of 1993. D'Amato admitted the mistake: "There was a very strong desire to make Creamette the one bigger brand beyond anything else. That's a great objective, [but] when you do it at the expense of your strong regional brands, maybe it doesn't make any sense."⁵

The snack food division also bedeviled D'Amato. He planned to launch a national Borden brand of chips and pretzels in the expectation that this could replace many of the company's regional snack brands. Combining the regionals' manufacturing and distribution costs under a single brand should enable Borden both to cut costs and also gain marketing muscle. The company tested the new snack line in Michigan, but results were only mediocre. Unfortunately, Borden was going up against PepsiCo's Frito-Lay and Anheuser-Busch's Eagle Snacks—major entrenched national brands. It could not wedge in. The company finally refocused its efforts to attempt to build up regional brands such as Jays and Wise; but they were ineffective or too late.

THE CHANGING OF THE GUARD

D'Amato's sweeping strategy to rejuvenate the ailing Borden left the company worse off than before. Two of its four divisions, dairy and snacks, were operating at losses. Its other two divisions, grocery products and chemicals, could not take up the slack. On October 27, 1993, Standards & Poor's downgraded much of Borden's debt. Since the beginning of 1993, Borden's share price had plummeted 43 percent.

In June 1993 D'Amato hired Ervin R. Shames, 53, as president and heir apparent. Whereas D'Amato's background had been in chemical engineering for most of his 30 years with Borden's, Shames was an experienced food marketer, having spent 22 years in the industry, holding top positions with General Foods USA

⁵ Lesly, p. 84.

and Kraft USA. He most recently had been chairman, president and chief executive of Stride Rite Corporation. In making Shames president, D'Amato gave him a compensation package that exceeded those of Borden's other top executives, including himself.

Shames and D'Amato now attempted to correct Borden's problems together. They quickly stopped the practice of offering deals to retailers to encourage heavier end-of-quarter shipments. While these deals temporarily boosted sales, they hurt profits and also stole business from the next quarter.

Shames and D'Amato accelerated the examination of Borden's various businesses. Teams of management consultants and financial advisers were brought in to help with the evaluation. As a consequence, morale among managers fearing drastic changes plummeted almost to the point of paralysis.

In October 1993, the independent directors of the board considered the possibility of selling the entire company. But the efforts proved futile. Hanson PLC and RJR Nabisco briefly appeared interested but talks broke down. Several other possible buyers, including Nestle SA, also looked over Borden's portfolio of businesses but declined to negotiate. The weak condition of Borden was proving a major hindrance to any buyout. It likely would have to solve its own problems without outside help.

Shames and D'Amato believed that the biggest problem was the fact that the company was spread too thin in too many mediocre businesses. Although it was unlikely that the entire company could be sold at this time, still certain parts should be salable. They had to decide which should be sold if the company was to be streamlined enough to reverse the consequences of its haphazard and even confused former growth mentality. An early recognized candidate for pruning was the \$1.4 billion chemical business. This had little relevance with the core food properties, but still it was a major profit generator as shown in Table 11.2.

D'Amato was not to see the conclusions of his latest efforts to turn around Borden. On December 9, 1993, the board of directors fired him, and left Shames suddenly in charge. At the same time, D'Amato's predecessor and former supporter, R.J. Ventres, resigned from his board seat. Operating results through 1993 were a disaster, as shown in Table 11.3.

TABLE 11.3 Operating Performance, 1990–1993

	Revenues (million \$)	% Change	Net Income (million \$)	% Change
1993	6,600*	(7.6)	(593)*	
1992	7,143	(1.3)	(253)	
1991	7,235	(5.2)	295	(19.0)
1990	7,633	—	364	—

*Estimates.

Source: Borden.

RECOVERY EFFORTS

Shames announced a \$567 million restructuring plan on January 5, 1994. This included the sale of the salty snacks division and other niche grocery lines. The dividend was also slashed for the second time in six months. In a speech to security analysts, Shames identified four reasons for Borden's problems: lack of focus, insufficient emphasis on brand names, absence of first-rate executives and managers, and a tangled bureaucracy. He vowed to purge weak managers, increase advertising with much greater focus on core lines, notably pasta, the namesake dairy products, and industrial businesses such as adhesives and wallcoverings. For example, he planned to increase advertising for pasta from \$2 million to \$8 million for 1994 and focus on the company's faded regional brands. The pasta would also be cross-marketed with *Classico*, the successful premium pasta sauce.

Shames also pledged to bring Borden from last place among food companies to the top 25 percent. See Table 11.4 for a ranking of Borden with other major competitors as of the beginning of 1994. He began bringing in a new management team, many of them his former proven colleagues. In a major shake-up, three senior managers announced their early retirement: the chief financial officer, the general counsel, and the former executive vice president in charge of the struggling snack-food and international consumer-products unit.⁶

Some security analysts were encouraged by Shames's speech. They believed that Borden's bringing in an experienced outsider—at the time, Shames had only

TABLE 11.4 Comparison of Borden and Major Competitors: 5-year Average, 1988–1993

	Return on Equity	Sales Growth	Earnings per Share
General Mills	42.8%	10.0%	10.4%
Kellogg	31.8	10.2	11.6
H.J.Heinz	25.4	5.8	8.6
Quaker Oats	24.6	4.9	12.2
Sara Lee	21.1	6.2	16.1
Hershey Foods	18.4	7.1	8.3
Campbell Soup	16.5	5.3	NM
Dole	11.7	11.7	-5.4
BORDEN	5.8	1.3	NM

NM: Not meaningful.

Source: Industry statistics as reported in *Forbes*, January 3, 1994, pp. 152–154.

Commentary: The poor performance of Borden compared to its major peers is starkly indicated here, with Borden dead last in 5-year average return on equity, sales growth, and earnings per share.

⁶ Suein L. Hwang, "Borden Aides Leaving as Part of Shake-Up," *Wall Street Journal*, February 15, 1994, p. A4.

been with the company for seven months—augured that the company was truly committed to the drastic changes needed for a turnaround. Other people were more skeptical. After all, Borden has been “restructuring” for five years. “Who’s to say the latest plan will work any better than previous ones?” Joanna Scharf, an analyst with S. G. Warburg & Co., was among such skeptics: “I found some of [Shames] remarks heartening. However, this is not something that is going to turn around in six months.” And she maintained she was not going to change her advice to investors to sell the stock.⁷

A Sputtering Recovery

The troubles of Borden did not go away. At a \$1 million cash salary plus mouth-watering stock options, Shames was unable to turn things around. His initial efforts were to build sales volume, but this adversely affected the bottom line of profitability. For example, with pasta, Borden held firm on prices despite a recent 75 percent increase in durum wheat prices, while competitors raised prices. The result: Borden gained less than a point of market share, but lost on the bottom line. So eager was Borden for volume that in November 1993 it paid an Oklahoma City-based supermarket chain \$9.5 million for preferential treatment on grocer shelves.⁸

Shames failed to curb costs. Even though he shed 7,000 employees, payroll costs actually rose. Some of this was hardly Shames’s fault. The board approved substantial salaries paid to former top executives. For example, D’Amato was paid \$750,000 in cash severance, and \$900,000 per year for four years plus \$65,000 in secretarial and legal fee reimbursements. Borden still maintained a fleet of company jets to fly board members around the country. Country club memberships of executives hardly attested to a firm on the verge of bankruptcy. Consultant and advisory fees numbered in the millions. The fat could not be trimmed, it seemed.

Efforts to sell off some of the units to ease the crushing burden of creditor demands were also less than successful. For example, H. J. Heinz Company bought Borden’s \$225 million (sales) food service division for only 31 percent of annual revenues, a miserably low price for assets that should have brought \$1 for every \$1 in revenues.⁹

In late 1994 Borden was bought for \$1.9 billion by Kohlberg Kravis Roberts and Co., a low figure for a \$6 billion company but then it had been losing money. Robert Kidder, former top executive of Duracell, became CEO. Borden, once a top 20 public firm became the third largest private firm in the United States. KKR directed hundreds of millions of dollars to updating plants, installing new systems, and developing new products. In May 1995 Borden underwent a complete restructuring, with all marketing efforts split into 11 business units, each with its own board of directors, capital structure, and operational control, thus assuring 100 percent accountability.¹⁰

⁷ Vindu P. Goel, “Putting Elsie Back on Track,” *Cleveland Plain Dealer*, January 23, 1994, pp. 1-E, 5-E.

⁸ Matthew Schifrin, “Last Legs,” *Forbes*, September 12, 1994, pp. 150ff.

⁹ *Idem*.

¹⁰ “A New Life for Borden,” *Prepared Foods*, July 1995, p. 35; and “Borden’s CEO Finds Answers to How It’s Been Losing Money,” *Cleveland Plain Dealer*, February 13, 1996, p. 5-C.

ANALYSIS

Acquiring other businesses is a common growth strategy. A company through acquisitions can quickly achieve a relatively large size, bypassing the time needed to develop such new ventures internally. By acquiring already proven businesses, the buyer can obtain personnel and management experienced to run such businesses effectively.

Several problems, however, can occur in such buyouts: First, a buying firm may pay too much and be saddled with heavy debt and interest overhead. Second, the acquisition may prove incompatible with the buyer's existing resources and strategy. In such a situation, it may find great difficulty in integrating the new enterprise with existing operations and making it a profit contributor.

In the 1980s, Ventres, the predecessor of D'Amato, took on \$1.9 billion in debt to acquire 91 regional food and industrial companies. He had hoped to build these up to be regional powerhouses and to marry efficiencies of scale in manufacturing with the marketing nimbleness of regional operations. By centralizing production in the most efficient plants, costs should be lowered and profits enhanced. And there was always the potential for a regional brand to take off and be worthy of national distribution. This was the theory behind many of Borden's acquisitions in the 1980s.

Unfortunately, theory and practice did not meld well. The businesses were never integrated and continued to operate autonomously with diverse and often competing brands. Production never achieved the efficiency of most of the large competitors and Borden still lacked their marketing clout. It also encountered great problems in allocating advertising among the diverse brands: Which should be given strong support and why? And should the other brands be allowed to languish?

With so many brands in its portfolio stable, reflecting the nearly 100 recent acquisitions, Borden lost focus. Key brands were often not sufficiently championed. Brand extensions, such as one for Lady Borden ice cream, were often overlooked or only half-heartedly attempted. One wonders how many opportunities were ignored by a management team whose attention was caught up in a frenzy for acquisitions.

Compounding its problems with unwise and unassimilated acquisitions, Borden management grievously misjudged the mood of the market. It overestimated consumers' willingness to pay premium prices for its most popular brands. Borden's stubbornness in maintaining high prices for Lady Borden milk at the very time when raw milk prices were collapsing simply invited competitors to increase their market share at Borden's expense. Attempts to raise ice cream prices backfired as well.

The early 1990s, a period of recession and considerable unemployment and fear of layoffs, brought a new consumer recognition that many national brands were not much, if any better, than competing private brands. Many national-brand manufacturers, faced with declining sales in the face of strong private-label competition, began price rollbacks. So it was not surprising that Borden found difficulty with a changed marketing environment. What was surprising was its slowness to adapt to these changing conditions.

WHAT WE CAN LEARN

Beware an Unfocused Strategy

An unfocused strategy often accompanies too much unrelated diversification. A firm has difficulty deciding what it is, other than being a conglomerate. Not many managements cope well with a lot of diversification, although many have tried to. Often such acquisitions become candidates for sale some years later, thus confirming flawed acquisition decisions.

In Borden's case, most of the acquisitions were related to its major food business. But there were too many, and they were not integrated into the main corporate structure. Such diffusion of resources and uncoordinated marketing efforts made it difficult indeed to achieve either cost savings or a unified and powerful approach to the marketplace.

Issue: How Much Decentralization?

Here we are confronted with the negative consequences of too much decentralization or autonomy. Borden acquisitions' autonomy led to lack of coordination and great inefficiency.

Does this have to be true? Or can decentralization work without losing control and efficiency? Can intrafirm competition among semi-independent units lead to greater performance incentive? The answer is yes, decentralization is often far more desirable than centralization. Still, there are degrees of decentralization. Too much uncontrolled autonomy led Borden's problems. There has to be some focus and common purpose along with sufficient controls to prevent unpleasant surprises. But in the final analysis, the issue depends on the competence of the managers. If they are highly competent, then an organization will likely thrive under decentralization. If they are incompetent, as appeared to be the case with Borden, then decentralization can be a disaster.

Run with Your Winners

Although any firm wants to develop new products and bring them to fruition as soon as possible, it must not neglect its older products and brands that are doing well, that are winners. Advertising and other marketing efforts, such as brand extension, should not be curtailed as long as the products are growing and profitable. Marketing commitments should perhaps even be increased for such winners, since favorable growth trends often can continue for a long time. Alas, Borden sometimes exercised the opposite strategy: It cut back on its winners and directed resources to futilely trying to build up weak regional brands.

But we should not completely condemn Borden for ignoring its winners. It threw all its advertising support behind Creamette, the leading national brand of pasta. But Creamette's sales failed to take off. Meantime, Borden's strong regional brands—in particular, Prince in the Northeast and Anthony's in the

West—stagnated with no support. D’Amato must have thought “damned if you do and damned if you don’t.” But there were reasons for the lack of success with the Creamette advertising, as we will examine next.

For Mature Products, Beware Using Primary-Demand Advertising

Despite a strong boost in marketing efforts for Creamette in 1992, the brand’s sales rose only 1.6 percent. At the same time, total U.S. pasta sales rose 5.5 percent.¹¹ Was this poor showing the fault of the product? Hardly, since it was the leading national pasta brand. Rather, the advertising was at fault. Most of it was built around recipes that did more to promote pasta consumption than to promote the superior qualities of Creamette. In other words, a primary-demand theme was used rather than a selective-demand theme stressing the merits of a particular brand. Because primary-demand advertising helps the industry and all competitors, it is best used with new products in a young growth industry. Primary-demand advertising is seldom appropriate in a mature industry. The results of the advertising efforts for Creamette confirm this. Shouldn’t Borden managers have been more savvy? They should never have approved such a theme for an advertising campaign.

CONSIDER

Do you see any other learning insights coming from this case?

QUESTIONS

1. Do you think the problems in Borden’s acquisition strategy stemmed from a flaw in the basic concept or in the execution? Support your position.
2. Is primary-demand advertising ever advisable for a mature product? If so, under what circumstances?
3. Prince is a strong regional pasta brand in the Northeast. What would it take to convert this into a national brand? Should Borden have attempted this?
4. Should Borden have made a strong effort to create a presence in the private brand market? Why or why not?
5. Critics have decried the lack of focus of Borden. What does this mean? How can the criticisms best be resolved?
6. “After firing D’Amato, the board one month later adopted virtually the same restructuring plan he had proposed. What an injustice!” Discuss.
7. How much of a price premium do you think national brands ought to command over private brands? Justify your position.

¹¹ Lesly, p. 84.

HANDS-ON EXERCISES

1. It is 1984, and you are the assistant to the president. He has asked you to design a growth plan for the next decade. What are your recommendations? Take care to avoid the pitfalls that actually beset the company.
2. It is early 1994. You are the assistant to the new CEO, Erwin Shames. The company is in sorry straits. What do you propose to enable your boss to meet his pledge to boost Borden from the bottom of the food-company heap to the top 25 percent?

INVITATION TO RESEARCH

Since Borden is now a private company under the stable of Kohlberg Kravis Roberts and Co., it is difficult to find as much information as if it were publicly held. Still, you may be able to find something about the present fortunes of the firm and its brands.

United Way: A Nonprofit Tries to Cope with Image Destruction

The United Way of America, the preeminent charitable organization in the United States, celebrated its 100-year anniversary in 1987. It had evolved from local community chests, and its strategy for fund-raising had proven highly effective: funding local charities through payroll deductions. The good it did seemed unassailable.

Abruptly in 1992, the image that United Way had created was jolted by revelations from investigative reporters of free-spending and other questionable deeds of its greatest builder and president, William Aramony. A major point of public concern was Aramony's salary and uncontrolled perks in a lifestyle that seemed inappropriate for a charitable organization that depended mostly on contributions from working people. He was later sentenced to seven years in prison for fraud, tax evasion, and conspiracy.

We are left to question the callousness and lack of concern with the ethical impact on the public image of such a major charitable and nonprofit entity. After all, unlike business firms that offer products or services to potential customers, charitable organizations depend on contributions that people give freely out of a desire to help society, with no tangible personal benefits. An image of high integrity and honest dealings without any semblance of corruption or privilege would seem essential for such organizations.

THE STATURE AND ACCOMPLISHMENTS OF THE UNITED WAY

Organizing the United Way as the umbrella charity to fund other local charities through payroll deductions established an effective means of fund-raising. As a nonprofit, the United Way became the recipient of 90 percent of all charitable donations. It gained strong employer support by involving them as leaders of annual campaigns, amid widespread publicity. This would consequently cause such an executive acute loss of face if his or her own organization did not go "over the top" in meeting campaign goals. As a result, employers sometimes used extreme pressure to achieve

100 percent participation of employees. A local United Way executive admitted that “if participation is 100 percent, it means someone has been coerced.”¹

For many years, outside of some tight-lipped gripes of corporate employees, the organization moved smoothly along, with local contributions generally increasing every year, although the needs for charitable contributions invariably increased all the more.

The national organization United Way of America (UWA) is a separate corporation and has no direct control over the approximately 2,200 local United Way offices. Most of the locals voluntarily contributed one cent on the dollar of all funds they collected. In return, the national organization provided training and promoted local United Way agencies through advertising and other marketing efforts.

Much of the success of the United Way movement in becoming the largest and most respected charity in the United States was due to the 22 years of William Aramony’s leadership of the national organization. When he first took over, the United Ways were not operating under a common name. He built a nationwide network of agencies, all operating under the same name and using the same logo of outstretched hands, which became nationally recognized as the symbol of charitable giving. Unfortunately in 1992, an expose of Aramony’s lavish lifestyle and other questionable dealings burdened local United Ways with serious difficulties in fund-raising.

WILLIAM ARAMONY

During Aramony’s tenure, United Way contributions increased from \$787 million in 1970 to \$3 billion in 1990. He increased his headquarters’ budget from less than \$3 million to \$29 million in 1991. Of this, \$24 million came from the local United Ways, with the rest coming from corporate grants, investment income, and consulting. He built up the headquarters staff to 275 employees.²

Aramony moved comfortably among the most influential people in our society. He attracted a prestigious board of governors, including many top executives from America’s largest corporations, but only three of the 37 came from nonprofit organizations. The board was chaired by John Akers, chairman and CEO of IBM. Other board members included Edward A. Brennan, CEO of Sears; James D. Robinson III, CEO of American Express; and Paul J. Tagliabue, commissioner of the National Football League. The presence of such top executives brought prestige to United Way and spurred contributions from some of the largest and most visible organizations in the United States.

Aramony was the highest-paid executive in the charity field. In 1992, his compensation package was \$463,000, this being nearly double that of the next

¹ Susan Garland, “Keeping a Sharper Eye on Those Who Pass the Hat,” *Business Week*, March 16, 1992, p. 39.

² Charles E. Shepard, “Perks, Privileges and Power in a Nonprofit World,” *Washington Post*, February 16, 1992, p. A38.

highest-paid executive in the industry, Dudley H. Hafner of the American Heart Association. The board fully supported Aramony, regularly giving him 6 percent annual raises.³

Investigative Disclosures

The *Washington Post* began investigating Aramony's tenure as president of United Way of America in 1991, raising questions about his high salary, travel habits, possible cronyism, and dubious relations with five spin-off companies. In February 1992, it released the following information of Aramony's expense charges.⁴

- Aramony had charged \$92,265 in limousine expenses to the charity during the previous five years.
- He had charged \$40,762 on airfare for the supersonic Concorde.
- He had charged more than \$72,000 on international airfare that included first-class flights for himself, his wife, and others.
- He had charged thousands more for personal trips, gifts, and luxuries.
- He had made 29 trips to Las Vegas, Nevada, between 1988 and 1991.
- He had expensed 49 journeys to Gainesville, Florida, the home of his daughter and a woman with whom he had a relationship.
- He had allegedly approved a \$2 million loan to a firm run by his chief financial officer.
- He had approved the diversion of donors' money to questionable spin-off organizations run by long-time aides and provided benefits to family members as well.
- He had passed tens of thousands of dollars in consulting contracts from the UWA to friends and associates.

United Way of America's corporate policy prohibited the hiring of family members within the actual organization, but Aramony skirted the direct violation by hiring friends and relatives as consultants within the spin-off companies. He paid hundreds of thousands of dollars in consulting fees, for example, to two aides in vaguely documented and even undocumented business transactions.

The use of spin-off companies provided flexible maneuvering. One of the spin-off companies Aramony created to provide travel and bulk purchasing for United Way chapters purchased a \$430,000 condominium in Manhattan and a

³ Joseph Finder, "Charity Case," *New Republic*, May 4, 1992, p. 11

⁴ Shepard, "Perks, Privileges and Power"; Kathleen Teltsch, "United Way Awaits Inquiry on its President's Practices," *New York Times*, February 24, 1992, p. A12; Charles E. Shepard, "United Way Report Criticizes Ex-Leader's Lifestyle," *Washington Post*, April 4, 1992, p. A1.

\$125,000 apartment in Coral Gables, Florida for Aramony's use. Another of the spin-off companies hired Aramony's son Robert Aramony as its president. Loans and money transfers between the spin-off companies and the national organization raised questions. No records showed that the board of directors had been given the opportunity to approve such loans and transfers.⁵

CONSEQUENCES

When the information about Aramony's salary and expenses became public, reaction was severe. Stanley C. Gault, chairman of Goodyear Tire & Rubber Co., asked: "Where was the board? The outside auditors?" Robert O. Bothwell, executive director of the National Committee for Responsive Philanthropy, said, "I think it is obscene that he is making that kind of salary and asking people who are making \$10,000 a year to give 5 percent of their income."⁶ At this point, let us examine the issue of executive compensation: Are many executives overpaid? See the Issue Box: Executive Compensation: Is It Too Much?⁷

As a major consequence of the scandal, some United Way locals withheld their funds, at least pending a thorough investigation of the allegations. John Akers, chairman of the board, noted that by March 7, 1992, dues payments were running 20 percent behind the previous year, and he admitted: "I don't think this process that the United Way of America is going through, or Mr. Aramony is going through, is a process that's bestowing a lot of honor."⁷

In addition to the decrease in dues payments, UWA was in danger of having its nonprofit status revoked by the Internal Revenue Service because of the loans to the spin-off companies. For example, it loaned \$2 million to a spin-off corporation in which the chief financial officer of UWA was also a director, this being a violation of nonprofit corporate law. Moreover, UWA guaranteed a bank loan taken out by one of the spin-offs, also a violation of nonprofit corporate law.⁸

The adverse publicity benefited competing charities, such as Earth Share, an environmental group. United Way, at one time the only major organization to receive contributions through payroll deductions, now found itself losing market share to other charities able to garner contributions in the same manner. For all the building that William Aramony had done, the United Way's status as the primary player in the American charitable industry was now in danger of disintegration due to his uncontrolled excesses.

On February 28, amid mounting pressure from local chapters threatening to withhold their annual dues, Aramony resigned. In August 1992, the United Way board of directors hired Elaine Chao, director of the Peace Corps, to replace Aramony.

⁵ Shepard, "Perks . . .," A38.

⁶ Susan Garland, p. 39; Felicity Barringer, "United Way Head Is Forced Out in a Furor over His Lavish Style," *New York Times*, February 28, 1992, p. A1.

⁷ Felicity Barringer, "United Way Head Tries to Restore Trust," *New York Times*, March 7, 1992, p. 81.

⁸ Shepard, "Perks," A38.

ISSUE BOX**EXECUTIVE COMPENSATION: IS IT TOO MUCH?**

At the time of criticisms of United Way's Aramony, a controversy began mounting over multi-million-dollar annual compensations of corporate executives. For example, in 1992, the average annual pay of CEOs was \$3,842,247; the 20 highest-paid ranged from over \$11 million to a mind-boggling \$127 million for Thomas F. Frist Jr., of Hospital Corporation of America.⁹ Pay of corporate executives has continued to climb robustly since 1992; these figures would be modest today.

Activist shareholders, including some large mutual and pension funds, began protesting the high compensations, especially for top executives of those firms that were not even doing well. New disclosure rules imposed in 1993 by the Securities & Exchange Commission (SEC) spotlighted questionable executive-pay practices. In the past—and still not uncommon today—complacent boards, themselves well paid and often closely aligned with the top executives of the organization, condoned liberal compensations. A major argument supporting high executive compensations is that their salaries are modest compared to some entertainers' and athletes' salaries, but their responsibilities are far greater. Another argument for high top-executive compensation is that pay incentives are needed to lure top talent, and that the present executive-pay system "has contributed to positive U.S. economic performance."

Institutional investors think a lot differently. Only 22 percent thought the pay system has helped the economy; over 90 percent saw top executives as "dramatically overpaid."¹⁰

In light of the for-profit executive compensations, Aramony's salary was modest, and results were on his side: He made \$369,000 in basic salary while raising \$3 billion; Lee Iacocca, at the same time, made \$3 million while Chrysler lost \$795 million. Where is the justice?

As head of a large for-profit organization, Aramony undoubtedly could have earned several zeros more in compensation and perks, with no raised eyebrows. But isn't the situation different for a nonprofit? Especially when revenues are derived from donations of millions of people of modest means? This is the controversy. On one hand, shouldn't a charity be willing to pay for the professional competence to run the organization as effectively as possible? But how do revelations of high compensation affect the public image and fund-raising of such nonprofit organizations?

What is your position regarding the compensation and perks of an Aramony, relative to the many times greater compensations of for-profit executives? How could CEO compensation be curbed?

⁹ John A. Byrne, "Executive Pay: The Party Ain't over Yet," *Business Week*, April 26, 1993, p. A1.

¹⁰ Carol Hymowitz, "Sky-High Payouts to Top Executives Prove Hard to Curb," *Wall Street Journal*, June 26, 2006, p. B1.

ELAINE CHAO

Chao's story is one of great achievement for a person only 39 years old. She was the eldest of six daughters in a family that came from Taiwan to California when Elaine was 8 years old and did not know a word of English. Through hard work, the family prospered. "Despite the difficulties . . . we had tremendous optimism in the basic goodness of this country, that people are decent here, that we would be given a fair opportunity to demonstrate our abilities," she told an interviewer.¹¹ Chao's parents instilled in their six daughters the conviction that they could do anything they set their minds to, and all the daughters went to prestigious universities.

Elaine Chao earned an economics degree from Mount Holyoke in 1975, then went on for a Harvard MBA. She was a White House fellow, an international banker, chair of the Federal Maritime Commission, deputy secretary of the U.S. Transportation Department, and director of the Peace Corps before accepting the presidency of the United Way of America.

Chao's salary was \$195,000, less than half that of Aramony. She cut budgets and staffs: no transatlantic flights on the Concorde, no limousine service, no plush condominiums. She expanded the board of governors to include more local representatives, and she established committees on ethics and finance. Still, she had no illusions about her job: "Trust and confidence once damaged will take a great deal of effort and time to heal."¹² The following Information Box discusses the particular importance of the public image for nonprofit agencies.

A Local United Way's Concerns

In April 1993, for the second time in a year, United Way of Greater Lorain County (Ohio) withdrew from the United Way of America. The board of the local chapter was still concerned about the financial stability and accountability of the national agency. In particular, it was concerned about the retirement settlement for Aramony. A significant "golden parachute" retirement package was being negotiated by the national board and Aramony; it was in the neighborhood of \$4 million. Learning of this triggered the decision to again withdraw from UWA.

There were other reasons as well for this decision. The national agency was falling far short of its projected budget, as only 890 of the 1,400 affiliates that had paid membership dues two years before were still paying. Roy Church, president of the Lorain agency, explained the board's decision: "Since February . . . it has become clear that United Way of America's financial stability and ability to assist locals has been put in question. The benefit of being a United Way of America member isn't there at this time for Lorain's United Way."¹³

Elaine Chao's task of resurrecting United Way of America would not be easy.

¹¹ "United Way Chief Dedicated," *Cleveland Plain Dealer*, March 28, 1993, p. 24-A.

¹² *Ibid.*

¹³ Karen Henderson, "Lorain Agency Cuts Ties with National United Way," *Cleveland Plain Dealer*, April 16, 1993, p. 7-C.

INFORMATION BOX

PUBLIC IMAGE FOR NONPROFIT ORGANIZATIONS

Product-oriented firms ought to be concerned and protective of their public image; even more so nonprofit organizations such as schools, police departments, hospitals, politicians, and most of all, charitable organizations, should be concerned. Let us consider here the importance of public image for representative nonprofits.

Large city police departments often have a poor image among important segments of the population. The need to improve this image is hardly less important than for a manufacturer faced with a deteriorating brand image. A police department can develop a “marketing” campaign to win friends. Examples of possible activities aimed at creating a better image are promoting tours and open houses of police stations, crime laboratories, police lineups, and cells; speaking at schools; and sponsoring recreation projects, such as a day at the ballpark for youngsters.

Public school systems, faced with taxpayers’ revolts against mounting costs and image damage owing to teacher strikes, need conscious effort to improve their image in order to obtain more public support and funds.

Many nonbusiness organizations and institutions, such as hospitals, governmental bodies, even labor unions, have grown self-serving, dominated by a bureaucratic mentality so that perfunctory and callous treatment is the rule and the image is in the pits. Improvement of the image can only come through a greater emphasis on satisfying the public’s needs.

Nonprofits are particularly vulnerable to public image problems because they depend solely on voluntary support. The need to be untainted by any scandal becomes crucial. In particular, great care should be exerted that contributions are being spent wisely and equitably, that overhead costs are kept reasonable, and that transparency affords little opportunity for fraud and other misdeeds. The threat of investigative reporting must be feared and guarded against.

How can a nonprofit organization be absolutely assured that moneys are not being misspent and that there are no ripoffs?

Chao’s Remedial Efforts

As it turned out, Elaine Chao did a fine job. She was hired to restore public faith and confidence in the United Way; and this she did. She oversaw formation of new oversight committees and established policies that would ensure “the United Way of America will be accountable and responsive to local United Ways.”¹⁴ The board of governors was expanded from 30 to 45 members and included more local representatives.

¹⁴ Matthew Tungate, “United Way Chief Hails Local Efforts,” *Cleveland Plain Dealer*, May 25, 1996, p. 2-B.

On May 20, 1996, she announced her resignation effective September 1. “My job is complete,” she said.¹⁵ Her plans were to lecture, join a Washington think tank, volunteer for Bob Dole’s presidential campaign, and work for the re-election of her husband, Sen. Mitch McConnell (R., Ky.).

Still, had United Way recovered completely from the scandal? Contributions had still not reached levels before the scandal came to light. Looking at one example, the nation’s leading chapter, Cleveland, saw donations slipping considerably from the 1989–90 campaign that raised \$52 million. Total contributions in 1995 were only \$40 million, and more than \$1 million below the goal set at the beginning of the campaign.¹⁶

The stigma of an abuse to the public image can be enduring. This may especially be true of public service organizations that derive their revenues from voluntary contributions.

See the following Information Box for a discussion of a related example of nonprofit callousness to its parties.

ANALYSIS

The lack of accountability to the donating public was a major contributor to UWA’s problems. Such a loosely run operation, with no one to approve or halt administrators’ actions, encouraged questionable practices. It also opened the way for great shock and criticism, come the revelation. The fact that voluntary donations were the principal source of revenues made the lack of accountability all the more crucial. In a for-profit organization, lack of accountability affects primarily stockholders; for a major charitable organization, it affects millions of contributors, who see their money and/or commitment being squandered.

Where full disclosure and a system of checks and balances is lacking, the organization invites vulnerability on two fronts. The worst case scenario is outright “white-collar theft,” when unscrupulous people find it an opportunity for personal gain. The absence of sufficient controls and accountability can make even normally honest persons succumb to temptation. Second, insufficient controls tend to promote a mindset of arrogance and allow people to play fast and loose with the system. Aramony seemed to fall into this category with his spending extravagances, cronyism, and other conflict-of-interest activities.

The UWA theoretically had an overseer: the boards, similar to the board of directors of business corporations. But when such boards act as rubber stamps, where they are closely in the camp of the chief executives, they are not really exercising control. This appeared to be the case with UWA during the “reign” of Aramony.

¹⁵ “Head of United Way to Leave Her Post Saying Job Is Done,” *Wall Street Journal*, May 20, 1996, p. B8.

¹⁶ Michael K. McIntyre, “United Way Changing Fund Drive Strategies,” *Cleveland Plain Dealer*, September 1, 1996, p. 4-B.

INFORMATION BOX**ANOTHER CONTROVERSY: GIRL SCOUTS AND THEIR COOKIES**

The main funding source for the nation's 2.6 million Girl Scouts is the annual cookie sales, estimated to generate \$400 million in revenue in 1992. The practice goes back some 70 years, although in the 1920s the girls sold homemade cookies. Now each regional council negotiates with one or two bakeries that produce the cookies, sets the price per box, which ranges from \$2 to \$3, and divides the proceeds as it sees fit. Typically, the Girl Scout troops get 10 to 15 percent, the council takes more than 50 percent, and the rest goes to the manufacturer.¹⁷

Criticisms have emerged regarding the dictatorial handling of these funds by the councils. There are 332 regional councils in the United States, each having an office and paid staff overseen by a volunteer board. Some councils have dozens of employees, with most serving mainly as policy enforcers and supervisors. At the troop level, volunteer leaders, often women with daughters in the troop, guide their units in the true tradition of scouting, giving their time tirelessly. For the cookie drives, the girls are an unpaid sales force—child labor, as critics assail—that supports a huge bureaucratic structure. Little of the cookie revenue comes back to the local troops.

The bureaucracy does not tolerate dissent well. The *Wall Street Journal* cites the case of a West Haven, Connecticut, troop leader, Beth Denton, who protested both the way the Connecticut Trails council apportioned revenue and the \$1.6 million in salaries and benefits paid to 42 council employees. After she complained to the state attorney general, the council dismissed her as leader.¹⁸

Admittedly, the individual salaries in the bureaucracy were not high by corporate standards or even by nonprofit standards, ranging up to about \$90,000. Perhaps more disturbing was that volunteer leaders saw no financial statement of their councils' expenditures and activities. (Note: I have found no evidence that the situation with Girl Scout cookies has changed since 1992. If it has, I would appreciate your sending me your information.)

Evaluate the council's position that annual financial records of their council's activities should be entirely confidential and limited to full-time staff.

¹⁷ Ellen Graham, "Sprawling Bureaucracy Eats up Most Profits of Girl Scout Cookies," *Wall Street Journal*, May 13, 1992, p. A1.

¹⁸ Graham, p. A4.

Certainly a board's failure to fulfill its responsibility is not unique to nonprofits. Corporate boards have often been notorious for promoting the interests of the incumbent executives. Although this situation of compliant boards has received publicity and criticism of late, and is changing in some organizations, it still prevails in others. See the Issue Box: Role of the Board of Directors for a discussion.

ISSUE BOX**WHAT SHOULD BE THE ROLE OF THE BOARD OF DIRECTORS?**

In the past, most boards of directors have tended to be rubber stamps, closely allied with top executives and even composed mostly of corporate officials. In some organizations today this is changing, mostly in response to critics concerned about board tendencies to always support the status quo and perpetuate the “establishment.” More and more, opinion is shifting to the idea that boards must assume a more activist role:

The board can no longer play a passive role in corporate governance. Today, more than ever, the board must assume an activist role—a role that is protective of shareholder rights, sensitive to communities in which the company operates, responsive to the needs of company vendors and customers, and fair to its employees.

This was written more than 20 years ago. But change is slow. Incentives for more active boards have been the increasing risks of liability for board decisions, as well as liability insurance costs. Although the board of directors has long been seen as responsible for establishing corporate objectives, developing broad policies, and selecting top executives, many people consider this no longer sufficient. Boards should also review management’s performance to ensure that the company is well run and that stockholders’ interests are furthered. Moreover, there is pressure that society’s best interests not be disregarded, which translates into an active concern for the organization’s public image or reputation—its ethical conduct.

But the issue remains: To whom should the board owe its greatest allegiance—the entrenched bureaucracy or the external publics? Without having board members representative of the many special interests affected by the organization, the inclination is to support the interests of the establishment.

Do you think a more representative and active board will prevent a similar scenario for United Way in the future? Why or why not?

Source: Lester B. Korn and Richard M. Ferry, Board of Directors Thirteenth Annual Study, New York: Korn/Ferry International, February 1986, pp. 1–2.

UPDATE

William Aramony was convicted of defrauding the United Way out of \$1 million. He was sentenced to seven years in prison for using the charity’s money to finance a lavish lifestyle.

Despite this, a federal judge ruled in late 1998 that the charity must pay its former president more than \$2 million in retirement benefits. “A felon, no matter how despised, does not lose his right to enforce a contract,” U.S. District Judge Shira Scheindlin in New York ruled.¹⁹

¹⁹ Reported in *Cleveland Plain Dealer*; October 25, 1998, p. 24-A.

United Way was still burdened with a tarnished reputation in 2000, when the board hired McKinsey & Co., a management consulting firm, to help overhaul its mission and operations. In early 2002 Brian Gallagher, a 21-year veteran of UWA who was running the Columbus, Ohio affiliate, was named chief executive. More pain was to come. In 2004 United Way's former Washington, D.C. chief pleaded guilty of stealing almost \$500,000. In 2006 the head of the New York City affiliate was found to have taken \$227,000 for personal use.

Gallagher used these episodes to help drive faster change. Membership requirements and reporting rules were significantly tightened, and some 150 affiliates were closed or merged, this a recommendation of the McKinsey consultants. The biggest consolidation was in Chicago, where 50 separate United Ways were now down to a single one for Metropolitan Chicago. "Today, United Way affiliates are more focused on solving problems facing local communities, and doing more to show donors how their dollars make a difference," Gallagher says. Fund raising has bounced back, with 2007 revenue growing 2.3 percent to \$4.07 billion.²⁰

United Way received good publicity for its aid after Hurricane Katrina in Fall 2005. For example, United Way of Northeast Louisiana normally handled 7,000 calls a year. It fielded more than 111,000 calls across Louisiana during September and October 2005. Other United Ways throughout the Gulf Coast states as well as in communities with large numbers of Katrina evacuees responded to hundreds of thousands of telephone calls seeking services such as shelters, food, medical assistance, job training, post-disaster assistance, and recovery information.²¹

Invitation to Make Your Own Analysis and Conclusions

How do you think Aramony's misuse of his position could have been prevented? What controls and accountability would you recommend? How would you persuade the Board to be more socially responsible?

WHAT WE CAN LEARN

Beware the Arrogant Mindset

A leader with a mindset of superiority to subordinates and even to concerned outsiders—who sees other opinions as not acceptable—is a formula for disaster, both for an organization and for a society. It promotes dictatorship, intolerance of contrary opinions, and an attitude that “we need answer to no one.” The consequences are as we have seen with William Aramony: moving over the edge of what most deem acceptable and ethical conduct, assuming the role of the final authority who brooks no questions or criticisms. The absence of real or imagined

²⁰ Sally Beatty, “A New Way,” *Wall Street Journal*, December 10, 2007, pp. R8 and R10.

²¹ <http://national.unitedway.org>

controls or reviews often brings out the worst in humans. We seem to need periodic scrutiny to avoid the trap of arrogant decision-making devoid of responsiveness to other concerns.

Checks and Balances Are Even More Important in Nonprofit and Governmental Bodies Than in Corporate Entities

For-profit organizations have “bottom-line” performance (i.e., profit and loss statistics) as the ultimate control and standard. Nonprofit and governmental bodies do not have this control, so they have no ultimate measure of their effectiveness.

Consequently, nonprofit organizations should be subject to the utmost scrutiny of objective outsiders. Otherwise, the temptation is there for abuses. Nonprofits do not even face the degree of competition that demands greater efficiency. Thus, without objective and energetic controls, nonprofits have a tendency to get out of hand, to be run as little dynasties unencumbered by the constraints that face most businesses. Fortunately, investigative reporters and increased litigation by aggrieved abused parties today act as the last-resort controls for such organizations. In view of the revelations of investigative reporters, we are left to wonder how many wasteful, abusive, and reprehensible activities have not yet been detected.

Marketing of Nonprofits Depends on Trust and Is Particularly Vulnerable to Bad Press

Nonprofits depend on donations for the bulk of their revenues. They depend on people to give without receiving anything tangible in return (unlike businesses). And the givers must have trust in the organization, trust that the contributions will be well spent, that the beneficiaries will receive maximum benefit, and that administrative costs will be low. Consequently, when publicity surfaces that such trust should be questioned, the impact can be devastating. Contributions can quickly dry up or be shunted to other charities.

With governmental bodies, of course, their perpetuation is hardly at stake with bad publicity. However, officials can be recalled, impeached, or not reelected. But these are not easily or quickly done.

CONSIDER

Can you add to these learning insights?

QUESTIONS

1. How do you feel, as a potential or actual giver to United Way campaigns, about Aramony’s “high living”? Would these allegations affect your gift giving?
2. What prescriptions do you have for thwarting arrogance in nonprofit and/or governmental organizations? Be as specific as you can, and support your recommendations.

3. How do you personally feel about the coercion that some organizations exert for their employees to contribute substantially to the United Way? What implications, if any, do you see as emerging from your attitudes about this?
4. “Since there is no bottom-line evaluation for performance, nonprofits have no incentives to control costs and prudently evaluate expenditures.” Discuss.
5. How would you feel, as a large contributor to a charity, about its spending \$10 million for advertising? Discuss your rationale for this attitude.
6. Do you think the action taken by UWA after Aramony was the best way to salvage the public image? Why or why not? What else might have been done?
7. Could the “child labor” of girl scout cookie marketing be better handled? If so, how?

HANDS-ON EXERCISES

1. You are an advisor to Elaine Chao, who has taken over the scandal-ridden United Way. What advice do you give her for as quickly as possible restoring the confidence of the American public in the integrity and worthiness of this preeminent national charity organization?
2. You are a member of the board of governors of United Way. Allegations have surfaced about the lavish life style of the highly regarded Aramony. Most of the board, being corporate executives, see nothing at all wrong with his perks and privileges. You, however, feel otherwise. How would you convince the other board members of the error of condoning Aramony’s activities? Be as persuasive as you can in supporting your position.

TEAM DEBATE EXERCISE

Debate this issue: No nonprofit organization can ever attain the efficiency of a business firm that always has the bottom line to be concerned about.

INVITATION TO RESEARCH

What is the situation with United Way today? Are all local agencies contributing to the national? Have donations matched or exceeded previous levels? What is Elaine Chou doing now? Has Brian Gallagher brought more transparency to the organization? How would you judge the public image of UWA today?

DaimlerChrysler—A Merger Made in Hades

It was supposed to be so right, almost a merger made in heaven, some said at the beginning. Instead, it turned out to be the opposite.

Chrysler was the smallest but since 1994 had been the most efficient U.S. auto producer, the one having the highest profit margin. Now its productivity and innovative strength would be blended with the prestige of Daimler's legendary Mercedes-Benz. Furthermore, during one of its periodic crises Chrysler had sold off its international operations to help raise needed money, and this merger would increase international exposure in a big way and mate it with a rich partner. The instigator, Juergen Schrempp of Daimler, was lauded for his intentions of building a new car company that would have global economies of scale.

Of course, there were two cultures involved, German and American. But in the executive offices, decision making would be shared, with Chrysler's CEO, Robert Eaton, being a co-chairman with Schrempp.

Chrysler management's expectations of equality with its prestigious merger partner were soon dashed. Schrempp, as it turned out, never intended equality. He had flagrantly misrepresented the merger package and quickly got rid of Chrysler top managers. Was this deception unacceptable ethical conduct, or was it rather a hard-nosed negotiating ploy that Chrysler management should have recognized?

In any case, in November 1998 this merger of "equals" was finalized. And the merger was to become a bitter cup.

CHRYSLER BEFORE THE MERGER

During the last several decades, Chrysler had had a checkered history. Some said that Lee Iacocca had performed a miracle at Chrysler. He became president of an almost moribund firm in November 1978. Its condition was so bad that he turned to Washington to bail out the company and obtained federal loan guarantees of \$1.5 billion to help it survive. By 1983 Iacocca had brought Chrysler to profitability and then to a strong performance for the next four years. He paid

back the entire loan seven years before it was due. Like a phoenix, the reeling number-three automaker had been given new life and respectability. Some said Iacocca should be president of the United States, that his talents were needed in the biggest job of all.

Iacocca turned to other interests in the latter half of the decade, but by 1988, the company was hurting again. To a large extent the new problems reflected capital deprivation: sufficient money had not been invested in new car and truck designs. This lack of funds was the result of the 1987 acquisition of American Motors Corporation (AMC). The crown jewel of this buyout was the Jeep line of sport-utility vehicles, which appealed to younger, more affluent buyers than Chrysler's older, lower-income customers. Still, Chrysler found itself saddled with the substantial inefficiencies that had bedeviled AMC.

An aging Iacocca again turned his full attention back to the car business, now seven years after retiring his company's horrendous bank debt. He staked the company's resources on four high-visibility cars and trucks: a minivan, the Jeep Grand Cherokee, LH sedans, and a full-size pickup. Fearful that the company might not survive until the new models came out, especially if a recession were to occur before then, Iacocca instituted a far-reaching austerity program, which cut \$3 billion from the company's \$26 billion annual operating costs.

By 1992, the company was riding high. Iacocca retired December 31, 1992, with a job well done. As he said on TV, "When it's your last turn at bat, it sure is nice to hit a home run."¹ Robert Eaton, formerly with GM of Europe, replaced Iacocca as Chrysler chairman.

As it moved to the millennium, Chrysler prospered because of a combination of innovative designs, segment-leading products, and rising sales throughout the auto industry. See Table 13.1 for the sales and net profit statistics of these golden years for Chrysler relative to its two U.S. competitors, General Motors and Ford.

AFTER THE MERGER

Seldom has a merger turned out worse, and so quickly. Perhaps because of morale problems and too much attention given to smoothing relations between Detroit and Stuttgart, the bottom line of Chrysler was wracked. Or maybe the problems at Chrysler had been latent, below the surface, and only needed the disruption of a massive takeover to surface. Or could the problems have been triggered by an unwise dictatorship by the German master?

On November 16, 1998, Daimler-Benz issued an additional \$36 billion of its stock to buy Chrysler. This, when added to the \$48 billion value of its existing stock brought total market value of DaimlerChrysler to \$84 billion. Early in December 2000, barely two years later, the collapsing DaimlerChrysler stock had a market value of only \$39 billion, less than Daimler alone was worth before the deal.

¹ Alex Taylor III, "U.S. Cars Come Back," *Fortune*, November 16, 1992, p. 85.

TABLE 13.1 Sales and Profit Comparisons, Big Three U.S. Automakers, 1993–1998 (millions of dollars)

	1993	1994	1995	1996	1997	1998
<i>Ford</i>						
Sales	108,521	128,439	137,137	146,991	153,637	144,416
Net Profit	2,529	5,308	4,139	4,371	6,920	6,579
	2.3%	4.1%	3.0%	3.0%	4.5%	4.5%
<i>GM</i>						
Sales	138,220	154,951	168,829	164,069	173,168	161,315
Net Profit	2,466	5,659	6,933	4,668	5,972	3,662
	1.8%	3.7%	4.1%	2.8%	3.4%	2.3%
<i>Chrysler</i>						
Sales	43,600	52,235	53,195	61,397	61,147	NA
Net Profit	(2,551)	3,713	2,025	3,529	2,805	NA
	(5.9)%	7.1%	3.8%	5.7%	4.6%	

Note: These are total company sales, the bulk of which are autos/trucks. But with nonvehicle diversifications, the sales will be somewhat overstated for autos/trucks.

Sources: Company public records. NA = Not applicable because of merger with Daimler.

Commentary: After a poor year in 1993—a \$2.5 billion loss—Chrysler really bounced back making a profit of \$3.7 billion, which was over 7 percent of sales, far above that of its two major competitors. Chrysler continued the strong showing with multibillion-dollar profits from 1994 on. In 1995, its 3.8 percent profit was well above Ford, but slightly less than GM: in 1996 and 1997 its profit margin again was the best. While we do not have specific figures for 1998, we know that it was also a good year. The collapse came in 1999.

Chrysler was bleeding money. During the second half of 2000, Chrysler lost \$1.8 billion and went through \$5 billion in cash, this at a time when GM and Ford were still doing well.

By 2000 Eaton was long gone, along with nine other top Chrysler executives, including the renowned designer, Thomas Gale. Then in November 2000, Eaton's successor James Holden, a Canadian, the last high-level non-German remaining, was also given the ax. His replacement was a Daimler executive, Deiter Zetsche, 47, a tall German with a walrus mustache. For chief operating officer, Zetsche brought with him Wolfgang Bernhard, 39, an intense young engineer with an MBA from Columbia who was a stickler for cost-cutting. It could have been worse: Zetsche could have brought a big team from Germany, instead of only one other man. Still, indignation surfaced at his putting German executives in top positions of this old American firm—a firm that had played an important part in defeating the Germans in World War II.

Eaton and the rest of the Chrysler hierarchy found to their dismay that this was not a merger of equals, despite Chairman Schrempp's 1998 statements to the contrary, not only to Chrysler's top management but also to the SEC (Securities and Exchange Commission), and the inclusion of the Chrysler name in the corporation

name. In reality, Chrysler had become only a division of Daimler. In interviews with the media, Schrempp admitted that subjugation of Chrysler had always been his intention, this a duplicity of no small moment.²

Later we will analyze why the merger so quickly proved a disaster.

Jurgen Schrempp

DaimlerChrysler Chairman Jurgen Schrempp, a trim 56, had an untarnished reputation going into the Chrysler merger. He began his career with Mercedes as an apprentice mechanic nearly forty years before, and had moved steadily upward. Now he acknowledged that he faced “outstanding” challenges with Chrysler. But he pointed out, “Five years ago in 1995, Daimler-Benz posted a loss of 6 billion marks (\$3 billion). We turned it around in a matter of two years. I think we have the experience and know-how to attend to matters, and if necessary we’ll do that at Chrysler . . . Our aim is to be the No. 1 motor company in the world.”³

Still, there were those who thought he destroyed Chrysler, that “he didn’t realize it was the people who counted, not the factories, which were old, or the sales and profits, which could come and go.”⁴ Schrempp either forced or encouraged key people to leave, and some would say that these departures were of the heart and soul of Chrysler. His duplicity in misleading top Chrysler management and shareholders that this was to be a merger of equals could hardly be viewed as anything but ambitious conniving.

During the merger finalization, it was predicted that Chrysler would earn more than \$5 billion in 2000, this being what it earned in 1998. In late 1999, however, Chrysler President James Holden reduced this prediction to only \$2.5 billion because of having to spend billions retooling for new model introductions at a time when an economic slowdown seemed to be looming.

The reduced profit expectation coming so soon after the merger was unacceptable to Schrempp, and he pressured Chrysler to pump up earnings for the first half of the year by building 75,000 more cars and trucks than could readily be sold, with these quickly shipped to dealers. (The accepted accounting practice was to consider a car as revenue to Chrysler when it reached a dealer’s lot, not when it was sold by the dealer.) As a result, Chrysler was just short of its \$2.5 billion target in the first half of 2000.

Not surprisingly, the inventory buildup resulted in showrooms overflowing with old model minivans, just as new models began arriving in August. With car sales in general now slowing because of the economy, Chrysler had to cut prices even on popular minivans, and it was necessary to increase rebates up to \$3,000 on the old models. These price cuts destroyed the profitability of Chrysler all the more since the company, in its optimism after record profits in the 1990s, had upgraded its cars

² For example, “A Deal for the History Books: The Auto Takeover May Be Remembered for All of the Wrong Reasons,” *Newsweek*, December 11, 2000, p. 57.

³ William J. Holstein, “The Conquest of Chrysler,” *U.S. News & World Report*, November 27, 2000, p. 54.

⁴ Jerry Flint, “Free Chrysler!” *Forbes*, October 30, 2000, p. 132.

and trucks, expecting to charge more for them. But with competition increasing and car pricing turning deflationary, the price hikes did not hold up, and this and the rebates severely affected profits in the third and fourth quarters. (See the following Information Box for a discussion of rebates.)

Schrempp Takes Action

With the huge losses in the second half of 2000, Schrempp sent Zetsche to Detroit with simple instructions: “My orders were to fix the place.”⁵ On his first day Zetsche fired the head of sales and marketing. Then in two months he developed a three-year turnaround plan. It called for cutting 26,000 jobs (29 percent of the workforce), reducing the cost of parts by 15 percent, and closing six assembly plants. Zetsche projected a breakeven point by 2002 and an operating profit of \$2 billion in 2003.⁶ This would still be well below the operating profit of Chrysler in 1993–1997, before the merger, as shown in Table 13.1.

His colleague from Stuttgart, Wolfgang Bernhard, organized engineers and procurement specialists into 50 teams to find ways to save money on parts. Suppliers were told to reduce prices by 5 percent as of January 2001, with a further 10 percent reduction over the next two years. Some companies such as Robert Bosch GmbH, the world’s second-largest parts maker, and Federal Mogul, said they would not cut prices. Zetsche observed, “If they do not support us to get to the 15 percent, we have to consider that in our future decisions.”⁷

INFORMATION BOX

REBATES

A rebate is a promise by a manufacturer to return part of the purchase price directly to the purchaser. The rebate is usually given to consumers, although it can be offered to dealers instead, in the expectation that they will pass some or all of the savings along to consumers.

Obviously, the objective of a rebate is to increase sales by giving purchasers a lower price. But why not simply reduce prices? The rebate is used instead of a regular markdown or price reduction because it is perceived as being less permanent than cutting the list price. This can give more promotional push by emphasizing the savings off the regular price, but only for a limited time. Rebates can be effective in generating short-term business, but they may affect business negatively once they have been lifted.

Do you see any dangers with rebates from the manufacturer’s viewpoint? As a consumer, would you prefer a rebate to a price reduction, or does it make any difference?

⁵ Alex Taylor III, “Can the Germans Rescue Chrysler?” *Fortune*, April 30, 2001, p. 109.

⁶ *Ibid.*

⁷ “Daimler Threatens to Drop Some Suppliers,” Bloomberg News as reported in *Cleveland Plain Dealer*, February 28, 2001, p. 6-C.

Bernhard also focused attention on improving quality as a way to cut costs. In particular, the four-wheel-drive trucks showed up poorly on quality surveys. The company began rigorously evaluating new models for quality while they were still in the design stage, so that parts or manufacturing processes could be changed before too much money had been committed.

Zetsche began to direct much of his attention to bringing back standout designs that Chrysler had been noted for in the 1990s. Of late, design and engineering efforts, such as the 2001 minivan and the 2002 Ram, seemed more evolutionary than revolutionary, with leadership allowed to slip while Toyota and Honda became stronger competitors.

Despite increased competition, Zetsche had a unique asset that he thought should help his company regain the edge: the prestige and competence of Mercedes-Benz technology. Mercedes previously had feared diluting its premium brand, but now it was directed to share components with Chrysler. New rear-wheel versions of the Chrysler Concorde and 300M coming out in 2004 and 2005, for example, were planned to make use of Mercedes electronics, transmissions, seat frames, and other parts. “If Zetsche can sprinkle some Mercedes magic on the Chrysler brand without damaging the premium status of Mercedes, Chrysler has a shot at doing well in the future.”⁸

To his credit, Zetsche worked hard to overcome the anti-German feelings that initially followed his and Bernhard’s arrival. To stem the potential brain drain, he persuaded some senior Chrysler executives and technicians to stay. And the drastic cutback of workers and closing of factories before long came to be viewed as necessary cost cutting to keep the company viable. Even UAW President Steve Yokich endorsed these actions: “[Otherwise] I don’t think there would be a Chrysler.”⁹

Other Problems for Schrempp

Two other major problems confronted Schrempp. In October 2000, despite misgivings by Chrysler executives, he acquired 34 percent of Mitsubishi Motors, with the option to up that to 100 percent after three years. Hardly had the deal been finalized than Mitsubishi admitted it had misled consumers about product quality for decades. It also announced that losses for the last six months had nearly doubled. Schrempp reacted by installing a turnaround expert as chief operating officer at Mitsubishi, accompanied by dozens of Japanese-speaking Daimler executives. All the while the new chief executive, Takashi Sonobe, was quoted as saying that he, not the German team, remained in charge, and that he saw no need for big changes. A contest of wills, this.¹⁰

DaimlerChrysler’s Freightliner, the leading North American heavy-truck maker, was also struggling as the North American market hit one of the steepest slumps in a decade. After an aggressive growth policy that involved acquisitions of other truck makers and a heavy investment in a facility for reconditioning used trucks to

⁸ Detroit manufacturing consultant Ron Harbour, as reported in *Fortune*, April 30, 2001, p. 110.

⁹ Taylor, p. 107.

