

Case Studies

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Introduction

Preparing an effective case analysis

In most strategic management courses, cases are used extensively as a teaching tool.¹ A key reason is that cases provide active learners with opportunities to use the strategic management process to identify and solve organisational problems. Thus, by analysing situations that are described in cases and presenting the results, active learners (that is, students) become skilled at effectively using the tools, techniques and concepts that combine to form the strategic management process.

The cases that follow are concerned with actual companies. Presented within the cases are problems and situations that managers and those with whom they work must analyse and resolve. As you will see, a strategic management case can focus on an entire industry, a single organisation or a business unit of a large, diversified firm. The strategic management issues facing not-for-profit organisations also can be examined using the case analysis method.

Basically, the case analysis method calls for a careful diagnosis of an organization's current conditions (as manifested by its external and internal environments) so that appropriate strategic actions can be recommended in light of the firm's strategic intent and strategic mission. Strategic actions are taken to develop and then use a firm's core competencies to select and implement different strategies, including business-level, corporate-level, acquisition and restructuring, international and cooperative strategies. Thus, appropriate strategic actions help the firm to survive in the long run as it creates and uses competitive advantages as the foundation for achieving strategic competitiveness and earning above-average returns. The case method that we are recommending to you has a rich heritage as a pedagogical approach to the study and understanding of managerial effectiveness.²

As an active learner, your preparation is critical to successful use of the case analysis method. Without careful study and analysis, active learners lack the insights required to participate fully in the discussion of a firm's situation and the strategic actions that are appropriate.

Instructors adopt different approaches in their application of the case analysis method. Some require active learners/students to use a specific analytical procedure to examine an organisation; others provide less structure, expecting students to learn by developing their own unique analytical method. Still other instructors believe that a moderately structured framework should be used to analyse a firm's situation and make appropriate recommendations. Your lecturer or tutor will determine the specific approach you take. The approach we are presenting to you is a moderately structured framework.

We divide our discussion of a moderately structured case analysis method framework into four sections. First, we describe the importance of understanding the skills active learners can acquire through effective use of the case analysis method. In the second section, we provide you with a process-oriented framework. This framework can be of value in your efforts to analyse cases and then present the results of your work. Using this framework in a classroom setting yields valuable experiences that can, in turn, help you to successfully complete assignments that you will receive from your employer. The third section is where we describe briefly what you can expect to occur during in-class case discussions. As this description shows, the relationship and interactions between instructors and active learners/students during case discussions are different than they are during lectures. In the final section, we

present a moderately structured framework that we believe can help you to prepare effective oral and written presentations. Written and oral communication skills also are valued highly in many organisational settings; hence, their development today can serve you well in the future.

Skills gained through use of the case analysis method

The case analysis method is based on a philosophy that combines knowledge acquisition with significant involvement from students as active learners. In the words of Alfred North Whitehead, this philosophy ‘rejects the doctrine that students had first learned passively, and then, having learned should apply knowledge’.³ In contrast to this philosophy, the case analysis method is based on principles that were elaborated upon by John Dewey:

Only by wrestling with the conditions of this problem at hand, seeking and finding his own way out, does [the student] think ... If he cannot devise his own solution (not, of course, in isolation, but in correspondence with the teacher and other pupils) and find his own way out he will not learn, not even if he can recite some correct answer with a hundred percent accuracy.⁴

The case analysis method brings reality into the classroom. When developed and presented effectively, with rich and interesting detail, cases keep conceptual discussions grounded in reality. Experience shows that simple fictional accounts of situations and collections of actual organisational data and articles from public sources are not as effective for learning as fully developed cases. A comprehensive case presents you

with a partial clinical study of a real-life situation that faced managers as well as other stakeholders, including employees. A case presented in narrative form provides motivation for involvement with and analysis of a specific situation. By framing alternative strategic actions and by confronting the complexity and ambiguity of the practical world, case analysis provides extraordinary power for your involvement with a personal learning experience. Some of the potential consequences of using the case method are summarised in Exhibit 1.

As Exhibit 1 suggests, the case analysis method can assist active learners in the development of their analytical and judgement skills. Case analysis also helps you learn how to ask the right questions. By this we mean questions that focus on the core strategic issues that are included in a case. Active learners/students with managerial aspirations can improve their ability to identify underlying problems rather than focusing on superficial symptoms as they develop skills at asking probing yet appropriate questions.

The collection of cases your instructor chooses to assign can expose you to a wide variety of organisations and decision situations. This approach vicariously broadens your experience base and provides insights into many types of managerial situations, tasks and responsibilities. Such indirect experience can help you to make a more informed career decision about the industry and managerial situation you believe will prove to be challenging and satisfying. Finally, experience in analysing cases definitely enhances your problem-solving skills, and research indicates that the case method for this class is better than the lecture method.⁵

Furthermore, when your instructor requires oral and written presentations, your communication skills will be honed through use of the case method. Of course, these added skills depend on your preparation as

Exhibit 1 | Consequences of student involvement with the case method

- 1 Case analysis requires students to practise important managerial skills—diagnosing, making decisions, observing, listening and persuading—while preparing for a case discussion.
- 2 Cases require students to relate analysis and action, to develop realistic and concrete actions despite the complexity and partial knowledge characterising the situation being studied.
- 3 Students must confront the *intractability of reality*—complete with absence of needed information, an imbalance between needs and available resources, and conflicts among competing objectives.
- 4 Students develop a general managerial point of view—where responsibility is sensitive to action in a diverse environmental context.

Source: C.C. Lundberg and C. Enz, 1993, ‘A framework for student case preparation’, *Case Research Journal*, 13 (Summer), p. 134.

well as your instructor's facilitation of learning. However, the primary responsibility for learning is yours. The quality of case discussion is generally acknowledged to require, at a minimum, a thorough mastery of case facts and some independent analysis of them. The case method therefore first requires that you read and think carefully about each case. Additional comments about the preparation you should complete to successfully discuss a case appear in the next section.

Student preparation for case discussion

If you are inexperienced with the case method, you may need to alter your study habits. A lecture-oriented course may not require you to do intensive preparation

for *each* class period. In such a course, you have the latitude to work through assigned readings and review lecture notes according to your own schedule. However, an assigned case requires significant and conscientious *preparation before class*. Without it, you will be unable to contribute meaningfully to in-class discussion. Therefore, careful reading and thinking about case facts, as well as reasoned analyses and the development of alternative solutions to case problems, are essential. Recommended alternatives should flow logically from core problems identified through study of the case. Exhibit 2 shows a set of steps that can help you to familiarise yourself with a case, identify problems and propose strategic actions that increase the probability that a firm will achieve strategic competitiveness and earn above-average returns.

Exhibit 2 | An effective case analysis process

Step 1: <i>Gaining familiarity</i>	<ul style="list-style-type: none"> a. In general – determine who, what, how, where and when (the critical facts of the case). b. In detail – identify the places, persons, activities and contexts of the situation. c. Recognise the degree of certainty/uncertainty of acquired information.
Step 2: <i>Recognising symptoms</i>	<ul style="list-style-type: none"> a. List all indicators (including stated 'problems') that something is not as expected or as desired. b. Ensure that symptoms are not assumed to be the problem (symptoms should lead to identification of the problem).
Step 3: <i>Identifying goals</i>	<ul style="list-style-type: none"> a. Identify critical statements by major parties (e.g. people, groups, the work unit, etc.). b. List all goals of the major parties that exist or can be reasonably inferred.
Step 4: <i>Conducting the analysis</i>	<ul style="list-style-type: none"> a. Decide which ideas, models and theories seem useful. b. Apply these conceptual tools to the situation. c. As new information is revealed, cycle back to sub-steps (a) and (b).
Step 5: <i>Making the diagnosis</i>	<ul style="list-style-type: none"> a. Identify predicaments (goal inconsistencies). b. Identify problems (discrepancies between goals and performance). c. Prioritise predicaments/problems regarding timing, importance, etc.
Step 6: <i>Doing the action planning</i>	<ul style="list-style-type: none"> a. Specify and prioritise the criteria used to choose action alternatives. b. Discover or invent feasible action alternatives. c. Examine the probable consequences of action alternatives. d. Select a course of action. e. Design an implementation plan/schedule. f. Create a plan for assessing the action to be implemented.

Source: C. C. Lundberg and C. Enz, 1993, 'A framework for student case preparation', *Case Research Journal*, 13 (Summer), p. 144.

Gaining familiarity

The first step of an effective case analysis process calls for you to become familiar with the facts featured in the case and the focal firm's situation. Initially, you should become familiar with the focal firm's general situation (for example, who, what, how, where and when). Thorough familiarisation demands appreciation of the nuances, as well as the major issues, in the case.

Gaining familiarity with a situation requires you to study several situational levels, including interactions between and among individuals within groups, business units, the corporate office, the local community and the society at large. Recognising relationships within and among levels facilitates a more thorough understanding of the specific case situation.

It is also important that you evaluate information on a continuum of certainty. Information that is verifiable by several sources and judged along similar dimensions can be classified as a *fact*. Information representing someone's perceptual judgement of a particular situation is referred to as an *inference*. Information gleaned from a situation that is not verifiable is classified as *speculation*. Finally, information that is independent of verifiable sources and arises through individual or group discussion is an *assumption*. Obviously, case analysts and organisational decision makers prefer having access to facts over inferences, speculations and assumptions.

Personal feelings, judgements and opinions evolve when you are analysing a case. It is important to be aware of your own feelings about the case and to evaluate the accuracy of perceived 'facts' to ensure that the objectivity of your work is maximised.

Recognising symptoms

Recognition of symptoms is the second step of an effective case analysis process. A symptom is an indication that something is not as you or someone else thinks it should be. You may be tempted to correct the symptoms instead of searching for true problems. True problems are the conditions or situations requiring solution before the performance of an organisation, business unit or individual can improve. Identifying and listing symptoms early in the case analysis process tends to reduce the temptation to label symptoms as problems. The focus of your analysis should be on the *actual causes* of a problem, rather than on its symptoms. Thus, it is important to remember that symptoms are indicators of problems; subsequent work facilitates discovery of critical causes of problems that your case recommendations must address.

Identifying goals

The third step of effective case analysis calls for you to identify the goals of the major organisations, business units and/or individuals in a case. As appropriate, you should also identify each firm's strategic intent and strategic mission. Typically, these direction-setting statements (goals, strategic intents and strategic missions) are derived from comments made by central characters in the organisation, business unit or top management team as described in the case and/or from public documents (for example, an annual report).

Completing this step successfully can sometimes be difficult. Nonetheless, the outcomes you attain from this step are essential to an effective case analysis because identifying goals, intent and mission helps you to clarify the major problems featured in a case and to evaluate alternative solutions to those problems. Direction-setting statements are not always stated publicly or prepared in written format. When this occurs, you must infer goals from other available factual data and information.

Conducting the analysis

The fourth step of effective case analysis is concerned with acquiring a systematic understanding of a situation. Occasionally cases are analysed in a less-than-thorough manner. Such analyses may be a product of a busy schedule or of the difficulty and complexity of the issues described in a particular case. Sometimes you will face pressures on your limited amounts of time and may believe that you can understand the situation described in a case without systematic *analysis* of all the facts. However, experience shows that familiarity with a case's facts is a necessary, but insufficient, step in the development of effective solutions – solutions that can enhance a firm's strategic competitiveness. In fact, a less-than-thorough analysis typically results in an emphasis on symptoms, rather than on problems and their causes. To analyse a case effectively, you should be sceptical of quick or easy approaches and answers.

A systematic analysis helps you to understand a situation and determine what can work and probably what will not work. Key linkages and underlying causal networks based on the history of the firm become apparent. In this way, you can separate causal networks from symptoms.

Also, because the quality of a case analysis depends on applying appropriate tools, it is important that you use the ideas, models and theories that seem to be useful for evaluating and solving individual and unique situations. As you consider facts and symptoms, a useful

theory may become apparent. Of course, having familiarity with conceptual models may be important in the effective analysis of a situation. Successful students and successful organisational strategists add to their intellectual tool kits on a continual basis.

Making the diagnosis

The fifth step of effective case analysis – diagnosis – is the process of identifying and clarifying the roots of the problems by comparing goals with facts. In this step, it is useful to search for predicaments. Predicaments are situations in which goals do not fit with known facts. When you evaluate the actual performance of an organisation, business unit or individual, you may identify over- or underachievement (relative to established goals). Of course, single-problem situations are rare. Accordingly, you should recognise that the case situations you study probably will be complex in nature.

Effective diagnosis requires you to determine the problems affecting longer-term performance and those requiring immediate handling. Understanding these issues will aid your efforts to prioritise problems and predicaments, given available resources and existing constraints.

Doing the action planning

The final step of an effective case analysis process is called action planning. *Action planning* is the process of identifying appropriate alternative actions. In the action planning step, you select the criteria you will use to evaluate the identified alternatives. You may derive these criteria from the analyses; typically, they are related to key strategic situations facing the focal organisation. Furthermore, it is important that you prioritise these criteria to ensure a rational and effective evaluation of alternative courses of action.

Typically, managers ‘satisfice’ when selecting courses of action; that is, they find *acceptable* courses of action that meet most of the chosen evaluation criteria. A rule of thumb that has proved valuable to strategic decision makers is to select an alternative that leaves other plausible alternatives available if the one selected fails.

Once you have selected the best alternative, you must specify an implementation plan. Developing an implementation plan serves as a reality check on the feasibility of your alternatives. Thus, it is important that you give thoughtful consideration to all issues associated with the implementation of the selected alternatives.

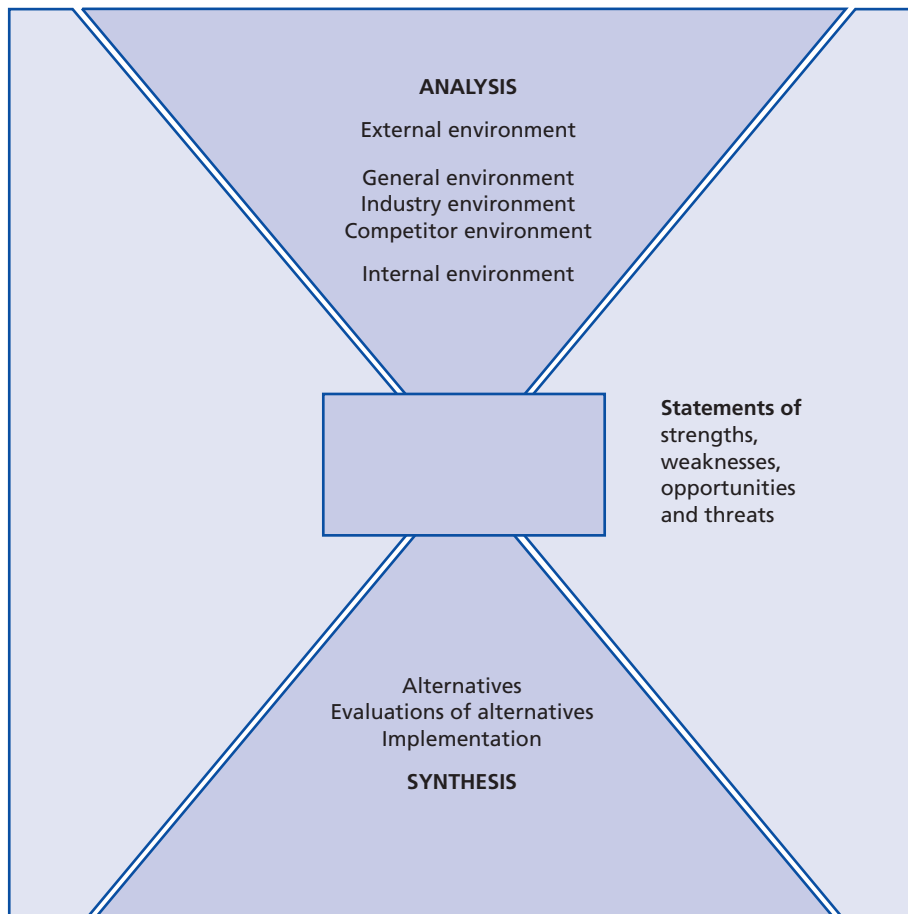
What to expect from in-class case discussions

Classroom discussions of cases differ significantly from lectures. The case method calls for instructors to guide the discussion, encourage student participation and solicit alternative views. When alternative views are not forthcoming, instructors typically adopt one view so that students can be challenged to respond to it thoughtfully. Often students’ work is evaluated in terms of both the quantity and the quality of their contributions to in-class case discussions. Students benefit by having their views judged against those of their peers and by responding to challenges by other class members and/or the instructor.

During case discussions, instructors listen, question and probe to extend the analysis of case issues. In the course of these actions, peers or the instructor may challenge an individual’s views and the validity of alternative perspectives that have been expressed. These challenges are offered in a constructive manner; their intent is to help students develop their analytical and communication skills. Instructors should encourage students to be innovative and original in the development and presentation of their ideas. Over the course of an individual discussion, students can develop a more complex view of the case, benefiting from the diverse inputs of their peers and instructor. Among other benefits, experience with multiple-case discussions should help students to increase their knowledge of the advantages and disadvantages of group decision-making processes.

Student peers as well as the instructor value comments that contribute to the discussion. To offer *relevant* contributions, you are encouraged to use independent thought and, through discussions with your peers outside of class, to refine your thinking. We also encourage you to avoid using ‘I think’, ‘I believe’ and ‘I feel’ to discuss your inputs to a case analysis process. Instead, consider using a less emotion-laden phrase, such as ‘My analysis shows’. This highlights the logical nature of the approach you have taken to complete the six steps of an effective case analysis process.

When preparing for an in-class case discussion, you should plan to use the case data to explain your assessment of the situation. Assume that your peers and instructor know the case facts. In addition, it is good practice to prepare notes before class discussions and use them as you explain your view. Effective notes signal to classmates and the instructor that you are prepared to engage in a thorough discussion of a case. Moreover,

Exhibit 3 | Types of thinking in case preparation: Analysis and synthesis

thorough notes eliminate the need for you to memorise the facts and figures needed to discuss a case successfully.

The case analysis process just described can help you prepare to effectively discuss a case during class meetings. Adherence to this process results in consideration of the issues required to identify a focal firm's problems and to propose strategic actions through which the firm can increase the probability that it will achieve strategic competitiveness.

In some instances, your instructor may ask you to prepare either an oral or a written analysis of a particular case. Typically, such an assignment demands even more thorough study and analysis of the case contents. At your instructor's discretion, oral and written analyses may be completed by individuals or by groups of two or more people. The information and insights gained through completing the six steps shown in Exhibit 2 are often of value in the development of an oral or written analysis. However, when preparing an oral or written presentation, you must consider the overall framework in which your information and

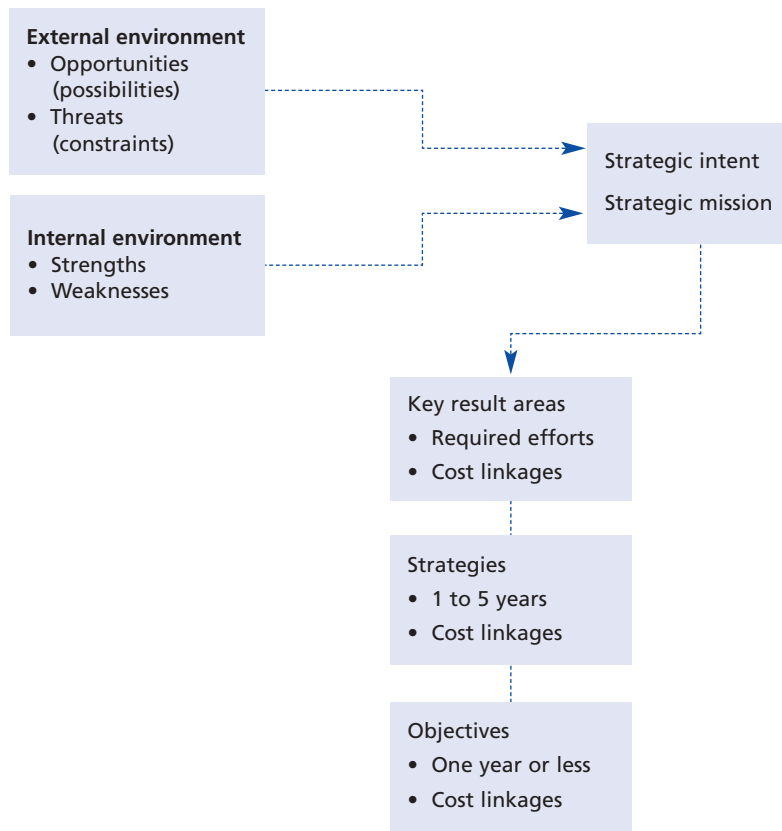
inputs will be presented. Such a framework is the focus of the next section.

Preparing an oral/written case strategic plan

Experience shows that two types of thinking are necessary to develop an effective oral or written presentation (see Exhibit 3). The upper part of the model in Exhibit 3 outlines the *analysis* stage of case preparation.

In the analysis stage, you should first analyse the general external environmental issues affecting the firm. Next, your environmental analysis should focus on the particular industry (or industries, in the case of a diversified company) in which a firm operates. Finally, you should examine the competitive environment of the focal firm. Through study of the three levels of the external environment, you will be able to identify a firm's opportunities and threats. Following the external environmental analysis is the analysis of the firm's

Exhibit 4 | Strategic planning process



internal environment, which results in the identification of the firm's strengths and weaknesses.

As noted in Exhibit 3, you must then change the focus from analysis to *synthesis*. Specifically, you must *synthesise* information gained from your analysis of the firm's internal and external environments. Synthesising information allows you to generate alternatives that can resolve the significant problems or challenges facing the focal firm. Once you identify a best alternative, from an evaluation based on predetermined criteria and goals, you must explore implementation actions.

Exhibits 4 and 5 outline the sections that should be included in either an oral or a written strategic plan presentation: introduction (strategic intent and mission), situation analysis, statements of strengths/weaknesses and opportunities/threats, strategy formulation and implementation plan. These sections, which can be completed only through use of the two types of thinking featured in Exhibit 3, are described in the following discussion. Familiarity with the contents of your textbook's 13 chapters is helpful because the general outline for an oral or a written strategic plan shown in Exhibit 5 is based on an understanding of the strategic management process detailed in those chapters.

External environment analysis

As shown in Exhibit 5, a general starting place for completing a situation analysis is the external environment. The *external environment* is composed of outside (external) conditions that affect a firm's performance. Your analysis of the environment should consider the effects of the *general environment* on the focal firm. Following that evaluation, you should analyse the *industry and competitor environmental trends*.

These trends or conditions in the external environment shape the firm's strategic intent and mission. The external environment analysis essentially indicates what a firm *might choose to do*. Often called an *environmental scan*, an analysis of the external environment allows a firm to identify key conditions that are beyond its direct control. The purpose of studying the external environment is to identify a firm's opportunities and threats. *Opportunities* are conditions in the external environment that appear to have the potential to contribute to a firm's success. In essence, opportunities represent *possibilities*. *Threats* are conditions in the external environment that appear to

Exhibit 5 | Strategic planning and its parts

- *Strategic planning* is a process through which a firm determines what it seeks to accomplish and the actions required to achieve desired outcomes
 - ✓ *Strategic planning*, then, is a process that we use to determine *what* (outcomes to be reached) and *how* (actions to be taken to reach outcomes)
- The effective *strategic plan* for a firm would include statements and details about the following:
 - ✓ *Opportunities* (possibilities) and *threats* (constraints)
 - ✓ *Strengths* (what we do especially well) and *weaknesses* (deficiencies)
 - ✓ *Strategic intent* (an indication of a firm's ideal state)
 - ✓ *Strategic mission* (purpose and scope of a firm's operations in product and market terms)
 - ✓ *Key result areas* (KRAs) (categories of activities where efforts must take place to reach the mission and intent)
 - ✓ *Strategies* (actions for each KRA to be completed within one to five years)
 - ✓ *Objectives* (specific statements detailing actions for each strategy that are to be completed in one year or less)
 - ✓ *Cost linkages* (relationships between actions and financial resources)

have the potential to prevent a firm's success. In essence, threats represent potential *constraints*.

When studying the external environment, the focus is on trying to *predict* the future (in terms of local, regional, and international trends and issues) and to *predict* the expected effects on a firm's operations. The external environment features conditions in the broader society *and* in the industry (area of competition) that influence the firm's possibilities and constraints. Areas to be considered (to identify opportunities and threats) when studying the general environment are listed in Exhibit 6. Many of these issues are explained more fully in Chapter 2.

Once you analyse the general environmental trends, you should study their effect on the focal industry. Often the same environmental trend may have a significantly different impact on separate industries. Furthermore, the same trend may affect firms within the same industry differently. For instance, with deregulation of the airline industry in the United States, older, established airlines had a significant decrease in profitability, while many smaller airlines, such as Southwest Airlines, with lower cost structures and greater flexibility, were able to aggressively enter new markets.

Porter's five forces model is a useful tool for analysing the specific industry (see Chapter 2). Careful study of how the five competitive forces (that is, supplier power, buyer power, potential entrants, substitute products and rivalry among competitors) affect a firm's strategy is important. These forces may

create threats or opportunities relative to the specific business-level strategies (that is, differentiation, cost leadership, focus) being implemented. Often a strategic group's analysis reveals how different environmental trends are affecting industry competitors. Strategic group analysis is useful for understanding the industry's competitive structures and firm constraints and possibilities within those structures.

Firms also need to analyse each of their primary competitors. This analysis should identify competitors' current strategies, strategic intent, strategic mission, capabilities, core competencies and a competitive response profile. This information is useful to the focal firm in formulating an appropriate strategic intent and mission.

Internal environment analysis

The *internal environment* is composed of strengths and weaknesses internal to a firm that influence its strategic competitiveness. The purpose of completing an analysis of a firm's internal environment is to identify its strengths and weaknesses. The strengths and weaknesses in a firm's internal environment shape the strategic intent and strategic mission. The internal environment essentially indicates what a firm *can do*. Capabilities or skills that allow a firm to do something that others cannot do or that allow a firm to do something better than others do it are called strengths. *Strengths* can be categorised as something that a firm does especially well. Strengths help a firm to take advantage of external opportunities or overcome

Exhibit 6 | Sample general environmental categories

<i>Technology</i>	<ul style="list-style-type: none"> ■ Information technology continues to become cheaper and have more practical applications. ■ Database technology allows organisation of complex data and distribution of information. ■ Telecommunications technology and networks increasingly provide fast transmission of all sources of data, including voice, written communications and video information.
<i>Demographic trends</i>	<ul style="list-style-type: none"> ■ Computerised design and manufacturing technologies continue to facilitate quality and flexibility. ■ Regional changes in population due to migration ■ Changing ethnic composition of the population ■ Ageing of the population ■ Ageing of the 'baby boom' generation
<i>Economic trends</i>	<ul style="list-style-type: none"> ■ Interest rates ■ Inflation rates ■ Savings rates ■ Trade deficits ■ Budget deficits ■ Exchange rates
<i>Political/legal environment</i>	<ul style="list-style-type: none"> ■ Antitrust enforcement ■ Tax policy changes ■ Environmental protection laws ■ Extent of regulation/deregulation ■ Developing countries privatising state monopolies ■ State-owned industries
<i>Socio-cultural environment</i>	<ul style="list-style-type: none"> ■ Increasing number of women in the workforce ■ Awareness of health and fitness issues ■ Concern for the environment ■ Concern for customers
<i>Global environment</i>	<ul style="list-style-type: none"> ■ Currency exchange rates ■ Free trade agreements ■ Trade deficits ■ New or developing markets

external threats. Capabilities or skill deficiencies that prevent a firm from completing an important activity as well as others do it are called weaknesses. *Weaknesses* have the potential to prevent a firm from taking advantage of external opportunities or succeeding in efforts to overcome external threats. Thus, *weaknesses* can be thought of as something the firm needs to improve.

Analysis of the primary and support activities of the value chain provides opportunities to understand how external environmental trends affect the specific activities of a firm. Such analysis helps to highlight strengths and weaknesses. (See Chapter 3 for an explanation of the value chain.) For the purposes of preparing an oral or written presentation, it is

important to note that strengths are internal resources and capabilities that have the potential to be core competencies. Weaknesses, on the other hand, have the potential to place a firm at a competitive disadvantage relative to its rivals.

When evaluating the internal characteristics of the firm, your analysis of the functional activities emphasised is critical. For instance, if the strategy of the firm is primarily technology-driven, it is important to evaluate the firm's R&D activities. If the strategy is market-driven, marketing functional activities are of paramount importance. If a firm has financial difficulties, critical financial ratios would require careful evaluation. In fact, because of the importance of financial health, most cases require financial analyses.

The appendix lists and operationally defines several common financial ratios. Included are exhibits describing profitability, liquidity, leverage, activity and shareholders' return ratios. Other firm characteristics that should be examined to study the internal environment effectively include leadership, organisational culture, structure and control systems.

Identification of strategic intent and mission

Strategic intent is associated with a mind-set that managers seek to imbue within the company. Essentially, a mind-set captures how we view the world and our intended role in it. Strategic intent reflects or identifies a firm's ideal state. Strategic intent flows from a firm's opportunities, threats, strengths and weaknesses. However, the major influence on strategic intent is a firm's *strengths*. Strategic intent should reflect a firm's intended character and a commitment to 'stretch' available resources and strengths in order to reach strategies and objectives. Examples of strategic intent include:

- The relentless pursuit of perfection (Lexus).
- To be the top performer in everything that we do (Phillips Petroleum).
- We are dedicated to being the world's best at bringing people together (AT&T).

The strategic mission flows from a firm's strategic intent; it is a statement used to describe a firm's unique intent and the scope of its operations in product and market terms. In its most basic form, the strategic mission indicates to stakeholders what a firm seeks to accomplish. An effective strategic mission reflects a firm's individuality and reveals its leadership's predisposition(s). The useful strategic mission shows how a firm differs from others and defines boundaries within which the firm intends to operate. For example:

- Cochlear's mission is to have 'clinical teams and recipients embrace Cochlear as their partner in hearing for life'; and
- Coca-Cola Amatil's mission is to have market leadership in every territory.

Hints for presenting an effective strategic plan

There may be a temptation to spend most of your oral or written case analysis on results from the analysis. It is important, however, that the *analysis* of a case should

not be over-emphasised relative to the *synthesis* of results gained from your analytical efforts – what does the analysis mean for the organisation (see Exhibit 3)?

Strategy formulation: Choosing key result areas

Once you have identified strengths and weaknesses, determined the firm's core competencies (if any), and formulated a strategic intent and mission, you have a picture of what the firm is and what challenges and threats it faces.

You can now determine alternative key result areas (KRAs). Each of these is a category of activities that helps to accomplish the strategic intent of the firm. For example, KRAs for Cochlear may include to remain a leader in hearing implant technology and to build links with hearing clinicians in Southeast Asia. Each alternative should be feasible (that is, it should match the firm's strengths, capabilities and, especially, core competencies), and feasibility should be demonstrated. In addition, you should show how each alternative takes advantage of the environmental opportunity or avoids/buffers against environmental threats. Developing carefully thought-out alternatives requires synthesis of your analyses and creates greater credibility in oral and written case presentations.

Once you develop a strong set of alternative KRAs, you must evaluate the set to choose the best ones. Your choice should be defensible and provide benefits over the other alternatives. Thus, it is important that both the alternative development and evaluation of alternatives be thorough. The choice of the best alternative should be explained and defended. For the two Cochlear KRAs presented earlier, the strategies are clear and in both cases they take advantage of competencies within the company and opportunities in the external environment.

Key result area implementation

After selecting the most appropriate KRAs (that is, those with the highest probability of enhancing a firm's strategic competitiveness), you must consider effective implementation. Effective synthesis is important to ensure that you have considered and evaluated all critical implementation issues. Issues you might consider include the structural changes necessary to implement the new strategies and objectives associated with each KRA. In addition, leadership changes and new controls or incentives may be necessary to implement these strategic actions. The implementation actions you

recommend should be explicit and thoroughly explained. Occasionally, careful evaluation of implementation actions may show the strategy to be less favourable than you originally thought. (You may find that the capabilities required to implement the strategy are absent and unobtainable.) A strategy is only as good as the firm’s ability to implement it effectively. Therefore, expending the effort to determine effective implementation is important.

Process issues

You should ensure that your presentation (either oral or written) has logical consistency throughout. For example, if your presentation identifies one purpose, but your analysis focuses on issues that differ from the stated purpose, the logical inconsistency will be apparent. Likewise, your alternatives should flow from the configuration of strengths, weaknesses, opportunities and threats you identified through the internal and external analyses.

Thoroughness and clarity also are critical to an effective presentation. Thoroughness is represented by the comprehensiveness of the analysis and alternative generation. Furthermore, clarity in the results of the analyses, selection of the best alternative KRAs and strategies, and design of implementation actions are important. For example, your statement of the strengths and weaknesses should flow clearly and logically from the internal analyses presented, and these should be reflected in KRAs and strategies.

Presentations (oral or written) that show logical consistency, thoroughness and clarity of purpose, effective analyses, and feasible recommendations are more effective and will receive more positive evaluations. Being able to withstand tough questions from peers after your presentation will build credibility for your strategic plan presentation. Furthermore, developing the skills necessary to make such presentations will enhance your future job performance and career success.

Appendix: Financial analysis in case studies

Exhibit A-1 Profitability ratios

Ratio	Formula	What it shows
1 Return on total assets	$\frac{\text{Profits after taxes}}{\text{Total assets}}$ or $\frac{\text{Profits after taxes + interest}}{\text{Total assets}}$	The net return on total investment of the firm or The return on both creditors’ and shareholders’ investments
2 Return on shareholders’ equity (or return on net worth)	$\frac{\text{Profits after taxes}}{\text{Total shareholders’ equity}}$	How effectively the company is utilising shareholders’ funds
3 Return on ordinary equity	$\frac{\text{Profit after taxes – preference share dividends}}{\text{Total shareholders’ equity – par value of preference shares}}$	The net return to ordinary shareholders
4 Operating profit margin (or return on sales)	$\frac{\text{Profits before taxes and before interest}}{\text{Sales}}$	The firm’s profitability from regular operations
5 Net profit margin (or net return on sales)	$\frac{\text{Profits after taxes}}{\text{Sales}}$	The firm’s net profit as a percentage of total sales

Exhibit A-2 Liquidity ratios

Ratio	Formula	What it shows
1 Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	The firm's ability to meet its current financial liabilities
2 Quick ratio (or acid-test ratio)	$\frac{\text{Current assets} - \text{inventory}}{\text{Current liabilities}}$	The firm's ability to pay off short-term obligations without relying on sales of inventory
3 Inventory to net working capital	$\frac{\text{Inventory}}{\text{Current assets} - \text{current liabilities}}$	The extent to which the firm's working capital is tied up in inventory

Exhibit A-3 Leverage ratios

Ratio	Formula	What it shows
1 Debt-to-assets	$\frac{\text{Total debt}}{\text{Total assets}}$	Total borrowed funds as a percentage of total assets
2 Debt-to-equity	$\frac{\text{Total debt}}{\text{Total shareholders' equity}}$	Borrowed funds versus the funds provided by shareholders
3 Long-term debt-to-equity	$\frac{\text{Long-term debt}}{\text{Total shareholders' equity}}$	Leverage used by the firm
4 Times-interest-earned (or coverage ratio)	$\frac{\text{Profits before interest and taxes}}{\text{Total interest charges}}$	The firm's ability to meet all interest payments
5 Fixed charge coverage	$\frac{\text{Profits before taxes and interest} + \text{lease obligations}}{\text{Total interest charges} + \text{lease obligations}}$	The firm's ability to meet all fixed-charge obligations, including lease payments

Exhibit A-4 Activity ratios

Ratio	Formula	What it shows
1 Inventory turnover	$\frac{\text{Sales}}{\text{Inventory of finished goods}}$	The effectiveness of the firm in employing inventory
2 Fixed assets turnover	$\frac{\text{Sales}}{\text{Fixed assets}}$	The effectiveness of the firm in utilising plant and equipment
3 Total assets turnover	$\frac{\text{Sales}}{\text{Total assets}}$	The effectiveness of the firm in utilising total assets
4 Accounts receivable turnover	$\frac{\text{Annual credit sales}}{\text{Accounts receivable}}$	How many times the total receivables have been collected during the accounting period
5 Average collection period	$\frac{\text{Accounts receivable}}{\text{Average daily sales}}$	The average length of time the firm waits to collect payments after sales

Exhibit A-5 Shareholders’ return ratios

Ratio	Formula	What it shows
1 Dividend yield on ordinary shares	$\frac{\text{Annual dividends per share}}{\text{Current market price per share}}$	A measure of return to ordinary shareholders in the form of dividends.
2 Price-earnings ratio	$\frac{\text{Current market price per share}}{\text{After-tax earnings per share}}$	An indication of market perception of the firm. Usually, the faster-growing or less risky firms tend to have higher PE ratios than the slower-growing or more risky firms.
3 Dividend payout ratio	$\frac{\text{Annual dividends per share}}{\text{After-tax earnings per share}}$	An indication of dividends paid out as a percentage of profits.
4 Cash flow per share	$\frac{\text{After-tax profits + depreciation}}{\text{Number of ordinary shares outstanding}}$	A measure of total cash per share available for use by the firm.

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Case 1

ABB in China, 1998

Suzanne Uhlen
Lund University

Michael Lubatkin
University of Connecticut

'I want to make ABB a company that encourages and demands innovation from all of its employees, and a company that creates the environment in which teamwork and innovation flourish,' declares ABB's CEO Göran Lindahl. In seeking new growth, Lindahl is escaping the long shadow of his predecessor, Percy Barnevik. The former CEO of ABB was argued to be one of the most successful international managers in Europe.

ABB, the world leader in electrical engineering, is a US\$35 billion electrical engineering group, with companies all over the globe. It operates primarily in the fields of reliable and economical generation, transmission and distribution of electrical energy.¹ Much has been written about the worldwide company. In 1996, ABB was ranked in the top 40 listed by *Fortune* 500. Recently, the company announced its newest reorganisation, making it more up to date with the global world, as the current CEO, Göran Lindahl, expressed.² In 1997, Lindahl took over from Barnevik as CEO of the technology giant and is feeling the demanding market and shareholder pressures.

ABB has different priorities in different markets. Western Europe and North America are the company's biggest markets. However, the high-potential markets are the Middle East, Africa, Latin America and Asia. These markets are growing fast, and ABB expects to have half of its customers in these regions not long into the 21st century. The priority is on building local manufacturing, engineering and other forms of added value. ABB wants to integrate these operations into the global networks to obtain full synergy effects and economies of scale.

During 1998, it was shown that the industrial production in OECD countries, in which ABB performs about 75 per cent of its total business, continues to grow, although at a slower pace than the strong growth rates of the previous year. Overall, industrial production in Europe is lower than the year before, but still high compared with historical levels. Current economic activity in North America is slowing compared with the strong economy of recent years. In Latin America, high interest rates are delaying the financial closing of projects in an environment of reduced economic activity. The Indian economy is slowing due to reduced exports as a result of its strong currency compared with others in the region. Southeast Asia is gradually stabilising at a low level, with reduced consumption and investments.

As a result of the ongoing economic uncertainty, overall global demand is forecast to remain soft in the near future. ABB expects to benefit with its well-established local presence around the world from higher demand in various industries and world markets. Appropriate cost cutting, continued selective tendering and successful working capital reduction programs are expected to continue contributing positively to the ABB Group results. The company recognises that the world is rapidly changing and increasingly unpredictable. Efforts have paid off and the group has taken its opportunities in Asia and positioned itself for future growth in what is seen to be 'the world's most dynamic market over a long term – China'.³

The interest in China is growing steadily, and companies in Japan, the Western European countries, the United States and elsewhere today view the Chinese market as having enormous potential. With a population of a billion and a growing economy, it seems to be worthwhile to gain a foothold in the market.⁴ On

the one hand, China represents a huge and largely untapped market. The Chinese market alone is potentially bigger than that of the United States, the European Community and Japan combined! On the other hand, China's new firms are proving to be very competitive, and China's culture is quite different from that of the West. However, the Chinese market growth remains relatively good for enterprises such as Procter & Gamble, Motorola, Nestlé and ABB. This market acts as a lifeboat to many worldwide companies suffering from the financial crisis in the rest of Southeast Asia. Nevertheless, discussions exist about China devaluing its currency, which might also drag China down into the crisis. Yet the country has not shown any visible scratches from the surrounding crisis. China seems to be unshakeable, and analysts are still valuing China as the country of the future.⁵ Thus, the changes in China are creating both opportunities and threats for established worldwide companies. This is a country that, according to *Management Today*, will be one of the top 10 economies in the world by the year 2010.⁶

Chinese influence

China will enter the next century as the rising power in Asia after two decades of astonishing economic growth that has transformed the country and that has given rise to new challenges.⁷

Many cities in China have more than 5 million inhabitants. It is a country that has had a growing economy which cannot be compared to that of any other country during almost three decades.⁸ It is argued that China is not like any other developing country, due to the rapid changes that are taking place in certain areas. In some areas, such as with home electronics,⁹ the development has surpassed that in Western countries, while in other areas, China lags far behind.

The Chinese culture and society is more than 5 000 years old, with a unique cultural heritage of philosophy, science and technology, societal structures and traditional administrative bureaucracy.¹⁰ With this in mind, it is no wonder, according to researchers, that conflicts often occur between Chinese and foreign cultures. This is caused by foreign managers being accustomed to other values and norms, some of which are not acceptable in China.¹¹

In the current half-year reports from worldwide companies, a distinct trend is noticed, according to Dagens Industri.¹² The more focus that the companies have put on basic industry, the more the Asian crisis tends to affect these companies. However, China can

save these companies and others, especially those companies operating in the business of infrastructure.¹³ Now that the Cold War with China has ended, economic growth is stabilising and the country is demanding a speedy reconstruction. The country has begun to enjoy unprecedented strategic latitude for the first time in 200 years, and it no longer faces the threat of aggression from superior powers.¹⁴ This has enabled the country to focus on economic developments as the driving force of both its domestic and foreign policies. According to Professor Yahuda, China's leaders are basing their legitimacy on providing stability and continued high levels of prosperity. The need for economic development is fuelled by many other factors, such as providing employment for a vast population that increases by some 15 million people a year. In addition, there are significant regional inequalities that can be addressed only by further economic development.¹⁵

China is expected to evolve into a hybrid system of authoritarianism, democracy, socialism and capitalism. Also recognised are the internal problems the country faces, such as environmental disasters, political struggles, and tensions between the emerging entrepreneurial economy and the vast parts of China still under state control.¹⁶ Today, China receives the most direct investment and foreign aid of any developing country. Many companies are eager to establish their presence in China, which, it is argued, attracts more than its proportionate share of investments.¹⁷ However, 'westerners cannot expect to know how China will develop and need to expect that the Chinese will always be different from them. Instead of trying to change China, they should look for positive steps that take their differences into account'.¹⁸

According to China's Premier, Zhu Rongji, China is indeed the largest market in the world. However, due to the problem of duplicate construction, there is a problem of over-supply in some areas. Nevertheless, the Premier states that the market is far from being saturated.¹⁹ Since China opened up its doors to the outside world in the late 1970s, a large number of foreign investors have gained rich returns from their investments, yet some have ended in failure. Some guiding keys to ensuring successful business in China, according to *China Daily*, include:²⁰

- Making long-term strategies for the Chinese market. Competition is intensifying and market exploitation needs time and patience. Foreign companies eager to get a quick return are usually disappointed at the results.

- Localising staff. They are familiar with the local business environment.
- Being aware of changes in policies and regulation. China is in the process of transforming from a planned economy to a market economy. Various policies and regulations are being revised and replaced, while new ones are being issued. Foreign investors must keep informed of the ongoing changes.
- Undertaking practical market research. Due to social, economic and cultural differences, practical and down-to-earth market research is a must before and during investment in China.

Chinese cultural influence

There is a consensus among several authors that China has a traditional respect for age, hierarchy and authority.²¹ This originates from the Confucian concept of *li* (rite, propriety), which plays an important role in maintaining a person's social position. *Li* can be seen today in the existing traditional bureaucracy and in vertical relationships concerning centralisation of decision making, and in corruption to some extent, which is acceptable in such a cultural context.²²

Second, the family is viewed as an essential social unit and there is a strong tendency to promote the collective or the group. Members within the family or group must maintain harmonious relationships, and these social relations are seen as more important than the individual.²³ Thus, the family or clan norms are adopted as the formal code of conduct, and members are bound to these standards. Other research found that in modern China, business and industrial enterprises were perceived as an extension of the family system.²⁴

Third, the concept of 'face' (*mianzi*) is seen as an important characteristic. As Ju noted, the general idea of *mianzi* is related to 'a reputation achieved through getting on in life through success and ostentation'.²⁵ *Mianzi* also serves to enhance harmony within the family or group, so that the positive is expressed publicly and any conflicts remain private.²⁶ Hong has found that the concept of *mianzi* still plays an important role in social relationships and organisational behaviour.²⁷ However, Yuan points out that there are two sides to this concept.²⁸ The first includes the individual's moral character, and the strong fear of losing this limits the person's behaviour. The second aspect of *mianzi* involves assertions about a person, which is not seen quite as seriously as the former type of loss of face.²⁹

The importance of personal relations (*guanxi*) is the fourth characteristic. According to Hong, persons with *guanxi* usually share a common birthplace, lineage,

surname or experience, such as attending the same school, working together or belonging to the same organisation.³⁰ A comparative study of decision making in China and Britain has revealed that Chinese managers use their personal *guanxi* more widely to exchange information, negotiate with planning authorities and accelerate decision-making processes than do managers from British firms.³¹ As it is, the network transmits information, and because contacts and cooperation are built on trust, it is seen as very serious if that trust is broken. If a trust is broken, the whole network will soon know about the incident and it is maintained that the person involved will have a hard time doing business again.³²

A company that has been doing business in the Chinese market since 1919 is ABB. At that time this was the first product delivery to China, and it was not until 1979 that ABB established its first permanent office. Almost 11 years later, the heart of almost every chairman of an energy company started to pound with excitement if it heard the words 'Asia' and 'electricity'. There were billions to be had from the booming demand for electricity in Asia.³³ But in recent years, the emerging Asian market has slowed down due to the financial crisis in the area. At the moment, it seems as if China is the only country not affected by this financial crisis, and consequently, there are many companies that are now trying to be successful in China.

ABB is argued to be a company with a good position in the Chinese market, due to good performance, delivery, autonomy and its good name. Today the company has nine representative offices and 15 joint ventures, and the number of employees in China has grown in four years from approximately 1 000 to 6 000.

Local roots

The strategy of ABB is to use its global strength to support the needs of its local customers around the world. However, in China, ABB has a fairly high import duty on its products, which limits how much the company can sell. The idea of setting up local production in China was to increase the market share, as most Chinese customers do not have foreign currency³⁴ and are consequently forced to buy locally produced goods with the local currency. Furthermore, the reason for ABB to localise in China was not to achieve lower production costs, as some locally supplied components are actually more expensive in China than elsewhere. Rather, it was to be closer to the local market, and therefore facilitate a few local modifications to the products and provide shorter delivery times to the customer.

The phrase ‘think global, act local’ is said to reflect ABB’s fundamental idea of strong local companies working together across borders to gain economies of scale in many areas.³⁵ In spite of ABB’s claims to respond swiftly and surely to market conditions,³⁶ some of the products in China are not truly adapted to the local market. Most of the products are designed for the IEC – the international standard association based in Europe. The company manufactures products that have to be tested according to different norms and standards. For example, North America ABB follows the ANSI standard, and Canada ABB follows the CSA standard.

However, some of ABB’s products would not pass a type test based on the Chinese standards. That is not because the quality is too low; on the contrary, the quality of ABB products is sometimes too high. The quality of some of the products has evolved far beyond the requirements of Chinese standards; therefore, these ABB products cannot meet local Chinese standards. The Chinese standards are based on what the local manufacturer can produce, because the country does not have much other information. As one manager at ABB in China stated,

We are not going to redesign our products in order to meet the standards, for the obvious reasons: Why should we take our quality out? Why shall we take the advances out? It does become an issue from time to time. Chinese are very risk averse, if we have not done the type test in China. It is more to cover themselves in case something goes wrong.

Some managers feel that when ABB tries to adapt the products to the Chinese local standard, there is a negative response. The customer regards Western standards as superior and is actually asking for the superior product. The Chinese customers are seen as tough and sometimes demand more tests than ABB’s products have gone through. Another reason put forward is insufficient feasibility studies when setting up new joint ventures in China. This delays the work when new information has to be collected about the market conditions. This aspect originates from the speed of changes in China and the difficulty for the company to catch up with what is going on.

However, when the so-called type tests of the product have been done, the company cannot change the design, due to the high costs involved in this test. Some criticism has been heard that ABB should adapt more to the Chinese situation, which the company cannot respond to concerning the technical design, because then the tests have to be done all over again. Of

course, it is different from product to product; for some of the products, as one manager said,

We have to adapt to the configurations the customers have a demand for, because they have an option – go to the competitor.

Still, in most cases, the local ABB companies in China are not allowed to change the products other than according to agreements with the licensee. The reason for this is that the technology partners³⁷ have the overall view of the quality and performance. The ABB corporation definitely does not want to have different product performance from different countries. The products must have the same descriptions, so that they are seen as the same product all over the world. Consequently, the local ABB company can only do a few modifications to the standard product for specific customers and cannot change the technology involved. The technology partners have a few alternatives that meet the demands of the Chinese customers, and these products are also tested, but do not necessarily meet the Chinese standards.

The local ABB company tries to follow the ABB Group’s policy, to be close to the customer and responsive to their needs.³⁸ In China, however, contracts are not commonly used, and this frequently obstructs satisfying many customer demands.

They keep on saying this is China and you should adapt to the Chinese way: OK, if you want to buy a Chinese product that’s fine, but this is our product – here are the terms and conditions. You can’t just give in to that; otherwise you will kill your company, because they expect you to accept unlimited liability and lifetime warranty, and the risks to which you would expose your company would eventually lead to its shutting down, so you just cannot do that.

ABB feels that to be close to the customer is the best guarantee that local requirements are met.³⁹ However, the headquarters in Zurich has also set up some rules about the kind of contracts that the local subsidiaries shall sign worldwide. In China, contracts are something rather new, and many Chinese customers do not want it that way. The consequence is that some ABB companies in China do not use the standard ABB contract and are actually responsive to the customers’ needs. When another ABB company comes to the same customer to set up a standard contract, the customer will refer them to the previous ABB company who did not seem to find

the contract necessary. The question asked by the confused customer is said to be,

Why do you then have to use a standard contract when the other ABB didn't?

Profit centres

ABB's strategy is to take full advantage of its economies of scale and at the same time be represented by national companies in many home markets where some 5 000 entrepreneurial profit centres are attentive to every local customer. These companies are independent and have to stand on their own economically. The individual company's profit can easily be compared to revenue. The individual ABB company is measured on its own performance and needs. It is recognised that the profit centres are efficient for decentralisation and that the organisation can act relatively fast. This enables the company to be sensitive and responsive to potential problems. Each company has a fair amount of autonomy, making the individual company flexible. Even though ABB brochures state that the strategy of having profit centres enables the easy transfer of know-how across borders,⁴⁰ the direction is pretty much one way – from the technology partners, business areas and country level, to the subsidiary – rather than a two-way exchange.

Nevertheless, some conflicts of interest have occurred because the local ABB company and all other licensees are more or less dependent on their licensors in Europe.⁴¹ In the local ABB company's case, one of their technology partners is measured like the others, on performance and profit. If it gives the local ABB company support, it will cost the former money, and likewise, if it sells the local ABB company components, it wants to make a profit. The consequence is that it is charging the local ABB company 25–100 per cent over and above the cost of its parts.

So in the end you end up calling them as little as possible and we end up buying parts from local suppliers that probably we should not buy from local suppliers. And we reduce our quality. They have great profit figures; we have some profit figures, but there are some real serious problems along the way.

The technology partner argues that the prices are high because first it has to buy from its supplier and then sell to the local ABB company. This makes the

products more expensive. The technology partners also pay for the type tests and all the product development.⁴²

Conflicts of this sort have been occurring for a long time within ABB, but nobody has yet found a solution. It is difficult for a company like ABB, which is working with so many different products, markets, and in different cultures, to have anything other than sole profit centres. If the profit centres did not aim for a profit when selling within the ABB Group, then the companies would no longer be independent companies. Being independent is seen as a strength, and therefore it would be against the laws of nature if the companies were not always aiming for a profit. Nonetheless, between these independent companies with profit centres there are some extreme examples:

Our partner in Y-country was selling the finished product in China before. Now he sells the parts to the joint venture in China and wants to charge more for the parts than he did for the finished product, and that is because it is in his interest and he will be evaluated on his performance. If he does not do that, his profits will be too low and he will be blamed for it. So he has got to do what he has got to do. That is what he is motivated to do and that is what he is going to do.

To some extent, the technology partners are selling indirectly to the Chinese market using non-official agents to avoid a high import tax and the high market price that exists on the Chinese market. ABB China is trying to force ABB companies to use only two official channels for ABB goods into the Chinese market – the locally produced by the local ABB company and the directly imported from a technology partner.

Structure

ABB is a huge enterprise with dispersed business areas which encompass the three segments of Power Generation, Transmission and Distribution, and Industrial Building Systems. However, this recently has been changed and divided into six segments. Before the reorganisation, every country had its national ABB head office, dealing with all the company business in that particular country. The other dimension of the matrix structure reflects the clustering of the activities of the enterprise into 36 Business Areas (BAs). Each BA represents a distinct worldwide product market. Simplified, each BA is responsible for worldwide market allocation and the development of a worldwide

technical strategy for that specific product line. Additional responsibilities for the BA are to coordinate who shall supply or deliver where, and also to work as a referee in potential disagreements between companies within the ABB Group.

However, in China, as in most developing countries, there is no BA in place and the decision power of the country management is consequently closer at hand. The power of the decision making tends to rest more heavily on the country level than on the BA level. Disagreements between licensees in Western countries and subsidiaries in China have been, and are, occurring, due to different business orientations. The local subsidiary in China has two or more licensors in Western countries, from which they buy components. Some of the licensees sold these components themselves before the local subsidiary was set up in China. In some cases, the licensee feels that the market in China was taken from them and that they therefore can compensate for potentially lost sales only by charging the Chinese subsidiary a higher cost. Consequently, if the disagreeing partner seeks the BA as a referee in this kind of case, the following happens, as explained by one manager:

The BA is looking at the global business – we can increase our global business if we set up a joint venture in China. But the technology partner can't increase their business if we set up a joint venture in China. If we set up a joint venture in China the technology partner wants to increase its business also, they are going to do some work, and of course want something for it. The BA is really powerless to push those along.

To date, the licensors have been paying for all the technology development, which is the reason for charging a higher price for the components they are selling. Since the enterprise is divided into 5 000 profit centres and because each of these profit centres wants a profit when selling a component or product, there have been some shortcomings in the coordination and cooperation between the licensors and the local Chinese subsidiary.

The licensor in X-country makes the same breakers that the local ABB company does and faces the same problems with quality. For example, in Germany, they do not inform their licensee in China, who will also run into the same problem with quality in the near future. The problem is also discussed at the local ABB company, but if it suggests changes to the licensor, the licensor will

evaluate on the basis of benefits to itself. Since they are going to invest their own resources, they are, of course, going to invest in areas beneficial to themselves first, or else charge the local ABB company extra. The consequences are thus summarised as follows:

We have had some things that would really help us here in China. But I don't even bother, because I know the reaction.

Over 80 per cent of what the Centres of Excellence produce is going to be exported,⁴³ making it important that the partners of the licensor manage the contemporary challenges and opportunities that can emerge. However, the BA divides the world markets into different areas in which the specific ABB companies are to be a first source.⁴⁴ Between some of the licensors and the local ABB company, this has resulted in certain disputes. For example,

We are responsible for the People's Republic of China's market and are supposed to be the sole source (or, rather, first source) because we have the expertise for this market. Our technology partner in X-country quotes into this market on a regular basis, does not inform us, and competes against us, and takes orders at a lower price. This can destroy our position in the marketplace.

According to the licensor, it does not quote in the local ABB company's market because a customer with foreign currency will prefer imported products. The licensor argues that it does not go into the Chinese market and offer its products, but does get enquiries from ABB in Hong Kong and delivers to it. Hong Kong sells the products directly to the Chinese customer after having increased the original price so that it is several times higher in China than in Europe. It is a decision of the ABB China management that the Hong Kong coordinated sales force shall sell the local ABB company's products on the Chinese market among imported products and locally joint venture produced products. It helps to have sales coordination when deciding whether the products should be imported or not.

The technology is owned today by the Centres of Excellence in Europe or so-called licensors who pay for all the product development. ABB has chosen these licensees to be responsible for the company's world source of this specific technology. These units are responsible for developing new products and look after

the quality. They arrange technical seminars about the technology, and by keeping special technology parts at only their factory. The strategic decision to keep special parts and the drawings of these parts at only one chosen factory enables the company to secure itself against competitors copying its products. Consequently, these parts will not be localised or purchased in China. However, for one products group (THS) there has been an organisational change, including the establishment of a unit called CHTET, which shall now own all new technology that is developed and also pay for the product development. This change now involves all product groups.

Multicultural

The current fashion, exemplified by ABB, is for the firms to be 'multicultural multinationals' and be very sensitive to national differences.⁴⁵ Barnevik did debate that a culturally diverse set of managers can be a source of strength. According to Barnevik, managers should not try to eradicate these differences and establish a uniform managerial culture. Rather, they should seek to understand these cultural differences, to empathise with the views of people from different cultures, and to make compromises for such differences. Barnevik believes that the advantage of building a culturally diverse cadre of global managers is to improve the quality of managerial decision making.⁴⁶

ABB in China is typified by a culturally diverse set of managers with a mixture of managerial ideas, derived from the managers' different national backgrounds, different values and different methods of working. It then depends on which stage in personal development the manager has reached if he or she is going to be influenced and absorb the new climate. Or, as one manager said,

If you are close to being retired you might not change so much; there isn't much point. But you can't work in the same way as you do at home – it just wouldn't work.

According to another manager, ABB is a very international company with a great deal of influence from Scandinavian culture. However, it is a mixture of many cultures and it really depends on where the ABB company is located. In China, the ABB culture is influenced by Chinese culture, by the environmental circumstances and by the laws. It is stricter in China than it is, for example, in Europe, because there are more rules. In spite of that, the managers do not feel that the result is a subculture of the ABB culture, rather

a mixture of managers from different cultures – 'we are a multi-domestic company'.

However, the top level of the ABB management is seen to be far away from the daily life at the subsidiary level in China, such as at the local ABB company. Or as one manager expressed it, 'Between that level and here, it's like the Pacific Ocean.' All the managers agree that what the top level, including Barnevik and Lindahl,⁴⁷ says sounds very good and that is how it should be. Some managers continued the discussion and expressed this difference:

Sounds like I'm working for a different ABB than these guys are. What they talk about is really good and that is how it should be. But then when I sit back and go into the daily work, that's not at all how it is. Somewhere along the line something gets lost between the theory and ideas at that level which is quite good. But when you get down to the working level and have to make it work, something really gets lost along the way.

Expatriates

It is the BA with its worldwide networks that recommends, after suggestions from local offices, who is going to be sent as an expatriate to China or any other country. Thereafter, it is a cooperation between the BA and the country level, but it is the latter that finally decides which potential foreign expatriate is appropriate. However, it is important that an expatriate be able to fit into the system when coming to China, given the high costs involved in being there. It is estimated that an expatriate costs the company about US\$250 000 a year, due to the high taxes the company is paying to have a foreign employee.

ABB's identity is supported by a coordinating executive committee and an elite cadre of 500 global managers, which the top management shifts through a series of foreign assignments. Their job is intended to knit the organisation together, to transfer expertise around the world and to expose the company's leadership to differing perspectives.⁴⁸

However, ABB in China is not yet a closely tied country unit, for several reasons. First, the expatriates come from the outside and most of their contacts are back in the home country. Most expatriates feel that the home office does not understand how difficult it can be to work abroad and that they need support. 'Sometimes it just feels like I'm standing in the desert screaming,' one expatriate expressed. The home office feels that the expatriates can be a burden because they need so much

support. It is the home office, along with the BA, that selects candidates for foreign placement, even though it has brief or no knowledge of how it is to work in that country. However, it would be impossible to have insights into how the working conditions are in the other operating countries.

Concerning growing a strong country unit, the expatriates are stationed in China on assignments for a relatively short time period, and are thus less able to build up informal networks. Few efforts are put into establishing an informal network, because the few contact persons the managers have today will eventually return home after a while and there is no formal way of contacting the replacing person. Of course, there is the formal LOTUS Notes®, which is a computer-based network with all managers worldwide included, but it is said to be deficient in building the preferred strong country unit within China. Finally, the managers do not feel they can offer the time to establish informal networks, due to the replacement of expatriates every two to three years. A worldwide policy within the company limits the expatriates to operating as such for not more than five years at a time. Executives have questioned this policy, saying that

It is during the first year you learn what is going on and get into your new clothes. During the second year you get to know the people and the system, the third year you apply what you learned and the fourth year you start to make some changes – and this is very specific for developing countries.

Three years ago, the expatriates did not get any information or education about the country-specific situation before being sent out to ABB's subsidiaries in China. Today, when there are about 100 expatriates with 25 different nationalities in China, it has changed, but it is mostly up to the individual to collect material and prepare for the acclimatisation. Within the worldwide corporation, there is no policy of formal training before one is sent out as an expatriate; rather, it is up to the home office of the expatriates to prepare the managers for the foreign assignments. Some argue that 'you could never prepare for the situation in China anyway, so any education wouldn't help'. Others say that this has resulted in a lot of problems with the expatriates, which results in even higher costs for the company if the expatriate fails.

When the expatriate's contract time is finished, he or she may feel unsure about placement back home. Thus, it is important for the expatriate to have close

contact with the home office and to make use of the free trips home. In most cases, the expatriates do not know what will happen when the contract expires and they are to return home.

The Chinese challenge

According to ABB, they prefer to send out managers with 10–15 years of experience. However, the task is difficult when the location may be in a rural area overseas and most managers with 10–15 years' experience have families who are less likely to want to move to these areas. Sometimes a manager gets sent to China when the company does not want to fire him.

So instead they send the manager to where the pitfalls are greater and challenges bigger and potential risks are greater.

It is found throughout the research that most expatriates have strong feelings about living in and adapting to the new environment in China. Newly arrived expatriates seem to enjoy the respect they get from the Chinese, as several managers delightedly expressed:

I love it here, and how could you not? You get a lot of respect just because you're a foreigner and life is just pleasant.

Other expatriates that have stayed a bit longer disliked the situation to a great extent and a number of expatriates have asked to leave because their expectations about the situation in China have not been fulfilled.⁴⁹

One country-specific situation is how to teach the Chinese employees to work in teams. The worldwide company ABB is especially focusing on creating an environment that fosters teamwork and promotes active participation among its employees.⁵⁰ This is a big challenge for Western managers (the expatriates) because the Chinese employees have a hard time working in a group, due to cultural and historical reasons. Some of the local ABB companies have failed in their attempt with team working, ad hoc groups and the like, because they have been in too much of a hurry. Or, as one manager said,

Here in China the management needs to encourage the teamwork a little bit, because it is a little against the culture and the nature of the people. This is not a question of lack of time for the managers, but I do not think we have the overall

commitment to do it. Some of us feel strongly that we should, others that we can't.

Another consequence is that expatriate management does not have the understanding or the commitment to teach local employees the company values, a situation that has resulted in unacceptable quality at some companies.

ABB has a great advantage in comparison to other worldwide companies due to its top priority of building deep local roots by hiring and training local managers who know their local markets.⁵¹ Replacing expatriates with local Chinese employees, where the local employees are set to be successors to the expatriates after a certain number of years, shows the commitment to the philosophy of having a local profile. However, as the Chinese employees are coming from an extremely different system from the Western expatriates, it takes quite a long time for the former to get exposed to Western management practices. To ease this problem and to teach Western management style, ABB China, among other companies, has recently set up an agreement with a business school in Beijing to arrange training for Chinese employees with good management potential. This is specific for ABB China, because in developed countries the employees are responsible for their own development.⁵² Recently ABB had its own school in Beijing for Chinese employees to learn ABB culture and management. Unfortunately, this school had to close due to the profit-centre philosophy, where even the school had to charge the individual ABB companies for teaching their employees.

ABB is sending about 100 local Chinese employees to an ABB company in a Western country every year. After problems with several employees quitting after training, ABB has set up precautions with a service commitment. The employee (or new employer) has to pay back the training investment if he or she quits, or the employee signs an agreement that he or she will continue working for ABB for a certain number of years. The problem with local employees quitting after ABB's investment in training has also been experienced in India and Thailand. It is shown in the personnel turnover rate, approximately 22 per cent within ABB China, that many local employees are aiming for the experience of working for an international company such as ABB and then move on to a better-paying job.

However, by having local employees, the local ABB company is responsive to local conditions and sensitive to important cultural objectives such as the Chinese *guanxi*.⁵³ It has been decided that the local employees should take care of the customer contact, since the

expatriates are usually stationed for only a few years at one location and are consequently not able to build up strong connections with customers.

Reorganisation

The organisation is decentralised based on delegated responsibility and the right to make decisions in order to respond quickly to customers' requirements. In the core of this complex organisation are two principles: decentralisation of responsibility, and individual accountability. These principles have been very relevant in China, which is a relatively young country for ABB to be operating in.⁵⁴ Decentralisation is highly developed, and the expatriate⁵⁵ managers have a wide responsibility that would normally demand more than one specialist in a Western company. However, in some instances the organisation is criticised for being too centralised.

The changes in China happen very quickly and, according to ABB brochures, the greatest efficiency gains lie in improving the way people work together.⁵⁶ Within the ABB China region, communication has its shortcomings. Companies with overlapping products or similar products do not exchange information to any large degree or coordinate their marketing strategies. On the technical side, communication is used frequently, which can be seen when a manager usually receives up to 100 e-mails a day from other ABB employees. However, tactics for building up effective informal communication are lacking between most ABB companies operating in China. The distances are large and, accordingly, a meeting demands greater efforts than in almost any other country in the world.

According to the former CEO, Percy Barnevik, the purpose with the matrix organisation is to make the company more bottom-heavy than top-heavy – 'clean out the headquarters in Zurich and send everybody out; have independent companies operating in an entrepreneurial manner', as one respondent mentioned. It is further maintained in the company brochures that these entrepreneurial business units have the freedom and motivation to run their own business with a sense of personal responsibility.⁵⁷

However, the result from the matrix organisation in China is that ABB subsidiaries have ABB China's objectives (the country level) as well as the BA's objectives to follow. ABB China is measuring how the different companies are performing within China. The BA, on the other hand, is measuring how the specific products are performing on a worldwide basis and what the profitability is for the products. Each BA has a financial controller, and each country level has one also.

*Rarely are the two coordinated, or do they meet.
So you end up with one set of objectives from each
... Duplication! Which one shall you follow?*

According to the ABB mission book, the roles in the two dimensions of the ABB matrix must be complementary.⁵⁸ It demands that both the individual company and the headquarters level are flexible and strive for extensive communication. This is the way to avoid the matrix interchange becoming cumbersome and slow. It is seen to be the only way to 'reap the benefits of being global (economies of scale, technological strength, etc.) and of being multidomestic (a high degree of decentralization and local roots in the countries in which we operate)'.

For many years, ABB was widely regarded as an exemplary European company, yet it is undergoing a second major restructuring within four years. CEO Göran Lindahl says that restructuring is aimed at making the organisation faster and more cost-efficient.⁵⁹ Due to the demands of a more global market, there are reasons for getting rid of the regional structure and concentrating more on the specific countries. The reorganisation has basically dismantled one half of the matrix: the country management. Henceforth, the BAs will manage their businesses on a worldwide basis and there will no longer be the confusion caused by BA and country management setting different objectives. At the same time, segments are split up (many BAs form a segment) to make them more manageable (for example, the Transmission and Distribution segment has been split into two segments: Transmission and Distribution). To conclude, the general managers of the individual joint ventures and other units will have only one manager above them in the organisation that has a global view of the business. In China, it also means the dismantling of the Hong Kong organisation as well as the Asia-Pacific organisation.

According to Göran Lindahl, the reorganisation is preparation for a much faster rate of change in the markets and for the company to be able to respond more effectively to the demands of globalisation. It is seen as an aggressive strategy to create a platform for future growth.

Future vision

CEO Göran Lindahl was appointed in 1997 to be the new president and chief executive of ABB. His view of the future is that it can no longer be extrapolated, but can be forecast by creativity, imagination, ingenuity and innovation – action based not on what was, but on what

could be. The corporate culture needs to be replaced by globalising leadership and corporate values. ABB is focusing on this by creating a unified organisation across national, cultural and business borders.

On the path towards the 21st century, ABB will focus on several essential elements: a strong local presence; a fast and flexible organisation; the best technology and products available; and excellent local managers who know the business culture, who are able to cross national and business borders easily, and who can execute your strategy faster than the competition.⁶⁰

*We are living in a rapidly changing environment, and our competitors will not stand still. In the face of this great challenge and opportunity, enterprises that adapt quickly and meet customer needs will be the winner, and this is the ultimate goal of ABB.*⁶¹

Appendix

Motorola

Motorola was involved in Russia and faced some problems with Glasnost and the decline of the country. At that time, the founder of the company, Galvin, realised that there was no future in Russia and declared that China was the country where the growth was to be. Consequently, Motorola established its first representative office in China in 1987 and has grown very quickly ever since. Today, China generates more than 10 per cent of Motorola's sales and the company has its major businesses in China.

Motorola has found that modernisation in China happens quickly and all their competitors are present in the country. They still predict China to be the potential leader in Asia for their business. The customers also have high expectations of the products Motorola is offering, because the products are regarded as being very expensive. However, the problem the company is facing in China is that the company is growing too quickly, or as expressed another way:

... it is like chasing a speeding train and trying to catch up with it.

Presently, Motorola has 12 000 employees and 200 expatriates in China, where the goal is that Chinese successors will take over the jobs of the expatriates. The expatriates are sent out on assignments for two to three years, with the possibility of renewal with a one-two

rotation, but limited to a maximum of six years as an expatriate. High demands are set on the expatriates, especially concerning the difficulties experienced in teaching teamwork to local employees. This is very important within the company, since all the strategy planning is done in teams. When the contract time for the expatriate has expired, the following is expressed:

You have done your job when the time comes and you have left the company and everything is working smoothly, but if everything is falling apart, you are a failure as an expatriate and have not taught a successor.

However, progress has been made in developing the company's local employees. Motorola has set up training abroad. The training, nevertheless, is preferably held within China, with rotation assignments and training at Motorola University. This company university was set up in 1994 when the company found that the Chinese universities did not turn out sufficiently well-trained students. Within the company, there is, however, a requirement that every employee worldwide shall have at least 40 hours of training, which is exceeded in China. There must be a combination of good training and mentor development. Motorola admits that it does not provide enough training for foreign expatriates before they come to China.

You get more understanding if you look like a foreigner and make some mistakes than if you don't. Overseas Chinese are measured through other standards than other foreigners.

Some expatriates just cannot handle the situation in China. If an expatriate fails, it has to be handled with care, otherwise the person loses face when coming back to the home office. The company also has pointed out that it needs expatriates with 10–15 years of experience in order to teach the local employees the company values and to transfer company knowledge. However, the people that are willing to change addresses and move to China are the younger employees with less than five years' experience.

The expatriates are often responsible for transferring technology knowledge and helping to start projects, especially the newly set-up Center of Excellence in Tianjin, where US\$750 million was invested. This was Motorola's first manufacturing research laboratory outside the United States. The company has invested US\$1.1 billion in China and has

plans to invest another US\$1–1.5 million. Motorola has also set up two branches of worldwide training universities to educate customers, suppliers and government officials, as well as its own employees. The invested money in China is from the earnings within the whole enterprise, with the motivation that the Chinese market is going to be huge. Sincere commitment has been made and the present CEO, Gary Tucker, expressed the following:

When Motorola has come to your country they never leave ... We manufacture in China, because this is where our market is. We get wealth by going to a lot of countries around the world and then doing well in that country.

The expansion strategy in China is through joint ventures. However, it is important that the Chinese partners bring something of value, which means that the partners have to be approved by the CEO. The company has become 'so decentralized that it has become bad', and it desires to reorganise more along customer than product lines. A practical reorganisation has taken place to move everybody operating in Beijing to the same newly built headquarters. However, entrepreneurial activities are also of importance, but difficult, due to financial motivation and autonomy.

In China, the products are localised with Chinese characters on the cellular phones and pagers. In 1987, Motorola started selling pagers and thought there would not be a big market because the telephone-net was not well established. The company invented codebooks, which enabled two-way communication. Fortunately, this also worked in Hong Kong, Singapore and Taiwan. After five years of operation in China, the company does not have deep roots in the market. Motorola has invested huge sums in sponsoring environmental protection, providing scholarships to students, building labs at universities, and donating money to primary schools in rural areas.⁶²

The worldwide organisation is a 'pyramid', with the corporate office on top and business units underneath – 'then put the apex at the bottom'. The corporate office works as the glue that holds the organisation together. In 1997, Motorola conducted a reorganisation to better reflect the global nature of the business.⁶³ The coordination is safeguarded by this new formal structure. However, the informal information flow is better, but it is overused. The information flow is mostly through e-mails. A manager gets approximately 70–100 e-mails a day, of which less than 30 per cent are really

useful. Regarding communication, the following was expressed:

Some days it feels like we have all these opportunities and we do not really communicate.

All the controllers or general managers in the joint ventures get together quarterly to solve problems and to counsel and support each other. Information is encouraged, but no system is developed to track what is going on in all the six districts in China where the company is operating. Competition between the different units is a common problem Motorola is experiencing, which results in the customers becoming confused. This is a problem that has no solution, due to the matrix organisation:

We do not have the answers, because if we are too centralised then we miss new opportunities. How do you encourage creativity and yet keep people from competing with each other?

What makes Motorola a worldwide company is a set of key common beliefs or guiding principles from the role model and father figure of the company, Galvin: 'Uncompromising integrity and constant respect for people – that is what makes us Motorola.' This is the principal code of conduct that Motorola practises, and which the management has to reread and sign every two years.

Motorola notes that it 'obviously' has to change because it is operating in the Chinese market – for example, show face, build relations and go to ceremonial meetings. It is essential that the partner is reliable, that the business makes sense and that it is legal. However, Motorola always looks the same all over the world, but it is the expatriates and their families who have made an effort to adapt to the surrounding changes.

The challenge for Motorola is doing business in China. China is very difficult for a company like Motorola

... because they would like to control the system and everything takes a long time because they will make sure that you are not cheating. You must be able to work with all the people that come from different departments and to let them trust you. Ordinary things like getting water, electricity, etc., is a huge problem. Doing business in the Chinese system is a challenge and therefore creates pressure because you get frustrated.

Procter & Gamble

In August 1998, China's largest international employer had been in China for 10 successful years. Procter and Gamble (P&G) has approximately 5 000 employees and 100 expatriates spread over 11 joint ventures and wholly owned enterprises in the country. P&G was ranked this year [1998] on *Fortune* magazine's 'World's Most Admired Companies' list. Currently, the biggest market for the company is China, where new companies are being established. However, before companies were established in China, a feasibility study was done. As with most other feasibility studies done in China, the information was outdated even though it was only one year old, and people were criticised for not having sufficient knowledge about the country's specific situation.

The expatriates sent to China for the P&G account are no more prepared for the situation, except for knowing that the company has a deep culture that will support them. Furthermore, a continuous effort exists within the company to put different cultural backgrounds together. Cultural values are also written down and are consistent all over the world. However, the different expatriates have a wide variety of cultural backgrounds, and their culture is coloured by their management style. This mixture of management styles might confuse the local Chinese employees.

The main benefit gained for an expatriate is the one offered in the daily work. One exception is made: for the expatriate salespeople, who get a whole year of orientation training and language training. In line with the localisation demands, the number of expatriates is decreasing. Due to the high costs involved in having expatriates, who are mostly three to four levels up in the organisation, one key strategy is to develop local employees. Everybody who is an expatriate for P&G has a sponsor, or contact, back home. It is essential to keep contact with the sponsor so that it is not just a name on a paper, and people are encouraged to go back home once a year at the company's cost. There is no official limit in expatriate policy within the company; however, most expatriates are on a three-year contract. The expatriate network is not yet an issue; however, the expatriates are said to be a very close group: 'We are all in this together and we have a common vision.'

The optimal goal for P&G is to develop the organisation so that it can be a Chinese-run company. Today, everything is made in the Chinese P&G factories for internal use, and the company opened up a research centre in Beijing, in cooperation with a prominent university.⁶⁴ If the company has developed a good idea

in China, the company will analyse how to reapply the idea in the rest of the world.

Counterfeits are the greatest competition for the company and an extensive problem. However, not all the products from P&G are sold in China and the quality of the products sold is not as high as it is in Western countries. The Chinese customers are unable to pay for better value; nevertheless, the company is trying to offer a consistency of quality to Chinese consumers.

In the Chinese P&G organisation, fewer layers are developed and the decision making takes a shorter time within the organisation. Because the company evolved very quickly and the market is so dynamic and changing, it has not had the time to implement the layers – it has ‘only tried to understand the market’. Consequently, the Chinese organisation and structure are not the same as in other countries, but it is more efficient. P&G will implement some of the ideas from China in other countries. At the current time, a reorganisation is taking place within the worldwide P&G Group where the organisation is being changed along with the culture and reward system – all to make the company more flexible.⁶⁵

As for the Chinese situation, *guanxi* is mentioned, which is difficult for the expatriates to establish, and consequently the company relies on the local staff. On the other hand, the local employees get an immense amount of education at P&G’s own school. Also, some of the company’s expatriates have an explicit responsibility to deal with company principles and values, and all the technical specifics for P&G. The company falls short with the expatriates, because ‘they are so into running the business that sometimes the coaching of the locals is not possible’.

One of the challenges Procter & Gamble faces in China is the difficulty in dealing with the government. The company has dealt with this by searching for a sophisticated government-relations manager who shall report not only to the head of operations in China but also to the chief executive of the company.⁶⁶

Nestlé

In the beginning of the 1980s, China asked the world’s largest food company – Nestlé – to come and build ‘milk streets’ in the country. China was unfamiliar with how to produce milk and turned to Nestlé, whose core business is actually milk powder. From that time the company has grown strongly in China and now has almost 4 000 employees, 200 of them foreign expatriates.

Today, Nestlé is regarded as having come from Swiss roots and turned into a transnational corporation.⁶⁷ Nestlé is argued to have its foundation in its history for being locally adaptive. During the First World War, Nestlé gave its local managers increasing independence to avoid disruptions in distribution.⁶⁸ This resulted in a great deal of Nestlé’s operations being established at other locations than its headquarters in Switzerland. Another cause was the company’s belief that the consumers’ tastes were very local and that there were no synergy effects to be gained by standardising the products. However, in 1993, the company started to rethink its belief in localisation, due to the increasing competition in the industry. Nestlé has acquired several local brands, influenced by its own country’s culture, causing Nestlé to standardise where it is possible.⁶⁹

However, although the company is growing in China, it is not always selling products with as much margin as desired. The downside is that they must have lower margins in order to be competitive, which might not always be profitable. On the question, ‘Why does Nestlé have to be in China?’, the following was expressed:

It is because China is a large country and if you have a company that is present in more than 100 countries, you see it as a must for all international companies to be present there. We supply all over the world and it is our obligation to bring food to the people – which is the company’s priority.

Nestlé entered China with a long-term strategy to focus on the long-run perspective. Nestlé’s overall approach is stated to be ‘Think global and act local!’ The company’s strategy is guided by several fundamental principles, such as the following:

Nestlé’s existing products will grow through innovation and renovation while maintaining a balance in geographic activities and product lines.⁷⁰

With regard to the local Chinese employees, they receive a few days of Nestlé education to learn about the Nestlé culture, but the expatriates have less training going to another country. It is up to the home country to decide if it is necessary to train expatriates before sending them on an often three-year foreign assignment. However, the leadership talent is highly valued within the company and consequently Nestlé has developed courses for this. The managers can independently develop their leadership talent without any connection

with the specific company style or culture. Community centres have been developed to help expatriates with their contacts, supporting these expatriates psychologically and even offering language training.

In 1997, Nestlé's *The Basic Nestlé Management and Leadership Principles* was published, aimed at making 'the Nestlé spirit' of the company generally known throughout the organisation by discussions, seminars and courses.⁷¹ According to the CEO of Nestlé China, Theo Klausner, this publication is the key factor in Nestlé's corporate culture and started the company's international expansion 130 years ago.⁷²

Within the organisation of Nestlé China, the company has developed a specific structure, due to the joint venture configuration. The information flow is easy and smooth between these regions, thanks to the company concentrating its activities in only three regions in China. However, communication is said to be on a high level; yet, it is not even necessary to get all levels involved. As an example, only one unit in China takes care of all the marketing. At the same time, each Nestlé company in China is responsible for its own turnover rate, which creates the flexible and

decentralised company Nestlé is today. Quite unique for a worldwide company, Nestlé does not have any external e-mail network; this is believed to concentrate the flow of information within the company.

A major challenge indicated for Nestlé in China is in building long relationships to establish Nestlé as the leading food company. A difficulty is to bring the products to a more acceptable level in terms of profitability. Legal difficulties are also more important than in any other country. Other challenges are the issues concerning change, about which the following was expressed:

Change happens every couple of months here – that is how the environment is. A lot of employees come from other more stable countries and sometimes find it difficult with all the changes. Change is how things are in China – it is normal. When something doesn't change, that is when you get worried! It is expected to change! This is different from other countries where changes can be difficult to get.

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Case 2

Ansett Airlines and Air New Zealand: A flight to oblivion?

Megan Woods
Peter Dowling
Dallas Hanson
University of Tasmania

In February 2001, less than a year after acquiring the major stake in Ansett, Air New Zealand admitted that it 'probably paid too much' for Ansett, but that the purchase was 'absolutely necessary to strategic growth'.¹ For Air New Zealand, the takeover was an opportunity to expand into the Australian domestic market, as well as to obtain ownership of a brand with a high level of international recognition and a strong service reputation. For Ansett, it meant financial and operational support for an airline still learning how to compete in a deregulated market, while struggling with cost inefficiencies and a dire need to re-equip its fleet. Much-needed capital and network support had been provided for Air New Zealand when Singapore Airlines acquired a 25 per cent stake in that airline, and also through the membership of both Ansett and Air New Zealand in the Star Alliance network, a global marketing and travel logistics alliance. The challenge now was to improve Ansett's competitiveness in the Australian market, develop the group's domestic, regional and global presence, and maximise the benefits that could be achieved through the alliance network. How had Ansett come to this point? Could it be done?

Ansett takes off

The history of Ansett Airlines (summarised in Exhibit 1) began in Victoria in 1936 when the airline was founded by Reginald Ansett as a complement to his road transport company. In 1937, the company was incorporated in order to fund the purchase of new aircraft and the expansion of flight services across interstate routes in competition with the established national carriers, Airlines of Australia and Australian National Airlines (ANA).² Over the next 10 years, Ansett expanded its facilities at Essendon Airport in

Melbourne, won contracts to service planes for the Royal Australian Air Force and the United States Air Force, and continued to build a competitive presence against the newly integrated ANA–Airlines of Australia network.

Limited horizons: Ansett under the two-airline policy

By the end of the Second World War, the Australian federal government had decided that its own involvement in the aviation industry should extend beyond regulation to the actual provision of flight services. With the passing of the *Australian National Airlines Act 1945*, the Australian National Airlines Commission was established as the statutory body responsible for aviation regulation in Australia and the provider of domestic flight services under the operating name of Trans Australian Airways (TAA). Constitutional limitations meant that as a Commonwealth agency, TAA was able to fly between states but not to operate services within individual states, and would therefore be unable to be established as the sole provider of flight services across Australia. So, the two-airline policy was developed, whereby any route or service which could not be handled by TAA would be handled by private airlines.³

Although the two-airline policy was promoted as providing the 'best of both worlds' between public service and private competition, in fact the Commission operated a virtual monopoly over Australian aviation. The Commission regulated the importation of aircraft into Australia, set fare levels, determined the passenger volume to be serviced on trunk routes, and decided which routes would be flown by TAA or by private airlines. In its initial form, the *Australian National*

Exhibit 1 | Ansett's company timeline

1936:	Ansett Airways founded by Reginald Ansett as an expansion of road transport services.
1937:	Ansett was incorporated and began flying interstate flight services in competition with Australian National Airlines (ANA) and Airlines of Australia.
1945:	Federal government passed the <i>Australian National Airlines Act</i> empowering the Australian National Airlines Commission to regulate Australian domestic aviation as well as provide flight services operating as Trans Australian Airways. The Commission acquired Qantas Airlines in 1947 and gave the airline exclusive rights to operate all international services to and from Australia.
1948:	Ansett Airways renamed as Ansett Transport Industries Ltd (ATI). The company expanded its transport and other businesses, including hotels, resort development and freight delivery.
1957:	Ansett purchased ANA and became Australia's major private carrier.
1979:	ATI acquired by News Limited and TNT, who each purchased a 50 per cent stake in the business. Reg Ansett continued as chairman.
1981:	Peter Abeles, CEO of TNT, became chairman of Ansett and continued to pursue the company's policy of diversification while expanding the airline's fleet of aircraft.
1990:	The Australian aviation market was officially deregulated.
1992:	Peter Abeles resigned as chairman of Ansett Holdings.
1996:	TNT sold its stake in Ansett Holdings Ltd to Air New Zealand for A\$325 million.
1997:	Rod Eddington became chief executive of Ansett, launched his Great Business Plan to cut costs and improve profitability, and began merging Ansett operations with those of Air New Zealand.
1999:	Ansett joined the Star Alliance global network.
2000:	Air New Zealand bought the remaining stake in Ansett Holdings from News Corporation for A\$650 million.
2001:	Ansett has a safety fiasco of major importance.

Airlines Act 1945 also contained two sections which allowed the Commission to invalidate the licences of private carriers to provide flight services simply by establishing a TAA service on the route (section 46) and prohibited private carriers from providing the same interstate services as TAA (section 47). When the Act was passed, Ansett and two other airlines mounted a legal challenge against these two sections, arguing that they prevented competition and established a monopoly over domestic air services. Their challenge was successful and they won the right to provide interstate services so long as these did not directly duplicate those offered by TAA.⁴

With TAA's entry into the industry, Ansett and ANA both lost the contracts they had previously held for the provision of governmental services such as freight and mail delivery. In 1947, competitive opportunities for Ansett and the other private airlines were constrained further when the federal government announced that it would acquire Qantas Airways Limited to be operated as the exclusive provider of all international services to and from Australia.⁵ Unable to expand internationally

or compete directly against the Commission, Ansett began to develop a number of strategies to circumvent or overcome TAA's opposition and strengthen its position against ANA in the passenger travel market.

In the passenger market, Ansett differentiated itself by offering lower fares than ANA, as well as two classes of seating. To avoid duplicating TAA's interstate services, Ansett scheduled all flights to make at least one stop between capital cities,⁶ and in this way was able to expand its flight network without engaging in head-to-head competition with the Commission. Ansett also began acquiring smaller state-based airlines, which were then integrated into the Ansett service network.

Ansett's acquisition strategy was adopted as a response to actions by TAA, who was at that time attempting to extend its own services. Unlike the other airlines, TAA did not require permission from the Commission to purchase new aircraft and was able to use this position to build commercial relationships with other airlines. TAA purchased a number of planes and resold or leased them to other carriers in return for cooperation on aligning flight services and the

establishment of long-term strategic relationships.⁷ Ansett, operating outside these relationships, responded by purchasing many of the remaining airlines. Further alliances with TAA were prevented, and Ansett was able to spread overhead costs over divisions, achieve economies of scale in support functions such as engineering and marketing, and generate a strong enough position to prevent another independent carrier from seeking to establish a similar foothold in the Australian market.⁸

To offset the pressures faced by the airline, Reg Ansett began expanding his transport network and moving into other business areas, again through acquisitions and mergers. Ansett Airways was renamed Ansett Transport Industries Ltd (ATI), and a subsidiary operation, Ansett Hotels, was established to build and operate hotels for the accommodation of passengers from the company's coach and airline services. In 1947, Ansett Hotels began developing resorts in the Barrier Reef so that the company could move into the holiday market, and by 1948 was the largest hotel operator in Australia.⁹

By 1952, a change in federal government saw a reconsideration of TAA's privileged position within Australian aviation. When efforts to amalgamate TAA and ANA proved unrealisable, the government negotiated the first 'Airlines Agreement' with ANA in an attempt to strengthen the airline's financial position and maintain TAA and ANA as the two major airline

operators in Australia.¹⁰ The agreement allowed ANA equal access with TAA to mail carriage, government business, lease of Commonwealth equipment and government security for loans for re-equipment, but failed to restore ANA to commercial health. In 1957, ATI bought out the struggling ANA and became the major private airline in Australia.¹¹

Although now the main competitor against TAA, Ansett was still constrained in its ability to improve its competitiveness against TAA or to differentiate its service from other carriers. TAA's position as a government-subsidised enterprise was one contributing factor, because Ansett was forced to operate with higher cost structures than TAA and this impacted on the airline's profitability.¹² The two-airline agreement was another limitation, because under the agreement, airlines had to offer the same fare structure and advise competitors of any schedule changes.¹³ This meant that in most cases, new services or schedules by one airline would be matched almost immediately by competitors, so there was little incentive or opportunity to develop distinctive points of competitive difference in core service areas.

