Case analysis is an essential part of a strategic management course and is also perhaps the most entertaining part of such a course. The ‘full story’ that follows this summary gives you considerable detail about how to go about a case analysis, but for now here is a brief account.

Before we start, a word about attitude – make it a real exercise. You have a set of historical facts; use a rigorous system to work out what strategies should be followed. All the cases are about real companies, and one of the entertaining bits of the analysis process is to compare what you have said they should do with what they really have done. So, it is best not to check the Internet to see current strategies until you have completed your analysis.

What follows is one analytical system, a fairly tight one that you may want to adapt according to how much time you have and the style of the case.

**EXTERNAL ANALYSIS**

**STEP 1 WHAT INDUSTRY IS IT?**
You must decide on this early. This is an important step, because it changes the analysis – for example, your industry analysis will yield different conclusions depending on what industry you determine.

**STEP 2 GENERAL ENVIRONMENT ANALYSIS**
Analyse the six generic elements – economic, socio-cultural, global, technological, political/legal and demographic – and work out what the important facts are. There may be many issues and facts in each element, but you put down only the important ones. It is also important to avoid the common error of over-emphasis on the firm in question. So, assuming the firm operates in the Australian ice-cream industry, the demographic analysis may have this comment: ‘A large baby boomer generation is now becoming more health-conscious. This presents opportunities in health foods and healthy alternatives for conventional foods. It also presents opportunities for low-fat ice creams.’ Or, in analysing the demographics of the Cochlear™ firm, you may conclude that there is a global market of 1.8 million profoundly deaf people and that this provides a huge undeveloped market for the implantable hearing devices industry.

**STEP 3 THE INDUSTRY ENVIRONMENT**
Analyse the five forces (that is, supplier power, buyer power, potential entrants, substitute products and rivalry among competitors) and explain briefly what is significant for each. For example, what are the issues involved in new entrants into the industry? For the implantable hearing devices industry, these may include the need for understanding of intricate new technology, possession of a reputation in the global deaf community for safe and effective product development, and links to research institutions. This makes the industry hard to enter. Each force needs a brief discussion followed by a short conclusion.

One extra consideration before you pull the analysis together and work out if this is an attractive industry (the main conclusion) is: Is there a key force or forces in your industry? Porter argues that there is a key force in any industry, one that exerts more influence than the other forces.

Now, is it an attractive industry? You need to explain, briefly, why or why not. Bear in mind that it is often not a clear decision because the forces are mixed – for example, there may be little concern about new entrants, suppliers or substitutes, but buyers may be fickle...
and rivalry high. In such cases, the key force analysis is very important.

Remember: It is the industry you analyse, not the firm.

**STEP 4 COMPETITIVE ENVIRONMENT**

Is there a strategic group that you need to take account of? What is the rivalry like in this group? What capabilities do the relevant firms have? What strategies do they follow? What threats do they represent?

**STEP 5 YOU NOW HAVE MATERIAL ABOUT OPPORTUNITIES AND THREATS**

It is easy to pull this together from the four steps you have now completed.

**INTERNAL ANALYSIS**

**STEP 6 THE FIRM’S RESOURCES, TANGIBLE AND INTANGIBLE**

List all relevant resources. It is useful to distinguish between tangible and intangible resources. Remember: Firms have many resources.

At this point, if you have the skills and time, you can analyse the financial information that almost all cases provide. This provides material for a financial resources paragraph.

**STEP 7 CAPABILITIES IDENTIFICATION**

Here you make a list of capabilities. Capabilities tell you what the firm can do.

Remember: Each firm may have a dozen or more capabilities, so include some that are very unlikely to be core competencies. This is a difficult step, because you must explain the capabilities carefully to indicate what the firm really does. For example, Cochlear has a capability for research in cochlear-related technology. It does not have a generic research capability.

**STEP 8 CORE COMPETENCY ANALYSIS**

For each capability, indicate which of the four tests for a core competency it meets. An easy way to do this is through use of a table. For example:

<table>
<thead>
<tr>
<th></th>
<th>Rare?</th>
<th>Valuable?</th>
<th>Costly to imitate?</th>
<th>Non-substitutable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Logistics management in cochlear technologies</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Research knowledge and skill in cochlear-related areas</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Etc.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This is an important step, because the core competencies are fundamental in the strategies you suggest – firms use their core competencies.

**STEP 9 WEAKNESSES**

What major weaknesses does the firm have – for example, old technology, very limited finance and poor cash flow, no succession planning?

**STEP 10 PULLING IT TOGETHER**

You now have all the material for an excellent SWOT (strengths/weaknesses, opportunities/threats) analysis. Pull together the earlier identification of opportunities and threats (step 5) with the internal analysis you have done. This resources-based, theory-oriented system gives you a powerful vocabulary to describe what simpler systems call ‘strengths’, and the other elements of the system allow you to systematically identify other significant factors in the mix.

**STEP 11 CURRENT STRATEGIES**

Work out the firm’s current strategies.

**STEP 12 STRATEGIES**

Here you take advantage of opportunities and handle threats. You should be able to make use of core competencies to do this.

You may need strategies at the business level, corporate level and international level (but it depends on the industry and on whether all are required). Also, bear in mind that you may need to specify functional-level
strategies to fit the generic strategies at the business level. For example, if your ice-cream company adopts a differentiation strategy, you must specify how it is differentiated (on what grounds – low fat?) and there must be associated innovation and marketing strategies (or, in the corporate-level strategy, a supporting acquisition strategy may be used to handle the innovation issue).

Make a list of alternative possibilities and use the external and internal analyses that you have conducted to assess them. Choose one set of alternatives. How do these differ from current strategies?

Make sure the strategies chosen fit in with your earlier analysis. Use all the conclusions in the earlier analysis. For example (and bear in mind that this is simplified to make the idea clearer), if you are in a rivalrous industry which has good growth prospects because of useful demographic change and you have good financial resources, you may argue for expansion into the new segment using available resources. If the finances were not there, this strategy would be difficult to support.

**USING THE COCHLEAR™ CASE AS A TRAINING CASE**

This case analysis process is easy to use once you have learned it, and the best way to learn is to try it out. The Cochlear™ case in this book is designed as a training case to help you do this. Don’t be concerned if you get a slightly different analysis to other people – one of the glories of case analysis is that they are never ‘right’; some, however, are more plausible than others.
In most strategic management courses, cases are used extensively as a teaching tool. A key reason is that cases provide active learners with opportunities to use the strategic management process to identify and solve organisational problems. Thus, by analysing situations that are described in cases and presenting the results, active learners (that is, students) become skilled at effectively using the tools, techniques and concepts that combine to form the strategic management process.

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

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

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

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

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

**SKILLS GAINED THROUGH USE OF THE CASE ANALYSIS METHOD**

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

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

The case analysis method brings reality into the classroom. When developed and presented effectively, with rich and interesting detail, cases keep conceptual discussions grounded in reality. Experience shows that simple fictional accounts of situations and collections of actual organisational data and articles from public sources are not as effective for learning as fully developed cases. A comprehensive case presents you with a partial clinical study of a real-life situation that faced managers as well as other stakeholders, including employees. A case presented in narrative form provides motivation for involvement with and analysis of a specific situation. By framing alternative strategic actions and by confronting the complexity and ambiguity of the practical world, case analysis provides extraordinary power for your involvement with a personal learning experience. Some of the potential consequences of using the case method are summarised in Exhibit 1.

EXHIBIT 1

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


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

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

Furthermore, when your instructor requires oral and written presentations, your communication skills will be honed through use of the case method. Of course, these added skills depend on your preparation as well as your instructor’s facilitation of learning. However, the primary responsibility for learning is yours. The quality of case discussion is generally acknowledged to require, at a minimum, a thorough mastery of case facts and some independent analysis of them. The case method therefore first requires that you read and think carefully about each case. Additional comments about the preparation you should complete to successfully discuss a case appear in the next section.
STUDENT PREPARATION FOR CASE DISCUSSION

If you are inexperienced with the case method, you may need to alter your study habits. A lecture-oriented course may not require you to do intensive preparation for each class period. In such a course, you have the latitude to work through assigned readings and review lecture notes according to your own schedule. However, an assigned case requires significant and conscientious preparation before class. Without it, you will be unable to contribute meaningfully to in-class discussion. Therefore, careful reading and thinking about case facts, as well as reasoned analyses and the development of alternative solutions to case problems, are essential. Recommended alternatives should flow logically from core problems identified through study of the case. Exhibit 2 shows a set of steps that can help you to familiarise yourself with a case, identify problems and propose strategic actions that increase the probability that a firm will achieve strategic competitiveness and earn above-average returns.

EXHIBIT 2

| Step 1: Gaining familiarity | a In general – determine who, what, how, where and when (the critical facts of the case).  
|                           | b In detail – identify the places, persons, activities and contexts of the situation.  
|                           | c Recognise the degree of certainty/uncertainty of acquired information.  |
| Step 2: Recognising symptoms | a List all indicators (including stated ‘problems’) that something is not as expected or as desired.  
|                           | b Ensure that symptoms are not assumed to be the problem. (Symptoms should lead to identification of the problem.)  |
| Step 3: Identifying goals | a Identify critical statements by major parties (e.g. people, groups, the work unit, etc.).  
|                           | b List all goals of the major parties that exist or can be reasonably inferred.  |
| Step 4: Conducting the analysis | a Decide which ideas, models and theories seem useful.  
|                           | b Apply these conceptual tools to the situation.  
|                           | c As new information is revealed, cycle back to sub-steps (a) and (b).  |
| Step 5: Making the diagnosis | a Identify predicaments (goal inconsistencies).  
|                           | b Identify problems (discrepancies between goals and performance).  
|                           | c Prioritise predicaments/problems regarding timing, importance, etc.  |
| Step 6: Doing the action planning | a Specify and prioritise the criteria used to choose action alternatives.  
|                           | b Discover or invent feasible action alternatives.  
|                           | c Examine the probable consequences of action alternatives.  
|                           | d Select a course of action.  
|                           | e Design an implementation plan/schedule.  
|                           | f Create a plan for assessing the action to be implemented.  |


GAINING FAMILIARITY

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

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

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

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

RECOGNISING SYMPTOMS

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

IDENTIFYING GOALS

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

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

CONDUCTING THE ANALYSIS

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

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

Also, because the quality of a case analysis depends on applying appropriate tools, it is important that you use the ideas, models and theories that seem to be useful for evaluating and solving individual and unique situations. As you consider facts and symptoms, a useful theory may become apparent. Of course, having familiarity with conceptual models may be important in the effective
analysis of a situation. Successful students and successful organisational strategists add to their intellectual tool kits on a continual basis.

**MAKING THE DIAGNOSIS**

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

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

**DOING THE ACTION PLANNING**

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

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

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

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**WHAT TO EXPECT FROM IN-CLASS CASE DISCUSSIONS**

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

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

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

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

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

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

**PREPARING AN ORAL/WRITTEN CASE STRATEGIC PLAN**

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

**EXHIBIT 3 Types of thinking in case preparation: Analysis and synthesis**

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

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

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

**EXTERNAL ENVIRONMENT ANALYSIS**

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

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

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

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

Porter’s five forces model is a useful tool for analysing the specific industry (see Chapter 2). Careful study of how the five competitive forces (that is, supplier power, buyer power, potential entrants, substitute products and rivalry among competitors) affect a firm’s strategy is important. These forces may create threats or opportunities relative to the specific business-level strategies (that is, differentiation, cost leadership, focus) being implemented. Often a strategic group’s analysis reveals how different environmental trends are affecting industry competitors. Strategic group analysis is useful for understanding the industry’s competitive structures and firm constraints and possibilities within those structures.
Firms also need to analyse each of their primary competitors. This analysis should identify their competitors’ current strategies, strategic intent, strategic mission, capabilities, core competencies and competitive response profile. This information is useful to the focal firm in formulating an appropriate strategic intent and mission.

**INTERNAL ENVIRONMENT ANALYSIS**

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

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**EXHIBIT 6 Sample general environmental categories**

| Technology                          | Information technology continues to become cheaper and have more practical applications  
|                                    | Database technology allows organisation of complex data and distribution of information  
|                                    | Telecommunications technology and networks increasingly provide fast transmission of all sources of data, including voice, written communications and video information  
| Demographic trends                 | Computerised design and manufacturing technologies continue to facilitate quality and flexibility  
|                                    | Regional changes in population due to migration  
|                                    | Changing ethnic composition of the population  
|                                    | Ageing of the population  
|                                    | Ageing of the baby boomer generation  
| Economic trends                    | Interest rates  
|                                    | Inflation rates  
|                                    | Savings rates  
|                                    | Trade deficits  
|                                    | Budget deficits  
|                                    | Exchange rates  
| Political/legal environment        | Antitrust enforcement  
|                                    | Tax policy changes  
|                                    | Environmental protection laws  
|                                    | Extent of regulation/deregulation  
|                                    | Developing countries privatising state monopolies  
|                                    | State-owned industries  
| Socio-cultural environment         | Increasing proportion of women in the workforce  
|                                    | Awareness of health and fitness issues  
|                                    | Concern for the environment  
|                                    | Concern for customers  
| Global environment                 | Currency exchange rates  
|                                    | Free trade agreements  
|                                    | Trade deficits  
|                                    | New or developing markets  

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

Analysis of the primary and support activities of the value chain provides opportunities to understand how external environmental trends affect the specific activities of a firm. Such analysis helps to highlight strengths and weaknesses. (See Chapter 3 for an explanation of the value chain.) For the purposes of preparing an oral or written presentation, it is important to note that strengths are internal resources and capabilities that have the potential to be core competencies. Weaknesses, on the other hand, have the potential to place a firm at a competitive disadvantage in relation to its rivals.

When evaluating the internal characteristics of the firm, your analysis of the functional activities emphasised is critical. For example, if the strategy of the firm is primarily technology-driven, it is important to evaluate the firm’s R&D activities. If the strategy is market-driven, marketing functional activities are of paramount importance. If a firm has financial difficulties, critical financial ratios would require careful evaluation. In fact, because of the importance of financial health, most cases require financial analysis. The appendix lists and operationally defines several common financial ratios. Included are exhibits describing profitability, liquidity, leverage, activity and shareholders’ return ratios. Other firm characteristics that should be examined to study the internal environment effectively include leadership, organisational culture, structure and control systems.

IDENTIFICATION OF STRATEGIC INTENT AND MISSION

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

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

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

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

HINTS FOR PRESENTING AN EFFECTIVE STRATEGIC PLAN

There may be a temptation to spend most of your oral or written case analysis on the results from the analysis. It is important, however, that the analysis of a case should not be over-emphasised relative to the synthesis of results gained from your analytical efforts – what does the analysis mean for the organisation (see Exhibit 3)?

STRATEGY FORMULATION: CHOOSING KEY RESULT AREAS

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

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

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

**KEY RESULT AREA**

**IMPLEMENTATION**

After selecting the most appropriate KRAs (that is, those with the highest probability of enhancing a firm’s strategic competitiveness), you must consider effective implementation. Effective synthesis is important to ensure that you have considered and evaluated all critical implementation issues. Issues you might consider include the structural changes necessary to implement the new strategies and objectives associated with each KRA. In addition, leadership changes and new controls or incentives may be necessary to implement these strategic actions. The implementation actions you recommend should be explicit and thoroughly explained. Occasionally, careful evaluation of implementation actions may show the strategy to be less favourable than you originally thought. (You may find that the capabilities required to implement the strategy are absent and unobtainable.) A strategy is only as good as the firm’s ability to implement it effectively. Therefore, expending the effort to determine effective implementation is important.

**PROCESS ISSUES**

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

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

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

**NOTES**

# APPENDIX: FINANCIAL ANALYSIS IN CASE STUDIES

## APPENDIX 1 PROFITABILITY RATIOS

<table>
<thead>
<tr>
<th>RATIO</th>
<th>FORMULA</th>
<th>WHAT IT SHOWS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Return on total assets</td>
<td>Profits after taxes</td>
<td>The net return on total investment of the firm</td>
</tr>
<tr>
<td></td>
<td>Total assets</td>
<td>or</td>
</tr>
<tr>
<td></td>
<td>or Profits after taxes + interest</td>
<td>The return on both creditors’ and shareholders’ investments</td>
</tr>
<tr>
<td></td>
<td>Total assets</td>
<td>How effectively the company is utilising shareholders’ funds</td>
</tr>
<tr>
<td>2 Return on shareholders’ equity (or return on net worth)</td>
<td>Profits after taxes</td>
<td>The net return to ordinary shareholders</td>
</tr>
<tr>
<td></td>
<td>Total shareholders’ equity</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Profit after taxes – preference share dividends</td>
<td>The firm’s profitability from regular operations</td>
</tr>
<tr>
<td></td>
<td>Total shareholders’ equity – par value of preference shares</td>
<td>The firm’s net profit as a percentage of total sales</td>
</tr>
<tr>
<td>3 Return on ordinary equity</td>
<td>Profit before taxes and before interest</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sales</td>
<td></td>
</tr>
<tr>
<td>4 Operating profit margin (or return on sales)</td>
<td>Profits after taxes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sales</td>
<td></td>
</tr>
<tr>
<td>5 Net profit margin (or net return on sales)</td>
<td>Profits after taxes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sales</td>
<td></td>
</tr>
</tbody>
</table>

## APPENDIX 2 LIQUIDITY RATIOS

<table>
<thead>
<tr>
<th>RATIO</th>
<th>FORMULA</th>
<th>WHAT IT SHOWS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Current ratio</td>
<td>Current assets</td>
<td>The firm’s ability to meet its current financial liabilities</td>
</tr>
<tr>
<td></td>
<td>Current liabilities</td>
<td></td>
</tr>
<tr>
<td>2 Quick ratio (or acid-test ratio)</td>
<td>Current assets – inventory</td>
<td>The firm’s ability to pay off short-term obligations without relying on sales of inventory</td>
</tr>
<tr>
<td></td>
<td>Current liabilities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Inventory</td>
<td>The extent to which the firm’s working capital is tied up in inventory</td>
</tr>
<tr>
<td>3 Inventory to net working capital</td>
<td>Current assets – current liabilities</td>
<td></td>
</tr>
</tbody>
</table>
### Appendix 3: Leverage Ratios

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
<th>What it Shows</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Debt-to-assets</td>
<td>Total debt / Total assets</td>
<td>Total borrowed funds as a percentage of total assets</td>
</tr>
<tr>
<td>2 Debt-to-equity</td>
<td>Total debt / Total shareholders' equity</td>
<td>Borrowed funds versus the funds provided by shareholders</td>
</tr>
<tr>
<td>3 Long-term debt-to-equity</td>
<td>Long-term debt / Total shareholders' equity</td>
<td>Leverage used by the firm</td>
</tr>
<tr>
<td>4 Times-interest-earned</td>
<td>Profits before interest and taxes / Total interest charges</td>
<td>The firm’s ability to meet all interest payments</td>
</tr>
<tr>
<td>(or coverage ratio)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Fixed charge coverage</td>
<td>(Profits before taxes and interest + lease obligations) / Total interest charges</td>
<td>The firm’s ability to meet all fixed-charge obligations, including lease payments</td>
</tr>
</tbody>
</table>

### Appendix 4: Activity Ratios

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
<th>What it Shows</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Inventory turnover</td>
<td>Sales / Inventory of finished goods</td>
<td>The effectiveness of the firm in employing inventory</td>
</tr>
<tr>
<td>2 Fixed assets turnover</td>
<td>Sales / Fixed assets</td>
<td>The effectiveness of the firm in utilising plant and equipment</td>
</tr>
<tr>
<td>3 Total assets turnover</td>
<td>Sales / Total assets</td>
<td>The effectiveness of the firm in utilising total assets</td>
</tr>
<tr>
<td>4 Accounts receivable turnover</td>
<td>Annual credit sales / Accounts receivable</td>
<td>How many times the total receivables have been collected during the accounting period</td>
</tr>
<tr>
<td>5 Average collection period</td>
<td>Accounts receivable / Average daily sales</td>
<td>The average length of time the firm waits to collect payments after sales</td>
</tr>
</tbody>
</table>
## Appendix 5 Shareholders’ Return Ratios

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
<th>What It Shows</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Dividend yield on ordinary shares</td>
<td>$\frac{\text{Annual dividends per share}}{\text{Current market price per share}}$</td>
<td>A measure of return to ordinary shareholders in the form of dividends</td>
</tr>
<tr>
<td>2. Price–earnings ratio</td>
<td>$\frac{\text{Current market price per share}}{\text{After-tax earnings per share}}$</td>
<td>An indication of market perception of the firm. Usually, the faster-growing or less risky firms tend to have higher PE ratios than the slower-growing or more risky firms</td>
</tr>
<tr>
<td>3. Dividend payout ratio</td>
<td>$\frac{\text{Annual dividends per share}}{\text{After-tax earnings per share}}$</td>
<td>An indication of dividends paid out as a percentage of profits</td>
</tr>
<tr>
<td>4. Cash flow per share</td>
<td>$\frac{\text{After-tax profits + depreciation}}{\text{Number of ordinary shares outstanding}}$</td>
<td>A measure of total cash per share available for use by the firm</td>
</tr>
</tbody>
</table>
Hearing with the Aid of Implanted Technology: The Case of Cochlear™ – An Australian High-Technology Leader

Dallas Hanson
University of Tasmania
Mark Wickham
University of Tasmania

The Cochlear Company of Australia: The Situation

Cochlear™ is a leading Australian company specialising in cochlear devices – that is, implantable hearing devices. It is the world leader in this market and a prominent innovator in the high-technology niche within which it operates. Cochlear originated in Australia but now sells globally in an increasingly competitive market.

At the end of 2006 the company was in a good position. Having had very poor results during the 2003–04 financial year, the results for 2005 and into 2006 were excellent. The share price had risen 150 per cent and turnover was up. Cochlear is that rare company, a high-tech Australian that is successful and focused on exports. But will it last? Several problems remain. Within the global deaf community there is a continuing and serious debate about the use of technology to aid hearing in the profoundly deaf, and this obviously threatens the market. Second, there is a sleeping issue in regulatory matters – an implant is expensive and personally invasive technology and it is reasonable to suggest that regulators will, every now and again, find fault with the processes used by one or more of the companies in the industry. In 2002 and 2005, for example, the US Food and Drug Administration (FDA) issued regulatory notifications of problems with implants. These notifications actually benefited Cochlear because their major competitor was more directly implicated, but it nevertheless shook the industry. Finally, is it safe for the company to be so dependent on one relatively narrow research and development (R&D) focused niche?

The Cochlear Implant Technology

A cochlear implant is a small electronic device that helps a profoundly (completely) deaf person to have a sense of sound. It is different from a hearing aid because it helps to compensate for damaged or non-functional parts of the ear, while a hearing aid amplifies sound for a partially functioning ear. The implant has four parts:

- a tiny but sensitive microphone that picks up sound
- a speech processor that selects and arranges useful sounds
- a transmitter and receiver that turns these sounds into electrical impulses
- a series of electrodes that are surgically implanted in the inner ear, which pick up the receiver’s impulses and transmit them to the brain (this process is analogous to how hearing people hear sounds).

The cochlear implant technology is getting more sophisticated all the time. It is a fast-moving technology, and changes are further enhancing the capacity of the devices as well as making them smaller and therefore more socially acceptable.

Implanting the devices is an invasive surgical procedure that has some risks. It is also expensive because it requires an experienced surgeon. Exhibit 1 shows the device.

A recent Cochlear company annual report outlines the details of this technology and indicates its intricacy:

Introduction to the Nucleus® 3 System

The unique features of the Nucleus® 3 System include:
CASE ONE: HEARING WITH THE AID OF IMPLANTED TECHNOLOGY

EXHIBIT 1 The Nucleus® 3 system

Longest battery life on the market: The ESPrit™ 3G speech processor is the only processor on the market with a battery life that lasts up to three days. Few interruptions and clear sound means better hearing.

Unique whisper setting provides more sound: The ESPrit 3G is the only speech processor on the market that features a special whisper setting designed to make soft sounds more audible – like rain falling or a person calling from another room.

Wireless FM and in-built telecoil: An in-built telecoil allows you to use the telephone with no additional attachments. The wireless FM provides access to sound in a variety of settings including cinemas, museums, meetings, classrooms, and wherever an FM system is in place for hearing-impaired participants. No additional cables are necessary.

The only pre-curved (contoured) electrode array on the market: The Nucleus® 24 Contour™ implant is the first implant choice for surgeons. It features a pre-curved electrode array, which has two important benefits: 1) the curve of the array puts the electrodes as close as possible to the hearing fibres in the cochlea to allow for the distinct sound; 2) the pre-curved shape of the array matches the shape of the cochlea, which helps to protect its delicate structure.

Titanium implant casing for best reliability: Nucleus® implants are durable and reliable and are made from Titanium. The Nucleus 24 Contour has never fractured on impact. Nucleus is built for a lifetime of use.

Removable magnet for safe MRI: Nucleus is the first implant to feature the removable magnet for MRI. This allows recipients to have a full-strength MRI if they require one.1

COCHLEAR, THE COMPANY

The history of Cochlear’s Nucleus® device goes back to 1967, when Graeme Clark started research on multi-channel cochlear implants. In 1978, Professor Clark implanted Rodney Saunders with a multi-channel cochlear device, and by 1982 a 22-channel device was implanted in Graham Carrick. (The more channels, basically, the better the hearing.) In 1985 the 22-channel Nucleus® device was approved by the FDA for use in adults, and in 1990 for use in children. By 1998, 10,000 children had been implanted, and by 2001 more than 60,000 adults and children had been implanted.2

Cochlear’s technology has obviously kept improving, and each component improvement improves the overall system. In 2003 the company announced a further significant improvement to its basic product: the Nucleus® 24 Contour Advance™ was designed to minimise trauma to the delicate Cochlear structures during implant surgery. It also developed a new MicroLink Adaptor for use with the speech processor and receiver. (This was a product of the alliance Cochlear has with European technology firm Phonok AG.) In 2005 they launched a new version, the Nucleus® Freedom which offers far more than previous devices (including smaller size, better performance and water resistance).3

The financial results for the six months to December 2005 were excellent. Profits increased by 33 per cent to $43 million and revenue was up 34 per cent to $221 million. The company has around 70 per cent of the world cochlear implant market.4 Sales in the United States were up 20.6 per cent; in Europe they were up 40 per cent on 2004–05; and in Asia they were up 12 per cent.

Cochlear’s manufacturing facilities are world class and have had repeated upgrades in order to maintain this status.

The firm is very focused on R&D and in 2005 devoted 11 per cent of total revenue to research. This compares to resources company BHP Billiton who devotes around 0.1 per cent to R&D while medical company CSL devotes around 7 per cent.5 As well as 220 research staff, it has major long-term research links with the CRC (Co-operative Research Centre) for Cochlear implant and

CASE ONE: HEARING WITH THE AID OF IMPLANTED TECHNOLOGY

Hearing Aid Innovation in Melbourne, as well as with the University of Melbourne itself. In addition, Cochlear has collaborative research arrangements with 80 other partners in 35 countries.6 The chief technology officer for the firm is one of the eight-member board, indicating the significance of research to the firm.

The organisation is very determined to maintain excellent links with implant recipients and the surgeons and audiologists that work with them. For example, in 2002, 70 surgeons attended the Sydney facility through Cochlear’s ongoing visiting surgeon program.

Cochlear has around 1000 staff representing 70 nations. It has an excellent training system for new staff. For example, in 2002, 43 new staff attended the Sydney headquarters for intensive training in the technology of implants and all aspects of the implantation process, including surgery. Cochlear is proud of the ethnic diversity of its staff.

The board is made up of six independent non-executive directors, the chief executive officer (CEO), and the chief technology officer. Cochlear has a good committee system and all meetings are well documented. In September 2002, Cochlear was named in the top three Australian companies for best corporate governance by Investor Relations Magazine.

In 2005 Cochlear acquired Swedish bone conduction hearing company Enteric Medical Systems for $195 million. This broadened the base for Cochlear. Enteric use a different process to create hearing. Using the baha range of technologies they use a small sound processor with a titanium device anchored to bone behind the ear. The sound is conducted through bone rather than the middle ear. This process suits single-sided hearing loss, unlike the cochlear process.

THE EXTERNAL WORLD FOR THE INDUSTRY

HEARING IMPAIRMENT

Hearing impairment ranges from mild to profound, and some people can hear some frequencies but not others. Mild hearing loss means that people can hear in quiet, one-on-one, situations but have problems in noisy environments such as cafés and bars. At the moderate level of loss, people find difficulty in hearing normal speech at any distance over a metre and are unlikely to hear well in crowded social situations. Profound hearing loss means that a person cannot hear a normal speaking voice or normal sounds. They may be helped by hearing aids, but tend to rely heavily on speech reading or sign language. Those with high-frequency loss (often caused by exposure to loud noises) can hear the person speaking but have difficulty hearing all the sounds. For example, the higher-pitched consonants such as P, S, F and CH may be confused, so ‘sun’ may be heard as ‘fun’ or ‘pat’ heard as ‘sat’.7

The market for cochlear devices is the profoundly deaf. The number of such people is difficult to determine. The UK National Deaf Children’s Society (NDCS) suggests that one in 1000 children are born with severe/profound hearing problems.8 The (Australian) Bionic Ear Institute estimates the potential market in the West plus Japan as three million devices. In China, there are possibly 35,000 people born each year who would benefit from the device.9 Even when discounted for unwillingness to risk the operation or lack of money, the numbers are huge. The companies competing in the industry concentrate on the United States and European markets and have barely penetrated the wider global market.

THE POLITICAL/LEGAL ENVIRONMENT

The cochlear industry is part of the general medical technology industry. Regulation is therefore significant and the US FDA is the most significant regulator because its findings have weight worldwide. The FDA must approve new devices before they can be sold in the United States. The FDA was also the initiator of the 2002 meningitis scare, which affected the whole industry. In Australia the equivalent authority is the Therapeutic Drugs Administration. In 2005 Advanced Bionics, Cochlear’s major competitor, was forced to recall hearing implants in the USA after the FDA determined a potential malfunction in their devices from moisture contamination.

With exports a major part of the industry other nation-specific regulatory matters are important. For example, in 2005 the Chinese customs department investigation into the tax-exempt status of implants interrupted Cochlear’s sales in China. (The sales problem was partly balanced by Cochlear’s successful launch of a specially-developed lower priced speech processor for the Chinese market.)
CASE ONE: HEARING WITH THE AID OF IMPLANTED TECHNOLOGY

THE GLOBAL ASPECT

The cochlear market has gradually expanded beyond Australia, the United States and Europe. Cochlear itself established its European offices in 1987 and an office in Japan and Hong Kong in the 1990s, while China was a major target in 2001. Cochlear devices are now sold in more than 60 nations. Given that profound deafness is a problem globally, it can be expected that the global market will continue to expand.

ECONOMICS AND COCHLEAR DEVICES

Cochlear devices cost around $50,000 for a lifetime service. Demand worldwide therefore comes from relatively affluent individuals, medical insurance companies and government organisations. It is possibly limited in poorer nations. However, within the OECD the middle to upper income groups are increasingly prosperous and these people are a potential market without government help. On the other hand, medical and insurance systems are gradually coming under increasing pressure as government tax incomes struggle to cope with competing demands for health, education and welfare services.

THE MENINGITIS CRISIS IN THE COCHLEAR IMPLANT INDUSTRY

On 24 July 2002 the FDA issued a notification that it had reports of a link between cochlear implants and bacterial meningitis (a potentially fatal infection of the lining of the surface of the brain). There were 43 such cases and 11 people died. There were reports that implants had been withdrawn from sale in Germany, France and Spain. On 25 July the FDA updated its warning and said it had now learned of 118 cases.

Cochlear responded to the crisis quickly. Graeme Clark claimed that the infection was related to a design change by their competitor, Advanced Bionics, that created ‘dead space’ within the ear, thus providing a home for bacteria. Professor Clark commented that: ‘It is a very great problem of engineers per se designing something without due recourse to biologists and medical people.’ Advanced Bionics temporarily withdrew its product from sale.

The meningitis scare has had a long-term ripple effect on the industry, and doubt remains despite a climb in share prices to those similar to levels prior to the scare. The deaf community and the medical profession have an ongoing debate about cochlear implants. For example, Blake Papsin, the director of the Cochlear implant program in Toronto, Canada, in early 2003, said:

In coming to terms with the relation between cochlear implants and meningitis, we should not lose sight of the benefit of this technology. For many children, the cochlear implant is a marvel that has allowed them to attain or regain hearing and speech. The growing number of candidates for cochlear implants, at least in Canada centres, reflects a conservative application of this technology based on the responsible evaluation of outcomes.

This debate simmers in deaf culture. It is made more complex by advances in other areas of neuro-technology that are leading to useful devices such as artificial sight. In addition, the increasing acceptance of altered body technology may affect the cochlear industry – many now feel it is normal to alter body parts by surgery (for example, with pectoral enhancement or breast enlargement) and this could affect the ‘normality’ of a cochlear implant in the wider (as distinct from deaf) culture.

DEBATE ABOUT THE IDEA OF COCHLEAR IMPLANTS IN THE DEAF COMMUNITY

The background to a vigorous debate about the active benefits of a cochlear implant is encapsulated in a 2002...
letter from Robert Adam, President of the Australian Association of the Deaf:

The truth is obvious: a cochlear implant is not a cure for deafness. Let me expand on this a little.

The Royal Institute for the Deaf in the UK has a fact sheet which mirrors the Australian Association of the Deaf’s view succinctly: A child with an implant will still be profoundly deaf when not wearing the implant. When wearing the implant, the child will be considered hard of hearing, or severely deaf, in the sense that a person with a hearing aid is described as hard of hearing.

The deaf culture is not just about a language – it is also about community, history and art. Like many minority cultures, there is a strong tradition of stories and folklore that is passed on from one generation to the next. There have been many captivating and moving stories about the way deaf people lived in the past and about how deaf culture has endured despite attempts to ‘cure’ deafness.16

In 2000 in the United States the debate was highlighted by a film documentary called Sound and Fury, which portrayed the Artinian family. The father, Pete, is deaf and he and his wife Nita have three deaf children. His family also includes brother Chris and his wife Mari. Chris and Mari had a deaf baby and decided to have an implant. Pete and Nita, leading anti-implant campaigners, objected but were then astonished when their own daughter requested an implant. Pete and Nita were afraid that their daughter would lose contact with deaf culture if she had an implant, so they decided to move to a more deaf-culture-oriented community. This complex family drama appealed to the US media, and the idea of a deaf culture contrasted with the benefits of cochlear implants became a subject of general debate.

In 2003 the tenor of the debate in the United States changed with the entry of Miss USA 1995, Heather Whitestone McCallum. She became profoundly deaf in infancy and had an implant in 2002. She then sprang into action, lobbying federal politicians for the industry, appearing on top-rating television shows, such as Good Morning America, and appearing in print media such as the bestselling USA Today. She has been credited with helping to change the US government’s mind on cochlear support – the government had been talking in 2002 of reducing funding for the implant procedure but ended up increasing it.17

COMPETITORS IN THE INDUSTRY

ADVANCED BIONICS

Advanced Bionics is a private US company founded in 1993, which is dedicated to the development of neuron-stimulation products – implantable devices that direct electrical impulses to nerves and muscles. The chairman, Alfred Mann, says the company aims to ‘enable the deaf to hear, the blind to see, and the lame to walk’. The company originated when Dr Robert Schindler from the University of California’s San Francisco cochlear program approached Mann for funding. Mann was already highly successful in implantable devices, the founder of a major heart pacemaker company (Pacemaker Systems) and high-tech wearable insulin-delivering pumps (MiniMed). In 2003 the Alfred Mann Foundation (Mann’s philanthropic research organisation) was working with Robert Greenberg, the CEO of Mann’s company Second Sight, a company devoted to the development of implants to enable vision. The implants would enable people with retinal disintegration to see. Greenberg claimed in 2003 that three people have been implanted and that the results were ‘pleasing’.18 Advanced Bionics has developed and sold the Clarion cochlear implant.

Advanced Bionics has been the focus for two FDA notifications, the meningitis scare and the 2005 water damage product recall. Both have given Cochlear an advantage over them.

In 2004 they were acquired by Boston Scientific, a global player in a broadly defined ‘less invasive’ medical implants industry. Less-invasive medical technologies mean alternatives to major surgery and other medical procedures that are typically traumatic to the body. Boston Scientific have been going for 25 years, have 28 000 employees and produce over 15 000 products.19 This now provides Advanced Bionics with financial muscle.

ALLHEAR INC. DESIGNS

This company manufactures and sells cochlear implants. The founder, Dr William House, produced a cochlear device in 1984 in conjunction with the 3M Corporation, one of the world’s leading innovation-driven corporations. The AllHear cochlear implant is unique because it uses a single short electrode that apparently does not destroy residue of hearing.20 In 2005, AllHear’s cochlear implants had still not been approved by the FDA for general sale in the United States.
**CASE ONE:**
Hearing with the Aid of Implanted Technology

**MED-EL**
Med-El developed one of the very first cochlear implants. It now produces the Sonata implant which the company claims is the smallest and thinnest titanium implant system. It has collaborative arrangements with a range of universities. Med-El has eight subsidiaries and nine service centres throughout the world. It is a fierce competitor. In 2005 they started implants in Australia with the first Med-El recipient a Melbourne woman.

**BACK TO COCHLEAR, THE COMPANY**
CEO Chris Roberts took over in February 2004. Roberts has had considerable success but he must cope with the competition and with the social and medical issues that threaten the industry. What should he do to maintain the dominance of Cochlear in its narrow industry? Should he expand beyond this industry?