¹⁰ Holstein, “The Conquest of Chrysler.”

sustain Freightliner's sale-buyback strategy, demand for new and used heavy trucks plummeted 50 percent, and prices fell sharply. It was expected that Schrempp would install a German national as head of this unit.¹¹

PROGNOSIS AT THE TIME

As of mid-2001, many observers were pessimistic of the probabilities of Schrempp resurrecting Chrysler any time soon. In the long term, perhaps; but they questioned whether creditors and shareholders would tolerate a long period of profit drain by Chrysler and low share prices for DaimlerChrysler stock. Rumors were that Deutsche Bank, DaimlerChrysler's largest shareholder, was getting ready to oust Schrempp, and that Chrysler would be broken up into smaller pieces and sold off.¹²

Still, friendly German banks and shareholders might be more patient than Wall Street. DaimlerChrysler was the first German firm to be listed on the New York Stock Exchange, and such a listing subjected Schrempp to the impatience of the international financial markets and their obsession with meeting quarterly earnings expectations. In an age of volatile markets, failure to meet such expectations often resulted in a company's stock price collapsing. This bothered Schrempp: "I don't think [it] is advantageous: focusing on quarterly results. It might well be that because we increase our spending, investment, whatever, for a very good reason, that I might occasionally miss what they [investors] expect from me."¹³

Schrempp would have another worry imperiling his job if Chrysler did not improve soon. The third-largest holder of DaimlerChrysler stock was the Las Vegas takeover tycoon Kirk Kerkorian, a powerful man with a reputation for being easily offended. Rumors held that Schrempp had not made himself available to see Kerkorian, but instead went to his ranch in South Africa.¹⁴

Chrysler executives, much as they might dislike Schrempp, could be worse off if he should be ousted. Mercedes executives ruled in Stuttgart headquarters, and without Chrysler's main supporter, Schrempp, Chrysler might not receive the resources needed to make a comeback. It might be broken up and sold, or left withering within DaimlerChrysler's empire.¹⁵

ANALYSIS

This case illustrates the downside of mergers and acquisitions. (We use the terms mergers and acquisitions somewhat similarly, but will consider "merger" as closer to the idea of equals coming together, while "acquisition" suggests a larger firm

¹¹ Joseph B. White, "Head of Truck Maker Freightliner Is Leaving Post," *Wall Street Journal*, May 25, 2001, p. A4.

¹² "Can the Germans Rescue Chrysler?" pp. 106–7.

¹³ Holstein, p. 69.

¹⁴ Reported in "A Deal for the History Books," p. 57.

¹⁵ See Robyn Meredith, "Batman and Robin," *Forbes*, March 5, 2001, pp. 67,68; and Jerry Flint, "Free Chrysler," *Forbes*, October 30, 2000, p. 132 for more discussion of these scenarios.

absorbing a smaller one.) The causes of these problems are diverse, although certain commonalities occur time and again.

We will examine the salient factors that led to the collapse of Chrysler soon after the merger under (a) those mainly Daimler's fault, (b) those Chrysler's fault, and (c) the externals that made the situation worse. Then we will examine this whole concept of a "merger of equals." Can there really be a merger of equals?

Daimler's Contribution to the Problem

The Morale Factor

Different cultures are often involved when a merger or acquisition takes place, even among seemingly similar firms. For example, one business culture may be more conservative and the other aggressive and even reckless; one may be formal and the other informal; one culture may insist on standard operating procedures (SOPs) being followed, while the other may be far less restricted; one may be dominated by an accountant or control mentality, which emphasizes cost analysis and rigidity of budgets, and the other by the sales mentality, which seeks maximum sales production and flexibility of operations even if expenses sometimes get out of line. Such differences impede easy assimilation.

This assimilation challenge for divergent corporate cultures becomes all the more difficult when different nationalities are involved—for example, Germanic versus American. National pride, and even prejudice, may complicate the situation.

It is hardly surprising that this mammoth merger of a proud German firm and an American firm with a long heritage should have presented morale problems. Especially with one party misled as to the sharing of leadership, the seeds were laid for extreme resentment. Some of this resentment among rank-and-file workers even went back to World War II.

But there were other obstacles to a smooth melding of the two firms. Daimler had to adjust from being an old-line German firm to becoming a huge international firm confronted with a diversity of cultures. "The German instinct is for hierarchy, order, planning. Daimler executives use Dr. or Prof. on their business cards. Many wear dark three-piece suits. Chrysler, by contrast, was known for a freewheeling creativity."¹⁶

Chrysler's company culture had been highly successful in the very recent past, as shown in Table 13.1 and in Table 13.2, which presents the gain in market share or competitive position during the 1990s. Its rather unrestrained-by-rules culture seemed to many to be the key to innovative thinking and technical leadership. With the merger it was not only being challenged but repudiated and supplanted by Germans who little appreciated the contributions of designers like Bob Lutz, who came up with products customers wanted that were not engineered at great cost and research. "The daring and imagination of the old Chrysler [is] buried under German management."¹⁷

¹⁶ Holstein, p. 56.

¹⁷ Flint, p. 132.

TABLE 13.2 Chrysler's Market Share of the Big Three U.S. Automakers, 1991–1998

	Chrysler's Sales Percentage of U.S. Car/Truck Automakers
1991	12.2
1992	13.7
1993	15.0
1994	15.6
1995	14.8
1996	16.5
1997	15.8
1998	NA

Sources: Calculated from publicly reported sales figures; 1998 figures not applicable due to merger in November.

Commentary: The improvement in Chrysler performance in the middle and late 1990s is clearly evident. Market-share improvement of even 0.05 percent translates into a gain in competitive position. And here we see a gain of more than 4.0 percent in 1996 and 3.6 percent in 1997. You can see how Chrysler's improving performance in the latter years of the 1990s would be attractive to Daimler.

Schrempp's Major Blunder

A miscalculation by Schrempp little more than a year after the merger was to have drastic consequences. His order to produce and ship 75,000 more older-model vehicles than could reasonably be sold before the new models came out, thus beefing up sales and profits for the first half of the year, resulted in huge imbalances of inventories in the last half and destroyed year-2000 results as well as the early months of 2001. This overproduction was the trigger that brought Chrysler its huge losses and even jeopardized the soundness of Schrempp's acquisition decision.

Chrysler's Contribution

One could argue that Chrysler had grown fat and inefficient after its years of success in the last half of the 1990s, that it was on the verge of a drastic decline in profits even if Daimler had not come on the scene to stir things up. By 1999 Chrysler showrooms were saddled with aging models, including the important minivans that were in their fifth year. While still the leader in minivan sales, Chrysler was losing market share to competitors with newer models, including the Honda Odyssey.

The prosperity of Chrysler in the mid-1990s may have reflected not so much inspired management as a combination of good luck factors: innovative designs and segment-leading products, yes, but also rising sales throughout the auto industry and a groundswell of demand for high-profit minivans and pickup trucks. Maybe the success of those years paved the way for the disaster that came shortly after

Daimler took over. The great demand for vehicles like the Ram pickup truck, Jeep Grand Cherokee, and Dodge Durango brought a heady confidence that these good times would continue. Accordingly, Chrysler projected market share to increase to 20 percent by 2005, far above anything ever attained before. (You can see from Table 13.2 that reaching a 20 percent market share was not very close.) So Chrysler spent heavily on refurbishing plants and buying new equipment. It went from having the fewest workers per point of market share in 1996 to the most by 1999. It was spending money extravagantly, and its entrepreneurial culture was operating unchecked. “The company lost its purpose and lost its direction,” the former chief engineer Francois Castaing said.¹⁸

The uncontrolled entrepreneurial culture led to poor communication and coordination, with each team buying its own components, such as platforms and parts for the different cars, thus not taking advantage of economies of scale. For example, the Durango and the Jeep had different windshield wipers, and Chrysler’s five teams specified three different kinds of corrosion protection for the rolled steel used to reinforce plastic bumper surfaces.¹⁹

Other lapses of good judgment included continuing production of old-model minivans as it was switching production to the new one, thus flooding the market. This yielding to the pressure of Schrempp, as we have seen earlier, was a major factor in the disastrous 2000 results. Could Chrysler executives have protested more vigorously? The practice of the old management to introduce new models in batches rather than spreading them over several years brought a feast or famine situation: very good years, and rather bad years in between.

External Factors

Certainly the merger was consummated at a time when the auto industry, and the economy in general, was on the threshold of a downturn. Chrysler apparently miscalculated such an eventuality, spending heavily for costlier models just before demand turned down, and its brands were not strong enough to command higher premiums from customers. By early 2001, Chrysler was outspending all other major automakers on rebates and other incentives.

Chrysler also seemed oblivious to the threat of competitors during its golden years. Despite heavy use of incentives, Chrysler lost market share for the first three months of 2001: a 14.2 percent market share vs. 15.1 percent for the same three months in 2000.

CAN THERE REALLY BE A MERGER OF EQUALS?

In reality there is seldom a merger of equals. Unless the two parties actually recapitalize themselves with new stock—and this is seldom done—there is always an acquirer and an acquiree. Even if both parties to the merger have equal seats on

¹⁸ As quoted in “Can the Germans Rescue Chrysler?” p. 109.

¹⁹ *Ibid.*

the board of directors, still the acquiring firm and its executives are more dominant. Even if the name of the new combined firm is completely changed, this does not assure a merger of equals. For example, in a well-publicized merger “of equals” in 2000 between Bell Atlantic and GTE, the name *Verizon* was created. But no one was fooled: Bell Atlantic was in charge. Furthermore, there can be no true merger of equals if one firm owns more of the consolidated stock (usually reflecting its larger size) than the other, and this is almost always the case. Daimler was certainly the larger firm in this merger, having paid \$36 billion for Chrysler while its own shares just before the merger had a market value of about \$48 billion.

How important is this merger of equals to the executives of acquired firms? Apparently to many it is not of major consequence as long as they get a good price for their stake, or as long as they believe the acquiring firm will honor their importance. Occasionally a merger negotiation will fall apart over the issue of who will be in charge. Take the example of Lucent and Alcatel of France, two of the world’s biggest makers of communications equipment: At the last minute on May 29, 2001, Henry B. Schacht, chairman of Lucent, called off the merger talks. “It started to feel more like an acquisition than a merger,” one of the Lucent participants explained. They could not accept the probability that Alcatel would be in charge.²⁰

UPDATE TO 2007–2008

At the beginning of 2002, Chrysler reported it had lost a staggering \$2 billion in 2001, and this brought a new wave of criticism of the merger—after all, it was four years after the deal. For the first years after the merger, Mercedes closely guarded its parts and designs for fear of eroding the Mercedes mystique. Now headquarters in Stuttgart, Germany, finally began forcing its far-flung operations to begin working together. In spring 2003, Chrysler introduced two models that reflected more German engineering: the Pacifica, a cross between a station wagon and a SUV; and the Crossfire, a sleek sports car. Waiting in the wings were a LX sedan and a SUV called the Magnum. Headquarters also began bringing engineers from its Mitsubishi subsidiary to Stuttgart in order to integrate some ideas for smaller cars.²¹

By 2004, nearly seven years after the merger, Chrysler was on an upswing, with its profits and market share growing because of improvements in quality and design, and drastic cost-cutting. Not the least of the contributors to the turnaround was a hot new car, the 300C. (The Pacifica introduced in 2003 had been a dud, partly because it was priced too high.) The new car was not only distinctive but significantly cheaper than equivalent competitive models. For example, a well-equipped version sold for \$36,000, while a similarly powered BMW retailed at \$60,000. Chrysler gave a 300C to Snoop Dogg, in return for a promise he’d include the car in a musical video, and with crowds being pulled into dealerships, Chrysler’s market

²⁰ For more details, see Seth Schiesel, *New York Times*, reported in *Cleveland Plain Dealer*, June 3, 2001, p. 1-H.

²¹ Neal E. Boudette, “At Daimler Chrysler, a New Push to Make Its Units Work Together,” *Wall Street Journal*, March 12, 2003, pp. A1 and A15.

share inched up to 13 percent from 12.7 percent a year earlier, this at a time when both Ford and GM were losing market share.

Alas, now that Chrysler was making money, Mercedes-Benz was faltering, with serious quality problems. Back in 1998 at the merger, Mercedes was the world's No. 1 luxury brand. Now it had slipped to the fifth largest. This reversal of fortune—whenever one part of the empire turns a corner, another part stumbles—raised doubt about the belief that vast size brings huge economies of scale. Jurgen Schrempp's global vision inspired other auto industry tie-ups, such as Ford's acquisition of Land Rover and Volvo, and GM's stake in Fiat, which also have had mixed results.

The see-sawing performance continued into 2006, now with Chrysler struggling to clear out a large inventory of unsold vehicles, while Mercedes seemed to have rebounded and recovered from its quality problems.²² By the end of 2006, the situation was worsening as Chrysler recorded a \$1.5 billion loss for the third quarter, joining GM and Ford in posting whopping losses. The U.S. auto industry was on the ropes as Tokyo-based Honda reported a profit. Chrysler's losses were blamed on falling sales of large sport utility vehicles, and also on the highest labor costs among the Big Three, thanks to the UAW rejecting similar concessions to those given to Ford and GM. Rumors surfaced that Chrysler might be put up for sale by parent DaimlerChrysler.²³

A Last Stand?

In August 2007 private equity firm Cerberus Capital Management bought Chrysler for \$7.4 billion. Most of the money went into Chrysler, not Daimler. The complex transaction resulted in only a \$680 million cash outflow for Daimler, whose acquisition of Chrysler in 1998 was valued at \$36 billion. Now, with the benefit of hindsight, the monumental acquisition mistake by Daimler can truly be recognized—not a blunder of hundreds of millions of dollars, but of billions.

The bargain price that Cerberus struck posed a rather optimistic prognosis for Chrysler. Former Treasury Secretary John Snow, Cerberus chairman, said: "There's a sense at Cerberus that U.S. manufacturing in general, and the auto industry in particular, continue to have a bright future, not only in America, but in the global economy." Others viewed saving Chrysler as a matter of national pride.²⁴

Three days after closing the deal, Cerberus installed Robert Nardelli, a controversial former CEO of Home Depot, as Chrysler's chief executive. He was known for his dictatorial manner and huge pay package at Home Depot, but it paid off for Home Depot until the housing industry collapsed. At Chrysler, he would have challenges aplenty to occupy him. But he will also have one huge advantage he did not have at Home Depot. As a private company—Cerberus may take Chrysler public some day if Nardelli can rejuvenate it—major decisions that once took months to

²² Stephen Power and Neal E. Boudetter, "Slide in Mercedes Performance Dent's Chrysler's Recent Revival," *Wall Street Journal*, February 9, 2005, pp. A1 and A6; and Steven Power, "DaimlerChrysler, VW Profits Rise, but Challenges Persist in the U.S.," *Wall Street Journal*, July 28, 2006, p. A2.

²³ Rick Popely, "Crisis at Chrysler after News of \$1.5 Billion Loss," *Chicago Tribune*, as reported in *Cleveland Plain Dealer*, October 26, 2006, p. C3.

²⁴ Joann Muller, "Chrysler's Last Stand," *Forbes*, November 26, 2007, pp. 169–180.

make can now be made in minutes. Long-term decisions are now possible that would have been difficult to justify in an environment where stockholders punish companies for missing earnings projections by even a penny a share.

Nardelli quickly toughened Chrysler's quality standards, making senior engineers responsible and hiring a "chief customer officer," an industry first, to monitor quality assurance and be an advocate for the buyer. Under Daimler, cost-cutting was the emphasis, perhaps to not upstage Mercedes cars. Nardelli pounced on cheap-looking Chrysler vehicles with tacky plastic interiors. "It's an earth-shattering moment in time. We don't do expensive things," noted one Chrysler engineer.²⁵

Invitation to Make Your Own Analysis and Conclusions

Could the early problems of the merger have been avoided? What are your recommendations?

WHAT WE CAN LEARN

Was the Flagrant Deception That This Would Be a Merger of Equals Unethical?

Outright deception and lies would seem the essence of unethical behavior, and perhaps illegal as well. It is when it comes to deceiving consumers. But in the hard negotiating climate of a merger, is a less truthful and trusting stance more the norm? Should we define ethical standards differently than when the hapless consumer is involved?

The situation is indeed different. The consumer is substantially disadvantaged before the greater product knowledge of the seller, and can easily be deceived by false claims. In a business-to-business situation, one would think that information would be shared equally, unless some fraud was involved. And even this should be uncovered if a careful audit was made before the transaction was finalized.

But verbal promises of sharing the administration? Even if written, such promises may be difficult to enforce. What does a "merger of equals" really mean: Is it "a genuine business model, or is it a takeover cloaked in the high-toned language of amity?" as Robert Bruner of University of Virginia's Darden Graduate Business School phrases it.²⁶

Chrysler's top managers should have suspected that their position might be temporary. After all, there is precedence for top-management displacement in mega-"mergers of equals": for example, David Coulter of Bank of America, and John Reed of Citigroup, due to political infighting and disappointed expectations.

²⁵ *Ibid.*, p. 176.

²⁶ Robert F. Bruner, "A Merger of Equals?" *Wall Street Journal*, January 20, 2004, p. B2.

Mergers Are No Panacea

For years in recurrent cycles of exuberance and caution, businesses have tried to solve the problem of growth with mergers and acquisitions. What you didn't have you could acquire faster and better than developing it yourself, so the reasoning went. The term *synergy* became widely used, especially in the 1980s to tout the great benefit and advantages of such mergers and acquisitions. (The following Information Box describes this concept of synergy.)

Wall Street dealmakers, investment bankers, and lawyers reap the bonanza from merger activities, but many of these mergers do not work out as well as expected, and some are even outright disasters.

We have seen the cultural conflict in the DaimlerChrysler merger. But this is just one of the things that can go wrong. Many acquisition seekers are so eager to get the target company because it has strength in market share or access to strategic technologies, or because it will make their firm so much bigger in its industry (with all the prestige of large size for the executives involved) that they

INFORMATION BOX

SYNERGY

Synergy results from creating a whole that is greater than the sum of its parts, and thus can accomplish more than the total of individual contributions. In an acquisition, synergy occurs if the two firms, when combined, are more efficient, productive, and profitable than they were as separate operations before the merger. Sometimes this is referred to as $2 + 2 = 5$.

How can such synergy occur? If duplication of efforts can be eliminated, if operations can be streamlined, if economies of scale are possible, if specialization can be enhanced, if greater financial, technical, and managerial resources can be tapped or new markets made possible—then a synergistic situation is likely to occur. Such an expanded operation should be a stronger force in the marketplace than the individual single units that existed before.

The concept of synergy is the rationale for mergers and acquisitions. But sometimes combining causes the reverse, negative synergy, where the consequences are worse than the sum of individual efforts. If friction arises between the entities, if organizational missions are incompatible, if the new organizational climate creates fearful, resentful, and frustrated employees, then synergy is unlikely, at least in the short- and intermediate term. Furthermore, if because of sheer optimism or an uncontrolled acquisitive drive, more is paid for the acquisition than it is really worth, then we have a grand blunder. With hindsight, that was the case with the Chrysler acquisition, in addition to the culture problem. With the price that Cerberus paid for a wounded Chrysler, it is highly unlikely that the private equity firm paid too much.

Do you think a typical committee or group has more synergy than the same individuals working alone? Why or why not?

are prepared to pay well, and often too much. Funds for such borrowing are usually readily available, heavy debt has income tax advantages, and profits may be distributed among fewer shares so that return on equity is enhanced. But all too often the best of the acquired human assets are soon sending out résumés to prospective new employers, and the assimilation and effective consolidation of the two enterprises may be years away. Furthermore, acquiring companies may be left with mountains of debt from over-ambitious mergers and acquisitions, thus greatly increasing the overhead to cover with revenues before profits can be realized.

Cultural Differences Should Be Considered in Mergers and Acquisitions

Cultural differences in perceptions, customs, ways of doing things, and prejudices often are not given enough heed. The acquiring firm expects to bulldoze its culture on the acquired firm (despite how this may affect pride and willingness to cooperate). As we saw with the Daimler merger with Chrysler—in reality a merger of unequals—arrogance and resentments were enduring.

Should the acquiring company express its dominance quickly, or should it try to be as soothing as possible? Morale will probably not be savaged in a soothing takeover, but there can be serious problems with this approach also. Permitting an acquisition to continue operating with little control can be a disaster waiting to happen, especially if the acquisition is a foreign firm.

How Much Can You Trust?

Both parties to a merger negotiation may express a commitment to equality. But such lip service may prove a facade. Even if executive positions are as evenly balanced as possible, one person may be a more dominant personality than the other, perhaps by dint of bigger stock ownership. Consequently, the merger of equals becomes in name only, with any equal standing of the acquired firm existing only at the convenience of the acquirer.

The Danger of Cannibalization

Cannibalization occurs when a new product takes away sales from an existing product. This is likely to occur whenever a new product is introduced, but flooding the market with the old product just before a new model introduction, as Daimler pressured Chrysler to do, is asking for problems. DaimlerChrysler found that it took both massive rebates of the old models as well as substantial price reductions of the new ones to move the inventory—all this destructive to profitability. The same scenario has confronted computer makers and other firms at the cutting edge of new technology. When do you let go the old model without jeopardizing lost sales in the interim?

We do not advocate stopping production of the older model when the new model is first announced. But it seems judicious to reduce production in the

months after the announcement. Then the newer, technologically advanced model should command a higher price than the older version. DaimlerChrysler's problems in 2000 were aggravated by the fact that the new models were not so much technologically superior as provided with expensive options that some buyers found not worth the extra money.

Let us not denigrate the desirability of cannibalizing. As products are improved, they should be brought to the marketplace as soon as possible, and not held back because there may be some cannibalization. The temptation to hold back is there, especially when the new product may have a lower profit margin than the product it is supplanting, perhaps because of competition and higher costs. Invariably, the firm that restrains an innovation because of fear of cannibalizing a high-profit product winds up making the arena attractive for competitors to gain an advantage. *Fear of cannibalization should not impede innovation.*

CONSIDER

Can you think of other learning insights?

QUESTIONS

1. Do you think Schrempp was wise to replace the top Chrysler executives? Why or why not?
2. How could Chrysler boss Robert Eaton have been so naive as to permit himself to be ousted from power in a negotiation that he actively campaigned for and accepted? Do you see any way he might have protected his position in the merger?
3. How specifically can a firm protect itself from the extreme risks of cannibalization?
4. Do you think the culture problems could have been largely avoided in this merger? How?
5. Dieter Zetsche was sent from Stuttgart headquarters to fix all-American Chrysler after the disastrous year 2000. On his first day in Detroit, he fired the head of sales and marketing. Discuss the advisability of such a quick action, considering as many ramifications and justifications as possible.
6. Evaluate the desirability of rebates rather than regular markdowns or price cuts.
7. Do you personally think the use of Mercedes parts in Chrysler vehicles would diminish the prestige of the Mercedes brand? Would it help Chrysler that much?
8. Do you think good times can ever be lasting in the auto industry? Why or why not?

HANDS-ON EXERCISES

1. You are one of Chrysler's biggest suppliers of certain parts. You are shocked at the decree by the new management of Chrysler that you must cut your prices by 5 percent immediately, and another 10 percent within two years. What do you do now? Discuss and evaluate as many courses of action as you can. You can make some assumptions, but spell them out specifically.
2. Place yourself in the position of Robert Eaton, CEO of Chrysler before the merger, and now "co-chairman" with Jurgen Schrempp. You have just been told that your services are no longer needed, that the co-chairman position has been abolished. What do you do at this point? Try to be specific and support your recommendations.
3. You are Steve Yokich, president of the United Auto Workers. You had initially endorsed the plans of Dieter Zetsche to cut costs severely, this including laying off 26,000 workers and closing six plants. You had been convinced that such downsizing was necessary to save Chrysler. Now many of your union members are storming about such arbitrary cuts. They are castigating you for supporting these plans, and you may be ousted. Discuss your actions.

TEAM DEBATE EXERCISES

1. In this case we have the great controversy of German top executives replacing American ones. Debate the desirability of such replacing versus keeping most of the American incumbents. I would suggest dividing up into two groups, with one being as persuasive as possible in arguing for bringing in fresh blood from German headquarters, and the other strongly contesting this. Be prepared to attack your opponents' arguments, and defend your own.
2. Debate the ethics of the flagrant deception by Daimler of this being a "merger of equals."

YOUR ASSESSMENT OF THE LATEST DEVELOPMENTS

Do you think Chrysler can again be a viable entity in the U.S. auto industry? Nardelli had a reputation for alienating employees at Home Depot. Do you think this will be a serious problem in his Chrysler tenure?

INVITATION TO RESEARCH

What is the situation with Chrysler today? Is Nardelli still chief executive? Have the Big Three U.S. automakers been able to counter the great inroads of Honda and Toyota? How does the future look for the U.S. firms? What ever happened to Jurgen Schrempp? To Dieter Zetsche? To Wolfgang Bernhard?

Newell's Acquisition of Rubbermaid Becomes an Albatross

John McDonough, CEO of Newell, specialized in buying small marginal firms and improving their operations. In ten years he bought 75 such firms and polished them by eliminating poorer products, employees, factories, and by stressing customer service. This format began to be called “Newellizing.” It was hardly surprising that most of the acquisitions had strong brand names, but mediocre customer service. Rubbermaid fit this mode, though it was by far the biggest acquisition and would nearly double Newell’s sales.

Rubbermaid, manufacturer and marketer of high-volume, branded plastic and rubber consumer products and toys, had been a darling of investors and academicians alike. For ten years in a row, it placed in the *Fortune* survey of “America’s Most Admired Corporations,” and it was No. 1 in both 1993 and 1994. It was ranked as the second most powerful brand in a Baylor University study of consumer goodwill, and received the Thomas Edison Award for developing products to make people’s lives better. Under CEO Stanley Gault, Rubbermaid’s emphasis on innovation often resulted in a new product every day, thereby helping the stock routinely to return 25 percent annually.

Surprisingly, by the middle 1990s, Rubbermaid began faltering, partly because of inability to meet the service demands of Wal-Mart, a major customer. Rubbermaid stock plummeted 40 percent from the 1992 high, leaving it ripe for a takeover. Newell Company acquired Rubbermaid on March 24, 1999, expecting to turn it around. But then Newell had to wonder . . .

THE ACQUISITION AND WOLFGANG SCHMITT

Former Rubbermaid CEO Wolfgang Schmitt felt a cloak of apprehension settling over him in May 1999. It was only two months after the merger with Newell had been completed, and things were not going as he expected.

Schmitt had become CEO a year after the legendary Stanley Gault retired in 1991. Gault had returned in 1980 to his hometown of Wooster, Ohio (Rubbermaid headquarters) after more than 31 years with the General Electric Company. During Gault's tenure, Rubbermaid stock split four times to the delight of stockholders. It was a tough act to follow.

Wolfgang often thought about this, but he was certainly a worthy successor to Gault. He had spent all his working life with Rubbermaid after graduating in 1966 from Otterbein College in Westerville, Ohio (about 60 miles from Wooster) with a degree in Economics and Business Administration. A recruiter visiting the campus convinced him to join Rubbermaid, a rapidly growing company. He started as a management trainee, and in 27 years worked his way up the corporate ranks to become chairman of the board and chief executive officer in 1993. He was proud of this accomplishment and thought his experience must be an inspiration to young people in the company. Any one of them could dream of becoming CEO, with hard work and loyalty. A significant highlight of his professional life came when he was invited back to Otterbein in November 1997 to inaugurate its Distinguished Executive Lecture Series.

During Schmitt's reign, Rubbermaid reached \$2 billion in sales in 1994. When it celebrated its 75-year anniversary a year later, Schmitt set the company's sights on \$4 billion in sales for the turn of the century. To do this, he knew it had to become a truly global company, and he instigated four foreign acquisitions that year.

He knew he was an effective CEO. When the Newell Company, a slightly larger multinational firm, expressed an interest in merging, Schmitt thought he owed it to his stockholders, and to himself, to pursue this. After all, the two firms' houseware and hardware products and marketing efforts were compatible, and their combination would result in a \$7-billion-a-year consumer products giant. Aiding Schmitt's decision to merge was a nice severance guarantee of \$12 million after taxes in addition to his stock options. While Newell's CEO John McDonough would assume the CEO position of the merged corporation, Schmitt was to be a vice chairman and would work closely with McDonough to ensure the smooth merger and to help mold the new company.

Now, barely two months later, Schmitt had been shunted aside. He did not have an office at headquarters, his name was not listed on a new report of the seven highest-paid executives, and he was not even included in the list of directors reported to the Securities and Exchange Commission (SEC). He couldn't help feeling betrayed about no longer having a role in the operations of the company, after he had been so instrumental in bringing about the merger. At 55 years of age, he still had many productive years left. More than this, there was the principle of the thing: This was like a kick in the teeth.

But he was not alone. The presidents of three of Rubbermaid's five divisions—Home Products, Little Tykes, Graco-Century, Curver, and Commercial Products—had already been replaced since the merger. Furthermore, in the Home Products division, only two of the top eight executives were still there.

NEWELL'S ASSESSMENT OF RUBBERMAID

If John McDonough of Newell was so unhappy with current Rubbermaid management and operations, why did he buy Rubbermaid in the first place—and for \$6.3 billion dollars, more than twice current sales? At a shareholders' meeting a few months after the acquisition, McDonough tried to explain. He told them that Rubbermaid was a troubled company, but that once it was pulled into the revered operations of Newell, it could be great again.¹

The shareholders were told that while jobs were being cut, the operations would be stronger in the long run. As a strength, McDonough noted that Rubbermaid commanded 94 percent brand loyalty and generated great customer traffic in stores. But Rubbermaid executives needed to slash unnecessary costs, introduce robotics, and reduce product variety. For example, was it necessary to have dozens of the same type of wastebasket?

Still, McDonough saw poor customer service as the biggest deficiency of Rubbermaid, the most unacceptable aspect of its operation, and the one that Newell could most easily correct. After all, Newell had achieved a 98.5 percent on-time delivery rate in dealings with Wal-Mart. He would see that Rubbermaid was brought up to this same performance standard.

Rubbermaid's Customer Service Problems

Perhaps a declining commitment to customer service dated back to the retirement of Gault, though Schmitt would likely dispute that. Customer service can erode without being obvious to top management. While some customers complain, many others simply switch their business to competitors. Still, Rubbermaid's lapses in customer service should have been obvious for years. After all, Wal-Mart was not tolerant with vendors not meeting its standards. When McDonough's people began digging deeper into Rubbermaid's operations, they found that the company wasn't even measuring customer service. This deficiency is almost the kiss of death when dealing with major retailers.

Up to the mid-1990s, about 15 percent of Rubbermaid's \$2 billion-plus revenues came from Wal-Mart. Rubbermaid had had an impressive earnings growth of at least 15 percent a year to go along with 20 percent operating margins, much of this due to the generous space Wal-Mart gave its plastic and rubber products. This was to change abruptly.

In 1995 Wal-Mart refused to let Rubbermaid pass on much of its higher raw material costs, and began taking shelf space away and giving it to smaller competitors who undersold Rubbermaid. This resulted in a major earnings drop (see Table 14.1) that forced Rubbermaid to shut nine facilities and cut 9 percent of

¹ Teresa Dixon Murray, "Newell Details Its Plans for Rubbermaid," *Cleveland Plain Dealer*, May 27, 1999, p. 1-C.

TABLE 14.1 Rubbermaid Sales and Earnings, 1992–1997

	1992	1993	1994	1995	1996	1997
Sales (in billions)	\$ 1.81	\$ 1.96	\$ 2.17	\$2.34	\$ 2.35	\$ 2.40
Net earnings (in millions)	184	211	228	59	152	143
Earnings percent of sales	10.2%	20.0%	18.9%	4.9%	14.2%	13.8%
Earnings per share	1.15	1.32	1.42	.38	1.01	.95

Source: Company reports.

Commentary: This six-year comparison of sales and the various profit indicators show rather starkly the decline in fortunes of Rubbermaid beginning in 1995. Sales remained practically static from 1995 on, although admittedly they were not growing very robustly in the three years before. The lack of growth occurred during a period of unprecedented economic prosperity.

The earnings comparisons show up worse. While acceptable earnings growth occurred up to 1995, they greatly worsened beginning in 1995. Not only were net earnings figures drastically reduced, but they showed little sign of recouping, even though there was some improvement from the bottom of 1995. Of course, net earnings as a percent of sales and per share also drastically declined from what they were in 1992–1994. Rubbermaid's major problems with Wal-Mart occurred in 1995.

its 14,000 employees. "When you hitch your wagon to a star, you are at the mercy of that star."²

Wal-Mart not only complained about poor deliveries but began taking more drastic action. Each day Wal-Mart gives suppliers such as Newell a two-hour time slot in which their trucks can deliver orders placed 24 hours before. Should the supplier miss the deadline, it pays Wal-Mart for every dollar of lost margin. Now such a fast replenishment of orders required that factories be tied in with Wal-Mart's computers. Rubbermaid began installing software to do this in 1996 and had spent \$62 million by 1999, but still was often not even achieving 80 percent on-time delivery service. This was unacceptable to Wal-Mart, and returns and fines for poor service rose to 4.4 percent of sales in 1998.³ Finally, Wal-Mart purged most of its stores of Rubbermaid's Little Tikes toy line, giving the space to a competitor, Fisher Price. See the following Information Box for a discussion of the power of a giant retailer and the demands it can make.

Wal-Mart had such a high regard for the customer service of Newell that, upon hearing of the impending merger, it again began carrying Little Tykes toys. McDonough vowed to get Rubbermaid's on-time delivery rate of 80 percent up to Newell's 98.5 percent, and he began ripping out Rubbermaid's computer system and writing off the entire \$62 million. In addition, McDonough claimed to be able to squeeze \$350 million of costs out of Rubbermaid, which would double its operating income.⁴

² Matthew Schifrin, "The Big Squeeze," *Forbes*, March 11, 1996, p. 46.

³ Murray, p. 3-C.

⁴ Michelle Conlin, "Newellizing Rubbermaid," *Forbes*, May 31, 1999, p. 118.

INFORMATION BOX**THE DEMANDS OF A GIANT RETAILER**

Giant retailers, especially the big discount houses, stand in a power position relative to their vendors. Part of this power lies in their providing efficient access to the marketplace. Imagine the problems of a large consumer goods manufacturer in trying to deal with thousands of small retailers rather than the few big firms that dominate their markets. These giant firms can account for 50 percent and more of many manufacturers' sales. However, if such a major customer is lost or not completely satisfied, a vendor's viability could be in jeopardy.

Retailers like Wal-Mart make full use of their power position. Take paying of invoices, for example. Many vendors give a 2 percent discount if bills are paid within ten days instead of 30. Wal-Mart routinely pays its bills closer to 30 days and still takes the 2 percent discount. Wal-Mart has also led in "partnering" with its vendors. This partnering really means that vendors have to pick up more of the inventory management and merchandising costs associated with Wal-Mart stores, with most of the costs involved in providing fast replenishment so that the stores can maintain lean stocks without losing customer sales through stockouts.

So-called slotting fees are common in the supermarket industry, with manufacturers paying to get things on store shelves. It was estimated that some \$9 billion annually changed hands in private, unwritten deals between grocery retailers and food and consumer goods manufacturers.⁵

The following is an example of a slotting fee stipulation of a supermarket chain:

Effective January 1, 2006

Our slotting fee is . . . \$4,500

An item authorized will remain authorized for a minimum of six months (as long as the basic cost does not go up substantially). Many times it is the "slotting fee" that determines whether or not we authorize an item.

Given the coercive power of a big retailer, a vendor is practically forced to meet their demands no matter what the cost.

Do you think a big manufacturer, such as Coca-Cola, can be coerced by a big retailer? Why or why not? What might determine the extent of retailer coercion? Can a manufacturer coerce a retailer?

⁵ John S. Long, "Specialty Items to Drive New Market," *Cleveland Plain Dealer*, October 6, 1999, p. 4-F.

AFTER THE MERGER

When Newell did not quickly turn Rubbermaid around and Newellize it, stockholders were shocked and disappointed. In a time of rising stock prices, Newell Rubbermaid's shares plunged 20 percent in one day in September 1999 as the

now-giant consumer goods firm warned that third-quarter earnings would fall short of expectations. This was only the latest in a string of negatives, and Newell Rubbermaid's stock was to lose almost half of its value since the Rubbermaid acquisition in March. It blamed lower-than-expected sales of Rubbermaid's plastic containers and Little Tykes toys. Still, company officials maintained that "the integration process remains on plan."⁶

A month later, coinciding with a Wal-Mart announcement that it was expanding vigorously in Europe, Newell Rubbermaid said it would focus on expanding overseas to serve domestic retailers who were moving abroad. The company had been getting a quarter of its sales outside the United States. "Our customers are going international," McDonough said. "We have the opportunity to follow them. It's a once-in-a-lifetime opportunity."⁷

The company also maintained that it had sharply reduced the number of late shipments of Rubbermaid products and expected to have 98 percent of orders shipped on time either in the present quarter or next.⁸

Was this a wise merger?⁹ Did Newell pay too much for a faltering Rubbermaid? It was hardly likely in the first year of a merger that management would admit to maybe making a mistake. But stockholders were betting with their money. Meantime, Wolfgang Schmitt pondered his exile and the erosion of value of his stock options.

DISAPPOINTMENT

John McDonough resigned as CEO in November 2000, after Newell Rubbermaid cut profit forecasts three times in the year after the Rubbermaid acquisition. Joseph Galli, a "master marketer," as *Forbes* proclaimed him, and the first outsider in the company's 99-year history, became the chief executive in January 2001.

Newell needed a rescuer. McDonough whose forte was buying underperforming companies and Newellizing them, had met his match. This was the third year of flat or falling profits. For 2001, sales were off 2.4 percent and net income down 42 percent, with share prices reflecting this. The \$6 billion purchase of Rubbermaid, its biggest deal, had brought Newell to its knees, and Rubbermaid remained the sickest division.

Joseph Galli

The 43-year-old Galli in 19 years at Black & Decker had built a reputation as a marketing wunderkind, a brand builder. He was running the company's crown jewel, the DeWalt brand, a high-margin line of power tools for skilled tradesmen and consumer do-it-yourselfers. Galli recruited teams of college graduates, dubbed "swarm teams," to be supermissionary salespeople hawking the DeWalt brand not only at

⁶ James P. Miller, "Newell Rubbermaid Shares Fall 20% As an Earnings Short Fall Is Predicted," *Wall Street Journal*, September 7, 1999, p. A4.

⁷ "Newell Rubbermaid to Resume Acquisitions, Expand Overseas," *Cleveland Plain Dealer*, October 6, 1999, p. 2-C.

⁸ *Ibid.*

INFORMATION BOX**MISSIONARY SALESPEOPLE**

Missionary or supporting salespeople do not normally try to secure orders. They are used by manufacturers to provide specialized services and create goodwill and more dealer push. They work with dealers, perhaps to develop point-of-service displays, train dealer salespeople to do a better job of selling the product, provide better communication and rapport between distributor and manufacturer, and in general, aggressively promote the brand. They are particularly important in selling to self-service outlets, such as supermarkets and discount stores, where there are no retail clerks selling to customers, so that displays, shelf space, and in-stock conditions have to be the selling tools.

Galli's super-missionaries or swarm teams of Galli were small armies of energetic college recruits who also worked Nascar races, trade shows, new store openings, and the like. A typical super-missionary was given the use of a new Ford Explorer Sport Trac, a territory of 14 Wal-Marts, and a mission: Make sure Newell's pens, bowls, buckets and blinds are neatly displayed, priced right, and piled high in prominent spots.⁹

Evaluate this statement: "Good customer service doesn't do you much good, but poor customer service can kill you."

⁹ Upbin, p. 100.

store openings but at union halls and Nascar races as well. See the Information Box: Missionary Salespeople.

Galli brought amazing growth to DeWalt, pushing \$60 million in sales in 1992 to more than \$1 billion by 1999, in the process providing 64 percent of the company's \$4.6 billion sales. By age 38, Galli was the second-highest-paid executive at Black & Decker and in line for the top position except that the CEO was not ready to step down anytime soon.

Galli left to be president of Amazon.com, staying only a year, then became chief of VerticalNet for 167 days. Some were calling him a tumbleweed, but conceded that if anybody could add sizzle to an unpretentious product line of such things as mop buckets, toilet brushes, and plastic containers, he might be the best.¹⁰

Galli spent his first three months at Newell Rubbermaid traveling the world and meeting every manager he could. His predecessor, John McDonough, was a diabetic whose leg was amputated in 1999 and who spent almost all his time at company headquarters in Beloit, Wisconsin; in his first six months, Galli spent just 36 hours there.

Newell hadn't run a national ad campaign on television in three years. In 2000, the firm spent 0.7 percent on research and development. (Even conservative Colgate spent 2 percent on the innovation of adding a new color of dish detergent.) Sales of

¹⁰ Bruce Upbin, "Rebirth of a Salesman," *Forbes*, October 1, 2001, pp. 95–104.

the Rubbermaid unit had declined every year since 1998 and were now at \$1.8 billion. No-name rivals were taking business away in major retailers such as Wal-Mart, Home Depot, Target, and Bed Bath & Beyond.

Galli tripled spending on new product development for Rubbermaid. He promoted the brand on prime-time TV for the first time in three years with a budget of \$15 million, more than was spent in the previous 10 years combined. He also budgeted \$40 million for swarm teams of well-paid college grads to push Newell Rubbermaid products at mass retailers, as they had done so successfully with power tools at Black & Decker.¹¹ Galli made his first acquisition in November 2002—buying American Saw and Manufacturing Co., thus expanding into the hand tool and power-tool market that he knew so well.¹² Could it be that Newell Rubbermaid was on the verge of a turnaround?

ANALYSIS

This case illustrates not only the risks of dealing with behemoth customers, but also the rewards if you can satisfy their demands. After all, in better days Newell Rubbermaid prepared to follow Wal-Mart to Europe and be a prime supplier of its stores there. But a vendor has to have the commitment and ability to meet stringent requirements. If a 24-hour delivery cycle is demanded, the vendor must achieve this regardless of costs. If selling prices are to be pared to the bone, efficiency must somehow be jacked up and production costs pruned, or else profitability may have to be sacrificed even to the point of extreme concern. Otherwise, the vendor can be replaced.

The alternative? To be content with far less revenues and a host of smaller accounts, or else to have such a brand name as to be partly insulated from price competition. Rubbermaid thought it had this, due to its public accolades of past years. Perhaps this contributed to its apathy regarding its delivery service. But Wal-Mart hardly was impressed with the superiority of this brand's products, which cost more than alternative suppliers and could not be delivered on time.

But note that improving service and shortening replenishment time are not easily or cheaply done. Rubbermaid spent \$62 million on computer technology to enable it to meet Wal-Mart's demands, but it was not enough. Better control of warehouse inventories and production schedules is essential. The vendor will need to carry more of the inventory burden traditionally assumed by the retailer and incur additional expenses and investment for more manpower and trucks and other equipment. Perhaps the most damning indictment of Rubbermaid's service deficiencies was how long these continued without being corrected. The problem initially surfaced in 1995, but by 1999 on-time deliveries had still not improved appreciably. What was Rubbermaid top management doing all this time? Wolfgang Schmitt can hardly escape the blame that in almost five years he had not corrected this serious problem with the most important customer.

¹¹ Upbin, p. 104.

¹² "Newell Rubbermaid To Buy American Saw in \$450 Million Deal," *Wall Street Journal*, November 25, 2002, p. B6.

The eagerness to merge that we saw in this case, by both McDonough of Newell and Wolfgang Schmitt of Rubbermaid, may not always be in the best interests of shareholders, and certainly not of employees. Communities also suffer, as plants are closed and headquarters moved. It may even not be in the best interest of the executives involved, as Schmitt realized to his dismay, despite taking home a sizable severance package. But is this enough to make up for losing the power and prestige of a top management position, and all the perks that go with it? And what if the value of the stock in the severance package crashes as Schmitt found to his further dismay? And McDonough in his holdings?

In this era of merger mania, a more sober appraisal is needed by many firms. Not all mergers are in the best interests of both parties. Too often a firm pays too much to acquire another firm, as we saw in an extreme example in the previous chapter where Daimler bought Chrysler for \$36 billion and nine years later got rid of it for \$680 million. Frequently the glowing prospects do not work out.

When an acquisition finally turns out to be unwise, especially where too much is paid for the acquired firm, the conclusion may be that someone fumbled the homework, that the research and investigation of the firm to be acquired was hasty, biased, or downright incompetent. Admittedly, in some cases several suitors may be bidding for the same acquisition candidate, and this then becomes a contest: Who will make the winning bid? The only beneficiaries to such a situation—besides the consultants, lawyers, and investment bankers—are the shareholders of the firm to be acquired.

UPDATE

Early in 2003, Galli announced plans to move the headquarters of Newell Rubbermaid from the “cornfields surrounding the hometown of Freeport, Illinois” to Atlanta, “the city of the future,” as Galli depicted it. He thought moving would be a signal that big changes were happening inside and out. He saw that the key to a new image was being in a city that symbolized change and innovation. It didn't hurt that Atlanta offered a sweet deal, potentially giving the company up to \$25 million in tax breaks, as well as \$1.3 million in cash for land and equipment purchases, as well as other tax relief.¹³

Galli's tenure since 2001 had not provided any breakthrough in sales, profits, and stock prices. The company had 2003 sales of about \$7 billion, not much higher than the 2000 sales of \$6.9 billion. For the first quarter of 2004, the net loss was \$74.9 million on sales of \$1.54 billion, and the share price was in the low \$20s. Newell sold three subsidiaries in early 2004, part of its strategy to divest underperforming “non-strategic” businesses. Now Galli announced that it was abandoning its growth-by-acquisition strategy “to reconfigure our portfolio, through divestitures and the exit of low-margin product lines.”¹⁴ Hardly a growth company anymore.

¹³ Peralte C, Paul and Patti Bond, “Out with the Old,” Cox News, as reported in *Cleveland Plain Dealer*, March 8, 2003, pp. C1, C3.

¹⁴ Marcia Pledger, “Newell Rubbermaid Continues Divesting,” *Cleveland Plain Dealer*, May 9, 2004, p. G4.

On October 18, 2005, Newell announced that Joseph Galli resigned by “mutual agreement,” after an inability to turn around the company. This capped his disappointing 4½-year tenure, during which he closed 84 facilities, cut 12,000 jobs, and sold \$1 billion of low-margin businesses. He was one of the hottest young CEOs when he came to Newell but “his enthusiasm and his feeling that he was Superman probably made him overoptimistic about what he could accomplish,” noted Scott Cowen, a Newell director.¹⁵

Invitation to Make Your Own Analysis and Conclusions

What went wrong with the Rubbermaid acquisition? Why couldn't it be corrected?

WHAT WE CAN LEARN

Customer Service Is Vital in Dealing with Big Customers

We saw in this case the consequences of not being able to meet the service demands of Wal-Mart. A vendor's very viability may depend on somehow gearing up to meet the service expectations. This should be a top priority if such a customer is not to be lost. Correcting the situation should be a matter of weeks or months, and not years.

The Well-Known Brand Name Does Not Always Compensate for Higher Prices or Poor Service When Dealing with Big Retailers

Generally we think of a well-respected brand name as giving the vendor certain liberties, of insulating the vendor at least somewhat from vicious price competition, and even excusing the vendor from some service standards such as prompt and dependable delivery. After all, a respected brand name gives an image of quality, which lesser brands do not have, as well as an assured body of loyal customers.

Well, Wal-Mart's dealings with Rubbermaid before the merger certainly disprove that notion.

How can this be? It still becomes a matter of power position. Not having Rubbermaid, or Little Tykes toys, was hardly damaging to Wal-Mart with its eager alternative suppliers. But the loss of Wal-Mart, even only the partial loss of being given less shelf space, was serious for Rubbermaid.

¹⁵ Evan Perez and Joann S. Lublin, “Newell CEO Resigns after Turnaround Bid Falts,” *Wall Street Journal*, October 18, 2005, p. A-11.

The Positive Aspects of Organizational Restructuring for Acquisitions Are Mixed

The idea of restructuring generally means downsizing. Some assets or corporate divisions may be sold off or eliminated, and the remaining organization thereby streamlined. This usually means layoffs, plant closings, and headquarters relocations. In Rubbermaid's case, the small Ohio town of Wooster faced the loss of its headquarters and some 3,000 jobs. Of course, management's defense always is that while jobs are being cut, the operations will be stronger in the long run—perhaps, but not always.

Where an organization has become fat and inefficient with layers of bureaucracy, some pruning of personnel and operations is necessary. But how much is too much, and how much is not enough? Certainly those personnel who are not willing to accept change may have to be let go. Weak persons and operations that show little probability of improvement need to be cut, just as the athlete who can't perform up to expectations can hardly be carried. Still, it is usually better to wait for sufficient information as to the "why" of poor performance before assigning blame for unsatisfactory operational results.

Periodic Housecleaning Produces Competitive Health

In order to minimize the buildup of deadwood, all aspects of an organization periodically ought to be objectively appraised. Weak products and operations should be pruned, unless solid justification exists for keeping them. Such justification might include good growth prospects or complementing other products and operations or even providing a desired customer service. In particular, staff and headquarters personnel and functions should be scrutinized, perhaps every five years, with the objective of weeding out the redundant and superfluous. Most important, these evaluations should be done objectively, with decisive actions taken where needed. While layoffs may result, they sometimes can be avoided by suitable transfers.

Going back to Rubbermaid, the five-year-long tolerance of little improvement in customer service was inexcusable, and one would think that heads should roll (as undoubtedly some did—and quickly—when Newell took over).

Is There Life without Wal-Mart for a Big Mass Market Consumer Goods Manufacturer

Can such a large manufacturer be strong and profitable without selling to the giant retailers? Certainly other distribution channels are available in reaching consumers, such as smaller retailers, different types of retailers, wholesalers, and the Internet. For smaller manufacturers, some of these are viable alternatives to Wal-Mart, Target, Kmart, and the various large department store corporations.

Newell's and Rubbermaid's products were diversified but still geared to rather pedestrian household and hardware consumer use, hardly the grist to create a fashion or fad demand. A limited distribution strategy, such as through

boutiques, would hardly produce sufficient sales volume. Only the mega-retailers could provide the mass distribution and sales volume needed. Of course, Wal-Mart was not the only large retailer, but it was the biggest. Kmart, Target, and the chain department stores were alternatives. But these tended to be just as demanding as Wal-Mart. This suggests that somehow the demands of giant retailers have to be catered to, regardless of costs or inclinations, by firms like Newell and Rubbermaid.

Missionary Salespeople Can Enhance Customer Service in Dealing with Large Retailers

Many vendors are realizing this today, and such sales-support staff are frequently used to provide the service, rapport, and feedback desirable in dealing with these most important clients. The vendor that provides the best such support may well win out over competitors. Furthermore, such missionaries may alert the vendor to emerging problems or competitive situations that need to be countered. Swarm teams like Galli's can be a powerful tool in winning the battle for shelf space. But they do not guarantee success, as Galli found in his 4½-year stint as Newell CEO.

Once the Growth Mode Is Lost, It Is Difficult to Win Back

Newell and its albatross acquisition, Rubbermaid, certainly are examples of this. Both were high flying in the early 1990s, but even Galli, a hot-shot marketer with his previous firm, had not been able to turn Newell Rubbermaid around before he was ousted in 2005.

CONSIDER

Can you add additional learning insights?

QUESTIONS

1. "Periodic evaluations of personnel and departments aimed at pruning 'deadwood' cause far too much harm to the organization. Such 'axing' evaluations should themselves be pruned." Argue this position as persuasively as you can.
2. Now present your most persuasive arguments for axing evaluations.
3. How do you account for Rubbermaid's inability to improve its delivery service to Wal-Mart? What factors do you see as contributing to this on-going deficiency?
4. Do you think Newell acted too hastily in discharging Schmitt and other top executives so soon after the merger? Why or why not?
5. Do you think Wal-Mart and the other large retailers are going too far in their demands on their suppliers? Where would you draw the line?

6. Stanley Gault's strategy of trying to introduce a new product every day was lauded as the mark of a successful firm permeated by innovative thinking. Do you agree?
7. Is it likely that a decades-old organization, such as Rubbermaid, would be bloated with excessive bureaucracy and overhead? Why or why not?
8. Why do you think Galli's swarm teams that were so successful with the power tools of Black & Decker did not apparently improve the operations of Newell Rubbermaid?

HANDS-ON EXERCISES

1. Be a Devil's Advocate (one who argues a contrary position). You have been asked by several concerned board members to argue against the avid "Newellizing" policy of John McDonough at the next board meeting. Marshall as many contrary or cautionary arguments as you can and present them persuasively, yet tactfully.
2. You are one of the three divisional presidents fired by McDonough in the first two months of the merger. Describe your feelings and your action plan at this point. (If you want to make some assumptions, state them specifically.)
3. You are a vice president of Rubbermaid, reporting to Wolfgang Schmitt in 1995. The first serious complaints have surfaced from Wal-Mart concerning unacceptable delivery problems. Schmitt has ordered you to look into the complaints and prepare a course of action. Be as specific as you can on how you would approach this and what recommendations you would make.

TEAM DEBATE EXERCISE

It is early 1998. The demands of Wal-Mart are intensifying, and Newell is making overtures to acquire Rubbermaid. Debate these two courses of action in this turnabout year for Rubbermaid: (1) We must gear up to meet Wal-Mart's demands, even though estimated costs of complying are \$300 million dollars in a new computer network and other capital and operating costs; versus: (2) It is better to sacrifice the increasingly dictatorial Wal-Mart account and seek alternative distribution. (For this option you need to come up with some creative alternatives, and defend them.)

INVITATION TO RESEARCH

What is Wolfgang Schmitt doing after being ousted from an active role with Newell Rubbermaid? Have Newell Rubbermaid's fortunes improved since Galli was ousted? How about the stock price? What is Galli doing now?

Euro Disney: Bungling a Successful Format

With high expectations, Euro Disney opened just outside Paris in April 1992. Success seemed assured. After all, the Disneylands in Florida, California, and more recently, Japan, were all spectacular successes. But somehow all the rosy expectations became a delusion. The opening results cast even the future continuance of Euro Disney into doubt. How could what seemed so right be so wrong? What mistakes were made?

PRELUDE

Optimism

Perhaps a few early omens should have raised some cautions. Between 1987 and 1991, three \$150 million amusement parks had opened in France with great fanfare. All had fallen flat, and by 1991 two were in bankruptcy. Now Walt Disney Company was finalizing its plans to open Europe's first Disneyland early in 1992. This would turn out to be a \$4.4 billion enterprise sprawling over 5,000 acres 20 miles east of Paris. Initially it would have six hotels and 5,200 rooms, more rooms than the entire city of Cannes, and lodging was expected to triple in a few years as Disney opened a second theme park to keep visitors at the resort longer.

Disney also expected to develop a growing office complex, this to be only slightly smaller than France's biggest, La Defense, in Paris. Plans also called for shopping malls, apartments, golf courses, and vacation homes. Euro Disney would tightly control all this ancillary development, designing and building nearly everything itself, and eventually selling off the commercial properties at a huge profit.

Disney executives had no qualms about the huge enterprise, which would cover an area one-fifth the size of Paris itself. They were more worried that the park might not be big enough to handle the crowds:

“My biggest fear is that we will be too successful.”

“I don’t think it can miss. They are masters of marketing. When the place opens it will be perfect. And they know how to make people smile—even the French.”¹

Company executives initially predicted that 11 million Europeans would visit the extravaganza in the first year alone. After all, Europeans accounted for 2.7 million visits to the U.S. Disney parks and spent \$1.6 billion on Disney merchandise. Surely a park in closer proximity would draw many thousands more. As Disney executives thought more about it, the forecast of 11 million seemed most conservative. They reasoned that since Disney parks in the United States (population of 250 million) attracted 41 million visitors a year, and then Euro Disney attracted visitors in the same proportion, attendance could reach 60 million with Western Europe’s 370 million people. Table 15.1 shows the 1990 attendance at the two U.S. Disney parks and the newest Japanese Disneyland, as well as the attendance/population ratios.

Adding fuel to the optimism was the fact that Europeans typically have more vacation time than do U.S. workers. For example, five-week vacations are commonplace for French and Germans, compared with two to three weeks for U.S. workers.

The failure of the three earlier French parks was seen as irrelevant. Robert Fitzpatrick, Euro Disneyland’s chairman, stated, “We are spending 22 billion French francs before we open the door, while the other places spent 700 million. This means we can pay infinitely more attention to details—costumes, hotels, shops, trash

TABLE 15.1 Attendance and Attendance/Population Ratios of Disney Parks, 1990

	Visitors	Population	Ratio
	(millions)		
United States			
Disneyland (Southern California)	12.9	250	5.2%
Disney World/Epcot Center (Florida)	<u>28.5</u>	<u>250</u>	<u>11.4%</u>
Total United States	41.4	500	16.6%
Japan			
Tokyo Disneyland	16.0	124	13.5%
Euro Disney	?	310 ^a	?

^a Within a two-hour flight.

Source: Euro Disney. *Amusement Business Magazine*.

Commentary: Even if the attendance/population ratio for Euro Disney is only 10 percent, which is far below that of some other theme parks, still 31 million visitors could be expected. Euro Disney “conservatively” predicted 11 million the first year.