By 1979, ATI had expanded into a variety of different business areas, some of which are listed in Exhibit 2. The diversity of operations contributed to an eventual takeover by TNT (who wanted the company's transport divisions) and News Limited (who wanted the television interests) in 1979. Both bought a 50 per cent

Exhibit 2 | Subsidiary operations of Ansett Transport Industries by 1979¹⁴

Subsidiary	Operations
Ansair	Manufacture of coaches and airport buses
Ansett Hotels	Largest hotel operator in Australia
Barrier Reef Islands Ltd	Resort management on Hayman and Daydream Islands
Ansett Travel Service	Retail travel services
Ansett Freight Express	Road freight services
Ansett Roadlines of Australia	Interstate coach services
Transport Industries Insurance	Insurance coverage for the transport divisions
Wridgways Holdings Ltd	Furniture removal
Albury Border Transport	Removalists
Avis Rent-A-Car	Automobile rental
Ownership interests	
ATV Channel 0 (later Channel 10) (ATI also held interests in four other TV stations around Australia)	Television broadcasting
Australian franchise of Diners Club International	Charge card services
Associated Securities Ltd	Finance (collapsed 1978)
Biro Bic (Australia and New Zealand)	Stationery and office supplies

stake in ATI, but Reg Ansett continued as chairman of the company until his death in 1981.¹⁵

A new navigator: ATI under Peter Abeles

Although ATI was highly diversified by the 1980s, Reg Ansett maintained a managerial style of tight control, characterised by his insistence on having a profit and loss report produced every Friday night in order to be able to track the company's operations. Known for being 'very demanding', Reg Ansett was also characterised as a 'tremendously loyal' man who 'knew his staff, his aircraft and the airline industry'.¹⁶ According to Ted Forrester, general manager of Ansett Airlines in 1986 and with the company for over 40 years, the key to Ansett's success was the level of control Reg Ansett held over the airline, along with his understanding of the industry's labour- and capital-intensiveness.¹⁷

After Reg Ansett's death, the CEO of TNT, Peter Abeles, took over as chairman of ATI. He continued to diversify the company, as well as to make plans for international expansion. In 1981, Ansett Airlines was relaunched with a new logo, new livery, refurbished terminals and upgraded in-flight services. Although Qantas still held exclusive rights to all international services out of Australia, Ansett began pursuing international expansion by negotiating to fly routes under the Qantas flight designator and by taking on the management of very small overseas airlines such as Air Vanuatu and Polynesian Airlines. In 1986, Ansett also signed an agreement with Qantas to operate joint travel centres and to establish Ansett as Qantas's preferred domestic carrier.¹⁸

Abeles invested in a wide range of new aircraft for the airline, which prompted one commentator to make a comparison with a child collecting Matchbox cars.¹⁹ The airline had always been a technological leader and introduced many new aircraft into Australia, but under Abeles, Ansett came to possess almost every available model of aircraft. As a result, Ansett was forced to spend far more on servicing, maintaining and flying its aircraft than its competitors did, at a time when it was already facing an increase in competitive pressure from established opponents and the growing possibility of new players entering the Australian market.

In 1985, James Strong became CEO of TAA. He instituted a program of significant cultural change to move the airline away from its image as a dowdy, public service enterprise. The airline was renamed Australian Airlines, and Strong began focusing on ways to target the market for business travel, such as providing more convenient scheduling, upgrading airport terminals and investing heavily in staff training. The business travel segment of the market became the focus for stiff competition between Ansett and Australian, and by March 1988, Australian had achieved a market share of 44 per cent compared to 36 per cent held by Ansett.²⁰ In response, Abeles announced a major relaunch of Ansett in May 1989, which included the introduction of business-class travel. Abeles had previously argued that introducing a business class to Ansett was unnecessary because 'our economy product was of the same standard as our competitors' business class'.²¹

The turbulence of deregulation

At the end of the 1980s, the federal government announced that it was deregulating the domestic aviation industry in order to encourage increased competition and responsiveness in the industry.²² Fares, importation of aircraft, passenger capacity and route assignment would no longer be subject to government regulation, and new entrants would be encouraged to move into the Australian market.²³

Almost immediately, Ansett and Australian began establishing their position in the new environment. Negotiations with the newly formed Federal Airports Commission culminated in a series of long-term leases for airport terminals, and the decision by both airlines to join the Galileo computer reservation system established Galileo membership as a key competitive factor





in the aviation industry.²⁴ Further changes began in 1989 with a wage claim by the airline pilots for a pay increase of almost 30 per cent. The airlines had identified cost reductions and productivity improvements as critical to success in deregulated competition, so the pay increase was rejected. To force the airlines to negotiate, the pilots resigned en masse, but the government then passed legislation which allowed international airlines and the Royal Australian Air Force to carry domestic passengers, so the domestic carriers were able to continue to operate without having to re-employ the pilots. The dispute finally ended in April 1990 when the airlines offered the pilots new contracts, but the contracts required the pilots to fly almost twice the number of hours per month as they had previously. As a result, the airlines only had to re-employ half as many pilots as they had hired previously.²⁵

The pilots' strike had a number of powerful consequences for the airline industry. The most immediate was the cost savings and efficiency increases which the airlines achieved with the new contracts. The second consequence was the disempowerment of the Australian Federation of Airline Pilots as an influence over the employment conditions of the industry. This gave the airlines greater freedom in their operating policies and employment negotiations. However, the strike also damaged the tourism industry in Australia by making air travel seem unreliable,²⁶ which was a particularly heavy blow for Ansett because of the company's high level of investment in the tourism industry.

Tough times on the tarmac

Deregulation in 1990 brought new competitive

pressures into Australian aviation almost immediately, from Compass Airlines and East West Airlines. Compass Airlines opened for business in October 1990, with an operating strategy of using only one type of aircraft to provide a one-class air service for the Australian holiday market, and offering lower fares than the major airlines. The airline only had access to two gates at Sydney and Melbourne airports, so Compass decided to operate with the largest possible aircraft and maximise the number of passengers per flight. The airline concentrated on a small number of key routes between Adelaide, Brisbane, Cairns, Melbourne, Sydney and Perth, and based its operations at Melbourne airport to achieve greater efficiencies in crew turnaround between flights.²⁷ Using only one aircraft type meant that training costs for pilots were lowered,²⁸ and the larger aircraft were more fuel-efficient and less costly to maintain than those used by Qantas or Ansett.²⁹

At around the same time, East West Airlines announced that it would soon begin building its own presence in the Australian domestic industry. East West Airlines had been a subsidiary of Ansett Transport Industries since 1987 but operated as an independent airline out of Sydney.³⁰ The only intrastate airline to compete with Ansett and Qantas on interstate services, East West announced in 1990 that it was repositioning itself as a leisure airline and aimed to become the top leisure carrier by 1993 by capturing key holiday markets and combining direct flight services with resort holiday packages.³¹ This was particularly threatening for Ansett, because it would involve increased competition in the markets for resort accommodation and travel packages as well as flight services.

In response to these new competitive pressures, Ansett and Qantas began an intense period of competition on fares and aggressive advertising which had not been seen before in Australian aviation.³² The fiercest competition with Compass was in the business market, the most profitable market segment.³³ Ansett and Australian wooed corporate customers with discounts and upgraded facilities, as well as matching Compass and East West on all discounted fares.³⁴ Compass had already encountered difficulties with refuelling facilities, delays in aircraft delivery from manufacturers, and reservations systems,³⁵ and eventually the economic recession, coupled with Compass's inadequate capital levels and failure to gain a hold in the business market, forced the airline to cease operations in 1991.³⁶ Despite being relaunched the following year as Compass II, the airline failed to strengthen its position and was declared bankrupt in

1993. East West continued to compete in the leisure markets as an independent airline until 1993, when it was merged with several other ATI subsidiaries.³⁷

Qantas climbs while Ansett loses altitude

As Ansett and Australian adjusted to intensified competition, the federal government announced that Qantas would be privatised and would purchase Australian Airlines in order to compete on both international and domestic fronts. Competition on international flight routes to and from Australia would be open to all airlines, who would also now be able to invest in each other. Soon after the announcement, British Airways purchased a 25 per cent stake in Qantas, and an improvement program to develop Qantas's competitiveness was launched. ATI responded by regrouping its various airline companies into Ansett Australia and Ansett International in order to consolidate services and reduce overheads.³⁸

Over the next five years, Qantas began cutting costs and building efficiencies through its alliance with British Airways, while Ansett focused on building its route network throughout Asia.³⁹ As Ansett dealt with aggressive competition from Qantas over domestic flight frequency, fare discounts and frequent flyer loyalty, Qantas capitalised on Ansett's decision to relinquish its hold on Melbourne and Brisbane and used these bases as international gates to build its overseas flight network.⁴⁰ By November 1996, Qantas held almost 40 per cent of the international market, while Ansett held just over 2.5 per cent.⁴¹ When the Asian financial crisis hit in the late 1990s, Ansett's competitiveness was undermined even further because the airline was heavily committed to its Asian service network. Qantas had already withdrawn many of its services throughout Asia and had redirected capacity towards more profitable markets such as North America and Europe.⁴²

Continued diversification of Ansett's business interests and escalating fleet management costs eventually sent Ansett into what one commentator described as 'financial free fall'.⁴³ In the financial year 1996–7, Ansett generated only \$39 million in revenue from its domestic operations, while the international operations made a loss of over \$41 million.⁴⁴ By this time, both News Corporation and TNT had expressed interest in selling their stakes in Ansett, and in an effort to improve performance, the company began to refocus on aviation and divest itself of non-core subsidiary operations, including Ansett Freight Express and

Turbine Components Australia.⁴⁵ In 1996, Air New Zealand purchased TNT's stake in Ansett Australia Holdings for \$325 million and Rod Eddington was established as chief executive of the airline to turn the company around and begin the process of integration with Air New Zealand.⁴⁶

Now boarding: Australian aviation in the late 1990s

In 1999, Australian airports handled over 50.5 million passengers, of which almost 15 million were international arrivals and departures.⁴⁷ Australian domestic travel offers one of the highest levels of unit revenue on domestic routes in the world,⁴⁸ as well as a springboard into the Asia-Pacific region, through which airline passenger traffic is predicted to grow by around 7 per cent per year for the next 20 years.⁴⁹ At the end of June 2000, Qantas, Ansett and new entrant Impulse held 83 per cent of the domestic market between them,⁵⁰ a segment that currently increases by 3–7 per cent annually.⁵¹ Although officially deregulated in 1990, the competitive dynamics of the industry have really only begun to change over the last five years with the arrival of new entrants into the market and, with them, new competitive pressures for Ansett and Qantas.

New entrants crowd the runway

Over the past five years, three new airlines began operating in the Australian market – Virgin Blue, Impulse Airlines and Spirit Airlines. (See Exhibit 3 for a brief background on each.) All began by offering low fares. Since the new entrants began operating, analysts estimate that the lower fares being offered have expanded rather than redivided the market for air travel because they have prompted discretionary travel as well as attracting customers who might otherwise have used alternative transport.⁵² However, slowing economic conditions and the increased passenger-carrying capacity of new aircraft are predicted to see fiercer competition develop as all five airlines seek to strengthen their positions and carve out greater market share.⁵³ A combination of rising fuel prices, savage fare reductions and competitors with deeper financial reserves have severely damaged Impulse's profitability and seen the airline's key institutional backers (Singapore firm CIG Investment) withdraw their financial support. To avoid the airline's collapse, founder Gerry McGowan sold Impulse to Qantas in May 2001, which has begun integrating the new acquisition into Qantas's network. Qantas's own competitiveness has been enhanced by the acquisition of

Exhibit 3 | New entrants in the Australian domestic aviation market

Impulse Airlines: Founded as a dedicated freight carrier for the Fairfax newspaper group, Impulse expanded into passenger services in 1993 and at its peak serviced 15 destinations across Victoria, New South Wales and Queensland.⁵⁴ Using only Boeing 717s, Impulse used smaller aircraft and more frequent services to target the business market, particularly small businesses and owner-operators who pay their own fares rather than hold a corporate account. Pushing Internet booking, Impulse also had an exclusive partnership agreement with Flight Centre, an Australia-wide low-cost travel agency.⁵⁵

Spirit Airlines: Spirit originally operated a 'flying coach' service along the east coast of Australia but now also flies services to Perth, Adelaide and Hobart. Offering budget fares but no advance bookings, Spirit only takes bookings through a direct phone line but offers the choice of paper or electronic ticketing, whereby passengers present photo identification at the check-in counter rather than be issued with a paper ticket.⁵⁶

Virgin Blue: A sister airline to Virgin Atlantic and Virgin Express, Virgin Blue currently flies from Brisbane to Sydney, Melbourne and Adelaide, and between Sydney and Adelaide. Presented as the 'fun' airline, Virgin, like Spirit, offers no-frills service where ticket prices cover only the cost of the flight. Virgin promotes the fact that passengers do not pay for extra features like airport lounge facilities, in-flight meals or frequent flyer programs in their ticket price, although passengers are able to purchase food and drinks during the flight.⁵⁷

additional planes and slots, so although the fare wars may cease in the industry, the competition is likely to remain fierce.

Yields and deals

Domestic airline fares in Australia are grouped into five separate categories: business, full economy, and economy with small, middle and deep discounts.⁵⁸ In order to generate the most revenue possible per flight, yield management or revenue management systems are used to market seats on flights as perishable products. Sophisticated computer systems use historical information and analyses of market demand to adjust the price of a seat depending on the number of seats available, any discounts which may apply, and the timing of demand, such as whether the seat is being booked four weeks or two days before the actual flight. Analysts compare actual with predicted booking levels to determine whether prices need to be adjusted for demand, and how many seats per flight should be allocated for various segments of the market.⁵⁹

While Ansett and Qantas use very sophisticated yield management systems to set fare levels, Virgin currently offers set fares on one-way and return tickets without advance purchase conditions, as well as 'walk-up' fares which can be purchased for the next available flight.⁶⁰ The new fare arrangements, coupled with aggressive price competition on several key east coast

routes, are predicted to affect the market for business travel as well as discretionary travel, as corporate clients force Ansett and Qantas to match the fare structures offered by competitors.⁶¹

Slotting in: The battle for Hazelton Airlines

An airline's ability to improve the competitiveness of its flight services and scheduling depends upon the number of slots it controls at different airports. A slot is a period of time that an airline can use for landing or takeoff and is the mechanism by which airports control the amount of traffic at various times of the day. In Australia, slots cannot be traded or sold, so the only way that an airline can increase the slots it can access is to buy another airline.

For this reason, ownership of Hazelton Airlines, a regional carrier in New South Wales, sparked a fierce bidding war in early 2001 between Qantas and Ansett. Adding Hazelton's slots to their own would have given either carrier over 50 per cent of the slots at Sydney airport, and would have affected their own ability to schedule flight services as well as the ability of other airlines to offer equally competitive scheduling arrangements. For this reason, the Australian Competition and Consumer Commission (ACCC) initially refused to allow either airline to gain ownership of Hazelton, and Qantas withdrew from the bidding.

Ansett persisted, and in March 2001 the ACCC announced that Ansett had addressed these concerns in its bid for ownership and the purchase would be approved.⁶²

Rewarding frequent flyers and frequent buyers

Frequent flyer programs are loyalty reward programs whereby customers are rewarded for the level of custom they provide for the airline. By November 2000, Ansett's Global Rewards program had 2.2 million members, while Qantas's Frequent Flyer program had 2.4 million. For each flight, customers earn reward points (Ansett) or miles (Qantas) which can then be redeemed for free flights, hotel accommodation and other benefits. Points have to be redeemed within five years,⁶³ and customers are graded according to the number of points they accumulate. Qantas, for example, has silver, gold or platinum tier status, but members must re-earn their status every 15 calendar months.⁶⁴ Members also accrue points through use of certain credit cards and affiliated organisations such as medical benefits funds and telephone companies.⁶⁵

Impulse and Virgin both targeted customers from the lower-yield end of the market, because the customer loyalty generated by frequent flyer programs in the higher end was too strong to compete with.⁶⁶ However, Impulse launched its own reward program whereby travellers received one free flight for every 10 full-fare flights they purchased, a move that was designed to attract smaller business customers.⁶⁷

The two main benefits of frequent flyer programs for airlines are customer loyalty and a database of detailed customer information that can be used to improve the effectiveness of marketing programs,⁶⁸ but there have also been difficulties associated with them. In June 2000, the ACCC announced that in response to

numerous complaints about the schemes, an investigation would be launched to investigate, among other things, whether frequent flyer programs discouraged competition by preventing new entrants from establishing a competitive presence in the industry,⁶⁹ and whether customers were being adequately informed of the conditions of point redemption, such as limited seat availability on certain flight services.⁷⁰

Worldwide travel with the World Wide Web

Until deregulation, air travel was most commonly booked through travel agencies, usually at the same time as a customer booked accommodation, car hire and other travel arrangements. In 1997, there were over 3 200 dedicated retail travel agents in Australia,⁷¹ but since deregulation, cost pressures have seen many airlines establish direct booking facilities through call centres, and now Internet booking services, to reduce overhead costs and avoid paying a commission to travel agents. On-line ticket sales are currently estimated to account for around 3 per cent of all airline ticket sales, but this is predicted to reach 15 per cent by 2005.⁷² For Qantas and Ansett, Internet bookings currently account for only 3–5 per cent of ticket sales, but Virgin Blue transacts around 35 per cent of its business over the Internet (and Impulse did more than 60 per cent), while Spirit Airlines only offers telephone bookings.⁷³

Expanding horizons with oneworld and the Star Alliance

Perhaps the most important development in the Australian, and indeed global, aviation industry in recent years has been the development of the Star Alliance and oneworld global networks. Both were launched in 1998 and grew quickly. Exhibit 4 shows the

Exhibit 4 | Partner airlines of the Star Alliance⁷⁴ and oneworld alliances⁷⁵

Star Alliance	Star Alliance partner airlines	oneworld
Ansett Australia	South African Airways	AerLingus
Air Canada	Virgin Atlantic Airways	American Airlines
Air New Zealand	SAS	British Airways
Australian Airlines	Singapore Airlines	Cathay Pacific
British Midland	Thai Airways International	Finnair
Lauda-Air	Tyrolean Airways	Ibena
Lufthansa	United Airlines	LanChile
Mexicana	VARIG	Qantas

member airlines of each at January 2001. Partners share flight codes, facilities such as airport terminals and passenger lounges, and marketing programs, while passengers belonging to any member's frequent flyer program are also credited for journeys on partner airlines.

The alliances were originally promoted by member airlines as an opportunity to extend flight networks, increase access to new markets and develop cost efficiencies through shared facilities, joint marketing efforts and strategic purchasing.⁷⁶ However, conflicts between some member airlines over promised membership benefits and the development of smaller alliance groups such as Qualiflyer suggest that the major alliance blocks may yet splinter if members feel that they would achieve increased benefits and more control over management of the alliances through smaller strategic networks.⁷⁷

Ansett/Air New Zealand fly a new formation

Eddington pilots the Great Business Plan

When Rod Eddington joined Ansett in 1997, he pronounced it a 'great airline but a poor business'⁷⁸ and set about improving the airline's profitability and ability to compete. During the sale negotiations between TNT and Air New Zealand, News Corporation indicated that it was interested in selling its share in Ansett Holdings, so when Eddington took over the management of Ansett Australia, another change of ownership in the near future was almost assured. To increase Ansett's attractiveness as an acquisition, Eddington began targeting cost reductions and improvements in profitability, which were predominantly achieved

through the merging of operations with Air New Zealand and the development of commercial partnerships with other airlines such as Singapore Airlines (SIA). Exhibit 5 illustrates the improvements in Ansett's financial performance that had been achieved under Eddington's leadership by the end of the 1999 financial year.

Eddington also began refocusing Ansett from being an 'airline with planes' to a 'brand with customers'.⁷⁹ Ansett was promoted as a 'virtual airline' which would help allied airlines to offer 'global travel solutions' by providing services in the Australian/Asian region that partner airlines could or would not offer.⁸⁰ In 1997, an alliance was formed between Ansett Australia, Ansett International, Air New Zealand and Singapore Airlines so that the airlines could provide more competitive international travel options and greater access to airline facilities for customers, as well as develop more efficient arrangements for fleet re-equipment and joint operations.⁸¹ The scope for benefits was extended in 1998 when all four airlines joined the Star Alliance network.⁸²

Flight teams and fuel crews: The merging of support functions

From 1997, Ansett and Air New Zealand began merging various support functions, including catering, ground handling, freight handling, information technology and marketing, in shared pursuit of cost savings and greater operational efficiencies.⁸³ They also formed a joint venture called Newco to operate as an independent aircraft maintenance and engineering company and to tender for contracts with Ansett and Air New Zealand as well as other airlines, thus obviating the need for in-house engineering and maintenance facilities.⁸⁴

Exhibit 5 | Ansett Holdings performance data, 1994–5 to 1998–9⁸⁵

Group profit and loss account	1994–5	1995–6	1996–7	1997–8	1998–9
Total revenue	3 129.8	3 301.3	3 395.6	3 505.4	3 511.3
Total expenses	3 031.3	3 319.9	3 376.0	3 445.6	3 363.7
Earnings before interest and tax	198.6	80.9	114.1	377.4	432.5
Trading profit	99.3	(13.5)	(0.3)	27.8	140.8
Sale of non-core assets and foreign exchange	(0.8)	(5.1)	19.9	32.0	6.8
Net profit after tax	52.6	58.4	(35.0)	29.5	156.8
Group balance sheet					
Total assets	3 675.5	3 748.8	3 908.6	4 145.1	3 689.1
Total debt	1 942.6	1 719.2	1 690.7	1 786.7	1 314.8
Total equity	316.0	377.1	540.7	537.2	697.4

New bearings on human resource management

At the time of Eddington's arrival at Ansett, the key challenge for Ansett's human resource management was addressing the low morale and high turnover which had developed during the previous years of ownership uncertainty.⁸⁶ As part of the response to this problem, there was a radical restructure of employee benefits packages. Previously, employee benefits, such as use of a company car and the structure of compensation packages, had been determined according to a rigid hierarchy of entitlements and linked to rank within the company. The new policy, designed to be more flexible and to give employees more control over their compensation, included choices over make and model of company-funded transport and flexibility over superannuation contributions, and contributed to a reduction in voluntary turnover over the next three years.⁸⁷

At the same time, Ansett was also facing the issue of reducing its staffing levels. In 1996, Ansett employed almost 18 000 employees, but by 1999, staff levels had fallen to less than 15 000 people. Most of these employees left under Eddington's 'job bank program' in which employees throughout the organisation were able to register their interest in voluntary redundancy before job cuts were announced. Further reductions were achieved through each level of management by requiring people to re-bid for a smaller number of positions.⁸⁸ When Air New Zealand purchased the remaining stake in Ansett in 2000, 13 board positions were also cut between the two airlines and over 250 middle management positions were eliminated, with Ansett executives predicting that 'only savage staff cuts will restore profitability and our ability to compete'.⁸⁹

Shedding the excess baggage: Fleet re-equipment

Ansett's wide assortment of aircraft types made fleet re-equipment a pressing issue for the airline and was the first area in which Ansett and Air New Zealand attempted to develop synergies between the two companies. As well as having too many different types of aircraft, Ansett also faced pressures from competitors who had upgraded to smaller, faster jet models, and from the impact of escalating fuel costs on the airline's profitability.⁹⁰ Originally intending to follow Qantas's lead and purchase the new aircraft it required, Ansett instead negotiated lease agreements for most of its new aircraft with Air New Zealand and Singapore Airlines. To expand Kendall Airlines, an Ansett subsidiary, 12

new 50-seat Canadair-Regional Jet Series 200 aircraft were ordered and two Boeing 747-400 aircraft leased from Singapore Airlines to replace two of its B747-300s used by Ansett International.⁹¹

Benefits to Ansett included lower re-equipment costs, joint purchasing of engineering and maintenance services with Air New Zealand, and reduced costs related to training and licensing staff to operate a variety of aircraft.⁹² However, Ansett's reliance on its commercial partners and on the maintenance of good relationships between Ansett, Air New Zealand and Singapore Airlines also increased. This had the potential to influence Ansett's future options to replace the three B747-300s currently leased from Singapore Airlines with smaller wide-bodied jets such as 777s and A340s, which offered improved fuel efficiency and roomier cabin facilities for passengers. The airline also had to begin planning how it would respond to the expected introduction of the 550-seater Airbus A3XX in 2006. The new aircraft design had been predicted to see aircraft size and in-flight service facilities become the focus of competition for international service networks,⁹³ and Ansett/Air New Zealand needed to ensure that it was well positioned to benefit from those recently ordered by Singapore Airlines.

Domesticating services in the Australian market

To revamp services in the Australian domestic market, Ansett and Air New Zealand developed new strategies for all of its newly acquired airlines (see Exhibit 6). Following in Air New Zealand's footsteps, Ansett began to pursue improved profitability by matching jet size to route demand and increasing flight frequency on higher-yield services.⁹⁴ New planes were ordered for Kendall Airlines so that Kendall's service frequencies and capacity could be expanded and it could continue to take on services for rural routes and below-100-seat markets from Ansett Australia.⁹⁵ Unprofitable routes in Queensland and the Northern Territory were taken over by independent carriers.⁹⁶ Kendall predicted that by May 2001, it would have around 90 southeastern flights operating on routes which were less than profitable for Ansett.⁹⁷

With all five domestic airlines competing on east-coast routes in Australia, frequency of services was set to become a key competitive issue for Ansett in the business travel market. To increase its appeal to business travellers, Ansett began focusing on increasing service frequencies and improving in-flight amenities, as well as scheduling more convenient connections with

international services.⁹⁸ In October 2000, Ansett admitted that their main competitive concern was fighting Qantas for the corporate market, the most profitable market sector.⁹⁹ After losing corporate travel accounts with the ANZ Bank,¹⁰⁰ BHP and the Department of Defence,¹⁰¹ Ansett decided to concentrate on maximising the benefits it could cultivate from deliberately targeting corporate clients during its sponsorship of the Sydney 2000 Olympic Games.¹⁰²

Going the long haul: International expansion

Shortly after purchasing the remaining stake in Ansett, Air New Zealand announced that Ansett Australia would continue to build flight services to North America under its own banner, but that Air New Zealand would do so by developing the network serviced by Ansett International. Holding only a 49 per cent stake in Ansett International, Air New Zealand nevertheless decided that it would develop services under Ansett's banner, rather than its own, in order to take advantage of the Ansett brand's higher level of international recognition and strong reputation for service quality.¹⁰³ With airline passenger traffic in the Asia-Pacific region forecasted to increase by 7 per cent per year for the next two decades,¹⁰⁴ Air New Zealand also announced that Ansett Australia and Air New Zealand would both increase services in the Asian region. The services would be provided using planes leased from Singapore Airlines¹⁰⁵ and according to 'whether ... commercial objectives are best served by

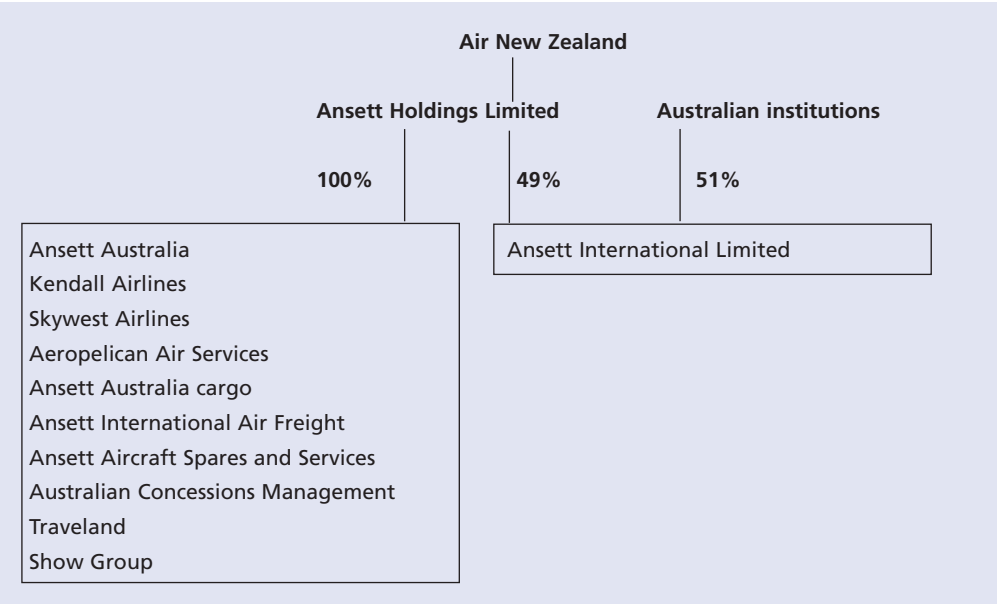
having (the routes) flown by (Star Alliance) partners or by including an Ansett product in the options'.¹⁰⁶

Ansett/Air New Zealand tests its wings

As well as addressing the internal changes of the merger, Ansett and Air New Zealand also had to consider how to respond to new external challenges in the local and global aviation industries. Locally, Qantas continued to hold a greater share of the Australian domestic business travel segment than Ansett, with the competition within the Australian market set to toughen as all parties sought increases to their market share.¹⁰⁷

One of the biggest challenges facing Ansett and Air New Zealand would be Ansett's recovery from severe damage to its reputation for safety. Failures in Ansett's safety and maintenance procedures saw the airline face two major safety crises between late 2000 and early 2001. Despite a warning from the Civil Aviation and Safety Authority (CASA) that Ansett needed to change its entire culture regarding safety,¹⁰⁸ the airline failed to act on a recommendation from Boeing to check the engine pylon mounts of their 767s, and the failure was only discovered when Ansett realised that compulsory inspections of its 767-200s had been overlooked. The planes were grounded over Christmas 2000 to conduct the inspections, which also damaged Ansett's reputation for reliability. The second crisis came in April 2001, when CASA grounded Ansett's entire fleet of 767s over the Easter holiday.¹⁰⁹ The delayed checks on the engine pylon mounts had found cracks in three of the planes,

Exhibit 6 | Ownership structure of Ansett/Air New Zealand¹¹⁰



and when this was compounded by a report that Ansett had unknowingly flown one of the planes on eight flights with a defective emergency slide, CASA gave Ansett 14 days to show why its operational licence should not be revoked.

As well as being a public relations nightmare, the grounding was a financial disaster for Ansett. Forced to lease planes from Air New Zealand, Air Canada and Qantas in order to transport its grounded passengers over the Easter period, Ansett also had to facilitate inspection of its entire maintenance and safety system, as well as deal with a nationwide customer response to the grounding. In defensive mode, Ansett launched an extensive media campaign to attribute the safety failures to the previous management team, and to convince customers that the airline had already begun extensive changes to its maintenance processes and culture. Ansett also spent \$30 million on an advertising campaign featuring celebrity endorsements of the airline, but whether this would restore customer confidence remained to be seen.

With the stage set for tougher competition in the Australian domestic market, Air New Zealand/Ansett needed to consider whether to develop its own no-frills service to compete at the lower end of the Australian market, or to focus on competing with service quality at the higher end of the market. If the latter option was adopted, how might the market for business travel be affected by developments in Internet and telephone technology designed to facilitate 'virtual conferencing'?

Would this prompt reductions in business travel similar to those which resulted from the economic recession in the early 1990s?¹¹¹

In the longer term, the airline also had to consider whether to maintain both the Ansett and Air New Zealand brands, or pursue the development of a single trans-Tasman brand.¹¹² Some analysts had predicted that the formation of the Star and oneworld alliances would lead to the lobbying of national governments and aviation authorities to allow jets owned by one airline to enter a country under one partner's flight codes, fly some domestic routes under the auspices of another partner, and fly out again under a third carrier's banner.¹¹³ If approved, the number of services provided by each partner airline (and therefore the revenues generated within the alliance) might come to be determined by which partner has the most valuable brand equity. In such circumstances, which brand was positioned to provide the best value to the airline?

The decisions made by the top-management of Ansett/Air New Zealand would determine not only whether the airlines would ever achieve the benefits expected from the merger, but whether in fact they could continue to compete in what had now become a highly competitive industry. Would the strategic alliances result in the growth of the airline's own service network, or would the airline's future lie in feeding regional travellers in the global networks of other airlines? Only time would tell.

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Case 3

BP–Mobil and the restructuring of the oil refining industry

Karel Cool
Jeffrey Reuer
Ian Montgomery
Francesca Gee
INSEAD

On 29 February 1996, British Petroleum (BP) and Mobil surprised investors and competitors with an unexpected announcement: after six months of secret talks, the two oil companies had agreed to merge their refining and retail sales operations in a pan-European joint venture.

The move was a new approach to confronting long-standing problems in the European oil market. In refining, international companies had been confronted with low returns, excess capacity and high exit costs; in retail, competition was heating up, especially from a new category of players: supermarkets. For years, major players had practised increasingly stringent cost cutting. Yet, none had attempted anything as ambitious as Mobil and BP.

When presenting the deal, Mobil and BP stressed their shared focus on financial performance and discipline and said that the combination provided an excellent fit in terms of geographic spread and quality of assets which would give them leadership in key markets. By pooling their US\$5 billion in European assets, BP and Mobil figured they could save US\$400–500 million a year. They said their combined market share in Europe would amount to 12 per cent in fuels, hard on the heels of market leaders Exxon and Shell, and 18 per cent in lubricants.

While oil industry analysts praised BP and Mobil for acting decisively, they also expressed some doubts about the joint venture. Was an alliance the best response to the industry's troubles at a time when other players were leaving the market altogether? 'It's an original deal,' said an investment banker, 'but it puts

them right in the middle: they are not niche players but they are not the leaders either. I wonder whether they are quite big enough.' To reap the dramatic savings they were announcing, Mobil and BP would have to close down more refineries and petrol stations and lay off thousands – an unpopular move in unemployment-stricken Europe.

The oil industry value chain

Oil was the world's main source of energy. Its end products were used in a variety of ways: transport by land, water and air (petrol,¹ diesel, jet propulsion fuels), heating (heating oil), lubricants (mainly in rolling mills, car engines, machinery and precision instruments), building materials (asphalt), etc. About 12 per cent of crude oil was converted into plastics and synthetic fibres. Crude oils varied substantially in looks, composition, density and flow properties, due to their different formation conditions. Crude from Libya and Algeria, for instance, was thin-bodied and yellowish with virtually no sulphur content. Venezuelan heavy oils, by contrast, were viscous, almost solid and dark black in colour with a lot of sulphur. Normal petroleum products could be made from all oils, but good crude (thin-bodied, low-sulphur) was easier to refine.

Upstream operations

Upstream operations, the generic name for all activities related to crude oil before refining, included exploration and production. Oil was found in underground reservoirs, surrounded by rock formations which geologists studied to identify the presence of oil. They used increasingly sophisticated and expensive tools, from surface mapping and aerial surveys to seismic soundings. Advanced drilling techniques had made it

This case is intended to be used as a basis for classroom discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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possible to explore new areas such as the seabeds of the Gulf of Mexico and the North Sea. Exploratory wells could reach 2 500 metres below the surface of the ocean. By 1996, world production averaged 65 million barrels per day (bpd).² While the world's largest oil fields were in the Middle East, part of production had moved to the North Sea and the Americas, the result of a switch to politically safer areas.

After a series of nationalisations, mostly in the 1970s, the upstream industry became dominated by major producers which owned most of the world's proven reserves. Aramco of Saudi Arabia was the biggest; other important players were Petroleos de Venezuela, Pemex of Mexico, the Kuwait Petroleum Company and Statoil of Norway. Exhibit 1 shows their share in world production.

Downstream operations

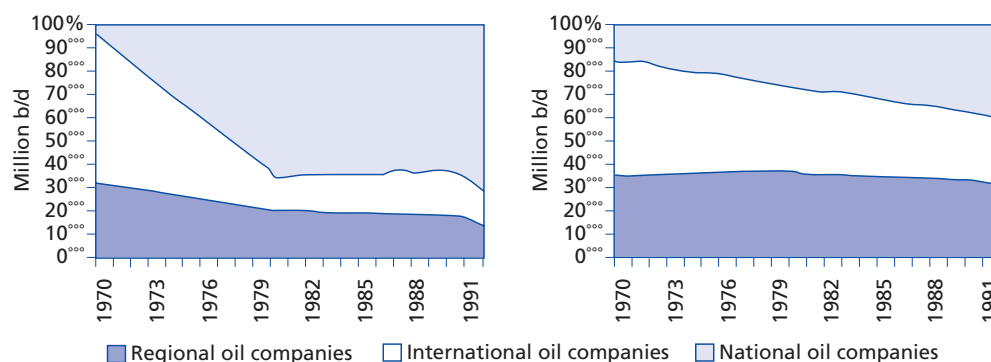
Downstream operations included transportation and storage of crude oil, processing, refining and marketing of final products to customers. Refining (described in Exhibit 2) essentially breaks down crude into various components which are then reconfigured into new products. While refineries could handle different qualities of crude and produce various end products, the more sophisticated refineries were better able to upgrade crude into high-value products. Although the product mix could not be changed completely, the way

plants were configured and the quality of crude afforded some flexibility.

Global refining capacity in 1996 stood at 78 million bpd. Refining was carried out in about 700 refineries which were evenly distributed between North America, Europe, Asia and the rest of the world. The average capacity was 100 000 bpd.³ Most of these plants had been planned before the 1973 oil shock when demand had been expected to grow almost indefinitely. Opening a new refinery took a long time and cost billions of dollars. Running it was comparatively inexpensive, but closing it down entailed substantial clean-up costs (estimated to be as high as US\$100 million) and redundancy costs. For these reasons, owners usually operated existing plants, even in a situation of over-capacity. Exhibit 3 shows the worldwide trend in refining.

In marketing, the largest volumes sold were petrol at the pump. Initially, service stations had been operated by large oil companies and small, independent operators. Lately, large out-of-town supermarkets had been joining the fray. Profitability was determined by the number and location of service stations and by supply logistics. Oil companies also offered specific services to industrial customers, supplies of jet fuel and bunkering (marine fuels, diesel oil and gas oil). These were usually delivered direct from the refinery.

Exhibit 1 | Distribution of control of world oil production and refining, 1970–91



Source: Booz-Allen & Hamilton, 'Dinosaurs can fly'.

Exhibit 2 | Refining processes and product flows

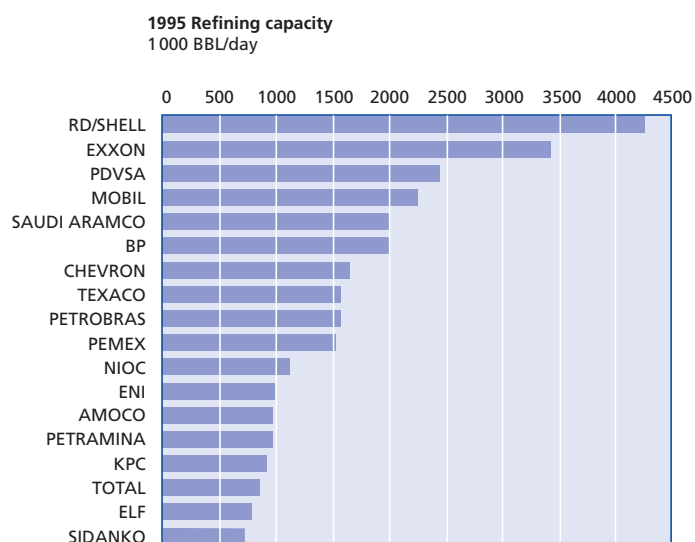
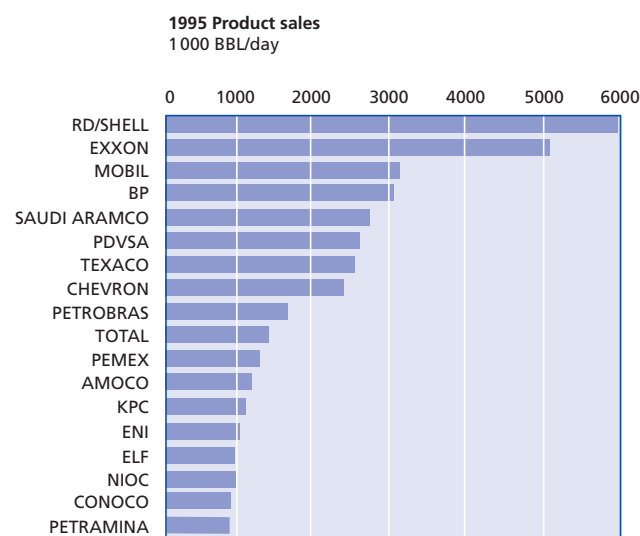
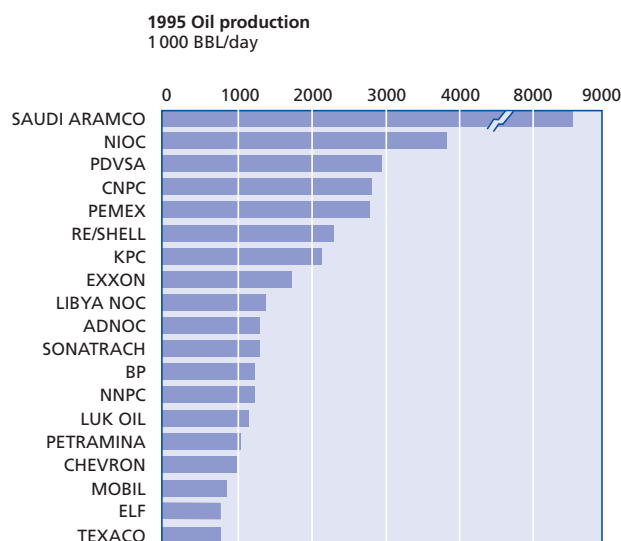
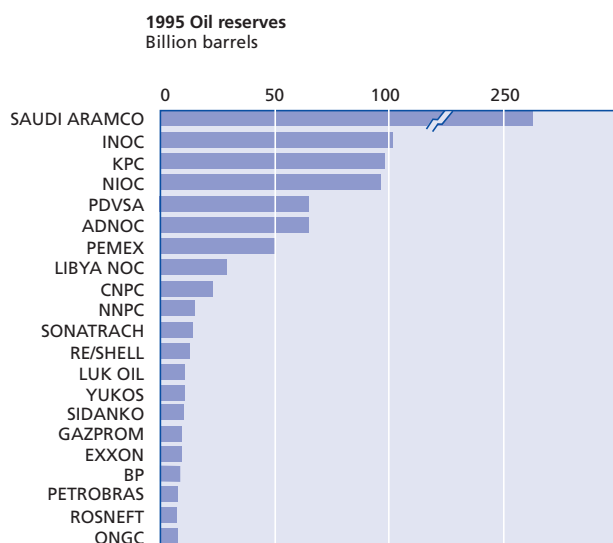
	Input	Intermediate	Output
Products	Crude oil	Kerosene, naphtha, gas oils, distillate	Gasoline, distillate, jet fuel, liquefied petroleum gas (LPG), and residuals
Processes	Crude distillation	Coker, hydrotreater, catalytic cracker, alkylation, hydrocracker, reformer	Distribution and retailing

Exhibit 3 | World refining capacity, 1980–96 (millions of tonnes)

Region	1980	1993	1994	1995	1996 (est.)
Western Europe	1 000.0	704.5	706.7	701.4	704.1
Middle East	205.8	255.0	266.2	264.8	269.8
Africa	107.4	145.9	144.2	144.1	145.3
North America	1 025.0	851.1	861.3	860.1	864.2
Latin America	436.3	375.4	367.8	371.0	372.6
Far East	572.0	682.9	720.9	740.2	814.3
Eastern Europe and FSU	769.7	642.3	642.6	636.6	632.5
Total	4 116.2	3 657.1	3 709.7	3 718.2	3 802.8

Source: Union Francaise des Industries Petrolieres (Bilan, 1996).

Exhibit 4 | Relative positions of large companies at various stages of the oil industry value chain, 1995



Source: National statistics; oil company annual reports.

Large integrated companies were dominating downstream operations. These included Shell, BP, Texaco, Gulf, Exxon, Mobil and Chevron. The last three had been formed after an antitrust decision to break up John D. Rockefeller's Standard Oil in 1911. These giant multinationals engaged in all aspects of the oil and gas business, from exploration and production to refining and marketing. Exhibit 4 shows their relative position in terms of reserves, output and sales.

Customer demand

Historically, the main driver of demand for oil had been the rate of economic growth. Demand also followed an annual cycle, peaking during the Northern Hemisphere's winter and falling in summer and stood at about 65 million bpd in 1996. The global oil market was still growing, albeit at a slower pace than in the 1960s and 1970s. After the Second World War, demand

Exhibit 5 | European energy market (existing and projected), 1995 and 2005

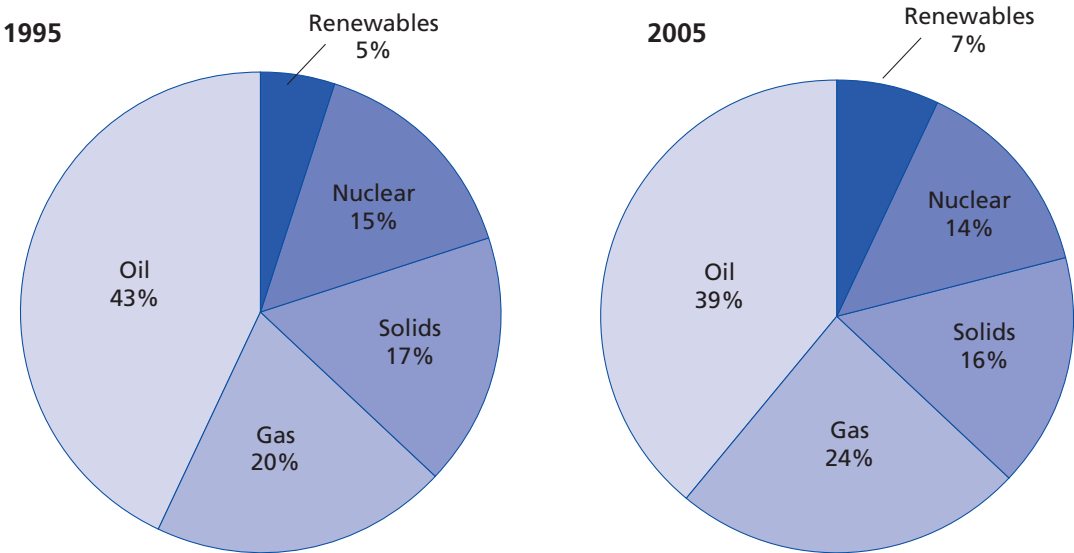
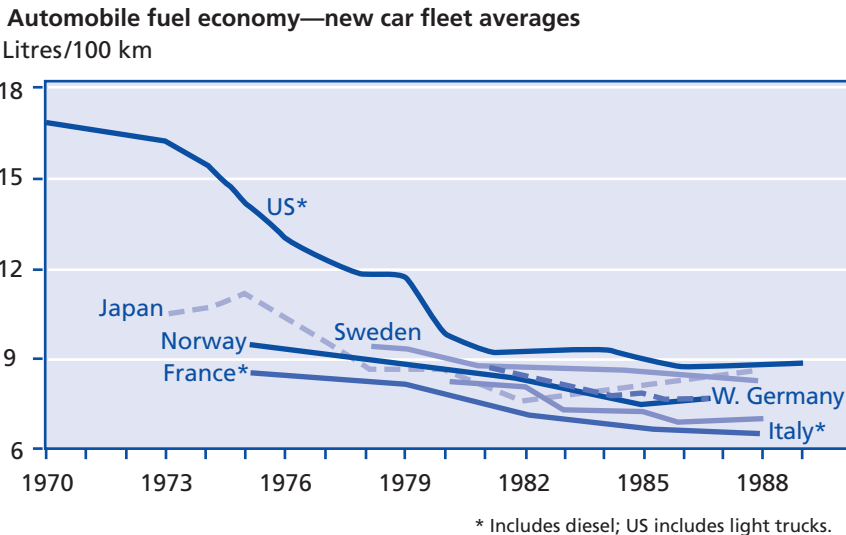
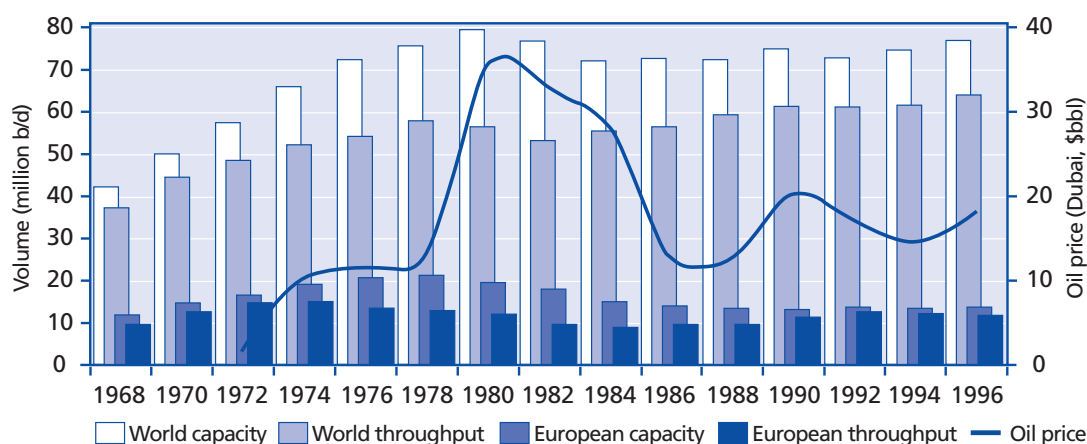


Exhibit 6 | Increase in automobile fuel efficiency, 1970–88



Source: International Energy Studies, LBL.

Exhibit 7 | Worldwide and European refining capacity and demand (throughput), 1968–96



Source: BP Statistical Review of World Energy, 1997.

had surged from 10 million bpd in 1945 to 60 million bpd in 1970. This had encouraged exploration, which soon unveiled large, accessible reserves in the Middle East.

The oil shock caused by OPEC's embargo in 1973–4 and the second shock in 1979 wrought such havoc to Western economies that governments embarked on long-term programs to reduce oil dependence. Coal, liquefied natural gas and nuclear power were developed as substitutes; energy conservation and efficiency gains were encouraged. (Exhibit 5 shows the expected shift away from oil until 2005; Exhibit 6 shows fuel savings achieved by car manufacturers.) The result was that between 1978 and 1985, oil's share of the total energy market in industrial countries fell to 43 per cent from 53 per cent.

The oil shocks, government programs and the cyclical nature of demand caused wide swings in oil prices. After the 1973 shock, the price per barrel increased from US\$2.90 in the summer to US\$11.65 in December. By 1979, it had shot up to US\$34. In 1985, OPEC stopped protecting its prices to regain demand. The Bellwether West Texas Intermediate futures

contract immediately lost two-thirds of its value to trade below US\$10. Internal conflict within OPEC and cheating on quotas led to over-production. While more volatility ensued, prices stabilised in the mid-1990s within a US\$15–18 range. Exhibit 7 plots spot prices in the 1990s.

The European downstream industry

Refining

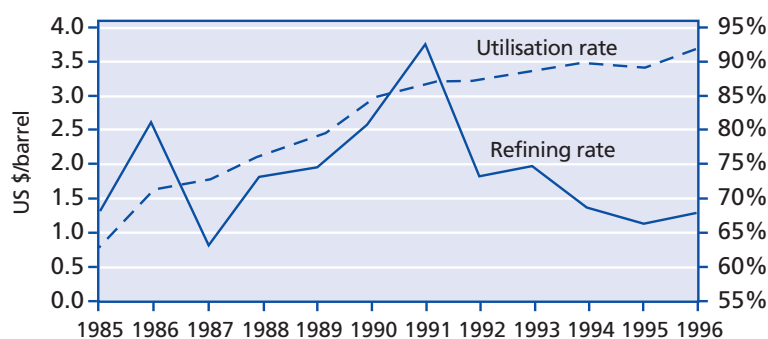
In recession-hit Europe in the mid-1990s, demand was nearly flat with growth forecasts of 0.5 per cent per annum until 2005. The market was depressed by fuel efficiency gains, higher duties, taxes (which governments often justified on environmental grounds), and increased supplies of nuclear power and natural gas. This stagnation was in stark contrast to the optimistic development programs prior to 1973 when demand had been expected to grow exponentially. Because of the long lead times for planning and building refineries, new plants had come onstream, resulting in

Exhibit 8 | European refining margins, 1991–6

DOLLAR MARGIN ON A BARREL OF COMPLEX NWE BRENT						
	1991	1992	1993	1994	1995	1996
Quarter 1	6.28	2.2	1.81	2.17	1.35	1.56
Quarter 2	3.37	1.92	2.26	1.43	1.67	1.75
Quarter 3	2.88	1.94	2.34	1.74	1.64	
Quarter 4	–2.89	1.92	2.4	1.67	1.46	

Source: Woods Mackenzie.

Exhibit 9 | European refining margins and utilisation, 1985–96



Source: Woods Mackenzie.

significant over-capacity in some parts of Europe. Exhibit 8 shows margins during the 1990s.

High exit costs, as well as governments' industrial and employment policies, were often blamed for the industry's failure to tackle over-capacity. There was also fragmented ownership of firms. The European refining industry had a mix of state-owned, integrated and independent companies. In most national markets, up to a dozen of these companies shared half the total capacity.

Over-capacity was also exacerbated by productivity improvements. Until 1991, capacity utilisation and margins had grown in parallel but this was no longer true, as Exhibit 9 shows. Demanding new regulations, often dictated by environmental concerns, had resulted in capacity creep. As margins declined, all producers were working to incrementally increase their capacity. Exhibit 10 shows capacity utilisation for major European oil companies.

The problem of over-capacity was aggravated by mismatches between the configuration of refineries (which had been planned for heavy Middle East crude)

and actual supplies (often, lighter North Sea oil). Demand for diesel also had grown much faster than expected, so that many refineries operating at capacity for diesel had spare capacity for petrol. Demand for fuel oil also had declined as supplies of natural gas became available. Exhibit 11 shows changes in the European demand mix.

Although oil companies generally aggregated into their published accounts their refining and marketing results, it was known that refining was far less profitable than marketing. Geographic differences in refining margins persisted. Margins had been higher in Asia where refining units were larger and yielded greater market power. In Europe, they were lower than in the United States where cheap prices for divested plants had enabled independent refiners to acquire assets which they operated at about 15 per cent return on capital. (Tosco, for instance, had bought refineries and retail sites from both Exxon and BP.) More lenient environmental laws, a flexible labour market, less price competition in a more consolidated industry, and the absence of direct central government control also helped

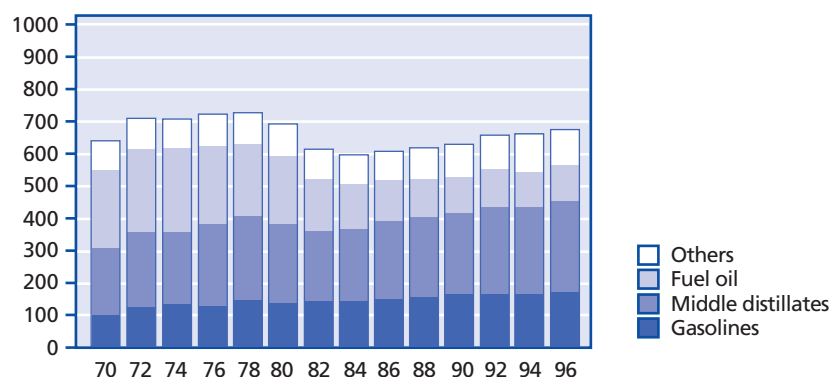
Exhibit 10 | Refining capacity utilisation rate, 1993–6

EUROPEAN REFINERS' UTILISATION RATE				
	1993	1994	1995	1996
Agip	78%	79%	74%	75%
Exxon	86	84	79	89
Repsol	86	87	87	84
Shell	100	100	98	102
Total	89	94	90	104
BP-Mobil	95	92	99	94
European average	86	88	88	91

Source: Woods Mackenzie.

Exhibit 11 | Demand mix

Regional consumption, 1970–96
OECD Europe (million tonnes)



Note: 'Middle distillates' refers to diesel.

Source: BP Statistical Review of World Energy, 1997.

make US downstream players more profitable than European ones.

Beyond these concerns, the European downstream industry was bracing itself for a huge bill following the European Commission's 1993 Auto-Oil program, which aimed at reducing levels of urban atmospheric pollution by the year 2010. The industry would probably need huge investments to improve the quality of diesel and petrol. This was likely to cost the industry a total of US\$16 billion over a 15-year period.

Marketing

Some 300 billion litres of petrol and other retail products were sold every year in Western Europe. The leaders, Shell and Exxon, each had about 12 per cent

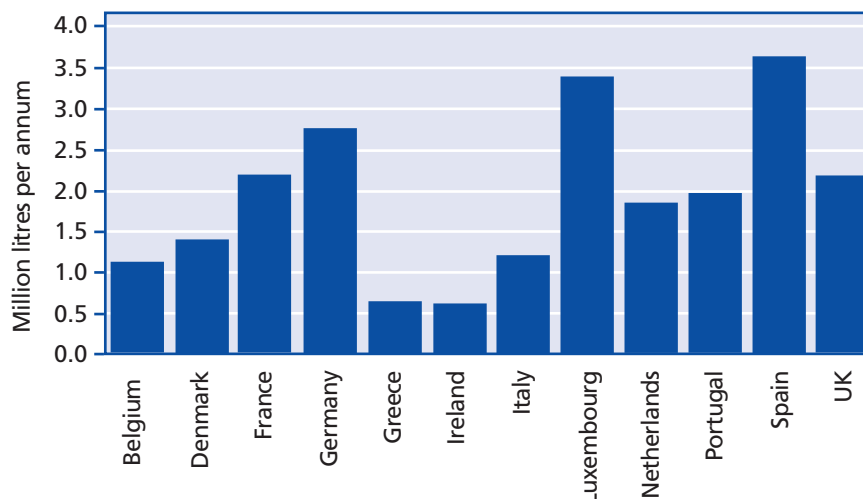
market share. There were some 120 000 service stations operated by the major integrated companies, supermarkets and independent retailers. Their number was falling rapidly (as shown in Exhibit 12). In France, there were 18 000 petrol stations left, compared with 47 000 in 1976, and a further 5 500 were expected to close. Germany too had 18 000, down from a peak of 46 700. In the United Kingdom, their number was forecast to fall below 10 000 by 2005, from 16 000 in 1996.

The Western European market was characterised by weak brands and changes in distribution channels, where supermarkets increasingly displaced small dealer networks while integrated companies and national players were trying to turn service station forecourts

Exhibit 12 | The trend in petrol retailing sites, 1987–96

	AVERAGE NUMBER OF RETAIL SITES			
	United Kingdom	Germany	France	Benelux
1987	20 197	20 751	31 100	15 510
1988	20 016	20 198	29 000	15 150
1989	19 756	19 802	27 700	14 699
1990	19 465	19 351	25 700	13 937
1991	19 247	18 898	23 700	13 211
1992	18 549	18 836	21 700	12 668
1993	17 969	18 464	20 000	11 820
1994	16 971	18 300	19 013	11 022
1995	16 244	17 957	18 406	10 490
1996	14 748	17 660	17 974	10 030

Source: Woods Mackenzie.

Exhibit 13 | Comparative average throughput per site, 1995

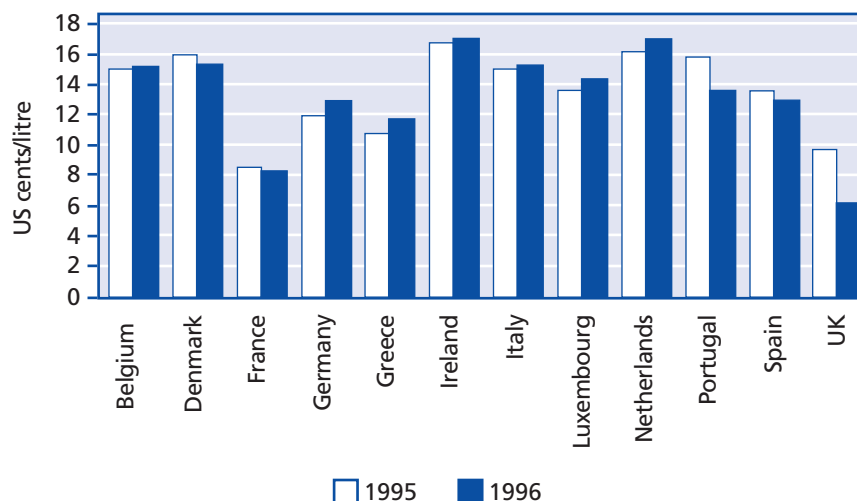
Source: Woods Mackenzie.

into convenience stores. (Exhibits 13 to 20 describe various characteristics of national markets.) Petrol was increasingly perceived as a commodity product, with gross sales margins of 2–4 per cent. Consumers bought mainly on convenience (proximity) and price. Even the ‘majors’ now competed on price. Brands remained weak and undifferentiated despite efforts to build them up; independent surveys showed that brand value, measured by the additional margin compared with an unbranded product, was minimal.

The weakness of brands had favoured the entry and growth of supermarkets. Huge shopping centres had sprung up near major cities and enjoyed many advantages. They had acres of free parking, and

customers had become used to visiting them every week. Filling up was just part of ‘one-stop shopping’. In 1996, their market share was already high in France (over 50 per cent), the United Kingdom (over 20 per cent) and Germany (over 10 per cent).

The average supermarket service station sold much more fuel than other service stations. In Britain, for example, the 664 supermarket stations had 20 per cent of the whole market. As ‘bulk’ buyers, they could negotiate lower prices for supplies. They could also take advantage of imbalances between supply and demand in their region. As a result, the supermarkets often paid lower wholesale prices than the integrated oil companies’ own marketing divisions.

Exhibit 14 | Retail petrol margins, 1995 and 1996

Source: Woods Mackenzie.

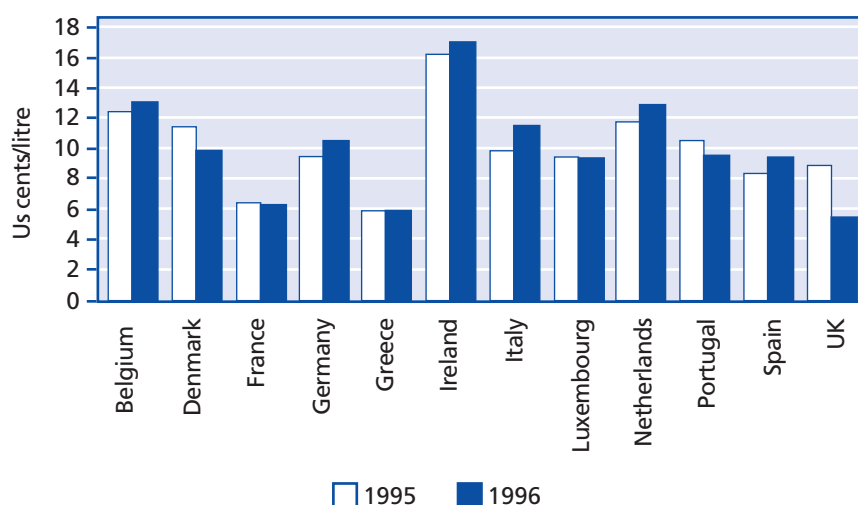
Supermarkets also seemed to operate on smaller margins than traditional service stations. Competitors grumbled that supermarkets didn't hesitate to sell at a loss in order to capture market share. In fact, French supermarkets had increased their prices as soon as they had established a degree of market power. While the growth of out-of-town supermarkets seemed to have peaked in the United Kingdom and France, it continued in Germany and Italy and was only starting up in Spain, Portugal and Ireland.

Independent retailers that could no longer compete went out of business. Other retailers tried to rise to the

challenge: they consolidated their networks, keeping only the more profitable locations, and engaged in price wars. Others tried to turn old rivals into allies, opening their own branded outlets on supermarket premises. This was Repsol's strategy in Spain with El Corte and Shell's in the Netherlands with Ahold.

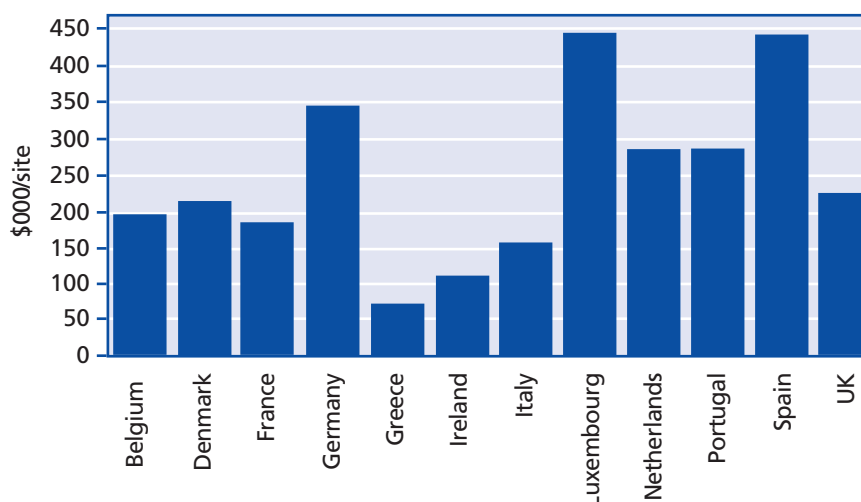
Another strategy was to develop convenience stores in existing service stations. Taking advantage of long opening hours and dedicated car parks, these new 'corner shops' offered goods and services such as cigarettes, newspapers, food and drinks, automated bank tellers, fax, photocopiers, post office, lottery and photo shops,

Exhibit 15 | Retail diesel margins, 1995 and 1996



Source: Woods Mackenzie.

Exhibit 16 | Comparative total gross margin per site, 1995



Source: Woods Mackenzie.

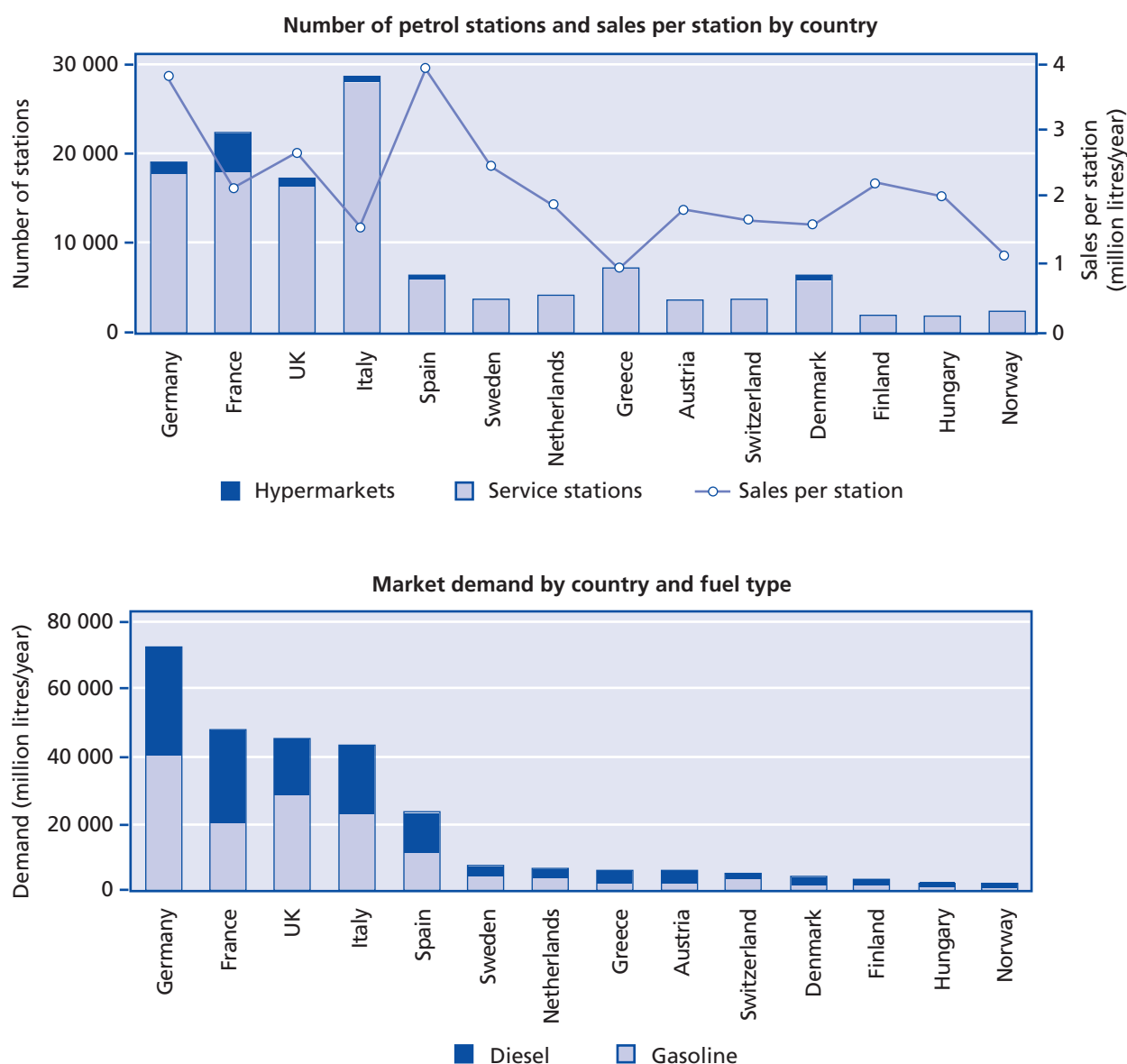
reducing the dependence of retailers on petrol sales. It was hoped that, in the longer term, forecourts would become shopping areas in their own right, maybe in partnership with established food retailers.

Opportunities in Eastern Europe

The stagnation of the Western European retail market was encouraging oil companies to look east. The collapse of communism in 1989 had left a dilapidated infrastructure and limited distribution networks, but upbeat forecasts for economic growth suggested that the downstream oil market would grow quickly. Oil

companies could enter this new market in two ways. First, existing oil assets could be purchased at bargain-basement rates. However, their low prices often reflected poor quality and under-investment; cleaning up the sites and meeting potential environmental liabilities could turn out to be enormously costly. Second, firms could build new refineries and retail networks. This was less uncertain, but it would take a long time and be hugely expensive. While these risks had made investment slower than expected, all the integrated oil companies had plans for Eastern Europe, with Shell, Exxon and Total leading the pack.

Exhibit 17 | Comparison of European countries – selected variables



Sources: *Petroleum Review*, June 1997; UFIP; national oil industry associations.

Exhibit 18 | The economics of selling petrol across Europe

REFINING NET PROFITABILITY ANALYSIS				
	United Kingdom	Italy	Germany	France
Retail costs				
Distribution	0.8	23.5	2.2	8
Advertising and promotion	0.5	15	1.4	4.5
Other marketing	1.3	33.5	3.4	11.5
Retail site costs	3.4	66	8.5	19
Retail revenue				
Unit margin	6.2	223	17.8	43
Non-fuel sources	1.5	12	4.3	4.5
	pence/litre	lire/litre	pfenning/litre	centimes/litre

Source: Woods Mackenzie.

Exhibit 19 | Market share data, 1996

ESTIMATED OVERALL MARKET SHARE					
	United Kingdom	Italy	Germany	France	Benelux
Exxon	16%	10%	11%	11%	16%
Shell	16	3	13	12	19
Total	5	n/a	2	21	6
Elf	3	n/a	6	21	n/a
Agip	n/a	19	2	1	n/a

Source: Woods Mackenzie

BP and Mobil's competitors in Europe

Historically, integrated companies had been able to mitigate the impact of price variations as upstream and downstream hedged each other's risk. Traditionally, high crude prices depressed downstream results and boosted upstream profits. Low oil prices supposedly had the opposite effect. However, from the mid-1980s, profitability fell both upstream (with lower crude prices) and downstream, where over-capacity and flat demand eroded margins.

Faced with these various challenges, downstream companies had taken steps to restructure, often in alliance with competitors. Overall, however, restructuring in Europe had remained less ambitious than in North America. The European players tended to only sell or swap assets. Their profitability was also lower, as illustrated in Exhibit 21.

Royal Dutch/Shell

Royal Dutch/Shell, the European market leader, had been founded in 1907 by merging a British and a Dutch group in order to counter the dominance of Standard Oil. With time, the group had become one of the world's largest corporations. Its operations in over 100 countries covered exploration and production of oil and natural gas, refining, marketing and chemicals, as well as coal mining, polymers, crop protection products and various metals.

In Europe, Shell was the second-largest refiner after Exxon, with annual capacity of 70 million tons and sales of 65 million tons. In marketing, it had been the leader with a 12 per cent market share and 8 500 retail sites. After the 1990–1 Gulf War, Shell had found itself with large inventories just as prices fell. The drop in profits had prompted a round of internal restructuring that had left analysts generally unimpressed. In 1996,

Exhibit 20 | Western European oil consumption, 1987–96

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Austria	9 359	9 145	8 948	9 489	10 158	9 913	9 984	10 074	10 136	10 816
Belgium	17 486	17 788	17 205	17 022	18 559	19 240	18 656	19 188	18 884	21 262
Denmark	8 997	8 351	7 898	7 704	7 879	7 648	7 665	8 100	7 847	8 128
Finland	9 810	9 561	9 410	9 371	9 058	8 786	8 541	8 913	8 664	8 960
France	77 528	77 616	80 518	79 636	84 124	84 337	82 718	82 984	84 234	85 871
Germany	120 020	120 172	112 954	117 617	125 062	126 134	127 451	126 102	126 210	128 358
Greece	10 351	10 948	11 379	11 328	12 133	12 190	12 072	12 541	13 273	14 212
Ireland	3 895	3 675	3 715	4 199	4 419	4 678	4 655	5 112	5 266	5 454
Italy	82 842	82 126	85 593	85 412	84 224	85 686	83 841	84 279	86 865	85 694
Luxembourg	1 285	1 316	1 450	1 585	1 848	1 897	1 892	1 884	1 736	1 808
Netherlands	17 902	18 680	18 293	17 537	18 038	17 840	16 923	17 365	18 264	17 295
Portugal	8 208	8 566	10 993	10 776	10 940	12 192	11 475	11 335	12 267	11 841
Spain	36 415	41 060	41 063	40 672	40 570	41 882	44 997	48 504	50 613	49 272
Sweden	15 032	16 119	15 122	13 735	13 941	14 570	14 161	15 058	15 330	17 719
United Kingdom	67 703	72 316	73 029	73 941	74 507	75 472	75 790	74 957	73 836	75 241
EU total	486 833	497 439	497 570	500 024	515 460	522 465	520 821	526 396	533 425	541 931
Iceland	608	596	538	540	565	561	718	729	731	780
Norway	7 402	7 087	6 909	6 737	6 599	6 560	6 147	6 407	6 442	7 171
Switzerland	12 211	12 247	11 774	12 612	12 790	12 969	12 117	12 508	11 577	11 923
Turkey	20 387	20 436	20 763	21 326	20 905	22 020	25 412	24 016	26 725	27 889
Western Europe Total	527 441	537 805	537 554	541 239	556 319	564 575	565 215	570 056	578 900	589 694

Thousands of metric tonnes.

Source: National statistics.

Exhibit 21 | Comparative financial data, 1991–6

	ROACE (91–96)	ROE (91–96)	Average NI (91–96)	Average CAPEX (91–96)	Average Market Cap (91–96)	Average P/E (91–96)	Price to Book (91–96)	Net Income 1996	Balance Sheet 1996	
British Petroleum	6.8%	8.2%	1 501	5 092	38 378	15.4	2.1	3 025	12 914	(£m)
Mobil	8.6	10.2	1 823	4,288	34 886	21.7	2.0	3 043	19 118	(£m)
Royal Dutch/Shell	20.6	10.7	6 028	9 848	100 752	18.1	1.8	5 591	39 299	(£m)
Exxon	12.1	15.4	5 788	7 081	87 849	15.3	2.3	6 975	45 456	(US\$m)
Agip	6.9	9.1	1 289	874	34 487	12.1	2.2	4 829	27 407	(LIT b)
Elf	4.3	4.6	744	4 167	19 592	24.0	1.3	7 518	99 709	(FF m)
Total	7.0	7.7	713	2 028	12 918	20.4	1.3	4 795	61 479	(FF m)
Repsol	13.9	15.7	769	1 332	8 967	12.1	1.9	120 932	986 886	(Ptas m)
Norsk Hydro	8.4	11.1	548	1 182	7 681	1.9	1.7	6 991	42 808	(NKR m)
Tosco	8.3	7.5	60	123	4 127	34.9	6.1	146	1 070	(US\$m)
Lyondell	26.2	61.9	167	342	1 858	37.4	4.1	96	1 040	(US\$m)
			(US\$m)	(US\$m)	(US\$m)					

Shell was planning to sell its Swiss refinery, close down lubricant plants and reduce its retail workforce.

An early mover into central and Eastern Europe, Shell had formed a joint venture with Agip and Conoco to take a 49 per cent stake in two Czech refineries. In 1996, it had swapped 38 of its sites in western Germany for 44 total sites in eastern Germany. It had also invested in some smaller markets such as Romania, Bulgaria and Slovenia.

Two recent public relations crises had damaged Shell's image. In 1995, it was forced to shelve plans to dump its used Brent Spar oil installation into the North Sea after vocal complaints led by Greenpeace and consumer boycotts orchestrated across Germany and the rest of Europe. And when Nigeria executed a leading dissident, human rights campaigners accused Shell of supporting a military dictatorship in contempt of minority rights.

Exxon

Exxon, the former Standard Oil of New Jersey (Esso), was the world's largest oil company in terms of revenue. After many of its Middle Eastern oil fields and facilities had been nationalised, Exxon had aggressively expanded exploration and production in safer regions in the 1980s. It suffered a major setback in 1989 when the *Exxon Valdez* tanker ran aground in Alaska, spilling 11 million gallons of oil. The initial clean-up bill was US\$3.6 billion with a lawsuit seeking US\$16.5 billion in compensatory and punitive damages still pending.

In Europe, Exxon had a retail market share of about 11 per cent. It had cut back on refining investments and was focusing on reducing costs. In refining, the size and integration of its assets gave it a cost advantage. In marketing, it had started a fierce price war in Britain with its 'Price Watch' campaign, which promised to match any competitor's prices within 5 kilometres.

Eastern Europe was a major area of new investment for Exxon. It had formed marketing joint ventures in Hungary (with state company AFOR) and in Poland (with a German partner). By 1996, 35 Esso stations were operating in Hungary, Poland, the Czech Republic and Slovakia.

National companies

Agip, the leading Italian integrated oil company, was part of the ENI Group. It had production and downstream activities in 13 countries and downstream activities only in a further 13 countries. However, most

of its refining and marketing operations were in Italy (which accounted for 41 per cent of 1995 sales). Agip's strategy was to maintain a strong presence in the attractive Italian market while gradually expanding elsewhere in Europe. In Italy, it wanted to increase return on capital by reducing excess capacity in refining and by closing down less profitable retail sites.

Elf Aquitaine, France's largest industrial company, had been formed in 1965 by merging several small state companies. It was gradually being privatised; the government still had a 13.3 per cent stake. Elf was a diversified conglomerate with interests in health and hygiene products and was refocusing on oil. Under a new chief executive, explicit goals had been set in terms of cost savings, debt reduction and return on capital; non-core assets were sold, resulting in a US\$1 billion net loss of 1994 from write-downs. Its new strategy was to focus on the upstream business, limiting downstream operations to France, Spain and Germany where Elf had a strong position. There were plans to leave the British market. Elf was expanding in Eastern Europe, although with mixed success. A joint venture with a Russian consortium and German public authorities to acquire 1 000 petrol stations in eastern Germany had proven expensive and unprofitable and Elf now wanted to sell.

Repsol, Spain's largest industrial company, had a 60 per cent share of the domestic oil market. The government, which had formed Repsol in 1987 to consolidate the fragmented Spanish oil industry, retained a 10 per cent stake. The company was expanding its natural gas business through acquisitions, mostly, but not solely, in Spain. Repsol's strategy was to defend its domestic position while expanding natural gas exploration and production. Targets for international expansion included Latin America as well as Portugal, southern France and northern Africa.

Total, Europe's fourth-largest oil and gas producer, had over 10 000 retail stations across the continent. It was listed on the New York Stock Exchange, yet the French government retained a 5 per cent stake. The company had invested aggressively upstream in exploration, especially in the former Soviet Union. Efforts to restore downstream profitability had included cost cutting and selling off less profitable assets (for example, refineries in Portugal and the Czech Republic were sold in 1995). In France, competition from the supermarkets had hurt profitability, prompting the company to trim retailing costs and launch an aggressive effort to regain market share.

Total wanted to expand in high-growth regions such as central and Eastern Europe, Portugal and Turkey, with a focus on marketing and distributing motor fuel. Total had invested FF 700 million in Hungary and the Czech Republic between 1992 and 1994. A joint venture with Benzina, owned by the Czech government, had been disappointing in terms of sites and market share. In Hungary, Total had 25 per cent of the LPG market after acquiring two marketing companies, Egaz and Kogaz, in 1993.

BP and Mobil

British Petroleum

One of the world's largest petroleum and petrochemical groups, BP had operations in some 70 countries, more than 56 000 employees and annual revenues of US\$79 billion. It had been fully privatised in 1987 when the British government sold its 51 per cent stake and had gradually become more diversified and decentralised.

Upstream, BP focused on oil exploration, with production facilities in Alaska, the Gulf of Mexico, Colombia and the North Sea. (Exhibit 22 summarises BP's upstream activities.) Downstream, BP had a weak position in the United States. Aggressive restructuring and asset disposals had not quite solved the problem of high costs and asset quality.

The company, however, had forced the admiration of industry watchers by staging a remarkable recovery under the successive CEOs David Simon and John Browne. In 1992, an unprecedented quarterly loss had caused it to nearly default on interest payments. Since then, BP increased earnings to US\$3.2 billion (from US\$900 million), while the share price had more than doubled. (See Exhibit 22 for an overview of cumulative returns.) By 1995, dividend payments were back above their 1992 level. (Exhibits 23 and 24 give financial data.) Analysts expected financial improvement to continue until at least the year 2000, thanks to higher output (by 5 per cent per annum on average) and a better product mix.

BP was seen as a leader in cutting costs: It had halved its total workforce to 56 500 in 1995 from 111 900 four years earlier. The company also sought greater efficiency through consolidation, reorganisation, and optimisation of storage and logistics. In refining, its strategy was to sell or close unprofitable refineries, upgrade others and generally improve operating

reliability. It had recently spent £171 million on a five-year, worldwide rebranding effort, with mixed success.

Europe was BP's main market, with 48 per cent of refinery capacity and 49 per cent of sales. The company had downstream operations in 18 countries. It employed some 15 500 people, including 4 000 service station staff, and owned, wholly or in part, eight European refineries with combined capacity of 760 000 bpd. (The planned sale of the Lavera plant in southern France would reduce this to 575 000 bpd.) BP and partner Texaco had also announced the closure of their Pernis refinery and the consolidation of their joint refining at BP's Europort plant in Holland. (Exhibit 25 has data on BP's refineries.)

BP sold 825 000 bpd of oil products through 5 600 retail sites. Its market share, 8 per cent in both fuels and lubricants, had been steady for years. (Exhibit 26 shows BP's market performance.)

In marketing, its two-pronged strategy was to upgrade facilities at prime retail sites to improve petrol throughput and increase non-fuel revenue and to pursue expansion in Eastern Europe where it planned to quadruple its 100 service stations. In the last two years, BP had sold 90 service stations in southwestern France to Repsol, 60 other French sites to PetroFina and eight Austrian sites to Shell. In the United Kingdom, it had acquired independent fuel distributor Charringtons.

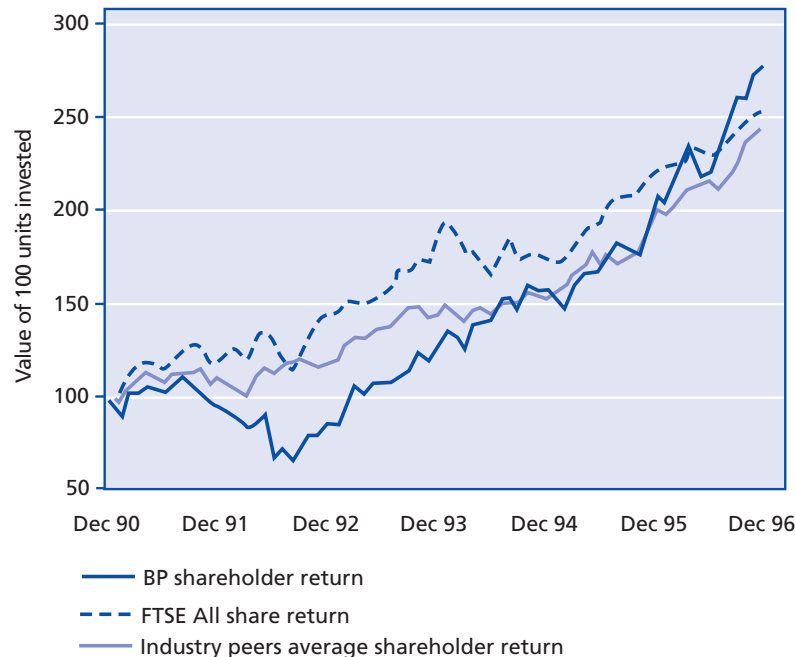
BP's success in cost cutting had spawned imitators and had not produced notable gains in its market share. Analysts believed that European oil companies (including BP) had cut 'all the fat and some of the muscle' and doubted whether any further cost reductions were possible.

Mobil

Mobil, founded as Standard Oil of New York, was the world's third-largest oil company after Exxon and Shell. It operated in over 100 countries with 50 000 employees and annual revenues of US\$73 billion; it owned 21 refineries and 28 tankers and shared ownership in over 58 000 kilometres of pipeline. Its response to the 1970s' oil shock had been to diversify. This had culminated in the acquisition of the Montgomery Ward department stores. Mobil later sold that business to concentrate once more on oil.

The company had worldwide earnings of US\$2.9 billion in 1995, nearly double the 1992 level of US\$1.5 billion. It had not suffered as badly as BP from the Gulf

Exhibit 22 | BP's upstream activities, 1990–6



War, but its performance had not improved as dramatically either. Analysts saw potential for more cost cutting and increased production. Exhibit 27 summarises Mobil's financial results.

Upstream, Mobil was a major player in both oil and natural gas. Output, which had dropped in 1994, was expected to increase 2–3 per cent annually in the medium term. A significant share of Mobil's revenue came from international exploration and production in Indonesia, Qatar, Nigeria, the North Sea and Canada, where it had a share in the Hibernia offshore oil field.

Mobil had a strong downstream position in the United States, especially in terms of market share and retail network. It was the world's leader in finished lubricants, with large market share in all regions. As part of its global strategy, Mobil had made considerable R&D investments in lubricants, and it was recognised as a quality brand in this business.

In Europe, Mobil's downstream operations had remained relatively weak despite extensive rationalisation. Analysts wondered whether it would have to leave the market. Mobil owned, wholly or in part, six European refineries with capacity of 350 000 bpd (about 16 per cent of its total capacity) but was planning to close its Woerthe plant in Germany. It made 25 per cent of its sales in Europe where its market share in fuels was only 4 per cent. In lubricants, however, it had 10 per cent share (Exhibit 28 has details). In 1996, Mobil's 8 000 workforce sold 550 000 bpd of oil products. About 2 000 service station staff operated

3 300 service stations in 22 European countries. In the last two years, Mobil had swapped 18 of its French service stations for eight Repsol stations in southern Spain.

