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THE DEPENDENCE OF PROFITABILITY ON INDUSTRY STRUCTURE

The cases in this chapter illustrate the ways that microeconomic forces and industry structure influence management decisions. Determining the prices to be charged and quantities to be produced requires that management understand customer, supplier, and competitor strategies, and these market realities vary among countries. Conceptual frameworks used in analyzing industry structure include Michael Porter's (1979) "five forces model," through which each industry can be analyzed from the perspective of the rivalry among existing competitors, the threat of new entrants, the bargaining power of buyers, the threat of substitutes, and the bargaining power of suppliers. A sixth force, the impacts of complementors, can be added to this model. Elements of microeconomic theory and game theory are analytical tools that help in the examination of how a change in price will affect sales volumes and hence revenue, costs, and profits.

Industry structures may differ significantly from one country to another, and these differences may provide a rationale for international investment. In particular, international investment can enable a firm to increase its profitability by shifting from a market where it has no significant competitive advantage to a market where its activities are unique. Strong competitors can limit expansion opportunities in a firm's home country, whereas the firm may benefit from a monopoly position if it invests in a foreign market. Differences in industry structures among countries can result from any of the environmental forces: for example, levels of economic development, types of political regulations, preferences of consumers, or stages of technologies. As Douglass North (1990) has discussed, many of a country's institutions can shape an industry's international competitiveness. Consequently, governments often seek to affect an industry structure, through a variety of programs and policies.

Some industry structures can lead to a "game" among participants in the sense that the actions of one participant will affect the profitability of other participants. Decisions must

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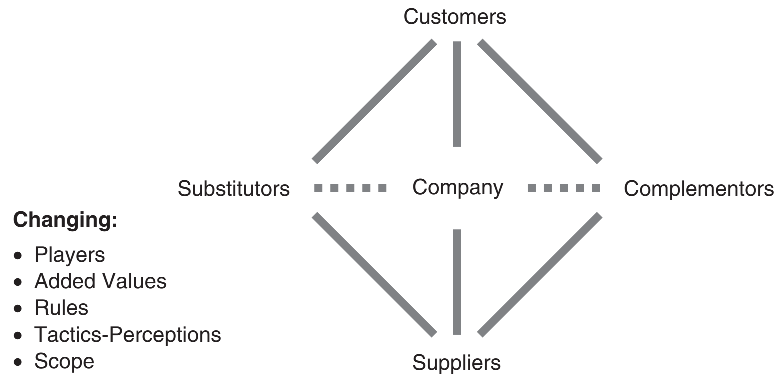

Diagram 1.1 The Value Net

be undertaken based on an evaluation of a series of possible outcomes, where each outcome depends on the reaction of others in the industry. From this perspective, Brandenburger and Nalebuff (1995) have suggested a useful framework for the analysis of an industry (see Diagram 1.1).

Participants may alter potential outcomes by changing the industry structure in a variety of ways. In particular, Brandenburger and Nalebuff (1995) suggest that each corporation should use what they refer to as "PARTS as a comprehensive, theory-based set of levers" to help generate strategies. Each letter in the phrase "PARTS" represents a lever for changing the industry structure. A firm may threaten to change the number of players (P) by indicating that it intends to enter an industry. The mere threat may result in the firm receiving a benefit, thereby altering the allocation of the value added among the participants. A firm may change the "added values" (A) by lowering the added value of others, as well as by increasing its own added value. A firm may change the rules (R), for example, by developing new pricing policies. A firm may change tactics (T) in ways that alter other players' perceptions and therefore their decisions. A firm may change the scope (S) of the game by severing linkages with other companies or building new alliances. Unlike Porter's (1979) five forces, which analyze an existing industry structure, this game theory approach examines ways to change the industry structure.

The concept of an industry as a "value chain" involves the analysis of the relative attractiveness of alternative business activities required in the process of creating products or services, where each link adds a certain value within the "chain." The "creative web" concept suggests perspectives and practices necessary to stimulate the innovation process among firms that are separate corporations but that work together within a value chain (Conklin & Tapp, 2000). Many organizational structures in the 21st century will rest on cooperation as well as competition. A set of corporations will work together to expand the value that is added by their group. Although the group as a whole faces competition from other groups, the organizational dynamic within each group seeks to improve the outcomes for all participants. The analysis of the creative web builds on the game theory framework, in that it focuses on the ways in which individual corporations may affect the success of each other. However, it sees this relationship as one where the objective is for

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all participants to win through innovation that increases the web's value added, enabling all participants to increase their financial gain. Outsourcing of various activities to other firms and shifting some activities to lower cost countries extends this concept of the creative web.

To evaluate the international competitiveness of a potential investment location for a specific industry or for a specific activity within the industry, Michael Porter's (1990) "diamond framework" is helpful. Countries differ in regard to factor conditions, demand conditions, rivalry among competitors, and related and supporting industries. These features, together with the role of government and of chance, may combine to create a competitive advantage in a region or country for certain types of activities that may then develop as a "cluster" of firms. Business investment decisions can be strengthened through such an analysis of industry/country competitiveness. New international trade and investment agreements can radically alter this "diamond," changing an industry/country competitive advantage. Trade and investment agreements, together with an industry structure of a value chain or a creative web, can facilitate the location of separable activities in different countries. Each of these countries may offer a competitive advantage for a specific type of activity, leading to the concept of an activity/country competitive advantage.

Samsung and the Theme Park Industry in Korea

The management of the Samsung Group has to decide whether to enter the Korean theme park industry. The case focuses on three main issues in the context of the entry decision: (a) the underlying forces that shape industry structure, competitive interaction, and profits; (b) the impact of globalization on industry structure; and (c) the relationship between a firm's resources and its strategy. Porter's (1979) five forces model is used to analyze the impact of the competitive forces on profitability.

PharmaPlus in Hungary

Hungary had strict laws defining what could be sold in a pharmacy and a "druggery" (which were two separate entities), yet PharmaPlus was attempting to combine the two within a single store. Management of PharmaPlus faced opposition from the regulatory body of pharmacists that had authority over each pharmacy's operations. The case deals with issues of lobbying stakeholders who have power, finding a sustainable competitive advantage in a market with many competitors that has never seen this type of business, and exploring potential international expansion in the context of Hungary entering the European Union (EU).

Singapore International Airlines: Preparing for Turbulence Ahead

By 2004, Singapore International Airlines (SIA) enjoyed a run of exemplary profitability and service performance. It had built its strategy around the principles of a differentiated positioning using its brand image, geographic location, and outstanding service as the

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cornerstones of its strategy. The case offers enough data to launch into a rich discussion of the industry factors that drive profitability and complements it with an in-depth look at the model of strategy that SIA had built to compete in the airline business. In recent years, there have been many environmental shocks, such as severe acute respiratory syndrome (SARS), that have challenged the continued viability of the model. The company entered into an equity alliance with Virgin that has destroyed significant value. It found itself challenged by the entry of many low-cost airlines in its home market. The case closes with a decision that SIA needed to make about how it would address the onset of low-cost competitors and whether it would make sense to move away from its differentiated premium approach.

Swatch and the Global Watch Industry

The efforts of Swatch to reposition itself in the increasingly competitive global watch industry are reviewed in this case. Extensive information on the history and structure of the global watch industry is provided, and the shrinking time horizons decision makers face in formulating strategy and in responding to changes in the industry are highlighted. In particular, the case discusses how technology and globalization have changed industry dynamics and have caused companies to reassess their sources of competitive advantage. Like other companies, Swatch faced the difficult task of deciding whether to emphasize product breadth or focus on a few key global brands. It also had to decide whether to shift manufacturing away from Switzerland to lower cost countries such as India.

Whirlpool Corporation's Global Strategy

This case deals with Whirlpool Corporation (Whirlpool) and its global expansion, which was driven by Whirlpool's objective of becoming the world market leader in home appliances. By the mid-1990s, serious problems had emerged in Whirlpool's international operations. In 1995, Whirlpool's European profit fell by 50%, and in 1996, the company reported a $13 million loss in Europe. In Asia, the situation was even worse. Although the region accounted for only 6% of corporate sales, Whirlpool lost $70 million in Asia in 1996 and $62 million in 1997. In Brazil, Whirlpool found itself a victim in 1997, and again in 1998, of spiraling interest rates. This case examines the concepts of global industry and global strategy and the related question of how globalization affects competition. The appliance industry produces products that are used in every country. Is it a global industry? Will the industry evolve like the automobile industry to the point that there are a small number of international firms present in all major markets? Or, will the industry remain a collection of local industries?

Wal-Mart Stores Inc.: Dominating Global Retailing

The case explores the fundamental features of the business model that Wal-Mart has been adopting, both in the United States and abroad. It places particular emphasis on the company's supplier management approaches, supplier strategies in doing business with

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Wal-Mart, and the company's track record in international operations. It offers insights into the ways in which Wal-Mart's suppliers can design their own strategies to ensure continued viability amid significant pricing pressure from the retail giant. It closes with important questions about the continued success of the company in the face of allegations of labor violations, increasing competition in foreign markets, and the likelihood of a supplier push-back against Wal-Mart's continued pressure to bring down its prices. The major objectives of this case are to illustrate the fundamental concepts of competitive advantage and how it is built and nurtured, explore issues of sustainability, look at Wal-Mart's strategies of supplier relationship management and the consequences of its restrictive practices in managing its supplier network, and examine the transferability of homegrown sources of competitive advantage to foreign locations.

The Global Branding of Stella Artois

Interbrew had developed into the world's fourth largest brewer by acquiring and managing a large portfolio of national and regional beer brands in markets around the world. Recently, senior management had decided to develop one of its premium beers, Stella Artois, as a global brand. The early stages of Interbrew's global branding strategy and tactics are examined, enabling students to consider these concepts in the context of a fragmented but consolidating industry.

Samsung and the Theme Park Industry in Korea

Prepared by Charles Dhanaraj and Young Soo Kim
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In October 1994, Her Tae-Hak, President of Samsung's Joong-Ang Development Company was driving to his office, past the "Yongin Farmland" (Farmland), an amusement complex sprawling over 3,700 acres in the Yongin valley. Her was spearheading a major drive within the company to position the theme park as one of the world's leading vacation resort towns. His master plan called for an investment of about US$300 million over the next five years, to be internally funded by the Samsung Group. Despite the booming Korean economy and the increasing demands for leisure attractions, the global competitive environment of the theme park industry raised several concerns. Should Samsung invest in such an aggressive expansion plan for Farmland? Was this an attractive industry for investment? Her was scheduled for a meeting with the Chairman of the Samsung Group for a formal presentation of the proposal at the end of the month.

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The Global Theme Park Industry

The early 1990s saw the emergence of theme parks as a major source of family entertainment, not just in the United States but around the world. The earliest evidence of a business where people "paid money to be terrified" was in the early 1600s when several Russians operated a sled ride with a 70-foot vertical drop. In the late 1800s, several theme parks were set up in Coney Island (New York) in the United States. The first roller coaster was set up in 1884, followed by an indoor amusement park, Sealion Park. In the 1930s, the amusement industry had to contend with alternative entertainment offered by the movie houses as well as setbacks due to economic depression. However, with the Disneyland Park opening in 1955 in California, the industry was revived and Walt Disney was credited with raising the profile, as well as the profitability, of the industry to a new height.

There was a variety of parks and attractions, each with a different approach to drawing crowds and showing them a good time:

- **Cultural and Education Parks** were a remnant of the old-fashioned type of European park. Such parks featured formal greens, gardens, and fountains. Generally they incorporated historical and educational exhibits.
- **Outdoor Amusement Parks** were small parks that served a metropolitan or regional market. These parks featured traditional thrill rides, carnival midways, and some entertainment. Most amusement parks did not have a theme to the architecture, rides, and entertainment.
- **Theme Parks** were generally family-oriented entertainment complexes that were built around a theme. Theme parks were larger and had a greater variety of rides and attractions than amusement parks.
- **Water Theme Parks** were a recent phenomenon, a special type of theme parks centered on water activities. Large water parks featured wave action pools, river rides, steep vertical drop slides, and a variety of twisting flume slides.

Most of the theme parks were members of the International Association of Amusement Parks and Attractions, which tracked the attendance at various theme parks. In 1993, North American parks accounted for 48 per cent of the worldwide attendance, Asian parks 33 per cent, European parks 14 per cent, and Central and South American parks four per cent (see Table 1).

North America

The Walt Disney Company was the largest park chain in the world with three major theme parks in the United States. Time Warner's Six Flags Corporation was the second largest with seven parks spread out in the United States. Paramount, Anheuser Busch and Cedar Fair were some of the other conglomerates who owned theme parks. In mid-1993, Paramount bought Canada's Wonderland theme park originally developed by Taft Broadcasting Company in 1981. Despite the mature nature of the industry in the United States, a number of theme parks were investing heavily in upgrading their facilities, and extending the theme parks' services.

Europe

In 1980, Alton Towers, a 60-year old park in North Staffordshire (England), comprised primarily of historic gardens, repositioned itself as a theme park by adding a roller coaster and some other attractions. The park was extremely successful within a very short span of time. The success of Alton Towers led to a number of new theme parks in the late 1980s and the early 1990s, including Blackpool Pleasure Beach (England) that featured the world's tallest roller coaster. In France alone, three major theme parks emerged in the early 1990s: Walt Disney's $3 billion Euro Disney, the $150 million Parc Asterix located northeast of Paris, and the $110 million Big Bang Schtroumpf (Smurfs) theme park just north of Metz. Six Flags Corporation and Anheuser-Busch both recently opened new theme parks in Spain coinciding with the 1992 Barcelona Olympics.

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Table 1 Top 50 Amusement/Theme Parks Worldwide (1994)

Rank	*Park & Location*	*Attendance (in millions)*
1	Tokyo (Japan) DISNEYLAND	16.030
2	MAGIC KINGDOM of Walt Disney World, Florida, United States	11.200
3	DISNEYLAND, Anaheim, California, United States	10.300
4	JAYA ANCOL DREAMLAND, Jakarta, Indonesia	9.800
5	EPCOT at Walt Disney World, Florida, United States	9.700
6	EURO DISNEYLAND, Morne La Voltee, France	8.800
7	YOKOHAMA (Japan) HAKKEIJIMA SEA PARADISE, Japan	8.737
8	DISNEY-MGM STUDIOS, Walt Disney World, Florida, United States	8.000
9	UNIVERSAL STUDIOS FLORIDA, Orlando, Florida, United States	7.700
10	BLACKPOOL (England) PLEASURE BEACH, England	7.000
11	YONGIN FARMLAND, Kyonggi-Do, South Korea	6.071
12	UNIVERSAL STUDIOS HOLLYWOOD, California, United States	4.600
13	SEA WORLD OF FLORIDA, Florida, United States	4.600
14	LOTTE WORLD, Seoul, South Korea	4.433
15	CHAPULTEPEC, Mexico City, Mexico	4.200
16	HUIS TEN BOSCH, Sosebo, Japan	3.902
17	TOSHIMAEN AMUSEMENT PARK, Tokyo, Japan	3.800
18	KNOTT'S BERRY FARM, Fuona Park, California, United States	3.800
19	SEA WORLD OF CALIFORNIA, San Diego, California, United States	3.700
20	BUSCH GARDENS, Tampa, Florida, United States	3.700
21	CEDAR POINT, Sandusky, Ohio, United States	3.600
22	SIX FLAGS MAGIC MOUNTAIN, Valencia, Calif, United States	3.500
23	SEOUL LAND, Seoul, South Korea	3.311
24	PARAMOUNT'S KING'S ISLAND, Ohio, United States	3.300
25	OCEAN PARK, Hong Kong	3.200
26	SIX FLAGS GREAT ADVENTURE, Jackson, New Jersey, United States	3.200
27	SANTA CRUZ BEACH BOARDWALK, California, United States	3.100
28	NAGASHIMA SPA LAND, Kuwona, Japan	3.008
29	TIVOLI GARDENS, Copenhagen, Denmark	3.000
30	SIX FLAGS OVER TEXAS, Arlington, Texas, United States	3.000
31	ALTON TOWERS, North Staffordshire, United Kingdom	3.000
32	SIX FLAGS GREAT AMERICA, Gumee, Illinois, United States	2.900
33	PARAMOUNT CANADA'S WONDERLAND, Maple, Canada	2.850
34	TAKARAZUKA (Japan) FAMILY LAND	2.796
35	SIX FLAGS OVER GEORGIA, Atlanta, United States	2.600
36	DE EFTELING, The Netherlands	2.550
37	PLAYCENTER, São Paulo, Brazil	2.500
38	DUNIA FUNTASI, Jakarta, Indonesia	2.500
39	PARAMOUNT'S GREAT AMERICA, California, United States	2.500
40	KNOTT'S CAMP SNOOPY, Bloomington, Minnesota, United States	2.500
41	EUROPA PARK, Germany	2.450
42	KORAKUEN, Tokyo, Japan	2.423
43	PARAMOUNT'S KINGS DOMINION, Virginia, United States	2.400
44	SIX FLAGS ASTROWORLD, Houston, Texas, United States	2.400
45	PLAYCENTER, São Paulo, Brazil	2.400
46	BUSCH GARDENS THE OLD COUNTRY, Virginia, United States	2.300
47	DAKKEN, Klampenborg, Denmark	2.300
48	LISEBERG, Gothenburg, Sweden	2.200
49	TOEI UZUMASA EIGAMURA, Kyoto, Japan	2.146
50	BEIJING (China) AMUSEMENT PARK	2.050

Source: Amusement Business.

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Asia

Tokyo Disneyland was opened in 1983 by Walt Disney as a joint venture with the Oriental Land Company (OLC). The success of Tokyo Disneyland set off a wave of theme park developments in Asia. OLC and Disney had agreed to open a second theme park, "Tokyo Disney Sea" in 2001. Ocean Park in Hong Kong, started in 1977, was the largest water park in Asia with an annual attendance of 3.2 million. Jaya Ancol Dreamland, located in North Jakarta, Indonesia, was one of the largest recreation complexes in south east Asia. Dreamland had a theme park (Dunia Fantasi), a waterpark complex, an oceanarium, a golf course, a beach and several hotels. China was a major growth market. Beijing Amusement park, started in 1981, reported that between 1990 and 1993 revenues increased over 2,000 per cent and earnings before interest and taxes were up 200 per cent. Over the next five years, six regional theme parks were to be developed with a total investment of over $100 million.

Financial Issues

The theme park business required a large-scale initial investment, typically ranging from $50 million to $3 billion. Depending on the real-estate markets, the cost of the land value itself could be very high. Theme parks required over 50 acres of land for a full scale development, with some of the theme parks utilizing 10,000 to 30,000 acres. Since accessibility of the park location was a key success factor in the industry, theme park developers chose land sites in a central area which was relatively expensive. Alternatively, they could choose a remote area at a low cost and develop the transportation network. In either case, the land development costs constituted nearly 50 per cent of the overall investment. The amusement machinery constituted 20 to 30 per cent of the total investment, and the working capital requirements took up the remaining 20 to 30 per cent of the investment. The amusement equipment required for the park was also expensive, most of it going from $1 million to $50 million. Businesses which had an in-house land development expertise or equipment technology had better control of these costs.

Many parks periodically added new attractions or renovated existing ones to draw repeat customers. The parks typically reinvested much of their revenue for expansion or upgrading purposes. The economies of scale and scope were significant in the industry. Increasingly, parks got larger and larger to generate more operating revenues. Also, companies had multiple parks to take advantage of the learning curve effects in the management of theme parks and the increased economies of scope. Most of the operating expenses for theme parks (about 75 per cent) were for personnel.

Admission fees[1] constituted over 60 per cent of the total revenues of a theme park, while the rest came primarily from food, beverage, and merchandise sales. To handle the admissions revenue a centralized ticket system was generally preferred. An all-inclusive admission price entitled customers to as many rides and shows as they desired. This approach led to longer stays at parks resulting in increased food and beverage sales. Another centralized admission method was to sell ride/show tickets in sets or coupon books (i.e., five coupons for $5, but 12 coupons for $10). Both approaches to centralized ticket sales minimized the number of employees handling money throughout the park resulting in improved efficiency and control.

Walt Disney Company's financial profile was generally used to assess the return on investment within the industry. The revenues for the theme parks segment of the Walt Disney Company were at US$2.042 billion in 1988 and grew to US$3.4 billion in 1993. Operating income was pegged at US$565 million in 1988 and US$747 million in 1993. The return on equity for the Walt Disney Company was pegged at 17 to 25 per cent. One of the analysts remarked on the theme parks segment of Walt Disney:

> Theme parks are going to become increasingly stable and annuity-like, with the ability to generate $700 to $750 million in cash flow a year.

There were signs of declining profitability in the U.S. operations, since the market was maturing and the competition was getting more intense. Tokyo Disneyland, the Japanese operation, was growing and profitable. However, EuroDisney, the European theme park, was a disaster for the company with huge losses since operations began in 1992. The company was expecting a break-even in 1995.

Marketing and Social Issues

The traditional appeal of theme/amusement parks was to preteens, teens, and young adults. Changing demographics were causing most parks to think in terms of a broader market, particularly families, corporate groups, and even senior citizens. There were five major market segments for theme parks:

- Local Families—people within a day's drive who visited mostly on weekends. Most parks focused exclusively on this segment, which generally constituted 60 to 75 per cent of the attendance.
- Children's Groups—schools, churches, recreation agencies, scouts, and other groups who traveled in buses on summer weekdays.
- The Evening Market—teens and young adults who came for entertainment, concerts, and romancing at night.
- Corporate Groups—included consignment sales and group parties.
- Tourists—a substantial market for large theme parks in destination areas such as Florida.

Customer satisfaction was a critical issue in theme parks management. Successful park managers used extensive marketing research to understand their customers and also spent a lot of effort in promoting the park. To reach the diverse groups, parks emphasized increased beautification and the range of entertainment and food services offered. Theme park managers were working with tour operators and government tourist promotion boards to draw the tourist crowds to their parks. Theme parks spent about 10 per cent of their annual revenues for advertising. Radio, newspaper, yellow page (telephone book) advertisements, family and group discounts, and direct mail were the most common promotional methods. Among large theme parks, television advertising was an excellent visual medium to capture the excitement. Some parks expended a major portion of their advertising budget for television promotion.

An issue for the theme parks industry was the seasonal and intermittent nature of the business. Theme parks' attendance peaked in the spring/summer and in the school holidays. Even in the holiday season, bad weather could adversely affect the attendance. The seasonal fluctuations put a lot of strain on the theme parks' management. During the peak season, the requirement for employees shot up; quite often the management had to find employees beyond the domestic territory and provide housing for out-of-town employees. The sudden surge in demand often choked the service systems such as transportation, building management, etc.

It was the availability of leisure time and a high discretionary income that drove the commercial recreation industry. Economic downturns had a severe impact on industry revenues. Also, consumers could substitute a visit to theme parks with other modes of entertainment. Consumers substituted products/services in order to try something new, different, cheaper, safer, better, or more convenient. Free admission parks and beaches, camping trips, or even video-movies at home were competing options for leisure time.

Regulatory Issues

Government regulations were quite strict because of the extensive land use, and the potential for serious accidents. Licensing requirements and methods of ascertaining operational expertise to ensure visitors' safety varied from country to country. In some countries, where land was scarce, governments limited the area of the land that the developers could take up for theme parks. Park administration was dependent on the

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government for utilities such as power, gas and water. A typical period required for arranging government approval for a theme park could be as high as two to five years, depending on the country.

A related issue was insurance premiums. Given the likelihood of accidents in the amusement parks and the possibility of serious injury, 100 per cent insurance coverage was a must in the industry. Although safety records in the industry were very good, the insurance premiums were extremely high in some parts of the world, particularly in the United States. However, the large premiums often drove the small players in the industry out of business. Countries in Asia did not have this handicap.

TECHNOLOGY ISSUES

The theme park industry had three classes of inputs: the building and construction services that provided landscaping and architectural support; the hardware providers that supplied amusement machinery; and the software providers that supplied management know-how.

The amusement machinery industry had grown over the years. Most of the large drives, such as the Hurricane or the Giant Wheel, were manufactured in Japan, Europe or the United States. There were fewer than 10 suppliers who were capable of developing quality machinery, such as DOGO of Japan, HUSS of Germany, and ARROW of the United States. Most of these suppliers worked globally, and the machinery were custom designed and made to order to fit the particular market and environment conditions. There were a large number of suppliers for the smaller machines, and quite often, they could be manufactured domestically. Special simulators for amusement purposes using proprietary technology were being developed by technology-intensive companies such as Sega Japan and Simex Canada.

The park management expertise commonly referred to as the "software" in the industry was not easily available. Leading theme park companies, such as Walt Disney Company, charged huge licensing fees which were over 10 per cent of the revenues. Also, they were very selective in choosing joint ventures in other countries. Disney went through an extensive market analysis and partner profile analysis for over three years in Europe before finalizing the venue in France with the joint venture partner. Mr. Yu, director-in-charge of the Farmland project, commented:

> We wanted to go for a joint venture with Walt Disney Corporation. But they somehow were not interested in Korea. So we had to go it alone. It takes a long time for theme park managers to develop service delivery of world class quality.

Although Walt Disney offered a number of educational programs to train other managers in the "Disney Management" style, the know-how seemed to be too sophisticated for the competitors to emulate.

Virtual reality (VR) was increasingly becoming a highly lucrative mass-market entertainment phenomenon. A new entry that was due to open in July 1994 was Joypolis, a $70 million interactive theme park owned by Sega Enterprises, with projected revenues of $37 million per annum. Sega had plans to open 50 such parks in Japan, and was negotiating with Universal Studios, California, for its first U.S. installation of a VR theme park.

YONGIN FARMLAND

Yongin Farmland (Farmland), opened in 1976, was the first amusement park in Korea. It was managed by Joong-Ang Development Company, one of the wholly owned subsidiaries of Samsung with a mission to provide a better quality of life through healthy open-air leisure activities. In addition to the Farmland management, Joong-Ang was responsible for the building maintenance at all Samsung's offices, as well as maintaining two golf courses. Farmland was located about an hour south of Seoul, and was

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The late Chairman Lee Byung-Chul founded the Samsung Group in 1938. Though started as a trading firm to supply rice and agricultural commodities to neighboring countries, Samsung moved quickly into import substitution manufacturing activities such as sugar refining and textiles. In the 1960s Samsung moved into electronics by establishing Samsung Electronics that developed VCRs, integrated circuits for televisions and telephone exchanges, electron guns for cathode ray tubes (CRTs), and cameras. The 1980s marked a major expansion for Samsung with its evolution into high-tech industry, such as semi-conductors, telecommunications, computers, factory automation systems, and aerospace. Samsung had accomplished remarkable growth (see Table 7). The 1994 revenues were expected to be about US$70 billion.

Samsung, with 206,000 employees operating in 65 countries, had recently reorganized the group into four core business subgroups, Electronics, Machinery, Chemicals, and Finance & Insurance, and one subgroup of independent affiliates. While the core groups represented specific technological area, the independent affiliates subgroup represented a diverse mosaic that included the trading activities of the company, Korea's highest-rated hotel, Korea's leading newspaper publisher, state-of-the-art medical and research institutes, and cultural and welfare foundations. The Joong-Ang Development Co. Ltd., the developer of the Yongin Farmland came under this subgroup.

In 1987, Lee Kun-Hee, son of the late Lee Byung-Chul, was appointed the chairman of the Samsung group. Lee accelerated the pace of growth at Samsung by pursuing aggressively high-technology areas and pushed the group to change from a quantity-oriented company to a quality-oriented company. Samsung's goal was to become one of the world's top ten corporations by the year 2000 by achieving annual sales of US$200 billion, and by producing products and services of the highest quality. Service quality and customer satisfaction become key phrases in all Samsung's activities and all the companies in the group were taking active part in the "quality revolution" initiated by Lee.

Exhibit 1 Samsung Group

owned by the Korean conglomerate, the Samsung Group (see Exhibit 1). The 3,700-acre attraction began as an agricultural center to demonstrate how mountainous land could be used productively for growing food products. Mr. Lee of Joong-Ang said,

> At that time, we had trouble raising enough food for our country. We created a model farm of how to work with an abandoned mountain by building a pig farm and planting fruit orchards. We changed the land use gradually through the years as we added entertainment elements.

The Wild Safari was opened in 1980, and the Rose Festival, an impressive rose garden filled with 6,000 rose bushes of 160 different varieties arranged according to various themes, opened in 1985. To provide for winter entertainment, the Sled Slope was opened in 1988. A drastic departure from the traditional theme parks was taken when Yongin Farmland opened a Motor-Park in late 1993. The motor park operations incurred a loss in the first year of operations (see Table 2 for the profit and loss statement).

In November 1993, Her took over as the President and Chief Executive Officer of the Joong-Ang Development Company. Prior to his assignment to Joong-Ang, Her was the CEO of Cheju Shilla, a luxury hotel on Cheju Island in Korea. Her was credited with developing a world-class sea resort at Cheju Shilla which surpassed in customer service established hotel chains such as Hotel Hilton. Since taking over the reins of the company, Her had focused on improving the customer satisfaction level at Farmland, and had also been developing the plans for Farmland's expansion. One of the major challenges was to see how the expansion plans for Farmland would match with the corporate strengths of the Samsung group. Her was aware that earlier attempts by previous management to expand Farmland had not met with the approval of the group's Chairman. There were concerns in many quarters that the theme park industry did not fit well with the "high-tech" and

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Table 2 Profit and Loss Statement for Yongin Farmland

	1991	*1992 (millions Korean Won)*	*1993*
Revenue			
Net Sales			
Admissions	24,829	30,885	35,004
Merchandise	3,255	3,684	5,378
Restaurants	10,309	12,604	14,835
Total	38,393	47,173	55,217
Expenses			
Park Operations	26,209	33,487	40,409
Sales and Administration	8,524	8,980	10,145
Others	1,215	1,350	1,433
Total	35,948	43,817	51,987
Operating Profit	2,445	3,356	3,230
Less Interest Expense	(1,724)	(1,100)	(3,417)
Profit/(Loss) after Interest	**721**	**2,834**	**(18)**

the "global" image of the Samsung Group, and also that the profitability might be very low.

The theme park industry was still in its early stages in Korea, and had a history of less than two decades. However, indications were that the industry was growing globally, with more players entering. Nevertheless, some of the managers did not see profitable growth opportunity in the theme park industry. One of the managers in Joong-Ang said:

> Theme parks may be a growing industry worldwide. That does not mean that it should be so in Korea. In Korea, we work five and a half days a week and we have annual vacation of only four to five days a year. Where do Korean people have time for theme parks?

Farmland Customers

Traditionally, Farmland focused on the local customers. Most of its customers came from surrounding areas within two hours' drive (see Table 3). The economic growth in Korea had been a major driving force in industry growth (see Exhibit 2).

Despite the early stage of growth in the Korean leisure industry, there were six theme parks in the Seoul area including Farmland. Most notable among these were Lotte World and Seoul Land. Lotte World, started in 1989, prided itself on having the world's largest indoor theme park with adjoining hotel, department store, shopping mall, folk village and sports centre. Commenting on Lotte's strategy, one of the managers at Lotte World said:

> We focus on a segment different from Farmland. Since we are located downtown, we cater to a clientele who want to drop by for a shorter period. Typically, we get office people who want to relax after a hard day's work or couples who would like to spend some time in a romantic environment.

Seoul Land, located near Seoul at Kyungkido, was also a key competitor to Farmland. With attendance at 3.37 million, Seoul Land ranked 23rd in the "Top 50 theme parks worldwide." Mr. Woon, one of the managers at Seoul Land, remarked:

> The park has a good reputation for quality special events and the people enjoy coming to the park because of its fresh air, beautiful scenery, and easy access.

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Table 3 Target Segments—Attendance and Population Data

Market Type	*Per cent of Total Attendance from the market type (%)*	*Population from the market type (in millions)*	*Estimated Current Capture rate (%)*	*Projected Population in 2000 AD (in millions)*
Primary resident market	73	19.2	19.30	20.2
Secondary resident market	20	13.8	7.30	14.7
Tertiary resident market	8	12.5	4.10	12.3
Total	**100**	**43.5**	**11.30**	**47.2**

Note:

1. The primary resident market is within one hour drive from Farmland, typically in a radius of up to 60 miles. The secondary market is within one to two hours, and the tertiary market is outside the two hour drive limit but within driving distance.
2. Percentage of total attendance is based on three repeat surveys of visitors to Farmland in early 1994.
3. The estimated capture rate is based on statistical projections from the survey respondents.
4. The analysis does not include overseas visitors, which constituted 25 per cent of the total attendance in 1993. Visitors were mostly from other Asian countries, such as Japan and Singapore.

Korea, with its population of 44 million people, had seen tremendous economic growth over the 1980s and 1990s, despite the political difficulties. Over 10 million Koreans lived in Seoul, and along with the other five metropolitan cities, the urbanization rate was at 74.4 per cent. Korean economic growth has often been dubbed as an "economic miracle." The per capita GNP had risen from US$4,210 in 1989 to US$7,513 in 1993. The growth rate for the second half of the 1990s was expected to be eight to nine per cent. The growth of the Korean economy was accompanied by an increasing prominence of large business groups, commonly known as "chaebol"—privately held industrial conglomerates involved in a wide range of businesses. Samsung, Hyundai, Sunkyong, Daewoo, Lucky-Goldstar, and Ssangyong were some of the better known chaebols.

Korean weather was a temperate climate since it was in the transitional zone between continental climate and subtropical maritime climate. The winter time stretched from December to mid-March when intense, cold dry spells alternated with spells of milder weather. Temperatures dropped to −20 degrees Celsius in some places. Heavy snow was expected in the mountains. Summer, stretching from June to early September, was hot and humid with temperatures rising to 35 degrees Celsius with heavy showers in June and July. Mid-July to mid-August was the peak of Korean vacation season. Many festivals came together in October. Despite the pressing political problems, the country was successful in attracting international events to the country—the most prominent being the Olympic games in Seoul in 1988. Tourist growth had been steady and approximately one third of the tourists in Seoul used a travel package from some travel agencies.

Exhibit 2 Korea in the 1990s

Despite the competition from other parks, Farmland had the highest growth rate within the Korean industry (Table 4). The seasonal nature of the theme park industry affected all the competitors, not necessarily in the same pattern (Table 5).

Pricing

Farmland was also going through a major change in its pricing structure. The pricing strategy in place (Table 6) was a combination of "pay-as-you-go" and "pay-one-price" system. Users had

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Table 4 Comparative Attendance in Seoul Area Amusement Parks (Figures in thousands)

	1990	*1991*	*1992*	*1993*
Yongin Farmland	3,786	4,300	4,810	5,113
Lotte World	4,578	4,529	4,605	4,476
Seoul Land	2,198	2,819	2,834	2,648
Dream Land	971	1,319	1,236	1,325
Children's Grand Park	2,107	2,334	2,263	2,159
Seoul Grand Park	1,356	1,431	1,590	1,772

Table 5 Comparable Monthly Attendance: Seoul Area Theme Parks (1993) (Figures in thousands)

Month	*Farmland*	*Lotte World*	*Seoul Land*
January	641	618	220
February	158	390	93
March	190	290	115
April	844	380	378
May	952	363	460
June	801	241	171
July	220	406	182
August	392	646	413
September	193	226	184
October	351	323	302
November	99	214	54
December	270	381	75
	5,111	4,478	2,647

the option of paying the admission fees and buying separate tickets for rides (pay-as-you-go), that were available as coupons (Big 5 for five rides). Membership in the park was available for a price, which provided free admission for a year. The other option was to buy a "passport" (termed as "pay-one-price") that provided admission as well as unlimited rides for one full day. The passport users were estimated at 17.4 per cent of the attendance in 1993, and the membership holders were estimated at 75 per cent. Farmland wanted to switch gradually to the pay-one-price scheme, which was the most common pricing scheme in the leading markets.

The prices across the major competitors were comparable. In 1993, average admissions and ride fee per person was 6,667 Won in Farmland, 7,279 Won in Lotte World, and 6,494 Won in Seoul Land. Theme parks also monitored the amount a visitor spent on food, beverages, and souvenirs. In 1993, average per-capita expenditure on food and beverage in the three parks was 2,874 Won in Farmland, 2,017 Won in Lotte World and 1,804 Won in Seoul Land and merchandise sales per capita were 996, 1,319, and 722 Won, respectively.

Operational Issues

While there was some indication that the Samsung Group would be willing to consider a

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Table 6 Yongin Farmland Pricing Policy (Figures in Korean Won)

	Adult	*Teen*	*Child*
Admission			
Individual	3,200	2,250	500
Group	2,550	1,150	500
Big 5	12,000	10,000	7,000
Passport	17,000	14,000	10,000
Membership Public			
Individual	39,000	31,000	29,000
Family 3		85,000	
Family 4		95,000	
Group 3		75,000	
Group 4		85,000	
Ski Sled Passport	13,000	13,000	10,000
Snow Sled Common		7,000	
Grass Sled		3,000	
Swimming Pool			
Admission	1,850	1,350	1,000
Rides			
Suspended Coaster	3,200	2,700	2,200
Major Rides (7)	3,000	2,500	2,000
Medium Rides (6)	2,500	2,000	1,700
Secondary Rides (5)	2,000	1,700	1,400
Tertiary Rides (5)		1,400	
Kiddy Rides (3)		800	
Pony Rides		1,700	
Time Machine	2,000	5,000	8,000
Lift	550	450	350

Table 7 Samsung Group Financial Highlights (in billions Korean Won)

	1992	*1993*	*1994 (Projected)*
Domestic Sales	23,680	24,609	27,736
Export Sales	14,531	16,755	23,578
Total Assets	38,016	40,964	50,491
Stockholder's equity	5,089	5,900	8,440
Return on equity	6%	7%	16%
Employees (thousands)	189	191	206

Exchange Rates: Korean Won/US$: 1992: 773 1993: 808 1994: 806

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proposal for expansion of the Farmland, Her had to contend with a number of operational issues at Farmland. Based on discussions with a number of managers and customers, Her had some idea of the various issues involved in the operation of Farmland.

Transportation

One major issue was accessibility to the park. Yongin was 60 kilometres south of Seoul, and during peak hours, it took as long as two hours to drive from Seoul to Farmland due to traffic jams. One resident who lived very close to the Yongin area said:

> Actually, it should take only 15 minutes to drive from my home to Farmland. But the traffic jam is so intense that if I go to Farmland, it may take almost an hour of crawling in the traffic. That's one main reason why I have not visited it so far.

One of the managers in the marketing group commented on the critical nature of this problem:

> In Korea, we work five and a half days a week. Most of the time on the working days the travel time is long. All the house chores have to be done only on the weekends. Given this fact, it is only to be expected that Korean customers would not be so keen to travel on a Sunday or on a holiday if the traffic is heavy.

However, many managers in Joong-Ang believed that the accessibility problem was only a temporary issue. Mr. Yu, Director of Personnel at Joong-Ang, commented:

> Travel difficulties are part of our life in Korea, given the small land and the large number of people. The government has plans to bring the subway up to Yongin, in which case Farmland would have a subway terminal, which will provide a lot of convenience to our people.

This was echoed by one of the visitors to Farmland, who commented:

> I hate sitting inside my house all day. I have to get out somewhere. Seoul is too crowded and I would like to go to some place to breathe some clean air. Beaches are closed most of the season, and if I want to go for some mountains or Pusan, it is too far away. So, I don't mind driving down to Yongin to spend a relaxed day. I will skip the rush hour by leaving early from the park.

Parking

Another related issue was parking. Farmland had ample parking space for about 8,000 cars at one time around the four sides of the park. One of the managers who conducted an extensive analysis of the parking space said:

> What we have now is more or less enough for the time being. We have enough space for about 8,000 cars and at four people per car we can accommodate about 32,000 people. If we assume the lot turning over at 1.7 times a day (at an average stay of six to eight hours), we can handle a peak attendance of 52,000. But the real problem is the seasonality. On peak days, we may get more visitors and quite often people may spend more time. If we are going to expand, this will be a major bottleneck.

Part of the expansion plan included augmenting the parking spaces and also providing a "Park and Ride" scheme for visitors so that they could travel comfortably from the various car parks to the entrance.

Environmental Issues

Expanding Farmland meant taking over more of the land mass available in the Yongin valley. A farmer living in the Yongin valley, who was vehemently opposed to the expansion ideas, said:

> They (Samsung) just want to expand their business. But they don't realize that one of the problems with cutting down the trees and leveling the ground will cause potential flooding in the surrounding region. This will damage all our crops. How will they compensate us?

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Organizational Inertia

It was also a challenge to introduce a dynamic environment within the Farmland organization. In order to succeed in the industry, Farmland had to go through a major reorientation in its organizational style. Farmland had initiated customer satisfaction surveys recently and it was brought to the attention of the management that the customer satisfaction levels were lagging behind the key competitor, Lotte World. As one of the marketing managers noted:

> Repeat business is very important to our survival. If we don't satisfy our customers, they won't come back and we won't have any business left. But, it is not in our Korean nature to smile at strangers. We are very serious people. So it becomes all the more difficult to get the type of service you can see at Disneyland.