¹ Steven Greenhouse, “Playing Disney in the Parisian Fields,” *New York Times*, February 17, 1991, Section 3, pp. 1, 6.

baskets—to create a fantastic place. There’s just too great a response to Disney for us to fail.”²

Nonetheless, a few scattered signs could be found that not everyone was happy with the coming of Disney. Leftist demonstrators at Euro Disney’s stock offering greeted company executives with eggs, ketchup, and “Mickey Go Home” signs. Some French intellectuals decried the pollution of the country’s cultural ambiance with the coming of Mickey Mouse and company: They called the park an American cultural abomination. The mainstream press also seemed contrary, describing every Disney setback “with glee.” And French officials in negotiating with Disney sought less American and more European culture at France’s Magic Kingdom. Still, such protests and bad press seemed contrived and unrepresentative, and certainly not predictive. Company officials dismissed the early criticism as “the ravings of an insignificant elite.”³

The Location Decision

In the search for a site for Euro Disney, Disney executives examined 200 locations in Europe. The other finalist was Barcelona, Spain. Its major attraction was warmer weather. But the transportation system was not as good as around Paris, and it also lacked level tracts of land of sufficient size. The clincher for the decision for Paris was its more central location. Table 15.2 shows the number of people within two to six hours of the Paris site.

The beet fields of the Marne-la-Vallee area were the choice. Being near Paris seemed a major advantage, since Paris was Europe’s biggest tourist draw. And France was eager to win the project to help lower its jobless rate and also to enhance its role as the center of tourist activity in Europe. The French government expected the project to create at least 30,000 jobs and to contribute \$1 billion a year from foreign visitors.

TABLE 15.2 Number of People within 2–6 Hours of the Paris Site

Within a 2-hour drive	17 million people
Within a 4-hour drive	41 million people
Within a 6-hour drive	109 million people
Within a 2-hour flight	310 million people

Source: Euro Disney. *Amusement Business* magazine.

Commentary: The much more densely populated and geographically compact European continent makes access to Euro Disney much more convenient than it is in the United States.

² Greenhouse, “Playing Disney,” 6.

³ Peter Gumbel and Richard Turner, “Fans Like Euro Disney but Its Parent’s Goofs Weigh the Park Down,” *Wall Street Journal*, March 10, 1994, p. A12.

To encourage the project, the French government allowed Disney to buy up huge tracts of land at 1971 prices. It provided \$750 million in loans at below-market rates and also spent hundreds of millions of dollars on subway and other capital improvements for the park. For example, Paris's express subway was extended out to the park; a 35-minute ride from downtown cost about \$2.50. A new railroad station for the high-speed Train a Grande Vitesse was built only 150 yards from the entrance gate. This enabled visitors from Brussels to arrive in only ninety minutes. And when the English Channel tunnel opened in 1994, even London was only three hours and ten minutes away. Actually, Euro Disney was the second largest construction project in Europe, second only to construction of the English Channel tunnel.

Financing

Euro Disney cost \$4.4 billion. Table 15.3 shows the sources of financing in percentages. The Disney Company had a 49 percent stake in the project, which was the most that the French government would allow. For this stake, it invested \$160 million, while other investors contributed \$1.2 billion in equity. The rest was financed by loans from the government, banks, and special partnerships formed to buy properties and lease them back.

The payoff for Disney began after the park opened. The company received 10 percent of Euro Disney's admission fees and 5 percent of the food and merchandise revenues. This was the same arrangement as Disney had with the Japanese park. But in the Tokyo Disneyland, the company took no ownership interest, opting instead only for the licensing fees and a percentage of the revenues. The reason for the conservative position with Tokyo Disneyland was that Disney money was heavily committed to building Epcot Center in Florida. Furthermore, Disney had some concerns about the Tokyo enterprise. This was the first non-American Disneyland and also the first cold-weather one. It seemed prudent to minimize the risks. But this turned out to be a significant blunder of conservatism, as Tokyo became a huge success, as the following Information Box discusses in more detail.

TABLE 15.3 Sources of Initial Financing for Euro Disney (percent)

Total to Finance: \$4.4 billion	100%
Shareholders equity, including \$160 million from Walt Disney Co.	32
Loan from French government	22
Loan from group of 45 banks	21
Bank loans to Disney hotels	16
Real estate partnerships	9

Source: Euro Disney.

Commentary: The full flavor of the leverage is shown here, with equity comprising only 32% of the total expenditure.

INFORMATION BOX

THE TOKYO DISNEYLAND SUCCESS

Tokyo Disneyland opened in 1983 on 201 acres in the eastern suburb of Urasasu. It was arranged that an ownership group, Oriental Land, would build, own, and operate the theme park, with advice from Disney. The owners borrowed most of the \$650 million needed to bring the project to fruition. Disney invested no money, but received 10 percent of the revenues from admission and rides and 5 percent of sales of food, drink, and souvenirs.

While the start was slow, Japanese soon began flocking to the park in great numbers. By 1990, some 16 million a year passed through the turnstiles, about one-fourth more than visited Disneyland in California. In fiscal year 1990, revenues reached \$988 million with profits of \$150 million. Indicative of the Japanese preoccupation with things American, the park served almost no Japanese food, and the live entertainers were mostly American. Japanese management even apologized for the presence of a single Japanese restaurant inside the park: “A lot of elderly Japanese came here from outlying parts of Japan, and they were not very familiar with hot dogs and hamburgers.”⁴

Disney executives were soon to realize the great mistake they made in not taking substantial ownership in Tokyo Disneyland. They did not want to make the same mistake with Euro Disney.

Would you expect the acceptance of the genuine American experience in Tokyo to be indicative of the reaction of the French and Europeans? Why or why not?

⁴ James Sterngold, “Cinderella Hits Her Stride in Tokyo,” *New York Times*, February 17, 1991, p. 6.

Special Modifications

With the experiences of the previous theme parks, and particularly that of the first cold-weather park in Tokyo, Disney construction executives were able to bring state-of-the-art refinements to Euro Disney. Exacting demands were placed on French construction companies, and a higher level of performance and compliance resulted than many thought possible to achieve. The result was a major project on time if not completely on budget. In contrast, the Channel tunnel was plagued by delays and severe cost overruns.

One of the things learned from the cold-weather project in Japan was that more needed to be done to protect visitors from such weather problems as wind, rain, and cold. Consequently, Euro Disney’s ticket booths were protected from the elements, as were the lines waiting for attractions, and even the moving sidewalk from the 12,000-car parking area.

Certain French accents—British, German, and Italian accents as well—were added to the American flavor. The park had two official languages, English and

French, but multilingual guides were available for Dutch, Spanish, German, and Italian visitors. Discoveryland, based on the science fiction of France's Jules Verne, was a new attraction. A theater with a full 360-degree screen acquainted visitors with a sweep of European history. And, not the least modification for cultural diversity, Snow White spoke German, and the Belle Notte Pizzeria and Pasticceria were right next to Pinocchio.

Disney foresaw that it might encounter some cultural problems. This was one of the reasons for choosing Robert Fitzpatrick as Euro Disney's president. While American, he spoke French and had a French wife. However, he was not able to establish the rapport needed and was replaced in 1993 by a French native. Still, some of his admonitions that France should not be approached as if it were Florida fell on deaf ears.

RESULTS

As the April 1992 opening approached, the company launched a massive communications blitz aimed at publicizing the fact that the fabled Disney experience was now accessible to all Europeans. Some 2,500 people from various print and broadcast media were lavishly entertained while being introduced to the new facilities. Most media people were positively impressed with the inauguration and with the enthusiastic spirit of the staffers. These public relations efforts, however, were criticized by some for being heavy-handed and for not providing access to Disney executives.

As 1992 wound down after the opening, it became clear that revenue projections were, unbelievably, not being met. But the opening turned out to be in the middle of a severe recession in Europe. European visitors, perhaps as a consequence, were far more frugal than their American counterparts. Many packed their own lunches and shunned the Disney hotels. For example, a visitor named Corine from southern France typified the "no spend" attitude of many: "It's a bottomless pit," she said as she, her husband, and their three children toured Euro Disney on a three-day visit. "Every time we turn around, one of the kids wants to buy something."⁵ Perhaps investor expectations, despite the logic and rationale, were simply unrealistic.

Indeed, Disney had initially priced the park and the hotels to meet revenue targets and assumed demand was there at any price. Park admission was \$42.25 for adults—higher than at the American parks. A room at the flagship Disneyland Hotel at the park's entrance cost about \$340 a night, the equivalent of a top hotel in Paris. It was soon averaging only a 50 percent occupancy. Guests were not staying as long or spending as much on the fairly high-priced food and merchandise. We can label the initial pricing strategy at Euro Disney as skimming pricing. The following Information Box discusses skimming and its opposite, penetration pricing.

Disney executives soon realized they had made a major miscalculation. While visitors to Florida's Disney World often stayed more than four days, Euro Disney—with one theme park compared to Florida's three—was proving to be a two-day

⁵ "Ailing Euro May Face Closure," *Cleveland Plain Dealer*, January 1, 1994, p. E1.

INFORMATION BOX

SKIMMING AND PENETRATION PRICING

A firm with a new product or service may be in a temporary monopolistic situation. If there is little or no present and potential competition, more discretion in pricing is possible. In such a situation (and, of course, Euro Disney was in this situation), one of two basic and opposite approaches may be taken in the pricing strategy: (1) skimming or (2) penetration.

Skimming is a relatively high-price strategy. It is the most tempting where the product or service is highly differentiated, since it yields high per-unit profits. It is compatible with a quality image. But it has limitations. It assumes a rather inelastic demand curve, in which sales will not be appreciably affected by price. And if the product or service is easily imitated (which was hardly the case with Euro Disney), then competitors are encouraged because of the high profit margins.

The penetration strategy of low prices assumes an elastic demand curve, with sales increasing substantially if prices can be lowered. It is compatible with economies of scale, and discourages competitive entry. The classic example of penetration pricing was the Model T Ford. Henry Ford lowered his prices to make the car within the means of the general public, expanded production into the millions, and in so doing realized new horizons of economies of scale.

Euro Disney correctly saw itself in a monopoly position; it correctly judged that it had a relatively inelastic demand curve with customers flocking to the park regardless of rather high prices. What it did not reckon with was the shrewdness of European visitors: Because of the high prices, they shortened their stay, avoided the hotels, brought their own food and drink, and only bought sparingly the Disney merchandise.

What advantages would a lower price penetration strategy have offered Euro Disney? Do you see any drawbacks?

experience at best. Many visitors arrived early in the morning, rushed to the park, staying late at night, then checked out of the hotel the next morning before heading back to the park for one final exploration.

The problems of Euro Disney were not public acceptance (despite the earlier critics). Europeans loved the place. Since the opening, it attracted just under 1 million visitors a month, thus easily achieving the original projections. Such patronage made it Europe's biggest paid tourist attraction. But large numbers of frugal patrons did not come close to enabling Disney to meet revenue and profit projections and cover a bloated overhead.

Other operational errors and miscalculations, most of these cultural, hurt the enterprise. A policy of serving no alcohol in the park caused consternation in a country where wine is customary for lunch and dinner. (This policy was soon reversed.) Disney thought Monday would be a light day and Friday a heavy one, and allocated staff accordingly, but the reverse was true. It found great peaks and valley in attendance: The number of visitors per day in the high season could be

ten times the number in slack times. The need to lay off employees during quiet periods came up against France's inflexible labor schedules.

One unpleasant surprise concerned breakfast. "We were told that Europeans don't take breakfast, so we downsized the restaurants," recalled one executive. "And guess what? Everybody showed up for breakfast. We were trying to serve 2,500 breakfasts at 350-seat restaurants. The lines were horrendous."⁶

Disney failed to anticipate another demand, this time from tour bus drivers. Restrooms were built for 50 drivers, but on peak days 2,000 drivers were seeking the facilities. "From impatient drivers to grumbling bankers, Disney stepped on toe after European toe."⁷

For the fiscal year ending September 30, 1993, the amusement park had lost \$960 million in U.S. dollars, and the future of the park was in doubt. (As of December 31, 1993, the cumulative loss was 6.04 billion francs, or \$1.03 billion.) The Walt Disney corporation made \$175 million available to tide Euro Disney over until the next spring. Adding to the problems of the struggling park were heavy interest costs. As depicted in Table 15.3, against a total cost of \$4.4 billion, only 32 percent of the project was financed by equity investment. Some \$2.9 billion was borrowed primarily from 60 creditor banks, at interest rates running as high as 11 percent. Thus, the enterprise began heavily leveraged, and the hefty interest charges greatly increased the overhead to be covered from operations. Serious negotiations began with the banks to restructure and refinance.

ATTEMPTS TO RECOVER

The \$960 million lost in the first fiscal year represented a shortfall of more than \$2.5 million a day. The situation was not quite as dire as these statistics would seem to indicate. Actually, the park was generating an operating profit. But nonoperating costs were bringing it deeply into the red.

While operations were far from satisfactory, they were becoming better. It had taken 20 months to smooth out the wrinkles and adjust to the miscalculations about hotel demand and the willingness of Europeans to pay substantial prices for lodging, meals, and merchandise. Operational efficiencies were slowly improving.

By the beginning of 1994, Euro Disney had been made more affordable. Prices of some hotel rooms were cut—for example, at the low end, from \$76 per night to \$51. Expensive jewelry was replaced by \$10 T-shirts and \$5 crayon sets. Luxury sit-down restaurants were converted to self-service. Off-season admission prices were reduced from \$38 to \$30. And operating costs were reduced 7 percent by streamlining operations and eliminating over 900 jobs.

Efficiency and economy became the new watchwords. Merchandise in stores was pared from 30,000 items to 17,000, with more of the remaining goods being pure U.S. Disney products. (The company had thought that European tastes might prefer more subtle items than the garish Mickey and Minnie souvenirs, but this was

⁶ Gumbel and Turner, A12.

⁷ *Ibid.*

proven untrue.) The number of different food items offered by park services was reduced more than 50 percent. New training programs were designed to remotivate the 9,000 full-time permanent employees, to make them more responsive to customers and more flexible in their job assignments. Employees in contact with the public were given crash courses in German and Spanish.

Still, as we have seen, the problem had not been attendance, although the recession and the high prices had reduced it. Some 18 million people passed through the turnstiles in the first 20 months of operation. But they were not spending money as people did in the U.S. parks. Furthermore, Disney had alienated some European tour operators with its high prices, and it diligently sought to win them back.

Management had hoped to reduce the heavy interest overhead by selling the hotels to private investors. But the hotels only had an occupancy rate of 55 percent, making them unattractive to investors. While the recession was a factor in such low occupancy rates, most of the problem lay in the calculation of lodging demands. With the park just 35 minutes from the center of Paris, many visitors stayed in town. About the same time as the opening, the real estate market in France collapsed, making the hotels unsalable in the short term. This added to the overhead burden and confounded business plan forecasts.

While some analysts were relegating Euro Disney to the cemetery, few remembered that Orlando's Disney World showed early symptoms of being a disappointment. Costs were heavier than expected, and attendance was below expectations. But Orlando's Disney World turned out to be one of the most profitable resorts in North America.

A FAVORABLE PROGNOSIS

Euro Disney had many things going for it, despite the disastrous early results. In May 1994, a station on the high-speed rail running from southern to northern France opened within walking distance of Euro Disney. This helped fill many of the hotel rooms too ambitiously built. Summer 1994, the 50th anniversary of the Normandy invasion, brought many people to France. Another favorable sign for Euro Disney was the English Channel tunnel's opening in 1994, which potentially could bring a flood of British tourists. Furthermore, the recession in Europe was bound to end, and with it should come renewed interest in travel. As real estate prices became more favorable, hotels could be sold and real estate development around the park spurred.

Even as Disney Chairman Michael Eisner threatened to close the park unless lenders restructured the debt, Disney increased its French presence, opening a Disney store on the Champs Elysees. The likelihood of a Disney pullout seemed remote, despite the posturing of Eisner, since royalty fees could be a sizable source of revenues even if the park only broke even after servicing its debt. With only a 3.5 percent increase in revenues in 1995 and a 5 percent increase in 1996, these could yield \$46 million in royalties for the parent company. "You can't ask, 'What does Euro Disney mean in 1995?' You have to ask, 'What does it mean in 1998?'"⁸

⁸ Lisa Gubernick, "Mickey N'est Pas Fini," *Forbes*, February 14, 1994, p. 43.

SUMMARY OF MAJOR MISTAKES

Euro Disney, as we have seen, fell far short of expectations in the first 20 months of its operation, so much so that its continued existence was even questioned. What went wrong?

External Factors

A serious economic recession that affected all of Europe undoubtedly was a major impediment to meeting expectations. As noted before, it adversely affected attendance—although still not all that much—but drastically affected spending patterns with frugality being the order of the day for many visitors. The recession also affected real estate demand and prices, thus saddling Disney with hotels it had hoped to sell at profitable prices to eager investors, and thereby take the strain off its hefty interest payments.

The company assumed that European visitors would not be greatly different from those visitors, foreign and domestic, of U.S. Disney parks. Yet, at least in the first few years of operation, visitors were much more price conscious. This suggested that those within a two- to four-hour drive of Euro Disney were considerably different from the ones who traveled overseas, at least in spending ability and willingness.

Internal Factors

Despite the decades of experience with the U.S. Disney parks and the successful experience with the newer Japan park, Disney still made serious blunders in its operational planning, such as the demand for breakfasts, the insistence on wine at meals, the severe peaks and valleys in scheduling, and even such mundane things as sufficient restrooms for tour bus drivers. It had problems in motivating and training its French employees in efficiency and customer orientation. Did all these mistakes reflect an intractable French mindset or a deficiency of Disney management? Perhaps both. But should not Disney management have researched all cultural differences more thoroughly? Further, the park needed major streamlining of inventories and operations after the opening. The mistakes suggested an arrogant mindset by Disney management: “We were arrogant,” concedes one executive. “It was like, ‘We’re building the Taj Mahal and people will come—on our terms.’”⁹

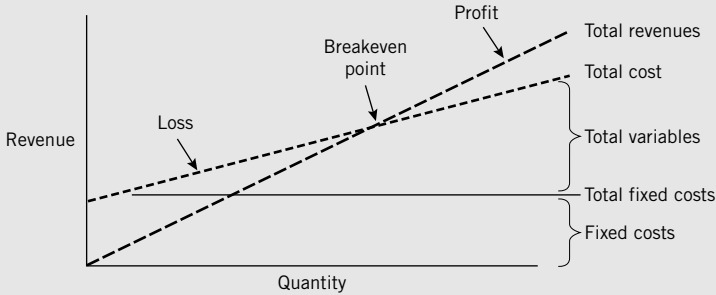
The miscalculations in hotel rooms and in pricing of many products, including food services, showed an insensitivity to the harsh economic conditions. But the greatest mistake was taking on too much debt for the park. The highly leveraged situation burdened Euro Disney with such hefty interest payments and overhead that the breakeven point was impossibly high, and even threatened the viability of the enterprise. See the following Information Box for a discussion of the important inputs and implications affecting breakeven, and how these should play a role in strategic planning.

Were such mistakes and miscalculations beyond what we would expect of reasonable executives? Probably not, with the probable exception of the crushing burden of debt. Any new venture is susceptible to surprises and the need to streamline

⁹ Gumbel and Turner, A12.

INFORMATION BOX**THE BREAKEVEN POINT**

A breakeven analysis is a vital tool in making go/no go decisions about new ventures and alternative business strategies. This can be shown graphically as follows: Below the breakeven point, the venture suffers losses; above it, the venture becomes profitable.



Let us make a hypothetical comparison of Euro Disney with its \$1.6 billion in high interest loans (some of these as high as 11 percent) from the banks, and what the situation might be with more equity and less borrowed funds:

For this example, let us assume that other fixed costs are \$240 million, that the average interest rate on the debt is 10 percent, and that average profit margin (contribution to overhead) from each visitor is \$32. Now let us consider two scenarios: (a) the \$1.6 billion of debt, and (b) only \$0.5 billion of debt.

The number of visitors needed to breakeven are determined as follows:

$$\text{Breakeven} = \frac{\text{Total fixed costs}}{\text{Contribution to overhead}}$$

$$\text{Scenario (a): Interest} = 10\%(\$1,600,000,000) = \$160,000,000$$

$$\begin{aligned} \text{Fixed costs} &= \text{Interest} + \$240,000,000 \\ &= 160,000,000 + 240,000,000 \\ &= \$400,000,000 \end{aligned}$$

$$\text{Breakeven} = \frac{\$400,000,000}{\$32} = 12,500,000 \text{ visitors needed to breakeven}$$

$$\text{Scenario (b): Interest} = 10\% (500,000,000) = \$50,000,000$$

$$\begin{aligned} \text{Fixed costs} &= 50,000,000 + 240,000,000 \\ &= \$290,000,000 \end{aligned}$$

$$\text{Breakeven} = \frac{\$290,000,000}{\$32} = 9,062,500 \text{ visitors needed to breakeven}$$

(continues)

THE BREAKEVEN POINT (*continued*)

Because Euro Disney expected 11,000,000 visitors the first year, it obviously was not going to break even while servicing \$1.6 billion in debt with \$160 million in interest charges per year. The average visitor would have to be induced to spend more, thereby increasing the average profit or contribution to overhead.

In making go/no go decisions, many costs can be estimated quite closely. What cannot be determined as surely are the sales figures. Certain things can be done to affect the breakeven point. Obviously it can be lowered if the overhead is reduced, as we saw in Scenario (b). Higher prices also result in a lower breakeven because of greater per customer profits (but would probably affect total sales quite adversely). Promotion expenses can be either increased or decreased and affect the breakeven point; but they probably also have an impact on sales. Some costs of operation can be reduced, thus lowering the breakeven. But the hefty interest charges act as a lodestone over an enterprise, greatly increasing the overhead and requiring what may be an unattainable breakeven point.

Does a new venture have to break even or make a profit the first year to be worth going into? Why or why not?

and weed out its inefficiencies. While we would have expected such to have been done faster and more effectively from a well-trying Disney operation, European, and particularly French and Parisian, consumers and employees showed different behavioral and attitudinal patterns than expected.

The worst sin that Disney management and investors could make would be to give up on Euro Disney and not to look ahead a few years. A hint of the future promise was Christmas week of 1993. Despite the first year's \$920 million in red ink, some 35,000 packed the park most days. A week later on a cold January day, some of the rides still had 40-minute waits.

POSTSCRIPT

On March 15, 1994 an agreement was struck, aimed at making Euro Disney profitable by September 30, 1995. The European banks would fund another \$500 million and make concessions such as forgiving eighteen months interest and deferring all principal payments for three years. In return, Walt Disney Company agreed to spend about \$750 million to bail out its Euro Disney affiliate. Thus, the debt would be halved, with interest payments greatly reduced. Disney also agreed to eliminate for five years the lucrative management fees and royalties it received on the sale of tickets and merchandise.¹⁰

The problems of Euro Disney were still not resolved by mid-1994. The theme park and resort near Paris remained troubled. However, a new source for financing

¹⁰ Brian Coleman and Thomas R. King, "Euro Disney Rescue Package Wins Approval," *Wall Street Journal*, March 15, 1994, pp. A3, A5.

had emerged. A member of the Saudi Arabian royal family agreed to invest up to \$500 million for a 24 percent stake in Euro Disney. Prince Alwaleed had shown considerable sophistication in investing in troubled enterprises in the past. Now his commitment to Euro Disney showed a belief in the ultimate success of the resort.¹¹

Finally, in the third quarter of 1995, Euro Disney posted its first profit, some \$35 million for the period. This compared with a year earlier loss of \$113 million. By now, Euro Disney was only 39 percent owned by Disney. It attributed the turn-around partly to a new marketing strategy in which prices were slashed both at the gate and within the theme park in an effort to boost attendance, and also to shed the nagging image of being overpriced. A further attraction was the new “Space Mountain” ride that mimicked a trip to the moon.

However, some analysts questioned the staying power of such a movement into the black. In particular, they saw most of the gain coming from financial restructuring in which the debt-ridden Euro Disney struck a deal with its creditors to temporarily suspend debt and royalty payments. A second theme park and further property development were seen as essential in the longer term, as the payments would eventually resume.

To the delight of the French government, plans were announced in 1999 to build a movie theme park, Disney Studios, next to the Magic Kingdom, to open in 2002. It was estimated that this expansion would attract an additional 4.2 million visitors annually, drawing people from farther afield in Europe. In 1998, Disneyland Paris had 12.5 million visitors, being France’s number-one tourist attraction, beating out Notre Dame.

Also late in 1999, Disney and Hong Kong agreed to build a major Disney theme park there, with Disney investing \$314 million for 43 percent ownership while Hong Kong contributed nearly \$3 billion. Hong Kong’s leaders expected the new park would generate 16,000 jobs when it opened in 2005, certainly a motivation for the unequal investment contribution.¹²

The Walt Disney Studios theme park opened in March 2002, as planned. It blended Disney entertainment with the history and culture of European film. Marketing efforts reflected a newfound cultural awareness, and efforts were focused largely on selling the new park through travel agents, whom Disney initially neglected in promoting Disneyland Paris. The timing could have been better, as theme parks were reeling from the recession and the threat of terrorist attacks. A second Disney park opened in Tokyo in 2001 and was a smash hit. But the new California Adventure park in Anaheim, California had been a bust.¹³

¹¹ Richard Turner and Brian Coleman, “Saudi to Buy as Much as 24% of Euro Disney,” *Wall Street Journal*, June 2, 1994, p. A3.

¹² “Hong Kong Betting \$3 billion on Success of New Disneyland,” *Cleveland Plain Dealer*, November 3, 1999, p. 2C; Charles Fleming, “Euro Disney to Build Movie Theme Park Outside Paris,” *Wall Street Journal*, September 30, 1999, pp. A15, A21.

¹³ Bruce Orwall, “Euro Disney CEO Named to Head Parks World-Wide,” *Wall Street Journal*, September 30, 2002, p. B8; Paulo Prada and Bruce Orwall, “A Certain ‘Je Ne Sais Quoi’ at Disney’s New Park,” *Wall Street Journal*, March 12, 2002, pp. B1 and B4.

By the end of 2004, Euro Disney was again facing record losses. Partly this was because of the resumption of full royalty payments and management fees to Walt Disney Co. But deeper problems were besetting it. Attendance had remained flat at about 12.4 million. The new Disney Studios Park opened to expectations of four million visitors, but only 2.2 million came in 2004, and many complained that it did not have enough attractions. Three major new attractions are scheduled to open in 2006 to 2008, with two of these for the Studios Park. For the first three months of 2005, the popular Space Mountain was closing for upgrading. In this scenario, the company planned “regular admission-price increases.” “The business model does not seem viable,” observed one portfolio manager.¹⁴

UPDATE 2005–2008

Something happened in January 2005. The French government realized that they really wanted Euro Disney to succeed. Despite the American-bashing that came after President Bush’s invasion of Iraq and President Jacques Chirac’s calling the spread of American culture an “ecological disaster,” another French preoccupation surfaced: the top priority of reducing France’s high unemployment. Euro Disney’s site was the biggest employer in the Paris region with 43,000 jobs, and it had created a booming urban sprawl on once-barren land.

Now Prime Minister Jean-Pierre Raffarin vowed not to let Euro Disney go bankrupt: “We are grateful to the American people and have lots of respect for their culture.” A state-owned bank contributed around \$500 million in investments and loan concessions. The hope was that new and expensive attractions and a better economic climate would bring a turnaround. Still, if the Tower of Terror ride and other new attractions failed to attract millions of new visitors, Disney and the French government might have to pour more money into this venture that once seemed such a sure thing. Under consideration was to open Charles de Gaulle airport to more low-cost airlines to make Euro Disney a cheaper destination.¹⁵

Disney also had a lot at stake in the success of Euro Disney. Failure would hurt its global brand image as it prepared to expand into China and elsewhere in the Far East. Perhaps the lessons learned in Paris of trying to keep visitors longer while saving on fixed costs would transfer. The following Information Box: Disneyland Hong Kong, suggests that some lessons learned in Europe and the early years in Hong Kong might finally be assimilating. Or are they?

¹⁴ Jo Wrighton, “Euro Disney’s Net Loss Balloons, Putting Financial Rescue at Risk,” *Wall Street Journal*, November 10, 2004, p. B3.

¹⁵ Jo Wrighton and Bruce Orwall, “Despite Losses and Bailouts, France Stays Devoted to Disney,” *Wall Street Journal*, January 26, 2005, pp. A1 and A6.

INFORMATION BOX

DISNEYLAND HONG KONG

When Disneyland Hong Kong opened in 2005, it struggled to connect with consumers. It missed its attendance target of 5.6 million visitors in its first year, and attendance dropped nearly 30 percent in the second year to only four million. The travel industry was quick to criticize that the park was too small and not appealing to mainland Chinese audiences. To better understand the China market, in the summer of 2007 Disney executives surveyed consumers in their homes and found that the park needed to be more Chinese; they also learned that the heritage of Disney stories was not known to most Chinese. Fortuitously, 2008 was the year of the rat, and they hoped to transform this into the “Year of the Mouse” with their rodents, Mickey and Minnie, dressed in special red Chinese outfits. Parades down Main Street featured a dragon dance and puppets of birds, flowers and fish, set to traditional Chinese music. Mickey and Minnie were joined by the god of wealth, and also gods of longevity and happiness.

Even with the research and fine tuning, some missteps still occurred. A Disney ad in 2006 featured a family consisting of two kids and two parents. China’s government, however, limits most couples to just one child. So the commercial had to be reset to show one child, two parents, and two grandparents. During the year of the mouse campaign, Disney hoped that “kids and families are discovering Disney stories together.”¹⁶

Design a marketing strategy for the theme park to better appeal to Chinese consumers.

¹⁶ Geoffrey A. Fowler, “Main Street, H.K.,” *Wall Street Journal*, January 23, 2008, pp. B1 and B2.

Invitation for Your Analysis and Conclusions

How do you account for Disney management erring so badly, both at the beginning and even for years afterwards. Any suggestions?

WHAT WE CAN LEARN

Beware the Arrogant Mindset, Especially When Dealing with New Situations and New Cultures

French sensitivities were offended by Disney corporate executives who often turned out to be brash, insensitive, and overbearing. A contentious attitude by Disney personnel alienated people and aggravated planning and operational

difficulties. “The answer to doubts or suggestions invariably was: Do as we say, because we know best.”¹⁷

Such a mindset is a natural concomitant of success. It is said that success breeds arrogance, but this inclination must be fought against by those who would spurn the ideas and concerns of others. For a proud and touchy people, the French, this almost contemptuous attitude by the Americans fueled resentment and glee at Disney miscues. It did not foster cooperation, understanding, or the willingness to smooth the process. One might almost speculate that had not the potential economic benefits to France been so great, the Euro Disney project might never have been approved.

Great Success May Be Ephemeral

We often find that great successes are not lasting, that they have no staying power. Somehow the success pattern gets lost or forgotten or is not well rounded. Other times an operation grows beyond the capability of the originators. Hungry competitors are always in the wings, ready to take advantage of any lapse. As we saw with Euro Disney, having a closed mind to new ideas or needed revisions of an old success pattern—the arrogance of success—makes expansion into different environments more difficult and even risky.

While corporate Disney has continued to have good success with its other theme parks, competitors are moving in with their own theme parks in the United States and elsewhere. We may question whether this industry is approaching saturation, and we may wonder whether Disney has learned from its mistakes in Europe.

Highly Leveraged Situations Are Extremely Vulnerable

During most of the 1980s, many managers, including corporate raiders, pursued a strategy of debt financing (leveraging) in contrast to equity financing (stock ownership). Funds for such borrowing were usually readily available, heavy debt had income tax advantages, and profits could be distributed among fewer shares so that return on equity was enhanced. During this time a few voices decried the over-leveraged situations of many companies. They predicted that when the eventual economic downturn came, such firms would find themselves unable to meet the heavy interest burden. Most lenders paid little heed to such lonesome voices and encouraged greater borrowing.

The widely publicized problems of some of the raiders in the late 1980s, such as Robert Campeau, who acquired major department store corporations only to find himself overextended and lose everything, suddenly changed some expansionist lending sentiments. The harsh reality dawned that these arrangements were often fragile indeed, especially when they rested on optimistic projections for asset sales, for revenues, and for cost savings to cover the interest payments. An economic slowdown hastened the demise of some of

¹⁷ Gumbel and Turner, p. A1.

these ill-advised speculations. The subprime mortgage bubble of 2007 and 2008 was arguably the supreme example of wild exuberance crashing down to bring the whole economy to within a whisker of recession.

Disney was guilty of speculative excesses with Euro Disney, relying far too much on borrowed funds, and assuming that assets, such as hotels, could be easily sold off at higher prices to other investors. As we saw in the breakeven box, hefty interest charges from such over-leveraged conditions can jeopardize the viability of the enterprise if revenue and profit projections fail to meet the rosy expectations.

Be Judicious with the Skimming Price Strategy

Euro Disney faced the classical situation favorable for a skimming price strategy. It was in a monopoly position, with no equivalent competitors likely. It faced a somewhat inelastic demand curve, which indicated that people would come almost regardless of price. So why not price to maximize per-unit profits? Unfortunately for Disney, the wily Europeans circumvented the high prices by frugality. Of course, a severe recession exacerbated the situation.

The learning insight from this example is that a skimming price assumes that customers are willing and able to pay the higher prices and have no lower-priced competitive alternatives. It is a faulty strategy when many customers are unable, or unwilling, to pay the high prices and can find a way to experience the product or service in a modest way.

CONSIDER

Can you think of other learning insights from this case?

QUESTIONS

1. How could the company have erred so badly in its estimates of spending patterns of European customers?
2. Could a better reading of the impact of cultural differences on revenues have been achieved?
3. What suggestions do you have for fostering a climate of sensitivity and goodwill in corporate dealings with the French?
4. How do you account for the great success of Tokyo Disneyland and the problems of Euro Disney? What are the key contributory differences?
5. Do you believe that Euro Disney might have done better if located elsewhere in Europe rather than just outside Paris? Why or why not?
6. "Mickey Mouse and the Disney Park are an American cultural abomination." Evaluate this critical statement.
7. Consider how a strong marketing approach might be made to both European consumers and middlemen, such as travel agents, tour guides, even bus drivers.

8. Discuss the desirability of raising admission prices at the very time when attendance is static, profits are nonexistent, and new attractions are months and several years in the future.

HANDS-ON EXERCISES

1. As the staff assistant to the president of Euro Disney, you already believe before the grand opening that the plans to use a skimming pricing strategy and to emphasize luxury hotel accommodations is ill advised. What arguments would you marshal to try to persuade the company to offer lower prices and more moderate accommodations? Be as persuasive as you can.
2. It is six months after the opening. Revenues are not meeting target, and a number of problems have surfaced and are being worked on. The major problem remains, however, that the venture needs more visitors and/or higher expenditures per visitor. Develop a business model to improve the situation.
3. How would you rid an organization, such as Euro Disney, of an arrogant mindset? Assume that you are an operational VP, and have substantial resources, but not necessarily the eager support of top management.

TEAM DEBATE EXERCISE

It is two years after the opening and Euro Disney is a monumental mistake, profit-wise. Two schools of thought are emerging for improving the situation. One is to pour more money into the project, build one or two more theme parks, and really make this another Disney World. The other camp believes more investment would be wasted at this time, that the need is to pare expenses to the bone and wait for an eventual upturn. Debate the two positions.

YOUR ASSESSMENT OF THE LATEST DEVELOPMENTS

Can you criticize the present business plan for Euro Disney? Do you think the lesson presumably learned should transfer well to the Far East?

INVITATION TO RESEARCH

What is the situation with Euro Disney today? Are expansion plans going ahead? How is Disneyland Hong Kong doing? Have any more recent parks been opened, and if so, are they encountering any problems?

Maytag: An Incredible Sales Promotion in England; Also, the Allure of Outsourcing

The atmosphere at the annual meeting in the little Iowa town of Newton had turned contentious. As Leonard Hadley faced increasingly angry questions from disgruntled shareholders the thought crossed his mind: “I don’t deserve this!” After all, he had only been CEO of Maytag Corporation for a few months, and this was his first chairing of an annual meeting. But the earnings of the company had been declining every year since 1988, and in 1992, Maytag had had a \$315.4 million loss. No wonder the stockholders in the packed Newton High School auditorium were bitter and critical of their management. But there was more. Just the month before, the company had the public embarrassment and costly atonement resulting from a monumental blunder in the promotional planning of its United Kingdom subsidiary.

Hadley doggedly saw the meeting to its close, and limply concluded: “Hopefully, both sales and earnings will improve this year.”¹

THE FIASCO

In August 1992, Hoover Limited, Maytag’s British subsidiary, launched this travel promotion: Anyone in the United Kingdom buying more than 100 UK pounds worth of Hoover products (about \$150 in American dollars) before the end of January 1993 would get two free round-trip tickets to selected European destinations. For 250 UK pounds worth of Hoover products, they would get two free round-trip tickets to New York or Orlando.

A buying frenzy resulted. Consumers had quickly figured out that the value of the tickets easily exceeded the cost of the appliances necessary to be eligible for them. By the tens of thousands, Britishers rushed out to buy just enough Hoover products to qualify. Appliance stores were emptied of vacuum cleaners. The Hoover

¹ Richard Gibson, “Maytag’s CEO Goes Through Wringer at Annual Meeting,” *Wall Street Journal*, April 28, 1993, A5.

factory in Cambuslang, Scotland that had been making vacuum cleaners only three days a week was suddenly placed on a 24-hour, seven days a week production schedule—an overtime bonanza for the workers. What a resounding success for a promotion! Hoover managers, however, were unhappy.

Hoover had never ever expected more than 50,000 people to respond. And of those responding, it expected far less would go through all the steps necessary to qualify for the free trip and really take it. But more than 200,000 not only responded but also qualified for the free tickets. The company was overwhelmed. The volume of paperwork created such a bottleneck that by the middle of April only 6,000 people had flown. Thousands of others either never got their tickets, were not able to get the dates requested, or waited for months without hearing the results of their applications. Hoover established a special hot line to process customer complaints, and these were coming in at 2,000 calls a day. But the complaints quickly spread, and the ensuing publicity brought charges of fraud and demands for restitution. This raises the issue of loss leaders—how much should we use loss leaders as a promotional device?—discussed in the following Issue Box.

Maytag dispatched a task force to try to resolve the situation without jeopardizing customer relations any further. But it acknowledged that it's “not 100% clear” that all eligible buyers will receive their free flights.² The ill-fated promotion was a

ISSUE BOX

SHOULD WE USE LOSS LEADERS?

Leader pricing is a type of promotion with certain items advertised at a very low price—sometimes even below cost, in which case they are known as loss leaders—in order to attract more customers. The rationale for this is that such customers are likely to purchase other regular price items as well with the result that total sales and profits will be increased. If customers do not purchase enough other goods at regular prices to more than cover the losses incurred from the attractively priced bargains, then the loss leader promotion is ill advised. Some critics maintain that the whole idea of using loss leaders is absurd: The firm is just “buying sales” with no regard for profits.

While UK Hoover did not think of their promotion as a loss leader, in reality it was: They stood to lose money on every sale if the promotional offer was taken advantage of. Unfortunately for its effectiveness as a loss leader, the likelihood of customers purchasing other Hoover products at regular prices was remote, and the level of acceptance was not capped, so that losses were permitted to multiply. The conclusion has to be that this was an ill-conceived idea from the beginning. It violated these two conditions of loss leaders: They should stimulate sales of other products, and their losses should be limited.

Do you think loss leaders really are desirable under certain circumstances? Why or why not?

² James P. Miller, “Maytag U.K. Unit Find a Promotion Is Too Successful,” *Wall Street Journal*, March 31, 1993, p. A9.

staggering blow to Maytag financially. It took a \$30 million charge in the first quarter of 1993 to cover unexpected additional costs linked to the promotion. Final costs were expected to exceed \$50 million, which would be 10 percent of UK Hoover's total revenues. This for a subsidiary acquired only four years before that had yet to produce a profit.

Adding to the costs were problems with the two travel agencies involved. The agencies were to obtain low-cost space available tickets and would earn commissions selling "packages," including hotels, rental cars, and insurance. If consumers bought a package, Hoover would get a cut. However, despite the overwhelming demand for tickets, most consumers declined to purchase the package, thus greatly reducing support money for the promotional venture. So, Hoover greatly underestimated the likely response and overestimated the amount it would earn from commission payments.

If these cost overruns added greatly to Maytag and Hoover's customer relations and public image, the expenditures would have seemed more palatable. But with all the problems, the best that could be expected would be to lessen the worst of the agitation and charges of deception. And this was proving to be impossible. The media, of course, salivated at the problems and were quick to sensationalize them:

One disgruntled customer, who took aggressive action on his own, received the widest press coverage, and even became a folk hero. Dave Dixon, claiming he was cheated out of a free vacation by Hoover, seized one of the company's repair vans in retaliation. Police were sympathetic: they took him home, and did not charge him, claiming it was a civil matter.³

Heads rolled also. Initially, Maytag fired three UK Hoover executives involved, including the president of Hoover Europe. Mr. Hadley, at the annual meeting, also indicated that others might lose their jobs before the cleanup was complete. He likened the promotion to "a bad accident . . . and you can't determine what was in the driver's mind."⁴

The issue, receiving somewhat less publicity, was why corporate headquarters allowed executives of a subsidiary such wide latitude that they could saddle parent Maytag with tens of millions in unexpected costs. Did top corporate executives not have to approve ambitious plans? A company spokesman said that operating divisions were "primarily responsible" for planning promotional expenses. While the parent may review such outlays, "if they're within parameters, it goes through."⁵ This raises the issue, discussed in the following Issue Box, of how loose a rein foreign subsidiaries should be allowed.

³ "Unhappy Brit Holds Hoover Van Hostage," *Cleveland Plain Dealer*, June 1, 1993, D1; and Simon Reeve and John Harlow, "Hoover Is Sued over Flights Deal," *London Sunday Times*, June 6, 1993.

⁴ Gibson, "CEO Goes Through Wringer," A5.

⁵ Miller, "Maytag UK Unit," A9.

ISSUE BOX

HOW LOOSE A REIN FOR A FOREIGN SUBSIDIARY?

In a decentralized organization, top management delegates considerable decision-making authority to subordinates. Such decentralization—often called a “loose rein”—tends to be more prevalent with foreign subsidiaries, such as UK Hoover. Corporate management in the United States understandably feels less familiar with the foreign environment and more willing to let the native executives operate with less constraints than it might with a domestic subsidiary. In the Maytag/Hoover situation, decision-making authority by British executives was evidently extensive, and corporate Maytag exercised little operational control, being content to judge performance by ultimate results achieved. Major deviations from expected performance goals, or widespread traumatic happenings—all of which happened to UK Hoover—finally gained corporate management attention.

Major advantages of extensive decentralization or a loose rein are: (1) top management effectiveness can be improved since time and attention is freed for presumably more important matters; (2) subordinates are permitted more self-management, which should improve their competence and motivation; and (3) in foreign environments, native managers presumably better understand their unique problems and opportunities than corporate management, located thousands of miles away, possibly can. But the drawbacks are as we have seen: Parameters within which subordinate managers operate can be so wide that serious miscalculations may not be stopped in time. Since top management is ultimately responsible for all performance, including actions of subordinates, it faces greater risks with extensive decentralization and giving a free rein.

“Since the manager is ultimately accountable for whatever is delegated to subordinates, then a free rein reflects great confidence in subordinates.” Discuss.

BACKGROUND ON MAYTAG

Maytag was a century-old company. The original business, formed in 1893, manufactured feeder attachments for threshing machines. In 1907, the company moved to Newton, Iowa, a small town 30 miles east of Des Moines, the capital. Manufacturing emphasis turned to home laundry equipment, and wringer-type washers.

A natural expansion of this emphasis occurred with the commercial laundromat business in the 1930s, when coin meters were attached to Maytag washers. Rapid growth of these coin-operated laundries took place in the United States during the late 1950s and early 1960s. The 1970s hurt laundromats with increased competition and soaring energy costs. In 1975 Maytag introduced new energy-efficient machines and “Home Style” stores that rejuvenated the business.

TABLE 16.1 Maytag Operating Results, 1974–1981 (in millions)

	Net Sales	Net Income	Percent of Sales
1974	\$229	\$21.1	9.2%
1975	238	25.9	10.9
1976	275	33.1	12.0
1977	299	34.5	11.5
1978	325	36.7	11.3
1979	369	45.3	12.3
1980	346	35.6	10.2
1981	409	37.4	9.1
Average net income percent of sales: 10.8%			

Source: Company operating statistics.

Commentary: These years show a steady, though not spectacular growth in revenues, and a generally rising net income, except for 1980. Of particular interest is the high net income percentage of sales, with this averaging 10.8 percent over the 8-year period, with a high of 12.3 percent.

The Lonely Maytag Repairman

For years Maytag reveled in a coup, with its washers and dryers enjoying a top-quality image, thanks to decades-long ads in which a repairman laments his loneliness because of Maytag's trouble-free products. (The actor who portrayed this repairman died in early 1997.) The result of this dependability and quality image was that Maytag could command a price premium: "Their machines cost the same to make, break down as much as ours—but they get \$100 more because of the reputation," grumbled a competitor.⁶

During the 1970s and into the 1980s, Maytag continued to capture 15 percent of the washing machine market and enjoyed profit margins about twice that of competitors. Table 16.1 shows operating results for the period 1974–1981. Whirlpool was the largest factor in the laundry equipment market, with a 45 percent share, but this was largely because of sales to Sears under the Sears brand.

Acquisitions

For many years, until his retirement December 31, 1992, Daniel J. Krumm had influenced Maytag's destinies. He had been CEO for 18 years and chairman since 1986, and his tenure with the company encompassed 40 years. In that time, the home-appliance business encountered some drastic changes. The most ominous occurred in the late 1980s with the merger mania, in which the threat of takeovers by hostile raiders often motivated heretofore conservative executives to greatly increase corporate indebtedness, thereby decreasing the attractiveness of their

⁶ Brian Bremmer, "Can Maytag Clean Up Around the World?" *Business Week*, January 30, 1989, p. 89.

TABLE 16.2 Maytag Operating Results, 1989–1992

	Revenue (000,000)	Net Income	% of Revenue
1989	\$3,089	131.0	4.3%
1990	3,057	98.9	3.2
1991	2,971	79.0	2.7
1992	3,041	(315.4)	(10.4)

Source: Company annual reports.

Commentary: Note the steady erosion of profitability, while sales remained virtually static. For a comparison with profit performance of earlier years, see Table 16.1 and the net income to sales percentages of this more “golden” period.

firms. Daniel Krumm was one of these running-scared executives, as rumors persisted that the company was a takeover candidate.

Largely as a defensive move, Krumm pushed through a deal for a \$1 billion buyout of Chicago Pacific Corporation (CPC), a maker of vacuum cleaners and other appliances with \$1.4 billion in sales. As a result, Maytag was burdened with \$500 million in new debt. Krumm defended the acquisition as giving Maytag a strong foothold in a growing overseas market. CPC was best known for the Hoover vacuums it sold in the United States and Europe. Indeed, so dominant was the Hoover brand in England that many people did not vacuum their carpets, but “hoovered the carpet.” CPC also made washers, dryers, and other appliances under the Hoover brand, selling them exclusively in Europe and Australia. In addition, it had six furniture companies, but Maytag sold these shortly after the acquisition.

Krumm had been instrumental in transforming Maytag, the number-four U.S. appliance manufacturer—behind General Electric, Whirlpool, and Electrolux—from a niche laundry-equipment maker into a full-line manufacturer. He had led an earlier acquisition spree in which Maytag had expanded into microwave ovens, electric ranges, refrigerators, and freezers. Its brands now included Magic Chef, Jenn-Air, Norge, and Admiral. The last years of Krumm’s reign, however, were not marked by great operating results. As shown in Table 16.2, revenues showed no gain in the 1989–1992 period, while income steadily declined.

Trouble

Although the rationale for internationalizing seemed inescapable, especially in view of a recent wave of joint ventures between U.S. and European appliance makers, still the Hoover acquisition was troublesome. While it was a major brand in England and in Australia, Hoover, had only a small presence in Europe. Yet this was where the bulk of the market was, with some 320 million potential appliance buyers.

The probabilities of the Hoover subsidiary being able to capture much of the European market were hardly promising. Whirlpool was strong, having ten plants there in contrast to Hoover’s two plants. Furthermore, Maytag faced entrenched European competitors such as Sweden’s Electrolux, the world’s largest appliance maker; Germany’s Bosch-Siemens; and Italy’s Merloni Group. General Electric had

TABLE 16.3 Operating Results of Maytag's Principal Business Components 1990–1992

	Revenue (000,000)	Income*(000)
1990		
North American Appliances	\$2,212	\$221,165
Vending	191	25,018
European Sales	497	(22,863)
1991		
North American Appliances	2,183	186,322
Vending	150	4,498
European Sales	486	(865)
1992		
North American Appliances	2,242	129,680
Vending	165	16,311
European Sales	502	(67,061)

*This is operating income, that is, income before depreciation and other adjustments.

Source: Company annual reports.

Commentary: While these years had not been particularly good for Maytag in growth of revenues and income, the continuing, and even intensifying, losses in the Hoover European operation had to be troublesome. And this was before the ill-fated early 1993 promotional results.

also entered the market with joint ventures. The fierce loyalty of European to domestic brands raised further questions as to the ability of Maytag's Hoover to penetrate the European market without massive promotional efforts, and maybe not even then.

Australia was something else. Hoover had a good competitive position there, and its refrigerator plant in Melbourne could easily be expanded to include Maytag's washers and dryers. Unfortunately, the small population of Australia limited the market to only about \$250 million for major appliances.

Britain accounted for half of Hoover's European sales. But at the time of the acquisition its major appliance business was only marginally profitable. This was to change: after the acquisition it became downright unprofitable, as shown in Table 16.3 for the years 1990 through 1992, as it struggled to expand in a recession-plagued Europe. The results for 1993, of course, reflected the huge loss from the promotional debacle. Hardly an acquisition made in heaven.

Maytag's earlier acquisitions also were becoming soured. Its acquisitions of Magic Chef and Admiral were diversifications into lower-priced appliances, and these did not meet expectations. But they left Maytag's balance sheet and its cash flow weakened (see Table 16.4). Perhaps more serious, Maytag's reputation as the nation's premier appliance maker became tarnished. Meanwhile, General Electric and Whirlpool were attacking the top end of its product line. As a result, Maytag found itself in the No. 3 or 4 position in most of its brand lines.

TABLE 16.4 Long-Term Debt As a Percent of Capital from Maytag's Balance Sheets, 1986–1991

Year	Long-Term Debt/Capital
1986	7.2%
1987	23.3
1988	48.3
1989	46.8
1990	44.1
1991	42.7

Source: Company annual reports.

Commentary: The effect of acquisitions, in particular that of the Chicago Pacific Corporation, can be clearly seen in the buildup of long-term debt. In 1986, Maytag was virtually free of such commitments; two years later its long-term debt ratio had increased almost seven fold.

ANALYSIS

Flawed Acquisition Decisions

The long decline in profits after 1989 should have triggered strong concern and corrective action. Perhaps it did, but the action was ineffectual as the decline continued, culminating in a large deficit in 1992 and serious problems in 1993. As shown in Table 16.2, the acquisitions brought neither revenue gains nor profitability. One suspects that in the rush to fend off potential raiders in the late 1980s, the company bought businesses it might never have under more sober times, and that it paid too much for these businesses. Further, they cheapened the proud image of quality for Maytag.

Who Can We Blame in the UK Promotional Debacle?

Corporate Maytag management was guilty of a common fault in their acquisitions: they gave newly acquired divisions a loose rein, letting them continue to operate independently with few constraints: “After all, these executives should be more knowledgeable about their operations than corporate headquarters would be.” Such confidence is sometimes misguided. In the UK promotion, Maytag management would seem as derelict as management in England. Planning guidelines or parameters were far too loose and undercontrolled. The idea of subsidiary management being able to burden the parent with \$50 million of unexpected charges, and to have such erupt with no warning, borders on the absurd.

Finally, the planning of the UK executives for this ill-conceived travel promotion defies all logic. They vastly underestimated the demand for the promotional offer and they greatly overestimated paybacks from travel agencies on the package deals. Yet it took no brilliant insight to realize that the value of the travel offer exceeded the price of the appliance—indeed, 200,000 customers rapidly arrived at

this conclusion—and that such a sweetheart of a deal would be irresistible to many, and that it could prove to be costly in the extreme to the company. A miscalculation, or complete naivete on the part of executives and their staffs who should have known better?

How Could the Promotion Have Avoided the Problems?

The great problem resulting from an offer too good could have been avoided, and this without scrapping the whole idea. A cost-benefit analysis would have provided at least a perspective as to how much the company should spend to achieve certain benefits, such as increased sales, greater consumer interest, and favorable publicity. See the following Information Box for a more detailed discussion of the important planning tool of a cost-benefit analysis.

A cost-benefit analysis should certainly have alerted management to the possible consequences of various acceptance levels, and of the significant risks of high acceptance. The company could have set limits on the number of eligibles: perhaps the first 1,000, or the first 5,000. Doing this would have held or capped the costs to reasonably defined levels, and avoided the greater risks. Or the company could have made the offer less generous, perhaps by upping the requirements, or by lessening the premiums. These more moderate alternatives would still have made an attractive promotion, but not the major uncontrolled catastrophe that happened.

Final Resolution of the Promotion Mess?

Maytag's invasion of Europe proved a costly failure. In summer 1995, Maytag gave up. It sold its European operations to an Italian appliance maker, recording a \$135 million loss.

Even by the end of 1996, the Hoover mess was still not cleaned up. Hoover had spent \$72 million flying some 220,000 people and had hoped to end the matter. But the fight continued four years later, with disgruntled customers who never flew taking Hoover to court. Even though Maytag had sold this troubled division, it still could not escape the emerging lawsuits.⁷

LATER DEVELOPMENTS

Leonard Hadley

In summer 1998, Leonard Hadley could look forward and backward with some satisfaction. He would retire the next summer when he turned 65, and he had already picked his successor. Since assuming the top position in Maytag in January 1993 and confronting the mess with the UK subsidiary his first few months on the job, he had turned Maytag completely around.

⁷ "Hoover Can't Clean Up Mess from Free Flights," *Cleveland Plain Dealer*, December 12, 1996, p. 1-C; and Dirk Beveridge, "Hoover Loses Two Lawsuits Tied to Promotion," *Gannett Newspapers*, February 21, 1997, p. 4-F.

INFORMATION BOX**COST-BENEFIT ANALYSIS**

A cost-benefit analysis is a systematic comparison of the costs and benefits of a proposed action. Only if the benefits exceed the costs would we normally have a “go” decision. The usual way to make such an analysis is to assign dollar values to all costs and benefits, thus providing a common basis for comparison.

Cost-benefit analyses have been widely used by the Defense Department in evaluating alternative weapons systems. In recent years, such analyses have been sporadically applied to environmental regulation and even to workplace safety standards. As an example of the former, a cost-benefit analysis can be used to determine if it is socially worth spending X million dollars to meet a certain standard of clean air or water.

Many business decisions lend themselves to a cost-benefit analysis. It provides a systematic way of analyzing the inputs and the probable outputs of major alternatives. In the business setting some of the costs and benefits can be very quantitative; they often should be tempered by non-quantitative inputs to reach the broadest perspective. Schermerhorn suggests considering the following criteria in evaluating alternatives:⁸

Benefits: What are the “benefits” of using the alternatives to solve a performance deficiency or take advantage of an opportunity?

Costs: What are the costs of implementing the alternatives, including direct resource investments as well as any potentially negative side effects?

Timeliness: How fast will the benefits occur and a positive impact be achieved?

Acceptability: To what extent will the alternatives be accepted and supported by those who must work with them?

Ethical soundness: How well do the alternatives meet acceptable ethical criteria in the eyes of multiple stakeholders?

What numbers would you assign to a cost-benefit analysis for Maytag Hoover’s plan to offer the free airline tickets, under an assumption of 5,000 takers? 20,000 takers, 100,000 takers? 500,000 takers? (Hint: We know that 200,000 people qualified for the free tickets, and that the final costs were expected to reach \$50 million. If we assume that costs would have a straight-line relationship with number of takers, then costs for 5,000 takers would be 2-1/2 percent of \$50 million, 20,000 takers would be 10 percent, and so on. Now you need to estimate the value of the benefits for the various levels of takers.)

What would be your conclusions for these various acceptance rates?

⁸ John R. Schermerhorn, Jr., *Management*, 6th ed. (New York: Wiley, 1999), p. 61.

He knew no one expected much change from him, an accountant who had joined Maytag right out of college. He was known as a loyal but unimaginative lieutenant of his boss, Daniel Krumm, who died of cancer shortly after naming Hadley his successor. After all, he reflected, no one thought that major change could come to an organization from someone who had spent his whole life there,

who was a clone, so to speak, and an accountant to boot. Everyone thought that change makers had to come from outside. Well, he had shown them and given hope to all number-two executives who resented Wall Street's love affair with outsiders.