In Germany, Mobil did not sell any retail fuels under its own brand but it was a major supplier to Aral, a joint venture with German group Veba Oel in which Mobil had a 28 per cent stake. Aral, which had by far the largest network of service stations in Germany, with a 20 per cent market share, had been one of the first German retailers to open convenience stores. It was energetically expanding non-fuel retailing and considered selling McDonald's hamburgers. For some products, however, and in other countries, Mobil competed with Aral.

The alliance

Discussions between Mobil and BP had begun in the summer of 1995; lawyers had become involved in October. The two companies had decided to form a partnership, with no changes in ownership of assets or equity. Setting up a traditional joint venture would have taken much longer because of the complex business of valuing assets, technologies and trademarks. Both BP and Mobil were familiar with using partnerships in their upstream activities.

The partnership would operate refineries, buy crude oil and other feedstocks for these refineries, refine and convert downstream products such as lubricants, and market them, both to retail and to industrial and

Exhibit 23 | British Petroleum earnings summary, 1991–6

	1991	1992	1993	1994	1995	1996E
Exploration and production						
United Kingdom	870	795	1 086	1 527	1 492	1 636
Rest of Europe	423	483	399	257	330	304
United States	1 673	1 607	1 277	920	1 251	1 246
Rest of world	54	91	123	169	386	437
Total	3 020	2 976	2 885	2 873	3 459	3 623
Refining and marketing						
United Kingdom	115	–132	36	119	92	13
Rest of Europe	407	175	245	189	–22	280
United States	211	2	270	173	43	250
Rest of world	586	416	582	509	528	591
Total	1 319	461	1 133	990	641	1 134
Chemicals						
United States	–19	64	26	35	216	175
Non-US	76	–106	–128	350	–216	750
Total	57	–42	–102	385	0	925
Other and corporate	–199	–60	–164	–79	–61	–13
Replacement cost operating profit	4 197	3 335	3 752	4 169	4 039	5 669
Gain/(loss) from asset sales	428	124	–60	55	–5	–11
Restructuring costs	–103	–1 884	–300	0	–1 525	0
Inventory gain/(loss)	–1 113	–187	–426	95	4	95
Historical cost operating profit	3 409	1 388	2 966	4 319	2 513	5 753
Interest expense	–1 280	–1 190	–1 013	–829	–787	–600
Pre-tax income	2 129	198	1 953	3 490	1 726	5 153
Income tax	–1 451	–1 000	–1 027	–1 059	–1 310	–1 476
Minority interest	57	–9	–7	–18	8	–20
Historical cost income	735	–811	919	2 413	424	3 657
Exploration and production						
US capital employed	7 639	7 237	7 064	7 017	7 124	7 480
US adjusted earnings	931	883	682	546	828	674
Foreign capital employed	11 199	9 912	9 787	10 594	11 502	12 422
Foreign adjusted earnings	843	784	969	1 042	1 322	1 441
Refining and marketing						
US capital employed	3 697	3 482	2 802	2 775	1 571	1 602
US adjusted earnings	139	1	176	112	59	162
Foreign capital employed	6 317	5 784	5 476	5 947	5 663	5 890
Foreign adjusted earnings	720	308	578	577	553	592

All numbers are in millions of dollars.

Source: Merrill Lynch, 1996, 'BP and Mobil – similar in size but different in the way they are'.

Exhibit 24 | BP Refining and marketing profitability, 1992–6

	1992	1993	1994	1995	1996	Average
Net profit after tax (£ million)						
Refining	20	180	6	–68	194	66.4
Marketing	240	575	640	474	485	482.8
Total	260	755	646	406	679	549.2
Operating capital (£ million)						
Total	6 137	5 593	5 591	4 637	5 137	5 419
Refining	53%	56%	61%	54%	43%	53.4%
Marketing	47	44	39	46	57	46.6
Return on average capital employed (ROACE)						
Refining	0.6%	5.6%	0.2%	–2.3%	8.2%	2.5%
Marketing	8.3	21.5	27.6	22.0	19.2	19.7
Total	4.2	12.9	11.6	7.9	13.9	10.1

Source: BP financial and operating information, 1992–6.

Exhibit 25 | Summary of BP downstream activity, 1991–5

Crude oil sources ⁽ⁱ⁾	Thousand barrels per day				
	1991	1992	1993	1994	1995
Produced from own reserves ⁽ⁱⁱ⁾					
United Kingdom	359	364	370	429	403
Rest of Europe	81	87	88	81	69
United States	738	688	627	605	572
Rest of world	37	23	32	32	56
	1 215	1 162	1 117	1 147	1 100
Produced from associated undertakings					
Abu Dhabi	141	131	125	118	113
Total production	1 356	1 293	1 242	1 265	1 213
Purchased					
United States	358	427	568	572	728
Rest of world	1 474	2 016	2 087	2 434	2 648
	1 832	2 443	2 655	3 006	3 376
Total	3 188	3 736	3 897	4 271	4 589
⁽ⁱ⁾ Crude oil in respect of which royalty is taken in cash is shown as a purchase: royalty oil taken in kind is excluded from both production and purchased oil. ⁽ⁱⁱ⁾ Oil production includes natural gas liquids and condensate.					
Crude oil sales	Thousand barrels per day				
	1991	1992	1993	1994	1995
United Kingdom	1 167	1 301	1 378	1 860	2 004
Rest of Europe	40	88	82	90	116
United States	391	479	497	534	693
Rest of world	27	33	30	15	24
Total	1 625	1 901	1 987	2 499	2 837

(Continues)

REFINERY THROUGHPUTS AND UTILISATION					
Refinery throughputs ⁽ⁱ⁾	Thousand barrels per day				
	1991	1992	1993	1994	1995
United Kingdom	194	185	184	183	193
Rest of Europe	525	570	617	593	661
United States	701	711	717	621	713
Rest of world	297	307	327	339	332
	<u>1 717</u>	<u>1 773</u>	<u>1 845</u>	<u>1 736</u>	<u>1 899</u>
For BP by others	<u>21</u>	<u>13</u>	<u>11</u>	<u>9</u>	<u>10</u>
Total	<u>1 738</u>	<u>1 786</u>	<u>1 856</u>	<u>1 745</u>	<u>1 909</u>
Crude distillation capacity at 31 December	2 066	2 020	1 963	2 004	2 000
Crude distillation capacity utilisation ⁽ⁱⁱ⁾	90%	94%	97%	94%	104%

⁽ⁱ⁾ Includes actual crude oil and other feedstock input both for BP and third parties.

⁽ⁱⁱ⁾ Crude distillation capacity utilisation is defined as the percentage utilisation of capacity per calendar day over the year after making allowance for average annual shutdowns at BP refineries (net rated capacity).

Crude oil input					
	Thousand barrels per day				
	1991	1992	1993	1994	1995
Low sulphur crude	69%	62%	63%	72%	71%
High sulphur crude	31	38	37	28	29

Refinery yield ⁽ⁱ⁾					
	Thousand barrels per day				
	1991	1992	1993	1994	1995
Aviation fuels	171	186	184	192	194
Gasolines	659	712	676	668	704
Middle distillates	530	549	603	574	548
Fuel oil	220	245	282	214	215
Other products	<u>212</u>	<u>218</u>	<u>230</u>	<u>196</u>	<u>286</u>
Total	<u>1 792</u>	<u>1 910</u>	<u>1 975</u>	<u>1 844</u>	<u>1 947</u>

⁽ⁱ⁾ Refinery yields exceed throughputs because of volumetric expansion.

Exhibit 26 | BP's pre-alliance market share, 1991–5

ESTIMATED MARKET SHARE						
	1991	1992	1993	1994	1995	Rank
Benelux	12.1%	12.2%	12.0%	12.3%	12.6%	4
France	7.8	8.1	8.0	8.5	8.0	5
Germany	8.2	8.6	8.5	8.8	8.8	6
Italy						
Spain/Portugal	8.4	8.1	6.9	6.9	6.7	3
United Kingdom	12.5	12.0	11.9	11.5	11.5	3
Ireland	12.6					
Austria	9.4	8.9	9.1	9.2	9.3	4
Switzerland	13.5	13.1	12.4	18.0	18.6	2
Denmark						
Norway						
Sweden	7.1	2.6	2.0	0.1	0.1	
Finland						
Greece	12.8	13.2	13.4	13.0	13.5	1
Turkey	8.0	8.0	8.0	8.1	8.1	

Source: Woods Mackenzie.

Exhibit 27 | Mobil earnings summary, 1991–6

	1991	1992	1993	1994	1995	1996E
US Petroleum						
Exploration and production	189	348	363	125	–107	444
Refining and marketing	116	–145	151	241	226	448
Total	305	203	514	366	119	892
Foreign Petroleum						
Exploration and production	1 094	1 042	1 289	951	952	1 150
Refining and marketing	819	329	554	–33	447	846
Total	1 913	1 371	1 843	918	1 399	1 996
Total Petroleum	2 218	1 574	2 357	1 284	1 518	2 888
Chemicals	217	136	44	102	1 164	375
Financing	–385	–316	–127	–209	–295	–240
Other and corporate	–130	–86	–190	–98	–11	–150
Accounting changes	0	–446	0	0	0	0
Net income	1 920	862	2 084	1 079	2 376	2 873
Exploration and production						
US capital employed	6 443	5 670	4 925	4 420	4 035	4 116
US adjusted earnings	189	423	432	306	332	444
Foreign capital employed	3 760	3 621	3 836	4 076	4 474	4 832
Foreign adjusted earnings	1 045	1 066	1 098	1 018	1 065	1 150
Refining and marketing						
US capital employed	4 705	5 286	5 071	5 155	5 128	5 231
US adjusted earnings	212	–17	296	273	330	448
Foreign capital employed	7 362	7 193	7 464	7 356	7 770	8 159
Foreign adjusted earnings	805	370	792	681	805	846

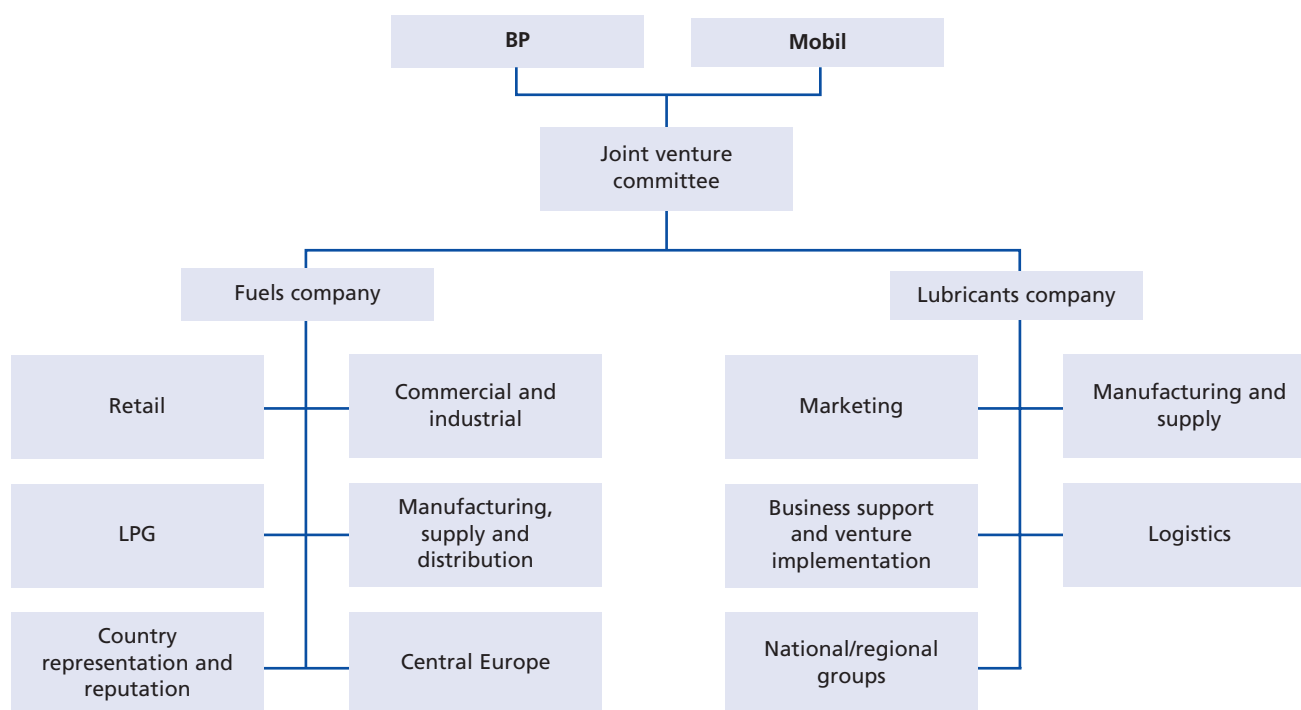
All numbers are in millions of dollars.
Source: Merrill Lynch, 1996, 'BP and Mobil – similar in size but different in the way they are'.

Exhibit 28 | Mobil's pre-alliance market share, 1991–5

	ESTIMATED MARKET SHARE					Rank
	1991	1992	1993	1994	1995	
Benelux	2.3%	2.2%	2.2%	2.3%	2.9%	8
France	5.5	5.3	4.5	4.6	4.3	6
Germany	7.1	7.4	7.5	7.3	7.1	7
Italy						
Spain/Portugal	2.2	2.0	2.1	2.8	2.6	6
United Kingdom	5.0	5.2	4.9	5.2	5.3	6
Ireland						
Austria	12.0	12.4	12.2	13.0	12.9	3
Switzerland	2.7	2.8	2.8	2.6	2.0	8
Denmark						
Norway	6.6	3.1	0.1	0.1	0.1	
Sweden						
Finland						
Greece	11.9	12.2	11.2	11.1	11.4	3
Turkey	10.9	10.8	12.6	12.9	12.6	3

Source: Woods Mackenzie.

Exhibit 29 | Structure of the BP–Mobil alliance



commercial customers, in Western and Eastern Europe (including west Russia), as well as in Turkey and Cyprus. The deal did not extend to international operations such as exploration and production, international trading, and basic research and development. Aviation fuels and lubricants, marine fuels and lubricants, and shipping, as well as natural gas marketing and chemicals, were also excluded.

In each country, Mobil and BP would combine their fuel and lubricant businesses through two separate partnerships, one for fuels, one for lubricants. BP would operate the fuels business as a whole, while Mobil would operate the lubricants business. All 8 000 service stations in the combined network would be rebranded with BP colours. They would display the alliance's logo and distribute Mobil oils.

BP as Fuels Operator and Mobil as Lubricants Operator would be controlled by a supervisory committee which would approve business plans, major acquisitions, closures, disposals and investments, and oversee the national Fuels and Lubricants partnerships. BP and Mobil would have the power to veto any of the committee's decisions. Exhibit 29 shows the alliance's organisational design.

BP and Mobil would have different equity stakes in each business: in fuels, BP would have 70 per cent and

Mobil 30 per cent; in lubricants, Mobil would hold 51 per cent and BP 49 per cent. This reflected the value of the two partners' assets in February 1996 as well as their strength and expertise across Europe. Profits and losses in each partnership would be shared in the same proportion as the firms' equity stakes. If either partner contributed less assets than the agreed ratio in a given country, it would have to bridge the gap through cash.

BP and Mobil would hand over all relevant fuels and lubricants assets to the joint venture (including 10 refineries, terminals, retail sites, pipelines and truck fleets). BP would transfer its lubricants activities to Mobil, and Mobil would transfer its fuels activities to BP. Even though the ownership of assets would not be transferred, the joint venture would enjoy indefinite and exclusive use of those assets. Employees would transfer from one company to the other where appropriate. Central services (such as information technology, human resources, legal and accounting management) would be merged under BP management. The new structure was expected to be fully implemented by mid-1998.

The expected benefits

The alliance would have US\$5 billion in assets (US\$3.4 billion from BP) and sales of US\$20 billion, with an

estimated 12 per cent market share in fuel retail (10 per cent according to the European Commission) and 18 per cent in lubricants. Combining the two retail networks would lead to redundant sites which could be sold without affecting overall sales volume. This and other asset disposals would produce one-off revenues of US\$200 million. However, this one-off benefit would be more than offset by exceptional charges to cover the costs of the alliance in its first year (US\$490 million for BP and US\$330 million for Mobil). The deal was also expected to produce annual savings of US\$400–500 million (most would come in the five largest markets) from three main sources.

Eliminating duplication (60 per cent of expected savings)

Most of the savings would come from operating as one business instead of two. This included operating a single accounting organisation and computer system. In refining, BP and Mobil would consolidate their portfolio, selling assets where there was a clear overlap in capacity (this was the case for three refineries in Bavaria, among others), a move that would maximise capacity utilisation. Both companies had found it difficult to find buyers for individual refineries in the past, but they hoped that a range of assets would be easier to sell.

Synergies (25 per cent)

These would arise from the complementarity of the two partners' downstream organisations. In terms of geography, a bigger network of stations with the right spread across Europe would cut distribution costs. In the United Kingdom, for instance, Mobil's network in the south of England complemented BP's strong presence in Scotland. In terms of product range, BP's strength in fuels complemented Mobil's leadership in lubricants. Duplicated storage and distribution facilities would be eliminated. The alliance would manage fuel storage at a pan-European level, ensuring a better balance relative to demand and reducing dependence on expensive external storage.

Thousands of jobs across Europe were earmarked for cuts, many from closing down overlapping service stations. In particular, between 2 000 and 3 000 non-service-station jobs (out of a total 17 500) would be cut. BP and Mobil were already the industry's cost leaders in petrol retailing; they had built increasingly large self-service stations and their combined network had lower costs than the small operators. Many competitors (especially national companies such as Total, Elf, Agip and Repsol) were thought to be unable to match those

cuts. Their governments, opposed to layoffs and fearing to lose control of a 'strategic' industry, were unlikely to let them merge or enter cost-cutting alliances.

Scale (15 per cent)

More refineries spread across major markets would reduce high transport costs to the retail site (shown in Exhibit 30). In many cases, this would obviate the need to buy from competitors.⁴ In the United Kingdom, BP had been forced to buy from other refiners because its refinery at Grangemouth, in Scotland, was too far from its retail network concentrated in the south of England. The alliance would now source from Mobil's refinery at Coryton. In France, the situation was similar: BP's refinery at Lavera served southern France and the Mediterranean market, but most of its petrol stations were in the Paris area. This forced it to buy from competitors. The alliance could use Mobil's refinery at Gravenchon to supply the Paris region. If buying from competitors was still necessary, at least BP and Mobil would have a stronger hand to negotiate.

The alliance could deliver better logistics, streamlined management processes, more efficient procurement, and economies of scale which BP saw as vital in the downstream industry. Together, Mobil and BP would be able to compete on prices with the largest European players. In particular, greater power in procurement, especially in lubricants packaging and non-fuel retail site supplies, was an obvious benefit.

Beyond cash savings

The two partners also expected other advantages from combining their operations. 'The key issue is competitive performance,' said John Browne, CEO of BP. 'BP and Mobil were number three and four in the European market; now we will be up there with the big players.' Together, they would be able to enter new markets, especially in central and Eastern Europe. They would achieve economies of scale in investment and logistics to enter these attractive markets. They would be in a better position to buy privatised companies, since governments favoured large investors.

A larger distribution network would also help attract food-retailing partners in new forecourt convenience stores and be better able to counter the supermarkets' negotiating power. Additional capacity to implement environmental investments would also be welcome. Finally, a wider geographic spread would make the joint venture less vulnerable to cyclical downturns as market conditions differed across Europe. For example, a strong, diversified pan-European player would be less affected by price wars in the United

Exhibit 30 | Transportation costs of petrol

Transportation	Cost
German rail	\$4.34 per mt + \$0.034 per km per mt
Polish rail	\$2.38 per mt + \$0.028 per km per mt
German road	\$0.046 per km per mt
Czech pipe	\$0.02 per km per mt
United Kingdom pipeline	\$0.013 to \$0.02 per km per mt
Rhine barge	\$0.022 to \$0.04 per km per mt
All amounts are in US dollars.	
mt = metric tonne	
Source: BP.	

Kingdom or domineering supermarkets in France. Size was seen as an important advantage, since it could smooth out some of the competitive conditions across Europe.

The uncertain future

Analysts' initial reaction to the deal was largely favourable. Most saw the alliance as an innovative response to the industry's problems; they underlined the advantages in terms of market power and brand power, as well as the complementariness of the two businesses. Both partners would gain from the deal: BP would be able to further cut costs and continue its expansion. For Mobil, it was an opportunity to reaffirm its position in the European market. 'The subtext of this BP-Mobil deal is that you need a 10 per cent market share to survive in the European market,' commented investment bank Morgan Stanley.

But there were some negative interpretations as well. In a sense, the alliance was an admission of failure: BP and Mobil were acknowledging their inability to achieve economies of scale on their own. Since neither could grow big enough and neither wanted to leave the market, they had to compromise. Another concern was that the deal still left Mobil and BP in a middle position, stuck between the national players (each strong in its own domestic market) and overall leaders Shell and Exxon. Some analysts also questioned the extent of possible synergies, considering that the two companies were not a perfect fit. 'A merger isn't a catch-all solution for the industry's fundamental problems,' said one. 'When you combine weak resources and low-quality assets, you do not make a strong company.'

While BP and Mobil had deliberately avoided an acquisition, the partnership still raised governance issues. Both partners had to give up a measure of control

and flexibility. The supervisory committee had considerable operational independence, but it remained subject to a veto from either company. While Mobil and BP both had a lot of experience in managing upstream alliances, no oil company had ever attempted such an ambitious deal downstream. Initially, their interests seemed aligned, but questions about the longer term remained.

There was also the tricky Aral issue. Mobil was now allied with two competing groups. Given the strength of the BP-Mobil marketing network, Aral was the clear loser. Some analysts felt that Mobil should sell its stake to enable Aral to find another partner. Others criticised Mobil's ability to manage complex alliances as the European Commission began investigating the two joint ventures.

The daunting task of actually merging operations still lay ahead. BP and Mobil executives were aware that most large mergers, no matter their strategic logic, failed to create value for shareholders. The challenges involved in bringing together different products, services, management systems and cultures, as well as workforces, while competing in the marketplace often precluded benefits. These issues could be even more problematic in this deal, because BP and Mobil continued to compete as independent corporations in petrol and other businesses elsewhere in the world.

Analysts also wondered how the relationship between the two partners would evolve over time. What if the deal turned out to be a half-hearted compromise that neither side was fully satisfied with? Neither was there a guarantee that European Union regulators would approve the deal. The combined market share of the two companies gave them a strong presence in several countries. Determined to root out anti-competitive behaviour, the European Commission was

targeting large, headline-grabbing mergers. If the alliance was shown to establish a dominant position that significantly restricted competition, the Commission could stop the deal. To overcome this hurdle, BP and Mobil had to provide enough information for the Commission to make a quick decision and they had to demonstrate that there was no threat to competition.

Commentators were already speculating about how BP and Mobil's competitors would respond to the move. Was it the beginning of industry-wide realignment? The next few years could be crucial. What would the two companies have to do to turn their deal into a success? Was the deal a masterstroke, or insufficient as some claimed? What would Mr Browne have to do to keep the performance of BP on track?

Endnotes

- 1 Known as gasoline in the United States. We use the word 'petrol' throughout to refer to retail motor fuels (petrol, diesel and other refinery products), unless otherwise specified.
- 2 One barrel equals 42 US gallons, or 159 litres.
- 3 The world's largest refinery was at Yukong in South Korea (770 000 bpd).
- 4 Because even the integrated oil companies didn't have refineries near all their major markets, they were often faced with a difficult choice: either they bought fuels internally and paid the cost of shipment, or they purchased from competitors. For this reason, major refining players such as Shell and Exxon often managed to extract high prices from retailers.

Case 4

Compaq in crisis

Adrian Elton

Eckhard Pfeiffer was named CEO of Compaq Computer Corporation in 1991. Since 1991, Compaq's annual revenues have increased almost ten times (see Exhibit 1) and its stock price has increased 1 072 per cent.¹ Compaq became the world's largest PC vendor in 1994 – two years ahead of schedule. In 1998, it was named Company of the Year by *Forbes* magazine. 'As long as Pfeiffer is at the wheel, Compaq will continue to execute with relentless efficiency,' said *Fortune* magazine in 1996.² In 1998, *The Economist* declaimed, 'Compaq's rivals now fall into two categories: those it is leaving behind and those whose corporate markets it threatens.'³

On 18 April 1999, Eckhard Pfeiffer was unceremoniously fired by Compaq's board of directors. How did the man who turned Compaq around in 1991 and built it into the premier PC vendor end up in such a position? What strategic decision during his tenure led to his downfall? What problems has he bequeathed to the CEO who follows him?

Company history

Compaq was founded in 1982 by three former Texas Instruments executives, Rod Canion, Jim Harris and Bill Murto. Their guiding idea was to build a 'portable' version of the IBM PC. They persuaded Benjamin Rosen of Sevin Rosen Management Company to fund a prototype, and later the company, and Compaq, was born. Rod Canion was its first president and Rosen became chairman of the board.

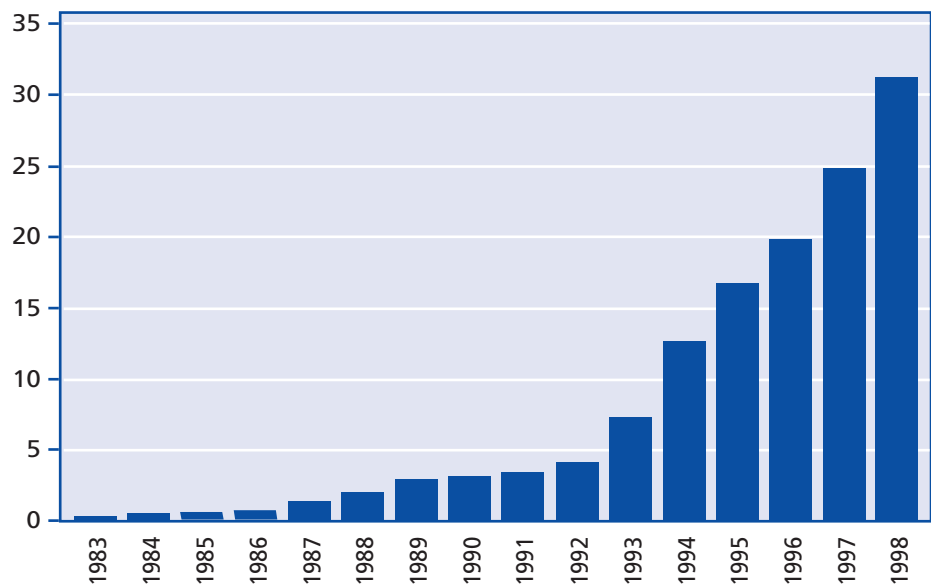
Compaq had two major advantages. First, it built an IBM-compatible machine that could run IBM software right out of the box. Demand for PCs was so great that IBM couldn't keep up, and dealers were happy to have Compaq fill the gaps.⁴ Second, Compaq didn't develop its own sales force and so its dealers didn't have any direct competition from the company. This was in stark contrast to the other major computer makers of the time, IBM and Apple.⁵

Compaq began setting records in its first year of operation with sales of US\$111 million. This was a record in first-year sales for a new business in any industry. In 1983, it began to sell in Europe and shipped its 100 000th PC. In 1985, the company began trading on the New York Stock Exchange and earned a place on the *Fortune* 500 list. No other company has grown so fast.

In 1986, Compaq became a serious threat to IBM by introducing a computer that used Intel's new 386 processor nine months before IBM did. Sales continued to increase, breaking US\$1 billion in 1987. Compaq introduced the first battery-powered laptop in 1988, and revenues that year were US\$2.1 billion, twice what they were the previous year. In 1990, international sales topped US sales for the first time, making Compaq a truly global corporation. Total sales were US\$3.2 billion, second only to IBM. All this in less than a decade.

In 1991, Compaq experienced its first hard times. There was a general industry downturn, and Compaq had the first layoffs in its history, releasing 12 per cent of its workforce. On 24 October, a day after reporting Compaq's first quarterly loss, Rod Canion was 'unexpectedly removed'⁶ from his position as CEO, and Eckhard Pfeiffer succeeded him.

This case was prepared under the direction of Professor Robert E. Hoskisson. The case is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative or strategic situation.

Exhibit 1 | Compaq's revenue growth, 1983–98 (US\$m)

Sources: *Compaq Home Page*, Financial Highlights: www.compaq.com/corporate/1998ar; P. Burrows, 1994, 'Compaq stretches for the crown', *Business Week*, 11 July, p. 140; 'Compaq reports record 1992 sales', 1993, *Business Wire*, 26 January; 'Compaq's history', 1991, *The Atlanta Journal and Constitution*, p. C3; 'Compaq Computer financial results', 1989, *Business Wire*, 1 February; 'Compaq Computer financial results', 1986, *Business Wire*, 1 February; 'Compaq Computer financial results', 1985, *Business Wire*, 11 February; *Christian Science Monitor*, 1984; 'Compaq wins by thinking big', *The San Diego Union-Tribune*, 19 April, p. D6.

Ben Rosen indicated that Canion's dismissal was not a knee-jerk reaction to bad quarterly results. He indicated that the board had been discussing creating an 'office of the president' to be shared by Canion and Pfeiffer, but Canion was not pleased by the idea. Forced to choose between them, the board opted in favour of Pfeiffer, mainly because of his international experience in a rapidly globalising industry.⁷

Michael Swavely, former president of Compaq's North American operations who retired in July 1991, commented, 'Change was overdue at Compaq.' Past success had generated a 'self-satisfied view of the world' that produced a reluctance to change, a fatal attribute in any industry, but especially in computer technology.⁸ The reasons Rosen gave for Compaq's falling sales and declining market share were tardiness in lowering prices and not enough emphasis on its core market, desktop PCs.⁹ Rod Canion had believed that Compaq could sell at a higher price based on its brand reputation for quality, and the company quickly found that was a fallacy.¹⁰

Compaq under Eckhard Pfeiffer

Eckhard Pfeiffer began his career at Compaq in 1983 when he left Texas Instruments to launch Compaq's

European operation. He was very successful, opening 20 subsidiaries and increasing sales in Europe, accounting for 54 per cent of Compaq's revenues in 1990.¹¹ Rod Canion brought Pfeiffer to Houston in January 1991 to be chief operating officer, and he succeeded Canion as CEO in October of 1991.

The first thing Pfeiffer did as CEO was cut the gross margins from 35 to 27 per cent¹² by slashing prices and effectively declaring war on the companies who built clones, which at that time held 60 per cent of the market.¹³ He also fired 25 per cent of the workforce and increased the number of resellers.¹⁴ Even amid restructuring, Compaq still managed to finish the year with increased revenue of US\$3.3 billion, slightly up from US\$3.1 billion the year before. Pfeiffer, with vision and determination, set a goal: Compaq will be the world's biggest PC producer in 1997 – in only six years. Industry analysts didn't think he could do it in such a short time.¹⁵

The first Compaq computers were high in performance and high in price, and they sold well until competitors introduced lower-priced machines with fewer extras.¹⁶ Compaq regrouped and in 1992 introduced a new low-cost PC called the ProLinea. There was 'a lot of doubt', Pfeiffer recalls. 'Would we ... bastardize the Compaq name?'¹⁷ Instead, the ProLinea

put Compaq back on track for continued growth, rapidly becoming the company's best-selling PC.¹⁸ Compaq nearly doubled its US market share to 23 per cent, surpassing both IBM and Apple. It also emerged as the favoured PC supplier in Europe, holding 10.3 per cent market share.¹⁹ Revenues continued to rise, reaching US\$4.1 billion at the end of the year.²⁰

In August 1993, Compaq took another giant stride forward and introduced the Presario, another PC directed towards individual consumers, especially those with little or no previous computing experience. The Presario broke all the records at Compaq, selling twice as fast as the ProLinea in the first 60 days.²¹ The Presario quickly became, and has remained, Compaq's mainstay, and the company finished the year with US\$7.2 billion in revenues.

In January 1994, the business world was shocked when Compaq announced that it would no longer exclusively use Intel's microprocessor chips in its computers. In explaining the choice to buy from Advanced Micro Devices (AMD), Compaq told the press that AMD was more than just an Intel clone; it also had products that would potentially fill some holes where Intel did not compete.²² Compaq also began to sell the Presario in Japan in 1995, traditionally a tough market for American companies.

Pfeiffer convened a company meeting in an arena in Houston in January 1995 where, in front of 16 000 employees and their families, he announced, 'We are No. 1! We made it in 1994! We've replaced IBM as the world's top PC vendor!'²³ Compaq had reached a six-year goal in only two years. Although Compaq products were not all that original, it had realised this accomplishment through exceptional execution. When Pfeiffer took over, he began by cutting prices and costs, not by looking for brilliant new engineering. He said, 'A ground rule is to set very aggressive cost goals to get very attractive entry-level products.'²⁴ Compaq finished 1994 with US\$10.9 billion in sales.

Having conquered the PC market, Compaq shifted its strategic focus slightly in 1995. It began to add value to the computers it sold, emphasising built-in networking and system management features.²⁵ The company also launched a worldwide service and support system to assure information technology workers that Compaq systems could reliably run business-critical applications and that the company could deliver the service and support they required. This brought Compaq one step closer to becoming a computer company rather than just a PC company.²⁶ Deciding to operate in the service sector as well as the hardware sector put the company in more direct

competition with industry giants Hewlett-Packard and IBM.

Compaq also decided to move into the networking business and signed a joint venture deal with Cisco Systems to build low-cost gear to connect servers to networks. Likewise, it signed a marketing agreement with Germany's ITK, which produces modems that link portable PCs to servers. It also closed a deal with Thomas-Conrad Co., a manufacturer of local-network cards for PCs. The final transaction in November 1995 was the acquisition of NetWorth, Inc., a company that makes high-speed network gear. All of this gave Compaq the technology to offer a complete networking package to its customers.²⁷ Revenues continued to rise, and the company finished the year with US\$14.8 billion in sales.²⁸

In 1996, Compaq landed two big contracts, one with Smith Barney and the other with General Motors. The contracts included purchase of both PCs and servers, a major step forward for enterprise-wide client-server computing.²⁹ Compaq's ProLiant server captured nearly 80 per cent of the Pentium server market, and Compaq shipped its 1 millionth server in November 1996, the first company in the industry to reach this milestone.³⁰

However, things were beginning to strain. In March, Pfeiffer had to warn analysts that Compaq might not meet its first-quarter earnings estimates, and the stock plunged. He acted quickly, ordering incentives for dealers and price cuts to lift demand. Revenues for the quarter jumped 42 per cent, and the stock recovered. This should have been cause for celebration, but the cost to the company of hitting the growth target was a drop in profit margin to 20 per cent – the lowest it had ever been. A troubling fact emerged: Compaq had been running twice as fast just to stay in place. Sales and revenues had increased, but profits hadn't moved. Pfeiffer wanted the company to continue growing at the rapid rate of the past years and reach US\$40 billion in revenues by the year 2000. Following a meeting with managers from around the world, a new strategy was forged: move aggressively into new product areas that will make Compaq a full-line information-technology company, capable of competing with IBM and Hewlett-Packard.³¹ Also, a new strategic approach was needed because IBM had reversed the trend and begun to take PC market share from Compaq.³²

In May 1997, Compaq announced another step into the networking business by acquiring Microcom, Inc., a company that makes networking gear. The line between the networking business and the computer business had become increasingly blurry, as computer companies

rushed to increase sales in the lucrative industry. Also, in June, Compaq announced that it was expanding by purchasing Tandem Computers, another computer maker, which helped the company expand its line to include more powerful servers and parallel commercial systems.³³

More symptoms of internal problems cropped up in 1997, as Pfeiffer had to make an extra effort to soothe its resellers after Compaq officials said they wanted a 'more direct relationship with customers'. Because of the inroads that Dell Computer had made into Compaq's sales, many resellers interpreted the remark to mean that Compaq was seriously considering turning to the direct on-line business model practised by Dell. Pfeiffer had to summon distributors to the company's Houston headquarters and reassert his commitment to Compaq's traditional distribution channels.³⁴

In October 1997, Compaq paid its first dividend and finished the year with sales of US\$24.5 billion.³⁵ However, its next move surprised the industry; in 1998, Compaq acquired Digital Equipment Company (DEC) for US\$9.6 billion – the largest computer buyout in history.³⁶ Digital, which was founded in 1957, was one of IBM's original competitors. It helped to bring computers out of back offices and into the hands of the general public, giving birth to the minicomputer market. When Compaq was formed, Digital was second only to IBM. However, bad leadership and bad technology decisions had made Digital into a second-tier player.³⁷

The acquisition of Digital considerably filled out Compaq's product line. Digital specialised in higher-end computers: workstations and Internet servers. More important, Digital brought to Compaq an excellent, large service and support organisation used to working with big companies and provided Compaq with the entrance into an upper-scale big business market that it had been trying to achieve for several years.³⁸ Additional assets were the Alta Vista Web search engine (which was later sold to KPMG) and the blazingly fast Alpha 64 bit processor chip. Analysts expected Compaq to bring its low-cost, no-holds-barred PC economics into the high-end computing markets that were dominated by IBM, Hewlett-Packard and Sun Microsystems. Such an approach could have potentially revolutionised the high-end computing business, and would make Compaq's regular PC business more competitive with Dell and Gateway 2000. Although some commentators raised concerns about the difference between the corporate cultures at Digital and Compaq, the merger moved forward and was finalised on 11 June 1998.

At the 1998 PC Expo trade show, Pfeiffer was invited to give the keynote address. In his speech, he discussed the five key areas that Compaq's strategy was focused on and what it was doing to accomplish each:

- *Industry standard computing*: 'Anywhere there is standards-based computing, Compaq wants to be the driver, whether it's in your home, your business or your car.'
- *Business critical computing*: Compaq will continue to invest in high-performance 64-bit computing with its Alpha chip.
- *Global service and support*: Compaq now has more than 25 000 service professionals around the world who can give customers support and availability services, systems integration and operations management. This gives customers a single point of accountability and lowers the cost and risk of ownership.
- *Cost-effective solutions for the enterprise*: 'We will focus on solutions that build on our leadership in enterprise platforms, expertise in key markets, service capabilities, and partnerships with industry-leading companies.'
- *Customers*: Compaq will leverage the account-based customer relationships nurtured by Digital and Tandem and combine them with Internet-based selling to provide customers with the most flexibility and choice. Compaq wants to be 'a strategic partner whose mission is to give you what you need, when you need it, and how you want it, at the lowest total cost'.³⁹

At the end of 1998, Compaq had US\$31.2 billion in sales revenues and, with the acquisition of Digital, was one of the largest computer companies in the world. It had a definite strategy, and although build-to-order companies were beginning to take away market share, it still had commanding market share.

The firing

On 9 April 1999, Pfeiffer announced to Wall Street that Compaq would probably not meet earnings expectations for the quarter; that they would in fact be about half of what analysts predicted. Compaq's stock plummeted on the news.⁴⁰

Benjamin Rosen, chairman of Compaq's board of directors, called a board meeting without Pfeiffer, and the board voted him out. On 18 April, Pfeiffer handed in his resignation to Compaq's board of directors. Rosen and two other board members, Frank P. Doyle and Robert T. Enloe, formed the Office of the Chief

Executive to run the company while they searched for another CEO. This office was not intended to be a passive caretaker of the company. Rosen said, 'The board is committed to move quickly to select the right Chief Executive Officer to lead the next era of Compaq's growth and development. In the interim, we will move decisively to take those actions that are indicated.'⁴¹

So where did Pfeiffer go wrong? What grave mistakes did he make that merited his removal as CEO? When he announced the quarterly results (or lack thereof), he attempted to blame Compaq's poor performance on a generally weak demand in the PC industry, lower profit margins and competitive pricing.

As with Rod Canion, he was not removed for simply having a bad quarter. The bad quarterly results were merely symptomatic of larger internal problems. Pfeiffer's complaints about weak demand, lower profit margins and competitive pricing were valid, but the other major PC makers (IBM, Dell, Hewlett-Packard and Gateway) were not struggling in the same way as Compaq. Even Rosen had said as much when he commented that Compaq itself was largely at fault for its disappointing financial performance.⁴² He also added that problems at Compaq were more severe than at first glance, and he wished they'd replaced Pfeiffer a year earlier.⁴³

To arrive at this point, Pfeiffer had begun to isolate himself from employees, even some of his own vice presidents and higher executives. He oversaw the construction of an executive parking garage at a company where parking places had never been reserved, visibly separating himself from the other employees. Security on the executive floor was repeatedly increased and access increasingly restricted. Pfeiffer and his inner circle worked out the acquisition of Digital, and the rest of the senior executives only found out about it the night before it was announced to the press. Apparently, Pfeiffer had become too insular, not open to feedback and new ideas from those below.⁴⁴

When he replaced Canion as CEO in 1991, Pfeiffer's aggressive initiatives changed Compaq's fortunes and turned the company around. But he seemed to have become less definite about making decisions. 'He was paralyzed by the speed with which the market was changing, and he couldn't make the difficult decisions,' says one former executive.⁴⁵

As a result of his indecision, there was a failure to execute as effectively as Compaq had in the past. 'Pfeiffer is not supposed to be the guy who fails on implementation,' says Jonathon Eunice, an analyst at

Illuminata Inc. 'Everyone talks about keeping the CEO accountable; almost no one does it. But [Rosen's] not afraid to fire his main guy and move on.' Eunice continues, 'The operations have been so sloppy for the second year in a row that it's almost staggering how off those numbers have been.'⁴⁶ The reason the office is called 'Chief Executive Officer' is because the CEO should execute strategy. Pfeiffer was no longer following through, getting things done, delivering on commitments. Benjamin Rosen told the press, 'The change [will not be in] our fundamental strategy – we think that strategy is sound – but in execution. Our plans are to speed up decision-making and make the company more efficient.'⁴⁷

Over time, Pfeiffer began to focus on being number one and forgot about understanding the customer. Long-time chief strategist Robert Stearns, who left Compaq in June 1998, says, 'In his quest for bigness, he lost an understanding of the customer and built what I call empty market share – large but not profitable.'⁴⁸ The acquisitions of Tandem Computers and especially of Digital Equipment were indicative of this flaw. Against the advice of some of the senior executives, Pfeiffer and his tiny inner circle negotiated for Digital and presented it to the rest of the company after it was already completed. 'Buying Digital played into Eckhard's fantasy, but it's turning out to be a beast that's consuming the company,' said one former executive.⁴⁹ Digital had proved to be tougher to integrate than predicted: the corporate cultures were more incompatible than first thought, and Compaq seemed to have lost its way, although it was likely to reach Pfeiffer's ambitious goal of US\$40 billion in earnings by 2000.

While Pfeiffer bears extensive blame for the company's poor performance, he should also be given a great deal of credit. Since becoming CEO in 1991, he turned Compaq around more than once and helped it grow into a tremendous power in the PC industry. 'Eckhard Pfeiffer oversaw a period of stunning growth in Compaq's history,' said Rosen. 'All those who benefited from that growth owe him a debt of gratitude.'⁵⁰ (See Exhibit 2 for Compaq's financial performance from 1994 to 1998.)

Wanted: CEO for a large Fortune 500 company

The board's search for a new CEO went on for three months. Rumours were rampant as many different people were considered for the job. Finally, on 22 July

Exhibit 2 | Compaq consolidated income statement, 1994–8 (year ended 31 December)

	1998	1997	1996	1995	1994
Revenue					
• Products	\$27 372	24 122	19 611	16 308	12 274
• Services	3 797	462	398	367	331
Total:	31 169	24 684	20 009	16 675	12 605
Cost of sales					
• Products	\$21 383	17 500	14 565	12 026	8 671
• Services	2 597	333	290	265	214
Total:	\$23 980	17 833	14 855	12 291	8 885
Other total costs	9 851	3 993	3 271	3 058	2 367
Income (loss) before taxes	(2 662)	2 758	1 883	1 326	1 353
Income taxes	81	903	565	43	365
Net income (loss)	(2 743)	1 855	1 318	893	988

All amounts are in US\$mn.

Source: Compaq Home Page, 1998 Annual Report:
www.compaq.com/corporate/1998ar/financials/5yr_summary_nf.html.

1999, Rosen called a press conference and announced that Michael A. Cappellas, the chief operating officer at Compaq, had been offered the job and accepted.

Cappellas joined Compaq in August 1998 as the chief information officer and became the acting chief operating officer in June 1999. Before coming to Compaq, he had worked at Schlumberger, an oil service company, for 15 years as an executive which included the company's first corporate director for information systems. In 1996, he moved to SAP America as the director of supply chain management, and in 1997 he joined Oracle Corporation as senior vice president before moving to Compaq.⁵¹

One of the first problems Cappellas faced as CEO was convincing shareholders and customers that he was capable of filling the job. Industry analysts were concerned by the appointment of an 'insider' who had been at the company for less than a year and who did not have any CEO experience. Many shared concerns about his ability to lead a large company like Compaq.⁵² This issue didn't bother Cappellas, who told the press, 'Strategy is about solving business problems. I've been in IT for many years, [so] I'm confident that I can do that.'⁵³

On the other hand, others were glad to see someone with a great deal of information technology experience appointed CEO. 'The companies that put marketing and sales people in as CEO never had to run a full enterprise infrastructure, and they have no idea what our [IT] problems are,' says Mike May, vice president of IT at Teknion Furniture Systems, a Compaq customer.⁵⁴ And

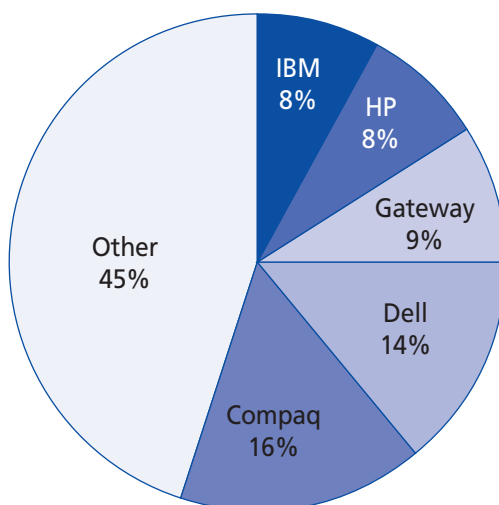
an analyst at J.P. Morgan & Co. comments, 'He is not well-known, but in terms of his qualifications, he's as credible as any of the other candidates we were hearing about.'⁵⁵ Cappellas's experience in information technology could prove to be an asset for Compaq. However, he faces a set of strong rivals.

Competition

Compaq competes with four other major competitors: Dell, IBM, Hewlett-Packard and Gateway. These companies will challenge Cappellas's capabilities in strategic leadership. (See Exhibit 3 for the PC market shares of Compaq and its dominant competition.)

Dell Computer

Dell was founded in 1985 by Michael Dell in Round Rock, Texas, with a unique premise: selling directly to the customer and bypassing resellers. Because it sells direct, Dell has greatly reduced inventory cost and turnover time. (Currently, turnover is every six days.) In 1996, Dell began to sell directly over the Internet, which now accounts for approximately 50 per cent of orders. Dell has used the Internet to offer specially catered customer service to its large corporate customers by constructing a personal web page for each. Dell has been increasing its high-profit product line for big business. Corporate sales account for most of Dell's revenue. In October 1999, Dell outsold Compaq for the first time in the PC market, increasing its market share to 18.1 per cent while Compaq's fell to 15.9 per cent.⁵⁶

Exhibit 3 | PC market share (first quarter 1999)

Source: PC Week Online, Archives: www.zdnet.com/pcweek/stories/jumps/0.4270,2263744,00.html.

IBM (International Business Machines)

IBM was incorporated in 1911. It was the first and biggest computer company, and pioneered the introduction of the PC in 1981. IBM faltered in the mid-1980s when confronted with Compaq and other rivals. In 1996, IBM began to regain market share in the PC market and came back to be second in the United States, after Compaq.⁵⁷ In 1999, it had US\$81.7 billion in revenues.

Despite its turnaround in the PC sector, IBM has shifted its focus to its more profitable services division and is marketing itself as an 'e-business', emphasising how it can help other companies get their companies online to take advantage of the Internet. This allows it to emphasise services such as high-end servers which also drives its hardware sales into a higher profit margin than PCs.⁵⁸ Currently, it holds 7.5 per cent of the PC market share in the United States.⁵⁹

Hewlett-Packard

Hewlett-Packard (HP) was founded by two engineers, Bill Hewlett and Dave Packard, in 1938 in a garage in Palo Alto, California. HP was incorporated the following year and has never stopped growing. Hewlett and Packard developed a remarkable corporate culture that encouraged communication and innovation, and their company has performed accordingly. HP began by building oscillators and evolved with the technology, building the scientific calculator that made slide rules obsolete, and eventually computers and other hardware.⁶⁰

HP gradually diversified into many areas, including communications and medical technology. In 1999, HP launched a new company, Agilent, consisting of its industry-leading test-and-measurement products, semiconductor products and chemical-analysis medical businesses. HP could now focus on its core business of computers and hardware, including printers. HP had computer-related revenue of US\$39.5 billion in its 1998 fiscal year⁶¹ and had 8 per cent of the PC market.⁶²

Gateway Computers

Gateway Computers was founded in 1985 by Ted Waitt. Like Dell, Gateway's business model is based on direct customised selling. In 1996, it began to sell computers on the Internet. Gateway has begun experimenting with various ways to earn more revenues from its customers. It opened 'Gateway Country Stores', bricks-and-mortar stores that are owned by the company; the stores carry no inventory but provide customer service and facilitate shopping for first-time customers by giving them the opportunity to test machines before buying. Gateway has also started up its own Internet service provider, which has taken off this past year, with half a million subscribers. At 9 per cent,⁶³ Gateway has more US PC market share than either IBM or HP.

Future challenges

Michael Cappellas has quite a formidable task in front of him. Although Compaq has many problems, it has just as many opportunities. The merger with Digital must be completed and assimilated into Compaq.⁶⁴

Buying Digital was to help Compaq grow into a full-line computer company offering a large range of products that would be driven by service solutions. Cappellas said, 'We underestimated the cultural issues and just the hard work it takes to integrate two companies like Compaq and Digital. And that drains a lot of energy in the field The core PC business was coming under attack, and the market was shifting just as the integration was draining management attention. So the timing was really bad.'⁶⁵

Completing Digital's integration will allow Compaq to expand into the profitable services business by leveraging Digital's admirable services arm. This will put it into direct competition with Hewlett-Packard and IBM. Business users are buying all-in-one packages of products and services. However, the solutions business at Compaq is not functioning well, while at the same time, margins in the PC business are falling.⁶⁶

To compete with Dell, Compaq must develop a better on-line strategy.⁶⁷ PCs depreciate approximately 1 per cent per week, and a company mustn't continually be caught with back inventory on its hands. To reduce the costs of back inventory, it needs to move to a more direct sales model.⁶⁸ When IBM tried selling direct, its dealers complained and IBM backed off; the company currently doesn't sell on-line. Compaq may need to find a happy medium between on-line and retail selling.

In May, a month after Pfeiffer's departure, Compaq announced a restructuring of the sales channel, reducing the number of places that it ships to from 29 to four.

This new 'Distributor Alliance Program' will reduce shipping and transaction costs.⁶⁹ It will also reduce inventories and thus cut the associated costs. All this will boost the bottom line, as well as open up many more opportunities and make Compaq a more viable competitor with Dell.

Cappellas stated, 'We did not do a good job of telling our story. We had fragmented marketing messages. Compaq had stood for the world's most powerful personal computing brand. Then we added the very high-end Tandem side, and then we brought in Digital. The customer lost track of who we were.'⁷⁰ Compaq has the opportunity to reinvent itself once more as a comprehensive computer company that can offer an enormous services benefit to its customers, instead of just being the 'world's top PC vendor'.⁷¹ This is a chance to realign the company's focus and become a computing behemoth like IBM.

In an interview, Cappellas was asked, 'Who do you worry about more, Dell or IBM?' He responded, 'I worry about IBM. They have done a very good job of positioning themselves around e-business. They sell the entire suite. They have a great solutions mindset. I have a great respect for them as a competitor.'⁷² At first glance, an observer would think that surely Dell should be Cappellas's big worry. However, as the quote indicates, Cappellas may seek to pursue a strategy similar to IBM's. Whatever strategic approach is taken, he has a significant challenge.

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Case 5

Gillette and the men's wet-shaving market

Lew G. Brown
Jennifer M. Hart
University of North
Carolina at Greensboro

SAN FRANCISCO

On a spring morning in 1989, Michael Johnson dried himself and stepped from the shower in his San Francisco Marina District condominium. He moved to the sink and started to slide open the drawer in the cabinet beneath the sink. Then he remembered that he had thrown away his last Atra blade yesterday. He heard his wife, Susan, walk past the bathroom.

'Hey, Susan, did you remember to pick up some blades for me yesterday?'

'Yes, I think I put them in your drawer.'

'Oh, okay, here they are.' Michael saw the bottom of the blade package and pulled the drawer open.

'Oh, no! These are Trac II blades, Susan, I use an Atra.'

'I'm sorry. I looked at all the packages at the drugstore, but I couldn't remember which type of razor you have. Can't you use the Trac II blades on your razor?'

'No. They don't fit.'

'Well, I bought some disposable razors. Just use one of those.'

'Well, where are they?'

'Look below the sink. They're in a big bag.'

'I see them. Wow, 10 razors for \$1.97! Must have been on sale.'

'I guess so. I usually look for the best deal. Seems to me that all those razors are the same, and the drugstore usually has one brand or another on sale.'

'Why don't you buy some of those shavers made for women?'

'I've tried those, but it seems that they're just like the ones made for men, only they've dyed the plastic pink or some pastel colour. Why should I pay more for colour?'

'Why don't you just use disposables?' Susan continued. *'They are simpler to buy, and you just throw them away. And you can't beat the price.'*

'Well, the few times I've tried them they didn't seem to shave as well as a regular razor. Perhaps they've improved. Do they work for you?'

'Yes, they work fine. And they sure are better than the heavy razors if you drop one on your foot while you're in the shower!'

'Never thought about that. I see your point. Well, I'll give the disposable a try.'

Engraph Corporation provided a grant to UNCG to support development of the case. Gillette's management cooperated in the field research for the case, which was written solely for the purpose of stimulating student discussion; the authors also drew from secondary sources. All incidents and events are real, but individual names were disguised at Gillette's request.

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History of shaving

Anthropologists do not know exactly when or even why men began to shave. Researchers do know that prehistoric cave drawings clearly present men who were beardless. Apparently these men shaved with clamshells or sharpened animal teeth. As society developed, primitive men learned to sharpen flint implements. Members of the early Egyptian dynasties as far back as 7 000 years ago shaved their faces and heads, probably to deny their enemies anything to grab during hand-to-hand combat. Egyptians later fashioned copper razors and, in time, bronze blades. Craftsmen formed these early razors as crescent-shaped knife blades, like hatchets or meat cleavers, or even as circular blades with a handle extending from the centre. By the Iron Age, craftsmen were able to fashion blades that were considerably more efficient than the early flint, copper and bronze versions.

Before the introduction of the safety razor, men used a straight-edged, hook-type razor and found shaving a tedious, difficult and time-consuming task. The typical man struggled through shaving twice a week at most. The shaver had to sharpen the blade (a process called stropping) before each use and had to have an expert cutler hone the blade each month. As a result, men often cut themselves while shaving; and few men had the patience and acquired the necessary skill to become good shavers. Most men in the 1800s agreed with the old Russian proverb: 'It is easier to bear a child once a year than to shave every day.' Only the rich could afford a daily barber shave, which also often had its disadvantages because many barbers were unclean.

Before King C. Gillette of Boston invented the safety razor in 1895, he tinkered with other inventions in pursuit of a product which, once used, would be thrown away. The customer would have to buy more, and the business would build a long-term stream of sales and profits with each new customer.

'On one particular morning when I started to shave,' wrote Gillette about the dawn of his invention, 'I found my razor dull, and it was not only dull but beyond the point of successful stropping and it needed honing, for which it must be taken to a barber or cutler. As I stood there with the razor in my hand, my eyes resting on it as lightly as a bird settling down on its nest, the Gillette razor was born.' Gillette immediately wrote to his wife, who was visiting relatives, 'I've got it; our fortune is made.'

Gillette had envisioned a 'permanent' razor handle on to which the shaver placed a thin, razor 'blade' with two sharpened edges. The shaver would place a top over

the blade and attach it to the handle so that only the sharpened edges of the blade were exposed, thus producing a 'safe' shave. A man would shave with the blade until it became dull and then would simply throw the used blade away and replace it. Gillette knew his concept would revolutionise the process of shaving; however, he had no idea that his creation would permanently change men's shaving habits.

Shaving in the 1980s

Following the invention of the safety razor, the men's shaving industry in the United States grew slowly but surely through the First World War. A period of rapid growth followed, and the industry saw many product innovations. By 1989, US domestic razor and blade sales (the wet-shave market) had grown to a US\$770 million industry. A man could use three types of wet shavers to remove facial hair. Most men used the disposable razor – a cheap, plastic-handled razor that lasted for eight to 10 shaves on average. Permanent razors, called blade and razor systems, were also popular. These razors required new blades every 11 to 14 shaves. Customers could purchase razor handles and blade cartridges together, or they could purchase packages of blade cartridges as refills. The third category of wet shavers included injector and double-edge razors and accounted for a small share of the razor market. Between 1980 and 1988, disposable razors had risen from a 22 per cent to a 41.5 per cent market share of dollar sales. During the same period, cartridge systems had fallen from 50 per cent to 45.8 per cent and injector and double-edge types had fallen from 28 per cent to 12.7 per cent. In addition, the development of the electric razor had spawned the dry-shave market, which accounted for about US\$250 million in sales by 1988.

Despite the popularity of disposable razors, manufacturers found that the razors were expensive to make and generated very little profit. In 1988, some industry analysts estimated that manufacturers earned three times more on a razor and blade system than on a disposable razor. Also, retailers preferred to sell razor systems because they took up less room on display racks and the retailers made more money on refill sales. However, retailers liked to promote disposable razors to generate traffic. As a result, US retailers allocated 55 per cent of their blade and razor stock to disposable razors, 40 per cent to systems and 5 per cent to double-edge razors.

Electric razors also posed a threat to razor and blade systems. Unit sales of electric razors jumped from

6.2 million in 1981 to 8.8 million in 1987. Low-priced imports from the Far East drove demand for electric razors up and prices down during this period. Nonetheless, fewer than 30 per cent of men used electric razors, and most of these men also used wet-shaving systems.

Industry analysts predicted that manufacturers' sales of personal care products would continue to grow. However, the slowing of the overall US economy in the late 1980s meant that sales increases resulting from an expanding market would be minimal and companies would have to fight for market share to continue to increase sales.

The Gillette Company dominated the wet-shave market with a 60 per cent share of worldwide razor market revenue and a 61.9 per cent share of the US market as of 1988. Gillette also had a stake in the dry-shave business through its Braun subsidiary. The other players in the wet-shave market were Schick with 16.2 per cent of market revenues, BIC with 9.3 per cent, and others, including Wilkinson Sword, with the remaining 12.6 per cent.

The Gillette Company

King Gillette took eight years to perfect his safety razor. In 1903, the first year of marketing, the American Safety Razor Company sold 51 razors and 168 blades. Gillette promoted the safety razor as a saver of both time and money. Early ads proclaimed that the razor would save US\$52 and 15 days' shaving time each year and that the blades required no stropping or honing. During its second year, Gillette sold 90 884 razors and 123 648 blades. By its third year, razor sales were rising at a rate of 400 per cent per year, and blade sales were booming at an annual rate of 1 000 per cent. In that year, the company opened its first overseas branch in London.

Such success attracted much attention, and competition quickly developed. By 1906, consumers had at least a dozen safety razors from which to choose. The Gillette razor sold for US\$5, as did the Zinn razor made by the Gem Cutlery Company. Others, such as the Ever Ready, Gem Junior and Enders, sold for as little as US\$1.

With the benefit of a 17-year patent, Gillette found himself in a very advantageous position. However, it was not until the First World War that the safety razor gained wide consumer acceptance. One day in 1917, King Gillette had a visionary idea: have the government present a Gillette razor to every soldier, sailor and marine. In this way, millions of men just entering the shaving age would adopt the self-shaving habit. By March 1918, Gillette had booked orders from the US

military for 519 750 razors, more than it had sold in any single year in its history. During the First World War, the government bought 4 180 000 Gillette razors as well as smaller quantities of competitive models.

Although King Gillette believed in the quality of his product, he realised that marketing, especially distribution and advertising, would be the key to success. From the beginning, Gillette set aside 25 cents per razor for advertising and by 1905 had increased the amount to 50 cents. Over the years, Gillette used cartoon ads, radio shows, musical slogans and theme songs, prizes, contests and cross-promotions to push its products. Perhaps, however, consumers best remember Gillette for its Cavalcade of Sports programs that began in 1939 with the company's sponsorship of the World Series. Millions of men soon came to know Sharpie the Parrot and the tag line, 'Look Sharp! Feel Sharp! Be Sharp!'

Because company founder King Gillette invented the first safety razor, Gillette had always been an industry innovator. In 1932, Gillette introduced the Gillette Blue Blade, which was the premier men's razor for many years. In 1938, the company introduced the Gillette Thin Blade; in 1946, it introduced the first blade dispenser that eliminated the need to unwrap individual blades; in 1959, it introduced the first silicone-coated blade, the Super Blue Blade. The success of the Super Blue Blade caused Gillette to close 1961 with a commanding 70 per cent share of the overall razor and blade market and a 90 per cent share of the double-edge market, the only market in which it competed.

In 1948, Gillette began to diversify into new markets through acquisition. The company purchased the Toni Company to extend its reach into the women's grooming-aid market. In 1954, the company bought Paper Mate, a leading marker of writing instruments. In 1962, it acquired the Sterilon Corporation, which manufactured disposable hospital supplies. As a result of these moves, a marketing survey found that the public associated Gillette with personal grooming as much as, or more than, with blades and razors.

In 1988, the Gillette Company was a leading producer of men's and women's grooming aids. Exhibit 1 lists the company's major divisions. Exhibits 2 and 3 show the percentages and dollar volumes of net sales and profits from operations for each of the company's major business segments. Exhibits 4 and 5 present income statements and balance sheets for 1986–8.

Despite its diversification, Gillette continued to realise the importance of blade and razor sales to the company's overall health. Gillette had a strong foothold in the razor and blade market, and it intended to use

this dominance to help it achieve the company's goal – 'sustained profitable growth'. To reach this goal, Gillette's mission statement indicated that the company should pursue 'strong technical and marketing efforts to assure vitality in major existing product lines; selective diversification, both internally and through acquisition;

the elimination of product and business areas with low growth or limited profit potential; and strict control over product costs, overhead expenses, and working capital'.

Gillette introduced a number of innovative shaving systems in the 1970s and 1980s as part of its strategy to

Exhibit 1 | Gillette product lines by company division, 1988

Blades and razors	Stationery products	Toiletries and cosmetics	Oral B products	Braun products
Trac II	Paper Mate	Adorn	Oral B toothbrushes	Electric razors
Atra	Liquid Paper	Toni		Lady Elegance
Good News	Flair	Right Guard		Clocks
	Waterman	Silkience		Coffee grinders and makers
	Write Bros.	Soft and Dri		
		Foamy		
		Dry Look		
		Dry Idea		
		White Rain		
		Lustrasilk		
		Aapri skin care products		

Exhibit 2 | Gillette's sales and operating profits by product line, 1986–8 (US\$m)

Product line	1988		1987		1986	
	Sales	Profits	Sales	Profits	Sales	Profits
Blades and razors	\$1 147	\$406	\$1 031	\$334	\$903	\$274
Toiletries and cosmetics	1 019	79	926	99	854	69
Stationery products	385	56	320	34	298	11
Braun products	824	85	703	72	657	63
Oral B	202	18	183	7	148	8
Other	5	(0.1)	4	2	48	(1)
Totals	<u>\$3 582</u>	<u>\$643</u>	<u>\$3 167</u>	<u>\$548</u>	<u>\$2 908</u>	<u>\$424</u>

Source: Gillette Company Annual Reports, 1985–8.

Exhibit 3 | Gillette's net sales and profit by business, 1984–8 (per cent)

Year	Blades and razors		Toiletries and cosmetics		Stationery products		Braun products		Oral B products	
	Sales	Profits	Sales	Profits	Sales	Profits	Sales	Profits	Sales	Profits
1988	32	61	28	14	11	9	23	13	6	3
1987	33	61	29	18	10	6	22	13	6	2
1986	32	64	30	16	11	3	20	15	5	2
1985	33	68	31	15	11	2	17	13	6	3
1984	34	69	30	15	12	3	17	12	3	2

Source: Gillette Company Annual Reports, 1985–8.

sustain growth. Gillette claimed that Trac II, the first twin-blade shaver, represented the most revolutionary shaving advance ever. The development of the twin-blade razor derived from shaving researchers' discovery that shaving causes whiskers to be briefly lifted up out

of the follicle during shaving, a process called 'hysteresis' by technicians. Gillette invented the twin-blade system so that the first blade would cut the whisker and the second blade would cut it again before it receded. This system produced a closer shave than a

Exhibit 4 | Gillette income statements, 1986–8 (US\$m except for per share data)

	1988	1987	1986
Net sales	\$3 581.2	\$3 166.8	\$2 818.3
Cost of sales	1 487.4	1 342.3	1 183.8
Other expenses	1 479.8	1 301.3	1 412.0
Operating income	614.0	523.2	222.5
Other income	37.2	30.9	38.2
Earnings before interest and tax	651.2	545.1	260.7
Interest expense	138.3	112.5	85.2
Non-operating expense	64.3	50.1	124.0
Earnings before tax	448.6	391.5	51.5
Tax	180.1	161.6	35.7
Earnings after tax	268.5	229.9	15.8
Earnings per share	2.45	2.00	.12
Average common shares outstanding, 000	109 559	115 072	127 344
Dividends paid per share	\$0.86	\$0.785	\$0.68
<i>Stock price range</i>			
High	\$49	\$45 7/8	\$34 1/2
Low	\$29 1/8	\$17 5/8	\$17 1/8

Source: Gillette Company Annual Reports, 1986–8.

Exhibit 5 | Gillette balance sheets, 1986–8 (US\$m)

		1988	1987	1986
Assets	Cash	\$ 156.4	\$ 119.1	\$ 94.8
	Receivables	729.1	680.1	608.8
	Inventories	653.4	594.5	603.1
	Other current assets	200.8	184.5	183.0
	Total current assets	1 739.7	1 578.2	1 489.7
	Fixed assets, net	683.1	664.4	637.3
	Other assets	445.1	448.6	412.5
	TOTAL ASSETS	2 867.9	2 731.2	2 539.5
Liabilities and equity	Current liabilities*	965.4	960.5	900.7
	Long-term debt	1 675.2	839.6	915.2
	Other long-term liabilities	311.9	331.7	262.8
	Equity†	\$ (84.6)	\$ 599.4	\$ 460.8

* Includes current portion of long-term debt: 1988 = \$9.6, 1987 = \$41.0, 1986 = \$7.6.

† Includes retained earnings: 1988 = \$1 261.6, 1987 = \$1 083.8, 1986 = \$944.3.

Source: Gillette Company Annual Reports, 1986–8.

traditional one-blade system. Gillette also developed a clog-free, dual-blade cartridge for the Trac II system.

Because consumer test data showed a 9-to-1 preference for Trac II over panellists' current razors, Gillette raced to get the product to market. Gillette supported Trac II's 1971 introduction, which was the largest new product introduction in shaving history, with a US\$10 million advertising and promotion budget. Gillette cut its advertising budgets for its other brands drastically to support Trac II. The double-edge portion of the advertising budget decreased from 47 per cent in 1971 to 11 per cent in 1972. Gillette reasoned that growth must come at the expense of other brands. Thus, it concentrated its advertising and promotion on its newest shaving product and reduced support for its established lines.

Gillette launched Trac II during a World Series promotion and made it the most frequently advertised shaving system in America during its introductory period. Trac II users turned out to be predominantly young, college-educated men who lived in metropolitan and suburban areas and earned higher incomes. As the fastest-growing shaving product on the market for five years, Trac II drove the switch to twin blades. The brand reached its peak in 1976 when consumers purchased 485 million blades and 7 million razors.

Late in 1976, Gillette, apparently in response to BIC's pending entrance into the US market, launched Good News!, the first disposable razor for men sold in the United States. In 1975, BIC had introduced the first disposable shaver in Europe; and by 1976 BIC had begun to sell disposable razors in Canada. Gillette realised that BIC would move its disposable razor into the United States after its Canadian introduction, so it promptly brought out a new blue plastic disposable shaver with a twin-blade head. By year's end, Gillette also made Good News! available in Austria, Canada, France, Italy, Switzerland, Belgium, Greece, Germany and Spain.

Unfortunately for Gillette, Good News! was really bad news. The disposable shaver delivered lower profit margins than razor and blade systems, and it undercut sales of other Gillette products. Good News! sold for much less than the retail price of a Trac II cartridge. Gillette marketed Good News! on price and convenience, not performance; but the company envisioned the product as a step-up item leading to its traditional high-quality shaving systems.

This contain-and-switch strategy did not succeed. Consumers liked the price and the convenience of disposable razors, and millions of Trac II razors began to gather dust in medicine chests across the country.

Many Trac II users figured out that for as little as 25 cents, they could get the same cartridge mounted on a plastic handle that they had been buying for 56 cents to put on their Trac II handle. Further, disposable razors created an opening for competitors in a category that Gillette had long dominated.

Gillette felt sure, however, that disposable razors would never gain more than a 7 per cent share of the market. The disposable razor market share soon soared past 10 per cent, forcing Gillette into continual upward revisions of its estimates. In terms of units sold, disposable razors reached a 22 per cent market share by 1980 and a 50 per cent share by 1988.

BIC and Gillette's successful introduction of the disposable razor represented a watershed event in 'commoditisation' – the process of converting well-differentiated products into commodities. Status, quality and perceived value had always played primary roles in the marketing of personal care products. But consumers were now showing that they would forgo performance and prestige in a shaving product – about as close and personal as one can get.

In 1977, Gillette introduced a new blade and razor system at the expense of Trac II. It launched Atra with a US\$7 million advertising campaign and over 50 million US\$2 rebate coupons. Atra (which stands for Automatic Tracking Razor Action) was the first twin-blade shaving cartridge with a pivoting head. Engineers had designed the head to follow a man's facial contours for a closer shave. Researchers began developing the product in Gillette's UK research and development lab in 1970. They had established a goal of improving the high-performance standards of twin-blade shaving and specifically enhancing the Trac II effect. The company's scientists discovered that moving the hand and face was not the most effective way to achieve the best blade-face shaving angle. The razor head itself produced a better shave if it pivoted so as to maintain the most effective shaving angle. Marketers selected the name 'Atra' after two years of extensive consumer testing.

Atra quickly achieved a 7 per cent share of the blade market and about one-third of the razor market. The company introduced Atra in Europe a year later under the brand name 'Contour'. Although Atra increased Gillette's share of the razor market, 40 per cent of Trac II users switched to Atra in the first year.

In the early 1980s, Gillette introduced most new disposable razors and product enhancements. Both Swivel (launched in 1980) and Good News! Pivot (1984) were disposable razors featuring movable heads. Gillette announced Atra Plus (the first razor with the patented Lubra-smooth lubricating strip) in 1985 just as

BIC began to move into the United States from Canada with the BIC shaver for sensitive skin. A few months later, Gillette ushered in Micro Trac – the first disposable razor with an ultra-slim head. Gillette priced the Micro Trac lower than any other Gillette disposable razor. The company claimed to have designed a state-of-the-art manufacturing process for Micro Trac. The process required less plastic, thus minimising bulk and reducing manufacturing costs. Analysts claimed that Gillette was trying to bracket the market with Atra Plus (with a retail price of US\$3.99 to US\$4.95) and Micro Trac (US\$0.99), and protect its market share with products on both ends of the price and usage scale. Gillette also teased Wall Street with hints that, by the end of 1986, it would be introducing yet another state-of-the-art shaving system that could revolutionise the shaving business.

Despite these product innovations and introductions in the early 1980s, Gillette primarily focused its energies on its global markets and strategies. By 1985, it was marketing 800 products in more than 200 countries. The company felt a need at this time to coordinate its marketing efforts, first regionally and then globally.

Unfortunately for Gillette's management team, others noticed its strong international capabilities. Ronald Perelman, chairman of the Revlon Group, attempted an unfriendly takeover in November 1986. To fend off the takeover, Gillette bought back 9.2 million shares of its stock from Perelman and saddled itself with additional long-term debt to finance the stock repurchase. Gillette's payment to Perelman increased the company's debt load from US\$827 million to US\$1.1 billion, and put its debt-to-equity ratio at 70 per cent. Gillette and Perelman signed an agreement preventing Perelman from attempting another takeover until 1996.

In 1988, just as Gillette returned its attention to new product development and global marketing, Coniston Partners, after obtaining 6 per cent of Gillette's stock, engaged the company in a proxy battle for four seats on its 12-person board. Coniston's interest had been piqued by the Gillette-Perelman US\$549 million stock buyback and its payment of US\$9 million in expenses to Perelman. Coniston and some shareholders felt Gillette's board and management had repeatedly taken actions that prohibited its shareholders from realising their shares' full value. When the balloting concluded, Gillette's management won by a narrow margin – 52 to 48 per cent. Coniston made US\$13 million in the stock buyback program that Gillette offered to all shareholders, but Coniston agreed not to make another run at Gillette until 1991. This second takeover attempt

forced Gillette to increase its debt load to US\$2 billion and pushed its total equity negative to (US\$84.6 million).

More importantly, both takeover battles forced Gillette to 'wake up'. Gillette closed or sold its Jafra Cosmetics operations in 11 countries and jettisoned weak operations such as Misco, Inc. (a computer supplies business), and S.T. Dupont (a luxury lighter, clock and watchmaker). The company also thinned its workforce in many divisions, such as its 15 per cent staff reduction at the Paper Mate pen unit. Despite this pruning, Gillette's sales for 1988 grew 13 per cent to US\$3.6 billion, and profits soared 17 per cent to US\$268 million.

Despite Gillette's concentration on fending off takeover attempts, it continued to enhance its razor and blade products. In 1986, it introduced the Contour Plus in its first pan-European razor launch. The company marketed Contour Plus with one identity and one strategy. In 1988, the company introduced Trac II Plus, Good News! Pivot Plus and Daisy Plus – versions of its existing products with the Lubra-smooth lubricating strip.

Schick

Warner-Lambert's Schick served as the second major competitor in the wet-shaving business. Warner-Lambert, incorporated in 1920 under the name William R. Warner & Company, manufactured chemicals and pharmaceuticals. Numerous mergers and acquisitions over 70 years resulted in Warner-Lambert's involvement in developing, manufacturing and marketing a widely diversified line of beauty, health and well-being products. The company also became a major producer of mints and chewing gums, such as Dentyne, Sticklets and Trident. Exhibit 6 presents a list of Warner-Lambert's products by division as of 1988.

Warner-Lambert entered the wet-shave business through a merger with Eversharp in 1970. Eversharp, a long-time competitor in the wet-shave industry, owned the Schick trademark and had owned the Paper Mate Pen Company prior to selling it to Gillette in 1955. Schick's razors and blades produced US\$180 million in revenue in 1987, or 5.2 per cent of Warner-Lambert's worldwide sales. (Refer to Exhibit 7 for operating results by division, and Exhibits 8 and 9 for income statement and balance sheet data.)

In 1989, Schick held approximately a 16.2 per cent US market share, down from its 1980 share of 23.8 per cent. Schick's market share was broken down as follows: blade systems, 8.8 per cent; disposable razors,

4.1 per cent; and double-edged blades and injectors, 3.3 per cent.

Schick's loss of market share in the 1980s occurred for two reasons. First, even though Schick pioneered the injector razor system (it controlled 80 per cent of this market by 1979), it did not market a disposable razor until mid-1984 – eight years after the first disposable razors appeared. Second, for years Warner-Lambert had been channelling Schick's cash flow to its research and development in drugs.

In 1986, the company changed its philosophy; it allocated US\$70 million to Schick for a three-year period and granted Schick its own sales force. In spite of Schick's loss of market share, company executives felt

they had room to play catch-up, especially by exploiting new technologies. In late 1988, Schick revealed that it planned to conduct 'guerrilla warfare' by throwing its marketing resources and efforts into new technological advances in disposable razors. As a result, Warner-Lambert planned to allocate the bulk of its US\$8 million razor advertising budget to marketing its narrow-headed disposable razor, Slim Twin, which it introduced in August 1988.

Schick believed that the US unit demand for disposable razors would increase to 55 per cent of the market by the early 1990s from its 50 per cent share in 1988. Schick executives based this belief on their feeling that men would rather pay 30 cents for a disposable

Exhibit 6 | Warner-Lambert product lines by company division, 1988

Ethical pharmaceuticals	Gums and mints	Non-prescription products	Other products
Parke-Davis drug	Dentyne	Benadryl	Schick razors
	Sticklets	Caladryl	Ultrex razors
	Beemans	Roloids	Personal Touch
	Trident	Sinutab	Tetra Aquarium
	Freshen-up	Listerex	
	Bubblicious	Lubraderm	
	Chiclets	Anusol	
	Clorets	Tucks	
	Certs	Halls	
	Dynamints	Benylin	
	Junior Mints	Listerine	
	Sugar Daddy	Listermint	
	Sugar Babies	Efferdent	
	Charleston Chew	Effergrip	
	Rascals		

Exhibit 7 | Warner-Lambert's net sales and operating profit by division, 1985–8 (US\$m)

Division		Net sales				Operating profit/(loss)			
		1988	1987	1986	1985	1988	1987	1986	1985
Healthcare	Ethical products	\$1 213	\$1 093	\$ 964	\$ 880	\$ 420	\$ 351	\$ 246	\$ 224
	Non-prescription products	1 296	1 195	1 077	992	305	256	176	177
	Total healthcare	<u>2 509</u>	<u>2 288</u>	<u>2 041</u>	<u>1 872</u>	<u>725</u>	<u>607</u>	<u>422</u>	<u>401</u>
	Gums and mints	<u>918</u>	<u>777</u>	<u>678</u>	<u>626</u>	<u>187</u>	<u>173</u>	<u>122</u>	<u>138</u>
	Other products*	<u>481</u>	<u>420</u>	<u>384</u>	<u>334</u>	<u>92</u>	<u>86</u>	<u>61</u>	<u>72</u>
Divested businesses									(464)
	R&D					(259)	(232)	(202)	(208)
	Net sales and operating profit	<u>3 908</u>	<u>3 485</u>	<u>3 103</u>	<u>3 200</u>	<u>745</u>	<u>634</u>	<u>599</u>	<u>(61)</u>

* Other products include Schick razors, which accounted for US\$180 million in revenue in 1987.

Source: Warner-Lambert Company Annual Report, 1987; *Moody's Industrial Manual*.

razor than 75 cents for a refill blade. In 1988, Schick held an estimated 9.9 per cent share of dollar sales in the disposable razor market.

Schick generated approximately 67 per cent of its revenues overseas. Also, it earned higher profit margins on its non-domestic sales – 20 per cent versus its 15 per cent domestic margin. Europe and Japan represented the bulk of Schick's international business, accounting for 38 per cent and 52 per cent, respectively, of 1988's overseas sales. Schick's European business consisted of 70 per cent systems and 29 per cent disposable razors, but Gillette's systems and disposable razor sales were 4.5 and 6 times larger, respectively.

However, Schick dominated in Japan. Warner-Lambert held over 60 per cent of Japan's wet-shave market. Although Japan had typically been an electric shaver market (55 per cent of Japanese shavers use electric razors), Schick achieved an excellent record and reputation in Japan. Both Schick and Gillette entered the Japanese market in 1962; and their vigorous competition eventually drove Japanese competitors from the industry, which by 1988 generated US\$190 million in sales. Gillette's attempt to crack the market flopped because it tried to sell razors using its own salespeople, a strategy that failed because Gillette did not have the distribution network available to Japanese companies. Schick, meanwhile, chose to leave the distribution to Seiko Corporation. Seiko imported

razors from the United States and then sold them to wholesalers nationwide. By 1988, Schick generated roughly 40 per cent of its sales and 35 per cent of its profits in Japan. Disposable razors accounted for almost 80 per cent of those figures.

BIC Corporation

The roots of the BIC Corporation, which was founded by Marcel Bich in the United States in 1958, were in France. In 1945, Bich, who had been the production manager for a French ink manufacturer, bought a factory outside Paris to produce parts for fountain pens and mechanical lead pencils. In his new business, Bich became one of the first manufacturers to purchase presses to work with plastics. With his knowledge of inks and experience with plastics and moulding machines, Bich set himself up to become the largest pen manufacturer in the world. In 1949, Bich introduced his version of the modern ballpoint pen, originally invented in 1939, which he called 'BIC', a shortened, easy-to-remember version of his own name. He supported the pen with memorable, effective advertising; and its sales surpassed even his own expectations.

Realising that a mass-produced disposable ballpoint pen had universal appeal, Bich turned his attention to the US market. In 1958, he purchased the Waterman-Pen Company of Connecticut and then incorporated as Waterman-BIC Pen Corporation. The company changed

Exhibit 8 | Warner-Lambert income statements, 1986–8 (US\$000)

	1988	1987	1986
Net sales	\$3 908 400	\$3 484 700	\$3 102 918
Cost of sales	1 351 700	1 169 700	1 052 781
Other expenses	2 012 100	1 819 800	1 616 323
Operating income	544 600	495 200	433 814
Other income	61 900	58 500	69 611
Earnings before interest and tax	606 500	553 700	503 425
Interest expense	68 200	60 900	66 544
Earnings before tax	538 300	492 800	436 881
Tax	198 000	197 000	136 297
Non-recurring item	—	—	8 400
Earnings after tax	340 000	295 800	308 984
Retained earnings	1 577 400	1 384 100	1 023 218
Earnings per share	5.00	4.15	4.18
Average common shares outstanding (000)	68 035	71 355	73 985
Dividends paid per share	2.16	1.77	1.59
Stock price range			
High	\$79 1/2	\$87 1/2	\$63 1/8
Low	\$59 7/8	\$48 1/4	\$45

Source: Moody's Industrial Manual.

Exhibit 9 | Warner-Lambert balance sheets, 1986–8 (US\$000)

		1988	1987	1986
Assets	Cash	\$ 176 000	\$ 24 100	\$ 26 791
	Receivables	525 200	469 900	445 743
	Inventories	381 400	379 000	317 212
	Other current assets	181 300	379 600	720 322
	Total current assets	1 264 500	1 252 600	1 510 068
	Fixed assets, net	1 053 000	959 800	819 291
	Other assets	385 300	263 500	186 564
	Total assets	2 702 800	2 475 900	2 515 923
Liabilities and equity	Current liabilities*	1 025 200	974 300	969 806
	Current portion			
	long-term debt	7 100	4 200	143 259
	Long-term debt	318 200	293 800	342 112
	Equity	\$ 998 600	\$ 874 400	\$ 907 322

*Includes current option of long-term debt.

Source: *Moody's Industrial Manual*.

its name to BIC Pen in 1971 and finally adopted the name BIC Corporation for the publicly owned corporation in 1982.

After establishing itself as the country's largest pen maker, BIC attacked another market – the disposable lighter market. When BIC introduced its lighter in 1973, the total disposable lighter market stood at only 50 million units. By 1984, BIC had become so successful at manufacturing and marketing its disposable lighters that Gillette, its primary competitor, abandoned the lighter market. Gillette sold its Cricket division to Swedish Match, Stockholm, the manufacturer of Wilkinson razors. By 1989, the disposable lighter market had grown to nearly 500 million units, and BIC lighters accounted for 60 per cent of the market.

Not content to compete just in the writing and lighting markets, BIC decided to enter the US shaving market in 1976. A year earlier, the company had launched the BIC Shaver in Europe and Canada. BIC's entrance into the US razor market started an intense rivalry with Gillette. Admittedly, the companies were not strangers to each other – for years they had competed for market share in the pen and lighter industries. Despite the fact that razors were Gillette's primary business and an area where the company had no intention of relinquishing market share, BIC established a niche in the US disposable-razor market.

BIC, like Gillette, frequently introduced new razor products and product enhancements. In January 1985, following a successful Canadian test in 1984, BIC announced the BIC Shaver for Sensitive Skin. BIC claimed that 42 per cent of the men surveyed reported

that they had sensitive skin, while 51 per cent of those who had heavy beards reported that they had sensitive skin. Thus, BIC felt there was a clear need for a shaver that addressed this special shaving problem. The US\$10 million ad campaign for the BIC Shaver for Sensitive Skin featured John McEnroe, a highly ranked and well-known tennis professional, discussing good and bad backhands and normal and sensitive skin. BIC repositioned the original BIC white shaver as the shaver men with normal skin should use, while it promoted the new BIC Orange as the razor for sensitive skin.

BIC also tried its commodity strategy on sailboards, car-top carriers and perfume. In 1982, BIC introduced a sailboard model at about half the price of existing products. The product generated nothing but red ink. In April 1989, the company launched BIC perfumes with US\$15 million in advertising support. BIC's foray into fragrances was as disappointing as its sailboard attempt. Throughout the year, Parfum BIC lost money, forcing management to concentrate its efforts on reformulating its selling theme, advertising, packaging and price points. Many retailers rejected the product, sticking BIC with expensive manufacturing facilities in Europe. BIC found that consumers' perceptions of commodities did not translate equally into every category. For example, many women cut corners elsewhere just to spend lavishly on their perfume. The last thing they wanted to see was their favourite scent being hawked to the masses.

Despite these failures, BIC Corporation was the undisputed king of the commoditisers. BIC's success with pens and razors demonstrated the upside potential

Exhibit 10 | BIC Corporation's net sales and income before taxes, 1986–8 (US\$mnn)

		1988	1987	1986
Net sales	Writing instruments	\$118.5	\$106.7	\$91.7
	Lighters	113.9	120.0	115.0
	Shavers	51.9	47.1	49.6
	Sport	10.6	16.8	11.3
	Total	<u>294.9</u>	<u>290.6</u>	<u>267.6</u>
Profit/(loss) before taxes	Writing instruments	\$16.7	\$17.5	\$15.0
	Lighters	22.9	28.2	28.5
	Shavers	9.4	8.5	8.0
	Sport	(4.7)	(3.5)	(3.6)
	TOTALS	<u>44.3</u>	<u>50.7</u>	<u>47.9</u>

Source: BIC Annual Reports, 1986–8.

Exhibit 11 | BIC Corporation consolidated income statements, 1986–8 (US\$000)

		1988	1987	1986
Net sales		\$294 878	\$290 616	\$267 624
Cost of sales		172 542	165 705	147 602
Other expenses		81 023	73 785	67 697
Operating income		41 313	51 126	52 325
Other income		4 119	1 836	7 534
Earnings before interest and tax		45 432	52 962	59 859
Interest expense		1 097	2 301	11 982
Earnings before tax		44 335	50 661	47 877
Tax		17 573	21 944	24 170
Extraordinary credit		—	—	2 486*
Utilisation of operating loss carry forward		2 800	—	—
Earnings after tax		\$ 29 562	\$ 28 717	\$ 26 193
Retained earnings		159 942	142 501	121 784
Earnings per share		2.44	2.37	2.16
Average common shares outstanding (000)		12 121	12 121	12 121
Dividends paid per share		0.75	0.66	0.48
Stock price range	High	\$30 3/8	\$34 7/8	\$35
	Low	\$24 3/8	\$16 1/2	\$23 1/4

*Gain from elimination of debt.

Source: *Moody's Industrial Manual*; BIC Annual Reports.

of commoditisation, while its failures with sailboards and perfumes illustrated the limitations. BIC concentrated its efforts on designing, manufacturing and delivering the 'best' quality products at the lowest possible prices. And although the company produced large quantities of disposable products (for example, over 1 million pens a day), it claimed that each product was invested with the BIC philosophy: 'maximum service, minimum price'.

One of BIC's greatest assets was its retail distribution strength. The high profile the company enjoyed at supermarkets and drugstores enabled it to win locations in the aisles and display space at the checkout – the best positioning.