Mr. Yu, who had pioneered a number of changes within the organization, recalled one event which demonstrated the type of organizational inertia the management had to deal with:

> Previously we had the head office at Seoul and we were managing the Farmland by 'remote control.' We were faxing information and directives up and down. But I somehow did not see that this would be the best way to work. I insisted that the head office had to be located where our products are and only after much persuasion could we move to this place.

Among other things, management was also considering a change in the recruitment process. Traditionally, Farmland had gone after the "academically best" graduates and students, which was the standard practice at Samsung. The management felt that they needed more service oriented people. The management wanted to recruit more female workers, the level of which at that time was below 25 per cent, but anticipated problems since most Korean women stopped working after marriage. Mr. Yu said:

> I think times are changing. For that matter, even if we have a high turnover, it may be good for us since fresh blood always brings in fresh ideas and we would be able to preserve some dynamism in our organization.

The Master Plan

Based on a detailed survey (Table 8) and tentative analysis, the management had put together a master plan to invest about $300 million in revamping Farmland. There were also suggestions of changing the name to provide a better image of the company. A master plan, for a phased investment of about $300 million dollars over the next two years, was being developed. Everland, Green Country, and Nature Land were some of the names proposed for the new "mountain resort." Included in the master plan were:

- A waterpark to be built adjacent to the existing theme park, at an estimated cost of US$140 million, with a Caribbean theme.
- A Global Fair, a fun-fair indicative of the major countries in the world, at an estimated cost of $85 million.
- Expansion of existing zoo, and parks including a night time laser show and a fable fantasy garden at an estimated cost of $50 million.

The funding would come mainly from the parent, Samsung Group, and also through corporate sponsorship of the other companies within the Samsung Group. The master plan also indicated that if the first phase was successful, a second phase of developing a resort town in Yongin, with luxury hotels, golf courses, and resort accommodations would occur. (Exact budget for the second phase was not available at that stage.) A number of managers within the company who were closely involved in developing the master plan felt strongly that the theme park expansion was not only a priority but also would be a profitable venture. The General Manager of the planning group commented:

> What we want to create is a destination resort town and a residential community where people can come, relax and enjoy themselves in a low-stress

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Table 8 Leisure Patterns of South Korean Customers (1994)

Question: Which is your most favoured spot for a one day holiday trip?

Selected Choice		*Theme*	*Nature*	*Resort/Spa*	*Fishing*	*Historic place*	*Other*
Total Response:	10,043	22.2%	22.0%	9.9%	7.0%	22.6%	6.3%
Sex:							
Male	5,354	19.7	22.2	8.4	9.8	22.1	17.8
Female	4,690	25.0	21.8	11.6	3.8	23.3	14.5
Age:							
10–20	1,359	41.5	15.1	2.1	3.7	22.1	15.5
21–30	2,634	23.2	26.5	4.3	6.5	22.7	16.8
31–40	2,799	24.8	22.5	7.9	9.4	20.3	15.1
41–50	1,586	12.0	23.0	13.7	8.1	26.5	16.7
Over 50	1,665	10.3	18.7	24.8	5.2	22.9	18.1
Education:							
Elementary	719	11.5	22.7	25.5	3.6	18.5	18.2
Middleschool	678	46.2	11.0	2.6	3.9	20.2	16.1
Junior high	840	12.2	21.9	18.4	7.1	24.5	15.9
Senior high	491	37.4	19.6	1.6	2.1	26.0	13.3
School graduate	4,286	20.8	23.3	9.9	8.5	21.7	15.8
University	3,030	21.8	22.9	6.7	7.1	24.3	17.2
Occupation:							
Professional	264	14.7	19.0	6.9	12.4	28.4	18.6
White collar	1,597	20.4	23.5	6.0	6.9	23.8	19.4
Sales and marketing	1,794	16.5	24.4	10.3	10.0	22.8	16.0
Service industry	772	20.6	21.2	10.6	9.2	21.8	16.6
Farming	281	12.8	31.5	19.3	6.9	15.5	14.0
Manufacturing	577	18.5	25.4	8.4	10.9	21.0	15.8
Housewife	2,582	22.1	21.9	14.8	4.1	22.6	14.5
Student	1,656	38.3	16.3	2.3	4.5	22.2	16.4
Unemployed	520	12.2	21.9	17.4	8.7	23.5	16.3

Question: Normally, when you go to theme parks, how many others accompany you?

Selected choice	0	2–3	4–5	6–10	11–20	over 21
	2%	**33%**	**38%**	**13%**	**4%**	**11%**

Question: How many hours do you spend in a theme park?

Selected choice	0–5 hours	6–7	8–9	10–11	12–13	14–15	over 16
	22%	**19%**	**18%**	**18%**	**12%**	**6%**	**5%**

Question: How much do you spend at the park in one day excluding admission (in thousands of won)?

Selected choice	0–5	5–10	10–15	15–20	20–25	25–30	30–35	35–50	over 50
	2%	**8%**	**19%**	**10%**	**21%**	**5%**	**16%**	**6%**	**15%**

Question: How do you normally come to the theme park?

Selected choice	Car	Tourbus	Bus	Train/subway	Other
	68%	**9%**	**13%**	**6%**	**4%**

Source: Korea Research Institute.

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environment. Samsung employs more than 180,000 people here in Korea. This will give them a place to come and be proud of. There will be plenty here for all members of the family as they grow.

We feel it is time to change from a farm-oriented name to a name which represents our new mission, which is to create a zeal for long-lasting life that is combined with the harmony of nature. If this plan is approved, we will become the prototype destination resort town in the entire world. We have visited them all, and when we're finished, there won't be any better!

Her wanted a comprehensive analysis of the theme park industry to ascertain the profitability of the industry. He wanted to present to the chairman of the Samsung Group a clear rationale why Samsung should invest in this industry.

NOTE

1. Admission fees varied from $5 to $25 depending on the location and reputation of the park.

PHARMAPLUS IN HUNGARY[1]

Prepared by Trevor Hunter under the supervision of Professors David W. Conklin and Jeffrey Gandz

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Always the optimist, Bernard "Boomer" Borschke was reviewing yet another setback in his plans to build a chain of North American-style drugstores in Hungary. As the recently appointed president of PharmaPlus Co. he had targeted 20 store openings in the first twelve months of operations but had fallen far short of his goal. Indeed, only one store had been opened in a small city 200 km from Budapest, while one roadblock after another seemed to be preventing further progress. As he prepared for a meeting with his senior management team, Borschke felt that it was time to review their experiences to date and decide whether the initial concept, which would revolutionize the pharmacy business in Hungary, was truly viable

HISTORY OF PHARMAPLUS

PharmaPlus was a division of The PharmaLand Share Holding Co. (PharmaLand), a privately owned Hungarian company. Initially, PharmaLand was a small producer of synthetic drugs, natural and healthcare products, cosmetics and food additives. Due to the phenomenal success of its main product, "Swedish Bitter," a herbal health tonic, the company was in the fortunate position of having excess resources at a time when the Hungarian government was privatizing its pharmacy industry.

Naturland acquired Pharmafontana in April 1996, and in August 1997, restructured itself into a new company called PharmaLand Holding Co. under the ownership of three entrepreneurs; Emil Szanto as President, Jozsef Szabo as Chief Executive Officer and Jozsef Medgyesi as Deputy General Manager.

Since the pharmacy industry had recently been privatized and was now fully open to competition, the company decided to complete its vertical integration and purchase a number of pharmacies. The goal was to create a chain

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which focused on the customer by providing good service, product selection and fair pricing. In short, the goal was to create a North American-style "drugstore" chain which would be named PharmaPlus.

To do this the three owners knew they would need someone with experience in this process to assist them. Through contacts in Canada, they learned that the pharmacy industry in Hungary was not that different from the Canadian situation 25 years ago. They decided it would be useful to look for guidance from someone who had helped develop the Canadian pharmacy industry. Their search lead them to Boomer Borschke.

Borschke was a veteran of the pharmacy industry, and as CFO of a major Canadian "drugstore" chain was well positioned to give advice. He was initially made aware of the Hungarian group while on a ski trip in Vail, Colorado in 1997. The group met in Toronto, and it was agreed that Borschke would visit the Hungarian operations in October to give them his opinion about the viability of the concept.

> In October 1996, I came over after our meeting in September. So I took a week, did some consulting, and wrote a report on my findings—about where they were and what they should be doing in the future.

People were hired to run operations based on the report that Borschke provided, but it was clear after just a few months that they were not leading the organization the way the owners had envisioned. They realized that if they wanted to set up a Canadian-style "drugstore," they needed senior management with experience running a Canadian-style "drugstore."

> We had all these meetings, and we discussed the same things again and again. Nothing was happening when I wasn't here even though the two individuals we had hired had been to Canada and understood what we were trying to accomplish.

> Jozsef Szabo asked me if I would consider taking on the presidency. I said, "I'll give you a week a month." They said "We want three weeks a month." We settled on three weeks a month, with a week off, but it's really been more like full-time.

The Hungarian Business Environment in 1997

Hungary, which celebrated its 1001th anniversary in 1997, had a population of 10.2 million, of which 20 per cent lived in the capital city, Budapest. Although Hungary had long rebelled against the Soviets, it was a country caught between Western ideas and reforming Soviet communism, since it was bordered by Austria in the West and Ukraine in the East. The influence these countries had on Hungarian reform created an invisible division of the country into two regions.

The Western part of the country was the recipient of the majority of the recent foreign investment surge, while the East had been virtually ignored as the Soviet's support vanished. The Hungarian government encouraged the development of industries in the West, since there was interest there, but provided no incentives for investment in the East. Companies like General Motors, Suzuki Motor Corp., Ford, IBM, Matsushita, Nokia, Audi, and Philips-Grundig had collectively invested over $3.4 billion in Western areas since 1990. The Eastern regions had received a fraction of this amount. Alone, Gyor and Szekesfehervar, both in the West, had new investments totalling $1.5 billion and $1.3 billion in 1995.

Toward the end of 1997, the government decided to make the East a priority and attempted to attract investment, with limited success in Miskolc and Nyiregyhaza. These efforts could be best described as suggestions rather than concrete incentives. No tax breaks, grants or monetary offerings were proposed.

Areas around Lake Balaton in the West were popular vacation areas for tourists from Germany and Austria due to the natural beauty and the favorable Hungarian exchange rate.

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There was also a great deal of cross-border consumerism from the West into Hungary. The East did not have affluent neighbors to come and spend time and money. The Ukraine was a politically unstable and poor area of the former Soviet Union.

In the middle of the country sat the heart of Hungarian business, Budapest, a thriving city with a long history and good infrastructure. The Budapest Stock Exchange's BUX index was formed in 1991. In a country that was in the final phase of privatization, that by all accounts was one of the most successful in Eastern Europe, having a concentrated source for investment capital (both domestic and foreign) was crucial. After an initial difficult period, the BUX reached a market capitalization of $8 billion in 1997. The strongest year for growth was 1996, when the BUX increased 133 per cent. However, 1997 promised to top that mark since the index officially doubled in August. Despite the high returns, international analysts were somewhat concerned about future growth due to the fact that the number of traded companies had fallen below 50 by mid-1997. Still, the prosperity of the city and the relative homogeneity of the market made Budapest a most lucrative opportunity.

The Hungarian government had privatized most of its industries, and had done so by a unique method. The State Privatization and Holding Company (APV Rt) acted as an agent between the owner (the State) and the purchaser. At times the APV Rt purchased the company outright or in a joint venture with the eventual full owner, maintaining ownership for some time, and receiving a high return on investment. Sometimes it just facilitated the sale. In any case, the State had strong powers to determine how the companies were operated after they were sold, by virtue of its control over the APV Rt.

The APV Rt was a type of venture capitalist for the government which was highly successful. The privatization of state assets had raised approximately $17 billion USD since it began in 1990,[2] giving Hungary the highest per capita rate of foreign direct investment in Eastern Europe at $1475 per year, and reducing the country's consolidated state debt from 86 per cent of GDP to 66 per cent[3].

The rationale for privatization was twofold. First, Hungary was trying for fast-track admittance to the European Union (EU). Secondly, as a lightly populated, land-locked, former Soviet Bloc country that was rich in natural resources, it had little choice but to reform its economy. Hungary had few other sources of hard currency to support its economy with the support of the Soviets now gone. Hungary had progressed so far socially and economically, that by 1997 it was invited to become a member of NATO in 1999.

Although industries were being reformed, the amount of government intervention was still high and the level of competition was intense and strong. Easy foreign access to the Hungarian market was a certainty with Hungary's impending acceptance to the EU. Closer associations with the West through contact via the EU and NATO would lead to higher expectations among Hungarian consumers.

The Hungarian Pharmacy Industry

Hungary's pharmacies were similar in fashion to those found in North America in the 1960s. The industry was highly regulated and traditional, with most of the regulations dating back to the days of the communist system. The traditions, however, were based on over 500 years of Hungarian pharmacy culture.

There were clear distinctions between what was considered a "pharmacy," and a "druggery."

Pharmacy

A pharmacy dispensed solely drugs and other over-the-counter (OTC) products related to health needs. The number of stock keeping units (SKUs) a pharmacy could carry was strictly limited, as was the size, location and method of advertising they could use. Pharmacies had a common look and layout to them. They were

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very formal, and all the products were behind glass where the customers could not handle them. Approximately three per cent of the products sold in a Hungarian pharmacy were mixed on site compared with less than one per cent in Canada. Based on this fact, there were strict regulations concerning the design, layout and characteristics of the laboratory, and the storage and control of raw materials. Pharmacies were strictly regulated as to where they could be located. (See Exhibit 1) In a city with a population of more than 100 000, there needed to be a minimum distance of 250 metres between stores; in larger cities there needed to be a 300-metre distance. Pharmacies could only serve areas which had a minimum of 5 000 people close by; hence they had to be in densely populated areas.

The Hungarian social security system covered many prescription drugs, referred to as "listed" products. Many of these drugs were on a "negative" margin meaning the more expensive the drug, the lower the margin for the pharmacist. The Health Ministry had recently "de-listed" several drugs from the "prescription only" list, but because they were no longer covered by the social security, sales dropped radically, seriously affecting the already slim profits of pharmacies.

Products which were sold in a pharmacy were generally purchased from a wholesaler who, in turn, dealt with the producer. By law, wholesalers could only add a 10 per cent mark-up to the retailer; however, they often offered certain forms of unregulated rebates. Retailers usually took a gross margin of 12-30 per cent, with the lower amount mainly on medicines, and the higher margin on health care products which were limited in number. There was also a value added tax (VAT) on other health care, non-medicinal products, which ranged from 12 to 25 per cent, that was passed directly to the end consumer. The consumer ended up paying nearly twice the price of the wholesaler. The result was that pharmacy products were very expensive for the average Hungarian whose monthly gross pay was FT 38 000 ($211 USD).

Druggery

A "druggery" was more like the notion of a North American "drugstore," except no pharmaceutical products were sold. The selection of products was wide. There were large chains such as the Hungarian AZUR, and the German Rossmans that had most of the best locations. Druggeries could sell the same higher margin products and services found in North America such as film processing, hosiery, cards, toys etc., which were often "impulse" buys. Druggeries were bright and had popular music playing in the background, although the staff wore white coats to look more official.

The owners of the druggeries could buy in bulk directly from the producer, thus making larger margins ranging between 25 to 35 per cent. They could advertise and have sales and had no location restrictions. In fact, it was very common to walk down a street and see several stores from the same chain only one or two blocks apart.

There were over 2000 pharmacies in Hungary, and roughly twice as many druggeries, ranging from large chains to small corner stores. Of these pharmacies, only 200 were located in Budapest. Since many Hungarians lived in rural settings, they were dependent on the smaller druggeries and pharmacies which were not owned by large chains. Industry insiders predicted there would be a rationalization of these businesses as competition intensified.

Regulation

The pharmacy industry was regulated by three levels of bureaucracy, the top level being the Ministry of Health headed by the Minister of Health who was an elected government representative and appointed to the position by the Prime Minister. The Health Minister was responsible for all matters concerning the health of Hungarian citizens.

Specific to the pharmacy industry, there was a board under the portfolio of the Ministry of

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1. *Act LIV of 1994* provides for certain rules related to the establishment and operation of pharmacies. The Act stipulates that a pharmacy is a **health care institution** which carries out health care service activities aimed at the supply of medicines.

Pharmacies may operate as public pharmacies, subsidiary pharmacies, institutional dispensaries, or medicine cases.

Public pharmacies provide for the direct and complete supply of medicine to the ill.

A **subsidiary pharmacy** operates as a part of the public pharmacy, however, its premises are not the same, and its principal responsibility is to supply medicine directly to the ill.

An **institutional dispensary** is an institution, established as part of a bed-patient medical institution, which provides a complete supply of medicine required for the operation of the latter.

A **medicine case** provides a specific range of medicines required for the remedial work of general practitioners.

According to the Act, public pharmacies may be established in settlements where the population numbers at least 5,000 or, in cities of a population exceeding 100,000, there is a distance of at least *250 metres*-in other settlements at least 300 metres-between the existing public pharmacy and the one to be established.

The address and operating area of new public pharmacies must be specified in the license issued for its establishment. The Minister of Public Welfare makes the decision on establishing public pharmacies after being informed of the Chamber. The Act regulates in detail the contents of the application for establishing public pharmacies and its appendices by pharmacy type.

The establishment of public pharmacies may be requested by pharmacists, subject to individual rights and entitled to manage pharmacies, or the representative body of the given settlement's local government.

It is only possible to operate public pharmacies subject to personal rights. Personal rights mean a personal right to operate a pharmacy, which is only permitted for pharmacists with suitable professional training. The legal rule prescribes at least five years of on-the-job training at a pharmacy. It is furthermore a requirement that the individual in question be authorized to manage the pharmacy (holder of a Hungarian or adopted pharmacist's degree trained, a member of a Chamber on the National pharmacists' registry, etc.) and agree to ANTSZ (the State Public Health and Medical Officer Service) assigning an official manager in cases specified by the legal rule.

Personal rights, as a main rule, may only be authorized on the basis of a national-scale tender and after the opinion of the Chamber is obtained. Within the pharmacy privatization process, the favored bidder in the process may receive personal rights without an invitation of the tender.

Except where provided otherwise by the Act, public pharmacies must be managed by the party entitled to personal rights.

A manager in charge must be appointed if the party entitled to personal rights is unable to discharge his personal management obligation. If the manager in charge must prospectively be employed for a duration not exceeding sixty days, this must simply be reported to ANTSZ, however, if a longer period is necessary, an ANTSZ license is required. If the party entitled to personal rights reaches pensionable age, it may enter a lease contract with the authorized pharmacist concerning the management on the public pharmacy, of course with the approval of ANTSZ and considering the Chamber's opinion.

Supervision of the pharmacies is a government task. Professional supervision is carried out by the Minister via ANTSZ. ANTSZ notifies the Chamber of any measures taken in the course of professional supervision. The Chamber is entitled to hold a professional inspection at the pharmacy if it is necessitated by any procedure carried out by a body of the Chamber.

ANTSZ may appoint an official manager in cases specified by the legal rule. The appointed official manager is obliged to report monthly to the party entitled to personal rights, or in his absence, to ANTSZ.

Exhibit 1 The Legal Aspects of the Operation of Pharmacies *(Continued)*

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2. Pharmacies may be operated in an individual enterprise or a limited partnership company.

A limited partnership company is an unincorporated association established by contract. Those members carry out common economic activities Company registration is a requirement of operation. At least two members are required for founding, one of whom is the acting member whose liability is unlimited. The acting members of a limited partnership company established for operating a pharmacy may only be pharmacists, with one of them being the pharmacist who has obtained personal rights. Individuals subject to personal rights may not be unlimited members of another limited partnership company established to operate a public pharmacy. The share ownership of the acting members within a limited partnership company must exceed 25 per cent.

The liability of non-acting members is limited to the proportion of their invested assets. Non-acting members are not entitled to manage the business.

Limited partnership companies may be established by a deed of association. The deed of association must be signed by all members. The following must be specified in the deed of association:

- the firm name and premises of the company,
- the names and addresses of the members,
- the activities of the company, and
- the amount of the company assets and the manner and time it is made available.

The deed of association must be countersigned by an attorney.

Non-acting members of limited partnership companies may only take part in the activities of the company if so authorized by the deed of association.

Non-acting members are not entitled to represent the company.

A limited partnership company is terminated if all acting members leave the company.

Exhibit 1 The Legal Aspects of the Operation of Pharmacies

Health called the Chamber of Pharmacists. This Chamber was *the* seat of influence in this industry because it was made up of actual pharmacists. The Chamber was given its authority by the Ministry. Members of the Chamber were appointed by the Association of Pharmacists which was comprised of elected pharmacists from around the country, on a basis of one member for every 20 pharmacists. Management at PharmaPlus was not sure exactly how a pharmacist became an appointee, because its power and the process of creating the Chamber came from two separate groups.

The Chamber held the real power within this industry because it could grant and revoke a pharmacist's license without which she or he could not practise. A pharmacist needed two things to operate a pharmacy, a license and a "right." A "right" was assigned to a certain geographic area, in which there could be a pharmacy. Aside from being a qualified pharmacist (i.e., having a license), a pharmacist needed the "right" to practise in any area. Like the licenses, these "rights" were granted and revoked by the Chamber.

Each of the nineteen counties or provinces of Hungary, and Budapest itself, had a Head Pharmacist who was appointed by the Chamber. The Head Pharmacist's role was that of a watchdog and regulator of the pharmacies in her/his area. She/he inspected the pharmacies to ensure they were following the laws, and reported any infractions to the Chamber. The Head Pharmacist also acted upon complaints of infractions against pharmacy laws.

Finally, there were the individual pharmacists. These people were responsible for the operation of their pharmacy, but had an even

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more important responsibility to their patients. Since this industry was health care-based, the relationship between the business and customer was more personal; hence the expectations of ethical operations were higher. Pharmacists were expected to adhere to a "Code of Ethics," which was external to the regulations of the Ministry of Health and Chamber of Pharmacists, yet run and enforced by the Chamber. This code extended beyond the dispensing of drugs into advertising, store appearance and the general operations of the business. Violations of the Code of Ethics could lead to a loss of the pharmacist's license.

By 1997, all the pharmacists "owned" their pharmacies thanks to the privatization effort of the Hungarian government. In actuality, however, the pharmacists usually had to find alternative sources of financing. Often the large wholesaling companies would provide loans to a pharmacist for her/him to "buy" the store and then would retain the pharmacist under salary allowing the pharmacist to "own" the minimum 25 per cent required by law. In most cases the financing arrangements required the pharmacists to assign their "right" to the wholesaler, giving the wholesalers the ability to install any pharmacist they chose within their assigned area. The arrangement was beneficial to the pharmacists because by becoming part of a chain, their costs were somewhat lowered, and the salaries they were paid were generous by Hungarian standards. But being part of a chain meant that they were subject to the wishes of the wholesaler who now controlled their "right." Thus by controlling the pharmacists' "right," the wholesalers had a strong influence over the pharmacists and to some extent could influence the Chamber.

There was a group of pharmacists, most of whom were in Budapest, who were fortunate enough to be in good locations and had been in business prior to the privatization of the market, and who were able to buy their stores and others outright. These pharmacists were very influential in the Chamber and very resistant to change since they had historically been successful. They were part of Hungary's newly rich. This group continued to do well after the privatization as a result of various factors: connections, location, customer loyalty etc.

Exhibit One shows some of the regulations pharmacies faced.

PharmaPlus

By November 1997, PharmaPlus was a group of 25 operating pharmacies (which were owned by PharmaPlus) and one "drugstore." "Drugstore" was the term PharmaPlus used to distinguish its proposed stores from the existing pharmacies or druggeries. To PharmaPlus, a "drugstore" was the combination of the two stores, which combined the best of each into a customer-focused retail chain similar to those found in Canada. The company had licenses for nine more pharmacists as well. The current location of the head office was in downtown Budapest in an office building owned by PharmaLand. (See Exhibit 2 for the PharmaLand information package). There were plans to move the offices to the brand new office building on the grounds of the Pharmafontana production facilities on the edge of the city.

In an empty corner of one of Pharmafonatana's warehouses, PharmaPlus built a complete, fully stocked prototype of the dream "drugstore" it called its "phantom" store. The purpose was to give visitors a realistic view of what the company eventually hoped to accomplish. The company took government officials, suppliers, pharmacists whose stores the company wished to buy, and even some competitors on the tour, usually to rave reviews. This phantom store was stocked with all the products and services PharmaPlus wished it could sell in the market, and was an important tool in the process of influencing those in power.

The one "drugstore" was located in a small town called Miskolc (pronounced Mish-coltz) 200 km north-east of Budapest. Miskolc had a population around 200 000 and was very economically depressed. Unemployment levels reached about 25 per cent, and the average monthly income was well below the national average. The store carried approximately 80 per cent of the

(Text continues on page 33)

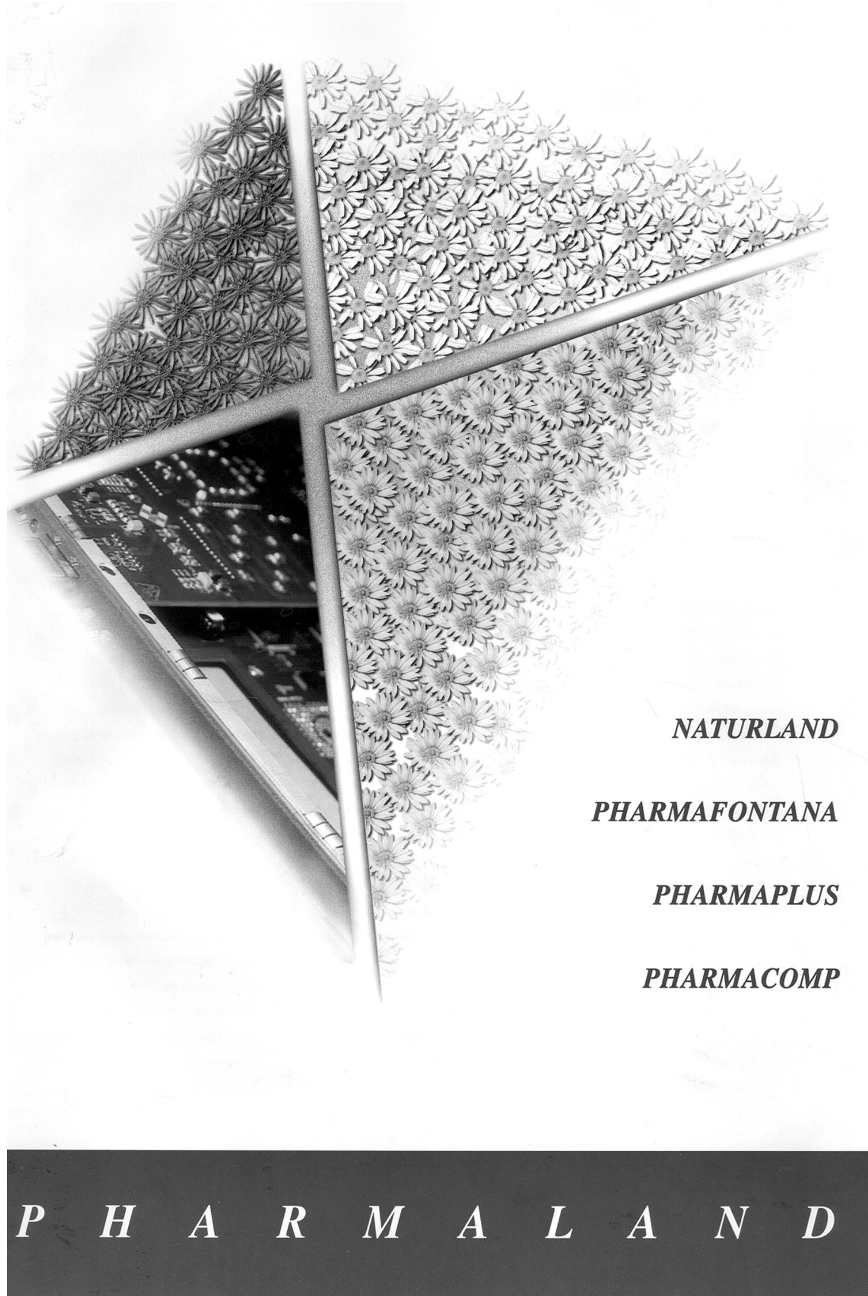

Exhibit 2 *(Continued)*

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PHARMALAND

PharmaLand Holding Co.

MISSION STATEMENT

IT IS OUR GOAL AT PHARMALAND TO ENSURE THAT ALL OF OUR VALUED BUSINESS PARTNERS ARE COMPLETELY SATISFIED WITH OUR DIVERSE RANGE OF SERVICES, THUS ENABALING THEM TO ACHIEVE SUCCESS IN ALL OF THEIR BUSINESS ENDEAVORS.

IT IS OUR AIM THAT THE USE OF OUR PRODUCTS WILL HELP OUR CUSTOMERS TO ENJOY HEALTHY AND HAPPY LIVES.

Emil Szántó *completed his secondary school studies in 1982 and then attended the University of Agriculture in Mosonmagyaróvár where he achieved an agricultural degree in 1988. After completing his undergraduate degree he obtained a foreign trade education at the Faculty of Foreign Trade of István Széchenyi School of Polytechnics in Győr. He is a co-founder of M-Land Ltd., the predecessor of Naturland Co.. Emil has been the President of Naturland Co. since its inception in 1993. At present, he is the also the President of PharmaLand Holding Co.*

After completing his secondary school studies in Győr in 1977, ***József Szabó*** *then obtained his degree in agricultural engineering in 1983 at the University of Agriculture in Mosonmagyaróvár. Following his studies at the university, he became a member of the College for Post Graduate Studies set up by the Committee for Qualification of the Hungarian Academy of Sciences. He also lectured at the Chair of Plant Cultivation of the University of Agriculture between 1986 and 1988. During this period he was published both locally and internationally. He is a co-founder of M-Land Ltd. the predecessor of Naturland Co. and its Managing Director. Currently, József is the Chief Executive Officer of PharmaLand Holding Co.*

In 1979, ***József Medgyesi*** *graduated from the Horticultural College in Kecskemét a division of the University of Gardinery and Food Industry in Budapest following completion of his secondary school studies. In 1980, he began cultivating medicinal herbs in the Mátraalja countryside where he set up an oil distillery and introduced the cultivation of plants containing volatile oils. He also took part in the cultivation, processing and commercialization of spices and naturally available medicinal herbs. From 1987, he was head of a branch of the MatraMed Economical Association for the Production of Paramedicines, eventually becoming the Director of the Association. After the acquisition of MatraMed Paramedicine Producing Ltd. by Naturland Co. in 1991, József became an executive of Naturland Co. and is presently the Deputy General Manager of PharmaLand Holding Co.*

Exhibit 2 *(Continued)*

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PharmaLand Holding Co.

The story of the Pharmaland Holding Co.

Social precedents

The economic and political system of Hungary has fundamentally changed over the past few years. The return of free elections in 1990 presented opportunities for a multi-party society and also for development of a market economy based on private companies.

The Naturland Share Holding Co.

In the first years of this change, hundreds of thousands of private enterprises were founded in Hungary. Some of these companies such Naturland Co. have shown outstanding progress. Naturland Co. was founded by its current owners in 1993, through restructuring their earlier companies.

The main profile of Naturland Co. was developing, manufacturing and distributing products of "natural origin". Within a relatively short period of time, the company reached outstanding professional and economic goals, resulting in rapid growth.

The Pharmafontana Share Holding Co.

By winning the privatization tender of Pharmafontana Co., the profile of Naturland Co. was dramatically changed. Pharmafontana Co. was the second largest state-owned wholesaler company for drugs in Hungary. Due to this new profile the structure of the company had to undergo a total reorganization.

The PharmaLand Share Holding Co.

PharmaLand Share Holding Co. was created to manage the diverse lines of business now controlled by this group. It has a capitalization of HUF 5.2 billion, employing over 750 people. During 1996, the firms encompassed by PharmaLand Holding Co. reached yearly sales of more than HUF 25 billion. The structure of the Holding Co. was formed by organizing each activity field into separate companies, thus ensuring a logical and clearly arranged organization for its work of word class standards.

PHARMALAND

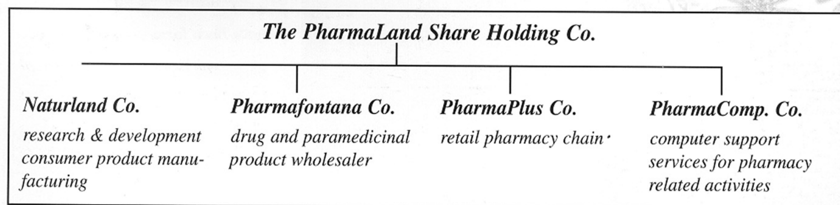

Exhibit 2 *(Continued)*

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Naturland Co. (Manufacture)

Naturland Co. was established in 1993 through restructuring of the owner's earlier companies. The main profile of Naturland Co. was the developing, manufacturing and marketing of "natural products". Of these products, the biggest success was "Swedish Bitter", which became one of the company's largest exported products.

The development and the financial and professional achievements of Naturland Co. called for international expansion, during which it participated in 6 international joint ventures.

1996 was a turning point in the life of the company. During the privatization process it acquired the Pharmafontana pharmaceutical manufacturing and wholesale company. The size of the company formed as a result prompted the creation of a new structure. Within the resulting PharmaLand Holdings, all production capacities, as well as the Research and Development are concentrated in Naturland Co.

The main activities of Naturland Co.

Manufacture of:

- *synthetic drugs*
- *natural and healthcare products*
- *cosmetics and food additives*

Research & Development of:

- *cosmeceuticals*
- *plant extracts*
- *analytical research*
- *medicine production technology*

The manufacturing process

The production takes place in a modern plant in an area of 2,500 square meters in the following Gaelic forms:

- *aqueous and alcoholic solutions*
- *extracts of medicinal herbs*
- *ointments, gels, emulsions*
- *powders, granulates, tablets*
- *tea blends of medicinal herbs*

Manufacturing agreements have been formed with numerous multi-national companies such as Procter & Gamble, Glaxo Wellcome, Ciba Geigy and Bayer AG.

Exhibit 2 *(Continued)*

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Naturland Co. (Manufacture)

NATURLAND®

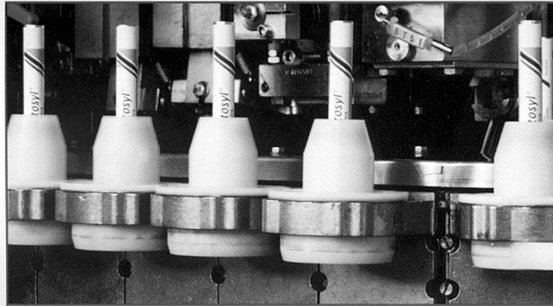
Quality assurance

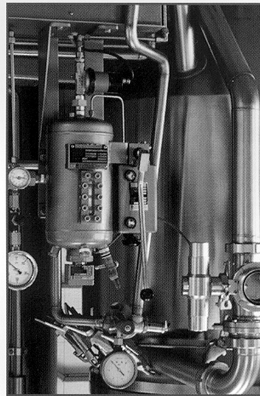
The quality and content uniformity are quided by the principles and regulations of the GMP and GLP. The in-process control, as well as the professional skill of the employees in all fields of the manufacturing process fulfill the expected standards of quality. The manufacturing process is controlled and documented by a state of the art computer system.

The Research and Development at Naturland Co.

At Naturland Co., a great emphasis is placed on Research and Development. During this activity, the results of the traditional healing are matched with the new scientific trends and methods.

The level of the R&D and the therapeutic safety of the products are provided by cooperation with "Semmelweis" Medical University, "Loránd Eötvös" University of Sciences and Naturland Co.





In meeting with the expectations of contemporary life styles, the strategic aims of Naturland Co. are focused on helping the prevention of disease, and the formation of a healthy way of life. Naturland Co. provides products in accordance with modern medicine and the expectations of society.

PRODUCTION	SALES
1995	550 M HUF
1996	660 M HUF
1997	expected 920 M HUF

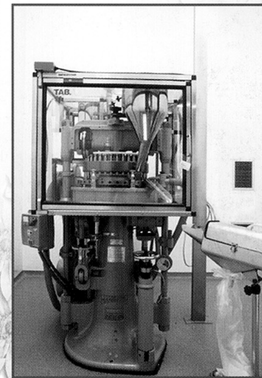


Exhibit 2 *(Continued)*

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PharmaPlus Co.

PharmaPlus stores represent a totally new concept in marketing for Hungarian Pharmacies. These stores are the first in Hungary to combine professional pharmacy services and a full selection drug store all under one roof.

The PharmaPlus chain of stores is very proudly 100% Hungarian owned and operated. We are also extremely proud to be the marketing leaders in this exciting new era of drug store retailing.

value and service

PharmaPlus endeavours to embody the North American concepts of good value, combined with fast, friendly customer service.

Fulfilling the customers' medication needs is always our top priority at PharmaPlus. We constantly strive to maintain the highest levels of professionalism in pharmacy while at the same time offering the customer a full selection of name brand health and beauty aid products at very competitive prices.

This innovative approach to pharmacy and drug store retailing will help us to realize the long term growth goals of PharmaPlus which is to have a retail presence in every major centre in Hungary.

Exhibit 2 *(Continued)*

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PharmaPlus Co.

PHARMA
PLUS

GOOD
VALUE AND
SELECTION

FRIENDLY SERVICE

HUNGARIAN
OWNED AND
OPERATED

Exhibit 2

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services and products the "phantom" store held, and was in fact pushing the envelope of legality with some products.

Borschke explained the rationale for opening their first store in this harsh environment:

> Miskolc just appealed to me in that it was a great centre of a lot of high-rise apartments on the main road in the city. There was a lot of pedestrian traffic by the store with a grocery store and doctors' offices right next door. It was poorer there, and we knew that going in, but if it worked there, it would surely work in Budapest.

The store was opened in July 1997 to a tremendous turnout due in part to a give-away promotion. PharmaPlus gave out "grab-bags" of health and beauty aids made up of free samples provided by suppliers. The give-aways were a part of the strategy devised for Miskolc. The whole concept of PharmaPlus was to provide fair prices with occasional advertised sales in a store that combined a pharmacy and a druggery, a friendly shopping environment based on service, and promotions. These elements were intended to differentiate PharmaPlus from the druggeries. Over 1000 people lined up outside for hours, and sales were brisk.

> I was driving from Budapest and every 15 minutes I would get a phone call: "It's close to a riot." "There are 300 people here." "Now there are 400." "They have been lined up since 4:00 in the morning." By the time we opened there were 1000 people there, and they just kept coming out of the woodwork. The doctors next door phoned the police. We had a riot.

In the weeks that followed the opening, PharmaPlus gave out 1000 cloth bags with the PharmaPlus name and logo on the outside. Borschke called these "walking billboards." Products which were seen as necessities, such as toilet paper, diapers etc., were targeted for price promotions and continued to attract crowds of customers. Other products were often bundled together such as cosmetics and a free cosmetic bag, or two of the same product for a lower price. Promotions like this were new to the customers and were meant to attract them from the local druggeries. After its opening sales continued to increase by over 10 per cent monthly, the store appeared to be a success.

The retail outlet was divided into two sales areas: pharmacy and front-shop. The front-shop area consisted of the higher margin, non-pharmaceutical products found in druggeries. It was planned that sales between the two areas would be roughly 50 - 50 as time went on. In the first months, sales were roughly 80 -20 per cent in favor of the pharmacy.

Borschke had nearly complete autonomy to operate the company as he saw fit. (See Exhibit 3 for the organizational structure of PharmaPlus). His management team was a young, entrepreneurial combination of Canadians and Hungarians. The owners were supportive of Borschke, but they were very busy. Since there was so much opportunity in the country at this time, they were constantly looking for new business investments that might or might not have been synergistic with current operations.

For example, since the production facilities of Pharmafontana were operating at 30 per cent of their capacity, the upper management was looking for ways to increase productivity. Emil Szanto travelled to the US to a private label drug manufacturers' convention to communicate the advantages of contracting with Pharmafontana to North American chains and distributors.

Borschke felt it was important to make the owners aware of what he felt was required monetarily and operationally. If the owner's goal was a chain of PharmaPlus stores, he felt an investment of at least FT 800 million ($4.3 million USD) in renovations, staff training, etc. was needed.

> We have turned down opportunities. We don't want to invest money if we can't do anything with it. The dream is to expand, but the money isn't there.