**NOTES**

4. www.cochlear.com
6. www.cochlear.com
The creation of a new venture is a multidimensional phenomenon; each variable describes only a single dimension of the phenomenon and cannot be taken alone...entrepreneurs and their firms vary widely; the actions they take or do not take and the environments they operate in and respond to are equally diverse—and all these elements form complex and unique combinations in the creation of each new venture.

INTRODUCTION

Delta Faucet Company is a division of Masco Corporation and is the largest US manufacturer of residential and commercial faucets and related accessories. The company manufactures the Delta®, Brizo™ and Peerless® faucet brands and holds the number one market share position in the United States. The market-leading Delta line, with a strong half-century heritage, delivers exceptionally well-made, stylish faucets and related accessories that are precisely crafted to be beautiful both inside and outside. Brizo provides high-end customers with distinctively designed, innovative faucets and accessories that complement today’s luxury kitchens and baths. Peerless offers value-driven, proven designs that don’t sacrifice style.

Delta Faucet is a worldwide leader in the manufacture, sales and distribution of bathroom accessory products. Delta Faucet commenced operations in Indianapolis, Indiana in 1954. Since its inception, the company has grown its operations to over 50 countries. This entrepreneurial orientation is underpinned by the pursuit of innovation, the willingness to take risks and a proactive stance towards understanding the global consumer and their needs. In 1999, as part of its global expansion, Delta Faucet commenced operations as a wholly owned subsidiary in the People’s Republic of China. This case considers Delta Faucet’s expansion and operation into China.

An entrepreneurial venture can be identified by the strategic behaviour of the organisation. Vesper supports earlier theory that there are five categories of behaviour that are characteristic of an entrepreneurial venture. These are:

1. introduction of new goods
2. introduction of new methods of production
3. opening of new markets
4. opening of new sources of supply
5. industrial reorganisation.

Of these, Delta’s expansion into China represents characteristic number three. Most entrepreneurial organisations venture into new overseas markets for two reasons. First, to use organisation-specific knowledge, primarily for manufacturing and sales activities, or second, to increase the stock of the organisation’s knowledge, primarily through research and development (R&D) activities. Delta Faucet’s foray into China embodies the manufacturing and sales activities reason. Many of the products that Delta Faucet markets in China are made from their manufacturing plant in Guangzhou, southern China. The Guangzhou operation also serves as a distribution centre for the agent intermediaries who buy and on-sell Delta Faucet’s products.
EXTERNAL ANALYSIS

INDUSTRY DEFINITION
Delta Faucet competes in the residential and commercial bathroom and kitchen accessory industry. This industry is characterised by the manufacture, sales and distribution of kitchen, bath and laundry products such as vanity basins, taps, and sinks to the building and construction industry as well as to various retailers throughout China. Delta Faucet serves two main customer types, namely, dealers who purchase and then resell to the building contractors in the construction industry and second, retailers who purchase and then sell goods to private individuals who seek to renovate their bathroom or kitchen areas.

GENERAL ENVIRONMENT ANALYSIS

ECONOMIC
China’s economy has experienced double digit compounded growth since she opened her doors to foreign trade in the late 1970s. This growth can be found in various areas of China’s economy including manufacture, exporting and the services sector. As a result of the dynamic growth in China’s economy, China’s consumers have also experienced increases in their individual wealth, especially in larger cities on China’s eastern seaboard. Increasingly, Chinese consumers are looking to foreign branded goods to satisfy their individual needs. These products are made more affordable by the steady increase in disposable income of Chinese consumers.

SOCIO-CULTURAL
As their wealth increases, Chinese consumers are looking to foreign brands to satisfy their needs. Younger consumers no longer subscribe to the ethnocentric view that they should buy home-made products to support local industry. Foreign branded goods are seen as being superior in their quality, design and performance. The purchase and use of foreign-made goods is seen as a status symbol of wealth and affluence.

INTERNATIONALISATION
More open markets, lower communication and transport costs and the availability of staff with more international experience have created opportunities for smaller organisations to enter international markets. Entrepreneurial organisations distinguish themselves from other organisations by a higher level of alertness to business opportunities and by a stronger willingness to pursue them without regard to the resources they control at the inception stage of the entrepreneurial venture. Johansson and Mattsson have provided a framework by which to understand how entrepreneurial organisations expand their operation. This framework suggests that the degree of international entrepreneurship is a function of both the organisation and the (international) markets that it attempts to compete in (see Exhibit 1).

EXHIBIT 1

<table>
<thead>
<tr>
<th>Low degree of internationalisation of the company</th>
<th>High degree of internationalisation of the market</th>
</tr>
</thead>
<tbody>
<tr>
<td>The early starter</td>
<td>The late starter</td>
</tr>
<tr>
<td>The lonely international</td>
<td>The international among others</td>
</tr>
</tbody>
</table>

With a presence in over 50 countries, and China being a nation with a low (but growing) degree of internationalisation, Delta Faucet is considered a ‘lonely international’ in the China market. A ‘lonely international’ is a pioneering organisation that attempts to expand market opportunities in nations where it is considered to have a sustainable competitive advantage. In the case of Delta Faucet, its competitive advantage comes from an industry-recognised brand name and reputation for quality products.

**Overcoming Foreignness**

Many entrepreneurial organisations attempting to market overseas face a potential burden of being a foreign owned company. Many consumers have an ethnocentric view of buying products from locally owned organisations thus supporting local industry, preservation of jobs and keeping profits within the country.

To overcome the liability of foreignness and to compete successfully in China against both local and foreign owned firms, organisations must find an entrepreneurial means by which to use their foreignness to their advantage. Delta Faucet achieves this by the parent company providing the China operation resources and capabilities (for example, technical expertise) necessary to compete successfully. In addition, in many developing economies such as China, products from Western nations such as the United States are seen by consumers as being superior to the locally produced equivalent and are thus sought after for their quality in performance and design.

**Markets Served**

Delta Faucet serves two primary markets in China. First, the residential market that consists of end user consumers who wish to purchase faucets for their kitchen or laundry at home. Second, the commercial market that consists of hospitality venues, schools and nurseries. Products are sold through sales channels such as agencies – however, while the same markets are served in China, no such large sales distribution agencies exist. One challenge facing Delta Faucet in China is the recruitment of national and regional sales agents in China to further broaden their sales base.

An area of sales growth in recent times for Delta Faucet has been the do-it-yourself (DIY) market segment within China. This segment is characterised by end user consumers who wish to buy product and install it themselves. With the economic boom comes a change in living. The lifestyle of consumers is getting faster, especially in the prosperous cities such as Beijing and Shanghai. Consumers also tend to value their spare time and are seeking out more ways to enjoy it, including developing hobbies. In this regard, consumers are changing their attitude towards DIY from one of work to one of enjoyment; an activity that gives them the opportunity to innovate and have fun. Major players such as Ikea have begun promoting the DIY nature of their furniture as a fun activity, in line with this attitude change.

**Competitive Environment**

Competitive aggressiveness refers to an organisation’s willingness to directly and intensely challenge its competitors to achieve entry into a market or to improve its position, that is, to outperform industry rivals in the marketplace. Delta Faucet’s main competition in the China market comes from US-based organisations as well as Japanese wholly owned subsidiaries operating in China.

**Internal Analysis**

**Resources Tangible and Intangible**

**Product Innovation**

Many of the products that Delta Faucet markets in China are manufactured locally (in Delta Faucet’s Guangzhou manufacturing plant), while some are imported from the US for sale locally. The industrial design of the faucets is conducted in China. The mechanical design is conducted in China. Delta Faucet conducts reverse-exporting whereby many of the faucets manufactured in Guangzhou are exported back to the US for sales in that market.

**Brands**

Delta Faucet markets its goods under three distinct brand names. The flagship Delta® brand delivers exceptionally well-made, stylish faucets and related kitchen and bath accessories. This market-leading product line features a unique combination of stylish looks and excellent quality, and is available in a wide variety of finishes. In addition, Delta markets under the Brizo™ brand name. Brizo™ is
the new premium faucet brand crafted by Delta Faucet Company that meets the demand for products that provide aesthetic beauty and superior performance. Brizo™ promises customers distinctively designed, inventive faucets and accessories that will live up to homeowners’ expectations of elegant style and performance. Finally, Peerless® is a Delta Faucet brand that offers value-driven, proven designs that do not sacrifice style. Each faucet is designed to give consumers confidence in their purchase.

By using multiple brands in the one market, Delta Faucet is able to target different segments of that market with a view of satisfying a broad range of consumer needs.

**CAPABILITIES IDENTIFICATION**

The strength of Delta Faucet’s China operation lies in the following areas:

- **Technical/engineering:** Delta Faucet invests resources in product innovation to ensure that the company develops, with technical expertise, state-of-the-art products that embody both modern and classical designs.

- **Quality assurance:** Delta Faucet employ strict internal quality assurance processes to ensure its products not only meet the company’s high expectations for quality, but also to ensure that products meet industry expectations of excellence.

- **Supply chain:** Delta Faucet’s integrated supply chain is located close to its manufacturing base in Guangzhou. This enables Delta Faucet to enjoy just-in-time (JIT) procurement, materials handling and manufacturing of its products for timely distribution to its consumers.

**CORE COMPETENCY ANALYSIS**

Dedicated to a total customer experience, Delta Faucet invests heavily in internal processes and systems to ensure exceptional customer satisfaction. From its integrated supply chain to its industry benchmarked quality assurance processes, Delta Faucet competes in its international markets on the basis of using its expertise in engineering to manufacture, distribute and market world class bathroom, kitchen and laundry accessory products.

**DECISION MAKING**

Early in its China operations, the decision making was decentralised, that is, most decisions regarding the China operation were made in Delta Faucet’s Guangzhou base. Gradually since then, much of the decision making has moved back to its Indianapolis headquarter base. All of the human resource decisions are still made locally, as are the decisions on the conduct of local market research. Head office in the United States has a high involvement in the decisions related to which Delta Faucet brands are sold in China.

**CURRENT STRATEGIES**

Delta Faucet uses product-based aggressive marketing strategies to increase its presence in the China market. This strategy is reliant on educating the market on the benefits of using Delta Faucet’s product range. The market emphasis is on promoting award-winning products that set industry standards in design, function and quality.

**COMPETITION**

The competition in China for bathroom accessories may be described as monopolistic competition. Nationally, there are numerous well resourced manufacturers of bathroom products. Barriers to market entry are low and many of the competitors, like Delta Faucet, are from overseas. At a retail level some of the competitors offer a comprehensive line of products (shower compartments, bath tubs, etc.) while others focus on a limited product range (for example, taps).

**ISSUE**

The main issue facing management at Delta Faucet is further expanding their brand presence in China’s booming construction market. Product innovation and increasing national distribution through reputable retailers are two drivers of the company’s expansion. This is occurring at a time when competition from overseas manufacturers is strong and buyers are becoming aware of their increasing choices for bathroom accessories.
ACKNOWLEDGEMENTS

The author would like to thank Mr Seng Lim from Delta Faucet and Mr Patrick Yu from Monash University for their kind cooperation in the preparation of this case study.

NOTES


We need a new, dynamic global partnership of business and politics. The dust of the trust crisis has settled somewhat. And many national governments have demonstrated their ability to act swiftly within their own territories. Now we should join forces in leading the way towards a wider, increasingly multilateral approach to Corporate Governance rules.¹

Ever since the announcement of the merger between Daimler-Benz AG and Chrysler Corporation in May 1998, the company had been in the spotlight. The merged company, DaimlerChrysler (DC), was a full-range provider controlling six car brands and eight truck brands. In addition, DC acquired strategic holdings in Mitsubishi Motors of Japan (37 per cent stake) and Hyundai Motors of Korea (10 per cent stake). In addition to extending its global reach, DC divested many of its non-core businesses as recommended by the financial community. Nevertheless, the dividend dropped from 2.35 in the first three years to 1.00 in 2001. By 2002 the turnarounds at Chrysler and Mitsubishi had led to profitability, and the dividend was raised by 50 per cent. However, by 2003, an ongoing price war in North America, with average rebates of US$4500 per vehicle, was proving costly and the outcome uncertain.

Over the years, DC became an international benchmark for global operations and management. As for all corporations, corporate governance was of special importance. New regulations, a lack of shareholder and public confidence in big business, and general uncertainty increased the pressure on companies to consider their governance structures. How could a company such as DC reconcile regulatory differences and the diverse expectations of various stakeholders around the globe? There was agreement that corporate governance ‘had to be lived’, but how?

BACKGROUND: UNDERSTANDING THE DAIMLERCHRYSLER MERGER

When the merger of Daimler-Benz AG and Chrysler Corporation was announced on 6 May 1998, this ‘merger in heaven’ came as a total surprise to everyone in the industry. Both companies seemed to complement each other well on geographic and product dimensions² and both had outstanding reputations. Forbes had even selected Chrysler as ‘company of the year 1996’:

You may think of Chrysler as an old-fashioned metal bender in a mature industry, cyclical as hell. You may think it’s just lucky with all those Jeeps and minivans when everyone happens to want a Jeep or minivan. Jeeps and vans go out of fad, Chrysler flops. That’s the perception – which is why Chrysler stock sells at less than seven times earnings. But perceptions notoriously lag reality, and we think the reality here is that Chrysler’s good luck is being leveraged by a superb management team that has made smart, disciplined decisions.³

Chrysler was perceived as a very efficient producer and thereby earning more cash than any other major car maker. Daimler-Benz’s luxury car division (Mercedes-Benz) was the envy of the industry. This was a ‘merger of equals’ with anticipated synergies of US$1.4 billion for a combined revenue of US$132 billion in its first year of operation. The merger of these two icons also caught the attention of the public right from the beginning. This US$36 billion merger became a symbol for what is generally described as a complex business environment for global players: total transparency, Wall Street formulating earnings growth, and immense scrutiny of all stakeholders involved.

* Research Associate George Radler prepared this case under the supervision of Professor Ulrich Steger as a basis for class discussion rather than to illustrate either effective or ineffective handling of a business situation. Copyright © 2003 by IMD – International Institute for Management Development, Lausanne, Switzerland. All rights reserved. Not to be used or reproduced without written permission directly from IMD, Lausanne, Switzerland.
With hindsight, the merger developments between 1998 and 2003 can be split into five phases. Exhibit 1 presents an overview of the five phases. While reading this case, please continue to refer to Exhibit 2 for the representation of the phases and the creation/elimination of various committees.

Revenues increased from €132 billion in 1998 to €162 billion in 2000, before falling to €150 billion for 2002 (refer to Exhibit 3 for a fact sheet on DaimlerChrysler for the five years up to 2002).
PHASE 1: MERGER
ANNOUNCEMENT 1998:
‘GET THE PARTY STARTED’

Initially, the rationale for the deal was clear. In an interview on 5 October 1998, Dieter Zetsche, board member of Daimler-Benz AG, explained:

Our problem has been that costs are high for these new technologies because of our low volume. We always lost the technology to competitors ... Like with ESP (electronic stability program), we wanted one year of exclusivity [from our suppliers]; but they gave us three months, and we had to fight for it. Chrysler will give us the volume. We can stay No. 1 in developing technology – and take it as soon as possible to Chrysler. ¹

The synergy target of US$1.4 billion (around 1 per cent of gross revenue) was generally seen as low, but there was only a limited overlap of products. Helmut Petri, executive vice president of production for Mercedes cars, explained at the time: ‘There will be no platform sharing.

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¹ Source: DaimlerChrysler.
We can share parts and components, but we won’t share platforms.” However, competitors in the industry considered platforms as the ‘holy grail’ for reaping synergies.

The first day of stock-trading for the DC share was on 17 November 1998 – it rose by around 30 per cent to the high €90s in the spring of 1999. Executives and board members were trying to turn DC into one company, not just a company name. The integration was organised around multiple clusters (issue resolution teams, or IRTs) and dealt with both automotive and non-automotive issues (refer to Exhibit 4 for an overview of the integration structure and IRT clusters). A corporate airline was set up to shuttle executives between Stuttgart (home of Daimler-Benz) and Auburn Hills, Michigan (home of Chrysler), with video or telephone conferences complementing the integration efforts.

As part of the strategy to become a truly global company, managers at DC continued to develop strategies for Asia. Asia was going to be the growth market for automobiles, but it was a missing link for DC. DC identified two possible partners and even performed due diligence for acquiring a stake in Nissan Motors. However, after a lively discussion within the management board, this idea was dropped.

As integration got off the ground, second quarter earnings (1999) failed to meet Wall Street expectations and the stock started to fall. In addition, the share was refused from the American S&P 500 index, a move that took the stock off the shopping list of many funds. By July, the company had to reduce its earnings growth expectations and suddenly synergies became very important. Automotive News, an industry journal,
stated: ‘Meanwhile, Wall Street, underwhelmed by the company’s performance to date, is expecting much more from DaimlerChrysler.’

**PHASE 2: SEPTEMBER 1999: ‘INTEGRATION IS OVER!’**

Jürgen Schrempp, on 27 September 1999, announced the completion of the integration of both companies. The formal integration achieved through the work of multiple IRTs was concluded and the Chairmen’s Integration Council was abandoned (after two of its eight members left the company). One of them, Tom Stallkamp, the president of North American Chrysler operations and the executive in charge of integrating the company, was replaced by James Holden. Holden was previously executive vice president of sales and marketing.

Following its earlier decision to focus its business lines, DC decided to concentrate on the automotive and trucking business. Non-core activities (Adtranz trains, Debitel telecommunications, European Aeronautic Defense and Space Company [EADS, maker of Airbus]) were either sold, prepared for sell-off, or merged with other companies. Selling some of the non-core businesses added financial flexibility for possible acquisitions.

But the geographic expansion continued. Schrempp and his team were convinced that they needed a local partner in Asia in order to participate in the forecasted growth there. In the summer of 2000, DC ultimately bought:

- a 34 per cent equity stake in Mitsubishi Motors of Japan, and later raised it to 37 per cent
- a 10 per cent equity stake in Hyundai Motors of South Korea.

With this set-up, DC did not need to consolidate these minority stakes, which was an issue given Mitsubishi Motors’ debt.

**PHASE 3: UP TO NOVEMBER 2000: ‘SILENT PHASE—DELIVER THE NUMBERS’**

The year 2000 was actually a good one for the car industry. Mercedes-Benz cars benefited from its product line extension and maintained strong financial results. The American market was performing very well and a new record was expected for the whole year. However, Chrysler was no longer able to grow with the market. A flood of new competitive models was expected in the minivan segment, of which Chrysler had up to a 55 per cent share (in the United States). As a result, Chrysler loaded its new minivan with expensive options and prices rose accordingly. However, sales of the new minivan were below expectations and the vehicles needed sales incentives/price reductions early on. For Chrysler’s other pillar of profitability, SUVs, a wide range of competitive products was suddenly taking market share from the firm and its products.

The results soon became visible: Chrysler’s US market share fell from over 16.2 per cent in 1998 to 13.5 per cent in 2000 and no miracle cure was to be expected from international demand. In order to move the vehicles, cash rebates/incentives of up to US$3000 had to be offered to consumers. At the same time, production costs spiralled out of control, as production capacity could not be reduced fast enough (refer to Exhibit 5 for a comparison of manufacturing hours by make). In late 2000, *Fortune* reported:

> After its merger with Daimler-Benz, Chrysler was in the midst of one of its once-a-decade swoons. Having ridden the crest of the 1990s boom with popular minivans and sport-utility vehicles, the company’s American managers had allowed costs to careen out of control and big gaps to open in Chrysler’s new-product program. Despite record U.S. auto sales, the company reported an operating loss.

Within DC, divisions had to meet prearranged profit and sales targets (‘deliver the numbers’). This approach made it relatively easy to compare different divisions and several executives hoped it ‘would bring back the Chrysler spirit’. Holden argued that Chrysler could not make money because of the huge incentives that were bringing down transaction prices. When the Chrysler Group missed a set of prearranged goals (and profit levels), a supervisory board meeting was held on 17 November 2000, and a decision was made to dismiss Holden – after only one year. DC brought in Dieter Zetsche, who had been running the commercial vehicles division, and he started three days later. However, in the autumn of 2000, the share price fell below €50.
PHASE 4: NOVEMBER 2000: ‘STARTING TURNAROUNDS’

The situation facing Zetsche when he arrived was complicated. According to Ward’s Autoworld, ‘to say that Zetsche inherited a mess is an understatement’. He arrived in Detroit with only his chief operating officer (COO), Wolfgang Bernhard, to a welcome that was anything but friendly. During a press conference, Zetsche was asked how many more Germans they should expect in Detroit. He replied: ‘Four. My wife and three kids.’

Excluding one-time write-offs, Chrysler Group lost US$1.8 billion in the last two quarters of 2000. Within DC, the Mercedes Car Group was producing strong cash flows and in Stuttgart, the public opinion was that Mercedes was financing the rest of the group. After three months, Zetsche presented his turnaround plan.

The Economist reported on 3 February 2001:

Chrysler’s German overlords this week mounted a dramatic assault on the growing losses at Daimler-Chrysler’s ailing American subsidiary. At least 26,000 jobs will go [equivalent to 20 per cent of the total workforce] in a reorganization that will close six plants and trim production at seven more . . . Analysts . . . noted the absence of any American assembly plants on the list. The plant in Belvidere, Illinois, which produces the slow-selling Neon, seemed a sure bet to be shuttered, but Chrysler inadvertently outsmarted itself two years ago, when it agreed to restrictions on plant shutdowns as part of its contract with the United Auto Workers union.

The turnaround plan called for lowering the breakeven point from 113 per cent of plant capacity in 2001 to 83 per cent in 2003.7 Zetsche’s first quarter (Q1, 2001) finished with an operating loss of US$1 billion, and the full year saw a loss of US$5 billion (including one-time effects) at Chrysler.

The equity stakes in Asia (Hyundai and Mitsubishi) developed differently. While Hyundai was becoming highly profitable due to very successful cars and trucks, Mitsubishi required more management attention. Rolf Eckrodt, formerly chief executive officer (CEO) of ADTRANZ trains (a DC subsidiary that was sold off in 2001), became COO of Mitsubishi Motors in January 2001 and in summer 2002, he left DC and took over as CEO of Mitsubishi Motors.

Mitsubishi Motors had too many models and no real successes. The company was plagued by a set of issues. Manager Magazin, a German publication, commented:
CASE THREE: DAIMLERCHRYSLER: CORPORATE GOVERNANCE DYNAMICS IN A GLOBAL COMPANY

‘No controlling, inefficient structures and processes, which killed the company due to excessive harmony. After two failed turnaround attempts, the company was unable to reform itself.’

The turnaround plan at Mitsubishi was drastic. Within three years, the production capacity was going to be cut by 28 per cent and material cost by 15 per cent. The turnaround was also a test for the DC merger, as it dispatched a group of 35 executives from both companies to Japan. The financial year 2000 ended with a loss of US$750 million at Mitsubishi.

Neither of the equity stakes in Asia were limited to cars. In 2002, both Mitsubishi and Hyundai spun off their truck and bus divisions. Soon afterwards, DC announced the acquisition of a 43 per cent share in Mitsubishi Fuso Truck and Bus Corporation for €760 million. In Korea, the Daimler Hyundai Truck Corporation was expected to be founded in 2003 with both companies holding equal shares.

DC’s truck division, with revenues of €28 billion in 2002, also saw considerable changes. In 2000, DC acquired Detroit Diesel, a highly regarded supplier of heavy-duty engines, and Western Star Trucks of Canada for US$877 million. But around the same time, Freightliner, DC’s trucking division in North America, was facing problems. The American market for new trucks decreased by 50 per cent. This slump hit Freightliner, the market leader for heavy trucks, especially hard. The demand for new trucks collapsed, and at the same time, leasing models were returned. ‘Easy credit’ and market values dropping below the book values led to a huge loss on each leasing truck returned. In the case of Freightliner, Jim Hebe, the CEO overseeing the leasing transactions, was replaced by Rainer Schmückle. Schmückle knew the company quite well from a previous assignment as Freightliner’s CFO.

PHASE 5: ‘MAINTAINING SUSTAINABLE SUCCESS’

By 2002, both Mitsubishi and Chrysler were profitable again. Chrysler recorded an operating profit and Mitsubishi Motors recorded an after-tax profit of US$290 million for 2002 – the highest ever in the history of Mitsubishi Motors! Although budgets were cut in many cases, the number of products increased. In the case of Chrysler, capital spending was reduced by about 30 per cent – while eight new models were added. Chrysler even developed a new model with the help of the Mercedes Car Group, the Chrysler Crossfire. Executives had high hopes for the new vehicles, as sales of Chrysler had fallen from 3.2 million units in 1999 to 2.8 million in 2002. Nevertheless, Chrysler set a growth target of one million additional units by 2011. Exhibit 6 summarises the results for 1998 and 2002.

However, 2003 remained a challenging year. The Financial Times reported on 5 June 2003:

Chrysler’s incentives for buyers have reached $4,500 per vehicle, almost doubling in a year . . . The company said Chrysler’s second-quarter operating loss would be about $1 billion – against analyst forecasts of a $500 million profit. Most of the difference was accounted for by an estimated [US]$400m–[US]$500m writedown in the value of 500,000 cars in dealers’ lots and by a cut in the second-hand value of cars held by rental companies.

By Q3, 2003, Chrysler was able to rebound to earn a profit, but the focus on controlling costs continued. The share price remained at around $30.

In order to reap the synergies, Chrysler and Mitsubishi also evaluated the development of a joint platform with an annual volume of one million cars. This was expected to enter the market by 2005. For the same year an annual capacity of 1.5 million units was expected.

EXHIBIT 6 Financial summary in € billion (at year-end)

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales</th>
<th>Operating profit</th>
<th>Sales</th>
<th>Operating profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td></td>
<td></td>
<td>2002</td>
<td></td>
</tr>
<tr>
<td>Mercedes Car Group</td>
<td>32.6</td>
<td>1.9</td>
<td>50.2</td>
<td>3.0</td>
</tr>
<tr>
<td>Chrysler Group</td>
<td>56.4</td>
<td>4.2</td>
<td>60.2</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Source: 2003, Der Spiegel, 8 September: 117.
CASE THREE: DAIMLERCHRYSLER: CORPORATE GOVERNANCE DYNAMICS IN A GLOBAL COMPANY

from a ‘global four cylinder engine’. Of this, 600 000 units would be made in a new factory that would be jointly owned by Chrysler, Mitsubishi and Hyundai. The engine would also be built in a Hyundai factory in Korea and in a Mitsubishi factory in Japan.

In summary, DC had considerably streamlined its portfolio. Exhibit 7 outlines major acquisitions and divestitures since 2000.

### CORPORATE GOVERNANCE AT GLOBAL CORPORATIONS POST-ENRON

Manfred Gentz, DC’s chief financial officer, commented as early as 1999 on the challenges of effective corporate governance:

The merger of the former Chrysler Corporation and the Daimler-Benz Aktiengesellschaft presented us with a number of integration challenges, including how to combine two different legal systems in such a way as to meet the differing expectations of each company’s shareholders and management. With DaimlerChrysler AG’s corporate governance, which was already finalized in the Business Combination Agreement of May 6 1998, we tried to find a solution that combines German and U.S. forms of corporate management.

While the merger was taking place and requiring considerable management attention, the external environment for corporate governance changed dramatically. Although DC was legally headquartered in Germany, it was traded on the New York Stock Exchange (NYSE) and hence had to adhere to many rules and regulations: Sarbanes–Oxley Act, SEC regulations, and the German Corporate Governance Code. On top of that, DC had to comply with German co-determination rules and other peculiarities in the different countries where DC operated. The effort and bureaucracy involved were considerable:

- **The Sarbanes–Oxley Act (SOA)** aimed to improve investor confidence and the accuracy of financial statements. It stated that CEOs and CFOs should certify the ‘appropriateness of the financial statements’ and that a firm’s audit committee should be totally independent.
- **US Securities and Exchange Commission (SEC)** stipulated more detailed requirements for audit committees – for example, committee members had to prove their familiarity with US–GAAP accounting rules. The chief regulators also wanted a better power balance among managers, board members, and shareholders.
- **The German Corporate Governance Code (Cromme Code)** provided an overview of various existing laws and regulations in order to create transparency for foreign investors (as opposed to creating new laws). This resulted in about 50 recommendations (for example, deductibility of liability insurance for

#### EXHIBIT 7 Major acquisitions and divestitures (year, company, value)

<table>
<thead>
<tr>
<th>Acquisitions</th>
<th>Divestitures</th>
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<tbody>
<tr>
<td>2000</td>
<td>2000 and 2002</td>
</tr>
<tr>
<td>Mitsubishi Motors</td>
<td>Debis Systemhaus</td>
</tr>
<tr>
<td>(34%, later 37%)</td>
<td>(IT Services)</td>
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<tr>
<td>€2 billion</td>
<td>€5.5 billion</td>
</tr>
<tr>
<td>2000</td>
<td>2001</td>
</tr>
<tr>
<td>Hyundai (10%)</td>
<td>-Debitel (mobile</td>
</tr>
<tr>
<td></td>
<td>phone operator)</td>
</tr>
<tr>
<td>US$428 million</td>
<td>€300 million</td>
</tr>
<tr>
<td>2000</td>
<td>2001</td>
</tr>
<tr>
<td>Detroit Diesel</td>
<td>ADTRANZ trains</td>
</tr>
<tr>
<td>and Western Star</td>
<td>US$725 million</td>
</tr>
<tr>
<td>US$877 million</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td></td>
</tr>
<tr>
<td>Mitsubishi Trucks</td>
<td></td>
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<tr>
<td>€760 million</td>
<td></td>
</tr>
</tbody>
</table>

Note: DC owns 33% of EADS. This stake was estimated at around €5 billion at the time of the IPO in 2000.
directors and officers; the need to disclose financial reports within 90 days). By law, publicly traded companies had to state whether they complied with each recommendation (refer to Exhibit 8 for the main headings of the code). If not, management was requested to publish reasons for not doing so. In addition, there were several suggestions covering items such as individual salaries of management board members.

Generally, the code was seen as an opportunity to evaluate control and management structures. Moreover, according to the code, members of the management board could be on a maximum of five different supervisory boards of listed companies if they held executive functions in other listed companies. The code also suggested more personal liability (including personal assets), and a maximum of two members could immediately transfer from the management board to the supervisory board. The code also strongly encouraged the creation of different committees. The chairman of the commission, Gerhard Cromme, explained: ‘[After all], an efficient and confidential discussion is not possible at regular supervisory board meetings.’

EXHIBIT 8 German Code for Corporate Governance

<table>
<thead>
<tr>
<th>Chapter 1: Foreword</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 2: Shareholders and the General Meeting</td>
</tr>
<tr>
<td>2.1 Shareholders</td>
</tr>
<tr>
<td>2.2 General Meeting</td>
</tr>
<tr>
<td>2.3 Invitation to the General Meeting, Proxies</td>
</tr>
<tr>
<td>Chapter 3: Cooperation between Management Board and Supervisory Board</td>
</tr>
<tr>
<td>Chapter 4: Management Board</td>
</tr>
<tr>
<td>4.1 Tasks and Responsibilities</td>
</tr>
<tr>
<td>4.2 Composition and Compensation</td>
</tr>
<tr>
<td>4.3 Conflicts of Interest</td>
</tr>
<tr>
<td>Chapter 5: Supervisory Board</td>
</tr>
<tr>
<td>5.1 Tasks and Responsibilities</td>
</tr>
<tr>
<td>5.2 Tasks and Authorities of the Chairman of the Supervisory Board</td>
</tr>
<tr>
<td>5.3 Formation of Committees</td>
</tr>
<tr>
<td>5.4 Composition and Compensation</td>
</tr>
<tr>
<td>5.5 Conflicts of Interest</td>
</tr>
<tr>
<td>5.6 Examination of Efficiency</td>
</tr>
<tr>
<td>Chapter 6: Transparency</td>
</tr>
<tr>
<td>Chapter 7: Reporting and Audit of the Annual Financial Statements</td>
</tr>
<tr>
<td>7.1 Reporting</td>
</tr>
<tr>
<td>7.2 Audit of Annual Financial Statements</td>
</tr>
</tbody>
</table>

As an American board member put it, ‘A German supervisory board meeting is like an opera’. Increasingly, the salaries of German supervisory board members were heavily debated among the general public. The lowest paid head of a supervisory board (Lufthansa Airlines) earned €21 000\(^{11}\) – the highest paid (Schering Pharmaceuticals) received

Intricacies of the German Corporate Governance System

The German system had some special features:

- The size of board meetings in this two-tier system was considerable. With 20 members of the supervisory board, plus the board of management, plus staff, there could easily be up to 40 people at the table.
Karl-Hermann Baumann, former CFO of Siemens and now on the supervisory boards of six big German companies (Siemens, Deutsche Bank, Eon, Linde, Schering and Thyssen-Krupp), earned a total salary of €589,000. In comparison, a board member at Nestlé earned on average €371,000 in 2002 (for one seat). At DC, the 2003 annual assembly voted for an increase from €51,000 to €75,000 for regular members of the supervisory board and from €102,000 to €225,000 for the chairman.

German corporate law was written with the aim of protecting creditors and thereby allowed companies to accumulate hidden reserves, using book values rather than market values in accounting, etc. This was in sharp contrast to the American system, where corporate laws were aimed at creating transparency for shareholders, allowing them to control management, and thereby limiting principal–agent conflicts.

**CORPORATE GOVERNANCE AT DAIMLERCHRYSLER**

At DC, trying to adhere to the different codes caused regulatory conflicts. While Sarbanes–Oxley increased the personal responsibilities of CEOs and CFOs, in Germany the members of the management board had collective responsibility (refer to Exhibit 9 for more conflicts). As part of this collective responsibility, the board met as a ‘legal entity’ rather than as a set of individuals. At the same time, Sarbanes–Oxley also led to considerable organisational adjustments, in order to comply with the comprehensive requirements. Schrempp explained:

> In this context, several international initiatives designed to improve corporate governance and restore public confidence in the corporate sector have been undertaken . . . I can tell you:

1. There can be no barriers to information.

2. The whole company has to be as committed to DaimlerChrysler’s balance sheet as Manfred Gentz [CFO] and I are. It is obvious that with their signature on those documents, the chairman and the CFO are accepting certain obligations for the company. Therefore, it is also clear that every senior executive must feel this obligation as well.

3. This means that we will install a cascade signing system. Starting with every General Manager and CFO of every business entity within DC and going to the top via every principal.

Due to the changes in the corporate governance landscape, considerable challenges lay ahead. As Dr Manfred Schneider, member of the supervisory board

**EXHIBIT 9 Managing conflicts**

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO/CFO Certification</td>
<td>Collective responsibility of the board of management</td>
<td>Personal responsibility of CEO and CFO</td>
</tr>
<tr>
<td>(Sarbanes-Oxley Act)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disclosure of Deviation to</td>
<td>Disclosure of deviation from German Code</td>
<td>Disclosure of significant differences to CG practices*</td>
</tr>
<tr>
<td>Regulation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(German Code, NYSE)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Audit Committee Appointment</td>
<td>Annual general meeting of shareholders</td>
<td>Audit committee</td>
</tr>
<tr>
<td>of Auditors (Sarbanes-Oxley Act, NYSE)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public Company Accounting</td>
<td>Secrecy agreement between company and auditor</td>
<td>Right to request confidential records from auditor</td>
</tr>
<tr>
<td>Oversight Board Inspections</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D&amp;O Insurance Policy</td>
<td>Introduce suitable deductible/excess</td>
<td>Deductible/excess not common</td>
</tr>
</tbody>
</table>

*Not yet in effect. 
Source: DaimlerChrysler.
at DC, explained: ‘We have to anticipate that in the future less people will be willing to become members of the supervisory board or even head of the supervisory board.’

For a global company such as DaimlerChrysler, corporate governance was centre stage. But corporate governance went far beyond the newly introduced six-page special in the 2002 annual report. This special feature covered the functioning of the annual meeting, a short explanation of the two-tier system and some of the legally non-binding arrangements: Executive Automotive Council (EAC), Chairman’s Council, and the International Advisory Board (IAB). The implications of the new corporate governance system were far-reaching, as can be seen by the developments on both boards and within various committees.

**THE MANAGEMENT BOARD: RUNNING DAIMLERCHRYSLER**

**DEVELOPMENTS**

Strong leaders, such as Lee Iacocca, often dominated the board of the former Chrysler Corp. Their ability was to get designers to ‘think outside the box’ while getting their managers to meet budgets and cost targets. In 1999, key executives of the former Chrysler Corp. left the DC management board, including Stallkamp (President), Gale (Design), and Cunningham (Strategy); co-chairman Bob Eaton followed in March 2000. On the former Daimler-Benz side, two members had left the board: Lauk (Trucks) and Tropitzsch (HR). After Holden’s dismissal in November 2000, two former Chrysler executives remained on the board (both in purchasing functions).

Between 1998 and 2003, the board’s size was reduced from 17 members to 11, and by 2003 only two members retained their original positions (Hubbert, Mercedes Car Group, and Gentz, CFO). In the process, the structure of the board was also changed. The organisational chart showed clear separations between operating and functional divisions (refer to Exhibit 10 for the evolution of the organisational chart). Several former board members remained as advisers to the company (Mangold, Bischoff, Valade). Interestingly, new board members appointed were only ‘deputy board members’, with a three-year contract rather than the usual five-year contract for regular board members (the norm in Germany). Company policy generally required board members over the age of 60 to have their contracts renewed on an annual basis.

**WORKING STYLE**

Initially the meetings were held in Stuttgart and Auburn Hills, but most American meetings were soon moved to New York (for travel reasons). English was the management language. Annually, there were between 22 (in 2003) and 35 (in 2000) meetings (refer to Exhibit 11 for the frequency and location of meetings).