Even though BIC controlled only the number three spot in the wet-shaving market by 1989, it had exerted quite an influence since its razors first entered the US market in 1976. In 1988, BIC's razors generated US\$52

Exhibit 12 | BIC Corporation balance sheets, 1986–8 (US\$000)

		1988	1987	1986
Assets	Cash	\$ 5 314	\$ 4 673	\$ 5 047
	Certificates of deposit	3 117	803	6 401
	Receivables, net	43 629	41 704	32 960
	Inventories	70 930	59 779	50 058
	Other current assets	37 603	47 385	34 898
	Deferred income taxes	7 939	6 691	5 622
	Total current assets	168 532	161 035	134 986
	Fixed assets, net	74 973	62 797	58 385
	Total assets	243 505	223 832	193 371
Liabilities and equity	Current liabilities*	55 031	54 034	45 104
	Current portion long-term debt	157	247	287
	Long-term debt	1 521	1 511	1 789
	Equity	\$181 194	\$164 068	\$142 848

*Includes current portion of long-term debt.

Source: *Moody's Industrial Manual*.

million in sales with a net income of US\$9.4 million; BIC held a 22.4 per cent share of dollar sales in the disposable razor market. Exhibit 10 presents operating data by product line, and Exhibits 11 and 12 give income statement and balance sheet data.

The introduction of the disposable razor revolutionised the industry and cut into system razor profits. However, despite the low profit margins in disposable razors and the fact that the industry leader, Gillette, emphasised razor and blade systems, BIC remained bullish on the disposable razor market. In 1989, a spokesperson for BIC claimed that BIC 'was going to stick to what consumers liked'. The company planned to continue marketing only single-blade, disposable shavers. BIC stated that it planned to maintain its strategy of underpricing competitors, but it would also introduce improvements such as the patented metal guard in its BIC Metal Shaver. Research revealed that the BIC Metal Shaver provided some incremental, rather than substitute, sales for its shaver product line. BIC executives believed that the BIC Metal Shaver would reach a 5–8 per cent market share by 1990.

Wilkinson Sword

Swedish Match Holding Incorporated's subsidiary, Wilkinson Sword, came in as the fourth player in the US market. Swedish Match Holding was a wholly owned subsidiary of Swedish Match AB, Stockholm, Sweden. The parent company owned subsidiaries in the United States that imported and sold doors, produced resilient

and wood flooring, and manufactured branded razors, blades, self-sharpening scissors and gourmet kitchen knives. (Exhibits 13 and 14 present income statement and balance sheet data on Swedish Match AB.)

A group of swordsmiths founded Wilkinson in 1772, and soldiers used Wilkinson swords at Waterloo, at the charge of the Light Brigade and in the Boer War. However, as the sword declined as a combat weapon, Wilkinson retreated to producing presentation and ceremonial swords. By 1890, Wilkinson's cutlers had begun to produce straight razors, and by 1898 it was producing safety razors similar to King Gillette's. When Gillette's blades became popular in England, Wilkinson made stroppers to resharpen used blades. Wilkinson failed in the razor market, however, and dropped out during the Second World War.

By 1954, Wilkinson decided to look again at the shaving market. Manufacturers used carbon steel to make most razor blades at that time, and such blades lost their serviceability rapidly due to mechanical and chemical damage. Gillette and other firms had experimented with stainless steel blades; but they had found that despite their longer-lasting nature, the blades did not sharpen well. But some men liked the durability; and a few small companies produced stainless steel blades.

Wilkinson purchased one such small German company and put Wilkinson Sword blades on the market in 1956. Wilkinson developed a coating for the stainless blades (in the same fashion that Gillette had coated the Super Blue Blade) that masked their rough

Exhibit 13 | Swedish Match AB income statements, 1986–8 (US\$000)

		1988	1987	1986
Net sales		\$2 814 662	\$2 505 047	\$1 529 704
Cost of sales		N/A	N/A	N/A
Operating expenses		2 541 128	2 291 023	1 387 360
Other expenses		108 206	95 420	48 711
Earnings before interest		165 328	118 604	93 633
Interest expense		5 386	19 084	21 618
Earnings before tax		159 942	99 520	72 015
Tax		57 612	29 996	39 165
Earnings after tax		102 330	69 554	32 850
Dividends paid per share		0.53	0.51	1.75
Stock price range	High	22.53	19.65	66.75
	Low	\$ 15.00	\$ 11.06	\$ 22.00

Source: *Moody's Industrial Manual*.

Exhibit 14 | Swedish Match AB balance sheets, 1986–8 (US\$000)

		1988	1987	1986
Assets	Cash and securities	\$ 159 616	\$ 117 027	\$323 993
	Receivables	611 372	561 479	297 321
	Inventories	421 563	415 116	258 858
	Total current assets	1 192 551	1 093 622	880 172
	Fixed assets, net	707 664	671 409	397 411
	Other assets	161 085	132 799	93 211
	Total assets	2 061 300	1 897 830	370 794
Liabilities and equity	Current liabilities	996 214	905 778	576 534
	Current portion long-term debt			
	Long-term debt	298 505	316 542	244 118
	Equity			

Source: *Moody's Industrial Manual*.

edges, allowing the blades to give a comfortable shave and to last two to five times longer than conventional blades. Wilkinson called the new blade the Super Sword-Edge. Wilkinson introduced the blades in England in 1961 and in the United States in 1962, and they became a phenomenon. Schick and American Safety Razor followed a year later with their own stainless steel blades, the Krona-Plus and Personna. Gillette finally responded in late 1963 with its own stainless steel blade; and by early 1964 Gillette's blades were outselling Wilkinson, Schick and Personna combined. Wilkinson, however, had forever changed the nature of the razor blade.

In 1988, Wilkinson Sword claimed to have a 4 per cent share of the US wet-shave market; and it was

predicting a 6 per cent share by mid-1990. Industry analysts, however, did not confirm even the 4 per cent share; they projected Wilkinson's share to be closer to 1 per cent. Wilkinson introduced many new products over the years, but they generally proved to be short-lived. The company never really developed its US franchise.

However, in late 1988, Wilkinson boasted that it was going to challenge the wet-shave category leader by introducing Ultra-Glide, its first lubricating shaving system. Wilkinson designed Ultra-Glide to go head-to-head with Gillette's Atra Plus and Schick's Super II Plus and Ultrex Plus. Wilkinson claimed that Ultra-Glide represented a breakthrough in shaving technology because of an ingredient, hydromer, in its patented lubricating strip. According to Wilkinson, the Ultra-

Glide strip left less residue on the face and provided a smoother, more comfortable shave by creating a cushion of moisture between the razor and the skin.

Wilkinson introduced Ultra-Glide in March 1989 and supported it with a US\$5 million advertising and promotional campaign (versus the Atra Plus US\$80 million multimedia investment in the United States). Wilkinson priced Ultra-Glide 5–8 per cent less than Atra Plus. Wilkinson was undaunted by Gillette's heavier advertising investment, and it expected to cash in on its rival's strong marketing muscle. Wilkinson did not expect to overtake Gillette but felt its drive should help it capture a double-digit US market share within two to three years.

Many were sceptical about Wilkinson's self-predicted market share growth. One industry analyst stated, 'Gillette dominates this business. Some upstart won't do anything.' One Gillette official claimed his company was unfazed by Wilkinson. In fact, he was quoted as saying, in late 1988, 'They [Wilkinson] don't have a business in the US; they don't exist.'

Nonetheless, Gillette became enraged and filed legal challenges when Wilkinson's television ads for Ultra-Glide broke in May 1989. The ads stated that Ultra-Glide's lubricating strip was six times smoother than Gillette's strip and that men preferred it to the industry leader's. All three major networks had reservations about continuing to air the comparison commercials. CBS and NBC stated that they were going to delay airing the company's ads until Wilkinson responded to questions they had about its ad claims. In an 11th-hour counterattack, Wilkinson accused Gillette of false advertising and of trying to monopolise the wet-shave market.

GILLETTE'S SOUTH BOSTON PLANT

Robert Squires left his work station in the facilities engineering section of Gillette's South Boston manufacturing facility and headed for the shave test lab. He entered the lab area and walked down a narrow hall. On his right were a series of small cubicles Gillette had designed to resemble the sink area of a typical bathroom. Robert opened the door of his assigned cubicle precisely at his scheduled 10 a.m. time. He removed his dress shirt and tie, hanging them on a hook beside the sink. Sliding the mirror up as one would a window, Robert looked into the lab area. Rose McCluskey, a lab assistant, greeted him.

'Morning, Robert. See you're right on time as usual. I've got your things all ready for you.' Rose

reached into a recessed area on her side of the cubicle's wall and handed Robert his razor, shave cream, aftershave lotion and a clean towel.

'Thanks, Rose. Hope you're having a good day. Anything new you've got me trying today?'

'You know I can't tell you that. It might spoil your objectivity. Here's your card.' Rose handed Robert a shaving evaluation card (see Exhibit 15).

Robert Squires had been shaving at the South Boston Plant off and on for all of his 25 years with Gillette. He was one of 200 men who shaved every work day at the plant. Gillette used these shavers to compare its products' effectiveness with competitors' products. The shavers also conducted R&D testing of new products and quality control testing for manufacturing. An additional seven to eight panels of 250 men each shaved every day in their homes around the country, primarily conducting R&D shave testing.

Like Robert, each shaver completed a shave evaluation card following every shave. Lab assistants like Rose entered data from the evaluations to allow Gillette researchers to analyse the performance of each shaving device. If a product passed R&D hurdles, it became the responsibility of the marketing research staff to conduct consumer-use testing. Such consumer testing employed 2 000 to 3 000 men who tested products in their homes.

From its research, Gillette had learned that the average man had 30 000 whiskers on his face that grew at the rate of half an inch (1.3 centimetres) per month. He shaved 5.8 times a week and spent three to four minutes shaving each time. A man with a life span of 70 years would shave more than 20 000 times, spending 3 350 hours (130 days) removing 27.5 feet (8.4 metres) of facial hair. Yet, despite all the time and effort involved in shaving, surveys found that if a cream were available that would eliminate facial hair and shaving, most men would not use it.

Robert finished shaving and rinsed his face and shaver. He glanced at the shaving head. A pretty good shave, he thought. The cartridge had two blades, but it seemed different. Robert marked his evaluation card and slid it across the counter to Rose.

William Mazeroski, manager of the South Boston shave test lab, walked into the lab area carrying computer printouts with the statistical analysis of last week's shave test data.

Exhibit 15 | Gillette shaving evaluation card

NUMB. _____ CODE _____ STA TEST# _____ NAME _____ EMP.# _____ DATE _____

IN-PLANT SHAVE TEST SCORECARD

INSTRUCTIONS: Please check one box in each column

Overall evaluation of shave	Freedom from nicks and cuts	Caution	Closeness	Smoothness	Comfort
<input type="checkbox"/> Excellent	<input type="checkbox"/> Excellent	<input type="checkbox"/> Exceptionally safe	<input type="checkbox"/> Exceptionally close	<input type="checkbox"/> Exceptionally smooth	<input type="checkbox"/> Exceptionally comfortable
<input type="checkbox"/> Very good	<input type="checkbox"/> Very good	<input type="checkbox"/> Unusually safe	<input type="checkbox"/> Very close	<input type="checkbox"/> Very smooth	<input type="checkbox"/> Very comfortable
<input type="checkbox"/> Good	<input type="checkbox"/> Good	<input type="checkbox"/> Average	<input type="checkbox"/> Average	<input type="checkbox"/> Average	<input type="checkbox"/> Average comfort smoothness
<input type="checkbox"/> Fair	<input type="checkbox"/> Fair	<input type="checkbox"/> Slight caution needed	<input type="checkbox"/> Fair	<input type="checkbox"/> Slight pull	<input type="checkbox"/> Slight irritation
<input type="checkbox"/> Poor	<input type="checkbox"/> Poor	<input type="checkbox"/> Excessive caution needed	<input type="checkbox"/> Poor	<input type="checkbox"/> Excessive pull	<input type="checkbox"/> Excessive irritation

Source: The Gillette Company.

Noticing Robert, William stopped. 'Morning, Robert. How was your shave?'

'Pretty good. What am I using?'

'Robert, you are always trying to get me to tell you what we're testing! We have control groups and experimental groups. I can't tell you which you are in, but I was just looking at last week's results, and I can tell you that it looks like we are making progress. We've been testing versions of a new product since 1979, and I think we're about to get it right. Of course, I don't know if we'll introduce it or even if we can make it in large quantities, but it looks good.'

'Well, that's interesting. At least I know I'm involved in progress. And, if we do decide to produce a new shaver, we'll have to design and build the machines to make it ourselves because there is nowhere to go to purchase blade-making machinery. Well, I've got to get back now; see you tomorrow.'

Thirty-Seventh Floor, The Prudential Center

Paul Hankins leaned over the credenza in his 37th-floor office in Boston's Prudential Center office building and admired the beauty of the scene that spread before him. Paul felt as though he were watching an impressionistic

painting in motion. Beyond the green treetops and red brick buildings of Boston's fashionable Back Bay area, the Charles River wound its way towards Boston Harbor. Paul could see the buildings on the campuses of Harvard, MIT and Boston University scattered along both sides of the river. Soon the crew teams would be out practising. Paul loved to watch the precision with which the well-coordinated teams propelled the boats up and down the river. If only, he thought, we could be as coordinated as those crew teams.

Paul had returned to Boston in early 1988 when Gillette created the North Atlantic Group by combining what had been the North American and the European operations. Originally from Boston, he had attended Columbia University and earned an MBA at Dartmouth's Tuck School. He had been with Gillette for 19 years. Prior to 1988, he had served as marketing director for Gillette Europe from 1983 to 1984, as the country manager for Holland from 1985 to 1986, and finally as manager of Holland and the Scandinavian countries.

During this 1983–7 period, Paul had worked for Jim Pear, vice president of Gillette Europe, to implement a pan-European strategy. Prior to 1983, Gillette had organised and managed Europe as a classic decentralised market. To meet the perceived cultural nuances within each area, the company had treated each country as a separate market. For example, Gillette offered the same products under a variety of sub-brand names. The company sold its Good News! disposable razors under the name 'Blue II' in the United Kingdom,

'Parat' in Germany, 'Gillette' in France and Spain, 'Radiator Getta' (shave and throw) in Italy, and 'Economy' in other European markets.

Jim Pear believed that in the future Gillette would have to organise across country lines, and he had developed the pan-European idea. He felt that shaving was a universal act and that Gillette's razors were a perfect archetype for a 'global' product.

Gillette had launched Contour Plus, the European version of Atra Plus, in 1985–6 and had experienced greater success than the US launch which took place at the same time. The pan-European strategy seemed to be both more efficient and more effective. Colman Mockler, Gillette's chairman, noticed the European success and asked Pear to come to Boston to head the new North Atlantic Group. Paul had come with him as vice president of marketing for the Shaving and Personal Care Group.

Paul turned from the window as he heard people approaching. Sarah Kale, vice president of Marketing Research; Brian Mullins, vice president of marketing, Shaving and Personal Care Group; and Scott Friedman, business director, Blades and Razors, were at his door.

'Ready for our meeting?' Scott asked.

'Sure, come on in. I was just admiring the view.'

'The purpose of this meeting,' Paul began, 'is to begin formulating a new strategy for Gillette North Atlantic, specifically for our shaving products. I'm interested in your general thoughts and analysis. I want to begin to identify options and select a strategy to pursue. What have you found out?'

'Well, here are the market share numbers you asked me to develop,' Scott observed as he handed each person copies of tables he had produced (see Exhibits 16 and 17). Like Paul, Scott had earned an MBA from the Tuck School and had been with Gillette for 17 years.

'These are our US share numbers through 1988. As you can see, Atra blades seem to have levelled off and Trac II blades are declining. Disposable razors now account for over 41 per cent of the market, in dollars, and for over 50 per cent of the market in terms of units. In fact, our projections indicate that disposable razors will approach 100 per cent of the market by the mid- to late 1990s given current trends. Although we have 56 per cent of the blade market and 58 per cent of the disposable razor market, our share of the disposable razor market has fallen. Further, you are aware that every 1 per cent switch from our system razors to our disposable razors represents a loss of US\$10 million on the bottom line.'

'I don't think any of this should surprise us,' Sarah Kale interjected. Sarah had joined Gillette after graduating from Simmons College in Boston and had been with the firm for 14 years. 'If you look back over the 1980s, you'll see that we helped cause this problem.'

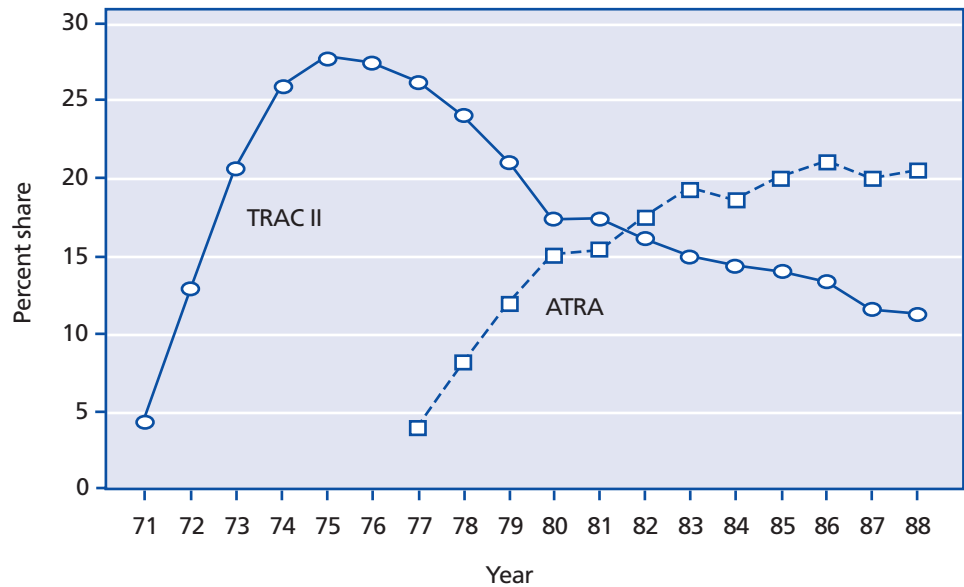
'What do you mean by that?' asked Paul.

'Well, as market leader, we never believed that the use of disposable razors would grow as it has. We went along with the trend, but we kept prices low on our disposable razors, which made profitability worse for both us and our competition because they had to take our price into consideration in setting their prices. Then, to compensate for the impact on our profitability from the growth of the disposable razor market, we were raising the prices on our system razors. This made disposable razors even more attractive for price-sensitive users and further fuelled the growth of disposable razors. This has occurred despite the fact that our market research shows that men rate system shavers significantly better than disposable razors. We find that the weight and balance contributed by the permanent handle used with the cartridge contributes to a better shave.'

Exhibit 16 | Gillette market share of dollar sales, 1981–8 (per cent)

Product or category	1981	1982	1983	1984	1985	1986	1987	1988
Atra blades	15.4	17.3	19.4	18.7	20.2	20.9	20.0	20.5
Trac II blades	17.5	16.4	15.2	14.6	14.1	13.5	11.8	11.4
Gillette blades	47.3	48.9	52.1	54.2	55.8	57.1	54.1	56.0
Gillette disposables	14.3	15.4	17.4	20.0	21.1	22.7	22.2	24.0
All disposables	23.0	23.2	27.0	30.6	32.7	34.9	38.5	41.1
Gillette disposables as % of all disposables	67.9	66.9	64.7	65.7	64.6	64.2	57.6	58.4
Gillette razors	50.3	52.5	54.9	58.8	62.2	67.6	64.1	61.0

Source: Prudential-Bache Securities.

Exhibit 17 | Gillette system cartridges, 1971–88 (dollar share of US blade market)

Source: The Gillette Company; Prudential-Bache Securities.

‘Yes, but every time I tell someone that,’ Paul added, ‘they just look at me as if they wonder if I really believe that or if it is just Gillette’s party line.’

‘There’s one other thing we’ve done,’ Scott added. ‘Look at this graph of our advertising expenditures in the US over the 1980s [see Exhibit 18]. In fact, in constant 1987 dollars, our advertising spending has fallen from US\$61 million in 1975 to about US\$15 million in 1987. We seem to have just spent what was left over on advertising. We are now spending about one-half of our advertising on Atra and one-half on Good News!. Tentative plans call for us to increase the share going to Good News!. Our media budget for 1988 was about US\$43 million. Further, we’ve tried three or four themes, but we haven’t stuck with any one for very long. We’re using the current theme, “The Essence of Shaving”, for both system and disposable products. Our advertising has been about 90 per cent product-based and 10 per cent image-based.’

‘Well, Scott’s right,’ Sarah noted, ‘but although share of voice is important, share of mind is what counts. Our most recent research shows a significant difference in how we are perceived by male consumers based on their age. Men over 40 still remember Gillette, despite our reduced advertising, from their youth. They remember Gillette’s sponsorship of athletic events, like the Saturday Baseball Game of the Week and the Cavalcade of Sports. They remember “Look Sharp! Feel Sharp! Be Sharp” and Sharpie the Parrot. They

remember their fathers loaning them their Gillette razors when they started shaving. There is still a strong connection between Gillette and the male image of shaving.’

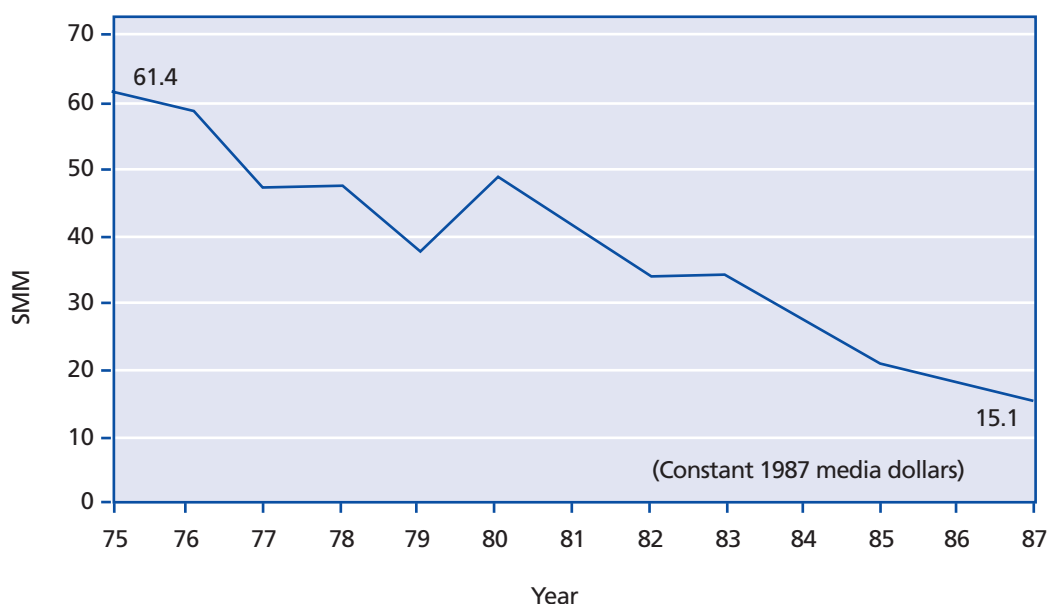
‘How about with younger men?’ asked Brian. Brian had joined Gillette in 1975 after graduating from Washington and Lee University and earning a master’s degree in administration from George Washington University.

‘Younger men’s views can be summed up simply – twin blade, blue and plastic,’ Sarah reported.

‘Just like our disposable razors!’ Paul exclaimed.

‘Precisely,’ Sarah answered. ‘As I say, we’ve done this to ourselves. We have a “steel” man and “plastic” man. In fact, for males between 15 and 19, BIC is better known than Gillette with respect to shaving. Younger men in general – those under 30, these “plastic” men – feel all shavers are the same. Older men and system users feel there is a difference.’

‘Yes,’ Paul interjected, ‘and I’ve noticed something else interesting. Look at our logos. We use the Gillette brand name as our corporate name, and the brand name is done in thin, block letters. I’m not sure it has the impact and masculine image we want. On top of that, look at these razor packages. We have become so product-focused and brand-manager-driven that we’ve lost focus on the brand name. Our brands look tired: there’s nothing special about our retail packaging and display.’

Exhibit 18 | Blade and razor media spending, United States, 1975–87

Source: The Gillette Company.

‘Speaking of the male image of shaving, Sarah, what does your research show about our image with women?’ asked Brian.

‘Well, we’ve always had a male focus and women identify the Gillette name with men and shaving, even those who use our products marketed to women. You know that there are more women wet shavers than men in the US market, about 62 million versus 55 million. However, due to seasonability and lower frequency of women’s shaving, the unit volume used by women is only about one-third that of the volume used by men. Women use about eight to 12 blades a year versus 25 to 30 for men. It is still very consistent for us to focus on men.’

‘Well, we’ve got plenty of problems on the marketing side, but we also have to remember that we are part of a larger corporation with its own set of problems,’ Brian suggested. ‘We’re only 30 per cent or so of sales but we are 60 per cent of profits. And, given the takeover battles, there is going to be increased pressure on the company to maintain and improve profitability. That pressure has always been on us, but now it will be more intense. If we want to develop some bold, new strategy, we are going to have to figure out where to get the money to finance it. I’m sure the rest of the corporation will continue to look to us to throw off cash to support diversification.’

‘This can get depressing,’ Paul muttered as he looked back at the window. ‘I can sense the low morale

inside the company. People sense the inevitability of disposability. We see BIC as the enemy even though it is so much smaller than Gillette. We’ve got to come up with a new strategy. What do you think our options are, Scott?’

‘Well, I think we’re agreed that the “do-nothing” option is out. If we simply continue to do business as usual, we will see the erosion of the shaving market’s profitability as disposable razors take more and more share. We could accept the transition to disposable razors and begin to try to segment the disposable razor market based on performance. You might call this the “give up” strategy. We would be admitting that disposable razors are the wave of the future. There will obviously continue to be shavers who buy based on price only, but there will also be shavers who will pay more for disposable razors with additional benefits, such as lubricating strips or movable heads. In Italy, for example, we have done a lot of image building and focused on quality. Now, Italian men seem to perceive that our disposable razors have value despite their price. In other words, we could try to protect the category’s profitability by segmenting the market and offering value to those segments willing to pay for it. We would de-emphasize system razors.

‘Or, we could try to turn the whole thing around. We could develop a strategy to slow the growth of disposable razors and to reinvigorate the system razor market.’

'How does the new razor system fit into all this?' Paul asked.

'I'm pleased that we have continued to invest in R&D despite our problems and the takeover battles,' Brian answered. 'Reports from R&D indicate that the new shaver is doing well in tests. But it will be expensive to take to market and to support with advertising. Further, it doesn't make any sense to launch it unless it fits in with the broader strategy. For example, if we decide to focus on disposable razors, it makes no sense to launch a new system razor and devote resources to that.'

'What's the consumer testing indicating?' asked Scott.

'We're still conducting tests,' Sarah answered, 'but

so far the results are very positive. Men rate the shave superior to both Atra or Trac II and superior to our competition. In fact, I think we'll see that consumers rate the new shaver as much as 25 per cent better on average. The independently spring-mounted twin blades deliver a better shave, but you know we've never introduced a product until it was clearly superior in consumer testing on every dimension.'

'Okay. Here's what I'd like to do,' Paul concluded. 'I'd like for each of us to devote some time to developing a broad outline of a strategy to present at our next meeting. We'll try to identify and shape a broad strategy then that we can begin to develop in detail over the next several months. Let's get together in a week, same time. Thanks for your time.'

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Case 6

Incat Tasmania's race for international success: Blue Riband strategies

Mark Wickham
Dallas Hanson
University of Tasmania

In 1999, Robert Clifford (aged 56) entered the *Business Review Weekly's* 'Richest 200 Australians' for the first time, qualifying for the elite group with an estimated net worth of some \$150 million.¹ Clifford is the founder and chairman of Incat Tasmania, a highly successful catamaran manufacturer in Hobart. His far-sightedness as a ship-builder, alongside his ability to manage innovation, enabled his small boat-building business (and river-ferry operation) to become a world force in the high-speed catamaran market, exporting to Europe, Asia and the Americas. So successful has the Incat operation been that, in 1999, it directly employed over 1 000 people, generated \$250 million in revenue and accounted for approximately 20 per cent of Tasmania's total export earnings.² The success and wealth that Clifford has generated through his catamaran business is a far cry from his somewhat 'humble' beginnings.

Robert Clifford a.k.a. 'Judge Dredge'

Robert (Bob) Clifford's start in the business world was founded upon what may be best described as a 'relatively unsuccessful scholarly career'. Indeed, during his high-school years at the exclusive Hutchins Boys School, a rash of subject failures resulted in his crowning as a 'dunce' by his teachers.³ Clifford, in his semi-autobiography, recalls an incident whereby he was also failed in his favourite subject, woodwork. The failure was awarded to Clifford when his teachers failed to believe (perhaps not unreasonably) that he could have possibly built, all by himself, a 14-foot (4.3-metre) yacht in his bedroom. Although the yacht was presented to the teachers for marking, it was a consensus view that he must have received considerable help from his family. It was an assumption that was only true to a

point. (His father did help to get his mother out of the house so that Clifford could remove windows and frames and actually get the boat out of the house!⁴)

After Clifford finished his tour of duty at school, he entered the workforce as a printing apprentice, a position that he soon resigned in favour of a family-oriented job as a fisherman. His job as a fisherman involved helping his father manage five crayfish and scalloping boats, which he had also helped to build. The family business was run on a tight budget and, as such, the firm's boat manufacturing premises equated to vacant land adjacent to their residential property. It was in such ship-building yards that Bob Clifford, with the help of his father and siblings, toiled from dawn until dusk in order to build their fleet. The resulting boats were named the *Moana*, *Dolphin*, *Gazelle*, *Lanzig* and *Leillateah*, and ranged from 10 metres to 15 metres in length.⁵

Their first boat, the *Moana*, was also the shortest in length and was built utilising the 'state of the art' fishing technologies of the day. However, the backbreaking, and at times very dangerous, scallop dredging process motivated the young Bob Clifford to redesign certain aspects of the operation. In particular, he was worried that the 'traditional' dredging process, whereby three individuals were required to place themselves in precarious positions from which to empty the dredging nets, was potentially hazardous to life and limb. To overcome this hazard, which stemmed from a dredging net that became rather difficult to manage with the added weight of a substantial catch, Clifford sought to innovate the process with a 'self-tipping net'. In an effort to make this much simplified, and much safer, dredging process a reality, Clifford constructed numerous models made from lightweight balsa wood held together by glue and pins. With the help of his

family, he successfully engineered a dredge that would 'self-tip' its cargo, removing the need for many dangerous moving parts and potentially hazardous human intervention. In order to implement a full-scale trial of this new system, the Cliffords built their second vessel, the *Dolphin*, with the new dredging design. After several real-life tests, further modifications were undertaken and a new and improved version was fitted to their third boat, the 54-foot (16.5-metre) *Gazelle*.⁶

The Clifford scallop boats were the only users of this new dredging technology for quite some time, with many other fishermen reluctant to change a dredging process that they were fully familiar with, and which heralded back some 50 years to their fathers and grandfathers. Times changed, however, as did occupational health and safety regulations. Today, scallop boats in Australia are universally fitted with virtually the same 'self-tipping' dredging system that was developed by Bob Clifford for his *Gazelle* in 1965.

The Clifford family business decided to expand its catchment area in late 1965 to include the rugged west coast of Tasmania. In keeping with previous efforts to expand their rewards through an improvement in their methods, Clifford decided to design a boat specifically for the region, rather than simply build 'another typical sailing craft common in Tasmania'. Unlike the eastern fishing regions, the west coast of Tasmania experiences winds that are affectionately known as 'the roaring forties', a number that refers to the wind speeds in the area. To help overcome these rather extreme conditions, Clifford designed the new boat (named the *Lanzig*) with a reinforced hull and an increased engine hold capable of housing a more powerful diesel engine. Expecting excellent catches from this region, he also included in the design a system of 'powerful bilges, capable of carrying a good load of fish a long distance'.⁷

Another opportunity to improve the family business's profitability arose in 1968 when a rival fisherman's vessel was sunk on a reef on the west coast of Tasmania. This loss of a vessel meant that the opportunities for an increased share in the new, and very promising, southern crayfishing season were available to those that supplied ships to the region. Having enjoyed entrepreneurial success previously, Clifford attempted to take advantage of the opportunity by designing and building the family's largest boat to date: the 15-metre *Leillateah*.

Due to the sheer size and scale of the *Leillateah* project, Clifford was forced to abandon the family's traditional methods for boat building. Instead of using vacant blocks and various family back yards, Clifford utilised the Battery Point boat-building sheds of a new

maritime friend, Max Creese. Creese was one of Tasmania's best-known boat builders, and provided Clifford with access to valuable materials, labour and 'experience' in the boat manufacturing process. The size of the new boat project was considerable, and required that a team of builders work 'around the clock' in order to complete the boat before the season opened. Clifford himself states that 'the importance of timing to an entrepreneurial business venture has been proven many times over'.⁸ The project was a success, and the *Leillateah* was completed on the Sunday before the season opened the following Wednesday. The effort proved to be very profitable for the Clifford family business, with the *Leillateah* returning one week after the season's opening with some five tonnes of crayfish in its hold.

From 1968 to 1972, the Cliffords' fishing business maintained a fleet of five vessels. As with most businesses, the profitability of the venture surged. At its most successful, the five vessels were returning with significant catches, the best of which yielded 81 dozen crayfish, three tonnes of shark and 150 bags of scallops. At its least successful, the business sent its fleet on a three-month, 6 000-nautical mile journey to the Gulf of Carpentaria for a return of two prawns.

During this time, there was little need for further innovations to be undertaken, and by late 1971, Bob Clifford had become somewhat dissatisfied with life as a Tasmanian fisherman. It was agreed early in 1972 to dissolve the family fishing business that had been created some seven years earlier. The father-son partnership had proved to be very successful over the years, with the pair generating enough revenue by 1972 to form what would prove to be a pivotal business partnership.

Clifford and Clifford Incorporated: Don't pay the ferrymen ...

During the early 1970s, there had been some talk of reintroducing a 'Trans-Derwent' ferry service, one that would predominantly serve Tasmania's tourist population.⁹ As had happened with the sinking of a rival's vessel some four years earlier, Clifford sensed an opportunity to re-employ his entrepreneurial skill and capture a 'new' market through the implementation of valuable innovations. He was extremely keen to initiate this business opportunity, and in 1972 Bob and his father formed the Sullivan's Cove Ferry Company on the Derwent River.¹⁰ So keen had Clifford been that, simultaneously, he approached the Marine Construction

Company (a boat-building venture in Rokeby, Hobart) with some preliminary design plans for his proposed 'Derwent River ferry'. As with the *Leillateah*, Clifford was keen to have production under way nearly immediately, and in fact, the details of the ferry's design were worked out by the builder and Clifford as construction progressed. By mid-1972, construction of Clifford's first ferry, the 20-metre steel-hulled *Matthew Brady* (named after a famous Australian bushranger) was completed. Armed with a suitable vessel to handle a ferry service across the Derwent River, all that the Sullivan's Cove Ferry Company had to accomplish was a successful bid for the rights to service the market. The company indeed was successful in its bid, and began operations late in 1972.

Business proved to be good in the early stages of the newly formed ferry service, with tourists and locals alike taking advantage of this novel attraction. In order for Clifford to generate sales growth, and indeed protect his source of income, he prudently decided to build a second ferry in case the *Matthew Brady* was unable to sail. A second ferry was designed, commissioned and built in 1973 (by the same Rokeby ship-building yard as the *Matthew Brady*). The Cliffords' new ferry, the *James McCabe*, was again named after a notorious Australian bushranger. Technologies had improved since the construction of the *Matthew Brady*, and the new ferry was somewhat faster and more comfortable than the mother ship. The decision to construct a second ferry was a rather fortuitous one, given the tragic events in early 1975.

On 5 January 1975, at 9.27 p.m., the bulk ore carrier *Lake Illawarra* crashed into the 19th pier of the Tasman Bridge, claiming 12 lives and severing the Eastern Shore's link with Hobart by knocking out an 80-metre section of the bridge.¹¹ Many tens of thousands of motorists and cyclists were now unable to travel easily to their required destinations, be it for work or pleasure. Bob Clifford found himself in the enviable position of 'being in the right place at the right time'.

... 'til they get you to the other side: Transportation returns to Van Dieman's Land

In response to the increased demand for transport that resulted from the Tasman Bridge tragedy, Clifford hurriedly built a third ferry, the *Martin Cash*. Such was the priority of the project that 'records were broken in the rush to get the craft into service quickly'.¹² The construction process was aided somewhat by the fact

that the new ferry was a sister ship to the original *Matthew Brady*, and therefore no new designs or alterations were required.

Although the ferry service now boasted three boats, demand still exceeded supply, and in late 1975 a fourth ferry was commissioned. Given the urgency of demand in the market, the latest ferry, the *Lawrence Kavanagh* (again a famous bushranger), was constructed in record time. As with the *Martin Cash*, there was little fanfare at its launch, simply a push into the Derwent River on her way to pick up a load of customers. The four 'bushrangers' were to serve as the west-east link for some three years while repairs to the Tasman Bridge were under way. In this time, Clifford's ferries transported in excess of 9 million paying passengers.

These 9 million passengers, forced to utilise the ferry service, provided Clifford with significant revenues, but they didn't come from the sale of transport tickets alone. Indeed, after finding a loophole in the Tasmanian licensing laws, Clifford was able to serve both counter meals and alcoholic beverages on his ferry rides, even though he did not possess what the law required – a dedicated dining area. It would appear that the law makers of the day had not considered the possibility that a ferry service would undertake such additional services. At its zenith, Clifford's 'bushranger fleet' was the largest licensee in Australia, averaging sales of 3 800 litres of beer per week; the sales from beer and food were so great that they accounted for more than 50 per cent of the entire revenues generated by the business.¹³

In order to improve customer service and increase the business's revenues, Clifford hired a new British-built fast-ferry, the *Michael Howe*. The *Michael Howe* was twice as fast and twice as comfortable as the 'bushranger fleet' owned by Clifford, and was an instant success with the general public. Unfortunately, the *Michael Howe* was also a maintenance-intensive investment, with 75 per cent of all company maintenance expenditure spent on the new 'hired hand'. Clifford was understandably unimpressed with the boat's design and maintenance requirements, despite the public's obvious delight with the faster service. The flaws that Clifford observed in the boat's design and structure (the mechanics were far too complicated and labour-intensive to be viable in the long term) once again reignited his innovative flair: 'If the English can sell 34 heaps of rubbish like this [around the world], how many properly engineered fast ships could we sell from Tasmania?'¹⁴ With this marketing opportunity well in his grasp, the Clifford business began its initial foray into the fast-ferry industry.

Clifford: Licensed to keel

The question for Clifford now concerned how to develop a boat with the speed and passenger appeal of a fast-moving vessel (such as a hovercraft), while maintaining the basic economies of a conventional ferry. Clifford studied the merits of numerous low-resistance hovercraft and the catamaran-style 'sidewall' hovercraft was chosen as the best available design template. Clifford utilised this hovercraft design, but altered it to include twin-hulls (somewhat wider than the norm for catamarans at the time) and to exclude altogether the 'air-lift equipment' that was standard to the hovercraft. The newly designed boat was described as 'thought-provoking' by naval engineering experts, and indeed, the prototype model was not sanctioned by the maritime authorities as a 'legal means for general public transportation'. This rejection was primarily due to a recent change in the maritime laws in Tasmania.

Under new legislation, Clifford (and every other boat manufacturer) was forced to seek the services of a qualified naval architect to endorse any new design – a time-consuming and rather expensive task given that no such professional practised in the state at the time. In order to get the required endorsement, Clifford had to travel to New South Wales to meet a certified naval architect, Phil Hercus, who resided in Sydney. The plans were checked for design flaws, and after a 'clean bill of health' was awarded by Hercus, the *Jeremiah Ryan* was conceived with the blessing of the authorities.

The *Jeremiah Ryan* was built in a Tasmanian government-owned wharf shed at Prince of Wales Bay in September 1977, and, according to Clifford, it could only have been described as 'ugly as sin'. Construction of the vessel was undertaken by collaboration between Clifford employees and a number of contracted 'expert' tradesmen. Although not as aesthetically pleasing as Clifford may have liked, the steel catamaran was considered a major breakthrough, achieving some 26 knots in initial speed trials, considerably more than the 18 originally hoped for in the design stage. After the success of the *Jeremiah Ryan*, Clifford and Hercus entered into a partnership to form International Catamarans Pty Ltd of Australia and launch the predecessor of one of Tasmania's most successful businesses ever.¹⁵

International Catamarans (Incat) Pty Ltd, buoyed by the success of their original catamaran design and construction, continued to employ innovative design and construction processes.¹⁶ To achieve this end, the company restructured its management team, which now 'professionally employed' the functional services of an

offshore project manager (Graeme Freeman) and the strategic services of three company directors (Bob Clifford, Phil Hercus and Kerry Sturmey).

By 1979, in an effort to reduce the weight of their boats, the company did away with the traditional steel-based catamaran designs in favour of an experiment with aluminium super-structures. The first steel-aluminium catamaran to be sold by Incat was the *James Kelly* in June 1979, which serviced ferry passengers across Macquarie Harbour. The project was considered 'highly important', as it was the initial foray into new ship-building technologies and processes, the most important of which is arguably the perfection of aluminium-based welding. However radical the design and building processes were, the end result was that the operators found the ferry to be much faster and cheaper to run than traditional ferry designs. Consequently, the operators considered the *James Kelly* a great success. The commercial success of the *James Kelly* soon became the talk of the maritime industry and resulted in the first orders for all-aluminium catamarans.¹⁷

In keeping with the innovative nature of the business to date, Clifford was only too happy to attempt this new all-aluminium catamaran. The lighter, and more aesthetically pleasing, vessel also proved to be a great success for the purchasers and was very popular with their customers. Clifford comments that, with this first effort (eventually named the *Fitzroy*), 'We had overcome our fear of the unknown and built an excellent aluminium vessel at our first try.'¹⁸ He also learned an important marketing lesson: a fast ship must *look* fast! In an effort to impress Incat's customers, the delivery voyage was used as an opportunity to show off the tremendous speed the boat had to offer. So impressed were the customers by the speed at which their new boat arrived that they immediately ordered five more similar vessels on the spot. Positive word of mouth soon followed, as did orders from all over Australia.

The majority of the interstate orders originated from Queensland, where operators were greatly interested in faster transport for their customers between islands, across bays and between reefs. For example, before the 'fast catamarans' serviced the outer Barrier Reef, only dedicated reef enthusiasts could visit the Great Barrier Reef on slow fishing vessels. Incat's new fast-catamarans essentially opened up the reef as a multimillion-dollar market to both domestic and international tourists.

A pivotal, and unplanned, marketing moment occurred on New Year's Eve 1981, when the 20-metre

catamaran the *Tangalooma* was filmed cruising at full speed through two-metre seas on its way to a year's end party. The media coverage was apparently very impressive and resulted in further orders being placed from around the nation. When it became clear that the Hobart facility could not keep up with consumer demand, the decision was undertaken to license others to construct catamarans to Incat's designs. This decision would constitute Incat's initial foray into the internationalisation process.¹⁹ Licences were granted to three ship-building yards in New Zealand, two in the United States, and one in each of the United Kingdom, China and Singapore. Interestingly, each of the firms licensed by Clifford in this period were located in areas of relatively high unemployment. Collectively, the licensing agreements resulted in the construction of 80 catamarans outside of Australia's borders. With the exception of the New Zealand and Singapore contracts, each of the licensees have since prospered, a result of strong world demand for specialised catamaran transport.

Changing tack: Incat's move from people to people and cargo

The increased demand for Incat's fast-ferries was accompanied by changes in consumer preferences. Although the market for people carriers was still characterised by strong demand, additional requests were being made for 'fast cargo carriers'. Clifford was once again faced with an opportunity to utilise his innovative skills, this time to build a catamaran that remained fast, yet was large enough to stow mass cargo.

Returning to the drawing board, Clifford created the blueprints for a new 30-metre catamaran, which was larger by far than anything previously designed or built. The new vessel, the *Spirit of Royleen*, had the capacity to transport 250 passengers in spacious comfort, as well as accommodate their luggage and the supplies needed by the holiday resort it serviced. Once again, the new vessel was a huge success, with both the purchaser and their passengers very satisfied with the quality and speed of the new service. The success also did not go unnoticed by those outside the maritime community. In late 1982, for example, orders were placed by the government-run Hydro-Electric Commission for a high-speed catamaran capable of transporting 150 workers or 30 tonnes of cargo to the newly planned 'Gordon below Franklin' power scheme site. At their request, Incat designed and built the *Trojan* fast-catamaran. The vessel was launched on 30 March 1983 in time to service the new electricity project;

however, it was soon 'unemployed', due to the successful protest of environmental groups against the damming scheme.

By 1984, Incat's catamarans had proved their worth, servicing the islands in Queensland's north through the speedy transportation of both people and cargo. An order by the resort operators on Keppel Island, however, would require that Clifford once again return to the drawing board, this time to overcome a rather difficult problem that presented itself for his, and indeed anyone's, boats – the resort had no jetty. The result was the design and construction of the *Keppel Cat 1* and its well-named successor, the *Keppel Cat 2*. These 'new cats' had the ability to dock on the beach and be unloaded of passengers and cargo via specially designed ramps. Needless to say, this design feature was highly valued by the Keppel Island holiday resort, as well as by the customers, as it sped up the trip to and from the island markedly. The *Keppel Cat 1* was a 'personal milestone' for International Catamarans as well, as it was the first vessel to be built by the company in a yard that was fully owned and operated by the firm.

By 1985, orders for Incat's range of products were coming from several international companies. Sealink, a British ferry company, ordered two 30-metre passenger catamarans (*Our Lady Patricia* and *Our Lady Pamela*) for their Portsmouth to Ryde service across The Solent in England. The British purchasers were more than impressed with the boats' performance during the delivery stage from Belgium to Portsmouth: a journey that usually took three days was completed in just one.²⁰

In 1986, another major marketing opportunity arose for Incat in the form of the 1987 defence of the America's Cup. By this stage, Incat was able to buy back *Keppel Cat 2* from the Keppel Island resort owners, due to diminishing demand for a dual boat service. Incat took up the offer to re-buy the boat and refurbish the vessel as an official media boat for the full six-month period of the America's Cup trials and finals. The exposure of the vessel to the world's media, especially given its sterling performance during the entire competition, was invaluable advertising for Incat. Clifford was not waiting for the market to react to this exposure, however, and before the America's Cup challenge was run and lost by Australia, he had already begun work on what he believed to be the next generation of saleable catamaran – the 'wave piercer'.

Clifford first advanced the idea of the wave-piercing catamaran in 1983, at which stage he had completed the construction of an eight-metre model for practical appraisal. The quality of the 'ride' experienced by the maximum of six passengers on the new vessel was

quoted as being 'unprecedented in choppy seas'. It took until 1986 for the designs and construction material requirements to be finalised through Incat's planning and design process. On 20 December 1986, the *Tassie Devil 2001* was launched and hurriedly fitted out on its way to Fremantle for the running of the America's Cup finals. On the delivery voyage across the Great Australian Bight, it was noted how easily the vessel could 'surf' down the rising seas. During its time as the premier passenger vessel of the series, the *Tassie Devil 2001* provided fast, smooth rides and an excellent standard of comfort. It was more economical than many of Incat's competitor craft, and the viewing world took notice. It was on the basis of the *Tassie Devil 2001* that the decision to go ahead with the design and construction of wave-piercing, car-carrying vessels was made.

The period from 1986 to 1988 saw the construction of two further innovative catamarans, the *Starship Genesis* and the wave-piercing *2000*. The *Starship Genesis* was built as part of experiments to improve the economy of the propulsion systems of the catamaran fleet. Although the novel approach to propulsion, which involved new 'surface-piercing' propellers, was successful, the idea has not been followed up on any further vessels. The *2000* was built following the great success of the *Tassie Devil 2001*, and was much improved with regards to its carpets, seating and timber-work finishes. The *2000* was purpose-built for the Hamilton Island resort complex, and, as with their other catamarans, was a complete success for their business.

International Catamarans: The end of the line

International Catamarans Pty Ltd was formed in 1977 as a partnership between Clifford and Hercus, a partnership that lasted for some 11 creative and profitable years. On 29 February 1988, the partners agreed to split the business to allow each to concentrate on their individual areas of expertise.²¹ The partnership dissolution resulted in the two halves of the business (that is, licensing and manufacturing) separating to operate as individual firms; one dealing with the design and manufacture of the catamarans, the other with licensing and 'other legal matters'. Needless to say, Bob Clifford undertook the operation of the manufacturing business, a move that was to see the formation of Incat Tasmania.

In order to modernise its operations and reduce costs, the construction of Incat's new fully owned

catamaran-manufacturing site, at Bender Drive on Prince of Wales Bay, began in 1988. Work that had already started on the latest catamaran project continued, with one the new sheds actually being built around the burgeoning vessel. In all, three new manufacturing sheds were constructed on the site between 1988 and 1991, and would include features such as a dry dock and a dedicated catamaran assembly line.²²

The new site also incorporated a partially government-funded 'college of aluminium training' from which workers could gain certification of their skills under the Technical and Further Education scheme (TAFE). This educational 'service' also provided scholarships for staff to attend the Faculty of Engineering at the University of Tasmania, some of which resulted in engineering doctorates for Incat staff.²³ By 1997, the training program had been so successful that a dedicated purpose-built 'educative centre' was completed near the shipyard. The new centre employed 17 training staff, had a floor space capacity of some 3 500 square metres, and featured 50 welding bays able to cater for 400 apprentices and trainees.²⁴ The Incat-based training program significantly contributed to Incat's broad skill-base by multi-skilling their actual (and potential) workers in the two primary areas of catamaran manufacture: aluminium welding and fabrication. Through government-subsidised training and development, Incat found itself with access to a highly skilled workforce with practically 'nowhere else to go'.

Clifford's first major project for the newly formed company was the construction of what was originally to be a 66-metre catamaran for the British company, Sea Containers. The design and construction of the car-carrying ferry would take nearly two years, a result of ongoing design changes (the boat would stretch to be a 74-metre giant by its end) and a troublesome change in Incat's manufacturing location. Originally named the *Christopher Columbus*, sea trials for the *Hoverspeed Great Britain* began just prior to Easter 1990. The boat, the largest built by Clifford to date, was in essence a compilation of the preceding 20 years of ship-building experience. Clifford said, 'In all imaginable ways the ship was a journey into the future. Never before had a ship of this size been built of aluminium. Never before had a ship carried cars at 40 knots.'

Despite the high praise of its creator, *Hoverspeed Great Britain* experienced major and simultaneous failures almost immediately it was put on sea trial. Some of the most severe failures included electrical overloads (which disabled important navigation devices), fires in

the hold and an 'unplanned' grounding upon rocks. The setbacks, however, failed to deter Clifford from continuing the sea trials of the vessel once tug boats had successfully freed it from its rocky prison some hours later.

After the sea trials were completed, and the technical errors defined and eliminated, the *Hoverspeed Great Britain* was indeed a sight to behold. So impressive was the sight that it was suggested to the president of the British company purchasing the vessel, James Sherwood, that the vessel would be capable of winning the Hales Trophy. The 'Blue Riband' Hales Trophy is awarded to the commercial vessel that undertakes the fastest crossing of the Atlantic Ocean, a record that in 1990 was held by the liner the SS *United States*. To win the trophy (a Blue Riband award), Clifford's vessel would have to cross the Atlantic in less than three days, 10 hours and 40 minutes.

The crossing attempt was a media event that generated a great deal of worldwide interest in both the Hales Trophy and, perhaps more importantly, Clifford's business. The *Hoverspeed Great Britain* was never in doubt to break the record and win the trophy, given that its average speed during the sea trials was in excess of that required. Once again, however, technical failures dogged the *Hoverspeed Great Britain's* journey, this time in the form of water-jet failure. Despite the problem, the *Hoverspeed Great Britain* managed to cross the finish line with an average speed exceeding the previous record by 1.1 knots per hour. Clifford had achieved a marketing triumph: he had managed to break a long-standing world record with a state-of-the-art, 74-metre aluminium catamaran, a vessel that utilised new technologies, new materials and an innovative design. And the world was there to see it.²⁵

The successful crossing fuelled demand for the new breed of large car-carrying catamarans. Within three years, Incat Tasmania filled eight orders for its 74-metre catamarans. The vessels were built for:

France: *Hoverspeed France*
 Denmark: *Hoverspeed Denmark*
 Scotland: *Hoverspeed Scotland*
 South America: *Patricia Olivia* and *Juan L*
 New Zealand: *Condor 10*
 Wales and Ireland: *Stena Sea Lynx*
 Tasmania and Victoria: *SeaCat Tasmania*

In order for Incat Tasmania to maintain its profitability and growth rate, Clifford once again resorted to drawing board innovations. This time, he was to design a catamaran with an even greater carrying capacity, one that would hopefully attract more orders

from larger operators. The result was the construction of the first 78-metre catamaran, the *Stena Sea Lynx 2*. This new vessel was capable of carrying 600 passengers and 150 cars. The point of difference in this catamaran was the innovative mezzanine car deck, a deck that was connected to the main vehicle deck by hydraulically operated ramps and stored an additional 41 cars. The boat was named the *Stena Sea Lynx 2* after it was purchased by the same Wales and Ireland transport company to replace the *Stena Sea Lynx*.

The success of the new 78-metre vessel, once again, did not go unnoticed by the marketplace. In 1994, Holyman sought to take advantage of the new carrier type and contracted with Incat Tasmania to build a second 78-metre vessel, the *Condor 11*. As with the *Hoverspeed Great Britain*, the sea trials of the *Condor 11* were not incident-free. In fact, *Condor 11's* trial in the waters south of Hobart would 'go down as a significant part of Hobart's maritime history'. On 8 October 1994, a navigational error and radar malfunction led to the *Condor 11* coming to an abrupt halt upon Black Jack Rock. It took the ship a full boat length to stop, with both the stern and the portside hull clear of the water. The media attention that the incident received (including a special seven-page feature story in the *Hobart Mercury* newspaper) was testimony to the magnitude of the event. Indeed, the *Condor 11* remained in the news for some six weeks, as rescue attempt after rescue attempt failed to free the ship.²⁶

At 7.40 a.m. on Sunday, 20 November (some 42 days after the incident), the final rescue attempt was undertaken. Using tugboats and a complex system of ropes and pulleys, the *Condor 11* was freed from the rocks and slipped back into the water. Despite damage to 10 of the 16 watertight compartments, the vessel floated on a near normal waterline, and was easily towed to Incat's newly completed dry dock for repairs. The incident did a lot to prove the structural integrity of the craft and the inherent safety features of the design. That a ship could withstand such maltreatment with a minimum of damage greatly impressed the maritime world.

Incat Tasmania: Eighty metres and beyond

By 1995, the world market for high-speed ferries had grown to generate sales revenues of just under A\$1.6 billion annually.²⁷ Not surprisingly, a significant number of businesses had entered the international catamaran industry to gain a share of this substantial revenue opportunity. By 1995, Clifford was faced with direct,

and intensifying, competition from both domestic firms (such as Austal Limited, Sea Wind, Venturer, Commercial Catamarans and Aussie Cat) and UK- and US-based firms (such as the US Catamaran Company and Prout Catamarans). Of greatest concern to Incat was the fact that these competitors were also newly internationalising firms, with access to similar resources (that is, revenues from international markets, raw materials and trained staff), and had likewise based their growth on the manufacture of innovative high-speed vessels. A number of Incat's competitors had also targeted the potentially lucrative Chinese market for fast-ferries, somewhat threatening Clifford's most immediate and highly prioritised internationalising strategy. It would appear that Incat Tasmania no longer had a monopoly in the world's high-speed catamaran market, nor the innovation and expertise required for success therein.

Clifford was well aware of the need to maintain Incat's revenue growth and protect its market share in the face of this increasingly competitive industry. As had been the case in the past, Clifford once again returned to the drawing board to design a 'new and improved catamaran' for the world's markets. The result was Incat's (and indeed the world's) first 80-metre-plus catamaran, the *Condor 12*. The innovative changes introduced by Clifford this time around would focus on 'passenger and crew safety', an important point of differentiation, given the spate of ferry disasters occurring in Europe at the time.²⁸

The *Condor 12* was equipped with four of the world's most advanced safety systems (known as the Marine Evacuation System, or MES). The MES ensures that the entire passenger population of the *Condor 12* (some 700 people) can be evacuated in an emergency in under 12 minutes, a time significantly less than that required by the peak international maritime safety body, the International Maritime Organisation. In addition to the MES, the *Condor 12* was fitted with an advanced and lightweight fire protection system, as well as single-leafed hinged fire doors, single and double sliding fire doors, engine room fire dampers, fire hatches and smoke baffles. These new features, combined with structural fire protection, formed the best fire protection system available for a high-speed aluminium craft. The safety features were well received by the new owners of the boat, which in 1996 was to serve as a major transport vessel for passengers crossing the English Channel.

The success of the *Condor 12* was once again evident to those in the market that provide a fast-ferry

service. Between 1996 and 1998, Incat was to produce a number of 80-metre-plus catamarans for the European market. As with the Incat tradition, the new catamarans became larger in size, with greater levels of comfort and safety, and the adoption of new and innovative technologies. The completed catamarans during this period are as follows:

- Stena Lynx 3*: 81 metres, English Channel ferry
- Holyman Express*: 81 metres, England–Belgium run
- Condor Express*: 86 metres, 800-passenger, 200-car capacity ferry for the UK
- Sicilia Jet*: 86 metres, Mediterranean Sea crossing vessel
- Condor Vitesse*: 86 metres, UK summer season ferry carrier
- Incat 045*: 86 metres, Bass Strait carrier
- Cat-Link IV*: 91 metres, Scandinavia
- Catalonia*: 91 metres, Spain

During this period, Incat averaged the construction and launch of one catamaran every 10 weeks. The most notable boat of the latest generation was the *Catalonia*, a 91-metre wave-piercing catamaran destined for Spain. Although the *Catalonia* was completed over-schedule (due to the inability of the company to physically perform the tasks required given the workload), it remained very much the latest 'showpiece' of the Incat empire. Unlike previous efforts, the *Catalonia* was fitted out with a duty-free shop and a number of extra luxurious features (such as staircases and plush carpeting). The more luxurious fit-out meant that she was noticeably heavier than other similarly sized catamarans. However, the *Catalonia* remained capable of travelling at a respectable 48 knots as a lightship, and 43 knots fully loaded. Despite the *Catalonia*'s size and weight, Clifford was confident that the craft was significantly advanced, and was therefore faster than the record-breaking *Hoverspeed Great Britain*. With this thought in mind, as well as the implications for marketing and sales growth, Clifford decided to revisit the Hales Trophy glory of 1990, this time using the *Catalonia* to secure a second 'Blue Riband vessel' for the company.

Incat's Hales Trophy defence: *Catalonia* and the Atlantic Ocean crossing

In mid-May of 1998, the *Catalonia* left Hobart, bound for New York from where the latest record attempt would begin. On Saturday, 6 June, the *Catalonia* hauled

anchor and set sail for the United Kingdom in an attempt to set a new record for the Hales Trophy, as well as a new record for the greatest distance travelled by a ship in a given 24-hour period. Once again, the mass media were on hand to witness the great feats undertaken by Clifford and his Incat team. Once again, the media, and the rest of the interested world, were treated to a triumph. The *Catalonia* had, in only its second international voyage, managed to become the first boat in history to cover in excess of 1 000 nautical miles in a 24-hour period. She had also crossed the Atlantic faster than any commercial vessel before her, establishing a new world record for Clifford and Incat.

While this journey was under way, the Incat manufacturing plant was putting the finishing touches on a new 91-metre catamaran named the *Cat-Link V*. Built for the Scandinavian company Scandlines, the boat was also to undertake a record-breaking attempt at the Atlantic Ocean crossing. Within weeks of the *Catalonia*'s efforts, the *Cat-Link V* successfully rewrote the record books and claimed the Hales Trophy and Blue Riband certification. What was most important for Clifford was the fact that now three Incat vessels had managed to break the speed records once held by a US vessel for 50 years, and to do it in absolute comfort.

Strong demand for Incat's wave-piercing catamarans resulted in the development of an important joint venture agreement with Afai Ships of Hong Kong. The joint venture was important, as it provided Incat with an initial foray into the high-potential Chinese market, as well as helping the company to keep up with the huge global demand for its vessels. The Chinese yard started work on its first vessel early in 1998, under the supervision of Graeme Freeman, an Incat manager. Most of the materials for the ships were supplied through the Tasmanian yard, and a constant team of Incat personnel and subcontractors travelled to Hong Kong to supervise each stage of construction.²⁹ The joint venture proved successful, with the first ship completed by May 1988 and a second ship's construction already under way. As with any licensing agreement, a major risk for Incat lies in the potential theft of its intellectual property, and therefore, potentially, the company's core competency of innovative catamaran design. Perhaps an indication of the innovative drive within the company, Incat management said of such concerns: 'We haven't really worried too much about the theft of our intellectual property. We work on the theory that whatever our licensees are stealing, they are stealing yesterday's work anyway.'³⁰

Growth into the future: Incat and the continued internationalisation of a Tasmanian icon

The main issue facing Bob Clifford and his team at Incat in 2001 is ensuring the continued growth of the company through innovation, diversification and globalisation in the face of increasing competition and tough global economic times. The history of successful marketing exercises, the constant flow of innovation throughout the organisation, and the ability of Incat to foster international relationships have, at least to date, seen the company rise from obscurity to a global leader in boating excellence. While there seems to be little change in the strength of global demand for high-speed vessels, cash flow problems did arise in early 2001 when six ships built by the company remained unsold for an extended period of time. The amount of money tied up in six idle ships equated to a substantial cutting back in employee overtime and other 'non-essential company expenditure'.

This cutback in 'non-essential' expenditure, unfortunately for Incat's workforce, apparently extended to include a 15 per cent pay-rise claim by the two major unions operating in the shipyard (the Australian Manufacturing Workers Union and the Construction, Forestry, Mining and Energy Union). Clifford's response to the pay claim was to dismiss it entirely, stating that pay increases at Incat will only result from an increase in catamaran sales. Given the state of the company's sales at the time (having six completed, but as yet unsold, vessels on the books), the pay claim appeared to be doomed to failure. In response to Clifford's statement that it would be easier for the union to 'get blood from a stone' than a pay rise based merely upon a 'cost-of-living' adjustment, industrial action was undertaken by some 650 workers in the form of a 24-hour strike. Clifford was forewarned of this imminent industrial action and acted immediately to release a statement to this sector of his workforce that branded some as 'donkeys with not enough brains to make their heads ache'.³¹ He continued to suggest that 'as "intelligent leaders" in tough economic times, Incat has no choice but to "cull the donkey population" for the good of the majority, and in doing so get rid of "The Weakest Links"'.³²

Incat's management, it seemed, was less than perturbed by this economic anomaly, and indeed undertook yet more design innovations along their way

to planning the construction of the first 120-metre catamaran. In 2001, 'tentative plans' were also announced to construct catamarans for a totally unrelated market – the US military service. It was lauded that the US government had a potential US\$10 billion to spend on new 'tactical response' vehicles, vehicles the service lacked for quick response to situations of armed conflict. Incat, rather fortuitously, had provided the Australian defence force with the use of a catamaran (the HMAS *Jervis Bay*) for such duties in the East Timor peace-keeping mission, and were therefore well positioned to bid for the US contract. Should the company indeed win the US contract, it would once again have to innovate its designs to accommodate the specific needs of the US military, as well as, once again, license out its manufacturing processes to an overseas construction company.³³

The business of building fast-ferries remains a relatively new one, and as such there is considerable scope for still further market development (continued catamaran-based construction) and market diversification (that is, new product lines). Given Incat's capabilities with its innovative aluminium products, an opportunity may indeed exist to manufacture a range of aluminium-based products other than just catamaran hulls. Clifford may be able to diversify Incat's product range further to include products such as 'run-about' boats, storage sheds and perhaps even small-aircraft fuselage. As Clifford himself states: 'There are always problems to be solved that will require the design of both new and innovative products. It is coming up with ideas that is essential, and for that you need people with their brains in gear. Likewise, new markets will emerge to be served, and our team is constantly working to "improve the breed". If there is one thing that I'm proud of, it is [Incat's] ability to solve problems and expand our horizons.'³⁴ Although this ability seems to have

always existed at Incat under Clifford's leadership, the question arises as to whether it will provide a continued source of competitive advantage into the future, given the similarly innovative capabilities of Incat's similarly 'internationalising' competition.

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Case 7

Kiwi Travel International Airlines Ltd

Jared W. Paisley
University of Manitoba

In recognition of his 'raw determination and tenacity' in cutting through red tape and surmounting huge obstacles to set up an airline – in the face of direct competition from industry giants Qantas and Air New Zealand – Ewan Wilson (29) was awarded the 1996 Young Entrepreneur of the Year Award.

Accepting the award, Ewan remarked, 'It's been a bumpy flight for the past couple of years, but we've changed the way New Zealanders will fly across the Tasman. If people won't concede anything else, they have to acknowledge that fares have been influenced by Kiwi International. People still make the mistake of saying I can't do something, but that only adds fuel to the fire and some of those people must be feeling pretty silly now. If I asked you to give me \$1 000 because I had a good idea for a business, it would be smart to give it to me.'

Ewan Wilson, CEO

The son of a psychiatrist and a nurse, Ewan Wilson was born in the small South Island town of Timaru, New Zealand. His two brothers have five university degrees between them, one sister is a newspaper editor, and his other sister a lab technician. Family members suspect that Ewan's drive to succeed stems in part from the fact that, in a highly academic family, he had his share of problems at school. According to one of his sisters, 'It

would have been very hard in my family, where everybody else who went through school sort of soared. He's the youngest and always felt like he had to run to keep up with the rest of us. Although he is not an academic, he's proved that he's got a business acumen that I can only describe as startling.'

'For a while they thought I was dyslexic,' stated Ewan. 'Obviously I'm not, but even today I will avoid at all costs having to write.' After leaving school at age 16, he worked as an Air Force steward and as a 'go-fer' for a small regional airline. He says he inherited his love for ports and airports from his father, and managed to get his pilot's licence ('I had a terrible job passing all the academic exams'). Ewan worked for a short time in Australia and at a pub in Yorkshire, England, and he spent six months washing cars in Montreal, Canada, where, in 1986, he married his French-Canadian wife, Monique.

Kiwi Travel

Ewan finally found his thing – selling airline tickets and arranging charter flights. He set up his own Montreal travel agency in 1988 and ran escorted tours to the Brisbane Expo. Shortly thereafter he sold the business to his brother-in-law, and, with his wife and twin daughters, moved from Montreal to Hamilton, New Zealand, where his parents lived.

Fresh from the cutthroat competition of North America, Ewan set about establishing his own Hamilton-based travel agency, Kiwi Travel, in 1990. 'I was not exactly Mr Popularity with the other travel agents,' commented Ewan, 'We were quite aggressive in our retail operation. We discounted; we *really* discounted.' Unlike the vast majority of the country's travel agents, Kiwi Travel was not a member of the

This case was prepared as a basis for classroom discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The cooperation of Kiwi Travel International Airlines and the Department of Strategic Management and Leadership – University of Waikato is gratefully acknowledged. Some of the historical information presented in this case was obtained from an article by Paul Panckhurst in the November 1995 issue of *North and South* magazine. Used with permission.

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Travel Agents' Association of New Zealand, which demanded a bond, qualified staff and financial reporting.

According to Ewan, the Association refused him membership because he and his staff did not have the required qualifications. 'That was b— s—! I was a bloody good travel agent who learned at the coalface, as did every one of my employees.' Always looking for his main chance, Wilson hooked up with three other young strivers and set up a company called Kiwi Travel Air Charters Ltd, later renamed Kiwi Travel International Airlines Ltd.

The air charter business takes off

Besides Ewan Wilson and his wife Monique, the directors of the new airline company were:

- Mike Tournier (30), an air traffic controller, ex-army, formerly from Hamilton but now living and working in Auckland;
- Mike Park (29), a friend of Tournier's and a pilot for Air New Zealand. Park later resigned his position as director of Kiwi Airlines, because his employer was 'not comfortable' with him holding a management position with a rival business; and
- Patrick Pruett (29), a University of Tennessee business graduate, formerly a travel agent in the United States. Pruett met Ewan Wilson when they roomed together for an airline computer reservation course in Houston, Texas, and later travelled to New Zealand for a 'working holiday' in Wilson's travel agency with, he says, 'US\$400 and a lot of ambition'. Wilson calls Pruett 'level headed and conservative – everything that I'm not – and my best friend.'

Each of the partners chipped in about NZ\$1 000 and, with a grand total of NZ\$5 000, chartered an old DC3 in June 1994 to transport passengers from Auckland and Wellington to Hamilton's National Agricultural Field Days. In Ewan's words: 'We made no money, but we had a hell of a lot of fun.'

In August and September 1994, they decided to 'go international', and offered flights on four consecutive Sundays from Hamilton to Brisbane, using a chartered Air Nauru plane. In December 1994, the group offered what Ewan termed a series of 'hugely profitable' charter flights to Western Samoa and Tonga. 'These were what really set us up,' said Pat Pruett, 'We could make NZ\$30 000 on each of those flights.'

Red tape and tight deadlines

In March 1995, New Zealand's Ministry of Transport advised Ewan that he could not run weekly charter flights indefinitely without an air service licence, because they effectively amounted to a scheduled service. But the Ministry was not in a hurry to close down the fledgling airline and gave him until January 1996 to make the switch. That extension allowed Kiwi Travel to start offering weekly Sunday charter flights from Hamilton to Brisbane, and sometimes other Australian destinations such as Cairns, Rockhampton, Coolangatta and Townsville. On the subject of market research, Ewan had this to say: 'We didn't do any. I just had a gut feeling it would work.'

Shortly thereafter, Ewan closed his travel agency so that he could concentrate on the airline business. A couple of months later, he decided to work towards launching a scheduled air service, and initially planned a fairly 'relaxed' implementation schedule, to meet the Ministry's January 1996 deadline. However, in early June 1995, Ewan and his partners got wind of a Boeing 737 available for lease from Adelaide-based National Jet Systems. It was a cargo plane which could be reconfigured to take passengers.

To proceed with the deal and to convince the Ministry of Transport that Kiwi Travel was 'a sound and viable operator', the four shareholders (Monique is not a shareholder) had to come up with more money. Pruett, Tournier and Park each set out to raise another NZ\$64 000. Pat Pruett had to borrow from his family in Nashville. By using funds from the sale of his house in Canada, and borrowing from his parents' life savings, Wilson was able to come up with NZ\$250 000. Altogether, including profits from charter operations, the group was able to increase Kiwi Travel International Airlines' paid-up capital from NZ\$200 to NZ\$778 000. This took three weeks. A summary of each shareholder's stake is shown in Exhibit 1.

The Bank of New Zealand (BNZ) provided an overdraft account on the strength of a registered security over the company, making the bank first in line if the company went broke. The BNZ did not, however, provide any start-up capital. In late June 1995, with the tentative National Jet Systems agreement in hand, Kiwi Travel began advertising and selling tickets for their scheduled Hamilton–Dunedin to Sydney–Brisbane flights to commence on 23 August 1995. Unfortunately, the deal fell through in July, when it became clear that National Jet Systems would not be able to convert the plane to passenger use in time for the 23 August launch

Exhibit 1 | Kiwi Travel International Airlines Ltd

Summary of shareholders, June 1995		
Shareholder	\$ Holdings	Paid capital (NZ\$)
Ewan Wilson	49%	381 220
Mike Park	17	132 260
Patrick Pruett	17	132 260
Mike Tournier	17	132 260
TOTAL	100%	NZ\$778 000

date. 'I guess we should have looked at that deal more carefully,' commented Pat Pruett. So there they were – six weeks before their first scheduled flight and no aircraft. Ewan recalled the rush that ensued:

We started faxing everywhere in the Pacific looking for a plane. At the end of July, I went off to the States and Europe and met with four or five operators. They said they needed 90 days, and I said I don't have bloody 90 days, I have less than five weeks!

Ewan finally came across a family-owned aircraft charter company called AvAtlantic, in Savannah, Georgia (Forrest Gump territory). They were willing to supply a Boeing 727, which could carry about 50 more passengers than the 737 but had a significant disadvantage in that it would have to refuel in Auckland before heading across to Australia. This extra 30-minute wait that passengers would have to endure was not something that Kiwi Airlines had planned on or mentioned in their advertisements. Returning to Hamilton from Georgia, Ewan interviewed prospective flight attendants over a weekend in early August, hired them on Monday, and four days later sent them packing off to Savannah for training.

With three weeks to go before their inaugural flight, Ewan Wilson had managed to line up an aircraft, but he still didn't have the licences his airline needed to fly. This involved negotiations with government organisations in the United States, Australia and New Zealand. As for the political approval, Kiwi Airlines required an air service licence from the New Zealand Ministry of Transport (MOT). AvAtlantic needed an air service certificate from New Zealand's Civil Aviation Authority (CAA) as the safety approval. The *International Air Services Licensing Act* required, among other things, an investigation of Kiwi Airlines' financial viability.

According to the head of the CAA:

At times the relationship was not easy. Mr Wilson did not really understand the depth and breadth of the safety requirements to get a licence, and would not sit still long enough to find out. We suggested Kiwi spend a day with us to allow full explanations of what was required of them, but Mr Wilson spent just 15 minutes.

The CAA was faced with the extra hassle of dealing with the media, with what it says were Wilson's unfounded claims of unfair treatment. Wilson acknowledged:

I hyped it up and put so much pressure on them, they decided to be very thorough with their investigations of AvAtlantic's application. They came over as arrogant as I am. I now know why it's so frustrating dealing with people like me, but it's not every day you get somebody calling you up saying you want to start a second international airline, and of course you take it as a joke. They think I'm pulling their leg, but I'm not. The feeling was 'Look, you're a travel agent, you're wasting our time', and I said, 'Well hold on, you're a government department and I'm a taxpayer, that's what you get paid for.'

Ewan claims that he would have loved to have spent a day with the CAA, but didn't know that the invitation existed.

There was doubt within the CAA as to whether the licence would be issued in time. Altogether, they had less than four weeks to complete investigations which normally take two to three months. They sent a staff member to Savannah and Ft Lauderdale to check on AvAtlantic's charter operations and maintenance facilities, and Ewan made sure he was on the same flight.

On 22 August 1995, the day before Kiwi's first scheduled flight, Ewan Wilson arrived back in Hamilton

aboard the freshly painted Boeing 727. A crowd of several hundred spectators cheered as Patrick Pruett ran up the steps of the aircraft waving the CAA approval which had just come in. The final international approval from the Australian authorities came in a short time later, and New Zealand's Transport Minister had already promised that an airservice licence would be granted, subject to CAA approval.

When asked whether it was responsible of Kiwi Travel to take bookings before the airline had a plane or the required licences, Ewan had this to say:

I knew I was going to have a plane and I knew the licences to fly would be granted. We had faith. If the licences had not been granted in time, we would have operated the scheduled flights as charter flights.

On 23 August 1995, the morning of Kiwi Travel's inaugural flight to Australia, Hamilton's airport was buzzing with excitement. Ewan Wilson had paint on his trousers, and the newly built check-in counter was still not completely dry. Behind the counter were Ewan's wife, Monique (known within the company as 'Fluffy'), working long days for no pay, and Pat Pruett, with bags under his eyes. Finally, everyone was loaded aboard, and the big silver bird sporting the new 'KIWI' logo took off over Hamilton amid applause and cheers from the passengers. New Zealand now had two international airlines. A chronology of events in Kiwi Travel's brief history is summarised in Exhibit 2.

'Peanuts and Cola' class

Ewan Wilson came up with the idea of offering at least 50 seats per flight at bargain-basement return fares of NZ\$349 (Hamilton–Sydney) and NZ\$399 (Hamilton–Brisbane), when other airlines were charging NZ\$629 (for example, Auckland). He dubbed these no-meal, no-bar service fares as 'Peanuts and Cola' class, which turned out to be a stroke of marketing genius. The media quickly latched on to the term, which gained national publicity and jammed the phone lines at Kiwi Travel's office.

In the early days, Kiwi Travel International Airlines wasn't getting much support from local travel agents, and they showed very little interest in booking Kiwi flights. Perhaps this was because they wanted to see if Kiwi would survive, or perhaps they were getting pressure from the major airlines; probably both. To get around this problem, Kiwi took the innovative step of setting up their own toll-free 800 number to handle bookings directly, which also meant they didn't have to

pay commissions to travel agents. Kiwi set up their own reservations centre with an initial complement of 30 staff.

All went well until 18 October 1995, when two tyres blew out as the Boeing 727 landed in Hamilton. Damage to the aircraft was minimal, and under the terms of their lease, AvAtlantic was to provide all service and repairs. Unfortunately, there were delays, caused in part by AvAtlantic's failure to provide parts locally, and Ewan even travelled to Georgia to personally escort the required parts back to New Zealand. In all, the plane was grounded for 10 days, at a cost to Kiwi of NZ\$500 000, as they had to book their passengers on other airlines.

Kiwi Travel attempted to sue AvAtlantic to recover their loss, and as a result, their business relationship soured. In November 1995, Ewan was able to source a nearly-new Boeing 757 from the British-based charter company Air 2000, and sent AvAtlantic's older 727 back. This new arrangement had several advantages for Kiwi:

- 1 The 757 could fly direct to Australia without having to stop in Auckland to fill up.
- 2 Their 'ACMI' lease required Air 2000 to assume all aircraft, crew, maintenance and insurance costs. This included provision of some NZ\$5 million in spare parts in New Zealand, four flight crews, three aircraft maintenance engineers and an operations supervisor.
- 3 As a large Northern Hemisphere operator, Air 2000 had the flexibility to provide Kiwi Travel with additional aircraft that might be required to cope with demand during the Southern Hemisphere's 'high season'.

Within one year (April 1995 – March 1996), Kiwi Travel International Airlines had grown from five staff to almost 200. In their first 10 months of operation, Kiwi's before-tax profit of NZ\$1.2 million was almost double their earlier forecasts. One airline analyst considered the company's financial performance 'stunning' (refer to Exhibit 3). Meanwhile, their chief rival, Air New Zealand, announced a 4 per cent decline in profit to NZ\$135 million for the six months ending December 1995, compared to NZ\$140 million for the same period the previous year.

Kiwi Travel's passenger movements increased from 256 per week in August 1994, to 1 500 in August 1995, to 3 500 in December 1995. Cargo grew from nothing in August 1995, to 14 tons per week in December of the same year. Managing this exponential growth has been no small feat for Ewan and his general manager, Patrick Pruett.

Exhibit 2 | Kiwi Travel International Airlines Ltd

Chronology of events, 1990–April 1996

1990: Ewan Wilson establishes a travel agency called Kiwi Travel in Hamilton, New Zealand.

June 1994: Ewan, his wife Monique, and three partners set up a company called Kiwi Travel Air Charters Ltd. They charter a DC3 to transport passengers from Auckland and Wellington to Hamilton's Agricultural Field Days.

August 1994: The company charters an Air Nauru jet. Offers four Sunday flights from Hamilton to Brisbane.

December 1994: A series of charter flights is offered to Western Samoa and Tonga.

March 1995: Ministry of Transport advises Kiwi that it required an air service licence if it wished to offer scheduled flights. Extension granted until January 1996.

April 1995: Scheduled weekly charters are offered from Hamilton to various destinations in Queensland: Brisbane, Cairns, Rockhampton, Coolangatta and Townsville.

May 1995: Ewan closes the travel agency to concentrate on the airline business. Company name changed to Kiwi Travel International Airlines Ltd.

June 1995: Ewan signs a lease for a Boeing 737 from National Jet Systems in Adelaide.

Advertising begins for trans-Tasman service, scheduled to commence on 23 August.

July 1995: National Jet Systems deal falls through. Kiwi scrambles to find another plane.

Boeing 727 leased from Georgia-based charter company AvAtlantic.

August 1995: Flight attendants interviewed, hired and sent to Georgia for training.

CAA operating approval granted one day before scheduled flights to begin.

August 23: Kiwi's inaugural flight to Australia takes off on schedule.

October 1995: Boeing 727 blows two tyres on landing. AvAtlantic is unable to supply parts and the plane is grounded for 10 days, at a cost to Kiwi of NZ\$500 000.

November 1995: Kiwi leases a nearly-new Boeing 757 from British-based charter company Air 2000 and sends the 727 back to AvAtlantic.

February 1996: Services begin from Dunedin.

March 1996: Kiwi Airlines' staff complement grows to almost 200, including 60 reservations staff, and company profits are described as 'stunning'. Competition heats up as Air New Zealand subsidiary Freedom Air offers more flights on Kiwi's routes.

April 1996: Air 2000 requests an early return of the Boeing 757. In its place, Kiwi leases a 737-400 and a 737-300.

The organisational structure was viewed internally as being 'fairly flat, project-oriented and floating'. For example, someone might be given the task of organising an in-flight magazine and would be responsible for that project from start to finish, reporting directly to Ewan or Patrick. Someone else might be put in charge of setting up an office in Christchurch. A general organisation chart (subject to change) is shown in Exhibit 4. The average age of Kiwi's employees was 27. 'Ours is a very young company,' stated Pat Pruett, 'I've been here almost two years – which makes me one of the old-timers.'

Many of Kiwi Travel's operations were contracted out, which allowed the airline to minimise capital investments while maximising their ability to expand quickly. The aircraft came with three flight crews and maintenance staff as part of the lease agreement. Catering and ground services, including baggage handling, were contracted. Flight attendants were Kiwi's employees, as were about 60 staff at their Hamilton reservation centre.

Kiwi planned to lease a second aircraft in June 1996 – an Airbus A320, which, at 180 seats, was slightly smaller than the Boeing 757 but still capable of direct trans-Tasman service. The A320 was to be leased through Orix, a Japanese bank and leasing firm, and was, according to Ewan, 'the most modern passenger aircraft in the world'. In New Zealand, a Christchurch destination was to be added with a feeder service¹ to Hamilton. Melbourne and Perth would be added to their Australian destinations (refer to Exhibit 5).

The competition heats up

'She's a tough old world out there, and we don't intend to let the grass grow under our feet in terms of addressing them or any other competitor,' were the words of Bob Matthew, chairman of Air New Zealand, when asked in a television interview for his thoughts on Kiwi Travel – New Zealand's second international airline.

There was no doubt in anybody's mind that the big airlines like Air New Zealand and Qantas could, as one

Exhibit 3 | Kiwi Travel International Airlines Ltd

Kiwi Airline's profit 'stunning' says analyst

by Andrea Fox

A [NZ]\$1.2 million before-tax profit announced by Hamilton's new Kiwi trans-Tasman airline is a 'stunning' result, says an aviation financial analyst.

The one-aircraft privately owned, no-frills airline yesterday said it had almost doubled its forecast profit of [NZ]\$700 000 for the 10 months from April 1995 to January.

In this period Kiwi's gross sales from tickets were [NZ]\$13.5 million – [NZ]\$2.5 million better than the airline's own predictions.

Chief executive Ewan Wilson said Kiwi had flown more than 50 000 people.

The broking house analyst, who would not be named because of possible repercussions from Air New Zealand, said if the announcement was correct, the recorded profit was stunning because Kiwi only had shareholder funds of [NZ]\$700 000.

The analyst took a 'cautious' approach to announcements from any company wanting to list on the Stock Exchange. Kiwi is preparing a prospectus for a possible September public share issue.

Kiwi, which started as a trans-Tasman charterer in 1994, became a scheduled international carrier last August. Today it has 155 staff in New Zealand and Australia.

The analyst said a small 'start-up' airline faced several perils, and Kiwi had encountered and apparently survived some of them.

'You can go out the back door very quickly if things go wrong. From the start he (Ewan Wilson) said he didn't intend to be a price setter. And it's clear Air New Zealand and Qantas (his trans-Tasman competitors) decided to drop their fares very quickly (to match) so things could have gone very wrong if he didn't get the yields.'

Another peril was only having one jet when mechanical failures struck. Kiwi was grounded for 10 days shortly after launching as a scheduled airline because of a serious tyre blowout. Mr Wilson said if not for the grounding the profit could have been [NZ]\$500 000 higher.

Kiwi had also been involved in rows – another peril. It's recent run-in with a Cook Islands agency over charters to Rarotonga could have cost it dearly.

Another risk was growing too quickly. The analyst was concerned at Kiwi's plan to build an [NZ]\$8 million building after its sharefloat.

Source: *Waikato Times*, 17 February 1996.

aviation analyst put it, 'squash Kiwi like a bug', should a price war develop. Ewan recognised this risk but remained philosophical:

If it gets too hot in the kitchen, we'll just get out of that kitchen. We'll keep coming up with new niches such as flying out of other provincial airports, but I believe we have a trump card – public support for the little guy. People still support the spirit of entrepreneurship. I think the public appreciates what is likely to happen to airfares if we're forced out of the market.

By early 1996, the kitchen was certainly getting warm (refer to Exhibit 6). Freedom Air, a subsidiary of Air New Zealand, was competing head-on with Kiwi Travel, by offering direct flights from Hamilton to Sydney for NZ\$299, or to Brisbane for NZ\$349. This compared to NZ\$329 (Sydney) and NZ\$379 (Brisbane) for Kiwi's 'Nuts and Cola' flights. In addition, Freedom's customers could, for an additional NZ\$9, choose between two nights' accommodation or two days' car rental in Australia.

Ewan Wilson filed a complaint with New Zealand's Commerce Commission, citing 'predatory pricing by Air New Zealand in an attempt to blast Kiwi out of the skies'. In response, legal counsel for Air New Zealand categorically denied that it had been involved in unlawful predatory pricing 'on certain Tasman routes, or indeed other predatory behaviour designed to eliminate a competitor'. Ewan disagreed, citing information on lease costs and passenger loadings which, he said, clearly showed that Freedom Air was operating well below cost.

To make matters worse, in April 1996 Ewan accused Freedom Air of 'poaching' his staff by offering flight attendants an expense allowance of NZ\$55 per flight in addition to their regular salary of NZ\$24 000 to NZ\$30 000 per year. He commented on this new development:

It's a case of Freedom deliberately targeting every one of our flight attendants. They want our staff because they are well trained and well qualified. I really feel hurt. Four of our flight attendants quit to work for Freedom Air, and three of them were from our original group.

Exhibit 4 | Kiwi Travel International Airlines Ltd

Company organisation chart
April 1996
New Zealand Operations

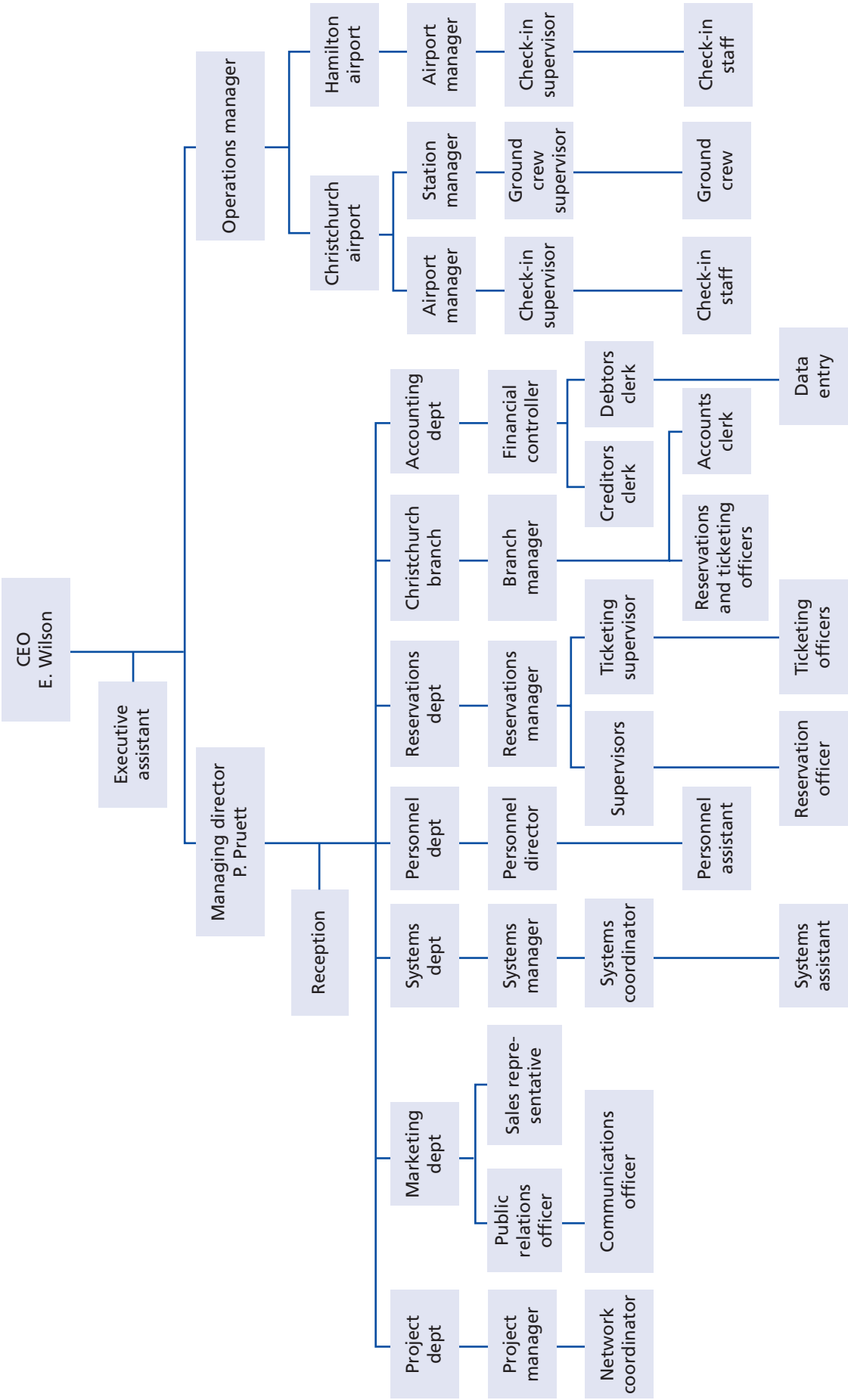


Exhibit 5 | Kiwi Travel International Airlines Ltd

Current and proposed flight route map, April 1996.