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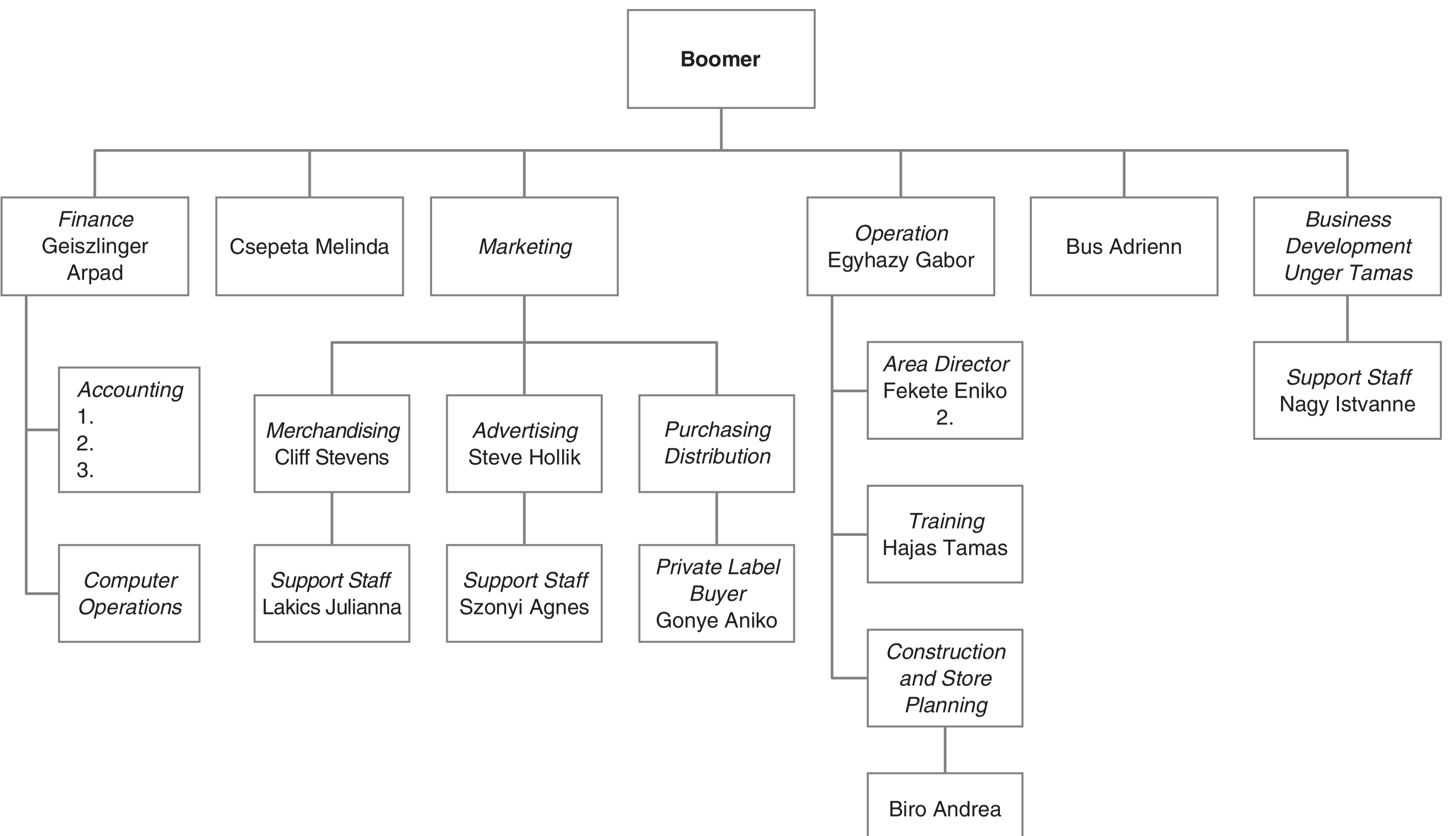

Exhibit 3 Organization Chart “Franchise Group”

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> In this organization, because it's a very large group, the pay-roll was one pay-roll. There were no cost centres, so finding out whether a location was making any money was impossible. I demanded to have monthly statements. I could demand all I wanted, but it never did anything because those kinds of control systems didn't exist.

Years of operating under communism led to inefficiencies which still permeated the company Boomer Borschke now ran. Internally and externally, there was a lack of control, and little information about the activities of the business.

Challenges

Laws

Borschke did not go into this venture naively; he expected some difficulty with the regulatory nature of a former communist country. However, he encountered strong resistance to change. It was a reflection of a society which had developed under a socialist mentality where there was no incentive to question or change the regulations.

> It wasn't a rude awakening. It was a slow awakening. Each day there was a new law which we didn't know before, and each law created more constraints and consumed more time.
>
> It's one of those things where people took a law and started to interpret it in their own way. That was the way the old system worked—there was no push to get anything done. There was no advantage to helping us. They could say, "You can't do that. There is a law against it." Then they wouldn't have to do it. The attitude was to not do anything because it was a lot easier than to try to do something for which there was no reward. I would say "Show me the law," and had many translated into English. Every time it turned out that the law allowed what we wanted to be done. It was the interpretation of the law that allowed them to not do something, which stopped the project.

There were times when the law was clear, but following it to the letter would be a detriment to business.

> We were developing our software in-house, but they had a law for using software as well. If you were using software, it had to be approved by the government. So the software was approved, but only for use on Hewlett Packard equipment. This equipment was prohibitively expensive. They wouldn't approve anything else. So we couldn't afford it. It would cost roughly two per cent of sales for the hardware and two per cent of sales for the software. That's sales! I'm sorry, I couldn't afford that. We couldn't throw that kind of money around.

This online accounting system would have allowed the operations manager to monitor inventory levels, sales, margins, etc. from his office in Budapest, rather than travelling to each store. This plan was shelved.

Traditions

While there were no direct competitors in the "drugstore" industry (since this industry did not exist), there were definitely strong substitutes to the new idea of a "drugstore." As noted, pharmacies were firmly entrenched in the social fabric of Hungary, and there was a strong resistance to change within the industry. Druggeries were a lot more abundant, well known and successful. PharmaPlus wanted to take high margin business from the druggeries by attracting the customers to their "one-stop-shopping" retail outlets.

Borschke spoke about the steps they planned to follow to create a change in the industry by trying to work with their competitors and the government.

> With the products listed today, it's difficult to have excitement in ads because you are going to have the same products featured all the time. The plan was to work with the Minister of Health and expand the number of products we carried. The next step was to get approval for a druggery and pharmacy together in one form or another. We had

> to get a license to run both of them together. What we have to do now is convince the pharmacists that are in the Chamber of Pharmacists that they need to change.

Borschke felt that it was a fundamental misunderstanding of what PharmaPlus was trying to accomplish for the whole industry, rather than just for themselves, which led to the resistance by other pharmacists. Pharmacies tended to be less profitable than druggeries due to the limitations on the products that could be offered. Margins on a pharmacy's products were slim, and the number of products they could sell exclusively was decreasing. Also, of the remaining products they could sell exclusively, thousands were being delisted from the group of drugs covered by the social security. Borschke's experience had shown him that this would mean a rapid drop in sales of these products. The pharmacists tried to lobby the Ministry to "re-list" more drugs to increase their sales. In fact, the majority of these products were "negative margin" drugs with high costs and low margins. Thus, by having more listed products which could only be sold in pharmacies, the pharmacies would have reduced profitability.

PharmaPlus wanted to change the laws to make the market more profitable for everyone and could not make its competitors see this, and in fact, the competitors fought to keep things the way they were.

> Their reasoning was this: if they sold more products in their stores, this would be seen as another way of making money, so the government would not give them more exclusive products to sell. That's short-term thinking if I've ever heard it before.

> Jozsef (Szabo, CEO of PharmaLand) was dealing with the Minister talking about the need for change, and the Minister was on our side. He agreed to allow us to sell more products in our "drugstore," giving us a wider selection so that we could earn money another way and still maintain a pharmacy. So he's on side. But you have these bureaucrats sitting here in between the Minister and us, and they're listening to the short-term thinking groups and calling for more products to be re-listed.

> Some of the pharmacists that are running the stores are coming to us saying "We like your plan," but there is a group in the Chamber that got in real early in the game, and they are driving Mercedes. They don't want change. They don't have to work. They've got the best locations and those things are pumping cash into their pocket. So they won't change. But this is only a short-term situation we and they are in. When the market changes, and it is changing, they won't be able to adjust and will be out of business.

The Miskolc store was proof to PharmaPlus that the concept of combining the druggery and pharmacy could be popular to the market. It also showed its competitors that PharmaPlus could be a threat to their comfortable way of life. Other pharmacists within the city were contacting the Chamber of Pharmacists in Budapest claiming that the PharmaPlus pharmacists were violating numerous codes, including the Code of Ethics.

> We were under total scrutiny. Everybody was watching. Last week the Minister gave us a license for our Dunahas store and the Chamber of Pharmacists and the Pharmacists Association took the Minister to court, not us, the Minister to court, for granting us a license. So it will be three months before we find out whether they have the right to challenge the Minister and a year for the court to make a decision.

> Since we fought them on other legal battles and won, they threw the Code of Ethics at us which is a tough one because if you go to court on the Code of Ethics, they are going to bring in the pharmacists that represent the Code, which are those people in the middle, who are not responsible to anybody. That's why we said earlier that our challenge was to get the pharmacists who were running the stores to realize what is going to happen by relisting products. We need them to go to the Chamber and say, "You're offside; we're going to replace you." We have 25 operating pharmacies from which we can most likely gather a good 10 strong pharmacists and then go out and get some of their friends.

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> My position since last October has been that you have to develop a base. You have to have a picture so people can see that a "drugstore" works. That's what Miskolc is. There is a certain group that don't want us to do it. We'll get the Minister of Health into the store and he'll say, "Yeah, there's no reason why you shouldn't be able to do that."

The Non-Service Mindset

The strategy for PharmaPlus' competitive advantage lay in offering products at a fair price with the opportunity for sales in a friendly, helpful atmosphere. Thus, it was crucial to the company's success that its employees embrace a mentality of strong customer focus. This concept was familiar to Borschke as a Canadian, but to a society which was reforming from communist rule, it was truly foreign.

> The service mentality does not exist here. The whole area of service has never been addressed here from my point of view. I think we can distinguish our stores from our competition by having a friendly place, easy, and quick.

Before Borschke was permanently hired as president, PharmaPlus had a Hungarian training its staff in customer service. The trainer was selected because of his experience in the West, but Borschke was not impressed with his efforts, and he was replaced. Borschke realized he first had to "train the trainer."

> That aspect, that training, we had to change the mentality so that they were servicing people and that the reason for our being is the customer. I went to one of our competitors on the opening day of our Miskolc store and they had 80 people in the store. We stood in line. We stood in line. We stood in line. They didn't care about us as customers. We were an interruption.

> Ensuring that our people don't operate like that is going to be one of the biggest challenges that we will deal with. We can meet all the prices on the market, but we want to be a neighbourhood "drugstore" that gives fast convenient service. That requires the right attitude from everyone, from the pharmacist to the cleaners.

The Present and Future of PharmaPlus

The law stated that a druggery could advertise as much as it liked, but a pharmacy could only advertise once a year. As a "drugstore," the only retail outlet of PharmaPlus did not fit either classification. PharmaPlus was said to be in violation of the Code of Ethics by trying to advertise; thus it was forced to stop, despite the fact that there was no law directly forbidding advertising. Borschke's goals were clear:

> I want to develop 20 North American-style "drugstores" in key locations and prove that they work. Then the idea would be to franchise.

> Once we get this operational, we'll go to the stock market; get the money to do the franchise; and, that is Joszef's dream, then we'll do Bulgaria, Romania, Slovakia, Slovenia, Croatia—all of the Eastern bloc. That's how we'll do it. I've been there to those countries and everything is the same. There is just a ton of potential.

> But, you know, that is what's frustrating. You know what you are doing is correct. You know that if you do it, it will work.

PharmaPlus could have advertised and lobbied the government further, but they risked losing the license of their only store and best source of revenue. They could also give in and ensure the safety of the license but risk the customer awareness they needed to be successful. Borschke and his management team needed to make some difficult decisions about the future strategy of the company.

Notes

1. PharmaPlus is of no affiliation to the Canadian Company Pharma Plus Drugmart Ltd.
2. Gabor Jelinek, "After Sell-off: New Bait Needed for Foreign Funds," Budapest Business Journal (November 17-23, 1997): 3-A.
3. Gabor Jelinek, "Privatization to Slash Debt Ft 100bln," Budapest Business Journal (November 17-23, 1997): 10.

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THUNDERBIRD
THE GARVIN SCHOOL OF INTERNATIONAL MANAGEMENT

SINGAPORE INTERNATIONAL AIRLINES: PREPARING FOR TURBULENCE AHEAD

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It was July in 2003. Mr. Chew Choon Seng, the CEO of Singapore International Airlines (SIA), put away the analyst reports that he had been poring over. Mr. Chew had just taken over the job of CEO from Mr. Cheong, who had retired after a long and spectacularly successful tenure at the helm of one the world's most admired airlines. Mr. Chew's initial tenure was, however, fraught with challenges.

Reeling from the fallout of the SARS (Severe Acute Respiratory Syndrome) outbreak in Singapore, Hong Kong, China, and neighboring regions which decimated passenger traffic, SIA had laid off over 400 employees in June to bring down its operating costs. An additional 156 cabin crew staff were laid off in late July. Senior management salary cuts averaging 22% had been announced, and negotiations were on with cabin and ground staff for further wage cuts. SARS, unfortunately, accompanied the outbreak of hostilities in Iraq, which itself dampened traffic through the prime Middle East markets. Faced with rising breakeven load factors,[1] the company appeared to have no choice but to trim its operating costs. However, these moves were viewed with widespread skepticism since SIA had the full backing of its majority shareholder, the Government of Singapore, a stance that the unions deemed unfriendly. Some believed that the company was using SARS and the Iraq war as convenient excuses to downsize. Analysts feared that these moves could have a negative impact on employee morale and, consequently, on passenger service, the hallmark of SIA's business strategy.

SIA had built its enviable track record around its superior strategy of differentiation. While this approach had worked for a long time, there were some chinks in the armor that were becoming evident. Competitors had been quick to copy many of the remarkable service innovations pioneered by SIA. The avenues for tangible differentiation that SIA had used in the past had become the norm. Every major air carrier now offered a choice of meals in economy class, innovative entertainment options in the cabins, and all the trappings of luxury that used to be the sole domain of SIA. Of particular concern was the increasing competition from international carriers headquartered in neighboring countries, such as Thai Airways, Cathay Pacific, Malaysian, and Qantas. These carriers had learned to duplicate some of the key features of SIA's competitive strategy, from recruitment to in-flight service and fleet management. This placed growing pressure on the firm to refine its differentiation strategy.

Low-cost carriers were beginning to make their presence felt in Asia for the first time. Some local firms such as Air Asia and Virgin Blue were ramping up to offer regional low-cost services

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along sectors that SIA had dominated for a long time. The Government of Singapore had recently authorized a new low-cost start-up to be based in Changi, the heart of SIA's empire. The government had also suggested that it might sell its 57% stake in SIA. This, some believed, would force SIA to compete on an even keel with other airlines. All along, they had felt that the unfair partnership between the government and SIA gave the company access to deep pockets—a charge that SIA had consistently denied.

The company had begun to spread its wings into major international markets a few years earlier with the acquisition of ownership interests in Air New Zealand and Virgin Atlantic. The Air New Zealand deal turned sour and SIA lost $157 million. Market watchers believed that the 49% ownership stake in Virgin that had cost SIA $1.6 billion in 1999 had already lost over 60% of its value. It was rumored that there were formidable obstacles in architecting a smooth partnership between the disparate, albeit service-oriented, cultures of Virgin and SIA.

Mr. Chew, it appeared, had his work cut out for him. He faced the challenging task of redefining the competitive strategy of SIA in turbulent times.

The International Airline Industry

The airline industry, traditionally, has been fragmented, primarily due to the limiting effects of national and international regulations. Constrained by landing rights and local ownership requirements, even large airline companies have only been able to develop dominance over their own regional markets at best. With the exception of the United States, dominant national flag carriers, typically owned by the national governments, have remained the only locally owned international carriers in their countries. However, the competitive dynamics in this industry started to change dramatically during the late 1990s. Deregulation, privatization, and the advent of new technologies started to reshape the industry on a global level.

The United States deregulated its airlines in 1978 and has since witnessed heightened competition and aggressive jockeying for market position. Europe entered the throes of a similar escalation of competition following the creation of the European Union and the disbanding of country-specific barriers to free-market competition among air carriers. In Asia, deregulation occurred in fits and starts, with some major regions allowing greater access to foreign carriers. For example, Japan made major strides in deregulation after selling off its shares in the then state-owned Japan Airlines, and permitted All Nippon Airways to serve international markets. In Latin America, many of the smaller national flag carriers were privatized. Countries such as Mexico and Argentina infused significant levels of market competition in their airline industries by removing anticompetitive barriers and privatizing their national airlines.

The trend seemed certain to gain further momentum. The major European nations were already in discussions with the United States to implement an open transatlantic market area where landing rights would be determined by free-market forces rather than regulatory policy. Open-skies agreements are bilateral agreements between countries that agree to provide landing and take-off facilities for air carriers originating in any of the partner countries. Such an agreement does not have the typical restrictions related to landing rights that are determined on a city-pair basis. For example, Singapore and the U.S. had signed an open-skies agreement under which a Singapore carrier could travel to any destination city in the U.S. and vice versa.

The twin trends of privatization and deregulation resulted in an increasingly global approach to strategic positioning in this industry. Although most large carriers still retained their regional dominance, many forged alliances with other leading carriers to offer seamless services across wider geographic areas. These alliances made most of the larger airline companies into de facto global organizations. With increasing geographic reach and decreasing regulatory barriers, many of the regions were witnessing acute competition, often in the form of fare wars. Consumers, in general, became much more price-sensitive than ever before. In attempting to keep up with

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the competition, many carriers upgraded their service offerings, contributing to declining yields in a price-conscious market. Chronic excess capacity worldwide only exacerbated this situation. Not surprisingly, there was a decline in passenger revenue yield in all geographic regions, and the airlines were fighting an uphill battle to extract higher levels of efficiencies from their operating structures.

The Rise of Alliances

By the late 1990s, alliances between air carriers in different parts of the world had become the norm rather than the exception. By 2004, most of the leading carriers around the world were part of mega-alliances which had evolved to include several carriers under a single alliance brand. The Star Alliance, for example, included ten carriers representing Asia-Pacific, North America, Latin America, and Europe. Oneworld, a similar network of partnerships, encompassed eight carriers spanning a similar geographical territory to Star. Alliances such as these were expected to redirect traffic, increase profitability, help leverage scale economies in operations, and differentiate services in the minds of consumers who wanted to buy travel services through a single carrier.

While they did seem like a wonderful strategic option even to established carriers, alliances brought their own set of thorny issues. There were invariably questions relating to level of service across carriers, safety records of the partners, and willingness to cede control to an alliance. The key issue seemed to be the difficulty in developing a consensus about how the partners would establish common safety, service, and performance standards. Further, in the European markets there was a potential for cross-shareholdings between carriers as privatization accelerated. It was feared that this could create a parallel network that might undercut alliances. Since individual airlines were typically allowed to negotiate side deals with other carriers on their own irrespective of their alliance membership, the likelihood of inter-network rivalry was also high.

SINGAPORE INTERNATIONAL AIRLINES

History and Culture of Singapore

Singapore witnessed bountiful growth and had become the envy of many neighboring countries by the late 1990s. Its per capita GNP increased by a phenomenal 32% in the 1990s, and currently stood at $37,401.[2] Much of the growth in modern Singapore could be traced back to the policies and priorities established by Mr. Lee Kuan Yew, the most powerful Prime Minister in the country's history. He was able to tap the patriotic spirit of his people when he announced his intent to develop Singapore to rival Switzerland in terms of standard of living. His emphasis on superior education standards, a controlled labor environment, and significant outlays for training and development all helped to enhance the quality of human capital. At the end of 2002, Singapore boasted a literacy rate of 93.7%, among the highest in the region. Singapore's Confucian work ethic dovetailed very well with Kuan's ambitions. It emphasized responsibilities over rights and placed enormous value on attributes such as hospitality, caring, and service. As a result of these efforts, Singapore in 2004 ranked among the best countries in terms of human capital and was often rated among the world's friendliest places to do business. Rising standards of living meant higher wages. Coupled with the small size of the local population and a very low unemployment rate, the availability of labor was seen as a potential stumbling block in the drive toward further growth. Many of the larger companies already depended on a sizable number of expatriates from neighboring countries, as well as the West, to staff positions.

A staunch believer in free trade and internally driven growth, Mr. Lee made it clear from the start that the "world does not owe Singapore a living." For example, in the air transportation sector, Mr. Yew's government declared that SIA, although the national carrier, would not receive any subsidies or protection from the government. It would have to sink or swim based on its own

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	Cathay Pacific				Malaysia Airlines				QANTAS				Singapore				Thai			
	2000	2001	2002	2003E	2000	2001	2002	2003E	2000	2001	2002	2003E	2000	2001	2002	2003E	2000	2001	2002	2003E
Capacity																				
Fleet Strength (Ns.)	64	75	79	80	93	97	100	100	147	178	193	196	92	93	92	96	79	81	81	81
Available ATK	11630	11827	12820	13576	7531	8055	7824	7978	11117	12187	12317	12506	16917	18034	18305	19774	7752	8490	8752	9022
Passenger ASK	61909	62790	63050	57249	48906	51238	52595	54266	85033	92943	95944	99509	87728	92648	94559	99566	55517	60459	63198	66061
Actual Traffic																				
Overall RTK	8650	8201	9522	8284.14	4853	5379	5150	5497	1718	1859	1598	1530	12038	12985	12735	14060	5469	5818	6027	6244
Passenger RPK	47153	44792	49041	35309.52	34930	38313	34709	37653	64149	70540	75134	77225	65718	71118	69995	74183	41347	45167	46571	50874
Load Factors																				
Overall (OLF)	75%	70%	76%	64%	65%	67%	66%	69%					71%	72%	70%	71%	71%	69%	69%	70%
Passenger (PLF)	76%	71%	78%	64%	71%	75%	66%	69%	75%	76%	78%	78%	75%	77%	74%	75%	75%	75%	74%	75%
Break-even Load	63%	70%	65%	71%									66%	67%	71%	71%	65%	66%	67%	66%
Yield																				
Overall (¢/RTK)	44.8	42.5	42.2	39.8									66.0	68.0	64.9	64.5	19.4	21.0	20.4	20.3
Passenger (¢/RPK)	6.1	5.8	5.7	5.4					10.9	11.3	11.3	11.2	9.1	9.4	9.0	9.1	2.1	2.2	2.2	2.2
Cargo (¢/FTK)	24.8	22.2	21.6	20.3									33.7	34.2	32.2	34.2	11.6	12.1	11.3	11.7
Operating Costs																				
Staff (¢/ATK)	7.6	7.7	9.5	9.9	4.7	5.2	6.0	6.4	12.9	14.3	10.0	11.2	4.6	5.2	5.5	6.5	6.0	6.0	6.0	6.5
Fuel ($/ATK)	6.5	6.0	5.5	6.0	3.5	5.2	6.0	6.1	4.9	7.5	7.0	6.9	4.6	6.7	5.5	6.6	5.5	5.5	5.5	6.0
Maintenance (¢/ATK)	2.8	3.1	3.2	2.6	11.6	11.6	13.0	13.6	17.9	20.9	22.0	23.1	3.1	2.4	4.1	4.6	2.7	2	2.3	2.3
Tot.Oper.Costs/ATK	28.7	29.2	28.2	26.6									43.7	45.4	44.9	45.5	45.2	32.1	32.6	36.6
Financials																				
Sales (local curr. - m)	34523	30,436	33090	28219	8288.3	9261	8695	8894	9107	10188	10868	11375	8899	9951	9448	10515	123352	129173	129015	127180
Oper. Income	5289	832	4750	−2850.119	−255.7	−1330	−836	339.1	874	696	680	567	1140	1347	482.3	717	14932	12227	18688	15282
Oper. Margin %	15.32%	2.73%	14.35%	−10.10%	−3.09%	−14.36%	−9.61%	3.81%	9.60%	6.83%	6.26%	4.98%	12.81%	13.54%	5.10%	6.82%	12.11%	9.47%	14.49%	12.02%

	British Airways				Lufthansa				KLM				AIR FRANCE				SWISS		
	2000	2001	2002	2003E	2000	2001	2002	2003E	2000	2001	2002	2003E	2000	2001	2002	2003E	2000	2001	2002
Indicator																			
Available ATK (bn)	25.84	25.58	22.85	21.33	23.56	23.94	22.76	22.57	13.12	13.18	12.69	12.95					0.91	0.85	5.15
Passenger ASK (bn)	168.36	166.68	151.05	139.17	122	128	120	120	76.05	75.22	72.29	74.82	102.30	110.28	116.46	119.60	6.5	6.25	31.52
Passenger Load Factor	69.8%	71.2%	70.4%	71.9%	71.3%	71.0%	74.0%	72.0%	77.0%	80.0%	79.0%	79.4%	76.0%	78.0%	76.0%	76.0%	71.8%	52.8%	71.0%
1Yield (¢/RTK)	47.01	49.21	51.28	49.33	1.39	1.31	1.40	1.26	47.1	51.7	51.4	51.5					0.22	0.16	0.22
Operating Costs																			
Staff	2481	2491	2409	2107	3625	4481	4660	4588	3693	1675	1747	1907	20295	3436	3738	3856	1107	313	983
Fuel	804	984	1028	842	2437	1621	1300	1316	1431	1038	983	886	6668	1625	1443	1369	355	174	551
Maintenance	661	640	673	592					1533	757	686	697	2925	598	652	477	541	17	117
Tot. Operating Costs	8856	9227	8450	7393	15404	18505	17500	17800	6201	6683	6626	6618	38642	10900	11204	10687	5905	1684	5304

Exhibit 1 Key Financial and Operating Statistics for Global Air Passenger Carriers *(Continued)*

Financials																			
Sales (local curr. - m)	8092	8556	8340	7688	16886	16690	16971	15144	13875	6960	6532	6485	67729	12280	12528	12687	6414	1282	4278
Opr. Income (m)	922	1087	–110	295	1482	–316	1592	–238	209	277	–94	–133	2355	443	235	192	108	–909	–299
Opr. Margin %	11.4%	12.7%	–1.3%	3.8%	8.8%	–1.9%	9.4%	–1.6%	1.5%	4.0%	–1.4%	–2.1%	3.5%	3.6%	1.9%	1.5%	1.7%	–70.9%	–7.0%
	USA																		
	United			*American*			*Delta*			*Northwest*			*US Airways*						
	2000	*2001*	*2002*	*2000*	*2001*	*2002*	*2000*	*2001*	*2002*	*2000*	*2001*	*2002*	*2000*	*2001*	*2002*				
Indicator																			
Capacity																			
Passenger ASM (bn)	175.49	164.85	148.83	161.03	174.69	172.2	154.97	147.84	141.72	103.36	98.36	93.42	66.57	66.74	56.36				
Actual Traffic																			
Passenger RSM (bn)	126.93	116.64	109.46	116.59	120.61	121.75	113	101.72	102.03	79.13	73.13	72.03	46.89	45.98	40.04				
Passenger Load Factor	72.30%	70.80%	73.50%	72.40%	69.40%	70.70%	72.90%	68.80%	72.00%	76.60%	74.30%	77.10%	70.40%	68.90%	71.0%				
Passenger Yield (¢/RPM)	13.25	11.7	10.8	14.06	13.08	11.86	13.86	12.74	12.08	12.04	11.24	10.76	16.13	14.32	13.05				
Operating Costs (m)																			
Staff	6730	7080	7029	6783	8032	8392	5971	6124	6165	3610	3963	3878	3637	3726	3255				
Fuel	2511	2476	1921	2495	2888	2562	1969	1817	1683	1872	1727	1439	1284	1103	782				
Maintenance	698	701	560	1095	1165	1108	723	801	711	640	669	576	504	532	405				
Tot. Operating Costs	18698	19909	17123	18322	21433	20629	15104	14996	14614	10846	10773	10335	9322	9971	8294				
Financials																			
Sales (local curr. - m)	19352	16138	14286	19703	18963	17299	16741	13879	13305	11415	9905	9489	9269	8288	6977				
Opr. Income (m)	654	–3771	–2837	1381	–2470	–3330	1637	–1602	–1309	569	–868	–846	–53	–1683	–1317				
Opr. Margin %	3.4%	–23.4%	–19.9%	7.0%	–13.0%	–19.2%	9.8%	–11.5%	–9.8%	5.0%	–8.8%	-8.9%	–0.6%	–20.3%	–18.9%				

Exhibit 1 Key Financial and Operating Statistics for Global Air Passenger Carriers

Source: Annual Reports, S.G. Securities Research, ABN Amro.

Definition of terms in Appendix.

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resources and ingenuity. Singapore literally adopted a free-skies approach whereby foreign flag carriers from other countries were welcome to serve the city-state without any restrictions. This meant heightened competition for SIA right from the start. However, the free-market philosophy also resulted in sharper rates of market growth. For example, roughly 35% of the equity base of Singapore was foreign in origin, and foreign investors owned 17% of all companies in the country, both testaments to the successful programs that attracted foreign capital and commerce to the island nation.

Tourism played a very significant role in the overall development of the country. Handicapped by small size and the lack of natural resources, Singapore had to rely on service industries such as tourism and finance to generate growth. It had always enjoyed an enviable status as an important geographic hub dating back to the pre-British colonization era. During its history as a British colony, Singapore provided an important stop-off point for travelers from Europe and Britain to the outlying colonies of Australia and New Zealand. Building on this historical reputation, Singapore evolved into an important Asian tourist hub.

Singapore International Airlines: The Company

SIA traced its roots to an organization called Malayan Airways that offered its first commercial passenger service in May 1947. The modern incarnation of SIA was born in 1972 when the Malaysia Singapore Airlines was officially split into two new airline companies, SIA and Malaysian Airlines System (later called Malaysia Airways). The long association with the Malaysian counterpart had proved to be quite beneficial to the fledgling company. The crews gained significant flight experience operating over rough geographical terrain in Southeast Asia. Their safety records were impeccable. This association also provided SIA personnel with crucial operating experience ranging from flight operations to matters of administrative importance. As part of the split, SIA got half the combined assets, most of the overseas offices, its headquarters building in Singapore, and a fairly new computer reservation system. By early 2003, SIA reached over 90 destinations in more than 40 countries in Asia, Europe, North America, the Middle East, the Southwest Pacific, and Africa. Its subsidiary, Silk Air, served feeder routes and reached 24 destinations in the South/Southeast Asian region. It was promoted as the choice for vacation travelers looking to travel short distances between various points of tourist interest in the region, such as Penang, Siam Reap, and Yangon.

SIA had established an enviable record both in terms of its operational performance and its profitability history. It was one of the few Asian airlines that had continuously posted profits even during lean years such as the 1990s economic downturn in Asia. Its short-term performance record had, however, begun to flag as a result of SARS, the war in Iraq, and the general economic malaise that had taken hold of most of its critical markets. It was against this backdrop that the company had to debate alternative courses of action.

On the Ground

SIA's legendary commitment to superior service began on the ground. It built a network of wholly owned subsidiaries and joint ventures to provide operational support in areas such as catering, terminal management, and aircraft maintenance. These subsidiaries were largely managed as autonomous entities that had to bid for orders from the parent and were rated number one in many of their core areas. The Singapore Airlines Terminal Services (SATS) subsidiary was one of the largest in the group. It offered a variety of terminal management services including catering, passenger and baggage handling, and ramp operations. SATS operated one of the largest flight kitchens in the world at Changi International Airport, producing an average of 45,000 meals a day. It had an impressive client list that included British Airways, Quantas, Lufthansa, and Japan Airlines and served more than 70% of all airlines

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flying into Singapore. SATS had also gone global through joint ventures in Beijing, Hong Kong, Ho Chi Minh City, Macau, Chennai, Male, Manila, Osaka and Taipei.

The Changi International Airport was indeed a crown jewel for SIA. Given its status as a national flag carrier, SIA occupied a pride of place at Changi, an airport that it also managed. The airport itself was rated among the best in the world by several global organizations. It often got top honors for its people-handling efficiency and cleanliness. For example, SIA made a promise to deliver a passenger's baggage within ten minutes after arrival in Changi and consistently delivered on that promise. Such a high standard would have been difficult but for the excellence of its subsidiary network, especially SATS. Changi was also the headquarters of SIA Engineering Company, a subsidiary that provided aircraft maintenance and engine overhaul services. As a testament to its engineering prowess, many global carriers engaged SIA Engineering to service their fleets. SIA Engineering also had a global presence through joint ventures with reputable companies such as Rolls-Royce and Pratt & Whitney.

The obsessive attention to detail began the moment the passenger decided to travel on SIA. The company was at the forefront of introducing electronic ticketing through its Web site. Online ticketing was being rolled out across all destinations in its network. To make it easy on the passengers, the company introduced automated check-in systems on certain flights that tended to attract a large number of travelers. It embraced technology in a variety of forms, allowing check-in via e-mail, telephone, and fax. The Silver Kris Lounge that SIA offered its first-class and raffles-class (business-class) passengers could be best described as "an oasis of peace and quiet"[3] amidst the hustle and bustle of the airport. It featured an environment with plush armchairs, deep-pile carpeting, aquariums, tropical gardens, and a décor that included original paintings by Singapore artists. Top-of-the-line-business equipment such as computers, fax services, and a stock ticker were standard amenities. It was one of the largest and most luxurious airport lounges in the world.

Fleet Acquisition and Management

Singapore Airlines came a very long way from its origins as a company that had a fleet of just ten aircraft serving a network of 22 cities. By 2003, it operated a fleet of 97 aircraft, almost all of them capable of long-haul, large-capacity flights. It had 28 more on order and was in line to be among the first companies to buy the 500-plus passenger, double-decker megaliner that Airbus would unveil shortly. It had planned its fleet acquisitions judiciously such that its fleet average was a little over five years old.[4] It was the world's largest operator of the Boeing 747-400 Megatops, a roomy aircraft capable of long-distance flights. Among the largest air carriers in the world, Delta Airlines came closest to SIA in terms of fleet age, with an average of roughly eight years. Most of the other carriers had large segments of their fleets in the 14+ years range.[5] Maintaining youth in its flight operations was no small achievement. It was a facet of competition that SIA took very seriously. It maintained an office in Seattle, Washington just to interface with Boeing designers and oversee the development of new additions to the SIA fleet. Newer aircraft were typically more fuel efficient and less maintenance intensive than older generations. SIA used a mix of leasing and outright purchase, primarily during economic lulls, to feed its appetite for new fleets, thus extracting maximum value for its investment.

SIA emphasized fleet selection because of strong signaling value. Newness implicitly signaled the potential customer that s/he could expect top-of-the-line technology, comfortable seating, and a safe trip, all of which were critical aspects around which differentiation could be built. SIA designed aircraft interiors that encompassed the latest amenities. For example, it was among the first to offer a personal video screen in every seat, even in its economy class. Its in-flight entertainment system, KrisWorld, delivered 22 video channels, 12 audio stereo

channels, and ten Nintendo game channels at every seat, with a Dolby surround-sound system that was specially designed for SIA. Its first-class cabins became the gold standard in the industry. They were outfitted with armchair-type seats that converted into comfortable beds at the push of a button. Clad in Connolly leather (the company that supplies leather products to Rolls Royce, Ferrari, and Jaguar) and trimmed in burl wood, the seats included built-in communication devices and an inflatable air mattress. The cabin crew provided a turn-down service where the bed linen was replaced on long trips. The famous French fashion house, Givenchy, designed all the serviceware. SIA tried to convey this air of exclusivity in its other cabins as well. Even in coach class, the seats were wider than average, with spacious leg room, leg rests, video screens, and ergonomic headrests. As part of its drive to be a top-notch air carrier, SIA gathered several firsts along the way. In 1991, it was the first transcontinental carrier to introduce in-flight telephones using advanced communications technology. It was the first with the Dolby surround-sound and personal video screens in coach. It was the first to offer fax services in the air. The list goes on. Plans were under way to upgrade the communications package to allow Internet access while in the air. It premiered an on-demand entertainment system called WISEMEN in its first-class and raffles-class cabins as early as 1990. This system was designed to function just like a personal home theater, featuring a range of movies and entertainment options that each passenger could individually choose and control.

The Softer Side of SIA

The company firmly believed that its employees were the primary drivers of the success that it enjoyed in the marketplace. Through a deft mixture of organizational culture, indoctrination, and ritual, SIA was able to meld the human assets into a formidable source of competitive advantage. A large number of its employees came from Singapore and Malaysia. As of 2003, it employed 14,000 people worldwide, and was the largest private sector employer in the country. The company established an extensive SIA Training Center in Singapore that served as the focal point for training programs targeted at cabin crew, commercial staff, flight crew, and flight operations personnel.

SIA executed a finely tuned recruitment and training strategy to keep its ranks stocked with exceptional talent. Most of the employees arrived at the company either through a cadetship (similar to an internship) program that attracted generalists, or a specialist program geared to functional experts in areas such as computer services and finance. The cadetship was an intensive on-the-job training program that cycled employees through a variety of functions as they moved up the hierarchy. SIA's commitment to employee training and development was reflected in the fact that it spent roughly 14 times as much per employee as the average Singaporean company. The company instituted a system of proven controls and mentoring guidelines that helped the employees develop their potential to contribute to the success of the organization. Over time, this built an enormous sense of camaraderie among the team, a very strong sense of identity and belonging, where the employees truly took pride in their organization. Although the employees had been quite accommodating in negotiating wage cuts during periods of economic crises, the cuts in 2002–2003 left a bad taste. The normally friendly unions had publicly expressed concern over the layoffs and salary reductions that followed in the wake of SARS and the Iraq war. Many among the rank and file viewed these actions as self-serving and suspect since the company had achieved close to normal passenger loads after the specter of SARS had faded. This distrust was indeed disturbing and seemed to spread across all ranks of employees from pilots to ground crew. It was the first time in recent memory that the company had to lay off employees in significant numbers.

The pool of talent with respect to pilots was indeed global. SIA had pilots from over fifty countries flying its fleet. Many of these pilots

were expatriates drawn by the allure of flying the latest equipment under professional working conditions at very generous levels of compensation. The company operated its own flying college with facilities in Jandakot, Australia, that focused on improving training efficiency and producing qualified pilots. The college served as an incubator for developing Singaporean pilots to meet SIA's growing demands. The company had a state-of-the-art flight training facility in Singapore which housed eight flight simulators where pilots were trained. All flight personnel were required to go through mandatory biennial proficiency checks. It was generally believed that the training programs, in this regard, were quite well administered, as reflected in the very high levels of safety that the company was able to achieve. It was the long-term intent to induct more Singapore nationals into the cockpit, a daunting proposition, especially since the number of local pilots available was quite low. This was augmented by graduates of the Singapore Armed Forces (SAF) which trained pilots for defense purposes. After completion of the mandatory employment with SAF, some of the trained personnel took jobs with SIA. Roughly half of SIA's pilots were expatriates. Normally, the expatriates were more expensive since the company had to bear a variety of expenses such as housing, schooling for children, travel, etc., in addition to base pay.

The complement of cabin crew was chosen through a very rigorous selection process. SIA considered them to be the brand ambassadors who should reflect the high standards of service excellence that its passengers expected. Although they were drawn from many ethnicities within the South/Southeast Asian region (mainly Malaysia, India, Japan, Korea, Taiwan, and Indonesia), they were mostly Singaporean. This recruitment strategy posed a stumbling block since the pool of available talent within Singapore was insufficient to draw from for long. Given the fact that SIA had some of the lowest labor costs among leading carriers, this home-based cost advantage had proven to be a critical ingredient in the success of the company. Any fall-off in the availability of local talent could adversely impact operating costs, especially if it necessitated the increased recruitment of expatriate personnel. Such a move would also raise questions about how globalizing its workforce would fit in with its historic branding approach, "The Singapore Girl." When SIA was formed, it had to compete against other airlines that had much more sophisticated fleets and passenger options. In combating this handicap and to distinguish itself in the marketplace, SIA launched the Singapore Girl as the embodiment of caring, comfortable, hospitable service. It also played well to the Oriental mystique that was then prevalent in the Western world where the company sought to establish a footing.

The image of the Singapore Girl was carefully nurtured. It began with a rigorous selection process and extensive training soon thereafter. The training program emphasized aspects such as passenger handling, social etiquette, and grooming. While no different on the surface from other competitors, the SIA program was far more intense and demanding. For starters, it lasted much longer than competitors' training programs and embraced some nontraditional aspects. For example, many of its cabin crew spent extensive periods of their training program in homes for the aged to gain a better appreciation of the special needs of this fast-growing passenger segment. The company's approach to molding attitudes and service-oriented behaviors transcended mere internalization of a set of physical practices and dos and don'ts by the cabin crew. The arduous training process was to be repeated periodically through preplanned refresher courses so that the crew could get acquainted with new cabin management technologies and service standards. Once in the fold of the organization, there was a marked effort on the part of management and staff to help each employee perform at his/her best potential. Various practices, such as detailed performance reviews and feedback at all levels, career counseling, and performance-based reward systems, were designed toward this end.

SIA was able to take advantage of local labor laws and practices in staffing cabin positions.