**CREATION OF NEW COMMITTEES**

In the first year of the merger, the chairmen’s integration council (CIC) was a central point of the integration. However, the overlap between the CIC and the board of management could not be avoided (refer to Exhibit 4) and all members of the management board were also allowed to join the meetings of the CIC. On the CIC, votes had to be unanimous, while on the management board they could be majority-based. The CIC ceased to exist in September 1999, as the integration was officially completed. Instead, two councils (Automotive, and Sales and Marketing) were set up to coordinate possible component sharing, etc. However, both councils were abandoned.

The potential for sharing components and parts increased fundamentally with the addition of partners in Asia. In order to reap ‘potentially huge synergies’ (Wall Street Journal Europe) from economies of scale and to improve the decision-making procedure, the executive automotive committee (EAC) was set up. This committee, co-chaired by Schrempp and Hubbert, normally met before each board meeting and prepared recommendations regarding the product portfolio, technology, production capacity, purchasing and supply, and sales and marketing. The EAC’s recommendations were then taken to the board (refer to Exhibit 12 for an overview of the EAC). Besides Hubbert and Schrempp, EAC members included Zetsche (Chrysler), Cordes (Trucks), Bischoff (Head of the Alliance Committee with Mitsubishi) and Grube (corporate development). All of them were board members, too.

Grube’s staff members prepared the materials for the EAC. Early in the process, the team considered corporate governance implications. Grube explained: ‘Strategic initiatives, e.g., our new efforts in China, are discussed on every aspect of our corporate governance

**1998**
17 members

- Jürgen E. Schrempp
  - Chairman
- Robert Eaton
  - Chairman
- Former Chrysler Executives
- Gary Valade
  - Global Purchasing
- Former Daimler-Benz Executives
- Thomas T. Stalakamp
  - President, Chrysler
- Tom Gale
  - Design, HR, Chrysler
- Thomas Sidlik
  - Purchasing, Chrysler
- T. Cunningham
  - Strategy, Chrysler
- James Holden
  - Sales, Chrysler
- Jürgen Hubbert
  - MB Passenger Cars
- Klaus Mangold
  - DC Services
- Manfred Gentz
  - HR, Daimler
- H. Tropitzsch
  - Finance
- Former Chrysler Executives
- K. D. Vöhringer
  - R&D
- Former Daimler-Benz Executives
- Dieter Zetsche
  - Sales, Mercedes
- Eckhard Cordes
  - Strategy, CIO
- Strategy, Chrysler
- Kurt Lauck
  - Mercedes Trucks
- Dasa Aerospace
- Manfred Bischoff
- Manfred Gentz
  - Finance
- K. D. Vöhringer
  - R&D
- Manfred Bischoff
  - Dasa Aerospace

**2003**
11 members (as of December)

- Jürgen E. Schrempp
  - Chairman
- Former Chrysler Executives
- Thomas Webber
  - R&D
- Former Daimler-Benz Executives
- Günther Fleig
  - HR & Labor
- Finance & Control
- Manfred Gentz
  - Finance & Control
- Corp. Development
- Rüdiger Grube
  - Rüdiger Grube
- Operating Divisions
- Bodo Ueber
  - DC Services
- Functional Divisions
- Dieter Zetsche
  - Chrysler
- Thomas Webber
  - R&D
- Thomas Webber
  - Chrysler
- Günther Fleig
  - HR & Labor
- Rüdiger Grube
  - Corp. Development
- New Members of the Board
  - (joined after 1998)
- Eckhard Cordes
  - Trucks
- Thomas Sidlik
  - Global Purchasing
- Jürgen Hubbert
  - MB Passenger Cars
- Wolfgang Bernhard
  - COO, Chrysler
- Jürgen Hubbert
  - MB Passenger Cars
- Günter Fleig
  - HR & Labor
- Rüdiger Grube
  - Corp. Development
- New Members of the Board
  - (joined after 1998)

EXHIBIT 11 Frequency and Location of Management Board Meetings

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>11</td>
<td>13</td>
<td>17</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>USA</td>
<td>17</td>
<td>18</td>
<td>9</td>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
<td>4</td>
<td>1</td>
<td>1</td>
<td>–</td>
</tr>
<tr>
<td>Total</td>
<td>29</td>
<td>35</td>
<td>27</td>
<td>24</td>
<td>22</td>
</tr>
</tbody>
</table>

*Planned
Note: Some of these board meetings lasted for two days. In this case, they were counted twice. This list also includes meetings of the strategic and planning process.

Source: Company information.
system. Strategy depends on feedback and consensus in our governance structure.

For cultural and legal reasons, a similar EAC structure was set up for the minority stakes in Asia. The Alliance Committee functioned in a similar way to the EAC. In 2002, a similar structure to the EAC was also created for trucks (Truck Product and Decision Committee).

## SUPERVISORY BOARD: KEEPING UP IN A CHANGING INDUSTRY

In the German two-tier system, the main function of the supervisory board was to supervise, advise on, and monitor business developments. At the same time, this board was also responsible for hiring board members (for which a two-thirds majority was required). The spoken language was German, but all documents were prepared in both German and English, with simultaneous translation at the meetings. The meetings remained driven by the issues. Lynton Wilson, former board member of Chrysler and current board member of DC, explained the style of these meetings:

Schrempp is a very American-style leader. He is open and [knows] he has to make sure to have relationships and support in the company. So the discussions are matter of fact, issue-related and [end with a decision] on what to do.

The DC supervisory board was led by Hilmar Kopper, former CEO and chairman of Deutsche Bank, who also sat on the boards of Akzo Nobel, Xerox, Solvay and Unilever. The media reported on the close working relationship between Kopper and Schrempp.

The supervisory board had seen few membership changes on the capital side over the years (refer to Exhibit 13 for the evolution of the supervisory board). The supervisory board met six times in 2003, both in the United States and in Germany.

## CORPORATE GOVERNANCE IN ACTION

DC, like any other global company, had to deal with increasing complexity. However, its corporate governance system had to combine both the American and German governance systems. Wilson explained: ‘We are talking here about two very different systems. In North America,

Former Members of Daimler-Benz AG:
Mr. Hilmar Kopper (Deutsche Bank AG)
Mr. Manfred Schneider (Bayer AG)
Mr. Berhard Walter (Dresdner Bank AG)
Mr. Mark Wössner (Bertelsmann AG)

Departures:
Sir John P. Browne (British Petroleum)

Former Members of Chrysler Corp.:
Mr. Robert J. Lanigan (formerly Owens)
Mr. Peter A. Magowan (SF Giants)
Mr. G. Richard Thoman (Xerox)
Mr. Lynton R. Wilson (BCE)

Departures:
Mr. Robert E. Allen (AT&T)

10 Labour Representatives:
Mr. Erich Klemm (works council)
Mr. Helmut Lense (works council)

Departures:
Mr. Willi Böhm (works council)
Mr. Karl Feuerstein (works council)
Mr. Manfred Göbels (works council)
Mr. Rudolf Kuda (German union)
Mr. Herbert Schiller (works council)
Mr. Peter Schönfelder (works council)
Mr. Bernhard Wurl (German union)
Mr. Steven A. Yokich (Am. UAW)

Replacements after 1998

Prof. Victor Halberstadt, Professor of Economics, University of Leiden, NL
Earl G. Graves, Chairman and CEO, Graves Ltd, New York, USA

Mr. Nate Gooden (UAW)
Mr. Heinrich Fiegel (Manager)
Mr. Thomas Klebe
Mr. Jürgen Langer (works council)
Mr. Gert Rheude (works council)
Mr. Udo Richter (works council)
Mr. Wolf Jürgen Röder (German union)
Mr. Stefan Schwaab (works council)

SHAREHOLDER COMMITTEE AND LABOUR COMMITTEE

The shareholder committee was a big change for the German establishment. CFO Gentz explained:

A shareholder committee modelled on the US-style board of directors was set up alongside the supervisory board. The committee included the two chairmen, all 10 shareholder representatives as well as four prominent outsiders. [This committee] has no decision-making powers, which rest solely with the supervisory board, but instead restricts itself to debate and counselling and provides fact-based recommendations to support opinion-forming among the shareholder representatives.

The committee met six times a year and had two sub-committees. The audit sub-committee dealt with the examination of financial accounts and dividend policy, while the nomination and compensation sub-committee dealt with remuneration of board members and senior executives. The aim was to ensure competitive packages

non-executive directors are much more involved and have certain responsibilities. In the German system, you have co-determination. Nevertheless, both systems work.

Three committees were established, each consisting of two shareholder and two employee representatives:

Presidential committee: Employment terms and remuneration for board members. It also conducted ‘preliminary discussions on key decisions to be taken by the supervisory board’.

Audit committee: Examination of annual and semi-annual statements of accounts. This committee also ensured the independence of the auditors. Sarbanes–Oxley greatly increased the importance of this committee’s work.

Mediation committee: In case of disagreement between supervisory board members with regard to the nomination of the new board (this was required by law).

Over the years, however, DC developed several legally non-binding committees, as follows:

SHAREHOLDER COMMITTEE AND LABOUR COMMITTEE

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CASE THREE: DAIMLERCHRYSLER: CORPORATE GOVERNANCE DYNAMICS IN A GLOBAL COMPANY

on a global scale, for which outside advisers were hired. However, the issues discussed in the shareholder committee were too similar to those discussed in the supervisory board – it was seen as a duplication, and the committee ceased to exist in January 2001.

Members of the workforce formed the labour committee to accommodate the needs of US and Canadian labour unions, which had only one seat on DC’s supervisory board. In addition, employees formed various international committees that were independent of the supervisory board; they met around five times in 2003.

ADDITIONAL COMMITTEES

CHAIRMAN’S COUNCIL

A new council was started in the autumn of 2001. The Financial Times reported in September 2001:

DaimlerChrysler, the international automotive group, is to become the first German-based company to embrace Anglo-Saxon corporate governance rules by forming an independent chairman’s council of non-executive directors . . . Officials describe the project as a ‘unique hybrid’ between Anglo-Saxon corporate governance and the co-determination preferred by most German companies.13

The Chairman’s Council consisted of six selected members of the capital side of the supervisory board and selected external members, including CEOs from blue chip companies. In a press statement, DC formalised the council:

The council will provide advice to management on global business strategy issues. Elements of American and European corporate governance structures are combined to meet the specific requirements of a truly global company and the interests of the different stakeholders. The legal rights and responsibilities of the supervisory board will remain untouched. The Chairman’s Council is complementary to the current governance structure.

INTERNATIONAL ADVISORY BOARD (IAB)

The IAB replaced the Daimler-Benz international advisory board, which was started in 1995. It usually met once a year. The IAB’s activities were outlined in the annual report:

The IAB of DaimlerChrysler advises the DaimlerChrysler Group on questions relating to global economic, technological, and political developments and their effect on the business activities of the group. It supports the DaimlerChrysler Board of Management but is not responsible for making business decisions. The meetings are private to encourage frank and open discussion.

(Refer to Exhibit 14 for members of the Chairman’s Council and IAB.) Exhibit 15 summarises the various levels of supervision and management in DC.

OUTSIDE VIEW: FINANCIAL MARKETS

From the beginning, there was a strong focus on pleasing the financial markets. DC tried to create awareness about the stock price and installed TV screens showing stock prices around headquarters. DC had done a lot to cater to the needs of institutional investors. Even before the merger, both companies had used US–GAAP accounting rules; afterwards DC added detailed reporting according to business segments, value-based stock options plans, and employee profit sharing based on operating profits. Nevertheless, the base of American shareholders was rapidly decreasing. By 31 December 2002, American shareholders accounted for only 14 per cent of total DC shareholders (down from 44 per cent in 1998). Most shareholders were based in Germany (57 per cent), with 21 per cent in the rest of Europe and 8 per cent in the rest of the world, other than the United States. The reduction in the number of American shareholders could have been the result of DC’s removal from the S&P 500 Index or, as an industry expert explained, ‘Americans don’t trust the two-tier boards’. The stock price development was unsatisfactory, but it was in line with that of major competitors (refer to Exhibit 16 for the share price development of DC and some competitors). Deutsche Bank remained the largest shareholder, owning 12 per cent, followed by the Emirate of Kuwait, with 7 per cent. Institutional investors held 54 per cent, private investors 27 per cent.

UNDERSTANDING RISKS

The globalisation of DC created many opportunities. However, for corporate governance purposes, it was also essential to understand the business risk. Besides risks
EXHIBIT 14 Members of the chairman’s council and international advisory board

<table>
<thead>
<tr>
<th>Chairman’s Council</th>
<th>International Advisory Board (IAB)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jürgen E. Schrempp</td>
<td>Chairman</td>
</tr>
<tr>
<td><strong>Internal Members</strong></td>
<td></td>
</tr>
<tr>
<td>Victor Halberstadt</td>
<td>Prof. of Economics, Leiden University Chairman of the Supervisory Board DCX</td>
</tr>
<tr>
<td>Hilmar Kopper</td>
<td>DC Board of Management</td>
</tr>
<tr>
<td><em>Internal Members</em></td>
<td><strong>External Members</strong></td>
</tr>
<tr>
<td>Robert J. Lanigan</td>
<td>Chairman Emeritus of Owens-Illinois Chairman of the Supervisory Board of Bayer AG</td>
</tr>
<tr>
<td>Dr. Manfred Schneider</td>
<td></td>
</tr>
<tr>
<td>Lynton R. Wilson</td>
<td>Chairman of the Board of Nortel Networks</td>
</tr>
<tr>
<td>Dr. Mark Wössner</td>
<td>Former CEO and Chairman of Bertelsmann</td>
</tr>
<tr>
<td><strong>External Members</strong></td>
<td></td>
</tr>
<tr>
<td>The Lord Browne</td>
<td>Group CEO of BP Amoco</td>
</tr>
<tr>
<td>Louis V. Gerstner Jr</td>
<td>Former Chairman and CEO of IBM</td>
</tr>
<tr>
<td>Minoru Makihara</td>
<td>Chairman of Mitsubishi Corp.</td>
</tr>
<tr>
<td>Dr. Daniel Vasella</td>
<td>Chairman &amp; CEO of Novartis AG</td>
</tr>
<tr>
<td>Lorenzo H. Zambrano</td>
<td>Chairman and CEO of Cemex</td>
</tr>
</tbody>
</table>

Source: Company information.

EXHIBIT 15 Levels of supervision and management (scheduled number of meetings in 2003)

<table>
<thead>
<tr>
<th>Controlling the Management...</th>
<th>Managing the Company...</th>
<th>Advising the Management...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supervisory Board</td>
<td>Board of Management</td>
<td>Chairman’s Council</td>
</tr>
<tr>
<td>6 meetings p.a.</td>
<td>22 meetings p.a.</td>
<td>5 meetings p.a.</td>
</tr>
<tr>
<td>International Employee</td>
<td>Executive Automotive</td>
<td>International Advisory</td>
</tr>
<tr>
<td>Committees</td>
<td>Committee</td>
<td>Board</td>
</tr>
<tr>
<td>5 meetings p.a.</td>
<td>10 meetings p.a.</td>
<td>1 meeting p.a.</td>
</tr>
</tbody>
</table>

...according to German Law & Co-Determination Principles

...combining German legal requirements and global business needs

...combining elements of US and European Corporate Governance
originating from off-balance sheet activities or bad debt, DC and other car companies faced considerable industry-specific risks: Being a global player and consolidating in euros, any drastic exchange rate fluctuations could severely impact the financial results. At the same time, large parts of the operating income resulted from financial services (for example, car leasing), a business dependent on many ‘outside’ forces. DC also faced considerable technology risks (for example, fuel cells, fuel efficiency, lightweight materials). Missing one trend could mean suffering for half a decade. The increasing number of brands brought with it the risk of wrong brand positioning. Also, because the factory assets were so specific to the industry, the exit risk was considerable. And since the merger, the company was also increasingly subject to North American risks such as product liability issues or court cases from disgruntled shareholders.

In 2003, Schrempp commented on the merger and corporate governance:

“When Daimler-Benz and Chrysler merged, there was no textbook written on how to do it. I admit, we were not as efficient from day one as we could have. But now the international cooperation and the implementation of the strategy work very well.”

And they broke new ground in corporate governance, too.
NOTES

1 Jürgen Schrempp, CEO, DaimlerChrysler AG, 2003.
2 See Rädler, Neubauer & Steger, ‘The DaimlerChrysler Merger: The Involvement of the Boards’, Case no. IMD-3-0771, for detailed corporate governance issues during the merger negotiations in 1998. The present case only covers the developments after the deal had taken place.
7 A. Taylor, 2001, ‘Can the Germans rescue Chrysler?’, Fortune, 30 April: 47.
11 Salary levels are for 2001 or 2002.
12 2003, ‘Neue Aufsichtsräte sind nur noch schwer zu finden’, Handelsblatt, 1 April.
14 2003, ‘Ein hartes Stück Arbeit,’ Interview with Jürgen Schrempp, Der Spiegel, 8 September: 120.
INTRODUCTION

Gunns Limited is a listed Australian forestry company that operates in the tourism-oriented island state of Tasmania, 40 degrees south of the equator. In a sluggish economy, Gunns has been a spectacular performer for a decade. In 2001 the share price was $3.50 and in late 2003 it was $13. It is the first Tasmanian company to be worth $1 billion. Despite this success it remains controversial, a target for green activists and a common topic for critical discussion in Tasmanian homes. In September 2003, Gunns was forced by a section of its shareholding to hold an extraordinary general meeting (EGM) to discuss forestry practices.

This case is about the company and the EGM. The key issues are these: is it possible for a company operating in a hostile social environment to present as a good corporate citizen? And, how does such a company best handle a mix of profit-oriented and green-oriented investors? Finally, are its practices sustainable? To make sense of these issues requires some background to be explained, and the first sections of the case thus provide a brief description of Tasmania and the ongoing forestry debate. This is followed by a history of Gunns. The EGM is then described and the issues discussed.

TASMANIA, THE ISLAND STATE, AND THE FORESTRY DEBATE

Tasmania is the smallest Australian state, just 315 kilometres across its greatest width. The middle of the island is mountainous and features scattered lakes and alpine vegetation, while the west faces the Southern Ocean and is rainswept, with much of it covered in impenetrable ‘vertical scrub’. The east coast is much dryer and has golden beaches; the north-west coast has deep soils and a climate suited to vegetable growing and dairying; and the south, and a plain next to the mountains (the midlands), is dry and a wool-growing area that achieves some of the highest prices for fine wool in the world. The government branch of Parks and Wildlife manages 354 reserves covering over one-third of the state, and the Forestry Commission, a state government authority, controls still more. Almost 1.4 million hectares of this is World Heritage listed. In this small place the world traveller can find the equivalents of the burnished hills of southern California, the hills of the grape districts of the South of France, Wordsworthian English countrysides (both his Lake District feel and the mannered and pretty countryside of the green south of England), and the golden beaches that are stereotypically Australian. The variety of vegetation and unique wildlife are the lures that attract tourists.

This is a pleasant land with a temperate climate first settled by Europeans in 1802. The new settlers set about clearing the land for agriculture, displacing the Indigenous inhabitants while setting up a wool/wheat/cattle system modelled on England, complete with hawthorn, oaks, rabbits and much other exotic material. There was a thriving timber industry harvesting an apparently inexhaustible resource, and successive Tasmania governments sought to attract foreign investment into it.

There were occasional outbursts from conservation-minded people, but the pattern of cutting/burning/clearing continued relatively quietly until 1972 when the post-war transition to hydro-electrification of industry via damming of major rivers collided with the nascent green movement. Damming policy was led by the Hydro Electric Corporation (HEC), at the time a virtual government within the government; one long-time post-war premier was popularly known as ‘Electric Eric’. The focus of...
debate was the damming of the south-west’s Gordon River and flooding of Lake Pedder, a big remote lake with an unusual large, sandy beach. This led to the formation of the United Tasmania Group, the world’s first formal green party. In 1976 the debate heated up with another major dam proposal and the formation of the Tasmanian Wilderness Society. A major campaign resulted. This was a world event – ‘No dams’ was the cry in big street marches all over Australia, and all levels of government and the High Court of Australia were involved before the HEC was blocked and the Franklin saved. Green debate was by then a staple of café conversation.

Meanwhile, export woodchipping had begun, mainly sourced from ‘charismatic’ old-growth eucalypts. Yehudi Menuhin, the great violinist and humanist, said of this: ‘I can’t begin to tell you the beauty of those forests . . . the forest of Tasmania is yet unsullied and unpolluted by our kind of civilization. That we should have to defend them is something quite unbelievable . . .’

His sentiments have been shared by a generation of Tasmanians who continue to contribute to an ongoing forestry debate on radio, in newspapers and on the streets. The issue is in the faces of the people of the capital city because the main log-route to the chipping place is the highway that passes through the city centre, past the Treasury building. Every day, scores of trucks go through with apparently excellent building/furniture timber on board in the form of long, solid logs. In 2002, a government-sponsored survey that was part of a ‘Tasmania Together’ process led by the government found that a significant majority of Tasmanians wanted an end to old-growth logging: the opinion crosses conventional political lines. The green side of the debate is led by green parliamentarians, (there are four in the 25-seat lower house), the Wilderness Society, the Tasmanian Conservation Trust and the Australian Conservation Foundation. On the other side, the government is solidly pro-forestry (it is a conservative union-influenced Labor government), and the pro-forestry Forest Protection Society (and there is no evident intention of irony in the name) is a vocal pressure group.

■ GUNNS: A COMPANY WITH CONNECTIONS

The two brothers Gunn started a building business in northern Tasmania in 1877 and soon turned to milling their own timber. They prospered and quickly became leading sawmillers. The industry was reliant on ‘crown-logs’, those cut off government land under licence, and Gunns had good access to this resource. The industry grew, as did Gunns, which, in the 1950s, initiated a policy of buying smaller sawmillers, private forests and rights to crown-logs. This process gathered pace after 1970 when it became evident that the supply of crown-logs was limited. From 1982, led by John Gay, Gunns also sought to consolidate its existing markets and expand into the growing export market for hardwood.

In 1986 the company was floated on the Australian Stock Exchange, with Gay as the chief executive officer (CEO). The board at that time included as chairman Peter Wade, CEO of the mining and pulp and paper giant, North Broken Hill; Edmund Rouse, the chair of a northern Tasmanian media firm; Mr Clements of the Tasmanian firm Clements and Marshall; and two members from HMA, major investors in Gunns. (In later moves, Wade was replaced by David McQuestin, a Rouse connection, and still later, a former premier, Robin Gray, was appointed.)

This was an era in which the external environment of Gunns was also undergoing crucial changes, especially politically. Liberal premier Robin Gray called a state election in 1989 only to lose his majority. Labor and the Independents (as the greens had been identified) combined to become the Labor Green Accord (LGA) to prevent the Liberals remaining as a minority government. This upset the forest industry, which campaigned for a second election before the LGA could take power. The campaign collapsed when Edmund Rouse was imprisoned for attempting to bribe Labor MP Jim Cox to cross the floor to prevent the LGA from taking power. A Royal Commission also implicated McQuestin (another latter-day board member of Gunns), then managing director of Examiner National Television (ENT) of which Rouse was a substantial shareholder. McQuestin was cleared of being unlawfully involved as a principal offender in Rouse’s bribery charges, though the investigation acknowledged that his acquiescence with Rouse’s direction was highly improper. During the investigation into these bribery charges, it was revealed that the campaign for a second election actually stemmed from Gray’s office, although it was funded by the forest industry.

The Labor Green Accord eventually came to power and, in a (failed) endeavour to settle the forest industry–conservation debate, the Forest and Forest Industry Council (FFIC) was established. However, before long, the FFIC shifted ground to become more concerned with preserving the forest industry, and proposed Resource Security legislation that would give the forest industry guaranteed access to the forests. At
the same time, the publicly owned Forestry Commission became a government business enterprise, and was given exemption from freedom of information legislation. Labor's attempt to pass the Resource Security legislation caused the downfall of the LGA coalition because it outraged the greens, and Labor was compelled to call an election in 1991 that returned the Liberals to power under Ray Groom's premiership.

Meanwhile, Gunns had positioned itself in the early 1990s to undertake the bulk of the seasoned hardwood milling, moulding and veneers in the north and northwest of the state, leaving only a handful of significant, independent, locally-owned family businesses remaining in this sector of the forests industry in that part of the state. In reaching this position, the company defended two High Court appeals against the issue of licences to cut timber. This strategic positioning continued through the late 1990s and beyond, illustrated by Gunns' buyout of Boral's Tasmanian woodchipping interests and the acquisition (aided by the ANZ Bank) of North Forest Products – owners of major tree holdings, including a 120,000-hectare tree farm. This saw Gunns become Tasmania's only woodchipping company, exporting 5.5 million tonnes of wood-chips from the state each year. A significant proportion of this came from old-growth forests, including the Styx Valley of the Giants (as it is called by the Wilderness Society) – the location of the world's tallest flowering eucalypts.

During this time, there was an additional pressure on Gunns and the government over tree plantations. The movement towards turning agricultural land into trees had grown over a decade, and the difficulties of other agricultural practices meant that a growing number of farmers were selling out to tree farmers – and Gunns is the biggest. This annoyed the nearby land-owners because of the loss of sun, it annoyed the greens because the tree farms are usually quick-growing species that do not provide a habitat for wildlife, and it annoyed tourism operators because it presents an ugly face to the world with chemical clearing of sites before planting and clear felling. Gunns had a direct and highly public dispute over chemical clearing in 2003 that further hindered its public image when an organic farmer near a new Gunns tree farm objected to the land clearing.6

PRESSESURING THE INSTITUTIONAL SHAREHOLDERS

The opening years of the twenty-first century saw one of Gunns' major shareholders, the Commonwealth Bank, targeted by the Wilderness Society, the society exhorting the bank's shareholders to pressure its board to use the bank's shareholding in Gunns (at the time, just over 17 per cent) to force the company to move out of the old-growth forests.

Other Australian banks came under pressure from various quarters, the ANZ Banking Group Ltd indicating that it did not hold a stake in Gunns but did have a banking relationship. Charles Goode, the chairman of ANZ, said that the bank takes environmental issues seriously. 'We are prepared to enter into dialogue with community groups such as the Wilderness Society,' Mr Goode said. In 2003, the board had a half-day strategy meeting on environmental issues and, as forecast in the Examiner on 14 December 2002, the chairman and some executives visited the Gunns forestry sites in Tasmania in February 2003. Gunns' managing director, John Gay, contended that the company had issued invitations to all the major banking institutions that had been targeted by the Wilderness Society with what he termed 'misinformation'.7

(At this point, an indication of the significance of these institutionals and some that follow is necessary: the ANZ, Westpac, Commonwealth and National Australia banks are Australia's biggest banks, and the AMP and Perpetual Trustees are the major insurance companies in the nation, while Bankers Trust (BT) is a major investment firm.)

CORPORATE INTRANSIGENCE

A group of 100 Gunns Ltd shareholders who opposed the firm's logging practices took the step of requesting an EGM of the company in February 2003. The group – coordinated by the Wilderness Society, but including shareholders from outside the society – relied on the new Corporations Law governing corporate regulation in Australia, which became effective on 15 July 2001. This scheme provides that the directors of a company must call and arrange to hold a general meeting on the request of:

- members with at least 5 per cent of the votes that may be cast at the general meeting

or

- at least 100 members who are entitled to vote at the general meeting.

Gunns Ltd initially refused to hold the special meeting. Executive chairman John Gay was reported
as saying that the directors considered the Wilderness Society’s demand was not valid under existing regulations, and had decided that convening a special meeting to consider the issues raised by the Society would be an inappropriate use of company funds.8 (The company maintained that the special meeting sought would cost tens of thousands of dollars.) The Tasmanian president of the Directors Institute, Gerald Loughran (who had a business in the north of the state), said that legislation to change the 100-person rule to a 5 per cent rule was before the Senate and he hoped it would soon be resolved.9 However, Loughran seemingly ignored the fact that the 100-person rule did apply at the time the request for a meeting was made.

Gunns maintained that the requisition notices were invalid, and that the shareholders who had called for an EGM had ‘clearly not abided by the articles of association of the company’, although the company did not give the actual reason that the requisition was deemed to be invalid. Executive chairman John Gay said that because of the Privacy Act he could not say exactly what was wrong with the requisition.10 He objected strongly and the Wilderness Society rethought its tactics.

The Wilderness Society then resubmitted a modified resolution calling for an EGM of Gunns Ltd. Campaigner Leanne Minshull indicated that the Society would take the issue to court if Gunns refused to call a meeting a second time. The meeting was duly called.

EXTRAORDINARY GENERAL MEETING, 29 AUGUST 2003

In the lead-up to the August EGM at Gunns, helpful corporate professionals entered the fray on the green side:

- Fund managers showed the Wilderness Society how to draft better resolutions.
- Lawyers gave pro bono advice on procedural matters, secondary boycotts and defamation issues.
- Naomi Edwards (retired partner of Deloitte Touche Tohmatsu and former director of Trowbridge Consulting) crunched numbers for the Wilderness Society to back its claim that the company could refrain from logging old-growth forests without losing money.
- An international business strategist used by some of Australia’s biggest companies provided advice on the campaign in Japan. (Most of the Gunns woodchips are exported to Japan and China, where they are used in paper production.)
- A 1980s corporate raider gave tips on tactics for dealing with corporations and hosted private lunches in Sydney to put activists in touch with senior executives.

Minshull did not ‘name names’, but she confirmed meetings with AMP, BT Financial Group, Commonwealth Bank, local and federal government superannuation schemes, National Australia Bank and Perpetual Trustees. Perpetual’s John Sevior said it was the first time he had experienced a campaign of this kind, and that it could be the first of many. ‘The world is getting more determined in a lot of ways,’ he said.11 One of the Sydney fund managers with whom Minshull had talks put up a proposal for a memorandum of understanding between Gunns, the Wilderness Society and institutional investors. Minshull believes that such cooperation is feasible, although the provisos she stipulated were uncompromising ‘...as long as the institutions tell Gunns to stop developing clear felling, selectively logging, or accepting product from certain forest areas’.12

The campaign seemed at the time to have had some effect. Westpac-owned BT Financial Group, which has a small undisclosed stake in Gunns, indicated its intention to abstain from voting, citing insufficient information on which to make a decision. The financial house said it recognised the sensitive nature of environmental issues, and that it believed there was a lack of adequate data or information on the possible effects of adopting the resolution.13 There was an international dimension to this campaign: as reported in the Age, Minshull indicated that a loose coalition of activist organisations around the world, including Friends of the Earth International, Britain’s WWF (World Wide Fund for Nature), Greenpeace and the Rainforest Action Network, helped on the Gunns campaign by lobbying institutional shareholders in Britain.14

In the end, no one really expected the Wilderness Society to get its way at the EGM. Gunns said that the shareholder activists controlled fewer than 250,000 shares, or about 0.3 per cent of the stock, and Minshull conceded that the resolution was unlikely to get anywhere near the 75 per cent needed. Gay accused the environmentalists of wasting shareholders’ money on what amounted to a protest meeting. ‘That is disgusting,’ he said. ‘They conceded they haven’t got a hope in hell
but they are taking this company through the pain.’ Gay indicated that there was no prospect of Gunns working with the activists, because the company operates within state laws and Tasmania is a signatory to the 1997 Regional Forest Agreement between the state and federal governments. ‘If I rejected (the opportunity) to take some logs, they would just issue them to someone else. They can keep coming but we don’t make the decisions. They are just damaging the shareholders of Gunns and the superannuation funds of Australia by harassing Gunns for a decision that Gunns doesn’t make. That’s how stupid it is.’

FIAT (the Forest Industries Association of Tasmania) weighed into the EGM issue by publishing half-page advertisements in all major newspapers, the text of which is shown in Exhibit 1.

EXHIBIT 1

NOTICE TO
GUNNS SHAREHOLDERS

THE GUNNS EXTRAORDINARY GENERAL MEETING THREATENS THE LIVELIHOOD OF THOUSANDS OF TASMANIANS EMPLOYED IN OUR SAWMILL AND VENEER INDUSTRIES

- Closing down more high-yielding forest will take away the resource needed to supply our sawmill and veneer industries that add high value to cut timber;
- 40% of our forests are already reserved – 4 times the international standard;
- mature timbers that supply our higher-value-adding industries are not available in regrowth or plantation forests;
- less than 1% of old-growth forest has been harvested in the last 5 years.

SUPPORT FOR THE WILDERNESS SOCIETY MOTION IS SUPPORT FOR A LOW-VALUE, WOODCHIP-DRIVEN FUTURE FOR TASMANIA’S FOREST INDUSTRY

VOTE NO TO PROTECT THOUSANDS OF TASMANIAN JOBS

Forest Industries Association of Tasmania

Source: 2003, Saturday Mercury, 23 August: 21

AMP Henderson indicated that it would vote against the Wilderness Society resolution at the EGM for Gunns to cease accessing logged old-growth forest timber from the so-called Tasmania Together region under Tasmania’s Regional Forest Agreement. AMP’s substantial shareholder notice in June 2003 stated that it owned 7.2 per cent of Gunns shares on issue. AMP Henderson’s chief investment officer, Merv Peacock, said that AMP had long discussions with a range of parties, including Gunns and Forestry Tasmania. He concluded that the resolution would have a material negative impact on the company’s profits and believed that the impact would be greater than that contained in analysis by actuary and Gunns shareholder, Naomi Edwards.

Overall, a trend towards an ‘abstain’ or ‘against’ vote at the EGM emerged, as institutional shareholders balanced the risk of a consumer backlash with their fiduciary obligation to investors. UniSuper, the university employees’ superannuation fund, announced that it would abstain, saying that a vote was ‘premature’, and the large Commonwealth government employee fund, PSS/CSS, decided to vote against the resolution. Perpetual Trustees and Colonial First State would not disclose their voting intentions, and the SIRIS Proxy Voting Service also declined to say how it advised its clients to vote at the meeting. No institutional shareholder went on record as supporting the Wilderness Society-led resolution. Dean Paatsch, director of SIRIS Governance Services Unit, said his considerations varied depending on whether the client had an environmental policy as part of its investment process. Paatsch said he believed that most institutions would abstain because of their concern for ‘reputation risk’.

The lead-up to the EGM drew in crusading contributions from both sides of the debate, highlighted by the Wilderness Society’s own advertisements under the headline shown in Exhibit 2.

EXHIBIT 2

Tell Gunns to stop logging our oldgrowth forests

Join us outside the Gunns special meeting on oldgrowth

The press also carried letters covering aspects of the situation. The following extracts (shown in Exhibits 3 and 4) from the Examiner on 24 August are representative of the range of the debate.

**EXHIBIT 3**

**Woodchips on a platter**

Those who see Paul Lennon as a hard man should have a look at his Forest Practices Amendment Bill 2003, currently before Parliament.

For the third time since 1998, the Forest Practices Board is being given an amnesty for any previous violations of planning regulations and its own rules regarding them.

As in FPA Amendment 48 of 1998, there is a bonus on top of forgiveness . . . the FPB has been empowered to overrule the state’s premier appellate planning body, the Resource Management and Planning Appeals Tribunal, when that body has found forestry to be inappropriate.

**EXHIBIT 4**

**Forest system is world class**

Tasmania’s Regional Forest Agreement is fast approaching its sixth anniversary.

This 20-year vision for our forests established a comprehensive, adequate and representative reserve system . . . it is a pity that green activists, who are a small group, refuse to accept (the) massive conservation gains from this landmark agreement.

The campaign also included Timber Communities Australia’s half-page advertisements in major newspapers on 27 August under the banner shown in Exhibit 5.

**EXHIBIT 5**

We are all proud members of Tasmania’s forest industry family.

Our forest industry supports one in every 20 Tasmanian jobs.

The advertisements, such as that in the Examiner on 27 August 2003, bore testimonials from a variety of ‘typical Tasmanians’ whose jobs in some way depended on the forest industry. On the day of the EGM itself, a large ‘open letter’ on behalf of 3000 employees and contractors of Gunns was published in the Examiner calling on Gunns’ board to reject outright the motion requiring the company ‘to ban processing of timber from a significant portion of Tasmania’s multiple use forests’.

The day before the EGM, Gunns released the company’s financial results, announcing its record $74 million after-tax profit for 2002–03. The 39 per cent profit increase was a result of strong demand across each of the company’s key markets. Total group turnover rose by 17 per cent to $610 million, with operating cash flow also up 17 per cent to $104 million.

**THE MEETING: GREEN FIZZER AND FOUNTAIN OF COMMERCIAL RATIONALITY?**

The EGM was held at 10 a.m. on 29 August at 110 Lindsay Street in Launceston, a city of about 60 000 people. More than 200 pro- and anti-logging demonstrators gathered outside Gunns’ offices, and log trucks lined the street in a show of strength for the industry. The resolution called on Gunns not to source any timber from the ‘Tasmania Together’ forests, which include the Styx, Tarkine, Great Western Tiers, Southern Forests, Tasman Peninsula, North-East Highlands, Eastern Tiers and proposed extensions to the Ben Lomond National Park. The Wilderness Society had encouraged shareholders to attend the EGM and vote for the resolution, had sought proxy voting rights, and, in the lead-up to the EGM, had run stalls outside many Commonwealth Banks providing information and pro forma letters for people to send to the bank.