Exhibit 6 | Kiwi Travel International Airlines Ltd

Freedom Air turns up heat on city rival

by Andrea Fox

Crunch time is looming for Hamilton's trans-Tasman airline industry.

Air New Zealand-connected Freedom Air yesterday announced it was increasing its limited Hamilton-trans-Tasman operations to seven days a week with low fares. It signals the acid test on Waikato's ability to support two high-frequency trans-Tasman airlines and keep the city's own airline Kiwi flying.

Freedom started in December, flying charters to Brisbane and Sydney from Hamilton, Dunedin, Auckland, Christchurch and Wellington.

Yesterday it announced a new schedule from late April, with more flights from Hamilton and Dunedin, and introducing Palmerston North as a gateway.

Auckland, Christchurch and Wellington would now be served on special dates with specific fares.

Introductory return fares between all Freedom's New Zealand gateways and Sydney would be [NZ]\$299 and Brisbane [NZ]\$349.

Kiwi chief executive Ewan Wilson, who pioneered Hamilton-trans-Tasman flights, said today Freedom's move was 'very nasty'. Kiwi's outlook was bleak without regional support.

'I can tell you now we can't match those fares if they continue them until the end of the year.'

Kiwi's Hamilton-Sydney return is [NZ]\$329, rising to [NZ]\$349 next month. Hamilton-Brisbane return is [NZ]\$379, rising to [NZ]\$399 next month.

May to September was the traditional money-spinning period for a trans-Tasman airline, before the low season of October-November, he said.

Freedom management did not respond to *Waikato Times* calls.

Regional aviation sources said Freedom loadings have been small, with sometimes only 12 people flying out on its 233-seat Boeing 757. The sources said Kiwi's Boeing 757 has had minimum loads of 150.

Freedom spokesman Stuart Eastman recently said Hamilton was the airline's 'soft spot'.

Hamilton airport chief executive Barry O'Connor said whether the region could support two full-time trans-Tasman airlines was 'anybody's guess'.

Waikato Development Foundation chief, Frank van der Velden, said Freedom's move was a 'classic case' of a big company 'using predatory tactics to take out competition that is hurting its bottom line'.

Consumers' Institute spokesman Peter Sutton said competition was good provided it was sustained. Waikato Chamber of Commerce president Gail Jones predicted Freedom would pull out immediately if Kiwi failed.

Air NZ last week reported a slight decline in its six-monthly financial result on the corresponding period last year. It cited trans-Tasman trade as a contributing factor.

Source: *Waikato Times*, 1 March 1996.

Exhibit 7 | Kiwi Travel International Airlines Ltd

Assumptions used in financial projections, 12 months ending 31 May 1997

Aircraft

1	Boeing B757	
	Capacity:	192 passengers
	ACMI lease cost:	US\$3 235 per hour for the first 250 hours, US\$2 805 per hour thereafter
	Fuel consumption:	10.24 litres per mile
	Airbus A320	
	Capacity:	180 passengers. In service commencing 1 July 1996
	ACMI lease cost:	US\$3 361 per hour for first 250 hours, US\$2 726 per hour thereafter
	Fuel consumption:	825 gallons per hour
2	Fuel cost:	US\$0.90 per gallon
3	Landing fees:	New Zealand = NZ\$585 per landing Australia = A\$731 per landing
	Terminal charges:	New Zealand = NZ\$1 per passenger Australia = A\$10 per passenger
4	Aircraft ferry costs:	US\$50 000 delivery and return charge per aircraft
5	Supplementary aircraft rental:	Payable at US\$65 000 per month for the first six months of the A320 lease term

Revenue

6	Passenger:	50% of passengers on 'Nuts and Cola' fares
7	Cargo:	B757 = 3 000 kg per sector at NZ\$0.50 per kg A320 = 2 000 kg per sector at NZ\$0.50 per kg
8	Duty free sales:	NZ\$11.00 per passenger per flight

Other costs

9	Catering:	NZ\$6.60 per person per rotation
	Beverages:	NZ\$2.58 per person per rotation
10	GST:	12.5%. Applicable to domestic (NZ) expenses and income only
	Income tax:	33%

Other assumptions

11	Exchange rates:	NZ\$1.00 = US\$0.647 NZ\$1.00 = A\$0.871
12	Depreciation:	Office equipment = 35% DV Motor vehicles = 26% DV Furniture & fittings = 9.5% DV

Exhibit 8 | Kiwi Travel International Airlines Ltd

Proposed flight schedules, 12 months ending 31 May 1997							
AIRBUS A320							
Destination	Mon	Tues	Wed	Thur	Fri	Sat	Sun
4 HLZ→BNE→HLZ→MEL→HLZ				✈			
3 BNE→HLZ→SYD→HLZ			✈				
5 HLZ→SYD→DUD→SYD→HLZ					✈		
2 BNE→SYD→HLZ→SYD→BNE		✈					
6 HLZ→SYD→HLZ→MEL→PER						✈	
1 BNE→DUD→BNE	✈						
7 PER→MEL→HLZ→BNE→HLZ→BNE							✈
BOEING B757 (or alternative)							
Destination	Mon	Tue	Wed	Thur	Fri	Sat	Sun
8 HLZ→CHC→SYD→CHC	✈						
9 CHC→MEL→PER→MEL→CHC		✈					
10 CHC→BNE→CHC→MEL→CHC			✈				
11 CHC→SYD→MEL→CHC				✈			
12 CHC→BNE→CHC					✈		
13 CHC→BNE→DUD→BNE→CHC						✈	
14 CHC→SYD→DUD→SYD→CHC→HLZ							✈
Destination Codes: BNE – Brisbane; CHC – Christchurch; DUD – Dunedin; HLZ – Hamilton; MEL – Melbourne; PER – Perth; SYD – Sydney.							

Ewan was quick to point out that his airline's initial marketing strategy was based upon location rather than price. They were trying to appeal to a niche market by offering direct air service to Australia from cities (such as Hamilton and Dunedin) which were not served by the other airlines. For example, prior to the arrival of Kiwi, Hamilton residents had no choice but to travel to Auckland if they wanted to catch a plane to Australia. The company's initial target market was the Central North Island region (approximate population of 650 000), and the Lower South Island region (approximately 250 000 people).

When Kiwi Travel announced its plans to expand service to Christchurch, Freedom Air responded by offering its own Australia-direct discount fares from that city. Christchurch was different from Hamilton and Dunedin in that it was already served by Qantas and Air New Zealand. This was clearly moving away from Kiwi's initial strategy of operating out of centres that did not have direct trans-Tasman air service. This move was explained by Rodney Macdonald, Kiwi's communications officer:

Moving into Christchurch is moving into Air New Zealand's territory, but they've already moved into

our territory by offering Freedom Air flights out of Hamilton. But they have actually shot themselves in the foot. In Christchurch, Air New Zealand staff complained that Freedom Air was taking their customers!

In effect, Air New Zealand ended up competing with themselves in the Christchurch market through their subsidiary Freedom Air.

March 1996

Considering that Kiwi Travel International Airlines and its competitive environment were changing, almost on a daily basis, the traditional exercise of 'long-range strategic planning' was almost impossible. Nevertheless, a major accounting firm was given the task of developing financial projections for the 12-month period from 1 June 1996 to 31 May 1997. These projections were made using historical information available at the time (if you consider seven months of scheduled airline operation 'historical') and other assumptions based upon company and industry experience. Refer to Exhibits 7–13 for a summary of these projections and related assumptions.

Exhibit 9 | Kiwi Travel International Airlines Ltd

Projected balance sheet, 31 May 1997 (NZ\$)	
Assets	
Current assets	
Cash	\$22 588 346
Deposits with suppliers	2 508 953
GST balance	1 533 705
Prepayments	25 000
Shareholders' current accounts	233 428
	<u>\$26 889 432</u>
Fixed assets (depreciated value)	
Furniture & fittings	6 145
Motor vehicles	39 731
Office equipment	204 288
Total fixed assets	<u>\$ 250 164</u>
Total assets	<u>\$27 139 596</u>
Liabilities & equity	
Current liabilities	
Bond – flight attendants	\$ 45 000
Flight deposits	6 979 742
Taxation balance	5 767 754
Accounts payable	1 784 993
Total current liabilities	<u>\$14 577 489</u>
Term liabilities	
Hire-purchase account payable	21 165
Authorised, issued & paid-up capital	778 000
Retained earnings	11 762 942
Total liabilities & equity	<u>\$27 139 596</u>
Source: Unaudited company records.	

The projections mentioned above assume the lease of an Airbus A320 aircraft commencing July 1996, to complement the existing aircraft, and the addition of new routes to include Christchurch, Melbourne and Perth. A net profit of NZ\$9.3 million on total revenue of NZ\$72.4 million was forecast for the period. According to Ewan Wilson:

We aim to become the number one independent airline in New Zealand, operating a variety of low-cost services and taking travel to a wide sector of the world market. Synergy will be sought with other airline and tour operators worldwide, to capitalise on seasonal reciprocity and global asset management. Part of our aims are to establish a strong presence in Hamilton, and develop vertical integration of our business in areas such as ground handling, catering, cargo and hangar facilities.

April 1996

In true Kiwi Airlines fashion, the company's situation once again 'changed overnight'. Their British leasing company, Air 2000, requested an early return of the Boeing 757. Instead of extending the lease as Kiwi had originally planned, Air 2000 wanted it back at the end of April. Ewan commented on this latest development:

Kiwi has an excellent relationship with Air 2000, so when they asked for the return of the 757 earlier than originally agreed, to accommodate a busier European summer than expected, we felt obliged to work with them.

In short order, Ewan managed to source two more aircraft to replace the 757. A 126-seat Air Nauru Boeing 737-400, scheduled to arrive at the end of April,

Exhibit 10 | Kiwi Travel International Airlines Ltd

**Projected statement of income and expenses,
12 months ending 31 May 1997 (NZ\$)**

<i>Income</i>	
Sales	\$87 328 380
Less: direct costs	66 115 668
Gross profit	\$21 212 712
<i>Expenses</i>	
ACC levy	\$ 18 000
Accounting & legal fees	18 000
Advertising & promotion	1 575 004
Aircraft ferry expenses	308 892
Cleaning & maintenance	24 000
Communication	379 500
Computer expenses	96 000
Contingency	200 004
Depreciation	124 606
Flight consumable	114 000
Freight	18 000
Fringe benefit tax	10 000
Insurance	996
Interest & bank charges	48 648
Miscellaneous expenses	24 000
Office costs:	
Brisbane office	456 000
Sales office	666 000
General expenses	22 800
Rent	54 300
Salaries, wages, benefits	1 805 928
SITA reservation system fees	276 000
Staff recruitment, seminars, training	346 000
Stationery & subscriptions	38 400
Supplementary aircraft rental	602 316
Travel & entertainment	54 000
Utilities	12 000
Vehicle expenses	36 000
Total expenses	\$ 7 329 394
Profit before taxation	\$13 883 318
Taxation (33%)	4 581 495
Net profit after tax	\$ 9 301 823

Source: Unaudited company records.

Exhibit 11 | Kiwi Travel International Airlines Ltd

Projected monthly income and expenses, 12 months ending 31 May 1997 (NZ\$)													
	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March	April	May	Total
Total sales	3 588 394	8 243 234	8 243 234	8 000 786	7 588 092	7 364 912	8 243 234	8 243 234	6 495 099	7 177 085	6 965 994	7 177 085	87 328 380
Less: direct costs	2 824 377	5 873 231	5 873 231	5 763 299	5 785 072	5 677 732	5 873 231	5 873 231	5 411 687	5 755 685	5 649 159	5 755 685	66 115 668
Gross profit	762 017	2 370 003	2 370 003	2 237 487	1 803 020	1 687 180	2 370 003	2 370 003	1 083 412	1 421 400	1 316 785	1 421 400	21 212 712
Less: expenses	599 851	595 851	674 051	703 050	701 051	637 050	532 665	556 415	556 415	569 665	602 665	600 665	7 329 394
Profit before taxation	162 166	1 774 152	1 695 952	1 534 437	1 101 969	1 050 130	1 837 338	1 813 588	526 997	851 735	714 120	820 735	13 883 318
Less: tax @ 33%	55 515	585 470	559 664	506 364	363 650	346 543	606 322	598 484	173 909	281 073	235 660	270 843	4 581 495
Net profit after tax	108 651	1 188 682	1 136 288	1 028 073	738 319	703 587	1 231 016	1 215 104	353 088	570 662	478 460	549 892	9 301 823

Note: One additional aircraft projected to commence July 1996. June figures reflect the operation of only one aircraft.

Exhibit 12 | Kiwi Travel International Airlines Ltd

Projected current account summary, 12 months ending 31 May 1997 (NZ\$)												
	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March	April	May
Opening bank balance	5 364 760	10 591 181	11 612 425	13 538 345	13 932 775	15 681 968	16 803 118	19 413 338	18 778 308	20 857 004	20 784 872	22 513 688
Total net cash movement	5 226 421	1 021 244	1 925 919	394 430	1 749 193	1 121 151	2 610 220	(635 030)	2 078 696	(72 132)	1 728 816	74 658
Closing bank balance	10 591 181	11 612 425	13 538 345	13 932 775	15 681 968	16 803 118	19 413 338	18 778 308	20 857 004	20 784 872	22 513 688	22 588 346

Exhibit 13 | Kiwi Travel International Airlines Ltd

**Projected statement of contribution to profit per destination,
12 months ending 31 May 1997 (NZ\$)**

Rotation destination	1	2	3	4	5	6	7	8	9	10	11	12	13	14	Total
Avg. aircraft costs per rotation															
ACMI	27 945	34 687	36 012	53 551	48 991	54 837	68 166	28 577	55 572	52 024	31 160	26 648	54 299	52 988	
Fuel	11 097	12 273	13 940	18 806	18 696	18 150	18 806	14 161	18 751	20 771	14 511	11 097	22 194	21 088	
Handling	4 018	12 114	7 010	9 079	8 958	9 809	9 079	7 448	13 102	10 436	8 666	5 218	10 436	12 896	
Landing charges	1 331	3 522	1 992	2 859	2 492	2 471	2 859	3 046	3 298	3 980	2 588	2 102	3 980	4 695	
Airway charges	3 968	8 997	4 810	6 759	6 932	7 154	6 759	3 564	7 888	7 562	3 594	3 968	7 562	7 188	
Aircrew	918	1 709	1 183	1 759	1 609	1 801	1 753	1 423	2 767	2 590	1 551	1 327	2 703	2 638	
Total	49 277	73 302	64 947	92 813	87 678	94 222	107 422	58 219	101 378	97 363	62 070	50 360	101 174	101 493	
Other costs per year															
Commission	280 449	358 488	392 235	556 751	519 840	461 311	625 826	282 631	386 159	513 504	294 782	258 814	513 504	496 614	5 940 908
Catering	97 346	194 693	149 020	194 693	194 693	194 693	243 366	134 598	179 464	179 464	134 598	89 732	179 464	224 330	2 387 154
Beverages	38 054	76 107	57 080	76 107	76 107	76 107	95 134	52 616	70 154	70 154	52 616	35 077	70 154	87 693	933 160
Total	415 849	629 288	595 335	827 551	790 640	732 111	964 326	469 845	635 777	763 122	481 996	383 623	763 122	808 637	9 261 222
Flight hours															
per rotation	7.17	8.9	9.24	13.75	12.57	14.07	17.49	7.41	14.41	13.49	8.08	6.91	14.08	13.74	
Number of rotations	52	52	52	52	52	52	52	48	48	48	48	48	48	48	
Avg. capacity loading	78.58%	78.58%	78.58%	78.58%	78.58%	78.58%	78.58%	74.0%	74.0%	74.0%	74.0%	74.0%	74.0%	74.0%	
Total seat capacity	180	180	180	180	180	180	180	192	192	192	192	192	192	192	
Avg. ticket income per head	\$532.33	\$680.33	\$744.33	\$1 056.33	\$986.33	\$875.33	\$1 187.33	\$582.09	\$795.09	\$1 057.09	\$607.09	\$533.09	\$1 057.09	\$1 086.09	
Other revenue															
Duty free sales	81 122	81 122	81 122	81 122	81 122	81 122	74 777	74 777	74 777	74 777	74 777	74 777	74 777	74 777	1 091 293
Net cargo revenue	104 200	208 400	156 300	208 400	208 400	208 400	260 500	215 145	286 890	286 860	215 145	143 430	286 860	358 575	3 147 505
Contribution summary:															
Total revenue	4 107 687	5 303 346	5 723 229	8 076 243	7 560 013	6 741 418	9 094 432	4 242 799	5 762 462	7 543 505	4 412 746	3 837 988	7 543 505	7 379 007	87 328 380
Total direct costs	2 982 291	4 290 953	3 977 899	5 661 423	5 357 050	5 639 377	6 559 205	3 253 720	5 480 756	5 416 299	3 448 548	2 790 442	5 598 459	5 659 246	66 115 668
Gross profit	1 125 396	1 012 393	1 745 330	2 414 820	2 202 963	1 102 041	2 535 227	989 079	281 706	2 127 206	964 198	1 047 546	1 945 046	1 719 761	21 212 712

Source: Unaudited company records.

and a 148 seat Boeing 737-300 from a leasing company called Aviareps, to commence service on 1 June 1996.

This is yet another exciting time for Kiwi. We are going from our current one aircraft with a seat capacity of 233 passengers, to a total of three aircraft with a seat capacity of 454. Life does not get any easier in the airline business, and we have to be proactive to keep our customers happy. The additional aircraft will allow us to offer a wider variety of flight schedules, including special flights for major events, and will give us greater depth in the area of aircraft backup. These changes will give Kiwi more flexibility to combat competition from Freedom Air.

Over the 'long term', Kiwi Airlines was considering a number of new initiatives:

- Establishment of New Zealand's first on-line booking system, which would allow Kiwi's customers to book

their own flights using a home computer and a credit card number. The company had recently launched their own website,² which was proving extremely popular.

- A public share float on the New Zealand Stock Exchange. Ewan had recently sold 10 000 of his shares to some friends, which had the effect of lowering his holdings from 49 per cent to about 47 per cent. Kiwi's own employees were considered good potential customers for some shares.
- Obtaining its own air operating certificate, and purchasing two new aircraft in May 1997.

Endnotes

- 1 It is important to note that Kiwi Travel's air service licence did not, at present, permit them to operate scheduled flights between points within New Zealand. They were only permitted to ferry their own international passengers to connection points for overseas flights. Kiwi planned to offer 'free' flights between Christchurch and Hamilton for their Kiwi class (full economy) passengers booked on international flights.
- 2 As of October 1997, Kiwi's web address was: www.kiwi-travel.co.nz/.

Case 8

Beefing up the beefless Mac: McDonald's expansion strategies in India*

Nitin Pangarkar
Saroja Subrahmanyam
National University of
Singapore

Background

In March 2001, the McDonald's Corporation's Indian operation was at a critical juncture in its evolution. Over the previous few months, the company had expanded its retail base from Mumbai (10 outlets) and Delhi (14 outlets) to Bangalore (one outlet), Pune (one outlet), Jaipur (one outlet) and the Delhi-Agra highway (one outlet). During 2001, McDonald's had plans to open 15 more outlets with one each in Ludhiana and Ahmedabad (see Exhibit 1 for a brief profile of the different cities and Exhibit 2 for a map showing their locations in India) and the rest in cities where it already had a presence. By 2003, the company planned to increase the number of outlets to 80 and the cumulative investment in India to more than Rs 10 billion. (The approximate exchange rate in March 2001 was Rs 46.50 = US\$1.) This would represent a threefold increase over the cumulative investment until June 2000 (Rs 3.5 billion). Three other cities (Agra, Baroda and Chandigarh) would also have at least one McDonald's outlet by 2003.

The Indian venture had been operational for more than four years and had recorded healthy growth but no profits. Commenting on the progress until that point in time, Vikram Bakshi (McDonald's partner in Delhi) said: 'Our growth and expansion in India over the last three years has definitely been very encouraging.' Only a few months previously, Amit Jatia (McDonald's other partner in charge of the Mumbai outlets) had said: 'We are still to recover our investment. You need a very large

base and break-even is normally after seven to ten years.' Despite the venture's lack of profits, Jatia also showed his enthusiasm for expansion when he said, 'Having cracked the Indian market, McDonald's is ready to leverage its initial investments in infrastructure to rapidly expand.'

Observers were wondering about the appropriateness of McDonald's bold strategic move. Was the additional investment wise, especially in view of the lack of profitability of the existing operations? Since many of the new cities to be entered were less Westernised than Mumbai or Delhi, many observers doubted whether the demand potential would be sufficient to justify the economic operation of outlets. The cost and availability of prime real estate in major Indian cities was another issue. Opening a new outlet required an average investment of Rs 30 million. In Mumbai and Delhi, where prime real estate was expensive, the investments could be higher. Finally, some analysts doubted whether McDonald's could afford to spend big amounts on advertising to create a strong brand-name reputation if its outlet base and customer base remained relatively narrow.

McDonald's – the global fast-food powerhouse

McDonald's is, by far, the world's biggest marketer of fast food. In 2000, it operated nearly 30 000 restaurants and had 1.5 million people serving 45 million customers each day in 120 countries. The company had built an impressive set of financial figures, with US\$40.2 billion in system-wide sales (out of which US\$24.5 billion was accounted for by franchised

This case was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative or business situation.

Exhibit 1 | Profile of the Indian cities targeted by McDonald's

Place	Population (000s)		Remarks	State	Annual per capita income in Rs	Annual per capita income in Rs
	1991	2001			(1997–8) ¹	(1997–8) ²
Agra	892	1 076	Tourist attraction; home to the Taj Mahal	Uttar Pradesh	7 263	5 890
Jaipur	1 459	1 893	Major tourist attraction	Rajasthan	9 356	7 694
Chandigarh	504	790	Capital city of two northern states, Punjab & Haryana	Punjab & Haryana	19 500	14 457
Ahmedabad	2 955	3 823	Major business centre in western India	Gujarat	16 251	13 709
Vadodara/Baroda	1 031	1 454	Business centre	Gujarat	16 251	13 709
Mumbai	9 926	12 903	Commercial capital of India	Maharashtra	18 365	16 217
Pune	1 567	2 004	Satellite town of Mumbai; manufacturing centre	Maharashtra	18 365	16 217
Ludhiana	1 043	1 482	Textile manufacturing centre in northern India	Punjab	19 500	1 457
Delhi	9 119	13 661	Capital city, seat of the central government	Delhi	22 687	19 091
Bangalore	2 660	3 637	India's Silicon Valley	Karnataka	11 693	11 153

Notes:

1 Income data from Per Capita Income (State-wise) – Maps of India. The figures refer to the whole state and not the particular cities. Income levels for cities are likely to be somewhat higher than the figures for the whole states.

2 Income data from the Associated Chambers of Commerce and Industry of India (<http://203.122.1.245/assocham/prels/04181.asp>). The figures refer to the whole state and not the particular cities. Income levels for cities are likely to be somewhat higher than the figures for the whole states.

Sources: Population data from www.world-gazetteer.com/fr/fr_in.htm.

restaurants), US\$21.7 billion in assets, US\$3.3 billion in operating profits and US\$2 billion in net profits. (See Exhibit 3 for a geographic analysis of McDonald's operations.) It was also routinely cited by the business press as being a savvy marketer. In June 1999, with a value of US\$26.231 billion, the McDonald's brand was rated as being the eighth most valuable brand in the world, ahead of well-known brands such as Sony, Nokia and Toyota.

McDonald's has had a long history in Asia. It entered the Japanese market in 1971, which was followed by entry into other newly industrialising economies (such as Singapore and Hong Kong, among others) in Asia. Entry into China occurred only in 1990. McDonald's entered India in 1996. (See Exhibit 4 for McDonald's start-up dates in East Asian and South Asian countries.) The late entry could be attributed to several factors, such as the fact that a significant percentage of India's population is vegetarian, the limited purchasing power of the population and the closed nature of the economy.

The Indian market

India is a vast subcontinent with an area one-quarter of that of the United States, and a population almost four times that of the US, at about 950 million. The per capita GDP is quite low, at US\$390 in 1999. However, after adjusting for purchasing power parity, India was ranked the fifth-largest economy in the world (ranking above France, Italy, the UK and Russia) with the third-largest GDP in Asia in 1999. (See Exhibit 5 for income distribution in India.) Among emerging economies, India is often considered second only to China.

India's economic diversity is matched by its social diversity. There are more than 20 major spoken languages and over 200 dialects. The Indian currency (Rupee) has its denomination spelt out not only in English and Hindi, but also in 13 other languages. About 50 per cent of the population is considered to be illiterate, and advertising reaches them via billboards and audiovisual means. For national launches, at least eight languages are used. In addition, the country faces

Exhibit 2 | McDonald's outlets in India (existing and planned)

a poor infrastructure with frequent power outages, even in New Delhi (the capital city) and Bangalore (India's Silicon Valley).

In terms of political system, India is a democracy. Since independence from the British in 1947, the economic system has historically been modelled on the socialist style. Under this system, the government strictly controls the entry and exit of domestic as well as multinational corporations (MNCs) into different sectors. MNCs also face a variety of other restrictions. Since 1991, India has started deregulating the economy. However, the socialist mind-set cannot be erased overnight. A Member of Parliament said of fast-food chains such as McDonald's and KFC, 'We want computer chips and not potato chips.'

The country has a few anti-Western factions, which have opposed the entry of MNCs in general. The mistrust of MNCs could be at least partially attributed to the fact that the British rule of India was rooted in the entry of the British East India Company (for trading purposes) into the country. There are also several small

Exhibit 3 | Geographic analysis of McDonald's operations and performance (financial year 2000)

	Geographic breakdown					
	Total	USA	Europe	Asia-Pacific	Latin America	Others
Revenues	14 243	5 259	4 754	1 987	949	1 294
Operating income	3 330	1 773	1 180	442	102	94
Total assets	21 684	7 877	7 084	2 790	1 856	1 069
Capital expenditures	1 945	469	798	224	246	161
Depreciation & amortisation	1 011	418	297	121	69	61

Notes:

- All figures in US\$ millions.
- Corporate accounted for US\$262 million (loss) to operating income, US\$1009 million of assets, US\$48 million of capital expenditures, and US\$46 million of depreciation and amortisation.
- Figures may not add up, due to rounding.

Source: www.mcdonalds.com.

but vocal groups of health activists and environmentalists that are opposed specifically to the entry of fast-food giants such as McDonald's and KFC. When KFC opened its restaurant in Bangalore in 1995, local officials found that KFC had excessive levels of monosodium glutamate (MSG) in its food and closed the outlet. The outlet soon reopened, however. Said Vandana Shiva, a vocal exponent of environmental and animal welfare issues, in an audio interview with McSpotlight,

The McDonald's experience, which is really the experience of eating junk while thinking you are in

heaven, because of the golden arches, which is supposed I guess to suggest that you enter heaven, and the clown Ronald McDonald, are experiences that the majority of the Indian population would reject. I think our people are too earthy. First of all, it would be too expensive for the ordinary Indian – for the peasant, or the person in the slums. It's an experience that a very tiny elite would engage in, and most of that elite – which knows what good food is all about – would not fall for it. McDonald's is doing no good to people's health, and in a country like India where first of

Exhibit 4 | Dates of McDonald's entry into East and South Asian markets

Year	Country
1971	Japan
1975	Hong Kong
1979	Singapore
1980	Philippines
1981	Malaysia
1984	Taiwan
1985	Thailand
1988	South Korea
1990	China (Shenzhen Special Economic Zone)
1991	Indonesia
1992	China (Beijing)
1996	India
1998	Pakistan
1998	Sri Lanka

Sources: J. L. Watson (ed), 1997, *Golden Arches East* (Stanford, CA: Stanford University Press), Table 2; *Food and Drink Weekly*, 26 October 1998.

all, we are not a meat culture, and therefore our systems are ill-adapted to meat in the first place, and where people are poorer – shifting to a diet like this will have an enormous impact.

Since 1991, when the Indian economy began opening up to foreign investments, many multinationals have rushed in – lured by the attraction of serving a large middle class, estimated at 300 million. However, even some of the well-known global brands failed with their initial strategies and were forced to reposition, including, in some cases, drastic reduction of prices. Some multinationals (for example, Peugeot) even had to close shop. Kellogg's, which entered with high-priced cereals (several orders of magnitude more expensive than a traditional Indian breakfast), faced a lack of demand. KFC initially failed to realise that Indians were repulsed by chicken skin, which was vital for the Colonel's secret batter to stick. Thus, apart from a lack of understanding of the local tastes, a combination of circumstances – including overestimation of the demand potential, rosy assumptions about the dismantling of bureaucratic hurdles to doing business, infrastructural inadequacies and, finally, inappropriate firm strategies (for example, pricing) – led to many failures and disappointments.

McDonald's entry strategy in India

McDonald's India was incorporated as a wholly owned subsidiary in 1993. In April 1995, the wholly owned subsidiary entered into two 50:50 joint ventures: with Connaught Plaza Restaurants (Vikram Bakshi) to own and operate the Delhi Restaurants; and Hardcastle Restaurants (Amit Jatia) to own and operate the Mumbai outlets.

Although McDonald's had done product adaptation to suit local tastes and cultures in several previous ventures, such as the Teriyaki Burger in Japan, rice dishes in Indonesia, noodles in Manila and McLox Salmon sandwiches in Norway, the degree of adaptation required in India was significantly greater. McDonald's replaced its core product, the Big Mac, with the Maharaja Mac. The latter had a mutton patty (instead of the beef patty in the Big Mac), to avoid offending the sensibilities of Hindus (80 per cent of the population), who consider killing cows as sacrilegious, and Muslims (12 per cent of the population), for whom pork is taboo. In addition, since 40 per cent of the market is estimated to be vegetarian, the menu included the McAloo Burger (based on potato), a special salad sandwich for vegetarians, and the McChicken kebab sandwich. It also

Exhibit 5 | Income distribution in India

Classification	Number of people (millions)	Households (millions)	Income in US\$
The Deprived	763	131	<600
The Aspirants	120	20	1 000–3 000
The Climbers	45	8	3 000–6 000
The Strivers	25	5	6 000–12 500
The Rich (total)	2.18	0.3545	>12 500
The Near Rich	1.55	0.25	12 500–25 000
The Clear Rich	0.444	0.074	25 000–50 000
The Sheer Rich	0.144	0.024	50 000–125 000
The Super Rich	0.039	0.0065	>125 000

Sources: Income figures are approximate and based on A. Chatterjee, 1998, 'Marketing to the superrich', *Business Today* (Living Media India Ltd), 22 April; W. Berryman and J. McManus, 1998, 'India: Turning the elephant economy', *Independent Business Weekly*, 24 June.

offered spicier sauces, such as McMasala and McImli (made from tamarind). Other elements of the menu, such as chicken nuggets, fillet fish sandwiches, fries, sodas and milkshakes, were in common with the rest of the McDonald's system.

In 1998, McDonald's India set up a menu development team to collect consumer feedback. Subsequently, the team came up with its menu vision, and new products since then have been based on this vision.

The adaptation of the strategy went well beyond the menu, encompassing many aspects of the restaurant management system. Two different menu boards were displayed in each restaurant – green for vegetarian products and purple for non-vegetarian products. Behind the counter, restaurant kitchens had separate, dedicated preparation areas for the meat and non-meat products. The kitchen crew (in charge of cooking) had different uniforms to distinguish their roles and did not work at the vegetarian and non-vegetarian stations on the same day, thus ensuring clear segregation. The wrapping of vegetarian and non-vegetarian food took place separately. These extra steps were taken to assure Indian customers of the wholesomeness of both products and their preparation. To convince Indian customers that the company would not serve beef and would respect the culinary habits of its clientele, McDonald's printed brochures explaining all these steps and took customers on kitchen tours.

McDonald's positioned itself as a family restaurant. The average price of a 'Combo' meal, which included

burger, fries and Coke, varied from Rs 76 for a vegetarian meal to Rs 88 for a Maharaja Mac meal. This could be compared with KFC meal prices at Rs 59 (Crispy Burger, regular fries and large Pepsi) and Rs 79 (KFC Chicken, Colonel Burger and regular Pepsi). McDonald's Happy Meal, which included a complimentary toy, was priced at Rs 46. The prices in India were lower than in Sri Lanka or Pakistan, and even the price of the Maharaja Mac was 50 per cent less than an equivalent product in the United States.

To fight its premium image among the public, the company undertook selective price cutting and ran some periodic promotions. In February 1999, the company was offering 'economy meals' for as low as Rs 29. The company reduced the price of vegetable nuggets from Rs 29 to Rs 19 and that of its soft-serve ice-cream cone from Rs 16 to Rs 7. Apparently, this still afforded McDonald's a healthy margin (40 per cent for cones). As Vikram Bakshi, explained, 'I will never become unaffordable, as I will not then be able to build up volumes.' The lower price could be attributed to two factors: the pricing strategies of MNC rivals as well as mid-range local restaurants, and the development of a local (low-cost) supply chain.

McDonald's pricing strategies, as well as special promotions, were influenced by rivals. In February 1999, several competitors were running special promotions, with KFC offering a meal inclusive of chicken, rice and gravy for Rs 39. For Rs 350, Pizza Hut was offering a whole family meal, including two medium pizzas, bread and Pepsi. Wimpy's was offering

mega meals at Rs 35. A typical vegetarian 'set meal', or 'thali' (which included Indian breads, rice, vegetables and yogurt) at a mid-range restaurant cost around Rs 50, which was considerably lower than a McDonald's meal.

Some analysts believed that that by introducing loss leaders (for example, cones), McDonald's wanted to highlight good value for all its products. Whether customers attracted by special promotions pay repeat visits to McDonald's remains to be seen.

In October 2000, the company introduced two new Indianised products to its menu – the Chicken McGrill and the Veg Pizza McPuff. At that point in time, 75 per cent of the menu in India was unique – that is, different from the rest of the McDonald's system. The Chicken McGrill had a grilled chicken patty topped with onions and mint sauce, to give it an Indian flavour. The Veg Pizza was a takeoff on the popular Indian samosa (potato-based curry puff) with differences in shape (rectangular) and stuffing (capsicum, onions and Mozzarella cheese with tomato sauce). In keeping with the low pricing strategy in India, these items were priced at Rs 25 and Rs 16, respectively.

With its value pricing and localised menu, McDonald's had attracted some loyal customers. One such customer said, 'A normal kebab, with all the trimmings, at a regular restaurant would cost more than Rs 25 and if the new McGrill is giving us a similar satisfaction with its mint chutney (sauce), then we'd rather eat in a lively McDonald's outlet than sitting in a cramped car on the road.'

Some elements of the promotional strategy remained the same as in other parts of the world. One instance of this included the emphasis on attracting children. A Happy Meal film was consistently shown on the Cartoon Network and the Zee (a local channel) Disney Hour. McDonald's also teamed up with Delhi Traffic Police and the Delhi Fire Service to highlight safety issues, again trying to create goodwill among schoolchildren. In October 1999, in conjunction with The Walt Disney Company and UNESCO, McDonald's launched a search for Millennium Dreamers. The program would bring together 2 000 young people from around the globe who had made a positive and significant impact on their communities. Based on the number of its outlets, India was allocated two representatives.

By June 2000, the company had started rolling out its first national campaign, as it was expanding beyond Mumbai and New Delhi. The campaign, budgeted at Rs 100 million, was expected to highlight (in phased order) the brand (the experience that there is something special

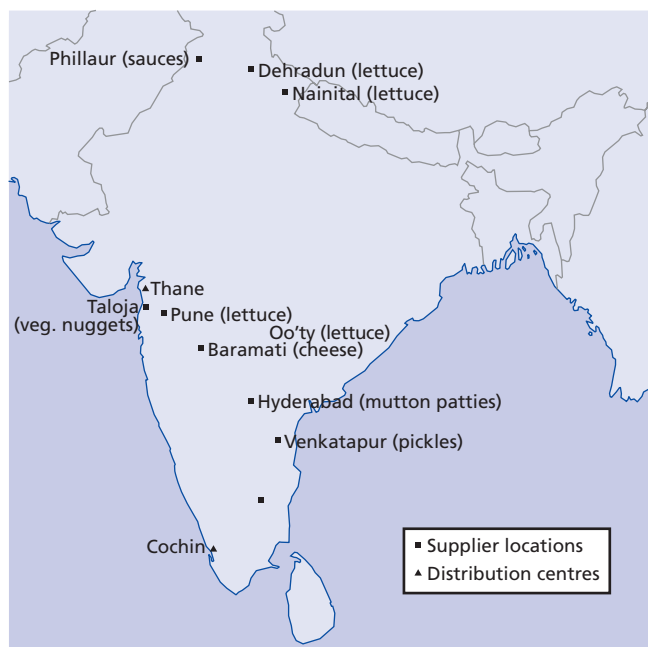
about McDonald's), food quality and variety. The company also ran special promotions during festivals, and 'vegetarian' days, and was even developing garlic-free sauces to bring in 'hard-core' vegetarian traffic.

In terms of the selection of cities, McDonald's followed the same strategy in India as in the rest of the world. Its initial focus on Mumbai and Delhi was driven by the following factors: they were the two largest cities in India; their citizens enjoyed relatively high income levels compared to the rest of the country; and they were exposed to foreign food and culture. After establishing a presence in the leading cities, McDonald's then moved to smaller satellite towns near the metropolitan cities (for example, from Delhi to Gurgaon and Noida, both suburbs of Delhi, and from Mumbai to Pune). McDonald's often found that there were positive spillover effects, in terms of its reputation, from the metropolitan cities to the satellite towns. In Jaipur, the company was hoping to attract foreign tourists.

Developing the supply chain

McDonald's search for Indian suppliers started as early as 1991. Its initial challenge was to develop local suppliers who could deliver quality raw materials, regularly and on schedule. In the five-and-a-half years until start-up, McDonald's spent as much as Rs 500 million (US\$12.8 million) to set up a supply network, distribution centres and logistics support. By mid-2000, some estimates placed the total investment in the supply chain at almost Rs 3 billion. Local suppliers,

Exhibit 6 | McDonald's supply chain in India



distributors and joint venture partners and employees had to match the restaurant chain's quality and hygiene standards before they became part of its system.

McDonald's experience in identifying and cultivating the supplier of lettuce provided an excellent illustration of the difficulties involved. In 1991, hardly any iceberg lettuce was grown in India, except for a small quantity grown around Delhi during the winter months. McDonald's identified a lettuce supplier (Mangesh Kumar from Ootacamund in Tamilnadu, a southern state) and helped him in a broad range of activities, from seed selection to advice on farming practices. In the case of several other suppliers, such as Cremica Industries which supplied the sesame seed buns, McDonald's helped them to gain access to foreign technology. In another instance, it encouraged Dynamix, the supplier of cheese, to establish a program for milk procurement by investing in bulk milk collection and chilling centres. This, in turn, led to higher milk yields and overall collections, as well as to an improvement in milk quality. McDonald's ended up with a geographically diverse sourcing network, with buns coming from northern India, chicken and cheese from western India, and lettuce and pickles from southern India. There were as many as 40 suppliers in the company's supply chain. (See Exhibit 6 for McDonald's supply chain.)

A dedicated distribution system was established to match the suppliers' production and delivery schedules with the restaurant's needs. The first two centralised distribution centres were set up near Mumbai and at Cochin (in the southernmost part of India) in joint ventures with two local retailers, both of whom had to learn from international distributors of McDonald's products how the restaurant chain handled distribution worldwide and, especially, how to enhance the quality of storage operations. The company estimated that each distribution centre could service about 25 outlets. McDonald's strove to keep the storage volumes of products high in order to exploit all possible economies of scale. The distribution centres were also expected to maintain inventory records and to interact with suppliers and the logistics firm to ensure that their freezers were well stocked. Said Amit Jatia, 'The most important part of our operations was the development of a cold chain [the process of procurement, warehousing, transportation and retailing of food products under controlled temperatures]. There is practically no need for a knife in any restaurant. All the chopping and food processing is done in the plants. Only the actual cooking takes place in the restaurants.'

Even with the suppliers and distribution system in place, McDonald's needed a distribution link to move

raw materials to its restaurants. Logistics management was contracted out to AFL Logistics – itself a 50:50 joint venture between Air Freight (a Mumbai-based firm) and FX Coughlin of the United States, McDonald's international logistics provider. AFL logistics was responsible for the temperature-controlled movement of all products (by rail, road or air, as appropriate) from individual suppliers to the regional distribution centres.

McDonald's had to work extremely hard at inculcating a service orientation in its employees, especially those involved in physical logistics, since the freshness of the food was at stake. The truck operators had to be explicitly and clearly instructed not to switch off the truck's refrigeration system to save on fuel or electricity. The corporation went to the extent of installing trapping devices, which would show the temperature chart through the entire journey.

Since 1999, McDonald's had started using India as an export base for cheese, lettuce and other products that went into its burgers. Exports had already begun to Sri Lanka, where it had opened in October 1998, and trial shipments had commenced to Hong Kong and the Middle East. Said Amit Jatia, 'Things are becoming global in nature. Once you set up a supply chain in a strategic location, it can service other countries as well.'

Past performance and planned strategies

During its first 12 months of operations, McDonald's opened seven outlets (four in Delhi and three in Mumbai), had 6 million customer visits and served 350 000 Maharaja Macs. By the end of 1998, the number of outlets had gone up to 14, and, by mid-2000, it had expanded to 25 outlets with an outlet in Pune and Jaipur. The estimates for average daily customer visits to a McDonald's outlet differed widely. According to a mid-range estimate (conservative estimates were half as much, whereas generous estimates could be about 40 per cent higher), in June 2000, McDonald's outlets were doing (on average) about 1 500 transactions (or bills raised) a day, serving over 3 500 visitors. This was a significant improvement over 1998 when a typical McDonald's restaurant was doing only 900 transactions per day (according to the same source). Industry sources, however, were in agreement that the spending per customer visit at McDonald's was around Rs 45.

The growth rate in McDonald's sales had been 70 per cent over the previous two years (1998–2000) and was expected to be sustained until 2002. This growth rate included the effect of starting up new outlets. Even with this growth, analysts were expecting that the

Indian operation would take three to four more years to break even overall. This was attributable to the heavy investments made in vendor development, infrastructure and brand building.

One gratifying aspect of McDonald's success was the fact that, by mid-2000, it derived as much as 50 per cent of its revenues from vegetable food items, thus disproving its critics – especially those who were sceptical of its ability to serve food that suited Indian palates. In 1997, customers rated McDonald's food as bland. By September 2000, the perception had changed, however. Customers thought that McDonald's food had a unique taste.

To exploit the opportunities created due to its better brand awareness and customer acceptance, McDonald's was following a three-pronged strategy: increase the seating capacity in existing outlets to cater to additional traffic; open new outlets in Mumbai and Delhi; and, finally, penetrate new cities.

McDonald's was also in talks with Delhi Metro Rail Corporation, Airports Authority of India, Indian Railways and Delhi Development Authority to open smaller McDonald's outlets in airports and railway stations, among others. The investments required to open these smaller outlets were only half that of the regular outlets.

High real estate prices were a thorny issue in nationwide expansion. In metropolitan cities such as Mumbai, prime real estate was extremely expensive and sometimes not available at all. The costs were also high in other cities such as Bangalore. 'Our expansion plans are always relative to the availability of real estate, Bakshi said.

McDonald's also had plans to set up several outlets along the Delhi-Agra national highway in a tie-up with a major petroleum refining and marketing organisation, Bharat Petroleum Corporation Limited. Jatia said, 'We feel both local tourists and foreigners travelling by road don't have many reliable eating options right now.' The first such outlet, a project estimated at Rs 35 million, was already in operation. The company proposed to offer highway travellers parking space and a play area for children. The emphasis on quality, service, cleanliness and value (QSCV) had been quite successful in drawing highway travellers in its home market (the United States). Some analysts, however, believed that highway travellers in India, who were typically truck and bus drivers, would not be willing to go in for the type of food or prices that McDonald's currently offered. In addition, McDonald's was looking at tie-ups with other oil companies, as well as retail vehicles such as malls, multiplexes or cinema halls.

Endnote

- * This case was first published, in an earlier form, in Kulwant Singh, Nitin Pangarkar and Gaik Eng Lim (eds), 2001, *Business Strategy in Asia: A Casebook* (Singapore: Thomson Learning).

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Case 9

Nucor Corporation and the US steel industry

Brian K. Boyd
Steve Gove
Arizona State University

Darlington, South Carolina, 1969. Making steel is a technically demanding, complex and dangerous process. Nucor Corp.'s initial foray into steel production was the latter. Instead of staffing the plant with seasoned steel veterans, Nucor hired farmers, mechanics and other intelligent, motivated workers. Those employees along with company executives and dignitaries in attendance at Nucor's mill opening fled the plant as the inaugural pour resulted in molten steel pouring on to the mill floor and spreading towards the crowd. Onlookers and employees alike were left wondering if Nucor would ever successfully produce steel.¹

The steel industry, a classic example of a market in the late stages of maturity, traces its roots to colonial-era blacksmiths who forged basic farm and household equipment. The industry grew (and consolidated) rapidly in the first half of the 20th century, with worldwide demand growing throughout the 1960s. However, a series of shifts in market dynamics led to dramatic industry-wide declines in growth and profitability. The dominant players faced the same problems as leaders of other mature industries – Ford and General Motors, for example: obsolete production facilities, bureaucratic management systems, heavily unionised workers and hungry foreign competitors. Due to its centrality in the economy, the decline of the steel industry was cited by some observers as evidence of the decline of the overall US economic system.

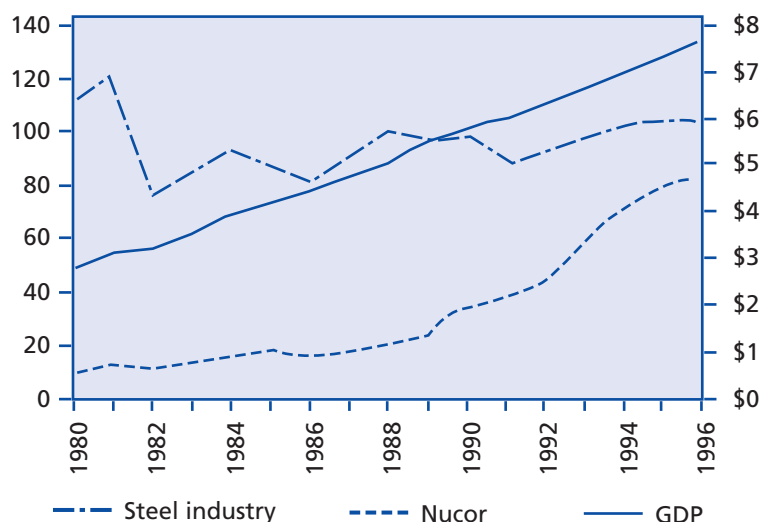
While foreign competition played a significant role in changing the US steel industry, an even larger factor emerged during the 1970s: minimill technology. Traditional 'integrated mills' rely on large-scale vertical integration including integrated coke and ore production. 'Minimills' used a new technology to recycle scrap steel and quickly stole most of the

commodity steel market away from integrated producers. This enabled minimills to enter a geographic market with a distinct cost advantage: they typically require a capital investment of US\$300 to US\$500 million, or 5–10 per cent of that required for an integrated mill. The minimill revolution has resulted in a dramatic dispersion of the steel manufacturers from the 'rust belt' to the primary population and growth areas of the United States. The impact of minimills on the industry is best demonstrated by looking at the former industry leader US Steel (now USX Corp.). In 1966, US Steel controlled 55 per cent of the American steel market; in 1986 it controlled only 17 per cent.

Despite its inauspicious foray into steel, Nucor Corp. has become the benchmark for both the US steel industry and US industry in general. Nucor is one of the fastest growing and most efficient steel producers in the world. Despite declining demand for steel, Nucor's growth has been phenomenal. Since pouring its first batch of steel in the 1960s to support in-house operations, the company has become one of the top five producers of steel in the United States. Without an R&D department, Nucor has repeatedly achieved technological feats other steel producers thought impossible. Their hourly pay is among the lowest in the industry, yet they have the highest productivity per worker of any steel producer in the US and near zero employee turnover. How has Nucor achieved such phenomenal success? Can it continue to do so?

US steel industry history

Steel has been a part of the domestic economic system since the colonial era, when iron (the parent of steel) was smelted and forged. The early 19th century, with the advent of steam engines, cotton gins and farming

Exhibit 1 | Comparative trends: GDP, steel industry output and Nucor output, 1980–96

Note: Information is overall trends; it is not to scale for comparison. GDP is scaled on right axis in trillions of 1992\$. Industry is scaled on left axis in million tons. Nucor is scaled on left axis in million tons, but shown at 10X.

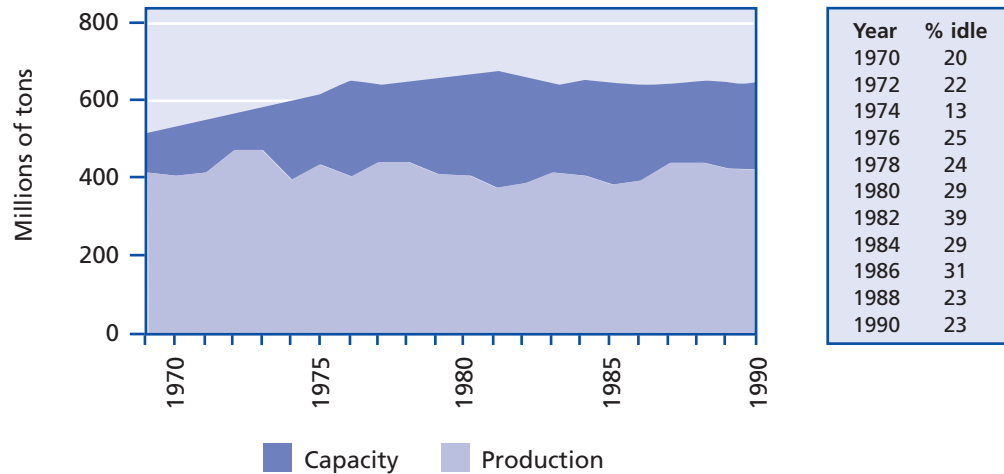
combines, advanced iron as a commodity of progress. The addition of carbon to iron yielded a material with additional strength, elasticity, toughness and malleability at elevated temperatures. The Civil War provided the impetus for the industry to organise, consolidate, expand and modernise to supply the vast quantities of steel required for warfare.

Following the Civil War, the construction of new transportation systems, public works projects, automobiles, bridges, ships and large buildings all fuelled a torrid expansion of the industry lasting through the turn of the century. Domestic economic expansion and two world wars maintained an unquenchable appetite for steel both in the United States and around the world in the first half of the 20th century. Even in the aftermath of the Second World War, America's steel industry prospered as it supplied an ever-expanding domestic economy and the rebuilding of war-ravaged infrastructures. This windfall for the domestic industry was in actuality one of the root causes for its eventual decline. US plants, left idle by the end of the war, were reactivated to support the Marshall Plan and MacArthur's rebuilding of Japan. The war-torn nations of the world, however, rebuilt their industrial facilities from the ground up, incorporating the latest production technology. Conversely, domestic producers were content with older, formerly inactivated facilities.

Global demand for steel expanded continuously throughout the 1960s; domestic producers elected not to meet this demand, choosing only to match domestic consumption requirements. This presented an

opportunity for up-start foreign producers to rejuvenate and strengthen themselves without directly competing against US producers. Throughout this expansion, the relationship between management and labour soured. In 1892, Henry Clay Frick's Pinkerton guards attacked striking workers, setting the stage for a contentious relationship between management and labour. Labour, represented by the United Steel Workers of America (USWA), and management began negotiating three-year collective bargaining agreements beginning in 1947. These negotiations frequently collapsed, and strikes following the third year of a contract became commonplace. Firms dependent on steel soon initiated a pattern of accumulating 30-day 'strike hedge' inventories to feed operations during strike shutdowns. In 1959, the USWA walked out for 116 days. In 1964, another strike required presidential intervention. The impact of these strikes reverberated throughout the economy. Major customers began to look for stable supplies of steel from foreign producers who, in 1959, met only 3 per cent of domestic demand. Fuelled by excess capacity and strike-induced demand, foreign producers were providing 18 per cent of domestic demand by the time a long-term labour accord was reached in the early 1970s. Foreign producers currently supply 20–25 per cent of the steel used in the United States.

Protectionists are quick to blame the Japanese for the decimation of the American steel industry. However, other countries have an even stronger presence in the US market: since 1991, for example, Canada has exported

Exhibit 2 | World capacity, production and idle capacity, 1970–90

more steel to the United States than has Japan. By 1994, Europe and other regions accounted for the bulk of steel imports. While foreign producers maintain a strong presence in the United States, the same cannot be said for American steel firms abroad. Exports by US firms have traditionally been minuscule, 1 per cent of production in the mid-1980s, but have grown to 3–5 per cent of production during the 1990s.

While the labour accords reached in the 1970s stabilised the supply of domestic steel, the cost of living adjustments (COLAs) and automatic wage adjustments included in the accords would prove to be detrimental to the industry's cash position during periods of reduced demand for steel. Such a situation was experienced in the 1970s when the domestic automobile industry, historically the largest consumer of steel in the United States, began to decline. Domestic producers attempted to remedy the resulting cash flow crisis with layoffs and price hikes, but the price hikes came at the expense of further market share erosion to low-cost foreign producers. While the industry claimed productivity improvements, these were often the result of layoffs and shutdowns, as opposed to process efficiency improvements.

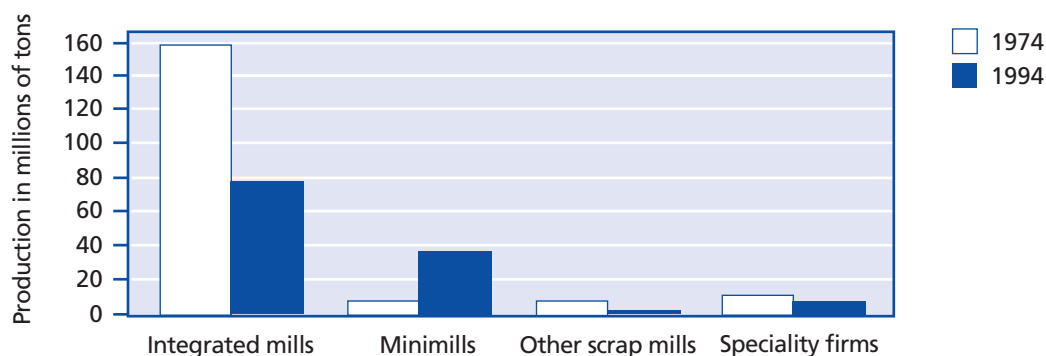
The slowdowns and closures of the 1970s set the stage for the steel industry's 'dark ages' – the period from 1980 to 1986 when steel output declined from 115 to 80 million tons despite an increase in real GDP. The energy crisis led to demand for smaller, lighter cars which require less steel, also resulting in less required tonnage. R&D in the steel industry led to stronger blends of steel. New materials, such as petroleum-based materials (plastics), organics (wood/pulp) and synthetic materials (fibreglass, epoxies) became significant threats

in several applications customarily met by steel. Overall employment in steel fell from 535 000 in 1979 to 249 000 in 1986.

Despite this decline, this was also a period of shakeout and dynamic activity in the industry. Slowly, and with the help of the federal government (primarily in tax and regulatory relief and enforcement of Uruguay Trade Agreements/Voluntary Restraining Agreements), some firms were able to revitalise their operations by streamlining production, selecting better markets, focusing production (minimills), improving facilities, stabilising labour contracts, and reducing labour content through plant modernisation, dollar devaluation and a reprieve from the onslaught of substitute materials. This gave the surviving firms an opportunity to recover and prosper.

Historically, demand for steel fluctuates in both the US and international markets due to its close ties to durable and capital goods, markets which suffer more acutely during austerity and are more prosperous during economic expansions. Economic swings notwithstanding, there has been little appreciable growth in steel demand between the 1950s and the 1990s. Current domestic production is approximately 100 million tons per year, far less than the 120 million tons of 1981. Decline in demand has led to substantial excess capacity. In 1980, for example, domestic producers had 25 per cent idle capacity. While the industry now operates at 90 per cent of capacity, this has come as a result of reduced capacity, not increased output; total domestic capacity declined by 30 per cent between 1980 and 1994. Capacity reduction in the steel industry is expensive, particularly for integrated producers. USX Corp., for example, eliminated 16 per cent of its capacity in 1983

Exhibit 3 | US production, 1974 and 1994



	1974	1994	% Change
Integrated mills	158	77	-51
Minimills	8	37	363
Other scrap mills	7	1	-86
Speciality firms' production in millions of tons	12	8	-33

at a cost of US\$1.2 billion. Still, by 1987, USX had 40 per cent idle capacity.

While large-scale, integrated producers such as USX were shedding excess capacity, a new type of competitor, 'minimills', was entering the market. Minimills utilise recycled steel (in the form of junk cars, scrap, etc.) as a primary ingredient. Unlike the integrated producers, minimills are less capital intensive, smaller and have historically focused on producing low-technology, entry-level products. Unlike integrated mills, which have seen production decline, minimills have seen explosive growth, with numerous plants opening in the late 1980s and 1990s.

Overall, the steel industry has all of the characteristics of a highly competitive market: stagnant demand, excess capacity and numerous global competitors. The ability of the largest firm to use its power to set prices is gone. Above-average industry margins are quickly targeted by other firms. These factors are compounded by a largely commodity-like product that minimises switching costs and customer loyalty. Not surprisingly, the profit performance of the industry has been weak; the industry as a whole lost money during much of the 1980s. In 1987, the first (albeit small) industry-wide profit in eight years was posted. With the exception of the 1990–1 recession, domestic producers have gradually improved the return on assets to a value of 6.1 per cent in 1994. A flurry of exits and Chapter 11 reorganisations led to an improved profit potential for remaining firms by the mid-1990s. The success is more pronounced in the minimill sector, although the integrated producers are presently healthy and now represent a new threat to the minimills.

Emerging industry trend

While in many ways the industry appears to have stabilised, a number of emerging trends threaten to cause further disruption within the industry to both integrations and minimills.

Minimill over-capacity

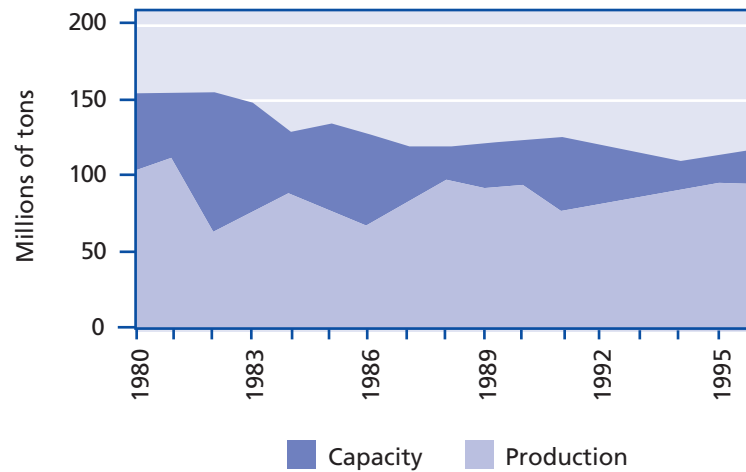
Starting in 1989, only one company, Nucor, was capable of producing flat-rolled steel using minimill technology. However, competing firms have started using similar technology and there were expected to be 10 new flat-roll minimills on-line by 1997, adding 13 million tons of production capacity – about 10 per cent of 1996 production – to the industry. This new capacity should become available just as steel consumption is expected to decline.

Scrap prices

Due to growing demand for scrap metal, its cost has become increasingly volatile in the 1990s. In 1994, for example, prices climbed as much as US\$50/ton to US\$165–170/ton, while 10 million tons of American scrap were exported to offshore customers. In 1996, prices reached US\$200/ton, and were expected to climb, but instead declined to US\$170–180/ton by the end of 1997.

Euro production

While growth has improved in recent years, demand for steel is still weak in much of Europe, particularly in Eastern European nations. Western Europe alone had 20 million tons of excess capacity in 1994, and Russian

Exhibit 4 | Domestic capacity and production, 1980–96

mills were operating at 65 per cent of capacity. Additionally, many European mills are state-owned and subsidised. Faced with weak performance and idle capacity, many of these mills are aggressively pursuing export opportunities in China and other parts of Asia. Russian steel exports approached US\$4 billion in 1993, double their 1992 level.

Antidumping rulings

US integrated steel producers filed 72 charges of dumping against foreign competitors – primarily the Germans and Japanese. In 1993, the International Trade Commission concluded that there was some justification for these charges, but not for others, and ruled that foreign steel caused no harm in 40 of the 72 cases. Stock prices for US producers (in aggregate) declined US\$1.1 billion in the 90 minutes following the announcement of the ruling.

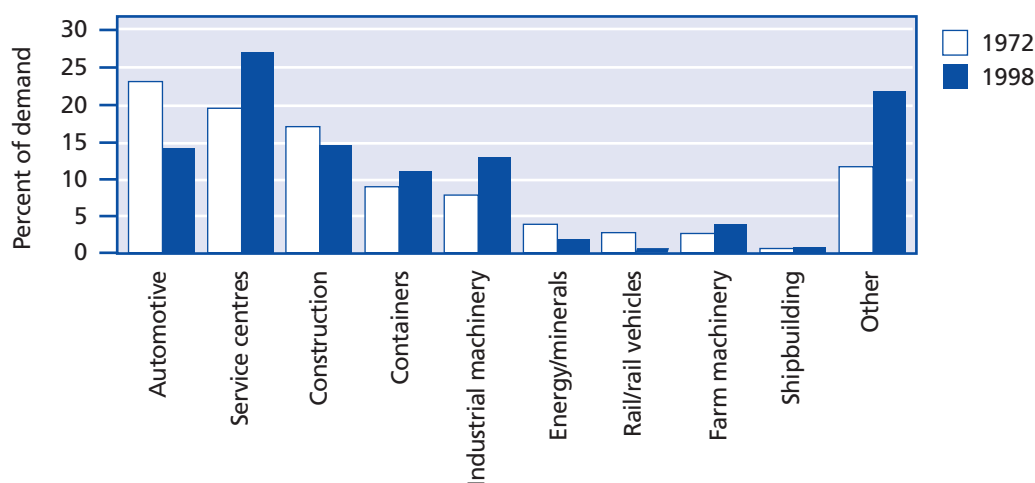
Industry economic structure

The domestic steel industry, until recent technological changes, was essentially composed of two vertically integrated sectors. The first was the raw steel production sector which encompassed steel-making operations from the unearthing of ores and coke to the basic ore reduction and smelting. The outcome or product of this sector was ingots, billets and slabs which are standard steel shapes. These products were then sent to finishing mills (the second sector) which conducted various heat treating and shaping processes to produce finished steel products such as bars, tubes, castings, forgings, plates, sheets and structural shapes. These two

sectors were typically housed under a single facility but as two distinct operations in what was termed the ‘integrated’ producer. Traditionally, steel manufacturers used batch processing, which involved heating a furnace of steel and pouring the entire furnace full of molten steel into billets, ingots and slabs. These intermediate products were then processed and the process was repeated. The onset of continuous casting technology (a process in which ores are reduced and poured into final shapes without the intermediate production of slabs and ingots) in the late 1970s has blurred the classical two-sector demarcation. Most producers today use the continuous casting process for producing isometric shapes, but raw steel must still be shipped to finishing mills for manufacture of more complex products.

The suppliers to the steel industry can be broadly assigned to three major classes: ore, energy and transportation. Since a preponderance of the final production cost is tied up in these input items, many producers have vertically integrated backwards by acquiring ore and coal/coke mining firms and transportation networks (rail and barge). The supply factors of production (transformation factors) are labour to operate plants, capital facilities and land. Recent modernisation has significantly substituted technology for labour in steel production.

Minimills are a significant force of change in the industry, as their supplier and customer requirements differ from the integrated mills. First, ore supplies are, to differing degrees, replaced by a need for access to large quantities of scrap steel. Second, minimills, while still large consumers of electricity, consume far less power than their integrated mill counterparts. This,

Exhibit 5 | Steel demand by market sector, 1972 and 1998

along with the lower output capacity of each plant, allows for placement of the mills closer to the third factor: the changing customer base. This has resulted in a radical shift in steel production in recent years from western Pennsylvania and Ohio to a much broader dispersion of steel mills throughout the United States. By one estimate, steel mills can now be found in over half of the US states.

The principal markets and customers for steel are the classical markets. Some sectors are on the decline, while others are fairly stable. The automotive sector was historically the largest consumer of steel in peacetime. Construction materials is now the largest sector, followed by the automobile and container industries, energy equipment, industrial machinery, farming equipment, car/rail production and various military applications. The reduced demand by the automobile industry is the result of the lower steel content in a modern automobile, a trend steel producers are aggressively trying to counter by banding together to form the Steel Alliance which is running a US\$100 million advertising campaign targeted at consumers and touting the advantages of steel for automobile design (and house construction).

Service centres are playing an increased role in the industry, acting as major distributors and wholesalers for finished steel products to steel consumers (construction firms, shipbuilders, machine fabricators, etc.). With the exception of the automobile and automobile part manufacturers (who contract directly with producers), most finished steel is delivered to end users via the steel service centre, moving some of the inventory management burden to the service centres for

a marginal mark-up to the end user. This presents a forecasting complication to planners and strategists, as all demand for steel is a derived demand. The forecaster must be able to look into the macro forces affecting an economy and project steel's role in the broader economic system from which a consumer demand pattern could be ascertained.

Steel production technology

Any attempt to consolidate steel and steel production technology into a few paragraphs would be doing the topic a disservice. However, two major issues deserve additional attention: production factors and substitutes. Automation has improved the competitive position of the industry by reducing its exposure to volatile labour markets and labour costs. It has also increased the flexibility of producers to shift product output and incorporate the continuous casting process. Closely related is the elimination of the old open-hearth furnace in favour of the blast-oxygen furnace and electric arc furnaces which are far more efficient, more easily automated and require less manpower. These furnaces also reduce stack emissions, a critical environmental requirement (and a concern that many foreign producers do not face). While technology has been a driver of change, labour agreements and relations have not always made it possible to fully exploit the benefits of technological improvements.

The proliferation of substitute materials is an important issue. It is important to note, however, that while substitutes have made significant inroads into steel markets over the last 30 years, they will likely

never replace steel as the commodity of choice for many applications. Steel will not be displaced (with very minor exceptions) as a material in strength applications: plastic is not strong enough; graphite-reinforced plastics and epoxies lack steel's thermal resistance properties; wood is not as strong or environmentally resistant as steel; and titanium remains a rare, expensive, strategically controlled material. Furthermore, steel comes in many different compositions (stainless, tool, high-strength, galvanised). The industry's R&D efforts have continued to evolve steel to meet the demands of customers. In short, steel remains – and is likely to remain – the material of choice in most applications.

Nucor Corporation

Nucor Corp. began life as the Nuclear Corporation of America. The latter was a highly diversified and marginally profitable company; its products included instruments, semiconductors, rare earths and construction. One of its potential acquisitions was Coast Metals, a family-owned producer of speciality metals. When the acquisition fell through, Nuclear hired one of Coast's top engineers as a consultant to recommend other acquisition targets. The engineer – Ken Iverson – had strong technical skills (including a graduate degree in metallurgy from Purdue University) and general management experience. Based on Iverson's recommendation, Nuclear acquired a steel joist company in South Carolina. Subsequently, Iverson joined Nuclear as a vice president in 1962. Nuclear built a second joist plant in Nebraska the following year. Iverson was responsible for supervising the joist operations as well as the research, chemical and construction segments. By 1965, the diversified company had experienced another string of losses, although the joist operations were profitable, and Iverson was promoted to president.

Recognising that its most valuable skills lay in its joist operations, Nuclear became Nucor Corp. and divested non-joist operations. New joist plants soon followed, including one in Alabama in 1967 and another in Texas in 1968. As a joist company, Nucor was dependent on American and foreign steel producers for its key input. Iverson decided to integrate backwards into steel making in the hopes of stabilising supply and lowering input costs for the joist business. So, Nucor began construction on its own steel mill in Darlington, South Carolina – a location close to an existing joist operation. The Darlington plant used the then new minimill technology. When the plant opened on 12 October 1969, the pouring of the first batch of steel resulted in molten steel cascading out of the mould and

across the floor of the plant. Despite the mishap, Nucor quickly became adept at minimill technology. In addition to supplying its own joist operations, it began competing with integrateds and other minimills in the commodity steel business. Iverson and Nucor soon became recognised as the 'Southwest Airlines' of steel: a simple, no-frills organisation, with a unique culture, highly motivated workers and the lowest cost structure of the industry. Some indicators of Nucor's success include:

- It is the only major player in the industry that can boast of 22 years of uninterrupted quarterly dividends (Nucor began paying quarterly dividends in 1973) and 30 years of continuous quarterly profits, despite numerous slumps and downturns in the industry (see Exhibits 6–14).
- Between 1980 and 1990, Nucor doubled in size. In comparison, the six main integrated producers reduced their steel-making capacity from 108 to 58 million tons during this period.
- In 1990, Nucor had six steel plants and a total annual capacity of 3 million tons. By 1995, it had added a seventh plant, and its overall capacity neared 8 million tons.
- In 1994, Nucor generated US\$1.50 in sales for every dollar in property, plant and equipment. The industry average was US\$0.95 before depreciation expenses. After depreciation, these ratios are US\$2.18 and US\$1.83 respectively.
- Nucor continues to be the industry leader in cost efficiency. In 1990, it produced 980 tons of steel per employee each year, at a net cost of US\$60/ton, compared to the industry average of 420 tons per employee at a cost of US\$135/ton. In 1994, Nucor's conversion cost was US\$170/ton, roughly US\$50–75 less than its competitors.

Nucor has primary mills located in Arkansas, Nebraska, Utah, South Carolina, Texas and Indiana. Additional operating facilities located in Fort Payne, Alabama; Conway, Arkansas; Saint Joe and Waterloo, Indiana; Wilson, North Carolina; and Swansea, South Carolina are all engaged in the manufacture of steel products. During 1997, the average utilisation rate of all operating facilities was more than 85 per cent of production capacity. Nucor competes in a number of distinct product segments, and the emphasis on these segments has changed substantially in recent years. Historically, the largest segment was the Nucor Steel division, which produces bar and light structural steel products. In 1991, this was its largest segment (measured by product volume). However, by 1995, sheet steel, once considered to be an exclusive product

Exhibit 6 | Historical data, 1955–96

Year	Net sales	Earnings			Earnings per share			Stockholders' equity			Common stock		
		Operations	Other	Net	Operations	Other	Net	Total assets	Amount	per share	Shares outstanding	Per Share	Amount
PRIOR MANAGEMENT													
1955	415 658	(39 359)	—	(39 359)	LOSS	—	LOSS	1 630 644	930 188	0.06	16 355 402	0.48	7 850 593
1956	1 653 007	(355 293)	—	(355 293)	LOSS	—	LOSS	1 881 385	848 934	0.04	20 573 241	0.23	4 731 845
1957	1 925 462	(546 270)	—	(546 270)	LOSS	—	LOSS	1 908 337	1 052 664	0.03	33 803 241	0.17	5 746 551
1958	2 020 886	(521 827)	—	(521 827)	LOSS	—	LOSS	1 717 335	672 638	0.02	35 628 981	0.21	7 482 086
1959	1 859 034	(260 161)	—	(260 161)	LOSS	—	LOSS	1 783 598	502 454	0.01	36 532 149	0.28	10 229 002
1960	2 182 204	(367 149)	(261 829)	(628 978)	LOSS	LOSS	LOSS	1 837 102	647 565	0.01	44 023 275	0.44	19 370 241
1961	4 014 416	379 006	(16 021)	362 985	0.01	LOSS	0.01	5 630 178	2 307 566	0.04	55 267 743	0.43	23 765 129
1962	9 100 958	24 095	(683 323)	(659 228)	—	LOSS	LOSS	7 184 395	1 952 764	0.03	56 646 415	0.23	13 028 675
1963	15 374 487	260 710	240 000	500 710	0.01	0.00	0.01	8 324 759	2 453 474	0.04	56 646 415	0.18	10 196 355
1964	17 485 319	33 264	30 000	63 264	—	—	—	10 337 955	2 796 719	0.05	57 809 552	0.18	10 405 719
1965	22 310 595	(431 013)	(1 803 748)	(2 234 761)	LOSS	LOSS	LOSS	6 937 251	762 380	0.01	58 695 962	0.26	15 260 950
PRESENT MANAGEMENT													
1966	23 006 483	698 900	635 000	1 333 900	0.01	0.01	0.02	8 109 190	2 239 882	0.04	59 310 011	0.23	13 641 303
1967	23 600 093	822 424	880 832	1 703 256	0.01	0.02	0.03	11 546 498	6 581 876	0.10	66 836 275	0.64	42 775 216
1968	35 544 913	1 002 954	1 235 982	2 238 936	0.01	0.02	0.03	16 501 866	9 288 771	0.14	68 078 687	0.78	53 101 376
1969	46 321 797	1 210 083	1 125 000	2 335 083	0.02	0.01	0.03	24 655 801	11 938 178	0.17	68 935 656	0.45	31 021 045
1970	50 750 546	1 140 757	—	1 140 757	0.02	—	0.02	28 800 183	13 101 313	0.19	69 001 709	0.27	18 630 461
1971	64 761 634	2 740 694	—	2 740 694	0.04	—	0.04	33 168 014	15 892 357	0.23	69 245 150	0.41	28 390 512
1972	83 576 128	4 668 190	—	4 668 190	0.07	—	0.07	47 537 247	20 929 525	0.30	70 353 577	0.54	37 990 932
1973	113 193 617	6 009 042	—	6 009 042	0.09	—	0.09	67 550 110	26 620 195	0.38	70 302 597	0.41	28 824 065
1974	160 416 931	9 680 083	—	9 680 083	0.14	—	0.14	82 038 748	37 103 939	0.50	73 712 586	0.30	22 113 776
1975	121 467 284	7 581 788	—	7 581 788	0.10	—	0.10	92 639 413	44 549 735	0.59	75 010 113	0.41	30 754 146
1976	175 768 479	8 696 891	—	8 696 891	0.11	—	0.11	119 095 581	54 084 970	0.70	77 790 707	0.74	57 565 123
1977	212 952 829	12 452 592	—	12 452 592	0.16	—	0.16	128 010 982	66 295 405	0.84	78 807 784	1.02	80 383 940
1978	306 939 667	25 848 849	—	25 848 849	0.33	—	0.33	193 454 693	92 129 119	1.15	80 261 028	1.74	139 654 189
1979	428 681 778	42 264 537	—	42 264 537	0.52	—	0.52	243 111 514	133 257 816	1.64	81 046 524	3.32	269 074 460
1980	482 420 363	45 060 198	—	45 060 198	0.55	—	0.55	291 221 867	177 603 690	2.16	82 199 964	5.82	478 403 790
1981	544 820 621	34 728 966	—	34 728 966	0.42	—	0.42	384 782 127	212 376 020	2.54	83 562 084	4.98	416 139 178
1982	486 018 162	22 192 064	—	22 192 064	0.27	—	0.27	371 632 941	232 281 057	2.77	83 951 292	5.21	437 386 231
1983	542 531 431	27 864 308	—	27 864 308	0.33	—	0.33	425 567 052	258 129 694	3.05	84 541 086	7.13	602 777 943
1984	660 259 922	44 548 451	—	44 548 451	0.53	—	0.53	482 188 465	299 602 834	3.53	84 966 474	5.38	457 119 630
1985	758 495 374	58 478 352	—	58 478 352	0.68	—	0.68	560 311 188	357 502 028	4.16	85 890 030	8.98	771 292 469
1986	755 228 939	46 438 888	—	46 438 888	0.54	—	0.54	571 607 644	383 699 454	4.54	84 525 192	7.72	652 534 482
1987	851 022 039	50 534 450	—	50 534 450	0.60	—	0.60	654 090 139	428 009 367	5.05	84 784 352	9.91	840 212 928
1988	1 061 364 009	70 881 020	38 558 822	109 439 842	0.83	0.46	1.29	949 661 710	532 281 449	6.25	85 150 764	11.94	1 016 700 122
1989	1 269 007 472	57 835 844	—	57 835 844	0.68	—	0.68	1 033 831 512	584 445 479	6.83	85 598 480	15.06	1 289 113 109
1990	1 481 630 011	75 065 261	—	75 065 261	0.88	—	0.88	1 035 886 060	652 757 216	7.59	85 950 696	15.50	1 332 235 788
1991	1 465 456 566	64 716 499	—	64 716 499	0.75	—	0.75	1 181 576 798	711 608 991	8.23	86 417 804	22.34	1 930 573 741
1992	1 619 234 876	79 225 703	—	79 225 703	0.92	—	0.92	2 507 382 255	784 230 713	9.04	86 736 700	39.19	3 399 211 273
1993	2 253 738 311	123 509 607	—	123 509 607	1.42	—	1.42	1 829 268 322	902 166 939	10.36	87 073 478	53.00	4 614 894 334
1994	2 975 596 456	226 632 844	—	226 632 844	2.60	—	2.60	2 001 920 165	1 122 610 257	12.85	87 333 313	55.50	4 846 998 872
1995	3 462 045 648	274 534 505	—	274 534 505	3.14	—	3.14	2 296 141 333	1 382 112 159	15.78	87 598 517	57.13	5 004 503 276
1996	3 647 030 387	248 168 948	—	248 168 948	2.83	—	2.83	2 619 533 406	1 609 290 193	18.33	87 795 947	51.00	4 477 593 297

Source: Nucor Corporation Web page (www.nucor.com/historicaldata.htm) 04/09/98.

Exhibit 7 | Annual balance sheets, 1977–96

Note – all US\$m	Dec-96	Dec-95	Dec-94	Dec-93	Dec-92	Dec-91	Dec-90	Dec-89
Assets								
Cash & equivalents	104.40	201.80	101.93	27.26	25.55	38.30	51.65	32.55
Net receivables	292.64	283.21	258.13	202.18	132.14	109.46	126.75	106.95
Inventories	385.80	306.77	243.03	215.02	206.41	186.08	136.64	139.45
Prepaid expenses	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other current assets	45.54	38.97	35.61	23.79	0.52	0.47	0.09	1.08
Total current assets	828.38	830.74	638.70	468.23	364.62	334.29	315.13	280.03
Gross plant property & equipment	2 698.75	2 212.89	1 977.58	1 820.99	1 574.10	1 261.53	1 086.37	1 048.01
Accumulated depreciation	907.60	747.49	614.36	459.95	448.34	414.25	363.12	294.22
Net plant property & equipment	1 791.15	1 465.40	1 363.22	1 361.04	1 125.77	847.28	723.25	753.80
Investments at equity	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other investments	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Intangibles	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deferred charges	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other assets	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total assets	2 619.53	2 296.14	2 001.92	1 829.27	1 490.38	1 181.58	1 038.38	1 033.83
Liabilities								
Long-term debt due in one year	0.75	0.15	0.25	0.20	0.20	2.00	2.21	2.27
Notes payable	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Accounts payable	224.37	214.56	182.85	165.74	119.30	93.76	78.72	89.75
Taxes payable	10.29	11.30	15.51	14.27	10.46	11.07	10.65	13.20
Accrued expenses								
Other current liabilities	230.25	221.12	183.86	170.29	142.02	122.34	134.00	88.34
Total current liabilities	465.65	447.14	382.47	350.49	271.97	229.17	225.58	193.56
Long-term debt	152.60	106.85	173.00	352.25	246.75	72.78	28.78	155.98
Deferred taxes	50.00	51.00	63.00	53.00	18.82	21.10	25.82	18.82
Investment tax credit	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Minority interest	265.71	220.66	175.99	143.09	140.50	124.05	105.44	81.02
Other liabilities	76.28	88.38	84.86	28.27	28.11	22.87	0.00	0.00
Total liabilities	1 010.24	914.03	879.31	927.10	706.15	469.97	385.62	449.39
Equity								
Preferred stock – redeemable	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Preferred stock – non-redeemable	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total preferred stock	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Common stock	35.95	35.90	35.80	35.70	17.78	8.86	8.82	8.78
Capital surplus	55.05	48.67	39.27	29.91	39.41	42.81	37.67	34.23
Retained earnings	1 535.95	1 315.85	1 065.80	854.86	745.26	678.16	624.66	559.90
Less: treasury stock	17.66	18.30	18.26	18.31	18.23	18.23	18.39	18.46
Common equity	1 609.29	1 382.11	1 122.61	902.17	784.23	711.61	652.76	584.45
Total equity	1 609.29	1 382.11	1 122.61	902.17	784.23	711.61	652.76	584.45
Total liabilities & equity	2 619.53	2 296.14	2 001.92	1 829.27	1 490.38	1 181.58	1 038.38	1 033.83
Common shares outstanding	87.80	87.60	87.33	87.07	86.74	86.42	85.95	85.60

Source: Compustat.

Dec-88	Dec-87	Dec-86	Dec-85	Dec-84	Dec-83	Dec-82	Dec-81	Dec-80	Dec-79	Dec-78	Dec-77
26.38	72.78	128.74	185.14	112.71	79.06	44.89	8.71	21.75	36.65	27.42	7.10
97.43	80.08	61.27	70.87	66.87	58.17	38.34	48.70	43.52	40.21	31.90	23.39
123.22	81.50	105.60	78.64	73.80	56.56	48.83	73.00	49.60	40.01	41.55	30.41
0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
0.74	0.36	0.14	0.11	0.08	0.11	0.48	0.98	0.49	0.50	0.25	0.26
247.76	234.72	295.74	334.77	253.45	193.89	132.54	131.38	115.37	117.36	101.11	61.16
942.27	618.54	452.26	376.23	359.97	338.66	322.85	318.86	219.10	160.46	115.25	86.67
240.37	199.16	181.43	150.95	131.87	107.36	83.78	66.25	46.02	35.88	26.72	20.73
701.90	419.37	270.83	225.28	228.10	231.31	239.07	252.62	173.07	124.58	88.53	65.94
0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	5.04	0.27	0.63	0.37	0.02	0.78	2.78	1.17	3.81	0.92
949.66	654.09	571.61	560.31	482.19	425.57	371.63	384.78	291.22	243.11	193.46	128.01
2.21	2.21	3.05	2.40	2.40	2.40	1.60	1.66	1.70	1.25	0.46	0.44
0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
93.17	68.46	53.17	35.47	32.69	37.14	22.95	32.24	36.64	26.42	24.15	12.08
35.80	24.34	14.31	27.60	23.71	14.81	12.54	10.73	4.36	15.91	15.64	4.44
84.92	52.46	47.91	55.78	41.74	34.14	29.02	28.41	23.79	19.96	15.54	13.35
216.11	147.47	118.44	121.26	100.53	88.49	66.10	73.03	66.49	63.54	55.79	30.30
113.25	35.46	42.15	40.23	43.23	45.73	48.23	83.75	39.61	41.40	41.47	28.13
15.32	19.32	27.32	41.32	38.82	33.22	25.02	15.62	7.52	4.92	4.02	2.62
0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
72.71	23.83	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.04	0.66
417.38	226.08	187.91	202.81	182.59	167.44	139.35	172.41	113.62	109.85	101.33	61.72
0.00	0.00	0.00	0.00	0.00	0.00	0.00					
0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
8.74	8.70	8.67	5.73	5.67	5.64	2.80	2.79	2.74	2.70	1.78	1.25
30.54	27.38	25.19	24.30	18.99	17.02	17.70	16.24	12.91	10.67	10.41	9.55
511.46	410.51	367.58	327.82	275.04	235.57	211.92	193.36	161.95	119.89	79.94	55.50
18.46	18.58	17.73	0.35	0.09	0.10	0.14					
532.28	428.01	383.70	357.50	299.60	258.13	232.28	212.38	177.60	133.26	92.13	66.30
532.28	428.01	383.70	357.50	299.60	258.13	232.28	212.38	177.60	133.26	92.13	66.30
949.66	654.09	571.61	560.31	482.19	425.57	371.63	384.78	291.22	243.11	193.46	128.01
85.15	84.78	84.52	85.89	84.97	84.54	83.95	83.57	82.20	81.05	80.26	78.80

Exhibit 8 | Annual cash flow statement, 1977–96

Note – all US\$m

	Dec-96	Dec-95	Dec-94	Dec-93	Dec-92	Dec-91	Dec-90	Dec-89
Indirect operating activities								
Income before extraordinary items	248.17	274.54	226.63	123.51	79.23	64.72	75.07	57.84
Depreciation and amortization	182.23	173.89	157.65	122.27	97.78	93.58	84.96	76.57
Extraordinary items and disc. operations	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deferred taxes	(8.00)	(15.00)	(2.00)	1.00	(3.00)	(4.00)	7.00	3.50
Equity in net loss (earnings)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Sale of property, plant, and equipment and sale of investments – loss (gain)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Funds from operations – other	82.57	48.18	17.67	9.75	23.17	26.11	29.71	8.32
Receivables – decrease (increase)	(9.43)	(25.07)	(55.96)	(70.03)	(22.69)	14.80	(19.80)	(9.52)
Inventory – decrease (increase)	(79.03)	(63.75)	(28.01)	(8.61)	(20.33)	(49.43)	2.81	(16.24)
Accounts payable and accrued liabs – inc (Dec)	9.81	31.72	17.11	46.44	25.53	11.54	(11.03)	(3.43)
Income taxes – accrued – increase (decrease)	(1.01)	(4.21)	1.24	3.81	(0.61)	0.42	(2.55)	(22.60)
Other assets and liabilities – net change	25.30	26.87	90.60	43.67	26.32	15.66	48.16	3.56
Operating activities – net cash flow	<u>450.61</u>	<u>447.16</u>	<u>424.95</u>	<u>271.79</u>	<u>205.41</u>	<u>173.40</u>	<u>214.33</u>	<u>98.00</u>
Investing activities								
Investments – increase	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Sale of investments	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Short-term investments – change	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Capital expenditures	537.44	263.42	185.32	364.16	379.12	217.72	56.75	130.20
Sale of property, plant, and equipment	1.59	0.92	5.22	1.30	2.12	0.55	0.83	1.26
Acquisitions	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Investing activities – other	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Investing activities – net cash flow	<u>(535.84)</u>	<u>(262.50)</u>	<u>(180.11)</u>	<u>(362.86)</u>	<u>(377.00)</u>	<u>(217.17)</u>	<u>(55.92)</u>	<u>(128.95)</u>
Financing activities								
Sale of common and preferred stock	7.07	9.67	9.50	8.51	5.60	5.35	3.59	3.86
Purchase of common and preferred stock	0.00	0.22	0.00	0.17	0.08	0.00	0.04	0.14
Cash dividends	28.06	24.49	15.69	13.91	12.13	11.22	10.30	9.40
Long-term debt – issuance	46.50	24.00	0.00	105.70	183.90	46.00	0.00	45.00
Long-term debt – reduction	0.15	90.25	179.20	0.20	11.73	2.20	127.27	2.21
Current debt – changes				0.00				
Financing activities – other	(37.52)	(3.51)	15.22	(7.16)	(6.73)	(7.51)	(5.29)	0.00
Financing activities – net cash flow	<u>(12.16)</u>	<u>(84.79)</u>	<u>(170.17)</u>	<u>92.77</u>	<u>158.84</u>	<u>30.42</u>	<u>(139.31)</u>	<u>37.11</u>
Exchange rate effect	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Cash and equivalents – change	<u>(97.40)</u>	<u>99.87</u>	<u>74.68</u>	<u>1.71</u>	<u>(12.75)</u>	<u>(13.35)</u>	<u>19.10</u>	<u>6.17</u>
Direct operating activities								
Interest paid – net	6.95	9.21	16.06	10.74	9.14	3.42	8.58	16.03
Income taxes – paid	152.90	176.50	124.37	57.52	40.82	34.68	31.70	46.90

CF—combined figure

NA—not available

NC—not calculable

Source: Compustat.