Within a few weeks of taking over, he'd fired a bunch of managers, especially those rascals in the UK who'd masterminded the great Hoover debacle. He determined to get rid of foreign operations, most of them newly acquired and unprofitable. He just did not see that appliances could be profitably made for every corner of the world, because of the variety of regional customs. Still, he knew that many disagreed with him about this, including some of the board members who thought globalization was the only way to go. Still, over the next 18 months he had prevailed.

He chuckled to himself as he reminisced. He had also overturned the decades-long corporate mindset not to be first to market with new technology because they would "rather be right than be first." His "Galaxy Initiative" of nine top-secret new products was a repudiation of this old mindset. One of them, the Neptune, a front-loading washer retailing at \$1,100, certainly proved him right. Maytag had increased its production three times and raised its suggested retail price twice, and still it was selling like gangbusters. Perhaps the thing he was proudest of was getting Maytag products into Sears stores, the seller of one-third of all appliances in the United States. Sears's desire to have the Neptune was what swung the deal.

As an accountant, he probably should be focusing first on the numbers. Well, 1997 was certainly a banner year, with sales up 10.9 percent over the previous year, while profitability as measured by return on capital was 16.7 percent, both sales and profit gains leading the industry. And 1998 so far was proving to be even better, with sales jumping 31 percent and earnings 88 percent.

He remembered the remarks of Lester Crown, a Maytag director: "Len Hadley has—quietly, softly—done a spectacular job. Obviously, we just lacked the ability to evaluate him [in the beginning]."⁹

Leonard Hadley retired August 12, 1999. He knew he had surprised everyone in the organization by going outside Maytag for his successor. He chose Lloyd Ward, 50, Maytag's first black executive, a marketing expert from PepsiCo, and before that Procter & Gamble, who had joined Maytag in 1996 and was currently president and chief operating officer.

However, with extreme regret Hadley found that his choice of successor was flawed, or maybe Ward was just a victim of circumstances mostly beyond his control. After 15 months, Ward left, citing differences with Maytag's directors amid sorry operating results. Hadley came out of retirement to be interim president and CEO. Some 3,400 Maytag workers, a quarter of Newton's population, roared when they heard the news. They had feared the company would be moved

⁹ Carl Quintanilla, "Maytag's Top Officer, Expected to Do Little, Surprises His Board," *Wall Street Journal*, June 23, 1998, pp. A1, A8.

to either Chicago or Dallas, or that it would be sold to Sweden's Electrolux. Hadley assured them that such things would never happen as long as he was at the helm.¹⁰ Hadley retired again in June 2001 when Ralph F. Hake became his successor.

Hake came to Maytag from Fluor Corporation, an engineering and construction firm, where he had been executive vice president. Before that, he spent 12 years in various executive positions with Maytag's chief rival, appliance manufacturer Whirlpool.

Hake kept the headquarters in Newton, Iowa, but moved three plants to Reynosa, Mexico, intensifying fears that Maytag might export even more jobs to countries with cheap labor. He tried to allay such concerns: "I do not anticipate multiple plant shutdowns or restructuring here." However, some analysts cautioned that consumers were becoming increasingly cost conscious—and less concerned with whether a product was made in the United States or abroad.

Hake also sought to move the company's product line beyond the traditional to more unusual products. He created a Strategic Initiatives Group with 10 to 12 members to introduce a premium-priced line of mixers, blenders, toasters, and coffee makers under the brand name Jenn-Air Attrezzi. The hope was that such a focus on creative thinking would move the company out of its slump.¹¹

The Allure (and Necessity?) of Outsourcing

Even though Hake had moved some manufacturing jobs to cheaper labor overseas, still Maytag was slow to do this compared to its competitors, and by 2005, it was hurting with its stock plummeting, and its dividend slashed in half. While 12 percent of its products were made abroad, larger competitors such as Whirlpool and General Electric had huge cost advantages with more than half their production overseas. In recent years, Maytag also had to compete against nimble Asian newcomers, including South Korean LG Electronics, which had brought innovative appliances to the United States a few years earlier.

In 2005, with its sickly stock price, Maytag now became an attractive buyout. Ripplewood Holdings, an investment group, bid \$14 a share for the company. This offer was bested by Whirlpool, which offered \$21 a share in cash and stock to Maytag shareholders, and the deal was sealed. American jobs, and Newton, Iowa jobs in particular, were in jeopardy.¹²

¹⁰ "Maytag Chief Quits As Profits Plummet," *Cleveland Plain Dealer*, November 10, 2000, p. 3-C; and Emily Gersema, "Maytag Rehires Former CEO after Time of Internal Turmoil," *Wall Street Journal*, January 15, 2001, p. 3-H.

¹¹ David Pitt, Associated Press, as reported in "Maytag's Moves to Mexico Under Fire," *Cleveland Plain Dealer*, August 6, 2003, p. C2; and Fara Warner, *New York Times*, as reported in "Maytag Cookin' with New Twist on Tools for the Kitchen," *Cleveland Plain Dealer*, September 14, 2003, pp. G1, and G6.

¹² Dennis K. Berman and Michael McCarthy, "Maytag to Be Sold to Investor Group for \$1.13 Billion," *Wall Street Journal*, May 20, 2005, pp. A3, A10; Joseph T. Hallinan, "Whirlpool Seals Maytag Deal; Antitrust Review Is Next Battle," *Wall Street Journal*, August 23, 2005, p. B10.

The End

On Thursday, October 25, 2007, the assembly lines in Newton, Iowa stopped and workers left the 2 million-square-foot factory for the last time. With the concomitant closing of the corporate headquarters, some 1,800 local workers now had to find other jobs. At its peak, Maytag had 4,000 workers in Newton, a town of 16,000 people 30 miles east of Des Moines. For most workers, it was a sad parting with a company that had provided for their families over generations. UAW Local 997 President Ted Johnson said this is part of a “widespread epidemic” of corporations cutting union jobs for lower-paying jobs that threaten the middle-class way of life. “It’s just wrong,” he said.¹³

Invitation for Your Own Analysis and Conclusions

Could American jobs have been better saved in this competitive appliance industry?

WHAT WE CAN LEARN

Beware Overpaying for an Acquisition

Hoping to diversify its product line and gain overseas business, Maytag paid \$1 billion for Chicago Pacific in 1989. As it turned out, this was far too much, and the debt burden was an albatross. Hadley conceded as much: “In the long view, it was correct to invest in these businesses. But the timing of the deal, and the price of the deal, made the debt a heavy burden to carry.”¹⁴

Zeal to expand, and/or the desire to reduce the attractiveness of a firm’s balance sheet with heavy debt and thus fend off potential raiders, do not excuse foolhardy management. The consequences of such bad decisions remain to haunt a company, and the ill-advised purchases often have to be eventually sold off at substantial losses. The analysis of potential acquisition candidates must be soberly and thoroughly done, and rosy projections questioned, even if this means the deal may be soured.

In Decision Planning, Consider a Worst-Case Scenario

There are those who preach the desirability of positive thinking, confidence, and optimism—whether it be in personal lives, athletics, or business practices. But expecting

¹³ David Pitt, Associated Press, as published in *Cleveland Plain Dealer*, October 26, 2007, p. C2.

¹⁴ Kenneth Labich, “Why Companies Fail,” *Fortune*, November 14, 1994, p. 60.

and preparing for the worst has much to commend it, since a person or a firm is then better able to cope with adversity, avoid being overwhelmed, and more likely to make prudent rather than rash decisions.

Apparently the avid acceptance of the promotional offer was a complete surprise; no one dreamed of such demand. Yet, was it so unreasonable to think that a very attractive offer would meet wild acceptance?

In Using Loss Leaders, Put a Cap on Potential Losses

Loss leaders, as we noted earlier, are items promoted at such attractive prices that the firm loses money on every sale. The expectation, of course, is that the customer traffic generated by such attractive promotions will increase sales of regular profit items so that total profits will be increased.

The risks of uncontrolled or uncapped loss leader promotions are vividly shown in this case. For a retailer who uses loss leaders, the loss is ultimately capped as the inventory is sold off. With UK Hoover there was no cap. The solution is clear: Attractive loss leader promotions must be capped, such as the first 100 or the first 1,000 or for one week only. Otherwise, the promotion should be made less attractive.

Beware Giving too Loose a Rein, thus Sacrificing Controls, Especially of Unproven Foreign Subsidiaries

Although decentralizing authority down to lower ranks is often desirable and results in better motivation and management development than centralization, it can be overdone. At the extreme, where divisional and subsidiary executives have almost unlimited decision-making authority and can run their operations as virtual dynasties, then corporate management essentially abdicates its authority. Such looseness in an organization endangers cohesiveness; it tends to obscure common standards and objectives; and it can even dilute unified ethical practices.

Such extreme looseness of controls is not uncommon with acquisitions, especially foreign ones. It is easy to make the assumption that these executives were operating successfully before the acquisition and have more firsthand knowledge of the environment than the corporate executives.

Still, there should be limits on how much freedom these executives should be permitted—especially when their operations have not been notably successful. In Maytag's case, the U.K. subsidiary had lost money every year since it was acquired. Accordingly, one would expect prudent corporate management to have condoned less decentralization and insisted on tighter controls than it might have otherwise.

The Power of a Cost-Benefit Analysis

For major decisions, executives have much to gain from a cost-benefit analysis. It forces them to systematically tabulate and analyze the costs and benefits of particular courses of action. They may find that likely benefits are so uncertain as to not be worth the risk. If so, now is the time to realize this, rather than after substantial commitments have already been made.

Without doubt, regular use of cost-benefit analyses for major decisions improves executives' batting averages for good decisions. Even though some numbers may have to be judgmental, especially as to probable benefits, the process of making this analysis forces a careful look at alternatives and most likely consequences. For more important decisions, input from diverse staff people and executives will bring greater power to the analysis.

CONSIDER

What additional learning insights can you add?

QUESTIONS

1. How could the promotion of UK Hoover have been better designed? Be as specific as you can.
2. Given the fiasco that did occur, how do you think Maytag should have responded?
3. "Firing the three top executives of UK Hoover is unconscionable. It smacks of a vendetta against European managers by an American parent. After all, their only 'crime' was a promotion that was too successful." Comment on this statement.
4. Do you think Leonard Hadley, the Maytag CEO for only two months, should be soundly criticized for the UK situation? Why or why not?
5. Please speculate: Why do you think this UK Hoover fiasco happened in the first place? What went wrong?
6. Evaluate the decision to acquire Chicago Pacific Corporation (CPC). Do this both for the time of the decision, and for now—after the fact—as a post mortem. Defend your overall conclusions.
7. Use your creativity: Can you devise a strategy for UK Hoover to become more of a major force in Europe?
8. Evaluate the reflections of Hadley in the summer of 1998. Do you agree with all of his convictions and actions? Why or why not?

HANDS-ON EXERCISES

1. You have been placed in charge of a task force sent by headquarters to England to coordinate the fire-fighting efforts in the aftermath of the ill-fated promotion. There is neither enough productive capacity nor enough airline seats available to handle the demand. How would you propose to handle this situation? Be as specific as you can and defend your recommendations.
2. As a staff vice president at corporate headquarters, you have been charged to develop company-wide policies and procedures that will prevent such a situation from ever occurring again. What would you recommend?

TEAM DEBATE EXERCISES

1. How tightly should you supervise and control a foreign operation? This Maytag example suggests very tightly. But is this an aberration, unlikely to be encountered again? Debate the issue of very tight controls versus relative freedom for foreign operations.
2. Debate the two sides of outsourcing, from the viewpoints of workers, of communities, of stockholders, of company executives, and even of what's best for our economy.

INVITATION TO RESEARCH

Can you find any information about the effect of Maytag leaving Newton? Have most of the workers found other jobs, perhaps in Des Moines? What has been the impact of Newton? Has the town been able to recover, perhaps by luring other businesses or developers willing to take over some or all of the abandoned Maytag buildings?

Kmart and Sears: A Hedge Fund Manager's Challenge



On November 17, 2004, Kmart Holding Corp. chairman Edward Lampert and Sears chairman and CEO Alan Lacy announced the deal for Kmart to buy the once-dominant Sears department store chain for \$11.5 billion. This merger of battered retail giants would propel the combination into the No. 3 position behind behemoth Wal-Mart, and Home Depot. This would be the second-largest retail merger ever. It would take the Sears name and be called Sears Holdings Corp.

Some analysts questioned how such a merger of two faltering firms—both long hampered by weak management, outdated stores, and inefficient operations—could make one winner. However, investors thought otherwise and bid up the stocks of both companies. Part of the investor zeal was faith in Edward Lampert as a turn-around expert extraordinaire. That, and the suspected value of the combined companies' real estate.

EDWARD LAMPERT

The 42-year-old Lampert had built a fortune buying struggling companies and turning them around. He had hitherto shunned publicity, though now this was difficult to do in such a highly visible merger. In 2003 any desire for secrecy was thwarted as he was kidnapped from the garage of his office building in Greenwich, Connecticut, with his captors demanding a \$1 million ransom. This tested Lampert's persuasive skills, and they were not found wanting, for he eventually convinced the kidnappers to let him go for \$40,000.

The son of a lawyer in a comfortable New York City suburb, Lampert's life became more focused after his father died when he was 14. Interested in finance, he graduated from Yale and joined Goldman Sachs after graduating. There he found a mentor, Robert Rubin, who later became U.S. Secretary of Treasury. Lampert left the firm in 1988 at age 28 to start a hedge fund, ESL Investments, with about \$25 million to invest. He had long been an admirer of Warren Buffett, second only to Bill Gates of Microsoft as the richest American. Buffett had gained his wealth by concentrating on undervalued, old-line companies that threw off lots of cash.

And just as Buffett did in the 1960s with Berkshire, then just a declining textile mill in New Bedford, Massachusetts, Lampert did with bankrupt Kmart, gaining control in 2003 and turning it into a powerful investment vehicle. His investors included the wealthy and famous, and he made them even wealthier as his hedge fund's annual returns since 1988 had averaged almost 30 percent.

Unlike other hedge funds, ESL did not trade stocks actively, but tended to take big positions and hold them long term. As an example of his investment style, Lampert in 1997 bought an initial stake in AutoZone, a leading auto-parts retailer that was struggling. By 1999, he had a seat on the board, installed a new CEO, and boosted cash flow. To help profits, he raised prices, cut store-management budgets, and shifted to less-experienced staff, and the company's stock price surged from the low \$20s in late 1999 to more than \$100 in October 2003.¹

Kmart had filed for Chapter 11 bankruptcy protection in January 2002, as it found itself unable to compete with the likes of Wal-Mart and Target. After the filing, more than 600 unprofitable stores were closed, 57,000 Kmart employees were terminated, and Kmart stockholders' common stock was wiped out. Lampert began buying Kmart debt after the filing, while a subsequent controversy over accounting and perks given to former executives had reduced the value of its bank debt to less than 70 cents on the dollar, and its bonds to about 35 cents on the dollar. He came to hold debt with a face value of about \$1 billion. But bad news continued for Kmart, and Lampert faced paper losses of \$100 million.

He demanded a seat on the court-sanctioned committee of holders of bank debt and bonds. There he argued against the slowness of the bankruptcy process and the "excessive" fees paid to lawyers and consultants. Lampert forced the resignation of Kmart's chief executive and installed Julian Day, a former Sears executive, as CEO. He pushed hard to get the company out of bankruptcy quickly. "He was absolutely confident that the business was worth something, despite an enormous amount of skepticism by most parties," said Henry Miller, a financial adviser to Kmart during its bankruptcy restructuring.²

But Lampert's hedge fund had to pour in more money to buy out Kmart's banks, and when the retailer emerged from bankruptcy in May 2003, he held more than 50 percent of Kmart's new stock through conversion of his debt holdings into equity. He then led an aggressive strategy of closing or selling another 600 stores. The proceeds from these, no longer having the burden of billions of dollars of debt, and severe cost-cutting brought a speedy financial turnaround, with profits being posted in each of the next four quarters after Lampert took over. The stock price meantime increased sevenfold from its price of \$15 a share when it emerged from bankruptcy, and the hedge fund had gained almost \$4 billion from its Kmart holdings. ESL Investments now owned 43 million shares of Kmart and 31 million shares of Sears. In the wake of the merger news, in one day it recorded paper profits of nearly \$600 million.

¹ Rachel Beck, "So, does 2 + 2 = 5 for Kmart, Sears?" Associated Press as reported in *Cleveland Plain Dealer*, November 23, 2004, p. C5.

² Gregory Zuckerman and Mitchell Pacelle, "Sears Suitor Faces a Tough Bet," *Wall Street Journal*, November 18, 2004, p. C4.

THE EVOLUTION OF KMART

Kmart had been a newcomer to the discount scene. The early discounters started a few years after World War II, offering goods in barns, lofts, warehouses, abandoned factories, all places of low overhead. Shopping amenities were few. Goods were displayed on pipe racks, maybe jumbled on tables, and there were no services and hardly any employees except those at the checkouts. But prices were far lower than traditional retailers could offer. Most of these early discounters were ill-managed, undercapitalized, and very vulnerable to the sophisticated management that S.S. Kresge Co. had developed in more than half a century of being the second largest variety chain, behind only Woolworth. The name Kresge was changed to Kmart in 1977.

Kmart destroyed its weaker competitors and was second only to Sears in sales until 1990. Sears, however, carried appliances, furniture, tools, some machinery, automobile accessories, and tires, as well as other goods that Kmart and department stores did not carry, so that Sears's sales statistics were not entirely comparable with Kmart.

Sam Walton started Wal-Mart in 1969, and in the late 1970s, Wal-Mart sales were only 5 percent of Kmart's. It had 150 stores to Kmart's more than 1,000 that were mostly in urban locations. Wal-Mart stayed in rural small towns where it developed technology to have lean inventories, reduce overhead to the lowest in the industry, yet keep shelves well stocked and be able to offer lowest prices.

When Wal-Mart finally began invading Kmart's turf, it had a significant price advantage that Kmart never was able to overcome. In addition, the Wal-Mart stores were newer than the aging stores of Kmart. In 1990 Wal-Mart caught up with Kmart, and then irresistibly surged ahead while Kmart faltered. In a desperate effort to win back customers, Kmart's management increased its inventory investment and tried to match Wal-Mart's prices. But with Wal-Mart's efficiency and low overhead, Kmart could not match its prices without going into the red. Unable to compete with Wal-Mart and an aggressive Target aimed at a slightly more affluent customer, Kmart became ripe for Lampert's takeover.

THE EVOLUTION OF SEARS

Sears spanned three centuries of being a dominant force in the retail industry. It started in the late nineteenth century when it sent thousands of rural Americans the Sears Roebuck catalog, quickly dubbed the "consumer's bible." This offered a huge variety of goods at prices far cheaper than they could be bought elsewhere. It even advertised itself as the "Cheapest Supply House on Earth," and turned America into a consumer democracy, where everyone had equal access to the same goods at the same price.³ Sears surpassed Montgomery Ward as the largest retailer in 1900, with sales of \$10 million to Ward's \$8.7 million. Never again would Ward

³ Cynthia Crossen and Kortney Stringer, "A Merchant's Evolution," *Wall Street Journal*, November 18, 2004, p. B1.

surpass Sears. The catalog became a fixture in millions of American homes—and outhouses—and enabled farm families to keep up with changing fashions and the raft of manufactured goods becoming available.

By the 1920s, with many of its customers migrating to the cities or else having cars and better roads, Sears's founding principle of bringing cheap merchandise to remote areas of the country was becoming obsolete. In a major strategic decision, it opened its first retail store in Chicago in 1925, and by 1933 had 400 stores. It launched its famous Kenmore and Craftsman brands in 1927, and started the Allstate Insurance Co. in 1931. In 1953 Sears issued its own credit card, and started the Discovery Card in 1985. In 1981 it diversified, acquiring Dean Witter Reynolds and Coldwell Banker. In 1993, Sears discontinued the catalog and sold its interests in its financial units. In 2002 it acquired Lands' End for \$1.9 billion.

By the 1990s Sears found itself squeezed by a changing retail environment. Its lower- and middle-class customers were flocking to the powerful and efficient Wal-Marts and Targets for low prices. Those wanting quality were drawn to Nordstrom or specialty retailers like Gap. Those looking for home improvement and building supplies were drawn to surging category-killer chains such as Home Depot, and Lowe's.

At the time of the merger with Kmart, Sears had 870 mostly mall-based stores and 1,100 specialty stores, with net income for partial 2004 of \$648 million; Kmart had 1,504 stores, almost all standing alone and not in malls, with net income for partial 2004 of \$533 million after Lampert had taken it out of bankruptcy and closed or sold about 600 losing stores.⁴ With its sluggish sales in recent years, Sears had also lost favor with investors until the announced merger.

LAMPERT'S CHALLENGE

Possible Problems

In order to generate the most short-term profit possible after buying distressed Kmart and thus drive share prices up, Lampert put no money into improving its stores—though many were old and drab—in the 18 months after it came out of bankruptcy protection. He reduced inventories, avoided most discounting, and cut advertising and other expenses. He was able to sell some stores to chains such as Home Depot and also some to Sears. Other unsaleable money-losing stores were closed. But his cash flow shored up the balance sheet with a \$3 billion cash hoard, and dazzled investors in the planned merger.

Since he made no significant investments, same-store sales slid drastically, 13 percent in one recent quarter. In the highly competitive retail environment, such frazzled stores would likely be lodestones for the chain's efforts to revive itself without major rejuvenation. But any major investments would reduce profits.

One objective of mergers is to combine and coordinate operations and products wherever possible, to avoid redundancies and strengthen existing product lines.

⁴ WSJ Research, "Down the Aisles," *Wall Street Journal*, November 18, 2004, p. B1.

Could some Sears goods be readily sold in Kmart stores and vice versa? Sears had strong brands in its Kenmore appliances and Craftsman tools. Wal-Mart was not much of a factor with such goods. But would it be practical to move these bulky appliances into Kmart's? Since such items require considerable space, there would be less room for groceries, paper goods, household staples, and similar products. They would also require a much higher level of employee than typically found in a Kmart, as well as major remodeling to support such large and high-priced items. None of the three competitors—Sears, Kmart, and Wal-Mart—was strong in apparel, although Wal-Mart was improving its quality and had introduced a more stylish George line. In 2002, Sears bought the Lands' End apparel brand, and this had done well in upscale markets, but not so well in less-affluent ones.

Neither Kmart or Sears had the merchandising/computer technology to match Wal-Mart in preventing out-of-stocks and overstocks of other goods. Anecdotal incidents of Kmart and Sears merchandising expertise were troubling. Visits to Kmart and Sears stores in Ohio by retail consultants after the merger was announced found Kmart depleted in some grocery items, while Sears still had baseball caps in November for faraway teams, such as Oakland, Atlanta, and San Francisco.⁵

Kmart was not alone in having steadily declining same-store sales. Sears's same-store sales had been declining for almost every month for the previous four years before the merger. CEO Alan Lacy had tried. He had reorganized departments, dropped product lines, changed store signs, added clothing lines, and laid off thousands of employees. He sold the credit-card business in 2003 to Citigroup at about the same time as Kmart was beginning its credit card. The Lands' End acquisition brought more expertise in apparel. Still, same-store sales declined. Would Lampert do any better?

Lampert's Goals for the New Merger

Lampert had a reputation for keeping his cards close to his vest. A plethora of analysts began speculating how he would proceed, and how successful he would be. Investors seemed dazzled by his past successes in turning around distressed companies. At a news conference after the announced merger, Lampert and Lacy of Sears talked about potential synergies, a buzz word often used to support a merger decision. See the following Information Box for an analysis of the synergy of Lands' End fitting in with the Kmart/Sears merger.

Lambert and Lacy talked of squeezing suppliers, thanks to the \$40 billion a year in buying power of the two companies. They talked of streamlining back-office operations. They predicted annual savings of \$500 million within three years. They would aim to synchronize such areas as merchandising and planning, with cross-selling between stores, bringing Craftsman tools, Diehard batteries, and possibly Kenmore appliances into Kmart's and Martha Stewart goods into Sears.

⁵ Amy Merrick and Ann Zimmerman, "Can Sears and Kmart Take On a Goliath Named Wal-Mart?" *Wall Street Journal*, November 19, 2004, p. B1.

INFORMATION BOX**LANDS' END: DOES IT FIT IN WITH THE NEW MERGER?**

Lands' End was a longtime catalog seller that had built a strong following with its high-quality items such as cashmere sweaters, its wide range of sizes and assortments, and its high level of customer service. It was based in a small Wisconsin town, and its most direct competitor was L.L. Bean, also from a small town, but in Maine.

Sears bought the company in 2002 for \$1.9 billion, hoping it would be a cornerstone brand and beef up apparel sales and draw customers who were buying appliances and other non-clothing items. Lands' End thought the exposure to potential customers in Sears' 870 locations would be healthy. The reverse was more the case. The wider exposure weakened Lands' End exclusivity, and it was often poorly positioned "in between men's suits, snow blowers, tools, denim and work clothes." Charlie O'Shea, an analyst for Moody's, said, "It hasn't done what I think Sears wanted it to do. The general idea was to take the higher-income demographic, the hard-line appliance shopper, and have them walk across the store and buy apparel." But this was not happening enough.

Kmart's takeover of Sears caused more consternation for Lands' End. The blue-collar image of Kmart seemed incompatible with the quality image Lands' End had built up over the years. Kmart had to wonder, too, whether Lands' End merchandise would sell in its stores, or simply take up precious space better used for other goods. Instead of the synergy $2 + 2 = 5$ effect, with the total result better than the two separate operations before, it seemed more a $2 + 2 = 3$, with the combined result worse than the two separate operations were before.

Do you think Lands' End goods would sell in Kmart stores? What would it take? How could Lands' End do better in Sears stores?

Source: Aaron Nathans, "Sears-Kmart Union Puts Lands' End in Double Jeopardy," *New York Times*, as reported in *Cleveland Plain Dealer*, January 13, 2005, C6.

Most Sears stores were in traditional malls, but malls were losing some favor with consumers. Research recently found that 80 percent of consumer shopping dollars were now spent elsewhere than malls, compared to about 60 percent in 1995. Furthermore, six of the nation's largest retailers were not in malls, this being twice the number of the late 1990s.⁶ Several hundred more Kmart stores could be converted into Sears stores, which would enable Sears to address the location problem in its business model, and begin to adapt to a retailing environment that had shifted to stand-alone big box stores. Some of this adaptation would be to a new

⁶ Amy Merrick and Dennis K. Berman, "Kmart to Buy Sears for \$11.5 Billion," *Wall Street Journal*, November 18, 2004, p. A8.

chain called Sears Grand, which was closer to the popular off-mall format of the Wal-Marts and Home Depots.

Sears Grand stores had a mix of appliances, lawn and garden goods, hardware, and clothing. Since these stores were bigger than regular Sears department stores, they could add products such as books and magazines, CDs and DVDs, as well as groceries and everyday necessities. Sears was testing such stores in different sizes and formats. See the following Information Box for a discussion of the advantage that chains offer of being able to test different strategies in a few stores, and hone their effectiveness before going larger scale. These stores were thought to be better able to compete in the home improvement market against the likes of Wal-Mart, Home Depot, Lowe's, and Best Buy.

What should concern investors is whether Lampert could make this third largest retailer sufficiently competitive in today's environment. Surely a semblance of growth is needed, with some new stores and rejuvenated ones—what might be called a patient turnaround strategy. But maybe this is not what Lambert plans to do. Would a status quo situation be acceptable as long as steady income was generated for the foreseeable future?

If Lampert succeeded in the turnaround, and the stock of the combined companies rose accordingly, then he would be well armed to pull off more deals, to be well on the way to becoming another Warren Buffett. But maybe he didn't need to be a hero. By squeezing cash out of every aspect of Kmart's operation over 18 months, he had already built a war chest of \$3 billion. Sears also had a \$2.7 billion cash reserve that could probably be increased as he wrung inefficiencies out of the aging firm. Kmart furthermore had \$3.8 billion in tax credits carried over from previous

INFORMATION BOX

ADVANTAGES OF CHAINS: OPPORTUNITY FOR EXPERIMENTATION

An organization with numerous similar outlets has an unparalleled opportunity for experimenting with new ideas in the quest for what might be most productive and compelling. Prospective strategy changes can be tested in a few stores, any promising modifications determined, and the success of the strategy ascertained from concrete sales and profit results.

All this can be done with relatively little risk since only a few outlets of the total chain are involved, and the strategy can be adopted throughout the organization only if results are favorable. Such experimentation is hardly possible for the firm with few comparable units, which usually is the case with manufacturers. But where it can be done, the risks in making major strategy changes are greatly reduced, and the arena for creative innovation is enhanced.

How would you design such an experiment for Sears Grand? Be as specific as you can, and make any assumptions needed.

losses that should shield profits for years to come. Continuing to accumulate a cash hoard might be enough to give Lampert the ammunition to pursue his goal of great wealth, and invest in other promising distressed bargains.

Some analysts felt that Lampert's best course of action would be to liquidate the underlying real estate of Kmart and Sears. However, once the best locations were sold off, would there be much left? In an uncertain economy, this speculative hope that liquidating real estate would fuel ever-rising stock prices could be wistful thinking.⁷ The real estate fall-back plan might well encounter other retailers unloading stores as well. Federated Department Stores and May Department Stores reportedly planned to sell off mall space. Other retail chains such as Toys "R" Us and Office Depot were expected to follow suit. As the economy approached a recession, prices and demand would likely decrease.⁸

The Fruition of the Merger

On March 24, 2005, with shareholders signing off, Kmart officially bought Sears for \$12.3 billion. Lampert told reporters, "It's an opportunity to transform two companies that once were great—to transform them into a great company relative to the twenty-first century. I think there's a presumption that you're going to see a lot of store closings. That's a wrong presumption. Our program is to keep as many stores open as we can." Lampert also denied that the company planned to get rid of Lands' End: "Lands' End isn't for sale. It's a great American brand, and I think it's a brand that we could run very, very well."

Some layoffs would be forthcoming among the 5,000 people working at the two firm's headquarters—the Kmart headquarters in Troy, Michigan would be combined with Sears' headquarters in Hoffman Estates, Illinois—but the vast majority of the 400,000 work force would keep their jobs. Plans were to convert about 400 of the Kmart stores over the next three years to a new midsize "Sears Essentials" store being launched outside traditional malls.

Standard & Poor's analysts cautioned investors that "the combination of heightened business risk, intense competition and possible under-achievement in the company's off-mall strategy could lead to sales and margin problems, as well as deteriorating credit measures."⁹

Sixty-nine percent of Kmart shareholders voted to approve the deal in a sparsely attended session lasting five minutes. Two hours later, Sears shareholders also voted 69 percent in favor of the deal, but the scene was raucous as retired and former Sears employees upset about the acquisition by Kmart clamored against the deal. "This is a sad and dark day for Sears Roebuck," a former auto center manager fumed at the meeting. "It is unbelievable that Kmart, two years out of

⁷ Jesse Eisinger, "Will Lampert Get It All to Fit?" *Wall Street Journal*, November 24, 2004, p. C1.

⁸ Jesse Eisinger, "Lampert Faces a Long Shot in Reviving Sears," *Wall Street Journal*, September 14, 2005.

⁹ Andrew Leckey, "Analysts Rate Sears Stock as a 'Hold,'" Tribune Media Services as reported in *Cleveland Plain Dealer*, March 30, 2005, p. C5.

bankruptcy, would be strong enough to purchase Sears, a company in business for over a century.”¹⁰

By early 2006, speculation in the business press focused on the possibility of Lambert taking Sears private. While acquiring the 60 percent of Sears that his hedge fund did not own could cost \$12 to \$15 billion, there would be no public shareholders to scrutinize and criticize his efforts. He could do this gradually by billion dollar buybacks each year. Then when the lofty share price eventually fell, he would be poised to buy the rest via a tender offer.¹¹

ANALYSIS

Whether operational gains can be achieved from the Sears/Kmart merger is uncertain, especially against the might of competitors Wal-Mart, Target, and Home Depot. Adding to the competitive uncertainties is the length of time needed to assimilate the merger in the disparate organizations and operations. Such assimilation could take years before any synergies might be realized. This suggests that this third largest retailer may be particularly vulnerable for some years, and continue to lose market share.

The great cash hoard that Lampert could generate from a stripped down Kmart and Sears operation, and the inflated stock prices influenced by all this cash and by the optimistic assessment of real estate values for liquidation, promised only a short-term reprieve. Long enough to get these two dinosaurs on the growth track again? Probably not. A better expectation would be of slowing the market-share erosion—provided that most of the cash is reinvested in the company.

How is the cash to be spent? If it is spent in seeking other acquisitions of declining businesses, and leaving Kmart and Sears to fend for themselves with deteriorating and sparsely funded stores in the arena of the world’s greatest retailers, then eventual survival is not promising. In ten years will there still be a Kmart and a Sears? But Lampert’s cash may grow considerably. Then he may be left with the reputation of a raider who guts his acquisitions. I wonder whether he really wants that. I also wonder whether he can pull off a turnaround of even modest proportions. Such a turnaround would undoubtedly take all of the accumulated cash—and probably more, taking on debt again—to rejuvenate stores, increase inventories, advertising, perhaps new computer technology.

Another option might be to gradually close the weaker chain, and pour resources into making the other stronger. This stronger entity would probably be Sears, and it appeals to a more affluent customer than Kmart’s blue-collar customer. Some Kmarts in more affluent neighborhoods might be convertible to Sears. But still this is going to take major investment.

Will Lampert succeed with Sears and Kmart? This really depends on how he defines “succeed.” Does it mean becoming a bigger factor in the marketplace? Does

¹⁰ Dave Carpenter, “Sears Sale to Kmart Gets Blue, er, Green Light,” Associated Press, as reported in *Cleveland Plain Dealer*, March 25, 2005, pp. C1 and C3.

¹¹ Mark Tatge and Miriam Gottfried, “What Is Eddie Buying?” *Forbes*, January 9, 2006, p. 40.

it mean accumulating more cash bonanza? We can see a clue to the longer term prospects in what happened to AutoZone, Lampert's first acquisition in 1997. This was the first testing of his strategy of cutting promotions, service, and investment in stores. AutoZone stock rose fourfold between 2001 and 2003 from the severe cost cutting. But in 2005, same-store sales fell 2 percent while two rivals' same-store sales were up 8 percent. The stock price never again reached its October 2003 high. Not putting any money in the stores drove customers to competitors. In the first quarter of 2006, Sears's shares jumped 13 percent on news that first-quarter profits more than doubled. But same-store sales fell 8.4 percent. An ill wind on the horizon?¹²

LATEST BREAKING NEWS, 2007 AND 2008

The near-recession and the stock market collapse because of the subprime real estate bubble, played havoc on most stocks, but rather more so with Sears Holdings Corp. By January 2008, Sears stock prices had fallen more than 40 percent from the previous July. Sales at the company's 3,800 Sears and Kmart stores were down 3.5 percent during the holiday season, with warnings of more declines to come. Selling some stores and property no longer was a viable option, as other retailers were hesitant to add stores, and tightening credit made developers unlikely to step in with other uses for the land.

Sears's frugal spending was destroying any reasonable prognosis for a turnaround of existing operations. Since Lampert took over, he cut capital spending to as little as \$500 million a year, not even enough to offset natural deterioration caused by age. Target Corp., with about the same annual sales as Sears, spent more than \$4 billion a year. The consequences of this austerity were evident in lighting, flooring, appearance of displays, even in maintenance of stores. On top of dowdy stores compared to competitors, merchandising mistakes at Christmas 2007 were particularly costly, with hefty markdowns needed to move merchandise even as the overall retail market became tougher.

Lampert announced in mid-January 2008 a major restructuring and reorganization to come. CEO Aylwin Lewis was terminated, and Bruce Johnson, head of logistics and operations, was named interim CEO. Lampert had a reputation of being a difficult boss, and a number of executives have departed during his tenure at Sears.¹³

By a month later, the situation had worsened, as results of the most important fourth quarter 2007—the Christmas season—were tallied. Sears's same-store sales fell 4.5 percent, continuing a two-year drop. Rivals also suffered from weak U.S. sales, but far less than Sears. Target reported same-store sales rose just 0.2 percent, while Wal-Mart had a 1.7 percent increase.

¹² Bernard Condon, "Cheapskate," *Forbes*, June 19, 2006, pp. 136–138.

¹³ George Anders, "Lampert's Unusual Tactics Aren't Working in Unusual Times," *Wall Street Journal*, January 23, 2008, p. A2; Gary McWilliams and Joann S. Lublin, "Sears CEO Departs, And Lampert Says He'll Cut Own Role," *Wall Street Journal*, January 29, 2008, pp. B1 and B2.

Lampert still maintained he would not invest in modernizing stores. He said he would look beyond Sears's own deteriorating stores for income from selling its big-name brands—highly regarded Kenmore, Craftsman, Lands' End, and Diehard—through other retailers. However, even Sears's market share of its major appliances fell to barely 30 percent in 2007 from about 40 percent in 2001, and Lowes and Home Depot became bigger factors in the appliance market.¹⁴

Invitation to Make Your Own Analysis and Conclusions

The issue is in doubt regarding Lambert's long-term success with his strategy. Draw your own prediction, and give your persuasive rationale.

WHAT WE CAN LEARN

Beware Optimistic Projections for Mergers

Optimistic assumptions have no place in merger decisions. Most mergers are consummated with rather high expectations of synergy and growth. Many of them do not work out as expected, at least within the desired timeframe of a year or two. Some never work out, and eventually the losing acquisitions are given up on, or hung on to while draining financial and managerial resources.

Will the great merger of Kmart and Sears to become the country's third-largest retailer meet Lampert's declared expectations, or will he flee from the scene with a hoard of cash (maybe not even this as recession becomes a factor) and two gutted former retail empires?

Assumptions Should Be Defended in Merger Decisions

Objectivity and conservative projections are called for in merger decisions. These are often the most important decisions the managers will ever have to make, and deserve thorough investigation and research. Top management should insist that assumptions and their reasoning be defended, at least as much as possible in an uncertain future. It is prudent to consider a worst-cast scenario: "What if?" The use of a devil's advocate can often be worthwhile in such major decisions to bring out all aspects of the opposing position.

Don't Depend on Stock Prices to Support a Risky Merger

The stock market is a volatile instrument. The get-rich motivation of some investors can foster wild and unreasonable speculations. It is not unusual for share prices of some firms to be bid up far beyond their fair value, with more and

¹⁴ Gary McWilliams, "Profit Down, Sears May Hold Yard Sale," *Wall Street Journal*, February 29, 2008, p. A13.

more investors living in a dream world and joining the bandwagon, only to have prices come tumbling down as more sobering realities become evident. Kmart's and Sears's prices seem to conform to this pattern: a gamble bid up to unrealistic levels, and then a collapse.

What happens to Lampert's grand scheme as the inflated stock prices of Kmart and the new enterprise, Sears Holdings Corp., lose their lofty valuations? This would mean less financial assets for future acquisitions. If the loss of valuation is severe, insufficient capital may limit Lampert's options. We wonder how Lampert's hedge fund, ESL Investments and its wealthy clients, would tolerate sharply falling share prices of this major holding in the fund. (As this is written, the share price of Sears has continued to fall from its 40 percent decline as of January 2008.)

Use Same-Store Sales Instead of Total Sales Statistics in Evaluating Retail Performance

A key measure of how a retail chain is doing (aside from income statistics) is same-store sales. The total sales figure reflects new store openings and tells nothing about how existing stores are doing, and may hide a deteriorating situation. For example, if existing stores are showing steadily declining sales—as both Kmart and Sears stores were at the time of the merger, and are still today—this is a major indicator of how vulnerable these stores are. One wonders if any can be converted to a growth mode again. For decisions regarding which stores to close, the trend in same-store sales has to be a major input. This is especially true if different store managers have still been unable to turn things around. A further analysis should be made before any decision to cut: Why is the store not doing better? Is it incompetence, bad location, aggressive competitors, untrained or unmotivated staff—what? What would it take to correct these problems, or correct them reasonably?

Old Facilities Are Vulnerable to Newer Competitors

Kmart and Sears both have older stores than most of the Wal-Marts, Targets, Home Depots, and Lowe's. This presents a quandary in trying to compete without major investments to rejuvenate and open new state-of-the-art stores. Customers prefer to shop at nicer stores, it is easier to attract better employees, and even suppliers tend to give preferential treatment to those firms they see as growing rather than stagnant. This is a conundrum for the retailer with old stores trying to compete. Where is the money coming from for major rejuvenation of existing stores? Would it be better to spend the limited resources on new stores? What is this going to do to overhead and the ability to compete against lowest prices?

Minimum Reinvestment May Be Desirable in Some Circumstances

Sometimes marginal property is not worth much additional investment. But it still may not be a candidate for closure, even though little or no growth is on

the horizon. It depends on how much overhead is required and whether it can generate some profit even at low sales. If the store or operation is debt free—and debt is a major factor in overhead—then it may be worth keeping for a while at least. (At this point, you may want to review the Breakeven Box in Euro Disney, Chapter 15, for the effect on sales needed to breakeven and make a profit, if debt overhead can be reduced.) With Lampert’s buying up the debt of Kmart in exchange for equity, the overhead was greatly reduced and these operations were grinding out a cash flow of \$3 million in the first 18 months of his control. The problem from Lampert’s perspective was whether stock price would stabilize at a high level, once the no-growth future became evident. This does not seem to be the case, undoubtedly to Lampert’s dismay.

CONSIDER

Can you think of other learning insights?

QUESTIONS

1. Do you think this merger can be saved? Why or why not?
2. Explain why total sales information for a retail chain is insufficient in evaluating performance.
3. Visit a Kmart store and a Wal-Mart store. What was your overall impression as to strengths and weaknesses?
4. Visit a Sears and a Target store. What was your overall impression as to their strengths and weaknesses?
5. Do you think you would like to be a Kmart store manager? A Sears manager? Do you see any implications for the company from such attitudes?
6. Does the size of the Kmart/Sears entity after the merger give it a competitive advantage? Why or why not?
7. Is market share all that important in this case? Discuss.
8. “Kmart does not really have to match the low prices of Wal-Mart. It should not even try.” Evaluate this statement by an analyst.

HANDS-ON EXERCISES

1. *Be a Devil’s Advocate* (one who argues a contrary position). Lampert has about decided to limit any additional investment in Kmart either for rejuvenating stores or building up inventory. Argue as persuasively as you can against this draconian decision. (You maybe should be a little diplomatic; you don’t want to antagonize him.)
2. You are an ambitious Sears store manager. Describe how you might design your career path to achieve a high executive position in Lambert’s new retail behemoth. (Assume that Lampert is not going to abandon this enterprise.)

3. You are a vice president of a prestigious consulting firm that has been hired by Lampert to advise him on how to turnaround his retailing dynasty. Develop a plan of action, identifying various options, and then persuasively recommending one.

TEAM DEBATE EXERCISES

1. The controversy has developed regarding whether Kmart and Sears should continue as two separate entities, or whether one or the other should be phased out with resources directed to only one. Debate the two positions using all the salient arguments you can muster for your position. You should be prepared to attack the other side.
2. You represent one group of shareholders of Lambert's hedge fund, ESL. Your group opposes this merger and believes everybody would be better off if the over \$3 billion cash hoard generated so far by Kmart is used for different growth opportunities. You will be debating another group of shareholders who favor the merger with Sears.

INVITATION TO RESEARCH

What is Lampert up to these days? Is he still trying to turnaround Kmart and Sears? What has happened to Sears stock? Has Lampert and his hedge fund bought out any other troubled firms? Has Lampert recouped his resources, or has he been discredited? Are investors in Lampert's ESL hedge fund leaving the fund?

**PART
FIVE**

**NOTABLE MARKETING
SUCCESSES**

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Southwest Airlines: Success Is Finally Contested

In 1992 the airlines lost a combined \$2 billion, matching a dismal 1991 and bringing their three-year red ink total to a disastrous \$8 billion. Three carriers—TWA, Continental, and America West—were operating under Chapter 11 bankruptcy, and others were lining up to join them. But one airline, Southwest, was profitable as well as rapidly growing—with a 25 percent sales increase in 1992 alone. Interestingly enough, this was a low-price, bare-bones operation run by a flamboyant CEO, Herb Kelleher. He had found a niche, a strategic window of opportunity and, oh, how he milked it! See the following Information Box for further discussion of a strategic windows of opportunity and their desirable accompaniment, SWOT analysis.

HERBERT D. KELLEHER

Herb Kelleher impressed people as an eccentric. He liked to tell stores, often with himself as the butt, and many involved practical jokes. He admitted that he sometimes was a little scatterbrained. In his cluttered office, he displayed a dozen ceramic wild turkeys as a testimonial to his favorite brand of whiskey. He smoked five packs of cigarettes a day. As an example of his zaniness, he painted one of his 737s to look like a killer whale, in celebration of the opening of Sea World in San Antonio. Another time, during a flight he had flight attendants dress up as reindeer and elves, while the pilot sang Christmas carols over the loudspeaker as he gently rocked the plane.

Kelleher is a “real maniac,” said Thomas J. Volz, vice-president of marketing at Braniff Airlines. “But who can argue with his success?”¹

Kelleher grew up in Haddon Heights, New Jersey, the son of a Campbell Soup Company executive. He graduated from Wesleyan University and New York University law school, then moved to San Antonio in 1961 where his father-in-law helped him set up a law firm. In 1968 he and a group of investors put up \$560,000 to found Southwest; of this amount, Kelleher contributed \$20,000.

¹ Kevin Kelly, “Southwest Airlines: ‘Flying High with ‘Uncle Herb’,” *Business Week*, July 3, 1989, p. 53.

INFORMATION BOX**STRATEGIC WINDOW OF OPPORTUNITY
AND SWOT ANALYSIS**

A strategic window is an opportunity in the marketplace, one not at present well served by competitors, that fits well with the firm's competencies. Strategic windows often last for only a short time (although Southwest's strategic window has been much more durable) before they are filled by alert competitors.

Strategic windows are usually found by systematically analyzing the environment, examining the threats and opportunities it holds. The competencies of the firm, its physical, financial, and people resources—management and employees and their strengths and weaknesses—should also be assessed. The objective is to determine what actions might or might not be appropriate for that particular enterprise and its orientation. This is commonly known as a SWOT analysis: analyzing the *strengths* and *weaknesses* of the firm, and assessing the *opportunities* and *threats* in the environment.

The analysis may be a formal part of the planning process or it may also be informal and even intuitive. We suspect that Herb Kelleher instinctively sensed a strategic window in short hauls and lowest prices. Although he must have recognized the danger that his bigger competitors would try to match his prices, he believed that with his simplicity of operation he would be able to make a profit while bigger airlines were racking up losses.

Why do you think the major airlines so badly overlooked the possibilities in short hauls at low prices?

In the early years he was the general counsel and a director of the fledgling enterprise. But in 1978 he was named chairman, despite his having no managerial experience, and in 1981 he became CEO. His flamboyance soon made him the most visible aspect of the airline. He starred in most of its TV commercials. A rival airline, America West, charged in ads that Southwest passengers should be embarrassed to fly such a no-frills airline, whereupon Kelleher appeared in a TV spot with a bag over his head. He offered the bag to anyone ashamed to fly Southwest, suggesting it could be used to hold “all the money you’ll save flying us.”²

He knew many of his employees by name, and they called him “Uncle Herb” or “Herbie.” He held weekly parties for employees at corporate headquarters. And he encouraged such antics by his flight attendants as organizing trivia contests, delivering instructions in rap, and awarding prizes for the passengers with the largest holes in their socks. But such wackiness had a shrewd purpose: to generate a gung-ho spirit to boost productivity. “Herb’s fun is infectious,” said Kay Wallace,

² Kelly, p. 53.

president of the Flight Attendants Union Local 556. “Everyone enjoys what they’re doing and realizes they’ve got to make an extra effort.”³

THE BEGINNINGS

Southwest was conceived in 1967, folklore tells us, on a napkin. Kelleher was still a lawyer, and Rollin King, one of his clients, had an idea for a low-fare, no-frills airline to fly between major Texas cities. He doodled a triangle on the napkin, labeling the points Dallas, Houston, and San Antonio.

The two tried to go ahead with the plan, but were stymied for more than three years by litigation, battling Braniff, Texas International, and Continental over the right to fly. In 1971, Southwest won, and it went public in 1975. At that time, it had four planes flying between the three cities. Lamar Muse was president and CEO from 1971 until he was fired by Southwest’s board in 1978. Then the board of directors tapped Kelleher.

At first, Southwest was in the throes of life-and-death low-fare skirmishes with its giant competitors. Kelleher liked to recount how he came home one day “beat, tired, and worn out. So I’m just kind of sagging around the house when my youngest daughter comes up and asks what’s wrong. I tell her, ‘Well, Ruthie, it’s these damned fare wars.’ And she cuts me right off and says, ‘Oh, Daddy, stop complaining. After all, you started ‘em.’”⁴

For most small firms, competing on a price basis with much larger, well-endowed competitors is tantamount to disaster. The small firm simply cannot match the resources and staying power of bigger competitors. Yet Southwest somehow survived. Not only did it initiate the cutthroat price competition, but it achieved cost savings in its operation that the larger airlines could not. The question then became: How long would the big carriers be content to maintain their money-losing operations and match the low prices of Southwest? And the big airlines eventually blinked.

In its early years, Southwest faced other legal battles. Take Dallas and Love Field. The original airport, Love Field, is close to downtown Dallas, but it could not geographically expand at the very time when air traffic was increasing mightily. So, a major new facility, Dallas/Fort Worth International airport, replaced it in 1974. This boasted state-of-the-art facilities and enough room for foreseeable demand, but it had one major drawback: it was 30 minutes farther from downtown Dallas. Southwest was able to avoid a forced move to the new airport and to continue at Love. But in 1978, competitors pressured Congress to bar flights from Love Field to anywhere outside Texas. Southwest was able to negotiate a compromise, now known as the Wright Amendment, that allowed flights from Love Field to the four states contiguous to Texas. In retrospect, the Wright Amendment forced onto Southwest a key ingredient of its later success: the strategy of short flights.⁵

³ Richard Woodbury, “Prince of Midair,” *Time*. January 25, 1993, p. 55.

⁴ Charles A. Jaffe, “Moving Fast by Standing Still,” *Nation’s Business*, October 1991, p. 58.

⁵ Bridget O’Brian, “Southwest Airlines Is a Rare Air Carrier: It Still Makes Money,” *Wall Street Journal*, October 28, 1992, p. A7.

GROWTH

Southwest grew steadily, but not spectacularly, through the 1970s. It dominated the Texas market by appealing to passengers who valued price and frequent departures. Its one-way fare between Dallas and Houston, for example, was \$59 in 1987 versus \$79 for unrestricted coach flights on other airlines.

In the 1980s, Southwest's annual passenger traffic count tripled. At the end of 1989, its operating cost per revenue mile—the industry's standard measure of cost-effectiveness—was just under 10 cents, which was about 5 cents per mile below the industry average.⁶ Although revenues and profits were rising steadily, especially compared with the other airlines, Kelleher took a conservative approach to expansion, financing it mostly from internal funds rather than taking on debt.

Perhaps the caution stemmed from an ill-fated acquisition in 1986. Kelleher bought a failing long-haul carrier, Muse Air Corp., for \$68 million, and renamed it TransStar. (This carrier had been founded by Lamar Muse after he left Southwest.) But by 1987, TransStar was losing \$2 million a month, and Kelleher shut down the operation.

By 1993 Southwest had spread to 34 cities in 15 states. It had 141 planes, and each of them made 11 trips a day. It used only fuel-thrifty 737s, and still concentrated on flying large numbers of passengers on high-frequency, one-hour hops at bargain fares (average \$58). Southwest shunned the hub-and-spoke systems of its larger rivals and took its passengers directly from city to city, often to smaller satellite airfields rather than congested major metropolitan fields. With rock-bottom prices, and no amenities, it quickly dominated most new markets it entered.

As an example of Southwest's impact on a new market, it came to Cleveland, Ohio in February 1992, and by the end of the year was offering 11 daily flights. In 1992, Cleveland Hopkins Airport posted record passenger levels, up 9.74 percent from 1991. "A lot of the gain was traffic that Southwest Airlines generated," noted John Osmond, air trade development manager.⁷

In some markets, Southwest found itself growing much faster than projected, as competitors either folded or abandoned directly competing routes. For example, in Phoenix, America West Airlines cut back service in order to conserve cash after a Chapter 11 bankruptcy filing. Of course, Southwest picked up the slack, as it did in Chicago when Midway Airlines folded in November 1992. And in California, Southwest's arrival led to several large competitors abandoning the Los Angeles-San Francisco route, unable to meet Southwest's \$59 one-way fare. Before Southwest, fares had been as high as \$186 one way.⁸

Now cities that Southwest did not serve were petitioning for service. For example, Sacramento, California sent two county commissioners, the president of the

⁶ Jaffe, p. 58.

⁷ "Passenger Flights Set Hopkins Record," *Cleveland Plain Dealer*, January 30, 1993, p. 3D.

⁸ O'Brian, p. A7.

chamber of commerce and the airport director, to Dallas to petition for service. Kelleher consented a few months later. In 1991 the airline received 51 similar requests.⁹

A unique situation was developing. On many routes, Southwest's fares were so low they competed with buses, and even with private cars. By 1991 Kelleher did not even see other airlines as his principal competitors: "We're competing with the automobile, not the airlines. We're pricing ourselves against Ford, Chrysler, GM, Toyota, and Nissan. The traffic is already there, but it's on the ground. We take it off the highway and put it on the airplane."¹⁰

Various aspects of Southwest's growth and increasingly favorable competitive position during the salient years from 1987 to 1991 are depicted in Tables 18.1, 18.2, 18.3, and Figure 18.1. While Southwest's total revenues were still less than the major airlines in the industry, its growth pattern indicated a major presence, and its profitability was second to none.

Tapping California

Southwest's formidable competitive power was perhaps never better epitomized than in its 1990 invasion of populous California. By 1992, it had become the

TABLE 18.1 Growth of Southwest Airlines: Various Operating Statistics, 1982–1991

Year	Operating Revenues (\$ millions)	Net Income (\$ millions)	Passengers Carried (thousands)	Passenger Load Factor
1991	\$1,314	\$26.9	22,670	61.1%
1990	1,187	47.1	19,831	60.7
1989	1,015	71.6	17,958	62.7
1988	880	58.0	14,877	57.7
1987	778	20.2	13,503	58.4
1986	769	50.0	13,638	58.8
1985	680	47.3	12,651	60.4
1984	535	49.7	10,698	58.5
1983	448	40.9	9,511	61.6
1982	331	34.0	7,966	61.6

Source: Company annual reports.

Commentary: Note the steady increase in revenues and in numbers of passengers carried. Although the net income and load factor statistics show no appreciable improvement, these statistics are still in the vanguard of an industry that has suffered badly in recent years. See Table 18.2 for a comparison of revenues and income with the major airlines.

⁹ *Ibid.*

¹⁰ Subrata N. Chakravarty, "Hit 'Em Hardest with the Mostest," *Forbes*, September 16, 1991, p. 49.

TABLE 18.2 Comparison of Southwest's Growth in Revenues and Net Income with Major Competitors, 1987–1991

	1991	1990	1989	1988	1987	% 5-Year Gain
<i>Operating Revenue Comparisons (\$ millions)</i>						
American	\$9,309	\$9,203	\$8,670	\$7,548	\$6,369	46.0
Delta	8,268	7,697	7,780	6,684	5,638	46.6
United	7,850	7,946	7,463	7,006	6,500	20.8
Northwest	4,330	4,298	3,944	3,395	3,328	30.1
Southwest	1,314	1,187	1,015	860	778	68.9
<i>Net Income Comparisons (millions)</i>						
American	(253)	(40)	412	450	225	
Delta	(216)	(119)	467	286	201	
United	(175)	73	246	426	22	
Northwest	10	(27)	116	49	64	
Southwest	27	47	72	58	20	

Source: Company annual reports.

Commentary: Southwest's revenue gains over these 5-years outstripped those of its largest competitors. While the percentage gains in profitability are hardly useful because of the erratic nature of airline profits during these years, Southwest stands out starkly as the only airline to be profitable each year.

second largest player, after United, with 23 percent of intrastate traffic. This was achieved by pushing down fares as much as 60 percent on some routes. The big carriers, which had tended to surrender the short-haul niche to Southwest in other markets, suddenly faced a real quandary in competing in the "Golden State." Now Southwest was being described as a "500 pound cockroach, too big to stamp out."¹¹

TABLE 18.3 Market Share Comparison of Southwest and Its Four Major Competitors, 1987–1991

	1991	1990	1989	1988	1987
Total Revenues:					
American, Delta, United, Northwest	\$29,757	\$29,144	\$27,857	\$24,633	\$21,835
Southwest Revenues	\$1,314	\$1,187	\$1,015	\$860	\$778
Percentage of big four	4.4	4.1	3.6	3.5	3.6
Increase in Southwest's market share, 1987–1991: 22%					

Source: Company annual reports.

¹¹ Wendy Zellner, "Striking Gold in the California Skies," *Business Week*, March 30, 1992, p. 48.