Some 20 speakers addressed the 90-minute meeting, and shareholders voted overwhelmingly against the resolution calling for Gunns to withdraw from 240 000 hectares of old-growth forest, the resolution being lost by 54.8 million to 248 000 votes. Institutions representing some 1.5 million votes abstained. Gay said the vote demonstrated clear support for the board. “This whole action was nothing more than a publicity stunt by the Wilderness Society, staged for political purposes in a futile attempt to attack a well-performing and legitimate Tasmanian business.” The resolution was easily defeated.
with 98 per cent of votes against. But most disappointing for green groups and activists was that only 2.6 per cent of voters abstained – the usual form of protest for institutional investors. So, Perpetual with 10.17 per cent, the Commonwealth Bank with 8.6 per cent, and AMP with 7.21 per cent were effectively saying they were in favour of logging old-growth forests – a stance that could cause them some grief at annual meetings in the future given the high level of activism on the issue. Despite always having the numbers, John Gay didn’t want too much debate from the floor. At one point he told the Wilderness Society's Leanne Minshull to 'sit down, young lady'.

WHAT DOES THE FUTURE HOLD FOR GUNNS?

The company is still at odds with protesting greens. In December 2004 the company sued 20 environmental activists and organisations for $6.3 million, including a mix of prominent activists such as Bob Brown as well as ‘ordinary citizens’ who have participated in protest actions against Gunns. The company claimed that the protesters had harmed the company by disrupting logging and woodchipping operations and also by vilifying the company to its customers and shareholders. This led to the ‘Gunns 20’ campaign against the company in which those sued and their supporters agitated against this use of tort law. In 2005 Gunns was ordered to pay a substantial part of the defendants’ costs. They have also withdrawn actions against six of the original defendants, and, following problems with their case in 2005, launched the third version of the case in the Supreme Court of Victoria. It is impossible to say if the action has silenced some potential protesters but it has certainly been a costly exercise for all concerned.

If greens versus industry is one theme in Tasmanian politics, another is building a world-class pulp mill to value-add the woodchip resource. In 2005 Gunns put forward a $1.4 billion proposal for a pulp mill at Bell Bay in the state’s north. This, according to due process, was considered by the independent Resource Planning and Development Commission (RPDC). The deliberations of the Commission were steady until the resignation of the chairman after alleged attempts to influence him by a forestry official. A retired judge was appointed to replace him and he also alleged attempts to influence him, this time by the Premier. The time-consuming process of deliberation and controversy frustrated the company and they withdrew the proposal from RPDC. The Tasmanian parliament then passed special fast track style legislation to give the mill the go ahead. Time will tell. In mid-2007 it was unclear that the mill would be built, and longer term unclear that any mill so far from markets could be commercially successful.

Gunns has perhaps faced the reality that a forestry firm, despite being law-abiding and popular with the institutional shareholders and government, cannot please the majority of the people. It is well protected by legislation that guarantees access to the critical wood resource and has a dedicated workforce, but it would be nice to be well regarded by a wide slice of the population. And will the institutional investors continue to support it? The next phase of activism will not be targeted at Gunns but at its investors. How much heat will a bank take for the sake of what is, for it, a minor investment? Is a concession to green thinking required?

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Toby Crispin has a big decision to make. He has the capital to expand in the Sydney indie (independent) music sector by expanding his record label but must make the decision to go ahead or not.

Indie music is a global phenomenon within popular music. It is a made up of people who are self-conscious about their opposition to the ‘music machine’ that supplies bland music to the masses. The culture is redolent with anti-machine messages in dress and fine art as well as music. In Australia, there is an indie scene in every capital city. The biggest, in terms of numbers of bands, is in Melbourne where the cost of living is cheap relative to Sydney, where there are cheap warehouse style rehearsal venues and where there are many hotels that support indie music. Sydney, however, has almost as big a band scene and is the industry centre for the Australian indie music industry. The Sydney scene is also interesting because it is focused almost entirely on a couple of inner city suburbs where indie figures are commonplace on the streets.

Toby's firm has ongoing income from running a 'club' in the indie market. That is, he has control over one night at a large hotel and runs it as an entry fee night club. This is a successful operation, which yields good profit. It is, however, a difficult operation to expand and his attention has therefore turned to further investment in the indie recording industry. He already has a record label and a three bands under contract. He also organises music events (festivals, special shows etc.). Should he use surplus capital to expand his record label/band activities in the indie music industry? His label/band business is too small to be a real player in the industry. Now is the time to either expand it or allow it to gradually decline into a vanity operation.

To help understand his situation it is necessary to describe his current label business and then the competitive environment.

**SHALLHAVEN, TOBY'S LABEL: A MUSIC LABEL AND PROMOTER**

The organisation started only three years ago. Although Toby started it with limited capital it is now a small–medium sized indie record label with three promising bands signed.

The business is based on people. Toby, 26, is the owner and chief executive officer (CEO). He has a business degree and experience in a major record label. He knows the indie music scene well and is an enthusiastic music listener. He is a broad thinker with good ideas and is an effervescent verbal communicator with widespread links in the music industry. He puts the deals together and is good at handling finances. Daniel, 25, is co-manager of the creative side of the organisation. He books the bands when they organise an event. He is the main A&R man for the organisation, that is, he goes to lots of gigs and finds new bands for the organisation. He is also songwriter and singer/guitarist in one of Shallhaven's bands and knows the industry well. He is a very fast and effective writer of media releases and any other written material. At the moment he only works part time because he wants to be successful as an artist rather than as a business person. Jonne, 22, is a writer who has worked for major publications. He handles publicity material and writing, along with Toby and Daniel. Andrew, 24, handles Internet and telephone communications. His job is to make sure everyone knows what the organisation does. Vicki, 19, does the accounts and handles the office work. She also has a good understanding of the industry. The team fits together well and they enjoy the work.

The organisation has a good Sydney office and good equipment. The Shallhaven brand is established in
the indie scene as a small development label focusing on indie music. That is, it signs young bands with a view to developing them to the point where they are attractive to a major label (in which case Shallhaven would be on a percentage of the contract signed with the major) or, more rarely, the band becomes big enough to prosper financially in the indie market. They have three bands at the moment. Billycarts is Daniel’s band and is an established but minor player in the scene with a dedicated following of several hundred and songs that get played on Triple J (the ABC’s youth radio network) every now and then. They could break into the big time some time soon. Gravymaker is also an indie act. He has a smaller following and is in the development phase of his career, recording an LP after a careful development phase. The Bookends are a gamble for Toby. They are dedicated musicians with a good creative urge but are unknown and still fairly young and inexperienced.

Each band may cost up to $30,000 a year to run, assuming a label is pushing them. This amount includes the costs of recording and marketing but little or nothing to the band directly.

The industry is extremely competitive and complex. This situation is explained in more detail below.

A GLOBAL MUSIC INDUSTRY: THE BROAD CONTEXT

Popular music is a global industry. It is dominated by major companies (the ‘majors’) such as Warners and Sony BMG, who handle production and distribution for a quickly changing list of ‘major artists’ but also includes thousands of minor record labels and tens of thousands of relatively unknown professional musicians, most of whom struggle to make money (any money) out of the business. The majors sell over 80 per cent of records per annum, by volume.

This is a complex business. It is categorised into a variety of styles (broad genres) and splinters further at the street level, into many sub-genres intimately known to insiders but a mystery to those outside. Broad genres take in things such as indie-pop (famous bands here are Oasis, Blur, and The Strokes), punk (famous bands include The Sex Pistols and Green Day) and rap/hip hop (for example, Eminem and NWA). As well, there is country music (Johnny Cash and Emmy-Lou Harris are examples of long-term successful acts here). This seems clear but confusion comes when one tries to work out how ‘grunge’ is really different from ‘punk’, or ‘hard-rock’, or any other broad genre from another. Then there are the sub-genres, so, for example, ‘brit-pop’ varies from ‘indie-pop’ and ‘new-wave’; ‘cal-punk’ is different from ‘hard-core’; and ‘alt-country’ from ‘country’. Johnny Cash was, for those in the know, country for most of his career and was then embraced by the alt-country people, who are, of course, rather anti-country!

These categories may seem obscure but matter because they guide bands and are useful marketing niches within the industry. Major labels typically try to cover the field, signing the most marketable bands within each genre and sub-genre. Indie labels, however, are typically specialists within one field, if only because they cannot afford to cover any more. Shallhaven, to be successful, must be very good at finding new talent in competition with all other players in this game.

There are still further grounds for complexity, which makes management difficult. One comes with regional variations in the music. The industry is certainly dominated by the global labels but every large city in the world has its own music industry with musicians playing songs linked to the local culture. Their link to the global industry is nevertheless significant because some of these people become global commodities. These rock-stars have glamorous media profiles and, in the public view at least, big incomes.

Indie labels rarely distribute and market records outside of a given ‘territory’ for which they sign their acts (Australia/New Zealand is one such territory, UK/Europe another, although it often occurs that an indie label will license the rights to a recording for, say, just Spain). Majors, on the other hand, are global in their reach and push, and will generally sign acts for worldwide deals. That is, they obtain from bands the exclusive right to market and sell recordings of that band anywhere.

For many years, major labels selling, first records then cassette tapes and now CDs, have dominated the global market. CDs and tapes, with their easy copyability, brought with them copyright changes that compensated labels and artists for copyright theft. Much harder to police, however, have been forms of copyright theft that have come with the spread of the world wide web and with it, file-sharing. File sharing has caused worldwide sales of CDs to plummet. Sites such as Myspace have also had an effect. Finally, the iPod/MP3 player revolution has also had a major effect on the industry; thousands of individual songs can be loaded onto a small portable machine and any song played at will. This presents less of a challenge to the industry since the labels are paid when
this is done formally (as it usually is) but it does challenge the idea of a ‘record’, that is, a number of songs by a band or musician on a single CD, vinyl record or tape.

In this changing technological context the major labels exist in a state of steady competitive rivalry. They compete for sales in order to gain revenue, they compete for good technological and marketing staff, and behind this they compete for the best musicians in all of the geographical and niche music markets.

This situation is rendered even more complex by the fact that the majors are themselves part of a larger organisation, and each major owns a number of other labels, usually in niche categories. A brief summary of this situation presents four majors that operate in Australia.

- Warner Music Australia is part of Warner Bros. This is part of the WEA group of labels that also includes Elektra and Atlantic records. In turn, it is part of TimeWarner, which also has movie distribution, TV networks, publishing and cable TV divisions. TimeWarner is part of AOL/Time Warner.
- Universal Music Australia is part of the music division of Vivendi Universal, which also has much larger publishing software, TV and movies, telecom, and environment divisions.
- Sony/BMG Music Entertainment (Australia) is part of the music division of Sony BMG. This huge organisation also has a much larger electronics manufacturing division and insurance, theatres, movies, TV and home audio and video divisions, as well as a larger publishing division and Internet business. This is by far the largest record label in the world.
- EMI Music Australia is part of the music division of EMI Group plc which also has motion pictures and software/manufacturing divisions. The music division also includes Virgin and Capitol and a large group of labels called the EMI Christian Music Group.

In Australia, Festival Mushroom Records was effectively a home grown major, possessing the rights to many acts that are huge within Australia, and a few that are huge outside it as well. It also possesses a publishing roster that is unparalleled in Australia. When this label collapsed early in November 2005 and was swallowed by Warners, it became a sad tale of an Australian loss of cultural control. The collapse was due to bad signings of bands and, perhaps, bad luck as well as competition from an increasingly globalised industry.

Because of their links to major corporations the global majors have financial resources that smaller labels cannot match. In addition, all have major distribution chains that are difficult to match for smaller players. The number of branded labels each of the majors controls also gives them the advantage of broad coverage of the entire spectrum of poplar music. In 2002 the Warner Bros stable, for example, included more than 50 labels and their Atlantic Records section includes another 16, while their Elektra stable has seven. Every niche within the global industry was covered by this spread of labels.

### DISTRIBUTION OF RECORDINGS

The majors have their own well-established distribution networks that ensure that their acts get distributed throughout Australia. Retailing is handled by chains such as Virgin who have a presence in major cities and by independent stores located in all towns of reasonable size. Conventional record stores carry little or no music classifiable as indie; if it is played on Triple J it may be carried so long as the label is big enough to have links to a store’s buyers, but usually that is not the case. JB Hi-Fi, a chain with multiple branches in all states but Tasmania, does carry indie music, at least that played on Triple J. The chain does not have an indie philosophy though, JB Hi-Fi is, in words from their website, ‘Australia’s fastest growing independent retailer of home entertainment’, a strictly commercial operation now owned by financiers who seek return on investment.

There are, in addition, indie record shops located in indie regions of Sydney, Melbourne and Brisbane. They operate according to the ‘indie ethic’ which puts independence before money and some stock only indie recordings. One example gives the flavour of such operations – in Surry Hills, the heart of Sydney’s indie industry, Graygo shop is located in an old domestic garage located off an alleyway. It is scrupulously clean and stocks several thousand indie recordings mostly from the Sydney scene. A band can go in for affirmation of their status as ‘recording artists’. On one visit 38 recordings had special stickers attached with descriptions from staff on what they sounded like and advice to buy. Rent is low and so is turnover.

### THE OTHER INDIE LABELS

Indie labels exist in the shadow of the majors. The list of indie labels on themusic.com (a good website for the
Australian music industry) lists 206 active labels, that is, labels that produced a record in the two years up to mid-2005. There are additional labels listed in the Australian Asian Music Industry Directory (www.imedia.com). Some of these are financed by or part owned by majors or by other multinational labels.

In the Sydney industry there are several ‘major indie’ labels, that is, labels that are established and handle a range of musicians and employ more than ten staff. Modular Records is an established indie label, which operates as a true indie organisation without being part of a major (www.modularpeople.com). Dew Process operates like an indie label but is a subsidiary of Universal and therefore has the advantage of Universal’s distribution network (www.dew-process.com). Spunk has major indie status but operates as a local agent for international acts; staff at Spunk identify emerging international acts and licence them for Australia (www.spunk.com).

Of the other two hundred or so significant indie labels that operate in Australia around one hundred are Sydney-based. Many of these are barely larger than a vanity label (one that produces the musician’s own work). Limited financial resources (money is required to produce a record, more on this soon), difficulties in distribution, limited marketing resources, and lack of an established brand make it difficult for these labels to compete with the majors or the major indies. They continue to operate because staff (usually the owner plus one or two others) require little pay and because there are so many bands after a label.

The aims of many of these labels are mixed. They aim for a successful act that will ‘make’ the label. At the same time, they hope for acts they can develop to the point that a major buys their contract with a percentage of future sales going to the indie label. If an indie label signs good acts they will prosper but because of the costs of running a development band, a series of signings of bands who do not succeed will drive a label out of the industry.

THE MUSICIANS INDIE SCENE

There is a massive global oversupply of wannabe rock musicians. Every small town has a band or several bands and every city has thousands. At any one time there are several hundred bands trying to ‘make it’ professionally in Sydney. It is difficult to give an accurate figure for the number of indie bands in Sydney because most fail in the end, to ‘make it’, and turnover is regular. However, a reasonable estimate is that there are 4000 bands active in the greater Sydney area, of which around 1000 are actually gigging regularly. The central indie venue, the Hopetoun Hotel, has about 600 separate bands on stage each year. Of these, about 100 or 150 are actually ‘players’ in the scene – bands that draw good crowds beyond their circle of friends, who attract decent shows at other respected venues, and who spend, or have spent on their behalf, reasonable amounts of money on promotion and so on. Maybe they have a song on the radio too.

The musicians involved with these bands are nearly all between 17 and about 30 (at 25 you are an old indie musician). They come from all parts of Australia, drawn to Sydney itself as well as the well-known indie scene. Most are male but there are females too. Girls are widely sought after – as singers, but also because it is perceived to be cool to have a girl in the band.

Most bands that make the big decision to try to make it in the scene consider hiring a manager. The idea is that the band concentrates on the music while the manager – for somewhere between 10 per cent and 20 per cent of revenue – handles business matters. This is likely to be the first contractual arrangement the band makes and is therefore their first exposure to the confusing process of checking a contract. There are a few major management firms – Aloha, the sprawling and powerful IMC, and the famous Winterman and Goldstein team at Ivy League, who manage, among others Jet, The Vines, Neon and Rocket Science. Most established labels have in-house management, Modular, for instance, are very good at managing their bands, placing them on strong (‘hip’) bills – that is, playing at hip gigs.

A LABEL INTERACTING WITH MUSICIANS

The thing that most musicians hunger for more than anything else is the respect of their peers, friends and other people that they respect. Few of them really care about the teenagers (mostly girls) who buy their albums. They want ‘street-cred’ and a flexible arrangement with a major label. The problem that they face is that these teenagers spend the dollars that keep the industry alive, and that the people that come knocking, offering the musicians the money with which they can ‘make it big’, are specialists in tapping precisely this market. The problems mount – everyone wants to make it, but they want to retain their street-cred. They want the perception that they are making cool music under their own conditions (a perception diluted by big money contracts signed behind
SUCCEEDING IN THE SYDNEY INDIE MUSIC INDUSTRY

CASE FIVE: SUCCESSING IN THE SYDNEY INDIE MUSIC INDUSTRY

The desire for label success is colourfully summarised by Steve Albini, who was producer of ‘In Utero’, a hugely successful album for Nirvana, the legendary grunge band:

Whenever I talk to a band who are to sign with a major label, I always end up thinking of them in a particular context. I imagine a trench, about four feet wide and five feet deep, maybe sixty yards long, filled with runny, decaying shit. I imagine these people, some of them barely acquaintances, at one end of this trench. I also imagine a faceless industry lackey at the other end holding a fountain pen and a contract waiting to be signed. Nobody can see what’s printed on the contract. It is too far away, and besides, the shit stench is making everybody’s eyes water. The lackey shouts to everybody that the first one to swim the trench gets to sign the contract. Everybody dives in the trench and they struggle furiously to get to the other end. Two people arrive simultaneously and begin wrestling furiously, clawing each other and dunking each other under the shit. Eventually, one of them capitulates, and there’s only one contestant left. He reaches for the pen, but the Lackey says: ‘Actually, I think you need a little more development. Swim again please. Backstroke.’ And he does of course.4

WHO MAKES THE MONEY?

Most indie musicians make no money out of music. They get few gigs and what they are paid more or less equals expenses. For example, a gig for a new band at one of the more significant indie hotels will yield about $100–$150 to be divided up among the band. Take transport costs and a few beers out of this and the net per person is close to zero dollars. And, we haven’t started to talk about the thousands of dollars of musical equipment that are required to get to this point. A typical guitarist in a band that has gone this far has a guitar worth around $1500 (usually more) and an amp worth more than $1000. He nearly always has a spare guitar and an acoustic guitar as well, and maybe his own ‘warm’ microphone.

MARKETING A BAND/RECORDING

To market a band or a new recording you must succeed in radio, in the press and, hopefully, in TV and on the street.

Getting played frequently on radio is vital to the success of a recording, because it leads to CD sales and successful touring for the band. There is fierce competition for the available time on radio so all labels put effort into getting their music onto high rotation.

Since the 1950s the majors in the USA have bribed radio stations to play specific tracks. ‘Payola’ is rampant in that industry and comes in the form of free trips and electronic goods as well as money. In July 2005, Sony BMG paid a fine of US$10 million for bribing radio stations and the prosecuting lawyer said at the time that he was investigating the other majors as well.5

The power of the majors – even without payola – is so great that indie labels have difficulty competing. Indie music however, has the advantage of being self-defined as ‘independent’ and in large cities has access to indie radio. In Sydney FBi is a purely indie station that plays music made by local bands. RRR and PBS serve a similar role in Australia’s other music capital, Melbourne. Triple J, although the youth-oriented station for ABC, is far more conservative but plays some indie music in an otherwise bland mix aimed at their vision of teen music made in Australia. They plug music by bands that have, to at least some extent, a national reputation – or strong management/label connections who ‘push’ their recordings onto air. Nova, a group of commercial FM radio stations (operating in the major Australian capital cities), aims at the late-teen early 20s youth market. It also plays some indie music. Nova concentrates on ‘made’ bands, those with established reputations and followings.

To get to the press it is necessary to write press releases that are designed to make the band and song(s) sound attractive to the radio stations targeted, to make personal contact with radio people, concentrating on the power brokers in the station (in Triple J, for example this is Richard Kingsmill), and to give demo CDs to as wide a variety of stations and reviewers as possible. A sample press release gives the flavour of these exchanges (see Exhibit 1).

As well as specific radio and press work, a band will do a gig that is the official launch of their record. This will be publicised in the street press (that is, free papers that are widely distributed in the indie world). Hopefully this is at a good indie venue and hopefully it is sold out. At the gig, with any luck, if the vibe is right, there will be an A&R person from one of the majors. There will be a review in the press of the gig and the band. Ideally a snowball effect will take shape and a real buzz on the streets will start to happen. If the label is a good one, they will have been calling every person in the industry trying to hassle the band into magazines and onto big bills. Maybe the band is able to secure a spot as an opening band on a national

...
tour, perhaps as the support act to a major headlining band. Then, the national reputation that gets you better radio play starts to build – the band is away!

**EXHIBIT 1**

Last seen playing hopscotch in a dirty alley way in Sydney's inner south, Sydney three-piece The Mares exist in reality apart from others. In this world Emmy-Lou Harris wields a bloodthirsty distorted flying V of a guitar, the Birthday Party are play-listed on the airways, and Frank Black likes to chew [rather than suck] the last bits of vanilla and strawberry lollypops. The Charleston EP was born in the universe of f...d pop . . .

Described by street press as 'Sydney's frenetic eclectic post-folk-soul-trash kids', The Mares specialise in a distorted take on pop. Think bits of Yeah Yeah Yeahs, but with a more abrasive edge. Kind of like Karen O got booted for a young sexy Frank Black. The Charleston EP is a shotgun mix of loud trashy pop, hauntingly beautiful melancholia and organ-tinged dance floor hits.

After this, there is word on the street. If a band is breaking, there is a buzz on the street and in the confined indie world, this is vital to success. The radio, press and launch management processes should build this buzz.

Making a record is, then, obviously vital to a band’s career. Unfortunately this is an expensive process and unless the band has a well-resourced backer it needs to convince a label to fund it. A 'demo' (cheapish demonstration) album is the first step to attracting a label and a good demo is essential.

After that, recording becomes a big exercise, which includes:
- hiring a studio
- hiring an engineer
- hiring a producer
- mastering the final product (a separate studio to the recording studio) plus requiring a mastering engineer’s time
- production of the early (free) CDs for trade (radio stations etc.)
- production of the saleable CDs.

The process is very expensive and is normally funded by the label. Depending on the technology that the band opts to use, studios typically cost in the realm of $1000 a day to rent, engineers typically inclusive. Producers then bill out at hourly rates equivalent to those charged by medical practitioners. The reputable mastering engineers typically charge around $200 per hour for their time (and typically possess hundreds of thousands of dollars of equipment that the band cannot access without paying such fees). Bands can cut as many corners as they wish, and typically do – however, it is normal that an EP will cost a band several thousand dollars to record. Such a recording is typically a big investment for a start-up band.

**THE DECISION**

Toby's decision, then, is a difficult one. The industry is attractive to him at a personal level and there is potential to obtain good returns. There is also a synergy between the successful club activities that Shallhaven conducts and the record label. He has three promising bands but needs one to really break soon. But, the chances are better with more bands. The time to either expand or gradually collapse the label is now. Which way should he go? Should he hire new staff? Borrow funds? Wait for a while to see if the bands he has are going to make it?

**NOTES**

1 This is not his real name – because of the secrecy that rules in this industry, all but the names of the major organisations have been changed.
3 Nirvana are the highest profile act that Albini has worked with. Other notable bands that he has produced include The Pixies; P.J. Harvey; Godspeed You Black Emperor; Palace Music (Will Oldham); Nine Inch Nails; and The Breeders. Combined these artists have sold many many millions of records.
Nucor Corp. took first place in the 2005 *Business Week* 50 list of the best performers of S&P 500 companies. Not bad for a company in an industry often considered unexciting and low tech! In 2004 sales were up 82 per cent, from US$6 to US$12 billion, and earnings went from US$0.40 to US$7.02 per share. In a little over a year the stock price tripled. Longtime employees with US$300,000 in their retirement stock saw it rise to more than US$1 million. The tonnes shipped increased 9 per cent with the average selling price up 66 per cent. However, scrap prices were up 74 per cent. At the beginning of 2005 prices seemed to be holding up because of the mergers in the United States and the state control of supply in China. And Nucor expected the first quarter of 2005 to double the 2004 results. This was a reasonable expectation since Nucor began the year with 70 per cent of its flat-rolled steel output for all of 2005 sold, compared to just 25 per cent a year earlier. Furthermore, in 2005 Nucor had two joint ventures with global partners to find alternatives to the use of scrap steel. In Brazil the company was working on an environmentally friendly way to produce pig iron. With Mitsubishi and the Chinese steelmaker Shougang, Nucor was building a facility in Western Australia to use the new HIs melt process to produce iron from iron ore finds and cold fines with less energy and pollution.

The previous three years had been among the worst down cycles in the steel industry’s history. During those years Nucor acquired failing competitors, increased its steel capacity and achieved a profit in every quarter. The world economy and demand had improved recently as prices went from US$300 a tonne to US$640 a tonne. Thus, Nucor expected profits to continue to grow for a while.

While bankruptcies had eliminated some excess capacity in the United States, and state-controlled China could hold back capacity to maintain prices, global competitors were consolidating, suppliers were raising their prices on iron ore and scrap and buyers were considering alternatives to steel. Nucor, and its new president Dan DiMicco, faced a challenge in continuing Nucor’s reputation for excellence.

### BACKGROUND

Nucor can be traced back to the company that manufactured the first Oldsmobile in 1897 and became the Reo Truck Company. As the company declined into bankruptcy in the post-war years, a 1955 merger created Nuclear Corp. of America. Following the ‘conglomerate’ trend of the period, Nuclear acquired various ‘high-tech’ businesses, such as radiation sensors, semi-conductors, rare earths and air-conditioning equipment. However, the company lost money continually and a fourth reorganisation in 1966 put 40-year-old Ken Iverson in charge. The building of Nucor had begun.

Ken Iverson had joined the Navy after high school in 1943 and had been transferred from officer training school to Cornell’s Aeronautical Engineering Program. On graduation he selected mechanical engineering/metallurgy for a master’s degree to avoid the long drafting apprenticeship in aeronautical engineering. His college work with an electron microscope earned him a job with International Harvester. After five years in its lab, his boss, and mentor, prodded him to expand his vision by going with a smaller company.

Over the next 10 years, Iverson worked for four small metals companies, gaining technical knowledge and increasing his exposure to other business functions. He enjoyed working with the presidents of these small companies and admired their ability to achieve outstanding results. Nuclear Corp., after failing to buy the company Iverson
worked for, hired him as a consultant to find another metals business to buy. In 1962, the firm bought a small joist plant in South Carolina (Vulcraft) that Iverson found, with the condition that he would be in charge of the plant.

Over the next four years Iverson built up the Vulcraft division as Nuclear Corporation struggled. The president, David Thomas, was described as a great promoter and salesman but a weak manager. A partner with Bear Stearns actually made a personal loan to the company to keep it going. In 1966, when the company was on the edge of bankruptcy, Iverson, who headed the only successful division, was named president and moved the headquarters to Charlotte, North Carolina, where he focused the company business first on the joist industry and then on steel production.

He immediately began eliminating the esoteric, but unprofitable, high-tech divisions and concentrated on the steel joist business he found successful. The company built more joist plants and in 1968 began building its first steel mill in South Carolina to ‘make steel cheaper than they were buying from importers’. By 1984 Nucor had six joist plants and four steel mills, all using the new ‘mini-mill’ technology.

From the beginning, Iverson had the people running the various plants, called divisions, make all the major decisions about how to build and run Nucor. The original board was composed of Iverson; Sam Siegel, his financial chief; and Dave Aycock, who had been with the South Carolina joist company before Nuclear acquired it. Siegel had joined Nuclear as an accountant in 1961. He had quit Nuclear but in its crisis agreed to return as treasurer if Iverson was named president. Aycock and Siegel were named vice presidents at the time Iverson was named president.

Dave Aycock had been very impressed with the original owner of Vulcraft, Sanborn Chase. Aycock had started his career as a welder there. He described Chase as ‘the best person I’ve ever known’ and as ‘a scientific genius’. He said he was a man of great compassion, who understood the atmosphere necessary for people to self-motivate. Chase, an engineer by training, invented a number of things in diverse fields. He also established the incentive programs for which Nucor later became known. With only one plant, he was still able to operate with a ‘decentralised’ manner. Before his death in 1960, while still in his 40s, the company was studying the building of a steel mill using newly developed mini-mill technology. His widow ran the company until it was sold to Nucor in 1962.

Aycock met Ken Iverson when Nuclear purchased Vulcraft, and they worked together closely for the next year and a half. Located in Phoenix at the corporate headquarters, Aycock was responsible to Iverson for all the joist operations and was given the task of planning and building a new joist plant in Texas. In late 1963 he was transferred to Norfolk, Nebraska, where he lived for the next 13 years and managed a number of Nucor’s joist plants. Then in 1977 he was named the manager of the Darlington, South Carolina, steel plant. In 1984, Aycock became Nucor’s president and chief operating officer, while Iverson became chairman and chief executive officer.

Aycock had this to say about Iverson: ‘Ken was a very good leader, with an entrepreneurial spirit. He was easy to work with and had the courage to do things, to take lots of risks. Many things didn’t work, but some worked very well.’ There is an old saying, ‘failure to take risk is failure.’ This saying epitomises a cultural value personified by the company’s founder and reinforced by Iverson during his time at the helm. Nucor was very innovative in steel and joists. Its plant at Norfolk was years ahead in wire rod welding. In the late 1960s it had one of the first computer inventory management systems and design/engineering programs. The company was very sophisticated in purchasing, sales and managing, and beat its competition often by the speed of its design efforts.

Between 1964 and 1984 the bankrupt conglomerate became a leading US steel company. It was a fairy-tale story. Tom Peters used Nucor’s management style as an example of ‘excellence’, while the barons of old steel ruled over creeping ghettos. NBC featured Nucor on television and The New Yorker magazine serialised a book about how a relatively small American steel company built a team that led the whole world into a new era of steelmaking. As the NBC program asked: ‘If Japan Can, Why Can’t We?’ Nucor had! Iverson was rich, owning US$10 million in stock, but with a salary that rarely reached US$1 million, compared to some US executives’ US$50 million or US$100 million. The 40-year-old manager of the South Carolina Vulcraft plant had become a millionaire. Stockholders chuckled, and un-unionised hourly workers, who had never seen a layoff in the 20 years, earned more than the unionised workers of old steel and more than 85 per cent of the people in the states where they worked. Many employees were financially quite secure.

Nucor owed much of its success to its benchmark organisational style and the empowered division managers. There were two basic lines of business, the first being the six steel joist plants which made the steel frames seen in many buildings. The second line included four steel mills that utilised the innovative mini-mill technology to supply first the joist plants and later outside customers. Nucor was still only the seventh-largest steel company in
America. Over its second 20 years, Nucor was to rise to become the second-largest US steel company. A number of significant challenges were to be met and overcome to get there, and once that horizon was reached, even greater challenges would arise. The following are the systems Nucor built and its organisation, divisions, management and incentive system.

**NUCOR’S ORGANISATION**

In the early 1990s, Nucor had 22 divisions (up to 30 by 2005), one for every plant, each of which had a general manager, who was also a vice president of the corporation. The divisions were of three basic types: joist plants, steel mills and miscellaneous plants. The corporate staff consisted of fewer than 45 people (25 in the 1990s). In the beginning Iverson had chosen Charlotte ‘as the new home base for what he had envisioned as a small cadre of executives who would guide a decentralized operation with liberal authority delegated to managers in the field’, according to South magazine.

Iverson gave his views on keeping a lean organisation:

Each division is a profit centre and the division manager has control over the day-to-day decisions that make that particular division profitable or not profitable. We expect the division to provide contribution, which is earnings before corporate expenses. We do not allocate our corporate expenses, because we do not think there is any way to do this reasonably and fairly. We do focus on earnings. And we expect a division to earn 25 percent return on total assets employed, before corporate expenses, taxes, interest or profit sharing. And we have a saying in the company – if a manager doesn’t provide that for a number of years, we are either going to get rid of the division or get rid of the general manager, and it’s generally the division manager.

A joist division manager commented on being in an organisation with only four levels:

I’ve been a division manager four years now and at times I’m still awed by it: the opportunity I was given to be a Fortune 500 vice president... I think we are successful because it is our style to pay more attention to our business than our competitors... We are kind of a ‘no nonsense’ company.

The divisions did their own manufacturing, selling, accounting, engineering and personnel management. A steel division manager, when questioned about Florida Steel, which had a large plant 145 kilometres away, commented, ‘I expect they do have more of the hierarchy.

I think they have central purchasing, centralised sales, centralised credit collections, centralized engineering, and most of the major functions’.

Nucor strengthened its position by developing strong alliances with outside parties. It did no internal research and development. Instead, it monitored other’s work worldwide and attracted investors who brought it new technical applications at the earliest possible dates. Although Nucor was known for constructing new facilities at the lowest possible costs, its engineering and construction team consisted of only three individuals. They did not attempt to specify exact equipment parameters, but asked the equipment supplier to provide this information and then held the manufacturer accountable. Nucor had alliances with selected construction companies around the country who knew the kind of work the company wanted. Nucor bought 95 per cent of its scrap steel from an independent broker who followed the market and made recommendations regarding scrap purchases. It did not have a corporate advertising department, a corporate public relations department, or a corporate legal or environmental department. It had long-term relationships with outsiders to provide these services.

The steel industry had established a pattern of absorbing the cost of shipment so, regardless of the distance from the mill, all users paid the same delivered price. Nucor broke with this tradition and stopped equalising freight. It offered all customers the same sales terms. Nucor also gave no volume discounts, feeling that with modern computer systems there was no justification. Customers located next to the plant guaranteed themselves the lowest possible costs for steel purchases. Two tube manufactures, two steel service centres and a cold rolling facility had located adjacent to the Arkansas plant. These facilities accounted for 60 per cent of the shipments from the mill. The plants were linked electronically to each other’s production schedules, allowing them to function in a just-in-time inventory mode. All new mills were built on large enough tracks of land to accommodate collaborating businesses.

Iverson didn’t feel greater centralisation would be good for Nucor. Hamilton Lott, a Vulcraft plant manager, commented in 1997, ‘We’re truly autonomous; we can duplicate efforts made in other parts of Nucor. We might develop the same computer program six times. But the advantages of local autonomy make it worth it’. Joe Rutkowski, manager at Darlington steel, agreed. ‘We’re not constrained; headquarters doesn’t restrict what I spend. I just have to make my profit contribution at the end of year.’
South magazine observed that Iverson had established a characteristic organisational style described as ‘stripped down’ and ‘no nonsense’. ‘Jack Benny would like this company,’ observed Roland Underhill, an analyst with Crowell, Weedon and Co. of Los Angeles. ‘So would Peter Drucker.’ Underhill pointed out that Nucor’s thriftiness didn’t end with its ‘spartan’ office staff or modest offices. ‘There are no corporate perquisites,’ he recited. ‘No company planes. No country club memberships. No company cars.’

Fortune noted: ‘Iverson takes the subway when he is in New York,’ a Wall Street analyst reports in a voice that suggests both admiration and amazement.’ The general managers reflected this style in the operation of their individual divisions. Their offices were more like plant offices or the offices of private companies built around manufacturing rather than for public appeal. They were simple, routine and businesslike.

DIVISION MANAGERS

The corporate personnel manager described management relations as informal, trusting and not ‘bureaucratic’. He felt there was a minimum of paperwork, that a phone call was more common than memos, and that no confirming memo was thought to be necessary.

A Vulcraft manager commented: ‘We have what I would call a very friendly spirit of competition from one plant to the next. And of course all of the vice presidents and general managers share the same bonus systems so we are in this together as a team even though we operate our divisions individually.’ He added: ‘When I came to this plant four years ago, I saw we had too many people, too much overhead. We had 410 people at the plant and I could see, from my experience at the Nebraska plant, we had many more than we needed. Now with 55 fewer men, we are still capable of producing the same number of tons as four years ago.’

The divisions managed their activities with a minimum of contact with the corporate staff. Each day disbursements were reported to the corporate office. Payments flowed into regional lock-boxes. On a weekly basis, joist divisions reported total quotes, sales cancellations, backlog and production. Steel mills reported tonnes-rolled, outside shipments, orders, cancellations and backlog.

Each month the divisions completed a two-page ‘Operations Analysis’, which was sent to all the managers. Its three main purposes were (1) financial consolidation, (2) sharing information among the divisions and (3) corporate management examination. The summarised information and the performance statistics for all the divisions were then returned to the managers.

The general managers met three times a year. In late October they presented preliminary budgets and capital requests. In late February they met to finalise budgets and treat miscellaneous matters. Then, at a meeting in May, they handled personnel matters, such as wage increases and changes of policies or benefits. The general managers as a group considered the raises for the department heads, the next lower level of management for all the plants.

VULCRAFT – THE JOIST DIVISIONS

One of Nucor’s major businesses was the manufacture and sale of open web steel joists and joist girders at seven Vulcraft divisions located in Florence, South Carolina; Norfolk, Nebraska; Ft Payne, Alabama; Grapeland, Texas; St Joe, Indiana; Brigham City, Utah; and Chemung, New York. Open web joists, in contrast to solid joists, were made of steel angle iron separated by round bars or smaller angle iron. These joists cost less, were of greater strength for many applications, and were used primarily as the roof support systems in larger buildings, such as warehouses and shopping malls.

The joist industry was characterised by high competition among many manufacturers for many small customers. With an estimated 40 per cent of the market, Nucor was the largest supplier in the United States. It utilised national advertising campaigns and prepared competitive bids on 80 to 90 per cent of the buildings using joists. Competition was based on price and delivery performance. Nucor had developed computer programs to prepare designs for customers and to compute bids based on current prices and labour standards. In addition, each Vulcraft plant maintained its own engineering department to help customers with design problems or specifications. The Florence manager commented: ‘Here on the East Coast we have six or seven major competitors; of course none of them are as large as we are. The competition for any order will be heavy, and we will see six or seven different prices.’ He added: ‘I think we have a strong selling force in the market place. It has been said to us by some of our competitors that in this particular industry we have the finest selling organization in the country.’