[illegible]

Exhibit 9 | Annual income statement, 1977–96

Note – all US\$m

	Dec-96	Dec-95	Dec-94	Dec-93	Dec-92	Dec-91	Dec-90	Dec-89
Sales	3 647.03	3 462.05	2 975.60	2 253.74	1 619.24	1 465.46	1 481.63	1 269.01
Cost of goods sold	2 956.93	2 726.28	2 334.11	1 843.58	1 319.60	1 209.17	1 208.12	1 028.68
Gross profit	690.11	735.77	641.49	410.16	299.64	256.29	273.51	240.33
Selling general & administrative expense	120.39	130.68	113.39	87.58	76.80	66.99	70.46	66.99
Operating income before deprec.	569.72	605.09	528.10	322.57	222.84	189.30	203.05	173.34
Depreciation depletion & amortization	182.23	173.89	156.65	122.27	97.78	93.58	84.96	76.57
Operating profit	387.49	431.20	370.45	200.31	125.06	95.73	118.09	96.77
Interest expense	7.55	9.28	14.59	14.32	9.03	2.60	8.10	16.88
Non-operating income/expense	7.84	10.41	1.08	1.12	1.30	2.69	1.23	5.74
Special items	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Pretax income	387.77	432.34	356.93	187.11	117.33	95.82	111.22	85.64
Total income taxes	139.60	157.80	130.30	63.60	38.10	31.10	36.15	27.80
Minority interest								
Income before extraordinary items & discontinued operations	248.17	274.54	226.63	123.51	79.23	64.72	75.07	57.84
Preferred dividends	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Available for common	248.17	274.54	226.63	123.51	79.23	64.72	75.07	57.84
Savings due to common								
Stock equivalents	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Adjusted available for common	248.17	274.54	226.63	123.51	79.23	64.72	75.07	57.84
Extraordinary items	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Discontinued operations	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Adjusted net income	<u>248.17</u>	<u>274.54</u>	<u>226.63</u>	<u>123.51</u>	<u>79.23</u>	<u>64.72</u>	<u>75.07</u>	<u>57.84</u>
Earnings per share (primary) – excluding extra items & disc op	2.83	3.14	2.60	1.42	0.92	0.75	0.88	0.68
Earnings per share (primary) – including extra items & disc op	2.83	3.14	2.60	1.42	0.92	0.75	0.88	0.68
Earnings per share (fully diluted) excluding extra items & disc op	2.83	3.13	2.59	1.41	0.91	0.75	0.87	0.68
Earnings per share (fully diluted) including extra items & disc op	2.83	3.13	2.59	1.41	0.91	0.75	0.87	0.68
EP from operations	2.83	3.14	2.60	1.42	0.92	0.75	0.88	0.68
Dividends per share	0.32	0.28	0.18	0.16	0.14	0.13	0.12	0.11

Source: Compustat.

	Dec-88	Dec-87	Dec-86	Dec-85	Dec-84	Dec-83	Dec-82	Dec-81	Dec-80	Dec-79	Dec-78	Dec-77
1	061.36	851.02	755.23	758.50	660.26	542.53	486.02	544.82	482.42	428.68	306.94	212.95
	832.88	671.55	575.45	569.69	510.83	434.62	382.32	434.61	356.12	305.98	220.50	162.32
	228.49	179.47	179.78	188.80	149.43	107.91	103.70	110.21	126.30	122.71	86.44	50.63
	62.08	55.41	65.90	59.08	45.94	33.99	31.72	33.53	38.16	36.72	28.66	19.73
	166.40	124.06	113.88	129.72	103.49	73.93	71.98	76.69	88.14	85.98	57.78	30.90
	56.27	41.79	34.93	31.11	28.90	27.11	26.29	21.60	13.30	9.71	7.46	5.93
	110.14	82.27	78.95	98.62	74.59	46.82	45.69	55.09	74.84	76.27	50.33	24.98
	9.18	3.94	5.32	4.36	4.62	4.80	8.41	10.67	3.53	4.30	2.87	2.82
	6.63	4.91	10.61	11.92	8.58	5.55	0.52	0.42	4.75	2.79	1.00	0.10
	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	107.58	83.23	84.24	106.18	78.55	47.56	37.79	44.83	76.06	74.77	48.45	22.25
	36.70	32.70	37.80	47.70	34.00	19.70	15.60	10.10	31.00	32.50	22.60	9.80
	70.88	50.53	46.44	58.48	44.55	27.86	22.19	34.73	45.06	42.27	25.85	12.45
	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	70.88	50.53	46.44	58.48	44.55	27.86	22.19	34.73	45.06	42.27	25.85	12.45
	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	70.88	50.53	46.44	58.48	44.55	27.86	22.19	34.73	45.06	42.27	25.85	12.45
	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	38.56	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	<u>70.88</u>	<u>50.53</u>	<u>46.44</u>	<u>58.48</u>	<u>44.55</u>	<u>27.86</u>	<u>22.19</u>	<u>34.73</u>	<u>45.06</u>	<u>42.27</u>	<u>25.85</u>	<u>12.45</u>
	0.83	0.60	0.54	0.69	0.53	0.33	0.27	0.42	0.55	0.52	0.33	0.16
	1.29	0.60	0.54	0.69	0.53	0.33	0.27	0.42	0.55	0.52	0.33	0.16
	0.83	0.60	0.54	0.68	0.53	0.33	0.27	0.42	0.54	0.52	0.32	0.16
	1.28	0.60	0.54	0.68	0.53	0.33	0.27	0.42	0.54	0.52	0.32	0.16
	0.83											
	0.10	0.09	0.08	0.07	0.06	0.05	0.04	0.04	0.04	0.03	0.02	0.01

Exhibit 10 | Annual ratios, 1977–96

Note – all ratios

	Dec-96	Dec-95	Dec-94	Dec-93	Dec-92	Dec-91	Dec-90	Dec-89
Liquidity								
Current ratio	1.78	1.86	1.67	1.34	1.34	1.46	1.40	1.45
Quick ratio	0.85	1.08	0.94	0.65	0.58	0.64	0.79	0.72
Working capital per share	4.13	4.38	2.93	1.35	1.07	1.22	1.04	1.01
Cash flow per share	4.90	5.12	4.40	2.82	2.04	1.83	1.86	1.57
Activity								
Inventory turnover	8.54	9.92	10.19	8.75	6.72	7.49	8.75	7.83
Receivables turnover	12.67	12.79	12.93	13.48	13.40	12.41	12.68	12.42
Total asset turnover	1.48	1.61	1.55	1.36	1.21	1.32	1.43	1.28
Average collection period (days)	28.00	28.00	28.00	27.00	27.00	29.00	28.00	29.00
Days to sell inventory	42.00	36.00	35.00	41.00	54.00	48.00	41.00	46.00
Operating cycle (days)	71.00	64.00	63.00	68.00	80.00	77.00	70.00	75.00
Performance								
Sales/net property, plant & equip	2.04	2.36	2.18	1.66	1.44	1.73	2.05	1.68
Sales/stockholder equity	2.27	2.50	2.65	2.50	2.06	2.06	2.27	2.17
Profitability								
Operating margin before depr (%)	15.62	17.48	17.75	14.31	13.76	12.92	13.70	13.66
Operating margin after depr (%)	10.62	12.46	12.45	8.89	7.72	6.53	7.97	7.63
Pretax profit margin (%)	10.63	12.49	12.00	8.30	7.25	6.54	7.51	6.75
Net profit margin (%)	6.80	7.93	7.62	5.48	4.89	4.42	5.07	4.56
Return on assets (%)	9.47	11.96	11.32	6.75	5.32	5.48	7.23	5.59
Return on equity (%)	15.42	19.86	20.19	13.69	10.10	9.09	11.50	9.90
Return on investment (%)	12.24	16.06	15.40	8.84	6.76	7.12	9.54	7.04
Return on average assets (%)	10.10	12.77	11.83	7.44	5.93	5.83	7.24	5.83
Return on average equity (%)	16.59	21.92	22.39	14.65	10.59	9.49	12.13	10.36
Return on average investment (%)	13.28	17.26	15.80	9.62	7.62	7.63	9.33	7.51
Leverage								
Interest coverage before tax	52.35	47.60	25.46	14.07	13.99	37.85	14.73	6.07
Interest coverage after tax	33.87	30.59	16.53	9.63	9.77	25.89	10.27	4.43
Long-term debt/common equity (%)	9.48	7.73	15.41	39.04	31.46	10.23	4.41	26.69
Long-term debt/shrhldr equity (%)	9.48	7.73	15.41	39.04	31.46	10.23	4.41	26.69
Total debt/invested capital (%)	7.56	6.26	11.77	25.22	21.08	8.23	3.94	19.26
Total debt/total assets (%)	5.85	4.66	8.65	19.27	16.57	6.33	2.98	15.31
Total assets/common equity	1.63	1.66	1.78	2.03	1.90	1.66	1.59	1.77
Dividends								
Divident payout (%)	11.31	8.92	6.92	11.26	15.31	17.34	13.72	16.25
Divident yield (%)	0.63	0.49	0.33	0.30	0.36	0.58	0.77	0.73

NC – not calculable

Source: Compustat.

Dec-88	Dec-87	Dec-86	Dec-85	Dec-84	Dec-83	Dec-82	Dec-81	Dec-80	Dec-79	Dec-78	Dec-77
1.15	1.59	2.50	2.76	2.52	2.19	2.01	1.80	1.74	1.85	1.81	2.02
0.57	1.04	1.60	2.11	1.79	1.55	1.26	0.79	0.98	1.21	1.06	1.01
0.37	1.03	2.10	2.49	1.80	1.25	0.79	0.70	0.59	0.66	0.56	0.39
1.49	1.09	0.96	1.04	0.86	0.65	0.58	0.67	0.71	0.64	0.41	0.23
8.14	7.18	6.25	7.47	7.84	8.25	6.28	7.09	7.95	7.50	6.13	NC
11.96	12.04	11.43	11.01	10.56	11.24	11.17	11.81	11.52	11.89	11.10	NC
1.32	1.39	1.33	1.46	1.45	1.36	1.29	1.61	1.81	1.96	1.91	NC
30.00	30.00	31.00	33.00	34.00	32.00	32.00	30.00	31.00	30.00	32.00	NC
44.00	50.00	58.00	48.00	46.00	44.00	57.00	51.00	45.00	48.00	59.00	NC
74.00	80.00	89.00	81.00	80.00	76.00	90.00	81.00	77.00	78.00	91.00	NC
1.51	2.03	2.79	3.37	2.89	2.35	2.03	2.16	2.79	3.44	3.47	3.23
1.99	1.99	1.97	2.12	2.20	2.10	2.09	2.57	2.72	3.22	3.33	3.21
15.68	14.58	15.08	17.10	15.67	13.63	14.81	14.08	18.27	20.06	18.83	14.51
10.38	9.67	10.45	13.00	11.30	8.63	9.40	10.11	15.51	17.79	16.40	11.73
10.14	9.78	11.15	14.00	11.90	8.77	7.78	8.23	15.77	17.44	15.78	10.45
6.68	5.94	6.15	7.71	6.75	5.14	4.57	6.37	9.34	9.86	8.42	5.85
7.46	7.73	8.12	10.44	9.24	6.55	5.97	9.03	15.47	17.38	13.36	9.73
13.32	11.81	12.10	16.36	14.87	10.79	9.55	16.35	25.37	31.72	28.06	18.78
9.87	10.37	10.91	14.70	12.99	9.17	7.91	11.73	20.74	24.20	19.35	13.19
8.84	8.25	8.21	11.22	9.81	6.99	5.87	10.27	16.87	19.36	16.08	NC
14.76	12.45	12.53	17.80	15.97	11.36	9.98	17.81	28.99	37.50	32.63	NC
11.76	11.07	11.28	15.79	13.78	9.54	7.70	13.53	23.00	27.42	22.67	NC
12.72	22.11	16.83	25.35	18.00	10.91	5.49	5.20	22.55	18.40	17.86	8.88
8.72	13.82	9.73	14.41	10.64	6.81	3.64	4.25	13.77	10.84	9.99	5.41
21.28	8.29	10.98	11.25	14.43	17.72	20.76	39.44	22.30	31.07	45.02	42.44
21.28	8.29	10.98	11.25	14.43	17.72	20.76	39.44	22.30	31.07	45.02	42.44
16.08	7.73	10.61	10.72	13.31	15.84	17.77	28.84	19.01	24.42	31.39	30.26
12.16	5.76	7.91	7.61	9.46	11.31	13.41	22.20	14.18	17.54	21.68	22.32
1.78	1.53	1.49	1.57	1.61	1.65	1.60	1.81	1.64	1.82	2.10	1.93
11.98	15.04	14.38	9.74	11.41	15.13	16.34	9.58	6.66	5.46	5.46	8.38
0.84	0.91	1.03	0.74	1.12	0.70	0.83	0.80	0.63	0.86	1.03	1.30

Exhibit 11 | Comparative income statements – SIC 3312

Note – all US\$m	NUCOR CORP Dec-96	BETHLHM STL Dec-96	BIRM STEEL Jun-96	CARPNTN TCH Jun-96	CHAPARR STL May-96	INLAND STL Dec-96	STEEL DYNAM Dec-96	USX-US STL Dec-96
Sales	3 647.0	4 679.0	832.5	865.3	607.7	2 397.3	252.6	6 547.0
Cost of goods sold	2 956.9	4 168.2	730.4	601.6	480.6	2 156.1	201.2	6 005.0
Gross profit	690.1	510.8	102.0	263.8	127.1	241.2	51.5	542.0
Selling general & administrative expense	120.4	105.5	37.7	112.9	26.1	54.7	13.8	–169.0
Operating income before deprec.	569.7	405.3	64.3	150.9	101.0	186.5	37.6	711.0
Depreciation depletion & amortization	182.2	268.7	34.7	35.2	29.5	124.6	19.4	292.0
Operating profit	387.5	136.6	29.6	115.6	71.5	61.9	18.2	419.0
Interest expense	7.6	60.3	18.5	19.3	10.0	50.7	23.7	97.0
Non-operating income/expense	7.8	12.9	10.4	–3.8	4.3	2.5	2.9	51.0
Special items	0.0	–465.0	–23.9	2.7	0.0	–26.3	0.0	–6.0
Pretax income	387.8	–375.8	–2.4	95.2	65.8	–12.6	–2.6	367.0
Total income taxes	139.6	–67.0	–0.2	35.0	23.8	–3.5	0.0	92.0
Minority interest	CF	CF	0.0	0.0	CF	0.0	0.0	CF
Income before extraordinary items & discontinued operations	248.2	–308.8	–2.2	60.1	42.0	–9.1	–2.6	275.0
Preferred dividends	0.0	41.9	0.0	1.6	0.0	25.8	0.0	22.0
Available for common	248.2	–350.7	–2.2	58.6	42.0	–34.9	–2.6	253.0
Savings due to common								
Stock equivalents	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0
Adjusted available for common	248.2	–350.7	–2.2	58.6	42.2	–34.9	–2.6	253.0
Extraordinary items	0.0	0.0	0.0	0.0	0.0	–8.8	–7.3	–2.0
Discontinued operations	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Adjusted net income	248.2	–350.7	–2.2	58.6	42.2	–43.7	–9.8	251.0

Source: Compustat.

Exhibit 12 | Comparative balance sheets – SIC 3312

Note – all US\$m	NUCOR CORP	BETHLHM STL	BIRM STEEL	CARPNTN TCH	CHAPARR STL	INLAND STL	STEEL DYNAM	USX-US STL
	Dec-96	Dec-96	Jun-96	Jun-96	May-96	Dec-96	Dec-96	Dec-96
Assets								
Cash & equivalents	104.4	136.6	6.7	13.2	20.0	0.0	57.5	23.0
Net receivables	292.6	311.6	111.6	137.1	49.5	225.6	32.5	580.0
Inventories	385.8	1 017.3	196.8	160.5	121.8	182.0	65.9	648.0
Prepaid expenses	0.0	0.0	1.4	0.0	7.8	0.0	0.0	0.0
Other current assets	45.5	22.9	11.6	13.8	0.0	18.6	1.6	177.0
Total current assets	828.4	1 488.4	328.0	324.5	199.1	426.2	157.4	1 428.0
Gross plant property & equip.	2 698.8	6 344.0	678.2	809.7	493.5	4 011.4	356.1	8 347.0
Accumulated depreciation	907.6	3 924.2	134.2	390.2	279.4	2 642.7	16.8	5 796.0
Net plant property & equipment	1 791.2	2 419.8	544.0	419.5	214.1	1 368.7	339.3	2 551.0
Investments at equity	0.0	50.0	0.0	9.8	0.0	221.4	0.0	412.0
Other investments	0.0	NA	0.0	0.0	0.0	0.0	0.0	209.0
Intangibles	0.0	160.0	46.1	18.8	59.2	0.0	0.0	39.0
Deferred charges	0.0	0.0	CF	91.5	2.0	CF	12.4	1 734.0
Other assets	0.0	991.7	9.9	48.0	1.0	326.5	13.2	207.0
TOTAL ASSETS	2 619.5	5 109.0	928.0	912.0	475.3	2 342.8	522.3	6 580.0
Liabilities								
Long-term debt due in one year	0.8	49.3	0.0	7.0	12.4	7.7	11.2	73.0
Notes payable	0.0	0.0	0.0	19.0	0.0	272.5	0.0	18.0
Accounts payable	224.4	410.4	83.2	75.8	34.1	217.7	41.2	667.0
Taxes payable	10.3	67.9	0.4	13.7	0.0	69.2	0.0	154.0
Accrued expenses	CF	313.3	32.8	56.5	15.9	73.3	9.2	387.0
Other current liabilities	230.2	116.5	0.0	0.0	0.0	3.9	0.0	0.0
Total current liabilities	465.7	957.4	116.4	172.0	62.4	644.3	61.6	1 299.0
Long-term debt	152.6	497.4	307.5	188.0	66.7	307.9	196.2	1 014.0
Deferred taxes	50.0	0.0	50.3	84.5	CF	0.0	0.0	0.0
Investment tax credit	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Minority interest	265.7	CF	0.0	0.0	CF	0.0	0.0	0.0
Other liabilities	76.3	2 689.1	5.6	158.4	51.3	1 179.8	0.0	2 637.0
Equity								
Preferred stock – redeemable	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Preferred stock – non-redeemable	0.0	14.1	0.0	5.8	0.0	0.0	0.0	7.0
Total preferred stock	0.0	14.1	0.0	5.8	0.0	0.0	0.0	7.0
Common stock	36.0	113.9	0.3	97.7	3.0	0.0	0.5	85.0
Capital surplus	55.0	1 886.3	331.4	13.5	178.5	1 194.5	303.8	NA
Retained earnings	1 535.9	(988.6)	137.6	256.6	126.9	(983.7)	(39.8)	NA
Less: treasury stock	17.7	59.7	21.1	64.5	13.4	0.0	0.0	0.0
Common equity	1 609.3	951.9	448.2	303.3	295.0	210.8	264.6	1 559.0
TOTAL EQUITY	1 609.3	66.0	448.2	309.1	295.0	210.8	264.6	1 566.0
TOTAL LIABILITIES & EQUITY	2 619.5	5 109.9	928.0	912.0	475.3	2 342.8	522.3	6 580.0

Source: Compustat.

Exhibit 13 | Comparative ratios – SIC 3312

	BETHLHM STL Dec-96	BIRM STEEL Jun-96	CARPNT TCH Jun-96	CHAPARR STL May-96	INLAND STL Dec-96	IPSCO INC Dec-96	NUCOR CORP Dec-96	STEEL DYNAM Dec-96	USX-US STL Dec-96	WEIRTON STL Dec-96
Liquidity										
Current ratio	1.55	2.82	1.89	3.19	0.66	2.98	1.78	2.56	1.10	2.14
Quick ratio	0.47	1.02	0.87	1.12	0.35	1.92	0.85	1.46	0.46	0.98
Working capital per share	4.75	7.40	9.18	4.76	-218099.97	9.48	4.13	2.01	1.52	7.31
Cash flow per share	-0.36	1.14	5.74	2.49	115499.99	2.76	4.90	0.35	6.68	0.32
Activity										
Inventory turnover	4.22	3.95	4.78	4.31	11.33	4.17	8.54	5.06	9.62	4.99
Receivables turnover	13.64	7.48	6.76	12.01	10.27	8.18	12.67	15.51	10.97	9.08
Total asset turnover	0.87	0.99	0.99	1.29	1.02	0.62	1.48	0.60	1.00	1.06
Average collection per (days)	26.00	48.00	53.00	30.00	35.00	44.00	28.00	23.00	33.00	40.00
Days to sell inventory	85.00	91.00	75.00	84.00	32.00	86.00	42.00	71.00	37.00	72.00
Operating cycle (days)	112.00	139.00	129.00	114.00	67.00	130.00	71.00	94.00	70.00	112.00
Performance										
Sales/net PP&E	1.93	1.53	2.06	2.84	1.75	1.07	2.04	0.74	2.57	2.27
Sales/stockholder equity	4.84	1.86	2.80	2.06	11.37	1.02	2.27	0.95	4.18	8.25
Profitability										
Oper. margin before depr (%)	8.66	7.73	17.44	16.61	7.78	15.78	15.62	14.89	10.86	4.24
Oper. margin after depr. (%)	2.92	3.56	13.36	11.76	2.58	13.39	10.62	7.21	6.40	0.05
Pretax profit margin (%)	-8.03	-0.28	11.00	10.82	-0.53	15.13	10.63	-1.01	5.61	-4.00
Net profit margin (%)	-6.60	-0.26	6.95	6.91	-0.38	10.35	6.80	-1.01	4.20	-3.22
Return on assets (%)	-6.86	-0.23	6.42	8.83	-1.49	5.93	9.47	-0.49	3.84	-3.42
Return on equity (%)	-36.84	-0.49	19.31	14.23	-16.56	10.53	15.42	-0.97	16.23	-29.83
Return on investment (%)	-23.96	-0.29	11.78	11.61	-6.73	7.08	12.24	-0.56	9.57	-7.43
Return on average assets (%)	-6.49	-0.26	6.72	8.88	-1.49	6.37	10.10	-0.61	3.86	-3.40
Return on average equity (%)	-32.23	-0.48	20.78	14.86	-15.31	11.01	16.59	-1.56	17.47	-25.59
Return on average invest. (%)	-21.59	-0.32	12.26	11.78	-5.95	7.62	13.28	-0.69	10.17	-7.29
Leverage										
Interest coverage before tax	-5.23	0.87	5.92	7.57	0.75	6.27	52.35	0.89	4.78	-0.22
Interest coverage after tax	-4.12	0.88	4.11	5.19	0.82	4.60	33.87	0.89	3.84	0.02
Long-term debt/common eq. (%)	52.25	68.61	61.99	22.61	146.06	48.73	9.48	74.15	65.04	288.89
Long-term debt/shrhdr eq. (%)	51.49	68.61	60.83	22.61	146.06	48.73	9.48	74.15	64.75	256.97
Total debt/invested cap. (%)	37.36	40.69	43.05	21.86	113.38	32.89	7.56	45.00	41.79	71.99
Total debt/total assets (%)	10.70	33.14	23.47	16.63	25.10	27.57	5.85	39.70	16.79	33.12
Total assets/common equity	5.37	2.07	3.01	1.61	11.11	1.77	1.63	1.97	4.22	8.72
Dividends										
Dividend payout (%)	0.00	-524.80	37.10	13.88	0.00	15.62	11.31	0.00	33.60	0.00
Dividend yield (%)	0.00	2.42	4.13	1.37	@NA	1.26	0.63	0.00	3.19	0.00

Note – all ratios.

Source: Compustat.

Exhibit 14 | Steel companies (SIC 3312) sorted by sales

Company name	SIC	1996 Sales	1996 Assets
Broken Hill Proprietary – ADR	3312	\$15 260.90	\$28 113.50
British Steel PLC -ADR	3312	\$11 882.00	\$12 939.60
Pohang Iron & Steel Co – ADR	3312	\$11 140.60	\$18 967.60
USX-US Steel Group	3312	\$6 547.00	\$6 580.00
Bethlehem Steel Corp	3312	\$4 679.00	\$5 109.90
LTV Corp	3312	\$4 134.50	\$5 410.50
Allegheny Teledyne Inc	3312	\$3 815.60	\$2 606.40
Nucor Corp	3312	\$3 647.03	\$2 619.53
National Steel Corp – CL B	3312	\$2 954.03	\$2 547.06
Inland Steel Co	3312	\$2 397.30	\$2 342.80
AK Steel Holding Corp	3312	\$2 301.80	\$2 650.80
Armco Inc	3312	\$1 724.00	\$1 867.80
Weirton Steel Corp	3312	\$1 383.30	\$1 300.62
Rouge Steel Co – CL A	3312	\$1 307.40	\$681.95
WHX Corp	3312	\$1 232.70	\$1 718.78
Texas Industries Inc	3312	\$985.67	\$847.92
Lukens Inc	3312	\$970.32	\$888.75
Grupo IMSA SA DE CV – ADS	3312	\$953.00	\$1 404.00
Algoma Steel Inc	3312	\$896.47	\$983.47
Quanex Corp	3312	\$895.71	\$718.21
Carpenter Technology	3312	\$865.32	\$911.97
Birmingham Steel Corp	3312	\$832.49	\$927.99
Oregon Steel Mills Inc	3312	\$772.82	\$913.36
Republic Engnrd Steels Inc	3312	\$746.17	\$640.58
Geneva Stl Co – CL A	3312	\$712.66	\$657.39
Highvld Stl & Vanadium – ADR	3312	\$695.36	\$957.28
Northwestern Stl & Wire	3312	\$661.07	\$442.52
Tubos de Acero de Mex – ADR	3312	\$645.16	\$1 027.85
Titan International Inc	3312	\$634.55	\$558.59
Florida Steel Corp	3312	\$628.40	\$554.90
J & L Specialty Steel	3312	\$628.02	\$771.93
Chaparral Steel Company	3312	\$607.66	\$475.34
Ipsco Inc	3312	\$587.66	\$1 025.00
Talley Industries Inc	3312	\$502.70	\$280.39
NS Group Inc	3312	\$409.38	\$300.03
Laclede Steel Co	3312	\$335.38	\$331.11
Keystone Cons Industries Inc	3312	\$331.18	\$302.37
Huntco Inc – CL A	3312	\$264.09	\$222.44
Steel Dynamics Inc	3312	\$252.62	\$522.29
Roanoke Electric Steel Corp	3312	\$246.29	\$167.02
Grupo Simec-Spon ADR	3312	\$214.64	\$509.72
Bayou Steel Corp – CL A	3312	\$204.43	\$199.27
New Jersey Steel Corp	3312	\$145.21	\$151.37
China Pacific Inc	3312	\$123.50	\$114.33
Kentucky Electric Steel Inc	3312	\$98.32	\$78.43
Steel of West Virginia	3312	\$95.33	\$79.30
UNVL Stainless & Alloy Prods	3312	\$60.26	\$42.10
Consolidated Stainless Inc	3312	\$50.82	\$51.25
Stelax Industries Ltd	3312	\$0.73	\$16.76

of integrated producers, accounted for the largest production volume. Heavy structural beams from a joint venture with Yamato Steel of Japan were the third-largest segment, followed by the Vulcraft joist division. Remaining products – including grinding balls, fasteners, ball bearings and prefabricated steel buildings – each account for relatively small proportions of total output.

While Nucor's first experience with steel was the result of backward integration by the Vulcraft joist division, the manufacture of steel has become the central focus of the firm. That focus has broadened to include sheet steel (1989) and heavy structural beams (1988). The company has also extended its focus to several downstream products, including fasteners and ball bearings (both in 1986) and prefabricated metal buildings (1988). With the exception of the ball bearings mill, which was acquired, new business segments are developed internally. Roughly 15 per cent of steel output is used internally for downstream operations. More recently, Nucor has chosen to integrate backwards from steel with a plant in Trinidad. This backward integration is aimed at lowering production costs; the plant produces iron carbide, which is expected to become an alternative to scrap in the minimill process.

Nucor's strategy

Nucor has chosen to avoid the formalised planning processes that are typically found in *Fortune* 500 firms. This lack of formalisation also extends to the company's mission statement, which is non-existent but known to all employees. The company does not have a formal mission statement, as management believes that most mission statements are developed in isolation, never seen or conveyed to employees, and have little in common with what the firm really does and how it operates. Nonetheless, all Nucor employees can tell you what their job entails and what the objective of the organisation is: the production of high volumes of quality, low-cost steel.² Nucor and its employees recognise that all the steel produced must meet industry standards for quality. In fact, Nucor frequently exceeds quality standards. High levels of production per man-hour result in low-cost and, subsequently, prices among the lowest in the industry.

Nucor's strategic intent is clearly known by employees, customers and its competitors. Each year, the business review of the annual report gives this succinct description of its scope of operations: 'Nucor Corporation's business is the manufacture of steel

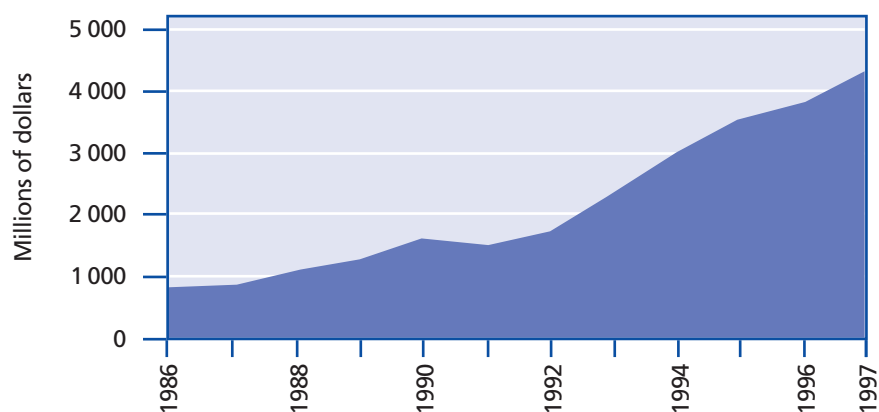
products.' The annual letter to shareholders gives this picture of the company:

Your management believes that Nucor is among the nation's lowest cost steel producers. Nucor has operated profitably for every quarter since 1966. Nucor's steel products are competitive with those of foreign imports. Nucor has a strong sense of loyalty and responsibility to its employees. Nucor has not closed a single facility, and has maintained stability in its work force for many years ... Productivity is high and labor relations are good.³

As with the mission, goals at Nucor are equally streamlined. Iverson has noted that in some companies planning systems are as much ritual as reality, resulting in plans and budgets that are inappropriate and unrealistic.⁴ Nucor has both long- and short-range goals. However, they are handled differently than at many firms. Short-term plans focus on budget and production for the current and next fiscal year. The plans are zero-based – created from actual needs and estimates for specific projects – not an updated copy of a prior year's budget. Long-range plans are a combination of the plans of different divisions and plant – a bottom-up approach to planning. The long-range plans are seen as guides – not gospel. The plans incorporate relative goals instead of specific milestones that the firm expects managers to achieve. Division and plant managers set their target goals knowing that they will be rewarded for meeting them, but not punished if for unexpected reasons they are not met.

Similarly, even plans for specific projects are minimalist. For example, the company handles new mill construction largely internally. Many aspects of the plant design are done 'on the fly' to save time. The company does not create finely detailed construction plans for new plants. Instead, it uses this experience as a guide for starting construction. It then fills in the details as construction proceeds.⁵ This approach allows Nucor to construct plants both faster and at less cost than their competitors. The Hickman, Arkansas, mill was completed six months ahead of schedule, going from groundbreaking to first commercial shipment in a mere 16 months.

By 1995, Nucor had become the fourth-largest domestic steel producer. CEO John Correnti targets annual growth at between 15 and 18 per cent – substantially above the 1–2 per cent rate of growth for the industry. Given Nucor's size and the industry's maturity, growth for Nucor requires taking market share away from the integrated producers. Most experts

Exhibit 15 | Nucor annual sales, 1986–97

agree that Nucor is well positioned to achieve such growth and sustain profitability, given its industry-leading cost structure. Steel industry analysts attribute Nucor's ability to grow in a constricting market to the firm's aggressive style of management, its innovative and revolutionary technologies, and a solid understanding of the dynamics and cost-drivers of the steel industry.

Nucor can trace its low-cost position to a combination of three factors: technological innovation, continuous process refinement and a strong corporate culture. Investments in any of the three alone is insufficient; the three elements must work together for the firm to be productive and successful.

Technological innovation at Nucor

Historically, the main distinction between minimills and integrated producers has been the range of products offered. While minimill technology is less capital intensive, the production process is also limited to commodity steel products: bars, angles and structural steel beams. Integrated producers largely retreated from these commodity products and concentrated on sheet steel, which was presumably safe from encroachment by the minis. Strategically, though, Nucor more closely resembles the integrated producers versus other minimills in terms of product offerings. Innovative use of technology is key to this strategy.

A prime example of Nucor's innovation was its foray into sheet steel. By the mid-1980s, Iverson had anticipated the coming shake-out among minimills; the lure of easy pickings from dinosaurs like Bethlehem Steel had drawn many firms into the minimill business, resulting in over-supply. Integrated mills produce steel sheet by starting with 10-inch-thick slabs of steel and repeatedly processing the slab through rollers to reduce

thickness and increase width. Multiple rolling machines result in a production line hundreds of yards long. Conventional wisdom said that it was impossible to produce the 10-inch-thick steel slabs needed to roll sheet steel in a minimill; their small electric arc furnaces simply did not have the same capability as the blast furnace used by an integrated mill. Nucor carefully researched emerging technology. Rather than develop a proprietary system, they licensed and modified a new German caster and began a US\$270 million experiment. This new plant – in Crawfordsville, Indiana – started up in 1987. The process was very different from making sheet steel in an integrated plant. Nucor's system involves the highly controlled continuous pouring of molten steel into a narrow mould and on to a conveyor belt to form a continuous two-inch-thick ribbon of semi-solid steel – pouring steel much in the same manner as frosting an endless cake using a pastry tube. The process requires sophisticated computer technology and monitoring to ensure constant quality and to avert costly and dangerous spills. This precisely sized ribbon of steel is then rolled to the specific thickness using a few, smaller-sized rolling machines. This results in a much smaller and less expensive plant than a traditional mill for the production of sheet steel.

The technical challenges of producing steel using this method are the basic requirements of entry into the minimill market. Profitability, however, is achieved through efficiency. Labour costs constitute a large portion of the cost of steel. Integrated producers can take up to four to five man-hours per ton to produce sheet steel, with three hours/ton on a productivity benchmark. In comparison, Nucor's Crawfordsville plant took only 45 man-minutes per ton. Such efficiency gave Nucor a US\$50–75 cost advantage per ton, a savings of nearly 25 per cent compared to their

Exhibit 16 | Nucor's principal manufacturing locations, 1997

Location	Size (ft2)	Products
Blytheville-Hickman, Arkansas	2 880 000	Steel shapes, flat-rolled steel
Norfolk-Stanton, Nebraska	2 280 000	Steel shapes, joists, deck
Brigham City-Plymouth, Utah	1 760 000	Steel shapes, joists
Darlington-Florence, South Carolina	1 610 000	Steel shapes, joists, deck
Grapeland-Jewett, Texas	1 500 000	Steel shapes, joists, deck
Crawfordsville, Indiana	1 410 000	Flat-rolled steel
Berkeley, South Carolina	1 300 000	Flat-rolled steel

competitors. By 1996, Nucor had production time down to 36 minutes per ton with additional savings expected. A second sheet plant was added in 1992, and capacity was expanded at both plants in 1994. Production capacity was 1 million tons in 1989, and 3.8 million tons in 1995.

Not content with the sheet steel market, Nucor chose to enter a new strategic segment in 1995: speciality steel. The Crawfordsville plant was modified to produce thin slab stainless steel – another ‘impossible’ feat for a minimill. Through experimentation, it was able to produce 2-inch-thick stainless steel slabs. It shipped 16 000 tons in 1995, 50 000 tons in 1996, and expects to hit a production capacity of 200 000 tons annually. Coincidentally, perhaps, its projected capacity mirrors the volume of stainless sheet imported to the United States – about 10 per cent of stainless steel demand in the United States.

Another example of technological innovation was Nucor's entry into the fastener steel segment. Fasteners include hardware such as hex and structural bolts and socket cap screws, which are used extensively in an array of applications, including construction, machine tools, farm implements and military applications. Dozens of American fastener plants shuttered their doors in the 1980s, and foreign firms captured virtually all of this business segment. After a year of studying the fastener market and available technology, Nucor built a new fastener plant in Saint Joe, Indiana. Productivity was substantially higher than that at comparable US plants, and a second fastener plant came on-line in 1995. The fastener plants receive most of their steel from the Nucor Steel division. With a production capacity of 115 000 tons – up substantially from 50 000 tons in 1991 – Nucor has the capacity to supply nearly 20 per cent of this market.

A final example of technological innovation concerns upstream diversification. Scrap steel is a critical input for minimills. Quality differences in scrap types coupled with insufficient supply have led to large

fluctuations in scrap costs. Frank Stephens, a mining engineer, had developed a technology to improve the efficiency of steel making through the use of iron carbide. Stephens had tried – unsuccessfully – to sell this process to US Steel, National Steel and Armco, among others.⁶ In comparison, to Nucor, iron carbide appeared to be an opportunity to reduce its reliance on the increasingly volatile scrap steel market. After speaking with the inventor of the process and touring an iron carbide pilot plant in Australia, Nucor made preliminary plans to construct an iron carbide pilot plant.⁷ The location selected – Trinidad – would provide the large quantities of low-cost natural gas needed for iron carbide production. Nucor estimated that establishing the pilot plant would require US\$60 million. However, as the process was unproven, Nucor would, in essence, be making a gamble that would yield an industry-revolutionising process or be investing US\$60 million in a plant that would be virtually worthless. To Nucor, the investment constituted a measured risk; while the investment to determine the feasibility was significant, if the process failed it would not cripple the firm. In 1994, Nucor opened the iron carbide pilot plant at a cost of US\$100 million – almost double expectations. At the end of 1995, the plant was operating at only 60 per cent of capacity. Still, Nucor was betting big on this opportunity. Nucor estimates that the use of iron carbide would allow them to reduce their steel-making costs by US\$50 per ton – a 20 per cent reduction. Additionally, Nucor is working on a joint venture with US Steel to manufacture steel directly from iron carbide, which could revolutionise the steel industry.

Process refinement at Nucor

Much of the business press focuses on the high-profile quantum advances made at Nucor, such as the creation of flat-rolled steel in an electric arc furnace and the use of iron carbide as a substitute for scrap. However, an emphasis on continuous innovation is felt throughout

the organisation and is equally important. A manager from Nucor's Crawfordsville mill observed that most of the innovation comes not from management, but from equipment operators and line supervisors. The job of management, says the manager, is to make sure the innovations can be implemented.⁸ For example, workers discovered that they could fine-tune surface characteristics of their galvanised steel (a benefit valued by many customers) simply by making small adjustments to the air pressure of a coating process. Changes such as these do not require management review or approval. Instead, equipment operators and line supervisors are authorised to innovate and implement processes that improve production. Such innovation is routine enough at Nucor that management does not track individual improvements. Rather, Nucor tracks innovation by looking at the end result – reductions in the amount of labour required to produce each ton of steel.

Employee innovation is driven by two factors. First, the company's bonus system means that any substantial improvements to efficiency will contribute to both the plant's performance and individual pay cheques. Second, the corporate culture emphasises how experiments – even failed ones – keep Nucor as the perennial benchmark for industry productivity. Experiments are conducted both at the time of mill start-up and on an ongoing basis. Typical of most mill start-ups, the start-up of Nucor's Hickman plant was fraught with problems. The high rate of the production line resulted in 'breakouts' – bad pours – of the 'ribbon' of steel for thin-slab casting. Though initially occurring at the rate of several per day, breakouts have been declining since the plant became operational. The high rates of production still result in two to five breakouts

per week and Nucor continues to make modifications to the equipment to reduce this level.

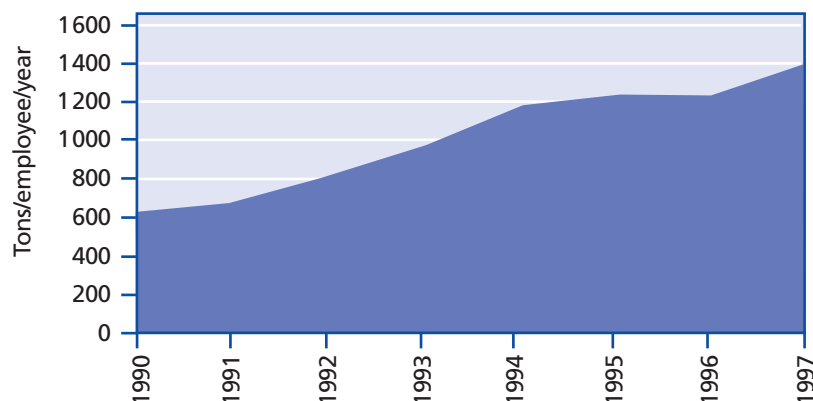
Focusing on clean-steel practices, the melt-shop people are developing mould powders that can handle the high-speed, thin-slab casting. Mould powders insulate, lubricate, aid uniform heat transfer, and absorb inclusions, all of which makes for cleaner steel. Unfortunately, no existing mould powders can handle hot steel at the rate Nucor could potentially produce it: 200 inches a minute. To reduce inclusions (impurities in the steel), Nucor is working to standardise all operating practices in the two furnaces and two ladle furnaces.

The Nucor philosophy towards innovation is that attempts at improvement will be accompanied by failures. Tony Kurley, a Nucor plant manager, recalls Nucor chairman Ken Iverson's expectation that success is making the correct decision 60 per cent of the time. What's important isn't the mistakes that are made, says Iverson, but the ability to learn from the 20 per cent that are truly mistakes and the 20 per cent that are sub-optimal decisions.⁹

This willingness to modify on the fly and 'shoot from the hip', as one melt-shop supervisor puts it, makes Nucor an exciting place to work. The lean, flexible workforce is continually trying new things, doing different jobs. Employees continue to engage in risk taking because the company rewards success and does not punish for failures. The result is that employees, from top managers to hourly personnel, are willing to take risks to achieve innovation and take ownership in their jobs.

At Nucor, the tolerance levels for failure are apparently high. In the 1970s, a Nucor plant manager was considering the replacement of the electric arc furnace in the plant with an induction furnace. At

Exhibit 17 | Nucor annual worker productivity, 1990–7



Nucor, the plant manager has the authority to select the type of furnaces used in his plant. There was no clearly right or wrong answer. A discussion yielded strong arguments in favour of the switch from some plant managers and equally enthusiastic arguments against the switch from others. The plant manager elected to make the switch at a cost to Nucor of US\$10 million. From the start, the new furnaces failed to live up to expectations and resulted in repeated shutdowns. Discussion shifted to the pluses and minuses of removing the furnace and within a year the furnace was removed. When the manager told Iverson of his decision, Iverson supported him, saying he had made the right decision – there was no sense in leaving the reminder of a bad decision lying around.¹⁰

Despite the price tag on this particular learning experience, management was unfazed. Iverson's comment on this failure was that the true problem is people *not* taking risks. Nucor has a saying: 'Don't study an idea to death in a dozen committee meetings; try it out and make it work.'

Through incremental advances, employees are continually able to streamline and refine the steel-making process. The data suggests that Nucor employees have not come close to exhausting these enhancements. Productivity, as measured in tons produced per employee, doubled from 1990 to 1995 (626 tons/worker and 1 269 tons/worker, respectively) and continues to climb. In 1997, productivity exceeded 1 400 tons/worker. How is Nucor able to realise such productivity gains in this mature industry? The following examples highlight incremental innovations.

Preventive maintenance

Preventive maintenance is a crucial but time-consuming task at a minimill. At Nucor-Yamato, a joint venture between Nucor and Yamato Kogyo, a Japanese steel producer, the plant had week-long shutdowns three times a year. During these periods, outside contractors – as many as 800 at a time – would strip, service and replace worn machinery. The outages could involve as many as 800 contractor personnel – a difficult task to manage. Further exacerbating the situation was the level of skill and low level of productivity of some contractor personnel. Aside from the challenges of hunting down missing contractors, the plant (and employees) suffered from the three weeks without production. The company addressed both of these concerns by eliminating the week-long shutdowns, instead tackling specific areas of the mill in focused, 24-hour shutdowns. This new process has several advantages, including spreading the

maintenance costs over a wider window and being able to use a smaller in-house staff that operates continually. Some maintenance jobs are large enough to still require multiple-day shutdowns, but the number of outside contractors has been reduced from 800 to 150. Through this program, downtime at the plant has fallen from 10 per cent to near 1 per cent. Some improvements are less dramatic, but significant nonetheless. A young engineer at a Nucor plant was concerned that too much was being spent to lubricate and maintain a series of supporting screws under a rolling line. He had a better idea. The screws, part of the original manufacturer's design, were replaced with metal shims, achieving an annual savings of over US\$1 million.

Reduced melt times

At the Crawfordsville plant, workers made a series of small changes, such as replacing an exhaust pipe and tinkering with the chemistry of the melt. By doing so, they reduced the melt time from 72 minutes to 65 minutes. While this may seem a small improvement, it meant that an additional 25 tons of steel could be poured in a single shift.

Revitalisation of outdated equipment

When Nucor bought a casting line from a German supplier, an obsolete reversing mill, which is used to reduce the thickness of steel, was thrown in as an afterthought to sweeten the deal. The capacity of the reducing mill was rated as 325 000 tons a year by the supplier. Nucor employees immediately began fiddling with the mill; the following are among the improvements and results:

- Changing the way the steel was fed into the machine increased capacity from 360 to 1 960 feet per minute.
- Changes reduced the time to thread the machine from five minutes to 20 seconds.
- Nucor changed the type and grade of lubricating oil and installed a bigger motor.

With these changes, Nucor processed 650 000 tons of steel during the first year the equipment was in operation – twice the machine's capacity as rated by its manufacturer. Nucor anticipates that an additional 10 per cent increase can be achieved.¹¹

New galvanising line

At one point, Nucor decided to install a galvanising line that coats finished steel to enhance its durability. Engineers from US\$17.8-billion USX Corp. visited the plant before the foundation for the line had even been poured, and Nucor engineers told them they would have

the line running by year's end. The USX visitors laughed because they had started building a similar line a year earlier and it still wasn't operational. The day after Christmas, USX ran its first coil through its new galvanising line. Twelve hours later, Nucor's US\$25 million galvanising line was operational. No other firm had constructed such a line for less than US\$48 million.¹²

Continuous production

In most minimills, the conversion of scrap to a finished product is a discontinuous process. Scrap is converted to ingots, for instance, which are then stockpiled for further conversion. When building their new Hickman plant in the early 1990s, Nucor tried an experiment: continuous production. All steps of the steel-making process are coordinated, from picking up the raw scrap, to melting it, forming it and laying down a finished coil. Continuous production is both faster (three to four hours from inputs to finished product) and more efficient. The downside? This just-in-time approach eliminates all slack or buffers in the process; problems at any point in the production line shut the entire operation down. How well has this new process worked? As with other Nucor plants, virtually none of the employees had ever worked in a steel mill before. Still, plant performance within one year of start-up was competitive with more established mills: 0.66 man-hours per ton, and a 91 per cent yield (percentage of scrap converted to finished product, a measure of efficiency). In late July 1993, the Hickman plant shipped 8 804 tons, setting a new Nucor record for the most tons shipped from a single plant in a day.¹³

Culture at Nucor

A key ingredient in any effective corporate culture is people. It is not surprising that many organisations, especially manufacturing firms, have dysfunctional cultures given the fear and distrust experienced by many workers, frequent layoffs and an 'us versus them' mentality. Executives of Bethlehem Steel, for example, constructed a golf course using corporate funds, then built a second and third course for middle managers and employees, respectively. Ken Iverson questioned how a company with a culture so dysfunctional as to require the construction of three golf courses to maintain the hierarchical distinction between executives, managers and line employees could ever expect to improve its operations.¹⁴

Nucor differs dramatically from its competitors. At Nucor, 'us versus them' clearly implies management and

workers united against competitors. One melt-shop supervisor described a sense of personal responsibility not only for his own job but also for the firm. He described his position at Nucor as being much like running his own company – a typical comment given the entrepreneurial environment Nucor has created. Decentralised authority and a sense of individual responsibility are a key part of that structure. John Correnti explains that he does not want to micro-manage the firm's operations. Doing so, he feels, would result in employees placing blame when things go wrong instead of taking responsibility and finding solutions. This, Correnti feels, results in line personnel having a realistic ability to control their own job environment, increase productivity and increase their pay.¹⁵

Still, Nucor is anything but a 'workers' paradise'. The standards for employee productivity are extremely high, and there are a number of painful reminders of this emphasis. For example, the steelworker who is 15 minutes late loses his production bonus for the day – as much as half of the day's pay. Thirty minutes late and the bonus for the entire week is forfeited. Workers are not paid for sicknesses less than three days, or for production downtime due to broken machinery. However, by most measures, Nucor is the employer of choice. There is extreme competition for new positions. The Darlington plant has routinely received 1 000 applications from a single job posting in the newspaper. Similarly, the new plant in Jewett, Texas (population 435), received 2 000 applications. Employee turnover rates are among the lowest in the industry. For example, the Crawfordsville, Indiana, plant lost a total of four employees between 1988 and 1994: two for drug use and two for poor performance. Nucor is a non-union shop with much of the opposition to unions coming from Nucor employees who feel that union rules would hurt productivity and subsequently their pay cheques. According to company folklore, there has been one labour dispute outside the mill gates, and plant supervisors had to protect union pamphleteers from angry employees!

How does Nucor achieve such levels of motivation and dedication? Iverson suggests that corporate America has confused the ideas of motivation and manipulation. Manipulation stipulates a one-sided relationship wherein management convinces employees to do things in the interest of management. Motivation involves getting employees to do things that are in the best interest of both parties. In the long term, Iverson says, motivation yields a strong company whereas manipulation destroys a company. With this in mind,

Nucor has identified the following elements as critical to effective employee motivation:

- 1 Everyone must know what is expected of them, and goals should not be set too low.
- 2 Everyone must understand the rewards, which must be clearly delineated and not subjective.
- 3 Everyone must know where to go to get help. The company must have a system that clearly tells the employee who to talk to when confused or upset.
- 4 Employees must have real voices. They must participate in defining the goals, determining the working conditions and establishing production processes.
- 5 The company must provide a feedback system so that employees always know how they, their group and the company are doing.¹⁶

The approach appears to work. A long-time Nucor employee recalls when the Darlington, South Carolina, plant could produce 30 tons of steel a day. The same plant now produces 100 tons of steel an hour. The worker says that, given the can-do attitude of employees and the focus on constant improvement, the 'sky is the limit' for additional improvements.¹⁷

While Nucor is a merit-oriented company, it also makes it clear that there are no 'classes' of employees. Top managers receive the same benefits as steel-makers on everything from vacation time to health insurance. There are no preferred parking spaces, and the 'executive dining room' is the delicatessen across the street. Incidentally, the corporate headquarters is located in a dowdy strip mall in Charlotte, North Carolina. Not surprisingly, there is no corporate jet or executive retreat in the Caymans. Officers travel in coach class on business trips, and the organisation is rife with legends of corporate austerity – such as Iverson travelling via subway when on business in New York City (true, incidentally). This emphasis on egalitarianism is an integral part of the Nucor culture. Iverson, wanting to eliminate even the smallest distinctions between personnel, ordered everyone to wear the same colour hardhat. In many plants, the colour of your hardhat is a highly visible signal of your level in the company hierarchy. Even at Nucor, some managers thought that their authority rested not in their expertise and management ability, but in the colour of their hat. This goal of egalitarianism has not been completely without problems. When it was brought to Iverson's attention that workers needed to be able to quickly identify maintenance personnel, Iverson admitted his mistake and at Nucor plants everyone

wears green hardhats except maintenance personnel who wear yellow so that they can be easily spotted.¹⁸

This approach appears transferable and the motivational effects are contagious. Iverson recalls when Nucor purchased a plant and immediately sold the limousine and eliminated executive parking spaces in favour of a first-come, first-serve system. Iverson greeted employees on their way into the plant and recalls one employee who parked in what was the boss's reserved spot and commented that the simple changes in the parking system made him feel much better about the company.¹⁹

Compensation and bonus system

Leadership by example can only induce so much behaviour; one of the more visible aspects of Nucor's culture is its compensation system, particularly the prominent bonus system. 'Gonna make some money today?' is a common greeting on the plant floor, and discussion of company financials is as common in the lunchroom as basketball scores. The bonus system is highly structured, consisting of no special or discretionary bonuses. The company is divided based on production teams of 25–50 individuals who are responsible for a complete task (such as a cold rolled steel fabrication line). The group includes everyone on that line, from scrap handlers to furnace operators, mould and roller operators, and even finish packagers. Managers get together and, based on the equipment being used, set a standard for production. This standard is known to everyone in advance and doesn't change unless the company makes a significant investment in capital equipment. With the standard in mind, employees make whatever changes they see fit to increase production. A bonus is paid for all production over the standard and there is no limit as to how much bonus can be paid. The only qualifier is that the production must be good – that is, of sufficient quality for sale. No bonus is paid for bad production. At the end of the week, all employees on a particular line get the same production bonus, which is issued along with their weekly cheques.²⁰

With bonuses, Nucor employees typically earn as much as their unionised counterparts in the integrated plants. Weekly bonuses have, in recent years, averaged 100–200 per cent of base wages. Typical production workers earn US\$8 to US\$9 in base pay plus an additional US\$16 per hour in production bonuses and averaged US\$60 000 in 1996, making them the highest-paid employees in the industry. Since Nucor locates its plants in rural locations, employee salaries are well

above the norm for any specific area, making Nucor jobs highly desirable.

Nucor also offers several other benefits to help motivate and retain employees. In the 1980s, it shifted to a work week of four 12-hour days. Workers take four days off and then resume another intensive shift – a practice borrowed from the oil industry. While this practice results in a lot of expensive overtime – Crawfordsville alone paid out an extra half a million dollars in 1995 due to the compressed work week – management feels that the ensuing morale and productivity gains pay for themselves. The company has also disbursed special US\$500 bonuses (four times in the last 20 years) in exceptionally good years. They also provide four years worth of college tuition support (up to US\$2 000/year) for each child of each employee – excluding only the children of corporate officers.

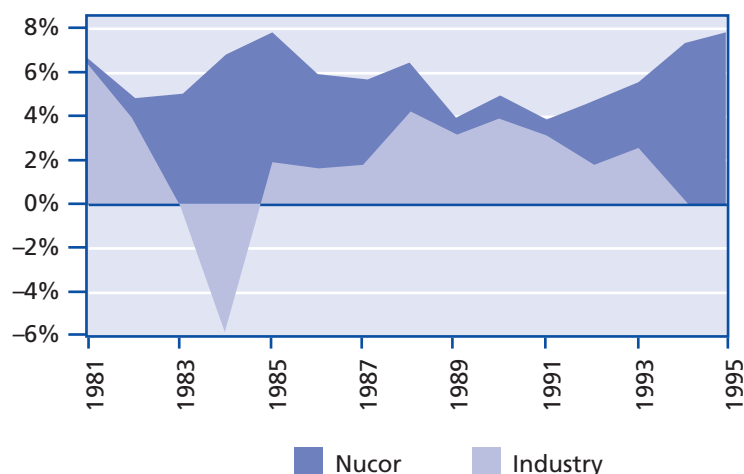
Job security

Listening to Nucor managers, it is difficult to determine which fact they are most proud of: 30 years of uninterrupted quarterly profits or 20 years since they have last had to lay off an employee. Nucor locates in rural areas and there are often few other employment opportunities, let alone other jobs at similar pay scales, so Nucor feels a strong responsibility for keeping workers employed, even during economic downturns.

Popular impressions aside, Iverson is clear to note that Nucor does not have a no-layoff policy. He cautions that Nucor will lay off employees as a last resort if the survival of the company is at stake.²¹ But during prior downturns, the company has chosen to ride

out slowdowns with its ‘Share the Pain’ program, which involves reduced work weeks and plant slowdowns instead of layoffs. What is most unusual with the program is that the brunt of poor performance is felt most heavily at upper parts of the organisation, particularly as long-term compensation is an integral part of the executive pay system. During a period of reduced demand for steel, the plants reduce their operations. For line personnel and foremen, this reduces their income by about 20 per cent. For department heads, who are covered by a bonus plan based on the profitability of their plant, slowdowns result in a reduction of about one-third of their pay. Nucor’s top managers have their pay based largely on return on shareholders’ equity – the measure most important to shareholders. This is hit the hardest and top managers see their pay decline the most – as much as two-thirds or three-quarters of their income is lost.²² This structure serves a number of purposes. First, the line personnel don’t feel that they are bearing the brunt of a downturn. Second, there is a great deal of motivation to further reduce the cost per ton so that Nucor can underprice any other producer and keep its mills active even during an economic downturn. Lastly, while the shareholders may not be happy with a reduced ROI, they at least know that management has an incentive to improve company performance. As an example, Iverson notes that in 1961 – a good year – he made US\$460 000 including bonuses. In 1982, though, Nucor fell shy of its 8 per cent return on equity and Iverson earned only US\$108 000.²³

Exhibit 18 | Nucor profitability vs. industry, 1981–95



Summary

How important is the corporate culture to Nucor's success? Management is free to point out that their advantage does not stem from proprietary technology. After all, most of their innovations – including thin-slab casting and the use of iron carbide – are based on technology developed by other firms. While they pioneered the modifications to make thin-slab casting possible, numerous other minimills are hot on their heels in this product segment. Nucor's plants are open to firms seeking to benchmark their operations, including other steel producers. When other firms tour a plant, they may see the same equipment as in their plant. Many comment on the culture of the plant. One visitor from an integrated producer commented that at his plant the culture is adversarial, management versus employee, with no trust between the parties. 'Us versus them' refers to workers versus management and production. In contrast, at Nucor, workers are seen striving together as a team, helping each other and working towards a common goal: the production of a high volume of low-cost, quality steel.²⁴

Iverson explains Nucor's success as being based on a combination of the technology used and the culture of the organisation. He is unsure if technology is 20, or 30, or even 40 per cent – but he's sure it is less than half of the formula for Nucor's achievements. The culture that Nucor instills is focused primarily on the long-term health of the organisation. For example, debt is avoided, start-up costs are not capitalised but rather are expensed in the current period, and depreciation and write-offs lean towards the detriment of short-term earnings. Iverson is adamant about not bowing to short-term pressures to manage earnings or spread dividends evenly

over a quarterly basis. He refuses to do it. He compares companies that try endlessly to meet short-term projections at the expense of a long-term approach to dogs on a leash – trying to perform a trick to satisfy the stock market. He admonishes short-term share speculators to stay away from the company. He compares Nucor to an eagle and invites long-term investors to soar with the company.²⁵

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Case 10

Pacific Dunlop: Caught on the half volley

Stuart Crispin
Mark Wickham
Dallas Hanson
University of Tasmania

Introduction

Time is not on Rod Chadwick's side. As managing director of Pacific Dunlop, he has one of the toughest jobs in Australia: trying to extract value from a conglomerate that is worth more 'dead than alive'. By January 2000, Pacific Dunlop's share price languished at a 14-year low, its market capitalisation value had dropped from \$3 billion to \$1.1 billion, and investors and analysts were calling for major restructuring within the company. Of greatest concern to all was the fact that the share price was now \$1.50 below the 'break-up' valuation for the company, making it a prime target for acquisition and dissolution for quick profit. At the core of Rod Chadwick's problems was a history of frequent acquisition by Dunlop, without any attempts to achieve synergies between business units, or indeed undertake any integration in management systems. Chadwick's position was not made any easier by the fact that the company's business units (with the exception of Ansell) operated in mature, low-growth and highly competitive markets. How had Pacific Dunlop come to be in such a precarious position, and how was Chadwick to improve the performance, and perhaps even ensure the survival, of this 'corporate dinosaur'?

Genesis, 1888–1920

The origins of Pacific Dunlop can be traced back to Belfast, Northern Ireland, where in 1888 a Scottish-born veterinarian by the name of John Boyd Dunlop invented the first pneumatic bicycle tyre. Before this time, bicycle tyres had been made out of solid rubber, ensuring a slow and uncomfortable ride for the cyclist. Dunlop's pneumatic tyre had an air-filled inner tube, which provided cyclists with a much more comfortable

ride and allowed them to travel at much faster speeds. The potential benefits of the pneumatic tyre to cyclists led Dunlop to patent his invention, and with a syndicate of business associates he formed the Dunlop Pneumatic Tyre Company in November 1889. Soon after its formation, the company moved production to a factory in Coventry, England.

The company's business grew steadily, with pneumatic tyres being exported to continental Europe, the United States and Australia. By 1891 the growing demand for Dunlop pneumatic tyres was so great that the company opened factories in France, Germany and North America. In 1893 it opened its first Australian factory in Tattersall's Lane, Melbourne. From its beginnings in Australia, the company was driven by a belief in the value of marketing and strong brand names. The company appointed its first 'publicity man' in 1895, long before such a position was common to Australian businesses. It also advertised widely in magazines, newspapers and on billboards, and was actively involved in the promotion of cycle racing, often sponsoring record-breaking long-distance bike rides. Such a strong marketing focus had the effect of making the Dunlop brand name synonymous with cycling and tyres in Australia.

While the growing popularity of cycling and cycle racing at the end of the 19th century was fuelling the worldwide demand for pneumatic tyres, the Dunlop Pneumatic Tyre Company had fallen into financial difficulties. A takeover of the Dunlop Pneumatic Tyre Company in 1896, and a major downturn in Dunlop's tyre sales both in Britain and in export markets such as the United States, had left the company in a poor financial position. To counter this, the company decided to sell its overseas holdings, and in 1899 a syndicate, led

Exhibit 1 | PDP, Pacific Dunlop Limited, company directors, 2000

Mr John T. Ralph (Chairman)
 Mr Rodney L. Chadwick (Managing director)
 Mr Anthony B. Daniels
 Ms S. Carolyn H. Kay
 Mr Robert J. McLean
 Professor David G. Penington
 Mr Ian E. Webber

by Canadian businessmen Richard Garland and John Palmer, bought the company's Australian and New Zealand operations and formed the Dunlop Pneumatic Tyre Company of Australasia Ltd. It was this company that was to be the forerunner of what is today Pacific Dunlop.

The first decade of the 20th century saw the arrival of the motorcar in Australia, and the newly formed Dunlop Pneumatic Tyre Company, with its core competencies in production of pneumatic tyres, was positioned strongly to be a major producer of tyres for the automotive industry. As it had previously done with bicycle tyres, Dunlop actively promoted motoring, sponsoring both motor races as well as attempts to set long-distance driving records. In fact, Dunlop's first advertising manager, Harry James, was at times himself the holder of several world long-distance driving records. At the same time, bicycle riding continued to be a popular pastime for many Australians. The growing demand for both bicycle and car tyres led the company to open a new factory in the Melbourne bayside suburb of Montague in August 1902.

The first years of the 20th century also proved to be highly competitive in the Australian tyre industry, providing a catalyst for what was to be one of the first of many acquisition strategies by Dunlop. The main source of competition for Dunlop came from the Pioneer Rubber Company, which was owned by Barnett Glass, who in 1876 had essentially founded the Australian rubber industry. Pioneer was the producer of a range of rubber goods, including tyres, and had significant advantages over Dunlop with regard to tyre quality control and reduced cost structures. Faced with a highly competitive market where profitability was low, Dunlop had two choices. The first was to compete with Pioneer and other tyre manufactures on price and quality, a difficult proposition given that the quality of tyre produced at Dunlop's Montague factory was relatively inferior. The second option was for Dunlop to

purchase its competitor. As would become Dunlop's trademark strategy in the future, Dunlop's management decided to purchase the Pioneer Rubber Company.

The purchase of the Pioneer Rubber Company served to strengthen Dunlop's position in the Australian tyre industry. Between 1905 and the beginning of the First World War in 1914, Dunlop's business continued to burgeon, with sales and profitability increasing markedly. In particular, the arrival of the 'Model-T' Ford in Australia made owning a car affordable for the average middle-class Australian and subsequently increased the demand for car tyres. In addition, the purchase of Pioneer enabled Dunlop to diversify into the manufacture of a range of rubber-based products. Dunlop also continued to produce Pioneer's range of wet-weather clothing, hot water bottles, shoes, mats, valves and washers, and increased sales and profitability through product innovation, such as the first Australian-made conveyor belts and moulded rubber hoses.

Interestingly, Dunlop divested Pioneer's condom operations, selling the operations to one of its employees, Eric Ansell. Ansell created the Ansell Rubber Company with an initial capital base of \$60. The company operated out of a factory in the Melbourne suburb of Richmond, and grew by the 1960s to become Australia's largest producer of condoms and rubber gloves. In 1969, Dunlop would buy back the Ansell operation, and grow this into a business with annual sales of \$1.2 billion and a capital value of \$1.1 billion. Today, Ansell is a core business unit for Dunlop, generating more sales revenue than that of their tyre division.

While the First World War impacted on Dunlop's sales figures and supplies of skilled labour, the company emerged from the war reasonably unaffected. Although the first post-war years were chaotic, both economically and socially, Dunlop remained profitable. In two out of every three years from 1908 to 1920, Dunlop had

managed to maintain high ('super-economic') profits, but this ratio would not be repeated again until the 1950s.

Turmoil I, 1920–50

The period from 1920 to 1950 was characterised by economic upheaval and catastrophic social change due to the effects of war. During this period, there would be the economic boom of the Roaring Twenties, the economic bust of the Great Depression and the social destruction of the Second World War. This period would see the introduction of massive increases in tariff protection for Australian manufacturers in an effort by the government to 'prop-up' the economy and create employment. This protection was greatest in industries such as tyre production and clothing, industries where Dunlop had a very strong presence. While these tariffs shielded Dunlop from overseas imports, it would have the long-term effect of reducing Dunlop's ability to compete successfully in the global marketplace.

During the 1920s the Australian tyre industry again became highly competitive. Competition came from both Australian tyre manufacturers, such as the Perdriau Rubber Company and a newly formed Barnett Glass Rubber Company, as well as from international manufacturers such as Goodyear. This competition threatened Dunlop's share of the Australian tyre market, as well as adversely affecting the profitability of the industry as a whole. As in the past, Dunlop had spent little on research and development, and their factories were not employing the latest in tyre production technology. Consequently, Dunlop tyres were again relatively inferior in quality to those of their competitors. Dunlop was again faced with stiff competition on price and quality, and with the challenge of making tough strategic choices.

Initially, in an effort to counter their problems with quality, Dunlop Australasia turned to England, and in return for a 25 per cent stake in the Dunlop Pneumatic Tyre Company of Australia Ltd, Dunlop England provided the company with new tyre technology. Unfortunately for the company, this technological support did little to improve quality standards, with many of the British tyre designs being unsuitable for Australian conditions. As a result, Dunlop once again sought to overcome the threat to their viability through a strategy based on acquisition. Dunlop approached both Perdriau and Barnett Glass with offers of a takeover, with Perdriau accepting the offer. In June 1929 the Dunlop Perdriau Rubber Company Ltd was

established, and the company subsequently purchased a controlling interest in Barnett Glass. While these purchases had the effect of reducing competitive pressure in the Australian tyre market, Dunlop did little to integrate the operations of the three companies. In fact, apart from the name change, the three companies continued to operate as completely separate entities.

Although Dunlop had been vulnerable in the tyre industry during the 1920s, it remained competitive in the production and sale of many other rubber goods, becoming the market leader in the production of rubber belting, hoses and clothing. In addition, Dunlop manufactured the first Australian-made balloon tyres for cars and aircraft tyres. It was during this period that Dunlop began the production of its famous sport shoe, the Dunlop Volley. Much of Dunlop's success with these products was again due to its strong marketing orientation, coupled with a tariff barrier that decreased the sales of imported products.

Within six months of acquiring Perdriau and Barnett Glass, the world plunged into the economic depression which began in 1929. Stock markets collapsed, banks closed, and businesses were forced to cease operations. Tyres and tubes were the first rubber goods to experience a major slump in demand. Sales of new cars fell dramatically, and those people who already owned cars reduced their usage equally dramatically in favour of horses and walking. People who continued to use their cars during the Depression favoured retreads over new tyres, further worsening demand and Dunlop's profitability. Although tyre sales were badly affected, the sale of Dunlop's other innovative rubber products fared considerably better.

To counter the effects of the Depression on their tyre revenues, Dunlop commenced an efficiency (cost-minimisation) drive in 1930. Hard decisions were made to rationalise operations, and some factories were closed. Relief also came from the political arena, with the election of a federal Labor government, which further raised tariffs on imported tyres. By 1932 the economic depression showed signs of lifting, and sales of Dunlop's other rubber products (for example, golf balls and clothing) had turned the company around. Dunlop, however, still faced considerable competition in the Australian tyre market, in particular from the Goodyear Tyre Company. While Goodyear had also suffered during the Depression, their ability to draw on the skills and expertise of their parent company in the United States meant that they emerged from the Depression as Australia's premier tyre wholesaler. Goodyear was able to 'poach' market share away from

Dunlop in the post-Depression period, with 50 per cent of new cars produced during the period 1930–3 being fitted with Goodyear tyres as the standard.

Dunlop was faced with the need to recapture the market share lost to Goodyear. However, the problem for Dunlop was that it had developed a habit of purchasing its major competitors rather than beating them in head-on competition. Unfortunately for Dunlop, Goodyear was not for sale. To overcome this problem, Dunlop opened up a dialogue with Goodyear. Both companies had been adversely affected by the precarious profitability of the industry during the Depression, and in February 1933 they agreed, quite legally at the time, to sell their tyres at a fixed price to dealers in order to shore up the profitability of the two companies.

However, by October, two factors within the tyre market would again place pressure on Dunlop. First, a shift in consumer demand away from high-quality tyres meant that savvy tyre dealers were able to sell cheap tyres far more easily and profitably. Consequently, the price fixing deal between Dunlop and Goodyear collapsed as prices fell. Second, the entry of Sir Frank Beaurepaire's Olympic Tyre and Rubber Company created increased competitive pressures in the tyre industry. These factors greatly affected Dunlop's sales and profitability, so much so that by the start of 1935 Dunlop's share price had fallen in value by one-fifth.

The performance of Olympic, and Dunlop's inability to compete in the Australian tyre industry, perplexed the board of Dunlop, especially as Dunlop had an extensive range of tyres sold under the Dunlop, Barnett Glass and Perdriau brand names. In theory, Dunlop, with its extensive range of tyres, should have been a dominant force in the market. However, Dunlop was a complacent and inefficient organisation. In effect, the purchase of Perdriau and Barnett Glass had been a phantom merger, with no attempt made to integrate the operations of the three companies, each continuing as a separate firm with its own factory, sales force and brand of tyres.

Slowly, the Dunlop board began to realise that their competitive problems stemmed from this basic inefficiency and its triplication of costs. The only way the company could restore its share price and position in the market was to address these problems. In December 1935, Wallace Andrew Bartlett was appointed the new general manager of the company, with a mandate to improve the competitive performance of the company via streamlining of operations and the rationalisation of company resources.

With the appointment of Bartlett, Dunlop would never be the same again. Between 1935 and the start of the Second World War in 1939, Bartlett would drastically restructure the company by reducing the size of its sales force, merging tyre production facilities and eliminating bureaucratic triplication. Bartlett's aim was to become less reliant on tyres, which had been the main source of Dunlop's problems in the past. It was his aim to make Dunlop a universal producer of rubber goods, focusing on a wider range of products such as foam rubber, upholstery, latex and cushions. Interestingly, in his restructuring of the company, Bartlett divested Dunlop's loss-making plastics division, even though the company was the market leader. The division was sold to John Derham and Partners, who would grow this business into Nylex, one of Australia's top 100 firms today.

War was again to impact on the company, but this time in a much more detrimental manner. By 1941, the Japanese invasion of Southeast Asia denied Dunlop access to vital raw materials, forcing the company to be innovative in the use of synthetic and recycled rubber in its products. In addition, the government, in an attempt to ensure sufficient supplies of rubber for the war effort, placed restrictions on the sale of rubber products to the general public. Dunlop became a large producer of products for the war effort, providing the Allied forces with tyres, bullets, inflatable boats, and gas masks. During the war the company removed Perdriau from its name, becoming Dunlop Rubber Australia Limited.

By the start of 1946 the war was over, and the restrictions on the sale of rubber products had been removed. Production freed up and sales of Dunlop's products began to increase. Once again, Dunlop would have to rely on market forces rather than government contracts and military requirements to drive sales. In 1948 the company was briefly thrown into chaos with the death of Wallace Bartlett. Bartlett had given the company focus and renewed vigour, and many on the board were concerned that his passing might herald a new era of uncertainty for the company. After careful consideration, Robert Blackwood was selected to be the new managing director. Unlike previous managing directors, Blackwood had his background in research and development, not sales and production, leading many to question how he would perform in the role.

The last years of the 1940s proved to be a time of renewed economic activity. After the dark times of the Second World War, business was again booming and markets were again rife with competitive action. The 1950s would prove to be a time of great prosperity, and one of the most successful periods in the history of the company.

Consolidation and expansion, 1950–66

Blackwood came to Dunlop with a belief in the virtues of ‘simplification’ and an attitude that ‘small is best’. While the measures undertaken by Bartlett had gone some of the way to improving Dunlop’s position, Blackwood and the board believed that more still needed to be done to restructure the company and improve its performance. Of highest priority was the streamlining of Dunlop’s production process by reducing the size of the factories employed in the manufacture of Dunlop’s range of products. Dunlop’s main factories at Drummoyne (Sydney) and Montague (Melbourne) had been built at the start of the century, and were now largely employing outdated technologies. Blackwood believed that new, smaller factories with current technologies (located closer to the main markets that they wished to serve) would provide Dunlop with the greatest flexibility in production and, therefore the greatest potential profits.

Blackwood was also keen to further diversify the company’s product range away from tyres. At the beginning of the 1950s, and despite all of the company’s previous efforts in product diversification, tyres still accounted for 70 per cent of Dunlop’s revenue. The Dunlop board was highly concerned with this reliance upon an industry with high tariff protection, protection that was in no way guaranteed into the future. In almost every month of the 1950s, Dunlop was tempted to manufacture a new range of goods. Its formal policy was to be less dependent on tyres and to diversify into related areas. Dunlop once again turned to corporate acquisition in order to achieve its goals. Between 1952 and 1960, Dunlop had made a number of significant purchases:

- Moulded Hair of Australia (a manufacturer of foam rubber);
- a 75 per cent holding in Trilby (ladies’ footwear);
- Kenworth Rubber Limited;
- Slazenger Australia (sporting goods);
- Buesst and Bills (bedding);
- Sleepmaker (mattresses);
- B.B.B Pty Ltd (mattresses);
- John Bull Rubber Company; and
- a joint venture with Olympic to form Wheels and Rims Australia.

During this period, Dunlop also redeveloped a chain of tyre retreading stores that it had purchased during the

war into retail distribution outlets for its range of tyres. This distribution network enabled Dunlop to compete more successfully with the Olympic Rubber Company, which distributed its tyres through the Beaurepaire chain of tyre centres. As a result of these acquisitions and redevelopments, the 1950s proved to be one of the most successful and profitable periods in Dunlop’s history. Dunlop was able to grow its business and profitability to such an extent that dividends of 10 per cent were easily paid on preference and ordinary shares, leaving large unpaid surpluses to help finance the expansion of factories and tyre depots.

Post-war prosperity was to experience its first serious downturn, however, in 1961. During that year, the Australian economy experienced a serious balance of payments problem, and the federal government imposed a ‘credit squeeze’ to curtail consumer demand. New car sales fell markedly as a result of this government policy, directly affecting Dunlop’s tyre revenues. Dunlop was also coming under increasing market pressure with the influx of cheap imported tyres, which by 1967 accounted for one in six tyre replacements.

While the ‘credit squeeze’ policy and the threat posed by imported tyres adversely affected Dunlop’s performance in the tyre market, their diversification enabled the organisation to weather the economic downturn relatively unscathed. In 1966, Blackwood stepped down as general manager. Without fanfare, he had turned Dunlop into one of Australia’s top five manufacturing companies, enjoying one of its most profitable periods in its history. Dunlop was now to enter a new phase in its history under the guidance of Eric Dunshea.

Turmoil II, 1966–80

Eric Dunshea had been the driving force behind Dunlop in the last three years of Blackwood’s reign. As company secretary, he had been responsible for overseeing the 1963 reorganisation of the company into five divisions: Automotive (tyres); Industrial; Footwear and Weatherproof Clothing; Flooring; and Sporting Goods. Under this reorganisation, each division was run as an autonomous group, with its own general manager. In a sense, the Dunlop Group was once again divided into separate entities. It was Dunshea’s success in this restructuring effort that persuaded the board to appoint him as Blackwood’s successor.

One of Dunshea's first efforts was to develop a 12-year plan for the company, which he believed would enable the firm to hold international competitors at bay. The plan was based on a massive capital works campaign, the largest ever conceived by an Australian company. This program was designed to improve Dunlop's existing stock of capital and allow it to produce greater amounts of quality goods at a much lower cost. This strategy proved to be successful from the very start, with Dunlop enjoying significant profit increases through both increased sales and cost minimisation.

By 1968, Dunshea's capital works campaign had been so successful that new projects were sought. Dunshea became 'obsessed' with the notion that Dunlop needed to seek new business opportunities in new industries that offered significant growth potential. Consequently, the incremental profitability generated by the capital improvement was channelled into a renewed acquisition strategy. Such was the fervour of the acquisition strategy that the capital improvements program, the goose laying the golden eggs, was effectively forgotten. Between 1968 and 1970, Dunshea would drive Dunlop into an unprecedented period of acquisition. In December 1968, it was decided that the company would buy a controlling interest in the following firms:

- Ernest-Hiller Holdings;
- Taft Australia;
- Julius Marlow Holdings;
- S.A. Rubber Holdings;
- Halandia Shoes; and
- Frankwell Engineering Industries.

On the first Friday in May 1969, the company decided to purchase the following additional firms:

- Pelaco;
- Yarra Falls;
- Universal Textiles;
- Warrnambool Woollen Mills;
- Qualitaire Holdings; and
- Ansell Rubber Company.

Dunlop's thirst for acquisitions became the talk of Australian business, and Dunshea's power over the board enabled him to implement this arguably excessive pursuit unhindered. It appeared to be Dunshea's goal to transform Dunlop into a conglomerate that would rival those of the Japanese *zaibatsu*. Unfortunately, the effects of Dunshea's buying spree would be somewhat detrimental to the company, and be felt many years into

the future. By mid-1971, the unthinkable was almost certain to occur: Dunlop was running out of cash. There were calls from within the company for each of the five divisions to cut their expenditure in favour of a cash-saving strategy. Concerns were also voiced about the lack of integration within the business, and the manner in which this affected both communication and efficiency within Dunlop.

While Dunlop was now far less dependent upon the tyre industry than it once was, the company as a whole was now faced with the double-edged sword of its diversification strategy: accumulated debt. By the end of 1971, Dunlop's debt problem peaked, with debt of \$1.25 for each \$1 of equity. In early 1972, Dunshea died, and control of the company changed: Leith Jarman was appointed CEO, and Robert Blackwood was recalled to the company as chairman of the board. It was felt that Blackwood had served the company well in his last managerial role, and was best suited to manage the firm back to health. At this time, the debt crisis had eased to \$1.18 debt to each \$1 of equity, but there were still grave fears that liquidators would be called in to deal with the situation. By mid-1973, Blackwood and Jarman had undertaken a massive course of pruning and streamlining of operations. Their efforts were hampered somewhat by the oil crisis of late 1973, a crisis that had presented the Western world with the economic effect of 'stagflation'. Stagflation affected Dunlop's sales across all of its product lines, which in turn plunged it back into negative sales growth and debt servicing issues.

Dunlop's initial response to the new crisis was to eliminate its fashion holdings from the corporate whole, as it was felt the company had no competence in this area and was paying too high an opportunity cost for the capital it had tied up in that industry. During this time, Dunlop also began to explore the cost minimisations available in the offshore production of its footwear into countries such as China and the Philippines. Dunlop was able to weather the economic conditions raised by the oil crisis, through both rationalisation and cost minimisation and the fact that one of its divisions – in particular, the Ansell Rubber Company – had become a major profit centre. By 1977 the company had emerged from the long storm. By the end of 1977, Dunlop had reduced its debt by \$18 million and increased its cash reserves to serviceable levels. To further improve Dunlop's performance, the company was given permission to go ahead with a capital hand-back. This had the effect of reducing the

number of Dunlop shares in the marketplace, thus increasing the share price as well as increasing the reportable earnings-per-share figures.

After successfully managing the company for a second period, Blackwood stood down from the chairman's position, having done more good for the company than perhaps any other individual. Unfortunately, Dunlop still held interests in a number of unattractive industries, made more so by the fact that the government of the day had flagged the end of tariff protection for those in manufacturing. The next 15 years would see Dunlop again employ a policy of diversification, this time into a plethora of unrelated industries.

Appetite for acquisition, 1980–91

In 1980 there were major changes in the top management of Dunlop. The new chairman of the board, Sir Brian Massy-Greene, replaced the departing Robert Blackwood, and John Gough took the position of CEO. Both men had been with the company for over 10 years, with Gough as the managing director of the footwear division, and Massy-Greene a board member. Their previous history with the company ensured a shared understanding between the two men of the need to continue restructuring the company.

A major factor to shape their thinking was their awareness that Dunlop mainly operated in highly protected industries. Since the 1920s the Australian government had established a 'Fortress Australia' policy, where the labour-intensive manufacturing sector had been artificially protected from international competition by a wall of tariffs and import duties. However, since the mid-1970s the government had progressively dismantled protectionist policies, and this agenda was to continue into the future.

Both men were aware of the deleterious effects that an end to tariff protection would have on the company's profitability. With its reliance on tariff-protected industries such as tyres, clothing and footwear, Dunlop had much to fear. Consequently, the company, under Gough and Massy-Greene, sought to lessen its exposure by a concerted move into non-tariff protected industries. Such a move would require Dunlop over the next 15 years to pursue an aggressive strategy of diversification, often into industries unrelated to their present operations. As the company would later find, such unrelated diversification had both positive and negative consequences.

Given the company's desire to diversify into new areas, it was interesting (if not ironic) that the first action taken by Dunlop in 1980 was to buy the Olympic Tyre and Rubber Company. Since forming in 1933, Olympic had been a thorn in the side of Dunlop, consistently outperforming them in tyre quality and sales. In addition, Olympic's distribution arm, the Beaurepaire Tyre Centres, had allowed Olympic to spread its reach across the country. However, the increasing maturity of the Australian tyre industry, coupled with the growing pressures from imported tyres, meant that the market could only support a few large manufacturers.

In May 1980, Dunlop approached Olympic to discuss the possibility of a takeover. However, Ian Beaurepaire, head of Olympic, rejected the initial offer out of hand. Beaurepaire felt that to sell to Dunlop would diminish his father's accomplishments. Dunlop, however, was determined that the sale should go ahead, and some weeks later Gough made a personal approach to Beaurepaire to discuss this possibility. Gough and Beaurepaire had been old family friends, and after several nights of long and intimate discussion, Beaurepaire relented and withdrew his opposition to the sale. After further negotiations, the deal was finally agreed to in May 1980, with Dunlop assuming a controlling interest in Olympic. After the takeover, the company changed its name to Dunlop Olympic Ltd.

No sooner was the takeover completed than the new entity itself would become a target for acquisition. In December 1980, mining and investment company North Broken Hill Ltd offered to buy the company. Rather than offering to pay cash for Dunlop, North offered Dunlop shareholders one North share for every Dunlop share. As North shares were superior in value to Dunlop share, this offer was very attractive to shareholders. The attractiveness of the offer depended on the relative value of the two companies' shares, and Dunlop decided that the best strategy to ward off this takeover was to employ delaying tactics, hoping for the desired change in the respective share values. Dunlop's prayers were answered when in 1981 there was a fall in mineral prices on the world market, consequently reducing the value of North shares and thus the attractiveness of their takeover offer. By the end of this campaign, North had only succeeded in acquiring approximately 20 per cent of Dunlop's shares, which it subsequently sold to institutional investors.

With the threat from North dissipating, Dunlop could concentrate on the integration of Olympic into



their corporate structure. During the integration process, it was discovered that Olympic had a core competency (and therefore a competitive advantage) in the production of tyres. With this realisation, the decision was taken to close Dunlop's Montague rubber works, with the bulk of tyre production being moved to Olympic's Footscray factory. While this move improved the quality of Dunlop's tyres, problems on the human resources front began to emerge. Ex-Montague employees relocating to the Olympic factory had problems adjusting, and for years in-fighting occurred between the two groups of employees, who continued to view each other as competitors. Dunlop, however, did little to rectify this situation.

In purchasing Olympic, Dunlop had acquired a 50 per cent holding in Olex Cable. Olex was a manufacturer of electrical cabling, and had been operated as a joint venture between Olympic and Nylex. Olex was already a highly profitable operation, and when the opportunity arose in 1982, Dunlop purchased the remaining 50 per cent of the company from Nylex. In 1983, Dunlop ventured further into the electrical industry with the purchase initially of Spinaway Cable, and the subsequent purchase of Lawrence and Hanson, Australia's oldest chain of electrical retailers. Electrical goods would eventually become a core business unit of Dunlop, growing to become the most profitable group in the company by 1986.

In the early 1980s, Dunlop made a number of other purchases. In 1982 it purchased Slumberland, the manufacturer of a range of bedding products. Dunlop already had a stake in the bedding industry through its Sleepmaker range, and it hoped that the purchase of Slumberland would improve this position. In the same year, Dunlop also purchased a 75 per cent stake in Winestock Footwear. This purchase made Dunlop one of the largest footwear customers of the People's Republic of China, and complemented its already substantial links with that country.

The process of acquisitions continued in 1984, with Dunlop Olympic purchasing Dunlop New Zealand Ltd (tyre manufacturer and retailing, industrial products and sporting goods), Olex Canzac Cables, Harpain (insulated panels), David Galt Industries (maker of Tontine pillows) and Pacific Polymers (manufacturers of industrial goods). Later that same year, Dunlop Olympic severed its ties with England, purchasing back Dunlop UK's 25 per cent share in the company. Shortly after the sale, Dunlop UK itself was bought out by BTR, making Dunlop Olympic the flagship of the Dunlop name worldwide.

While continuing to make acquisitions, Dunlop also attempted to increase its profitability through the introduction of the innovative 'Pulsar Battery' in 1984. Dunlop had first manufactured batteries in 1949, then had slowly increased its focus on batteries, first through a joint venture with Oldhams in 1960, and second through the purchase of Marshall (Batteries) Holdings Pty Ltd in 1967. The arrival of the Pulsar battery was much heralded. It had taken the company 17 years of research and development to develop the Pulsar, at a cost in excess of \$32 million. The Pulsar was thought to have many advantages over existing batteries, in that it was much smaller, lighter and technologically advanced. Dunlop commenced mass production of the Pulsar in 1985, building a new factory at Geelong to service the Australian market, and purchasing North American battery manufacturer Chloride Group plc for its US and Canadian production. In 1986 the Pulsar was awarded the Australian Product Design Award, and it appeared that it would be a successful product for the company.