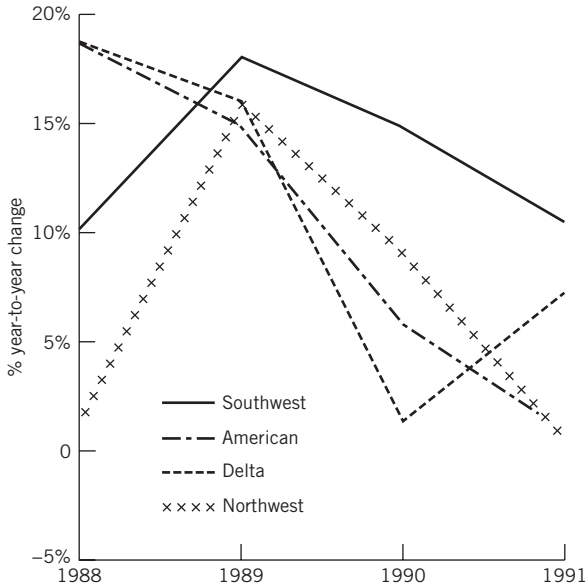


Figure 18.1 Year-to-year percentage changes in revenues, Southwest and its three major competitors, 1988–1991.

The California market was indeed enticing. Some eight million passengers each year flew between the five airports in metropolitan Los Angeles and three in the San Francisco Bay area, this being the busiest corridor in the United States. It was also one of the pricier routes, as the low fares of AirCal and Pacific Southwest Airlines had been eliminated when these two airlines were acquired by American and US Air.

Into this situation Southwest charged, with low fares and frequent flights. While airfares dropped, total air traffic soared 123 percent in the quarter Southwest entered the market. Competitors suffered; American lost nearly \$80 million at its San Jose hub, while US Air also lost money even though it cut service drastically. United, the market leader, quit flying the San Diego-Sacramento and Ontario-Oakland routes, where Southwest had rapidly built up service. The quandary of the major airlines was all the greater since this critical market fed traffic into the rest of their systems, especially the lucrative transcontinental and trans-Pacific routes. They could hardly abdicate California to Southwest. American, for one, considered creating its own no-frills shuttle for certain routes. But the question remained: could anyone stop Southwest with its formula of lowest prices, lowest costs, and frequent schedules? And, oh yes, good service and fun.

INGREDIENTS OF SUCCESS

Although Southwest's operation under Kelleher had a number of rather distinctive characteristics contributing to its success pattern and its seizing of a strategic window of opportunity, the key factors appear to have been cost containment, employee commitment, and conservative growth.

Cost Containment

Southwest has been the lowest-cost carrier in its markets. While its larger competitors might try to match its cut-rate prices, they could not do so without incurring sizable losses. Nor did they seem able to trim their costs to match Southwest. For example, in the first quarter of 1991, Southwest's operating costs per available seat mile (i.e., the number of seats multiplied by the distance flown) were 15 percent lower than America West, 29 percent lower than Delta's, 32 percent lower than United's, and 39 percent lower than US Air's.¹²

Many aspects of the operation contributed to these lower costs. Since all its planes were Boeing 737s, costs of training, maintenance, and inventory could be reduced. And since a plane earns revenues only when flying, Southwest was able to achieve a faster turnaround time on the ground than any other airline. Although competitors took upwards of an hour to load and unload passengers and then clean and service the planes, some 70 percent of Southwest's flights had a turnaround time of 15 minutes, while 10 percent had even pared the turnaround time to 10 minutes.

Southwest had also curbed costs in customer service. It offered peanuts and drinks, but no meals. Boarding passes were reusable plastic cards. Boarding time was minimal because there were no assigned seats. Southwest subscribed to no centralized reservation service. It did not even transfer baggage to other carriers; that was the passengers' responsibility. Admittedly, such customer-service frugality would be less acceptable on longer flights—and this helped to account for the difficulty competing airlines had in cutting their costs to match Southwest's. Still, if the price is right, many passengers might also opt for no frills on longer flights.

Employee Commitment

Kelleher was able to achieve an esprit de corps unmatched by other airlines despite the fact that Southwest employees were unionized. His relationship with the unions was not adversarial, so that Southwest was able to negotiate flexible work rules, with flight attendants and even pilots helping with plane cleanup. Employee productivity continued very high, permitting the airline to be lean staffed. Kelleher resisted the inclination to hire extravagantly when times were good, necessitating layoffs in leaner times. This contributed to employee feelings of security and loyalty. The low-key attitude and sense of fun that Kelleher engendered helped, perhaps more than anyone could have foreseen. Kelleher declared, "Fun is a stimulant to people. They enjoy their work more and work more productively."¹³

Conservative Growth Efforts

Not the least of the ingredients of success was Kelleher's conservative approach to growth. He resisted the temptation to expand vigorously—for example, to seek to

¹² Chakravarty, p. 50.

¹³ *Ibid.*

fly to Europe or get into head-to-head competition with larger airlines with long-distance routes. Even in its geographical expansion, conservatism prevailed. The philosophy of expansion was only to do so when enough resources could be committed to go into a city with ten to twelve flights a day, rather than just one or two. Kelleher called this “guerrilla warfare,” with efforts concentrated against stronger opponents in only a few areas, rather than dissipating strength by trying to compete everywhere.

Even with a conservative approach to expansion, the company showed vigorous but controlled growth. Its debt, at 49 percent of equity, was the lowest among U.S. carriers. Southwest also had the airline industry’s highest Standard & Poor’s credit rating,

GALLOPING TOWARD THE NEW MILLENNIUM

In its May 2, 1994 edition, prestigious *Fortune* magazine devoted its cover story to Herb Kelleher and Southwest Airlines. It raised an intriguing question:¹⁴ “Is Herb Kelleher America’s Best CEO?” It called him a “people-wise manager who wins where others can’t.” Southwest’s operational effectiveness continued to surpass all rivals in such productivity ratios as cost per available seat mile, passengers per employee, and employees per aircraft. Only Southwest remained consistently profitable among the big airlines, by the end of 1998 having been profitable for 26 consecutive years. Operating revenue had grown to \$4.2 billion (it was \$1.3 billion in 1991—see Table 18.2), and net income was \$433 million, up from \$27 million in 1991.

In 1999, Herb Kelleher was named CEO of the Year by *Chief Executive* magazine.

Geographical Expansion

Late in October 1996, Southwest launched a carefully planned battle for East Coast passengers that would drive down air fares and pressure competitors to back away from some lucrative markets. It chose Providence, Rhode Island, just 60 miles from Boston’s Logan Airport, thus tapping the Boston-Washington corridor. The Providence airport escaped the congested New York and Boston air-traffic-control areas, and from the Boston suburbs was hardly a longer trip than to Logan Airport. Experience had shown that air travelers would drive considerable distance to fly with Southwest’s cheaper fares.

As Southwest entered new markets, most competitors refused any longer to try to compete price-wise—they simply could not cut costs enough to compete. Their alternative then was either to pull out of these short-haul markets, or be content to let Southwest have its market share while they tried to hold on to other customers by stressing first-class seating, frequent-flyer programs, and other in-flight amenities.

¹⁴ Kenneth Labich, “Is Herb Kelleher America’s Best CEO?” *Fortune*, May 2 1994, pp. 45–52.

In April 1997 Southwest quietly entered the transcontinental market. From its major connecting point of Nashville, Tennessee, it began nonstops both to Oakland, California and to Los Angeles. With Nashville's direct connections with Chicago, Detroit, Cleveland, Providence, and Baltimore-Washington, as well as points south, this afforded *one-stop*, coast-to-coast service, with fares about half as much as the other major airlines.

Two other significant moves were announced in late 1998. One was an experiment. On Thanksgiving Day, a Southwest 737-700 flew *nonstop* from Oakland, California to the Baltimore-Washington Airport, and back again. It provided its customary no-frills service, but a \$99 one-way fare, the lowest in the business. The test was designed to see how pilots, flight attendants, and passengers would feel about spending five hours in a 737 with only peanuts and drinks served in flight. The older 737s lacked the fuel capacity to fly coast-to-coast nonstop, but with Boeing's new 737-700 series this was no problem. The Thanksgiving Day test was a precursor of more nonstop flights as Southwest had firm orders for 129 of the new planes to be delivered over the next seven years. This would enable it to compete with the major carriers on their moneymaking transcontinental flights.

In November 1998 plans were also announced for starting service to MacArthur Airport at Islip, Long Island, which would enable Southwest to tap into the New York City market. By late 1999 it was flying to 54 cities in 29 states. Table 18.4 lists these cities.

TABLE 18.4 Cities Served by Southwest October 1999

Albuquerque	Ft. Lauderdale	Midland/Odessa	Rio Grande Valley (South Padre Island/Harlingen)
Amarillo	Hartford, CT ^a	Nashville	
Austin	Houston (Hobby & Bush Intercontinental)	New Orleans	Sacramento
Baltimore-Washington		Oakland	St. Louis
Birmingham	Indianapolis	Oklahoma City	Salt Lake City
Boise	Islip (Long Island)	Omaha	San Antonio
Burbank	Jackson, MS	Ontario, CA	San Diego
Chicago (Midway)	Jacksonville	Orange Country	San Francisco
Cleveland	Kansas City	Orlando	San Jose
Columbus	Little Rock	Phoenix	Seattle
Corpus Christi	Los Angeles (LAX)	Portland	Spokane
Dallas (Love Field)	Louisville	Providence, RI	Tampa
Detroit (Metro)	Lubbock	Raleigh-Durham	Tucson
El Paso	Manchester, NH	Reno/Tahoe	Tulsa

^a Service to Hartford, Connecticut, began October 31, 1999.

UPDATES

To 2006

By mid-2002, with the 9/11 disaster still affecting airline travel, Southwest was the only major carrier that had been operating profitably in the 18 months since. U.S. airlines were posting losses of as much as \$8 billion in 2002—eclipsing the record in 2001 of \$7.7 billion, with the loss in the more profitable business travel being particularly acute. The high-cost airlines faced enormous pressure from low-fare carriers, most notably Southwest, but also from Internet sites that allowed bargain hunting. Southwest was now the nation's sixth largest airline, and it had been profitable for 29 consecutive years.

In June 2001, just months before the September 11 attacks, Herb Kelleher retired. He was replaced by James Parker, who had joined Southwest in 1986, and Parker readily admitted he was no Herb Kelleher. His immediate challenge was to contain operating costs of soaring liability insurance and unionized workers agitation for raises to match rich contracts negotiated at other airlines before September 11. However, the bankruptcies of United Airlines and US Airways in late 2002 highlighted the need for airlines to slash billions in operating costs, notably through labor givebacks of extravagant union contracts, and this helped subdue new labor demands.¹⁵

In the increasingly brutal airline market, even Southwest was getting squeezed. It still remained profitable and its seat capacity for the first half of 2004 was up 29 percent from four years earlier, but because of mounting price competition, revenue had risen only 18 percent during this time. It remained profitable while the worldwide airline industry had incurred losses of about \$30 billion since 2001. But Southwest now faced price competition from a new breed of low-price competitors, such as JetBlue Airways, which offered such amenities as inflight TV. The bigger airlines also were posing greater competition for they had substantially lowered their costs and their ticket prices. Some pilots on major airlines, with their compensation givebacks, were even making less than Southwest pilots. In this environment, CEO James Parker abruptly retired after only three years on the job. He was replaced in July 2004 by 50-year-old Gary Kelly, former chief financial officer of Southwest.

In early 2005 Southwest announced its invasion of the Pittsburgh market, taking advantage of US Airways's major service cuts there. This was the latest move in Southwest's continuing buildup in the East. It had entered the Philadelphia market in May 2004, and with its arrival, traffic rose more than 51 percent and average fares fell more than 37 percent. Pittsburgh now had six low-cost carriers, and the dominant hub position of US Airways had eroded.¹⁶

¹⁵ Scott McCartney, "Southwest Sets Standards on Costs," *Wall Street Journal*, October 9, 2002; Daniel Fisher, "Is There Such a Thing as Nonstop Growth?" *Forbes*, July 8, 2002, pp. 82, 84.

¹⁶ Melanie Trottman, "At Southwest, New CEO Sits in a Hot Seat," *Wall Street Journal*, July 19, 2004, pp. B1 and B3; Melanie Trottman, "Southwest Feels Squeeze," *Wall Street Journal*, August 23, 2004, p. B3; Melanie Trottman, "Southwest Will Fill US Airways' Pittsburgh Gap," *Wall Street Journal*, January 6, 2005, p. D9.

Southwest also added Fort Myers, Florida, and Denver in 2005, and planned to offer flights to Washington's Dulles airport by Fall 2006. Its Baltimore presence already tapped Washington's northern and eastern Maryland suburbs, and now Dulles would expose it to the burgeoning population in northern Virginia.

Changes on the Horizon

In these expansions into more competitive airports, the growth was nudging Southwest toward becoming a typical big airline. It even began testing whether it should move to assigned seating instead of its hallmark open-seating policy; early results suggested that assigned seating could shave a minute or so off boarding time, but would lead to more disappointed customers. Still, it had no first-class seating, no meals, and no posh airport VIP clubs. By the end of 2006, Southwest had 478 planes, more than United's 460 mainline jets. Long promoted as "*the* low-fare carrier," it had raised fares nine times since the middle of 2005, including a \$10 increase on some flights over the July Fourth weekend.

CEO Kelly maintained that nothing was imminent, but "it's a matter of when, not if," Southwest will launch service to Mexico, Canada, or even the Caribbean. As it grew larger, change was threatening to dilute Southwest's efficiency built around its all-Boeing 737 fleet. The possibility of flying 100-seat jets to smaller markets was being considered. Further erosion of the successful bare-bones business plan seemed probable, such as adding some type of in-flight entertainment. The market niche as the lowest-fare carrier was eroding.

Several other factors threatened the bare-bones leadership. One was the end of Southwest's advantage over rivals in fuel costs. It had used contracts to lock in future fuel prices—a fuel-hedging program—and this saved \$900 million in 2005, but would wind down in 2007. The other was largely a factor of its 60 consecutive quarterly profits by July 2006, a record of profitability unique in the industry. Labor negotiations loomed, and while Southwest's pilots were the highest paid in the industry, thanks to big pay cuts for pilots in the major airlines, Southwest's pilots maintained that they had earned raises.¹⁷

By the end of 2006, the so-called legacy carriers had become reinvigorated. With their restructuring, often under the umbrella of bankruptcy, and the severe price cutting of previous years, they now had costs that only discounters previously could enjoy; in addition these major airlines had the premium overseas traffic that discounters did not have. This situation impacted stocks of JetBlue, AirTran, Frontier Airlines, and Southwest as they reported sharply lower profits.¹⁸

¹⁷ Compiled from Dan Reed, "At 35, Southwest's Strategy Gets More Complicated," *USA Today*, July 11, 2006, pp. B1 and B2; Susan Warren, "Keeping ahead of the Pack," *Wall Street Journal*, December 19, 2005, pp. B1 and B3; and Susan Warren, "Southwest to Offer Flights to Dulles Starting This Fall," *Wall Street Journal*, April 5, 2006, p. B2.

¹⁸ Melanie Trottman and Susan Carey, "'Legacy' Airlines May Outfly Discount Rivals," *Wall Street Journal*, October 30, 2006, pp. C1 and C4.

The Situation in 2007 and 2008

The business plan that had been so successful since the beginning 40 years before, now was challenged in an environment of aggressive low-price competitors as well as legacy carriers also competing on price. Southwest CEO Gary Kelly reduced expansion plans. Underperforming flights were moved to more lucrative routes. For example, daily flights from Baltimore to Cleveland and Providence to Phoenix were reduced, while flights to Denver added 14 daily arrivals. Nonstop flights on some routes, such as between Philadelphia and Los Angeles, and Baltimore and Oakland were even eliminated.

In addition to streamlining schedules and routes to maximize efficiency, Southwest sought to win more business travelers willing to pay somewhat higher fares for amenities, such as renovated boarding areas featuring roomier seats and power outlets, workstation counters with stools, and flat-screen TV sets. Preferential boarding, bonus frequent-flier credits, and free cocktail vouchers were offered in “Business Select” fares. The corporate sales team that promoted flying Southwest to company travel agents was expanded to 15 people. The open boarding system was modified to issue passengers numbers dictating their order of boarding, thereby cutting time in line to five minutes from up to an hour. Further amenities were being considered, such as Internet access and movies or television.¹⁹ The fear was that these moves toward the mainstream would compromise Southwest’s uniqueness.

In March 2008 revelations about negligence with regard to safety inspections and maintenance caused greater management concern than changing the boarding system or offering more amenities.

A Lapse of a Once-Stellar Reputation

In early March 2008 the Federal Aviation Administration (FAA) accused Southwest of “serious and deliberate” safety violations and proposed a \$10.2 million fine, a fine believed to be the largest ever imposed on a major U.S. passenger carrier. The penalty stemmed from Southwest’s negligence in continuing to fly 46 older Boeing 737s without the required inspections of the fuselage from June 2006 to March 2007. The inspections were aimed at finding cracks in aging planes that could bring down a modern jetliner. Six of the planes were found to have cracks, the longest a few inches, but these were not serious enough by themselves to bring down a plane. A week later Southwest temporarily grounded another 38, after it could not determine whether an important safety inspection had been done properly.

Southwest had prided itself in never having a passenger fatality due to a crash. It was generally regarded as the best-run domestic airline. “They start off with a lot of money in the goodwill bank, and they make a really, really bad mistake,” said a travel manager.²⁰ But Southwest’s lapse was to be the tip of the

¹⁹ Susan Stellan, “Now Boarding Business Class,” *New York Times*, February 26, 2008, p. C6.

²⁰ Compiled from Jeff Bailey, “New Inspections Ground 38 Southwest Jets,” *New York Times*, March 13, 2008, pp. C1 and C4; Andy Pasztor, “FAA Seeks to Fine Southwest \$10.2 Million,” *Wall Street Journal*, March 7, 2008, p. A4; Andy Pasztor and Melanie Trotman, “Southwest Airlines CEO Apologizes for Lapses,” *Wall Street Journal*, March 14, 2008, pp. B1 and B2.

iceberg: Other airlines soon had to ground their planes until tardy safety inspections were completed.

Invitation to Make Your Own Analysis and Conclusions

1. Your analysis, please, of CEO Kelly's contemplated new business plan for Southwest.
2. Do you think this inspection snafu will have any long-term effect on Southwest's public image?

WHAT WE CAN LEARN

The Power of Low Prices and Simplicity of Operation

If a firm can maintain prices below its competitors, and do so profitably and without sacrificing quality of service, then it has a powerful advantage. We note in Chapter 20 the great advantage Vanguard had with its lowest expense ratio in the mutual fund industry. Southwest also achieved this with its simplicity of operation and no frills, but dependable service. Competition on the basis of price is seldom used in most mature industries (although the airline industry has been an exception), primarily because competitors can often quickly match prices with no lasting advantage to anyone. As profits are destroyed, only customers benefit, and then only in the short run before the industry realizes the futility of price competition. (With new and rapidly changing industries, price competition is effective as productivity and technology improve and marginal competitors are driven from the market.)

The effectiveness of the cost controls of Southwest, however, showed the true competitive importance of low prices. Customers love the lowest-price producer, *if* the provider does not sacrifice too much quality, comfort, and service. While there was some sacrifice of service and amenities with Southwest, most customers found this acceptable because of the short-haul situation; and dependable and reasonable service was still maintained. Today, though, the price advantage of Southwest is being attacked.

An intriguing factor regarding the relationship of customer satisfaction and price is explored in the following Information Box.

The Power of a Niche Strategy

Directing business efforts toward a particular customer segment or niche can provide a powerful competitive advantage, especially if no competitor is directly catering to this niche and is not likely to do so. Such an untapped niche then becomes a strategic window of opportunity.

INFORMATION BOX**THE KEY TO CUSTOMER SATISFACTION: MEETING CUSTOMER EXPECTATIONS**

Southwest consistently earned high ratings for its customer satisfaction, higher than those of its giant competitors. Yet, these major airlines all offered more food service than Southwest's peanuts and drinks. They also provided such additional amenities as advance-seat assignments, in-flight entertainment on longer flights, the opportunity to upgrade, and a comprehensive frequent-flyer program. Yet Southwest got the highest points for customer satisfaction.

Could something else be involved here?

Let's call it *expectations*. If a customer has high expectations, perhaps because of a high price and/or the advertising promising high-quality, luxury accommodations, dependable service, or whatever, then if the product or service does not live up to these expectations, customer satisfaction dives. Turning to the airlines, customers were not disappointed in the service of Southwest because they do not expect luxury; Southwest does not advertise this. They expect no frills, but pleasant and courteous treatment by employees, dependable and safe flights, and the low prices. On the other hand, expectations are higher for the bigger carriers with their higher prices. This is well and good for the first- or business-class service. But for the many who fly coach . . . ?

Do you think there is a point where a low-price/no frills strategy would be detrimental to customer satisfaction? What might it depend on?

Source: This idea of expectations affecting customer satisfaction was suggested by Ed Perkins for Tribune Media Services and reported in "Hotels Must Live Up to Promises," *Cleveland Plain Dealer*, November 1, 1998, p. 11-K.

Kelleher revealed the niche strategy of Southwest: While other airlines set up hub-and-spoke systems in which passengers were shunted to a few major hubs from which they were transferred to other planes going to their destination, "we wound up with a unique market niche: we are the world's only short-haul, high-frequency, low-fare, point-to-point carrier. . . We wound up with a market segment that is peculiarly ours, and everything about the airline has been adapted to serving that market segment in the most efficient and economical way possible."²¹ See the following Information Box for a discussion of the criteria needed for a successful niche or segmentation strategy.

Southwest has been undeviating in its pursuit of its niche. For years, while others tried to copy, none were able to fully duplicate it. For years Southwest

²¹ Jaffe, p. 58.

INFORMATION BOX

CRITERIA FOR SELECTING NICHE OR SEGMENTS

In deciding what specific niches to seek, these criteria should be considered:

1. *Identifiability.* Is the particular niche identifiable so that those persons who constitute it can be isolated and recognized? It was not difficult to identify the short-route travelers, and while their numbers may not have been readily estimated, this was soon to change as demand burgeoned for Southwest's short-haul services.
2. *Size.* The segment must be of sufficient size to be worth the efforts to tap. And again, the size factor proved to be significant: Southwest soon offered 83 flights daily between Dallas and Houston.
3. *Accessibility.* For a niche strategy to be practical, promotional media must be able to reach the segments without much wasted coverage. Southwest had little difficulty in reaching its target market through billboards, newspapers, etc.
4. *Growth potential.* A niche is more attractive if it shows some growth characteristics. The growth potential of short-haul flyers proved to be considerably greater than for airline customers in general. Partly the growth reflected customers won from other higher-cost airlines and airlines with less frequent flights. And some of the emerging growth reflected customers' willingness to give up their cars to take a flight that was almost as economical and certainly more comfortable.
5. *Absence of vulnerability to competition.* Competition, both present and potential, should be considered in making specific niche decisions. By quickly becoming the low-cost operator in its early routes, and gradually expanding without diluting its cost advantage, Southwest became virtually unassailable in its niche. The bigger airlines with their greater overhead and less flexible operations could not match Southwest prices without going deeply into the red. And the more Southwest became entrenched in its markets, the more difficult it was to pry it loose.

But nothing remains forever. Today Southwest's position is less unassailable.

Assume you are to give a lecture to your class on the desirability of a niche strategy, and you cite Southwest as a classic example. But suppose a classmate asks: "If a niche strategy is so great, why didn't the other airlines practice it?" How will you respond?

was the nation's only high-frequency, short-distance, low-fare airline. As an example of its virtually unassailable position, Southwest accounted for more than two-thirds of the passengers flying within Texas, and Texas was the second largest market outside the West Coast. When Southwest invaded California, some San Jose residents drove an hour north to board Southwest's Oakland flights, skipping the local airport where American had a hub. And in Georgia so many people were bypassing Delta's huge hub in Atlanta and driving

150 miles to Birmingham, Alabama to fly Southwest that an entrepreneur started a van service between the two airports.²²

Unlike many firms, Southwest did not permit success to dilute its niche strategy. It did not attempt to fly to Europe or South America, or match the big carriers in offering amenities in coast-to-coast flights—yet! In curbing such temptations, it has not sacrificed growth potential. It still has many U.S. cities to embrace. Despite its price advantage now being countered by low-price competitors and even some major airlines trying to reduce their overheads to better compete with discount carriers on certain routes, Southwest was still the market leader in its niche.

Seek Dedicated Employees

Stimulating employees to move beyond their individual concerns to a higher level of performance, a truly team approach, was by no means the least of Kelleher's accomplishments. Such an esprit de corps enabled planes to be turned around in 15 minutes instead of the hour or more of competitors; it brought a dedication to serving customers far beyond what could ever be expected of a bare-bones, cut-price operation; it brought a contagious excitement to the job obvious to customers and employees alike.

Kelleher's extroverted, zany, and down-home personality certainly helped in cultivating such dedicated employees. So did his legendary ability to remember employee names, his sincere interest in employees, as well as company parties. Flying in the face of conventional wisdom, which says an adversarial relationship between management and labor is inevitable with the presence of a union, Southwest achieved its great teamwork while being 90 percent unionized. It helped, though, that Kelleher started the first profit-sharing plan in the U.S. airline industry in 1974, with employees eventually owning 13 percent of the company stock.

Whether such worker dedication can pass the test of time, and the test of increasing size, is uncertain. Kelleher himself has retired and his two successors have different personalities. Yet here is a model for an organization growing to large size and still maintaining employee commitment. In a previous case (see Chapter 10) we saw how another airline CEO, Gordon Bethune, had a similar leadership style and was able to turn a sick operation around in an amazingly short time.

The attainment of dedicated employees is partly a product of the firm itself, and how it is growing. A rapidly growing firm—especially when such growth starts from humble beginnings, with the firm as an underdog—promotes a contagious excitement. Opportunities and advancements depend on growth. And where employees can acquire stock in the company, and see their shares rising, potential financial rewards seem almost infinite. Success tends to create a momentum that generates continued success.

²² O'Brian, A7.

Beware Compromising a Stellar Reputation

A stellar reputation is built up over years of adhering to best practices, whether these be honest advertising, superb customer service, high ethical and environmental efforts, dependability, or assured safety. For an airline, nothing is more important than safety. Top management's visible commitment must be undeviating, since it is easy for an organization to become complacent with its attention focused more on other problem areas. This suggests that even routine scheduled service checks should reach the desks of high-level executives. Anything that could threaten safety needs to be prioritized. Admittedly, the lack of any accidents can lull an organization, but this must not be allowed to happen.

CONSIDER

Can you identify additional learning insights that could be applicable to other firms in other situations?

QUESTIONS

1. In what ways might airline customers be segmented? Which segments or niches would you consider Southwest's prime targets? Which segments probably would not be?
2. Discuss the pros and cons for expansion of Southwest beyond short hauls. Which arguments do you see as most compelling?
3. Evaluate the effectiveness of Southwest's unions.
4. On August 18, 1993, a fare war erupted. To initiate its new service between Cleveland and Baltimore, Southwest announced a \$49 fare (a sizable reduction from the then standard rate of \$300). Its rivals, Continental and US Air, retaliated. Before long, the price was \$19, not much more than the tank of gas it would then take to drive between the two cities—and the airlines also supplied a free soft drink. Evaluate the implications of such a price war for the three airlines.
5. A price cut is the most easily matched marketing strategy, and usually provides no lasting advantage to any competitor. Identify any circumstances where you see it desirable to initiate a price cut and potential price war.
6. Do you think it likely that Southwest will remain dominant in its niche despite the array of discount carriers? Why or why not?
7. What is your forecast for the competitive environment of the airline industry ten years from now?
8. How would you ensure that no lapses in inspections and maintenance ever occur again? Be as specific as you can. Can you absolutely guarantee no lapses?

HANDS-ON EXERCISES

1. Herb Kelleher has just retired and you are his successor. Unfortunately, your personality is far different from his: you are an introvert and far from flamboyant, and your memory for names is not good. What would be your course of action to try to preserve the great employee dedication of the Kelleher era? How successful do you think you will be? Did the board make a mistake in hiring you?
2. Herb Kelleher has not retired. He is going to continue until 70, or later. Somehow, his appetite for growth has increased as he has grown older. He has charged you with developing plans for expanding into longer hauls, and maybe to South and Central America, and even to Europe. Be as specific as you can in developing such expansion plans.
3. How would you feel personally about a five-hour transcontinental flight with only a few peanuts, and no other food or movies? Would you be willing to pay quite a bit more to have more amenities?

TEAM DEBATE EXERCISE

The Thanksgiving Day nonstop transcontinental experiment went fairly well, although customers and even flight attendants expressed some concern about the long, five-hour flight with no food and no entertainment. No one complained about the price.

Debate the two alternatives of going ahead slowly with the transcontinental plan with no frills, or adding a few amenities, such as some food, reading material, or whatever else might make the flight less tedious. You might even want to debate the third alternative of dropping this idea entirely at this time.

YOUR ASSESSMENT OF THE LATEST DEVELOPMENTS

The so-called Legacy Airlines saw revenues and profits resurging by the end of 2007, to the detriment of Southwest and the other discount carriers. What is your assessment of this situation from Southwest's standpoint? Is this only a short-term phenomenon, or is the discounter model—low fares and rapid, mostly domestic growth—vulnerable long term?

INVITATION TO RESEARCH

What is Southwest's current situation? What is its market share in the airline industry? Is it still maintaining a high growth rate? Has the decision been made to expand the nonstop transcontinental service, and have any changes been made in the no-frills service for this. How about international flights? Have other discount carriers, such as JetBlue, made any sizable inroads in Southwest's niche?

Nike: A Powerhouse

By the late 1970s and early 1980s, Nike had wrested first place in the athletic shoe industry from Adidas, the firm that had been supreme since the 1936 Olympics when Jesse Owens wearing Adidas shoes won his medals in front of Hitler, Germany, and the world.

In the early 1980s, Reebok emerged as Nike's major competitor, becoming No.1 in this industry by 1987. But Nike fought back, and three years later had regained the top-dog position. By the latter 1990s and into the new millennium, Nike decisively pulled away in revenues and profitability. By 2008, its revenues reached \$16 billion a year, and no else could touch this largest sports footwear and apparel company in the world.

But let us start 20 years ago when Nike had some tough competition, and see if we can determine how it so outdistanced its nearest rival, Reebok.

REEBOK

History

The ancestor to Reebok goes back to the 1890s when Joseph William Foster made himself the first known running shoes with spikes. By 1895, he was hand-making shoes for top runners. Soon, the fledgling company, J. W. Foster & Sons, was furnishing shoes for distinguished athletes around the world.

In 1958 two of the founder's grandsons started a companion company, which they named—fittingly they thought—after an African gazelle: Reebok. This company eventually absorbed J. W. Foster and Sons.

In 1979 Paul Fireman, a partner in an outdoor sporting goods distributorship, saw Reebok shoes at an international trade show. He negotiated for the North American distribution license and introduced three running shoes in the United States that year. It was the height of the running boom. These Reeboks were the most expensive running shoes on the market at the time, retailing for \$60. But no matter, demand burgeoned, outpacing the plant's capacity, and production facilities were established in Korea.

In 1981 sales were \$1.5 million. But a breakthrough came the next year. Reebok introduced the first athletic shoe designed especially for women. It was a shoe for

aerobic dance exercise and was called the Freestyle. Whether accidentally or with brilliant foresight, Reebok anticipated three major trends that were to transform the athletic footwear industry: (1) the aerobic exercise movement, (2) the great embracing of women with sports and exercise, and (3) the transference of athletic footwear to street and casual wear. Sales exploded from \$13 million in 1983 to \$307 million in 1985.

Shifting Competitive Picture for Reebok

In 1987 Reebok's share of the U.S. athletic footwear market surpassed archrival Nike's as it racked up sales of \$1.4 billion against Nike's plateauing sales of \$900 million. Somehow, Reebok's sales growth then slowed, and in 1990 Nike overtook it, with \$2.25 billion in sales to Reebok's \$2.16 billion. The margin widened as Reebok began to lose ground, not sporadically but steadily. Its meteoric sales increases of a few years before were no more, and stock market valuations and investor enthusiasm reflected this decline in fortunes.

Part of the shift in competitive position could be attributed to Nike's savvy advertising and to its two well-paid athlete endorsers: Michael Jordan and Pete Sampras. But perhaps Reebok could blame itself more for the change in its fortunes. Certainly as the 1990s moved toward mid-decade, the flaws of Reebok were becoming more obvious and self-destructing.

Paul Fireman had purchased Reebok in 1984 and led it to more than a ten-fold increase in sales in only five years. But with such growth, directors felt they needed an executive with experience running a big operation. Fireman, who owned 20 percent of the company's stock, didn't object. He maintained that he was glad to give up day-to-day responsibilities. While retaining the titles of chairman and CEO, he turned his attentions to private pursuits, including building a golf course on Cape Cod.

The new management proved inept. Amid mediocre performance, Reebok went through three different top executives in the next five years. Nothing seemed to stem the tide, and Reebok continued losing ground to Nike. Finally, in August 1992, Fireman again took active charge and he wasted little time bringing in a new management team. At the same time, he introduced aggressive plans for the company to regain its competitive position.

Aggressive Thrusts of Reebok

Fireman first attacked Nike in the basketball arena. Nike's share of basketball shoes was almost 50 percent, against Reebok's 15 percent. But about this time, Michael Jordan retired from basketball to try baseball. "Nike's success has become their albatross," Fireman exulted. "Jordan is no longer on the radar screen."¹ He signed up Shaquille O'Neal, "the next enduring superstar," and planned to destroy the market dominance of Nike.

¹ Geoffrey Smith, "Can Reebok Regain Its Balance?" *Business Week*, December 20, 1993, p. 109.

The pressure was stepped up on Nike at the NBA All-Star game in February 1994, when Reebok launched a national ad campaign for its Instapump. This was a sneaker that had no laces, but instead was inflated with CO₂ to fit the foot. It was pricey, retailing for \$130, but seemed on the cutting edge. Fireman expected this innovation to account for 10 percent of all Reebok's sales in three years.

Reebok also attacked another Nike stronghold—the \$250 million market for cleated shoes, of which Nike had 80 percent. In January 1993 Reebok introduced a new line of cleated shoes aimed at high-school athletes. Fireman predicted that these sales should triple by 1994 to \$45 million. In 1994 he also aimed an offensive into the outdoor hiking and mountaineering market, with 12 new shoes that he predicted would produce \$100 million in new sales.

During the years Fireman was not at the helm, Reebok had tried a number of advertising slogans, such as “UBU” and “Physics Behind Physique.” None of them were notably effective compared to the Nike “Just Do It” theme. Fireman now approved a new unifying theme for all ads, “Planet Reebok.”

Fireman also did an about-face with his endorsement promotions. Despite Nike's heavy use of endorsements in its advertising, Reebok always had been reluctant to do much, thinking the huge sums celebrity athletes demanded were unreasonable. Suddenly Fireman signed O'Neal in 1992 for \$3 million, and then went on to sign endorsement deals with some 400 football, baseball, and soccer stars. The brand logo was also changed to an inverted “V” with a slash through it that he hoped consumers would identify with high performance. “We'll be the market leader by the end of 1995,” Fireman predicted.²

Consequences

Unfortunately, the aggressive efforts of Fireman to rejuvenate the company and win back market leadership continued to sputter. Some flaws were coming to light. For example, with Shaquille O'Neal, the Shaq Attaq shoe seemed a sure thing for teens. But it bombed. The problems: the shoes were white with light blue trim, and they cost \$130. But now black shoes were the hot look, and how many teens could afford \$130? In the first six months of 1993, sales of Reebok basketball shoes fell 20 percent, despite Shaq's influence.

By 1995, operating costs were surging, up to 32.7 percent of sales compared with 24.4 percent in 1991. They also exceeded the industry average of 27 percent. Reebok admitted that the increased costs were partly due to its aggressive pursuit of endorsement contracts with athletes as well as sporting-event sponsorships. For example, the company had signed up 3,000 athletes to wear Reebok shoes and apparel at the 1996 Olympics in Atlanta, up from 400 four years before. It had also bought endorsements from the San Francisco 49ers and other NFL teams, as well as basketball star Rebecca Lobo, to wear its products.

Some of the prior endorsements had not worked out well: Tennis pro Michael Chang had a \$15 million endorsement contract, but Sampras and Agassi, both Nike

² *Ibid.*, p. 108.

endorsers, had eclipsed Chang. Shaquille O'Neal became unhappy with his \$3 million Reebok contract and began looking around for bigger money.

Reebok's costs also were increased by expenditures to fix distribution snags and to open a new facility in Memphis.

Other Reebok problems stemmed from management turmoil, including the departures and resignations of top executives. Some shareholders questioned whether Fireman was too difficult a boss: "How do you attract first-rate talent when there's been a history of turnover at the top?"³

Adding to Reebok's difficulties were price-fixing charges brought by the Federal Trade Commission. The government contended that Reebok had told retailers their supplies would be cut off if they discounted Reebok shoes too much. In May 1995, Reebok agreed to pay \$9.5 million to settle the price-fixing charges, saying that while no evidence of wrongdoing was established, still it settled to avoid costly litigation.

But the more serious Reebok problem was in its relations with the major retailer player in the athletic footwear industry—Foot Locker.

The Struggle to Win Foot Locker

By 1995, Woolworth's Foot Locker, a chain of some 2,800 stores, had become the biggest seller of athletic footwear. It and related Woolworth units accounted for \$1.5 billion of the \$6.5 billion U.S. sales, this being some 23 percent. Nike had a winning relationship with this behemoth customer. In 1993 Nike's sales in Foot Lockers were \$300 million, while Reebok was slightly behind, with \$228 million. Two years later, Nike's Foot Locker sales had risen to \$750 million, while Reebok's dropped to \$122 million.⁴

The decline of Reebok's fortunes with Foot Locker can be attributed to poor handling by top management of this important relationship. Fireman seemed to resent the demands of Foot Locker almost from the beginning. For example, in the 1980s when Reebok's aerobics shoes were facing robust demand, Foot Locker wanted exclusivity, that is, special styles only for itself. The retailer saw exclusivity as one of its major weapons against discounters and was getting such protection from other manufacturers—but not from Reebok, which persisted in selling its shoes to anybody, including discounters, near Foot Locker stores.

In contrast, Nike had been working with Foot Locker for some years and by 1995 had a dozen items sold only by the chain, including Flights 65 and 67, high-priced basketball shoes. While Fireman began belatedly trying to fix the relationship, little had apparently been accomplished by the end of 1995.⁵

Adding to Reebok's troubles in cracking this major chain, Foot Locker's customers were mainly teens and Generation-X customers willing to pay \$80 to \$90 for

³ Joseph Pereira, "In Reebok-Nike War, Big Woolworth Chain Is a Major Battlefield," *Wall Street Journal*, September 22, 1995, p. A6.

⁴ *Ibid.*, p. A1.

⁵ *Ibid.*, p. 6A.

INFORMATION BOX**IMPORTANCE OF MAJOR ACCOUNT MANAGEMENT**

Recognizing the importance of major customers has come belatedly to some sellers, probably none more belatedly than Reebok. These very large customers often represent a major part of a firm's total sales volume, and satisfying them in an increasingly competitive environment requires special treatment. Major account management should be geared to developing long-term relationships. Service becomes increasingly important in cementing such relations (as we saw in Chapter 14, the Newell Rubbermaid case). To this end, understanding and catering to customer needs and wants is a must. If this means giving such important customers exclusivity, and making them the absolute first to see new goods and samples, this ought to be done unhesitatingly.

Such account management has resulted in changes in many organizations. Separate sales forces are often developed, such as "account managers" who devote all their time to one or a few major customers, while the rest of the sales force calls on smaller customers in the normal fashion. For a customer the size of Foot Locker, senior executives, even company presidents, need to become part of the relationship.

Given that you think the demands of a major retailer are completely unreasonable, what would you do if you were Mr. Fireman: give in completely, hold to your principles, negotiate, or what?

shoes. But Reebok had given up that high-end niche with most of its products. Reebok's primary customer base had become older people and pre-teens unwilling or unable to pay the high prices.

Aggravating the poor relationship with Foot Locker was Reebok's carelessness in providing samples on time to Foot Locker buyers. Because of the chain's size, buying decisions had to be made early in the season. Late-arriving samples, or no samples, virtually guaranteed that such new items would not be purchased in any appreciable quantity. See the preceding Information Box for a discussion of the importance of major customers.

NIKE**History**

Phil Knight was a miler of modest accomplishments. His best time was a 4:13, hardly in the same class as the below-4:00 world-class runners. But he had trained under the renowned coach Bill Bowerman at the University of Oregon in the late 1950s. Bowerman had put Eugene, Oregon on the map when year after year he turned out world-record-setting long-distance runners. Bowerman was constantly experimenting with shoes: He had a theory that an ounce off a running shoe might make enough difference to win a race.

In the process of completing his MBA at Stanford University, Knight wrote a research paper based on the theory that the Japanese could do for athletic shoes what they were doing for cameras. After receiving his degree in 1960, Knight went to Japan to seek an American distributorship from the Onitsuka Company for Tiger shoes. Returning home, he took samples of the shoes to Bowerman.

In 1964 Knight and Bowerman started their own business. They each put up \$500 and formed the Blue Ribbon Shoe Company, sole distributor in the United States for Tiger running shoes. They put the inventory in Knight's father-in-law's basement, and they sold \$8,000 worth of these imported shoes that first year. Knight worked by days as a Cooper & Lybrand accountant, while at night and on weekends he peddled these shoes mostly to high-school athletic teams.

Knight and Bowerman finally developed their own shoe in 1972 and decided to manufacture it themselves. They contracted the work out to Asian factories where labor was cheap. They named the shoe Nike after the Greek goddess of victory. At that time they also introduced the "swoosh" logo, which was highly distinctive and subsequently was placed on every Nike product. The Nike shoe's first appearance in competition came during the 1972 Olympic trials in Eugene, Oregon. Marathon runners persuaded to wear the new shoes placed fourth through seventh, whereas Adidas wearers finished first, second, and third in the trials.

On a Sunday morning in 1975, Bowerman began tinkering with a waffle iron and some urethane rubber, and he fashioned a new type of sole, a "waffle" sole whose tiny rubber studs made it springier than those of other shoes currently on the market. This product improvement—seemingly so simple—gave Knight and Bowerman an initial impetus, helping to bring 1976 sales to \$14 million, up from \$8.3 million the year before, and from only \$2 million in 1972.

Now Nike was off and running. It was to stay in the forefront of the industry with its careful research and development of new models. By the end of the decade Nike was employing almost one hundred people in the research and development section of the company. Over 140 different shoe models were offered, many of these the most innovative and technologically advanced on the market. Such diversity came from models designed for different foot types, body weights, sexes, running speeds, training schedules, and skill levels. By 1981, Nike led all athletic shoemakers with approximately 50 percent of the total market. Adidas, the decades-long market leader, saw its share of the market fall well below that of Nike.

Nike Goes Public

In 1980 Nike went public, and Knight became an instant multimillionaire, reaching the coveted Forbes Richest Four Hundred Americans with a net worth estimated at just under \$300 million.⁶ Bowerman, at age 70, had sold most of his stock earlier and owned only 2 percent of the company, worth a mere \$9.5 million.

⁶ "The Richest People in America—The Forbes Four Hundred," *Forbes*, Fall 1983, p. 104.

In the January 4, 1982 edition of *Forbes* in the “Annual Report on American Industry,” Nike was rated number one in profitability over the previous 5 years, ahead of all other firms in all other industries.⁷

But by the latter 1980s, Reebok had emerged as Nike’s greatest competitor, and threatened its dynasty. A good part of the reason for this was Nike’s underestimation of an opportunity. Consequently, it was late into the fast-growing market for shoes worn for the aerobic classes that were sweeping the country, fueled by best-selling books by Jane Fonda and others. Reebok was there with the first athletic shoe designed especially for women: a shoe for aerobic dance exercise.

Figure 19.1 shows the sales growth of Reebok and Nike from their beginnings to 1995. Of particular note is the great growth of Reebok in the mid-80s; in only a few years it had surpassed Nike, which was at a plateau as it missed the new fitness opportunity. Then as can graphically be seen, Reebok began slowing down—a slowdown it was unable to turn around through the mid-1990s, while Nike again surged. Table 19.1 shows net income comparisons. Both firms had somewhat erratic incomes, but the early income growth promise of Reebok relative to Nike, as with sales, could not be sustained. This is confirmed with later revenue and income figures from 1995 to 1998, shown in Table 19.2.

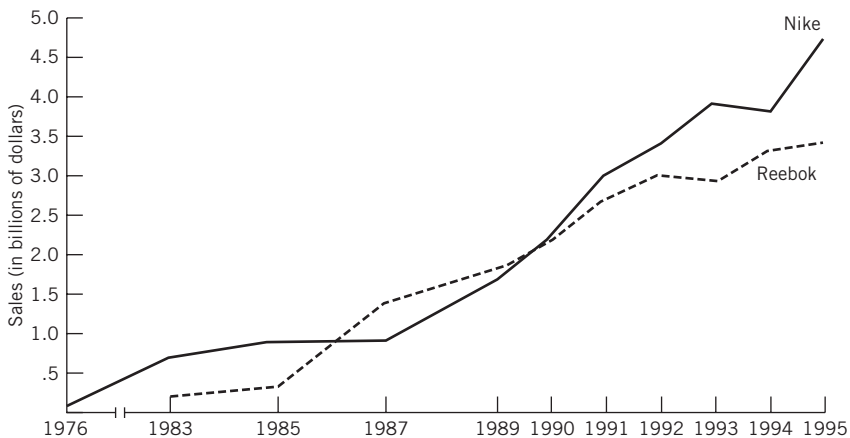


Figure 19.1 Sneaker Wars: Sales. Nike and Reebok 1976–1995 (billions of dollars).

Source: Company annual reports.

Commentary: Here we can graphically see the charge of Reebok in the later 1980s that for a few years surpassed Nike but then faltered by 1990 as Nike surged even farther ahead.

⁷ *Forbes*, January 4, 1982, p. 246.

TABLE 19.1 Sneaker Wars: Net Income Comparisons, Nike and Reebok 1985–1994 (billions of dollars)

	Nike	Reebok
1985	\$ 10.3	\$ 39.0
1986	59.2	132.1
1987	35.9	165.2
1988	101.7	137.0
1989	167.0	175.0
1990	243.0	176.6
1991	287.0	234.7
1992	329.2	114.8
1993	365.0	223.4
1994	298.8	254.5

Source: Company annual reports.

Commentary: Note how much more profitable Reebok was than Nike in the late 1980s. In one year, 1987, it was almost five times more profitable. But then in 1990 the tide swung strongly in Nike's favor. Note also that Nike's profitability was far steadier than Reebok's during this period.

TABLE 19.2 Nike versus Reebok Comparative Operating Statistics, 1995–1998

	Nike	Reebok	Nike % of Total
Revenues (million \$):			
1995	\$4,761	\$3,481	57.8%
1996	6,471	3,478	65.0
1997	9,187	3,644	71.6
1998	9,553	3,225	74.8
Net Income (million \$)			
1995	400	165	70.8
1996	553	139	79.9
1997	796	135	85.5
1998	400	24	82.2

Source: Calculated from company reports.

Commentary: In this comparative analysis, the further widening of the gap between Nike and Reebok is clearly evident. In revenues, Nike's market share against Reebok has grown from 57.8 percent to 74.8 percent in these four years—a truly awesome increase in market dominance. In net income, Nike's comparative performance is even more impressive, despite the poor 1998 profit performance partly due to poor economic conditions in the Asian markets. Nike's profits were down, but not nearly as much as Reebok's.

Nike's Rejuvenation

The recharge of Nike, after letting its guard down to the wildly charging Reebok, is a significant success story. Usually, when a front runner loses momentum, the trend is difficult to reverse. But Phil Knight and Nike were not to be denied.

Still, in 1993, Nike did not look like a winner, even though it had wrested market dominance from Reebok. From the high 80s in February of that year, share prices plummeted to the mid-50s. The reason? Nike's sales were up only 15 percent and earnings just 11 percent, nothing outstanding for a once-hot stock. So Wall Street began questioning: How many pairs of sneakers does the world need? (Critics had assailed McDonald's under the same rationale: How many hamburgers can the world eat?) Knight's response was that the Nike mystique could sell other kinds of goods: outdoor footwear, from sandals to hiking boots; apparel lines, such as uniforms, for top-ranked college football and basketball teams—from pants and jerseys to warm-up jackets and practice gear; even golf clothing and equipment. And these same products would be eagerly sought by the general public.

The greatest boost to the image of Nike in the years around the millennium was Tiger Woods. Phil Knight had given him a \$40 million contract in 1996, just after he won his third straight U.S. Amateur championship, and was about to turn pro. The next year Tiger won the prestigious Masters Golf Tournament by the biggest margin ever achieved, in the most watched golf finale in the history of television. In the golf tournaments, while wearing the conspicuous swoosh, Tiger focused attention on Nike as not even Michael Jordan had been able to do.

Could it be that an athletic shoe company could still face a growth industry? Apparently so, through wise diversifications within the larger athletic goods industry. See the following Issue Box for a discussion of how a business should define itself.

In his quest to remain the dominant player, Knight recalled what he learned from his old coach and Nike cofounder, Bill Bowerman: "Play by the rules, but be ferocious."⁸

But Knight and Nike were not ferocious to their customers. They pampered them, as we have seen in the relations with Foot Locker. And by the end of 1995, Nike's sales lead over Reebok was 38 percent. By 1999 it was 213 percent.

Handling Adversity

In the summer of 1996, Nike as well as many other U.S. manufacturers came under fire for farming production out to "sweatshops" in poor countries of the world in order to reduce manufacturing costs. Nike became the major target for critics of these "abuses."

Then in April 1997 came another blow to Nike's image. Thirty-nine members of the Heaven's Gate cult committed suicide, all wearing Nikes with the swoosh logo readily visible. The "Just Do It" slogan of Nike was trumpeted as being entirely apt, and some even spoofed that Nike's slogan should be changed to "Just Did It."

Environmental factors, by no means unique to Nike, also tormented the firm. Demand in Asia was drastically reduced due to deep recession there. Another

⁸ Fleming Meeks, "Be Ferocious," *Forbes*, August 2, 1993, p. 41.

ISSUE BOX

HOW SHOULD WE DEFINE OUR BUSINESS?

Nike had developed its business horizons through the following sequence:

running shoes → athletic shoes → athletic clothing → athletic goods

In so doing, it greatly expanded its growth potential. This idea of expanding the perception of one's business was first put down on paper by Theodore Levitt in a seminal article, "Marketing Myopia" in the *Harvard Business Review* in July–August 1960. Levitt suggested that it was shortsighted for railroads to consider themselves only in the railroad business, and not in the much larger transportation business. Similarly, petroleum companies should consider themselves in the energy business, and plan their strategies accordingly.

Can such expansion of a firm's business definition go too far? Even in Levitt's day, could a railroad really have the expertise to run an airline? Looking to Nike today, and its expanding views of tapping into the athletic goods market, do you think football equipment is a viable expansion opportunity? Fishing tackle?

troubling portent was the public's growing disenchantment with athletes. Fan interest seemed to be dropping, perhaps reflecting a growing tide of resentment at overpriced athletes proving to be selfish, arrogant, and decadent—the very role-models that Nike, Reebok, and other firms spent millions to enlist.

Knight had to wonder at another disturbing possibility: Had Nike grown too big? Was its logo, the swoosh, too pervasive, to the point that it turned some people off? Was even the tag line, "Just Do It," becoming counterproductive?

Concerned about such questions, Nike began reassessing. A new advertising campaign had the softer tag line, "I can." Nike began toning down its use of the swoosh, removing it from corporate letterheads and most advertising, and replacing it with a lowercase "nike."

Later Developments

At the beginning of the new millennium, Nike's dominant position continued to strengthen. Changing fashion trends, new products, cost cutting, and an Asian revival aided Nike. It found that with the public's growing disenchantment with many athlete endorsers it could shave its marketing budget by \$100 million. Furthermore, prospects for 2000 were optimistic. Sales of athletic gear peak in Olympic years, and the expectations were reasonable that the summer games in Sydney, Australia would stimulate a big buying spree in merchandise where Nike had a 35 percent market share.⁹

⁹ Leigh Gallagher, "Rebound," *Forbes*, May 3, 1999, p. 60.

Reebok turned out to benefit most from the Olympics; its shoes were seen on 2,500 pairs of feet. It had also scored a coup in sponsoring the CBS hit, *Survivor*. But after years of missteps, its market share was just 12 percent, although Paul Fireman was predicting this would rise to 25 percent within the next six years. The company was pursuing a smarter distribution strategy with less emphasis on discount chains and more on courting mall retailers, such as Foot Locker, for whom Fireman was now giving some exclusive rights. Reebok also was trying to win back teenage boys—who were spurning its conservative, even frumpy shoes—with new colorful designs endorsed by professional basketball player Allen Iverson, its latest endorser.

Nike continued to push its apparel lines that in 2001 accounted for about a third of the total \$9 billion of sales, with particular attention given to women's wear. It opened NikeTown stores where shoppers could see the full range of products displayed in a hands-on environment. But it was also trying to boost its exposure in department stores, which were notorious for driving hard bargains.

See Table 19.3 for operating results of Nike and Reebok at the turn of the century. You can see from these statistics that Nike's dominance was increasing. Despite Reebok's improved showing in 2001, it still lagged far behind.

On November 19, 2004, Philip Knight, 69, retired from day-to-day management of his company, although he would remain chairman of the board. The announcement was not unexpected as he had two co-presidents who were seen as possible successors. But he went outside the company to choose William Perez, the chief executive of family-controlled S.C. Johnson & Son, a consumer-products company, with such brands as Drano, Windex, and Glade air fresheners—rather tame these compared to the big athlete endorsers. But Mr. Perez was a marathoner and a buyer of Nike shoes for 27 years, and had “vast international experience that will help Nike expand further into markets abroad.” Knight explained this choice

TABLE 19.3 Nike versus Reebok Comparative Operating Statistics, 1999–2001

	Nike	Reebok	Nike % of Total
Revenues (million \$):			
1999	\$8,995	\$2,872	75.8%
2000	9,449	2,865	76.7
2001	9,893	2,993	76.8
Net Income (million \$)			
1999	579	11	98.1
2000	590	81	87.9
2001	663	103	86.6

Source: Calculated from company reports.

Commentary: In this latest comparative analysis, Nike dominance has grown well beyond that during 1995–1998 (see Table 19.2). In revenues, Nike's market share against Reebok averaged 76.4 percent in those three years, while Nike has over 90 percent of the combined profitability of the two firms.

of an outsider as preserving the leadership balance at the company rather than upsetting it by elevating one of the company's executives.

Phil Knight had tried to step back from active participation in daily operations in the late 1990s, but sales slipped and he eventually took back the helm. The management transition now came at a time when performance was stronger than ever. Total sales in the previous year had climbed to \$12 billion and orders for the current year were up 9.9 percent.¹⁰

Nike now was closely monitoring its outsourcing after bad publicity of worker abuses had subjected it to strong criticisms. In November 2006 it cut ties with one of its biggest suppliers of soccer goods after finding multiple labor, environmental, and health violations by a Pakistan-based manufacturer. Nike warned its retailers that they could expect a shortage of hand-stitched soccer balls until new suppliers could be found.¹¹

Update, 2007–2008

A year after bringing Perez on board, Knight axed him. Somehow he didn't fit in with the company culture. The cost of this exercise was at least \$15 million in pay and severance benefits. Mark Parker, 52, a loyal 29-year veteran, became the new CEO, and he made some significant changes once he was in the leadership position. The biggest change was reorganizing the company. It had been divided by categories of products, such as shoes, apparel, golf clubs. Parker now divided it by sport, with a division for soccer (shoes and apparel combined), a division for running, one for basketball, one for men's fitness, another for women's fitness, and the like. Dreamer athletes, those people who want to dress as if they were athletes, were given their own division, called Sports Culture.

The term *micromarketing* was used to describe Nike's new emphasis. This would be a world away from *mass marketing* where a sneaker was just a sneaker, with little differentiation from other sneakers. In a micromarket a sneaker was something with a special feature such as a seemingly unique air cushion, or even a microchip inside the shoe that communicated with an iPod to track mileage. The mass market sneaker might sell for \$30, while the latter sneakers might be closer to \$200. The result of this micromarket approach and the various divisions by sports brought an unbelievably diverse product line, some 13,000 different sneaker and apparel styles. For example, "there is one shoe aimed only at Native American athletes, another for cricket players in India, yet another for folks who play lacrosse." With such a huge selection, one would think that marketing and manufacturing efficiency would be compromised. Yet for the fiscal year ending May 2008, Nike would be a \$16 billion company in revenues, with \$1.6 billion net income.¹²

¹⁰ Stephanie Kang and Joann S. Lublin, "Nike Taps Perez of S.C. Johnson to Follow Knight," *Wall Street Journal*, November 19, 2004, pp. A3 and A6.

¹¹ Stephanie Kang, "Nike Cuts Ties with Pakistani Firm," *Wall Street Journal*, November 21, 2006, p. B5.

¹² Monte Burke, "On the Run," *Forbes*, February 11, 2008, pp. 82–87.