Nucor aggressively sought to be the lowest-cost producer in the industry. Materials and freight were two important elements of cost. Nucor maintained its own fleet of almost 150 trucks to ensure on-time delivery to
all of the states, although most business was regional due to transportation costs. Plants were located in rural areas near the markets they served. Nucor’s move into steel production was a move to lower the cost of steel used by the joist business.

**JOIST PRODUCTION**

On the basic assembly line used at the joist divisions, three or four of which might make up any one plant, about six tonnes of joists per hour would be assembled. In the first stage eight people cut the angles to the right lengths or bend the round bars to the desired form. These were moved on a roller conveyer to six-man assembly stations, where the component parts would be tacked together for the next stage, welding. Drilling and miscellaneous work were done by three people between the lines. The nine-man welding station completed the welds before passing the joists on roller conveyers to two-man inspection teams. The last step before shipment was the painting.

The workers had control over and responsibility for quality. There was an independent quality control inspector who had the authority to reject the run of joists and cause them to be reworked. The quality control people were not under the incentive system and reported to the engineering department.

Daily production might vary widely, since each joist was made for a specific job. The wide range of joists made control of the workload at each station difficult; bottlenecks might arise anywhere along the line. Each workstation was responsible for identifying such bottlenecks so that the foreman could reassign people promptly to maintain productivity. Because workers knew most of the jobs on the line, including the more skilled welding job, they could be shifted as needed. Work on the line was described by one general manager as ‘not machine type but mostly physical labor’. He said the important thing was to avoid bottlenecks.

There were four lines of about 28 people each on two shifts at the Florence division. The jobs on the line were rated on responsibility and assigned a base wage, from US$11 to US$13 per hour. In addition, a weekly bonus was paid on the total output of each line. Each worker received the same percentage bonus on his other base wage. The Texas plant was typical, with the bonus running 225 per cent, giving a wage of US$27 an hour in 1999.

The amount of time required to make a joist had been established as a result of experience; the general manager had seen no time studies in his 15 years with the company. As a job was bid, the cost of each joist was determined through the computer program. The time required depended on the length, number of panels and depth of the joist. At the time of production, the labour value of production, the standard, was determined in a similar manner. The South Carolina general manager stated, ‘In the last nine or ten years we have not changed a standard’.

The Grapeland plant maintained a time chart, which was used to estimate the labour required on a job. The plant teams were measured against this time for bonus. The chart was based on the historical time required on the jobs. Every few years the time chart was updated. Because some of the changes in performance were due to equipment changes, generally the chart would be increased by half the change and the employee would benefit in pay from the other half. The last change, in 2003, saw some departments pay increased by as much as 10 per cent. The production manager at Grapeland considered himself an example for the Nucor policy – ‘the sky is the limit’. He had started in an entry position and risen to the head of this plant of 200 people.

Exhibit 1 shows the productivity of the South Carolina plant in tonnes per man-hour for a number of years. The year 1999 set a record for overall tonnage before a downturn that bottomed in 2002, but had begun to rise again by 2004.

**EXHIBIT 1 Tonnes per man-hour**

<table>
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<th>Year</th>
<th>Tonnage</th>
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<tbody>
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<tr>
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</tr>
<tr>
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</tr>
<tr>
<td>1981</td>
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<td>2000</td>
<td>0.241</td>
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**STEEL DIVISIONS**

Nucor moved into the steel business in 1968 to provide raw material for the Vulcraft plants. Iverson said, ‘We got into the steel business because we wanted to build a mill that could make steel as cheaply as we were buying it from foreign importers or from offshore mills’. Thus, Nucor
entered the industry using the new mini-mill technology after taking a task force of four people around the world to investigate new technological advancements. A case writer from Harvard recounted the development of the steel divisions:

By 1967 about 60 percent of each Vulcraft sales dollar was spent on materials, primarily steel. Thus, the goal of keeping costs low made it imperative to obtain steel economically. In addition, in 1967 Vulcraft bought about 60 percent of its steel from foreign sources. As the Vulcraft Division grew, Nucor became concerned about its ability to obtain an adequate economical supply of steel and in 1968 began construction of its first steel mill in Darlington, South Carolina. By 1972 the Florence, South Carolina, joist plant was purchasing over 90 percent of its steel from this mill. The Fort Payne, Alabama, plant bought about 50 percent of its steel from Florence. Since the mill had excess capacity, Nucor began to market its steel products to outside customers. In 1972, 75 percent of the shipments of Nucor steel was to Vulcraft and 25 percent was to other customers.

Between 1973 and 1981 Nucor constructed three more bar mills and their accompanying rolling mills to convert the billets into bars, flats, rounds, channels and other products. Iverson explained in 1984:

In constructing these mills we have experimented with new processes and new manufacturing techniques. We serve as our own general contractor and design and build much of our own equipment. In one or more of our mills we have built our own continuous casting unit, reheat furnaces, cooling beds and in Utah even our own mill stands. All of these to date have cost under $125 per ton of annual capacity – compared with projected costs for large integrated mills of $1,200–$1,500 per ton of annual capacity, ten times our cost. Our mills have high productivity. We currently use less than four man hours to produce a ton of steel. Our total employment costs are less than $60 per ton compared with the average employment costs of the seven largest U.S. steel companies of close to $130 per ton. Our total labour costs are less than 20 percent of our sales price.

In 1987 Nucor was the first steel company in the world to begin to build a mini-mill to manufacture steel sheet, the raw material for the auto industry and other major manufacturers. This project opened up another 50 percent of the total steel market. The first plant, in Crawfordsville, Indiana, was successful, and three additional sheet mills were constructed between 1989 and 1990. Through the years these steel plants were significantly modernised and expanded until the total capacity was three million tonnes per year at a capital cost of less than US$170 per tonne by 1999. Nucor’s total steel production capacity was 5.9 million tonnes per year at a cost of US$300 per tonne of annual capacity. The eight mills sold 80 per cent of their output to outside customers and the balance to other Nucor divisions.

By 2005, Nucor had 16 steel facilities producing three times as much steel as in 1999. The number of bar mills had grown to nine mills with capacity of 6 million tonnes by the addition of Birmingham’s four mills with 2 million tonnes and Auburn’s 400,000 tonnes. The sheet mills grew to four and increased capacity one-third with the acquisition of Trico. Nucor-Yamato’s structural steel capacity was increased by half a million tonnes from the South Carolina plant. The new million-tonne plate mill opened in North Carolina in 2000. Ninety-three per cent of production was sold to outside customers.

All four of the original ‘bar mills’ were actually two mills operating side by side. One mill concentrated on the larger bar products, which had separate production and customer demands, while the other mill concentrated on smaller diameter bar stock. Throughout Nucor each operation was housed in its own separate building with its own staff. Nucor designed its processes to limit work-in-process inventory, to limit space, to utilise a pull approach to material usage and to increase flexibility.

The Steelmaking Process

A steel mill’s work is divided into two phases: preparation of steel of the proper ‘chemistry’ and the forming of the steel into the desired products. The typical mini-mill utilised scrap steel, such as junk car parts, instead of iron ore, which would be used in larger, integrated steel mills. The typical bar mini-mill had an annual capacity of 200,000 to 600,000 tonnes, compared with the 7 million tonnes of Bethlehem Steel’s Sparrow’s Point, Maryland, integrated plant.

In the bar mills, a charging bucket fed loads of scrap steel into electric arc furnaces. The melted load, called a heat, was poured into a ladle to be carried by an overhead crane to the casting machine. In the casting machine, the liquid steel was extruded as a continuous, red-hot solid bar of steel and cut into lengths weighing some 400 kg called billets. In the typical plant, the billet, about 10 cm in cross-section and about 600 cm long, was held temporarily in a pit where it cooled to normal temperatures. Periodically billets were carried to the rolling mill and placed in a reheat oven to bring them up to 1090°C, at which temperature they would be malleable.

In the rolling mill, presses and dies progressively converted the billet into the desired round bars, angles, channels, flats and other products. After being cut to standard lengths, they were moved to the warehouse.
CASE SIX: NUCOR IN 2005

Nucor’s first steel mill, which employed more than 500 people, was located in Darlington, South Carolina. The mill, with its three electric arc furnaces, operated 24 hours per day, five-and-a-half days per week. Nucor had made a number of improvements in the melting and casting operations. The general manager of the Darlington plant developed a system that involved preheating the ladles, allowing for the faster flow of steel into the caster and resulting in better control of the steel characteristics. Thus, less time and lower capital investment were required at Darlington than at other mini-mills at the time of its construction. The casting machines were ‘continuous casters’, as opposed to the old batch method. The objective in the ‘front’ of the mill was to keep the casters working. At the time the Darlington plant was also perhaps the only mill in the country that regularly avoided the reheating of billets. This saved US$10–12 per tonne in fuel usage and losses due to oxidation of the steel. The cost of developing this process had been US$12 million. All research projects had not been successful. The company spent approximately US$2 million in an unsuccessful effort to utilise resistance-heating. It lost even more on an effort at induction melting. As Iverson told Metal Producing: ‘That costs us a lot of money. Time wise it was very expensive. But you have got to make mistakes and we’ve had lots of failures.’

The Darlington design became the basis for plants in Nebraska, Texas and Utah. The Texas plant had cost under US$80 per tonne of annual capacity. Whereas the typical mini-mill at the time cost approximately US$250 per tonne, the average cost of Nucor’s four mills was under US$135. An integrated mill was expected to cost between US$1200 and US$1500 per tonne.

The Darlington plant was organised into 12 natural groups for the purpose of incentive pay. Two mills each had two shifts with three groups – melting and casting, rolling mill and finishing. In melting and casting there were three or four different standards, depending on the material, established by the department manager years ago based on historical performance. The general manager stated, ‘We don’t change the standards’. The caster, key to the operation, was used at a 92 per cent level – one greater than the claims of the manufacturer. For every good tonne of billet above the standard hourly rate for the week, workers in the group received a 4 per cent bonus. For example, with a common standard of 10 tonnes per run hour and an actual rate for the week of 28 tonnes per hour, the workers would receive a bonus of 72 per cent of their base rate in the week’s pay cheque. In the rolling mill there were more than 100 products, each with a different historical standard. Workers received a 4 per cent to 6 per cent bonus for every good tonne sheared per hour for the week over the computed standard. A manager stated: ‘Meltshop employees don’t ask me how much it costs Chaparral or LTV to make a billet. They want to know what it costs Darlington, Norfolk, Jewitt to put a billet on the ground. . . Scrap costs, alloy costs, electrical costs, refractory, gas, etc. Everybody from Charlotte to Plymouth watches the nickels and dimes.’

MANAGEMENT PHILOSOPHY

Aycock, while still the Darlington manager, stated:

The key to making a profit when selling a product with no aesthetic value, or a product that you really can’t differentiate from your competitors’, is cost. I don’t look at us as a fantastic marketing organization, even though I think we are pretty good; but we don’t try to overcome unreasonable costs by mass marketing. We maintain low costs by keeping the employee force at the level it should be, not doing things that aren’t necessary to achieve our goals, and allowing people to function on their own and by judging them on their results.

To keep a cooperative and productive workforce you need, number one, to be completely honest about everything; number two, to allow each employee as much as possible to make decisions about that employee’s work, to find easier and more productive ways to perform duties; and number three, to be as fair as possible to all employees. Most of the changes we make in work procedures and in equipment come from the employees. They really know the problems of their jobs better than anyone else.

To communicate with my employees, I try to spend time in the plant and at intervals have meetings with the employees. Usually if they have a question they just visit me. Recently a small group visited me in my office to discuss our vacation policy. They had some suggestions and, after listening to them, I had to agree that the ideas were good.

In discussing his philosophy for dealing with the workforce, the Florence manager stated:

I believe very strongly in the incentive system we have. We are a non-union shop and we all feel that the way to stay so is to take care of our people and show them we care. I think that’s easily done because of our fewer layers of management . . . I spend a good part of my time in the plant, maybe an hour or so a day. If a man wants to know anything, for example an insurance question, I’m there and they walk right up to me and ask me questions, which I’ll answer the best I know how.
We don’t lay our people off and we make a point of telling our people this. In the slowdown of 1994, we scheduled our line for four days, but the men were allowed to come in the fifth day for maintenance work at base pay. The men in the plant on an average running bonus might make $17 to $19 an hour. If their base pay is half that, on Friday they would only get $8–$9 an hour. Surprisingly, many of the men did not want to come in on Friday. They felt comfortable with just working four days a week. They are happy to have that extra day off.

About 20 per cent of the people took the fifth day at base rate, but still no one had been laid off, in an industry with a strong business cycle.

In an earlier business cycle the executive committee decided in view of economic conditions that a pay freeze was necessary. The employees normally received an increase in their base pay the first of June. The decision was made at that time to freeze wages. The officers of the company, as a show of good faith, accepted a 5 per cent pay cut. In addition to announcing this to the workers with a stuffer in their pay envelopes, meetings were held. Each production line, or incentive group of workers, met in the plant conference room with all supervision – foreman, plant production manager and division manager. The economic crisis that the company was facing was explained to the employees by the production manager and all of their questions were answered.

### THE PERSONNEL AND INCENTIVE SYSTEMS

The foremost characteristic of Nucor’s personnel system was its incentive plan. Another major personnel policy was providing job security. Also, all employees at Nucor received the same fringe benefits. There was only one group insurance plan. Holidays and vacations did not differ by job. Every child of every Nucor employee received up to US$1200 a year for four years if they chose to go on to higher education, including technical schools. The company had no executive dining rooms or restrooms, and no fishing lodges, company cars, or reserved parking places.

Jim Coblin, Nucor’s vice president of human resources, described Nucor’s systems for *HR Magazine* in a 1994 article: ‘No-frills HR at Nucor: A lean, bottom-line approach at this steel company empowers employees.’ Coblin, as benefits administrator, received part-time help from one of the corporate secretaries in the corporate office. The plants typically used someone from their finance department to handle compensation issues, although two plants had personnel generalists.

Nucor plants did not have job descriptions, finding they caused more problems than they solved, given the flexible workforce and non-union status of Nucor employees. Surprisingly, Coblin found performance appraisal a waste of time. If an employee was not performing well, the problem would be dealt with directly. He had observed that when promotional opportunities became available, the performance appraisals were not much help filling the position. So he saw both of these as just more paperwork. The key, he believed, was not to put a maximum on what employees could earn but to pay them directly for productivity. Iverson firmly believed that the bonus should be direct and involve no discretion on part of a manager.

Employees were kept informed about the company. Charts showing the division’s results in return-on-assets and bonus payoff were posted in prominent places in the plant. The personnel manager commented that as he travelled around to all the plants, he found everyone in the company could tell him the level of profits in their division. The general managers held dinners at least once but usually twice a year with their employees. The dinners were held with 50 or 60 employees at a time, resulting in as many as 20 dinners per year. After introductory remarks, the floor was open for discussion of any work-related problems. There was a new employee orientation program and an employee handbook that contained personnel policies and rules. The corporate office sent all news releases to each division where they were posted on bulletin boards. Each employee in the company also received a copy of the annual report. For the last several years the cover of the annual report had contained the names of all Nucor employees.

Absenteism and tardiness was not a problem at Nucor. Each employee had four days of absences before pay was reduced. In addition to these, missing work was allowed for jury duty, military leave, or the death of close relatives. After this, a day’s absence cost employees their bonus pay for that week and lateness of more than a half-hour meant the loss of bonus for that day.

Safety was a concern of Nucor’s critics. With 10 fatalities in the 1980s, Nucor was committed to doing better. Safety administrators had been appointed in each plant and safety had improved in the 1990s. The company also had a formal grievance procedure, although the Darlington manager couldn’t recall the last grievance he had processed.

The company had conducted attitude surveys every three years for over two decades. These provided management insight into employee attitudes on 20 issues and allowed comparisons across plants and divisions.
There were some concerns and differences but most employees appeared very satisfied with Nucor as an employer. The surveys suggested that pay was not the only thing the workers liked about Nucor. The personnel manager said that an NBC interviewer, working on the documentary ‘If Japan Can, Why Can’t We’, often heard employees say, ‘I enjoy working for Nucor because Nucor is the best, the most productive, and the most profitable company that I know of’.

The average hourly worker’s pay was over twice the average earnings paid by other manufacturing companies in the states where Nucor’s plants were located. In many rural communities where Nucor had located, it provided better wages than most other manufacturers. The new plant in Hertford County illustrated this point, as reported in a 21 June 1998, article in the Charlotte Observer titled ‘Hope on the Horizon: In Hertford County, Poverty Reigns and Jobs Are Scarce’. Here the author wrote: ‘In North Carolina’s forgotten northeastern corner, where poverty rates run more than twice the state average, Nucor’s US$300 million steel mill is a dream realised. . .’ The plant on the banks of the Chowan River in North Carolina’s banks coastal district would have its employees earning a rumored US$60,000 a year, three times the local average manufacturing wage, upon completion. Nucor had recently begun developing its plant sites with the expectation of other companies co-locating to save shipping costs. Four companies have announced plans to locate close to Nucor’s property, adding another 100 to 200 jobs. People couldn’t believe such wages, but calls to the plant’s chief financial officer got ‘we don’t like to promise too much, but US$60,000 might be a little low’. The average wage for these jobs at Darlington was US$70,000. The plant’s CFO added that Nucor didn’t try to set pay ‘a buck over Wal-Mart’ but went for the best workers. The article noted that steel work is hot and often dangerous, and that turnover at the plant may be high as people adjust to this and Nucor’s hard-driving team system. He added, ‘Slackers don’t last’. The state of North Carolina had given US$155 million in tax credits over 25 years. The local preacher said ‘In 15 years, Baron [a local child] will be making US$75,000 a year at Nucor, not in jail. I have a place now I can hold in front of him and say “Look, right here. This is for you”’.

THE INCENTIVE SYSTEM

There were four incentive programs at Nucor, one each for (1) production workers, (2) department heads, (3) staff people, such as accountants, secretaries and engineers, and (4) senior management. All of these programs were based on group performance.

Within the production program, groups ranged in size from 25 to 30 people and had definable and measurable operations. The company believed that a program should be simple and that bonuses should be paid promptly. ‘We don’t have any discretionary bonuses – zero. It is all based on performance. Now we don’t want anyone to sit in judgment, because it never is fair’ said Iverson. The personnel manager stated: ‘Their bonus is based on roughly 90 per cent of historical time it takes to make a particular joist. If during a week they make joists at 60 per cent less than the standard time, they receive a 60 per cent bonus.’ This was paid with the regular pay the following week. The complete pay cheque amount, including overtime, was multiplied by the bonus factor. A bonus was not paid when equipment was not operating: ‘We have the philosophy that when equipment is not operating everybody suffers and the bonus for downtime is zero.’ The foremen were also part of the group and received the same bonus as the employees they supervised.

The second incentive program was for department heads in the various divisions. The incentive pay here was based on division contribution, defined as the division earnings before corporate expenses and profit sharing are determined. Bonuses were reported to run between 0 and 90 per cent (average 35–50 per cent) of a person’s base salary. The base salaries at this level were set at 75 per cent of industry norms.

There was a third plan for people who were not production workers, department managers or senior managers. Their bonus was based on either the division return-on-assets or the corporate return-on-assets depending on the unit they were a part of. Bonuses were typically 30 per cent or more of a person’s base salary for corporate positions.

The fourth program was for the senior officers. The senior officers had no employment contracts, pension or retirement plans, or other perquisites. Their base salaries were set at about 75 per cent of what an individual doing similar work in other companies would receive. Once return-on-equity reached 9 per cent, slightly below the average for manufacturing firms, 5 per cent of net earnings before taxes went into a pool, which was divided among the officers based on their salaries. ‘Now if return-on-equity for the company reaches, say 20 per cent, which it has, then we can wind up with as much as 190 per cent of our base salaries and 115 per cent on top of that in stock. We get both.’ Half the
bonus was paid in cash and half was deferred. Individual bonuses ranged from zero to several hundred per cent, averaging 75 to 150 per cent.

However, the opposite was true as well. In 1982 the return was 8 per cent and the executives received no bonus. Iverson’s pay in 1981 was approximately US$300,000 but dropped the next year to US$110,000. ‘I think that ranked by total compensation I was the lowest paid CEO in the Fortune 500. I was kind of proud of that, too.’ In his 1997 book, Plain Talk: Lessons from a Business Maverick, Iverson asked, ‘Can management expect employees to be loyal if we lay them all off at every dip of the economy, while we go on padding our own pockets?’ Even so by 1986, Iverson’s stock was worth over US$10 million dollars and the one-time Vulcraft manager was a millionaire.

In lieu of a retirement plan, the company had a profit sharing plan with a deferred trust. Each year 10 per cent of pretax earnings was put into profit sharing for all people below officer level. Twenty per cent of this was set aside to be paid to employees in the following March as a cash bonus and the remainder was put into trust for each employee on the basis of percentage of their earnings as a percentage of total wages paid within the corporation. The employee was vested after the first year. Employees received a quarterly statement of their balance in profit sharing.

The company had an employer monthly stock investment plan to which Nucor added 10 per cent to the amount the employee contributed on the purchase of any Nucor stock and paid the commission. After each five years of service with the company, the employee received a service award consisting of five shares of Nucor stock. Moreover, if profits were good, extraordinary bonus payments would be made to the employees. For example, in December 1998 each employee received an US$800 payment.

According to Iverson:

I think the first obligation of the company is to the stockholder and to its employees. I find in this country too many cases where employees are underpaid and corporate management is making huge social donations for self-fulfillment. We regularly give donations, but we have a very interesting corporate policy. First, we give donations where our employees are. Second, we give donations that will benefit our employees, such as to the YMCA. It is a difficult area and it requires a lot of thought. There is certainly a strong social responsibility for a company, but it cannot be at the expense of the employees or the stockholders.

Having welcomed a parade of visitors over the years, Iverson had become concerned with the pattern apparent at other companies’ steel plants: ‘They only do one or two of the things we do. It’s not just incentives or the scholarship program; it’s all those things put together that results in a unified philosophy for the company.’

**BUILDING ON ITS SUCCESS**

Throughout the 1980s and 1990s Nucor continued to take the initiative and be the prime mover in steel and the industries vertically related to steel. For example, in 1984 Nucor broke with the industry pattern of basing the price of an order of steel on the quantity ordered. Iverson noted, ‘Some time ago we began to realize that with computer order entry and billing, the extra charge for smaller orders was not cost-justified’. In a seemingly risky move, in 1986 Nucor began construction of a US$25 million plant in Indiana to manufacture steel fasteners. Imports had grown to 90 per cent of this market as US companies failed to compete. Iverson said ‘We’re going to bring that business back; we can make bolts as cheaply as foreign producers’. A second plant, in 1995, gave Nucor 20 per cent of the US market for steel fasteners. Nucor also acquired a steel bearings manufacturer in 1986, which Iverson called ‘a good fit with our business, our policies and our people’.

In early 1986 Iverson announced plans for a revolutionary plant at Crawfordsville, Indiana, which would be the first mini-mill in the world to manufacture flat-rolled or sheet steel, the last bastion of the integrated manufacturers. This market alone was twice the size of the existing market for mini-mill products. It would be a quarter of a billion dollar gamble on a new technology. The plant was expected to halve the integrated manufacturer’s US$3 of labour per tonne and save US$50 to US$75 on a US$400 per tonne selling price. If it worked, the profit from this plant alone would come close to the profit of the whole corporation. Forbes commented: ‘If any mini-mill can meet the challenge, it’s Nucor. But expect the going to be tougher this time around.’ If successful, Nucor had the licensing rights to the next two plants built in the world with this technology.

Nucor had spent millions trying to develop the process when it heard of some promising developments at a German company. In the spring of 1986, Aycock flew to Germany to see the pilot machine at SMS Schloemann-Siemag AG. In December the Germans came to Charlotte for the first of what they thought would be many meetings to hammer out a deal with Nucor. Iverson shocked them when he announced Nucor was ready to proceed to build the first plant of its kind.

Keith Busse was given the job of building the Crawfordsville, Indiana, steel sheet plant. The process of bringing this plant online was so exciting it became the basis for a best-selling book by Robert Preston, which
was serialised in *The New Yorker*. Preston reported on a conversation at dinner during construction between Iverson and Busse. Thinking about the future, Busse was worried that Nucor might someday become like Big Steel. He asked: ‘How do we allow Nucor to grow without expanding the bureaucracy?’ He commented on the vice presidents stacked on vice presidents, research departments, assistants to assistants and so on. Iverson agreed. Busse seriously suggested, ‘Maybe we’re going to need group vice presidents’. Iverson’s heated response was, ‘Do you want to ruin the company? That’s the old Harvard Business School thinking. They would only get in the way, slow us down’. He said the company could at least double, to US$2 billion, before it added a new level of management. ‘I hope that by the time we have group vice presidents I’ll be collecting Social Security.’

The gamble on the new plant paid off, and Busse, the general manager of the plant, became a key man within Nucor. The new mill began operations in August of 1989 and reached 15 per cent of capacity by the end of the year. In June of 1990 it had its first profitable month and Nucor announced the construction of a second plant, in Arkansas.

In December 1992, Nucor signed a letter of intent with Oregon Steel Mills to build a sheet mill on the West Coast to begin in 1994. This project was later cancelled. The supply and cost of scrap steel to feed the mini-mills was an important future concern to Iverson. So at the beginning of 1993 Nucor announced the construction of a plant in Trinidad to supply its mills with iron carbide pellets. The innovative plant would cost US$60 million and take a year and a half to complete. In 1994 the two existing sheet mills were expanded and a new US$500 million, 1.8 million tonne sheet mill in South Carolina was announced, to begin operation in early 1997.

In what the *New York Times* called the company’s ‘most ambitious project yet’, in 1987 Nucor began a joint venture with Yamato Kogyo Ltd to make structural steel products in a mill on the Mississippi River in direct challenge to the Big Three integrated steel companies. John Correnti was put in charge of the operation. Correnti built and then became the general manager of Nucor-Yamato when it started up in 1988. In 1991 he surprised many people by deciding to double Nucor-Yamato’s capacity by 1994. It became Nucor’s largest division and the largest wide flange producer in the United States. By 1995, Bethlehem Steel was the only other wide flange producer in the United States. By 1995, Bethlehem Steel became Nucor’s largest division and the largest wide flange producer in the United States. By 1995, Bethlehem Steel was the only other wide flange producer in the United States. By 1995, Bethlehem Steel was the only other wide flange producer in the United States. By 1995, Bethlehem Steel was the only other wide flange producer in the United States. By 1995, Bethlehem Steel was the only other wide flange producer in the United States.

Nucor started up its first facility to produce metal buildings in 1987. A second metal buildings facility began operations in late 1996 in South Carolina and a new steel deck facility, in Alabama, was announced for 1997. At the end of 1997 the Arkansas sheet mill was undergoing a US$120 million expansion to include a galvanising facility.

In 1995 Nucor became involved in its first international venture, an ambitious project with Brazil’s Companhia Siderurgica National to build a US$700 million steel mill in the state of Ceara. While other mini-mills were cutting deals to buy and sell abroad, Nucor was planning to ship iron from Brazil and process it in Trinidad.

Nucor set records for sales and net earnings in 1997. In the spring of 1998, as Iverson approached his 73rd birthday, he was commenting: ‘People ask me when I’m going to retire. I tell them our mandatory retirement age is 95, but I may change that when I get there.’ It surprised the world when, in October 1998, Ken Iverson left the board. He retired as chairman at the end of the year. Although sales for 1998 decreased one per cent and net earnings were down 10 per cent, the management made a number of long-term investments and closed draining investments. Start-up began at the new South Carolina steam mill and at the Arkansas sheet mill expansion. The plans for a North Carolina steel plate mill in Hertford were announced. This would bring Nucor’s total steel production capacity to 12 million tonnes per year. Moreover, the plant in Trinidad, which had proven much more expensive than was originally expected, was deemed unsuccessful and closed. Finally, directors approved the repurchase of up to five million shares of Nucor stock.

Still, the downward trends at Nucor continued. Sales and earnings were down 3 per cent and 7 per cent respectively for 1999 (see Appendix 1 for financial reports and Appendix 2 for financial ratios). However, these trends did not seem to affect the company’s investments. Expansions were underway in the steel mills and a third building systems facility was under construction in Texas. Nucor was actively searching for a site for a joist plant in the Northeast. A letter of intent was signed with Australian and Japanese companies to form a joint venture to commercialise the strip casting technology. To understand the challenges facing Nucor, industry, technology and environmental trends in the 1980s and 1990s must be considered.

**The US Steel Industry in the 1980s**

The early 1980s had been the worst years in decades for the steel industry. Data from the American Iron and Steel Institute showed shipments falling from 100 million
tonnes in 1979 to the mid-80 levels in 1980 and 1981. A slackening in the economy, particularly in auto sales, led the decline. In 1986, when industry capacity was at 130 million tonnes, the outlook was for a continued decline in per-capita consumption and movement toward capacity in the 90–100 million-tonne range. The chairman of Armco saw ‘millions of tons chasing a market that’s not there: excess capacity that must be eliminated’.

The large, integrated steel firms, such as US Steel and Armco, which made up the major part of the industry, were the hardest hit. The Wall Street Journal stated: ‘The decline has resulted from such problems as high labour and energy costs in mining and processing iron ore, a lack of profits and capital to modernize plants, and conservative management that has hesitated to take risks.’

These companies produced a wide range of steels, primarily from ore processed in blast furnaces. They had found it difficult to compete with imports, usually from Japan, and had given market share to imports. They sought the protection of import quotas. Imported steel accounted for 20 per cent of the US steel consumption, up from 12 per cent in the early 1970s. The US share of world production of raw steel declined from 19 per cent to 14 per cent over the period. Imports of light bar products accounted for less than 9 per cent of the US consumption of those products in 1981, according to the US Commerce Department, while imports of wire rod totaled 23 per cent of US consumption.

Iron Age stated that exports, as a percentage of shipments in 1985, were 34 per cent for Nippon, 26 per cent for British Steel, 30 per cent for Krupp, 49 per cent for USINOR of France and less than 1 per cent for every American producer on the list. The consensus of steel experts was that imports would average 23 per cent of the market in the last half of the 1980s.

Iverson was one of the very few in the steel industry to oppose import restrictions. He saw an outdated US steel industry that had to change.

We Americans have been conditioned to believe in our technical superiority. For many generations a continuing stream of new inventions and manufacturing techniques allowed us to far outpace the rest of the world in both volume and efficiency of production. In many areas this is no longer true and particularly in the steel industry. In the last three decades, almost all the major developments in steelmaking were made outside the U.S. I would be negligent if I did not recognize the significant contribution that the government has made toward the technological deterioration of the steel industry. Unrealistic depreciation schedules, high corporate taxes, excessive regulation and jaw-boning for lower steel prices have made it difficult for the U.S. steel industry to borrow or generate the huge quantities of capital required for modernization.

By the mid-1980s the integrated mills were moving fast to get back into the game: they were restructuring, cutting capacity, dropping unprofitable lines, focusing products and trying to become responsive to the market. The industry made a pronounced move toward segmentation. Integrated producers focused on mostly flat-rolled and structural grades; reorganised steel companies focused on a limited range of products; mini-mills dominated the bar and light structural product areas; and specialty steel firms sought niches. There was an accelerated shutdown of older plants, elimination of products by some firms and the installation of new product line with new technologies by others. High-tonnage mills restructured to handle sheets, plates, structural beams, high quality bars and large pipe and tubular products, which allowed resurgence of specialised mills: cold-finished bar manufacturers, independent strip mills and mini-mills.

The road for the integrated mills was not easy. As Purchasing pointed out, tax laws and accounting rules slowed the closing of inefficient plants. Shutting down a 10000-person plant could require a firm to hold a cash reserve of US$100 million to fund health, pension and insurance liabilities. The chairman of Armco commented: ‘Liabilities associated with a planned shutdown are so large that they can quickly devastate a company’s balance sheet’.

Joint ventures had arisen to produce steel for a specific market or region. The chairman of USX called them ‘an important new wrinkle in steel’s fight for survival’ and stated, ‘If there had been more joint ventures like these two decades ago, the U.S. steel industry might have built only half of the dozen or so hot-strip mills it put up in that time and avoided today’s over-capacity’.

The American Iron and Steel Institute reported steel production in 1988 of 99.3 million tonnes, up from 89.2 million in 1987, and the highest in seven years. As a result of modernisation programs, 60.9 per cent of production was from continuous casters. Exports for steel increased and imports fell. Some steel experts believed the United States was now cost competitive with Japan. However, 1989 proved to be a year of ‘waiting for the other shoe to drop’, according to Metal Center News. US steel production was hampered by a new recession, the expiration of the voluntary import restraints and labour negotiations in several companies. Declines in
The economic slowdown of the early 1990s did lead to a decline in the demand for steel through early 1993, but by 1995 America was in its best steel market in 20 years and many companies were building new flat-roll mini-mills. A Business Week article at the time described it as ‘the race of the Nucor look-alikes’. Six years after Nucor pioneered the low-cost German technology in Crawfordsville, Indiana, the competition was finally gearing up to compete. Ten new projects were expected to add 20 million tonnes per year of the flat-rolled steel, raising US capacity by as much as 40 per cent by 1998. These mills opened in 1997 just as the industry was expected to move into a cyclical slump. It was no surprise that worldwide competition increased and companies that had previously focused on their home markets began a race to become global powerhouses. The foreign push was new for US firms that had focused on defending their home markets. US mini-mills focused their international expansion primarily in Asia and South America.

Meanwhile in 1994, US Steel, North America’s largest integrated steel producer, began a major business process re-engineering project to improve order fulfillment performance and customer satisfaction on the heels of a decade of restructuring. According to Steel Times International: ‘U.S. Steel had to completely change the way it did business. Cutting labour costs, and increasing reliability and productivity took the company a long way towards improving profitability and competitiveness. However, it became clear that this leaner organization still had to implement new technologies and business processes if it was to maintain a competitive advantage.’ The goals of the business process re-engineering project included a sharp reduction in cycle time, greatly decreased levels of inventory, shorter order lead times and the ability to offer real-time promise dates to customers. In 1995, the company successfully installed integrated planning/production/order fulfilment software and results were very positive. US Steel believed that the re-engineering project had positioned it for a future of increased competition, tighter markets and raised customer expectations.

In late 1997 and again in 1998, the decline in demand prompted Nucor and other US companies to slash prices in order to compete with the unprecedented surge of imports. By the last quarter of 1998 these imports had led to the filing of unfair trade complaints with US trade regulators, causing steel prices in the spot market to drop sharply in August and September before they stabilised. A press release by US Secretary of Commerce William Daley stated ‘I will not stand by and allow US workers, communities and companies to bear the brunt of other nations’ problematic policies and practices. We are the most open economy of the world. But we are not the world’s dumpster’. In early 1999 the American Iron and Steel Institute (AISI) reported in its Opinion section of its web page the following quotes by Andrew Sharkey and Hank Barnette. Sharkey said: ‘With many of the world’s economies in recession, and no signs of recovery on the horizon, it should come as no surprise that the United States is now seen as the only reliable market for manufactured goods. This can be seen in the dramatic surge of imports.’ Barnette noted: ‘While there are different ways to gauge the impact of the Asian crisis, believe me, it has already hit. Just ask the 163,000 employees of the U.S. steel industry.’

The Commerce Department concluded in March 1999 that six countries had illegally dumped stainless steel in the United States at prices below production costs or home market prices. The Commerce Department found that Canada, South Korea and Taiwan were guilty only of dumping, while Belgium, Italy and South Africa also gave producers unfair subsidies that effectively lowered prices. However, on 23 June 1999, the Wall Street Journal reported that the Senate decisively shut off an attempt to restrict US imports of steel despite industry complaints that a flood of cheap imports was driving them out of business. Advisors of President Clinton were reported to have said the President would likely veto the bill if it passed. Administrative officials opposed the bill because it would violate international trade law and leave the United States open to retaliation.

The American Iron and Steel Institute (AISI) reported that in May 1999, US steel mills shipped 8,330,000 net tonnes, a decrease of 6.7 per cent from the 8,927,000 net tonnes shipped in May 1998. It also stated that for the first five months of 1999 shipments were 41,205,000 net tonnes, down 10 per cent from the same period in 1998. AISI president and CEO Andrew Sharkey III said: ‘Once again, the May data show clearly that America’s steel trade crisis continues. US steel companies and employees continue to be injured by high levels of dumping and subsidized imports... In addition, steel inventory levels remain excessive, and steel operating rates continue to be very low.’
As the 1990s ended, Nucor was the second-largest steel producer in the United States, behind USX. The company’s market capitalisation was about two times that of the next smaller competitor. Even in a tight industry, someone can win. Nucor was in the best position because the industry was very fragmented and there were many marginal competitors.

**STEEL TECHNOLOGY AND THE MINI-MILL**

A new type of mill, the ‘mini-mill’, had emerged in the United States during the 1970s to compete with the integrated mill. The mini-mill used electric arc furnaces initially to manufacture a narrow product line from scrap steel. The leading US mini-mills in the 1980s were Nucor, Florida Steel, Georgetown Steel, North Star Steel and Chaparral. Between the late 1970s and 1980s, the integrated mills’ market share fell from about 90 per cent to about 60 per cent, with the integrated steel companies averaging a 7 per cent return on equity, the mini-mills averaging 14 per cent, and some, such as Nucor, achieving about 25 per cent. In the 1990s mini-mills tripled their output to capture 17 per cent of domestic shipments. Moreover, integrated mills’ market share fell to around 40 per cent, while mini-mills’ share rose to 23 per cent, reconstructed mills increased their share from 11 per cent to 28 per cent, and specialised mills increased their share from 1 per cent to 6 per cent.