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About 60% of the cabin staff was female, and it was expected that most of them would only fly for five to ten years. While male cabin crew members were employed as regular employees, female crew had to work through a system of five-year renewable contracts. Only five such contract renewals were permitted.[6]

SIA's in-cabin service became legendary; the standard that other airlines aspired to reach. In a recent survey by *Condé Nast Traveler*, a well-respected travel magazine, SIA was ranked overall as the "Best International Airline." This was the tenth time that SIA was chosen for the prestigious honor in the eleven years that the award had been given. The respondents rated SIA's cabin service as the best in the world, a testament to the company's emphasis on excellence in this arena. Such awards were nothing new for SIA, which had garnered over a hundred from august organizations such as Zagat, Condé Nast, OAG Worldwide, ASEAN (Association of South East Asian Nations) Tourism Association, and magazines such as *Asia Money* and *Business Traveller*.

Competing in the New Millennium

By the late 1990s, competition in the airline business had become decidedly global, although very few carriers could legitimately claim to be global carriers. Carriers in the Asia-Pacific region had taken a page from the SIA playbook in offering premium services at consistently low fares. Those in Europe and North America had strengthened their positions through alliances. SIA had already taken some important steps to fortify its position globally. It had joined the Star Alliance, a powerful network of carriers that included Lufthansa, United, Ansett, Air New Zealand, All Nippon Airways, South Africa Airways, Air Canada, Thai, Varig, and SAS. It was believed that this would allow the members to offer code-sharing services, fine-tune traffic flows to increase revenues and efficiency, and combine their buying power to negotiate favorable terms for securing inputs such as food and allied services. Translated from an SIA perspective, this opened several destinations that SIA did not yet serve. It could take advantage of code sharing to carry a greater number of passengers to destinations within Europe and the United States. For example, it served only four major cities in the U.S., Los Angeles, San Francisco, Las Vegas, and New York. Hence, the relationship with United could extend that limited set of destinations to encompass a considerably larger number of primary and secondary cities. A similar argument could be made with respect to leveraging the new relationship with Varig to fly to more destinations in South America, a region that was not well represented in SIA's route structure. However, despite the obvious advantages, the alliance network did bring with it some concerns.

It remained to be seen whether the other network carriers would be able to rise to the levels of SIA's hallmark service standards. Should there be shortfalls, it was quite likely that the brand image that SIA had so carefully nourished could be tarnished, especially among its loyal first-class and business-class passengers. Joining a network amounted to delegating some aspects of brand management to the collective group of companies such that the identity of the network would transcend the individual identities of the members. The loss of control over some key decisions, such as scheduling and flight frequency, could also pose challenges in the future. It also raised critical questions about the imitability of core competences. Would the partner firms be able to learn more about the critical aspects of SIA's recipe for sustainable competitive advantage?

Equity Partnerships

In balancing growth potential against the ability to control the alliance, SIA acquired an 8.3% equity stake in Air New Zealand to cement a long partnership with the New Zealand carrier. Since Air New Zealand already owned 50% of Ansett Airways, SIA would have the benefit of the additional alliance with Ansett as well. It was

expected that these moves would strengthen SIA's position in the Australasian market that was growing significantly. However, this grand design crumbled when Air New Zealand's fortunes started turning sour. The government of New Zealand injected capital to shore up the company, but this had the negative effect of diluting SIA's ownership position. In very short order, SIA was left with a sizable loss and had to beat a hasty retreat from this initial foray to establish control of the key Australia-Asia routes.

In late 1999, the company had made a bold move to acquire 49% of the equity of U.K.-based Virgin Atlantic Airways for $1.6 billion. This was considered a fairly steep price to pay for a deal that offered little operating control in the near term for SIA. However, the company felt that the partnership would cement SIA's ability to leverage Virgin's transatlantic routes, among the most lucrative worldwide. Virgin was also well-known for its exacting service standards, and consistently turned up in the number two spot behind SIA in most surveys of customer satisfaction. The partnership, however, did come with its own baggage. Virgin had clearly stated that it would not consider joining the Star Alliance, thus placing SIA in a delicate position. This meant that SIA would invoke the ire of other alliance partners should it favor Virgin over United and others for channeling some of its transatlantic passengers.

Sir Richard Branson, the founder and CEO of Virgin, had imbued his company with an aggressive style of management. The company was a trendsetter and known for breaking traditional barriers in its march toward recognition. Mr. Branson himself was a bit of a publicity seeker and seemed to revel in periodically taking controversial public positions. For example, when British Airways decided to retire its fleet of the supersonic Concorde jetliners, Mr. Branson offered to pay £1 in exchange for the fleet, believing it was a fair price for BA, which had been virtually given the fleet for free by the British government. Some believed that the swashbuckling management style of Virgin contrasted sharply with the button-down conservative style of SIA. Soon after the partial purchase of Virgin was completed, Branson announced plans to move into the Australasia market with low-cost services through a new company named Virgin Blue. He offered SIA the opportunity to participate in the venture, but SIA passed on the deal since it felt that it had already established significant market presence with its partial ownership of Air New Zealand. This proved to be a costly decision. When the Air New Zealand deal failed to bear fruit for SIA, the company was left with no viable alternative to capitalize on growth in the region. It was rather ironic to see that Virgin Blue was posting very good returns in that region.

As the company was itself reeling from the misfortunes of the post-9/11 era, its alliance partner, Virgin, was going through a similar trough that required fresh injection of capital. The partners had to plough in more funds at a particularly difficult time. It remained to be seen how well the partnership would be able to weather the sequential shocks that plagued global aviation.

Low-Cost Carriers in Asia

Unlike U.S. and Europe, Asia had been slow in responding to the phenomenon of low-cost carriers. Propelled by the success of companies such as easyJet and Ryanair in Europe and Southwest and Jet Blue in the U.S., many new competitors were setting their sights on the Asian market. Historically, the Asian market seemed immune to the low-cost approach, given the traditional barriers to entry such as the longer flight distances, fewer alternative airport options, and lower passenger densities. However, in recent times many of these barriers had begun to fall, and some legitimate low-cost carriers were jockeying for position. There were at least six main contenders in the market as of early 2003, and an additional player was gearing up for entry using Singapore as a base. Based on the experience of large network carriers in Europe after the advent of easyJet and Ryanair, the large players in Asia, such as SIA, were bound to face incredible pricing pressures. Many of the new players were

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focusing on South Pacific and East Asian routes, prime SIA territory.

Air Asia and Virgin Blue were credible threats. Air Asia was based in Malaysia and offered services at highly discounted rates to domestic destinations within the country. Its operations model used Kuala Lumpur as its central hub, but plans were on the anvil for expanding into Johor, a location that was within driving distance from Singapore. Although it had a very small fleet of only seven Boeing 737s, it planned to carry close to two million passengers by 2004. Its attractive fares would certainly drive traffic its way. For example, it was offering a round-trip ticket from Kuala Lumpur to the resort island of Penang for US$10, while its closest competitor, Malaysia Air, charged US$101 for the same trip. Network carriers were suddenly at a disadvantage. Air Asia also boasted that it had the lowest cost base of any passenger airline in the world at US2.5¢ per available seat kilometer compared to US5.1¢ for SIA. Air Asia was set to bring the competition to SIA in the near future. It had recently scouted Changi International and Seletar Airport in Singapore to explore the possibility of setting up operations there. The company suggested that it would offer a one-way fare of US$28 from Changi to Kuala Lumpur, a sector where SIA was currently charging US$109.

A group of investors in Singapore had marshaled a substantial amount of money to mount a low-cost carrier to be named ValuAir that would operate from Singapore. The company, the brainchild of former SIA Deputy Chairman Mr. Lim Chin Beng, promised to be a formidable competitor in the near future.

Virgin Blue, an offshoot of Virgin Airways, had captured 30% of the domestic Australian market within three years. In its aggressive rise to market dominance, Virgin Blue acquired control over blocks of gates and terminal space in key airports such as Sydney. This all but eliminated the possibility of another carrier besides Virgin Blue and Qantas, the national flag carrier, from building rival air service networks in that country. Virgin Blue was also contemplating service offerings from Australia to New Zealand and Fiji. In the very short period of time that Virgin Blue was active in Australia, it had demonstrated how vulnerable network competitors were to low-cost competition. Qantas was at the receiving end of this onslaught in Australia and wound up losing a significant chunk of its market share. It was clear that SIA could not wish away the impending threat.

The Future of SIA

Mr. Chew Choon Seng had a host of challenging competitive issues ahead of him. How should SIA continue to differentiate itself from the copycats who seemed to be doing a very creditable job at imitating SIA in terms of cabin service and amenities? What new signaling devices could SIA harness to set itself apart from the competition? The very people who had been instrumental in helping the company become the best in its class were now disgruntled after the staff cuts and salary givebacks. They would somehow have to be motivated once again to help SIA ride the successive waves of crisis. It was of paramount importance to stem the threat of low-cost competition before it became a larger phenomenon. How should the emergence of low-cost carriers be addressed? SIA was at a crossroads in its history. The next few strategic moves would determine whether it would rise from its status as the best Asian airline to become a global player commanding the respect of the world's largest carriers.

Notes

1. Breakeven load factor is an industry measure of capacity that must be carried for the flight to break even.
2. Government of Singapore, Department of Statistics, www.singstat.gov.
3. BBC program.
4. Fleet data and age obtained from www.singaporeair.com.

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5. *Asian Airline Analyzer*, UBS Investment Research, June 2003.

6. J. Clark. “They Enjoy Being a ‘Girl,’ “ USA Today, November 19, 2002.

APPENDIX

Available Ton Kilometer (ATK) A measure of capacity expressed in terms of aircraft payload multiplied by kilometers flown

Available Seat Kilometers (ASK) A measure of seat capacity available defined by the number of seats multiplied by kilometers flown

Revenue Ton Kilometers (RTK) The total traffic carriage measured by the revenue-generating weight (in tons) of load carried multiplied by kilometers flown

Revenue Passenger Kilometers (RPK) A passenger traffic measure expressed as the total number of passengers carried multiplied by kilometers flown

Passenger Load Factor (PLF) Passenger Load Factor in RPKs is expressed as a percentage of ASKs which indicates utilization of seat capacity (RPK/ASK)

Cargo Load Factor (CLF) Cargo load in RTKs expressed as a percentage of ATKs which indicates utilization of total capacity

Overall Load Factor (OLF) Total passenger and cargo load expressed as a percentage of total passenger and cargo capacity (ATKs) which indicates utilization of total capacity

Break-Even Load factor Unit cost per ATK divided by overall yield—provides an indication of the load factor needed for the airline to break even at the operating profit level

Yield Amount of revenue generated by each unit of load expressed in cents per RTK for cargo or cents per RPK for passengers

Unit Cost Expenditure required to produce a unit of capacity expressed in cents per ATK for cargo or cents per ASK for passengers

SWATCH AND THE GLOBAL WATCH INDUSTRY[1]

Prepared by Cyril Bouquet under the supervision of Associate Professor Allen Morrison

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In early June 1999, the management of the Swatch Group could be satisfied with the company’s accomplishments over the last 15 years. Thanks to its 14 brands and unusual approach to marketing, and with 116 million finished watches and movements produced in 1997, the Swatch Group had helped resuscitate the Swiss watch industry and become, in value terms, the world’s largest watch manufacturer. Despite an enviable track record, there was a growing sense of anxiety over the future of the company in an industry that seemed to be in a perpetual state of change.

EARLY HISTORY

Until 1957, all watches were mechanical. The aesthetics of the exterior visible elements (dials, hands and case) as well as the reliability and accuracy of a traditional timepiece depended on the meticulous care and precision that had been

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dedicated to its manufacturing and assembling processes. Mechanical watches consisted of between 100 and 130 components that were to be fitted together in the ébauche (winding stem, gear train) and regulating parts (mainspring, escapement, balance wheel). Most expensive watches contained at least 15 jewels (very hard stones such as synthetic sapphires or rubies that had been drilled, chamfered and polished), which were inserted in places that were most subject to metal wear. The tiny dimensions of a watch case did not leave much room for approximation, and watchmakers were required to have a great deal of micro-mechanical engineering expertise, craftsmanship spirit, patience, experience and ingenuity.

By most accounts, the first reliable pocket watch was invented in 1510 by Peter Henlein, a locksmith from Nuremburg, but the promising art of watchmaking in Germany was rapidly killed by the Thirty Years War (1618 to 1648). Starting in the late 1500s, the development of the watchmaking industry in Europe traced its roots to the flight of protestant Huguenots who were driven out of France by a series of religious persecutions. The Huguenots found refuge in Geneva, bringing with them skills in numerous handicrafts. For centuries, Geneva had been a centre of ornate jewelry making, but it was left with little industry after John Calvin's famous *Sittenmandate* edicts against luxury and pleasure had progressively put an end to the goldsmiths' activities in the city. Looking for a new source of income, and with their knowledge of metals, skills in jewelry making and artistic flair, many Genevan goldsmiths embraced the watchmakers' profession.

As they were becoming more and more numerous, watchmakers decided to regulate their activities, and incorporated into a guild in 1601. The development of the industry in Geneva and the surrounding Jura mountains was rapid. By 1686, there were 100 masters in Geneva; 165 in 1716; and 800 in 1766 employing some 3,000 people. By 1790, Geneva exported more than 60,000 watches throughout Europe. Many of the Genevese moved north along the French frontier in the Vallée de Joux, Neuchatel and La Chaux-de-Fonds (see Exhibit 1).

The emergence of the watch industry in Switzerland was a blessing for the local farmers who could extract only modest agricultural revenues from their mountainous terrain. In fact, many families—who had been educated through a close-knit system of community schools—were looking for an additional source of income, particularly during the long and snow-filled winters. Thanks to advances in new machine powered watchmaking tools, individual Swiss families began to specialize, some in the production of single components, others in assembly. The small size of watches and watch components allowed for relatively easy transportation from mountain farms and villages to commercial centres.

Swiss watches were sold exclusively through jewelry and up-scale department stores, which were also fully responsible for repair and after-sales services. Watches were purchased as lifetime investments and were often handed down from generation to generation. Swiss watches found ready acceptance throughout Europe and later in the U.S., in part because of their promotion by jewellers who saw them as a source of ongoing revenues through their repair services.

In the 18th and 19th centuries, English competitors were a constant challenge for the Swiss who undertook serious efforts to overcome early British supremacy. First, the Swiss invested in education and training, establishing several watchmaking academies at home and watch-repair schools in major foreign markets. Second, and to strengthen their image internationally, they created a "Swiss made" label, which would become by 1920, an important symbol of quality, style and prestige. Third, the Swiss significantly improved process technology, setting up the world's first mechanized watch factory in 1839. British watchmakers made no attempt to mass manufacture watches until much later. Seeing mass production techniques as a threat to their craft, they persuaded Parliament to pass a law barring the use of specialty production tools in the British watch industry, and devoted

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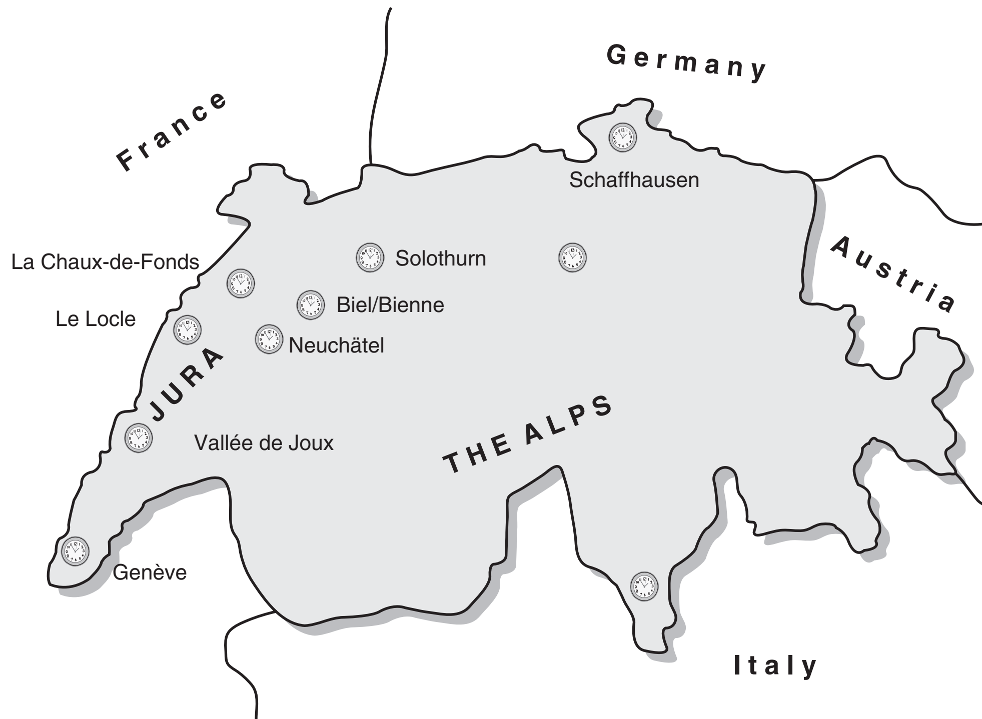

Exhibit 1 Watch Production in Switzerland

Source: FH, Federation of the Swiss Watch Industry.

themselves to the production of very expensive marine chronometers. As a result, the British watch industry steadily declined during the 19th century, while the Swiss industry was on its way to achieving world dominance, thanks to significant advances in design, features, standardization, interchangeability of parts and productivity. In 1842, Adrien Philippe introduced complicated watches featuring perpetual calendars, fly-back hands and/or chronographs. Other early Swiss names included Beaume & Mercier (1830), Longines (1832), Piaget (1874), Omega (1848), Movado (1881) and Rolex (1908).

The U.S. watch industry appeared in the middle of the 19th century. Local production consisted of high-volume, standardized products manufactured in machine-driven factories. U.S. watches—such as the US$1 *Turnip* pocket watch introduced under the Ingersoll brand name by the Waterbury Clock Company—were cheap but also of very poor quality. Anyone who wanted a "real" watch bought Swiss.

In the early 20th century, the hard economic times (collapsing sales and soaring unemployment) following the First World War, led to a profound reorganization of the Swiss watch industry. Almost 2,500 distinct watchmaking firms grouped together into three associations, namely the Federation of the Swiss Watch Industry (FH) in 1924, the Ebauches SA in 1926, and the group Union des Branches Annexes de l'Horlogerie (UBAH) in 1926. The associations agreed to co-ordinate activities (for example, watch components had to be bought from members of the associations only) and maintain high prices. The Swiss Laboratory for Watchmaking Research

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(CEH) was also founded in 1924, with the objective of strengthening the country's technological advantage. Finally, and in response to the world depression at the time, the Swiss government pushed several important watch assembly firms to form a holding company, ASUAG, in 1931.

Postwar Competitive Changes (1945 to 1970)

By 1945, the Swiss accounted for 80 per cent of the world's total watch production, and 99 per cent of all U.S. watch imports. Swiss watch production was divided among nearly 2,500 distinct companies, 90 per cent of which employed fewer than 50 people. Despite the 200-year dominance of Swiss watchmaking companies, much would change in a short period of time.

U.S. Competitors

The main source of competition for the Swiss arose from two American watchmakers, Timex and Bulova. Using a combination of automation, precision tooling and simpler design than that of higher-priced Swiss watches, U.S. Time Corporation introduced in 1951 a line of inexpensive (US$6.95 to US$7.95), disposable, yet stylized and highly durable Timex watches, whose movements had new hard alloy bearings instead of traditional and more expensive jewels. Hard alloy metals allowed for the creation of durable watches at lower costs than jewelled lever timepieces. They also allowed U.S. Time to more effectively automate its production lines, further lowering costs.

Traditional jewellers were very reluctant to carry the brand for a variety of reasons. Its prices and margins were slim compared to those offered by the Swiss, while the watches' riveted cases could not be opened, thereby eliminating the possibility for jewellers to generate aftersales repair revenues. Locked out of jewelry stores, Timex had no choice but to innovate in its marketing and distribution strategy. Their first extensive worldwide advertising campaign on television, "Took a licking and kept on ticking," was to become a legend in marketing history. Consumer demand soared after John Cameron Swazey, a famous news U.S. commentator, was featured in live "torture tests" commercials emphasizing the watch's low cost and incredible durability. The disposable aspect of Timex watches (no local repair involved) pushed the company to develop new distribution channels, including drugstores, discount houses, department stores, catalogue showrooms, military bases and sporting goods outlets. By 1970, Timex (having changed its name from U.S. Time) had established a manufacturing and/or marketing presence in over 30 countries and become the world's largest watch manufacturer in terms of units sold.

Bulova was the leading U.S. manufacturer of quality, jewelled-lever watches. Integrating the highly accurate tuning fork technology bought from a Swiss engineer in 1959, after the main Swiss companies had turned down the technology, Bulova introduced *Accutron* in 1962. Five years later, *Accutron* was the best selling watch over $100 in the U.S. Bulova also formed a partnership with Japan's Citizen Watch Company to produce the movements for the *Caravelle* line, designed to meet the low-cost/high quality challenge imposed by Timex. By 1970, Bulova had expanded its international presence all around the world, and become the largest seller of watches, in revenue terms, in both the United States and the world overall.

Japanese Competitors

Like the U.S. industry, the Japanese watch industry was highly concentrated. In 1950, three main competitors, K. Hattori (which marketed the Seiko brand), Citizen and Orient accounted for 50 per cent, 30 per cent, and 20 per cent of the Japanese market respectively. Their positions were protected by the 70 per cent tariff and tax sales imposed on all imported watches by the Japanese government.

As the Japanese market became saturated in the 1960s, Hattori and Citizen moved aggressively into other Asia Pacific countries. After first exporting from Japan, Hattori and Citizen established component and assembly operations in low cost Hong Kong, Singapore and Malaysia. With hundreds of millions of unserved consumers, the region was also a highly attractive market. From a position of strength in Asia, the Japanese watch companies began in earnest to push into Europe and North America.

The Swiss response to the growing power of U.S. and Japanese competitors was limited. In 1962, the Swiss FH and ASUAG created a research organization, the Centre Electronique Horloger (CEH) to develop a competitive alternative to the tuning fork technology patented by Bulova. These efforts were unsuccessful, in part because of only lukewarm support from member companies. A rising worldwide demand for watches did little to slow the steady decline in the Swiss share of the world market (from 80 per cent in 1946 to 42 per cent in 1970).

Changing Technologies (1970 to 1990)

The advent of light-emitting diodes (LED) and liquid crystal display (LCD) watches constituted a true revolution in the world of watchmaking, as they allowed the digital display of time. In 1970, Hattori Seiko became the first to develop and commercialize a quartz watch named *Astron*, based on LED technology.

Despite their novelty, LED watches had many flaws. A button had to be pushed to activate the display of LED watches, a process that consumed a lot of electrical energy and wore out batteries quickly. Additionally, most people felt that LEDs were distracting and inconvenient to use. In 1973, Seiko introduced the world's first LCD quartz watch with six-digit display and by the late 1970s, LCDs dominated the digital segment. However, digital watches remained largely plagued by quality problems, and consumers never fully embraced the style. Quartz analogue watches, which involved a more delicate manufacturing, and conserved—with their hands and gear train—the traditional appearance of mechanical timepieces, increasingly gained consumers' acceptance. By 1984, over 75 per cent of all watches sold around the world were based on quartz technology, versus only three per cent in 1975. The large majority of quartz watches were analogue.

Quartz watches used an integrated circuit, made up of numerous electronic components grouped together on the basis of a few square millimetres. Extremely accurate, thanks to their high frequency of vibrations (32 kHz), they were accurate to less than one second per day. Generally more sophisticated—in terms of functions—than their mechanical counterparts, they were also far less expensive to manufacture. The average production cost of a standard quartz watch fell from US$200 in 1972 to about US$0.50 in 1984, the cost of components being constantly driven down by the main U.S. chipmakers such as National Semiconductor and Texas Instruments.

Faced with soaring international competition, the Swiss abolished all internal regulations in 1981, and the industry began to consolidate. Many firms merged in an attempt to leverage their marketing and/or manufacturing capabilities. The largest operation resulted in the creation of the Société Suisse pour L'Industrie Horlogère (SSIH), which controlled brands such as Omega and Tissot, among others.

The Japanese Industry

Convinced that technologically sophisticated watches could allow Swiss prices at Timex costs, Hattori Seiko and Citizen made important efforts to promote the new quartz technology. Large investments were made in plant and equipment for fully automated high-volume production of integrated circuits, batteries and LCD panels. Hattori's production lines were designed to produce up to 1,000,000 watches per year per product line. Manufacturing/assembly facilities were set up all around the world (Japan, the

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United States, western Europe, Australia, Brazil, Hong Kong, Korea, Mexico). To ease the transition, employees were retrained, relations with distributors were reinforced, and advertising budgets were increased.

By 1979, Hattori produced about 22 million watches annually and became the world's largest watch company in terms of revenues, with sales approaching US$1.2 billion, versus only US$503 million for the Swiss ASUAG. Citizen launched the world's first wristwatch movement with a thickness of less than one millimetre in 1978, and became the global leader in both movement and finished wristwatch production volumes in 1986.

Casio entered the watch market in 1974 with a digital model priced at US$39.95. Its subsequent low-cost, multifunction digital plastic watches were rapidly fitted with gadgetry such as timers and calculators. By 1980, the company had captured 10 per cent of the Japanese digital watch market, and became the world's second most important player in the under US$50 world watch market, behind Timex.

Hattori, Casio and Citizen were largely integrated companies. Most operations, from the production of movements and components to the assembly and distribution of finished watches, were carried out through wholly owned subsidiaries and/or majority joint ventures. In 1980, Japan produced about 67.5 million watches, up from 12.2 million in 1970.

The U.S. Industry

U.S. competitors were relatively slow to get on the electronic bandwagon. Neither Bulova nor Timex's facilities easily allowed the production of quartz crystal or integrated circuits. In fact, they were rapidly becoming obsolete in light of those new technologies sweeping the industry. In addition, Timex was struggling with management problems as Mr. Lehmkuhl—who had run the business for almost 30 years with no clear successor—fell ill and could no longer work. Nevertheless, both companies finally entered the quartz watch market in the mid-1970s, sourcing their quartz components from a variety of suppliers and backing their product lines with full-scale advertising and promotion campaigns. The Timex model was priced at US$125, which was 60 per cent below Seiko's least expensive watch on the market at that time.

About 100 semiconductor firms such as National Semiconductor, Texas Instruments (TI), and Litronix, were also attracted to the promising market for digital watches and circuits for electronic movements in the mid-1970s. Most started as suppliers of quartz movements and components, then invested in high-volume, fully automated watch-manufacturing plants. The belief was that their huge existing distribution channels for consumer electronics products would give them a strong competitive advantage. Watches were introduced at very aggressive prices (TI's retailed at $19.95 in 1976 and $9.99 in 1977). In 1978, TI's digital watch sales reached $100 million, for a pretax profit of US$28 million. However, stagnant demand coupled with continuous price wars and numerous distribution problems led all semiconductor firms to exit the market one by one. In the end, most customers felt uncomfortable buying watches in electronic stores where the semiconductor firms had a distribution advantage.

The price wars following the arrival of these semiconductor firms were also largely detrimental to the main U.S. watchmaking companies. Although it was constantly underpriced by Texas Instruments, Timex turned down a number of propositions to form manufacturing partnerships with several chipmakers. Some observers argued that Timex was probably too proud to accept the idea of co-operation. Timex lost US$10 million in 1980, being surpassed by Seiko as the world's largest watch manufacturer company (both in units and total sales), while its share of the U.S. market fell to under 33 per cent. The two other U.S. players remaining in the industry were not in a much better situation. Bulova experienced three years of significant losses before being purchased by Loews Corporation; Hamilton lost $15 million in 1970 and went bankrupt in 1978: the

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Pulsar rights were bought by Seiko and the remaining assets purchased by SSIH.

Watchmaking Activities in Hong Kong and Korea

By the end of the 1970s, Hong Kong had become the highest volume producer of timepieces in the world. Japanese, American and European watchmakers had all established assembly plants (mechanical, digital and quartz analogue watches) in the city to take advantage of highly skilled, cheap labor and favorable tax conditions. Numerous local semiconductor firms had also engaged in the production of low-cost digital quartz watches that were then distributed through local retail chains and department stores, or exported, mainly towards mainland China.

The timepiece industry in Korea also experienced considerable growth in the 1970s. By 1988, the country's total watch exports amounted to US$39 million, along with a rising reputation in the eyes of the world for quality assembling capabilities.

The Hong Kong and Korean watch industries benefited from their flexible manufacturing systems, capable of handling small quantity orders in different styles. However, downward pressures on prices and low profit margins discouraged local watch producers from investing in technology and branding.

The Swiss Industry Responds Slowly

Although the Swiss pioneered quartz technology, they were particularly reluctant to adopt the new technology. Contrary to the Japanese, their industry structure was very fragmented and, therefore, not adapted to high-volume mass production procedures. Besides, electronic watches were regarded as being unreliable, unsophisticated, and not up to Swiss quality standards. Consequently, digital and analogue quartz watches were regarded as just a passing fad, and in 1974, accounted for only 1.7 per cent of the 84.4 million watches exported from Switzerland. Instead, the Swiss focused on the high-end, mechanical segment of the industry, where traditional craftsmanship remained the deciding factor.

As SSIH and ASUAG regularly increased prices to maintain profitability, foreign competition rapidly established a strong foothold in the low and middle price ranges where the Swiss were forced to abandon their leadership, virtually without a fight. Compounding the problems faced by the Swiss, the U.S. dollar more than halved its value against the Swiss franc during the 1970s. The appreciating Swiss franc effectively raised the export prices of Swiss watches (see Exhibit 2).

The Swiss industry experienced a severe crisis in the late 1970s and early 1980s. Its exports of watches and movements decreased from 94 million in 1974 to 43 million in 1983, while its world market share slid from 43 per cent to less than 15 per cent during that same period. Employment fell from 90,000 (1970) to 47,000 (1980) to 34,000 (1984) and bankruptcies reduced the number of firms from 1,618 to 860 to 630 respectively. These competitive changes resulted mainly from the seeming inability of the Swiss to adapt to the rapid emergence of new watch technologies.

	1950–1970	*1971*	*1972*	*1974*	*1976*	*1978*	*1980*
Swiss Franc	4.37	4.15	4.15	3.58	2.89	2.24	2.18

Exhibit 2 Exchange Rate to the U.S. Dollar (Annual Average)

Source: International Monetary Fund Yearbook of Statistics.

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Near Death Experience

In the early 1980s, Swiss watch production hit an all time low. SSIH and ASUAG faced liquidation and a profound restructuring of the Swiss industry became necessary. The Swiss government provided financial assistance and initiated the "electronic watch" program in 1978 to promote new technologies as well as the production of electronic watch components in Switzerland. But this initiative was not sufficient, and in 1981 SSIH reported a loss of SFr142 million, giving the company a negative net worth of SFr27.4 million. The Swiss creditor banks—which had just taken over the country's two largest watchmaking groups—were getting ready to sell prestigious brand names, such as Omega, Tissot or Longines to the Japanese. But Nicolas Hayek, the already well-known founder and CEO of Hayek Engineering, a consulting firm based in Zurich, was convinced he could revive the Swiss industry and regain lost market share, primarily in the lower-end segment. He invested $102 million—mostly his own money—and led a group of 16 investors in buying back the two groups, before orchestrating their merger in 1983.

SMH and Swatch

Hayek teamed with Dr. Ernst Thomke to head the new group, Société Micromécanique et Horlogère (SMH). After the merger, SMH owned many of the country's famous watchmaking names, such as Omega, Tissot, Longines and Rado. Five years later, the group had become the world's largest watchmaking company. Its first product initiative, Swatch, was to become an enormous commercial success, as well as the main instrument behind the revitalization of the entire Swiss industry.

The Swatch mania marked the 1980s for the Swiss industry. The Swatch (contraction of "Swiss" and "watch") was conceived as an inexpensive, SFr50 (US$40), yet good quality watch, with quartz accuracy, water and shock resistance, as well as a one-year guarantee. The concept was challenging. Particular efforts were needed to reduce production costs down to Asian levels. Watch engineers slashed the number of individual parts required in the production of a watch from 91 to 51, and housed them in a standardized plastic case that could be produced on a fully automated assembly line. For the first time ever, it became possible to produce cheap watches in high cost Switzerland. By 1985, production costs were decreased to under SFr10 per unit, and only 130 people were needed to assemble the first eight million Swatch models. By comparison, 350 people were still required to assemble 700,000 Omega watches.

Swatch was an immediate success. Within two years of its 1983 launch, sales were averaging 100,000 units a months, for a cumulative total of 13 million sold. In 1985, Swatch accounted for over 80 per cent of SMH's total unit sales, and by 1989, just six years after its debut, the company had placed 70 million Swatches on customers' wrists.

Marketing was key to the watch's success. Franz Sprecher, an independent consultant, and Max Imgrüth, a graduate of New York's Fashion Institute of Technology, helped SMH position the watch as a lifestyle symbol and fashion accessory, not as a traditional timekeeping instrument. With their trendy and colorful designs, models were created for every occasion.

Initially, the media appeared to be mesmerized by Hayek's charismatic style and unusual approach to marketing. This resulted in lots of free media coverage and publicity. The company also spent liberally on special events and public relation activities. SMH budgeted about SFr5 million per Swatch product line per year in promotional money, and used celebrity endorsements extensively. Swatches were sold through nonconventional channels of distribution such as discount houses and department stores, where variety and low prices constituted the main selling points. Swatch made a few attempts to diversify, but its line of accessories (casual clothing and footwear, umbrellas, sunglasses, and cigarette lighters) experienced mixed success and was discontinued in 1988.

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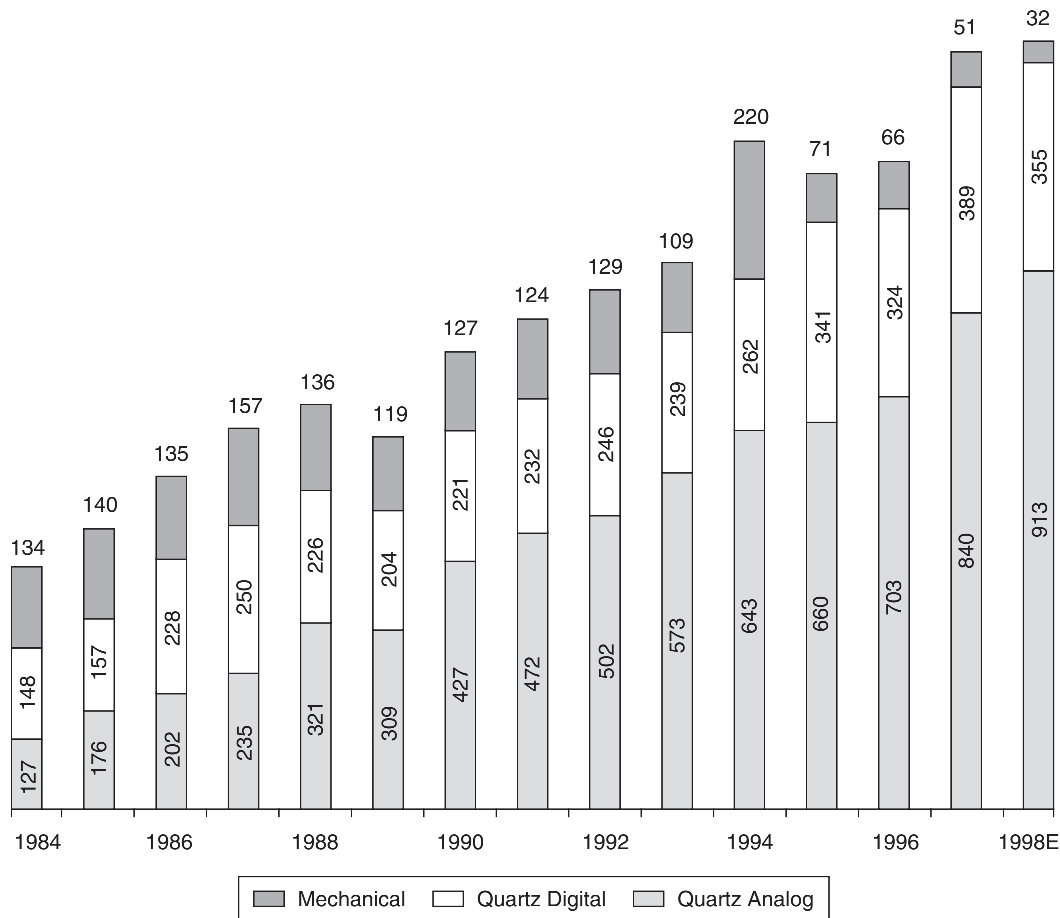

Exhibit 3 Global Watch Production; 1984 to 1998

Source: FH, Federation of the Swiss Watch Industry, and Japan Clock and Watch Association

Competing in Real Time (1990s)

Global watch production grew steadily in the 1990s, at a rate of about four per cent per annum, and reached 1.3 billion watches in 1998, equivalent to 22 per cent of the world's population (see Exhibit 3). The production of mechanical watches (and to a lesser extent, that of digital watches) gradually decreased over the years, while that of analogue quartz watches rose 11 per cent per year on average. In 1998, quartz watches—digital and analogue—accounted for about 97 per cent of the worldwide industry's production in volume. On average, annual watch purchases were about one unit per person in North America, and 0.6 unit per person in Europe and Japan. Together these three regions—which accounted for 14 per cent of the world's population—generated about 56 per cent of global watch demand (see Exhibit 4).

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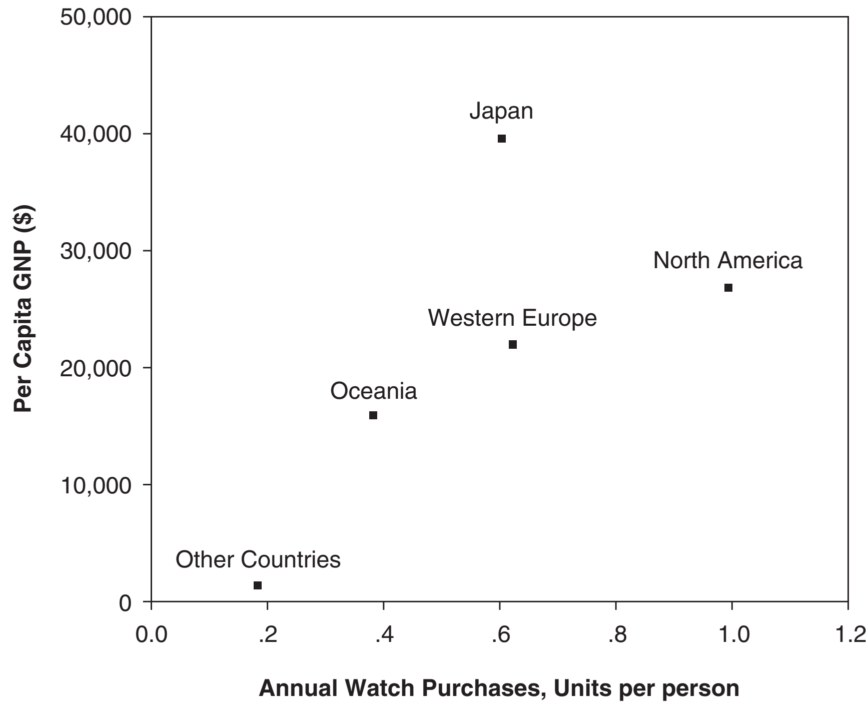

Exhibit 4 Per Capita GNP and Annual Watch Purchases, by Region

Source: Japan Clock and Watch Association, United Nations Demographic Yearbook, The World Bank.

Industry Restructuring

The global watch industry experienced downward profit pressures in the 1990s, as many watchmakers incessantly cut prices—driven in part by a push for economies of scale. Overcapacity and tough head-to-head competition led prices of basic watch movements to be slashed by over 30 per cent in 1998 alone. By the end of the decade, consolidation had reduced the number of watch movement manufacturers from 30 to just three (the Swatch Group—having changed its name from SMH—as well as Seiko and Citizen). The achievement of a critical mass was becoming a necessity to compete globally in all segments of the industry.

Several types of internal reorganizations allowed companies to realize economies of scale and/or maintain profitability. These included:

Restructuring Initiatives

Many watchmaking companies reacted to declining prices in their core business by increasing productivity and shifting manufacturing overseas. With the exception of the Swatch Group, most watch companies manufactured in Southeast Asia exclusively.