ANALYSIS

The case shows the whipsawing of the two major competitors in what was once merely the athletic shoe industry, an industry now expanded far beyond its original focus. In its youth, Nike had outgunned the old entrenched Adidas, only to find Reebok surpassing it in the mid-1980s as it failed to recognize quickly enough a new opportunity. But Nike came back stronger than ever after a brief hiccup, capitalizing on the mistakes of Reebok with its own aggressiveness.

The most controllable factor in the divergent success patterns of these competitors had to be customer relations. Nike catered to its customers, especially the large dealers such as Foot Locker, while Reebok was surprisingly nonchalant and even arrogant in such relationships. A maker of even high-demand goods is myopic if it is arbitrary and dictatorial toward dealers. This relationship should be *symbiotic*, with both parties benefiting from it and spurning any temptation to capitalize on a perceived king-of-the-hill position. The caprice of fashions and fads should quickly destroy any smugness, as was the case with the Shaq Attaq shoes and the expensive endorsements of Shaquille and others.

In other aspects of its comeback, Nike may have lucked out. Its choice of athletes to endorse were some who became dominant figures in their sport, ones lionized by fans. The advertising theme of Nike also caught on: “Just do it,” had great appeal to youth. But such home runs can never be guaranteed.

The success and visibility of Nike and its products brought with it critical public scrutiny. Was Nike—and other U.S. manufacturers as well—guilty of violations of accepted moral and ethical standards in farming out production to foreign subcontractors in Third World countries using child labor at low wages? Critics condemned this as exploitation to maximize profits. But others pointed out that while long hours in a smelly shoe or garment factory may be less than idyllic, it was superior to subsistence farming or laboring in even harsher workplaces.

Could Reebok or some other firm arise to challenge Nike? That seems less likely today, with Nike’s revenues four times greater than Reebok’s, and net income six times greater. Still, the gap could be closed with a striking new product innovation—or if Nike becomes complacent. Remember the 3 C’s of Boeing in Chapter 7, when it opened the gates for AirBus. And, dare we forget, Nike vanquished the dominant Adidas in its early days.

Invitation to Make Your Own Analysis and Critique

Your analysis, please, of CEO Parker’s count of different sneaker and apparel styles at 13,000.

WHAT WE CAN LEARN

No One Is Immune from Mistakes; Success Does Not Guarantee Continued Success

Some executives delude themselves into thinking success begets continued success. It is not so! No firm, market leader or otherwise, can afford to rest on its laurels, to disregard a changing environment and aggressive but smaller competitors. Adidas had as commanding a lead in its industry as IBM once had in computers. But it was overtaken and surpassed by Nike, a rank newcomer, and a domestic firm with few resources in an era when foreign brands (of beer, watches, cars) had a mystique and attraction for affluent Americans that few domestic brands could achieve. But Adidas let down its guard at a critical point. Similarly, but to much lesser degree, Nike then lagged against Reebok as it underestimated or was unaware of the growing interest among women in aerobic dancing and other physical activities.

Don't Underestimate the Importance of Catering to Major Customers

A firm should seek to satisfy all its customers, but for the larger ones, the major accounts, the need to satisfy their needs and wants is absolutely vital. In few cases is the stark contrast between effective and ineffective dealings with larger customers more obvious than between Nike and Reebok in their relations with the huge Foot Locker retail chain. Even though a manufacturer may resent the demands of a powerful retailer, the alternative is either meeting them or losing part or all of the business to someone else. However, a better course of action is to work closely with the large customer in a spirit of cooperation and mutual interest, not in an adversarial power struggle. The idea of a *symbiotic* relationship should permeate the dealings, making a good relationship a plus for both parties.

Consider the Power of Public Image

Granted that technological differences in running shoes have narrowed so that any tangible advantage of a brand is practically imperceptible, what makes Nike stand out? Isn't it the image and the Nike swoosh that identifies the brand? See the following Information Box for a discussion of the "swoosh."

Items like running shoes, athletic equipment, and apparel have high visibility. For many youth, the sight of famous and admired athletes actively using the brand is an irresistible lure, feeding the desire to emulate them even if only through wearing the same brand . . . and maybe dreaming a little. The popularity of a brand becomes a further attraction: being cool, belonging to the in-group.

Is Nike's success in building its image transferable to other firms whose products cannot be identified with use by the famous? Do such firms have any possibilities for developing image-enhancing qualities for their brands? They certainly do.

INFORMATION BOX**THE NIKE “SWOOSH” LOGO**

The Nike “swoosh” is one of the world’s best-recognized logos. In the very early days of Nike, a local design student at Portland State University was paid \$35 for creating it. The curvy, speedy-looking blur turned out to be highly distinctive and has from then on been placed on all Nike products. Phil Knight even has the swoosh logo tattooed on his left calf. Because it has become so familiar, Nike no longer adds the name Nike to the logo. (Tiger Woods wears a cap and other clothing with the swoosh well visible.)

The power of such a well-known logo makes Nike’s sponsorship of famous athletes unusually effective as they wear shoes and apparel displaying it in their sports exploits.

In your judgment, do you think Nike could have achieved its present success without this unique but simple logo? What do you think of the Reebok logo?

Consider the long-advertised lonesome Maytag repairman. Maytag had been highly successful in building a reputation, an image, for dependability and assured quality. In so doing it was able to sustain a higher price advantage over its competitors. A carefully nurtured image of good quality, dependability, reliable service, and being in the forefront of technology or fashion can bring a firm great success in its particular industry.

Is There a Point of Diminishing Returns with Celebrity Endorsements?

One would think there would be, eventually. Athlete celebrities demand big bucks. Are their endorsements worth the price? Perhaps only in moderation, and only with the best of the best. But one cannot always predict with certainty the future exploits of any athlete, even a Michael Jordan or Tiger Woods. Yet contracts are binding. While some would criticize Nike for too much emphasis on celebrity advertising, the right role models can pay dividends. But the overkill of Reebok in seeking celebrity endorsements led to burgeoning costs and a mediocre payoff in sales. The message seems clear: Overuse of celebrity endorsements can be a financial drain. Added to this is the always-present risk that the athlete celebrity in contact sports may have a career-ending injury, or be guilty of some nefarious activity that destroys his or her image.

Is a Great Executive the Key?

Was the rejuvenation of Nike and the decline of Reebok due mostly to the talents of a Phil Knight versus a Paul Fireman? Does the success of an enterprise depend almost entirely on the ability of its leader? Such questions have long baffled experts.

Several aspects of this issue are worth noting. The incompetent is usually clearly evident and identifiable. The great business leader may also be, but

perhaps he or she simply lucked out. In most situations, competing executives are reasonably similar in competence. They have vision, the support of their organizations, and reasonable judgment and prudence. What then makes the difference? A good assessment of opportunities, an advertising slogan that really hits, a hunch of competitor vulnerability? Yes. But how much is due just to a fortuitous call, a gamble that paid off?

We know that Phil Knight had a history of great successes. After all, he beat Adidas, and brought Nike from nowhere to the premier athletic apparel firm in the world. Add to this his handling of a great challenge by moving Nike, for a second time, into the heady air of market leader. Was his ability as a top executive so much greater than that of Fireman? Would his absence have destroyed the promise of Nike?

Perhaps the basic question is: Can one person make a difference? Does that person have to be infallible? But Phil Knight was not infallible. He had a major perceptual lapse in the mid-1980s. But Fireman's lapses were more serious.

In the final analysis, Knight made a great difference for Nike. Certainly we can identify other leaders who made great differences: Sam Walton of Wal-Mart, Herb Kelleher of Southwest Airlines, Lee Iacocca of Chrysler, Ray Kroc of McDonald's come readily to mind. Sometimes, one person can make a major difference, but they can still make bad decisions, misjudgments. Perhaps their success was in having a higher percentage of good decisions and, yes, having a little luck on their side. Since Knight stepped down in 2004, Nike has had two new CEOs, one from outside the firm and the other a 29-year Nike veteran. The outside CEO lasted a year, but maybe Knight became prejudiced against him. The insider, Parker, seems to be doing very well. Now we have a chance to see whether Knight left an enduring legacy, chose his successor wisely, or is himself irreplaceable.

CONSIDER

Can you think of additional learning insights?

QUESTIONS

1. "The success of Nike was strictly fortuitous and had little to do with great decision making." Evaluate this statement.
2. In recent years Nike has moved strongly to develop markets for running shoes in the Far East, particularly in China. Discuss how Nike might go about stimulating such underdeveloped markets.
3. How could anyone criticize Fireman for signing up Shaquille O'Neal to a lucrative endorsement contract? Discuss.
4. Do you think the swoosh logo has become too widespread, that it is turning off many people?
5. Given that all decision makers will sometimes make bad calls, how might the batting averages of correct decisions be improved? Can they really be improved?

6. Do you think the athletic goods industry has limited potential? Or is it still a growth industry? Your opinions, and rationale, please.
7. Is there a danger in catering too much to major customers? Discuss.
8. What do you think of the inverted V slash logo of Reebok? How would you evaluate it against Nike's swoosh?
9. Critics have condemned Nike's targeting ghetto youth with its expensive celebrity shoes. What is your opinion about this? Unethical? Shrewd marketing? A tempest in a teapot?

HANDS-ON EXERCISES

1. Philip Knight is concerned about the criticisms of labor abuses in some of his Asian contractors. He fears that Congress will enact punitive and restrictive legislation. He charges you with getting to the heart of the problem, and proposing remedies. This will have to be done quickly since Knight has been ordered to appear before a Congressional committee in another month. Describe how you would proceed. At stake may be a promotion to vice president.
2. It is 1985, and you are a staff assistant to CEO Fireman of Reebok. Reebok's production of shoes can hardly meet the burgeoning demand. The future seems unlimited. However, you sense a danger on the horizon, and that is not paying sufficient attention to your major customers, particularly Foot Locker. Design a program for Reebok to build stronger relations with its major customers. Develop a persuasive presentation to sell this to Fireman, and be prepared to answer his objections.
3. Be a Devil's Advocate (one who argues an opposing viewpoint to test the decision). Array all the rationale you can for *not* deemphasizing the swoosh. Be persuasive.

TEAM DEBATE EXERCISE

Debate the issue of endorsements for athletes. How much is too much? Where do we draw the line? Should we go only for the few famous? Or should we gamble on lesser-knowns eventually making it big and offer them long-term contracts? Argue the two sides of the issue: aggressive and conservative.

INVITATION TO RESEARCH

Is Nike still in a vigorous growth mode? Have any weaknesses become apparent? Is Nike still committed to an extravagantly diverse product line? Is Mark Parker still the CEO? What is Philip Knight doing? Are any "sleeper" competitors emerging, such as a newly energized Adidas? What new big names have signed endorsement contracts with Nike? Have there been any new problems with Nike's outsourcing? How are the NikeTown retail stores doing?

Vanguard: Is Advertising Really Needed?

By the turn of the century, Vanguard Group had become the largest mutual fund family in the world, besting Fidelity Investments. While Fidelity was increasing its fund assets about 20 percent a year, Vanguard was growing at 33 percent. Fidelity advertised heavily, while Vanguard did practically no advertising, spending a mere \$8 million for a few ads to get people to ask for prospectuses. The Kaufmann Fund, one-hundredth Vanguard's size, spent that much for advertising, and General Mills spent twice as much just to introduce a new cereal, Sunrise.¹

What was Vanguard's secret? How wise is it with such a consumer product to spurn advertising? The answer lies in the vision and steadfastness of John C. Bogle, the founder and now retired chairman.

JOHN BOGLE AND THE CREATION OF VANGUARD

In 1950, as a junior at Princeton, Bogle was groping for a topic for his senior thesis. He wanted a topic that no one had written about in any serious academic paper. In December 1949 he had read an article in *Fortune* on mutual funds. At that time, all mutual funds were sold with sales commissions often 8 percent of the amount invested, and this was taken off the top as a front-end load. (This meant that if you invested \$1,000, only \$920 would be earning you money. Today we find no funds with a front-end load more than 6.5 percent, so there has been some improvement.) In addition, these funds had high yearly overheads or expense ratios. As Bogle thought about this, he wondered why funds couldn't be bought without salespeople or brokers and their steep commissions, and whether growth could not be maximized by keeping overhead down.

Right after graduation he joined a tiny mutual fund, Wellington Management Company, and moved up rapidly. In 1965, at age 35, he became the chief executive. Unwisely, he decided to merge with another firm, but the new partners turned out

¹ Thomas Easton, "The Gospel According to Vanguard," *Forbes*, February 8, 1999, p. 115.

to be active managers (buying and selling with a vengeance), generating high overhead costs. The relationship was incompatible with Bogle's beliefs, and in 1974 he was fired as chief executive.

He decided to go his own way and change the "very structure under which mutual funds operated" into a fund distribution company mutually owned by shareholders. The idea came from his Princeton thesis, and included such heresies as "reduction of sales loads and management fees," and "giving investors a fair shake" as the rock on which the new enterprise would be built. He chose the name "Vanguard" for his new company after the great victory of Lord Nelson over Napoleon's fleet with his flagship, HMS Vanguard. Bogle launched the Vanguard Group of Investment Companies on September 26, 1974, and he hoped "that just as Nelson's fleet had come to dominate the seas during the Napoleonic wars, our new flagship would come to dominate the mutual fund sea."²

But success was long in coming. Bogle brought out the first index fund the next year, a fund based on the Standard & Poor's 500 Stock Price Index, and named it Vanguard 500 Index Fund. It was designed to mirror the market averages, and thus required minimal management decisions and costs. It flopped initially. Analysts publicly derided the idea, arguing that astute management could beat the averages every time, though they ignored the costs of high-priced money managers and frequent trading.

Twenty-five years later, this Vanguard flagship fund that tracks the 500 stocks on the Standard & Poor's Index had more than \$92 billion in assets and had beat 86 percent of all actively managed stock funds in 1998, and an even higher percentage over the past decade. By early 2000, it overtook Fidelity's famed Magellan Fund as the largest mutual fund of all. The relative growth between Magellan and Vanguard's 500 Index for the five salient years 1994 to 1999 is shown in Table 20.1.

The Vanguard family of funds had become the world's largest no-load mutual fund group, with 12 million shareholders and \$442 billion in assets as of the beginning of 1999. Fidelity, partly load and partly no-load, had nearly \$700 billion, but the gap was closing fast.

TABLE 20.1 Relative Growth Comparisons of the Two Largest Mutual Funds

	Assets (millions \$)		5-Year Gain
	6/30/94	6/30/99	(percentage)
Fidelity Magellan	\$33.179	\$97.594	194.2%
Vanguard 500 Index	8.443	92.644	997.3

Source: Company reports.

Commentary: Especially notable is the tremendous growth of Vanguard's 500 Index Fund in these five years, growing from \$8 billion in assets to over \$92 billion.

² John C. Bogle, *Common Sense on Mutual Funds*, New York: Wiley, 1999, pp. 402–403.

The Messiah

A feature article in *Forbes*'s February 8, 1999 issue had this headline: "The Gospel According to Vanguard—How do you account for the explosive success of that strange business called Vanguard? Maybe it isn't really a business at all. It's a religion."³

Bogle's religion was low-cost investing and service to customers. He believed in funds being bought and not sold, thus, no loads or commissions to salespeople or brokers. Customers had to seek out and deal directly with Vanguard. The engine was frugality with the investor-owner's best interests paramount. This was not advertised, not pasted on billboards, but the gospel was preached in thousands of letters to shareholders, editors, Securities & Exchange Commission members, and members of Congress. Bogle made many speeches, comments to the news media, appearances on such TV channels as CNBC, and wrote two best-selling books. With his gaunt face and raspy voice, he became the zealot for low-cost investing, and the major critic of money managers who trade frenetically, in the process running up costs and tax burdens for their investors. As the legions of loyal and enthusiastic clients grew, word-of-mouth from past experiences and favorable mentions in business and consumer periodicals such as *Forbes*, *Wall Street Journal*, *Money*, and numerous daily newspapers, as well as TV stations brought a groundswell of new and repeat business to Vanguard.

Bogle turned 70 in May 1999 and was forced to retire from Vanguard's board. The new chairman, John J. Brennan, 44, seemed imbued with the Bogle philosophy, and vision. He said, "We're a small company, and we haven't begun to explore our opportunities, yet." He noted that there's Europe and Asia, to say nothing of the trillions of dollars held in non-Vanguard funds. "It's humbling."⁴

Great Appeal of Vanguard

Performance

Each year, *Forbes* presents "Mutual Funds Ratings" and "Best Buys." The Ratings lists the hundreds of mutual funds that are open end, that is, those that can be bought and sold at current net asset prices.⁵

The Best Buys are those select few that *Forbes* analysts judged to "invest wisely, spend frugally, and you get what you pay for," and that performed best in shareholder returns over both up and down markets. Vanguard equity and bond funds dominated *Forbes*' Best Buys:

Of 43 U.S. equity funds listed in the various categories, 12 were Vanguard funds.

Of 70 bond funds, 27 were Vanguard.⁶

³ Easton, p. 115.

⁴ Easton, p. 117.

⁵ A far smaller number of mutuals are closed-end funds that have a fixed number of shares and are traded like stocks. These generally have higher annual expenses, yet sell at a discount from net asset value. We will disregard these in this case.

⁶ *Forbes*, August 23, 1999, pp. 128, 136–7.

Forbes explains that “the preponderance of Vanguard funds in our Best Buy Tables is a testament to the firm’s cost controls. Higher expenses, for most other fund families, are like lead weights. Why carry them?”⁷ Table 20.2 shows representative examples of the substantially lower expenses of Vanguard funds relative to others on the Best Buy list.⁸

Looking at total averages, the typical mutual fund has an expense ratio of 1.24 percent of assets annually. The ratio for Vanguard’s 101 funds was .28 percent, almost a full percentage point lower.⁹

TABLE 20.2 Comparative Expense Ratios of Representative Mutual Funds

	Annual Expenses per \$100
<i>Balanced Equity Funds:</i>	
Vanguard Wellington Fund	0.31
Columbia Balanced Fund	0.67
Janus Balanced Fund	0.93
Ranier Balanced Portfolio	1.19
<i>Index Equity Funds:</i>	
Vanguard 500 Index	.18
T. Rowe Price Equity Index 500	.40
Dreyfus S&P 500 Index	.50
Gateway Fund	1.02
<i>Municipal Long-Term Bonds:</i>	
Vanguard High Yield Tax Exempt	.20
Dreyfus Basic Muni Bond	.45
Strong High Yield Muni Bond	.66
<i>High-Yield Corporate Bonds:</i>	
Vanguard High Yield Corp.	.29
Fidelity High Income	.75
Value Line Aggressive Income	.81
Ivesco High Yield	.86

Source: Company records as reported in *Forbes Mutual Fund Guide*, August 23, 1999.

Commentary: The great cost advantage of Vanguard shows up very strikingly here. It is not a slightly lower expense ratio, but one that is usually three or four times lower than similar funds. Take, for example, the category of Index Equity Funds, where the goal is to simply track the Index averages, which suggests passive management rather than free-wheeling buying and selling. Yet Vanguard’s costs are far below the other funds: in one case, the Gateway fund is five times higher.

⁷ *Ibid.*, p. 136.

⁸ *Ibid.*, pp. 128, 137.

⁹ Easton, p. 116.

How does Vanguard achieve such a low expense ratio? We noted before the reluctance to advertise; nor does it have any mass sales force. Its commitment has been to pare costs to the absolute minimum. But there have been other economies.

Fidelity and Charles Schwab have opened numerous walk-in sales outposts. Certainly these bring more sales exposure to prospective customers. But are such sales promotion efforts worth the cost? Vanguard decided not. It had one sales outpost in Philadelphia, but closed it to save money.

Vanguard discouraged day traders and other market timers from in-and-out trading of its funds. It even prohibited telephone switching on the Vanguard 500 Index; redemption orders had to come by mail. Why such market timing discouragement? Frequent redemptions run up transaction costs, and a flurry of sell orders might impose trading costs that would have to be borne by other shareholders as some holdings might have to be sold.

Not the least of the economies is what Bogle calls passive investing, tracking the market rather than trying to actively manage the funds by trying to beat the market. The funds with the highest expense ratios are hedge funds and these usually are the most active traders, with heavy buying and selling. Yet, they seldom beat the market but squander a lot of money in the effort and burden shareholders with sizable capital gains taxes because of the flurry of transactions. Still, the common notion prevails that more is better, that the more expensive car or service must be better than its less expensive alternative. See the following Information Box for another discussion of the price-quality perception.

Another factor also contributes to the great cost advantage of Vanguard. It is a mutual firm, organized as a nonprofit owned by its customers. Almost all other financial institutions, except TIAA-CREF (and we will discuss this shortly), have stock ownership with its heavy allegiance to profit maximization.

Customer Service

Many firms proclaim a commitment to customer service. It is the popular thing to do, rather like motherhood, apple pie, and the flag. Unfortunately, pious platitudes do not always match reality. Vanguard's commitment to service seems to be more tangible.

Service to customers is often composed of the simple things, such as just answering the phone promptly and courteously, or responding to mail quickly and completely, or giving complete and unbiased information. Vanguard's 2,000 phone representatives are ready to answer the phone by the fourth ring. During a market panic or on April 15 when the tax deadline stimulates many inquiries, CEO John Brennan brings a brigade of executives with him to help man the phones. Vanguard works to make its monthly statements to investors as complete and easy-to-understand as possible, and it leads the industry in this.

The philosophy of a customer-service commitment was espoused by Bogle. "Our primary goal: to serve, to the best of our ability, the human beings who are our clients. To serve them with candor, with integrity, and with fair dealing. To be the stewards of the assets they have entrusted to us. To treat them as we would like the stewards of our own assets to treat us."

INFORMATION BOX**THE PRICE-QUALITY PERCEPTION**

We previously touched on price-quality perception in the Boston Beer Case in Chapter 4. There, Jim Koch was successful in marketing his Boston Beer as some of the highest-priced beer in the industry, with its superior taste and quality even over the imports. The same perception applies to perfume, liquor, and many other consumer products. “You get what you pay for,” is a common belief, and its corollary is that you judge quality by price: The higher the price, the higher the quality. But this notion leads many consumers to be taken advantage of, and enables top-of-the-line brands and products to command a higher profit margin than lower-priced alternatives. Admittedly, sometimes we are led to the more expensive brand or item for the prestige factor.

When it comes to money management, by no means do high fees mean better quality; the reverse is usually true. And prestige should hardly be a factor here since we are not inclined to show off our investments like we might a new car. Does a high-expense index fund deliver better performance than a cheap one, than Vanguard? Not at all. And hedge funds as we noted before seldom even beat the averages despite running up some of the highest expenses in the mutual fund industry. Looking at Table 20.2, which shows typical expense ratios of Vanguard and its competitors, are the other funds doing a better job than Vanguard with their expenses three to five times higher? Not at all! Their high expense ratios take away from any performance advantage, even if their frequent trading resulted in somewhat better gains, and that seldom is achieved.

If Vanguard advertised its great expense advantage aggressively to really get the word out, do you think it would win many more customers? Why or why not?

Bogle described a talk he gave to Harvard Business School in December 1997 on how “our focus on human beings had enabled Vanguard to become what at Harvard is called a ‘service breakthrough company.’ I challenged the students to find the term human beings in any book they had read on corporate strategy. As far as I know, none could meet the challenge. But ‘human beingness’ has been one of the keys to our development.”¹⁰

Not the least of the consumer best interests has been a commitment to holding down taxable transactions for shareholders. Vanguard has led the industry with tax-managed funds aimed at minimizing the capital gains distributions that confront most mutual fund investors to their dismay at the end of the year.

COMPETITION

Why is Vanguard’s low-expense approach not matched by competitors? All the other fund giants that sell primarily to the general public are for-profit companies. Are they willing to sacrifice profits to win back Vanguard converts? Not likely. Are they

¹⁰ Bogle, pp. 423, 424.

willing to reduce their hefty marketing and advertising expenditures? Again, not likely. Why? Because advertising, not word-of-mouth, is vital to their visibility and to seeking out customers.

TIAA-CREF

One potential competitor looms, another low-cost fund contender. TIAA-CREF, which manages retirement money for teachers and researchers, in 1997 launched six no-load mutual funds that are now open to all investors. The funds' annual expenses range from 0.29 per cent to 0.49 per cent, comparable with Vanguard's. A significant potential attraction over Vanguard is that each fund's investment minimum is just \$250, compared with Vanguard's usual minimum of \$3,000. As of late August 1999, the combined assets of the six TIAA-CREF funds was \$1.5 billion, far less than the near \$500 billion of Vanguard at the time.

TIAA-CREF is also run solely for the benefit of its shareholders, being another mutual, with the long-term aim of providing fund-management services at cost. Still, there is some doubt that expense ratios can be kept low should the new funds fail to attract enough investors.

Is this a gnat against the giant Vanguard? Perhaps; however, the low investment requirement of only \$250 should certainly attract cost-conscious investors who cannot come up with the \$3,000 that Vanguard requires on most of its funds. Still, six fund choices versus the more than 100 of Vanguard is not very attractive yet. Efforts to be as tax-efficient as Vanguard are also unknown.

ANALYSIS

The success of Vanguard with its disavowal of most traditional business strategies flies in the face of all that we have come to believe. It suggests that heavy advertising expenditures may at least be questioned as not always desirable—and what a heresy this is. It suggests that relying on word-of-mouth and whatever free publicity can be garnered may sometimes be preferable to advertising. All you need is a superior product or service. It supports the statement that textbooks like to shoot down: “If you build a better mousetrap, people will come.” Conventional wisdom maintains that without advertising to get the message out, this better mousetrap will fade away from lack of buyer knowledge and interest. But the planning of Bogle and Vanguard to tread a different path and not be dissuaded, despite the critics, illustrates a remarkable and enduring commitment first formulated more than three decades ago.

How do we reconcile Vanguard with the commonly accepted notion that communication is essential to get products and services to customers (except perhaps when selling solely to the government or to a single customer)?

Maybe we should not try to fit Vanguard into such traditional beliefs. Maybe it is the exception, the anomaly, in its seeming repudiation of them. Still, let us not be too hasty in this judgment.

I do not believe that Vanguard contradicts traditional principles of marketing and business strategy. Rather, it has revealed another approach to the communication component: the effective use of word-of-mouth publicity. If we have a distinctive

product that can be tangibly demonstrated as superior in relative cost advantages to competitors, then demand may be stimulated without mass advertising. Word-of-mouth, enhanced or developed through formal publicity—from media, public appearances and publications—can replace massive advertising expenditures of competitors. But is there a downside to all this? Let us examine the role of word-of-mouth in more detail in the following Information Box.

Vanguard illustrates a commendable application of one important business strategy principle: the desirability of uniqueness or product differentiation. It differentiated itself from competitors in two respects: (1) its resolve and ability

INFORMATION BOX

THE POTENTIAL OF WORD-OF-MOUTH AND UNPAID PUBLICITY

Word-of-mouth advertising, by itself, is frowned on by the experts. It is the sign of a marginal firm, one without sufficient resources to get established. Such a firm is bound to succumb to competitors who are better managed with better resources, so they say. At best, they may acknowledge for word-of-mouth advertising prospects is that if the firm can survive for an unknown number of years, and if it really has a superior product or service, then it might finally attain some modest success.

Compared to spending for advertising, word-of-mouth takes far longer to have any impact, and firms seldom have the staying power to wait years, so the belief holds. The best strategy would be to have both, with healthy doses of advertising to jumpstart the enterprise, and let favorable word-of-mouth reinforce the advertising.

As we have seen, Bogle and his Vanguard repudiated the accepted strategy, yet became highly successful. Still, it took time, even decades. If you look at Table 20.1, in 1994 after 16 years the flagship Index 500 fund had reached \$8 billion in assets; not bad, but far below the heavily advertised Magellan fund of Fidelity. The growth of the Index 500 fund has accelerated only in recent years. Would more advertising have shortened the period?

Bogle would maintain that such advertising would have destroyed the uniqueness of Vanguard by making its expenses like other funds. He would also likely contend that the favorable publicity enhanced the word-of-mouth influence of satisfied shareholders, and thus there was no need for expensive advertising. But in the early years of Vanguard it did not have much favorable publicity. On the contrary, it took experts a long time to admit that a low-expense fund with passive management could do as well or better than aggressively managed funds with a lot of buying and selling and big trading and marketing expenses.

So the success of Vanguard without much formal advertising attests to the success of word-of-mouth heavily seasoned by favorable free publicity. But was it too conservative, especially in the early years?

Do you think Vanguard should have advertised more, especially in its early days? Why or why not? If yes, how much more do you think it should have spent?

to bring out a low-priced product and at the same time one of good quality, and (2) its achievement of good customer service despite the low price.

Even today, after several decades of competitors seeing this highly effective strategy, Vanguard still is virtually unmatched in its uniqueness, except for one newcomer that is hardly a contender, but could be a factor should Vanguard let down its guard and be tempted to seek more profits.

Can Vanguard Continue As Is?

Is it likely Vanguard can continue its success pattern without increasing advertising and other costs and becoming more like its competitors? Why should it change? It has become a giant with its low-cost strategy. The last decade saw a growing momentum created by favorable word-of-mouth and publicity that made the need for heavy advertising and selling efforts far less than in the early years. It took bravery, or audacity, in those early years not to succumb to the Lorelei beguilement that advertising and commission selling was the only viable strategy. Something would be lost if Vanguard were to change its strategy and uniqueness and become a higher-cost imitation of its competitors.

If Vanguard is so good, why are so many investors still doing business with the higher-cost competitors? We can identify four groups of consumers who are not customers of Vanguard:

1. Those who have not studied the statistics and editorials of publications like *Forbes*, *Money*, and *Wall Street Journal*, and are not aware of the Vanguard advantage.
2. Those who are naive in investing and content to let someone else—brokers or bankers—advise them and reap the commissions.
3. Those who are swayed by the massive advertisements of firms like Fidelity, Dreyfus, Rowe Price, and others.
4. Those who put their faith in the price–quality perception: the higher the price the higher the quality, with quality guaranteeing higher investor returns.

In addition to continued investments of its ardent customers, Vanguard should find potential in the gradual eroding of the commitment of these four consumer groups. Of course, the overseas markets also offer a huge and virtually untapped potential for Vanguard.

Invitation for Your Own Analysis and Conclusions

You do not have to agree with Bogle's planning strategy. Playing the devil's advocate (one who argues for the opposite viewpoint), persuasively present another perspective. (You may want to do some research on American Funds, and also review Chapter 17, the exploits of Edward Lampert, hedge fund manager extraordinaire.)

UPDATE

In the new millennium, several shifts in the relative positions of the major players in the mutual fund industry were taking place. By 2005, the assets of the three largest fund houses and their percent change from 2000 were:

	Assets (\$billion): 2000	2005	Percent Change
Vanguard	\$448.3	\$747.1	67%
American	333.2	714.4	114
Fidelity	569.3	629.7	11

As you can see, Vanguard had forged to the top, easily surpassing Fidelity. But American Funds was charging fast, more than doubling its assets, and seeming likely to soon overtake Vanguard as the largest mutual fund family. What is there about American that makes it so appealing to investors?

American Funds is the complete opposite of Vanguard in almost all respects. Its funds try to beat the market by being actively managed with, of course, the higher expenses coming from this. Adding to the costs, it is distributed through brokers who love to sell the American family of funds because of a nice 5.75% sales commission. It does no advertising (similar to Vanguard in this), and its stock pickers shun the limelight and appear on no TV chat shows. CEO Paul Haaga scorns the self-proclaimed virtues of arch-rival Vanguard. He refers to Bogle as “a saint with his own statue.” Unlike most funds that have a chief stock-picking manager, with American it is difficult to know who is selecting specific stocks since each fund has as many as eight managers, all seemingly equal. So, who is an investor to blame for a poor performance? Still, American’s biggest funds have mostly done better than the S&P 500, and this performance along with eager broker recommendations have lured investors. However, skeptics point to academic studies of the difficulty of beating the market over long periods, especially as funds get larger. Vanguard doesn’t have to worry about this, since many of its assets are in index funds that aim only to match the market.

A harbinger that beating the market for American may be becoming more difficult were the latest asset figures for the largest equity funds. As of July 31, 2006, the equity assets (i.e., stock only) of Vanguard were \$532.7 billion. Fidelity was next with \$444.7 billion, while American with only 29 funds was third at \$386.3. Matching Forbes Best Buys recommendations, described earlier for 1999 with those of 2006, Vanguard stock funds had 25% of the recommendations in 2006—slightly below 1999—but its bond funds recommendations were 49% for 2006, well above 1999 figures.¹¹

¹¹ “Fund Survey: Family Counseling,” *Forbes*, September 18, 2006, p. 186, and 188–189. Also used in this update: Michael Maiello, “The Un-Vanguard,” *Forbes*, September 19, 2005, pp. 182–185; and “How the Largest Funds Fared,” *Wall Street Journal*, December 4, 2006, p. R6.

WHAT WE CAN LEARN

Marketing Can Be Overdone

The success of Vanguard shows that marketing can be overdone. Too much can be spent for advertising, without realizing congruent benefits. Sales expenses and branch office overhead may get out of line. Yet, few firms dare reduce such costs lest they be competitively disadvantaged. For example, it is the brave executive who reduces advertising in the face of increases by competitors, though the results of the advertising may be impossible to measure with any accuracy. Still, despite Vanguard's success in downplaying advertising, one has to wonder how much faster the growth might have been if it had budgeted more dollars for selling, at least in the early years.

Can Word-of-Mouth Do the Job of Advertising by Itself?

In Vanguard's case, word-of-mouth combined with favorable unpaid publicity from the media made it the largest mutual fund family in the industry. However, the time it took for word-of-mouth, even eventually with good publicity, to build demand has to be a negative. Without such favorable publicity, it would have taken far longer.

The Benefits of Frugality

There is far too much waste in most institutions, business and nonbusiness. Some waste comes from undercontrolled costs and such extravagances as lavish expense accounts and entertainment, and expenditures that do little to benefit the bottom line. Other factors may be a top-heavy bureaucratic organization saddled with layers of staff personnel, and/or too many debt payments due to heavy investments in plant and equipment or mergers. Heavy use of advertising may not always pay off enough to justify the expenditures. In money management, trading costs may get far out of line.

Vanguard shows the benefit of austerity in greatly reduced expense ratios for its funds compared to competitors. More and more astute investors are at last recognizing this unique cost advantage that not only gives a better return on their investment dollars but some of the best customer service in the industry.

The Power of Differentiation

Firms seek to differentiate themselves, to come up with products or ways of doing business that are unique in some respect from competitors. This is a paramount quest of marketing strategy and accounts for the massive expenditures for advertising. Too often attempts to find uniqueness are fragile, not very substantial, and easily lost or countered by competitors. Sometimes, though, they can be rather enduring, as for example the quality-image perception perpetrated by advertisements featuring the lonely Maytag repairman, as described in Chapter 16. If a firm can effectively differentiate itself from competitors, it gains a powerful advantage and may even be able to charge premium prices.

While Vanguard seemingly disregarded marketing, John Bogle found a powerful and enduring way to differentiate through low-cost quality products and superb customer service. For decades no competitor has been able to match this attractive uniqueness.

Beware Placing too Much Faith in the Price–Quality Relationship

We are drawn to judge quality by a product's price relative to other choices. Often this is justified, although the better quality may not always match the higher price. In other words, the luxury item may not be worth the much higher price, except for the significant psychological value that some people see in the prestige of a fine brand name. Unfortunately, there are some products and services where the higher price does not really reflect higher quality, better workmanship, better service, and the like. Then we are taken advantage of with this price–quality perception. Beware of always judging quality by price.

CONSIDER

Can you think of additional learning insights?

QUESTIONS

1. “The success of Vanguard is due to media exploitation of what would otherwise be a very ordinary firm.” Discuss.
2. Why do you think people continue to buy front-end load mutual funds with 5–6 percent commission fees when there are numerous no-load funds to be had?
3. Do you think Bogle's shunning advertising was really a success, or was it a mistake?
4. Was Vanguard's failure to open walk-in sales outposts a mistake and an example of misplaced frugality? Why or why not?
5. What are the differences in passive and active fund management? How significant are they?
6. “Vanguard seems too good. There must be a downside.” Discuss.
7. What is a service breakthrough company?
8. Can publicity ever take the place of massive advertising expenditures?

HANDS-ON EXERCISES

1. You are an executive assistant to John Brennan, the new CEO of Vanguard now that Bogle has retired. Brennan is thinking of judiciously adding some marketing and advertising expenditures to the paucity that Bogle had insisted on. He has directed you to draw up a position paper on the merits of adding

some advertising and even some walk-in sales outposts such as other big competitors have already done. (You may be instructed to make a cost/benefit analysis, which is described in a box in Chapter 16.)

2. You are John Brennan, CEO. It is 2009, and TIAA-CREF is turning out to be a formidable competitor, and is gaining fast on your first-place position in the industry. What actions would you take, and why? Discuss all ramifications of these actions that you can think of?

TEAM DEBATE EXERCISES

1. You are a member of the board of directors of Vanguard. John Bogle is approaching the retirement age as set forth in the company policies. However, he wants to continue as chairman of the board, even though he is willing to let Brennan assume active management. Debate the issue of whether to force Bogle to step down or bow to his wishes.
2. Debate Bogle's no-advertising policy.

INVITATION TO RESEARCH

Is Vanguard still No. 1 in the mutual fund industry? Has it increased its advertising expenditures? Has Brennan made any substantial changes? How is TIAA-CREF doing? How is American Funds doing?

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**PART
SIX**

ETHICAL MISTAKES

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Merck's Vioxx Catastrophe and Other Problems

Newton Acker, 71, was on a bicycling vacation with his wife in southern France. While he had some arthritis, he was otherwise exceptionally healthy, with low blood pressure and cholesterol. Indicative of his fitness, he bicycled 5000 miles a year. Indicative of his longevity potential, his parents had lived to age 90. Yet on September 3, 2004, this paragon of good health suddenly died of a stroke.

On September 30, four weeks later, Merck pulled Vioxx from the market after a study showed it doubled the risk of heart attacks and strokes. "That's the answer," Acker's son, a F-16 pilot, immediately thought, as his dad had been taking Vioxx for 14 months before his death. He blamed Merck for failing to act sooner, and planned to sue.¹

Vioxx was a \$2.5-billion-a-year arthritis drug and provided well over ten percent of the \$22 billion revenues of the pharmaceutical giant. Some 20 million Americans had taken Vioxx by the time of the recall. Tort lawyers salivated at the tens of thousands who may have had "major adverse events" attributable to the drug, and they rushed to set up toll-free numbers to solicit potential clients. The cost of settling the lawsuits could well run into the tens of billions of dollars, which would be the biggest legal onslaught the drug industry had ever seen. Merck's stock dropped \$33 billion in value between September 30 and November 1.

Let us examine how Merck got into this mess, whether it was fully culpable and ethically a pariah, or whether it was the victim of tragic circumstances. What could it have done to prevent this catastrophe, and what could it do at this point?

CEO RAYMOND GILMARTIN WITH EDWARD SCOLNICK, AND MERCK

The 63-year-old Merck chairman, Raymond Gilmartin, was soft spoken, calm, and seemingly unruffled as he tried to defend the company. Merck had had a towering past. From its labs came major drugs to treat AIDS, osteoporosis, high cholesterol,

¹ Example cited in Matt Herper and Robert Langreth, "Merck's Mess," *Forbes*, November 1, 2004, p. 50.

and hypertension. The company had been in the vanguard in donating millions of dollars worth of medicines to fight infectious Third World diseases—an embracing of social responsibility dating from the 1940s. In *Fortune's* corporate reputation survey, Merck was the Most Admired Company in American business for seven straight years in the 1980s. Its stock was among the bluest of blue-chip stocks.²

Much of the research reputation of Merck came from Edward M. Scolnick, the president of Merck Research Labs, who was a physician and a world-class scientist. He motivated an uncommon burst of R&D productivity, that in a five-year period in the 1990s brought to market fifteen unique drugs, many becoming blockbusters. For a decade until he retired in 2003, he was the de facto No. 2 man at Merck, and the only inside director on the board besides CEO Gilmartin.

Scolnick's leadership and example permeated the research organization. He had graduated from Harvard Medical School, and personally had authored some 200 scientific articles. His own drive for perfection motivated his staff, and Merck scientists considered themselves the best in the industry. For two decades, Merck research published more scientific papers and patented more compounds than any of its competitors. The company was known for providing meticulous supporting documents for its Food and Drug Administration (FDA) submissions for approval. These along with its superb reputation in science brought faster approvals than any of its competitors. For example, between 1995 and 2001, Merck submitted 13 major new drugs, and all were approved with an average review time of less than eleven months—Vioxx actually won approval in just six months of review. Pfizer's submissions during the same period faced an average review time of over two years. Quick approval could mean hundreds of millions in sales.³ The renown of Merck's Research Labs and of its scientists, however, also fostered a negative culture, one of arrogance and insularity.

Gilmartin was picked by the board in 1994 to return the company more to its roots and be more research driven. His predecessor, Roy Vagelos, had made a number of acquisitions in efforts to diversify Merck from its core drug-research business. Gilmartin was the first nonscientist to head the company, having been trained in electrical engineering, and had been CEO of Becton Dickinson where he gained a reputation for efficiency and as a turnaround expert.

Gilmartin sold off many of Merck's non-core businesses, including Medco, a \$30-billion-a-year drug-distribution company that had been purchased just before Vagelos retired. The recommitment of Merck to its core research brought Gilmartin and Scolnick into a close alliance, with Gilmartin usually deferring to Scolnick. The drugs in the pipeline were Scolnick's babies—he took personal interest in them, not only in their medical utility but even to their positioning in the marketplace—and many had phenomenal growth. Take the case of Fosamax.

Fosamax

Fosamax was an innovative drug for osteoporosis, the bone loss women often experience as they age. It was introduced in 1995 but attracted little public attention at

² John Simons and David Stipp, "Will Merck Survive Vioxx?" *Fortune*, November 1, 2004, pp. 91–104.

³ *Ibid.*, pp. 96, 97.

the time. However, Scolnick envisioned a market much larger than ailing old ladies. He urged Merck to launch a public-awareness campaign, and the drug produced \$280 million in sales in its first year.

Not long after its release for the market, the FDA threatened to revoke its approval when it was discovered that Fosamax caused some patients to experience erosion in the esophagus. Scolnick went on a vigorous letter-writing campaign, contacting doctors and sending more supporting data to the FDA. In the end the FDA consented to keep Fosamax on the market with a warning label telling patients to sit upright for an hour after taking the drug. Scolnick had saved the drug, and by 2003 its sales were \$2.7 billion.

Other blockbusters followed. In 1995 also came Cozaar, a \$2.5-billion-a-year drug for hypertension. Crixivan, for HIV, was introduced the next year. In 1998, five medicines came out of Merck's labs, including the \$2-billion-a-year asthma remedy, Singulair, and Propecia for baldness. But by 1999, it was becoming more difficult for all drug companies to find blockbusters—the easier ones had already been found, and more difficult science was needed for any more blockbusters, and these carried higher risks of failure or potential problems. Merck came into the new millennium facing patent expirations and few miracle drugs in the pipeline.

Vioxx

Vioxx was the last of Scolnick's blockbusters. It was discovered in a Merck lab in 1994, and was one of a new class of painkillers called Cox-2 inhibitors. These reduced pain and inflammation without the side effects of ulcers and gastrointestinal bleeding that could result from common painkillers like ibuprofen. Some estimated that drugs like ibuprofen, called nonsteroidal anti-inflammatory drugs (NSAIDs), killed more than 10,000 Americans a year due to intestinal bleeding.⁴

Vioxx worked wonders in clinical trials with arthritis patients, and the FDA approved it quickly in May 1999. Scolnick trumpeted to the press that he was taking Vioxx himself for back pain. On the cover of its 1999 annual report, Merck proclaimed that the drug was "its biggest, fastest, and best launch ever."

Over the next five years, Vioxx became one of the great triumphs of *direct-to-consumer* marketing. Merck spent more than \$500 million on commercials proclaiming its virtues, and some 20 million Americans had taken it, and it was generating \$2.5 billion in annual sales, second only to Celebrex, a \$3 billion-a-year drug that Pfizer acquired when it bought Pharmacia in 2003. See the following Issue Box for a discussion of pharmaceutical advertising campaigns, one of the fastest-growing ad categories in recent years.

Warning Signs

There were early warning signs about Vioxx. Even before the FDA had approved it, scientists at the University of Pennsylvania discovered that Cox-2 inhibitors interfered with enzymes believed to play key roles in warding off cardiovascular

⁴ *Ibid.*, p. 100.

ISSUE BOX**DIRECT-TO-CONSUMER ADVERTISING—IS IT VASTLY OVERDONE?**

Merck spent more than \$500 million on commercials proclaiming the virtues of Vioxx, only to have it revealed to be a risky remedy for arthritis. The pharmaceutical industry had discovered the effectiveness of advertising prescription drugs directly to consumers instead of the medical profession. By barraging consumers with the benefits of such drugs, drug companies hoped that many would either demand these prescriptions or at least express strong interest to their doctors—and this proved to be very effective marketing. Often these heavily advertised brands became blockbusters, generating billions of dollars for their drug companies. Over the past decade, pharmaceutical advertising exploded to become the 10th largest advertising category in the United States. The ads had become increasingly aggressive as drug companies promoted their products as hip, using imagery similar to that for soda, sneakers, and cars—for example, having pert women pitching erectile-dysfunction drugs. The debate over whether such marketing was appropriate had raged for years, but nothing deterred the new order of things. In 2003, expenditures for prescription-drug ads jumped 24 percent to \$3.21 billion. Meanwhile, ad spending on transportation and tourism rose only 0.2 percent.

Merck's removal of Vioxx from the marketplace reopened criticisms about the efficacy and tone of direct-to-consumer drug advertising. "The advertising and promotions played a major role in making people think Vioxx was safer and more effective than it is, and safer than other drugs and treatments for arthritis and pain," said Sidney Wolfe, director of Public Citizen's Health Research Group. Another cause for concern as advertising stimulated demand quickly for new drugs was that millions of people would become users before any serious side effects could be discovered. Thereby, many more people would be exposed to risks, as they were with Vioxx. But it is doubtful that Merck's recall will induce drug makers to voluntarily retreat from their increasingly aggressive advertising stance.

Do you think the aggressive drug advertising should be curtailed? Why or why not? If so, what limits would you impose?

Sources: Brian Steinberg and Suzanne Vranica, "Not Such a 'Beautiful Morning'" *Wall Street Journal*, October 2, 2004, pp. B1 and B4; and Anna Wilde Mathews and Barbara Martinez, "Celebrex Drama May Finally Prompt Changes at the FDA," *Wall Street Journal*, December 20, 2004, pp. B1 and B4.

disease. The researchers reported this to the companies involved and then to the academic media that this was something that could lead to heart attacks and strokes.

Merck thought the evidence of cardiovascular effects was inconclusive and even conflicting. Then in early 2000, Merck's own 8,000-person study found that arthritis patients taking Vioxx had three times as many serious cardiovascular

problems as those on naproxen, sold under the Aleve brand. However, Merck dismissed the result, contending that the discrepancy was due to an extra heart benefit from the naproxen, thus making Vioxx look bad by comparison. Still, in April 2002, Merck updated the Vioxx label to include information about possible cardiovascular risk.

The company embarked on another long-term study of 2,600 patients, called APPROVe, aimed at seeing whether Vioxx would lead to a reduction of colon polyps. The researchers also compared Vioxx with a placebo instead of another drug to test definitively whether the arthritis drug increased cardiovascular risk. On September 23, 2004, Gilmartin was told that the APPROVe study indeed showed that patients using Vioxx had twice the risk of getting a heart attack or stroke as those on a placebo, but only after eighteen months of regular use. At that point Gilmartin and other executives made the decision to recall Vioxx. And the hornet's nest was unleashed.

THE CONTROVERSY

Arguments for Not Recalling Vioxx

Compelling arguments could be raised that Vioxx should not have been recalled, that it was doing far more good than harm. The company could go to the FDA, and have the product information updated with the new findings. The majority of the outside clinicians Merck consulted suggested it do that, since there were clearly millions of people who were benefiting without getting heart attacks.

Merck thought the decision to recall Vioxx was an example of the company's high ethical standards. Gilmartin told *Fortune* that he never had any doubt about his course of action: "Withdrawing the drug was going to be the responsible thing to do. It's built into the principles of the company to think in this fashion. That's why the management team came to such an easy conclusion." Most employees felt the same way. Peter Kim, who succeeded Scolnick when he retired in 2002, said, "There has been an incredible outpouring of emotion that says, 'I'm proud that we did the right thing. And I'm proud to be part of an organization that would actually do the right thing.'"⁵

Critics of Merck's Delay

Despite the withdrawal, Merck faced a torrent of criticisms from scientists who believed that Merck largely ignored warning signs because it was so hungry for sales. Harvard researcher Daniel Solomon who had studied Cox-2 inhibitors observed, "If Merck were truly acting in the interest of the public, of course they should have done more studies on Vioxx's safety when doubts about it first surfaced." He also criticized the FDA for not pressuring Merck to resolve the doubts faster. William Castelli, former director of the Framingham Heart Study, an influential investigator of cardiac risk factors, raised another issue. Since Cox-2 inhibitors

⁵ Simons and Stipp, p. 102.

reduce inflammation, which is a probable risk factor for heart disease, many researchers expected Vioxx to reduce the risk of heart attacks rather than raise it. When some studies “suggested the exact opposite, it should have rung everyone’s bell that something was not right.”⁶

Perhaps the most vocal critic was Eric Topol, chairman of cardiology at the Cleveland Clinic. He and a number of other researchers had raised questions about Vioxx in medical journals as far back as 2001. Shortly after Vioxx was withdrawn, he wrote a stinging rebuke in the *New England Journal of Medicine*. He wrote, “Had the company not valued sales over safety, a suitable trial could have been initiated rapidly [to pin down Vioxx’s cardiovascular risk] at a fraction of the cost of Merck’s direct-to-consumer advertising campaign.”⁷ Merck refused to accept the evidence of three early research studies that found Vioxx increasing heart attack risk. The company maintained that the studies were unreliable and were contradicted by several other studies that showed no risk.

Even if Merck would not accept these research findings of increased heart attack risk with Vioxx, it should have been alerted by more than 400 lawsuits that had been filed on behalf of Vioxx patients before the recall. This was the tip of the iceberg that was to rise to 3,000 calls in the week following the recall.

Defenders of Merck

While trial lawyers could see no reasonable justification for Merck’s delay in recalling Vioxx, some other experts questioned the validity of the criticisms. They saw these criticisms aimed more at enriching lawyers and destroying the pharmaceutical industry through an excess of litigation and reactionary over-regulation. Did Merck and the FDA err so badly with a widely used drug that draconian measures should have been taken by both?

We should recognize that all drugs have side effects, especially when taken in large doses and over long term. More than 10,000 people die per year from gastrointestinal bleeding caused by drugs like naproxen and ibuprofen, and this was the side effect that newer drugs like Vioxx and Celebrex were designed to avoid. Do the possible side effects nullify the good that can come from these drugs? And who should be the right people to weigh the benefits against the risks—courts and regulators or doctors and patients?

The concept of *relative risk* has been posed as key to decisions on drug benefits and dangers. Take disabling arthritis for example. The study that led to the withdrawal of Vioxx in September found 7.5 events of cardiovascular problems per 1,000 in the placebo groups versus 15 per 1,000 among those taking Vioxx, and only after 18 months at a high dose. This, of course, is a doubling of the risk factor with heavy and long-time use. But for our arthritis patient disabled and in severe pain, would 15 chances out of 1,000 of getting a heart attack convince you to drop Vioxx? Indeed, Merck’s decision to withdraw Vioxx would seem irresponsible to those

⁶ Simons and Stipp, p. 104.

⁷ *Ibid.*

patients who could not find relief elsewhere. Incidentally, the point could be raised that this irresponsibility in withdrawing the drug could also extend toward Merck's shareholders who were savaged by Merck's concession that the drug was a disaster and had no place in pharmacology, thus leaving the battleground to trial lawyers thirsting for such an admission. Of particular interest should be Pfizer's reaction with its own Celebrex, a Cox-2 inhibitor like Vioxx, which follows in the next section.⁸

Should Pfizer's Celebrex Also Be Withdrawn?

At \$3 billion-a-year in sales, Celebrex was the best-selling Cox-2 inhibitor, with Vioxx number 2 at \$2.5 billion. Yet, when the news broke of Vioxx's recall September 30, Pfizer stubbornly refused to take Celebrex off the market, as well as its Bextra, another Cox-2 inhibitor. Earlier research studies had involved only Vioxx and while Celebrex and Bextra were of the same family of drugs, they had mostly eluded the same implications of potential cardiovascular risks. At this point, Pfizer stood to gain big from Vioxx's troubles, with many people expected to switch to Celebrex.

The situation changed on a Thursday night the middle of December. Pfizer CEO Henry McKinnell got an unexpected phone call at his home in Greenwich, Connecticut. He learned that a review of a cancer study had for the first time linked high doses of Celebrex to greater heart-attack risks, even greater than those associated with Vioxx.

McKinnell and his colleagues decided to keep the drug on the market. They bet that the medical community and consumers would decide there was a need for a Cox-2 inhibitor like Celebrex. They took a calculated risk with this decision. If more adverse information came to light, Pfizer would face an intense legal attack. Then there was a concern whether doctors would continue to prescribe the drug.

Also lurking in the wings was the FDA's eventual decision on Cox-2 inhibitors. Indicative of how serious the FDA was taking this matter, it asked Pfizer to suspend its use of direct-to-consumer advertising and alter its marketing to doctors while the company and regulators examined the data from the National Institutes of Health trial. "It was a desire not to have mixed messages going out to physicians and patients," said John Jenkins, director of the FDA's office of new drugs. "We thought it would be very strange for consumers to be watching the evening news and see a story about Celebrex's potential risk, and then see an ad with a contrasting message."⁹

See the following Information Box for the latest information on the FDA's changing stance regarding drugs already approved and in the marketplace.

⁸ The reasoning in this section is influenced by "The Painkiller Panic," in the editorial of *Wall Street Journal*, December 23, 2004, p. A10.

⁹ Scott Hensley, Ron Winslow, and Anna Wilde Mathews, "As Safety Issue Hit Celebrex, Pfizer Decides to Hang Tough," *Wall Street Journal*, December 20, 2004, p. A6.

INFORMATION BOX**FDA ESTABLISHES BOARD TO REVIEW APPROVED DRUGS**

Plans for a special monitoring board to keep checking on medicines once they are on the market were announced February 15, 2005, on the eve of a three-day scientific meeting on the safety of prescription painkillers like Vioxx and Celebrex that blossomed into a \$5 billion-a-year business before potential killer side effects came to light. A medical journal questioned whether continued use of such products was justified. "Because there are well-established options for treatment of all the approved indications for these drugs, it is reasonable to ask whether the use of the drugs can now be justified," Dr. Jeffrey Drazen, editor of the *New England Journal of Medicine*, wrote.

The FDA said it wasn't currently planning to seek new regulatory authority, such as the ability to suspend the marketing of a drug when safety questions arise or prevent direct-to-consumer advertising of newly approved drugs. That would require changes in the law, but it said it could consider such a move in the future. Currently, the agency has the authority to force the removal of a drug from the market, but only if the product is an imminent health hazard, which might take years to go through the legal process. The board will be charged with making recommendations to the agency if it thinks action is needed, but will lack the authority to pull drugs or change labeling. It also is to recommend when the agency should alert consumers about potentially problematic drugs at an early stage.

Does this sound like the new board will be the answer for drug safety? Why or why not?

Sources: Randolph E. Schmid, *Associated Press*, as reported in "New Panel to Check Ongoing Drug Risks," *Cleveland Plain Dealer*, February 16, 2005, p. A12; and Anna Wilde Mathews and Leila Abboud, "FDA Establishes Board to Review Approved Drugs," *Wall Street Journal*, February 16, 2005, pp. A1 and A6.

With word of the study, new prescriptions dropped 56 percent in one week. A subsequent review of patient data by WellPoint, the nation's largest provider of health benefits, found that both Vioxx and Celebrex increased patients' risk of heart attack and stroke about 20 percent, while Bextra increased the risk 50 percent.¹⁰

OUTLOOK FOR MERCK**How Bad Will the Lawsuits Get?**

Given the millions who were taking Vioxx—potentially 80 million worldwide—it is a certainty that many thousands have suffered heart attacks. Of course, many of these would statistically have suffered heart attacks without having taken Vioxx.

¹⁰ "Painkiller Study Reinforces Cardiovascular Risk," *Wall Street Journal*, February 15, 2005, p. D4.

Surely Vioxx cannot be blamed for the great majority of these. But plaintiffs' lawyers will have little difficulty finding medical experts who will testify as to a causal relationship, and jurors will be more inclined to make decisions favoring a grieving spouse rather than a large corporation. And the drug industry hardly has a sterling reputation these days of skyrocketing drug prices and its widely publicized pressures to prohibit cheaper Canadian drug imports. The cost of settling lawsuits could well be in the tens of billions.