Some experts believed that a relatively new technology, the twin shell electric arc furnace, would help mini-mills increase production, lower costs and take market share. According to the *Pittsburgh Business Times*: ‘With a twin shell furnace, one shell – the chamber holding the scrap to be melted – is filled and heated. During the heating of the first shell, the second shell is filled. When the heating is finished on the first shell, the electrodes move to the second. The first shell is emptied and refilled before the second gets hot.’ This increased the production by 60 per cent. Twin shell production had been widely adopted in the last few years. For example, Nucor Steel began running a twin shell furnace in November 1996 in Berkeley, South Carolina, and installed another in Norfolk, Nebraska, which began operations in 1997. ‘Everyone accepts twin shells as a good concept because there’s a lot of flexibility of operation,’ said Rodney Mott, vice president and general manager of Nucor-Berkeley. However, this move toward twin shell furnaces could mean trouble in the area of scrap availability. According to an October 1997 quote in *Pittsburgh Business Times* by Ralph Smaller, vice president of process technology at Kvaerner, ‘Innovations that feed the electric furnaces’ production of flat-rolled[steel] will increase the demand on high quality scrap and alternatives. The technological changes are just beginning and will accelerate over the next few years’.

According to a September 1997 *Industry Week* article, steelmakers around the world were now closely monitoring the development of continuous ‘strip casting’ technology, which may prove to be the next leap forward for the industry. ‘The objective of strip casting is to produce thin strips of steel (in the 1-mm to 4-mm range) as liquid steel flows from a tundish – the stationary vessel that received molten steel from the ladle. It would eliminate the slab-casting stage and all of the rolling that now takes place in a hot mill.’ Strip casting was reported to have some difficult technological challenges, but companies in Germany, France, Japan, Australia, Italy and Canada had strip-casting projects under way. In fact, all of the significant development work in strip casting was taking place outside the United States.

Larry Kavanagh, American Iron and Steel Institute vice president for manufacturing and technology, said ‘Steel is a very high-tech industry, but nobody knows it’. Today’s most productive steelmaking facilities incorporated advanced metallurgical practices, sophisticated process-control sensors, state-of-the-art computer controls and the latest refinements in continuous casting and rolling mill technology. Michael Shot, vice president of manufacturing at Carpenter Technology Corp. in Reading, Pennsylvania, a specialty steels and premium-grade alloys company, said, ‘You don’t survive in this industry unless you have the technology to make the best products in the world in the most efficient manner’.

**ENVIRONMENTAL AND POLITICAL ISSUES**

Not all stakeholders were happy with the way Nucor did business. In June 1998, *Waste News* reported that Nucor’s mill in Crawfordsville, Indiana, was cited by the US Environmental Protection Agency for alleged violations of federal and state clean-air rules. In addition to the incident in Indiana, concerns were also expressed in North Carolina. Specifically, the Pamlico-Tar River Foundation, the NC Coastal Federation and the Environmental Defense Fund had concerns about the state’s decision to allow the company to start building before the environmental review was completed. According to the *News & Observer* website, ‘The environmental groups charge that the mill will discharge 6,720 tons of pollutants into the air each year.’
Moreover, there were other concerns about the fast-track approval of the facility being built in Hertford County. First, this plant was located on the banks of one of the most important and sensitive stretches of the Chowan, a principle tributary to the national treasure Albemarle Sound and the last bastion of the state’s once vibrant river-herring fishery. North Carolina passed a law in 1997 that required the restoration of this fishery through a combination of measures designed to prevent overfishing, restore spawning and nursery habitats, and improve water quality in the Chowan. ‘New federal law requires extra care in protecting essential habitat for the herring, which spawn upstream,’ according to an article in the Business Journal. Second were the concerns regarding the excessive incentives the state gave to convince Nucor to build a US$300 million steel mill in North Carolina. Some questioned whether the promise of 300 well-paying jobs in Hertford County was worth the US$155 million in tax breaks the state was giving Nucor to locate here.

### MANAGEMENT EVOLUTION

As Nucor opened new plants, each was made a division and given a general manager with complete responsibility for all aspects of the business. The corporate office did not involve itself in the routine functioning of the divisions. There was no centralised purchasing, hiring and firing, or division accounting. The total corporate staff was still less than 25 people, including clerical staff, when 1999 began.

In 1984, Dave Aycock moved into the corporate office as president. Ken Iverson was chief executive officer and chairman. Iverson, Aycock and Sam Siegel operated as an executive board, providing overall direction to the corporation. By 1990 Aycock, who had invested his money wisely, owned over 600,000 shares of Nucor stock, five hotels and farms in three states, and was ready to retire. He was 60, five years younger than Iverson, and was concerned that if he waited, he and Iverson might be leaving the company at the same time. Two people stood out as candidates for the presidency: Keith Busse and John Correnti. In November, Iverson called Correnti to the Charlotte airport and offered him the job. Aycock commented, ‘Keith Busse was my choice, but I got outvoted’. In June 1991 Aycock retired and Keith Busse left Nucor to build an independent sheet mill in Indiana for a group of investors.

Thus Iverson, Correnti and Siegel led the company. In 1993, Iverson had heart problems and major surgery. Correnti was given the CEO role in 1996. The board of directors had always been small, consisting of the executive team and one or two past Nucor vice presidents. Several organisations with large blocks of Nucor stock had been pressing Nucor to diversify its board membership and add outside directors. In 1996 Jim Hlavacek, head of a small consulting firm and friend of Iverson, was added to the board.

Only five, not six, members of the Board were in attendance during the board of directors meeting in the fall of 1998, due to the death of Jim Cunningham. Near its end, Aycock read a motion, drafted by Siegel, that Ken Iverson be removed as chairman. It was seconded by Hlavacek and passed. It was announced in October that Iverson would be a chairman emeritus and a director, but after disagreements, Iverson left the company completely. It was agreed Iverson would receive US$500,000 a year for five years. Aycock left retirement to become chairman.

The details of Iverson’s leaving did not become known until June of 1999 when John Correnti resigned after disagreements with the board and Aycock took his place. All of this was a complete surprise to investors and brought the stock price down 10 per cent. Siegel commented, ‘The board felt Correnti was not the right person to lead Nucor into the 21st century’. Aycock assured everyone he would be happy to move back into retirement as soon as replacements could be found.

In December 1999 Correnti became chairman of rival Birmingham Steel, with an astonishing corporate staff of 156 people. With Nucor’s organisational changes, he predicted more overhead staff and questioned the company’s ability to move as fast in the future: ‘Nucor’s trying to centralize and do more mentoring. That’s not what grew the company to what it is today.’

Aycock moved ahead with adding outside directors to the board. He appointed Harvey Gantt, principal in his own architectural firm and former mayor of Charlotte; Victoria Haynes, formerly BF Goodrich’s chief technology officer; and Peter Browning, chief executive of Sonoco (biographical sketches of board members and executive management are provided in Appendices 3 and 4). Then he moved to increase the corporate office staff by adding a level of executive vice presidents over four areas of business and adding two specialist jobs in strategic planning and steel technology. When Siegel retired, Aycock promoted Terry Lisenby to CFO and treasurer, and hired a director of IT to report to Lisenby (see Exhibits 2 and 3, the organisation charts in 2000 and 2004).

Jim Coblin, vice president of human resources, believed the additions to management were necessary, ‘It’s not bad to get a little more like other companies’.
He noted that the various divisions did their business cards and plant signs differently; some did not even want a Nucor sign. Sometimes six different Nucor salesmen would call on the same customer. ‘There is no manager of human resources in the plants, so at least we needed to give additional training to the person who does most of that work at the plant,’ he stated. With these new additions there would be a director of information technology and two important committees, one for environmental issues and the second for audit.

He believed the old span of control of 20 might have worked well when there was less competition. Aycock considered it ‘ridiculous’. ‘It was not possible to properly manage, to know what was going on. The top managers have totally lost contact with the company.’ Coblin was optimistic that having executive vice presidents would improve management. The three annual meetings of the general managers had slowly increased from about one-and-a-half days to about two-and-a-half days and had become more focused. The new EVP positions would bring a perspective
above the level of the individual plants. Instead of 15 individual detailed presentations, each general manager would give a short, five-minute briefing and then there would be an in-depth presentation on the Group, with team participation. After some training by Lisenby, the divisions had recently done a pretty good job with a SWOT analysis. Coblin thought these changes would make Nucor a stronger global player.

To Jeff Kemp, the new general manager of strategic planning and business development, the big issue was how to sustain earnings growth. In the US steel industry there were too many marginal competitors. The US government had recently added to the problem by giving almost US$1 billion to nine mills, which simply allowed them to limp along and weaken the industry. He was looking for Nucor’s opportunities within the steel industry. He asked why Nucor had bought a bearing company. His experience in the chemical industry suggested a need for Nucor to establish a position of superiority and grow globally, driving industry competition rather than reacting. He argued that a company should protect its overall market position, which could mean sacrifices for individual plants. Aycock liked Kemp’s background in law and accounting, and had specifically sought someone from outside the steel industry to head up Nucor’s strategic planning. By June 2000 Kemp had conducted studies of other industries in the US market and developed a working document that identified opportunities worthy of further analysis.

‘Every company hits a plateau,’ Aycock observed. ‘You can’t just go out and build plants to grow. How do you step up to the next level? I wouldn’t say it’s a turning point but we have to get our strategic vision and strategic plans.’ He stated, ‘We are beginning Nucor’s first ever strategic planning sessions; it was not necessary before.’ His conclusions were partly the result of an imaging study Nucor had conducted.

In early 2000, Nucor had an outside consulting firm conduct a survey of the company’s image as seen by the top 10 to 15 managers, including the corporate office. It also gathered the views of a few analysts and media personnel. In looking at the survey, one saw the managers still agreed that Nucor valued risk taking, innovation and a lean management structure with aggressive, hard-working employees who accepted the responsibility of failure along with the opportunity for success. They seemed to see Nucor as a way of doing business – not just a way of making steel – in terms of values and personality, not just business terms. When asked to associate Nucor’s persona with a public figure, John Wayne was the clear choice.

The managers in the field seemed to believe the new layer of management was needed and were not concerned about a loss of decentralisation. They liked the new management team and the changes so far, particularly the improved communications with the corporate office. However, the corporate managers thought the company was changing much faster than the division managers. They also held a more positive view of the company on such things as how good the company was in their community or with the environment.

The people from the media had positive views of Nucor as hard-working and committed to its employees, an innovative risk-taking economic powerhouse. Some, most familiar with the company, believed the company needed to do a better job of communicating its vision during a period of transition.

Aycock believed Nucor needed to be quick to recognise developing technology in all production areas. He noted the joint venture to develop a new strip caster, which would cast the current flat-rolled material in a more finished form. The impact could be ‘explosive’, allowing Nucor to build smaller plants closer to markets. This would be particularly helpful on the West Coast. Nucor would own the US and Brazilian rights, its partners the rest. He was also looking forward to the next generation of steel mills and wanted to own the rights, this time. He praised Iverison’s skill at seeing technology and committing to it.

He was very interested in acquisitions, but ‘they must fit strategically’. A bar mill in the upper central midwest and a flat-rolled plant in the north-east would be good. A significant opportunity existed in pre-engineered buildings. Aycock intended to concentrate on steel for the next five to six years, achieving an average growth rate of 15 per cent per year. In about seven years he would like to see Nucor ready to move into other areas. He said Nucor had already ‘picked the low-hanging grapes’ and must be careful in its next moves.

Daniel DiMicco assumed the role of Nucor’s president and chief executive officer in September 2000, when David Aycock stepped down as planned. Peter Browning was elected chairman of the board of directors. Aycock retired from the board a year later.

Sales for 2000 increased 14 per cent over 1999 to reach a record level. Earnings were also at record levels, 27 per cent over 1999. The year had begun on a strong footing but had turned weak by the year’s end. While Nucor remained profitable, other steel companies faced bankruptcy. A Vulcraft plant was under construction in New York. It was the company’s first north-eastern operation and expanded the geographical coverage into a new region. Nucor was also attempting a break-through technological step in strip casting at Crawfordsville, the
Casstrip process. Nucor sold its grinding ball process and the bearing products operation because they were not a part of the core business.

In the company’s annual report, DiMicco laid out plans for 2000 and beyond: ‘Our targets are to deliver an average annual earnings growth of 10 to 15 per cent over the next 10 years, to deliver a return well in excess of our cost of capital, to maintain a minimum average return on equity of 14 per cent and to deliver to return on sales of 8 to 10 per cent. Our strategy will allow Nucor becoming a “Market Leader” in every product group and business in which we compete. This calls for significant increases in market share for many of our core products and the maintenance of market share where we currently enjoy a leadership position.’ While pointing out that it would be impossible to obtain this success through the previous strategy of Greenfield construction, he added: ‘There will now be a heavy focus on growth through acquisitions. We will also continue growing through the commercialisation of new disruptive and leapfrog technologies.’

STEEL AND NUCOR IN THE 21ST CENTURY

In early 2001 the Wall Street Journal predicted that all but two of the United States’ biggest steelmakers would post fourth-quarter losses. AK Steel Holding Corp. and Nucor Corp. were expected to have profits for the fourth quarter of 2000, while US Steel Group, a unit of USX Corp., was expected to post a profit for the year but not the fourth quarter. By 1 October more than 20 steel companies in the United States, including Bethlehem Steel Corp. and LTV Corp., the nation’s third and fourth largest US steel producers, respectively, had filed for bankruptcy protection. Over a dozen producers were operating under Chapter 11 bankruptcy-law protection, which allowed them to maintain market share by selling steel cheaper than non-Chapter 11 steelmakers. On 20 October the Economist noted that of the 14 steel companies followed by Standard & Poor’s, only Nucor was indisputably healthy. In the fall of 2001, 25 per cent of domestic steel companies were in bankruptcy proceedings, although the United States was the largest importer of steel in the world. Experts believed that close to half of the US steel industry was the largest importer of steel in the world.

The year 2001 turned out to be one of the worst ever for steel. There was 9/11, a recession and a surge of imports. DiMicco broke with Nucor’s traditional opposition to government intervention to make a major push for protective tariffs. He stated: ‘The need to enforce trade rules is similar to the need to enforce any other law. If two merchants have stores side by side, but one sells stolen merchandise at a vast discount, we know that it’s time for the police to step in.’ In March 2002 President George W. Bush, after an investigation and recommendation by the International Trade Commission, imposed anti-dumping tariffs under section 201 of the Trade Act of 1974. These tariffs were designed to limit imports. The European Union immediately threatened reprisals and appealed to the World Trade Organization. In December China imposed its own three-year program of import duties. Steel prices rose 40 per cent in 2002 after...
While many steel companies floundered, Nucor was able to take advantage of the weakened conditions. In March 2001, Nucor made its first acquisition in 10 years, purchasing a mini-mill in New York from Sumitomo Corp. Nucor had hired about five people to help plan for future acquisitions. DiMicco commented, 'It's taken us three years before our team has felt this is the right thing to do and get started making acquisitions'. In the challenged industry, he argued, it would be cheaper to buy than to build plants. Nucor purchased the assets of Auburn Steel, which gave it a merchant bar presence in the north-east and helped the new Vulcraft facility in New York. The company then acquired ITEC Steel, a leader in the emerging load bearing light gauge steel framing market, and saw an opportunity to aggressively broaden its market. Nucor increased its sheet capacity by roughly one-third when it acquired the assets of Trico Steel Co. in Alabama for US$120 million. In early 2002, it acquired the assets of Birmingham Steel Corp. The US$650 million purchase of four mini-mills was the largest acquisition in Nucor's history.

In addition to making acquisitions to efficiently increase its market share and capacity, Nucor was actively working on new production processes that would provide technological advantages. It acquired the US and Brazilian rights to the promising Castrip process for strip casting, the process of directly casting thin sheet steel. After development work on the process in Indiana, it began full-time production in May 2002 and produced 7000 tonnes in the last 10 months of 2002. Moreover, in April Nucor entered into a joint venture with a Brazilian mining company, CVRD, the world's largest producer of iron-ore pellets, to jointly develop low-cost iron-based products. Success with this effort would give it the ability to make steel from scratch by combining iron ore and coke rather than using scrap steel.

As the year ended Nucor executives were encouraged by the decrease in total steel capacity and what appeared to be a recovery in prices from record lows, and expected slight improvement for 2002. However, 2002 proved to be a difficult year for Nucor. Revenue increased 11 per cent and earnings improved 43 per cent over weak 2001, but the other financial goals were not met. Nucor did increase its steelmaking capacity by more than 25 per cent. Looking ahead to 2003 the company anticipated a challenging year. However, an executive commented, 'Nucor has a long-standing tradition of successfully emerging from industry downturns stronger than ever. It will be no different this time'.

During 2003 prices of steel rose in the United States and Asia as global demand outpaced supply in some areas. China, with its booming economy, drove the market. An article in the Wall Street Journal on 15 October quoted Guy Dolle, chief executive of Arcelor SA of Luxembourg, the world's largest steelmaker in terms of steel product shipped, as saying, 'China is the wild card in the balance between supply and demand'. World prices did not soar dangerously because the steel industry continued to be plagued by overcapacity. Still, steel-hungry China and other fast-growing nations added to their steel capacity.

Imports of steel commodities into the United States fell in August 2003 by 22 per cent. A weakened dollar, the growing demand from China, and tariffs imposed in 2002 by President Bush drove away imports. Domestic capacity declined, increasing capacity utilisation from 77.2 per cent to 93.4 per cent as producers consolidated, idled plants, or went out of business. Prices for iron ore and energy rose, affecting integrated producers. Mini-mills saw their costs rise as worldwide demand for scrap prices rose. Thus, US steelmakers boosted their prices. By February 2004, a growing coalition of US steel producers and consumers were considering whether to petition to limit soaring exports of scrap steel from the United States, the world's largest producer of steel scrap. The United States had exported an estimated 12 million tonnes of steel scrap in 2003, a 21 per cent increase from 2002. Moreover, the price of scrap steel was up 83 per cent from a year earlier to US$255 a tonne. At the same time the price of hot rolled sheet steel rose 30 per cent to US$360 a tonne. One result was that the International Steel Group (ISG) replaced Nucor as the most profitable US steel producer. ISG was created when investor Wilbur Ross began acquiring the failing traditional steel producers in America, including LTV, Bethlehem and Weirton. These mills used iron ore rather than scrap steel.

When 2003 ended Nucor struck a positive note by reminding its investors that the company had been profitable every single quarter since beginning operations in 1966. But while Nucor set records for both steel production and steel shipments, net earnings declined 61 per cent. While the steel industry struggled through one of its deepest down cycles with weak prices and bankruptcies throughout the industry, Nucor increased
its market share and held on to profitability. It worked on expanding its business with the automotive industry, continued its joint venture in Brazil to produce pig iron, and pursued a joint venture with the Japanese and Chinese to make iron without the usual raw materials. In February 2004 the company was ‘optimistic about the prospects for obtaining commercialization’ of its promising Castrip process for strip casting in the United States and Brazil. Moreover, Nucor was optimistic because the Bush administration was using its trade laws to curtail import dumping, and Nucor expected higher margins.

Global competition continued. Nucor has good reason to be proactive. According to the Wall Street Journal, Posco steelworks in Pohang, South Korea, enjoyed the highest profits in the global steel industry as of 2004. Moreover, Business Week reported that the company had developed a new technology called Finex, which turns coal and iron ore into iron without coking and sintering and was expected to cut production costs by nearly one-fifth and harmful emissions by 90 per cent. The company had also expanded its 80 Korean plants by investing in 14 Chinese joint ventures. By December 2004 demand in China had slowed and it had become a net steel exporter, sparking concerns of global oversupply.

Global consolidation continued. In October 2004 London’s Mittal family announced that it would merge its Ispat International NV with LNM Group and ISG to create the world’s largest steelmaker, with estimated annual revenue of US$31.5 billion and output of 57 million tonnes. This would open a new chapter for the industry’s consolidation, which had been mostly regional. Although the world’s steel industry remains largely fragmented with the world’s top 10 steelmakers supplying less than 30 per cent of global production, Mittal Steel will have about 40 per cent of the US market in flat-rolled steel. Moreover, Mittal, which had a history of using its scale to buy lower-cost raw materials and import modern management techniques into previously inefficient state-run mills, was buying ISG, a US company which already owned the lowest-cost, highest-profit mills in the United States. In January 2005 Mittal announced plans to buy 37 per cent of China’s Hunan Valin Iron & Steel Group Co.

With output of around 20 million tonnes each, US Steel and Nucor face an uncertain environment as the industry consolidates. Some argue if they don’t grow quickly they might be taken over by foreign makers trying to gain entry into the United States. According to Business Week, Karlis Kirsis, managing partner of World Steel Dynamics Inc., an information service, said ‘everybody’s in play these days’ in the wake of the Mittal’s planned merger with ISG. Even as US Steel and Nucor make bids of their own, South Korea’s Posco and Belgium’s Arcelor might snap them up.

APPENDIX 1A Balance sheet 2000–04

<table>
<thead>
<tr>
<th>As of</th>
<th>31/12/04</th>
<th>31/12/03</th>
<th>31/12/02</th>
<th>31/12/01</th>
<th>31/12/00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>779.05</td>
<td>350.33</td>
<td>219.00</td>
<td>462.35</td>
<td>490.58</td>
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<tr>
<td>Marketable securities</td>
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<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Receivables</td>
<td>962.76</td>
<td>572.48</td>
<td>483.61</td>
<td>330.86</td>
<td>350.18</td>
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<td>Total inventories</td>
<td>1 239.89</td>
<td>560.40</td>
<td>588.99</td>
<td>466.69</td>
<td>461.15</td>
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<tr>
<td>Other current assets</td>
<td>193.26</td>
<td>137.35</td>
<td>157.34</td>
<td>133.80</td>
<td>79.53</td>
</tr>
<tr>
<td>Total current assets</td>
<td>3 174.96</td>
<td>1 620.56</td>
<td>1 448.94</td>
<td>1 393.70</td>
<td>1 381.44</td>
</tr>
<tr>
<td>Net</td>
<td>2 818.31</td>
<td>2 817.14</td>
<td>2 932.06</td>
<td>2 365.66</td>
<td>2 329.42</td>
</tr>
<tr>
<td>Gross</td>
<td>2 818.31</td>
<td>2 817.14</td>
<td>2 932.06</td>
<td>2 365.66</td>
<td>2 329.42</td>
</tr>
<tr>
<td>Deposits &amp; other assets</td>
<td>139.95</td>
<td>54.66</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Total assets</td>
<td>6 133.22</td>
<td>4 492.36</td>
<td>4 381.00</td>
<td>3 759.36</td>
<td>3 710.86</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>471.55</td>
<td>329.86</td>
<td>247.23</td>
<td>189.24</td>
<td>203.33</td>
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<tr>
<td>Curr. long-term debt</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
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### APPENDIX 1A (Cont’d)

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<th>As of</th>
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<th>31/12/02</th>
<th>31/12/01</th>
<th>31/12/00</th>
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</thead>
<tbody>
<tr>
<td>Accrued expense</td>
<td>565.28</td>
<td>299.73</td>
<td>319.36</td>
<td>294.92</td>
<td>354.73</td>
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<tr>
<td>Income taxes</td>
<td>28.96</td>
<td>n/a</td>
<td>8.95</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Other current liabilities</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>1065.79</td>
<td>629.59</td>
<td>575.54</td>
<td>484.16</td>
<td>558.06</td>
</tr>
<tr>
<td>Deferred charges/inc.</td>
<td>514.57</td>
<td>439.85</td>
<td>371.27</td>
<td>329.39</td>
<td>260.05</td>
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<tr>
<td>Long-term debt</td>
<td>923.55</td>
<td>903.55</td>
<td>878.55</td>
<td>460.45</td>
<td>460.45</td>
</tr>
<tr>
<td>Other long-term liab.</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>2503.91</td>
<td>1972.99</td>
<td>1825.36</td>
<td>1274.00</td>
<td>1278.56</td>
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<tr>
<td>Minority interest</td>
<td>173.31</td>
<td>177.28</td>
<td>216.65</td>
<td>283.89</td>
<td>301.34</td>
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<tr>
<td>Preferred stock</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Common stock</td>
<td>73.75</td>
<td>36.43</td>
<td>36.27</td>
<td>36.13</td>
<td>36.04</td>
</tr>
<tr>
<td>Capital surplus</td>
<td>147.21</td>
<td>117.40</td>
<td>99.40</td>
<td>81.19</td>
<td>71.49</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>3688.56</td>
<td>2641.71</td>
<td>2641.58</td>
<td>2538.88</td>
<td>2478.79</td>
</tr>
<tr>
<td>Treasury stock</td>
<td>451.96</td>
<td>453.46</td>
<td>454.26</td>
<td>454.74</td>
<td>455.37</td>
</tr>
<tr>
<td><strong>Total shareholder equity</strong></td>
<td>3455.99</td>
<td>2342.08</td>
<td>2322.99</td>
<td>2201.46</td>
<td>2130.95</td>
</tr>
<tr>
<td><strong>Total liab. &amp; shr. equity</strong></td>
<td>6133.22</td>
<td>4492.36</td>
<td>4381.00</td>
<td>3759.36</td>
<td>3710.86</td>
</tr>
</tbody>
</table>

In millions of USD

Source: Data by Thomson Financial, Nucor web page.

### APPENDIX 1B Income statement 2000-04

<table>
<thead>
<tr>
<th>Period ended</th>
<th>31/12/04</th>
<th>31/12/03</th>
<th>31/12/02</th>
<th>31/12/01</th>
<th>31/12/00</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net sales</strong></td>
<td>11376.83</td>
<td>6265.82</td>
<td>4801.78</td>
<td>4333.71</td>
<td>4756.52</td>
</tr>
<tr>
<td><strong>Cost of goods sold</strong></td>
<td>9128.87</td>
<td>5996.55</td>
<td>4332.28</td>
<td>3914.28</td>
<td>3929.18</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>2247.96</td>
<td>269.27</td>
<td>469.50</td>
<td>419.43</td>
<td>827.34</td>
</tr>
<tr>
<td>R &amp; D expenditure</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Selling, general &amp; admin exps.</td>
<td>415.03</td>
<td>165.37</td>
<td>175.59</td>
<td>150.67</td>
<td>183.18</td>
</tr>
<tr>
<td>Depreciation &amp; amort.</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Non-operating income</td>
<td>-79.30</td>
<td>-12.4</td>
<td>-49.57</td>
<td>-82.87</td>
<td>-150.65</td>
</tr>
<tr>
<td>Interest expense</td>
<td>22.35</td>
<td>24.63</td>
<td>14.29</td>
<td>6.53</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Income before taxes</strong></td>
<td>1731.28</td>
<td>66.88</td>
<td>230.05</td>
<td>179.36</td>
<td>493.51</td>
</tr>
<tr>
<td>Prov. for inc. taxes</td>
<td>609.79</td>
<td>4.1</td>
<td>67.97</td>
<td>66.41</td>
<td>182.61</td>
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<tr>
<td>Minority interest</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Realised investment (gain/loss)</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Other income</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Net income before extra items</strong></td>
<td>1121.49</td>
<td>62.77</td>
<td>162.08</td>
<td>112.95</td>
<td>310.90</td>
</tr>
<tr>
<td>Extra items &amp; disc. ops.</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>1121.49</td>
<td>62.77</td>
<td>162.08</td>
<td>112.95</td>
<td>310.90</td>
</tr>
</tbody>
</table>

In millions of USD

Source: Nucor web page, data by Thomson Financial.
APPENDIX 2  Nucor valuation ratios 2004

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/E (TTM)</td>
<td>7.38</td>
<td></td>
</tr>
<tr>
<td>Per share ratios</td>
<td></td>
<td>5 year annual growth</td>
</tr>
<tr>
<td>Dividend per share</td>
<td>0.47</td>
<td>Revenue – 5 year growth</td>
</tr>
<tr>
<td>Book value per share</td>
<td>21.54</td>
<td>Div/share – 5 yr growth</td>
</tr>
<tr>
<td>EPS fully diluted</td>
<td>7.02</td>
<td>EPS – 5 year growth</td>
</tr>
<tr>
<td>Revenue per share</td>
<td>71.21</td>
<td>Financial strength</td>
</tr>
<tr>
<td>Profit margins</td>
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<tr>
<td>Operating margin</td>
<td>16.23</td>
<td>Current ratio</td>
</tr>
<tr>
<td>Net profit margin</td>
<td>9.86</td>
<td>LT debt to equity</td>
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<tr>
<td>Gross profit margin</td>
<td>19.88</td>
<td>Total debt to equity</td>
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<tr>
<td>Dividends</td>
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<td></td>
</tr>
<tr>
<td>Dividend yield</td>
<td>1.13</td>
<td>Return on assets (ROA)</td>
</tr>
<tr>
<td>Dividend yield – 5 yr avg.</td>
<td>1.28</td>
<td>Return on invested capital (ROIC)</td>
</tr>
<tr>
<td>Dividend per share (TTM)</td>
<td>0.52</td>
<td>Asset turnover</td>
</tr>
<tr>
<td>Dividend payout ratio</td>
<td>6.66</td>
<td>Inventory turnover</td>
</tr>
</tbody>
</table>

Source: Data by Thomson Financial, Nucor web page.

APPENDIX 3  Board of directors and executive management

In 1990
Board: Iverson, Aycock, Cunningham, Siegel, Vandekieft.
Executive Office: Iverson, Aycock, Siegel.

1991 to 1994
Board: Iverson, Aycock, Siegel, Cunningham, Correnti.
Executive Office: Iverson, Siegel, Correnti, Lisenby, Prichard.

1995 to 1996
Board: Iverson, Aycock, Siegel, Cunningham, Correnti, Hlavacek.
Executive Office: Iverson, Siegel, Correnti, Doherty, Prichard.

In 1997
Board: Iverson, Aycock, Siegel, Cunningham, Correnti, Hlavacek.
Executive Office: Iverson, Siegel, Correnti, Lisenby, Prichard.

In 1998
Board: Aycock, Siegel, Correnti, Hlavacek, Browning, Gantt, Haynes.
Executive Office: Aycock, Siegel, Correnti, Parrish, Rutowski, Lisenby, Prichard.

1999 to 2000
Board: Aycock, Siegel, Hlavacek, Browning, Gantt, Haynes.
Executive Office: Aycock, Lisenby, DiMicco, Lott, Parrish, Rutkowski, Coblin, Prichard.

2002 through 2003
Board: Browning, Daley, DiMicco, Gantt, Haynes, Hlavacek, Milchovich, Waltermire.
APPENDIX 4 Biographies of selected board members and executive managers

Peter C. Browning has been the president and chief executive officer of Sonoco Products Company and senior officer since 1993. He was previously the president, chairman, and chief executive officer of National Gypsum Company. He was elected chairman of Nucor’s board of directors in September 2000 and became the non-executive chairman of Nucor when David Aycock retired from the board in 2001.

Daniel R. DiMicco was executive vice president of Nucor-Yamato Steel, Nucor Steel Hertford (plate division), and Nucor Building Systems before becoming president. He graduated from Brown University in 1972 with a Bachelor of Science degree in engineering, metallurgy, and materials science. He received a Masters degree in metallurgy from the University of Pennsylvania in 1975. He was with Republic Steel in Cleveland as a research metallurgist and project leader until he joined Nucor in 1982 as plant metallurgist and manager of quality control for Nucor Steel in Utah. In 1988 he became melting and castings manager. In 1991 he became general manager of Nucor-Yamato and a vice president in 1992. In September 2000 he was elected president and chief executive officer of Nucor. In 2001, when Aycock retired, he became vice chairman, president and chief executive officer of Nucor.

Harvey B. Gantt was a partner in Gantt Huberman Architects for more than 25 years. He also served as mayor of Charlotte, North Carolina, and was active in civic affairs. He was the first African American graduate of Clemson University. He joined Nucor’s board of directors in 1998.

Victoria F. Haynes is the president of Research Triangle Institute in Chapel Hill, North Carolina. Until 2000, she was the chief technical officer of B. F. Goodrich Co. and vice president of its advanced technology group. She started with Goodrich in 1992 as vice president of research and development. She joined Nucor’s board of directors in 1998.

James D. Hlavacek is the managing director of market driven management. Mr Hlavacek was a neighbour and long-time friend of Mr Iverson. He joined Nucor’s board of directors in 1995.

Terry S. Lisenby is chief financial officer and an executive vice president. He graduated from the University of North Carolina at Charlotte in 1976 with a Bachelor of Science degree in accounting. Mr Lisenby held accounting and management positions with Seidman and Seidman, Harper Corporation of America and Concept Development, Inc. He joined Nucor in September 1985 as manager of financial accounting. He became vice president and corporate controller in 1991 and assumed the role of chief financial officer on 1 January 2000.

Hamilton Lott Jr is executive vice president over Vulcraft operations, cold-finished operations in Nebraska, and the Utah grinding ball plant. He graduated from the University of South Carolina in 1972 with a Bachelor of Science degree in engineering and then served in the United States Navy. He joined Nucor in 1975 as a design engineer at Florence. He later served as engineering manager and as sales manager at Nucor’s Vulcraft division in Indiana. He was general manager of the Vulcraft division in Texas from 1987 to 1993 and the general manager in Florence from 1993 to 1999. He became a vice president in 1988 and joined the executive office in 1999.

D. Michael Parrish is executive vice president for the four steel plants and Nucor Fastener. He graduated from the University of Toledo in 1975 with a Bachelor of Science degree in civil engineering. He joined Nucor in September 1975 as a design engineer for Vulcraft and became engineering manager at Vulcraft in 1981. In 1986 he moved to Alabama as manufacturing manager and in 1989 returned to Utah as vice president and general manager. In 1991 he took the top job with Nucor Steel Texas, and in 1995 at Nucor Steel Arkansas. In January 1999 he moved into the corporate office as executive vice president.

Joseph A. Rutkowski is executive vice president of Nucor Steel in Indiana, Arkansas, and Berkeley (South Carolina), and of Nucor Bearing Products. He graduated from John’s Hopkins University in 1976 with a Bachelor of Science degree in materials science engineering. He held metallurgical and management positions with Korf Lurgi Steeltec, North American Refractories, Georgetown Steel, and Bethlehem Steel. He joined Nucor in 1989 as manager of cold finish in Nebraska and became melting and casting manager in Utah before becoming vice president and general manager of Nucor Steel in Darlington in 1992. In 1998, he moved to Hertford as vice president and general manager to oversee the building of the new plate mill.
DirecTV is important to News Corp. because it provides the missing link in News Corp.’s network of satellite TV platforms around the world.1

Rupert Murdoch, News Corp.’s chairman, seemed to be on top of the world in early 2005. (DirecTV’s stock price between 2004 and 2005 is shown in Exhibit 1.) With the successful acquisition of DirecTV, Murdoch’s dreams of building a content and distribution empire were coming true. With savvy investments in Internet technologies, quality content and a strong hold on distribution, News Corp. looked like an invincible media powerhouse at the end of 2004. This optimism was reflected in Murdoch’s own words:2

Our satellite platforms now span four continents, and we have more than 26 million subscribers. What that network of platforms gives us is, I believe, the perfect balance of assets for any media company: We have a great mix of subscription and advertising revenue, as well as a great mix of content and distribution businesses – [and] we’re spread geographically in a way no other media company in the world can match.

* News Corp. in 2005: Consolidating the DirecTV acquisition. Reprinted by permission of Ravi S. Madapati, ICFAI Knowledge Center, ICFAI University, Hyderabad, India.

EXHIBIT 1 DirecTV stock price (January 2004–January 2005)


■ BACKGROUND NOTE

The DirecTV acquisition seemed to mark a turning point for Murdoch. DirecTV’s roots went back to 1932, when Hughes Aircraft was set up to build experimental aeroplanes for Howard Hughes. During World War II, the company began building a mammoth flying boat to serve as a troop carrier. After the war, the company entered the
In 1953, it underwent a major shake-up when about 80 of its top engineers walked out, dissatisfied with Hughes, who was becoming distant and difficult to deal with. The US Air Force also threatened to cancel the company's contracts because of Hughes's erratic behaviour.

Hughes transferred the company's assets to the Howard Hughes Medical Institute (with himself as its sole trustee) and hired former Bendix Aviation executive Lawrence Hyland to run the company. The institute produced the first beam of coherent laser light in 1960 and placed the first communications satellite into geosynchronous orbit in 1963. The Hughes-built Surveyor landed on the moon in 1966.

In 1984, the US Department of Defense cancelled several missile contracts and the institute found it difficult to fund research and development. The next year the institute sold Hughes Aircraft to General Motors (GM) for US$5.2 billion. GM combined its Delco Electronics car parts unit with Hughes to form GM Hughes Electronics (GMHE). GMHE acquired General Dynamics' missile business in 1992.

In 1995, GMHE became Hughes Electronics and launched its DirecTV satellite service. The same year, the company strengthened its defence business by acquiring CAE-Link (training and technical services) and Magnavox Electronic Systems (warfare and communications systems). Hughes bought a majority stake in satellite communications provider PanAmSat in 1996.

In 1998, the company boosted its stake in PanAmSat to 81 per cent. The investment and sluggish sales led to a drop in profits for 1998. Hughes also took a public relations hit in 1998, when several of its satellites failed and temporarily halted most US pager activity.

To gain customers and expand its broadcast channel offerings, Hughes bought United States Satellite Broadcasting and the satellite business of rival Primestar and folded the businesses into DirecTV in 1999.