Pursuing Acquisitions

In tune with its strategy to reinforce its position in the luxury or prestige brands, the Swatch Group acquired Blancpain in 1992, thereby also taking control of Frederic Piguet, a company admired for its complex, high-quality mechanical movements. In January 1999, the Swatch Group purchased the total shares of Favre and Perret, the highly reputed producer of quality

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Swiss watchcases. As another example, Gucci, the luxury Italian company, acquired Severin Montres, its 23-year Swiss watch manufacturer, for $150 million in November 1997. The following year, Gucci's watch sales increased by 160 per cent to $60.1 million. "There is no question that Gucci is destined to become more than a shoe and bag business," said De Boisgelin, an equity analyst with Merrill Lynch in London.[2]

Accessing New Distribution Channels

Watchmakers traditionally used independent agents to sell products around the world. However, increasing difficulties controlling the merchandising and pricing policies used by local retailers led many of them to alter their strategies. In 1997, the Swatch Group opened 61 new free-standing Swatch stores (mostly operated as franchisees), bringing the total to 120 (including five megastores) in more than 20 countries. Despite the risks involved, the strategy was promising: sales at New York's Swatch Time Shop boutiques approached 100,000 units in 1998, up 32 per cent over 1997. By taking over 85 per cent of its distribution network, Tag Heuer increased its gross margins from 45 per cent to 65 per cent, which more than offset the cost of running local subsidiaries. According to CEO Christian Viros, the move allowed "greater control of our destiny, better control of the implementation of our marketing programs, better understanding of local issues, and greater reactiveness to new developments."[3]

Creating New Niche Products

Despite ongoing consolidation, there was a viable place for niche companies with clearly defined brands and images. By the late 1990s, Switzerland had about 600 watchmaking companies, employing 34,000 employees, in addition to the big four (The Swatch Group, The Vendôme Luxury Group, Rolex and Tag Heuer), which together accounted for 75 per cent to 80 per cent of Swiss industry turnover. As examples of niche players, St. John Timepieces entered the industry in 1997 with a collection of Swiss watches specifically designed for sophisticated women, retailing from $450 to $18,000. Breitling scarcely deviated from the aerial image it established in 1884. In 1999, it equipped Breitling Orbiter 3's pilots, Bertrand Piccard and Brian Jones, with wristwatches for their successful, first nonstop 26,602 miles balloon flight around the world.

Increasing Advertising

The overabundance of supply in the industry implied that watchmakers had to find ways to distinguish their offerings from those of their competitors. Advertising expenditures reached unprecedented levels. In the 1990s, 40 per cent of the value of all Swiss advertisements in international media promoted wristwatches, not banking institutions. Seiko's 1998 *Electricity* campaign was backed with a 60 per cent increase in media spending, while Timex allocated about US$8 million in 1999 to market its *Turn 'n' Pull* Alarm watches.

Huge advertising budgets were not, per se, a guarantee of success. The campaigns also needed to be creative in order to get consumers' attention. Companies turned down conservative ads in favor of eye-popping, humorous, and thought-provoking messages that obtained an emotional reaction from viewers. For example, Bulgari formed a one-year partnership with Alitalia, Italy's national airline, to have a personalized Boeing 747 fly around the world with a three-dimensional image of its latest cutting-edge aluminum timepiece painted on the fuselage. Audemars Piguet's ad crusade, "Who is behind an Audemars Piguet Watch?" featured mysterious men and women showing off their watch faces while their own faces remain obscured. Other watchmakers tried to get exposure in action-packed movies such as *Men in Black* and *Lethal Weapon 4* (Hamilton), James Bond (Omega), or *Armageddon* (Tag Heuer). Strong marketing muscle was also put behind sports partnerships. For example, Tag Heuer and Hugo Boss had long been associated with Formula One auto racing, and Spanish-based Festina with cycling events such as the Tour de France.

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Emphasizing Quality

Faced with strong competition from independent, low cost Asian producers, many European and U.S. watchmakers chose to gradually reposition their brands in the upper market, and proposed increasingly expensive and sophisticated watches. According to the Federation of the Swiss Watch Industry, the average price of a Swiss wristwatch, taking account of all materials, rose from US$132 in 1996 to US$157 in 1997. A growing number of customers were becoming aware of quality and increasingly wanted a watch with lasting value.

Emphasizing Technology

The end of the 1990s looked promising in terms of technological breakthroughs. Bulova's *Vibra Alarm* watch featured dual sound and vibrating alarms. In Seiko's *Kinetic*, an oscillating weight was set in motion by the slightest movements of the wearer's arm ("If you're going to create electricity, use it!"). Timex's *DataLink* pioneered the utilization of wristwatches as wearable information devices. Following Timex's lead, various watch manufacturers introduced multifunctional watches that could be interfaced with personal computers. Other manufacturers designed watches with built-in global positioning systems (Casio, Timex), or offered fast, customized and reliable access to Internet services.

Accentuating Fashion

Another noticeable trend was the entry of fashion house designers. By 1999, and partly thanks to the Swatch revolution, people increasingly believed that they were judged by what they wore on their wrists. Fashion designers strove to create new watch brands to meet every one of their possible fashion needs. Some decided to put their signatures on stylized watches produced in co-operation with major specialist manufacturers. Examples included Emporio Armani (Fossil), Calvin Klein (The Swatch Group), Guess (Timex) and Yves St Laurent (Citizen). Others, such as Bulgari, Hermes, and Dior set up their own in-house manufacturing operations. "We have very high expectations for this side of the business," said Guillaume de Seynes, director of Hermes Montres. "Watches are already our fourth biggest product in sales terms after leather, silk, and ready-to-wear. We've made a significant investment in the new factory because we expect even faster growth in the future."[4]

Developments in the Hong Kong and Japanese Industries

In the late 1990s, Hong Kong was the world's dominant centre for watch assembly. In 1998, about 80 per cent of all watches produced worldwide were assembled in the city (see Exhibit 5).

Japanese watch manufacturers saw their combined domestic and overseas watch production rise about 14 per cent per year in the 1990s. Particularly strong in the sports watch segment, the Japanese offered an impressive range of multifunction chronographs for virtually any type of outdoor activity, including diving, mountain climbing and flying. However, sales and profitability deteriorated between 1993 and 1996 due to a rapid appreciation of the yen. In addition, the average unit price of analogue quartz movements fell by nearly 50 per cent to ¥234 in the first half of the decade, and by over 30 per cent in 1998, as major companies boosted production. This collapse severely shook the industry, and many manufacturers, such as Orient Watch, had to exit the market. Throughout the last half of the 1990s, Seiko and Citizen began cutting production in order to hold prices firm.

Citizen maintained its world's volume leadership with 2,500 new models released every year and 311 million timepieces produced in 1997 (about 25 per cent of the world's total and 36 per cent of the global market for analogue quartz watches). Sales were mainly dependent upon Japan (38 per cent), Asia (32 per cent), America (15 per cent) and Europe (14 per cent). Two new collections—the light-powered *Eco-Drive* watches and the affordable luxury *Elegance Signature* dress watches—marked the company's desire to

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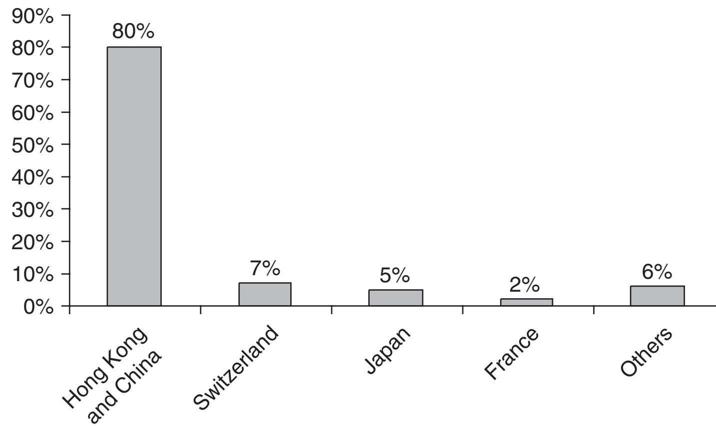

Exhibit 5 World Production of Finished Watches: 500 Million Pieces (1997)

Source: Federation of the Swiss Watch Industry

move from traditional sports watches towards more sophisticated or expensive timepieces.

Seiko introduced a few technological marvels in the early 1990s, such as the *Perpetual Calendar* watch, with the first built-in millennium plus (1,100 years) calendar, *the Scubamaster*, with the first integrated computerized dive table, and the *Receptor MessageWatch*, with paging functions and built-in antenna that allowed access to specialized information services and incoming alphanumeric messages. In 1995, Seiko introduced the *Kinetic* series, backed with a $20 million advertising campaign. The futuristic line became the driving force behind the company's growth in the late 1990s, accounting for 25 per cent of Seiko's $3 billion global sales. Great hopes were also placed on *Kinetic*'s lower-cost cousin, the $200 *Pulsar* solar-powered quartz watch, which was launched at the end of 1996.

Casio enjoyed a significant expansion of its wristwatch division, thanks to the successful launches of the *G-shock* and *Baby-G* product lines. The company was particularly strong in the U.S. (second largest market share after Timex), but also heavily dependent on domestic Japanese sales, which made up two-thirds of total *G-shock* and *Baby-G* sales. A depressed Japanese economy in the late 1990s had a profound negative effect on the company's profits, which were estimated to drop from ¥38 billion in 1998 to ¥19 billion in 1999.[5]

THE U.S. INDUSTRY

The biggest single watch market in the world was also the one with the largest trade deficit. In 1991, exports amounted to $73.4 million compared to an import total of $1.84 billion. Thanks to a factory in Little Rock, Arkansas, Timex was the only U.S. watch company with any domestic production in the late 1990s.

Timex

From sports watches and classic styles to watches featuring *Star Trek* and Walt Disney characters, Timex offerings strove to address a variety of consumer trends in the 1990s. The production of watches for Guess, Timberland, Nautica, and Reebok further emphasized Timex's willingness to reach a mass audience. Two innovations distinguished the company. The first was the durable, multi-function *Ironman Triathlon* watch, named after the gruelling annual Hawaiian sports event. Initially positioned as an instrument for serious athletes, the watch rapidly appealed to a wider audience of pedestrian

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Brand	Share	Brand	Share
Timex	30.6%	Gitano	2.0%
Casio	7.8%	Gucci	1.9%
Seiko	7.4%	Swatch	1.6%
Guess (Timex)	5.0%	Rolex	1.1%
Armitron (Gluck)	4.5%	Movado	1.0%
Citizen	4.0%	Tag Heuer	0.8%
Fossil	3.5%	Hamilton (Swatch)	0.7%
Pulsar (Seiko)	3.1%	Tissot (Swatch)	0.7%
Lorus (Seiko)	2.5%	Omega (Swatch)	0.5%
Bulova	2.2%	Rado (Swatch)	0.2%

Exhibit 6 Share of Purchasers by Brand in the U.S. Market—1999

Source: Euromonitor.

customers. By late 1990s, it was the word's best selling sports watch with more than 25 million units sold since its 1986 introduction. The second was *Indiglo*, a patented luminescent dial technology launched in 1992, and credited with more than doubling the company's sales by 1994. *Indiglo* received considerable attention in 1993 after a group of people trapped in the World Trade Center bombing had been led to safety by an *Indiglo* owner, who guided them down 34 flights of pitch-black stairs through the glow of his Timex watch. Other technological innovations rapidly followed, with Timex *DataLink*, a $139 wristwatch allowing wireless transfer to and from a desktop PC, and *Beepwear*, a $160 alphanumeric pager wristwatch developed and commercialized in partnership with Motorola.

Timex's annual sales exceeded $600 million in the late 1990s, one-quarter of which came from the U.S. market where the company remained the top selling watch company, far ahead of its main competitors. By 1999, with a 30 per cent market share in its hands, Timex had sold more watches in the U.S. than the next five competitors combined (see Exhibit 6). However, the huge majority of these watches were manufactured in Asia.

New Entrants in the 1990s

By the early 1990s, mainland China and India had emerged among the fastest growing watch markets in the world. With a combined population of 2.1 billion people, these markets could not be ignored, especially after a series of government decisions to liberalize trade and investment in those countries. A number of reputable watchmaking companies had established a presence in India and mainland China, despite the threat of counterfeiting (about 50 per cent of wristwatches sold in those markets were either counterfeited or smuggled in). Most came in via the trading route, appointing local distributors such as Dream Time Watches in India. This strategy was ideal for the Swiss, who could capitalize on the well-appreciated label "Swiss made." Others such as Timex, Seiko and Citizen established their own production facilities, often in co-operation with key local partners.

Titan Industries was probably one of the most remarkable industry success stories of the 1990s. The group was established in 1987, with a greenfield investment of $130 million from giant Indian conglomerate Tata Group and the government of Tamil Nadu state, where Titan built one of the world's biggest integrated watch factories, near India's technological centre Bangalore. Constantly scanning the world for best practices, Titan sourced designs and technology from France, Switzerland and Germany, watchstraps from Austria, and cases from Japan. This world-class strategy created a remarkably successful company. During its first year of operation, 750,000 high-quality finished timepieces were produced and, in 1997, the company enjoyed a

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dominant 60 per cent share of the organized Indian watch market, with pretax profits amounting to US$7.5 million on turnover of US$96 million. Titan's management believed the company had little choice but to internationalize, partly to defend its own domestic position. Mr. Desai, Titan's vice-chairman and managing director commented on the need to globalize: "India is being globalized and the whole world is now turning up in India. So the kind of protection we've enjoyed will go. It's going to get very crowded."[6] By 1997, the company exported over 600,000 watches annually and had established offices in Dubai, London, New York and Singapore. However, by the end of the 1990s and despite the company's recent $20 million advertising campaign, it was difficult to predict international success. Seducing consumers into buying $120 to $700 Indian-made wristwatches was challenging given the country's poor reputation for the quality of its exports.

The Swiss Industry in the Late 1990s

In the late 1990s, watch production in Switzerland was the country's third most important industry behind the chemical-pharmaceutical and electronic industries. In 1998, 34 million timepieces were produced in Switzerland for a total value of SFr8.2 billion.[7] Of those, 90 per cent were exported, positioning the country as the world's leading exporter—in value—of finished watches (see Exhibit 7).

The Swiss industry had the ability to provide consumers with a comprehensive choice of products in all market segments. Whatever their needs and preferences (mechanical versus quartz technologies; diamond set watch of precious metals versus stainless steel, plastic or ceramic; classic appearance versus trendy design), consumers could always find a "Swiss made" solution when shopping for their wristwatches. Of course, the Swiss industry stood apart in the upper market range where its watches had gained an unequalled reputation for quality, styling, reliability and accuracy. In 1998, the average price of watches exported by Switzerland was SFr235, four times higher than the average of the world industry (see Exhibits 8 and 9). The "Swiss made" label remained one the oldest examples of a registered and fiercely protected national branding name, which could be used only on watches and clocks containing at least 50 per cent Swiss-manufactured components by value.

The Vendôme Luxury Group accounted for about 20 per cent of Swiss industry turnover, privately-held Rolex for 15 per cent, and Tag Heuer—which sold over 673,000 units in 1997, for seven per cent. The Swatch Group was the main player with a third of industry turnover. Thanks to its 14 brands (Blancpain, Omega, Rado, Longines, Tissot, Calvin Klein, Certina, Mido, Hamilton, Pierre Balmain, Swatch, Flick Flack, Lanco, and Endura), the group had gained a presence in all price and market categories.

Swiss watches were sold all around the world. Exports to the United States increased by more than 10 per cent in 1998 for the third consecutive year. Sales in Europe were also on the rise, especially in Spain (+41.3 per cent), Italy (+18 per cent) and France (+16 per cent). In Asia, the ongoing economic crisis depressed demand and put downward pressures on prices (the demand in Hong Kong, Singapore, Thailand and Taiwan dropped by 23 per cent or SFr500 million in 1998). In 1997, Tag Heuer saw Asian sales drop by 21.4 per cent from SFr130 million to SFr102.9 million, accounting for the brand's overall 5.4 per cent decrease.

The Swatch Group

In value terms, the Swatch Group was the world's leading manufacturer of watches (14 per cent share of the world market). In 1998, the Swatch Group increased its gross sales and net profits by 7.1 per cent and 7.5 per cent respectively. With a growth averaging 15 per cent to 25 per cent per year, Omega had been a major profit driver for the group (see Exhibit 12), thanks to a successful repositioning strategy initiated in the early 1990s. To rejuvenate the brand, cheaper, silver-plated gold was used to replace more

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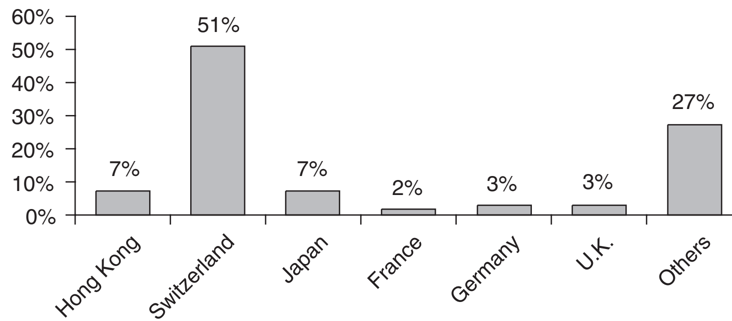

Exhibit 7 World Production of Finished Watches in Value Terms: 16 Billion Swiss Francs (1997)
Source: Federation of the Swiss Watch Industry.

	Turnover in SFr. Million	*Market Share*
Rolex	2,200	28%
Vendôme*	1,540	20%
Swatch Group**	1,000–1,100	14%
Gucci	620	8%
TAG Heuer	470	6%
Patek Philippe	250	3%
Bulgari	215	3%
Chopard	195	3%
Jaeger LeCoultre	180	2%
Audemars Piguet	120	2%
Other (Ebel, IWC, Breguet,. . .)	910	12%
Total	**7,750**	**100%**

Exhibit 8 Luxury, Prestige and Top Range: Global Market Players (1998)

Source: Bank Leu estimates, Vendôme Group Data.

*(Cartier, Piaget, Vacheron and Constantin, Beaume & Mercier)
**(Blancpain, Omega, Rado, Longines)

expensive metals (platinum, titanium, solid gold and special steel alloys). The company also streamlined its models from 2,500 to 130 representing four distinct product lines. Other major initiatives consisted of integrating distribution and launching a new advertising campaign (with Cindy Crawford, Michael Schumacher, Martina Hingins and Pierce Brosman as high-profile "ambassadors"). The strategy was quite successful and with an average price point 50 per cent lower than its main competitor, Rolex, Omega seemed to have plenty of room to grow.

Despite the success of the Omega brand, the Swatch Group was facing several issues. Management problems were plaguing the organization. Key figures such as Klaus Schwab, a

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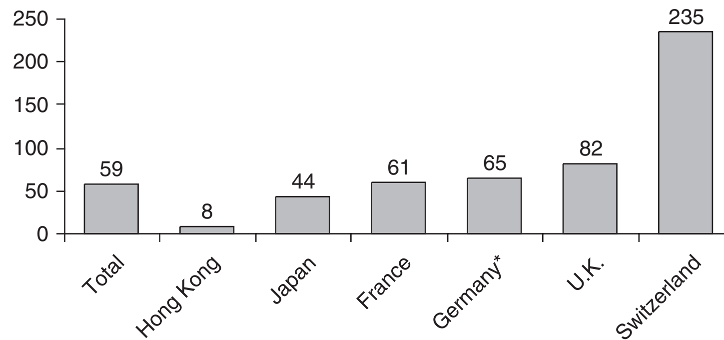

Exhibit 9 Average Price of Watches in 1998 (In Swiss Francs)
Source: Federation of the Swiss Watch Industry.

	Units	*%*	*Value*	*%*	*Swatch market share*
Mass (under $50)	124,653	78%	2,056	34%	9%
Middle market ($50–299)	31,840	20%	2,219	37%	4%
Upper/Luxury ($300)	2,705	2%	1,771	29%	21%
Total	**159,198**	**100%**	**6,046**	**100%**	**11%**

Exhibit 10 U.S. Market and Swatch group's Market Share—1999
Source: Dresdner Kleinwort Benson estimates.

professor at the University of Geneva and founder of the World Economic Forum in Davos, Drs. Stephan Schmidheiny, Pierre Arnold and Walter Frehner all stepped down from the board of directors in the mid-1990s. Several managing directors also left the group in the last two years. Hayek's management style was resulting in growing criticism in the company. Dr. Ernst Thomke, a former partner, had less-than-flattering comments about Hayek: "He has to be the big boss alone, and can never share opinions. He was a consultant all his life and he wanted to become a marketer and product developer. But he never learned that job."[8]

The Swatch Group was also experiencing persistent difficulties in establishing a strong foothold in the U.S. market, where it faced stiff competition from Timex, Casio, Seiko and Citizen. Even the Swatch Group's role as the official timekeeper of the 1996 Summer Olympic Games in Atlanta failed to significantly boost interest in the company's offerings. Although, the group generated about 19 per cent of its sales in the U.S. its market share in the basic and middle-priced segments was particularly weak (see Exhibits 6 and 10). Finally, its highly successful and emblematic Swatch brand appeared to be at a crucial crossroads.

The brand had sold a total of 200 million watches since its introduction in 1983. A Collectors' Club (100,000 members worldwide) was founded in 1990 to create an international link between fans around the world. Limited edition watches, special events, and the quarterly *Swatch World* journal also contributed to reinforce the value of the brand. Demand rapidly

exceeded supply for a number of special launches and collectors started to compare the rarity of their collections, to trade and to speculate around Swatches during auction sales. In the early 1990s, it looked as if Swatch's expansion had no limit. So great was management's confidence that the group even decided to actively contribute to the development and market introduction of the small ecological smart car.

Despite the growing interest of many, Swatch sales had plateaued at 18 million to 20 million units a year. In 1998, sales and profit margins were well below the levels achieved in the early 1990s as Swatch was facing increased competition from the likes of Fossil and Guess. One concern was whether there were too many Swatch products on the market. Another concern centred on the product mix. Many young Swatch fans of the past wanted more expensive and sophisticated watches as their incomes increased. A proliferation of products also led to a growing problem with Swatch distributors. Many retailers were dropping Swatch from their shelves. The number of stores selling the trendy watch decreased from 3,000 in the early 1990s to 1,200 in 1998. For Steven Rosdal, co-owner of Hyde Park Jewelers, expressed the views of some retailers: "Swatch came out with more products than the market could bear, and the consumers seemed to back off. I guess if you use the word 'fad' for anything, it could be used for Swatch."[9]

The group was undertaking several steps to revamp and differentiate the brand. First, Swatch was trying to reposition itself from a low-margin, high-volume business involved in day-to-day fashion watches to a high-margin, high-volume enterprise focusing on watches fitted with state-of-the-art electronic gadgetry. As an example of its repositioning efforts, it launched the *Access* watch in 1995, which could be programmed to function as a pass to access ski lifts, hotel chains, public transport and numerous other applications. Although the watch had yet to achieve its commercial potential, there were promising signals: Swatch equipped the Lisbon universal exhibition with one million units and about 200 ski resorts in some 17 countries. Also, with assistance from German Electronics giant Siemens, Swatch developed *Swatch Talk*, a Dick Tracy type wristwatch with an integrated mobile telephone. Finally, Swatch created the *Swatch Beat,* as a completely new global concept of time, as well as a whole new area of market potential. With *Swatch Beat*, time was the same all over the world "No Time Zones, No Geographical Borders." People using the same clock could agree to a phone call at "500," without time zone arithmetic required. The day was divided into 1,000 units (each one being the equivalent of one minute and 26.4 seconds) with a new BMT meridian created in Bienne, home of the Swatch Group.

As a second initiative, Swatch launched a new advertising campaign ("Time is what you make of it") designed to reinforce the brand's primary message ("Innovation, provocation, fun. Forever.") Sponsorship was primarily focused on new and youth-oriented sports or events with an offbeat lifestyle, such as snowboarding, mountain biking, bungee jumping, and rock climbing.

However, in October 1998, Swatch sold its minority 19 per cent shareholding of Micro Compact Car, the vehicle producer, to manufacturing partner Daimler-Benz. Although the group was still looking for key partners to develop the hybrid electric *Swatchmobile,* management made it clear that its core business remained the watch industry and microelectronics.

Strategic Decisions

In early June 1999, Hayek was under growing pressure to clarify the company's strategy. Many observers and shareholders were wondering whether the original management philosophy that shaped the company's success remained viable.

Conventional wisdom suggested that all watch companies should locate manufacturing activities in countries that offered low-cost production solutions. The Swatch Group had always remained committed to its Swiss home base, leaving the bulk of its technology, people and manufacturing in the isolated villages

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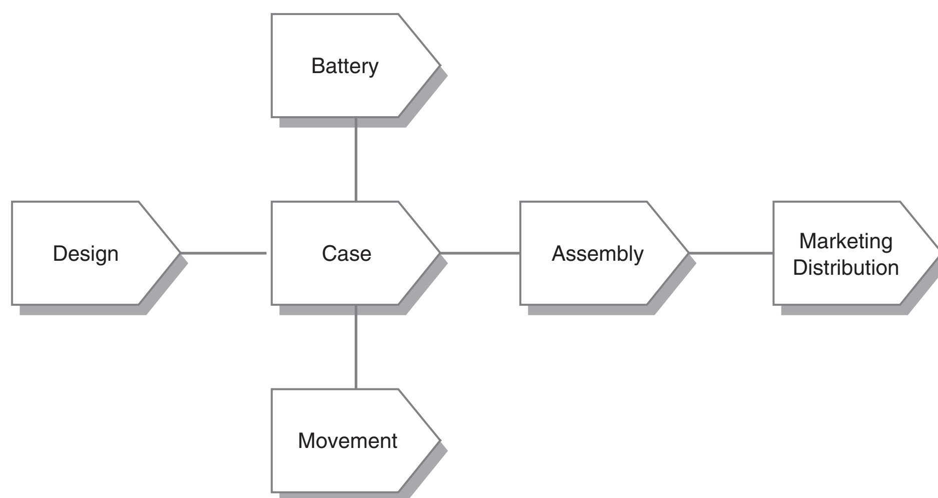

Exhibit 11 Watch Production and Value Added Chain

	Units in thou.	Average price in SFr*	Turnover in SFr. million	% of total	EBIT in SFr. million	% total	Margin in %
Omega	550	1,200	670	28%	147	47%	22%
Swatch	26,000	36	925	38%	79	25%	9%
Tissot	1,600	100–150	210	9%	20	6%	10%
Rado	300	570	170	7%	31	10%	18%
Longines	550	270	150	6%	23	7%	15%
Calvin Klein	600	130	75	3%	4	1%	5%
Blancpain	10	6,500	65	3%	6	2%	9%
Other	1,500	80	145	6%	3	1%	2%
Total	**31,110**	**80**	**2,410**	**100%**	**312**	**100%**	**13.0%**

Exhibit 12 The Swatch Group's Turnover and Margin Estimates for 1998

Source: Bank Leu estimates.

*Factory gate price

surrounding the Jura Mountains. Those places possessed hundred years of experience in the art of watchmaking. Employees had spent generations in the factories controlled by the Swatch Group, where they developed a special feel and touch for this business along with a true sense of organizational commitment. However, the company's junior secretaries in Switzerland earned more than senior engineers at competitors in Thailand, Malaysia, China or India. Maybe it was time to move on and stop building watches in one of the most expensive countries in the world. But which, if any, of the value-added chain activities should be moved (see Exhibit 11)?

With its huge domestic demand and low-cost labor, India offered interesting sourcing opportunities. Many industry analysts believed that Titan Industries was looking for key foreign partners,

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after the demise of an early alliance with Timex. Would a partnership with a company like Titan make sense, or if and when the company were to move, should it go it alone?

Another trend management had to address was the movement of many watch companies into ever-more narrow or differentiated market niches. The Swatch Group was present in all market segments and price categories, but its performance depended mainly on four brands names, Omega, Swatch, Tissot and Rado, which together accounted for 82 per cent of total sales and 88 per cent of operating profit in 1998 (see Exhibit 12). Perhaps it was time to reorganize the company's portfolio. Advertising budgets had already been reallocated towards the luxury and high-tech markets, where the company was also constantly looking for key partners and acquisition targets. However, for many industry observers, this product market strategy (luxury-high tech and/or globalization) was becoming too complex for the company's internal capabilities, as indicated in the failure of the smart car project.

Notes

1. This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of the Swatch Group or any of its employees.
2. Women's Wear Daily, March 20, 1998.
3. Chief Executive, 1998.
4. Financial Times, April 24/25 1999
5. In June 1999 US$1 = ¥119
6. Financial Times London Edition. Financial Times. September 10, 1997; 43.
7. In June 1999, SF 1 = US$0.66.
8. Time, March 28, 1994.
9. Jewellers' Circular-Keystone, December 1998

THUNDERBIRD
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Whirlpool Corporation's Global Strategy

Prepared by Meredith Martin, Simon Algar, and Vipon Kumar under the supervision of Professor Andrew C. Inkpen

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> *We want to be able to take the best capabilities we have and leverage them in all our companies worldwide.*
>
> —David Whitman, Whirlpool CEO, 1994, Quoted in the *Harvard Business Review*

In 1989, Whirlpool Corporation (Whirlpool) embarked on an ambitious global expansion with the objective of becoming the world market leader in home appliances. Beginning with the purchase of a majority stake in an appliance company owned by Philips, the Dutch electronics firm, Whirlpool purchased a majority stake in

an Indian firm, established four joint ventures in China, and made significant new investments in its Latin America operations.

However, by the mid-1990s, serious problems had emerged in the company's international operations. In 1995, Whirlpool's European profit fell by 50% and in 1996, the company reported a $13 million loss in Europe. In Asia, the situation was even worse. Although the region accounted for only 6% of corporate sales, Whirlpool lost $70 million in Asia in 1996 and $62 million in 1997. In Brazil, Whirlpool found itself a victim in 1997, and again in 1998, of spiraling interest rates. Despite the company's investments of hundreds of millions of dollars throughout the 1990s to modernize operations there, appliance sales in Brazil plummeted by 25% in 1998. Whirlpool expected that 1999 would be the third straight year of declining sales for the Brazilian subsidiary.

In response to these problems, Whirlpool began a global restructuring effort. In September 1997, the company announced that it would cut 10% of its global workforce over the next two years and pull out of two joint ventures in China. In announcing the cuts, Whirlpool's CEO David Whitwam said, "We are taking steps to align the organization with the marketplace realities of our industry."[1] In Latin America, 3,500 jobs were abolished, and significant investments were made to upgrade plants and product lines.

After the optimism of the early 1990s, what went wrong with Whirlpool's global strategy? Was the company overly ambitious? Was there a lack of understanding about how to create an integrated global strategy? Or, were the problems the result of changes in the competitive and economic environments in Europe, Asia, and Latin America? Should Whirlpool have foreseen the problems and reacted earlier?

The Appliance Industry in the Late 20th Century

Approximately 120 million home appliances are sold in developed countries each year.[2] The appliance industry is generally classified into four categories: laundry, refrigeration, cooking, and other appliances. Appliances are constructed in capital intensive plants, and design usually varies among countries and regions.

The North American Industry

Although it was estimated that 46 million appliances were sold in North America annually, the market was expected to grow little in the late 1990s. Saturation levels were high, with virtually 100% of households owning refrigerators and cookers and over 70% owning washers. Because of the limited growth opportunities, competition was fierce. In the United States, the industry had consolidated in the 1980s, leaving four major competitors: Whirlpool, General Electric, Electrolux, and Maytag (see Exhibit 1 for more detail). These four firms controlled about 80% of the market.[3] Each firm offered a variety of products and brands segmented along price lines. Distribution of these appliances was generally through sales to builders for new houses or to retailers, such as department stores and specialty resellers.

In a *Harvard Business Review* article in 1994 called "The Right Way to Go Global," David Whitwam, Whirlpool's CEO, described the competitive situation that existed in the early 1990s:

> Even though we had dramatically lowered costs and improved product quality, our profit margins in North America had been declining because everyone in the industry was pursuing the same course and the local market was mature. The four main players—Whirlpool, General Electric, Maytag, and White Consolidated, which had been acquired by Electrolux—were beating one another up everyday.[4]

With limited growth opportunities and a handful of major players in the United States, it was critical that firms focus on cost reduction, productive efficiency, and product quality. Product innovation was also critical, although few major innovations had occurred in recent years. The apppliance firms segmented their

GE Appliance

General Electric Appliance was the second-largest manufacturer of household appliances in the U.S. (behind Whirlpool). Other brand names produced by the company included Monogram, Profile, Profile Performance, Hotpoint, and some private brands for retailers. GE Appliance comprised approximately 6% of the parent company's sales and had the top market share position in India and Mexico. In addition, the company had a 50–50 joint venture with General Electric Co., the leading appliance firm in the United Kingdom.

Maytag

Maytag's products were generally aimed at the mid-to-high end of the market and commanded a premium price based on product quality and reliability. Other brand names produced by Maytag included Jenn-Air, Magic Chef, Performa, and Hoover. Maytag entered the European market in 1989, but after a decline in profits, pulled out of Europe in 1995. Maytag had a limited international presence in China.

AB Electrolux

AB Electrolux was the world's largest producer of household appliances. Other Electrolux brand names included Frigidaire, Tappan, and Kelvinator. The Swedish company had the number one market share in Europe and number four market share in North America. Electrolux entered the United States when it bought White Consolidated Industries in 1986. The firm was actively expanding overseas into Eastern Europe, China, India, South East Asia, and Latin America.

Exhibit 1 Major Competitors in the United States

Sources:
Hoovers Online. Accessed 2/9/00.

Remich, Norman C. "A Kentucky Thoroughbred that is Running Strong," *Appliance Manufacturer*, July 1995: GEA-3.

Steinmetz, Greg and Carl Quintanilla. "Tough Target: Whirlpool Expected Easy Going in Europe, and It Got a Big Shock," *Wall Street Journal*, 10 April 1998: Sec. A:1.

products according to different consumers' needs, and each strived to achieve greater economies of scale. Still, by the end of the 1990s, the competitive landscape remained unattractive. Profit margins continued to decline for most firms. Many analysts believed that the market for appliances was saturated and that there would be little increase in growth rates. This saturation had left the distributors focusing primarily on replacement purchases and purchases for new housing developments.

The European Industry

In the early 1980s, there were approximately 350 producers of household appliances in Europe. With consolidation in the industry, by the late 1980s the number had shrunk to about one hundred.[5] By early 1995, it was estimated that five of the companies, including Electrolux (with a 25% market share), Philips Bauknecht, and Bosche-Siemens, controlled over 70% of the market.[6] The industry was highly regionalized, with many of the companies producing a limited number of products for a specific geographic area.

The European market consisted of more than 320 million consumers whose preferences varied by country and by region. For example, Swedes preferred galvanized washing machines to withstand the damp salty air.[7] The British washed their clothes more often than the Italians did, and wanted quieter machines. The French liked to cook on gas at high temperatures, splattering grease on cooking surfaces, and so preferred self-cleaning ovens, while the Germans liked to cook on electric stoves at lower temperatures and did not need such features.[8]

Distribution of the appliances in Europe was different than in the United States. Most appliances were sold through independent retailers, who had become organized in buying groups or as multiple store chains.[9] A smaller channel was

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through independent kitchen specialists who sold complete kitchen packages, including appliances.[10]

The Asian Industry

Asia, the world's second-largest home appliance market, was also the fastest growing market of the 1980s. By the mid-1990s, it was growing at a rate of between 8% and 12% annually, a rate that was expected to continue well past the year 2000.[11] The industry was highly fragmented, consisting of manufacturers primarily from Japan, Korea, and Taiwan. Matsushita, the market leader, held less than 10% market share outside Japan.

Asian consumer preferences were different from those in Europe or North America. Kitchen appliances needed to be smaller to fit in Asian kitchens. Lack of space sometimes required the consumer to store the appliance in an outside hallway and transport it into the kitchen for use.[12] Therefore, high value was placed on appliances that were portable, usually lightweight and on wheels, and easily hooked up to electrical and water supplies. Refrigerators also tended to be smaller and more colorful. Indeed, when Asian countries first began to experience significant economic growth, some East Asians viewed their refrigerators as status symbols and liked to display them prominently, perhaps even in the sitting room. Clothes dryers and dishwashers were uncommon in most Asian countries, but most homes had microwaves.

Appliances in Asia were traditionally sold through small retail shops. However, the industry was beginning to witness a shift away from these small shops and towards distribution through national, power retailer organizations, especially in China and parts of Southeast Asia.

The Latin American Industry

The economic stability in Latin America in the 1990s made the region an attractive growth proposition. The appliance makers hoped that the days of hyperinflation and economic mismanagement were over, and they were pleased to see that governments were reducing tariffs. Distributors in Latin America were generally responsible for marketing a company's appliances to small independent retailers in the region.[13] In 1994, there were over 65 competitors in the Latin American market, many of them subsidiaries of U.S. parents.

Whirlpool Corporation

Whirlpool was founded in 1911 as The Upton Machine Co. in St Joseph, Michigan, to produce an electric motor-driven wringer washer. The company merged with The Nineteen Hundred Washer Company in 1929 and began to sell their first automatic washing machine through Sears, Roebuck & Co. in 1947. The Whirlpool brand was introduced in 1948 and steadily built a strong retail relationship with Sears. Through a series of acquisitions and mergers, the company emerged as a leading force in the U.S. appliance industry with annual revenue reaching $2 billion in 1978 (see Exhibit 2 for more detail on Whirlpool's history). Whirlpool's headquarters was in Benton Harbor, Michigan.

As of 1998, Whirlpool Corporation claimed to be the world's leading manufacturer of major home appliances. The company manufactured in thirteen countries and marketed its products under eleven major brand names (including Kenmore, Sears, KitchenAid, Roper, Inglis, and Speed Queen) to over 140 countries. Whirlpool's sales were $8.2 billion in fiscal year 1997.

The Globalization of Whirlpool

Whirlpool's first international investment was in 1957 when the firm acquired an equity interest in Multibras S.A., a Brazilian manufacturer of white goods. In 1969, the company entered the Canadian market by purchasing an equity interest in Inglis Ltd. and acquired sole ownership in 1990.

By the mid-1980s, Whirlpool saw that, despite increasing efficiencies and product quality, its profit margins were rapidly decreasing in North

1911	Upton Machine Co. is founded in St. Joseph, Michigan, to produce electric motor-driven wringer washers.
1916	First order for washers is sold to Sears, Roebuck and Co.
1929	Upton Machine merges with Nineteen Hundred Washer Company of Binghamton, New York. The new firm, Nineteen Hundred Corp., operates plants in Michigan and New York until Binghamton is closed in 1939.
1942	All facilities are converted to wartime production until end of World War II in 1945.
1947	The company's first automatic washer is introduced to the market by Sears.
1948	A Whirlpool brand automatic washer is introduced, thus establishing dual distribution—one line of products for Sears, another for Nineteen Hundred.
1950	Nineteen Hundred Corporation is renamed Whirlpool Corporation. Automatic dryers are added to the product line.
1951	LaPorte, Indiana, plant is acquired. It will become the company's parts distribution center. Whirlpool merges with Clyde (Ohio) Porcelain Steel and converts the plant to washer production. All washers eventually will be produced here.
1955	Manufacturing facilities are purchased in Marion, Ohio, from Motor Products Corp., and dryer production is transferred there. Whirlpool merges with Seeger Refrigerator Co. of St. Paul, Minnesota, and the Estate range and air conditioning divisions of R.C.A. RCA Whirlpool is established as the brand name; Whirlpool-Seeger Corporation, as the company name. A refrigeration plant is acquired in Evansville, Indiana, from International Harvester.
1956	First full line of RCA Whirlpool home appliances is introduced. RCA will be used with the Whirlpool brand name until 1967. New administrative center is completed on 100-acre site in Benton Harbor.
1957	Company name is changed back to Whirlpool Corporation. Appliance Buyers Credit Corporation is established as a wholly owned finance subsidiary. It will be renamed Whirlpool Financial Corporation in 1989.
1957	Whirlpool invests in Brazilian appliance market through purchase of equity interest in Multibrás S.A. It is renamed Brastemp S.A. in 1972.
1966	The Norge plant in Fort Smith, Arkansas, is acquired, adding more than one million sq. ft. of refrigeration manufacturing space.
1967	Toll-free Cool-Line® Telephone Service begins. Renamed the Consumer Assistance Center in 1990, it gives customers direct, 24-hour access to Whirlpool. The company's first totally new manufacturing facility is completed in Findlay, Ohio. Dishwashers and, later, ranges will be manufactured there.
1968	The Elisha Gray II Research & Engineering Center is completed in Benton Harbor. For the first time, annual revenues reach $1 billion.
1969	The company enters the Canadian appliance market through purchase of an equity interest in Inglis Ltd. Sole ownership is established in 1990.
1970	Construction is completed on a new plant in Danville, Kentucky. Production of trash compactors and, later, vacuum cleaners is transferred there.
1976	Whirlpool increases its investment in the Brazilian market through purchase of equity interests in Consul S.A., an appliance manufacturer, and Embraco S.A., a maker of compressors.
1978	Annual revenues reach $2 billion.
1983	The company announces a phaseout of washer assembly at St. Joseph. All washers will be made at Clyde.
1984	The St. Paul Division is closed. Production of freezers and ice makers moves to Evansville.
1986	Whirlpool purchases the KitchenAid division of Hobart Corporation. A majority interest is purchased in Aspera s.r.l., an Italian compressor manufacturer. Whirlpool will become sole owner before the business is sold to Embraco of Brazil in 1994. Whirlpool closes most of its St. Joseph Division. The remaining machining operation is renamed the Benton Harbor Division.
1987	Whirlpool and Sundaram-Clayton Limited of India form TVS Whirlpool Limited to make compact washers for the Indian market. Whirlpool will acquire majority ownership in 1994.
1988	A joint venture company, Vitromatic S.A. de C.V., is formed with Vitro, S.A. of Monterrey, to manufacture and market major home appliances for Mexican and export markets. Whirlpool acquires the Roper brand name, which it will use to market a full line of value-oriented home appliances.