While it had taken Dunlop 17 years to develop the Pulsar, it would take just 17 months for them to realise it was not the success they had expected. The Pulsar was inefficient and costly to produce, with a rejection rate of around 15 per cent at the Geelong factory. In addition, the Pulsar had been designed for the larger vehicles common to the 1970s, not the smaller, streamlined cars of the 1980s. The cost of retooling the factories to accommodate the need for different battery sizes was found to be prohibitive. In addition, the market did not perceive the Pulsar battery to offer a point of difference. To counter this problem, Dunlop introduced the Switch battery, which was effectively two Pulsar batteries combined into the one unit, with a switch allowing the consumer to switch cells should the main cell go 'flat'. While the Switch proved more successful than the Pulsar, it still failed to prevent further factory closures and reductions in stock levels.

The failure of the Pulsar battery scheme was not considered a major financial disaster for Dunlop, given

that profit levels remained healthy due to the excellent economic conditions that prevailed at the time of its launch. In 1985, acquisitions continued, with Dunlop purchasing outright the Hamilton Shoe Company, Apair Ltd (latex gloves), Flexible Hose Ltd, Celluform (manufacturer of polystyrene boxes), Futurform (plastic compounds), Lamprecht (industrial gloves), Kelga (industrial gloves) and Pharmaseal (surgeons' gloves). Controlling interests in Chemtron (an electrical wholesaler) and lesser shares in Holeproof Industries Ltd (clothing) were also acquired. Dunlop also entered into a joint venture with M.S. Mcleod to distribute tyres in South Australia and Western Australia.

In 1986, after a further series of acquisitions (including Joubert & Joubert (foam), Hallmark industries (fibre products), Frank Allen Tyres, R.D. Park and Solomon Bros (electrical distribution), A.J. Clader & Hoey Fry (industrial) and Desco (footwear)), watershed financial highlights were achieved by Dunlop, with sales exceeding \$2 billion and profit exceeding \$100 million for the first time. By 1986, Dunlop had truly become an acquisition-driven company. Indeed, as the chairman himself reports in the annual financial statement, 'acquisitions help growth'. Importantly for Dunlop, profits from their international operations exceeded 25 per cent of the total profit figure. Such a strong performance signalled Dunlop's emergence as a significant international manufacturer. From this point, it would become an objective of Dunlop's management to have 30 per cent of their total company profits derived from their international operations.

In line with its move towards an international focus, Dunlop engaged in a series of joint ventures with leading Chinese manufacturers to produce their ever-expanding range of products. This series of joint ventures was to provide Dunlop with access to cheaper production, thus enabling it to compete more effectively in the global marketplace, while providing Dunlop with a foothold in the potentially lucrative Chinese market.

While Dunlop disclosed high profitability in its 1986 annual report, there were some financial indicators that could potentially undermine its performance in the future. The first major financial issue was its debt to equity ratio. While hard measures had had to be taken in the mid-1970s to reduce Dunlop's debt and ward off the liquidators, its spending spree of the 1980s had again returned Dunlop to a potentially precarious position, owing more than it owned. By 1985, for example, the ratio of debt to equity was 131.7 per cent, improving slightly in the following year to 122.2 per cent. Although this ratio should

perhaps have been of great concern to management, only passing attention was given to the fact in the 1986 annual report.

A second issue was that of the structure of the Dunlop Corporation. In 1986, Dunlop controlled operations in six separate divisions:

- International Battery Group;
- Electrical Products;
- Consumer Products;
- Latex and Medical Products;
- Tyre Retailing; and
- Tyre Manufacturing.

As it had done in the past, Dunlop operated these divisions as autonomous entities, both between the divisions themselves, as well as between the business units within the divisions. The only requirement Dunlop placed upon its acquisitions strategy through the 1980s was that the target firm be profitable. In growth markets, little attention was given to whether a target firm could actually add synergistic value to the Dunlop Group. As a result, very few synergies were sought, or achieved, between and within Dunlop's many business units. This acquisition strategy was found to be effective in times of economic growth. However, in times of economic downturn and lower earnings, the lack of synergistic efficiencies within Dunlop meant that the firm was relatively unable to achieve cost savings and to compete efficiently in the majority of its markets.

At the end of 1986, Dunlop again decided to change its corporate name, this time to better reflect its position in Australia and its significance as a player in the international marketplace. The name selected was Pacific Dunlop. The 'Dunlop' name was retained as it represented a link to its past, while 'Pacific' was added as it indicated not only its main region of operations, but also complied with an image of a 'fresh and clean' start to a new era.

The 'new era' began with a continuation of the past. Dunlop embarked upon yet another round of acquisitions, with one of its major purchases being Bonds, Coats, Patons Ltd (the manufacturer of such brands as Gotcha, Bonds, Dry-Glo and Cotton-Tails). This purchase made it the largest manufacturer of clothing in Australia – a long way from its beginnings as a tyre manufacturer. Increasingly, Dunlop's acquisition strategy focused on the purchase of leading brand names. According to CEO John Gough, Dunlop's business was the 'management of outstanding brands with high public awareness'. By this stage it already had a strong stable of brands, such as Adidas, Slazenger, Olympic, Ansell, Sleepmaker, Marshall, Bonds and Holeproof.

In addition, Dunlop entered into a joint venture with Goodyear in an effort to combine their Australian, New Zealand and Papua-New Guinea operations. This venture was given the corporate title of the South Pacific Tyre Company Ltd, and effectively reduced the competitive nature of the tyre industry by assimilating a number of major tyre brands into the one corporate group.

Management problems began to emerge in 1987, by which stage the company was operating 163 factories and over 1 000 retail outlets in countries throughout the globe. The company's head office was relatively small, with most of the key decisions delegated to the individual divisions, business units and subsidiary companies. The decentralisation of control ensured that there was little cooperative effort throughout the company. To counter this issue, further restructuring of its divisions was undertaken. The six-division structure was maintained as a framework; however, the composition of these divisions was changed:

- Batteries;
- Consumer Products;
- Electrical Products;
- Latex and Medical Products;
- Industrial Products; and
- Tyre Manufacturing and Retailing.

The restructure was viewed as a success, gauged by the increasing profitability of the firm. Dunlop managed to increase its profits of the previous year by 34 per cent, as well as to exceed a 20 per cent return on shareholder funds for the first time. International operations were still delivering excellent returns, accounting for 33 per cent of the group's total profit margin. On the back of the company's record-breaking profit margins, John Gough decided to 'call it a day', resigning his CEO position at the end of 1987, and undertaking the lesser position of deputy chairman. His replacement was Phillip Brass, who, like Gough, was a company insider,

transferring from the general manager position in the footwear division.

Although Dunlop undertook a number of acquisitions in 1988, arguably the most important were those of Nucleus Ltd and Telectronics. These two companies were the leading manufacturers of cutting-edge medical technologies, namely heart pacemakers and bionic (Cochlear) implants. Dunlop believed that such purchases would enable the group to reap the rewards of the new life-saving technologies, while further diversifying the company away from its reliance on rubber. Dunlop also strengthened its position in the automotive spare-parts and servicing industry through its purchase of Repco Auto Parts, Trader's Auto, and Check-Point Brake and Clutch. In total, Dunlop spent \$424 million on acquisitions in 1988, while only \$147 million was spent on capital improvements. To fund this buying spree, Dunlop had borrowed a further \$267 million, compared with \$62 million the previous year.

By 1988, it was becoming apparent to Dunlop that its Ansell operations were fast becoming the major contributor of profit to the company. While many of Dunlop divisions still operated in mature markets with low growth potential, Ansell was a world leader in the production of such items as surgical gloves, medical gloves, household gloves, balloons and condoms. Much of the growth in Ansell's sales, both in medical gloves and condoms, had been driven by the worldwide fear of the HIV epidemic. To support the growth of Ansell, one of the capital works programs undertaken by Dunlop was the establishment of a new Ansell factory in Sri Lanka.

The five-year period 1985–9 had been a period of exceptional performance for Dunlop. During this time, earnings per share had exceeded a compound growth of 18 per cent per year and a return on shareholder equity exceeding 20 per cent. The company was continuing to generate funds from a much more diverse basis of operation. This basis was further expanded in 1989 by the purchases of Nicolet (hearing aids) and 3M's pacemaker implant business. These acquisitions were designed to build on the foundation provided for by Nucleus in the medical technology arena. In line with its expansion into a wider range of business activities, Dunlop restructured its operating divisions, replacing its six-division structure with a seven-division structure comprised of:

- Ansell International;
- Distribution Group;
- GNB Batteries;
- Medical Group;



- Pacific Brands;
- Industrial Foam, Fibre and Cable; and
- South Pacific Tyres.

The good times continued for Dunlop in 1990, with profits reaching a record high of \$300 million, on the back of total company sales of over \$5 billion. The company made a further round of acquisitions, purchasing the Roberts Group (market leaders in floor coverings), Vita Pacific (manufacturer of bedding and outdoor furniture) and Burton Cables (manufacturer of the Click brand of electrical accessories). Dunlop also entered into a second joint venture with Goodyear, this time in industrial rubber products. Through this joint venture, the two companies would increase their production of both steel-cord and fabric conveyer belting.

By the start of 1991, Dunlop's program of acquisitions had achieved the desired effect of reducing the company's exposure to the tyre industry, with only 10 per cent of revenue now derived from tyres. However, many on the board of Dunlop were still concerned that these acquisitions had not gone far enough, with many of the company's businesses operating in markets that were expected to mature by 1995. In a bold attempt to improve this situation, Dunlop would undertake its most ambitious takeover to date, with the 1991 purchase of Petersville Sleigh. Petersville Sleigh was a giant in the food industry, controlling highly visible brands such as Peters, Pauls, Edgell, Birds Eye, Four 'n' Twenty Pies, Wedgwood and Herbert Adams pies, cakes and pastries, and Robur and Twinings teas. In addition to their food interests, Petersville Sleigh bought Banbury Engineering (sellers of heavy earthmoving equipment), two retail chains (Hardy's and Robb Brown), a group of sawmills, and half of shipping company Patrick Sleigh.

Dunlop saw many similarities between itself and Petersville Sleigh. Both were manufacturers, both were Australian-owned, both were marketing-led companies, and both had strong ties with their retailers. Certainly, Petersville Sleigh had highly recognisable brands and excellent market share in most of its product markets. By Dunlop's estimations, Petersville controlled 40 per cent of the ice cream market, 35 per cent of frozen foods, 40 per cent of pies and pastries, and 20 per cent of the baby food market. By purchasing Petersville Sleigh, Dunlop would automatically become one of the largest players in the Australian food industry, an industry it perceived to have considerable growth potential.

The problem for Dunlop was that the share market did not share its enthusiasm for the Petersville Sleigh takeover. Many questioned Dunlop's estimation that the food market was a growth industry, highlighting that growth in this industry was largely tied to population and Australia's population growth had stagnated. Questions were also raised about Dunlop's view of the similarities between the two companies, failing to see the links between pacemakers and ice cream (except, perhaps, that too much of one would lead to dependence later in life on the other). The financial position of Petersville Sleigh was also a cause for concern. Under the control of previous owner Adsteam, considerable amounts of the company's funds had been channelled into somewhat 'dubious' investments and servicing the debt of the Adsteam Group.

In spite of these opposing views, Dunlop went ahead with the takeover, paying over \$390 million for Petersville Sleigh. With this takeover complete, Dunlop had spent \$1.5 billion on acquisitions in just four years. This had, however, come at a cost, with the company's debt to equity ratio now running at 165.8 per cent, representing an outstanding debt of \$572 million. As a result of this acquisition, Dunlop again changed its corporate structure, moving from seven to five operating divisions, these being:

- Consumer Products (Pacific Brands, Pacific Brands Food Groups);
- Healthcare (Medical Group and Ansell International);
- Automotive (GND Batteries and South Pacific Tyres);
- Building and Construction; and
- Distribution.

Each of these divisions continued to operate autonomously, each with their own managing directors responsible for the performance of that group. Increasingly, the company's actions were driven by a belief in the value of strong brands, and that strong brands would provide the springboard to further growth.

Skidding into decline, 1991–2000

In late 1991 and early 1992 the Australian economy went into a recession that 'we had to have'. With Dunlop's exposure to building and construction, and to consumer markets such as clothing, footwear and food, the recession had a major impact on the company's profitability, reducing total company profit by over 10 per cent. At the same time, the company's accumulated debt increased from \$572 million to \$711 million, a

figure that represented an 11-fold increase over 1987 debt levels. The combined effect of the economic downturn and the recent purchase of Petersville Sleigh brought Dunlop's acquisitions spree forcibly to a halt.

Rather than purchasing more firms, Dunlop turned its attention to consolidating its recent acquisitions. In particular, considerable attention was given to improving the performance of Petersville Sleigh. Closer inspection of the company (after acquisition) revealed that although it was generating cash and owned brands that were market leaders, its plant and equipment were underinvested to such a point that these same brands were basically profitless. Had the equipment been at a current standard, an extra \$34 million in profit could have been generated from its food operations. Dunlop also found that what profit was being made by Petersville Sleigh was coming from the company's comparatively small non-food operations.

Problems also began to emerge for Dunlop in its Teletronics business. Teletronics was a leading manufacturer of pacemakers, designed to regulate the heartbeat of patients with cardiac problems. However, during 1992, doctors began to report design problems with Teletronics' pacemakers, some even citing them as the cause of patient death. The problems from Teletronics would cost Dunlop dearly. Over the next four years, six deaths and 36 injuries were attributed to the Teletronic heart pacemaker, and would cost the company in excess of \$400 million in lawsuits and out-of-court settlements. In 1996, Dunlop sold its holdings in Teletronics to distance itself from the major issues arising from its operations. Unfortunately, the damage had already been done to Dunlop's reputation and bank balance.

By 1993, the Australian economy began to show signs of recovery, with Dunlop's profits improving by 15 per cent over the previous year, and the company being successful in winning two contracts to supply fibre-optic cable to the value of \$125 million. While Dunlop had regained some of the ground lost to the recession, the Dunlop board expressed concerns that the company's range of products and global markets had not protected Dunlop from the ravages of the recession, as hoped. The blame for the company's worse-than-expected performance was placed squarely by analysts upon the continuing lack of integration between business units and divisions.

In order to overcome such criticism, and to improve the performance of its Pacific Brands Food Group, Dunlop purchased Plumrose Food Australia and New Zealand. Plumrose controlled such brands as Yoplait, Petit Miam, Leggo's, Harvest and Plumrose. It was

expected that the addition of Plumrose would enable Dunlop to achieve 'significant synergies' in its food operations and to overcome some of the problems they had in food production. The purchase of Plumrose also increased the 'stable of leading Australian brands' controlled by Dunlop.

By 1994, Dunlop management claimed that the strength of the company came from both the diversity of its product range and its global operations. Management believed that further product innovation and market development would generate still greater growth in the future. This philosophy was put into practice by a number of joint ventures and licensing agreements with Asian countries. The bulk of this activity was centred upon China, a country once thought of by Dunlop as largely a base for cheaper production, but now viewed as a high-potential market for sales and profit growth. Dunlop planned to double its investment in China over the next five years, increasing its total assets in that country to \$400 million. Of greatest note for this financial year was the company's success in achieving a contract to provide fibre-optic cabling for the Chinese government. This project would enable telecommunications between the east and west of the country to improve to world-best standards.

Dunlop, despite the purchase of Plumrose, still experienced problems with its food division. To further improve the profitability of the division, the company invested money in a new 'state of the art' chip manufacturing plant at Ulverstone in Tasmania. Unfortunately, due to the design of the plant, any fault along the production line would result in the total shutdown of all factory operations. As Murphy's Law would suggest, the plant experienced major production stoppages early in its life. Although the factory did overcome some teething difficulties, and had increased the profitability of the group, sales figures failed to achieve much over half of the projected \$100 million forecast by management.

The poor performance of the company's food operations in 1994 was to act as a precursor for the particularly difficult year that the entire company would experience in 1995. Under the weight of apparent inefficiencies and spiralling debt (now running at some \$1.2 billion), Dunlop's profit for the year ran at some 20 per cent below the previous year. The share price fell accordingly, and pressure was put to bear on management to take immediate and corrective action to prevent the company from sliding even further into decline. As a result, the board decided to adopt a new 'strategy' to focus on what were now to be considered

'core business areas': GNB Technologies, Pacific Industries, Pacific Brands and Distribution. In line with this strategy, Pacific Brands Food was sold. Dunlop also divested its Cochlear operations to avoid any further damage to its reputation from impending and potential lawsuits against that subsidiary. To support what the company viewed as its 'new core businesses', a number of new acquisitions were made: Smith & Nephew plc (medical gloves) and Boydex Outerwear (a clothing manufacturer). It was hoped that by focusing on a few 'core business areas', Dunlop could become far more streamlined than in the recent past and finally achieve synergies between its operations.

Despite the major restructuring and divestment undertaken by the company throughout 1994 and 1995, the pressure on Brass to step down as CEO grew to such an extent, that in February 1996 he resigned his position, with Rod Chadwick assuming the role. It was widely viewed that Brass's biggest mistakes were to buy into businesses (such as medical and food) that were outside Pacific Dunlop's core activities of clothing, rubber, cables and industrial products. Indeed, media coverage had described Pacific Dunlop as 'just another bloated and hopelessly over-diversified conglomerate'. In accepting the role of CEO, Chadwick cited the need to rebuild consumer confidence in Pacific Dunlop within 18 months or face the real possibility of takeover – or perhaps even liquidation.

Chadwick recognised that Ansell International had proved to be the company's 'shining light', and that an improvement in Pacific Dunlop's performance as a whole would require further funding for this business unit. To achieve this end, the only major acquisitions undertaken by Pacific Dunlop in 1996–7 were those of JK Chemicals (in 1996), an Indian condom manufacturer, and Golden Needles Knitting (in 1997), the world's leading safety gloves manufacturer.

By mid-1997, the market was warming to Chadwick's focus, and Dunlop's share price and profitability were both beginning to improve. Chadwick's vision and efforts to change the corporate culture within Pacific Dunlop impressed market analysts. As part of Chadwick's plans, the seemingly impenetrable walls between the company's divisions and business units were dismantled by moving people between divisions and promoting cross-divisional communications. This was a revolutionary new approach for Dunlop, which, in the past, had believed that the divisions and business units were best run as single and autonomous entities.

It was also part of Chadwick's vision that unprofitable or underperforming business units be

divested from the company, and that operations should be further streamlined through factory closures. Increasingly, attention was focused on GNB Batteries, which was one area of operation performing well below expectations. While the company was happy to hold on to GNB for the time being, the possibility that this unit would be divested was only dependent upon the location of a buyer.

Chadwick's popularity with market analysts and the stock market soon came to an end. While promising much improvement by way of streamlining and divestments, profit levels slumped drastically during 1998, resulting in a subsequent fall in share price. Apart from Ansell, all of Pacific Dunlop's businesses performed poorly. Further divestments were forthcoming in a 'last ditch' effort to achieve improved performance. Most notable was the sale of Olex to a US corporation, removing Pacific Dunlop from the cabling industry altogether.

Ironically, for Pacific Dunlop, its most profitable activities at this time were to emanate from the rubber industry, the industry on which it had always attempted to lessen its reliance. Ansell, the world leader in latex rubber products, was the standout performer for Pacific Dunlop. Ansell's earnings for 1998 exceeded \$150 million (41 per cent of the company's total), while its individual value was put at \$2.5 billion (75 per cent of Pacific Dunlop's market capitalisation value). The potential of Ansell to add value to Pacific Dunlop was well recognised by market analysts and Pacific Dunlop's management. The company adopted a strategy that no further large acquisitions would be undertaken, in favour of a series of small purchases aimed to strengthen Ansell's position in the world market.

Despite the sound approach undertaken by Chadwick, Pacific Dunlop's performance on the stock market continued to decline rapidly. Few major industrial stocks had performed as badly as Pacific Dunlop in the mid- to late 1990s, its share price halving in the period post-1995 and wiping a staggering \$1.4 billion from shareholder value. Potential investors were obviously sceptical about Pacific Dunlop's ability to perform – even to survive – into the near future. In fact, the company itself was actively scouting the world for potential buyers for its non-rubber industry divisions. The problem for Pacific Dunlop, however, was that apart from Ansell, its 'for sale' divisions were not attractive, as they represented underperforming entities in mature, low-growth industries. In fact, discounting Ansell from the company, the remaining business divisions were valued at a mere \$10 million each. Arguably its most saleable division was its distribution

Exhibit 2 | PDP, Pacific Dunlop Limited, balance sheets, 2000

Balance sheets
of Pacific Dunlop Limited and Controlled Entities
for the year ended 30 June 2000

		Consolidated			The Company		
(\$mn)	Notes	2000	1999	1998	2000	1999	1998
Current assets							
Cash	11	1 077.9	1 072.3	997.3	28.0	30.7	31.2
Receivables	12	784.7	987.5	978.7	2 798.0	2 404.1	2 243.4
GNB assets held for sale		591.2	—	—	18.8	—	—
Inventories	13	848.7	952.2	1 021.9	162.8	175.8	210.7
Prepayments		41.5	58.9	58.5	21.8	28.1	13.6
Total current assets		3 344.0	3 070.9	3 056.4	3 029.4	2 638.7	2 498.9
Non-current assets							
Receivables	12	39.2	45.8	69.8	29.7	34.5	48.6
Investments	14	127.6	148.4	166.9	2 853.6	3 034.6	3 065.2
Property, plant and equipment	15	658.2	1 065.8	1 257.7	93.0	120.9	212.1
Intangibles	16	627.8	607.8	683.4	18.5	14.5	46.4
Future income tax benefit	17	272.0	280.2	363.8	145.3	154.5	142.4
Other		16.9	—	—	16.4	—	—
Total non-current assets		1 741.7	2 148.0	2 541.6	3 156.5	3 359.0	3 514.7
Total Assets		5 085.7	5 218.9	5 598.0	6 185.9	5 997.7	6 013.6
Current Liabilities							
Accounts payable	18	566.4	725.7	795.8	1 881.2	1 957.5	1 853.6
Borrowings	19	1 889.4	1 340.3	1 419.4	1 485.7	1 107.1	1 167.0
Provisions	20	403.9	508.3	562.4	203.8	209.3	230.6
Other	21	3.3	7.1	2.4	1.4	2.9	2.6
Total current liabilities		2 863.0	2 581.4	2 780.0	3 572.1	3 276.8	3 253.8
Non-current liabilities							
Accounts payable	18	5.7	14.0	14.2	0.4	0.4	0.7
Borrowings	19	627.7	781.0	848.1	626.0	627.0	656.1
Provisions	20	71.8	174.9	228.2	5.7	4.6	5.9
Other	21	17.6	33.3	35.8	17.6	18.9	20.3
Total non-current liabilities		722.8	1 003.2	1 126.3	649.7	650.9	683.0
Total liabilities		3 585.8	3 584.6	3 906.3	4 221.8	3 927.7	3 936.8
Net assets		1 499.9	1 634.3	1 691.7	1 964.1	2 070.0	2 076.8
Shareholders' equity							
Share capital	5	1 617.2	1 776.0	514.9	1 617.2	1 776.0	514.9
Reserves	6	(31.2)	(102.1)	1 188.9	10.2	10.0	1 266.0
(Accumulated losses)/retained profits	6	(103.6)	(65.4)	(38.2)	336.7	284.0	295.9
Shareholders' equity attributable to Pacific Dunlop Limited shareholders		1 482.4	1 608.5	1 665.6	1 964.1	2 070.0	2 076.8
Outside equity interests in controlled entities	10	17.5	25.8	26.1	—	—	—
Total shareholders' equity		1 499.9	1 634.3	1 691.7	1 964.1	2 070.0	2 076.8

The above balance sheets should be read in conjunction with the accompanying notes.

Exhibit 3 | PDP, Pacific Dunlop Limited, profit and loss statements, 2000

**Profit and Loss Statements
of Pacific Dunlop Limited and Controlled Entities
for the year ended 30 June 2000**

(\$mn)	Notes	Consolidated			The Company		
		2000	1999	1998	2000	1999	1998
<i>Revenue</i>							
Sales revenue		5 725.8	5 680.0	5 473.0	1 691.2	1 933.1	2 004.5
Other revenue	4	<u>88.4</u>	<u>333.8</u>	<u>122.9</u>	<u>266.7</u>	<u>466.5</u>	<u>314.5</u>
<i>Total revenue</i>		<u>5 814.2</u>	<u>6 013.8</u>	<u>5 595.9</u>	<u>1 957.9</u>	<u>2 399.6</u>	<u>2 319.0</u>
<i>Costs and expenses</i>							
Cost of goods sold		4 080.2	3 951.8	3 806.5	1 060.0	1 246.1	1 339.6
Selling general and administrative		<u>1 395.3</u>	<u>1 662.4</u>	<u>1 410.0</u>	<u>530.9</u>	<u>973.2</u>	<u>949.2</u>
<i>Total costs and expenses</i>		<u>5 475.5</u>	<u>5 614.2</u>	<u>5 216.5</u>	<u>1 590.9</u>	<u>2 219.3</u>	<u>2 288.8</u>
Interest expense	3	146.4	142.9	153.6	122.2	110.2	113.4
Operating profit/(loss) before abnormal items and income tax		192.3	256.7	225.8	244.8	70.1	(83.2)
Abnormal items before income tax	7	<u>(244.9)</u>	<u>(94.0)</u>	<u>(157.5)</u>	<u>(235.8)</u>	<u>54.8</u>	<u>(15.4)</u>
<i>Operating profit/(loss) before income tax</i>		<u>(52.6)</u>	<u>162.7</u>	<u>68.3</u>	<u>9.0</u>	<u>124.9</u>	<u>(98.6)</u>
Income tax attributable to operating profit/(loss)	8	29.8	51.2	44.5	13.0	(8.5)	(91.7)
Operating profit/(loss) after income tax		(82.4)	111.5	23.8	(4.0)	133.4	(6.9)
Outside equity interests in operating profit after income tax		4.1	5.7	(1.0)	—	—	—
<i>Operating profit/(loss) after income tax attributable to Pacific Dunlop Limited shareholders</i>		(86.5)	105.8	24.8	(4.0)	133.4	(6.9)
(Accumulated losses)/Retained profits at the beginning of the financial year		(65.4)	(38.2)	116.1	284.0	295.9	449.8
Adjustment to retained profits at the beginning of the financial year on initial adoption of revised AASB1016 Accounting for Investments in Associates	1	—	—	(23.3)	—	—	—
Amount transferred from share capital	6	160.0	—	—	160.0	—	—
Aggregate of amounts transferred from reserves	6	<u>(8.4)</u>	<u>12.1</u>	<u>(11.6)</u>	<u>—</u>	<u>(0.8)</u>	<u>(2.8)</u>
<i>Total available for appropriation</i>		<u>(0.3)</u>	<u>79.7</u>	<u>106.0</u>	<u>440.0</u>	<u>428.5</u>	<u>440.1</u>
<i>Dividends provided for or paid</i>							
Redemption of Bonds Preference Shares		—	0.6	—	—	—	—
Interim and final dividends	9	103.3	144.4	144.1	103.3	144.4	144.1
Under provision for prior year interim and final dividends		—	0.1	0.1	—	0.1	0.1
(Accumulated losses)/retained profits at end of financial year		(103.6)	(65.4)	(38.2)	336.7	284.0	295.9
<i>Summary of operating profit for the year</i>							
Operating profit/(loss) after income tax attributable to Pacific Dunlop Limited shareholders		(86.5)	105.8	24.8	(4.0)	133.4	(6.9)
Abnormal items after income tax attributable to Pacific Dunlop Limited shareholders							
<i>Operating profit after income tax before abnormal items attributable to Pacific Dunlop Limited shareholders</i>		<u>140.9</u>	<u>199.8</u>	<u>180.8</u>	<u>225.1</u>	<u>78.5</u>	<u>8.5</u>
Earnings per share based on operating profit after income tax attributable to Pacific Dunlop Limited shareholders							
Basic earnings per share before goodwill amortisation and abnormal items				cents	cents	cents	
				17.5	23.2	21.1	
Basic earnings per share before abnormal items				13.6	19.4	17.6	
Basic earnings per share inclusive of abnormal items				(8.4)	10.3	2.4	

The above profit and loss statements should be read in conjunction with the accompanying notes.

arm, consisting of Repco and the wholesale distributors of Pacific Dunlop's electrical and automotive parts, which was still exhibiting a reasonable return.

Chadwick's challenge, 2001–

Certainly, it can be said that Pacific Dunlop has had more than its share of bad luck, stemming back to the 1920s when it purchased Perdriau and Barnett Glass just before a depression decimated the tyre market. It had also been unlucky in 1992, just after the major purchase of Petersville Sleigh, to encounter the economic downturn of the 'recession that Australia had to have'. Pacific Dunlop, however, could also be accused of habitual bad management, manifesting itself in spectacular acquisitions (primarily undertaken by Dunshea and Brass) and an ongoing failure to achieve synergies between any of its operations and divisions.

Chadwick, as CEO entrusted with the job of improving Dunlop's performance and standing in the market, was forced to ask himself the question: 'Is the predicament facing Pacific Dunlop a result of bad luck or bad management?' and, regardless of the answer, how was he to turn things around? Should Chadwick actively listen to the advice of contemporary market analysts, he would find himself faced with several important strategic choices. The first would be to consolidate the business units as they exist, and to attempt (through further restructuring) to better integrate their operations such that the firm could actually harness any available synergistic advantages. The second choice would be for Dunlop to undertake further acquisition measures, as it had done in the past reasonably successfully, in order to purchase its way back to profitability – surely the bad luck of the 1990s could not continue forever. A third choice, and perhaps most popularly advanced, is the divestment of all businesses with the exception of the Ansell Group, the one truly excellent profit centre that the company possesses.

Whichever strategic decision Chadwick undertakes, it would seem that he can ill afford to ignore the effects of the external economic forces at play. Throughout its entire history, it would seem that Pacific Dunlop's management has operated in a virtual vacuum, seemingly oblivious to the external economic environment and the effect that this environment has had on the company. Will this external environment enforce a liquidation of Pacific Dunlop, or will Chadwick be able to reverse the decades of bad luck and bad management and see the company continue into the third millennium as a force to be reckoned with?

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Case 11

Philip Morris

Rhonda Fronk
Bill Pilgrim
Bill Prosser
Regan Urquhart
Monte Wiltse
University of Oklahoma

Introduction

After the second quarter of 1998, Philip Morris chairman and chief executive officer Geoffrey C. Bible could look back upon both positive and negative occurrences within the tobacco industry that had an impact on his company during the first half of the year. In its favour, the industry avoided comprehensive federal tobacco legislation in 1998. Such legislation was avoided primarily for two reasons. First, an advertising campaign linking the legislation to tax increases for government spending spurred conservative opposition to the proposed legislation. Second, the President was involved in an investigation regarding possible felony violations. The investigation forced the President to focus his energies on events other than the tobacco legislation.

Philip Morris, however, was still concerned with the continued prospect of future federal legislation that might have a severe impact upon the profitability of the firm's domestic operations. Additionally, there were significant and numerous legal actions being taken against Philip Morris by parties claiming damages caused by tobacco products. On the operations side, the company had seen a decline of almost 6 per cent in cigarette shipments in the second quarter due in part to price increases and consumer promotions.¹

Given this background, there are a number of ethical, legal and operational issues facing Philip Morris. As the health risks associated with the use of tobacco have become more evident, public sentiment against tobacco companies is becoming increasingly negative. Many feel that the companies have a

responsibility to eliminate nicotine from their products and to discontinue marketing to minors. Others claim that management's only responsibility is to shareholders and not to the public at large. How can Philip Morris continue its success in the midst of pending and threatened litigation and negative public sentiment both in the United States and abroad?

This case begins with an overview of the tobacco industry and a brief history of Philip Morris Company to provide background for the current legal situation. The case will also discuss current Philip Morris competitors such as B.A.T. Industries plc and Gallaher Group plc. Philip Morris business units will be discussed and their financial performance will be addressed. Once the current competitive and internal situations are described, the case will end with a discussion of the legal issues facing Philip Morris and a summary of the future strategic issues the company will face.

Overview of the tobacco industry

The Mayan people first introduced tobacco to Native North Americans in the 15th century. Tobacco use quickly spread throughout Europe and Russia, and by the 17th century it had reached China, Japan and the western coast of Africa.² Early proponents claimed that medicinal properties could be found in tobacco.

Tobacco fields were found in colonial America as early as 1615. Tobacco quickly became the staple crop and principal currency in the colony of Jamestown. After 1776, the tobacco business spread to North Carolina and as far west as Missouri. By the late 1880s, the United States was the second-largest tobacco producer after China and was responsible for about 9 per cent of world production.³

This case was prepared under the direction of Professor Robert E. Hoskisson. The case is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

About 50 million people in the United States currently smoke a total of 570 billion cigarettes each year.⁴ For the first part of the 20th century, society's general attitude was that smoking relieved tensions and produced no ill effects. As recently as the 1940s, smoking was considered harmless, but laboratory and clinical research have proven that smoking can be harmful.⁵

Because of a dramatically noticeable rise in previously rare lung cancer, the American Cancer Society and other organisations began studies comparing death among smokers and non-smokers over a period of several years. All such studies found increased mortality among smokers. As a result of this information, the government became involved in the early 1960s, and ongoing reports and warnings have been issued since that time. All cigarette advertising was banned from radio and television starting in 1971.⁶ Research suggests that smokers crave the effect of nicotine. In a 1988 report, the Surgeon General declared nicotine to be an addictive drug comparable to other addictive substances in its ability to induce dependence.⁷ A 1989 report stated that smoking definitely did cause cancer and therefore warranted substantial investigation.⁸

Medical studies have established that the overall mortality rate is twice as high among middle-aged men who smoke as among those who do not. The American Cancer Society estimated that cigarettes are responsible for 30 per cent of all US cancer mortality. Cigarette

smoke is also estimated to be responsible for 83 per cent of all lung cancer mortality in the United States. Lung cancer is seven times as likely to strike a smoker as a non-smoker. Smoking can also be tied to a number of other forms of cancer and disease, such as strokes and emphysema. While this information, combined with awareness campaigns, has reduced the number of male smokers, there has been a rise in female and teenage smokers despite the Surgeon General's reports.

Cigarette consumption, which accounts for most tobacco use in the United States, dropped slightly after 1964, when a special report to the US Surgeon General linked cigarette smoking with lung cancer, coronary artery disease and other ailments. Since 1987, US cigarette consumption has been slipping by about 2 per cent per year (also see Exhibit 1).⁹ This has resulted in two major industry strategies: diversify at home and pursue international business. According to Robert Miles, author of *Coffin Nails and Corporate Strategies*, diversification was the most substantial strategy implemented by the tobacco companies in response to the decreasing consumption.¹⁰ The companies pursuing international business found the formerly communist regions of Eastern Europe and China to be ideal markets for American cigarette makers. Also, tobacco consumption is rising rapidly in developing countries, where tobacco use is projected to increase 2.8 per cent annually. This is supported by a 1974 to 1987 US tobacco export increase from US\$650 million to US\$3.4 billion.¹¹

Exhibit 1 | Tobacco products, United States' per-capita consumption

Year	Units		Smoking tobacco#	Pounds		Total tobacco products*
	Cigarettes	Large cigars and cigarillos#		Chewing tobacco#	Snuff*	
1996 ^P	2 482	32.7	0.1	0.6	0.31	4.70
1995 ^R	2 505	27.5	0.1	0.7	0.31	4.70
1994 ^R	2 524	25.3	0.2	0.7	0.32	4.90
1993 ^R	2 543	23.4	0.2	0.7	0.30	5.37
1992	2 641	24.5	0.2	0.8	0.29	5.30
1991	2 720	25.1	0.2	0.8	0.28	5.54
1990	2 826	26.4	0.2	0.8	0.28	5.62
1989	2 926	27.9	0.2	0.8	0.27	5.68
1988	3 096	29.1	0.3	0.9	0.26	6.11
1987	3 197	31.7	0.3	0.9	0.25	6.30

* Consumption per capita, 18 years and over.
Consumption per male, 18 years and over.
^P Preliminary.
^R Revised.

Source of information: Department of Agriculture.
Source: Standard and Poor's, 1997, 'Alcoholic beverages and tobacco', *Standard and Poor's Industry Survey*, 11 September, p. 12.

The US tobacco industry is highly profitable. It is estimated that one in four Americans smoke, and the average smoker spends US\$260 per year on tobacco products.¹² Leaders in the market maintain a monopolistic position because of extremely difficult barriers to entry. Tobacco companies also enjoy almost no capital, research or advertising costs. The product sells as is, leaving no incentive for change. The demand for the product has driven itself, resulting in minimal advertising requirements. Social consciousness alone has greatly reduced the industry's advertising budgets.

Brief history of Philip Morris

In 1847, Philip Morris opened a tobacco shop in London. It was in this London shop that he began making cigarettes. After Morris's death before the turn of the century, the company was sold to William Thomson. Mr Thomson introduced cigarettes to the United States in 1902.

During this same period, the American Tobacco Trust controlled 92 per cent of the world's tobacco.¹³ A 1911 US Supreme Court decision broke the trust into four separate companies. Those companies would become American Tobacco (now B.A.T. Industries), R. J. Reynolds, Loews' Lorillard unit and Liggett & Meyers (now Brooke Group subsidiary Liggett Group).

In 1919, American investors purchased Philip Morris and US production began in 1929. Shortly thereafter, the original companies of the American Tobacco Trust began to raise their prices. Philip Morris successfully took advantage of this situation by offering its product at a lower price.

Philip Morris's success can be attributed to its expertise in sales and marketing. The company's early growth was tied to its close alliances with tobacco wholesalers and retailers along the East Coast. As the market evolved, Philip Morris became more dependent on its advertising campaigns. Early on, Philip Morris was promoted as a milder cigarette. Later the company claimed that its English blend did not cause something referred to as 'cigarette hangover'.¹⁴ The company's 1955 introduction of the 'Marlboro man' enabled it to capitalise on the American cowboy image.

Today, Philip Morris is the world's largest cigarette maker. The company leads the cigarette industry in market share, followed by RJR Nabisco and B.A.T. subsidiary, Brown & Williamson. Marlboros account for about a third of all US sales. At the same time, the company gets almost half of its revenues (but only one-third of its profits) from food and beer subsidiaries that

include Kraft and Miller Brewing Company. Miller is ranked number two among US beer makers after Anheuser-Busch (see Exhibit 2). The company also operates a financial service and operated a real estate investment division until its sale in 1997.

Overview of competitors

The following overview provides a description of each of Philip Morris's major competitors. Ultimately, this will provide a background to discuss how individual firms might respond to the legal threat considered later.

B.A.T. Industries plc

B.A.T. Industries plc is the world's second-largest tobacco company. It owns both Brown & Williamson (the third-largest tobacco company in the United States) and British-American Tobacco. B.A.T. controlled 16 per cent of the US cigarette market share in 1997.¹⁵ It is planning to spin off the tobacco portion of its business in September or October. In 1997, sales by segment were as follows: tobacco, 71 per cent (53 per cent operating profit); insurance, 29 per cent (47 per cent operating profit).¹⁶ BAT owns 40 per cent of Imasco, which is a Canadian business centred around tobacco and banking. The company has 164 000 employees.¹⁷ Return on equity for the five years including 1993–7 has ranged from 25.2 to 30.0 per cent.¹⁸ Its major tobacco brands are GPC Approved, Kool and Lucky Strike. The chief executive officer (CEO) is Martin Broughton and the company is headquartered in London, England. Shares are traded on the American Stock Exchange (ASE) under the symbol BTI.

Gallaher Group plc

Gallaher Group plc is the largest manufacturer of tobacco products in the United Kingdom, with 39.6 per cent of the market in 1997.¹⁹ In 1997, sales by region were as follows: UK, 87 per cent (84 per cent operating profit); outside UK, 13 per cent (16 per cent operating profit).²⁰ The company currently has about 3 600 employees.²¹ Its major tobacco brands are Silk Cut, Berkeley, Mayfair, Sovereign and Sobranie. Gallaher's lower-priced offerings, Mayfair and Sovereign, are selling well mostly because consumers faced with higher prices due to increased taxation are switching to less expensive brands. The CEO is Peter Wilson and the company is headquartered in the UK. Shares are traded on the New York Stock Exchange (NYSE) under the symbol GLH.

Exhibit 2 | Philip Morris products

Tobacco				
Marlboro	Cambridge	Caro	Lark	Next
Benson & Hedges	Basic	Chesterfield	L&M	Peter Jackson
Virginia Slims	<i>Selected international brands*</i>	Diana	Longbeach	Petra
Merit		f6	Multifilter	Philip Morris
Parliament	Bond Street	Klubowe	Muratti	
Food	Sauceworks	whipped	<i>Fresh pasta & sauces</i>	Aladdin
Grocery aisles	cocktail,	topping mix	Di Giorno	Africana
<i>Beverages</i>	horseradish,	Kraft dessert	<i>Processed meats</i>	Cote d'Or
Coffee	sweet 'n sour	toppings	Oscar Mayer	Daim
Maxwell House	and tartare	Refrigerated case	hot dogs, cold	Figaro
Sanka	sauces	<i>Cheese</i>	cuts and bacon	Freia
Yuban	<i>Confectioneries</i>	Parmesan/Romano	Oscar Mayer	Hollywood
General Foods	Altoid's mints	Kraft	Lunchables	Korona
International	Callard &	Kraft Free	Louis Rich turkey	Marabou
Coffees	Bowser toffees	Di Giorno	products (hot	Milka
Maxim	La Vosgienne	Natural	dogs, cold cuts	Peanott
Soft drinks	Toblerone	Cracker Barrel	and bacon).	Poiana
Country Time	and Tobler	Harvest Moon	Louis Rich	Prince Polo
Crystal Light	chocolates	Processed American	Carving Board	Suchard
Kool-Aid	<i>Dry desserts</i>	cheese	sliced meats	Sugus
Tang	D-Zerta	Kraft Deluxe	<i>Pickles & sauerkraut</i>	Terry's of York
Capri Sun	Jell-O	Kraft Singles	Claussen	Toblerone
<i>Post cereals</i>	Minute brand tapioca	Kraft Super Slice	Freezer case	Other
Alpha-Bits	<i>Dry grocery</i>	Kraft Cheez	<i>Desserts</i>	Estrella snacks
Banana Nut Crunch	Baker's	Whiz	Cool Whip	Frisco beverages
Blueberry Morning	chocolate and	Light n' Lively	<i>Pizza</i>	Kraft ketchup,
Cranberry Almond	coconut	Old English	Di Giorno	peanut butter
Crunch	Calumet baking	Velveeta	Jack's	Magic Moments
Frosted Shredded	powder	Cream cheese	Tombstone	Miracle Whip
Wheat	Oven Fry	Philadelphia	<i>Selected</i>	Miracoli
Fruit & Fiber	coatings	Philly Flavors	<i>international</i>	Simmenthal
Grape-Nuts	Shake 'N Bake	Temp-Tee	<i>brands*</i>	Vegemite
Great Grains	Sure-Jell and	Other cheeses	<i>Cheese</i>	Beer
Honey Bunches of	Certo pectins	Althenos	Dairylea	Miller Lite
Oats	<i>Ethnic foods</i>	Chumy	El Caserio	Miller High Life Best
Honeycomb	Taco Bell	Di Giorno	Eden	Molson non-alcohol
Honey Nut Shredded	dinner kits,	Hoffman	Invernizzi	Miller Lite Ice
Wheat	salsa and meal	Polly-O	Philadelphia	Miller Beer
Natural Bran Flakes	components	<i>Dairy products</i>	Sottilette	Meister Brau
Pebbles	<i>Meals/side dishes</i>	Breakstone's	P'tit Quebec	Foster's brew
Raisin Bran	Kraft macaroni	sour cream and	Coffee	Miller Genuine
Shredded Wheat	& cheese	cottage cheese	Blendy	Red Dog
Shredded Wheat 'n	Minute rice	Breyer's yogurt	Carte Noire	Leinenkugel's
Bran	Stove Top	Jell-O yogurt	Gevalia	Asahi
Spoon Size Shredded	Velveeta shells &	Knudsen sour	Grand' Mere	Magnum
Wheat	cheese	cream and	Kaffee HAG	Draft
Toasties	<i>Salad dressings</i>	cottage cheese	Jacobs Kronung	Icehouse
Waffle Crisp	Good Seasons	Light n' Lively	Jacobs Monarch	Celis Presidente malt
100% Bran	mixes	low-fat cottage	Jacques Vabre	liquor
<i>Condiments & sauces</i>	Kraft	cheese, yogurt	Kenco	Miller Genuine
Kraft mayonnaise	Seven Seas	Sealtest cottage	Maxim	Lowenbrau
Kraft barbecue sauces	<i>Snacks</i>	cheese, dips and	Nabob	Shipyard
Miracle Whip	Handi-Snacks	sour cream	Saimaza	Sharp's
Bull's-Eye barbecue	<i>Toppings</i>	<i>Desserts</i>	Splendid	Draft Light
and grilling sauces	Dream Whip	Ready-to-eat Jell-O	Confectioneries	Milwaukee's

*Not generally available in the United States as Philip Morris products.

Source: Philip Morris Annual Report, inside back cover.

Imasco Ltd

Imasco Ltd is the dominant company in the Canadian cigarette industry with almost 65 per cent of the Canadian market.²² Tobacco accounts for more than 50 per cent of the company's operating profit.²³ Return on equity for the five years including 1993–7 ran between 13.7 and 17.3 per cent.²⁴ The company's major tobacco brands are Players and du Maurier. These brands continue to do well even with the virtual ban on tobacco advertising in Canada, which confirms an industry belief that advertising restrictions 'freeze' market positions. Restrictions make it harder for smaller rivals or new entrants to persuade consumers to switch brands. The CEO is Brian Levitt and the company is headquartered in Montreal, Canada.

RJR Nabisco Holdings Corporation

RJR Nabisco, formerly R. J. Reynolds, is the second-largest US producer of cigarettes with about 25 per cent of the market.²⁵ The company has major positions in both the food and tobacco industries. Food products include Oreo, Chips Ahoy!, Ritz, Wheat Thins, Cream of Wheat and LifeSavers. The company has approximately 80 000 employees.²⁶ Return on equity for the four years including 1994–7 ran between 7.0 and 9.5 per cent.²⁷ Its major tobacco brands include Winston, Salem, Camel, Doral, Vantage and More. RJR is test marketing a new tobacco brand named Eclipse in several markets in the United States. Eclipse – which primarily heats tobacco rather than burning it – reduces second-hand smoke by 80 per cent and leaves practically no ash, stains or lingering odour.²⁸ The CEO is Steven Goldstone and the company is headquartered in New York City. Shares are traded on the NYSE under the symbol RN.

Loews Corporation

Loews is a diversified investment company. Its primary business segments are a multi-line insurance company (85 per cent of 1997 revenues, 81 per cent operating profit)²⁹ and tobacco segment (12 per cent of 1997 revenues, 29 per cent operating profit).³⁰ In 1997, Loews held around 8 per cent of the US cigarette market.³¹ The company employs approximately 35 000 people.³² Return on equity for the five years including 1993–7 ran between 5.0 and 21.4 per cent.³³ The company's major tobacco brands include Newport, Kent and True. The CEO is L. A. Tisch and the company is headquartered in New York City. Shares are traded on the NYSE under the symbol LTR.

UST Inc.

UST Inc. is the leading US producer of smokeless tobacco with approximately a 75 per cent share of the moist smokeless segment.³⁴ Smokeless tobacco products accounted for 86 per cent of sales as well as 97 per cent of the company's profits.³⁵ The company has approximately 4 500 employees.³⁶ Return on equity for the five years including 1993–7 ran between 74.9 and 164.5 per cent.³⁷ Its major brands include Copenhagen, Skoal, Borkum Riff and Don Tomas pipe tobacco. The company has been able to price its products at a premium to the market. It is now beginning to face serious competition from discounters that can deliver similar products for about half the price UST is charging. UST is reluctant to compete in the discount market for fear of cannibalising sales from their premium brands. UST has started a promotional initiative that puts a 'made date' on cans of Copenhagen that indicates the freshness of the product to the consumer. This has led to an increase in the number of cans being returned. The CEO is Vincent Gierer, Jr, and the company is headquartered in Greenwich, Connecticut. Shares are traded on the NYSE under the symbol UST.

Universal Corporation

Universal Corporation, formerly known as Universal Leaf Tobacco, is the largest leaf tobacco exporter/importer in the world. It purchases, processes and sells tobacco to manufacturers. Because many of the other competitors are vertically integrated, Universal is a direct competitor in supply and otherwise indirectly affects competition. The company has approximately 25 000 employees.³⁸ Return on equity for the five years including 1993–7 was between 9.3 and 21.5 per cent.³⁹ The CEO is A. B. King and the company is headquartered in Richmond, Virginia. Shares are traded on the NYSE under the symbol UVV.

Philip Morris's business units

Philip Morris understood the need to diversify long before the introduction of the current formal tobacco litigation. Philip Morris and R. J. Reynolds were among the first to begin a serious program of diversification only a few years after the 1964 Surgeon General's Report.⁴⁰ Major acquisitions began in 1969 with the purchase of Miller Brewing Co. and continued through the late 1980s with the acquisition of Kraft Foods. After the 1985 acquisition of General Foods, former Philip Morris CEO Hamish Maxwell said, 'We wanted to

lessen our dependence on cigarettes as our earnings source, and to spur growth.⁴¹ By making several major diversification efforts, Philip Morris was able to invest a portion of its cash and diversify the risk of what it perceived to be an inevitable tobacco liability. The resulting family of products created by these acquisitions is delineated in Exhibit 2.

Tobacco

Philip Morris USA (PMUSA) holds the nation's largest market share in retail tobacco sales with 51 per cent. According to *The Maxwell Consumer Report* issued by Wheat, First Securities, Inc., Philip Morris USA has been the leading cigarette company in the US market since 1983.⁴² This claim is founded upon the strength of the brand name of its leading cigarette, Marlboro. Marlboro itself holds 35.2 per cent market share in domestic sales.⁴³ Other Philip Morris tobacco brand names include Basic, Merit, Benson & Hedges, Parliament and Virginia Slims. In 1997, domestic tobacco provided 38 per cent of domestic operating revenue, while providing for 47 per cent of domestic operating income. Operating income margins were 24 per cent in 1997, down significantly from 33 per cent in 1996.

Philip Morris International (PMI) has a cigarette market share of at least 15 per cent in more than 40 markets, including Argentina, Australia, Belgium, the Canary Islands, the Czech Republic, Finland, France, Germany, Hong Kong, Italy, Japan, the Netherlands, the Philippines, Poland, Singapore, Spain, Switzerland and Turkey.⁴⁴ Marlboro is the largest-selling brand internationally as well, with 6 per cent of the world market. Philip Morris maintains brands internationally that include Bond Street, Parliament, L&M and Chesterfield. PMI utilises a practice of expanding into new international markets by acquiring existing local brands.⁴⁵ This practice has recently been used in Poland, Portugal and Mexico. PMI operating revenues are much more dependent upon tobacco, with 70 per cent of operating revenues coming from tobacco sales, but it has much lower profitability than its domestic counterpart, with only a 17 per cent operating income margin.

Food

Kraft Foods, Inc. (KFI) is the largest processor and marketer of retail packaged food in the United States. KFI is a combination of General Foods Corp., which was acquired in September 1985 for US\$5.75 billion,⁴⁶

and Kraft Foods, Inc., which was acquired through a hostile takeover in December 1988 for US\$12.9 billion.⁴⁷ The investment community questioned Philip Morris at the time of these acquisitions for investing in businesses with significantly smaller operating income margins than the traditional tobacco margins. At the time of the General Foods acquisition, analyst David A. Goldman of Dean Witter was quoted as saying, 'Those turkeys, ... this is dumb.'⁴⁸ Philip Morris has been able to increase the operating margins on the food business by utilising superior marketing skills, capitalising on the industry knowledge of key personnel from both Kraft and General Foods, and reducing expenses by leveraging common resources across the entire food business.

KFI owns trademarks to major brand names, which include Jell-O, Oscar Mayer, Maxwell House, Post Cereals, Kool-Aid, DiGiorno Pizza and Altoids. In 1997 the domestic division of KFI generated 48 per cent of domestic operating revenues and 41 per cent of domestic operating margins. KFI has shown significant growth in operating income margins, from 14 per cent in 1995 to 17 per cent in 1997.

Internationally, the food business unit has been a globalisation of the existing Kraft and General Foods brand names as well as the acquisition of large international brands. Subsidiaries and affiliates of KFI manufacture and market a wide variety of coffee, confectionery, cheese, grocery and processed meat products in Europe, the Middle East, Africa and the Asia-Pacific region. The international portion of the food business provided an operating income margin of 12 per cent in 1997.

Beer

Philip Morris acquired Miller Brewing in 1969 from W. R. Grace.⁴⁹ In 1969, Miller sales placed seventh in the domestic beer market. In less than six years, Miller moved from seventh to fourth place in domestic beer sales and it currently holds the number two position behind Anheuser-Busch. This growth is attributed to the superior marketing expertise of Philip Morris and the overlapped target customer segments for both product categories.

In 1997, the Miller Brewing Company provided Philip Morris with only 3.7 per cent of operating income at a margin of 11 per cent, significantly less than both the tobacco and food business units. The international portion of this business represents only 6 per cent of the volume of the beer business. Philip

Morris has decided to keep the beer business mainly domestic. This was demonstrated when Miller sold its 20 per cent equity stake in Molson Breweries in Canada, but retained majority ownership of Molson USA, LLC, in order to maintain importing, marketing and distribution rights for Molson and Foster's brands in the United States.

Philip Morris's financial performance

The diversification practices of Philip Morris Companies Inc., combined with its ongoing market dominance of the tobacco industry, have yielded tremendous growth in earnings for the company. Exhibit 3 highlights selected financial data of Philip Morris Companies Inc. during the past 11 years. One illustration of the company's growth is its increase in net earnings. This number grew from US\$1.8 billion in 1987 to US\$6.3 billion in 1997, with an average annual increase of 25 per cent.

Exhibits 4 and 5 show the Philip Morris Companies Inc. balance sheets and results of operations for the six months ending 30 June 1998 and for the years ended 31 December 1995–7. Comparisons of operating results between reporting periods and items of significant impact on operating results are discussed in the following three sections. The discussion will highlight general (consolidated) operations, discuss operating results of the domestic tobacco and international tobacco business segments, and conclude with summary results.

Results of operations – general

As Exhibit 5 illustrates, for the first six months of 1998, operating revenues were in excess of US\$37 billion. This represented a 2 per cent increase over the comparable 1997 period for the combined Philip Morris Companies Inc. This increase was primarily the result of an increase in sales of domestic tobacco, international tobacco and North American food operations. Financial services and real estate operating revenues decreased due to the sale of the real estate business in 1997.⁵⁰

Several unique events affected income during the first six months of 1998. In February 1998, the company announced voluntary early retirement and separation programs for salaried and hourly employees, which resulted in pre-tax charges of US\$327 million. During the same six-month period, the company recorded pre-tax charges of US\$806 million related to the settlement of healthcare cost recovery litigation in

Minnesota and US\$199 million related to 'Most Favored Nation' clauses in previous state settlement agreements with the states of Mississippi and Texas. Excluding these charges, as well as results from operations divested in 1997, underlying operating income increased 7.4 per cent, or US\$484 million, over the first six months of 1997.⁵¹

Operating revenues in 1997 were approximately US\$72 billion, as seen in Exhibits 5 and 6. This was an increase of US\$2.9 billion, or 4.1 per cent, over 1996. This improvement was due primarily to sales increases in domestic and international tobacco and North American food operations. Operating profit, however, showed a slight decline of 0.2 per cent, or US\$25 million, in comparison to the 1996 results.⁵²

Operating results in 1997 were also affected by several singular events. The operating profit decrease was the result of several pre-tax charges. These included US\$1.5 billion paid by Philip Morris Incorporated, the company's domestic tobacco subsidiary, for settlement of healthcare cost recovery litigation in Mississippi, Florida and Texas; a one-time charge from a Florida class action suit settlement; and a US\$630 million charge for realignment of the international food operations. Operating profit included a US\$774 million pre-tax gain on the sale of ice cream businesses in Brazil and a US\$103 million pre-tax gain on the sale of real estate operations.⁵³

Results of operations – domestic tobacco

During the first six months of 1998, operating revenues of US\$7.01 billion for Philip Morris Inc. represented an increase of 10.1 per cent over 1997, due to pricing and improved product mix, partially offset by lower volume. In the same 1998 period, this segment recorded pre-tax charges of over US\$1 billion related to tobacco litigation settlements (mentioned previously), and US\$309 million related to voluntary early retirement and separation programs for salaried and hourly employees. Operating income decreased 53.6 per cent from the comparable 1997 period, due primarily to the aforementioned tobacco litigation settlement charges; higher marketing, administration and research costs; charges for the voluntary early retirement and separation programs; and lower volume.⁵⁴

In 1997, operating revenues of US\$13.5 billion in this business segment (Exhibit 6) represented an increase of 8.2 per cent over 1996 because of pricing, higher volume and an improved product mix. This category sustained the US\$1.5 billion charge for litigation settlement mentioned previously. Operating profit for

Exhibit 3 | Philip Morris Companies Inc. and subsidiaries, selected financial data – 11-year review (US\$mn, except per share data)

	1997	1996	1995	1994	1993	1992	1991	1990	1989	1988	1987
Operating revenues	72 055	69 204	66 071	65 125	60 901	59 131	56 458	51 169	44 080	31 273	27 650
Cost of sales	26 689	26 560	26 685	28 351	26 771	26 082	25 612	24 430	21 868	13 565	12 183
Operating income	11 663	11 769	10 526	9 449	7 587	10 059	8 622	7 946	6 789	4 397	3 990
Net earnings (including cumulative effect of accounting changes)	6 310	6 303	5 450	4 725	3 091	4 939	3 006	3 540	2 946	2 337	1 842
Total assets	55 947	54 871	53 811	52 649	51 205	50 014	47 384	46 569	38 528	36 960	21 437
Total long-term debt	12 430	12 961	13 107	14 975	15 221	14 583	14 213	16 121	14 551	16 812	5 983
Stockholders' equity	14 920	14 218	13 985	12 786	11 627	12 563	12 512	11 947	9 571	7 679	6 823
United States export sales	6 705	6 476	5 920	4 942	4 105	3 797	3 061	2 928	2 288	1 863	1 592
Federal excise taxes on products	3 596	3 544	3 446	3 431	3 081	2 879	2 978	2 159	2 140	2 127	2 085
Foreign excise taxes on products	12 345	11 107	9 486	7 918	7 199	6 157	5 416	4 687	3 608	3 755	3 331
Basic EPS (including per-share cumulative effect of accounting changes)	2.61	2.57	2.17	1.82	1.17	1.82	1.08	1.28	1.06	0.84	0.65
Diluted EPS (including per-share cumulative effect of accounting changes)	2.58	2.54	2.15	1.81	1.17	1.80	1.07	1.27	1.05	0.83	0.64
Dividends declared per share	1.60	1.47	1.22	1.01	0.87	0.78	0.64	0.52	0.42	0.34	0.26
Book value per common share outstanding	6.15	5.85	5.61	5.00	4.42	4.69	4.53	4.30	3.43	2.77	2.40
Market price per common share at year end	45.25	37.67	30.08	19.17	18.54	25.71	26.75	17.25	13.88	8.50	7.13

Source: Philip Morris Companies Inc. 1998 Exhibit 13 Annual 10-K Report to Security Holders for 1997 6 March p. 35.

	(a)			(b)		
	30 June 1998	31 December 1997	1996	30 June 1998	31 December 1997	1996
ASSETS	LIABILITIES					
Consumer products:	Consumer products:					
Cash and cash equivalents	4 605	2 282	240	847	157	260
Receivables, net	5 293	4 294	4 466	1 577	1 516	1 846
Inventories:				2 505	3 318	3 409
Leaf tobacco	4 166	4 348	4 143			
Other raw materials	1 910	1 689	1 854	2 148	2 149	2 106
Finished product	3 043	3 002	3 005	1 667	1 234	1 331
Total inventories	9 119	9 039	9 002	1 083	942	
Other current assets	1 840	1 825	1 482	1 790		
				3 467	3 780	2 726
				1 000	862	1 269
				975	972	978
Total current assets	20 857	26 479	24 192	15 976	15 071	14 867
Property, plant and equipment, at cost:				12 289	11 585	11 827
Land and land improvements		666	664	920	889	731
Buildings and building equipment		5 114	5 168	2 506	2 432	2 372
Machinery and equipment		12 667	12 481	6 630	6 218	5 773
Construction in progress		1 555	1 659			
Sub-total	20 595	20 002	19 972			
Less accumulated depreciation	(8 740)	(8 381)	(8 221)	38 321	36 195	35 570
Total property, plant and equipment	11 855	11 621	11 751			
Goodwill and other intangible assets, net of accumulated amortization of 5 087; 4 814; and 4 391)				103		173
Other assets	17 557	17 789	18 998	838	845	1 134
	3 023	3 211	3 015	3 933	3 877	3 636
				146	110	140
Total consumer products assets	53 292	50 061	48 954	5 020	4 832	5 083
				43 341	41 027	40 653

Exhibit 4 | Philip Morris Companies Inc. and subsidiaries, consolidated balance sheets (US\$m) (continued)

	(a) 30 June 1998	(b) 31 December 1997	(b) 31 December 1996
Financial services and real estate:			
Finance assets, net	5 900	5 712	5 345
Other assets	<u>171</u>	<u>174</u>	<u>572</u>
Total financial services and real estate assets	<u>6 071</u>	<u>5 886</u>	<u>5 917</u>
STOCKHOLDERS' EQUITY			
Common stock, par value 0.33-1/3 per share	935	935	935
(2 805 961 317 shares issued)			
Earnings reinvested in the business	26 111	24 924	22 478
Currency translation adjustments	<u>(1 330)</u>	<u>(1 109)</u>	<u>192</u>
Sub-total	<u>25 716</u>	<u>24 750</u>	<u>23 605</u>
Less cost of repurchased stock 374 902 778;			
380 474 028; and 374 615 043 shares)	<u>(9 694)</u>	<u>(9 830)</u>	<u>(9 387)</u>
Total stockholders' equity	<u>16 022</u>	<u>14 920</u>	<u>14 218</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>59 363</u>	<u>55 947</u>	<u>54 871</u>

^(a) Source: Philip Morris Companies Inc., 1998, Form 10Q, Quarterly Report for the Quarterly Period Ended June 30, 1998, 31 July, pp. 2-3.

(b) Source: Philip Morris Companies Inc., 1998, Exhibit 13, *Annual 10-K Report to Security Holders for 1997*, 6 March, pp. 36–8.

Exhibit 5 | Philip Morris Companies Inc. and subsidiaries, consolidated statements of earnings (US\$m, except per share data)

	(a) Six months ended 30 June 1998 (Unaudited)	(b) For the years ended 31 December		
		1997	1996	1995
Operating revenues	\$37 361	\$72 055	\$69 204	\$66 071
Cost of sales	13 590	26 689	26 560	26 685
Excise taxes on products	8 419	15 941	14 651	12 932
Gross profit	15 352	29 425	27 993	26 454
Marketing, administration and research costs	8 354	15 720	15 630	15 337
Settlement charges	1 005	1 457		
Amortization of goodwill	290	585	594	591
Operating income	5 703	11 663	11 769	10 526
Interest and other debt expense, net	482	1 052	1 086	1 179
Earnings before income taxes and cumulative effect of accounting changes	5 221	10 611	10 683	9 347
Provision for income taxes	2 103	4 301	4 380	3 869
Earnings before cumulative effect of accounting changes	3 118	6 310	6 303	5 478
Cumulative effect of accounting changes	0	0	0	(28)
Net earnings	\$3 118	\$6 310	\$6 303	\$5 450
Per-share data:				
Basic earnings per share before cumulative effect of accounting changes	\$1.28	\$2.51	\$2.57	\$2.18
Cumulative effect of accounting changes				(0.01)
Basic earnings per share	\$1.28	\$2.61	\$2.57	\$2.17
Diluted earnings per share before cumulative effect of accounting changes	\$1.28	\$2.58	\$2.54	\$2.16
Cumulative effect of accounting changes				(0.01)
Diluted earnings per share	\$1.28	\$2.58	\$2.54	\$2.15

(a) Source: Philip Morris Companies Inc., 1998, Form 10Q, *Quarterly Report for the Quarterly Period Ended June 30, 1998*, 31 July, p. 4.

(b) Source: Philip Morris Companies Inc., 1998, Exhibit 13, *Annual 10-K Report to Security Holders for 1997*, 6 March, p. 39.

1997 decreased 22.3 per cent from 1996, due to litigation charges; higher marketing, administration and research costs; higher fixed manufacturing costs; higher volume; and the improved product mix. Excluding the impact of litigation settlement charges, Philip Morris Inc.'s operating profit for 1997 increased 12.3 per cent over 1996.⁵⁵

Results of operations – international tobacco

During the first six months of 1998, operating revenues of Philip Morris International were US\$14.3 billion, an increase of 4.5 per cent over the comparable 1997 period, including excise taxes. Increases were caused by

price increases, favourable volume/mix and the consolidation of previously unconsolidated subsidiaries. Operating income for this period increased 11.1 per cent over the comparable 1997 period for primarily the same reasons.⁵⁶

During 1997, tobacco operating revenues of this segment were US\$26.3 billion (Exhibit 6) which is US\$2.2 billion over 1996, including a US\$1.2 billion increase in excise taxes. Excluding excise taxes, operating revenues increased US\$1 billion, due primarily to price increases; favourable volume/mix; and the consolidation of previously unconsolidated and newly acquired subsidiaries. Operating profit for 1997 increased 12.6 per cent over 1996, because of these same factors.⁵⁷

Exhibit 6 | Philip Morris Companies Inc. and subsidiaries, consolidated operating results

	Operating revenues								
	(US\$m)(a)			Operating revenue (%)					
	1997	1996	1995	1997	1996	1995			
Tobacco									
Domestic	\$13 485	\$12 462	\$11 493	18.7%	18.0%	17.4%			
International	26 339	24 087	20 823	36.6	34.8	31.5			
Total tobacco	39 824	36 549	32 316	55.3	52.8	48.9			
Food	27 690	27 950	29 074	38.4	40.4	44.0			
Beer	4 201	4 327	4 304	5.8	6.3	6.5			
Financial services	340	378	377	0.5	0.5	0.6			
Operating revenues	\$72 055	\$69 204	\$66 071	100.0%	100.0%	100.0%			
	Operating income								
	(US\$m)(b)			Operating income (%)			Operating income margins (%)		
	1997	1996	1995	1997	1996	1995	1997	1996	1995
Tobacco	\$7 830	\$8 263	\$7 177	64.1%	67.4%	65.4%	19.7%	22.6%	22.2%
Food	3 647	3 362	3 188	29.8	27.4	29.1	13.2	12.0	11.0
Beer	456	437	444	3.7	3.6	4.0	10.9	10.1	10.3
Financial services	296	192	164	2.4	1.6	1.5	87.1	50.8	43.5
Operating income	\$12 229	\$12 254	\$10 973	100.0%	100.0%	100.0%			
	Assets(c) (US\$m)			Return on assets (%)					
	1997	1996	1995	1997	1996	1995			
	1997	1996	1995	1997	1996	1995			
Tobacco	\$14 820	\$13 314	\$11 196	52.8%	62.1%	64.1%			
Food	\$30.926	\$32 934	\$33 447	11.8	10.2	9.5			
Beer	\$1 455	\$1 707	\$1 751	31.3	25.6	25.4			
Financial services	\$5 886	\$5 917	\$5 632	5.0	3.2	2.9			

(a) Source: Philip Morris Companies Inc., 1998, Exhibit 13, *Annual 10-K Report to Security Holders for 1997*, 6 March, p. 20.

(b) Source: Philip Morris Companies Inc., 1998, Exhibit 13, *Annual 10-K Report to Security Holders for 1997*, 6 March, p. 26.

(c) Source: Philip Morris Companies Inc., 1998, Exhibit 13, *Annual 10-K Report to Security Holders for 1997*, 6 March, p. 48.

Summary results

A summary of operating results for Philip Morris Companies, Inc. indicates that the tobacco business segment provides a substantial portion of the company's revenues. For the six months ended 30 June 1998, domestic tobacco sales of US\$7.011 billion represented 32.9 per cent of tobacco revenues and 18.8 percent of operating revenues, while international tobacco sales of US\$14.325 billion represented 67.1 per cent of tobacco revenues and 38.3 per cent of total operating revenues.⁵⁸ For the year ended 31 December 1997, domestic tobacco sales of US\$13.485 billion represented 33.9 per cent of tobacco revenues and 18.7 per cent of total operating revenues, while international tobacco sales of US\$26.339 billion represented 66.1 per cent of tobacco revenues and 36.6 per cent of total operating revenues.⁵⁹

Philip Morris legal issues

In recent years, tobacco companies have been faced with significant legal threats, as noted in the previous financial results section. In the past, tobacco companies were able to maintain defence. Things started to change in 1988, when Liggett was ordered to pay the first award in a liability suit.⁶⁰ Later, in 1994, Florida passed a law making it legal to sue cigarette makers for reimbursement of Medicaid expenses from smoking-related illnesses. A total of 39 states have filed suit seeking compensation for healthcare costs. Adding to tobacco firms' potential problems, the US President declared nicotine a drug and placed it under the jurisdiction of the Federal Drug Administration.⁶¹

Philip Morris faces a tremendous amount of tobacco-related litigation both in and outside the United

Exhibit 7 | Overview of pending tobacco-related litigation against Philip Morris Companies Inc. as of 1 August 1998

Category	Approximate number of cases pending	
	In the United States	Outside the United States
(1) Smoking and health cases alleging personal injury brought on behalf of INDIVIDUAL plaintiffs	400	20
(2) Smoking and health cases alleging personal injury brought on behalf of a CLASS of individual plaintiffs	65	4
(3) Health care cost recovery cases brought by state and local governments and similar entities seeking reimbursement for health care expenditures allegedly caused by cigarette smoking	140	1

Source: This information was obtained from Philip Morris Companies Inc., Form 10Q, *Quarterly Report for the Quarter Ended June 30, 1998* and filed 31 July 1998. For a detailed listing of the pending litigation for categories (2) and (3) above, please refer to Exhibit 99 of the aforementioned Form 10Q.

States. The pending legal proceedings pertain to many different issues, but generally fall into three basic categories: individual smoking and health cases, class action smoking and healthcare cost recovery cases.⁶²

The smoking and health cases vary according to the claim being made. Claims such as negligence, gross negligence, strict liability, fraud, misrepresentation, design defect, failure to warn, breach of express and implied warranties, breach of special duty, conspiracy, concert of action, violations of deceptive trade practice laws and consumer protection statutes, and claims under the federal and state *Racketeer Influenced and Corrupt Organization Act* (RICO) statutes are common among the pending legal proceedings.⁶³ Currently, approximately 400 smoking and health cases have been filed and served against Philip Morris in the United States and approximately 25 cases are pending outside of the United States. Of the 400 cases, only 22 allege personal injuries as a result of exposure to environmental tobacco smoke.⁶⁴

The healthcare cost recovery cases mostly seek reimbursement for Medicaid and/or other healthcare-related costs allegedly incurred through the fault of tobacco companies. Some of the recovery cases seek future damages as well (Exhibit 7).⁶⁵ Approximately 140 healthcare cost recovery cases are currently pending against Philip Morris. Of the 140 cases, 37 were filed by states, 70 were filed by unions, six were filed by HMOs, eight were filed by city and county governments, five by

Native American tribes, and five by federal and state taxpayers.⁶⁶

Other tobacco-related claims are also common. For instance, one claim asserts that Philip Morris allegedly failed to manufacture a fire-safe cigarette when they possessed knowledge of a technology that would produce a cigarette that was less likely to cause fires. Cigarette price-fixing claims and suits filed by former asbestos manufacturers also add to the list of tobacco-related cases against Philip Morris.⁶⁷

In an effort to increase stability and decrease uncertainties in the tobacco industry, Philip Morris and other tobacco companies have adopted a Memorandum of Understanding (referred to as the Resolution). The purpose of the Resolution is to address the majority of the legal and regulatory issues that the tobacco industry faces. Issues discussed in the Resolution include: advertising and marketing, product warning and labelling, underage smoking reduction goals, enforcement of no sales to underage consumers by the states, and surcharges against the industry for failure to reduce underage smoking.⁶⁸

Philip Morris has proposed its own form of legislation safeguarding against sales to minors. Steve Parrish, Philip Morris's senior vice president of corporate affairs, and Richard H. Verheij, UST executive vice president and general counsel, presented the plan. The plan includes a ban on outdoor advertising within 1 000 feet of a school or playground and also calls for a minimum age of 18 for the sale of

Exhibit 8 | Actual and/or proposed regulations on the tobacco industry

- Excise tax increases
- Federal regulatory controls
- Requirements regarding disclosure of cigarette ingredients and other proprietary information
- Requirements regarding disclosure of the yields of tar, nicotine and other components of cigarette smoke
- Governmental and grand jury investigations
- Increased smoking and health litigation
- Federal, state and local governmental and private bans and restrictions on smoking
- Restrictions on tobacco manufacturing, marketing, advertising and sales
- Legislation and regulations to require substantial additional health warnings on cigarette packages and in advertising
- Elimination of the tax deductibility of tobacco advertising and promotional costs
- Legislation or other governmental action seeking to ascribe to the tobacco industry responsibility and liability for the purported adverse health effects associated with smoking

Source: Philip Morris Companies Inc., 1998, Form 10Q, *Quarterly Report for the Quarterly Period Ended June 30, 1998*, 31 July, p. 26.

tobacco products. The plan would ban vending sales by requiring face-to-face sales and would ban the sale of single cigarettes and mini packs (fewer than 20 cigarettes to a pack). Cigarette sampling would also be banned in areas where minors are allowed to enter.⁶⁹

It is difficult for Philip Morris to predict the uncertain outcome of the litigation it is facing, and it is unable to estimate potential losses that may result from an unfavourable outcome. It is also hard to predict the effect that the pending litigation will have upon current smokers and cigarette sales. The company does feel that it has valid and concrete defences against the pending litigation, and the officers stress their willingness to continue to defend the company.⁷⁰

The future

What must Philip Morris Companies, Inc. do in the future to maintain its financial success in light of ongoing tobacco litigation, proposed legislation and increasing public sentiment against smoking? A recent comment from *The Wall Street Journal* states: 'Even as the 30 stocks making up the Dow Jones industrial average have been pummeled over the past month, one company has managed to stand out: Philip Morris Co.'s.⁷¹ Philip Morris continues to outdistance its competitors in the tobacco industry and to show marked success in its beer and packaged food divisions. In the United States and abroad, many actual and/or proposed regulations are pending. These regulations (listed in Exhibit 8), along with the aforementioned

potential liabilities arising from unfavourable outcomes of litigation, could have negative effects on the future operating results of Philip Morris Companies, Inc. as well as its competitors.

How will the current litigation affect the nature of competition? How will competitors choose to manage their own litigation threat?

How can Philip Morris balance social responsibility with business success? Do legislation and litigation present imminent threats to the company's tobacco segment? What business strategies can Philip Morris use to hedge against possible adverse effects on or elimination of this segment of its operations?

Endnotes

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Case 12

Pisces Group of Singapore*

Siah Hwee Ang
Kulwant Singh
National University of
Singapore

Introduction

China, Malaysia, Saudi Arabia, Singapore, Thailand. Retailing, department stores, electronic manufacturing, optics, transportation, hotels, trading, garment manufacturing and retailing, textiles and electronics component manufacturing, property development, industrial parks, transportation, optical products, food, travel and entertainment. In a few short years, Pisces Holdings had rapidly expanded from its single small clothing store in Singapore to become a diversified firm with multiple ventures spread over several countries. Its aggressive expansion suggested a strong commitment to its announced target of turning a family-owned firm into a public company. Yet this expansion also suggested the need for the firm to rationalise its businesses and to build its organisation to support its strategy for long-term success. In late 1996, it was clear that the Pisces Group needed to make fundamental decisions on its strategy for future success.

Pisces traced its roots to a small *pasar malam* (night market) stall in Singapore in the early 1970s. This was a small family venture, run by the eldest son of the Ang family, Ang Chin Thian. The small, makeshift operation comprised a display table that would be moved to different parts of the city on different nights, to sell low-end clothing to casual shoppers. The early going was difficult, but gradually it developed into a reasonably successful, if unglamorous, operation. However, as Singapore developed rapidly, night markets fell in popularity and had almost ceased to exist by the late 1970s. The need to find an alternative business, and their relative success in selling clothes, encouraged the family to focus on the retail clothing business.

Ang Chin Thian and his four brothers started Pisces with a single retail store in the Chinatown shopping district of Singapore in 1986. The store essentially replicated their night market stall format, selling a range of value-for-money clothing to price-conscious customers. Over time, the range of products sold expanded to include household items, and the store's format evolved into that of a clothing and household goods-oriented department store. However, the focus continued to be on low-end products, and the range of items sold was relatively limited. Almost all goods sold in the store were sourced from China. This format proved to be successful and sales grew steadily throughout the 1980s. By 1989, the operation was so successful that Pisces started limited manufacturing of its own garments in China. By 1991, Pisces had achieved an annual turnover of S\$50 million and was a well-known outlet in the Chinatown area of Singapore.

Pisces appeared to have a simple formula for success: 'We focus on value-for-money garments and have a niche market in the mid-lower income group. The question is whether you know the target audience, are able to get what they want and sell the products to them at the right price,' Seah Hwee Hock, a senior manager at Pisces, pointed out. Pisces believed that its long experience in garment retailing gave it the experience to source and manufacture the right products at low cost. In addition, Pisces' smaller store size and low rental were 'good for local shoppers' and made it easier for the stores to break even. Despite its success, Pisces believed that it would be difficult to grow sales by about 20 per cent annually in a mature store location in Singapore. This concern appeared to be the major driver behind the strategy adopted in the

early 1990s, of rapidly expanding its businesses by establishing new stores.

Transformation and growth

With its first retail outlet successfully established, Pisces went on an expansion spree between 1992 and 1993, establishing three more department stores in various parts of Singapore. These were based on the same department store format of its original store. This was quickly followed by the opening of several small outlets in the middle-class housing estates, in which the majority of Singapore's population resided. These stores provided easy access to the middle-class, price-sensitive, retail-clothing segment that Pisces targeted. By 1993, Pisces had transformed itself into a retail chain with 16 stores accounting for a total retail space of about 100 000 square feet.

The firm subsequently explained the rationale for its rapid expansion in retailing as follows: 'By expanding the number of stores, we can achieve greater economies of scale,' said Seah Hwee Hock. 'The ideal location for us is in housing estates where we can capture the local crowd.' The firm also prided itself on its flexibility and speed, as reflected in what it called, a 'hit and run' strategy. 'We never stayed in one housing estate for more than four months. After we sold our goods, we packed up and went to another estate. What's the point of staying? All the goods that people in the neighbourhood wanted to buy from you, they would have done so already,' explained Ang Chin Thian.

In February 1994, Pisces announced plans to enter a new niche in the retail sector, investing S\$1 million in renovations for its first large discount store. This store, PMart, was located on Singapore's high-end Orchard Road tourist belt. An additional discount store was to be opened in Singapore in 1995, and two more in Malaysia in the next two years. This new large discount store format appeared to have become popular in Singapore at that time, as the giant US discounter, Kmart, had set up the first of its three new stores in 1994. Market rumours abounded that other large discounters would soon establish operations in the country. In April 1994, Pisces acquired four small retail outlets in housing estates for S\$5 million.

In September 1994, Pisces acquired 40 per cent of Circuits Plus, a 15-year-old manufacturer of printed circuit boards (PCBs). The acquisition for more than S\$10 million was made through a newly established subsidiary, Pisces Technologies Holdings (PTH). PTH identified its core businesses as PCB manufacturing,

electronics components trading, and the development and engineering of data communication products.

PTH announced its intention to buy other companies that had complementary capabilities to that of Circuits Plus. It also aimed to undertake turnkey projects, as well as to enter the original equipment manufacturing business. In addition, it was planning to set up PCB manufacturing plants in China by 1995. Shortly thereafter, Pisces announced that it had invested S\$7.6 million in a joint venture with a Singapore firm to set up a transport and chartering business.

Pisces' group general manager, Koh Hee Hiong, explained the rationale for the diversification as follows: 'Traditionally, we have been in retail and garment manufacturing. This is the first time we are getting into areas like transport and hotels. This is to turn the company from a family-owned interest to a public company.' He further explained that the investment in the Singapore transport company was designed to help the firm build its expertise in preparation for entry into the inland transportation business in China. Similarly, the purchase of a stake in Circuits Plus was part of its plan to build a factory in this business in China.

These investments foreshadowed several new ventures over the next few months, reflecting what appeared to be a major change of strategy. The key element of this strategy was a major focus on foreign expansion. The timing of the expansion was fortuitous, as the Singapore retail market experienced a significant slowdown from 1994. Tourist shopping expenditures, which accounted for much of the high-end retail clothing market, had begun to decline. This trend, overbuilding in the high-end shopping belt and a slowdown in regional tourism were starting to hurt the retail clothing and department store businesses. The year 1994 also saw the first of several closures of major department stores in Singapore, and the emergence of a much more difficult retailing environment.

Foreign expansion

Pisces' foreign ventures had a quiet start in June 1992, when it was invited to the Middle East on a business mission organised by the Arab Business Center. During that trip, it clinched a deal to sell its consumer products at Happy Family Department Store in Saudi Arabia. Under the agreement, Pisces was required to reorganise and manage the store. In addition, it was to display more than US\$3 million (S\$4.86 million) worth of goods such as clothing and sportswear at the store each year. The Saudi Arabian company's chairman

announced that Pisces' business strategy, management style and range of consumer products suited the store. Pisces' general manager believed that Pisces could help the Happy Family store, as it was poorly organised and lacked the purchasing and marketing expertise that Pisces possessed. For a small but ambitious operation, this endeavour represented an impressive achievement. It presaged what was to become an important part of the Pisces model, foreign expansion.

In September 1993, Pisces announced a S\$20 million purchase of a 75 per cent stake in Kingdom Corporation, a Singapore-based firm that traded optical products such as spectacle frames and sunglasses. Earlier in August 1993, Kingdom had closed its five-year-old manufacturing plant in Singapore and relocated it to China, as it was too expensive to operate in Singapore. The new US\$1 million (S\$1.58 million) facility near Shanghai was expected to commence operations by the end of 1993. Kingdom was majority-owned by Thailand's textile and fashion group TTI, although the acquisition by Pisces would reduce its stake in Kingdom to 9 per cent.

Pisces announced that it intended to use TTI's connections in China to accelerate its penetration into the Chinese market and to support its intention to obtain a listing on the Singapore stock market. Pisces believed that joint ownership of Kingdom with TTI would allow it to tap into TTI's extensive contacts in China. Pisces also announced that it would sell Kingdom's products in China, in its newly established 130 000-square-foot department store in Guilin and in other stores it planned to set up with TTI. TTI would also supply the garments and textiles for Pisces' stores in China. The links between Pisces and TTI were further strengthened by TTI's subsequent announcement that it planned to sell to Pisces 10 per cent of its subsidiary garment company, Lu Thai Textiles. This sale had received the approval of Lu Thai Textile's equal owner, the Chinese provincial government. Lu Thai Textiles had an annual turnover of US\$23.5 million, and had received approval for a stock listing in China, a relatively rare event in China in the early 1990s.

In December 1993, Pisces formed a joint venture, Qintraco Resources Development, with Chinese company Five Rings Holdings to carry out bilateral trading and investment activities. Five Rings, which was awaiting approval for listing on the Shanghai bourse, was a textile manufacturer that exported more than 60 per cent of its products to more than 40 countries. The first effort of this joint venture was to set up a S\$10 million garment plant in Malaysia, with each firm investing an equal share of S\$5 million.

In May 1994, Pisces announced a second venture with Five Rings, to be run by Qintraco. Shaanxi Speeding Transportation was a US\$1.82 million (S\$2.84 million) venture to transport goods from Xian to Shanghai using a fleet of 40 container lorries and tankers. Pisces claimed that this was the first operation of its kind in the area. The same month, a US\$2 million joint venture with Zhao Feng Real Estate Development Company was formed to operate 50 taxis in Shanghai.

In August 1994, Pisces Land (a wholly owned subsidiary of Pisces) committed to a 75 per cent share of a S\$30 million (US\$17 million) joint venture with China-based Beihai Port Authority to build and operate for 50 years an industrial park in Guangxi Province. Pisces' investment would be financed from borrowing and internal reserves, while its Chinese partner's stake came from granting the 50-year land lease. Pisces explained that its motivation for the investment in Beihai was its strategically located port in the south part of China, where it could be a gateway to and from the southern land-locked provinces. Pisces expected the project to start generating returns by mid-1996.

The Guangxi industrial park was the group's fourth property development in China. The others were investments in a S\$20 million housing estate in Shanghai, a S\$10 million industrial park in Quanzhou, Fujian, and a S\$10 million residential bungalow project in Chengdu. The last venture was 55 per cent owned by Pisces, with the rest held by a Chinese entrepreneur. With 12 of the 31 units sold, Pisces announced the development of another 40 units in the same project in 1995.

In addition, two other projects, a 43-unit landed development in Shanghai and a 24-hectare township project in Quanzhou, would be launched in 1995.

Later in 1994, Pisces expanded its real estate efforts, making the following three hotel investments in China:

- S\$4.6 million in Zhejiang Province;
- S\$4.9 million to purchase a hotel on Hainan Island from Five Rings; and
- S\$8 million to purchase 54 per cent of a 400-room hotel on Qingdao Island.

As its property portfolio grew, Pisces announced in late 1994 that it would focus on property development, predominantly in China, over the next few years. Pisces explained that this diversification into property was a result of the soft retail market in Singapore. Much of its future focus would be on its China businesses, where 40 per cent of its operations were based.

Despite the range of these ventures, Pisces continued to expand its retail operations. Together with another Singapore firm, it opened three department stores in

China – in Xiamen, Fuzhou and Suzhou – for a total investment of S\$5 million. Pisces also announced discussions with a Chinese company to open another three outlets in Qingdao, Shanghai and Hunan.

Structure and ownership

To keep up with its expansion, Pisces expanded the number of its directors from five to 12. It also hired more people with wider expertise and experience. ‘This is no longer a family-run organisation, so we have increased the number of board seats to reflect the professional-run nature of the business ... We are no longer a retail and garment company but a diversified, international company, as our venture in China shows,’ Koh Hee Hiong, Pisces’ general manager, explained. Yet Pisces retained the essence of a family-based firm, being driven by the Ang brothers while apparently retaining the flexibility and informality associated with such firms.

Pisces also indicated that it intended to continue its aggressive expansion and faced relatively few constraints. Funding its acquisitions was not a problem, as internal sources, other shareholders, venture capital companies and investors were ‘more than willing’ to fund projects. Instead, the problem was to find suitable acquisitions.

In July 1994, Pisces sold 30 per cent of the ownership in Pisces Group (its parent holding company) for S\$18 million to Chinese firm Shenzhen Gintian. Shenzhen Gintian was a diversified company engaged through more than 40 wholly owned or joint venture subsidiaries in sectors ranging from real estate, textiles and securities trading, to high-tech industrial and commercial services. In 1988, Shenzhen Gintian had been the first state-owned enterprise in China to obtain a public listing on the Shanghai bourse, and it subsequently obtained a second listing in Hong Kong. In 1993, it had a turnover of S\$220 million (RMB \$1.099 billion) and operating profit of S\$27 million. It was believed to possess good *guanxi* (connections) with the authorities in China, which would facilitate the extensive approval process required for major business ventures in the country. Pisces explained that this link would provide it with greater China expertise, and would enhance its chances of obtaining a main board listing in Singapore, a target it hoped to achieve by 1997. Observers believed that Shenzhen Gintian invested in Pisces to access Singapore’s financial markets and to acquire knowledge of Singapore’s very well-regarded public housing program.

Further changes in the company’s capital structure took place towards the end of 1994 when Transpac

Capital, a venture capital management company, invested S\$10 million in convertible loans issued by the company. The loan would be convertible into an 18 per cent stake in Pisces at the option of Transpac. It was believed that Transpac was attracted in part by the valuation of Pisces for about S\$55 million, which appeared conservative relative to the company’s projected 1995 net profits after tax of about S\$9 million. The entry valuation of six times the prospective price/earning ratio was considered low in the light of the then booming stock market conditions and Pisces’ foray into technology-related investments. This investment was hailed by Pisces as recognition that it had made the transition from a family-run business into a professionally managed conglomerate.