In early 2000, Hughes sold its satellite manufacturing business to Boeing in an effort to focus on its faster growing communications services businesses. GM also issued a tracking stock for Hughes but retained ownership of all the company's assets. Also that year, GM announced that it would try to sell Hughes.

Hughes bought Telocity (later renamed DirecTV Broadband), an Internet service provider that used DSL (digital subscriber line) technology, for about US$177 million in 2001. As negotiations to sell Hughes to Rupert Murdoch's News Corp. continued in 2001, EchoStar made an unsolicited bid to buy Hughes for US$30.4 billion in stock and US$1.9 billion in assumed debt. Soon News Corp. dropped out of the bidding and GM reached a US$25.8 billion deal with EchoStar. Even as the US Justice Department and the Federal Communications Commission (FCC) looked likely to block the company's sale to EchoStar, Hughes announced that it was confident the deal would win regulatory approval by the end of the year. However, the companies abruptly called off the merger in December 2002.

In a sudden turn of events, GM sold its 19.8 per cent interest in Hughes Electronics to News Corp. in 2003. News Corp. acquired another 14.2 per cent from common stockholders, amounting to a 34 per cent stake in Hughes Electronics, which it quickly transferred to its 82 per cent-owned Fox Entertainment Group. In 2004, Hughes Electronics changed its name to The DirecTV Group, declaring its focus and commitment to the DirecTV brand.

**DIRECTV'S BUSINESS**

DirecTV, the first entertainment service in the United States to deliver all digital-quality, multi-channel TV programming to an 18-inch satellite dish, provided people across the United States with a much-needed alternative to cable. For the first time, rural consumers who were not being served by cable had access to programming like their urban and suburban counterparts. DirecTV's business included:

- **DirecTV US**, which was the largest provider of direct broadcast satellite (DBS) television services and the second largest MVPD4 provider in the United States behind Comcast. DirecTV provided its customers with access to hundreds of channels of digital-quality video and audio programming that was transmitted directly to its customers' homes or businesses via high-powered geosynchronous satellites. As of 31 December 2003, DirecTV had about 12.2 million subscribers, of whom about 10.7 million were DirecTV’s subscribers (see Exhibit 2). The remaining subscribers received DirecTV service from members and affiliates of the National Rural Telecommunications Cooperative. DirecTV also provided premium professional and collegiate sports programming such as the NFL’s Sunday Ticket package, which allowed subscribers to view as many as 14 NFL games played each Sunday during the regular season.
PanAmSat, which owned and operated 25 satellites that were capable of transmitting signals to geographic areas covering over 98 per cent of the world’s population. PanAmSat provided satellite capacity for the transmission of cable and broadcast television programming from the content source to the cable operator or to the consumer’s home. PanAmSat’s satellites were able to reach nearly 100 per cent of all cable subscribers in the United States. In addition, PanAmSat provided satellite services to telecommunications carriers, government agencies, corporations and Internet service providers.

Hughes Network Systems (HNS) provided broadband satellite networks and services to both consumers and enterprises. HNS constituted the DirecTV Network Systems segment. HNS was a leader in the global market for VSAT private business networks with more than 500,000 terminals shipped or ordered. Spaceway, a more advanced satellite broadband communications platform under development, would provide customers with high-speed, two-way data communications on a more cost-efficient basis than systems that were currently available. The first Spaceway satellite service was expected to be introduced in 2005.

EXHIBIT 2 DirecTV: Important numbers

![Graphs showing DIRECTV U.S. Cumulative Subscribers, DIRECTV U.S. Average Monthly Revenue per Customer (ARPU), and DIRECTV U.S. Monthly Customer Churn](image)

THE DIRECTV DEAL

Don’t worry. We don’t want to take over the world. We just want a piece of it.6

Television programs were delivered by cable or through satellite. Satellite had broader reach than cable. Cable operators beamed programming content through cables to the subscribers’ homes. In the case of satellite television, satellites orbiting in the sky did the job, without the need for any cable connection.

Murdoch had been excited about satellite communications right from his childhood. In the mid-1980s, Murdoch paid £10 million for a controlling interest in Sky Television (Sky), a pan-European channel that aired common programs to several European countries. By 1987, Murdoch had spent £40 million on Sky, which reached nearly 12 million homes in 20 European countries. In 1990, after prolonged negotiations, BSB, a television channel, merged with Sky into a single company, British Sky Broadcasting (BSkyB). Between 1989 and 1992, the combined entity reported losses of about US$1.2 billion. As BSkyB introduced better programs and aired soccer matches exclusively, it achieved a turnaround by the end of 1992 and revenues rose to £385 million.

By 1993, BSkyB reached financial stability. Over the next four years, the company developed new content and innovative programs. By 1997, 25 per cent of British homes were subscribers to the channel. By 2001, BSkyB had 5 million customers and had become the first digital television channel in the world by moving its operations from analogue to digital. By June 2002, BSkyB had 6.1 million subscribers and a 20 per cent increase in revenues over 2001.

Meanwhile, DirecTV had made significant progress with its direct broadcast satellite services. Attractive sports content, aggressive marketing and free installation resulted in rapid penetration of DirecTV. By 2000, DirecTV had enrolled more than 9.5 million subscribers to become the largest satellite-based provider of television content in the United States. DirecTV offered more than 225 programming channels to 60 million homes in about 40 cities in the US.

Murdoch realised DirecTV would add the strategic US market to his worldwide network of satellite distribution that included BSkyB in Britain, Star TV in Asia, Foxtel in Australia, SkyTel in Latin America and Stream in Italy. DirecTV would eliminate dependence on cable distribution in the US market and fortify News Corp.’s fast-growing cable networks, which included Fox News, Fox Sports, National Geographic and Speed Channel, which carried motor sports. DirecTV gave Murdoch the missing link in News Corp.’s worldwide satellite-distribution system. As press reports put it, the DirecTV acquisition made Murdoch ‘a general in both the content and distribution camps’.7

In September 2000, Murdoch offered $22 billion for a 35 per cent stake in DirecTV. But negotiations between News Corp. and DirecTV proceeded slowly. A 25 per cent decline in the stock of Hughes Electronics in February 2001 slowed down the talks further. In April 2001, Murdoch reduced his bid for a 30 per cent stake and got Microsoft to commit US$3 billion in cash for the deal. In August 2001, EchoStar surprised everyone by announcing an unsolicited US$32.3 billion bid for DirecTV. EchoStar and DirecTV together controlled about 92 per cent of the US satellite pay-TV market. Murdoch lobbied intensely and succeeded in getting the merger blocked on anti-trust grounds. Finally in April 2003, News Corp. acquired GM’s 19.9 per cent stake in Hughes and a further 14.1 per cent from public shareholders and GM’s pension and other benefit plans.

Following the completion of the acquisition, Murdoch became chairman of Hughes, while News Corp.’s former co-chief operating officer, Chase Carey, became the president and chief executive officer (CEO). The public shareholders as well as GM’s pension and other benefit plans owned all of GM’s common stock, which represented 80.1 per cent of interest in Hughes Electronics. GM retained a 19.9 per cent stake in Hughes.

DirecTV gave News Corp. considerable bargaining power. News Corp. had plans to add one million subscribers a year, using DirecTV. Fox TV stations were expected to let DirecTV viewers choose their angle on their television sets at sports events or create their own video news magazines.8 At any given time, as many as one-in-five US households would be watching News Corp.’s shows. DirecTV was also expected to fortify News Corp.’s own channels against competition from Comcast and TimeWarner. News Corp. looked well placed to drive down the prices of entertainment and sports programming. With so many viewers hooked up to DirecTV, no programmer would risk not being in News Corp.’s system. At the same time, Murdoch, known for his aggressive marketing tactics, would have the leverage to force his cable and satellite rivals to carry his programs at premium prices.
It was widely reported that Murdoch might distribute set-top boxes at a very low price to attract subscribers to DirecTV. Meanwhile, rivals such as Comcast and TimeWarner Cable were attempting to expand their own distribution networks. Comcast acquired AT&T Broadband in 2003 for US$54 billion. AT&T Broadband owned regional sports rights, telephony and two-way Internet interactivity over cable lines. Comcast was also seeking to enhance its partnership with programmers such as Viacom.

In many ways, Comcast, the number 1 cable system in the US, looked to be the only rival that could remotely match the power of News Corp. After closing the AT&T Broadband deal, Comcast had pursued various deals to strengthen its distribution network. Comcast had even made a hostile bid to take over Walt Disney in February 2004 for US$56 billion before backing out. Comcast had held firm on fees for pricy cable channels, won favourable deals for equipment, and put pressure on Hollywood to change its long-standing movie-release tradition so that it could get movies ahead of video stores and sell them over cable.

Comcast had launched various initiatives to strengthen its content. It had partnered with Radio One to launch a new channel targeting African Americans. Comcast had also acquired TechTV to cater to video gamers. In December 2003, Comcast struck a deal with Chicago's major sports teams – the Chicago Bulls, Cubs, White Sox and Blackhawks – to create a new sports channel, leaving Murdoch's Fox Sports Chicago with no big draws. Comcast had also struck a deal with Viacom channels, such as MTV and Nickelodean, to supply content to Comcast's 21 million subscribers for as long as five years.

Cable had an important advantage over satellite. Cable offered high-speed, two-way Internet access, including phone capability. Satellite was still mostly a one-way service. But cable still needed millions of dollars of investments to upgrade to digital technology. About 40 million cable subscribers in 2005 did not have digital technology. Satellite, by default, was digital. This meant that cable companies such as Comcast could offer digital technology features such as electronic program guides and video-on-demand only if they upgraded. By the end of 2004, both systems (satellite and cable) were engaged in intense competition to be big players in new consumer technologies such as the digital video recorder (DVR), high-definition TV and a host of other products that were reshaping home entertainment.

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**AFTER THE ACQUISITION**

Murdoch's BSkyB had already redefined the way people watched television programs in the UK, where the company controlled about 70 per cent of the pay-TV market. It had launched many innovative programs for the UK consumer, such as alternating camera angles to stay focused and switching off the sound and listening to a different channel broadcast, among others. With the help of DirecTV, Murdoch planned to introduce these features in the much bigger US market.

After acquiring DirecTV, News Corp. immediately restructured DirecTV and settled labour disputes. News Corp. dismantled everything at DirecTV that did not have anything to do with satellite broadcasting. Half of the employees were retrenched. Then, Murdoch sold DirecTV's 80 per cent stake in satellite-launch service business PanAmSat to leverage buyout firm KKR for US$2.5 billion. DirecTV's set-top-box manufacturing business was sold to Thomson. The company's holdings in XM Satellite Radio were sold for a pre-tax profit of US$387 million. Murdoch then spent approximately US$1.4 billion to buy Pegasus Communications and the National Rural Telecommunications Cooperative, both rural satellite companies with about 1.4 million subscribers combined.

DirecTV launched new satellites. Modelling itself on the success of BSkyB, DirecTV announced it would introduce interactive television features to the American audience. From a technology-driven company, DirecTV was becoming more like a content-house, like the rest of News Corp. Carey commented, 'At the end of the day, people buy DirecTV because they care about great television'.

DirecTV was betting heavily on the popularity of football. Just as it did in the UK, DirecTV finalised a five-year US$3.5 billion deal with NFL Football Games for broadcasting rights. This was a critical deal for DirecTV to keep cable operators such as Comcast and TimeWarner Cable out of the reach of football, a popular game in the US. A DirecTV employee commented: 'People have been fooling around with interactive TV for four to five years. Finally, this marriage of interactive TV and the NFL may be the thing that breaks the dam wide open.'

The company sent two-minute clips of every NFL game every Sunday evening to subscribers who had DVRs.

DirecTV was also meeting real-time statistics requests during football games. Viewers could also receive information from DirecTV about a particular team or
a particular player. DirecTV was also re-vamping its movie programs based on the popular video-on-demand programs of cable companies. While DirecTV could not beam video-on-demand due to technical reasons, it was compiling requests from subscribers and getting ready to start video-on-demand.

In 2004, News Corp. launched various aggressive promotion campaigns. In an effort to increase its reach, DirecTV dropped the price of its DVR. It also launched a promotion that would give new customers a DirecTV set-top box for free. According to analysts, DirecTV spent about US$670 to acquire and keep a new subscriber in 2002, while it spent about US$758 in 2003 and US$894 in 2004. Operating profits fell from about US$459 million in 2003 to about US$54 million in 2004. Meanwhile, the churn rate (the rate at which customers leave each month) was increasing. Compared to the monthly average of 1.5 per cent in 2003, the rate climbed to 1.7 per cent in 2004 (see Exhibits 3 and 4 for more information about DirecTV).

**EXHIBIT 3 DirecTV: Highlights**

- Largest digital multi-channel service provider in the U.S. with 12.2 million customers as of year-end 2003
- Increased revenues 19% to $7.7 billion and operating profit before depreciation and amortization improved 59% to $970 million in 2003
- Increased owned and operated customer base approximately 13% by adding approximately 1.2 million net new owned and operated customers in 2003 — Added over 3 million gross owned and operated subscribers in 2003, an all-time record for a single year
- Generates the highest average monthly video revenue in the U.S. multi-channel entertainment industry with $63.90 per customer in 2003, an increase of 7% over 2002
- Broadcasts all of the local channels in 64 top markets, representing 72% of U.S. television households as of year-end 2003 — Expects to expand local channel coverage to at least 130 top markets representing 92% of U.S. television households during 2004
- Ranked “#1 in Customer Satisfaction Among Satellite and Cable TV Subscribers Two Years in a Row” by J.D. Power and Associates
- Distributes over 850 digital video and audio channels, expanding significantly with the expected successful launch of the DIRECTV 7S satellite in 2004

**EXHIBIT 4 DirecTV: Important financials**

<table>
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<tr>
<th>Valuation Measures</th>
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<tbody>
<tr>
<td>Market Cap (intraday)</td>
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<tr>
<td>Enterprise Value (10 Jan 05)</td>
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<td>Trailing P/E (ttm, intraday)</td>
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<td>Forward P/E (fye 31-Dec-05)</td>
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<td>PEG Ratio (5 yr expected)</td>
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<td>Price/Sales (ttm)</td>
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<tr>
<td>Price/Book (mrq)</td>
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<tr>
<td>Enterprise Value/Revenue (ttm)</td>
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<tr>
<td>Enterprise Value/EBITDA (ttm)</td>
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</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial Highlights</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Fiscal Year</td>
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<tr>
<td>Fiscal Year Ends</td>
<td>31 Dec</td>
</tr>
<tr>
<td>Most Recent Quarter (mrq)</td>
<td>30 Sep 04</td>
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<tr>
<td>Profitability</td>
<td></td>
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<tr>
<td>Profit Margin (ttm)</td>
<td>-5.70%</td>
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<tr>
<td>Operating Margin (ttm)</td>
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<td>Management Effectiveness</td>
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</tr>
<tr>
<td>Return on Assets (ttm)</td>
<td>-3.51%</td>
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<td>Return on Equity (ttm)</td>
<td>-6.79%</td>
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<td>Income Statement</td>
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<tr>
<td>Revenue (ttm)</td>
<td>10.49B</td>
</tr>
<tr>
<td>Revenue Per Share (ttm)</td>
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</tr>
<tr>
<td>Revenue Growth (lfy)</td>
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</tr>
<tr>
<td>Gross Profit (ttm)</td>
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<tr>
<td>EBITDA (ttm)</td>
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<tr>
<td>Net Income Avl to Common (ttm)</td>
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<tr>
<td>Diluted EPS (ttm)</td>
<td>-0.427</td>
</tr>
<tr>
<td>Earnings Growth (lfy)</td>
<td>N/A</td>
</tr>
</tbody>
</table>

| Balance Sheet                       |       |
| Total Cash (mrq)                    | 3.31B |
| Total Cash Per Share (mrq)          | 2.39  |
| Total Debt (mrq)                    | 2.43B |
| Total Debt/Equity (mrq)             | 0.313 |
| Current Ratio (mrq)                 | 1.975 |
| Book Value Per Share (mrq)          | 5.608 |


Source: Reuters, Yahoo Finance.
Murdoch and Carey remained upbeat about DirecTV, even as competition from cable companies increased. Carey commented: ‘We’ve been helped by the fact that we are very focused on the television experience. The cable companies are fighting the broadband battle and are much more commoditized than television.’

But News Corp.’s position had been weakened by some compromises made while closing the DirecTV deal. The FCC had already banned large cable operators from discriminating against rival programmers. So News Corp. could not use to its advantage the muscle power of DirecTV. News Corp. also had to submit to arbitration if cable operators accused it of using its most popular channels as bargaining tools. But these restrictions were temporary as they expired in six years. By then News Corp. would have about six million more subscribers according to company projections. There was also nothing in law that could stop DirecTV from collaborating with Fox Sports, another News Corp. subsidiary, for content.

THE ROAD AHEAD

We want DirecTV to be the best television experience in the world and The DirecTV Group to realize its value potential for our shareholders. We plan to reinvent DirecTV into an entrepreneurial, efficient and agile business. Our management team will establish DirecTV as the leader in exciting, rewarding and compelling television and we are determined to grow our business while maximizing profitability.

With DirecTV, Murdoch had gained access to 12 million subscribers in the United States. In early 2004, Murdoch’s media empire consisted of businesses that generated US$30 billion a year and reached out to just about every corner of the world. No other media company controlled such a mix of programming and the means to deliver it to households as News Corp. did.

For the nine months ended 2004, revenues at DirecTV rose 21 per cent to US$8 billion. Net loss from continuing operations and before changes in accounting standards from Australian to US GAAP rose from US$68 million to US$768 million. These results reflected a larger subscriber base and gains on the sale of XM Satellite stock, offset by asset impairment charges.

Meanwhile, in early January 2005, DirecTV announced plans to make its own DVR by the middle of 2005. DirecTV outsourced its DVR requirements to TiVo, the industry leader. According to DirecTV, the new device would be a step-up from the current TiVo offering with a 90-minute live TV buffer, a built in TV ‘bookmarking’ system, and other interface refinements.

DirecTV did face a few concerns at the end of 2004. DirecTV Latin America had filed for Chapter 11 bankruptcy in early 2003, and withdrawn from the market in 2004. Later in the year, DirecTV announced plans to reorganise its Latin American operations.

In January 2005, DirecTV reported that the US Securities and Exchange Commission (SEC) was seeking further accounting details on deals done with Pegasus Communications, the National Rural Telecommunications Cooperative and Thomson, all done in the second quarter of 2004. The SEC had also launched an investigation on the US$1.47 billion write-down of its Spaceway satellites in the third quarter 2004. DirecTV reported that it might be required to change how it accounted for those transactions, which might increase its depreciation and amortisation expenses.

A DirecTV spokesman commented: ‘We’re providing them with the information they requested. This is not an investigation, it’s a routine inquiry’. Meanwhile, Moody’s, the credit rating agency, had raised its bond ratings on DirecTV, citing improving operating performance and a focus on its satellite pay-TV business. Moody’s raised the company’s rating to ‘Ba2’, which was two steps below investment grade, from ‘Ba3’. Analysts saw this as a positive reinforcement on how DirecTV was managed.

News Corp. moved fast to acquire complete control in Fox Entertainment Group, which in turn held a controlling interest in DirecTV. In an effort to simplify News Corp.’s corporate structure, Murdoch offered to buy the remaining publicly held shares of Fox Entertainment Group in a US$6 billion stock deal in January 2005. News Corp. owned about 82 per cent of the equity and 97 per cent of the voting power of Fox Entertainment.

REFERENCES

Shawcross, W., 1992, Murdoch, the Making of a Media Empire, Simon & Schuster.


CASE SEVEN: NEWS CORP. IN 2005: CONSOLIDATING THE DIRECTV ACQUISITION


NOTES
2 Murdoch, ‘News Corp.’.
3 Which it later sold to the buyout firm Kohlberg, Kravis & Roberts (KKR) in 2004.
4 Multi-channel Video Programming Distributors such as cable companies like Comcast. DirecTV is the second largest MVPD, exceeded only by Comcast. AOL Time Warner is third followed by EchoStar, which is the fourth largest player.
5 National Football League.
7 Grover & Lowry, ‘Rupert’s world’.
8 Grover & Lowry, ‘Rupert’s world’.
11 Lashinsky, ‘Murdoch’s air war’.
It was one of those rainy, misty spring days in Shanghai, when Mr Sven Patuschka, head of the electrical engineering (EE) division of Shanghai Volkswagen (SVW), was meeting with Mr Liang Sui in May 2004. Mr Liang, an electrical engineer, had been working for SVW for eight years. They were meeting in the project room with dozens and dozens of Gantt charts and other graphs colourfully decorating the otherwise grey office room. Next to Mr Patuschka was a picture showing the development of SVW. Ever since SVW had started its operations in Shanghai, the variety of models being manufactured locally had increased. Year by year, the workload of EE had expanded. EE was moving from a replicating office to an electronics and electrics development unit. New skills and new structures were required to successfully face this new challenge laying ahead.

Mr Patuschka looked at Mr Liang and said:

Year by year the complexity and the volume of our responsibilities is increasing. We need to change our structure in order to be able to react quicker to changes and especially to be able to communicate more efficiently. Problems should be reported even before they arise, so that we can react in time. Every part that falls under the responsibility of EE should be delivered in time for SOP and of best quality. I would like to put you in charge of project management in EE. Your task is to evaluate the possible advantages and disadvantages of implementing project management in EE. Thereafter, you should initiate all necessary actions in order to successfully implement project management. We need more transparency in order to efficiently coordinate our efforts. The reporting must be up-to-date and supply us with correct information at any time. I would like to see more self-initiative by project managers and Fathers of Parts. They should communicate more directly with the appropriate person instead of taking the long and tiresome way up the hierarchy. Good luck!

Mr Patuschka watched Mr Liang leave the meeting room, leaned back in his chair, and thought about the challenge lying ahead. First, he had to convince his engineers.

*Bianca Kramer prepared this case under the supervision of Professor Lutz Kaufmann to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality. Reprinted by permission of WHU, Professor Dr Lutz Kaufmann, Burgplatz 2, D-56179 Vallendar. Copyright © 2004 by WHU, Version 2004-11-01. No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means – electronic, mechanical, photocopying, recording, or otherwise – without the permission of the supervising author.

**ORGANISATIONAL FRAMEWORK**

**SHANGHAI VOLKSWAGEN AUTOMOTIVE CO. LTD**

Shanghai Volkswagen, the first European–Chinese joint venture, was founded in March 1985 when the German
CASE EIGHT: SHANGHAI VOLKSWAGEN

Car manufacturer Volkswagen AG signed a contract with the Shanghai Automotive Industry Corporation (SAIC). The latest contract, called ‘Amended and Restated Joint Venture Contract’, was renewed in April 2004, extending the terms of the 50:50 joint venture to the year 2030.

SVW was located in Anting International Auto City, 30 minutes north-west of Shanghai. It employed 13,332 people, manufactured seven product series (see Exhibit I), and had an annual production capacity of 450,000 units (see Exhibit 2). Having been recognised as one of the biggest foreign investors, SVW was included in the ‘Top Ten Joint Ventures in China’. The company’s official languages were Chinese and German. In addition, English was commonly spoken among most Chinese engineers.

EXHIBIT 1 Shanghai Volkswagen Models

Touran At the time of this case, the SVW Touran was still in its development phase. The expected launch had been scheduled in the last quarter of 2004.

Gol In February 2003 the Gol made its entrance into the Chinese market. Also originating from Brazil, the first two-door car made in China has had a difficult start in a country where cars are produced some centimeters longer than their European relatives. After some initial starting problems, sales have been steadily increasing, amounting to 11,001 units in 2003.

Polo Released in December 2001, the SVW Polo has ever since won several prices. The Polo is not only produced to satisfy local needs, but also exported to Australia. Both the Polo Notchback as well as the Polo Hatchback are manufactured at SVW. In 2003, a total of 570,180 units were sold in China.

Passat SVW launched its first SVW Passat in June 2000. In 2003, 123,854 units were sold, constituting a leading figure among its Chinese peers in the B-plus category.

Santana The SVW Santana, be it the Santana B2 originally coming from Germany, the Santana 2000 originating in Brazil, or the newest Santana 3000 version of the old Santana B2, which has been developed in Shanghai and launched in January 2003, has been well received by the Chinese market. With a sales volume of 124,002 for the Santana B2 and 89,032 for the Santana 2000 in 2003, it is currently SVW’s best-selling car, the only one in China to exceed the 200,000 units mark. The Chinese love its spacious design and appreciate its affordable price. The old Santana 2000 has been substituted by the newer 3000 version. Today, only the Santana B2 and the Santana 3000 are still manufactured in Anting.

Source: Shanghai Volkswagen.

SHANGHAI AUTOMOTIVE INDUSTRY CORPORATION

SAIC5 is one of the top three vehicle groups in China, currently owning 55 subsidiary companies in which it has directly invested (see Exhibit 3), one of which is General Motors. Like the other vehicle groups, SAIC is a state-owned enterprise.

VOLKSWAGEN GROUP

VW is most likely the brand that immediately comes into your mind when thinking about German cars. The car manufacturer is located in Wolfsburg, northern Germany. Volkswagen has manufacturing plants in 11 European countries.
**EXHIBIT 2  Excerpt from Key Figures**

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<th>2002</th>
<th>2003</th>
<th>Change</th>
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<td><strong>Total Car Output</strong></td>
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<td>405,252</td>
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<td>Santana B2</td>
<td>88,436</td>
<td>124,034</td>
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<td>Santana 2000</td>
<td>90,119</td>
<td>89,059</td>
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<tr>
<td>Passat</td>
<td>70,091</td>
<td>123,954</td>
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<tr>
<td>Polo</td>
<td>30,239</td>
<td>57,180</td>
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<tr>
<td>*<em>Car Sales</em></td>
<td>278,642</td>
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<td>Santana B2</td>
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<td>Santana 2000</td>
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<td>Polo</td>
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<td><strong>Headcount</strong></td>
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<td><strong>Productivity (car/man)</strong></td>
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<td>30.7</td>
<td>17.20%</td>
</tr>
<tr>
<td><strong>Ground Area (m²)</strong></td>
<td>2,786,034</td>
<td>3,051,828</td>
<td>9.50%</td>
</tr>
<tr>
<td><strong>Floor Space (m²)</strong></td>
<td>817,960</td>
<td>817,960</td>
<td>0.00%</td>
</tr>
</tbody>
</table>

*The sales figures refer to SVW sales volume.


**EXHIBIT 3  SAIC Subsidiary Companies**

The following list is not intended to be complete, but should rather give an idea of the complexity of SAIC:

**Shanghai General Motors**
50:50 joint venture with American General Motors, manufacturing the Buick.

**SAIC-GM-Wuling Automobile**
A three-way joint venture, invested by SAIC, GM, and Lizhou Wuling Automotive.

**Shanghai Yizheng Automotive**
Wholly owned company of SAIC (Group), manufacturing the Sabre.

**Shanghai Bus Manufacturing Corporation**
Jointly invested by SAIC and Shanghai Airplane Corporation.

**Shanghai Xingfu Motorcycle Works**
Wholly owned company of SAIC.

countries and seven countries in America, Asia and Africa, amounting to a total of currently 45 manufacturing plants worldwide (see Exhibit 4).

The brands Audi, Bentley, Bugatti, Lamborghini, Seat, Skoda and Volkswagen constituted the Volkswagen group in 2003.

In addition to the joint venture with SAIC, VW had a second joint venture in China. FAW VW, located in Changchun, was a joint venture with First Automotive Works (FAW) (see Exhibit 5). The Volkswagen office in Beijing was used exclusively for administrative purposes. No cars were manufactured there.

THE CHINESE AUTOMOTIVE SECTOR: RAPID GROWTH AND FIERCE COMPETITION

China is host to more than 100 car manufacturers. It is characterised by a high degree of decentralisation and fragmentation. Since 1994, the Chinese government has declared the automotive sector to be one of the five key industries and has hence started to follow an explicit industry policy for the automotive industry.

By law, foreign car makers intending to manufacture in China must enter a joint venture with local car makers, in which their share is limited to a 50 per cent stake in the venture. In June 2004 there were 13 international car makers forming more than 20 joint ventures to produce passenger vehicles in China. In addition the newest Auto Industry Development Policy (2004–06) reconfirms that ‘a foreign investor is allowed to establish no more than two JVs producing the same category of complete vehicles’.

Imports are strongly suppressed in order to reinforce local production. Forty per cent of all value creation has to be local content. This is one of the reasons why local content has become such an important issue for car makers in China. Potential cost savings are another. In addition to capital, technologies and know-how flow into the state organisations through these joint ventures. The Chinese car manufacturing industry is still highly regulated by the state. This is possible only because the Chinese government is well aware of the fact that it has an attractive and tremendous market to offer. They tend to believe that the foreign car makers need China more than China needs them. As part of the tenth Five-Year Plan (2001–05), the government intends to drastically reduce the number of domestic manufacturers or to consolidate them into bigger groups. Finally, the Chinese government is aspiring to develop the three big Chinese automotive groups – FAW, SAIC and Dongfeng Motor Co. (Dongfeng) – into internationally competitive organisations (see Exhibit 6).

EXHIBIT 4 Volkswagen Global Manufacturing Plants

Source: Volkswagen AG.
**EXHIBIT 5 Volkswagen group in China**

**Volkswagen Group**

**JV: FAW Volkswagen Automotive Co. Ltd.**

- Models produced: Audi A4, A6; VW Jetta, Bora, Golf
- Ownership:
  - Volkswagen 40%
  - First Auto Works 60%
- Capacity 2003: 300,000
- Production 2003: 302,346
- Unit Sales 2003: 302,385

**JV: Shanghai Volkswagen Automotive Co. Ltd.**

- Ownership:
  - Shanghai Automotive Industry Corp. 40%
  - China National Automobile Industry Corp. 10%
  - First Auto Works 60%
- Capacity 2003: 450,000
- Production 2003: 403,252
- Unit Sales 2003: 398,006


**EXHIBIT 6 Automotive group production in China (units)**

<table>
<thead>
<tr>
<th>Group</th>
<th>2002</th>
<th>2003</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>FAW</td>
<td>678,253</td>
<td>908,078</td>
<td>33.9%</td>
</tr>
<tr>
<td>SAIC</td>
<td>541,306</td>
<td>796,969</td>
<td>47.2%</td>
</tr>
<tr>
<td>Dongfeng</td>
<td>420,933</td>
<td>475,362</td>
<td>12.9%</td>
</tr>
<tr>
<td>BAIC</td>
<td>180,485</td>
<td>347,947</td>
<td>92.8%</td>
</tr>
<tr>
<td>Chang’an</td>
<td>201,581</td>
<td>247,945</td>
<td>23.0%</td>
</tr>
<tr>
<td>China Aviation</td>
<td>173,030</td>
<td>200,007</td>
<td>15.6%</td>
</tr>
<tr>
<td>Jinbei</td>
<td>85,518</td>
<td>124,438</td>
<td>45.5%</td>
</tr>
<tr>
<td>GAIG</td>
<td>64,467</td>
<td>122,568</td>
<td>90.1%</td>
</tr>
<tr>
<td>Changhe</td>
<td>154,941</td>
<td>118,721</td>
<td>23.4%</td>
</tr>
<tr>
<td>Nanjing</td>
<td>83,937</td>
<td>99,469</td>
<td>18.5%</td>
</tr>
<tr>
<td>Jianghuai</td>
<td>76,371</td>
<td>93,646</td>
<td>22.6%</td>
</tr>
<tr>
<td>Soueast</td>
<td>47,516</td>
<td>86,655</td>
<td>82.4%</td>
</tr>
<tr>
<td>Jiangling</td>
<td>51,386</td>
<td>63,169</td>
<td>22.9%</td>
</tr>
<tr>
<td>Qingling</td>
<td>31,893</td>
<td>34,866</td>
<td>9.3%</td>
</tr>
<tr>
<td>CNHTC</td>
<td>13,047</td>
<td>21,136</td>
<td>62.0%</td>
</tr>
<tr>
<td>15 Group Total</td>
<td>2,869,076</td>
<td>3,738,500</td>
<td>30.3%</td>
</tr>
<tr>
<td>Industry Total</td>
<td>3,286,804</td>
<td>4,443,686</td>
<td>35.2%</td>
</tr>
<tr>
<td>Group Share</td>
<td>87.3%</td>
<td>84.1%</td>
<td></td>
</tr>
</tbody>
</table>

Source: 2004, Fourin China Auto Weekly, 10 May.
At one point, SVW had a market share of just above 50 per cent. In the first half of 2003 it had dived down to 20.3 per cent (see Exhibits 7 and 8). As a reaction, Volkswagen increased its investment in China and began to focus more on the sales and marketing side than before.

THE ELECTRICAL ENGINEERING DIVISION

The EE division forms part of the product engineering division, which itself falls under the responsibility of the technical director of SVW (see Exhibit 9). Shanghai Volkswagen was organised according to functional areas.

TASKS OF THE EE DIVISION

That year (2003) 34 engineers were responsible for the development of local electronic and electrics parts suppliers. By the end of the year, this figure was forecast to increase to 50. The tasks of EE were numerous. First of all, every part that related to electronics or electrics was the responsibility of EE. It was the duty of the responsible engineer to find suitable suppliers who were able to manufacture and even sometimes develop in cooperation with SVW the required parts. In some cases the task of development was performed directly in VW Wolfsburg or in cooperation with SVW. Special rules concerning the testing and release applied to these parts.

In general, one had to distinguish between two scenarios. In the first, a certain part had been developed by VW in Germany and was planned to be localised in China. In most cases, this meant that the purchasing department would identify potential suppliers. The engineer then had to try to help the manufacturer produce the same part. Technical drawings from Germany were then sent to SVW. In the second scenario, a part had been either fully or partially developed by SVW. At that time only small parts were developed locally. However, with the increasing level

**EXHIBIT 7 Development of Chinese market shares of top 10 car manufacturers**

<table>
<thead>
<tr>
<th>Manufacturer</th>
<th>Sales May 2003 (units)</th>
<th>Market Share</th>
<th>Sales Jan–May 2003 (units)</th>
<th>Sales Jan–May 2002 (units)</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>SVW</td>
<td>31,131</td>
<td>19.5%</td>
<td>159,345</td>
<td>84,643</td>
<td>88%</td>
</tr>
<tr>
<td>FVW</td>
<td>22,310</td>
<td>14.0%</td>
<td>111,122</td>
<td>17,905</td>
<td>55%</td>
</tr>
<tr>
<td>SGM</td>
<td>15,678</td>
<td>9.8%</td>
<td>58,607</td>
<td>36,469</td>
<td>61%</td>
</tr>
<tr>
<td>Changan Suzuki</td>
<td>7,176</td>
<td>4.5%</td>
<td>45,661</td>
<td>27,500</td>
<td>66%</td>
</tr>
<tr>
<td>FAW-Tianjin</td>
<td>7,897</td>
<td>4.9%</td>
<td>43,920</td>
<td>39,711</td>
<td>11%</td>
</tr>
<tr>
<td>DCAC</td>
<td>8,377</td>
<td>5.2%</td>
<td>42,654</td>
<td>25,589</td>
<td>67%</td>
</tr>
<tr>
<td>Guanzhou Honda</td>
<td>9,631</td>
<td>6.0%</td>
<td>36,721</td>
<td>21,398</td>
<td>72%</td>
</tr>
<tr>
<td>Fengshen</td>
<td>4,386</td>
<td>2.7%</td>
<td>23,116</td>
<td>11,090</td>
<td>11%</td>
</tr>
<tr>
<td>Chery</td>
<td>5,269</td>
<td>3.3%</td>
<td>21,791</td>
<td>18,553</td>
<td>17%</td>
</tr>
<tr>
<td>Others</td>
<td>48,017</td>
<td>30.0%</td>
<td>196,109</td>
<td>54,731</td>
<td>258%</td>
</tr>
<tr>
<td>Total</td>
<td>159,872</td>
<td>100.0%</td>
<td>739,046</td>
<td>391,589</td>
<td>89%</td>
</tr>
</tbody>
</table>

Source: Shanghai Volkswagen.
of expertise and the increasing demand for custom-made products, EE was getting more and more involved in the development process of electronics and electrical parts. What both scenarios had in common was that it was the task of EE to make sure that the suppliers were able to manufacture the required part. The quality control of the delivered part, however, was the responsibility of quality management (QM). Only some tests were performed by EE; the majority of testing was done in Germany and/or by QM. Pricing negotiations as well as general purchasing activities fell under the responsibility of the purchasing department and were not part of EE.

EE was mainly concerned with the technical aspects of a part, such as compiling drawings, checking the compliance with the bill of material, evaluating delivered samples by suppliers and, finally, the crucial step of receiving the release permission.

Important steps to take were the respective releases of each part. The first one to obtain was the approval of the product committee. Here the decision was made whether a certain part was needed or not for a certain car. The concept release initiated the beginning of the design process. The third step, the design release, initiated the actual sourcing process as well as the nomination of the supplier for the manufacturing. Finally, if the manufacturer of the part was able to deliver an acceptable quality at an acceptable price, the part was ready for the start of production (SOP).
CASE EIGHT: SHANGHAI VOLKSWAGEN

PROCESSES IN EE

The EE project process began at the market, from where new product ideas were generated. If a new idea was considered worthwhile, it was passed on for discussion to a committee consisting of representatives of VW, SVW, the product engineering division and the product management division. If the idea passed this committee, it was passed on to the SVW and VW product strategy committee. If it was approved by VW, the EE process of a new project officially started (see Exhibit 10). Every division, be it quality management, product management, the plants, the planning division, development, sales, purchasing, finance, or logistics, was involved in certain stages of the product manufacturing process. For simplification purposes, the process will be reduced to the following milestones: First, a concept had to be developed; when the concept was approved a first prototype could be made. If the prototype was satisfactory, the purchasing division would nominate a supplier. The supplier would then develop a first design. If the design passed the tests, the supplier would start to manufacture a sample, which, depending on the requirements, would be tested in Shanghai and/or Germany. If all tests were okay, the final release would be obtained.