Gilmartin conceded that withdrawing the blockbuster Vioxx would hurt short-term profits. But he insisted the company's financial position would carry it through: "We're fortunate to have been managed conservatively, because this is the kind of event that you want to be able to protect yourself against."¹¹ The company had more than \$10 billion in liquid assets. Even after the Vioxx recall, Standard & Poor's and Moody's kept Merck's triple-A bond rating, for the time being.

But adversity was not finished with Merck. In November 2003, the company was forced to cancel work on potential blockbuster drugs for depression and diabetes. The former didn't work in a pivotal clinical trial, and the diabetes drug was found to pose a cancer risk. Furthermore, anticholesterol Zocor and its \$5 billion-a-year revenue went off patent in 2006 and Merck urgently needed to replace those sales. The stock price of \$95 in 2000, was under \$30 by February 2005.

WHAT IS MERCK'S BEST STRATEGY FOR THE FUTURE?

With Merck seemingly on the ropes, Wall Street and consultants were talking merger as a possible solution to Merck's difficulties. Much of the talk involved Schering-Plough—Merck had sales of \$22.9 billion in 2004, while Schering-Plough's sales were \$8.3 billion. The two companies had worked well together on a joint venture for two cholesterol-lowering medicines, Zetia and Vytarin. Schering's CEO, a turnaround specialist, would be a logical contender to succeed Gilmartin.

But Gilmartin was against a large-scale merger. He believed Merck should not shift from his strategy of reducing costs while entering partnerships with smaller, innovative companies and licensing promising compounds. Gilmartin admitted Merck's scientists had been arrogant and unwilling to work with others in the past, but insisted this had changed, as evidenced by 47 licensing deals in 2003 versus 10 in 1999.¹² The problem with licensing deals was that with so many big companies chasing the same deals, licensing was becoming ever more expensive. This left the option open for buying small biotech companies outright.¹³ But with its share price down 35 percent since the Vioxx withdrawal, and with little likelihood that this price would go up anytime soon, and while the threat of

¹¹ Simons and Stipp, p. 92.

¹² Simons and Stipp, p. 104.

¹³ Jeanne Whalen and Leila Abboud, "Big Pharma, Flush With Cash, Is Looking Acquisitive," *Wall Street Journal*, February 16, 2005, pp. C1 and C4.

lawsuits hung over its head, Merck was hardly in a power position for attractive merger terms.

ANALYSIS

We find conflicting attitudes regarding Merck's removal of Vioxx from the market. Some well-known doctors thought Merck waited far too long in trying to protect its profitability. Others praised it for full disclosure of information and taking action only after contradictory research findings were sorted out and evaluated. Merck's biggest competitor, Pfizer, with a comparable drug, Celebrix, even refused to take it off the market. All the while, trial lawyers were readying their ammunition for a full assault on Merck, the likes of which the drug industry had never seen before. How are we to judge the culpability of Merck? And yes, perhaps the double culpability of Pfizer for standing pat with its hand? The full judgments of the relative culpabilities will probably be years away as the lawsuits wend their ways through the judicial system.

Did Merck Make a Monumental Marketing Mistake?

It can be argued that Merck made two monumental marketing mistakes. First, it should have been more receptive to the early indications that something might be amiss with Vioxx. It should not have been so blinded by skepticism that the early research studies were inconclusive and that the early lawsuits were rare exceptions and provided no cause-and-effect relationships. It should have undertaken intensive research studies to ascertain the truth. In those early days it could well have involved Cleveland Clinic's Dr. Topol, a renowned heart specialist and researcher and the most vocal critic of Vioxx, and it should have kept in close touch with the FDA.

However, it is not difficult to understand Merck's procrastination. Holding back the marketing of this blockbuster drug would mean millions in profits lost. Additional research would perhaps have raised doubts that might have destroyed the future promise. Then the benefits in relieving severe arthritic pain seemed so great, and the number of heart attack and stroke risks so minor in comparison. Sure, the bottom line would be affected if the marketing were delayed or muted—and the critics pounced on this for the recall delay—but I suspect that with Merck's culture and the quick recall once the full measure of the side effects was established, that the bottom line took second place in the decision. (I'm not that sure about Pfizer.)

The second mistake that Merck made was to recall so quickly. The FDA, as a regulatory agency, should have been fully involved in this decision. The very real factor was whether the good outweighed the bad with this drug, and agreement was lacking here. Perhaps the FDA should have encouraged Merck to go ahead with Vioxx but with warnings prominently placed. If physicians and their patients felt the cardiovascular risk was too great, then they would not use it. Otherwise, accept the risk, and perhaps closely monitor the possible risk factors in the individual

patient. The advertising should probably be toned down, and full and prominent disclosure made.

As we noted in the Issue Box, pharmaceutical advertising is close to getting out of control, both in the amount spent and in the claims and emotional images repeated time and time again. I do not believe the industry can regulate itself in toning down these marketing efforts, which suggests that government may need to do some regulating in the future.

Invitation: What Would You Do? Direct-to-Consumer Advertising

You have a sure winner! The drug has been thoroughly tested before being recently introduced to the market, and it seems to be a wonder drug, perhaps in the \$3 billion-revenue range. Side effects appear to be acceptable. The board wants a massive consumer advertising campaign. What would you do? Be specific.

UPDATE—2007–2008

Merck's troubles hardly diminished. A pending \$4.85 billion Vioxx settlement was expected to bring more than three years of litigation to an end. But several other top-selling products were facing challenges. A growing number of patients were alleging that osteoporosis blockbuster Fosamax was causing serious side effects of bone breakdowns of the jaw as well as elsewhere in the body, and severe pain. To make the Fosamax situation worse, its patent protection was lost in February 2008; and even without the lawsuits, sales would be far less than the \$3 billion in 2006.

Prescriptions for the cholesterol drug Vytorin, heavily marketed by a joint venture of Merck and Schering-Plough in a single tablet combination of simvastatin and Zetia, were falling amid questions of its effectiveness in reducing risk of heart attacks and other cardiovascular problems. Making this situation worse and critics more incensed were revelations that the study was completed in April 2006, but the results were not disclosed until January 14, 2008. During that time, combined annual sales of Vytorin and Zetia grew to more than \$5 billion. Now there was doubt that the pill was any better than far less expensive generics. Truly, big Pharma was letting its public image be tarnished. See the following Issue Box: Spending Billions to Woo Doctors, for a discussion of other questionable marketing activities of the pharma industry.¹⁴

¹⁴ Compiled from such sources as Sarah Rubenstein, "Merck Posts \$1.63 billion Loss on Vioxx Charges," *Wall Street Journal*, January 21, 2008, p. B6; Heather Won Tesoriero, "Fight Brews over Merck Product," *Wall Street Journal*, January 30, 2008, p. A12; Anna Wilde Mathews and Avery Johnson, "Pharmaceutical Industry Faces Increased Scrutiny," *Wall Street Journal*, January 23, 2008, p. A14.

ISSUE BOX**SPENDING BILLIONS TO WOO DOCTORS**

For years, pharmaceutical companies have courted doctors with gifts, consulting fees, and trips to persuade them to prescribe their drugs. The drug industry maintains that its voluntary guidelines recommend only “modest” meals and gifts and that the sales representatives provide vital information to doctors. The facts decry the “modest,” especially in recent years as massive spending is up to \$7 billion a year “to win the hearts and minds of doctors” with another \$18 billion spent on free drug samples.

Reformers point to the sheer momentum of the industry’s massive spending on marketing to doctors—up 275 percent from 1996 to 2004—along with the rising costs of health care and the safety problems of such heavily promoted drugs as Vioxx, and now others coming to light. While few critics would deny that new drugs have saved lives, new medications are typically more expensive than older or generic versions and can have adverse side effects that were not apparent in initial clinical tests. And in some cases these new expensive drugs are no more effective than older drugs, as we have seen with Vytorin and Zetia.

Do all these freebies influence doctors? While some maintain that they stay completely objective, and are even speaking out against these gifts and favors on websites, such as No Free Lunch and PharmedOut, a study in the *New England Journal of Medicine* found that 94 percent of the doctors polled said they had “direct ties” to the drug industry.

Do you think these practices need to be curbed? If so, what would you recommend?

Source: Cited in Barbara Basler, “Ties That Bind,” *AARP Bulletin*, January–February 2008, pp. 20–26.

WHAT WE CAN LEARN**Always Be Ready for the Worst Scenario**

Firms particularly involved with health and safety—but not limited to these—need to be prepared for a worst scenario, that something catastrophic might happen with their product(s). It is good to have contingency plans for coping with such extreme crises. For a drug firm, it is not unrealistic to think that a blockbuster drug could have ill effects not discovered in the early trials, and even be deadly with long-term use. Here are sample questions that should be considered in any preparation for a worst scenario: How is this situation to be handled? What public relations efforts need to be planned? Should top executives be

personally involved in such public relations? Should a total recall be made, or will a partial one be sufficient. How are we to handle the millions, and even billions of costs emanating from this? How can we avoid the worst of litigation? What governmental bodies should we interact with? What changes in strategies ought to be considered, if any? How can we best insure against this worst scenario happening?

It is so much easier to make plans, and even brainstorm, in the calm setting of an office or committee room or boardroom than in the frenzied panic of a situation suddenly gone bad. Also, while we're thinking about crisis situations, certain prudent policies should be followed for crisis-avoidance. For example, don't allow key personnel to be on the same plane, or even in the same car. Understudies should be trained to take over key jobs, at least temporarily, in the event of such unexpected happenings as serious injury or death, or unexpected resignation. And what about a computer breakdown, or a fire, or another 9/11?

Be Alert to Early Hints of Trouble

Sometimes crises come suddenly and catastrophically. Other times they come on "little cat feet." These early hints of something amiss often go practically unnoticed until they mushroom into something much more serious. We saw in Chapter 5 in the Coca-Cola case where a few Belgian schoolchildren getting sick after drinking Cokes led to a far worst contamination scare. There was even an earlier warning a month before when four people in an Antwerp pub became sick from drinking a bad-smelling Coke.

The early hints of trouble with Vioxx for the most part went unnoticed—a few lawsuits, questionable research findings, one or two scientists and physicians warning. It was so easy to find reasons not to be concerned about these, to excuse them as not valid, not representative, contradictory, even overzealous. It was also so easy to discredit their importance as the sporadic side effects that any drug will have. With millions and billions at stake for a blockbuster drug that had already been approved by the FDA and with all accompanying research data fully supportive, a delaying or withdrawal from the market at that time would have been almost heretical. Yet it would have been the right decision to investigate the conflicting information and not release Vioxx until all questions were cleared up. If the early hints of problems had been investigated before the marketing was in full force, the trauma would have been more muted.

Eagerness to Sue Should Be Factored into Some Decisions

In today's litigious environment, a firm with any risk of lawsuits needs to factor in this very real consequence of doing business today. It should surely be a deterrent for actions that come close to crossing the line. Insurance and financial reserves may need to be established, rather than paying out dividends, if

the risk of litigation is particularly high, as it would seem to be for pharmaceutical firms. When we consider the possibility of tens of billions in lawsuits for Merck, decisions should certainly be taken to try to avoid this possibility. Perhaps this is what influenced Merck to recall Vioxx so abruptly, and maybe too hastily, especially as some lawyers will see this as an admission of guilt. Unfortunately, the possibility of vulnerability to lawsuits seemed not to influence Merck's decisions to disregard early warning signs.

Particularly interesting in this case is the contrary decision by Pfizer not to withdraw its Celebrex from the market. How this will play out in the courts remains to be seen. In the meantime, Pfizer was expecting to reap a harvest at Merck's expense, but instead new prescriptions for Celebrex were drastically down.

The Pharmaceutical Industry Needs to Improve Its Public Image

Drug firms have reputations, despite recent advances in medicines, that are in the pits. They are seen as uncaring, profit-mongering makers of products not always better than existing products, sometimes less safe, and with the huge advertising budgets, substantially higher priced. Anything negative receives widespread press coverage. This is not surprising in this time of high drug prices, and with the aggressive actions of major drug companies to curb importation of much cheaper drugs from Canada. Stories of massive lobbying by the industry in Washington have not gone unnoticed by many consumers. The power of special interest groups has affected the objectivity of the FDA, various members of Congress, and even the executive branch of the government—all to the detriment of the average consumer, so is the common belief. This negative image, which seems of little concern by the industry, poses grave consequences and dangers. Jury awards in damage suits consequently yield judgments out of proportion to actual injuries in many cases—the grieving spouse versus the huge uncaring drug firm, this is an unequal contest in the courtroom. This industry truly needs to be concerned about its public image and take strong measures to improve it.

CONSIDER

Can you add to these learning insights?

QUESTIONS

1. On balance, do you think Merck is an ethical and socially responsible company? Why or why not? How about Pfizer?
2. How could the disaster with Vioxx have been avoided in the first place?
3. What is your opinion of pharmaceutical advertising?

4. Discuss the idea of *relative risk*. What is the significance of it for the drug firm itself, for the FDA, for tort lawyers, and for the consumer?
5. Do you think Merck CEO Gilmartin acted wisely in recalling Vioxx? Why or why not?
6. “The more than \$10 billion Merck has hoarded attests to the obscene profits these drug companies are making at our expense,” a consumer advocate speaks up. Evaluate this statement.
7. “The FDA is in the pocket of the drug industry. What a travesty this is.” Comment.

HANDS-ON EXERCISES

1. You have been a public relations consultant to Merck and know the company well. You have just been summoned to the office of CEO Gilmartin. His hands tremble as he tells you of the latest research finding that Vioxx doubles the incident of heart attacks and strokes. He wants you to lay out a public relations plan that would ease the repercussions of this catastrophe. Be as specific as you can. If you have to make some assumptions, state them clearly and keep them reasonable.
2. You are a staff assistant to Gilmartin. He wants you to analyze two courses of action for expanding the firm in 2005. Should this be through licensing, or should it be through merging with other companies? Or something else? Present all the factors bearing on this decision that you can, and discuss their relative merits and priorities.
3. Be a *devil’s advocate*. Array all the arguments you can to Chief Executive Henry McKinnell of Pfizer that the company is making a big mistake in not pulling Celebrex off the market as Merck has done with Vioxx.

TEAM DEBATE EXERCISES

1. It is early 1999 and Vioxx has just been introduced to the market and a massive advertising campaign is planned for it. At the same time, several small research studies have indicated possible heart attack risks. Debate these two positions: (1) Abort the market introduction until the questionable research findings can be verified or disproved, and (2) Continue with the marketing plans since these research studies are small and of questionable validity. (Don’t be swayed by what actually happened. In 1999 there was little expectation that anything could go wrong with this great new breakthrough drug.)
2. It is 2004 and the latest research report confirms that Vioxx doubles the risk of heart attacks and strokes. Debate the decision to pull Vioxx off the market. Array as many arguments as you can for either decision, and be prepared to attack the arguments of the other side.

INVITATION TO RESEARCH

- What is the situation with Merck and Vioxx today?
- Has Merck made any large acquisitions?
- Is Pfizer's Celebrex still on the market, or has it been recalled?
- Has the FDA's new oversight committee been effective in improving drug safety?
- Has the drug industry made any inroads in improving its public image?
- Has consumer advertising by the drug industry been curtailed? How about massive marketing expenditures to doctors?

MetLife: Deceptive Sales Practices

In August 1993, the state of Florida cracked down on the sales practices of giant Metropolitan Life, a company dating back to 1868, and the country's second largest insurance firm. MetLife agents based in Tampa, Florida were alleged to have duped customers out of some \$11 million. Thousands of these customers were nurses lured by the sales pitch to learn more about "something new, one of the most widely discussed retirement plans in the investment world today."¹ In reality, it was a life-insurance policy in disguise, and what clients were led to think were savings deposits were actually insurance premiums.

As we will see, the growing scandal rocked MetLife, and eventually brought it several billion dollars in fines and restitutions. What was not clear for certain was the full culpability of the company: Was it guilty only of not monitoring agent performance sufficiently to detect unethical and illegal activities, or was it the great encourager of such practices?

RICK URSO: THE VILLAIN?

The first premonitory rumble that something bad was about to happen came to Rick Urso on Christmas Eve 1993. Home with his family, he received an unexpected call from his boss, the regional sales manager. In disbelief, he heard there was a rumor going around the executive suites that he was about to be fired. Urso had known that the State of Florida had been conducting an investigation, and that company auditors had also been looking into sales practices. And on September 17, two corporate vice-presidents had even shown up to conduct the fourth audit that year, but on leaving they had given him the impression that he was complying with company guidelines.

Urso often reveled in his good fortune and attributed it to his sheer dedication to his work and the company. He had grown up in a working-class neighborhood, the son of an electrician. He had started college, but dropped out before graduating.

¹ Suzanne Woolley and Gail DeGeorge, "Policies of Deception?" *BusinessWeek*, January 17, 1994, p. 24.

His sales career started at a John Hancock agency in Tampa in 1978. Four years later, he was promoted to manager and was credited with building up the agency to number two in the whole company.

He left John Hancock in 1983 for MetLife's Tampa agency. His first job was as trainer. Only three months later, he was promoted to branch manager. Now his long hours and overwhelming commitment were beginning to pay off. In a success story truly inspiring, his dedication and his talent as a motivator of people swept the branch from a one-rep office to one of MetLife's largest and most profitable. By 1993, the agency employed 120 reps, 7 sales managers, and 30 administrative employees—and he was the head. In 1990 and 1991, Urso's office won the company's Sales Office of the Year award. With such a performance history, the stuff of legends, he became the company's star, a person to look up to and to inspire trainees and other employees.

Urso had the passion of an evangelist: "Most people go through life being told why they can't accomplish something. If they would just believe, then they would be halfway there. That's the way I dream and that's what I expect from my people."² He soon became known as the "Master Motivator," and increasingly was the guest speaker at MetLife conferences.

On the Monday after that Christmas, the dire prediction came to pass. He was summoned to the office of William Groggans, the head of MetLife's Southeast territory, and there was handed a letter by the sober-faced Groggans. With trembling hands he opened it and read that he was fired; the reason: engaging in improper conduct.

The Route to Stardom

Unfortunately, the growth of his Tampa office could not be credited to simple motivation of employees. Urso found his vehicle for great growth to be the whole-life insurance policy. This was part life insurance and part savings. As such, it required high premiums, but only part earned interest and compounded on a tax-deferred basis; the rest went to pay for the life insurance policy. What made this so attractive to company sales reps was the commission: A Met whole-life policy paid a 55 percent first-year commission. In contrast, an annuity paid only a 2 percent first-year commission.

Urso found the nurses market to be particularly attractive. Perhaps because of their constant exposure to death, nurses were easily convinced of the need for economic security. He had his salespeople call themselves "nursing representatives," and his Tampa salespeople carried their fake retirement plan beyond Florida, eventually reaching 37 states. A New York client, for example, thought she had bought a retirement annuity. But it turned out to be insurance even though as a single woman she didn't need such coverage because she had no beneficiaries.³

As the growth of the Tampa agency became phenomenal, Urso's budget for mailing brochures was upped to nearly \$1 million in 1992, ten times that of any other MetLife office. This gave him national reach.

² Weld F. Royal, "Scapegoat or Scoundrel," *Sales & Marketing Management*, January 1995, p. 64.

³ Jane Bryant Quinn, "Yes, They're Out to Get You," *Newsweek*, January 24, 1994, p. 51.

Urso's own finances increased proportionately because he earned a commission on each policy his reps sold. In 1989, he was paid \$270,000. In 1993, as compensation exceeded \$1 million, he moved his family to Bay Shore Boulevard—the most expensive area of Tampa.

Early Warnings

A few complaints began surfacing. In 1990 the Texas insurance commissioner warned MetLife to stop its nursing ploy. The company made a token compliance by sending out two rounds of admonitory letters. But apparently nothing changed. See the following Information Box about the great deficiency of token compliance without follow-up.

An internal MetLife audit in 1991 also raised some questions about Urso's pre-approach letters. The term *nursing representative* was called a "made-up" title. The auditors also questioned the term *retirement savings policy* as not appropriate for the product. However, the report concluded by congratulating the Tampa office for its contribution to the company. Not surprisingly, such mixed signals did not end the use of misleading language at that time.

Allegations Intensify

In summer 1993, Florida state regulators began a more in-depth examination of the sales practices of the Urso agency. The crux of the investigation concerned

INFORMATION BOX

THE VULNERABILITY OF COMPLIANCE IF IT IS ONLY TOKEN

A token effort at compliance to a regulatory complaint or charge tends to have two consequences, neither good in the long run for the company involved:

1. Tokenism gives a clear message to the organization: "Despite what outsiders say, this is acceptable conduct in this firm." Thus is set the climate for less-than-desirable practices.
2. Vulnerability to harsher measures in the future. With the malpractice continuing, regulators, convinced that the company is stalling and refusing to cooperate, will eventually take more drastic action. Penalties will move beyond warnings to become punitive.

Actually, the firm may not have intended to stall, but that is the impression conveyed. If the cause of the seemingly token effort is really faulty controls, one wonders how many other aspects of the operation are also ineptly controlled so that company policies are ignored.

Discuss the kinds of controls MetLife could have imposed in 1990 that would have made compliance actual and not token.

promotional material Urso's office was sending to nurses nationwide. From 1989 to 1993, millions of direct-mail pieces had been sent out. Charges finally were leveled that this material disguised the product agents were selling. For example, one brochure coming from Urso's office depicted the Peanuts character Lucy in a nurse's uniform. The headline described the product as "retirement savings and security for the future a nurse deserves." Nowhere was insurance even mentioned, and it was alleged that nurses across the country had unknowingly purchased life insurance when they thought they were buying retirement savings plans.

As the investigation deepened, a former Urso agent, turned whistleblower, claimed he had been instructed to place his hands over the words "life insurance" on applications during presentations.

As a result of this investigation, Florida Insurance Commissioner Tom Gallagher charged MetLife with serious violations.

METLIFE CORRECTIVE ACTIONS, FINALLY

Under investigation by Florida regulators, the company's attitudes changed. At first, MetLife had denied wrongdoing. But eventually it acknowledged problems. Under mounting public pressure, it agreed to pay \$20 million in fines to more than 40 states as a result of unethical sales practices of its agents. It further agreed to refund premiums to nearly 92,000 policyholders who had bought insurance based on misleading sales information between 1989 and 1993. The refunds were expected to reach \$76 million.

MetLife fired or demoted five high-level executives as a result of the scandal. Urso's office was closed, and all seven of his managers and several reps were also discharged. Life insurance sales to individuals were down 25 percent through September 1994 over the same nine-month period in 1993. Standard & Poor's downgraded MetLife's bond rating based on these alleged improprieties.

Shortly after the fines were announced, the Florida Department of Insurance filed charges against Urso and 86 other MetLife insurance agents, accusing them of fraudulent sales practices. The insurance commissioner said, "This was not a situation where a few agents decided to take advantage of their customers, but a concerted effort by many individuals to dupe customers into buying a life insurance policy disguised as a retirement savings plan."⁴

Now MetLife attempted to improve its public image by instituting a broad overhaul of its compliance procedures. It established a corporate ethics and compliance department to monitor behavior throughout the company and audit personal insurance sales offices. The department was also charged to report any compliance deficiencies to senior management and to follow up to ensure the implementation of corrective actions.

In MetLife's 1994 *Annual Report*, Harry Kamen, CEO, and Ted Athanassiades, president, commented on their corrective actions regarding the scandal:

⁴ Sean Armstrong, "The Good, The Bad and the Industry," *Best's Review*, P/C. June 1994, p. 36.

We created what we think is the most effective compliance system in the industry. Not just for personal insurance, but for all components of the company. We installed systems to coordinate and track the quality and integrity of our sales activities, and we created a new system of sales office auditing.

Also, there were organizational changes. And, for the first time in 22 years, we assembled all of our agency and district managers—about a thousand people—to discuss what we have done and need to do about the problems and where we were going.⁵

Meantime, Rick Urso started a suit against MetLife for defamation of character and for renegeing on a \$1 million severance agreement. He alleged that MetLife made him the fall guy in the nationwide sales scandal.

The personal ramifications for Urso's life were not inconsequential. More than a year later he was still unemployed. He had looked for another insurance job, but no one would even see him. "There are nights he can't sleep. He lies awake worrying about the impact this will have on his two teenagers." And he laments that his wife cannot go out without people gossiping.⁶

WHERE DOES THE BLAME LIE?

Is Urso really the unscrupulous monster who rose to a million-dollar-a-year man on the foundations of deceit? Or is MetLife mainly to blame for encouraging, and then ignoring for too long, practices aimed at misleading and even deceiving?

The Case against MetLife

Undeniably, Urso did things that smacked of the illegal and unethical. But did the corporation knowingly provide the climate? Was his training such as to promote deceptive practices? Was MetLife completely unaware of his distortions and deceptions in promotional material and sales pitches? There seems to be substantial evidence that the company played a part; it was no innocent and unsuspecting bystander.

At best, MetLife top executives may not have been aware of the full extent of the hard-selling efforts emanating at first from Tampa and then spreading further in the organization. Perhaps, in the quest for exceptional bottom-line performance, they chose to ignore any inkling that things were not completely on the up and up. "Don't argue with success" may have become the corporate mindset.

At the worst, the company encouraged and even demanded hard selling and tried to pretend that it could be accomplished with acceptable standards of performance. If such standards were not met, the company's top executives could argue that they were not aware of any wrongdoing.

There is evidence of company culpability. Take the training program for new agents. Much of it was designed to help new employees overcome the difficulties of selling life insurance. In so doing, they were taught to downplay the life insurance

⁵ *MetLife 1994 Annual Report*, p. 16.

⁶ Royal, p. 65.

aspects of the product. Rather, the savings and tax-deferred growth benefits were to be stressed.

New agents learning to sell insurance over the phone were told that people prefer dealing with specialists. It seemed only a small temptation to use the title *nursing representative* rather than *insurance agent*.

After the scandal MetLife admitted that the training might be faulty. Training had been decentralized into five regional centers, and the company believed that this might have led to a less standardized and controlled curriculum. MetLife has since reorganized, so that many functions, including training and legal matters, were now done at one central location.⁷

The company's control or monitoring was certainly deficient and uncoordinated during the years of misconduct. For example, the marketing department promoted deceptive sales practices, while the legal department warned of possible illegality but took no further action to eliminate it.

AN INDUSTRY PROBLEM?

The MetLife revelations focused public and regulatory attention on the entire insurance industry. The Insurance Commissioner of Florida also turned attention to the sales and marketing practices of New York Life and Prudential. The industry itself seemed vulnerable to questionable practices. Millions of transactions, intense competition, and a widespread and rather autonomous sales force—all these afforded opportunity for misrepresentation and other unethical dealings.

For example, just a few months after the Tampa office publicity, MetLife settled an unrelated scandal. Regulators in Pennsylvania fined the company \$1.5 million for “churning.” This is a practice whereby agents replace old policies with new ones for which additional commissions are charged and policyholders are disadvantaged. Class-action suits alleging churning were also filed in Pennsylvania against Prudential, New York Life, and John Hancock.

But problems go beyond sales practices. Claims adjusters may attempt to withhold or reduce payments. General agents may place business with bogus or insolvent companies. Even actuaries may create unrealistic policy structures.

With a deteriorating public image, the industry faced further governmental regulation from both state and federal agencies. But cynics, both within and outside the industry, wondered whether deception and fraud were so much a part of the business that nothing could be done about them.⁸

ANALYSIS

Here we have an apparent lapse in complete feedback to top executives. But maybe they did not want to know. After all, nothing was life-threatening here, no product safety features were being ignored or disguised, nobody was in physical danger.

⁷ “Trained to Mislead,” *Sales & Marketing Management*, January 1995, p. 66.

⁸ Armstrong, p. 35.

This raises a key management issue. Can top executives hide from less-than-ethical practices—and even illegal ones—under the guise that they did not know? The answer should be *No!* See the Information Box below for a discussion of management accountability.

We are left with MetLife's top management grappling with the temptation to tacitly approve the aggressive selling practices of a sales executive so successful as to be the model for the whole organization, even though faint cries from the legal staff suggested that the practices might be subject to regulatory scrutiny and disapproval.

The harsh appraisal of this situation is that top management cannot be exonerated for the deficiencies of subordinates. If controls and monitoring processes are defective, top management is still accountable. The pious platitudes of MetLife managers insisting that they have now corrected the situation hardly excuse them for permitting it to have developed in the first place.

Ah, but embracing the temptation is so easy to rationalize. Management can always maintain that there was no good, solid proof of misdeeds. After all, where do aggressive sales efforts cross the line? When do they become more than simply "puffing," and become outright deceptive? See the Information Box on the following page regarding puffing, an admittedly gray area of the acceptable. Lacking

INFORMATION BOX

THE ULTIMATE RESPONSIBILITY

In the Maytag case in Chapter 16, we examined a costly snafu brought about by giving executives of a foreign subsidiary too much rein. With Met Life the problem was gradually eroding ethical practices. In both instances top management still had ultimate responsibility and cannot escape blame for whatever went wrong in the organization. Decades ago, President Truman coined the phrase, "The buck stops here," meaning that in this highest position rests the ultimate seat of responsibility.

Any manager who delegates to someone else the authority to do something will undoubtedly hold them responsible to do the job properly. Still, managers must be aware that their own responsibility to higher management or to stockholders cannot be delegated away. If the subordinate does the job improperly, the manager is responsible.

Going back to MetLife, or to any corporation involved with ethical and illegal practices, top executives may try to escape blame by denying that they knew anything about the misdeeds. This should not exonerate them. Even if they knew nothing directly, they still set the climate.

In Japan the chief executive of an organization involved in a public scandal usually resigns in disgrace. In the United States top executives until recently often escaped full retribution by blaming their subordinates and maintaining that they themselves knew nothing of the misdeed. Is it unfair to hold a top executive culpable for the shortcomings of some unknown subordinate?

INFORMATION BOX**WHERE DO WE DRAW THE LINE ON PUFFING?**

Puffing is generally thought of as mild exaggeration in selling or advertising. It is generally accepted as simply the mark of exuberance toward what is being promoted. As such, it is acceptable business conduct. Most people have come to regard promotional communications with some skepticism—"It's New! The Greatest! A Super Value! Gives Whiter Teeth! Whiter Laundry! . . ." and so on. We have become conditioned to viewing such blandishments with suspicion. But dishonest or deceptive? Probably not. As long as the exaggeration stays mild.

But it can be a short step from mild exaggeration to outright falsehoods and deceptive claims. Did MetLife's "nursing representatives," "retirement plans," and hiding the reality of life insurance cross the line? Enough people thought so, including state insurance commissioners and the victims themselves. This short step can tempt more bad practices than if the line between good and bad were more definitive.

Do you think all exaggerated claims, even the mild and vague ones known as puffing, should be banned? Why or why not?

indisputable evidence of misdeeds, why should these executives suspect the worst, especially since their legal departments, not centralized as they were to be later, were timid in their denunciations?

Turning to controls, a major caveat should be posed for all firms: In the presence of strong management demands for performance—with the often implicit or imagined pressure to produce at all costs, or else—the ground is laid for less than desirable practices by subordinates. After all, their career paths and even job longevity depend on meeting these demands.

Such abuses are more likely to occur in a climate of decentralization and *laissez-faire*. A results-oriented structure suggests that it's not how you achieve the desired results, but that you meet them. So, while decentralization, on balance, is usually desirable, it can lead to undesirable practices in an environment of top management laxity.

At the least, it leads to opportunistic temptation by lower- and middle-level executives. Perhaps this is the final indictment of MetLife and Rick Urso. The climate was conducive to his ambitious opportunism. For a while it was wonderful. But the abuses of accepted behavior could not be disguised indefinitely.

And wherever possible, top management will repudiate its accountability.

The Handling of the Crisis

MetLife responded slowly to the allegations of misconduct. A classic mode for firms confronted with unethical and/or product liability charges is to deny everything, until evidence becomes overwhelming. Then they are forced to acknowledge

problems under mounting public pressure—from regulatory bodies, attorneys, and the media—and have to scramble with damage control to try to undo the threats to public image and finances. In MetLife’s case, fines and refunds approached \$100 million early on. They would eventually reach almost \$2 billion.

Being slow to act, to accept any responsibility, and, for top executives, exhibiting aloofness until late in the game are actions that inflame public opinion and regulatory zeal. How much better for all involved, victims as well as the organization itself, if initial complaints are promptly followed up. And, if complaints are serious, they should be given top management attention in a climate of cooperation with any agencies involved as well as the always interested media.

LATER DEVELOPMENTS

On August 18, 1999, MetLife agreed to pay out at least \$1.7 billion to settle final lawsuits over its allegedly improper sales practices. The agreement (in which MetLife admitted no wrongdoing) “involved” about 6 million life insurance policyholders and a million annuity-contract holders. Essentially, these customers were expected to get one-to-five years of free term-life insurance coverage.

MetLife argued for years that it had done nothing wrong. It had previously dispensed with most of its litigation problems by settling rather than going to trial. The incentive for settling these final class-action suits, even at the cost of a massive charge, was to clear the way for MetLife’s planned conversion to a stockholder-owned company from its current status as a policyholder-owned mutual company. “Clearly it’s something they needed to put behind them before they demutualized” or went public.¹⁰

Harry Kamen, CEO of MetLife, had brought Robert Benmosche, age 57, an ex-Wall Streeter, on board in 1995 to turn things around. Benmosche solved many of MetLife’s problems and became chairman when Kamen retired in 1998. In April 2000 he took the company public and the stock offering raised \$5.2 billion.

In his relentless restructuring, Benmosche axed poor performers—some 1,300 including 154 assistant vice presidents and higher in 2001—and demanded better results and ethical standards. He required agents to work full-time, instead of part-time, as many had previously done: “I knew this was needed after I met someone who complimented one of my agents for his plumbing skills,” explained Benmosche. He also compelled all agents to get securities licenses so they could sell investments like variable annuities. Bonuses were now tied into performance reviews and a division’s financial results, and officer’s bonuses were partly paid in stock that they were discouraged from selling: “If the top people . . . don’t do what they have to do to make sure the company strongly survives, we should lose our shirts.” MetLife’s revenues in 2001 were \$32 billion, up 18 percent since Benmosche became chairman.¹¹

¹⁰ Deborah Lohse, “MetLife Agrees to Pay Out \$1.7 Billion or More to Settle Policyholder Lawsuits,” *Wall Street Journal*, August 19, 1999, p. B14.

¹¹ Carrie Coolidge, “Snoopy’s New Tricks,” *Forbes*, April 15, 2002, pp. 100–102.

Demutualization, or taking a company public, has the powerful advantage of easier availability of funds due to stock offerings. But there are some drawbacks. The chief one is that public ownership exposes a firm to more visibility and criticism. The following Information Box describes alleged abuses of executive compensation for another big insurance company.

INFORMATION BOX

CRITICISMS OF PRUDENTIAL INSURANCE COMPANY

Prudential had long cultivated its image as the “Rock,” using a logo of the Rock of Gibraltar, symbol of permanence and stability. But like MetLife, it faced investigations and litigation over deceptive sales practices that affected millions of policyholders in the 1980s and early 1990s, and its sales of life-insurance policies slowed markedly. The company set aside more than \$2 billion to cover the costs of litigation, and took a \$1.64 billion charge against 1997 earnings. To try to resurrect its tarnished image, it increased advertising expenditures to \$130 million in 1996 and 1997.

In August 1998, it came under fire of another kind, with disclosures of hefty compensations paid its executives, this despite the performance downturn: the top 100 executives averaged \$820,000 in 1997, up 30 percent from 1994. By contrast, MetLife’s top hundred executives averaged \$600,000 in 1997, and State Farm had less than three dozen earning \$350,000 or more.¹²

The compensation criticisms probably would not have surfaced had Prudential not sought to end its mutual status and move to public ownership, which would enable it to raise money more easily for purposes such as acquisitions. But demutualization exposed Prudential to critical scrutiny by huge institutional investors, notably the California Public Employees’ Retirement System, and TIAA-CREF, a giant pension fund. These major shareholders regularly examine executive-compensation records of publicly traded companies.

Should executives be richly compensated when their firms are not doing well? Is it right to criticize a firm whose executives are far more richly rewarded than others in the same industry? Is it right for institutional investors to criticize and try to change policies in firms they invest in?

¹² Scot J. Paltrow, “As a Public Company Prudential May Find Pay Scales Draw Fire,” *Wall Street Journal*, August 14, 1998, pp. A1 and A8.

Invitation to Make Your Own Analysis and Conclusions

Do you think Urso’s career could have been salvaged? What could he have done? What could higher management have done to save this man’s gifted but misguided career? Or was he worth saving?

WHAT WE CAN LEARN

Beware the Head-in-the-Sand Approach to Looming Problems or Public Complaints

Ignoring or giving only token attention to suspected problems and regulatory complaints sets a firm up for a possible massive crisis. Covering one's eyes to malpractices and danger situations does not make them go away; they tend to fester and become more serious. Prompt attention, investigation, and action is needed to prevent these problem areas from getting out of hand. MetLife could have saved itself several billion dollars if it had acted on the early complaints of misrepresentation and misleading customers.

Unethical and Illegal Actions Do Not Go Undetected Forever

It may take months, it may take years, but a firm's dark side will eventually be uncovered. Its reputation may then be besmirched; it may face loss of customers and competitive position, and it may face heavy fines and increased regulation.

The eventual disclosure may come from a disgruntled employee (a whistleblower). It may originate from a regulatory body or an investigative reporter. Or it may come from revelations emanating from a lawsuit. Eventually, the deviation is uncovered, and retribution follows. Such a scenario should be—but is not always—enough to constrain those individuals tempted to commit unethical and illegal actions.

What made the MetLife deceptive practices particularly troubling is that they were so visible, and yet were so long tolerated. Much of the sales organization seemed to lack a clear definition of what was acceptable and what was not. Something was clearly amiss both in the training and in the monitoring and evaluation of agent personnel.

The Control Function Is Best Centralized in Any Organization

Where the department or entity that monitors performance is decentralized, tolerance of bad practices is more likely than when centralized. The reason is rather simple. Where legal or accounting controls are decentralized, those conducting them are more easily influenced and are likely to be neither as objective nor as critical as when they are further from the situation. Reviewers and evaluators should not be close to the people they are examining. And they should report only to top management.

A Strong Sales Incentive Program Invites Bad Practices

The lucrative commission incentive for the whole-life policies—55 percent first-year commission—was almost bound to stimulate abusive sales practices, especially when the rewards for this type of policy were so much greater than for

any other. Firms often use incentive programs and contests to motivate their employees to greater efforts. But if some are tempted to cross the line, the end result in public scrutiny and condemnation may not be worth whatever increases in sales might be gained.

Large Corporations Are Particularly Vulnerable to Public Scrutiny

Large firms, especially ones dealing with consumer products, are very visible. This visibility makes them attractive targets for critical scrutiny by activists, politicians, the media, regulatory bodies, and the legal establishment. Such firms ought to be particularly careful in any dealings that might be questioned, even if short-term profits have to be restrained. In MetLife's case the fines and refunds eventually approached \$2 billion. Although the firm maintained, in its *1994 Annual Report*, that all the bad publicity was behind it, that there were no ill effects, some analysts wondered how quickly a besmirched reputation could truly be restored, especially with competitors eager to grab the opportunity presented.

Sometimes a Tarnished Reputation Can Be Rather Quickly Restored

Contrary to some experts, there is compelling evidence that customers tend to quickly forget misdeeds, as they apparently did with MetLife under the new management of Benmosche. We will see a similar restoration of reputation with the unsafe tires of Firestone in Ford Explorers in the next chapter. While the poor image of Continental Airlines was not due to product safety or deception, but rather to years of deteriorating service, this image was quickly turned around with enlightened, fresh management. Perhaps these experiences should be comforting to a firm that incurs image damage, perhaps through its own fault, or maybe because of factors not directly under its control. It does help, however, if there is a change in top management. Still, in cases of unethical conduct, fines and perhaps a plethora of lawsuits are more immediate consequences of culpability.

CONSIDER

What additional learning insights do you see?

QUESTIONS

1. Do you think Rick Urso should have been fired? Why or why not?
2. Do you think the MetLife CEO and president should have been fired? Why or why not?

3. Why was it seemingly so desirable to avoid the term, “life insurance”? What is wrong with life insurance?
4. Given the widespread publicity about the MetLife scandal, did you think the firm could regain consumer trust in a short time?
5. “This whole critical publicity has been blown way out of proportion. After all, nobody was injured, not even in their pocketbook. They were sold something they really needed, for their own good.” Evaluate.
6. “You have to admire that guy, Urso. He was a real genius. No one else could motivate a sales organization as he did. They should have made him president of the company. Or else he should become an evangelist.” Evaluate.
7. Do you think the arguments are compelling that the control function should be centralized rather than decentralized? Why or why not?

HANDS-ON EXERCISES

Before

1. It is early 1990. You are the assistant to the CEO of MetLife. Rumors have been surfacing that life insurance sales efforts are becoming not only too high pressure but also misleading. The CEO has ordered you to investigate. You find that the legal department in the Southeast Territory has some concerns about the efforts coming out of Urso’s highly successful Tampa office. Be specific about how you would investigate these unproven allegations, and explain how you would report them to your boss, assuming that some questionable practices seem apparent.
2. It is 1992. Internal investigations have confirmed that Urso and his “magnificent” Tampa office are using deceptive selling techniques in disguising the life insurance aspects of the policies they are selling. As the executive in charge in the Southeast, describe your actions and rationale at this point. (You have to assume that you do not know the consequences.)

After

3. The _____ has hit the fan. The scandal has become well-publicized, especially with such TV programs as *Dateline* and *20/20*. What would you do as top executive of MetLife at this point? How would you attempt to save the public image of the company?

TEAM DEBATE EXERCISE

The publicity is widespread about MetLife’s “misdeeds.” Debate how you would react. One position is to defend your company and rationalize what happened and downplay any ill-effects. The other position is to meekly bow to the allegations and admit wrongdoing and be as contrite as possible.

INVITATION TO RESEARCH

Is MetLife still prospering under Benmosche? Can you find any information that contradicts that the situation has virtually been forgotten by the general public? Can you find out whether Rick Urso has found another job? Could you develop the pros and cons of a mutual (policyholder owned) firm and a public firm owned by stockholders?

Ford Explorers with Firestone Tires: Ill-Handling a Killer Scenario

A product defect that leads to customer injuries and deaths through manufacturer carelessness constitutes the most serious crisis that any firm should face. In addition to destroying brand reputation, ethical and social responsibility abuses are involved, and then legal and regulatory consequences. Managing such a crisis becomes far worse, however, when the manufacturer knew about the problems and concealed them, or denied them.

This case is unique, in that two manufacturers were culpable, but each blamed the other. As a result, Firestone and Ford were savaged by the press, public opinion, the government, and a host of salivating lawyers. Massive tire recalls destroyed the bottom lines and even endangered the viability of Bridgestone/Firestone, while sales of the Ford Explorer, the world's best-selling sport-utility vehicle (SUV), plummeted 22 percent in April 2001 from the year before, while domestic sales of SUVs overall climbed 9 percent.

A HORROR SCENARIO

Firestone tires mounted on Ford Explorers were linked to more than 200 deaths from rollovers in the United States, as well as more than 60 in Venezuela and a reported 14 in Saudi Arabia and neighboring countries. A widely publicized lawsuit took place in Texas in the summer of 2001. It had been expected that the jury would determine who was most to blame for the deaths and injuries from Explorers outfitted with Firestone tires.

Ford settled its portion of the suit for \$6 million, one month before the trial began. While Firestone now became the sole defendant, jurors were also asked to assess Ford's responsibility for the accident.

The lawsuit was brought by the family of Marisa Rodriguez, a mother of three who was left brain-damaged and paralyzed after the steel belt and tread of a Firestone tire tore apart during a trip to Mexico in March 2000. As a result, the Explorer rolled

over three times, crushing the roof above Mrs. Rodriguez in the rear seat; her husband Joel, who was asleep in the front passenger seat, was also injured. The live pictures of Mrs. Rodriguez in a wheelchair received wide TV coverage.

After the federal court jury in the Texas border town of McAllen had been deadlocked for four days, a settlement was reached with Bridgestone/Firestone for \$7.85 million. (The plaintiffs originally had asked for \$1 billion.)

The out-of-court settlements with both Ford and Firestone did not resolve the issue of who was most to blame for this and the hundreds of other injuries and deaths. But a lawyer for the Rodriguez family predicted that sooner or later a verdict would emerge: “There’s going to be trials and there’s going to be verdicts. We’ve got Marisa Rodriguezes all over the country.”¹

ANATOMY OF THE PROBLEM

The Ford/Firestone Relationship

Ford and Firestone had a long, intimate history. In 1895, Harvey Firestone sold tires to Henry Ford for his first automobile. In 1906 the Firestone Tire & Rubber Company won its first contract for Ford Motor Company’s mass-produced vehicles, a commitment that continued through the decades.

Henry Ford and Harvey Firestone became business confederates and best friends who went on annual summer camping trips, riding around in Model T’s along with Thomas Edison and naturalist John Burroughs. Further cementing the relationship, in 1947 Firestone’s granddaughter, Martha, married Ford’s grandson, William Clay Ford, in a dazzling ceremony in Akron, Ohio that attracted a Who’s Who of dignitaries and celebrities. Their son, William Clay Ford Jr., was to become Ford’s chairman.

In 1988 Tokyo-based Bridgestone Corporation bought Firestone, 20 years after the Japanese company sold its first tires in the United States under the Bridgestone name. In 1990, Ford introduced the Explorer SUV to replace the Bronco II in the 1991 model year. It became the nation’s top-selling SUV, and the Explorer generated huge profits for more than a decade. Bridgestone/Firestone was the sole supplier of the Explorer’s tires.

The Relationship Worsens

The first intimation of trouble came in 1999 when, after 14 fatalities occurred, Ford began replacing tires of Explorers in Saudi Arabia and nearby countries. The tire failures were blamed on hot weather and underinflated tires. At the time, overseas fatalities did not have to be reported to U.S. regulators, so the accidents received scant attention in the media.

The media caught the scent in early 2000 when television reports in Houston revealed instances of tread separation on Firestone’s ATX tires, and the National

¹ “Firestone Agrees to Pay \$7.5 Million in Tire Suit,” *Cleveland Plain Dealer*, August 25, 2001, pp. A1 and A13; also, Milo Geyelin and Timothy Aepfel, “For Firestone, Tire Trial Is Mixed Victory,” *Wall Street Journal*, August 27, 2001, pp. A3 and A4.

Highway Traffic Safety Administration (NHTSA) started an investigation. By May, four U.S. fatalities had been reported, and NHTSA expanded the investigation to 47 million ATX, ATXII, and Wilderness tires.

In August 2000, as mounting deaths led to increasing pressure from consumers and multiple lawsuits, Firestone voluntarily recalled 14.4 million 15-inch radial tires because of tread separation. The plant in Decatur, Illinois was implicated in most of these accidents. Ford and Firestone agreed to replace the tires, but estimated that 6.5 million were still on the road. Consumer groups sought a still wider recall, charging that Explorers with other Firestone tire models were also prone to separation leading to rollovers.

In December 2000 Firestone issued a report blaming Ford for the problems, claiming that the Explorer's design caused rollovers with any tread separations. On April 20, 2001, Ford gave NHTSA a report blaming Firestone for flawed manufacturing.

In May 2001 Ford announced that it was replacing all remaining 13 million Firestone Wilderness AT tires on its vehicles, saying that the move was necessary because Ford had no confidence in the tires' safety. "We feel it's our responsibility to act immediately," Ford CEO Jacques Nasser said. Ford said the move would cost the automaker \$2.1 billion, although it hoped to get this money back from Firestone.

Firestone Chairman and CEO John Lampe defended his tires, saying "no one cares more about the safety of the people who travel on our tires than we do. When we have a problem, we admit it and we fix it."²

The Last Days

It is lamentable when a long-lasting close relationship is severed. But on May 21, 2001, Lampe abruptly ended the 95-year association, accusing Ford of refusing to acknowledge safety problems with its vehicles, thus putting all the blame on Firestone.

The crisis had been brewing for months. Many Firestone executives did not trust Ford and even exchanging documents was done with rancor, with major disagreements in interpreting the data. Firestone argued that tread-separation claims occurred ten times more frequently on Ford Explorers than on Ranger pickups with the same tires, thus supporting their contention that the Explorer was mostly at fault. Ford rejected Firestone's charges about the Explorer, saying that for ten years the model "has ranked at or near the top in terms of safety among the 12 SUVs in its class." It stated that 2.9 million Goodyear tires mounted on more than 500,000 Explorers had "performed with industry-leading safety."³

The climax came in a May 21 meeting attended by Lampe and a contingent of Ford officials, during which both sides maintained that the other was to blame.

² Ed Garsten, Associated Press, as reported in "Ford Tire Tab \$2.1 Billion," *Cleveland Plain Dealer*, May 23, 2001, pp. 1-C and 4-C.

³ Timothy Aepfel, Joseph B. White, and Stephen Power, "Firestone Quits as Tire Supplier to Ford," *Wall Street Journal*, May 22, 2001, pp. A3 and A12.

INFORMATION BOX**HOW EMOTION INFLUENCES COMPANY REPUTATION**

The second annual corporate-reputation survey conducted by the Harris market-research firm and the Reputation Institute, involving 26,011 respondents, found that Emotional Appeal—trust, admiration and respect, and generally good feelings toward—was the driving force in how people rated companies. The survey found that advertising did not necessarily change opinions. For example, despite a \$100 million advertising campaign about what a good citizen Philip Morris Company was in feeding the hungry and helping victims of domestic violence, the company still received low marks on trust, respect, and admiration. But the most recent poll showed that Philip Morris no longer had the worst reputation in America. This distinction went to Bridgestone/Firestone, with Ford receiving the lowest reputation rating among auto companies.

Once lost, a company's reputation or public image is usually difficult to regain. For example, Exxon Mobil's reputation for environmental responsibility was still given low grades more than a decade after the destructive Alaskan oil spill involving the tanker Exxon Valdez.

Do you think Firestone's quest to improve its reputation should face the same problems as those occurring from the Exxon Valdez? Why or why not?

Source: Ronald Alsop, "Survey: Emotion Drives Public Perception of Companies," *Wall Street Journal*, February 11, 2001, p. 5-H.

Discussions broke down regarding any working together to examine Explorer's role in the accidents. At that point, Lampe ended their relationship. Each party then was left to defend itself before Congress and the court of public opinion, and ultimately a siege of lawsuits. See the Information Box: How Emotion Influences Company Reputation for a discussion of how emotion drives consumers in their perception, good and bad, of companies.

Advantage to Competitors

Major competitors Goodyear and Michelin, as well as smaller competitors and private-label tire makers, predictably raised tire prices 3 to 5 percent. Goodyear then tried to increase production robustly to replace the millions of Firestone tires recalled or soon to be, but it was trying to avoid overtime pay to bolster profits. In a written statement, Goodyear said, "We are working very closely with Ford to jointly develop an aggressive plan to address consumers' needs as quickly as possible."⁴

⁴ Thomas W. Gerdel, "Goodyear, Michelin Raising Consumer Tire Prices," *Cleveland Plain Dealer*, May 23, 2001, pp. 1-C and 4-C.

The decrease in auto sales in the slowing economy that began in 2000 had led Goodyear to production cutbacks, including cutting 7,200 workers worldwide as it posted an 83 percent decline in profits in 2000. Now it was challenged to gear up to handle the windfall of the ending of the Ford/Firestone relationship.

WHERE LIES THE BLAME?

In years to come courts and lawyers will sort out the culpability controversy. The outcome is in doubt, and the finger of blame points to a number of sources, though the weighting is uncertain. While Ford and Firestone should share major responsibility, NHTSA and the motoring public were hardly blameless.

Ford

The question whether the design of Ford's Explorer made it more prone to rollover than other SUVs would be decided in the courtroom. One thing seemed clear: Ford recommended a low inflation level for its Firestone-equipped tires, and this would subject them to more flex in the sidewall and greater heat buildup. With high-speed driving in hot weather, such a high-profile vehicle would be more prone to roll over with any tire trouble, especially with inexperienced drivers. For example, Ford's recommended tire pressure was 26 pounds and this would bring the car's center of gravity lower to the ground. This would seem good, but only at first look. Required by the government, the Uniform Tire Quality Grade (UTQG) provides comparative manufacturer information. Tires are subjected to a series of government-mandated tests that measure performance in treadwear, traction, and temperature resistance. All testing is done by the tire manufacturer. Ford was alone among SUV makers in equipping the Explorer with grade C tires rather than the more heat-resistant B tires that were the near universal standard on most SUVs. To make the C grade, tires had to withstand only two hours at 50 mph when properly inflated and loaded, plus another 90 minutes at speeds up to 85 mph. This standard dated back to 1968, when sustained highway speeds were much lower than today. Now, people drive hour after hour at speeds well above 70 mph.

The C-rated Firestones were used on millions of Ford pickup trucks without problems. However, in contrast with SUVs, most pickup trucks are not taken on long-haul, high-speed road trips filled with family and luggage.

Ford CEO Jacques Nasser justified replacing 13 million tires by claiming the Firestones were failing at a rate higher than Goodyears mounted on 2 million Explorers in the mid-1990s. But the Goodyears carried the B rating. The dangerous effect of heat buildup was shown by most Explorers' accidents taking place in hot Southern states and other hot-climate countries with high speed limits.

Ford engineers should have been aware of these dangers, if not immediately—certainly after a few years—and adapted the Explorer to customers who drive fast, pay little attention to tire maintenance, and are prone to panic with a blowout and flip the car. Unfortunately, the American legal environment, the tort system, makes the manufacturer vulnerable to lawsuits and massive damage claims should it

acknowledge in retrospect that it had made a bad mistake in its tire selection and pressure recommendation. So the temptation was to blame the tiremaker, and spend millions to turning it into a media monster.

Bridgestone/Firestone

Firestone tires were far from blameless. Early on, investigations of deadly vehicle accidents linked the causes to tire failure, notably due to shoddy manufacturing practices at the Firestone plant in Decatur, Illinois; the 6.5 million tire recall by Firestone was of the 15-inch radial ATX and ATX11 tires and Wilderness AT tires made in this plant. In June 27, 2001, the company announced the plant would be closed. But Firestone's poorly controlled manufacturing process proved not to be limited to this single operation. See the Information Box: A Whistleblower "Hero"

INFORMATION BOX

A WHISTLEBLOWER "HERO"

Alan Hogan was honored in June 2001 by the Civil Justice Foundation for exposing how employees at a Bridgestone/Firestone plant in North Carolina routinely made defective tires. This consumer advocacy group, founded by the Association of Trial Lawyers of America, bestowed similar "community champion" awards on tobacco whistle-blower Jeffrey Wigand, and on Erin Brockovich, who exposed hazardous waste dangers and was the subject of a popular movie.

With his insider's knowledge of shoddy tire-building practices, Hogan was widely credited with bringing about the first recall. He testified at a wrongful death lawsuit in 1999 that he witnessed the crafting of countless bad tires built with dried-out rubber and wood bits, cigarette butts, screws, and other foreign materials mixed in. Hogan, who had quit the company and opened an auto-body shop in his hometown, became a pariah among many people for his revelations about the community's major employer, and company attorneys looked into his work and family life for anything they could use to discredit him. They tried to portray him as a disgruntled former employee. An anonymous fax accused him of spreading "vicious, malicious allegations" about the company. Employees were warned not to do business with car dealerships that dealt with his body shop.

But Hogan persevered, and eventually won recognition and accolades. "I'm surprised it took this long," he said. "Maybe now people will see this is the way it's been since 1994, 1995, when they started covering this up." His whistle-blowing credentials were now in high demand as an expert witness in other lawsuits.

Do you see any reasons why Hogan may not have been completely objective in his whistle-blowing efforts?

Source: Dan Chapman, Cox News, as reported in "Firestone Ex-Worker Called Hero in Recall," *Cleveland Plain Dealer*, May 29, 2001, p. 1-C.

about the whistle-blower who exposed another plant's careless disregard of safe tire production.

Still, there were contrary indications that the fault was not all Bridgestone/Firestone's, that Ford shared the blame. General Motors had detected no problems with Firestones it used as standard equipment in 14 of its models. In fact, in July 2001 GM named Firestone as its supplier of the year for the sixth consecutive time. Honda of America was also loyal to Firestones, which it used on best-selling Civics and Odysseys.⁵

On September 14, 2001, months after all Firestones had been recalled from Ford Explorers, an apparently skilled driver, a deputy bailiff driving home from court, was killed when he lost control of his Explorer and it flipped over a guardrail, slid down an embankment and rolled over several times.⁶

Government

Public Citizen and other consumer groups were critical of the government, maintaining that it was too slow in completing its initial Firestone investigation and had dragged its feet in any investigation of the Explorer. A Public Citizen study saw the use of the specific Firestone tires as coming from cost- and weight-saving miscalculations and gambles by Ford, "making what was already a bad problem into a lethal one." Not just the companies were at fault, but Federal regulators were lax in not toughening standards on SUVs to prevent roofs from collapsing in rollover crashes. "The human damage caused is barbaric and unnecessary," the study concluded.⁷

The Driver

There is no doubt that drivers contributed to accidents. They did so by neglecting tire pressure so that it was often below even the low recommendations of Ford, by heavily loading vehicles, and by driving too fast over long periods so that heat could build up to dangerous levels. Added to this, the lack of driving expertise to handle emergency blowouts was often the fatal blow. Yet, could a carmaker, tire maker, or government really expect the average consumer to act with strict prudence? Precautions, be they car standards or tire standards, needed to be imposed with worst scenarios in mind as to consumer behavior.