Then, in January 1995, Pisces sold a 15.2 per cent ownership stake to Pacific Can Investment Holdings for S\$6.68 million. Pacific Can was a Singapore-listed company whose principal activities included investment holdings and the provision of management services to related companies. Its intention was to use Pisces’ network of business contacts in China and the region for its own expansion. Pacific Can had been linked to Pisces indirectly since 1994, through its 13 per cent ownership of Kingdom, the first foreign investment made by Pisces.

Further growth and transformation

The year 1995 saw a change in the direction, though not in the speed, of Pisces’ expansion. The acquisition strategy appeared to shift towards technology-oriented ventures, particularly through its technology arm, Pisces Technologies Holdings (PTH).

In January 1995, Pisces was ready to expand its PCB manufacturing business beyond Singapore. It did this through an agreement with Chinese shoe manufacturer Double Star Corporation to set up a S\$7.35 million plant in Qingdao to manufacture PCBs. Pisces, holding a 55 per cent stake, would provide management know-how, while Double Star would contribute the land and working capital. Pisces would then distribute Double Star’s other products when the Chinese company set up its regional office in Singapore in 1996.

Further supporting its PCB manufacturing effort, Pisces invested S\$5.7 million in a PCB manufacturing plant in Malaysia. The factory, which it bought at a discount, was expected to bring in S\$15–20 million in revenues for Pisces. Pisces also announced that it would double its capacity at its Singapore PCB operation by

mid-1996. Revenue from PCB operations was expected to double to S\$30 million by 1996 as a result of these investments.

In August 1995, Pisces bought General Electronics & Instrumentation Corporation (GEIC) through a share swap with its shareholders. GEIC specialised in the distribution of electrical and electronic equipment and components, and the provision of hardware and software engineering. It had an annual turnover of S\$30 million. As Pisces paid for its stake through shares in subsidiary PTH, this had the effect of reducing the group's shareholding in its technology arm from 56 per cent to 25 per cent.

At about the same time, Pisces paid S\$0.3 million for a 30 per cent stake in Falco Technologies, a technology start-up that made automatic printer and computer sharing devices. Falco intended to diversify into liquid crystal displays, electronic components manufacturing, factory automation and system integration. Pisces' management recognised that although their acquisition of Falco did not exactly fit into their diversification plans, as Falco's products were further downstream, it believed that Falco's design team would bring PTH closer to being a provider of engineering solutions.

Pisces then signed a preliminary agreement for its third technology acquisition, for 30 per cent of Hongguan Technologies through a share swap. Hongguan was a machinery maker and system integrator. The 30 per cent purchase was to be

concluded at the end of 1995. However, Pisces indicated that it would increase its stake over time, until it took over full ownership of Hongguan.

As a result of these acquisitions, PTH was expected to contribute 20 per cent of group revenue, while garment manufacturing, wholesaling and retailing would comprise 42 per cent of turnover. The balance would come from its property and transport division. Pisces projected group turnover of S\$100 million in 1995, up 53.8 per cent from S\$65 million in 1994. It forecasted a bright future, and expected to grow by 20 per cent annually over the next few years. Perhaps the only worrying sign was that in mid-1995, Ang Chin Thian, Pisces' founder and main driving force, resigned as chairman because of poor health. His four brothers jointly took over the leadership of the firm.

The situation in 1996

After a brief stay of two years and a loss of S\$12.6 million, American discount giant Kmart decided to pull out of Singapore in June 1996. Although Kmart said that its decision to close its three stores was part of an internal worldwide consolidation, the move was widely viewed as reflecting a lack of confidence in the Singapore retail market.

Nevertheless, Pisces' two PMart department stores were operating well, as were its other retail outlets in Singapore. Exhibit 1 provides a summary of the performance of Pisces' various clothing and department store operations in Singapore. According to Pisces, its

Exhibit 1 | Pisces Group: Retail and wholesale trading (\$ million)

	Pisces Group			PMart International			Pisces Chain Store			Pisces Garments			Cheap & Good Trading		
	1996	1995	1994	1996	1995	1994	1996	1995	1994	1996	1995	1994	1996	1995	1994
Sales	7.55	9.01	1.66	10.59	5.10		7.3	8.43	4.68	15.45	15.00	25.12	13.13	14.02	16.15
Profit after tax	-0.79	-1.21	0.03	0.30	0.07	-0.03	-0.45	0.07	0.33	0.56	0.59	1.37	-0.31	0.10	1.05
Total assets	89.48	77.37	41.97	5.43	3.25	0.23	4.81	4.56	3.10	12.70	13.16	14.78	15.07	16.54	16.90
Current assets	37.76	22.18	7.07	4.47	2.63	0.15	4.50	4.27	2.86	11.18	11.31	12.51	12.03	13.32	13.52
Total liabilities	50.06	41.54	11.36	4.59	2.71	0.26	3.66	2.96	1.57	5.55	6.57	8.78	10.53	11.69	12.15
Current liabilities	38.84	27.58	8.16	4.32	2.55	0.26	3.62	2.92	1.55	5.02	5.78	7.80	9.99	10.85	11.32
Shareholders' funds	39.42	35.83	30.61	0.84	0.54	-0.03	1.15	1.60	1.53	7.15	6.59	6.00	4.54	4.85	4.75
Working capital ratio	0.97	0.80	0.87	1.03	1.03	0.58	1.24	1.46	1.84	2.23	1.96	1.60	1.20	1.23	1.19
Total debt/equity ratio	55.95	53.69	27.07	84.52	83.46	115.03	76.10	64.85	50.66	43.69	49.90	59.39	69.86	70.68	71.88

PMart International, Pisces Chain Store, Pisces Garments and Cheap & Good Trading are subsidiaries under the retail and wholesale trading division of Pisces Group.

combined retail operations would have a turnover of S\$40 million in 1997 and all its stores would be profitable.

Yet, Pisces' success was dependent on much more than its retail operations in Singapore. It was clear that Pisces had undergone a radical transformation. From a largely Singapore-based retailer, Pisces had in the space of little more than two years transformed itself into a diversified conglomerate with more than 50 subsidiaries in textiles, electronics component manufacturing, property development, industrial parks, hotels, transportation, trading and optical products. In addition, it had other smaller ventures in food, travel and entertainment. Observers wondered how well it would integrate these operations, how well it would perform, and what its strategy would be in future. Would its spate of acquisitions continue? In that case, would it continue its diversification?

Endnote

- * This case was first published in Kulwant Singh, Nitin Pangakar and Gaik Eng Lim (eds), 2001, *Business Strategy in Asia: A Casebook* (Singapore: Thomson Learning).

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Raffles, Singapore's historic hotel*

Kulwant Singh
Nitin Pangarkar
Gaik Eng Lim
Ng Seok-Hui
National University of
Singapore

History

The story of Raffles Hotel really began in 1869, when, with the opening of the Suez Canal, travelling abroad for pleasure became a new passion of aristocrats and the super-rich. Together with their wives, fiancées or lovers, they took long cruises on P&O and Lloyd Triestino ships to exotic cities around the globe, where they stayed in hotels of unsurpassed class, such as Cairo's Shepherd Hotel, Bombay's Taj Mahal Hotel and Rangoon's Strand Hotel.

It did not take long for four Armenian brothers,¹ Aviet, Arshak, Martin and Tigran Sarkies, to see the opportunities that lay in accommodating these well-heeled travellers. On 1 December 1887, after an eight-day search, they found a favourable location – an old bungalow on the south waterfront of Singapore island. It had plenty of space for shady gardens, and was close enough to the Padang² yet remote enough from the hubbub of the harbour. A deal was struck with the bungalow's Arab owner with a yearly payment of 127 Spanish dollars. The Sarkies then began renovations to construct a 20-room hotel that was a cross between a Florentine palazzo and a French chateau. It was built using deeply coursed plasterwork with rusticated columns, arches, and a wide verandah running completely around all four sides of the building. Lofty rooms were built to suit the tropical climate.

The brothers named it 'Raffles Hotel', after the island's founder, Sir Stamford Thomas Raffles, who had established a trading post in Singapore for the British East India Company in 1819. His free trade policy had enabled Singapore to flourish as a commercial and trading centre.

The early 20th century was the golden age of world travel and Raffles Hotel soon attracted royalty, the rich and the powerful. It became a social hub of the well-heeled from the East and West – Crown princes, dukes, and local notables such as Sir Frank Swettenham and Sir Henry Keppel, along with a great many colonial military and civil bigwigs. Raffles was referred to as the 'Rendezvous of the Elite'. Tigran Sarkies, quick to capitalise on the human penchant for rubbing shoulders with the rich and famous, would publish lists of the celebrities who stayed at Raffles. Tigran was an irrepressible promoter of Raffles. Once, Rudyard Kipling, having stayed at Raffles, was prompted to write: 'Feed at Raffles and sleep at the Hotel de l'Europe'³ and '... where the food is as excellent as the rooms are bad'.⁴ Tigran blithely turned these sentiments to the hotel's advantage by extracting the words, 'Feed at Raffles – where the food is excellent.' Another brother, Arshak, loved to delight guests with jokes and party tricks. One of his all-time favourites was to balance a glass of whisky on his bald head, and waltz around the ballroom without spilling a drop.

Raffles underwent constant renovation and expansion to keep up with the business boom over the years. Its 1899 reopening was a brilliant affair. The whole hotel was illuminated by 800 bulbs and five arched lights that blazed at the main entrance. Raffles was Singapore's first hotel to have electricity, which it generated from its own dynamos. It was also the first private enterprise to have a telephone and attached bathroom with running water in each room.

During the years 1929–31, Arshak Sarkies embarked on extravagant renovations which resulted in a bankruptcy court suit. The renovation had unfortunately coincided with the Malayan rubber slump and the Great Depression. However, despite

This case was funded by a grant from the National University of Singapore.

problems with creditors, Raffles survived with the help of a few hopeful investors. Between the 1920s and 1940s, Raffles began to show its age. Guests complained about leaking roofs, broken windows, cracked pillars and peeling plaster. The Sarkies, ever sanguine, saw it differently and increased advertising in the *Daily News* that read, ‘For a taste of genuine antiquity, stay at Raffles Hotel.’

On 15 February 1942, Singapore fell to the invading Japanese army. Raffles was appropriated during the Japanese Occupation and turned into military quarters for senior Japanese officers. By the 1970s and 1980s, Raffles was showing its age badly – with run-down, roach-infested rooms, creaky doors, rattling windows and leaking taps. When Roberto Pregarz, an Italian, took over as general manager in 1972, 115 out of the hotel’s 127 rooms were vacant.⁵ Raffles was also losing some S\$250 000 a year. Around it, old shophouses and colonial buildings were being razed to make way for the country’s development. Raffles’ seafront was soon replaced by reclaimed land for commercial development. Next to it, the Westin Stamford, the tallest hotel in Asia, soared proudly. Raffles stuck out like a derelict, decaying grandeur in the hustle and bustle of modern Singapore, and was regarded by many locals as an overrated colonial relic. There was talk of tearing down the hotel, but the intervention of a few concerned, influential individuals, as well as a growing appreciation among the nation’s governing technocrats of the importance of preserving historical artifacts, led to

Raffles being officially gazetted as a historical landmark on 3 March 1987 – the grand old hotel.

Two years later, the hotel was closed for a two-and-a-half-year restoration at a cost of S\$160 million. The restoration work was a delicate affair. Care was taken to preserve the original colonial architecture of the three-storey building. Each of its 104 spacious and luxurious suites had 14-foot moulded ceilings, overhead fans, central air-conditioning, furnishings, marble bathrooms and hand-woven oriental rugs on teakwood floors. Raffles’ suites, which recreated the style and ambience of the hotel’s heyday at the turn of the century, had modern amenities skilfully blended in.

The new Raffles

Raffles Hotel’s suites cost between S\$650 and S\$6 000 a night in 1995 (Exhibit 1). For S\$6 000 a night, the most expensive in Singapore,⁶ one could enjoy a colonial ambience, a luxurious 260-square-metre suite, which included sitting and dining rooms, two bedrooms, three bathrooms with a changing area, a private balcony, jacuzzis, and a 24-hour valet service. Comparatively, the presidential suites of other neighbouring top-end hotels,⁷ which were usually taken up by heads of state, royalty, top corporate staff, celebrities and millionaires, went for between S\$2 700 and S\$4 960 a day.

Guests came predominantly from the United States (30 per cent) and Europe (30 per cent), with Japan and Australia making up about 25 per cent. Asians and visitors from a few other countries formed the remaining 15 per cent. Corporate clients represented 30

Exhibit 1 | Suite rates at Raffles Hotel effective from 1 April 1995

Suites	S\$
Courtyard	650
Bras Basah	700
Palm Court	750
Gallery	750
Personality	800
Noel Coward	950
Somerset Maugham	950
Grand Hotel	4 000
Sarkies	from 6 000
Raffles	from 6 000

Note: All rates (except Grand Hotel) are for single occupancy and are subject to 10 per cent service charge, 1 per cent government tax and 3 per cent goods and services tax. Additional person charge S\$50 up to a maximum of two additional persons.

Source: *The Tariff Schedule*, 1995, Raffles Hotel.

per cent of all occupants, while well-heeled, prominent travellers (including celebrities and politicians) comprised 65 per cent. The remaining 5 per cent of the hotel's guests were independently wealthy and wanted to commemorate special occasions with a stay at Raffles.

The hotel arcade

The hotel owned the Raffles Arcade which housed 12 food-and-beverages (F&B) outlets, six function areas, a mini-museum, a theatre playhouse, and 70 retail shops which included speciality stores such as Tiffany's, Hour Glass, Louis Vuitton, Jim Thompson, Hanae Mori and Donna Karan. The museum, opened free to the public, displayed photographs of famous guests such as Charlie Chaplin and Douglas Fairbanks Sr, a collection of 19th-century photographs of Singapore and Southeast Asia, and a safe in which the original maker of the cocktail concoction, the Singapore Sling, Ngiam Tong Boon, allegedly kept his secret recipe.

Raffles ran five of the speciality shops, selling a range of 500 merchandise items from coffee, spices and jams to notepads, T-shirts, shorts, caps and gold cufflinks. All these items were specially designed for the hotel and bore the Raffles name.

About 8 000 local people visited Raffles' F&B outlets each day. The food, costing between S\$5 and S\$10, was affordable and comparable to many other food centres.

Management

Raffles Hotel was managed by Raffles International Group, a wholly owned subsidiary of DBS Land which had a 56.67 per cent stake in Raffles. Raffles Investments Limited owned the remaining 43.33 per cent. Besides managing Raffles Hotel, Raffles International also offered tourism consultancy services, including hotel development, marketing and management, heritage conservation and restoration.

After renovation, Raffles Hotel changed in more than just appearance. For the first time in its history, Raffles' general manager was a Singaporean and a woman – Jennie Chua. All previous general managers had been European males – from Italy, Switzerland and Britain. Chua, an urbane and articulate woman, held a postgraduate degree from Cornell University in the United States and had over 25 years of hotel experience.

Raffles had a staff strength of 870, including about 130 executives. Until 1987, staff and their family members used to work at the hotel for generations. With the closing of the hotel for restoration, many were

asked to leave. Hotel rules were strict – doormen, porter boys, chambermaids and waiters were required to undergo rigorous training. Doormen wore military uniforms that were meant to evoke memories of Raffles' early heyday.⁸ Half of the staff wore designer uniforms. Others wore batik clothes with motifs of the orchid, Singapore's national flower, as well as the traveller's palm tree. Staff were trained to observe and attend to the smallest needs of individual guests – for example, a painting in a suite would be taken down if it was observed that a guest disliked it.

Raffles sought to recreate the old-world charm and ambience of its illustrious past. For Raffles, nostalgia and old-world service go hand in hand. Management's rule of thumb was 'the older the better'. Its mission was 'to delight patrons with many memorable experiences'.

Marketing

Marketing Raffles had always involved building upon its rich history and colourful events. One poignant tale had the last tiger of Singapore shot dead under a billiard table at Raffles in 1902. The real story was that the tiger was, in fact, a circus escapee, and anyone would have been very happy to see it shot. The tiger episode was now a part of the history of the hotel and lent itself well to promoting Raffles' exoticism. Besides the tiger in that era, there had been encounters with a python, a pig and a wild boar, so much so that *The Straits Times*, Singapore's local paper, was prompted to write: 'No sportsman in Asia should miss paying a visit to Raffles ...'⁹

Another story Raffles used in promoting the hotel's exceptional service was that of the 70-year-old guest who refused to sleep in her room unless a mosquito net was set over her bed, just the way it was in her earlier stay at the hotel in 1937. Although the use of such mosquito nets had long been abandoned as all the suites were installed with air-conditioners, the staff nonetheless spent all night dutifully sewing her a fresh one from remnants of cloth found in a storeroom.

Raffles had been a respite for some of the most famous writers in English literature – Rudyard Kipling, Joseph Conrad and Noel Coward. Many of their handwritten letters and manuscripts were found in the hotel's museum. Raffles had used this fact to their advantage in their advertising. The hotel boasted of Somerset Maugham spending a whole morning writing under a frangipani tree in the hotel's Palm Court. Raffles continued to encourage this tradition by inviting well-known travel writers and journalists to Raffles to experience its ambience and personalised service.

Raffles Hotel, well-aware of the power of the visual medium in capturing the public imagination, had often volunteered its unique setting for films¹⁰ and television productions. After all, as one writer wrote, 'There may be a hundred other luxury hotels, Hiltons, Sheratons, and Westins; but there is only one Raffles.'¹¹ The hotel also used network marketing and word of mouth, as well as calling on prospective and current corporate clients, in selling its rooms.

Raffles' ratings

Institutional Investor Magazine, in a 1993 hotel survey of the world's best hotels, ranked Raffles Hotel 18th in the world and seventh in the Asia-Pacific region.¹² It was rated highly for its excellent, professional service, security, and amenities such as huge American king-size beds, Persian carpets, interesting furniture, attractive bathrooms with old Peranakan-style¹³ tiles, good disposable toothbrushes, soap and shampoo specially

Exhibit 2 | Raffles Hotel's balance sheet at 31 December 1992 and 1993

	1993 S \$000	1992 S \$000
FIXED ASSETS	162 661	171 678
INVESTMENT PROPERTY	175 300	175 300
INVESTMENTS	2 678	2 654
DEFERRED EXPENDITURE	6 544	7 496
CURRENT ASSETS		
Stocks	1 715	1 591
Trade debtors less provision S\$189 819 (1992: S\$174 326)	3 660	3 096
Other debtors and prepayments	696	385
Fixed deposits	3 916	4 281
Cash and bank balances	128	233
	<u>10 115</u>	<u>9 586</u>
CURRENT LIABILITIES		
Trade creditors	3 746	3 558
Other creditors and accrued charges	19 646	26 186
Due to related companies (non-trade)	209	189
Provision for income tax	90	24
Proposed final dividend	243	243
Bank overdraft (unsecured)	6 614	605
	<u>30 548</u>	<u>30 805</u>
NET CURRENT LIABILITIES	20 433	21 219
NON-CURRENT LIABILITIES		
Bank loans	130 500	147 100
Loan from holding company	17 000	17 488
Loan from shareholder	13 000	13 373
	<u>166 250</u>	<u>157 948</u>
SHARE CAPITAL		
Authorised: 100,000 ordinary shares of S\$1 each	100 000	100 000
Issued and fully paid: 66 600 000 ordinary share of S\$1 each	66 600	66 600
RESERVES		
Investment revaluation reserve	89 246	87 234
Unappropriated profit	10 404	4 114
	<u>99 650</u>	<u>91 348</u>
	<u>166 250</u>	<u>157 948</u>

Source: Raffles Hotel.

packaged for Raffles by Floris of London, and fruit trays. However, Raffles did not fare well on a number of items. Drain-holes in the showers were too small and occasionally caused flooding. Rooms in the S\$600 range were a trifle small to be suites. There was no comprehensive minibar range, or coffee or tea service, while breakfast had to be ordered by phone. Toiletry items were limited (for example, body lotion, which is usually available in most hotels, is not provided) and bathrobes were oversized for women guests.

Financial performance

Raffles Hotel reported brisk business barely a month after its reopening. Initial occupancy rate was about 60 per cent, but management reported about 79 per cent – the industry average in 1994. Its 12 F&B outlets were booked in advance to up to 80 per cent of their capacity during meal-times,¹⁴ with 70 per cent of the bookings done by locals. For Raffles, 90 cents on the dollar were

earned for each room, while F&B outlets earned on average 35 cents on the dollar before taxes. At least one function a night was booked at the hotel's banquet halls until the end of the year. Raffles Hotel's balance sheet, profit and loss, and changes in financial position statements for 1992 and 1993 are shown in Exhibits 2–4.

The Asian financial crisis

In late 1997, the vibrant economies of Asia crumbled one after another as the full force of the Asian financial crisis hit the countries of Thailand, Indonesia, South Korea, Malaysia and Hong Kong, causing their economies to dive into a recession. Currencies plunged, with the Indonesian rupiah being affected the worst, diving in January 1998 to Rp 15 000 to US\$1 from Rp 2 000 to US\$1 before the crisis. Civil and political unrest ensued in Indonesia. Singapore was not spared, although the impact of the crisis hit it less severely

Exhibit 3 | Raffles Hotel's profit and loss statement at 31 December 1992 and 1993

	1993 S\$000	1992 S\$000
TURNOVER	65 682	64 446
PROFIT BEFORE TAXATION	6 623	5 903
After charging the following:		
Auditors remuneration	30	29
Depreciation of fixed assets	7 297	7 259
Director's fee	26	24
Amortisation of deferred expenditure	1 182	1 117
Provision for doubtful trade debts	36	136
Interest expense		
—holding company	512	—
—related companies	391	—
—others	4 474	6 151
And after crediting the following:		
Interest income	80	109
TAXATION	(90)	(90)
PROFIT AFTER TAXATION	6 533	5 813
Dividends	(243)	(243)
PROFIT FOR THE YEAR RETAINED	6 290	5 570
UNAPPROPRIATED PROFIT/(LOSS) BROUGHT FORWARD	4 114	(1 456)
UNAPPROPRIATED PROFIT CARRIED FORWARD	10 404	4 114

Source: Raffles Hotel.

Exhibit 4 | Raffles Hotel's changes in financial position at 31 December 1992 and 1993

	1993 S \$000	1992 S \$000
SOURCE OF FUNDS		
Profit before taxation	6 623	5 903
Adjustments for item not involving the movements of funds:		
Amortisation of deferred expenditure	1 182	1 117
Depreciation of fixed assets	7 297	7 259
	<u>8 479</u>	<u>8 376</u>
TOTAL GENERATED FROM OPERATIONS	15 102	14 279
FUNDS FROM OTHER SOURCES		
Bank loans	—	11 700
	<u>15 102</u>	<u>25 979</u>
OTHER APPLICATIONS		
Dividends paid	243	—
Income tax paid	90	—
Purchase of fixed assets	428	4 237
Purchase of investments	24	82
Payment of bank loans	16 600	—
Increase/(decrease) in working capital	<u>(2 283)</u>	<u>21 660</u>
	<u>15 102</u>	<u>25 979</u>
INCREASE/(DECREASE) IN WORKING CAPITAL		
Inventory	124	437
Deferred expenditure	230	496
Debtors	875	910
Creditors	2 126	14 993
Amount owing to/by related companies	<u>841</u>	<u>1 234</u>
	<u>4 196</u>	<u>18 070</u>
Increase/(decrease) in net liquid funds:	(470)	(31)
Fixed deposits, cash and bank balances	<u>(6 009)</u>	<u>3 621</u>
Bank overdraft	<u>(6 479)</u>	<u>3 590</u>
	<u>(2 283)</u>	<u>21 660</u>

Source: Raffles Hotel.

than other countries. Its economy contracted, with tens of thousands of workers being laid off in 1998, the trough of the recession. By 1999, the worst was over for most of the countries, although problems still remained. Many people were still unemployed, political unrest still existed and economic restructuring had yet to be completed. The tourism and hotel industry was badly hit.

The Asian financial crisis and the Singapore hotel industry

The crisis caused a drop in the tourism industry in Singapore. It did not help that, even before the Asian financial crisis was precipitated in August, the region had experienced thick smog caused by the indiscriminate burning of forests by logging and plantation companies in Sumatra, Indonesia. In 1997 and 1998, visitor arrivals dropped to 7.19 million and 6.24 million, respectively, from 7.29 million in 1996. Total revenue from tourism dropped to S\$8.3 billion in 1998, bringing revenue back to the level in 1990.

Hotels in Singapore suffered a 32 per cent decrease in revenue per available room (RevPar) from S\$143.74 in 1997 to S\$97.97 in 1998. The RevPar registered a further decline to S\$89.86 by end-1999. However, the 1999 RevPar was accompanied by an increase in occupancy levels of 74.7 per cent – that is, a 3.4 per cent increase compared to the 1998 level. By the end of June 2000, five-star hotels enjoyed an occupancy level of 82.9 per cent. The higher occupancy levels resulting from the region's recovery from the crisis were reflected in the increased visitor arrivals in 1999 of 6.96 million. As the region continued to recover from the crisis, visitor arrivals in Singapore were expected to remain healthy.

Raffles Hotel: Performance

In the years of the Asian economic crisis, Raffles Hotel suffered from the lower tourist arrivals in Singapore. In 1997 and 1998, Raffles Hotel registered a lower turnover and profit. In 1997, its profit declined by S\$1.2 million. The decline in turnover and profit persisted in 1998. Raffles Hotel's turnover booked a decline of S\$10.9 million. The hotel topped the industry, with an average room rate of S\$599 in 1997 and above S\$580 in 1998. In the first half of 1999, the average room rate for the industry fell approximately 17 per cent compared to the first half of 1998. Raffles Hotel's decrease for the first half of 1999 was approximately 4 per cent.

Its revenue from F&B, which had contributed significantly to overall revenues, was affected as a result of lower local spending. Rental revenue from the Raffles Hotel Arcade was also adversely affected. In spite of the recession years, capital expenditures for Raffles Hotel in 1997 and 1998 were approximately S\$2.13 million and S\$1.99 million, respectively.

Raffles continued to be rated well internationally. In 1998, it was in the *Conde Naste Traveler* list of the 'Top Hotels in the World' and was ranked among the top 25 hotels in the world in the 'Readers Select World's Best Hotels' survey in *Institutional Investor* magazine.

Competition

Between 1996 and 1999, the vicinity of Raffles Hotel saw the completion of Suntec City, a huge complex of office buildings, exhibition centres and shopping mall; Chjmes, a sprawling turn-of-the-century convent girls' school now housing shops, restaurants and galleries; two malls, the up-market Millenia Walk and the underground mall CityLink; and two high-end hotels, the Ritz-Carlton Millennia and the Conrad International. While the new shopping malls and office buildings brought more visitors and tourists into the area, the two hotels posed new competition for Raffles.

A survey of room rates by the consulting company Arthur Anderson concluded that room rates in Singapore should be higher. In 1999, Singapore's average room rate was S\$161, compared to Hong Kong's S\$209. It should have been on a par with Hong Kong's, but for the intense competition in the hotel industry. According to Conrad International's sales and marketing director, Theresa Choo, 'Each time any hotel decides to raise room rates, a competitor hotel of a higher standard either matches or lowers theirs.'¹⁵

This situation was not helped by the fact that 65–75 per cent of total room supply in Singapore was in the up-scale and deluxe hotels – defined to be the business, business and pleasure, and meetings, incentives, convention and exhibition visitors – while the market for such hotels is limited to around 30 per cent of total visitor arrivals.¹⁶

Ownership¹⁷

Raffles Hotel was 56.7 per cent owned by Raffles Holdings Limited, which in turn was 45 per cent owned by DBS Land Limited (DBSL), one of the largest property groups in Singapore (Exhibit 5). Raffles Holdings was listed on the Singapore Stock Exchange in December 1999.

Raffles Holdings had expanded locally and internationally. As of 1999, it owned 2 626 deluxe hotel rooms and suites representing approximately 10 per cent of the deluxe hotel rooms available in Singapore. Its international expansion was marked in 1997 by the purchases of hotels in London and Hamburg, in Germany, as well as the establishment of two hotels in Cambodia. Among the hotels owned by Raffles Holdings, the Raffles Hotel Singapore was positioned as the flagship product (Exhibit 6).

In building its hotel portfolio, Raffles Holdings developed a three-tiered branding strategy. All of its hotels were marketed using the Raffles International master brand, capitalising on the distinctive Raffles name. However, there were some distinctions among the hotels' targeting and positioning strategies. Hotels marketed under the Raffles brand were targeted at affluent and leisure travellers and were luxury landmark hotels or distinctive properties located in gateway cities. These included Raffles Hotel; Brown's Hotel, London; Hotel Vier Jahreszeiten, Hamburg; and Hotel Le Royal, Phnom Penh, Cambodia. In 1994, Raffles Hotel formed a joint venture with the owner of the 19th-century Galle Face Hotel, Colombo, Sri Lanka, to restore and redevelop the historic hotel. A year later, the deal was called off because the cost of the facelift was more expensive than estimated. The distinctive positioning of the hotels belonging to this category, vis-à-vis other top international hotels, was their 'memorable experience'.

The Raffles Resort brand comprised luxury resorts in locations with strong appeal to the leisure market, including individual, family, incentive and special interest travellers. The resort hotels were designed to

take their distinctive form and character from their local culture, history and natural environment. Raffles Holdings owned and operated the Grand Hotel d'Angkor, a Raffles Resort in Siem Reap, Cambodia, near the Angkor Temple complex, and was developing Raffles Resorts in Mallorca, Spain, and on the islands of Bali and Bintan in Indonesia.

The third category was marketed under the Merchant Court brand name and targeted at the middle and upper mid-level market segments and designed to appeal to both business and leisure travellers.

Besides hotels, which contributed approximately 70 per cent to the group's turnover, Raffles Holdings also owned and managed the Raffles City complex, a 337 384-square-metre mixed-use property located in Singapore's central business district. The Raffles City complex comprised the Westin Stamford and Westin Plaza hotels, the Raffles City Convention Center, and a retail and office complex. These two hotel properties were leased out to RC Hotels through Raffles Holdings' wholly owned subsidiary, Raffles City (Pte) Limited. Raffles City (Pte) Limited received rental fees from RC Hotels. The Westin Hotel Company managed and operated the two hotels under the Westin brand name and received a management fee based on a percentage of gross operating profits.

Raffles Holdings' strategy was to 'build upon the Raffles international master brand name to create a diversified group of luxury hotels and resorts in strategic locations throughout the world'.

In addition to expansion, they also formed a cross-marketing alliance with three top-ranked hotels in Europe. Raffles Holdings was also part of Global

Exhibit 5 | Raffles Holdings' hotel portfolio, June 1999

Hotel	Location	Total no. of rooms
Raffles Brand		
Raffles Hotel	Singapore	104 suites
Brown's Hotel	London, England	118
Hotel Vier Jahreszeiten	Hamburg, Germany	158
Hotel Le Royal	Phnom Penh, Cambodia	208
Raffles Resort Brand		
Grand Hotel d'Angkor	Siem Reap, Cambodia	128
Merchant Court Brand		
Merchant Court Singapore	Singapore	476
Asset Managed Hotels		
Westin Stamford	Singapore	1 263
Westin Plaza	Singapore	783

Source: Raffles Hotel.

Exhibit 6 | Raffles Holdings Limited, principal operating companies

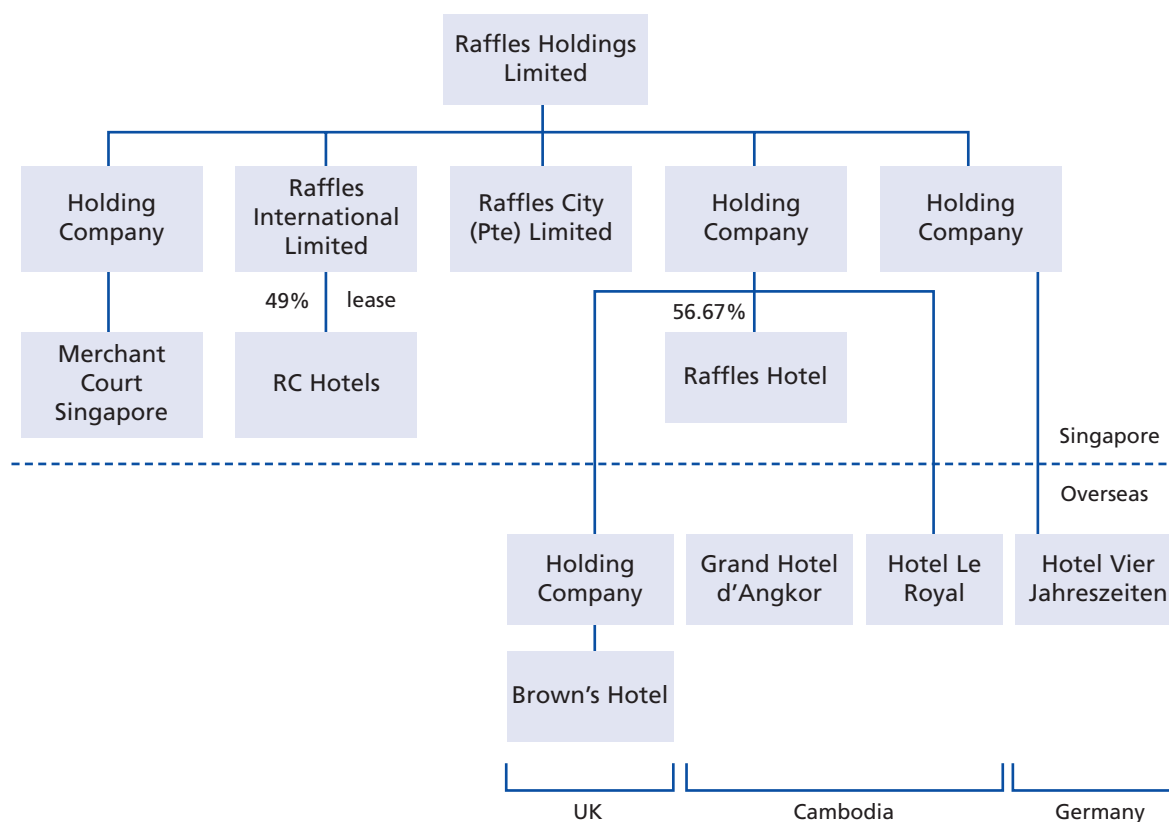


Exhibit 7 | Distribution of visitor arrivals by residence, 1993–8

Residence	1993	1994	1995	1996	1997	1998
Americas	6.06	6.20	5.97	6.30	6.40	6.82
Asia	69.57	71.30	73.30	72.94	72.26	67.67
ASEAN	30.71	31.62	31.15	31.30	32.56	30.12
China	3.51	2.39	2.83	3.11	3.27	4.70
Hong Kong SAR	3.93	3.93	3.92	3.96	3.68	4.38
Japan	15.58	16.08	16.52	16.07	15.20	13.52
S. Korea	3.09	4.20	4.92	5.27	4.15	1.59
Taiwan	6.65	7.40	7.89	7.25	6.94	5.81
Others	6.10	5.68	6.07	5.98	6.46	
Europe	15.87	14.74	13.53	13.75	13.72	15.74
Oceania	6.97	6.29	5.98	5.91	6.43	8.33
Africa	1.52	1.46	1.22	1.09	0.98	1.27
Not stated	0.01	0.01	0.00	0.00	0.21	0.18
Total %	100	100	100	100	100	100
Total arrivals	6 425 778	6 898 951	7 137 255	7 292 521	7 197 963	6 242 153

Note:

* Oceania includes Australia, New Zealand and other countries in Oceania.

Source: Singapore Annual Report on Tourism Statistics, 1998, Table 3.

Exhibit 8 | Statement of operations based on number of rooms, 1998

	Less than 350 rooms Ratio to revenue	351 to 500 rooms Ratio to revenue	501 rooms & above Ratio to revenue
Revenues			
Room department	56.1%	54.8%	55.1%
Food department	27.8	28.9	29.2
Beverage department	8.4	8.6	10.3
Telephone department	2.0	1.4	1.6
Other operated department	1.0	1.0	1.1
Rentals and other income	4.7	4.6	2.6
Total revenues	100%	100%	100%
Departmental costs & expenses*			
Room department	24.9%	28.1	20.6
Food & beverage department	78.7	85.6	73.0
Telephone department	113.7	111.9	103.4
Total cost & expenses	44.8%	49.8	42.2
Total operated departments income	55.2%		
Undistributed operating expenses	55.2	71.9	79.4
Administrative & general	10.7%	14.4	27.0
Marketing & guest entertainment	5.9%	5.9	4.0
Property operation & maintenance	5.4%	6.0	8.7
Energy costs	5.4%	5.4	4.0
Total undistributed expenses	27.3%	26.1	55.7
Income before management fees & fixed charges**	28.0%	19.5%	34.6%
Notes:			
* The ratio of departmental costs and expenses to revenues generated by the respective departments. For example, the costs and expenses of the room department amount to 24.9 per cent of revenues generated by the room department for hotels with less than 350 rooms.			
** Fixed charges include property tax, insurance, rent, interest, depreciation, etc.			
Source: 1998 Singapore Hotel Industry Survey of Operations, Singapore Hotel Association			

Distribution Systems, a major reservations system used by travel agents for flights and accommodation.

Raffles Holdings believed that it should capitalise on its management expertise and master brand name through securing management contracts for properties owned by third parties. By securing management contracts, it could improve its return on capital and enhance its management fee income.

F&B and service were considered critical to its success. As such, it established the Culinary Academy at Raffles Hotel, which served as a test kitchen for Raffles Holdings' new food concepts and as a training site for its culinary employees. It also provided F&B appreciation programs to hotel guests as well as interested locals. It developed a proprietary training program, 'Excel Through Training', which was used in

its training centres in Singapore, Cambodia and Germany. It recently collaborated with the Cambodian government to establish the Cambodia Hotel and Tourism Academy to provide training in the hotel industry.

The future

Raffles Holdings believed that there was really no competition for Raffles Hotel, although it acknowledged that their hotels competed for guests with other hotels in the highly competitive lodging industry in various countries. How can Raffles Holdings help its flagship hotel, Raffles Hotel, compete better in this very competitive industry? How should Raffles Holdings itself pursue its growth strategy?

Exhibit 9 | Labour cost, 1998

	Hotel industry (\$)	Ratio to revenue (%)	Analysis by number of rooms		
			Less than 350 rooms	351 to 500 rooms	501 & above rooms
			Ratio to revenue (%)	Ratio to revenue (%)	Ratio to revenue (%)
*Labour cost per available room					
Room department	5 287	8.1	8.5	9.6	5.8
Food & beverage department	9 828	14.8	13.8	16.5	12.5
Telephone department	310	0.5	0.5	0.5	0.4
Administrative & general department	3 441	6.3	6.3	5.5	4.1
Marketing department	1 467	2.2	2.2	2.6	1.7
Property operation & maintenance department	1 519	2.3	2.5	2.6	1.7
Total labour cost	21 852	34.2	33.8	36.7	26.2

Note:

* Total payroll and related expenses (salaries and wages, including vacations and employees' benefits).

Source: 1998 Singapore Hotel Industry Survey of Operations, Singapore Hotel Association.

Exhibit 10 | Comparison of rates of selected hotels, 2000

	Single/double rooms	Suite
Raffles	—	\$650–\$6 000
Four Seasons	\$435–\$500	\$580–\$4 500
Shangri-La	\$375–\$550	\$500–\$3 200
Westin Stamford	\$340–\$380	\$450–\$1 700
Westin Plaza	\$360–\$400	\$700–\$2 100
Hyatt Regency	\$450–\$530	\$1 200–\$3 800
Ritz-Carlton	\$430–\$475	\$550–\$5 000
Conrad International	\$360–\$400	\$550–\$3 300

Endnotes

- * This case was first published as two separate cases ('Raffles Hotel (A)' and 'Raffles Hotel (B)') in Kulwant Singh, Nitin Pangarkar and Gaik Eng Lim (eds), 2001, *Business Strategy in Asia: A Casebook* (Singapore: Thomson Learning).
- 1 The Sarkies brothers also owned the Strand Hotel in Rangoon.
- 2 A large rectangular assembly ground for national events in those days, enclosed by important government administrative buildings and commerce buildings on its northern side and the waterfront on its southern side.
- 3 A European competitor hotel of Raffles, also in the vicinity of the waterfront.
- 4 At that point in time, Raffles had previously served as a boarding house for schoolgirls.
- 5 N. Ghosh, 1989, 'The selling of Raffles', *Business Times*, 9–10 November.
- 6 'Raffles Hotel will boast the dearest suites in August', 1991, *The Straits Times*, 27 March.
- 7 Top-end hotels are equivalent to five-star hotels based on the amount of amenities and quality of services provided. In Singapore, hotels are categorised according to the number of rooms they have. Examples of top-end hotels include the Westin Stamford & Westin Plaza, Four Seasons, Shangri-La and Hyatt Regency.
- 8 'Re-opening of Raffles will see most staff in designer uniforms', 1991, *The Straits Times*, 22 July.
- 9 K. Chopard, 1987, *The Tiger's Tale* (Singapore: Landmark Books).
- 10 One such film is *Pretty Polly*, which starred Trevor Howard and Hayley Mills in 1967.
- 11 I. Sharp, 1986, *There is Only One Raffles* (London: Souvenir Press).
- 12 'Raffles Hotel voted one of the world's best', 1993, *Business Times*, 12 October.
- 13 Tiles that affect the style favoured by Peranakan Chinese (that is, Chinese born in the Straits Settlements of Peninsular Malaysia).
- 14 'Rooms 79% occupied, F&B outlets 80% booked at meal-times', 1991, *Business Times*, 14 October.
- 15 K. Boo, 2000, 'It's a price war out there in the hospitality industry', *The Straits Times*, 30 August.
- 16 C. Khoo, 2000, 'Address hotel sector's imbalance holistically', *Business Times*, 31 August, p. 12.
- 17 Raffles Holding Limited Prospectus, 1 December 1999.

Case 14

Southwest Airlines, 1996

Andrew Inkpen
Valerie DeGroot
Thunderbird, The
American Graduate School
of International
Management

In January 1996, Southwest Airlines (Southwest) entered the Florida and southeastern US markets. The company planned to operate 78 daily flights to Tampa, Fort Lauderdale and Orlando by August of the following year. With the expansion into Florida, the northeast remained the only major US air traffic region where Southwest did not compete. The northeast US market had generally been avoided by low-fare airlines such as Southwest because of airport congestion, air traffic control delays, frequent inclement weather and dominance by a few major airlines. Airports such as Logan International in Boston, J.F.K. International in New York, and Newark International were among the busiest and most congested airports in the country. Continental Airline's attempt to introduce widespread, low-fare operations in the East during 1994–5 was a financial disaster.

With the move into Florida and the potential challenges associated with the northeastern market, questions were being raised about Southwest's ability to maintain its position as America's most consistently profitable airline. In particular, there were concerns whether Southwest was growing too fast and deviating from its proven strategy. Would entry into the Florida market, and possibly the northeastern market, jeopardise 25 years of success? Success resulted in a focused strategy based on frequent flights, rapid turnarounds at airport gates, and a careful selection of markets and airports that avoided ground and air traffic control delays. Herb Kelleher, the charismatic president, co-founder and chief executive officer of the airline, wrote to his employees in 1993: 'Southwest has had

more opportunities for growth than it has airplanes. Yet, unlike other airlines, it has avoided the trap of growing beyond its means. Whether you are talking with an officer or a ramp agent, employees just don't seem to be enamored of the idea that bigger is better.'¹

The US airline industry

The nature of the US commercial airline industry was permanently altered in October 1978 when President Jimmy Carter signed the *Airline Deregulation Act*. Before deregulation, the Civil Aeronautics Board regulated airline route entry and exit, passenger fares, mergers and acquisitions, and airline rates of return. Typically, two or three carriers provided service in a given market, although there were routes covered by only one carrier. Cost increases were passed along to customers, and price competition was almost nonexistent. The airlines operated as if there were only two market segments: those who could afford to fly and those who couldn't.²

Deregulation sent airline fares tumbling and allowed many new firms to enter the market. The financial impact on both established and new airlines was enormous. The fuel crisis of 1979 and the air traffic controllers' strike in 1981 contributed to the industry's difficulties, as did the severe recession that hit the United States during the early 1980s. During the first decade of deregulation, more than 150 carriers, many of them new start-up airlines, collapsed into bankruptcy. Eight of the major 11 airlines dominating the industry in 1978 ended up filing for bankruptcy, merging with other carriers or simply disappearing from the radar screen. Collectively, the industry made enough money during this period to buy two Boeing 747s (Exhibit 1).³ The three major carriers that survived

Exhibit 1 | Airline operating data, 1986–94

Seat-miles flown											
	America-		Pan-		Pan-		Pan-		Pan-		Total All Majors
	American	West	Continental	Delta	Eastern	Northwest	American	Southwest	TransWorld	United	USAir
1994	110 658	17 852	49 762	98 104		52 110	0	29 624	27 938	95 965	58 311
1993	117 719	16 980	49 690	99 852		52 623	0	34 759	25 044	98 652	55 918
1992	114 418	18 603	49 143	100 904		52 430	0	21 371	30 483	89 605	56 027
1991	104 616	19 460	48 742	94 350		48 847	9 042	18 440	29 684	88 092	56 470
1990	102 864	18 139	48 385	87 748	25 299	47 210	12 157	16 456	33 942	86 085	58 014
1989	98 638	13 523	47 107	82 440	15 489	44 372	11 670	14 788	35 246	82 758	40 652
1988	88 620	11 994	53 343	79 719	41 126	39 349	10 331	13 370	35 024	84 240	28 234
1987	77 724	10 318	54 626	71 504	50 156	41 499	8 217	11 457	33 566	86 246	20 014
1986	66 901	4 296	27 778	50 448	52 556	27 561	8 901	9 712	29 534	78 568	18 254
Total	882 158	131 165	428 576	765 069	184 626	406 001	60 318	169 977	280 461	790 211	391 894
											4 490 456
Revenue per passenger-miles (RPMs) (in cents)											
	America-		Pan-		Pan-		Pan-		Pan-		USAir
	American	West	Continental	Delta	Eastern	Northwest	American	Southwest	TransWorld	United	
1994	13.11	10.81	11.50	13.93		13.93	0	11.65	12.67	11.81	15.92
1993	13.65	11.13	11.97	14.66		13.06	0	11.92	12.78	12.49	17.94
1992	12.03	10.36	11.01	14.02		12.21	0	11.78	11.13	11.88	16.97
1991	13.11	10.00	11.79	14.30		12.79	10.02	11.25	11.31	12.21	16.93
1990	12.86	11.14	12.48	14.21		13.24	11.65	11.48	12.34	12.71	16.37
1989	12.27	11.84	12.04	13.91	11.71	13.02	11.98	10.49	12.10	12.18	15.83
1988	11.92	10.52	10.61	13.52	12.00	12.54	10.94	10.74	11.47	10.86	15.33
1987	11.06	9.66	9.34	13.11	11.02	11.73	9.97	10.02	11.02	10.10	14.91
1986	10.23	9.90	8.56	13.54	11.26	10.48	10.12	10.59	10.07	9.87	14.93
Passenger load factor (per cent)											
	America-		Pan-		Pan-		Pan-		Pan-		USAir
	American	West	Continental	Delta	Eastern	Northwest	American	Southwest	TransWorld	United	
1994	62.35	67.99	62.48	64.68		64.88	0.00	66.80	62.73	69.80	62.02
1993	59.21	65.56	62.20	61.52		63.51	0.00	68.09	62.38	63.80	58.59
1992	63.12	61.62	63.14	60.59		62.24	0.00	64.52	62.94	66.15	58.60
1991	60.86	64.94	61.80	59.95		62.90	60.53	61.14	60.94	64.23	58.22
1990	61.48	60.99	58.42	57.98	60.80	62.53	60.00	60.60	58.90	63.85	59.54
1989	63.6	57.7	60.3	63.6	61.9	60.9	61.2	62.7	59.4	65.4	61.2
1988	63.1	57.9	58.8	57.6	61.8	61.8	63.4	57.7	59.9	67.4	61.3
1987	63.7	56.1	60.7	55.5	65.3	61.8	64.1	58.9	62.0	65.0	65.3
1986	65.6	61.0	62.7	57.4	60.6	54.9	51.4	58.3	59.5	65.6	61.1

	Operating revenues (US\$mn)										Total All	
	America- American	West	Continental	Delta	Eastern	Northwest	Pan- American	Southwest	TransWorld	United	USAir	Majors
1994	10 631	1 414	4 091	9 514		5 325		2 417	2 555	8 966	6 394	51 307
1993	10 828	1 332	4 128	9 653		4 928		2 067	2 325	8 794	6 364	50 419
1992	9 902	1 281	3 840	9 164		4 464		1 685	2 510	7 861	5 974	46 681
1991	9 429	1 359	4 014	8 593		4 356	596	1 314	2 464	7 790	5 895	45 810
1990	9 203	1 322	4 036	7 697		4 298	946	1 187	2 878	7 946	6 085	45 598
1989	8 670	998	3 896	7 780	1 295	3 944	957	1 015	2 918	7 463	4 160	43 096
1988	7 548	781	3 682	6 684	3 423	3 395	804	860	2 777	7 006	2 803	39 763
1987	6 369	577	3 404	5 638	4 054	3 328	625	699	2 668	6 500	2 070	35 932
1986	5 321	330	1 676	4 245	4 093	1 815	553	620	2 064	5 727	1 787	28 231
Total	77 901	9 394	32 767	68 968	12 865	35 853	4 481	11 864	23 159	68 053	41 532	

	Net operating income/(loss) (US\$mn)										Total All	
	America- American	West	Continental	Delta	Eastern	Northwest	Pan- American	Southwest	TransWorld	United	USAir	Majors
1994	432	146	(145)	123		725		290	(81)	262	(466)	1 286
1993	357	121	56	335		268		281	(63)	184	(143)	1 396
1992	(251)	(64)	(183)	(225)		(203)		182	(191)	(354)	(397)	(1 686)
1991	40	(79)	(218)	(115)		17	(186)	62	(233)	(412)	(233)	(1 357)
1990	103	(32)	(191)	(176)		(132)	(280)	82	(134)	(34)	(437)	(1 231)
1989	709	48	124	677	(666)	57	(118)	98	10	302	(239)	1 002
1988	794	18	(87)	441	(187)	19	(181)	86	113	461	144	1 621
1987	483	(35)	(56)	383	66	72	(260)	41	79	97	263	1 133
1986	378	4	91	212	61	(25)	(283)	81	(77)	51	164	657
Total	3 045	127	(609)	1 655	(726)	798	1 308	1 203	(577)	557	(1 344)	

Source: Department of Transportation.

Source: Department of Transportation.

intact – Delta, United and American – ended up with 80 per cent of all domestic US air traffic and 67 per cent of trans-Atlantic business.⁴

Competition and lower fares led to greatly expanded demand for airline travel. By the mid-1990s, the airlines were having trouble meeting this demand. Travel increased from 200 million travellers in 1974 to 500 million in 1995, yet only five new runways were built during this time period. During the 1980s, many airlines acquired significant levels of new debt in efforts to service the increased travel demand. Long-term debt-to-capitalisation ratios increased dramatically: Eastern's went from 62 to 473 per cent, TWA's went from 62 to 115 per cent, and Continental's went from 62 to 96 per cent. In contrast, United and Delta maintained their debt ratios at less than 60 per cent, and American Airline's ratio dropped to 34 per cent.

Despite the financial problems experienced by many fledgeling airlines started after deregulation, new firms continued to enter the market. Between 1992 and 1995, 69 new airlines were certified by the FAA. Most of these airlines competed with limited route structures and lower fares than the major airlines. The new low-fare airlines created a second tier of service providers that save consumers billions of dollars annually and provided service in markets abandoned or ignored by major carriers. One such start-up was Kiwi Airlines, founded by former employees of the defunct Eastern and Pan Am airlines. Kiwi was funded largely by employees: pilots paid US\$50 000 each to get jobs and other employees paid US\$5 000.

Despite fostering competition and the growth of new airlines, deregulation created a significant regional disparity in ticket prices and adversely affected service to small and remote communities. Airline workers generally suffered, with inflation-adjusted average employee wages falling from US\$42 928 in 1978 to US\$37 985 in 1988. About 20 000 airline industry employees were laid off in the early 1980s, while productivity of the remaining employees rose 43 per cent during the same period. In a variety of cases, bankruptcy filings were used to diminish the role of unions and reduce unionised wages.

Industry economics

About 80 per cent of airline operating costs were fixed or semi-variable. The only true variable costs were travel agency commissions, food costs and ticketing fees. The operating costs of an airline flight depended primarily on the distance travelled, not the number of passengers on board. For example, the crew and ground

staff sizes were determined by the type of aircraft, not the passenger load. Therefore, once an airline established its route structure, most of its operating costs were fixed.

Because of this high fixed-cost structure, the airlines developed sophisticated software tools to maximise capacity utilisation, known as *load factor*. Load factor was calculated by dividing RPM (revenue passenger miles – the number of passengers carried multiplied by the distance flown) by ASM (available seat miles – the number of seats available for sale multiplied by the distance flown).

On each flight by one of the major airlines (excluding Southwest and the low-fare carriers), there were typically a dozen categories of fares. The airlines analysed historical travel patterns on individual routes to determine how many seats to sell at each fare level. All of the major airlines used this type of analysis and flexible pricing practice, known as a *yield management system*. These systems enabled the airlines to manage their seat inventories and the prices paid for those seats. The objective was to sell more seats on each flight at higher yields. (Total passenger yield was passenger revenue from scheduled operations divided by scheduled RPMs.) The higher the ticket price, the better the yield.

Although reducing operating costs was a high priority for the airlines, the nature of the cost structure limited cost-reduction opportunities. Fuel costs (about 13 per cent of total costs) were largely beyond the control of the airlines, and many of the larger airlines' restrictive union agreements limited labour flexibility. Although newer aircraft were much more fuel-efficient than older models, most airlines had sharply lowered their new aircraft orders to avoid taking on more debt. At the end of June 1990, US airlines had outstanding orders to buy 2 748 aircraft. At the end of June 1996, orders had fallen to 1 111.⁵ (A new Boeing 737 cost about US\$28 million in 1995.)

To manage their route structures, all of the major airlines (except Southwest) maintained their operations around a 'hub-and-spoke' network. The spokes fed passengers from outlying points into a central airport – the hub – where passengers could travel to additional hubs or their final destination. For example, to fly from Phoenix to Boston on Northwest Airlines, a typical route would involve a flight from Phoenix to Northwest's Detroit hub. The passenger would then take a second flight from Detroit to Boston.

Establishing a major hub in a city like Chicago or Atlanta required an investment of as much as US\$150 million for gate acquisition and terminal construction.

Although hubs created inconveniences for travellers, hub systems were an efficient means of distributing services across a wide network. The major airlines were very protective of their so-called fortress hubs and used the hubs to control various local markets. For example, Northwest controlled more than 78 per cent of the local traffic in Detroit and 84 per cent in Minneapolis. When Southwest entered the Detroit market, the only available gates were already leased by Northwest. Northwest subleased gates to Southwest at rates 18 times higher than Northwest's costs. Southwest eventually withdrew from Detroit, one of only three markets the company had abandoned in its history. (Denver and Beaumont, Texas, were the other two.)

Recent airline industry performance

US airlines suffered a combined loss of US\$13 billion from 1990 to 1994 (Exhibit 1).⁶ High debt levels plagued the industry. In 1994, the earnings picture began to change, with the industry as a whole reducing its losses to US\$278 million.⁷ Overall expansion and health returned to the industry in 1995 and 1996. In 1996, net earnings were a record US\$2.4 billion. (See Exhibit 2 for 1995 airline performance and Exhibit 3 for 1995 market share ratings.) For 1996, revenue

forecasts were US\$7.2 billion with a net profit of US\$3 billion.

In 1996, for the first time in 10 years, the industry had a profitable first quarter (US\$110 million). Numerous statistics indicated that the industry was in good shape: load factors were up to 68–69 per cent in 1996; fares were up 5 per cent; and yields were up to 13.52 cents per passenger-mile. The break-even load factor fell 2.5 points to about 65 per cent and unit costs dropped by 0.4 per cent in 1995.⁸ The expiration of a 10 per cent domestic ticket tax resulted in net lower-priced tickets to customers despite increased fares. Traffic growth outpaced the 1.7 per cent industry rise in capacity.

Future pressures on the industry

Despite the recent positive financial performance, concerns over fare wars, over-capacity in some markets, increased fuel prices and the possibility of economic recession created significant uncertainty about the future. In particular, cost pressures were expected from several factors:

- 1 *Labour costs.* The average salary per airline employee from 1987 to 1996 rose at a rate faster than the increase in the CPI index (4.4 per cent increase in

Exhibit 2 | Airline performance

	Revenue (\$000s)	Net profit (\$000s)	RPM (000s)	ASM (000s)
American	15 501 000	167 000	102 900 000	155 300 000
United	14 943 000	349 000	111 811 000	158 569 000
Delta	12 194 000	510 000	86 400 000	130 500 000
Northwest	9 080 000	392 000	62 500 000	87 500 000
USAir	7 474 000	119 000	37 618 000	58 163 000
Continental	5 825 000	224 000	40 023 000	61 006 000
TWA	3 320 000	(227 400)	25 068 683	38 186 111
Southwest	2 872 751	182 626	23 327 804	36 180 001
America West	1 600 000	53 800	13 300 000	19 400 000
Alaska	1 417 500	17 300	9 335 000	15 299 000
American Trans Air	715 009	8 524	4 183 692	5 951 162
Tower Air	490 472	10 689	1 208 001	1 455 996
Mesa	454 538	14 012	1 179 397	2 310 895
Conair	418 466	N/A	1 187 706	2 274 695
ValuJet	367 800	67 800	2 600 000	3 800 000
Hawaiian	346 904	(5 506)	3 171 365	4 238 320
Atlantic Southeast	328 725	51 137	763 000	1 700 000
Midwest Express	259 155	19 129	1 150 338	1 794 924
Reno Air	256 508	1 951	2 090 017	3 322 475

Source: *Business Travel News*, 27 May 1996, and *Air Transport World*, March 1996.

Exhibit 3 | Airline market shares

1995 Company rankings	% Market share	1985 Company rankings	% Market share
United	21.0	American	13.3
American	19.3	United	12.5
Delta	16.0	Eastern	10.0
Northwest	11.7	TWA	9.6
Continental	7.5	Delta	9.0
USAir	7.2	Pan Am	8.1
TWA	4.7	NWA	6.7
Southwest	4.4	Continental	4.9
America West	2.5	People Express	3.3
American Trans Air	1.2	Republic	3.2
Others	4.5	Others	19.4
Total	100.0	Total	100.0

Sources: Department of Transportation and Standard & Poor's, cited by *Industry Surveys*, 1 February 1996.

labour costs compared with a 3.7 per cent CPI increase over the same period).⁹ Pressure from labour was expected to increase as employees sought a share of the airlines' recent record profits. The possibility of new federal regulations concerning aircrew flight and duty time requirements were also an issue. It was estimated that the potential costs from regulation changes could be as high as US\$1.2 billion in the first year and US\$800 million in each subsequent year.

- 2 *Aircraft maintenance.* The ageing of the general aircraft population meant higher maintenance costs and eventual aircraft replacement. The introduction of stricter government regulations for older planes placed new burdens on those operating them.
- 3 *Debt servicing.* The airline industry's debt load of approximately 65 per cent greatly exceeded US industry averages of about 40 per cent.
- 4 *Fuel costs.* Long-term jet fuel cost was uncertain. Prices had risen 11 cents per gallon from July 1995 to May 1996. Proposed fuel taxes could cost the industry as much as US\$500 million a year.
- 5 *Air traffic delays.* Increased air traffic control delays caused by higher travel demand and related airport congestion were expected to negatively influence airlines' profitability.

Southwest Airlines' background

In 1966, Herb Kelleher was practising law in San Antonio when a client named Rollin King proposed starting a short-haul airline similar to California-based Pacific Southwest Airlines. The airline would fly the

'Golden Triangle' of Houston, Dallas and San Antonio and by staying within Texas, avoid federal regulations. Kelleher and King incorporated a company, raised initial capital and filed for regulatory approval from the Texas Aeronautics Commission. Unfortunately, the other Texas-based airlines – namely, Braniff, Continental and Trans Texas (later called Texas International) – opposed the idea and waged a battle to prohibit Southwest from flying. Kelleher argued the company's case before the Texas Supreme Court, which ruled in Southwest's favour. The US Supreme Court refused to hear an appeal filed by the other airlines. In late 1970, it looked as if the company could begin flying.

Southwest began building a management team and purchased three surplus Boeing 737s. Meanwhile, Braniff and Texas International continued their efforts to prevent Southwest from flying. The underwriters of Southwest's initial public stock offering withdrew and a restraining order against the company was obtained two days before its scheduled inaugural flight. Kelleher again argued his company's case before the Texas Supreme Court, which ruled in Southwest's favour a second time, lifting the restraining order. Southwest Airlines began flying the next day, 18 June 1971.¹⁰

When Southwest began flying to three Texas cities, the firm had three aircraft and 25 employees. Initial flights were out of Dallas's older Love Field Airport and Houston's Hobby Airport, both of which were closer to downtown than the major international airports. Flamboyant from the beginning, original flights were staffed by flight attendants in hot-pants. By 1996, the

flight attendant uniform had evolved into khakis and polo shirts. The 'Luv' theme was a staple of the airline from the outset and became the company's ticker symbol on Wall Street.

Southwest management quickly discovered that there were two types of travellers: convenience, time-oriented business travellers and price-sensitive leisure travellers. To cater to both groups, Southwest developed a two-tiered pricing structure. In 1972, Southwest was charging US\$20 to fly between Houston, Dallas and San Antonio, undercutting the US\$28 fares of the other carriers. After an experiment with US\$10 fares, Southwest decided to sell seats on weekdays until 7 p.m. for US\$26 and after 7 p.m. and on weekends for US\$13.¹¹ In response, in January 1973, Braniff Airlines began charging US\$13 for its Dallas–Houston Hobby flights. This resulted in one of Southwest's most famous ads, which had the caption 'Nobody's going to shoot Southwest out of the sky for a lousy \$13.' Southwest offered travellers the opportunity to pay US\$13 or US\$26 and receive a free bottle of liquor. More than 75 per cent of the passengers chose the US\$26 fare and Southwest became the largest distributor of Chivas Regal scotch whisky in Texas. In 1975, Braniff abandoned the Dallas–Houston Hobby route. When Southwest entered the Cleveland market, the unrestricted one-way fare between Cleveland and Chicago was US\$310 on other carriers; Southwest's fare was US\$59.¹² One of Southwest's problems was convincing passengers that its low fares were not just introductory promotions but regular fares.

Southwest's operations

Although Southwest grew to be one of the largest airlines in the United States, the firm did not deviate from its initial focus: short-haul (less than 500 miles), point-to-point flights; a fleet consisting only of Boeing 737s; high-frequency flights; low fares; and no international flights. In 1995, the average Southwest one-way fare was US\$69. The average stage length of Southwest flights was 394 miles, with flights of 600 miles making up less than 2.5 per cent of the airline's capacity. Kelleher indicated in an interview that it would be unlikely that the company's longer flights (those more than 600 miles) would ever exceed 10 per cent of its business.¹³ On average, Southwest had more than 40 departures per day per city, and each plane flew about 10 flights daily, almost twice the industry average.¹⁴ Planes were used an average of 11.5 hours a day, compared with the industry's 8.6 hours per day average.¹⁵ Southwest's cost per available seat-mile was

the lowest in the industry (Exhibit 4) and the average age of its fleet in 1995 was 7.9 years, the lowest for the major carriers. Southwest also had the best safety record in the airline business.

Southwest was the only major airline to operate without hubs. Point-to-point service provided maximum convenience for passengers who wanted to fly between two cities, but insufficient demand could make such non-stop flights economically unfeasible. For that reason, the hub-and-spoke approach was generally assumed to generate cost savings for airlines through operational efficiencies. However, Southwest saw it another way: hub-and-spoke arrangements resulted in planes spending more time on the ground waiting for customers to arrive from connecting points.

Turnaround time – the time it takes to unload a waiting plane and load it for the next flight – was 15 minutes for Southwest, compared with the industry average of 45 minutes. This time saving was accomplished with a gate crew 50 per cent smaller than that of other airlines. Pilots sometimes helped to unload bags when schedules were tight. Flight attendants regularly assisted in the cleaning of planes between flights.

Relative to the other major airlines, Southwest had a 'no frills' approach to services: reserved seating was not offered and meals were not served. Customers were handed numbered or colour-coded boarding passes based on their check-in order. Seating was first come, first served. As a cost-saving measure, the colour-coded passes were reusable. As to why the airline did not have assigned seating, Kelleher explained: 'It used to be we only had about four people on the whole plane, so the idea of assigned seats just made people laugh. Now the reason is you can turn the airplanes quicker at the gate. And if you can turn an airplane quicker, you can have it fly more routes each day. That generates more revenue, so you can offer lower fares.'¹⁶

Unlike some of the major carriers, Southwest rarely offered delayed customers a hotel room or long-distance telephone calls. Southwest did not use a computerised reservation system, preferring to have travel agents and customers book flights through its reservation centre or vending machines in airports. Southwest was the first national carrier to sell seats from an Internet site. Southwest was also one of the first airlines to use ticketless travel, first offering the service on 31 January 1995. By June 1996, 35 per cent of the airline's passengers were flying ticketless, at a cost savings of US\$25 million per year.¹⁷ The company was a 1996 Computerworld Smithsonian Awards Finalist for the

Exhibit 4 | Cost per available seat-mile data

Short-haul costs*			
(Based on standardised seating, 500-mile hop)			
Company	Plane	Cost (in cents)	Per cent
American	F-100	12.95	202
USAir	F-100	12.05	187
USAir	737-300	11.49	179
United	737-300	11.17	174
American	MD-80	11.02	171
Continental	737-300	10.18	158
Northwest	DC-9-30	10.18	158
TWA	DC-9-30	9.67	150
Continental	MD-80	9.58	149
Delta	MD-80	8.77	136
Northwest	MD-80	8.76	136
TWA	MD-80	8.29	129
America West	737-300	7.96	124
Alaska	MD-80	7.59	118
ValuJet	DC-9-30	6.58	102
Reno Air	MD-80	6.53	102
Southwest	737-300	6.43	100
Long-haul costs			
(Based on standardised seating, 1 400-mile hop)			
Company	Plane	Cost (in cents)	Per cent
USAir	757	6.72	134
American	757	6.70	134
United	757	6.51	130
Northwest	757	5.83	116
Continental	757	5.70	114
Delta	757	5.61	112
American Trans Air	757	5.40	108
America West	757	5.02	100

* Second quarter 1995 data.

Source: Roberts Roach & Associates, cited in *Air Transport World*, June 1996, p. 1.

rapid development and installation of its ticketless system within a four-month time frame.

Over the years, Southwest's choice of markets resulted in significant growth in air travel at those locations. In Texas, traffic between the Rio Grande Valley (Harlingen) and the 'Golden Triangle' grew from 123 000 to 325 000 within 11 months of Southwest's entering the market.¹⁸ Within a year of Southwest's arrival, the Oakland–Burbank route became the 25th-largest passenger market, up from 179th. The Chicago–Louisville market tripled in size 30 days after Southwest began flying that route. Southwest was the

dominant carrier in a number of cities, ranking first in market share in more than 50 per cent of the largest US city-pair markets. Exhibit 5 shows a comparison of Southwest in 1971 and 1995.

Southwest's performance

Southwest bucked the airline industry trend by earning a profit in 23 consecutive years. (See Exhibit 6 for Southwest's financial performance.) Southwest was the only major US airline to make a profit in 1992. Even taking into account the losses in its first two years of operation, the company averaged an annual 12.07 per

cent return on investment. In 1995, for the fourth year in a row, Southwest received the coveted Triple Crown award given by the US Department of Transportation for having the best on-time performance, best luggage handling record and fewest customer complaints. No other airline achieved that record for even one month.

Southwest accomplished its enviable record by challenging accepted norms and setting competitive thresholds for the other airlines to emulate. The company had established numerous new industry standards. In 1991, Southwest flew more passengers per employee (2 318 versus the industry average of 848) than any other airline, while at the same time having the fewest number of employees per aircraft (79 at Southwest, compared with the industry average of 131).¹⁹ Southwest maintained a debt-to-equity ratio much lower than the industry average. The ratio was 50 per cent in 1995, with cash holdings of US\$400 million. In addition, Southwest had a credit rating of 'A', with a US\$460 million line of credit in 1995. Southwest was the only airline with an investment-grade credit rating.

Southwest's fleet of 737s had grown to 224 by 1995, up from 106 in 1990 and 75 in 1987. New aircraft deliveries were expected to average 22 per year until 2000, split equally between purchases and leases.²⁰ Revenues more than doubled between 1987 and 1995. Profits grew even faster during the same period. In 1994, Southwest tripled annual capacity growth, measured by available seat-miles, to 30 per cent and flew to 46 cities in 22 states. The number of flights per day in 1995 was 2 065 serving 46 cities, up from 1 883 flights in 1994.

Herb Kelleher

Southwest's CEO, Herb Kelleher, managed the airline with a leadership style of flamboyance and fun and a

fresh, unique perspective. Kelleher played Big Daddy-O in one of the company videos, appeared as the King of Rock (Elvis Presley) in in-flight magazine advertisements, and earned the nickname 'High Priest of Ha-Ha' from *Fortune* magazine.²¹ Although Kelleher was unconventional and a maverick in his field, he led his company to consistently new standards for itself and for the industry. Sincerely committed to his employees, Kelleher generated intense loyalty to himself and the company. His ability to remember employees' names and to ask after their families was just one way he earned respect and trust. At one point, Kelleher froze his salary for five years in response to the pilots agreeing to do the same. Often when he flew, Kelleher would help the ground crew unload bags or help the flight crew serve drinks. His humour was legendary and served as an example for his employees to join in the fun of working for Southwest. He was called 'a visionary who leads by example – you have to work harder than anybody else to show them you are devoted to the business'.²²

Although Kelleher tried to downplay his personal significance to the company when questions were raised about succession, many analysts following Southwest credited the airline's success to Kelleher's unorthodox personality and engaging management style. As one analyst wrote, 'The old-fashioned bond of loyalty between employees and company may have vanished elsewhere in corporate America, but it is stronger than ever at Southwest'.²³

The Southwest spirit

Customer service far beyond the norm in the airline industry was not unexpected at Southwest and had its own name – Positively Outrageous Service. Some examples of this service included: a gate agent

Exhibit 5 | Southwest 25-year comparison, 1971 and 1995

	1971	1995
Size of fleet	4	224
Number of employees at year end	195	19 933
Number of passengers carried	108 554	44 785 573
Number of cities served	3	45
Number of trips flown	6 051	685 524
Total operating revenues	2 133 000	2 872 751 000
Net income (losses)	(3 753 000)	182 626 000
Stockholders' equity	3 318 000	1 427 318 000
Total assets	22 083 000	3 256 122 000

Source: K. Freiberg and J. Freiberg, 1996, *Nuts: Southwest Airlines' Crazy Recipe for Business and Personal Success* (Austin, TX: Band Press), p. 326.

Exhibit 6 | Southwest Airlines 10-year financial summary, 1986–95

	Selected consolidated financial data¹ (in thousands except per share amounts)									
	1995	1994	1993	1992	1991	1990	1989	1988	1987	1986
Operating revenues:										
Passenger	\$2 760 756	\$2 497 765	\$1 144 421	\$973 568	\$1 267 897	\$1 144 421	\$973 568	\$828 343	\$751 649	\$742 287
Freight	65 825	54 419	42 897	33 088	26 428	22 196	18 771	14 433	13 428	13 621
Charter and other	46 170	39 749	37 434	146 063	84 961	70 659	65 390	17 658	13 251	12 882
Total operating revenues	2 872 751	2 591 933	2 296 673	1 802 979	1 379 286	1 237 276	1 057 729	860 434	778 328	768 790
Operating expenses	2 559 220	2 275 224	2 004 700	1 609 175	1 306 675	1 150 015	955 689	774 454	747 881	679 827
Operating income	313 531	316 709	291 973	193 804	72 611	87 261	102 040	85 980	30 447⁹	88 963
Other expenses (income) net	8 391	17 186	32 335	36 361	18 725	(6 827)⁶	(13 696)⁷	620⁸	1 374¹⁰	23 517
Income before income taxes	305 140	299 523	259 637	157 443	53 886	80 434	115 736	85 360	29 073	65 446
Provision for income taxes³	122 514	120 192	105 353	60 058	20 738	29 829	41 231	27 408	8 918	15 411
Net income³	\$182 626	\$179 331	\$154 284⁴	\$97 385⁵	\$33 148	\$50 605	\$74 505	\$57 952	\$20 155	\$50 035
Income per common and common equivalent share³	\$1.23	\$1.22	\$1.05⁴	\$0.68⁵	\$0.25	\$0.39	\$0.54	\$0.41	\$0.14	\$0.34
Cash dividends per common share	\$0.4000	\$0.4000	\$0.3867	\$0.3533	\$0.3333	\$0.3223	\$0.3110	\$0.2943	\$0.2890	\$0.2890
Total assets	\$3 256 122	\$2 823 071	\$2 576 037	\$2 368 856	\$1 854 331	\$1 480 813	\$1 423 298	\$1 308 389	\$1 042 640	\$1 061 419
Long-term debt	\$661 010	\$583 071	\$639 136	\$735 754	\$617 434	\$327 553	\$354 150	\$369 541	\$251 130	\$339 069
Stockholders' equity	\$1 427 318	\$1 238 706	\$1 054 019	\$879 536	\$635 793	\$607 294	\$591 794	\$567 375	\$514 278	\$511 850
Consolidated financial ratios¹										
Return on average total assets	6.0%	6.6%	6.2%⁴	4.6%⁵	2.0%	3.5%	5.5%	5.1%	1.9%	4.8%
Return on average stockholder's equity	13.7%	15.6%	16.0%⁴	12.9%⁵	5.3%	5.4%	12.9%	10.3%	4.0%	10.3%
Debt as a percentage of invested capital	31.7%	32.0%	37.7%	45.5%	49.3%	35.0%	37.4%	39.4%	32.8%	39.8%

Consolidated operating statistics:²

Revenue passengers carried	44 785 573	42 742 602 ¹¹	36 955 221 ¹¹	27 839 284	22 669 942	19 830 941	17 958 263	14 876 582	13 503 242	13 637 515
RPMs (000s)	23 327 804	21 611 266	18 827 288	13 787 005	11 296 183	9 958 940	9 281 992	7 676 257	7 789 376	7 388 401
ASMs (000s)	36 180 001	32 123 974	27 511 000	21 366 642	18 491 003	16 411 115	14 796 732	13 309 044	13 331 055	12 574 484
Load factor	64.5%	67.3%	68.4%	64.5%	61.1%	60.7%	62.7%	57.7%	58.4%	58.8%
Average length of passenger haul	521	506	509	495	498	502	517	516	577	542
Trips flown	685 524	624 476	546 297	438 184	382 752	338 108	304 673	274 859	270 559	262 082
Average passenger fare	\$61.64	\$58.44	\$59.97	\$58.33	\$55.93	\$57.71	\$54.21	\$55.68	\$55.66	\$54.43
Passenger revenue yield per RPM	11.83¢	11.56¢	11.77¢	11.78¢	11.22¢	11.49¢	10.49¢	10.79¢	9.65¢	10.05¢
Operating revenue yield per ASM	7.94¢	8.07¢	8.35¢	7.89¢	7.10¢	7.23¢	6.86¢	6.47¢	5.84¢	6.11¢
Operating expenses per ASM	7.07¢	7.08¢	7.25¢ ¹²	7.03¢	6.76¢	6.73¢	6.20¢	5.82¢	5.61¢	5.41¢
Fuel cost per gallon (average)	55.22¢	53.92¢	59.15¢	60.82¢	65.69¢	77.89¢	59.46¢	51.37¢	54.31¢	51.42¢
Number of employees at year end	19 933	16 818	15 175	11 397	9 778	8 620	7 760	6 467	5 765	5 819
Size of fleet at year end ¹³	224	199	178	141	124	106	94	85	75	79

¹ The Selected Consolidated Financial Data and Consolidated Financial Ratios for 1989-92 have been restated to include the financial results of Morris. Years prior to 1989 were immaterial for restatement purposes.

² Prior to 1993, Morris operated as a charter carrier; therefore, no Morris statistics are included for these years.

³ Pro forma for 1989-92 assuming Morris, an S-Corporation prior to 1993, was taxed at statutory rates.

⁴ Excludes cumulative effect of accounting changes of US\$15.3 million (US\$.10 per share).

⁵ Excludes cumulative effect of accounting changes of US\$12.5 million (US\$.09 per share).

⁶ Includes US\$2.6 million gains on sales of aircraft and US\$3.1 million from the sale of certain financial assets.

⁷ Includes US\$10.8 million gains on sales of aircraft; US\$5.9 million from the sale of certain financial assets; and US\$2.3 million from the settlement of a contingency.

⁸ Includes US\$5.6 million gains on sales of aircraft and US\$3.6 million from the sale of certain financial assets.

⁹ Includes TranStar's results to 30 June 1987.

¹⁰ Includes US\$10.1 million net gains from the discontinuance of TranStar's operations and US\$4.3 million from the sale of certain financial assets.

¹¹ Includes certain estimates for Morris.

¹² Excludes merger expenses of US\$10.8 million.

¹³ Includes leased aircraft.

volunteering to watch a dog (a Chihuahua) for two weeks when an Acapulco-bound passenger showed up at the last minute without the required dog crate; an Austin passenger who missed a connection to Houston, where he was to have a kidney transplant operation, was flown there by a Southwest pilot in his private plane. Another passenger, an elderly woman flying to Phoenix for cancer treatment, began crying because she had no family or friends at her destination. The ticket agent invited her into her home and escorted her around Phoenix for two weeks.²⁴

Southwest Airlines' customers were often surprised by the 'Southwest Spirit'. On some flights, magazine pictures of gourmet meals were offered for dinner on an evening flight. Flight attendants were encouraged to have fun: songs, jokes and humorous flight announcements were common. One flight attendant had a habit of popping out of overhead luggage compartments as passengers attempted to stow their belongings, until the day she frightened an elderly passenger who called for oxygen.²⁵ Herb Kelleher once served in-flight snacks dressed as the Easter Bunny.

Intense company communication and camaraderie were highly valued and essential to maintaining the *esprit de corps* found throughout the firm. The Southwest Spirit, as exhibited by enthusiasm and extroverted personalities, was an important element in employee screening conducted by Southwest's People Department. Employment at Southwest was highly desired. When the company held a job fair in Oklahoma City, more than 9 000 people attended in four days.²⁶ In 1995, 5 444 employees were hired from the 124 000 applications received and 38 000 interviews held.²⁷ Once landed, a job was fairly secure. The airline had not laid off an employee since 1971. Employee turnover hovered around 7 per cent, the lowest rate in the industry.²⁸ More than half of Southwest's 22 000 employees had been hired after 1990. In 1990, Southwest had only 8 600 employees and less than 6 000 in 1987.

During initial training periods, efforts were made to share and instill Southwest's unique culture. New employee orientation, known as the new-hire celebration, included Southwest's version of the Wheel of Fortune, scavenger hunts, and company videos including the 'Southwest Airlines Shuffle' in which each department introduced itself, rap style, and in which Kelleher appeared as Big Daddy-O.

Advanced employee training regularly occurred at the University of People at Love Field in Dallas. Various classes were offered, including team building, leadership and cultural diversity. Newly promoted supervisors and

managers attended a three-day class called 'Leading with Integrity'. Each department also had its own training department focusing on technical aspects of the work. 'Walk-a-Mile Day' encouraged employees from different departments to experience first hand the day-to-day activities of their co-workers. The goal of this program was to promote respect for fellow workers while increasing awareness of the company.²⁹

Employee initiative was supported by management and encouraged at all levels. For example, pilots looked for ways to conserve fuel during flights, employees proposed designs for ice storage equipment that reduced time and costs, and baggage handlers learned to place luggage with the handles facing outward to reduce unloading time.

Red hearts and 'Luv' were central parts of the internal corporate culture, appearing throughout the company literature. A mentoring program for new hires was called CoHearts. 'Heroes of the Heart Awards' were given annually to one behind-the-scenes group of workers, whose department name was painted on a specially designed plane for a year. Other awards honoured an employee's big mistake through the 'Boner of the Year Award'. When employees had a story about exceptional service to share, they were encouraged to fill out a 'LUV Report'.

Southwest placed great emphasis on maintaining cooperative labour relations. Within the firm, almost 90 per cent of all employees were unionised. The company encouraged the unions and their negotiators to conduct employee surveys and to research their most important issues prior to each contract negotiation. Southwest had never had a serious labour dispute. The airlines' pilot union, SWAPA, represented 2 000 pilots. At its 1994 contract discussion, the pilots proposed a 10-year contract with stock options in lieu of guaranteed pay increases over the first five years of the contract. In 1973, Southwest was the first airline to introduce employee profit sharing.

Southwest's imitators

Southwest's low-fare, short-haul strategy spawned numerous imitators. By the second half of 1994, low fares were available on more than one-third of the industry's total capacity.³⁰ Many of the imitators were new start-up airlines. The Allied Pilots Association (APA) claimed that approximately 97 per cent of start-ups resulted in failures. According to the APA, only two of 34 start-up airlines formed between 1978 and 1992 were successful, with success defined as surviving 10 years or longer without bankruptcy. The two successful

firms, Midwest Express and America West, had both been through Chapter 11 bankruptcy proceedings. APA's prognosis for newer airlines was equally pessimistic, with only Frontier and Western Pacific of the 19 start-ups formed since 1992 perceived as having good prospects for long-term survival.³¹ Three of the 19 had already folded by 1996, and ValuJet was grounded after its May 1996 crash in the Florida Everglades.

The major airlines had also taken steps to compete directly with Southwest. The Shuttle by United, a so-called airline within an airline, was started in October 1994. United's objective was to create a new airline owned by United with many of the same operational elements as Southwest: a fleet of 737s, low fares, short-haul flights and less restrictive union rules. Although offering basically a no-frills service, the Shuttle provided assigned seating and offered access to airline computer reservation systems. United predicted that the Shuttle could eventually account for as much as 20 per cent of total United US operations.

United saturated the West Coast corridor with short-haul flights on routes such as Oakland–Seattle, San Francisco–San Diego and Sacramento–San Diego. Almost immediately, Southwest lost 10 per cent of its California traffic. Southwest responded by adding six aircraft and 62 daily flights in California. In April 1995, United eliminated its Oakland–Ontario route and proposed a US\$10 fare increase on other flights. By January 1996, United had pulled the Shuttle off routes that did not feed passengers to its San Francisco and Los Angeles hubs. In early 1995, United and Southwest competed directly on 13 per cent of Southwest's routes. By 1996, that number was down to 7 per cent.³²

Cost was the major problem for United in competing with Southwest. The Shuttle's cost per seat-mile remained at about 8 cents, whereas Southwest's cost was close to 7 cents. Two factors were largely responsible for the Shuttle's higher costs. First, many passengers booked their tickets through travel agents, which resulted in commission fees. Second, many of the Shuttle's flights were in the San Francisco and Los Angeles markets, both of which were heavily congested and subject to costly delays. In addition, the Shuttle was unable to achieve the same level of productivity as Southwest. Nevertheless, by launching the Shuttle, United was able to gain market share in the San Francisco and Los Angeles markets, largely at the expense of American, USAir and Delta.

Continental Lite (CALite) was an effort by Continental Airlines to develop a low-cost service and revive the company's fortunes after coming out of bankruptcy in April 1993. CALite began service in

October 1993 on 50 routes, primarily in the southeast. Frequency of flights was a key part of the new strategy. Greenville–Spartanburg got 17 flights a day and in Orlando, daily departures more than doubled. CALite fares were modelled after those of Southwest and meals were eliminated on flights of less than 2.5 hours.

In March 1994, Continental increased CALite service to 875 daily flights. Continental soon encountered major operational problems with its new strategy.³³ With its fleet of 16 different planes, mechanical delays disrupted turnaround times. Various pricing strategies were unsuccessful. The company was ranked last among the major carriers for on-time service, and complaints soared by 40 per cent. In January 1995, Continental announced that it would reduce its capacity by 10 per cent and eliminate 4 000 jobs. By mid-1995, Continental's CALite service had been largely discontinued. In October 1995, Continental's CEO was ousted.

Delta was developing its 'Leadership 7.5' campaign, intended to cut costs by US\$2 billion by mid-1997 and lower its ASM costs to 7.5 cents. Western Pacific (WestPac) was one of the newest domestic start-up airlines building on Southwest's formula, while adding its own twists. WestPac began flying out of a new airport in Colorado Springs in April 1995. WestPac's fleet consisted of 12 leased Boeing 737s. The airline started with 15 domestic destinations on the West Coast, East Coast, southwest and midwest, and all medium-length routes. Offering an alternative to the expensive Denver International Airport, business grew quickly. The company made a profit in two of its first four months of operation. Load factors averaged more than 60 per cent in the first five months of operation, and were 75.9 per cent in August. Operating cost per available seat-mile averaged 7.37 cents during the early months and dropped to 6.46 cents within five months. The Colorado Springs Airport became one of the country's fastest growing as a result of WestPac's market entry. WestPac had one-third of the market share and had flown almost 600 000 passengers during its first seven months.

One of WestPac's most successful marketing efforts was the 'Mystery Fare' program. As a way to fill empty seats, US\$59 round-trip tickets were sold to one of the airline's destinations, but which one remained a mystery. Response greatly exceeded the airline's expectations; thousands of the mystery seats were sold. 'Logo jets', also known as flying billboards, were another inventive approach by the start-up company. Jets painted on the outside with client advertising raised more than US\$1 million in fees over a one-year period. The airline also

benefited from recent advances in ticketless operations. A healthy commission program to travel agents and a diverse, non-union workforce were other features of WestPac operations.³⁴

Morris Air, patterned after Southwest, was the only airline Southwest had acquired. Prior to the acquisition, Morris Air flew Boeing 737s on point-to-point routes, operated in a different part of the United States than Southwest and was profitable. When Morris Air was acquired by Southwest in December 1993, seven new markets were added to Southwest's system.

Southwest's move into Florida

In January 1996, Southwest began new flights from Tampa International to Fort Lauderdale, Nashville, New Orleans, St. Louis/Lambert International Airport, the Birmingham, the Houston/Hobby Airport and the Baltimore/Washington International Airport. Saturation and low initial fares were part of Southwest's expansion strategy. Some of the routes would have as many as six daily flights. In April, service began from Orlando International Airport, with 10 flights headed to five different airports. Southwest's goal was to operate 78 daily flights to Tampa, Fort Lauderdale and Orlando.

Availability of assets and staff was a potential restriction on the airline's expansion possibilities. Ground crews were being transferred from other Southwest locations, with pilot and flight attendants coming from Chicago and Houston bases to cover the Florida expansion. Ten new Boeing jets were on order for the Florida routes.

Expansion into the northeast

With Southwest established as a leader in many aspects of the industry, continued success was hard to doubt. Yet, Southwest had shown itself to be vulnerable, at least for a short time, to the well-planned competition from Shuttle by United on the West Coast. New airlines, such as WestPac, had also proved capable of innovating and quickly becoming profitable.

The proposed entry into the northeastern region of the United States was, in many respects, the next logical move for Southwest. The northeast was the most densely populated area of the country and the only major region where Southwest did not compete. New England could provide a valuable source of passengers to Florida's warmer winter climates. Southwest's entry into Florida was exceeding initial estimates. Using a low-fare strategy, ValuJet had, until its crash, built a strong competitive base in important northeastern markets.

Despite the large potential market, the northeast offered a new set of challenges for Southwest. Airport congestion and air traffic control delays could prevent efficient operations, lengthening turnaround time at airport gates and wreaking havoc on frequent flight scheduling. Inclement weather posed additional challenges for both air service and car travel to airports. Southwest had already rejected some of the larger airports as too crowded, including LaGuardia, J.F.K. International and Newark International airports. Some regional airports lacked facilities required by a high-volume airline. For example, Stewart International Airport, near Newburgh, New York and north of New York City, lacked basic facilities such as gates and ticket counters.

The critical question for Southwest management was whether expansion to the northeast, and particularly New England, was premature. Or, would the challenge bring out the best in a firm with a history of defying conventional wisdom and doing things its own way?

Endnotes

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