Exhibit 2 Whirlpool History *(Continued)*

1989	Whirlpool and N.V. Philips of the Netherlands form a joint venture company, Whirlpool Europe B.V., from Philips major domestic appliance division, to manufacture and market appliances in Europe. Whirlpool will become sole owner in 1991. Appliance operations in the United States, Canada, and Mexico are brought together to form the North American Appliance Group (NAAG). Annual revenues catapult over the $6 billion mark.
1990	A program is launched to market appliances in Europe under the dual brands Philips and Whirlpool. Whirlpool Overseas Corporation is formed as a subsidiary to conduct marketing and industrial activities outside North America and Western Europe. An Estate brand of appliances targeted to national accounts is introduced.
1991	The company commits globally to its Worldwide Excellence System, a total quality management program dedicated to exceeding customer expectations. NAAG repositions its refrigeration business. The Port Credit, Ontario, plant is closed. Top- and bottom-mount refrigerators are consolidated at Evansville, side-by-side refrigerators at Fort Smith.
1992	Whirlpool assumes control of SAGAD S.A., of Argentina. Whirlpool Hungarian Trading Ltd. is formed to sell and service appliances in Hungary. Whirlpool Tatramat is formed to make and sell washing machines and market other major home appliances in Slovakia. Whirlpool will take controlling interest in 1994. A Small Appliance Business Unit is formed to operate on a global basis. Revenues top $7 billion. The South American Sales Co. (SASCo), a joint venture with Whirlpool's Brazilian affiliates, begins directing export sales to 35 Latin American countries.
1993	Whirlpool Overseas Corporation is replaced by two separate regional organizations: Whirlpool Asia and Whirlpool Latin America. Whirlpool Asia sets up headquarters in Tokyo with regional offices in Singapore, Hong Kong, and Tokyo. Sales subsidiaries are opened in Poland and the Czech Republic, adding to Whirlpool Europe's growing presence in Eastern Europe. Whirlpool wins the $30 million Super Efficient Refrigerator Program sponsored by 24 U.S. utilities. Inglis Ltd. becomes Canada's leading home appliance manufacturer.
1994	Whirlpool Asia and Teco Electric & Machinery Co. Ltd. form Great Teco Whirlpool Co. Ltd. to market and distribute home appliances in Taiwan. Whirlpool becomes a stand-alone brand in Europe. Brazilian affiliates Consul and Brastemp merge to form Multibrás S.A. Electrodomésticos. Whirlpool breaks ground in Tulsa, Oklahoma, for a new plant to make freestanding gas and electric ranges. Whirlpool's Asian headquarters is moved to Singapore, and the number of operating regions is increased from three to four. Whirlpool exits vacuum cleaner business. To strengthen competitiveness, a major restructuring is announced in North America and Europe. One U.S. and one Canadian plant close. Total revenues top $8 billion.
1995	An executive office is formed in Whirlpool Asia to lead the company's rapid growth and manage strategic deployment in the region. Whirlpool acquires controlling interest in Kelvinator of India Ltd., one of India's largest manufacturers and marketers of refrigerators. TVS Whirlpool Ltd. changes name to Whirlpool Washing Machines Ltd. (WWML). Construction is completed on a new plant in Greenville, Ohio. KitchenAid small appliances will be manufactured there. Whirlpool begins to sell appliances to Montgomery Ward. Whirlpool Europe opens representative office in Russia. Whirlpool Financial Corporation (WFC) is established in India. Whirlpool assumes control of Beijing Whirlpool Snowflake Electric Appliance Group Co. Ltd., a refrigerator and freezer manufacturing joint venture. Beijing Embraco Snowflake Compressor Co. Ltd., a compressor manufacturing joint venture, is formed between Embraco and Beijing Snowflake. Whirlpool has a minority position in the joint venture. Whirlpool acquires controlling interest in Whirlpool Narcissus (Shanghai) Co. Ltd., a washing machine manufacturing joint venture. Whirlpool acquires majority ownership of SMC Microwave Products Co. Ltd., a microwave oven manufacturing joint venture. Shenzhen Whirlpool Raybo Air-Conditioner Industrial Co. Ltd., an air conditioner manufacturing joint venture, is formed with Whirlpool having a majority stake. Whirlpool investments in Asia increase to over US$350 million, and employees total more than 9,300.
1996	Whirlpool Europe opens sales subsidiaries in Romania and Bulgaria. Production of electric and gas ranges officially begins in Whirlpool's new plant in Tulsa, Oklahoma. The company's new Greenville, Ohio, plant, which manufactures KitchenAid small appliances, begins production. The Ft. Smith Division in Arkansas begins production of trash compactors. Whirlpool Asia employees total more than 12,000. Whirlpool Europe acquires the white goods business of Gentrade of South Africa. The acquisition provides Whirlpool a sales and manufacturing base in this country.

Exhibit 2 Whirlpool History

Source: <http://www.whirlpool.com>

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America. Top management believed that if the company continued to follow its current path, the future would be "neither pleasant nor profitable."[14] They considered restructuring the company financially or diversifying into related businesses but eventually settled on further global expansion for two main reasons: the company wished to take advantage of less mature markets around the world and it did not want to be left behind by its competitors, which had already begun to globalize.

Whitwam's Vision and Platform Technology

David Whitwam joined Whirlpool in 1968 as a marketing management trainee and rose through the sales and marketing ranks to succeed Jack Sparks as CEO in 1987. Although Whitwam admitted that he had never actually run a multinational company until Whirlpool bought Philips in 1989, he believed that:

> The only way to gain lasting competitive advantage is to leverage your capabilities around the world, so that the company as a whole is greater than the sum of its parts. Being an international company—selling globally, having global brands or operations in different countries—isn't enough.[15]

Whitwam was convinced that most companies with international divisions were not truly global at all, as their various regional and national divisions still operated as autonomous entities rather than working together as a single company. He believed that the only way to achieve his vision of an integrated international company, or one company worldwide, was through intensive efforts to understand and respond to genuine customer needs and through products and services that earn long-term customer loyalty.

Whitwam talked about his vision of integrating Whirlpool's geographical businesses so that the company's expertise would not be confined to one location or product. He forecast appliances such as a World Washer, a single machine that could be sold anywhere, and he wanted to standardize the company's manufacturing processes. According to Whitwam,

> Today products are being designed to ensure that a wide variety of models can be built on the same basic platform . . . Varying consumer preferences require us to have regional manufacturing centers. But even though the features . . . vary from market to market, much of the technology and manufacturing processes involved are similar.[16]

Given this view that standardization should be the focus, Whirlpool planned to base all its products, wherever they were built or assembled, on common platforms. These platforms would produce the technological heart of the product, the portion of the product which varied little across markets. The products could then be diversified to suit individual and regional preferences. In this way, the parts that the customer sees—the dimensions of the appliance, the metal case, and the controls—could be varied by segment or market to fulfill consumers' needs. The products would also have to meet rigorous quality and environmental standards to ensure that they could be used in different countries around the world.

Whitwam believed that the platform technology would bring a $200 million annual savings in design and component costs by the time it was fully implemented in the year 2000.[17] In addition, management was convinced that the platform strategy would put the company two to three years ahead of its competitors.

Platform technology, however, represented only the beginning of Whirlpool's globalization strategy. According to Whitwam in the 1994 interview, Whirlpool could not truly achieve its goal of globalization until:

> . . . we have cross-border business teams . . . running all of our operations throughout the world . . . There will also come a day when we'll identify a location where the best skills in a certain product area should be concentrated, and that place will become the development center for that type of product . . . [but] while we may have only one major design center for a given product, not everyone associated with that product will have to be located there.[18]

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Developing and Implementing the Global Strategy

By 1987 Whirlpool had adopted a five-year plan to develop a new international strategy. The company's 1987 Annual Report included the following statement:

> The U.S. appliance industry has limited growth opportunities, a high concentration of domestic competitors, and increasing foreign competition. Further, the United States represents only about 25% of the worldwide potential for major appliance sales. Most importantly, our vision can no longer be limited to our national borders because national borders no longer define market boundaries. The marketplace for products and services is more global than ever before and growing more so every day.

Recent industry forecasts indicated that approximately three-quarters of the growth in domestic appliance sales between 1995 and 2000 would be in East Asia (including Australia), Eastern Europe, and South and Central America. According to the forecasts, by 2000 these three regions (excluding Japan) would account for about 34% of sales.

European Expansion

In 1989, Whirlpool bought a major stake in N.V. Philips, a struggling Dutch appliance operation, and then purchased the remaining equity in 1991 for a total of $1.1 billion.[19] Whitwam believed that the U.S. and European markets were very similar and hoped that Whirlpool would be able to replicate their successes in the United States in the new market through implementation of a pan-European strategy. Whirlpool management also believed that the European market was becoming more "American." Research performed by the company indicated that European integration was making it more difficult for smaller companies to survive and that the industry was ripe for consolidation. Whirlpool's plan was to be one of the big players following this consolidation, and Whitwam was expecting a 20% share of the $20 billion market by the year 2000.[20] Whirlpool's strategy was to focus on brand segmentation and operational efficiency. It was believed that the company that produced the most innovative products while reducing costs would capture the market.

The European subsidiary, Whirlpool Europe BV (WEBV), created a brand portfolio segmented by price. Bauknecht (Philip's German brand) served as the company's high-end product while Ignis served as the lower-end, value brand. The Philips/Whirlpool brand filled the middle range.[21] However, the company decided to heavily market the Whirlpool brand name at the expense of managing its other European brands. Managers at Bauknecht in Germany saw their marketing budgets slashed and Bauknecht's market share fell from 7% to 5%.[22] By 1995, however, consumer research showed Whirlpool to be the most recognized appliance brand name in Europe, despite the fact that many Germans, Italians, and French had a problem pronouncing the name.

To better manage sales and service throughout the region, Whirlpool set up two centralized distribution centers: one in Cassinetta, Italy, and one in Schorndorf, Germany. Operations were streamlined in order to achieve reduced costs through economies of scale, and considerable efforts were put toward product innovation and increasing operational efficiency. This strategic focus was overlaid with a global outlook, and managers were regularly rotated between Europe and the United States. The rotation generated a crossover of ideas but annoyed retail clients who felt that they had no continuity when dealing with senior managers.

The early years of European expansion were successful. Sales and profits increased steadily, and Whirlpool made a profit of $129 million in Europe in 1993. The company was able to cut costs by reducing the number of suppliers it dealt with and by using common parts in its appliances.

However, Whirlpool was not the only company aggressively attacking the market, and

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competition subsequent to Whirlpool's entry grew fierce. Electrolux and Bosch-Siemens both greatly improved their efficiency, along with many of the smaller European companies. The European companies laid off large numbers of workers, built up their core businesses, and concentrated on generating profits. Bosch-Siemens expanded its overseas operations while keeping production local and the company managed to raise its non-German revenue by more than 30% in five years. Electrolux shed all of its non-appliance businesses and cut its workforce by 15,000, closing 25 factories. Electrolux invested in new factories and achieved higher efficiency. Both Electrolux and Bosch-Siemens increased their profitability.

Across the industry, European plants doubled their output from 1990 to 1998 and cut the time needed to build a washing machine from five days to eight hours. Companies embraced computer-aided design techniques to speed the development of products. In 1997, it was reported that a new washing machine could move from the ideas stage to the shops in just 2-1/2 years, twice as fast as only a few years before. The "value gap" which existed between appliances in the United States and Europe also closed by an estimated 15% to 20% for all appliances.[23]

The state of the retail sector also changed. Traditionally, the producers had determined price in the European appliance industry. These producers had been able to reduce their costs through greater operational efficiencies and had allowed the retailers to keep their margins constant. However, by the 1990s, the number of retail outlets across Europe had fallen significantly, giving the larger surviving retailers more power when dealing with manufacturers. Recession in Europe also caused consumers to become more cost-conscious, and brands such as the low-price firm Indesit won considerable market share.

With all companies becoming more efficient as producers, there was a shift towards product innovation as the basis for competition. For example, Whirlpool increased the size of the entrance of its front-loading washing machines, thus allowing clothes to be pushed into the machine more easily and contributing to increased sales. Companies also attempted to improve customer service and to create appliances that were more friendly to the environment. Such changes were not going unnoticed, but the industry appeared to be extremely mature. Not only were new entrants, such as Whirlpool, GE, Daewoo of South Korea, and Malaysia's Sime Darby, trying to build up sales from a small base, but the traditional European producers had become more aggressive. More than that, few were making tactical or strategic errors. Seeing the increased costs of competition and the growing intensity of rivalry, Maytag left the European market in 1995, selling its Hoover unit at a $130 million loss. Leonard Hadley, Maytag's chairman, commented, "Europe isn't an attractive place to try to go in and dislodge the established players."[24]

Eastern Europe was seen as the next great battleground and Whirlpool expanded its operations in 1996 to newly developing countries in Eastern and Central Europe. In 1997, Whirlpool opened new offices in Romania, Bulgaria, Turkey, Morocco, and South Africa from its European headquarters. Sales in the initial years were disappointing.

Problems for Whirlpool

Whirlpool's sales leveled off in the mid-1990s and profits began to fall. Sales only increased 13% from 1990 to 1996, which was far from the levels management had expected. The company initiated a major restructuring in 1995 and laid off 2,000 employees. The restructuring did not solve the problems and in 1996, the company's European operations recorded a loss of $13 million. Between 1995 and 1997, the company also witnessed a rise in materials and labor costs. Exhibit 3 shows Whirlpool's stock prices versus the S&P 500. Exhibits 3 and 4 show Whirlpool corporate and business unit financial information.

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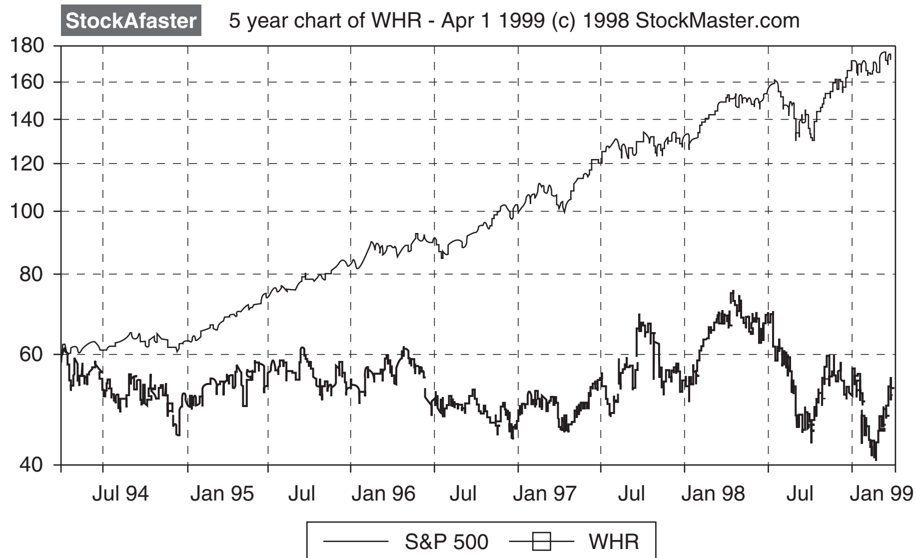

Exhibit 3 Whirlpool Share Price*

*The Whirlpool share price is on the bottom.

Whirlpool announced a second restructuring in 1997. The company planned to cut a further 4,700 jobs worldwide, or about 15% of its workforce, mostly in Europe. In 1998, WEBV had a 12% market share and held the number three market position. However, in 1998, the profit margin had reduced further to 2.3%, compared to 10% in the U.S.

Whirlpool's managers blamed a number of causes—reduced consumer demand, poor economic growth, the rising Italian lira, intense competition, and even the European Monetary Union—for its poor performance in Europe but shareholders were unimpressed. Indeed, Scott Graham, analyst at CIBC Oppenheimer, commented in 1998, "The strategy has been a failure. Whirlpool went in big [into overseas markets] and investors have paid for it."

In 1998, Whirlpool's goals remained the same, but the timeframes for delivery grew. Whitwam attributed the performance to temporary problems in the newer regions of activity and believed that Whirlpool was now "coming through the challenges." He and the rest of his management team remained resolute:

> We were convinced when we first bought [the Philips operation] and we're convinced now. The benefits from Europe have begun to flow. But they have yet to be recognized.[25]

Asian Expansion

Whirlpool's strategy in Asia consisted of five main points: partnering to build win-win relationships; attracting, retaining, and developing the best people; ensuring quality in all aspects of the business; exceeding customer needs and expectations; and offering four key products (refrigerators, washers, microwaves, and air conditioners). Although Whirlpool announced in 1987 a full-scale cooperation with Daiichi, a department store retailer in Japan, the company decided to focus its efforts in Asia primarily on India and China. There were two main reasons

Balance Sheet	Dec-98 US$MM	Dec-97 US$MM	Dec-96 US$MM	Dec-95 US$MM
Cash	636	578	129	149
Securities	0	0	0	0
Receivables	1,711	1,565	2,366	2,117
Allowances	116	156	58	81
Inventory	1,100	1,170	1,034	1,029
Current Assets	3,882	4,281	3,812	3,541
Property and Equipment, Net	5,511	5,262	3,839	3,662
Depreciation	3,093	2,887	2,041	1,883
Total Assets	7,935	8,270	8,015	7,800
Current Liabilities	3,267	3,676	4,022	3,829
Bonds	1,087	1,074	955	983
Preferred Mandatory	0	0	0	0
Preferred Stock	0	0	0	0
Common Stock	83	82	81	81
Other Stockholders' Equity	1,918	1,689	1,845	1,796
Total Liabilities and Equity	7,935	8,270	8,015	7,800
Income Statement	*Dec-98 US$MM*	*Dec-97 US$MM*	*Dec-96 US$MM*	*Dec-95 US$MM*
Total Revenues	10,323	8,617	8,696	8,347
Cost of Sales	9,596	8,229	8,331	6,311
Other Expenses	39	377	65	31
Loss Provision	45	160	63	50
Interest Expense	260	168	165	141
Income Pre Tax	564	–171	130	242
Income Tax	209	–9	81	100
Income Continuing	310	–46	156	209
Discontinued	15	31	0	0
Extraordinary	0	0	0	0
Changes	0	0	0	0
Net Income	325	–15	156	209
EPS Primary	$4.09	($0.20)	$2.08	$2.80
EPS Diluted	$4.06	($0.20)	$2.07	$2.76

Exhibit 4 Whirlpool Financial Statements

Source: Whirlpool Annual Reports.

for this decision. First, recent changes in government regulations in both countries made it possible for foreign corporations to own a controlling interest in a manufacturing company. Second, the large populations of India and China reduced the risk of establishing large-scale operations there.

Whirlpool decided that the best way to enter the Asian market was through joint ventures, as they would allow the company to quickly establish a manufacturing presence in Asia. Once it had accomplished this goal, Whirlpool planned to build its own manufacturing facilities in the region. In 1987, Whirlpool announced an agreement with Sundram Clyton of India to manufacture compact washers for the Indian market, a joint venture which later became known as Whirlpool Washing Machines Limited. In 1993,

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the Asian group established regional headquarters in Tokyo and a pan-Asian marketing, product development, and technology center in Singapore.

Whirlpool intensified its Asian acquisition strategy in 1995 with various acquisitions and joint ventures in both India and China. The company bought controlling interest in Kelvinator in India, combined it with Whirlpool Washing Machines Limited, and renamed the new entity Whirlpool of India (WOI). In addition to giving Whirlpool a 56% interest in WOI, the Kelvinator purchase gave the company direct access to more than 3,000 trade dealers in India. Between 1994 and 1995, the company also set up four joint ventures in China, as it believed that China's market for appliances was likely to equal or surpass that of North America within ten years. By 1996, Whirlpool's investment in Asia had reached $350 million and they employed over 12,000 people. In 1997, the Asian businesses generated over $400 million in sales.

Despite its investments, however, the company suffered operating losses in Asia of $70 million in 1996 and $62 million in 1997. In 1997, Whirlpool decided to restructure its Chinese operations when overcapacity in the refrigerator and air-conditioning markets drove prices down significantly. In 1997, Whirlpool decided to find strategic alternatives for the two money-losing joint ventures which catered to these two markets.

Smaller Chinese companies were also seizing considerable market share away from the multinational foreign competition. Haier, a Chinese producer of air conditioners, microwave ovens, refrigerators, and dishwashers publicly announced plans to become a global brand by 2002 and had already expanded into Indonesia and the Philippines. In addition, the Chinese government was strongly encouraging consumers to "buy Chinese."[26] Too many producers were making similar goods, and production soon outpaced demand. For example, although Whirlpool believed it would take approximately five to six years for the market to become saturated, the refrigerator and air conditioning markets were deemed saturated just two years after Whirlpool established its joint ventures in China. In addition, the company's Asian operations produced products of poorer quality than its Japanese rivals.[27]

Competition and overcapacity were not the only problems for Whirlpool. The company had overestimated the size of the market. The Chinese middle class that could afford new home appliances numbered only about 120 million and there was no tradition in China of changing appliances that worked properly.

Once in China, Whirlpool also realized that it had not properly understood the distribution system. The company discovered that there were huge geographical distances between Chinese cities and that the country lacked strong distribution channels. The company had not expected to face major problems with telecommunications and, despite the country's huge labor supply, Whirlpool had difficulties finding qualified people for its factories.

The situation in India was similar. Despite having invested heavily in advertising and promotions, Whirlpool blamed overcapacity and difficult trading conditions in the refrigerator sector for its losses. Nevertheless, Whitwam remained confident:

> Our lower cost structure and focus on the remaining majority-owned joint ventures in China, combined with our strong market position in India and Asia-Pacific sales subsidiaries, leave Whirlpool well positioned for future growth and profitability in this region . . . Our growing knowledge of Asia and ability to draw on the other global resources of Whirlpool will lead to continued improvement in our operating performance in 1998 and beyond, especially as we manage through a difficult market and economic environment.[28]

Whirlpool continued to invest money in India and committed over $100 million to build a new plant near Pune to produce chlorofluorocarbon-free and frost-free refrigerators for the Indian market. The company began construction of the new facility in 1997 and the factory began commercial production in the first quarter of 1998.

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LATIN AMERICAN EXPANSION

Throughout most of the 1990s, Brazil was Whirlpool's most profitable foreign operation.[29] The company first bought into the Brazilian market in 1957 and held equity positions in three companies: Brasmotor S.A., Multibras, and Embraco. These companies held a 60% market share and after 40 years of operating in Brazil, had extremely high brand recognition and brand loyalty. Whirlpool took over Philip's Argentine subsidiary, SAGAD, in 1992. In the mid-90s, sales and profit figures were good, with sales up 28% in 1994-1995, and 15% in 1996. In 1997, Brazilian operations recorded approximately $78 million in earnings.

Because Latin America had lower appliance penetration rates than Europe and the United States (e.g., only 15% of Brazilian homes owned microwaves, compared with 91% in the United States), the region appeared to be a good target for expansion. By the mid-1990s, Latin America was beginning to achieve economic stability, and growth was sure to follow. Consumers felt the same way. Many consumers were now able to replace old and worn-out appliances using budget plans and credit arrangements.

In 1997 in Brazil, Whirlpool spent $217 million to increase its equity share in Brasmotor from 33% to 66%. Whirlpool then invested another $280 million in 1997 and 1998 to renew plants and product lines. The company introduced data transfer systems, flexible production lines, and launched new products. Shortly after Whirlpool made these large investments in Brazil, however, interest rates in the country began to climb. The Brazilian government doubled interest rates in October 1997 and again in 1998. As a result, the currency depreciated and the economy suffered. In real terms, the *real* fell more than 50% in the six months prior to January 1999. Total foreign investment in Brazil slumped, and the country was eventually forced to request a $41.5 billion credit line from the International Monetary Fund in order to help rescue the economy.

Worse yet, Whirlpool's market research told them that consumers had reacted quickly to the economic problems. Many were afraid of job cuts in the worsening economy and were wondering whether Brazil would resort to the traditional solution of printing money to solve the economic problems. Consumers foresaw inflation and realized that they would not be able to afford to purchase Whirlpool's appliances, especially on credit. As Antonio da Silva, a 37-year-old maintenance worker said, "I'm afraid to pay over many months because you don't know if interest rates or inflation will rise again."[30]

In 1998, Whirlpool's Brazilian sales fell by 25%, or $1 billion.[31] Equally important, Whirlpool's *real* reserves had shrunk in value against the dollar, and the company was expecting inflationary pressures. As a result, in late 1998 the company announced more restructuring to its Latin American operations. Whirlpool immediately cut 3,200 jobs (about 25% of the workforce) to improve efficiency, and the company planned to cut out levels in the production chain in its seven factories in Brazil, Argentina, and Chile. At the same time, the company increased its marketing efforts in the region.

As of 1998, Whirlpool was still confident of a return to profitability in Latin America. The company believed that industry shipments to Brazil in 1999 would equal those in 1997. *Business Week* characterized the company as bullish:

> The experience of surviving Brazil's many debt crises, bouts of hyperinflation, and military governments has given Whirlpool a been-there, done-that aura of confidence.[32]

But, given Whirlpool's poor showing in the earlier phases of its globalization plan, it still had far to go in convincing the many skeptics and disappointed shareholders that globalization was the best strategy. Many analysts were unsure whether Whirlpool's self-confidence was actually deserved or if it was little more than self-delusion.

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		Sales (in millions of US dollars)		
	Dec-97	*Dec-96*	*Dec-95*	*Dec-94*
North America	5263	5310	5093	5048
Europe	2343	2494	2428	2373
Asia	400	461	376	205
Latin America	624	268	271	329
Other	–13	–10	–5	–6
Total	**8617**	**8523**	**8163**	**7949**
		Operating Profit (in millions of US dollars)		
	Dec-97	*Dec-96*	*Dec-95*	*Dec-94*
North America	546	537	445	522
Europe	54	–13	92	163
Asia	–62	–70	–50	–22
Latin America	28	12	26	49
Restructuring charge	–343	–30		–248
Business dispositions	–53			60
Other	–159	–158	–147	–154
Total	**11**	**278**	**366**	**370**

Exhibit 5 Whirlpool Business Unit Sales and Operating Profit

Source: Whirlpool Annual Reports.

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THUNDERBIRD

THE GARVIN SCHOOL OF INTERNATIONAL MANAGEMENT

Wal-Mart Stores Inc.: Dominating Global Retailing

Prepared by Professor Kannan Ramaswamy

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Mr. Lee Scott could afford the look of confidence. He had just spoken to investment analysts about the phenomenal results from the second quarter of 2003. Despite the general weakness in the world economy and the uncertain environment that prevailed, Wal-Mart had reported sales growth of 11%, amounting to $6.4 billion. The company's associates were indeed doing the Wal-Mart cheer in faraway places like Germany, South Korea, China, and the United Kingdom. In three decades, it had grown from its rural Arkansas roots to become the world's largest company, and quite possibly the most powerful retailer.

The meteoric growth did bring with it a fair share of problems. At a macro level, there had always been questions about the ability of Wal-Mart to sustain the pace of growth it had demonstrated in recent years. Once the company vaulted over the $200 billion level in annual sales, it was clear that incremental growth would be challenging. There was a nationwide backlash against big-box retailers, and Wal-Mart was front and center in that controversy. Some of the upstart chains such as Dollar General were gearing up to nip at the heels of Wal-Mart. They claimed that customers felt lost inside the cavernous stores of Wal-Mart and that they would gladly shop at Dollar General stores, which, although much smaller, offered comparable low prices.

The emerging markets that held a lot of promise were being bitterly contested by other major players such as Carrefour, Metro, Auchan, Ahold, and Tesco. Since many of these competitors had moved into the international marketplace long before Wal-Mart, there was an experience curve handicap that Wal-Mart had to contend with.

From an operational viewpoint, the suppliers were in for a rocky ride, since the nature of their relationship with Wal-Mart had begun to change radically. Given its huge base of power, the company was able to extract significant price concessions from its suppliers. It had recently intensified promotion of its own labels and store brands that competed directly against the likes of Procter & Gamble (P&G) and Kraft. The suppliers felt that their long years of belt-tightening were not being rewarded by Wal-Mart and that they were increasingly asked to do more for less. Some had been reduced to contract manufacturers, churning products that would be sold under one of Wal-Mart's many labels.

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All was not well within the Wal-Mart family either. Some employees had filed suit against Wal-Mart, alleging that the company forced them to work overtime without any pay. This suit, some believed, had the makings of a large class-action suit, probably amongst the biggest in the realm of employment law in recent years. A similar case in Oregon was decided in favor of the employees. There was yet another pending lawsuit that charged that the company routinely discriminated against women in job promotions, especially at the supervisory and managerial levels. It was reported that although roughly 90% of Wal-Mart associates were women, they represented only 15% of the positions in top management, a disparity that was at the heart of the gender discrimination suit. To complicate matters further, in late October 2003, Wal-Mart was the target of raids by the Immigration and Naturalization Service of the U.S. Government. The agency reported that it was examining whether Wal-Mart was hiring illegal immigrants in contravention of the law.

The challenges were indeed formidable, despite the legendary strengths that the company had built upon in the past. Even Mr. Lee Scott acknowledged the uphill climb when he observed, "We'd be silly to sit here and tell you it's not a challenge."1 Although Wal-Mart had systematically decimated the negative projections of analysts in the past, it was once again the subject of doubt and naysaying. Mr. Scott had to prove himself all over again.

The World of Discount Retailing

Discount retailing had evolved into a global industry within a fairly short span of time. Pushed in large part by Wal-Mart in the U.S. and counterparts such as Carrefour, Ahold, Metro, Tesco, and others worldwide, global discount chains had cornered a significant chunk of the global retail business. The fundamentals of the business models that had evolved in various parts of the world seemed to coalesce around the principles that had been perfected by Wal-Mart. All the chains leveraged global economies of scale in purchasing, and negotiated favorable volume-based contracts with manufacturers, many of whom were themselves global. Coupled with sophisticated information systems that optimized supply chain planning and execution, the retailers were able to cut a lot of excess cost from the system and pass on some of the savings to the end customer. The competitive battle was, therefore, fought largely in terms of their ability to lure shoppers on the basis of their merchandise mix, price offers, and convenience. International expansion outside their own regions of familiarity became the norm rather than the exception. Carrefour, for example, operated in 32 countries; many of them, such as Taiwan and Brazil, were distinctly different from France, the company's home base. The global expansion was based on the simple premise that customers everywhere, irrespective of nationality, would be attracted to the value of the offer that the global retail chains

Rank	*Retailer*	*Sales ($bn)*	*Earnings ($ mil)*	*Stores (#)*	*Nationality*
1	Wal-Mart	244.5	8039	4688	USA
2	Carrrefour	86.3	1440	9725	French
3	Ahold	81.7	n/a	8800	Dutch
4	Metro	57.9	464	2310	German
5	Tesco	45.8	1178	2291	British

Exhibit 1 The World's Five Leading Global Retailers*

Source: DSN Retailing Today, July 7, 2003, and *MMR*, May 26, 2003.

*Data for 2002

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Country	*Global Retailers (#)*
France	14
Poland	13
Spain	12
Germany	11
USA	11
Belgium	11
UK	10
Thailand	10
Taiwan	10
China	10
Portugal	10
Czech Republic	10
Denmark	8
Netherlands	7
Italy	7

Exhibit 2 Global Market Penetration by International Retailers*

*Data from www.planetretail.net 2004

made—a selection of merchandise that was unrivalled at prices that were unequalled.

The evolution of the discount concept had come full circle, and the major players were locked in competitive battles that transcended mere national boundaries. They catered to a global customer base that was very much multicultural. They carefully orchestrated strategies in each country setting so that they could dominate both at the local and global levels, often using mergers and acquisitions to gain market share quickly. As a result of this growth trajectory, many of the large markets were contested by more than one global retailer. Competitive advantage in this elite group seemed to turn on deep pockets, innovative strategic thinking, and faultless execution. Contemporaneous with the jockeying for position in the developed country markets, the major chains were locked in battles for supremacy in the emerging markets as well. Many of the emerging markets had begun a wave of deregulation and allowed even *de novo* entry of established global players. Markets such as Argentina, Brazil, Hungary, Turkey, and India were within sight of the global discount retailing revolution. Given the significantly higher growth rates that these markets promised, the early entrants were sure to profit.

Creating the Wal-Mart Empire

Mr. Sam Walton founded the first Wal-Mart in 1962, originally christened as Wal-Mart Discount City. The store was located in Rogers, Arkansas, a rural town of budget-conscious shoppers. The Wal-Mart concept had evolved from a chain of Ben Franklin stores that Mr. Walton and his brother operated in Arkansas and Missouri as franchisees. When Sam took his discount retailing concept to Ben Franklin's management, they did not seem interested in it. He decided to set off on his own—and the rest, as they say, is history.

Mr. Walton was an astute entrepreneur beyond compare. He quickly realized that volume and inventory-turn velocity were the defining elements of competitive advantage in the discount retail business. He was convinced that the concept would work in small towns with populations of 5,000 to 25,000 people, locations that often lacked viable retail alternatives. Armed with the conviction of a true entrepreneur, Mr. Walton and his brother had opened 18 Wal-Mart stores by 1969 when the company was incorporated formally. In a little over the three decades that followed, the company had 4750 stores in a variety of formats across the globe, and sales had grown to roughly $245 billion. The company was widely seen as the beacon of shareholder value, the darling of investors, and the customer's champion.

Wal-Mart capitalized on its rural locations to establish important competitive advantages during its infancy. Many rural markets were characterized by populations that were scratching a subsistence level of living with very few employment alternatives. Mr. Walton saw this as a captive market that was tailor-made for a successful rollout of the discount retail model. It

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also proved to be a recruiter's paradise where a steady job at a decent wage was all that was needed to attract employees to staff its stores. Retail competition was minimal, and this allowed some flexibility in pricing merchandise, since price wars were unlikely. Local labor and real estate costs were also much lower compared to competitors who were focused on the larger cities. The stores were decidedly austere in appearance. They were essentially big boxes illuminated brightly with fluorescent lighting, stocked with shelves that carried a wide range of merchandise. All of these advantages translated into a superior operating cost structure and a veritable fortress of profitability for Wal-Mart that its city rivals found impossible to duplicate.

The company was able to quickly expand its range of merchandise in becoming a convenient one-stop shop for a large rural base. However, the rural market strategy did come with its own challenges. Wal-Mart initially found it difficult to persuade its suppliers to serve the remote stores that formed its network. This meant that inventories were replenished more slowly, leaving empty shelves and lost sales. Since inventory velocity was such an important part of Mr. Walton's original concept, the company was forced into building large warehouses to fill its own needs. This subsequently led to establishing its own logistics operations, complete with a fleet of trucks, and a private satellite system as well. All of this saved money and helped the company deliver on its promise to offer some of the lowest prices to its customers.

In becoming the largest company in the world, Wal-Mart spawned a wide range of best practices across all managerial functions. The wheel had turned full circle from the days when Mr. Walton would scour discount chain competitors for best practices, to a time when Wal-Mart was being constantly studied for new wisdom on management and strategy. Contemporary thinking on retail operations, location, and supply chain management was being shaped by Wal-Mart's success.

The Way Things Worked

By 2003, Wal-Mart stores were located very close to major cities, mostly along the outer edges in the suburbs. The rural network was still intact and the company had stores in all 50 states in the United States. All stores were quite uniform, both in their external and internal appearance. A substantial part of the real estate was leased and custom-built by the property owners. Given the fact that many of the smaller communities had been blanketed with stores, the company started driving into suburbs. It was, however, not met with quite the same enthusiasm that it received in the rural settings. Local community activists in various parts of the country were banding together to use zoning laws to keep the big-box retailer out of their backyard. It was against this backdrop that Wal-Mart started conceptualizing new store formats that would have a small enough footprint to remain unobtrusive.

Irrespective of the store format, some of the fundamentals remained the same. Every prospective Wal-Mart shopper was greeted at the door by a cheerful greeter. Most of the greeters were senior citizens from the local communities. The company found that the greeters had the desirable effect of reducing pilferage as well, and the cheerful welcome did help the courteous image. The shelves were fully stocked with a wide range of products—over 120,000 in standardized layouts. The stores did not carry any backroom inventory, and this helped maximize retail selling space. Each store was broken down into smaller departments such as housewares, pharmaceuticals, and horticulture—each with a department manager in control. A substantial portion of employee bonuses was linked to departmental level performance, thus motivating employees to do their best within their assigned departments. Although centrally orchestrated, managers did have some leeway in adjusting prices to factor in local realities. Wal-Mart did not necessarily price its products below the lowest competitor price; instead, it aimed to set prices as low as possible. This meant that the prices did vary from store to

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store to reflect the level of competition that prevailed. The company did very little direct advertising. In contrast to competitors such as Target, who regularly featured glossy advertisements, Wal-Mart limited its advertising to 12 or 13 circulars a year. The circulars reflected the same bare-bones approach that the stores had adopted. There were no expensive models or glossy spreads. The company used its own associates as models for the circulars, and even used it as a motivational tool by choosing associates based on their performance.

Selling to Wal-Mart

> *The second worst thing a manufacturer can do is sign a contract with Wal-Mart. The worst? Not sign one.*
>
> —Anonymous Consultant[2]

Wal-Mart managed all its purchasing functions from its offices in Bentonville, Arkansas. It deployed a fairly small group of buyers who were charged with managing the entire buying function for the giant retailer. Manufacturers were not permitted to use middlemen or agents to mediate the relationship with the buyers. All negotiations were carried out in small, windowless offices with a décor that could be described as Spartan at best—"one fluorescent light, one table, one photo of Mr. Sam."[3] The buyers were tough negotiators and demanded a wide array of price and service concessions. For example, Mr. Katzenberg, CEO of DreamWorks, one of the world's leading movie companies, was requested by Wal-Mart to produce a customized video of *Shrek,* a mega-hit cartoon character, doing the Wal-Mart cheer, as a motivating tool for Wal-Mart associates. DreamWorks produced a suitable video in keeping with Wal-Mart's wishes. Despite the bare-knuckles negotiating environment, Mr. Katzenberg observed, "I've been there three times in the last 45 days. I cannot tell you how much I respect and love the bare-essentials efficiency . . . I'm flattered by the opportunity they've offered."[4] Indeed, Wal-Mart was the largest single revenue generator for Hollywood. The same was true of several other industries as well. For example, Wal-Mart in the U.S. was individually responsible for selling 35% of all pet food, 24% of all toothpaste,[5] the largest volume of jewelry, groceries, DVDs, CDs, toys, guns, diapers, sporting goods, bedding, and much, much more. Needless to say, this retail channel power was instrumental in helping establish a very favorable negotiating position for the company. Its purchasing volumes were gargantuan and the company had the power to bestow its riches on any supplier it chose. It was clear that the legion of over 30,000 suppliers needed Wal-Mart much more than Wal-Mart needed them, and they would do all they could to make sure that the retail giant was appeased and happy.

Right from its inception, the company had employed a "national brand" strategy in its merchandising. By carrying all the well-known brands at relatively lower prices, it was able to demonstrate the superior value it brought to its customers. The national brands were also important from an advertising point of view. Since the manufacturers either ran large campaigns themselves or shared campaign expenses with retailers, Wal-Mart was able to proportionately reduce its advertising budgets. The national brand approach was also central to Wal-Mart's approach of capturing market share from its competitors. For example, in September 2003, well ahead of the peak of the toy season, Wal-Mart began discounting the price of a dancing toy, a sure winner from Fisher Price, a unit of Mattel, the leader in toys. It was priced at an amazing 22% below what Toys 'R' Us was charging. Wal-Mart believed that its discounting approach would help customers clearly see where the bargains were and help pull market share from its toy store rivals. After all, national brands were quite visible and sought after. Mattel, however, was quite concerned that its brand might be tarnished as a result of such discounting practices.