CONSEQUENCES

Each company maneuvered to cast blame primarily on the other. Ford announced in May 2001 that it would triple the size of the Firestone recall—a \$2.8 billion prospect, a cost Ford wanted to shift to the tire maker. Firestone, at that point,

⁵ Garsten, "Ford Tire Tab," pp. C1 and C4; and Alison Grant, "Bridgestone/Firestone Faces Struggle to Survive," *Cleveland Plain Dealer*, August 5, 2001, pp. H1 and H5.

⁶ "SUV Flips, Killing Deputy Bailiff, 24," *Cleveland Plain Dealer*, September 15, 2001, p. B5.

⁷ Alison Grant, "Government, Goodyear Still Navigating a Bumpy Road," *Cleveland Plain Dealer*, August 5, 2001, p. H5.

severed its long relationship with Ford by refusing to supply the company with more tires. CEO Lampe maintained Ford was trying to divert scrutiny of the rollover-prone Explorer by casting doubt on the safety of Firestone tires.

Both parties suffered in this name calling and buck passing. By Fall 2001, sales of Explorers were off sharply, as consumers wondered whether the hundreds of Explorer crashes were due to the SUV's design, or Firestone tires, or both. Ford lost market share to Toyota and other foreign rivals in the SUV market. In July 2001, it reported its first loss from operations since 1992. It also faced 200 product liability lawsuits involving Explorer rollovers. Still, Ford was big enough to absorb problems with one of its models.

Smaller Bridgestone/Firestone faced a more dangerous situation. In 2000 its earnings dropped 80 percent, reflecting the costs of recalling millions of tires as well as a special charge to cover legal expenses. The Firestone unit, which accounted for 40 percent of the parent company's revenue, posted a net loss of \$510 million after it took a \$750 million charge for legal expenses. Sales were forecast to plunge 20 percent in 2001, and costs of lawsuits could eventually reach billions of dollars, to the point where some analysts doubted Firestone as a brand could survive.⁸

Options Firestone Faced

The esteemed Firestone brand, launched more than a century before, had been the exclusive tire supplier to the Indy 500. Now its future was in doubt, despite decades of brand loyalty. The brand faced three options:

Option #1

Some thought the company should try to deemphasize Firestone, and push business to the Bridgestone label. This would likely result in some loss of market segmentation and the flexibility of having distinct low-end, mid-level, and premium tires. Others thought such a halfhearted approach would simply prolong the agony of hanging on to a besmirched brand.

Option #2

Obliterate the Firestone name, it being irretrievable. "Firestone should just give up," said one public relations analyst. "They've damaged themselves so severely." A University of Michigan Business School professor called the brand dead: "Can you imagine any jury claiming that somebody who's suspected of building bad tires is innocent?"⁹

Option #3

Try to salvage the brand. Some questioned the wisdom of abandoning the century-old Firestone name, with its rich tradition and millions of cumulative advertising

⁸ Akiko Kashiwagi, "Recalls Cost Bridgestone Dearly; Firestone's Parent's Profit Drops 80%," *Washington Post*, February 23, 2001, p. E03.

⁹ Grant, "Struggle to Survive," p. H5.

dollars. They thought that with money, time, and creative advertising, Bridgestone/Firestone should be able to restore its image. But to do so, Roger Blackwell of Ohio State University thought the company needed to make an admission of regret: “The lawyers will tell them not to admit blame . . . But they need to do what Johnson & Johnson did when someone was killed by their product [cyanide-tainted Tylenol]. A credible spokesman got on TV and had tears in his eyes when he spoke.” An independent tire dealer who lost \$100,000 in sales in 2000, but was confident of a rebound, supported this option: “The American public is quick to forget,” he said.¹⁰

POSTMORTEM

Buyers of Ford Explorers with Firestone tires for years faced far higher risks of deaths and injuries, both in the United States and abroad, than they would have from other models. The *New York Times* reported that the tire defects, and their contribution to accidents, were known in 1996.¹¹ Not until August 1999 did Ford begin replacing tires on Explorers in Saudi Arabia, calling the step a “customer notification enhancement program.” Fourteen fatalities had already been reported. Not until March 2000, after television reports of problems, did federal regulators and the two manufacturers take all this seriously.

Ford, in its concern with the bottom line, stubbornly refused to admit that anything was wrong with its SUV; meanwhile Firestone couldn’t seem to clean up its act in the Decatur, Illinois plant—and even some other plants, where carelessness and lack of customer concern prevailed. Minor ethical abuses became major when lives were lost, but the foot-dragging continued until lawyers came on the scene. Then these two tried to cover their mistakes with finger pointing, while a vulnerable public continued to be in jeopardy. Throughout this time, saving lives did not apparently have a very high priority. Eventually, the consequences came back to haunt the companies, with hundreds of lawsuits, millions of tire recalls, and denigration of their public images.

How could this have been permitted to happen? After all, those in top management were not deliberately vicious men. They were well intentioned, albeit badly misguided. Perhaps their worst sin was first to ignore, and then refuse to admit and try to cover up increasingly apparent serious risk factors.

Part of the problem was the stubborn mindset of top executives that nothing was wrong: a few accidents reflected driver carelessness, not a defective product. Neither company would assume the worst scenario: that this was a dangerous product used on a dangerous product that was killing people, and neither Ford nor Firestone could escape blame.

Forty years earlier, a somewhat similar situation occurred with the GM Corvair, a rear-engine car that exhibited instability under extreme cornering conditions,

¹⁰ *Ibid.*

¹¹ Keith Bradsher, “SUV Tire Defects Were Known in ’96 but Not Reported; 190 Died in Next 4 years,” *New York Times*, June 24, 2001, p. 1N.

causing it to flip over. Ralph Nader gained his reputation as a consumer advocate in his condemnation of this “unsafe” car with a best-selling book, *Unsafe at Any Speed*. GM executives back then also refused to admit there was any problem—until eventually the evidence was overwhelming, lawsuits flourished, and the federal government stepped in with the National Traffic and Motor Vehicle Safety Act of 1966. Among other things, this act required manufacturers to notify customers of any defects or flaws later discovered in their vehicles.

GM executives, like those of Ford and Firestone 40 years later, were honorable men. Yet something seems to happen to the conscience and the moral sensitivity of top executives. They commission actions in their corporate personas that they would hardly dream of doing in their private lives. John DeLorean, former GM executive, was one of the first to note this dichotomy:

These were not immoral men who were bringing out this car [the Corvair]. These were warm, breathing men with families and children who as private individuals would never have approved [this project] for a minute if they were told, ‘You are going to kill and injure people with this car.’ But these same men, in a business atmosphere, where everything is reduced to terms of costs, corporate goals, and production deadlines, were able to approve a product most of them wouldn’t have considered approving as individuals.¹²

We have to raise the question: Why this lockstep obsession with sales and profits at all costs? See the Information Box: The “Groupthink” Influence for a discussion of this issue.

LATER DEVELOPMENTS

On October 30, 2001, Ford Motor Company announced that Jacques Nasser would be replaced as CEO by William Clay Ford Jr., 44—the first Ford family member to be in charge since 1979. Ford is the son of William Clay Ford Sr., who is the grandson of founder Henry Ford and brother of Henry Ford II. Nasser had been under pressure for months for Ford’s loss of market share and tumbling profitability and the adverse publicity of the Explorer.

In December 2001, the newly-designed 2002 Ford Explorer received a top score in a crash test from the Insurance Institute for Highway Safety. Changes in the 2002 Explorer to improve passenger protection were part of the automaker’s “commitment to continuous improvements,” a Ford spokesperson said.¹³

Firestone also bounced back, despite dire predictions of the brand’s demise, as U.S. operations suffered a \$1.7 billion loss in 2001 on top of a \$510 million loss in 2000. Some called this “the most unlikely brand resurrection in marketing history.”

¹² J. Patrick Wright, *On a Clear Day You Can See General Motors*, Grosse Point, Mich.: Wright Enterprises, 1979, pp. 5–6.

¹³ Christopher Jensen, *Cleveland Plain Dealer*, December 12, 2001, pp. C1 and C4.

INFORMATION BOX**THE “GROUPTHINK” INFLUENCE ON UNETHICAL BEHAVIOR**

The callousness about “killer” cars would, as John DeLorean theorized, probably never have prevailed if an individual was making the decision outside the corporate environment. But bring in *groupthink*, which is decision by committee, and add to this a high degree of organizational loyalty (vs. loyalty to the public interest), and such callousness can manifest itself. Why can the moral standards of groupthink be so much lower than individual moral standards?

Perhaps the answer lies in the “pack mentality” that characterizes certain committees or groups highly committed to organizational goals. All else then becomes subordinated to these goals, being a single-minded perspective. Within any committee, individual responsibility for decision is diluted since this is a committee decision. Furthermore, without the contrary arguments of a strong “*devil’s advocate*” (i.e., one who argues the opposing viewpoint, sometimes simply to be sure that all sides of an issue are considered), a follow-the-leader syndrome can take place, with no one willing to oppose the majority views.

But there is more to it than that. Chester Barnard, a business executive, scholar, and philosopher, noted the paradox:

People have a number of private moral codes that affect behavior in different situations, and these codes are not always compatible. Codes for private life, regarding family and religion, may be far different from codes for business life. Throughout the history of business, it has not been unusual to find that the scrupulous and God-fearing churchgoer is far different when he or she conducts business during the week: A far lower ethical standard prevails during the week than on the Sabbath. Nor has it been unusual to find that a person can be a paragon of love, understanding, and empathy with his or her family but be totally lacking in such qualities with employees or customers. (Chester I. Barnard, *The Functions of the Executive*, Cambridge, Mass.: Harvard University Press, 1938, p. 263.) We might add that even tyrants guilty of the most extreme atrocities, such as Hitler and Saddam Hussein, have been known to exude great tenderness and consideration for their intimates.

What does it take for a person to resist and not accept the majority viewpoint? What do you think would be the characteristics of such a person? Do you see yourself as such a rebel?

Much of the credit for the survival was credited to Firestone CEO John Lampe, who crisscrossed the country giving pep talks to hundreds of Firestone’s 10,000 dealers. These dealers became fiercely loyal at a time when 75 percent of tire buyers were influenced by dealers’ recommendations, according to industry estimates. Several splashy new tires were brought out, including the Firehawk Indy 500, which became a hit with racing fans. “We are selling as many Firestone tires as we’ve ever sold,” one large dealer noted.

With communication improving between the two companies, Lampe could see signs that the rift with Ford was ending, and William Clay Ford even mentioned his great-grandfather Harvey Firestone in a Ford commercial. “It was a very honest thing to do. He didn’t have to do that,” Lampe observed.¹⁴

Invitation to Make Your Own Analysis and Conclusions

Design a program for pursuing a better relationship between Ford and Firestone executives during the crisis. How would you sell your program to the executives? What would be the likely result? Are there any worthwhile learning experiences that could come from this?

WHAT WE CAN LEARN

A Firm Today Must Zealously Guard against Product Liability Suits

Any responsible executive needs to recognize that product-liability suits, in today’s litigious environment, can bankrupt a firm. The business arena has become more risky, more fraught with peril for the unwary or the naively unconcerned. Consequently, firms need to do careful and objective testing of any product that can affect customer health and safety. Sometimes testing may require that production be delayed, even if the competition gains some advantage from the delay. The risks of putting an unsafe product on the market outweigh competitive concerns.

Suspicious and Complaints About Product Safety Must Be Thoroughly Investigated

We should learn from this case that immediate and thorough investigation of any suspicions or complaints is essential, regardless of the confidence management may have in the product or of the glowing recommendations of persons whose objectivity could be suspect. To procrastinate or ignore complaints poses risks that should be unacceptable.

Sometimes the root of the problem is not obvious, or is more complex than first thought. In this Ford/Firestone case, objective research should have focused on both the Explorer and the Firestone tires, and on how the situation could be remedied to minimize rollovers and save lives.

¹⁴ Todd Zaun, “Defying Expectations, Bridgestone Embarks on a Turnaround,” *Wall Street Journal*, March 12, 2002, p. A21; and Jonathan Fahey, “Flats Fixed,” *Forbes*, May 27, 2002, pp. 40–41.

Health and Safety of Customers Is Entirely Compatible with the Firm's Well-Being

It is a lose/lose situation if this is ignored: The customer is jeopardized, but eventually the firm is, too, as lawsuits grow and damages increase. Why, then, the corporate mindset of “us versus them”? There should be no conflicting goals. Both win when customer welfare is maximized.

In the Worst Scenario, Go for a Conciliatory Salvage Strategy

Ford and Firestone faced a crossroads by late 1999 and early 2000. Reports of fatalities linked to Ford Explorers and Firestone tires were trickling in, the first occurring in the hot climate of Saudi Arabia, and in a matter of months these were to become a flood. How should a company react?

A salvage strategy can be attempted by toughing it out, trying to combat the bad press, denying culpability, blaming someone else, and resorting to the strongest possible legal defense. This essentially is what Ford opted to do—it blamed Firestone for everything and spent millions advertising to promote this contention.

Firestone was more vulnerable since its shredded tires could hardly be denied, and it was forced to recall millions of tires, although it stoutly maintained that the cause of the shredding was underinflation and the selection of tires of the wrong quality, as well as the Explorer itself. At stake were company reputations and economic positions, viability for Firestone, and, most important, the lives of hundreds of users.

Conciliation usually is the better salvage strategy. This calls for recognition and full admission of the problem and removal of the risk, even if it entails a full-market withdrawal until the source of the problem can be identified and correction made. Expensive, yes, but far less risky for the viability of the company and certainly for the health of the customers involved.

Neither strategy is without substantial costs. But the first course of action puts major cost consequences in the future, where they may turn out to be vastly greater as legal expenses and damage awards skyrocket. The second course of action poses an immediate impact on profitability, and will not avoid legal expenses, but may save the company and its reputation and return it to profitability in the near future.

Where Blame Is Most Likely Shared, the Solution of the Problem Lies Not in Confrontation but in Cooperation

This is the most grievous component of the violations of the public trust by Ford and Firestone: denial and confrontation, rather than both parties working together to solve the problem of product safety. But accepting this is so hard for proud executives (and also scared ones) who fear admitting that they may be culpable.

CONSIDER

Can you think of additional learning insights?

QUESTIONS

1. Can a firm guarantee complete product safety? Discuss.
2. Based on the information presented, which company do you think is most to blame for the deaths and injuries? What led you to your conclusion?
3. “If an Explorer driver never checks the tire pressure and drives well above the speed limit, he has no one to blame but himself in an accident—the vehicle and not the tires.” Discuss.
4. Do you think the government should be blamed in the Explorer deaths and injuries? Why or why not?
5. Would you give credence to the “community champion” awards bestowed by a consumer advocacy group founded by the Association of Trial Lawyers, and given to Alan Hogan in June 2001 for exposing careless tire production? Why or why not?
6. “Admittedly the groupthink mindset may be responsible for a few unethical and bad decisions, but isn’t this mindset more likely to consider the consequences to the company of delivering unsafe products, and support aggressive corrective action?” Evaluate this statement.
7. Have you had any experience with a Ford Explorer? If so, what is your perception of its performance and safety?
8. Have you had any experience with Firestone tires? What is your perception of their performance and safety?

HANDS-ON EXERCISES

1. Place yourself in the position of John Lampe, CEO of Firestone, as the crisis worsens and accusations mount. Discuss how you would try to change the climate with Jacques Nasser of Ford from confrontational to cooperative. Be as specific as you can. Do you think you would be successful?
2. Firestone is on its knees after massive tire recalls and monstrous damage suits. You are a consultant brought in to help the firm recover. Be as specific as you can in recommending a course of action and prioritizing things to do. Make any assumptions you need to, but keep them reasonable. Defend your recommendations. (Do not be swayed by what actually happened. Things could have been done better.)
3. You are a trusted aide of Nasser. Support his confrontational stance with Firestone before the Ford board of directors.
4. Be a *Devil’s Advocate*. In a staff meeting the topic comes up that your SUVs have been involved in a number of deaths. The group passes this off as due to reckless drivers. Argue persuasively a contrary position.

TEAM DEBATE EXERCISES

1. Debate the issue of dropping or keeping the Firestone name. Defend your position and attack the other side.
2. Debate the issue of whether to stand by Nasser at the height of the confrontation, or removing him. Be as persuasive as you can.

INVITATION TO RESEARCH

- Can you find statistics about how competing tire companies, particularly Goodyear and Michelin, fared during and after the Firestone recall?
- Are Ford and Firestone friends again?
- Is the Ford Explorer still the top SUV?
- Do you sense any learning experience coming from this catastrophe?

Conclusions: What We Can Learn

Remember, the thesis of this book is that we can learn from past mistakes (as well as successes). Perhaps this could be restated: “*We should learn.*” In the words of the great philosopher, George Santayana, “Those who ignore history are bound to repeat it.” This is true of the military, world affairs, economic decisions, politics, and certainly business decision making.

In considering mistakes, three things are worth noting: (1) Even the most successful organizations make mistakes but survive as long as they maintain a good “batting average” of satisfactory decisions; (2) Mistakes should be effective teaching tools for avoiding similar errors in the future, and (3) Firms can bounce back from adversity, and turnaround.

We can make a number of generalizations from these mistakes and successes. Of course, we recognize that marketing is a discipline that does not lend itself to laws or maxims. Examples of exceptions to every principle or generalization can be found. However, the decision maker does well to heed the following insights. For the most part, they are based on specific corporate and entrepreneurial experiences and should be transferable to other situations and other times.

INSIGHTS REGARDING OVERALL ENTERPRISE PERSPECTIVES

Importance of Public Image

The impact of an organization’s public image was a common thread through a number of cases—for example, Nike, Southwest Airlines, Vanguard, Disney, Maytag, Harley-Davidson, Boston Beer, and United Way.

Nike shows the power of an image that was compatible with the product and attractive to the target market. The carefully nurtured association with some of the most esteemed male and female athletes in the world—many of whom its customers were eager to emulate, if only in their dreams—propelled Nike and its swoosh logo to dominance in the athletic apparel industry. Still, we saw a

positive image become tarnished for Nike. But oh how it bounced back to dominate the industry.

Southwest's image of friendliness, great efficiency, and unbeatable prices led it to an unassailable position among short-haul airlines. Now it seeks to expand its image to longer hauls. And at long last, other airlines are becoming more competitive costwise, even the big legacy airlines that were able to gain major concessions from unions under threat of bankruptcy. Vanguard has also used its image of frugality and great customer service in the mutual fund industry to propel it to the top with relatively little advertising. Harley-Davidson was able to develop its image one step further—to a mystique with a devoted cult following. Boston Beer was able to capitalize on its image of highest quality to go along with its highest price beer.

Some images were less favorable. Disney found its image did not travel well to Paris, nor did Maytag's quality image to its United Kingdom subsidiary. The non-profit United Way was brought to its knees by revelations about the excesses of its longtime chief executive, William Aramony.

The importance of a firm's public image should be undeniable. Yet some continue to disregard their image and either act in ways detrimental or else ignore the constraints and opportunities that a reputation affords.

Power of the Media

We have seen or suspected the power of the media in a number of cases. Coca-Cola, Firestone and Ford, Vanguard, and United Way are obvious examples. This power is often used critically—to hurt a firm's public image. The media can fan a problem or exacerbate an embarrassing or imprudent action. In particular, this media focus can trigger the herd instinct, in which increasing numbers of people join in protests and public criticism. Investigative reporters can perform a real public service by exposing unsavory activities, as with United Way. But in Vanguard's case, positive media attention minimized the need for much advertising.

We can make these five generalizations regarding image and its relationship with the media:

1. It is desirable to maintain a stable, clear-cut image and undeviating objectives.
2. It is difficult and time-consuming to upgrade an image.
3. An episode of poor quality can leave a lasting stigma.
4. A good image can be quickly lost if a firm relaxes in an environment of aggressive competition.
5. Well-known firms are especially vulnerable to critical public scrutiny and should use great care in safeguarding their reputations.

However, one recent case, Continental Airlines, makes us qualify the second and third generalizations. Under a new CEO, Gordon Bethune, Continental was

able to turn itself around in near-record time. But United Way was not able to, nor was Merck with its Vioxx drug.

No Guarantee of Continued Success

That success does not guarantee continued success or freedom from adversity is a sobering realization that must come from examining these cases. Many of the mistakes occurred in notably successful organizations, such as Ford and Firestone, Harley-Davidson, Disney, Boeing, Maytag, MetLife, even United Way. How could things go so badly for such organizations conditioned to success? The three C's mindset offers some explanation.

The Three Cs Mindset

We can also call this the “king of the hill” syndrome. The three Cs are complacency, conservatism, and conceit. With this organizational atmosphere, success actually brings vulnerability. To avoid this, an attitude of never underestimating competitors can be fostered by:

- Bringing fresh blood into the organization for new ideas and different perspectives.
- Establishing a strong and continuing commitment to customer service and satisfaction—this should be more than just lip service.
- Conducting periodic corporate self-analyses designed to detect weaknesses as well as opportunities in their early stages.
- Continually monitoring the environment and being alert to any changes (more about this later).

The business environment is dynamic, sometimes with subtle and hardly recognizable changes, at other times with violent and unmistakable changes. To operate in this environment, an established firm must be on guard to defend its position.

Adversity Need Not Be Forever

Just as a dominant firm can lose its momentum and competitive position, so can a faltering organization be turned around. If such a firm can at least maintain some semblance of viability, then there is hope. Continental Airlines and Harley-Davidson are examples of such comebacks. We have placed the McDonald's case in the Comeback section, although its problems were not as acute as those of the other two firms. But the proud growth had stalled, and it took a perceptive CEO to recognize that devoting major efforts to existing outlets rather than frenetically opening more outlets could bring a slower but more profitable growth. As Starbucks encounters similar growth pains, one wonders if such a strategy is not in order.

What Should Our Business Be?

An organization's business, its mission and purpose, should be clearly determined and spelled out, and well communicated by those involved in policy making. Otherwise, the organization lacks unified and coordinated objectives, which is akin to trying to navigate without a map.

Good judgment suggests choosing safe rather than courageous goals. But in the heady optimism for high-techs in the 1990s, few such firms could resist the temptation to go for the moon, and spend and plan accordingly with no semblance of frugality. Rather, we suggest controlled growth (aggressive moderation) for firms as they plan their growth, and Boston Beer and Southwest exemplify this.

Determining what a firm's business is or should be gives a starting point for specifying goals. Several elements help with this determination.

A firm's resources and distinctive abilities and strengths should play a major role in determining its goals. It is not enough to wish for a certain status or position if resources and competencies do not warrant this. To take an extreme example, a railroad company can hardly expect to transform itself into an airline, even though both may be in the transportation business. A Kmart or Sears is hardly likely to successfully imitate a Neiman Marcus.

Environmental and competitive opportunities ought to be considered. The initial inroads of foreign carmakers into the United States stemmed from environmental opportunities for energy-efficient vehicles at a time when U.S. car-makers had ignored this area. Vanguard found opportunity in lower expense ratios for its mutual funds than the rest of the fund industry was willing or able to match; the same for Southwest Airlines. The recent emergence of aggressive hedge funds, armed with huge war chests from wealthy investors and looking for faltering companies with depressed stock prices, such as Kmart and Sears, represents the new wave in the business arena. But in the more difficult business climate of 2008, such strategies deserve more sober appraisals.

Need for Growth Orientation—Not Reckless Growth

The opposite of a growth commitment is a status quo philosophy, one uninterested in expansion or the problems and work involved. Harley-Davidson was content, despite being pushed around by foreign competitors, until eventually a new management reawakened it decades later.

In general, how tenable is a low-growth or no-growth philosophy? Although at first glance it seems workable, such a philosophy sows the seeds of its own destruction. More than half a century ago, the following insight was made:

Vitality is required even for survival; but vitality is difficult to maintain without growth, at least in the American business climate. The vitality of a firm depends on the vigor and ambition of its members. The prospect of growth is one of the principal means by which a firm can attract able and vigorous recruits.¹

¹ Wroe Alderson, *Marketing Behavior and Executive Action*, Homewood, IL: Irwin, 1957, p. 59.

Consequently, a firm not obviously growth-minded finds it difficult to attract able people. Customers see a growing firm as reliable, eager to please, and constantly improving. Suppliers and creditors tend to give preferential treatment to a growth-oriented firm because they hope to retain it as a customer when it reaches large size.

But emphasizing growth can be carried too far. The growth must be kept within the abilities of the firm to handle. Cases such as Southwest, Boston Beer, and Vanguard showed how firms can grow rapidly without losing control. But we also have the bungled growth efforts of Maytag's Hoover Division in the United Kingdom, where controls were loosened far too much for a foreign subsidiary. And Boeing, Newell Rubbermaid, and Borden show the fallacy of reckless growth. Not to be outdone, we saw the unethical growth climate at MetLife. Good financial judgment and decent ethical behavior must not be sacrificed to the siren call of growth. With relatively new firms, growth can easily outpace management competence and the ability to effectively utilize mass infusions of investment capital.

Another aspect of growth to be considered is market potential and *saturation*. Chain retailers need to be especially concerned with this. McDonald's found that opening ever more outlets was destroying profitability. When in the last few years it switched its emphasis to increasing revenues at its present outlets, profitability substantially increased, and money was there to increase dividends and make shareholders happy. Starbucks may also be facing a saturated market and is considering a new strategy.

Therefore, an emphasis on growth can be carried too far. Somehow the growth must be kept within the capabilities of the firm and the potential of the market.

In our championing of aggressive moderation, we can make these generalizations about the most desirable growth perspectives:

1. Growth targets should not exceed the abilities and resources of the organization. Growth at any cost—especially at the expense of profits and financial stability—should be shunned. In particular, tight controls over inventories and expenses should be established, and performance monitored closely.
2. The most prudent approach to growth is to keep the organization and operation as simple and uniform as possible; to be flexible in case sales do not meet expectations; and to keep the breakeven point as low as possible, especially for new and untried ventures. Vanguard, Southwest Airlines, and Dell Computer's great competitive advantages were in their much lower overhead than anyone else in their industries. Boston Beer in its early days is another example of giving priority to a low breakeven point.
3. Rapidly expanding markets pose dangers from both too conservative and overly optimistic sales forecasts. The latter may overextend resources and jeopardize viability should demand contract; the former opens the door to more aggressive competitors. There is no correct answer to this dilemma, but management should be aware of the risks and the rewards of both extremes.

4. A strategy emphasizing rapid growth should not neglect other aspects of the operation. For example, older stores should not be ignored in the quest to open new ones.
5. Decentralized management is more compatible with rapid growth than centralized because it puts less strain on home-office executives. However, delegation must have well-defined standards and controls as well as competent subordinates. Otherwise, the Maytag Hoover fiasco may be repeated.
6. The safety and integrity of the product and firm's reputation must not be sacrificed in pursuit of growth and profits. This is especially important when customers' health and safety may be jeopardized, as Ford and Firestone encountered with the Ford Explorer.

The Rush to Merge

Some have called the rush to merge *merger mania*. Mergers and acquisitions often work out badly for employees, communities, even stockholders. Only the top executives and the lawyers, bankers, and consultants usually come out ahead. The payday for a top executive can be awesome. For example, the merger of Procter & Gamble and Gillette resulted in a payday for James Kilts, CEO of Gillette, of at least \$185 million.²

We have seen three cases in which acquisitions turned out horrendous: Newell Rubbermaid, DaimlerChrysler, and Maytag. The slowness in increasing profits after the Hewlett-Packard merger with Compaq contributed to Carly Fiorina's firing in February 2005. The ultimate success of Kmart and Sears in their merger remains questionable, although the hedge fund headed by Edward Lampert at first reaped the rewards of cutting costs to the bone with negligible reinvestment. While Kmart and Sears were losing market share, investors salivated at the cash flow. In 2008 the situation is changing to a downside.

Forbes magazine reported on some recent large mergers that were losers:

Daimler-Benz buys Chrysler, May 1998, for \$46 billion.

“A perfect fit,” said Juergen Schrempp, CEO of Daimler.

Outcome: Daimler in 2007 sold Chrysler for only \$7.4 billion.

AT&T buys Tele-Communications, June 1998, for \$48 billion.

“Undisputed leader in . . . the fastest-growing segments of the communications services industry.”

Outcome: Cable businesses sold for half the original price.

America Online buys Time Warner, January 2000, for \$173 billion.

“We did wrestle a little bit with valuations . . . but most of the time was spent on social issues.”

Outcome: Times Warner stock off from \$73 to \$18.³

² Charles Forelle and Mark Maremont, “Gillette CEO Payday May Be Richer,” *Wall Street Journal*, February 3, 2005, p. B2.

³ “Seemed Like a Good Idea at the Time,” *Forbes*, February 28, 2005, p. 38.

- Cautions:** Don't rush into the merger or acquisition.
Beware of optimistic projections for mergers.
Assumptions should be defended in merger decisions.
Really examine compatibility of the two firms.
Beware overpaying for an acquisition.

Strategic Windows of Opportunity

Several of the great successes we examined resulted from exploiting strategic windows of opportunity. Southwest found its opportunity by being so cost effective that it could offer both cut-rate fares and highly dependable short-haul service that no other airline could match. Similarly Vanguard found its strategic niche with the lowest expense ratios and overhead in the mutual fund industry. Jim Koch found a narrow opening for some of the highest-priced beer in the industry. And Howard Schultz found a strategic window for gourmet coffee in a social environment.

We make these generalizations regarding opportunities and strategic windows:

1. Opportunities often exist when a traditional way of doing business has prevailed in the industry for a long time—maybe the climate is ripe for a change.
2. Opportunities often are present when existing firms are not entirely satisfying customers' needs.
3. Innovations are not limited to products but can involve customer services as well as such things as methods of distribution.
4. For industries with rapidly changing technologies—usually new industries—heavy research and development expenditures are usually required if a firm is to avoid falling behind its competitors. But heavy R&D did not guarantee being in the forefront, as shown by Hewlett-Packard, and other competitors of Dell Computer.

Power of Judicious Imitation

Some firms are reluctant to copy successful practices of their competitors; they want to be leaders, not followers. But successful practices or innovations may need to be copied if a firm is not to be left behind. Sometimes the imitator outdoes the innovator. Success can lie in doing the ordinary better than competitors.

For 50 years, Boeing was the innovator in the commercial jet industry, sometimes taking big risks to do so. Its biggest risk was in the 1960s when it almost bankrupted itself to build the 747, which was twice the size of any other plane in commercial use. Now Airbus is the innovator with its huge plane, the 600-seat A380. Boeing decided not to follow Airbus's lead, and at this time, this looks like a wise decision.

We can make this generalization: It makes sense for a company to identify the characteristics of successful competitors (and even of some noncompeting firms) that led to their success, and then adopt these characteristics if they are compatible with the imitator's resources. Let someone else do the experimenting and risk taking. The imitator faces some risk in waiting too long, but this usually is far less than the risk of being the innovator.

Managing Change and Crises

Crises are unexpected happenings that pose threats, moderate to catastrophic, to the organization's well-being. A number of our cases involved crisis situations: Firestone/Ford, Boeing, Euro Disney, Maytag, United Way, MetLife, Continental, Borden, and Merck. Some—such as United Way, Euro Disney, Merck and Continental—handled their crises reasonable well, although we can question how such crises were allowed to happen in the first place. However, Firestone/Ford, Maytag, and MetLife failed badly in salvaging the situation.

Most crises are preventable if a company takes precautions. This suggests being alert to changing conditions, having contingency plans, and practicing risk avoidance. For example, it is prudent not to have key executives traveling on the same air flight; it is prudent to insure key executives so that their incapacity will not endanger the organization; and it is prudent to set up contingency plans for a strike, an equipment failure or plant shutdown, the loss of a major distributor, unexpected economic conditions, or a serious lawsuit. Some risks, of course, can be covered by insurance, but others not. The mettle of any organization may be severely tested by an unexpected crisis. This especially is true after 9/11: In an age of terrorism, anything is possible.

Crises and significant environmental changes may necessitate adjustments in the organization and way of doing business. Firms should avoid making hasty or disruptive moves or, at the other extreme, responding too late and too grudgingly, as MetLife, and Firestone/Ford did. The middle ground is usually best. Advanced planning can help a company minimize trauma and enact effective solutions. This advanced planning should include worst-case scenarios.

Environmental Monitoring

The dynamic business environment may involve changes in customer preferences, in competition, in the economy, and in technology, which can become obsolete very quickly. It may involve changes on the international scene—such as NAFTA, OPEC machinations, worsening problems in the Middle East, changes in Eastern Europe and Africa, rampant outsourcing, quality-control problems and wildly increasing consumption in Asia, and, of course, new threats of terrorism. For example, Harley-Davidson and Boeing failed to detect and act upon significant changes in their industries. Disney encountered different customer attitudes in Europe than it had experienced before. Pepsi, in South America, failed to realize the intricacies of penetrating and protecting its several markets there. Maytag was slow to shift production jobs to cheaper overseas workers, and found itself unable to compete with competitors like Whirlpool. Even McDonald's did not recognize that the fast-food

industry was at long last becoming saturated, with the growth it had known for half a century seemingly a thing of the past.

How can a firm stay alert to subtle and insidious or more obvious changes? It should have *sensors* to constantly monitor the environment. The sensor may be a marketing or economic research department, but in many instances a formal organizational entity is not necessary to provide primary monitoring. *Executive alertness* is required. Most changes do not occur suddenly and without warning, though we know the possibility exists. Feedback from customers, sales representatives, and suppliers; the latest news and projections in business journals; and even simple observations of what is happening in stores, advertising, prices, and new technologies can provide information about a changing environment. Unfortunately, in the urgency of handling day-to-day operating problems, managers may miss clues of imminent changes in the competitive environment.

Following are generalizations regarding vulnerability to competition:

1. Initial market advantage tends to be rather quickly countered by competitors.
2. Countering by competitors is more likely when an innovation is involved than when the advantage comes from more commonplace effective management, such as superb cost controls or customer service.
3. An easy-entry industry is particularly vulnerable to new and aggressive competition, especially if the market is expanding. In new industries, severe price competition usually weeds out marginal firms.
4. Long-dominant firms become vulnerable to upstart competitors because of their complacency, conservatism, and even conceit (the three Cs). They frequently are resistant to change and myopic about the environment.
5. Careful monitoring of performance at *strategic control points* can detect weakening positions before situations become serious. (This point is discussed further in the next section.)
6. In expanding markets, increases in sales may hide a deteriorating competitive situation. More important is market share data, how our firm is doing relative to its competitors.
7. A no-growth policy, or a temporary absence from the marketplace, even if fully justified by extraordinary circumstances, invites competitive inroads.

Effective Organizations

We can identify several characteristics of the most effective organizations:

Management by Exception

With diverse and far-flung operations, it becomes difficult to closely supervise all aspects. Successful managers therefore focus their attention on performances that deviate significantly from the expected norms at *strategic control points*. Such points should include market share, profitability measures, turnover ratios, expense ratios,

and the like, broken down by individual operational units. Trend information is important: is performance getting better or worse? Subordinates can be left to handle ordinary operations and less significant deviations, so that the manager is not overburdened with details.

Management by exception failed, however, with Maytag and its overseas Hoover division. Seemingly, no budget restraints and approvals were required for expenditures of any amount. The lack of such approval requirements could be directly blamed for the reprehensible promotional plans. By the time results came in, it was too late.

The Deadly Parallel

As an enterprise becomes larger, a very effective organizational structure is one made up of operating units of comparable characteristics. Sales, expenses, and profits can then be more readily compared, enabling strong and weak performances to be identified so that appropriate action can be taken. Besides providing control and performance evaluation, this *deadly parallel* structure fosters intra-firm competition that can stimulate best efforts. For the deadly parallel to be used effectively, operating units must be fairly equalized, perhaps by size or through quotas or similar categories of sales potential. This is not difficult to achieve with retail units, since departments and stores can be divided into sales volume categories—often designated as A, B, and C units—and operating results compared within the category. The deadly parallel can also be used with sales territories and certain other operating units for which sales and applicable expenses and ratios can be directly measured and compared with similar units.

Lean and Mean

A new climate is sweeping our country's major corporations. In one sense it is good: it enhances their competitiveness. But it can be destructive. Vanguard, Southwest Airlines, Boston Beer and Dell Computer are examples of the lean-and-mean movement. Lean-and-mean firms develop flat organizations with few management layers, thus keeping overhead low, improving communication, involving employees in greater self-management, and fostering an innovative mindset.

In contrast, we saw the organizational bloat of Boeing and Borden with their many management levels, entrenched bureaucracies, and massive overhead. A virtual cause-and-effect relationship exists between the proportion of total overhead committed to administration/staff and the ability to cope with change and innovate. It is like trying to maneuver a huge ship: bureaucratic weight slows the response time.

The problem with the lemming-like pursuit of the lean-and-mean structure is knowing how far to downsize without cutting into bone and muscle. As thousands of managers and staff specialists can attest, productivity gains have not always been worth the loss of jobs, the destruction of career paths, and the possible sacrifice of long-term potential. Boeing had a sorry history of slashing jobs in the early 1990s and lost its market share advantage over Airbus when it could not increase production quickly enough to meet demand later in the decade. With the economic downturn of 2007/8, many firms are cutting employees, some drastically such as

banks and the U.S. automakers. While these cutbacks may be necessary, where skilled workers are involved, long-term growth may be affected.

Coping with Resistance to Change

People, like organizations, do not handle change well. Change is disruptive; it destroys accepted ways of doing things and muddles familiar authority and responsibility patterns. Previously important positions may be downgraded or even eliminated, and people who view themselves as highly competent in a particular job may be forced to assume unfamiliar duties amid the fear that they cannot master the new assignments. When the change involves wholesale terminations in a major downsizing, as with Kmart and Sears, and Boeing in its down cycles, the resistance and fear of change can become so great that efficiency is seriously jeopardized.

Normal resistance to change can be eased by good communication with participants about forthcoming changes, thus dampening rumors and fears. Acceptance of change is helped if employees are involved as fully as possible in planning the changes, if their participation is solicited and welcomed, and if assurances can be given that positions will not be impaired, only changed. Gradual rather than abrupt changes also make a transition smoother.

In the final analysis, however, making needed changes and embracing new opportunities should not be delayed or canceled because of possible negative repercussions on the organization. If change is desirable, as it often is with long-established bureaucratic organizations, then it should be done without delay. Individuals and organizations can adapt to change—it just takes some time.

Delegation Overdone

Good managers delegate as much as possible to subordinates. By giving them some freedom and as much responsibility as they can handle, future leaders are developed. More than this, delegation allows higher executives to concentrate on the most important matters. Other areas of operation need come to their attention only where performances deviate significantly from what is expected at strategic control points—thus we have *management by exception*.

Management by exception failed, however, with Maytag and its overseas Hoover division. The flaw lay in failing to monitor faulty promotional plans. Admittedly, with diverse and far-flung operations it becomes more difficult to closely monitor all aspects, but still there should be strategic control points to warn of impending dangers. At the least, home office approval of expenditures above a certain amount must be enforced.

The Euro Disney difficulties may have resulted from not enough autonomy. The European operation did not adjust well to a somewhat different playing field, in which customers were far more price-conscious than had been experienced before.

At the top executive level, United Way found the excesses of its chief, William Aramony, to be unacceptable. Here, the board of directors could be faulted for being far too tolerant of a chief executive's questionable behavior. This raises another issue: How closely should the board exercise control?

Board of Directors Patsies

A board of directors can monitor top management performance closely and objectively, or it can be completely supportive and uncritical. In the latter situation, the board exercises no controls on top management; in the former, it becomes an important control factor at the highest level.

Given the potential control power of the board, top executives find their own interests best served by packing the board with supporters. Aramony of United Way had such a sympathetic and supportive board that his excesses went unmonitored until investigative reporters blew the whistle.

Instead of assuming the status of watchdogs for investors' best interests, such patsy boards ill-serve them.

Systematic Evaluations and Controls

Organizations need feedback to determine how well something is being done, whether improvement is possible, where it should occur, how much is needed, and how quickly it must be accomplished. Without feedback or performance evaluation, a worsening situation can go unrecognized until too late for corrective action.

As firms become larger, the need for better controls or feedback increases because top management can no longer personally monitor all aspects of the operation. Mergers and diversifications, which often result in loosely controlled decentralized operations—for example, again, Maytag and its overseas unit—need systematic feedback on performance all the more.

Financial and expense controls are vital. After all, if costs and inventories get severely out of line—and, worse, if this is not recognized until late—then the very viability of the firm can be jeopardized. Many of the exuberant high-tech enterprises found that heedless extravagances hastened their demise, leaving the field to such stalwarts as Hewlett-Packard and Dell.

Performance standards are another critical means of control for widespread operations. Unless operating standards are imposed and enforced, uniformity of performance is sacrificed, resulting in unevenness of quality and service and a lack of coordination and continuity among the different units. Even unethical and illegal practices may ensue, as we saw with MetLife. Instead of running a tight ship, managers face a loose and undisciplined one.

INSIGHTS REGARDING SPECIFIC STRATEGY ELEMENTS

Can Advertising Do the Job?

The cases provide several insights regarding the effectiveness of advertising, but they also present unanswered questions and contradictions. At the time of Coca-Cola's blunder with its New Coke, it was spending \$100 million more for advertising than Pepsi and all the while losing market share. Vanguard became the star of the mutual

fund industry with virtually no advertising; unlike its competitors, it relied on word-of-mouth and free publicity.

However, the right theme can bring success as shown by Nike's great success with celebrity endorsements in creating an image irresistible to many of its customers. Merck and its competitors in the drug industry aroused great demand with their massive advertising expenditures. Then we have a case where promotional efforts were too effective: Maytag Hoover's promotional campaign created more customer demand than it could possibly handle.

Thus we see the great challenge of advertising. We never know for sure how much should be spent to reach planned objectives, perhaps of increasing sales by a certain percentage or gaining market share. However, despite the inability to measure directly the effectiveness of advertising, only the brave—or foolhardy—executive stands pat in the face of increased promotional efforts by competitors.

We draw these initial conclusions: There is no assured correlation between expenditures for advertising and sales success. But the right theme or message can be powerful. In most cases, advertising can generate initial trial. But if the product or service does not meet expectations, customers will not buy again. With institutional (nonproduct) advertising, it is difficult to evaluate the effectiveness. Such ads are almost akin to advertising on faith.

Ah, but we saw in the Google case a new kind of advertising: *targeted advertising*, where the person interested in a particular product expressed the interest in clicking on a Web site. The advertiser only paid for the number of clicks, and this made Google wealthy beyond all expectations.

Limitations of Marketing Research

Marketing research is touted as the key to better decision making, the mark of sophisticated professional management. The popular belief is that the more money spent for marketing research, the less chance for a bad decision. But there is no guarantee of that, as we saw with Coca-Cola.

At best, marketing research increases the batting average of good decisions—maybe only a little, sometimes quite a bit. To be effective, research must be current and unbiased. Customer attitudes can change significantly if months elapse between the research and the product introduction. The several million dollars spent in taste-test research for Coca-Cola hardly reassures us about the validity of even current marketing research. Admittedly, results of taste tests are difficult to rely on, simply due to the subjective nature of taste preferences. Still, the Coca-Cola research did not even uncover the latent and powerful loyalty toward tradition and gave a false “go” signal for the new flavor.

We do not imply that marketing research has little value. Most flawed studies would have been worthwhile with better design and planning. Marketing research should have enabled Disney to better structure its pricing and other strategies to the unique situation facing its Euro Disney project.

Surprisingly, many successful new ventures used little formal research. Vanguard, Southwest Airlines, McDonald's, and Nike in their early days, apparently relied on entrepreneurial hunch rather than sophisticated research, as apparently did the

founders of Google and Starbucks. Why have we not seen more extensive use of marketing research for new ventures? Consider the following major reasons:

- Most of the founding entrepreneurs did not have marketing backgrounds and, therefore, were not familiar and confident with such research.
- Available tools and techniques are not always appropriate to handle some problems and opportunities. There may be too many variables to ascertain their full impact, and some of these variables will be intangible and impossible to measure precisely. Much research consists of collecting past and present data that, although helpful in predicting a stable future, are little help in charting revolutionary new ventures. If risks are higher without marketing research for new ventures, these may be offset by the potential for great rewards.

The Importance of Price As an Offensive Weapon

Price promotions are the most aggressive competitive strategy and the one most desirable from the customer's viewpoint. We saw three notable marketing successes that geared their major strategy on lower prices than competitors: Vanguard, Dell Computer, and Southwest Airlines. Euro Disney found its European customers resisting its high prices. Lower price competitors cut into the profits of Borden, Newell Rubbermaid, and Maytag. The high-price strategy—higher even than most imports—was a positive differentiation for Boston Beer. And Starbucks achieved great success by raising coffee to a new level, with higher prices than ever seen before amid a coffee house environment. Hewlett-Packard so far has been able to milk its printer ink business with exorbitantly high prices.

The major disadvantage of price competition is that other firms, if they can, are almost forced to meet the price-cutter's prices—in other words, the strategy is easy to match. Consequently, when prices fall for an entire industry, no firm has any particular advantage and all suffer diminished profits. Thus, price-cutting gives no competitive advantage, so goes the conventional thinking. We saw three major successes with price competition, but these came from greater operating efficiencies and lower overhead costs that still permitted good profits, while most competitors could not match their prices without losing money.

In general, other strategies are more effective for most firms—strategies such as dependable quality, higher product and brand image, better service, and improved warranties—all aspects of nonprice rather than price competition.

Still, in new industries characterized by rapid technological change and production efficiencies, severe price competition is the norm, and this weeds out marginal operations. Even a larger firm in such an industry may not be insulated from price competition that can jeopardize its viability.

Analytical Marketing Tools

We identified several of the most useful analytical tools for decision making. In Euro Disney we discussed *breakeven analysis*, a highly useful means for making go/no-go

decisions about new ventures and alternative business strategies. In the Maytag case, we described the *cost-benefit analysis* that might have prevented the bungled promotion in England. The Southwest and Boston Beer cases introduced us to the SWOT (strengths, weaknesses, opportunities, threats) analysis. While these marketing tools do not guarantee the best decisions, they do bring objective and systematic thinking into the art of decision-making.

A Kinder, Gentler Stance?

In a number of cases, we could identify an arrogant mindset as leading to difficulties. The French did not appreciate the arrogance of Disney, and the Euro Disney project was almost a disaster. Arrogance played a role in the Firestone/Ford Explorer disaster, and the haughty mindset of German masters contributed to the debacle of the DaimlerChrysler merger. And it may be a negative for Google in its dealings, if it is not corrected. In the nonprofit arena, the dictatorial Aramony led to United Way's serious problems.

At the other extreme, is there room in today's competitive environment for a kinder, gentler stance by a business firm? While a firm is in contact with numerous parties, let us consider this question with regard to suppliers and distributors, customers, and employees.

Relations with Suppliers and Distributors

With the movement toward just-in-time deliveries in the search for more efficiency and cost containment, manufacturers and retailers are placing greater demands on suppliers. Those who cannot meet these demands will usually lose out to competitors able to do so. The big manufacturer or retailer can demand even more from smaller suppliers, since it is in the power position and the loss of its business could be overwhelming. We saw the problems of Rubbermaid in being unable to meet the service demands of Wal-Mart. At the least, the big customer deserves priority attention since its business is so important to any supplier.

Some of the big retailers, such as Wal-Mart and Home Depot as well as supermarket chains, impose "slotting fees." A slotting fee (described in a box in the Newell Rubbermaid case) essentially is a toll charged by the retailer for the use of its space; suppliers pay this up-front if they wish to be represented in the retailer's stores. Other demands include driving cost prices down to rock bottom, even if this destroys the supplier's profits, and insisting that the supplier take responsibility for inventory control, even stocking shelves, as well as providing special promotional support. It is common for big customers to make suppliers wait longer to be paid while the cash discount for prompt payment is routinely taken.

While the big organizations argue that the use of clout leads to greater marketing efficiencies and lower consumer prices, it can be carried too far. The term *symbiotic relationship* describes the relationship between the various channel-of-distribution members: All benefit from the success of the product, and it should be to their mutual advantage to work together. Thus the manufacturer and the dealers

and distributors should represent a valued partnership. They are on the same side; they are not in competition with one another.

The threat of *outsourcing* has developed into a powerful club for big firms in relations with their suppliers, and also their employees. It often poses such extreme demands, especially regarding prices, that the supplier or the employee has no defense. Is outsourcing overdone today?

Relations with Customers

Most firms pay lip service to customer satisfaction, but some go much further in this regard than others. The participation of Harley-Davidson at rallies and other events helped develop a cult following. While not exactly gaining a cult following, Vanguard has created a loyal and enthusiastic body of customers. A symbiotic relationship can also be seen as applying to manufacturer–customer relations: They both stand to win from highly satisfied customers. And again, isn't a kinder, gentler relationship a positive?

Giving Employees a Sense of Pride and a Caring Management

The great turnaround of Continental from the confrontational days of Frank Lorenzo has to be mainly attributed to the people-oriented environment fostered by Gordon Bethune. The marvel is how quickly it was done, started with such a simple thing as an open-door policy to the executive suite and full communication with employees.

Still, Continental was not unique in this enlisting of employees to the team. Herbert Kelleher fostered this as Southwest Airlines began its great charge. John Bogle imbued Vanguard with his concept of frugality and customer service. The new entrepreneurial powerhouses, Google and Starbucks, had great morale as they began their climb. Google's employee perks were unsurpassed in the business world, and the stock options that were lavishly given to employees in the early days were powerful incentives.

Then we have the other extreme. Frank Lorenzo, the predecessor of Bethune, devastated Continental with his confrontational labor–management relations. Boeing's problems with its peaks and valleys of layoffs and hiring destroyed pride and *esprit de corps*. A sense of pride was certainly latent with such a prestigious product, but without workplace stability a great opportunity was lost to cement employee morale. Lampert's handling of the Kmart/Sears acquisition is another textbook case of how to destroy pride and morale.

In addition to a people-oriented management, another key factor in cultivating employee teamwork lies in the perceived growth prospects of the firm. Where growth prospects look good, even coming back from the adversity of Continental, then employees can grasp that extra measure of enthusiasm and motivation. And, of course, the Kmart/Sears organizations had no such prospects.

Ethical Considerations

A firm tempted to walk the low road in search of greater short-run profits may eventually find that the risks far outweigh the rewards. Even more risky is not to

admit mistakes and product safety risks, as characterized Ford and Firestone, with such safety deficiencies costing hundreds of lives. While we cannot delve very deeply into social and ethical issues these insights are worth noting:⁴

- A firm can no longer disavow itself from the possibility of critical ethical scrutiny. Activist groups often publicize alleged misdeeds long before governmental regulators will.
- Trial lawyers are quick to pounce on anything that might bring big payoffs from deep-pocketed defendants.
- The media will help fan public scrutiny and criticism of alleged misdeeds.

Should a firm attempt to resist and defend itself? The overwhelming evidence is to the contrary. The bad press, the continued adversarial relations, and the effect on public image are hardly worth such a confrontation. The better course of action may be to back down as quietly as possible, repugnant though that may be to a management convinced of the reasonableness of its position. Rapport with the media may be gained by corporate openness and cooperation, with company top executives readily available to the press.

GENERAL INSIGHTS

Impact of One Person

In many of the cases one person had a powerful impact on the organization. Ray Kroc, of McDonald's, who converted a small hamburger stand into the world's largest restaurant operation, is an outstanding example, but we also have Herb Kelleher of Southwest Airlines, tormentor of the mighty airlines, and Gordon Bethune who brought Continental Air back from the depths. Let us not forget John Bogle, the founder and crusader of the Vanguard Fund Family, and his gospel of frugality. Then we have Phil Knight of Nike, who could never break the four-minute mile in college but went on to bring Nike world leadership in running and other athletic gear. More recently, there is Howard Schultz, the dreamer who begot Starbucks. For turnaround accomplishments, virtually unknown is Leonard Hadly, who quietly turned Maytag around after the disaster with its UK subsidiary; but it was short-lived after he retired.

One person can also have a negative impact on an organization. William Aramony almost destroyed all that he had built up with United Way. Frank Lorenzo devastated Continental Airlines, and only Gordon Bethune saved it. And there is Edward Lampert, the hedge firm manager, who bought struggling Kmart and Sears, and instead of trying to shore them up, drew money out of them to give his shareholders great short-term profits, until the economic downturn of 2008 sent

⁴ For more depth of coverage, see R.F. Hartley, *Business Ethics, Mistakes and Successes*, New York: Wiley, 2005.

the share prices crashing. The impact of one person, for good or ill, is one of the recurring marvels of history, whether business history or world history.

Prevalence of Opportunities for Entrepreneurship Today

Despite the maturing of our economy and the growing size and power of many firms in many industries, opportunities for entrepreneurship are more abundant than ever. Opportunities exist not only for the change-maker or innovator, but also for the person who only seeks to do things a little better than existing, and complacent, competition.

Most entrepreneurial successes are unheralded, although dozens have been widely publicized, such as Bill Gates of Microsoft, and Michael Dell, founder of Dell Computer. Boston Beer and Southwest Airlines, and even McDonald's and Vanguard, are not so many years away from their beginnings. Opportunities are there for the dedicated, with venture capital to support promising new businesses helping many fledgling enterprises. As a new business shows early promise, initial public offerings (IPOs) (i.e., new stock issues) become important sources of capital, and of great wealth for the entrepreneurs. In Part I we saw the recent great successes of the founders of Google and Starbucks, and the wealth that they created for many of their employees as well as to themselves.

But entrepreneurship is not for everyone. The great venture capitalists look at the person, not the idea. Typically they distribute their seed money to resourceful people who are courageous enough to give up security for the unknown consequences of their embryonic ventures, who have great self-confidence, and who demonstrate a tremendous will to win.

CONCLUSION

We learn from mistakes and from successes, although every marketing problem and opportunity seems cast in a unique setting. One author has likened business strategy to military strategy:

Strategies which are flexible rather than static embrace optimum use and offer the greatest number of alternative objectives. A good commander knows that he cannot control his environment to suit a prescribed strategy. Natural phenomena pose their own restraints to strategic planning, whether physical, geographic, regional, or psychological and sociological.⁵

He later adds:

Planning leadership recognizes the unpleasant fact that, despite every effort, the war may be lost. Therefore, the aim is to retain the maximum number of facilities and the basic organization. Indicators of a deteriorating and unsalvageable total situation are, therefore, mandatory . . . No possible combination of strategies and tactics, no

⁵ Myron S. Heidingsfield, *Changing Patterns in Marketing*, Boston: Allyn & Bacon, 1968, p. 11.

mobilization of resources . . . can supply a magic formula which guarantees victory; it is possible only to increase the probability of victory.⁶

Thus, we can pull two concepts from military strategy to help guide marketing strategy: the desirability of flexibility in an unknown or changing environment and the idea that a basic core should be maintained during crises. The first suggests that the firm should be prepared for adjustments in strategy and business plans as conditions warrant. The second suggests that there is a basic core of a firm's business that should be the final bastion to fall back on for regrouping if necessary. Harley-Davidson certainly had such a core as it saw its market share fall from 70 percent to 5 percent: its heavy machines.

Regarding the basic core of a firm, every viable firm has some distinctive function or *ecological niche* in the marketing environment:

Every business firm occupies a position which is in some respects unique. Its location, the product it sells, its operating methods, or the customers it serves tend to set it off in some degree from every other firm. Each firm competes by making the most of its individuality and its special character.⁷

Woe to the firm that loses its ecological niche.

QUESTIONS

1. Design a program aimed at mistake avoidance. Be as specific, as creative, and as complete as possible.
2. Would you advise a firm to be an imitator or an innovator? Why?
3. "There is no such thing as a sustainable competitive advantage." Discuss.
4. How would you build controls into an organization to ensure that similar mistakes do not happen in the future?
5. Array as many pros and cons of entrepreneurship as you can. Which do you see as most compelling?
6. Do you agree with the thought expressed in this chapter that a firm confronted with strong ethical criticism should abandon the product or the way of doing business? Why or why not?
7. We have suggested that the learning insights discussed in this chapter and elsewhere in the book are transferable to other firms and other times. Do you completely agree with this? Why or why not?
8. Do you agree or disagree with the author's contention that a kinder, gentler stance toward channel members would be desirable and profitable? Why or why not?

⁶ *Ibid.*

⁷ Alderson, p. 101.

HANDS-ON EXERCISE

Your firm has had a history of reacting rather than anticipating changes in the industry. As the staff assistant to the CEO, you have been assigned the responsibility of developing adequate sensors of the environment. How will you go about developing such sensors?

TEAM DEBATE EXERCISES

1. Debate the extremes of forecasting for an innovative new product: conservative versus aggressive.
2. Debate whether *outsourcing* has gone too far and needs to be reined in for the good of the country.

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