Supplier Company	*Main Products*	*% of Sales from Wal-Mart*
Dial Corporation	Toilet soaps	28
Clorox Corporation	Liquid bleach	23
Mattel Corporation	Toys	23
Revlon	Perfumes/cosmetics	22.5
Procter & Gamble Co.	Toilet soaps, detergents	17
Energizer Holdings Inc.	Batteries	16.3
Kraft Foods	Packaged foods	12.2
Gillette Co.	Shavers, batteries	12
Kellogg Co.	Breakfast cereals	12

Exhibit 3 Wal-Mart's Influence Over its Suppliers*

**Source:* Company annual reports.

Once the stores had gained some recognition of their own, Mr. Walton launched the idea for in-store brands, starting with a dog food named Ol' Roy after his pet golden retriever. Since then, the company leveraged its scale and shelf space to pit its own brands against those that are nationally established. The bad news for its suppliers was that Wal-Mart was winning big with its in-store brands. Ol' Roy, for example, was the world's largest selling dog food, outstripping such established giants as Ralston Purina and Nestle. Nationally, the trend toward store brands was gathering momentum. According to a study by A. C. Nielsen, national brands grew by 1.5% in 2001 and 2002, but store brands grew by 8.6%. The loss of share for the national manufacturers had been so steep that many of them had shifted their manufacturing capacity to produce store brands for the leading retailers such as Wal-Mart.[6] One analyst estimated that about 40% of Wal-Mart revenues were attributable to its in-store brands, which ran the gamut from batteries to ibuprofen, from tuna to dog food, and most other items in between.[7]

Getting Wal-Mart supplier credentials was a laborious and taxing process. The company articulated very stringent requirements ranging from product quality, shipping, stocking, and in-store displays. It required all its suppliers to transact business using Retail Link, a proprietary electronic data interchange (EDI), an information processing system that allowed the electronic tracking of purchase orders, invoices, payments, and inventories. The company had moved to require some of its suppliers to incorporate RFID (Remote Frequency Identification Devices) technology in all their packaging. These RFID chips were small, unobtrusive chips that would form part of individual packages of goods that the suppliers sold through Wal-Mart. This technology would offer the company significantly enhanced capabilities in tracking sales of individual items within the stores, a potential gold mine of inventory and customer preference data. Although many suppliers had to scale a steep learning curve and make significant resource commitments to make their operations compatible with Wal-Mart's automated technology demands, there were tangible payoffs. Given the close linkage with Wal-Mart, the system allowed suppliers to monitor inventory levels and stock movements in each store. This was valuable in understanding customer preferences and also in predictive modeling to plan for inventory several months ahead of time. The company was a willing teacher, often educating its suppliers on the finer points of cost control and efficiency. It routinely dispensed advice to its suppliers on how they could redesign their product, packaging, or process to reduce costs. When Wal-Mart taught, the suppliers were willing pupils. Jack Welch, the former CEO of General Electric, once observed

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that he learned more about the customers who bought GE light bulbs from Wal-Mart's supplier reports than he did from his own marketing department. After all, the relationship between the manufacturer and the end user was no longer a direct one. It increasingly went through Wal-Mart.

Raising prices was unheard of. Suppliers who sent in invoices at higher prices compared to the past continued to be compensated at old rates. Wal-Mart simply ignored price increases. As a matter of management practice, it had even begun billing its suppliers for missed or delayed deliveries. It was experimenting with a new system called *Scan 'n Pay* under which suppliers would be paid for an item after it had been scanned out upon sale to a customer. Thus, the supplier was actually going to bear much of the risk associated with the goods that it had offered for sale at Wal-Mart. Suppliers had to participate in *Roll Back* campaigns which were essentially funded by selling at extremely low margins, often much lower than the already low margins that Wal-Mart negotiated. The roll-back price offerings were meant to attract store traffic.

Rubbermaid's brush with Wal-Mart was a textbook example of the company's approach to supplier management. When resin prices rose by 80%, Rubbermaid was forced to increase its prices for plastics products that were bestsellers at Wal-Mart stores. Wal-Mart believed that Rubbermaid ought to absorb much of the price increases instead of passing it along to buyers. When Rubbermaid seemed disinclined to listen, Wal-Mart cut the shelf space it had allocated for Rubbermaid products and promoted competitors who were more willing to listen. Rubbermaid was soon forced into a merger with Newell as a consequence.

On-time delivery was not just a goal that suppliers aspired to reach—it was demanded as a prerequisite for a continued working relationship with Wal-Mart. On-time delivery meant that the products were expected to show up just as they were needed—not earlier, and certainly not later. There was an opportunity cost associated with empty shelf space, and the supplier who caused the stockout was held responsible for compensating the company. These penalties were typically deducted before Wal-Mart settled its payments with the supplier in question. The company used a supplier scorecard to keep track of the performance metrics of each of its suppliers. Much of this data was also accessible to the suppliers in the spirit of full transparency. In addition to superior supply-chain performance, suppliers were required to uphold quite stringent standards of employment and fair labor practices at all their manufacturing facilities worldwide. Wal-Mart deputed audit teams to ensure compliance at manufacturer locations. The range of standards included issues such as compensation and overtime pay, working conditions and environment, and discrimination. All suppliers were required to prominently display the Wal-Mart code of standards at their facilities. Although this had the desirable effect of emphasizing an image of honesty and fairness, critics often viewed these measures with suspicion, seeing them as public relations ploys.

In building its *Modular Category Assortment Planning System* (MCAP), Wal-Mart designated *category captains* in each product category. The category captain had to pull together a variety of such packages integrating its own products with those of other competitors. These packages had to take into account local demand patterns and preferences, store traffic flows, and mix of price points to fit with market needs. Some of the category captains designed over a thousand such integrated packages each year for Wal-Mart.

Suppliers employed a wide variety of strategies to sell to Wal-Mart. These options ranged from passive submission to the dictates of the giant retailer, to active engagement in maximizing their own piece of the Wal-Mart pie. Newell-Rubbermaid exemplified a creeping shelf-capture approach. It offered a wide range of largely nonseasonal, low-technology, high-volume essentials that were relatively low priced. It positioned itself as a single source for a large range of products that included a diverse portfolio spanning paint brushes, blinds, storage containers, plastic furniture, writing instruments, household tools, and cookware. Although seemingly

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diverse, the company used its portfolio to acquire more and more shelf space at the mass-market retailers. Wal-Mart accounted for 16% of Newell's sales in 2003. The company had positioned itself as a very responsive, highly flexible supplier, often taking the lead in proposing new ways to improve retailer efficiency. Newell was the originator of the legendary supplier scorecard that Wal-Mart used to rate all its suppliers. Its inventory management skills were admired at Wal-Mart to such an extent that Wal-Mart began using Newell as the benchmark for supplier performance. Newell had even invested a sizable sum in building a scaled version of a Wal-Mart store at its Bentonville office. It experimented with various in-store displays and storage optimization techniques, using its scale model of the store, before recommending alternatives to the giant retailer. It adopted a good, better, best approach to managing its product lines. Each line had options across the three price points. This provided the important benefit of capturing shelf space because the mass market retailer did not have to shop with multiple suppliers to fill out its offerings across a range of price points. Newell had multiple sales teams that specialized in each product line. Initially, this had the additional advantage of having different personnel negotiate with Wal-Mart buyers for distinct pieces for Newell's business. However, all its dealings with Wal-Mart were internally coordinated through a separate office dedicated to Wal-Mart and managed by a presidential level executive. It continuously sought to acquire new product lines by taking over poorly managed manufacturing operations. Every single acquisition had to meet the basic requirement of using the mass retailer as its primary sales channel. These acquisitions benefited from the pre-existing relationship with retailers such as Wal-Mart who were willing to give the new lines a shot in the marketplace. The company was very forthcoming in sharing its insights about its customers and product ideas with Newell, all in the name of making Wal-Mart a more comprehensive shopping experience. After all, distribution channel access was half the battle.

Rayovac, the battery manufacturer, chose a different path in entrenching itself at Wal-Mart. To begin with, it offered prices that were about 20% lower than Duracell and Energizer, the competing battery brands. In some cases, it was able to offer 50% more product at the same price points as its competitors. This was an important encouragement to Wal-Mart, which proceeded to designate more shelf space for Rayovac products. Seeing the rise of Rayovac's market share, Wal-Mart declared that it would enter the battery business with its own private label. Although Rayovac shares dropped dramatically in response to the announcement, the company was able to work out a private label manufacturing arrangement with Wal-Mart, restricting the entry to alkaline batteries. The belief was that Rayovac's superior branding and dominant market share (>80%) in its high margin products, batteries for hearing aids, would be protected from the Wal-Mart juggernaut. This strategy had the twin benefits of giving Wal-Mart what it wanted and at the same time ensuring that Duracell and Energizer were held at bay. Rayovac had, in essence, used Wal-Mart to outrun its competitors. By 2003, Wal-Mart accounted for 26% of Rayovac revenues in a relationship that was very much similar to that between a vassal and the king. Rayovac even acquired Varta, a large battery manufacturer in Germany, to keep pace with Wal-Mart's globalization effort.

Leveraging Technology and Logistics

Wal-Mart was a leader in the use of technology to maximize operational efficiency. Very early on, the company realized the value of proactive investments in technology and deployed a private satellite network. The satellite network worked in conjunction with the EDI system and a point-of-sales system to capture store sales data in real time. Every time a customer made a purchase, the point-of-sales system transmitted the details of the transaction through the satellite network to the warehouses which were the staging grounds for inventory management.

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Wal-Mart had progressively moved from simple inventory management to data mining, an approach that offered the company rich insights into customer buying patterns. This allowed the company to better customize some of its offerings on a regional basis along with its usual traiting approaches which factored in local consumer tastes and preferences. These insights helped manufacturers understand regional differences much better and design their products accordingly.

The company managed much of its own logistics through a central hub-and-spoke system of warehouses and distribution centers. It was estimated that the corporate logistics department handled over a million loads each year. These central hubs were located in such a way as to cater to Wal-Mart stores within a 250-mile radius. All of them had easy access from interstates and were conveniently located in less-populated rural areas that were within driving distance from store concentrations. The warehouses were quite massive structures with loading and unloading bays on either side of the building. There was very little inventory storage in these centers. Instead, the company designed them to use cross-docking, a practice that allowed the transshipment of inventory from an inbound truck to an outbound truck that was loading to carry merchandise to the stores. The whole process was orchestrated through a system of conveyors within the warehouse to route the correct merchandise to each truck. Much of the seasonal merchandise was unloaded from trucks coming in from manufacturers to trucks that were outbound to stores in a matter of ten minutes. Distribution orders were generated based on previous-day sales, with allowances for weather patterns and seasonality. This resulted in a replenishment cycle that was only 48 hours long at most.

During the return leg of the trip to deliver merchandise, the trucks stopped off at manufacturer locations to haul inventory to the warehouses. This process, known as backhauling, minimized the need for contracted shipping services, and saved shipping costs. Instead, the suppliers had to pay a fee for using the Wal-Mart system for distribution. It was believed that most of the suppliers willingly did so because they were unable to match the efficiency levels that Wal-Mart's distribution setup offered. All suppliers were required to use the Retail Link system to keep the logistics planners in Bentonville informed about the availability of cargo for shipping to warehouses, thus enabling backhauling. It was a veritable logistics company with a level of efficiency that rivaled even dedicated trucking fleets. Appendix 1 provides indicators of comparative efficiency for major U.S. retailers.

Different Stores for Different Folks

By early 2004, Wal-Mart had come a long way from its big-box rural beginnings. It now operated four different store formats: Wal-Mart discount stores, Supercenters, Neighborhood Markets, and Sam's Clubs, in addition to its walmart.com online store. Within the U.S., the first three formats were referred to as *Domestic One* formats.

Appendix 2 provides comparative financial and operating statistics for major U.S.-based retailers that compete against Wal-Mart.

Culture, People, and Processes

By 2004, Wal-Mart was the largest employer in private industry worldwide. It counted over 1.3 million associates amongst its ranks. Mr. Walton had imparted a very strong sense of identity among his employees, which was largely rural at the time. The company employed a flat organizational structure with the store managers playing pivotal roles in linking management personnel in Bentonville with field operations.

Frugality was a central tenet at the company, and every associate was expected to fully adopt this value in all its manifestations. This meant that, as a matter of policy, all company travel was limited to economy class, although Wal-Mart had a fleet of 20 aircraft that ferried executives to various parts of its empire. Associates who traveled on buying trips to manufacturer locations were expected to stay in a budget motel. Even executives stayed two to a room and

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Format	*Size Unique features*	
Discount Stores	40,000–120,000 sq. ft. 80,000 SKUs 1,600 in operation	• The original format for Wal-Mart in rural locations • Brightly lit atmosphere • Wide product selection ranging from apparel to lawn and garden items • Offered the initial learning for the firm in inventory management
Supercenters	110,000–220,000 sq. ft. 100,000 SKUs, of which 30,000 are grocery items 1,300 in operation	• Combines fresh vegetables, dairy products, and other groceries with nonfood items • Open 24 hours a day • Includes additional features such as a tire and lube outlet, restaurant, portrait studio, film processing, hair salon, bank, and gas station • Ideal vehicle to leverage the frequency of grocery purchase to increase spillover nonfood revenues
Neighborhood Markets	42,000–55,000 sq. ft. 24,000 SKUs	• Targeted toward the urbane city markets • Styled as a more modern retail format with contemporary fittings and fixtures • Carries an extensive range of fresh vegetables, fruits, dairy products, and other groceries • More accessible in-city locations • Offers a drive-through pharmacy, bakery, and an in-store coffee bar • Typically located in markets where Supercenters are located so that distribution synergies can be leveraged while reaching a distinctly different market audience
Sam's Clubs	110,000–130,000 sq. ft. 4,000 SKUs	• Geared toward the small businesses that buy in bulk and large families that might be attracted to buying in larger quantities to take advantage of price discounts • Warehouse format with little customer service • Requires an annual membership ($35 for individuals and $30 for small businesses) to shop at these stores

Exhibit 4 Store Formats, Target Markets, and Unique Features

eschewed taxis to the extent possible. Wal-Mart's buyers sometimes called suppliers collect. New supplier proposals that lacked detail were returned at the expense of the suppliers. The company's headquarters were also reflective of the tightfistedness. They were housed in warehouse style buildings with a minimalist décor. Visitors had to pay for a cup of coffee or a soda even at headquarters.

The customer centric dictum permeated everything that Wal-Mart did. Mr. Walton had set out the basic tenets of the company upon its founding. These tenets included a "10-foot rule," which required every employee to greet a customer

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who came within ten feet of the employee. Mr. Walton exhorted all his associates to practice "aggressive hospitality," to exude caring, warmth, and hospitality towards every single customer who walked into the store. Given the rural roots of the company, these basic values of customer service became an integral part of the way in which Wal-Mart did business.

The company prided itself on the deep connections that it had with its associates. It offered a range of development opportunities spanning scholarships to college-bound associates, business skill acquisition programs, and a systematic mentoring program that paired successful managers with junior associates, to name a few. Almost all senior positions within the company were filled through promotions from within. Many amongst the upper echelon had started on the shop floor or in the warehouses and had moved their way up the ladder. Roughly 65% of Wal-Mart's management associates started out as hourly associates.

It hired locally for most of its foreign operations, supplementing the local workforce with a handpicked team of managers who had to go through a grueling program in the U.S. before they took charge of overseas operations. Employees who worked at the foreign stores had an equal chance at being promoted into management ranks and moved to headquarters. The company launched a new *Accelerated International Management Program* for a select group of associates who were identified for assuming leadership roles in international operations. This premier program was run collectively by the senior leadership of the company and focused on cross-border learning, knowledge management, and international best practices. The company was quite receptive to the idea of job enrichment and job rotation as a means of developing its human resources. Many of these lateral and vertical moves resulted from an elaborate performance appraisal system that the company had developed. The appraisal included elements of the 360º feedback approach under which the associates were evaluated by their peers, superiors, and subordinates.

Harnessing a veritable army of associates did indeed pose important challenges. The company was accused of paying very low wages—about $8.23 an hour in the case of sales clerks, according to *Business Week*.[8] This amounted to $13,861 per year, below the federal poverty line of $14,630 for a family of three. Its record in terms of employee diversity also came under increasing fire. Some critics noted that although women comprised 90% of the customer service managers, they accounted for only 15% of store manager positions. This alleged unfair labor practice was the subject of a lawsuit in California. This lawsuit had the potential of ballooning into a major issue for the company since the judge was considering class action status so that a large number of plaintiffs might join the class action against the company. Wal-Mart associates nationwide filed 40 cases against the company, alleging that it sought to keep labor costs low by leveraging its clout to force employees to work overtime without offering overtime pay.[9] These transgressions were closely watched by the unions who had always wanted to bring Wal-Mart employees under their fold. The nonunion moniker was being chipped away. The first salvo had been launched by the meat-cutters in a store in Jacksonville, Texas, who won the right to unionize in early 2003. They would have been the first group in 41 years to bargain collectively with Wal-Mart but for an operational change that was instituted by the company. Wal-Mart announced that it would sell only pre-cut meat in its stores, with immediate effect.

It's a Small World After All

Wal-Mart first set foot outside the U.S. in 1991 when it acquired a minority interest in a joint venture with a Mexican company, Cifra, a retailer of repute. In a short span of time, the company set up operations in nine countries with over 1,300 stores system-wide. By 2003, international operations accounted for close to 17% of

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total revenues. It had started in textbook fashion, sticking close to home with forays into countries of geographic proximity such as Mexico, Puerto Rico, and Canada. After penetrating promising regions of South America, the company had ventured into Europe.

Wal-Mart evaluated market potential based on economic and political risk, growth potential, and availability of real estate for development. In countries where the market had become saturated, Wal-Mart used acquisitions to gain a toehold. In markets where land was easily available, it pursued organic growth. The acquisition strategy paid off in locations such as Puerto Rico and the U.K. where the target firms were already adopting many of the core Wal-Mart practices, but in countries like Germany, there were big questions that remained.

The Americas

Wal-Mart launched it globalization efforts with an initial foray into Mexico with a local partner, Cifra. Boosted by the tremendous success of the Mexican operations, Wal-Mart increased its ownership position over time, and controlled 62% of Walmex, the joint venture, by 2004. The Mexican strategy was a blend of elements culled from the successful approach that the company had adopted in the U.S., along with significant local twists. The partner, Cifra, brought along a range of store formats and retail outlets including restaurants, apparel stores, a chain of Bodega Aurrera stores targeted at the lowest income strata, and Superama stores which were geared to middle- and high-income customers. The company managed to rationalize these different store formats, focusing on the Bodega stores as the primary vehicle for expansion along with Sam's Club and Supercenter concepts imported from the U.S. After some initial hiccups, the Mexican operations became an important shot in the arm for Wal-Mart, contributing 26% of all international revenues. The company leveraged important location specific advantages in Mexico to grow a supplier base at relatively low cost and augment needs in other parts of the world. It held major buyer-seller meets and was able to groom close to 300 reliable suppliers with enough muscle to export to the U.S., and also pursue additional opportunities in other markets in the Wal-Mart empire. The Mexican retail experience served as a good template for stores in Brazil and Puerto Rico as well. In Brazil, for example, Wal-Mart duplicated many of the defining features of its Bodega stores from Mexico in its Todo Dia stores that were geared toward the low income customer segment. The company also pursued opportunistic product expansion in Mexico to enter segments that were outside the scope of traditional retail operations. For example, it offered a money transfer service between the U.S. and Mexico that targeted the immigrant community. This service was so popular that the industry leader, Western Union, witnessed steep declines in its market share.

The company's fortunes outside Mexico were quite mixed. Brazil and Argentina had been quite unstable given the fluctuating fortunes of their respective economies. In Brazil, the company was a victim of intense price wars and strategic maneuvering by its rival, Carrefour, which adopted aggressive tactics. Wal-Mart accused its rivals of leaning on suppliers to choke its supply lines. Carrefour demonstrated a new variation of the "Everyday Low Price" strategy when its employees began distributing fliers in Wal-Mart parking lots showing price comparisons between the two stores on an almost real-time basis. Wal-Mart had also taken longer to climb the experience curve in these markets since its merchandising approach had to be rethought several times before it captured the attention of the local customers. Rivals such as Carrefour were much ahead in the merchandising game and were able to leverage their longer experience in South America to their advantage.

Europe

Breaking into Europe was quite difficult and expensive. Wal-Mart first set foot in Europe

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Country	*Mode of Entry*	*Store Population*	*Associates*
Argentina	Greenfield	11 Supercenters, 1 Distribution Center	4,000
Brazil	Greenfield	13 Supercenters, 9 Sam's Clubs, and 2 Todo Dia stores	6,000
Canada	Acquisition	213 Discount Stores	52,000
China	Joint venture	21 Supercenters, 5 Sam's Clubs, and 2 Neighborhood Stores	15,000
Germany	Acquisition	92 Supercenters	15,500
Japan	Joint venture	400 Supermarkets	30,500
Korea	Acquisition	15 Supercenters	3,000
Mexico	Joint venture	124 Bodega Stores, 51 Sam's Clubs, 78 Supercenters, and 457 other stores	96,000
Puerto Rico	Greenfield Acquired local chains after entry	9 Discount Stores, 9 Sam's Clubs, 2 Supercenters, and 33 other stores	11,000
United Kingdom	Acquisition	247 Discount Stores, 21 Distribution Centers	125,000
United States		1,494 Discount Stores, 1,386 Supercenters, 56 Neighborhood Markets, and 532 Sam's Clubs	Over 1 Million

Exhibit 5 Wal-Mart's Global Empire

when it acquired Wertkauf, a German retailer that had fallen on bad times in 1997. It subsequently bought another chain, Interspar, to gain more reach and size in the country. It proceeded to import its own management team from the U.S. to convert these chains into Wal-Mart stores. Wal-Mart's rural culture did not blend well with German sensibilities, and integration soon became a flashpoint. The peculiarities of German law that prohibited some of the staple discounting approaches of the company, combined with the language differences and distinctive market preferences, further accentuated the problems. Local competition was quite strong, and the reigning leader, Metro, A.G., proved to be a formidable competitor. The home-grown management talent was surprisingly unable to implement the Wal-Mart way at the new acquisitions. As one analyst observed, "One of the surprises about Wal-Mart is how weak in conventional managers they are. They are very good at what they do in the Wal-Mart way. But you wouldn't put them in the same roles in other groups."[10]

Beleaguered by troubles in Germany, Wal-Mart decided to search for a better foothold in Europe and was attracted to Asda, a Wal-Mart look-alike that had a sizable footprint in the U.K. Asda had imbibed some of the very same practices in inventory control, merchandising, and pricing that Wal-Mart had pioneered, right down to its own morning cheer. The acquisition proved to be phenomenally successful even at the steep price of £6.7 billion in 1999. Since Asda was a successful venture even at the time of the acquisition, and perhaps reeling from the bad experience at *Wal-Martization* in Germany, the company did not send in the troops of managers from Bentonville to oversee the Asda integration. Local managers were given much more leeway in decision-making. Asda managers actually helped Wal-Mart resuscitate its failing German business. They also developed new techniques in merchandising. John Menzer, the chief of Wal-Mart's International division, observed, "What we learnt from Asda is now incorporated in our systems in Korea, the U.S., South America, and everywhere."11 One

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example was the adoption of the *George* line of fashion clothing that was developed by Asda. This line had proven to be such a powerful draw among the fashion-conscious buyers that Wal-Mart decided to bring the line to its operations in the U.S. as well. It was part of Wal-Mart's desire to expand its appeal to the up-market clientele that was the exclusive domain of Target, its competitor in the U.S. "As we grow around the world, it is important to our success that we exchange best practices among all the countries where we operate," observed Mr. Craig Herkert, Executive Vice President and COO of Wal-Mart International.

Although Asda had proven to be a remarkable success, the rivalry for supremacy in Europe was far from settled. Carrefour, Tesco, Ahold, and Metro were all fighting for the crown. Carrefour had a much wider reach and a portfolio of different store formats that seemed to give it an advantage in the marketplace where property was expensive. Tesco also proved to be a worthy rival since it, too, had originated with a "pile 'em high and sell 'em cheap" philosophy. It had expanded rapidly from its fresh-food origins as a grocer into nonfoods and hard goods. It had also built a network of stores across significant markets in Europe, especially in developing countries and emerging markets of the old Communist world. These were regions where price was a key competitive weapon and being first counted a lot.

Asia

Wal-Mart's Asia strategy began to unfold in 1996 with the opening of a Supercenter and a Sam's Club in the economically rich region of Shenzhen in China. The company later established operations in Korea through an acquisition of four stores from Makro. Given the relatively high real estate costs in Seoul, Wal-Mart adopted a multistory format, with stores often encompassing six to eight stories. Japan was the third component of the Asia strategy. Wal-Mart built on its Mexican experience with joint ventures and initially entered Japan through a minority joint venture with Seiyu, a well-established local retail chain. In two years, the company was quite happy with the results of the joint venture, and hence exercised its option to increase its holdings and become a majority partner. While China and Japan proved to be relatively successful entries, the performance in Korea was disappointing. Chains owned by the Korean *chaebols* had forged better supplier links than Wal-Mart could, and in a tradition-bound society, those ties were vital. These chains also had better access to real estate and, consequently, proved to be tenacious competitors.

China was especially promising since the company had been able to roll out many of its core strategies successfully. It bought 95% of its products locally, and even leveraged its Chinese supply network to export products worth $12 billion12 to its U.S. operations and close to $20 billion by mid2003. The company was China's eighth largest trading partner, ahead of Russia and the U.K. After entering Shenzhen, the company moved into Beijing through a separate joint-venture arrangement and also expanded to the rural heartland of the country. Asia was indeed a very promising market, but one fraught with challenges like the Korean experience had shown. It was clear that the company had a long way to go before it dominated these regional markets.

The value of the global network that Wal-Mart was building could be gleaned from a comment made by Mr. John Menzer, the Chief of International Operations at Wal-Mart. In describing the key elements of Wal-Mart's strategy for its apparel lines, Mr. Menzer observed, "Fashion starts in Europe. Next stop is now South America, because they are half a season behind. We're able to forecast U.S. buying patterns by what happens in South America. That is globalization."[13]

Being Big Isn't So Easy

As Wal-Mart moved forward to assert its dominance as the world's largest retailer, the

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road was not very clear. The company was increasingly coming under fire on a variety of fronts, ranging from employee compensation to supplier control and de facto censorship. On the competitive front, although there was no obvious threat that was readily visible, it was believed that the emergence of Dollar General and similar firms in the U.S. was serious enough to warrant a close watch. The mixed results of international expansion were yet another aspect that required long-term thinking.

Given the large size and reach that the company had built, many feared that it had grown to become too powerful. For example, some recording artists contended that Wal-Mart filtered the music that it sold in its stores, thus acting as a self-appointed censor. Music that was believed to carry a message that did not blend with Wal-Mart's values was not sold in its stores. This, some said, had a chilling effect on creativity and was working toward homogenizing the marketplace by letting smaller towns dictate popular culture. The same filtering effect was noticed in magazines and books. Publications such as *Maxim's* and *Stuff* were summarily banned from stores. The covers of magazines such as *Cosmopolitan, Glamour*, *Redbook,* and *Marie Claire* were routinely obscured with opaque binders. The enforcement appeared selective in the eyes of some. Wal-Mart claimed that it was just responding to the concerns expressed by the local community. The censorship even spread to drugs and medications. Wal-Mart was the only large pharmacy chain to refuse to stock *Preven*, a morning-after contraceptive manufactured by Gynetics that was legally approved for sale in the U.S. by the Food and Drug Administration. Gynetics' salespeople were apparently told that Wal-Mart did not want its pharmacists grappling with the moral dilemma of abortion. The drug, however, prevented pregnancies and did not cause abortions, according to the manufacturer. Mr. Roderick McKenzie, the founder of Gynetics, observed, "When you speak to God in Bentonville, you speak in hushed tones,"[14] although it did not seem to help Gynetics. Was Wal-Mart deciding what was good for the world?

Dollar Stores was a phenomenon that had the makings of a niche-based challenger. This company was catering to the low-income strata, "the salt of the earth" as it characterized it. The market was indeed sizable since 37% of all U.S. households earned less than $25,000 per year. Interestingly, this was also one of the fastest growing segments of the population. The Dollar General store was about 6,800 square feet—roughly 1/6 the size of the smallest Wal-Mart store. It kept its inventory low by trimming the variety of products it offered. It carried about 3,500 items on average, leaning more heavily on hard goods and nonperishables. It used an innovative pricing approach that comprised only 20 price points, ranging from $1 to $35. The simplicity of this system was an important factor in attracting a customer's attention to potential bargains. The stores did not offer special sales, nor did they use advertising to attract customers. They relied on word-of-mouth instead. Although it was a tough negotiator when it came to suppliers, the suppliers were indeed happy to do business with Dollar General. After all, they were assured that they would not be competing against the top brand in their category. Dollar General largely relied on a #2 brand approach, stocking a selection of five or six brands at most, a mix that typically excluded the top industry brand. The company had over 6,000 stores in the U.S., most of them in communities of less than 25,000 or in low-income urban neighborhoods. The company relished its locations that were close to the big-box retailers. Mr. Cal Turner, Jr., remarked, "We love to be next to them. We are in a different niche. We're a convenience bargain store, and our prices are excellent, relative to theirs. They run their promotions . . . we inherit the traffic."15 The company had almost doubled its sales revenue in the five-year period from 1999 to 2003. Although with over $6 billion in sales (it was still not anywhere comparable in size to Wal-Mart), it did seem to have the ingredients of a disruptive innovator in the retailing world.

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APPENDIX 1: COMPARATIVE EFFICIENCIES (SALES PER FOOT: SPF) OF LEADING U.S. RETAILERS

Merchandiser	*SPF 2000*	*SPF 2001*	*SPF 2002*	*Sq. ft. Basis*	*Avg. sq. ft. per Store*	*Sales per Store*	*Total Stores*	*Total Sales ($000)*
Costco	$763	$757	$771	gross	137,000	105,683,152	374	37,993,093
Sam's Club	$469	$491	$497	gross	124,462	61,857,561	525	31,702,000
Wal-Mart	$387	$406	$422	gross	135,195	55,924,898	2,875	244,524,000
Target	$268	$274	$278	selling	122,280	32,942,045	1,147	36,236,250
Kmart	$236	$235	$212	selling	73,601	15,603,348	1,829	30,762,000
Dollar Tree Stores	$238	$217	$199	selling	5,442	1,083,000	2,263	2,329,188
Dollar General		$142	$148	gross	6739		6113	
Home Depot	$415	$388	$370	gross	108,000	40,144,000	1,532	58,247,000

Source: www.bizstats.com/spf1.htm

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Appendix 2: Comparative Statistics for Large U.S.-Based Discount Retailers

Indicator	Wal-Mart			Costco			Dollar General			Target		
	2001	*2002*	*2003*	*2000*	*2001*	*2002*	*2001*	*2002*	*2003*	*2001*	*2002*	*2003*
Sales	193116	219672	244524	31621	34137	37993	4550	5322	6100	36851	39826	43917
Cost of sales	150255	171562	191838	28322	30598	33983	3300	3813	4376	25214	27143	29260
Operating expenses	31550	36173	41043	2805	3207	3648	935	1136	1297	8218	8924	10181
Advertising expenses	574	618	676							824	924	962
Operating Profit	11311	11937	13644	1037	992	1131	1250	1509	1724	3419	3759	4476
Net Income	6295	6671	8039	631	602	700	71	208	265	1264	1368	1654
Net income per share	1.4	1.49	1.81	1.35	1.29	1.48	0.21	0.62	0.79	1.4	1.52	1.82
Inventories	21644	22614	24891	2490	2739	3127	896	1131	1123	4248	4760	4449
Long-term debt	12501	15687	16607	790	859	1211	720	339	330	5634	8088	10186
Shareholders equity	31343	35102	39337	4240	4883	5694	862	1041	1288	6519	7860	9443
Total Stores	4188	4414	4688	313	345	374	5000	5540	6113	1307	1381	1475
Total Assets		83527	94685	8634	10090	11620		2552	2333		24154	28603
International Sales												
International Assets												
Operating profit (Intl)												
ROS (Intl)												
ROA (Intl)												
Cost of sales/Sales	0.78	0.78	0.78	0.90	0.90	0.89	0.73	0.72	0.72	0.68	0.68	0.67
Operating margin %	5.86	5.43	5.58	3.28	2.91	2.98	27.47	28.35	28.26	9.28	9.44	10.19
Net margin %	3.26%	3.04%	3.29%	2.00%	1.76%	1.84%	1.56%	3.91%	4.34%	3.43%	3.43%	3.77%
Inventory/sales	0.11	0.10	0.10	0.08	0.08	0.08	0.20	0.21	0.18	0.12	0.12	0.10
Inventory turns	6.94	7.75	8.08	11.37	11.70	11.59	3.68	3.76	3.88	5.94	6.03	6.35
Operating exp./Sales	0.16	0.16	0.17	0.09	0.09	0.10	0.21	0.21	0.21	0.22	0.22	0.23
Adv. exp/Sales	0.30%	0.28%	0.28%							2.24%	2.32%	2.19%
Sales/Assets		2.63	2.58	3.66	3.38	3.27		2.09	2.61		1.65	1.54
Return on Assets		7.99%	8.49%	7.31%	5.97%	6.02%		8.15%	11.36%		5.66%	5.78%
Return on Equity		19.00%	20.44%	14.88%	12.33%	12.29%	8.24%	19.98%	20.57%	19.39%	17.40%	17.52%
Return on Sales	3.26%	3.04%	3.29%	2.00%	1.76%	1.84%	1.56%	3.91%	4.34%	3.43%	3.43%	3.77%

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THE GLOBAL BRANDING OF STELLA ARTOIS

Prepared by Professors Paul W. Beamish and Anthony Goerzen

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In April 2000, Paul Cooke, chief marketing officer of Interbrew, the world's fourth largest brewer, contemplated the further development of their premium product, Stella Artois, as the company's flagship brand in key markets around the world. Although the long-range plan for 2000-2002 had been approved, there still remained some important strategic issues to resolve.

A BRIEF HISTORY OF INTERBREW

Interbrew traced its origins back to 1366 to a brewery called Den Hoorn, located in Leuven, a town just outside of Brussels. In 1717, when it was purchased by its master brewer, Sebastiaan Artois, the brewery changed its name to Artois.

The firm's expansion began when Artois acquired a major interest in the Leffe Brewery in Belgium in 1954, the Dommelsch Brewery in the Netherlands in 1968, and the Brassiere du Nord in France in 1970. In 1987, when Artois and another Belgian brewery called Piedboeuf came together, the merged company was named Interbrew. The new company soon acquired other Belgian specialty beer brewers, building up the Interbrew brand portfolio with the purchase of the Hoegaarden brewery in 1989 and the Belle-Vue Brewery in 1990.

Interbrew then entered into a phase of rapid growth. The company acquired breweries in Hungary in 1991, in Croatia and Romania in 1994, and in three plants in Bulgaria in 1995. Again in 1995, Interbrew completed an unexpected major acquisition by purchasing Labatt, a large Canadian brewer also with international interests. Labatt had operations in the United States, for example, with the Latrobe brewery, home of the Rolling Rock brand. Labatt also held a substantial minority stake in the second largest Mexican brewer, Femsa Cervesa, which produced Dos Equis, Sol, and Tecate brands. Following this major acquisition, Interbrew went on, in 1996, to buy a brewery in the Ukraine and engaged in a joint venture in the Dominican Republic. Subsequently, breweries were added in China in 1997, Montenegro and Russia in 1998, and another brewery in Bulgaria and one in Korea in 1999.

Thus, through acquisition expenditures of US$2.5 billion in the previous four years, Interbrew had transformed itself from a simple Belgian brewery into one of the largest beer companies in the world. By 1999, the company had become a brewer on a truly global scale that now derived more that 90 per cent of its volume from markets outside Belgium. It remained a privately held company, headquartered in Belgium, with subsidiaries and joint ventures in 23 countries across four continents.

THE INTERNATIONAL MARKET FOR BEER

In the 1990s, the world beer market was growing at an annual rate of one to two per cent. In 1998, beer consumption reached a total of 1.3 billion hectolitres (hls). There were, however, great regional differences in both market size and growth rates. Most industry analysts split the world market for beer between growth and mature markets. The mature markets were generally

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Region	% of Global Consumption	Growth Index ('98 Vs 92)	Per Capita Consumption
Americas	35.1%	112.6	57
Europe	32.8%	97.7	54
Asia Pacific	27.2%	146.2	11
Africa	4.6%	107.7	8
Middle East/Central Asia	0.4%	116.0	2

Exhibit 1 The World Beer Market in 1998

Source: Canadean Ltd.

considered to be North America, Western Europe and Australasia. The growth markets included Latin America, Asia, Central and Eastern Europe including Russia. Although some felt that Africa had considerable potential, despite its low per capita beer consumption, the continent was not considered a viable market by many brewers because of its political and economic instability (see Exhibit 1).

Mature Markets

The North American beer market was virtually stagnant, although annual beer consumption per person was already at a sizeable 83 litres per capita (lpc). The Western European market had also reached maturity with consumption of 79 lpc. Some analysts believed that this consumption level was under considerable pressure, forecasting a decline to near 75 lpc over the medium term. Australia and New Zealand were also considered mature markets, with consumption at 93 lpc and 84 lpc, respectively. In fact, volumes in both markets, New Zealand in particular, had declined through the 1990s following tight social policies on alcohol consumption and the emergence of a wine culture.

Growth Markets

Given that average consumption in Eastern Europe was only 29 lpc, the region appeared to offer great potential. This consumption figure, however, was heavily influenced by Russia's very low level, and the future for the large Russian market was unclear. Further, some markets, such as the Czech Republic that consumed the most beer per person in the world at 163 lpc, appeared to have already reached maturity. Central and South America, on the other hand, were showing healthy growth and, with consumption at an average of 43 lpc, there was believed to be considerable upside. The most exciting growth rates, however, were in Asia. Despite the fact that the market in this region had grown by more than 30 per cent since 1995, consumption levels were still comparatively low. In China, the region's largest market, consumption was only 16 lpc and 20 to 25 lpc in Hong Kong and Taiwan. Although the 1997 Asian financial crisis did not immediately affect beer consumption (although company profits from the region were hit by currency translation), demand in some key markets, such as Indonesia, was reduced and in others growth slowed. The situation, however, was expected to improve upon economic recovery in the medium term.

Beer Industry Structure

The world beer industry was relatively fragmented with the top four players accounting for only 22 per cent of global volume—a relatively low figure as compared to 78 per cent in the soft drinks industry, 60 per cent in tobacco and

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44 per cent in spirits. This suggested great opportunities for consolidation, a process that had already begun two decades prior. Many analysts, including those at Interbrew, expected that this process would probably accelerate in the future. The driver behind industry rationalization was the need to achieve economies of scale in production, advertising and distribution. It was widely recognized that the best profit margins were attained either by those with a commanding position in the market or those with a niche position. However, there were several factors that mitigated the trend towards rapid concentration of the brewing industry.

One factor that slowed the process of consolidation was that the ratio of fixed versus variable costs of beer production was relatively high. Essentially, this meant that there was a limited cost savings potential that could be achieved by bringing more operations under a common administration. Real cost savings could be generated by purchasing and then rationalizing operations through shifting production to more efficient (usually more modern) facilities. This approach, however, required large initial capital outlays. As a result, in some markets with "unstable" economies, it was desirable to spread out capital expenditures over a longer period of time to ensure appropriate profitability in the early stages. A second factor that may have had a dampening effect on the trend towards industry consolidation was that local tastes differed. In some cases, beer brands had hundreds of years of heritage behind them and had become such an integral part of everyday life that consumers were often fiercely loyal to their local brew. This appeared to be a fact in many markets around the world.

Interbrew's Global Position

Through Interbrew's acquisitions in the 1990s, the company had expanded rapidly. During this period, the company's total volumes had increased more than fourfold. These figures translated to total beer production of 57.5 million hls in 1998 (when including the volume of all affiliates), as compared to just 14.7 million hls in 1992. Volume growth had propelled the company into the number four position among the world's brewers.

Faced with a mature and dominant position in the declining Belgian domestic market, the company decided to focus on consolidating and developing key markets, namely Belgium, the Netherlands, France and North America, and expansion through acquisition in Central Europe, Asia and South America. Subsequently, Interbrew reduced its dependence on the Belgian market from 44 per cent in 1992 to less that 10 per cent by 1998 (total volumes including Mexico). Concurrently, a significant milestone for the company was achieved by 1999 when more than 50 per cent of its total volume was produced in growth markets (including Mexico). Interbrew had shifted its volume so that the Americas accounted for 61 per cent of its total volume, Europe added 35 per cent, and Asia Pacific the remaining four per cent.

Taken together, the top 10 markets for beer accounted for 86 per cent of Interbrew's total volume in 1998 (see Exhibit 2). The Mexican beer market alone accounted for 37 per cent of total volume in 1998. Canada, Belgium, the United States and the United Kingdom were the next most important markets. However, smaller, growing markets such as Hungary, Croatia, Bulgaria, and Romania had begun to increase in importance.

Adding to its existing breweries in Belgium, France and the Netherlands, Interbrew's expansion strategy in the 1990s had resulted in acquisitions in Bosnia-Herzegovina, Bulgaria, Canada, China, Croatia, Hungary, Korea, Montenegro, Romania, Russia, the Ukraine, the United States, in a joint venture in South Korea, and in minority equity positions in Mexico and Luxembourg. Through these breweries, in addition to those that were covered by licensing agreements in Australia, Italy, Sweden and the United Kingdom, Interbrew sold its beers in over 80 countries.

Rank	Country	Volume (000 HL)	Market Share
1	USA	3,768	1.6%
2	China	526	0.3%
3	Germany	—	—
4	Brazil	—	—
5	Japan	—	—
6	UK	3,335	5.5%
7	Mexico	21,269	45.0%
8	Spain	—	—
9	South Africa	—	—
10	France	1,915	8.4%
Total		**30,813**	**3.6%**

Exhibit 2 Interbrew's 1998 Share of the World's Top 10 Markets

Source: Canadean Ltd.

Interbrew's Corporate Structure

Following the acquisition of Labatt in 1995, Interbrew's corporate structure was divided into two geographic zones: the Americas and Europe/Asia/Africa. This structure was in place until September 1999 when Interbrew shifted to a fully integrated structure to consolidate its holdings in the face of industry globalization. Hugo Powell, formerly head of the Americas division, was appointed to the position of chief executive officer (CEO). The former head of the Europe/Africa/Asia division assumed the role of chief operating officer, but subsequently resigned and was not replaced, leaving Interbrew with a more conventional structure, with the five regional heads and the various corporate functional managers reporting directly to the CEO.

Recent Performance

1998 had been a good year for Interbrew in terms of volume in both mature and growth markets. Overall, sales volumes increased by 11.1 per cent as most of the company's international and local brands maintained or gained market share. In terms of the compounded annual growth rate, Interbrew outperformed all of its major competitors by a wide margin. While Interbrew's 1998 net sales were up 29 per cent, the best performing competitor achieved an increase of only 16 per cent. Of Interbrew's increased sales, 67 per cent was related to the new affiliates in China, Montenegro and Korea. The balance was the result of organic growth. Considerable volume increases were achieved also in Romania (72 per cent), Bulgaria (28 per cent), Croatia (13 per cent), and the United States (14 per cent). While volumes in Western Europe were flat, duty-free sales grew strongly. In the U.S. market, strong progress was made by Interbrew's Canadian and Mexican brands, and Latrobe's Rolling Rock was successfully relaunched. In Canada, performance was strong, fuelled by a two per cent increase in domestic consumption. Labatt's sales of Budweiser (produced under license from Anheuser Busch) also continued to grow rapidly.

Given that the premium and specialty beer markets were growing quickly, particularly those within the large, mature markets, Interbrew began to shift its product mix to take advantage of this trend and the superior margins it offered. A notable brand success was Stella Artois, for which total global sales volumes were up by

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19.7 per cent. That growth came from sales generated by Whitbread in the United Kingdom, from exports, and from sales in Central Europe where Stella Artois volumes took off. The strong growth of Stella Artois was also notable in that it was sold in the premium lager segment. In Europe, Asia Pacific and Africa, Interbrew's premium and specialty beers, which generated a bigger margin, increased as a proportion of total sales from 31 per cent in 1997 to 33 per cent in 1998. This product mix shift was particularly important since intense competition in most markets inhibited real price increases.

Success was also achieved in the United States specialty beer segment where total volume had been growing at nine per cent annually in the 1990s. In 1998, Interbrew's share of this growing market segment had risen even faster as Labatt USA realized increased sales of 16 per cent. The other continuing development was the growth of the light beer segment, which had become over 40 per cent of the total sales. Sales of Labatt's Blue Light, for example, had increased and Labatt Blue had become the number three imported beer in the United States, with volumes up 18 per cent. Latrobe's Rolling Rock brand grew by four per cent, the first increase in four years. Interbrew's Mexican brands, Dos Equis, Tecate and Sol, were also up by 19 per cent.

Following solid volume growth in profitable market segments, good global results were realized in key financial areas. Net profit, having grown for each of the previous six consecutive years, was 7.7 billion Belgian francs (BEF) in 1998, up 43.7 per cent from the previous year. Operating profit also rose 7.9 per cent over 1997, from 14.3 to 15.4 BEF; in both the Europe/Asia/Africa region and the Americas, operating profit was up by 8.5 per cent and 4.9 per cent respectively. Further, Interbrew's EBIT margin was up 58.1 per cent as compared to the best performing competitor's figure of 17.0 per cent. However, having made several large investments in Korea and Russia, and exercising an option to increase its share of Femsa Cerveza in Mexico from 22 per cent to 30 per cent, Interbrew's debt-equity ratio increased from 1.04 to 1.35. As a result, interest payments rose accordingly.

Interbrew also enjoyed good results in volume sales in many of its markets in 1999. Although Canadian sales remained largely unchanged over 1998, Labatt USA experienced strong growth in 1999, with volumes up by 10 per cent. There was a positive evolution in Western European volumes as well, as overall sales were up by 6.5 per cent overall in Belgium, France and the Netherlands. Central European markets also grew with Hungary showing an increase of 9.6 per cent, Croatia up by 5.5 per cent, Romania by 18.9 per cent, Montenegro by 29 per cent, and Bulgaria with a rise of 3.6 per cent in terms of volume. Sales positions were also satisfactory in the Russian and Ukrainian markets. Further, while South Korean sales volume remained unchanged, volumes in China were 10 per cent higher, although this figure was still short of expectations.

Interbrew Corporate Strategy

The three facets of Interbrew's corporate strategy, i.e., brands, markets and operations, were considered the "sides of the Interbrew triangle." Each of these aspects of corporate strategy was considered to be equally important in order to achieve the fundamental objective of increasing shareholder value. With a corporate focus entirely on beer, the underlying objectives of the company were to consolidate its positions in mature markets and improve margins through higher volumes of premium and specialty brands. Further, the company's emphasis on growth was driven by the belief that beer industry rationalization still had some way to go and that the majority of the world's major markets would each end up with just two or three major players.

Operations Strategy

Cross fertilization of best practices between sites was a central component of Interbrew's operations strategy. In the company's two main markets, Belgium and Canada, each brewery

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monitored its performance on 10 different dimensions against its peers. As a result, the gap between the best and the worst of Interbrew's operations had narrowed decisively since 1995. Employees continuously put forward propositions to improve processes. The program had resulted in significantly lower production costs, suggesting to Interbrew management that most improvements had more to do with employee motivation than with pure technical performance. In addition, capacity utilization and strategic sourcing had been identified as two areas of major opportunity.

Capacity Utilization

Given that brewing was a capital-intensive business, capacity utilization had a major influence on profitability. Since declining consumption in mature markets had generated excess capacity, several of Interbrew's old breweries and processing facilities were scheduled to be shut down. In contrast, in several growth markets such as Romania, Bulgaria, Croatia and Montenegro, the opposite problem existed, so facilities in other locations were used more fully until local capacities were increased.

Strategic Sourcing

Interbrew had begun to rationalize its supply base as well. By selecting a smaller number of its best suppliers and working more closely with them, Interbrew believed that innovative changes resulted, saving both parties considerable sums every year. For most of the major commodities, the company had gone to single suppliers and was planning to extend this approach to all operations worldwide.

Market Strategy

The underlying objectives of Interbrew's market strategy were to increase volume and to lessen its dependence on Belgium and Canada, its two traditional markets. Interbrew dichotomized its market strategy into the mature and growth market segments, although investments were considered wherever opportunities to generate sustainable profits existed. One of the key elements of Interbrew's market strategy was to establish and manage strong market platforms. It was believed that a brand strength was directly related to a competitive and dedicated market platform (i.e., sales and distribution, wholesaler networks, etc.) to support the brand. Further, Interbrew allowed individual country teams to manage their own affairs and many felt that the speed of success in many markets was related to this decentralized approach.

Mature Markets

Interbrew's goals in its mature markets were to continue to build market share and to improve margins through greater efficiencies in production, distribution and marketing. At the same time, the company intended to exploit the growing trend in these markets towards premium and specialty products of which Interbrew already possessed an unrivalled portfolio. The key markets in which this strategy was being actively pursued were the United States, Canada, the United Kingdom, France, the Netherlands and Belgium.

Growth Markets

Based on the belief that the world's beer markets would undergo further consolidation, Interbrew's market strategy was to build significant positions in markets that had long-term volume growth potential. This goal led to a clear focus on Central and Eastern Europe and Asia, South Korea and China in particular. In China, for example, Interbrew had just completed an acquisition of a second brewery in Nanjing. The Yali brand was thereby added to the corporate portfolio and, together with its Jingling brand, Interbrew became the market leader in Nanjing, a city of six million people.

In Korea, Interbrew entered into a 50:50 joint venture with the Doosan Chaebol to operate the Oriental Brewery, producing the OB Lager and Cafri pilsener brands. With this move, Interbrew took the number two position in the Korean beer

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market with a 36 per cent share and sales of 5.1 million hls. The venture with Doosan was followed in December 1999 by the purchase of the Jinro Coors brewery. This added 2.5 million hls and increased Interbrew's market share to 50 per cent of total Korean volume. Thus, the Interbrew portfolio in Korea consisted of two mainstream pilsener brands, OB Lager and Cass, the two local premium brands, Cafri and Red Rock, and Budweiser, an international premium brand.

In Russia, Interbrew expanded its presence by taking a majority stake in the Rosar Brewery in Omsk, adding the BAG Bier and Sibirskaya Korona brands. Rosar was the leading brewer in Siberia with a 25 per cent regional market share, and held the number four position in Russia. New initiatives were also undertaken in Central Europe with acquisitions of a brewery in Montenegro and the Pleven brewery in Bulgaria, as well as the introduction of Interbrew products into the Yugoslavian market. Finally, although Interbrew had just increased its already significant investment in Mexico's second largest brewer from 22 per cent to 30 per cent, Latin America remained a region of great interest.

Brand Strategy

A central piece of Interbrew's traditional brand strategy had been to add to its portfolio of brands through acquisition of existing brewers, principally in growth markets. Since its goal was to have the number one or two brand in every market segment in which it operated, Interbrew concentrated on purchasing and developing strong local brands. As it moved into new territories, the company's first priority was to upgrade product quality and to improve the positioning of the acquired local core lager brands. In mature markets, it drew on the strength of the established brands such as Jupiler, Belgium's leading lager brand, Labatt Blue, the famous Canadian brand, and Dommelsch, an important brand in the Netherlands. In growth markets, Interbrew supported brands like Borsodi Sor in Hungary, Kamenitza in Bulgaria, Ozujsko in Croatia, Bergenbier in Romania, Jingling in China, and OB Lager in Korea. In addition, new products were launched such as Taller, a premium brand in the Ukraine, and Boomerang, an alternative malt-based drink in Canada.

A second facet of the company's brand strategy was to identify certain brands, typically specialty products, and to develop them on a regional basis across a group of markets. At the forefront of this strategy were the Abbaye de Leffe and Hoegaarden brands and, to a lesser extent, Belle-Vue. In fact, both Hoegaarden and Leffe achieved a leading position as the number one white beer and abbey beer in France and Holland. The Loburg premium pilsener brand also strengthened its position when it was relaunched in France. Further, in Canada, Interbrew created a dedicated organization for specialty beers called the Oland Specialty Beer Company. In its first year of operation, the brands marketed by Oland increased its volumes by over 40 per cent. More specifically, sales of the Alexander Keith's brand doubled and the negative volume trend of the John Labatt Classic brand was reversed. The underlying message promoted by Oland was the richness, mystique and heritage of beer.

To support the regional growth of specialty beers, Interbrew established a new type of café. The Belgian Beer Café, owned and run by independent operators, created an authentic Belgian atmosphere where customers sampled Interbrew's Belgian specialty beers. By 1999, Belgian Beer Cafés were open in the many of Interbrew's key markets, including top selling outlets in New York, Auckland, Zagreb and Budapest, to name a few. The business concept was that these cafés were to serve as an ambassador of the Belgian beer culture in foreign countries. They were intended to serve as vehicles to showcase Interbrew's specialty brands, benefiting from the international appeal of European styles and fashions. Although these cafés represented strong marketing tools for brand positioning, the key factors that led to the success of this concept were tied very closely to the individual establishments and the personnel running them. The bar staff, for example, had to be trained to serve the

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beer in the right branded glass, at the right temperature, and with a nice foamy head. It was anticipated that the concept of the specialty café would be used to support the brand development efforts of Interbrew's Belgian beers in all of its important markets.

The third facet of Interbrew's brand strategy was to identify a key corporate brand and to develop it as a global product. While the market segment for a global brand was currently relatively small, with the bulk of the beer demand still in local brands, the demand for international brands was expected to grow, as many consumers became increasingly attracted to the sophistication of premium and super-premium beers.

The Evolution of Interbrew's Global Brand Strategy

Until 1997, Interbrew's brand development strategy for international markets was largely *laissez faire*. Brands were introduced to new markets through licensing, export and local production when opportunities were uncovered. Stella Artois, Interbrew's most broadly available and oldest brand, received an important new thrust when it was launched through local production in three of the company's subsidiaries in Central Europe in 1997. This approach was consistent with the company's overall goals of building a complete portfolio in high growth potential markets.

By 1998, however, the executive management committee perceived the need to identify a brand from its wide portfolio to systematically develop into the company's global brand. Although the market for global brands was still small, there were some growing successes (e.g., Heineken, Corona, Fosters and Budweiser) and Interbrew believed that there were several basic global trends that would improve the viability of this class of product over the next couple of decades. First, while many consumers were seeking more variety, others were seeking lower prices. It appeared that the number of affluent and poor consumer segments would increase at the expense of the middle income segments. The upshot of this socioeconomic trend was that eventually all markets would likely evolve in such a way that demand for both premium and economy-priced beers would increase, squeezing the mainstream beers in the middle. A second trend was the internationalization of the beer business. As consumers travelled around the world, consuming global media (e.g., CNN, Eurosport, MTV, international magazines, etc.), global media were expected to become more effective for building brands. A global strategy could, therefore, lead to synergies in global advertising and sponsoring. In addition, the needs of consumers in many markets were expected to converge. As a result of these various factors, Interbrew believed that there would be an increasing interest in authentic, international brands in a growing number of countries. Interbrew had a wide portfolio of national brands that it could set on the international stage. The two most obvious candidates were Labatt Blue and Stella Artois.

The Labatt range of brands included Labatt Blue, Labatt Blue Light and Labatt Ice. To date, however, the exposure of these brands outside of North America had been extremely limited and they were not yet budding global brands. Of the total Labatt Blue volume in 1998, 85 per cent was derived from the Canadian domestic and U.S. markets, with the balance sold in the United Kingdom. The Labatt brands had been introduced to both France and Belgium, and production had been licensed in Italy, but these volumes were minimal. The only real export growth market for Labatt Blue appeared to be the United States, where the brand's volume in 1998 was some 23 per cent higher than in 1995, behind only Corona and Heineken in the imported brand segment. The Labatt Ice brand was also sold in a limited number of markets and, after the appeal of this Labatt innovation had peaked, its total volume had declined by more than 25 per cent since 1996. Total Labatt Ice volume worldwide was just 450,000 hls in 1998, of which 43 per cent was sold in Canada, 33 per cent in the

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	1995	*1996*	*1997*	*1998*
Budweiser (incl. Bud Light until '98)	69.48	71.10	72.43	40.00
Bud Light	n/a	n/a	n/a	30.00
Heineken	3.87	3.78	3.85	3.78
Becks	1.68	1.71	1.72	1.78
Carlsberg	1.47	1.39	1.31	1.22
Stella Artois	1.08	1.00	0.96	0.92
Fosters	1.48	1.11	1.40	1.43
Kronenbourg	5.65	5.53	5.35	5.60
Amstel	2.30	2.23	2.21	2.18
Corona	12.89	14.09	14.80	15.18

Exhibit 3 Domestic Sales History of Major International Brands (million hectolitre)

United States, and 21 per cent in the United Kingdom.

Stella Artois as Interbrew's International Flagship Brand

The other potential brand that Interbrew could develop on a global scale was Stella Artois, a brand that could trace its roots back to 1366. The modern version of Stella Artois was launched in 1920 as a Christmas beer and had become a strong market leader in its home market of Belgium through the 1970s. By the 1990s, however, Stella's market position began to suffer from an image as a somewhat old-fashioned beer, and the brand began to experience persistent volume decline. Problems in the domestic market, however, appeared to be shared by a number of other prominent international brands. In fact, seven of the top 10 international brands had experienced declining sales in their home markets between 1995 and 1999 (see Exhibit 3).

Stella Artois had achieved great success in the United Kingdom through its licensee, Whitbread, where Stella Artois became the leading premium lager beer. Indeed, the United Kingdom was the largest market for Stella Artois, accounting for 49 per cent of total brand volume in 1998. Stella Artois volume in the U.K. market reached 2.8 million hls in 1998, a 7.6 per cent share of the lager market, and came close to 3.5 million hls in 1999, a 25 per cent increase over the previous year. By this time, over 32,000 outlets sold Stella Artois on draught.

Apart from the United Kingdom, the key markets for Stella Artois were France and Belgium, which together accounted for a further 31 per cent of total brand volume (see Exhibit 4). With these three markets accounting for 81 per cent of total Stella Artois volume in 1999, few other areas represented a significant volume base (see Exhibit 5). Beyond the top three markets, the largest market for Stella Artois was Italy, where the brand was produced under license by Heineken. Stella Artois volume in Italy had, however, declined slightly to 166,000 hls in 1998. Licensing agreements were also in place in Sweden and Australia, but volume was small.

Stella Artois was also produced in Interbrew's own breweries in Hungary, Croatia and Romania, with very pleasing 1998 volumes of 84,000 hls, 120,000 hls, and 60,000 hls, respectively. After only three years, the market share of Stella Artois in Croatia, for example, had reached four per cent—a significant result, given that the brand was a premium-priced product. In all Central European markets, Stella Artois was priced at a premium; in Hungary, however, that premium was lower than in Croatia and Romania where, on an index comparing Stella's price to

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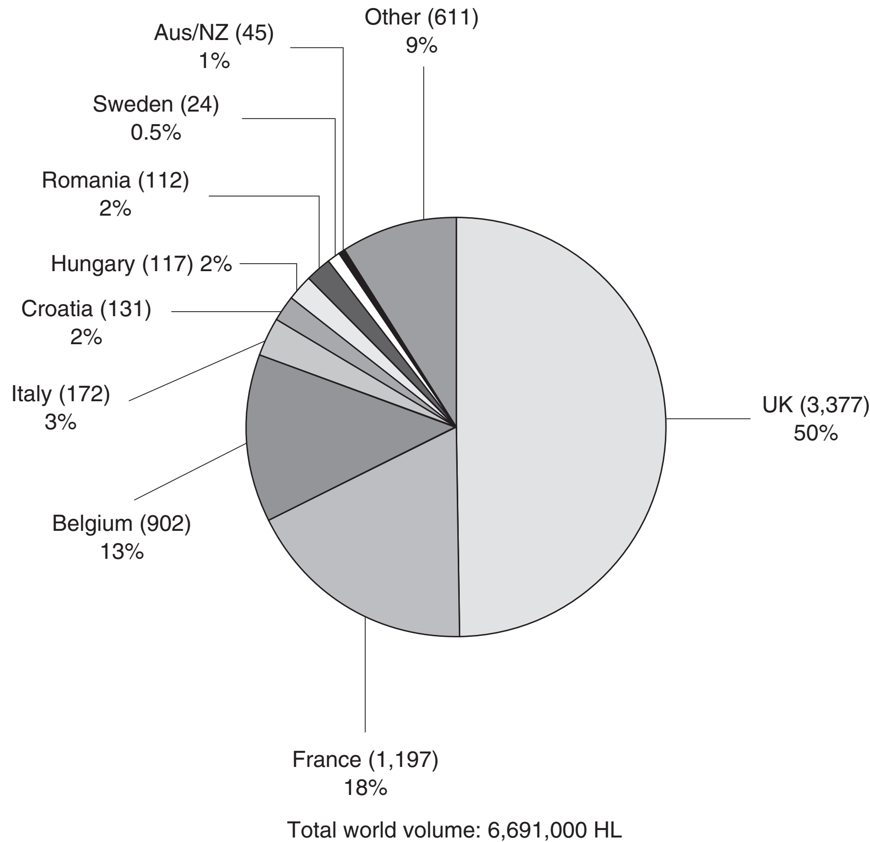

Exhibit 4 1999 World Sales Profile of Stella Artois

that of core lagers, the indices by country were 140, 260 and 175 respectively.

Promising first results were also attained in Australia and New Zealand. Particularly in New Zealand, through a "seeding" approach, Interbrew and their local partner, Lion Nathan, had realized great success in the Belgian Beer Café in Auckland where the brands were showcased. After only two years of support, Stella Artois volume was up to 20,000 hls, and growing at 70 per cent annually, out of a total premium segment of 400,000 hls. Interbrew's market development plan limited distribution to top outlets in key metropolitan centres and priced Stella Artois significantly above competitors (e.g., 10 per cent over Heineken and 20 per cent over Steinlager, the leading domestic premium lager brand).

The evolution of the brand looked very positive as world volumes for Stella Artois continued to grow. In fact, Stella Artois volume had increased from 3.4 million hls in 1992 to a total of 6.7 million hls in 1999, a rise of 97 per cent. Ironically, the only market where the brand continued its steady decline was in its home base of Belgium. Analysts suggested a variety of reasons to explain this anomaly, including inconsistent sales and marketing support, particularly as the

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	1997	*1998*	*1999*
Production:			
Belgium	965	921	902
France	1,028	1,110	1,074
Hungary	59	84	117
Croatia	54	120	133
Romania	17	60	112
Bulgaria	—	—	3
Bosnia-Herzegovina	—	—	2
Montenegro	—	—	0
Total Production	**2,123**	**2,295**	**2,343**
License Brewing:			
Italy	162	166	172
Australia	6	11	22
New Zealand	7	11	22
Sweden	29	27	24
Greece	7	7	10
UK	2,139	2,815	3,377
Total Licensed	**2,350**	**3,037**	**3,627**
Export:			
USA	—	—	7
Canada	—	—	5
Other Countries	92	49	202
Duty Free	245	389	507
Total Export	**337**	**438**	**721**
Overall Total	**4,810**	**5,770**	**6,691**

Exhibit 5 Stella Artois Sales Volume Summary (000 hectolitre)

organization began to favor the rising Jupiler brand.

Overall, given Interbrew's large number of local brands, especially those in Mexico with very high volumes, total Stella Artois volume accounted for only 10 per cent of total Interbrew volume in 1999 (14 per cent if Femsa volumes are excluded). Interbrew's strategy of nurturing a wide portfolio of strong brands was very different as compared to some of its major competitors. For example, Anheuser-Busch, the world's largest brewer, focused its international strategy almost exclusively on the development of the Budweiser brand. Similarly, Heineken sought to centre its international business on the Heineken brand and, to a lesser extent, on Amstel. While the strategies of Anheuser-Busch and Heineken focused primarily on one brand, there were also great differences in the way these two brands were being managed. For example, Budweiser, the world's largest brand by volume, had the overwhelming bulk of its volume in its home U.S. market (see Exhibit 6). Sales of the Heineken brand, on the other hand, were widely distributed across markets around the world (see Exhibit 7). In this sense, Heineken's strategy was much more comparable to that of Interbrew's plans for Stella Artois. Other brands that were directly comparable to Stella Artois, in terms of total volume and importance of the brand to the overall sales of the company, were Carlsberg and Foster's with annual sales volumes in 1998 of

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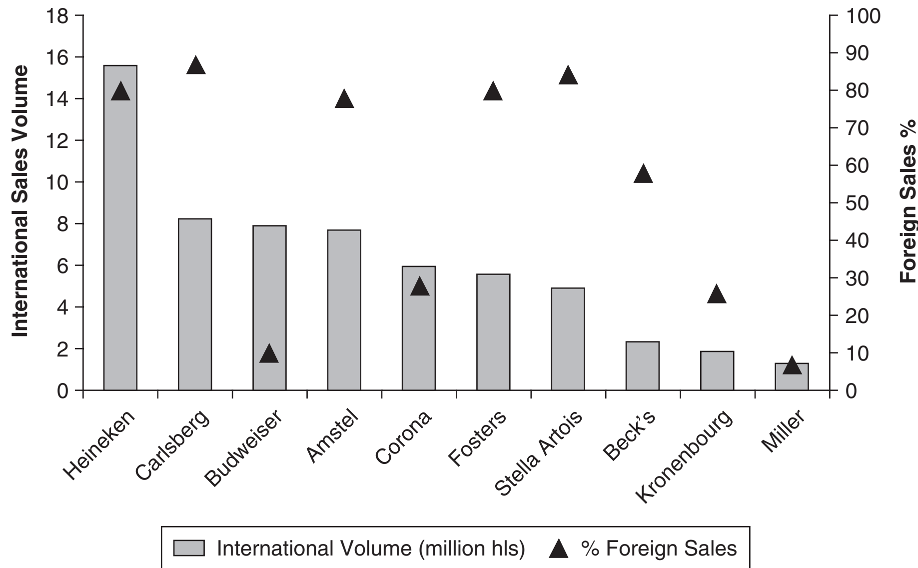

Exhibit 6 Top 10 Brewers by International Sales

9.4 million hls and 7.1 million hls, respectively. While Foster's was successful in many international markets, there was a heavy focus on sales in the United Kingdom and the United States (see Exhibit 8). Carlsberg sales volume profile was different in that sales were more widely distributed across international markets (see Exhibit 9).

Stella's Global Launch

In 1998, Interbrew's executive management committee settled on Stella Artois, positioned as the premium European lager, as the company's global flagship brand. In fact, the Interbrew management felt that stock analysts would be favorably disposed to Interbrew having an acknowledged global brand with the potential for a higher corporate valuation and price earnings (P/E) multiple.

As the global campaign got under way, it became clear that the organization needed time to adapt to centralized co-ordination and control of Stella Artois brand marketing. This was, perhaps, not unexpected given that Interbrew had until recently operated on a regional basis; the new centralized Stella brand management approach had been in place only since September 1998. In addition, there were often difficulties in convincing all parties to become part of a new global approach, particularly the international advertising campaign that was the backbone of the global plan for Stella Artois. Belgium, for example, continued with a specific local advertising program that positioned Stella as a mainstream lager in its home market, and in the United Kingdom, Whitbread maintained its "reassuringly expensive" advertising slogan that had already proved to be so successful. For other less-established markets, a global advertising framework was created that included a television concept and a series of print and outdoor executions. This base advertising plan was rolled out in 1999 in 15 markets, including the United States, Canada, Italy, Hungary, Croatia, Bulgaria, Romania, New Zealand and France (with a

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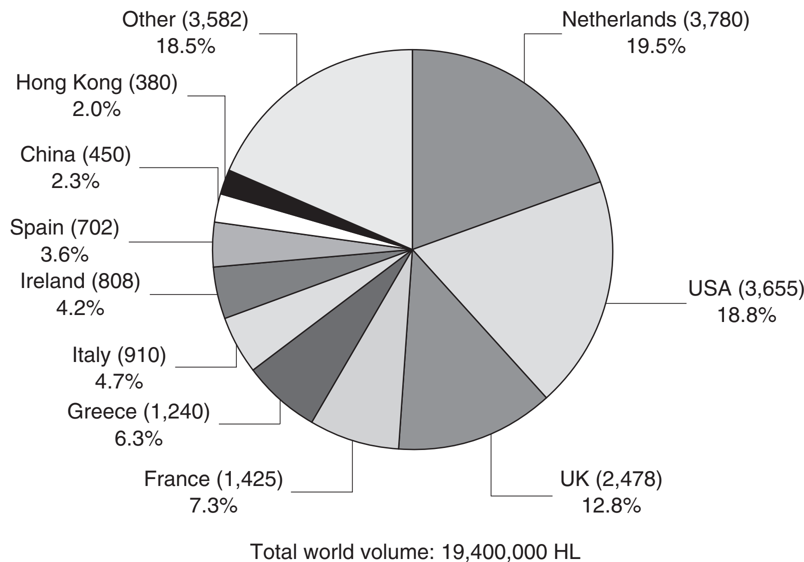

Exhibit 7 1998 Heineken World Sales Profile

slightly changed format) after research suggested that the campaign had the ability to cross borders. The objective of this campaign was to position Stella Artois as a sophisticated European lager. It was intended that Stella Artois should be perceived as a beer with an important brewing tradition and heritage but, at the same time, also as a contemporary beer (see Exhibit 10).

In 1998, an accelerated plan was devised to introduce Stella Artois to two key markets within the United States, utilizing both local and corporate funding. The U.S. market was believed to be key for the future development of the brand since it was the most developed specialty market in the world (12 per cent specialty market share, growing 10 per cent plus annually through the 1990s), and because of the strong influence on international trends. Thus, Stella Artois was launched in New York City and Boston and was well received by the demanding U.S. consumer and pub owner. Within 1999, over 200 pubs in Manhattan and 80 bars in Boston had begun to sell Stella Artois on tap. To support the heightened efforts to establish Stella Artois in these competitive urban markets, Interbrew's corporate marketing department added several million dollars to Labatt USA's budget for Stella Artois in 2000, with commitments to continue this additional funding in subsequent years.

Current Thinking

Good progress had been made since 1998 when Stella Artois was established as Interbrew's global brand. However, management had revised its expectations for P/E leverage from having a global brand. The reality was that Interbrew would be rewarded only through cash benefits from operational leverage of a global brand. There would be no "free lunch" simply for being perceived as having a global brand. In addition, in an

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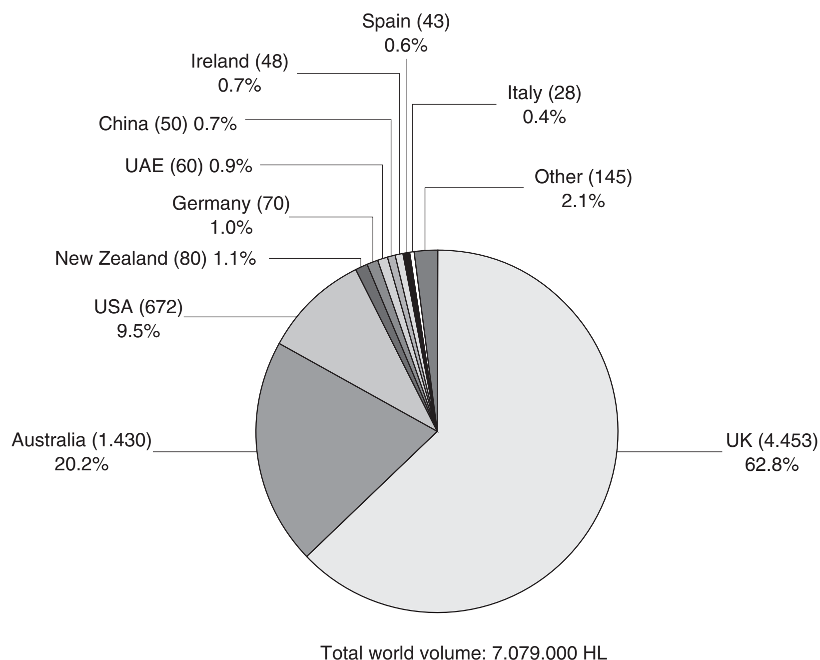

Exhibit 8 1998 Foster's World Sales Profile

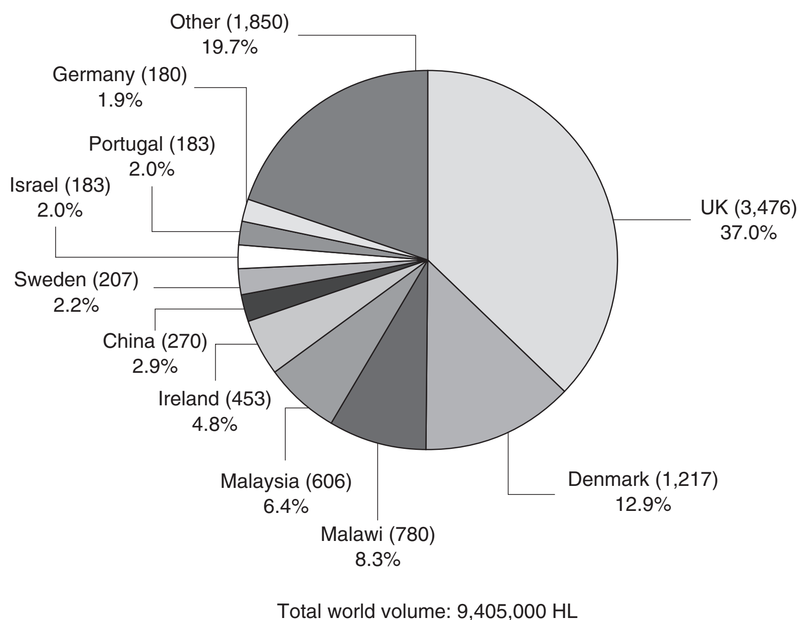

Exhibit 9 1998 Carlsberg World Sales Profile

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Brand Positioning

To males, between 21 to 45 years of age, that are premium lager drinkers, Stella Artois is a European premium lager beer, differentially positioned towards the product.

Stella Artois offers a modern, sophisticated, yet accessible drinking experience with an emphasis on the very high quality of the beer supported by the noble tradition of European brewing.

The accent is on the emotional consequence of benefit: a positive feeling of self esteem and sophistication.

Character, Tone of Voice

Sophistication
Authenticity, tradition, yet touch of modernity
Timelessness
Premium quality
Special, yet accessible
Mysticism
European

Exhibit 10 Global Positioning Statement

era of tight fiscal management, it was an ongoing challenge to maintain the funding levels required by the ambitious development plans for Stella Artois. As a result, in early 2000 the prevailing view at Interbrew began to shift, converging on a different long-range approach towards global branding. The emerging perspective emphasized a more balanced brand development program, focusing on the highest leverage opportunities.

The experience of other brewers that had established global brands offered an opportunity for Interbrew to learn from their successes and failures. Carlsberg and Heineken, for example, were two comparable global brands that were valued quite differently by the stock market. Both sold over 80 per cent of their total volumes outside their domestic market, and yet Heineken stock achieved a P/E ratio of 32.4 in 1999 versus Carlsberg's figure of only 17.1. According to industry analysts, the driving force behind this difference was that Heineken maintained a superior market distribution in terms of growth and margin (see Exhibit 11). The key lesson from examining these global brands appeared to be that great discipline must be applied to focus resources in the right places.

In line with this thinking, a long range marketing plan began to take shape that made use of a series of strategic filters to yield a focused set of attractive opportunities. The first filter that any potential market had to pass through was its long-term volume potential for Stella Artois. This volume had to trace back to a large and/or growing market, the current or potential sizeable premium lager segment (at least five per cent of the total market), and the possibility for Stella Artois to penetrate the top three brands. The second screen was the potential to achieve attractive margins after an initial starting period of approximately three years. The third filter was whether or not a committed local partner was available to provide the right quality of distribution and to co-invest in the brand. The final screen was the determination that success in the chosen focus markets should increase leverage in other local and regional markets. For example, the size and stature of Stella Artois in the United Kingdom was a significant factor in the easy sell-in of Stella Artois into New York in 1999.

Once filtered through these strategic market development screens, the global branding plans for Stella Artois began to take a different shape. Rather than focus on national markets, plans emerged with an emphasis on about 20 cities, some of which Interbrew was already present in (e.g., London, Brussels, New York, etc.). This

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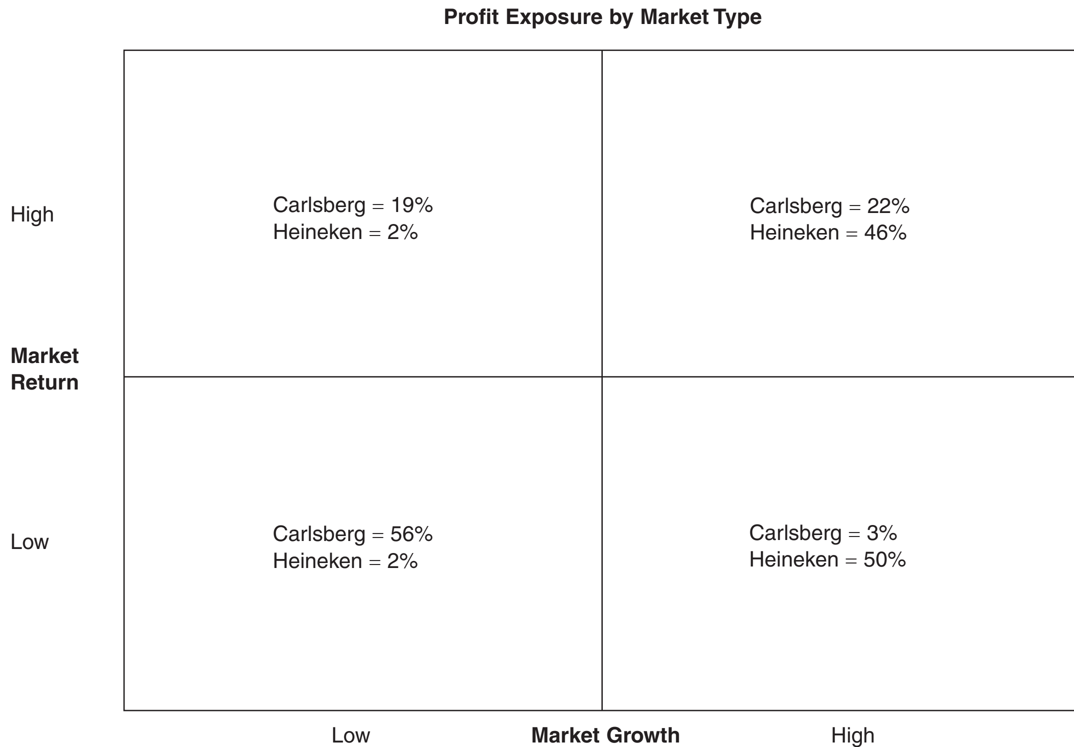

Exhibit 11 A Comparison of Carlsberg and Heineken

approach suggested that the next moves should be in such potential markets as Moscow, Los Angeles and Hong Kong. Some existing cities would receive focused efforts only when distribution partner issues had been successfully resolved to solidify the bases for sustained long term growth. The major cities that fit these criteria provided the right concentration of affluent consumers, who would be attracted to Stella's positioning, thus providing scale for marketing and sales, investment leverage, as well as getting the attention and support of motivated wholesalers and initial retail customers. These venues would thereby become highly visible success stories that would be leveragable in the company's ongoing market development plans.

Thus, the evolving global branding development plan required careful planning on a city-by-city basis. Among the demands of this new approach were that marketing efforts and the funding to support them would have to be both centrally stewarded and locally tailored to reflect the unique local environments. A corporate marketing group was, therefore, established and was charged with the responsibility to identify top priority markets, develop core positioning and guidelines for local execution, assemble broadly based marketing programs (e.g., TV, print advertising, global sponsorships, beer.com content, etc.), and allocate resources to achieve the accelerated growth objectives in these targeted cities. To ensure an integrated development effort the company brought all pivotal resources together, under the leadership of a global brand development director. In addition to the brand management team, the group included regional sales managers who were responsible for licensed partner management, a customer services group,

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a Belgian beer café manager, and cruise business management group. Another significant challenge that faced the corporate marketing group was to ensure that all necessary groups were supportive of the new approach. This was a simpler undertaking among those business units that were wholly owned subsidiaries; it was a more delicate issue in the case of licensees and joint ventures. A key element of managing brands through a global organizational structure was that the head office team had to effectively build partnerships with local managers to ensure their commitment.

Fortunately, much of the initial effort to establish Stella Artois as a global brand had been done on a city-by-city basis and, as such, there was ample opportunity for Interbrew to learn from these experiences as the new global plan evolved. In the late 1990s, for example, Stella Artois was introduced to various Central European cities (e.g., Budapest, Zagreb, Bucharest and Sofia). In each of these cities, Interbrew's marketing efforts were launched when the targeted premium market was at an early stage of development. Further, distribution and promotion was strictly controlled (e.g., product quality, glassware, etc.) and the development initiatives were delivered in a concentrated manner (e.g., a media "blitz" in Budapest). In addition, results indicated that the presence of a Belgian Beer Café accelerated Interbrew's market development plans in these new areas. These early successes suggested that brand success could be derived from the careful and concentrated targeting of young adults living in urban centres, with subsequent pull from outlying areas following key city success.

The key lessons of these efforts in Central Europe proved to be very valuable in guiding the market development plan in New York City. In this key North American city, the rollout of Stella Artois was perceived by the analysts as "one of the most promising introductions in New York over the last 20 years" and had generated great wholesaler support and excitement. Among the tactics used to achieve this early success was selective distribution with targeted point of sale materials support. In addition, a selective media campaign was undertaken that included only prestigious outdoor advertising (e.g., a Times Square poster run through the Millennium celebrations). Similarly, the sponsoring strategy focused only on high-end celebrity events, Belgian food events, exclusive parties, fashion shows, etc. Finally, the price of Stella Artois was targeted at levels above Heineken, to reinforce its gold standard positioning. This concerted and consistent market push created an impact that resulted in the "easiest new brand sell" in years, according to wholesalers. The success of this launch also built brand and corporate credibility, paving the way to introductions in other U.S. cities as well as "opening the eyes" of other customers and distribution partners around the world.

To pursue this new global development plan over the next three years, a revised marketing budget was required. Given that the corporate marketing department was responsible for both the development of core programs as well as the selective support of local markets, the budget had to cover both of these key elements. To achieve these ends, total spending was expected to more than double over the next three years.

While great progress had been made on the global branding of Stella Artois, Cooke still ruminated on a variety of important interrelated issues. Among these issues was the situation of Stella Artois in Belgium—would it be possible to win in the "global game" without renewed growth in the home market? What specific aspirations should Interbrew set for Belgium over the next three years? Further, what expectations should Interbrew have of its global brand market development (e.g., volumes, profit levels, number of markets and cities, etc.)? How should global success be measured? With respect to Interbrew's promotional efforts, how likely would it be that a single global ad campaign could be successful for Stella Artois? Was there a particular sponsorship or promotion idea that could be singled out for global leverage? And what role should the Internet play in developing Stella Artois as a true global brand?