It is important to keep in mind that the EE process was part of an overall SVW and VW process as well as of several smaller projects. The input of the EE process often depended on the output of other departments. The output of some milestones in return flew into several other SVW or VW processes. There was a strong interrelationship between the numerous divisions and even between SVW and VW operations as well as suppliers’ operations.

DO’S AND DON’TS OF EE

Falling under the jurisdiction of SVW’s product engineering division, EE directly coordinated its effort with this division. At the same time, they closely cooperated with their German counterpart, the local content division in Germany, which was responsible for managing all local content efforts worldwide. Furthermore, the German local content division in Wolfsburg supplied the technical support and monitoring in order to guarantee standard quality all over the world. Depending on the importance of a part and of the experience of SVW and its test centre...
facilities, there were several parts for which all required testing could be performed and the release could be issued in Shanghai by SVW. For the majority of parts, however, samples had to be sent to Germany after passing the initial examination in Shanghai. Thereafter, tests were performed in Germany and the results were sent to SVW. If the part passed the quality requirements, EE could progress with the following steps. Time schedules as well as costs were estimated centrally for a vehicle series by Shanghai Volkswagen’s product engineering division and not by EE. Project managers of EE had no influence on budgets, time schedules and other resources.

**PEOPLE AT SVW**

Visiting the SVW plant in Shanghai for the first time, Bianca Kramer, a trainee at Shanghai Volkswagen, had the impression of walking through a miniature replication of VW Wolfsburg in Germany. Every now and then she saw a German manager crossing the street, there was a German canteen serving semi-German dishes, and the official language was Chinese as well as German. Entering the EE division Bianca was greeted with a warm ‘guten tag’. Almost every Chinese engineer here spoke fluent German. Around a third of SVW’s higher-level management was in fact German. At a first glance, one got the impression that SVW was a rather German company and that its Chinese employees were quite Westernised. At that time, around 60 German expatriates plus 20 trainees were employed by SVW.

However European they might have appeared, the deeper one got involved with your Chinese colleagues and the more one got to know them, the more one started to realise that certain rules that tend to be true in Germany or any other European country had to be revised in China. It should be noted that, although Shanghai lies within China, it was not representative of the country as a whole. Shanghai was a mega city where East and West met. It was more Westernised and more open than the rest of China. Still, management rules that functioned well in Germany had to be adapted before being implemented in China. In the following, only a few relevant differences are highlighted.

**LOSING ONE’S FACE MEANS DISGRACE**

A phenomenon most often mentioned when discussing cultural differences is something that the Chinese call *diu lian.* It is of utmost importance for Chinese people to ‘keep their face’ at all times. There are numerous ways to lose one’s face. Not being able to deliver an answer is unacceptable. Rather they will give a wrong answer than not give an answer at all. Not being able to control your temper is another source of *diu lian*. Losing one’s face can also be caused by others when you are not treated according to your social status. A face can be thought of as the treatment and respect someone earns due to his social standing. In Europe the concept is less important. In China however, losing one’s face can be the source of severe social pain. This might cause serious problems in
CASE EIGHT: SHANGHAI VOLKSWAGEN

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project management. *Diu lian* might be translated as ‘to feel disgrace’.

GUANXI MAKES THE WORLD GO ’ROUND

You cannot talk about Chinese culture without mentioning *guanxi*. In Chinese society a person without *guanxi* is not considered a human being. *Guanxi* describes the connections someone has. It is a strictly two-sided affair. When someone does a favour for you, you are expected to make up for it one day. In general *guanxi* means that you do a favour for someone, but it can also mean that rules are interpreted differently for friends.

*Guanxi* should not be misunderstood as corruption. It is an ancient Chinese tradition and very similar to the Western idea of networking. *Guanxi* touches every aspect of daily life. For project management it means that people who possess a lot of *guanxi* will succeed more quickly. On the other hand, two people who are unfamiliar with one another will spend considerable time on establishing a personal relationship before the actual work starts.

In China, work and private life are one and cannot be separated. If you criticise someone’s work, you criticise their personality. The Western approach of ‘business is business; life is life’ can cause severe problems.

POLITENESS – OR HOW NOT TO SAY WHAT YOU REALLY MEAN

Chinese people always smile. They have a gentle, subtle way of expressing nuisances and problems in order to avoid hurting their counterpart. Be it due to respect or due to their dislike of confrontation, Chinese employees will hardly ever say ‘no’ to their manager. They will say ‘maybe’, ‘I will try’, or other phrases, but won’t directly express a ‘no’. It is up to the manager to be sensitive enough to filter and interpret the true meaning of what is said. Talking about problems becomes a sensitive issue. As initiating a conversation about problems is impossible, problems are hidden or mentioned in a way that is so indirect that Western people have difficulty understanding the subtle hints. When trying to detect possible problems, one has to go through a series of indirect questions until finally the counterpart might mention the cause. This procedure of repeatedly asking indirect questions is unusual for Western managers, but should be respected when working together with their Chinese colleagues.

SHAPED BY HISTORY: CONTROL AND SELF-INITIATIVE

Due to China’s long history of control and its authoritarian government, Chinese people have become used to being told what to do. From an early age, they adhere to authorities and respect hierarchical structures. In the old China, but even in today’s Chinese society, people have been educated to conform. Set rules are not to be questioned, but accepted and followed.

Until recently EE was concerned mainly with developing suppliers who were able to reproduce existing parts. The drawings were sent from Germany and an EE engineer together with a local supplier would try to replicate them as best as possible, following the set procedures and adapting the set specifications. Recently, however, SVW itself has started to develop smaller parts and is intending to develop more and more locally, utilising its own know-how and expertise. In order to develop, fundamentally different capabilities are required from the engineers. Now, all of a sudden, they are asked to think differently, develop their own ideas, look ahead and even, at times, take several steps without the tight guidance and control from Germany.

Europeans always feel too vain to copy ideas, even if suitable solutions already exist. The Chinese culture has never been blinded by false innovativeness, but has learned to filter and copy the best ideas of others.

In Germany control is always associated with negative images. In China, people are used to regular control and seem to have problems working independently. They follow step-by-step, but are not used to being required to take several steps at once or look further into the future and make independent decisions. Self-initiative has long been suppressed. It might appear to Europeans that Chinese people lack self-initiative. But considering the high risk associated with taking self-initiative and, hence, the risk of losing one’s face — making a fool of oneself — Chinese are less eager to take this risk.

The challenge of taking more responsibility and exercising more self-initiative is a double-sided issue. It is an opportunity but at the same time offers a great risk of failing. To take this risk, Chinese need to be additionally rewarded. This becomes a problem in companies like SVW where promotions are often blocked or take place only very irregularly. Other kinds of rewards are required.
MANAGING INFORMATION: WHAT IS REALLY IMPORTANT

Related to the above-mentioned control issue is the problem of distinguishing between important and less important issues. In general, a demand from a German is always considered more important than a demand from a Chinese. A request from a higher-level manager is always considered more important than lower-management issues. Orders are followed without critically questioning them or taking influences on the whole project into consideration. Commands are executed without being critically evaluated and without taking possible consequences for the project as a whole into consideration. For a division that is as integrated into several processes and divisions as EE, this can have severe consequences.

COMMUNICATION: WHEN ‘I DON’T UNDERSTAND’ HAS A DIFFERENT MEANING

Although most engineers are able to express themselves very well in German, only a few German managers are equivalently fluent in Chinese. Be it during meetings or daily communication, the language gap is always apparent and often causes problems.

Be it due to these language differences or because people tend to hold on to their peers, two phenomena tend to be a reality throughout SVW. German employees when calling SVW generally call the German representative in SVW regardless of their hierarchical position and working field. This happens although there are highly educated Chinese colleagues available who are fluent in English, German, or both. On the other hand, the Chinese employees are reluctant to communicate directly with their German counterparts. Instead of making a telephone call, they send an email. Even if there is no reply after several days, they hesitate to write again or just pick up the phone.

As a result, communication between Germany and Shanghai VW is often time-consuming and not very effective. In order to improve this situation, SVW and VW hold a biweekly video conference where the most important issues are discussed immediately. This has been a great help, but there is further need for improvement in day-to-day operations.

THE PHILOSOPHY OF PLANNING

Germans are famous for being passionate planners. They tend to thoroughly plan every little detail with great patience. The reason for this is the German belief that life can be planned. Chinese people tend to believe that things change constantly and that life is unpredictable, which makes long-term planning useless.

Chinese people tend to plan one step after each other; they try to understand the bigger picture by understanding the smaller units. Germans first want to understand the bigger picture before breaking it down into smaller units. Plans are considered binding. Deviations lead to a cause analysis, which forms part of project management.

In China, people treat plans with more flexibility. They are not binding. Deviations form part of a plan and do not require further cause analysis.

DAILY OBSTACLES IN EE

Problems in EE were not new or unusual. Most German managers at SVW were frustrated by the same things. Communication was bad and slow, problems were hidden, and people tended to wait for orders rather than take self-initiative. The planning horizon seemed to be from day-to-day.

Regarding EE, this meant that rather than reporting critical information directly to Mr Patuschka, the engineer would prefer to first inform the subdivision manager, who would then decide whether and in which format to report the problem. The result was a distorted and slow flow of information. Related to the problem of communication was the way in which problems were hidden until the last minute.

WHAT HAD HAPPENED SO FAR

Until now EE had been using some project management tools such as Gantt charts and traffic lights charts (see Exhibits 11 and 12). EE not only was organised according to functional areas, namely electronics, electrics, and electric supply and fittings, but also had one responsible engineer, called a project manager, for each car model that was manufactured in Shanghai. The task of these project managers was to gather information and inform the relevant parties. Due to the lack of coordination, however, each project manager had developed their own reporting system. There were no standardised documents within EE. Product engineering, which was one level above the EE division, made use of standardised timetables and other charts for the project as a whole.
Despite all efforts that had been undertaken, project management in EE was functioning on paper rather than in practice. When asked, most project managers admitted that they did not clearly understand the purpose of project management and perceived it as additional work without any extra benefits. This attitude was reflected in old status reports still covering the walls of the project room.

### LOOKING AHEAD

Reading the newspaper and the numerous newsletters, Mr Patuschka could see it everywhere. The Chinese market was the fastest-growing market in the world. It was the market where car makers’ dreams of high growth and expansion could still be dreamed.

Despite the expected growth of the Chinese automotive market, more and more critical comments were surfacing. As more and more car makers entered the market and increased their production capacity, competition was increasing seriously. The first signs of a fierce price competition were already apparent. Buyers deferred the purchase of a new car, expecting the prices to drop even further the following year.

GM, Volkswagen’s biggest competitor in China, had announced only the previous week that it was planning to introduce almost 20 new models and invest US$3 billion over the next three years. In May, GM had cut prices on two of its core models, the Buick Regal sedan and the GL executive wagon, by 11 per cent – a great shock to the Chinese car-making industry.

Mr Patuschka looked at his division and knew that in order to survive this dynamic competition, Shanghai Volkswagen had to be reshaped. Quicker response times and development cycles would become more and more important for success.
At the time, SVW was preparing the launch of the SVW Touran the following year and in the years to come they were considering to continuously introduce more models. Local content would be increased not only to leverage local low-cost suppliers but also to allow for quicker response times. Knowledge transfer no longer should be one-sided, but in future more and more two-sided.

SVW would grow significantly and so would EE. Liang Sui had to think about how he could possibly introduce project management in EE and what adaptations he would have to make, in order to successfully implement project management and to improve the performance of the electrical engineering division.

NOTES

1 In China the first name is listed after the surname – Mr Liang Sui is Mr Liang.
2 SOP = Start of Production. Deadline for TPE: all parts have to be released before SOP.
3 The ‘Father of Parts’ is responsible for a certain part within a project.
4 ‘Shanghai Volkswagen in brief’.
5 Please refer to the home page of SAIC Group, www.saicgroup.com, for more information.
6 This paragraph is based only on personal experiences. It does not claim to be objective, but rather tries to give the reader some insight in the culture at Shanghai Volkswagen.
7 These observations are based on personal observations in SVW by the author and are not intended to be representative. Some observations might be linked to SVW/VW’s organisational culture.
It was a warm April evening in 2003 and Television New Zealand’s chief executive officer (CEO) Ian Fraser was sitting in his office overlooking Auckland’s business district as it was getting quiet after another busy day. Fraser, however, could not enjoy this serenity. He found himself confronted with an uncertain future in a diverse, complex and fragmented media landscape. The lights at the TVNZ headquarters would burn late that night as Fraser and his top executives debated the future of their company.

When TVNZ’s board of directors appointed Fraser to the CEO position in April 2002, everybody was confident that he was the right person to take the company through the transition, from a purely commercial TV station to a public sector broadcaster. After a lengthy and distinguished career as a journalist, broadcast presenter and the New Zealand Symphony Orchestra’s CEO, Fraser felt that this was a position well worth embracing, even if it was to be a challenging one. He found himself inheriting a formerly successful state-owned company, but the future from the outset looked anything but comfortable.

On 1 March 2003, a new era in New Zealand broadcasting began as TVNZ began to give effect to its Charter (see Exhibit 1). The previous 14 years had seen TVNZ operate as a state-owned enterprise with a purely commercial focus. However, the change in government policy transforming TVNZ from a state-owned enterprise to a Crown-owned enterprise, forced TVNZ to balance its commercial objectives with a set of public broadcasting objectives, as set out in the Charter. The Television New Zealand Act 2003, which was passed on 27 February 2003, not only introduced the Charter, but also set up TVNZ’s transmission business as a separate state-owned enterprise with a purely commercial focus.

Since the restructuring phase took place, Fraser was left wondering if this dream opportunity had turned into a nightmare. With his reputation on the line, Fraser now faced immense challenges in the leading seat of responsibility guiding TVNZ to become a sustainable public broadcaster in the digital age.

**THE BEGINNINGS**

Television was introduced to New Zealand in 1960. The initial format consisted of a two hour broadcast per day (in the evening) by one station to the four major centres – Auckland, Wellington, Christchurch and Dunedin. The operation was under the control of the New Zealand Broadcasting Corporation (BCNZ), a government department that also operated radio networks. This structure remained relatively unchanged until 1972 when the government approved the licence for a second television channel. Despite there being an application from a privately owned Independent Television Corporation,
EXHIBIT 1  TVNZ Charter

“The TVNZ Charter was formally implemented on 1 March 2003. The Charter shall apply to all those parts of TVNZ's operations that contribute to its broadcast content. It shall be predominantly fulfilled through free-to-air broadcasting.

TVNZ shall:
- feature programming across all genres that informs, entertains and educates New Zealand audiences;
- strive always to set and maintain the highest standards of programme quality and editorial integrity;
- provide shared experiences that contribute to a sense of citizenship and national identity;
- ensure in its programmes and programme planning the participation of Maori and the presence of a significant Maori voice;
- feature programming that serves the varied interests and informational needs and age groups within New Zealand society, including tastes and interests not generally catered for by other national television broadcasters;
- maintain a balance between programmes of general appeal and programmes of interest to smaller audiences;
- seek to extend the range of ideas and experiences available to New Zealanders;
- play a leading role in New Zealand television by setting standards of programme quality and encouraging creative risk-taking and experiment;
- play a leading role in New Zealand television by complying with free-to-air codes of broadcasting practice, in particular any code with provisions on violence;
- support and promote the talents and creative resources of New Zealanders and of the independent New Zealand film and television industry;

In fulfilment of these objectives, TVNZ will:
- provide independent, comprehensive, impartial, and in-depth coverage and analysis of news and current affairs in New Zealand and throughout the world and of the activities of public and private institutions;
- feature programming that contributes toward intellectual, scientific and cultural development, promotes informed and many-sided debate and stimulates critical thought, thereby enhancing opportunities for citizens to participate in community, national and international life;
- in its programming enable all New Zealanders to have access to material that promotes Maori language and culture;
- feature programmes that reflect the regions to the nation as a whole;
- promote understanding of the diversity of cultures making up the New Zealand population;
- feature New Zealand films, drama, comedy and documentary programmes;
- feature programmes that serve the interests and informational needs of Maori audiences, including programmes promoting the Maori language and programmes addressing Maori history, culture and current issues;
- include in programming intended for a mass audience material that deals with minority interests;
- feature New Zealand and international programmes that provide for the informational, entertainment and educational needs of children and young people and allow for the participation of children and young people;
- maintain and observe a code of ethics that addresses the level and nature of advertising to which children are exposed;
- feature programmes that encourage and support the arts, including programmes featuring New Zealand and international artists and arts companies;
- reflect the role that sporting and other leisure interests play in New Zealand life and culture and;
- feature programming of an educational nature that supports learning and the personal development of New Zealanders.”


the new licence was granted to the existing state monopoly – the NZBC. Colour television was introduced in 1973 and the second channel, now known as TV2, commenced transmission in 1975.

The following year, NZBC was broken up into several divisions: a Broadcasting Council, two television corporations, a radio corporation and an independent engineering body. Subsequently, the two relatively autonomous television corporations entered a period of a ‘corporate’ style competition for resources and an audience. The introduction of the Broadcasting Act 1976 by the national government halted this brief period of rivalry. The Broadcasting Council was abolished, and the two television channels and the existing radio network were combined into the Broadcasting Corporation of New Zealand (BCNZ).
REFORMS OF THE 1980s

By the mid-1980s BCNZ had evolved into a powerful government department with a nationwide network of broadcasting services. Nevertheless, restructuring was again on the horizon. The newly elected Labour government initiated major changes towards deregulation and market competition. The year 1986 brought the introduction of the State-Owned Enterprises Act 1986, which indicated a new direction for government-owned trading organisations (SOEs). The primary objective of SOEs was to operate as other privately owned commercial entities, while generating revenue for the Crown. Towards 1987, the government decided that the SOE model would be applied in the broadcasting sector. The result was the establishment of a new broadcasting regime in 1988, with the intention of improving economic efficiency in the broadcasting industry.

In 1988, BCNZ was split into two separate and independent SOEs: Radio New Zealand and Television New Zealand (TVNZ). Consequently, television operations were separated from other broadcasting activities. Television One and Channel 2 were to be managed by TVNZ. The transmission sites and facilities used by TVNZ under the BCNZ regime were to be managed by Broadcasting Communications (BCL), a subsidiary of TVNZ. The responsibility for providing broadcasting policy advice to the government was passed on to the Department of Trade and Industry (now the Ministry of Economic Development).

The reform of the New Zealand broadcasting industry in 1988 saw the establishment of separate, independent bodies and structures that were to deliver non-commercial, public service broadcasting benefits. Those independent bodies were Broadcasting Standards Authority and NZ On Air. The function of these institutions was to ensure:

- universal coverage
- appropriate broadcasting standards
- promotion of national identity
- support for the democratic process
- supplementary minority interest programming.

NZ On Air was also made responsible for collecting the Public Broadcasting Fee and distributing its funds to a range of broadcasting services it was set up to provide. Those funds were opened up to competitive tender by any broadcaster or producer. These new rules of the game forced TVNZ to compete for money that had always been available to the state broadcaster.

Furthermore, deregulation introduced competition, in the form of TV3, in 1989. The TV3 television was operated by the CanWest Media Works company. This was the first private commercial network in New Zealand. In 1997, the Canadian-based CanWest Global Group acquired the entire TV3 television network. TVNZ responded with aggressive ‘defender and prospector’ strategies pursuing radical change in the company’s strategy, structure, culture and operations.

RADICAL CHANGES IN TVNZ’S STRATEGY AND STRUCTURE

The challenge was to remove the accumulating slander, both within and outside the organisation, that TVNZ was moribund; that it consisted of a bunch of civil servants who knew nothing about business; that it was not free-enterprise oriented; and it could not compete against the heat that TV3 was generating.

Throughout the process of corporatisation in 1988 and the appointment of a new CEO, TVNZ changed its overall strategic orientation and supporting structural arrangements. Television broadcasting, incorporating Television One (TVOne) and Channel 2 (TV2), was proclaimed the company’s core business. Both channels operated under a unified organisational structure, Television Networks, further supported by three departments – sales and marketing, responsible for the division’s advertising income; production, responsible for rationalising production operations and increasing financial efficiency; and human resources, responsible for human resource policies, employment relations and downsizing. The most significant change, however, was the formation of three subsidiary companies, South Pacific Pictures, Avalon Studios and Broadcast Communications, which were to operate the company’s non-core activities and further employ efficiently available resources. South Pacific Pictures, established in 1988, was responsible for the production of the drama genre. It was organised as a project-based organisation, characterised by a non-standard format of production activities, with only a limited number of full-time employees, and contractual arrangements at the individual and organisational levels. This was the company that made Shortland Street. The company’s largest production facility, Avalon Studios, was given the status of a profit centre. The Avalon TV centre, which managed about 23,000 square metres of studios, equipped with the latest technology, was given a chance to employ these facilities...
profitably for both TVNZ’s core business and external markets. The establishment of the former engineering division of BCNZ, Broadcasting Services, as Broadcast Communications Ltd (BCL), enabled TVNZ to provide television production, transmission and engineering services to various broadcasting companies and to enter into the telecommunications market.

The 1990s started a new era of TVNZ’s organisational development, characterised by various inter-organisational arrangements. At the corporate level, TVNZ established equity relationships with Sky Network TV (SKY) and Clear Communications Ltd. Investments in related businesses, particularly telecommunications and international broadcasting, were considered strategically important for the company’s growth. Furthermore, as part of its strategy to establish itself as the leading provider of services to video and film industry in New Zealand, Avalon Studios bought the National Film Unit.

A further important development, which characterised this stage of TVNZ’s restructuring, was the establishment of 27 strategic business units (SBUs). The rationale behind this reorganisation was in establishing each unit not generating income from external markets as an SBU. Their performance could then be monitored and their operations would become financially transparent. The establishment of SBUs introduced an internal-charging system, which promoted competition with external providers and gave managers the freedom to organise their operations independently. However, the vision did not prove effective in practice. The system increased the volume of internal transactions and accordingly increased the costs of these internal exchanges. It further introduced confusion into established relationships among various providers of resources, and put into conflict relations between individual managers’ behaviour and overall organisational objectives.10

With the new CEO’s arrival in 1995 and a critical review of TVNZ’s operations, TVNZ entered into a new stage of development – consolidation. The new CEO refocused management attention to the core business, emphasising quality of broadcasting and cost efficiency. Organisational structure was simplified. Instead of a large number of strategic business units, all with their own boards of management, the new structure consisted of three major divisions – television, production and distribution. In this structural arrangement, the two national channels were put under the management umbrella of TVNZ Television. TVNZ Production was comprised of Avalon Studios, South Pacific Pictures, Moving Pictures and some other smaller operational units. South Pacific Pictures was sold in 1997 with some other ‘non-core businesses’. TVNZ Distribution included the major TVNZ’s transmission service company BCL.

Each stage of TVNZ’s history has been led by a distinctive CEO style. The first CEO, Julian Mounter (1986–91), took the state broadcaster into the commercial era and opened the door to competitive television as a response to the commencement of TV3’s operations. His successor, Brent Harmon (1991–95), had a global vision and looked overseas for growth opportunities. Much of this direction was reversed under Chris Anderson (1995–98), who refocused to the process of getting back to core operations.11 The fourth CEO, Rick Ellis (1998–2002), strove to move the company towards a digital future and bring ‘a business focus as opposed to a pure television focus’.12 However, the election of another Labour-led government in 1999 heralded a new era of change for TVNZ as well as a new style of leadership for the company.

### TVNZ in the 2000s

TVNZ was a commercially successful SOE over the past decade, returning NZ$366 million in dividends to the government since 1990 and retaining about 70 per cent market share.13 The year 2001 saw a reduced level of return due to a declining advertising market but even so TVNZ still posted an after-tax dividend of NZ$17.1 million. BCL’s contribution, in terms of profit, formed a significant component of TVNZ’s success. This transmission arm of TVNZ contributed over 70 per cent to the company’s profits in 2002.14 In March 2000, TVNZ launched a portal website, www.nzoom.com.15 The site was designed to provide a gateway to the world wide web as well as a mixture of local and international content. ‘It’s a web business, rather than a web site for a television business’, said the general manager of strategy and marketing at the time.16 In a similar way to its television counterpart, revenue was earned primarily through banner advertising and sponsorship.

The management structure of TVNZ was also changed with the resignation of CEO Rick Ellis and his replacement by Ian Fraser. The appointment of Fraser came with the wave of a series of key appointments in the management of TVNZ between 2001 and 2002. These changes were announced as a move designed to enable TVNZ to ‘remain competitive’ in an increasingly fragmented media environment.17 Interestingly, it was
this fragmented media environment that attracted Rick Ellis, former general manager of Wang NZ and managing director of Wang UK, to the job of TVNZ CEO. The move towards digital television and convergence of technologies was seen by Ellis as an outstanding opportunity for TVNZ’s future development. Ellis’s four-year long contract had come to the end in April 2002. During this time he had managed an annual turnover of nearly half a billion New Zealand dollars and 1400 employees. Even so, he failed on several attempts in convincing the government to invest into TVNZ’s digital future.

DIGITAL TELEVISION

Digital television is a method of transmitting television and other information into the home. In comparison to analogue television, which all present New Zealand terrestrial (that is, land-based) television services employ, digital television can offer additional programs using the same amount of spectrum, as well as integrated teletext, electronic program guides and features such as choices of camera angles or language. Additional services can also be distributed, including Internet access, email, banking and teleshopping.

The key to understanding digital television is that it is an enabling technology, allowing prospects for certain forms of development. Once digital technology is in people’s homes, it will open up a world of opportunity for broadcasters, advertisers and the public. Digital television is seen by many in the broadcasting industry as the inevitable replacement of analogue, in form similar to the way digital mobile phones are replacing analogue mobile phones.

New Zealand was expected to follow the trend in other countries and migrate from the current analogue television to digital television over the next 10 to 15 years. At the beginning of the twenty-first century, the government was in the process of policy development in relation to digital television to ensure that public and private broadcasters were able to use the technology. This process was somewhat complex as government had several major roles to fulfil in respect to this digital vision. These were:

- allocation and management of the spectrum on which commencement of digital terrestrial television relies
- setting up the market framework which ensured competition safeguards are adequate and standards are adopted and maintained
- taking into account the implications of digital television for the TVNZ and the Maori Television service, and programming funded through NZ On Air and Te Mangai Paho.

Deciding which perspective to take in the digital landscape was a cornerstone decision for both the government and TVNZ. The devised government policy on digital television and TVNZ’s digital arrangements would present a foundation for TVNZ’s long-term strategy and position in the industry. SKY was the only digital broadcaster in New Zealand reaching over 30 per cent of households (around 422 000 pay TV customers). The constant push of Rick Ellis on the government to make a digital deal did not, however, bear any fruit. The government turned down the initial 2000 digital plan between TVNZ and the British company NTL to develop pay channels. This plan required more than NZ$200 million in investment, and the government considered this proposal as too risky. Apparently, the government did not want TVNZ to compete with SKY; it instead preferred a joint agreement with SKY over the transmission of TVNZ’s channels on the SKY satellite. In 2001, another potential joint venture with TelstraSaturn, an Australian company, also failed. TelstraSaturn abandoned its deal with TVNZ in order to refocus on its telecommunications business, rather than pay TV. Instead, the end of year 2001 saw a deal with SKY.

Thus, by the end of 2002, TVNZ had no digital policy. Unlike its counterparts, BBC in the UK and ABC in Australia, it had no digital channels or interactive services established. Many argued that because of public service and Charter imperatives, the government decided to stay away from the conundrums and major risks associated with mainstream digital television.

MANAGEMENT ISSUES

A great concern for TVNZ was the issue of government intervention in its day-to-day operations, which might lead to a loss of editorial autonomy. This fear was stressed explicitly by the former TVNZ news executive Paul Cutler: ‘Over the years I’m quite sure every politician in New Zealand wishes he could run TVNZ, and particularly its news service. So the temptation is there.’ The question of autonomy was a factor that overlapped a number of the issues confronting TVNZ. Independence from direct government interference was viewed as a crucial factor in TVNZ’s credibility and future viability. Although, according to some, the chief executive’s job was not a
political appointment, Fraser had good connections in government circles. His experience in the political arena could have been thought to be a strong advantage in running a public broadcaster.33

Fraser instigated several changes to top management during the first few weeks of his appointment. He eliminated the head of television position held by Shaun Brown, a person with considerable television experience, and created two new positions, the head of programming and head of new business development. According to Fraser, TVNZ had to be ‘differently aligned at top management level to meet the challenge of the planned TVNZ charter’.34 Brown was one of the three high level executives who recently left TVNZ – the other two being Paul Cutler, the head of news and Rick Ellis, CEO. On an organisational level, TVNZ maintained the divisional structure that was adopted in the mid-1990s (see Exhibit 2). In 2002, the company had 1492 staff with a majority of these (1057) employed in the two television channels of TVNZ.

TVNZ: A CROWN COMPANY

In June 2002, TVNZ was restructured and formed into a Crown company. By legal status, this was a different entity from SOE. TVNZ, as a Crown company, combined a directed government motivation for social accountability with financial profitability. The new company, while still bearing the requirement of profitability, was now to concentrate more on social responsibilities in a public broadcasting role and shift away from the commercially focused SOE model.35

One consequence of the new model was the radical change in TVNZ’s organisational structure. The government decided to break up TVNZ group into two entities, a Crown-owned public broadcasting company (TVNZ) and an SOE responsible for running a national and international transmission business (Transmission Holdings Limited, THL). THL included former BCL and TVNZ Australia. The TVNZ group would function as a holding company and each of the new entities would be governed by a separate board of directors. The government’s rationale for the creation of a Crown company was clear when understood in relation to the initiatives outlined in the broadcasting Charter. However, the reasoning behind the removal of BCL from TVNZ’s control lacked any clarification from the government. It was expected that the new structure would take place in December 2003. The new SOE, THL, was projected to achieve revenue returns of about NZ$20 million per year.36 This money would be out of reach from TVNZ to employ in its remaining business units, notably the two television channels. As a result there was repeated concern that the divestment of BCL would increase TVNZ’s dependency on direct government funding support and subsequently reduce autonomy.

These concerns were perhaps secondary to the effect that BCL’s departure would have had on TVNZ’s ability to develop strategic networking. BCL was used in the 1990s by TVNZ as a link to related but diverse industries within New Zealand and also throughout the Asia-Pacific region.

The removal of BCL from TVNZ’s business portfolio placed pressure on TVNZ to reassess its core competencies. Whereas in 1992 TVNZ considered itself a telecommunications company rather than merely a broadcaster,38 the divestment of BCL would end this vision and force TVNZ to focus on new goals.

THE CHARTER

The broadcasting Charter was implemented in March 2003. It was instigated by the Labour government in 2000, who had set about to boost their idea of quality programming on TVNZ. Marion Hobbs, the Broadcasting Minister between 1999 and 2002, stated that:

the value of TVNZ to the nation is not only what is on its balance sheet but also what it delivers on screens . . . The changes mean that TVNZ will be able to focus on meeting its obligations as a public broadcaster with its own charter, just as happens with public broadcasters worldwide and our own Radio New Zealand.39

However, concerns from the public, opposition politicians and, privately at least, top-level TV executives alike, proposed that a radical transition in to the new Charter model may force the government to pump money in to TVNZ.40 In response to such concerns Hobbs, stated that the changes in TVNZ programming were likely to be gradual. By implementing these gradual changes, TVNZ would avoid a huge drop in ratings and a fall in advertising revenue (see Exhibit 3).41 Moreover, Hobbs believed that the Charter would be a key driver of cultural change in
CASE NINE: TELEVISION NEW ZEALAND: BALANCING BETWEEN COMMERCIAL AND SOCIAL OBJECTIVES

EXHIBIT 2 TVNZ management structure 2002–03

TVNZ and that the shift from an exclusive commercial focus would create opportunities for more creative work in the company.⁴²

Nevertheless, there was a question as to a choice of either a ‘radical’ or ‘gradual’ change under the Charter. Some media experts considered that TVOne was already fulfilling 95 per cent of its obligations under the Charter from the perspective of greater society. Thus, the Charter would make very little difference to the content aired on this channel.⁴³ TVNZ’s advertising revenue would

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most likely depend on how the Charter was going to be implemented. For example, the frequency and time frame of ‘indigenous’ program screening; and whether or not the Charter would apply equally to TVOne and TV2; and whether TV2 would interpret the Charter differently so as to provide a relatively stable revenue stream.

In considering the implementation of the Charter, Fraser and his executive team had to have an awareness of a shift in a number of factors that existed in the media environment and difficulties that would be encountered if they were to be ignored. Pay TV, the Internet, radio and other media such as outdoor advertising mediums, for example, bus shelters, billboards and bus advertising, were increasingly fragmenting the market. As a consequence, TVNZ’s two ‘free-to-air’ channels were faced with increased competition for the ever important advertising dollar. Moreover, the television industry as a whole was facing significant challenges to reverse a nine year long trend which saw television’s share of advertising revenue decreased by 6.3 per cent.44 Former TVNZ’s CEO, Rick Ellis, pointed out that this trend was a global phenomenon. Free-to-air broadcasters around the world

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**EXHIBIT 3** TVNZ advertising revenues, 1997–2002 (in NZ$ million)

![Graph showing TVNZ advertising revenues, 1997–2002](chart.png)


**EXHIBIT 4** TVNZ transmission revenues, 1997–2002 (in NZ$ million)

![Graph showing TVNZ transmission revenues, 1997–2002](chart2.png)

### EXHIBIT 5 TVNZ financial trends, 1998–2002 (in NZ$)

<table>
<thead>
<tr>
<th></th>
<th>12 months Ended</th>
<th>12 months Ended</th>
<th>12 months Ended</th>
<th>6 months Ended</th>
<th>12 months Ended</th>
</tr>
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<tr>
<td></td>
<td>30/06/02</td>
<td>30/06/01</td>
<td>30/06/00</td>
<td>30/06/99</td>
<td>31/12/98</td>
</tr>
<tr>
<td></td>
<td>$000</td>
<td>$000</td>
<td>$000</td>
<td>$000</td>
<td>$000</td>
</tr>
<tr>
<td><strong>Group Financial Performance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Television advertising revenue</td>
<td>285,666</td>
<td>284,663</td>
<td>295,772</td>
<td>125,130</td>
<td>270,607</td>
</tr>
<tr>
<td>Other revenue</td>
<td>191,608</td>
<td>196,412</td>
<td>177,628</td>
<td>70,650</td>
<td>155,500</td>
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<tr>
<td><strong>Total revenue</strong></td>
<td>477,274</td>
<td>481,075</td>
<td>473,400</td>
<td>195,780</td>
<td>426,107</td>
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<tr>
<td><strong>Net surplus after taxation</strong></td>
<td>19,353</td>
<td>29,950</td>
<td>43,102</td>
<td>167,291</td>
<td>45,035</td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
<td>8,600</td>
<td>17,100</td>
<td>30,200</td>
<td>106,160</td>
<td>31,500</td>
</tr>
<tr>
<td><strong>Group Financial Position</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Funds employed:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>140,000</td>
<td>140,000</td>
<td>140,000</td>
<td>140,000</td>
<td>140,000</td>
</tr>
<tr>
<td>Foreign currency translation reserve</td>
<td>(897)</td>
<td>(111)</td>
<td>403</td>
<td>190</td>
<td>47</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>216,680</td>
<td>205,927</td>
<td>193,077</td>
<td>180,175</td>
<td>119,044</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td>355,783</td>
<td>345,816</td>
<td>333,480</td>
<td>320,365</td>
<td>259,091</td>
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<td>Current liabilities</td>
<td>77,632</td>
<td>86,067</td>
<td>101,152</td>
<td>111,067</td>
<td>60,505</td>
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<td>Term liabilities</td>
<td>80,450</td>
<td>87,600</td>
<td>46,830</td>
<td>125,997</td>
<td>124,462</td>
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<td><strong>Total funds employed</strong></td>
<td>513,865</td>
<td>519,483</td>
<td>481,462</td>
<td>557,429</td>
<td>474,058</td>
</tr>
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<td>Assets employed:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>174,465</td>
<td>192,633</td>
<td>185,208</td>
<td>272,546</td>
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<td>Term portion of programme rights</td>
<td>37,439</td>
<td>33,215</td>
<td>45,083</td>
<td>51,016</td>
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<td>Property, plant and equipment</td>
<td>251,048</td>
<td>237,379</td>
<td>227,226</td>
<td>207,388</td>
<td>216,110</td>
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<td>Investments, intangibles and licences</td>
<td>45,984</td>
<td>49,037</td>
<td>14,887</td>
<td>17,589</td>
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<td>Investment in associate</td>
<td>139</td>
<td>80</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Future income tax benefit</td>
<td>4,790</td>
<td>7,139</td>
<td>9,058</td>
<td>8,890</td>
<td>8,364</td>
</tr>
<tr>
<td><strong>Total assets employed</strong></td>
<td>513,865</td>
<td>519,483</td>
<td>481,462</td>
<td>557,429</td>
<td>474,058</td>
</tr>
<tr>
<td>Financial Ratios</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating surplus/total revenue*</td>
<td>8.0%</td>
<td>9.5%</td>
<td>18.6%</td>
<td>10.9%</td>
<td>16.0%</td>
</tr>
<tr>
<td>Net surplus after taxation/equity (average)</td>
<td>5.5%</td>
<td>8.8%</td>
<td>13.2%</td>
<td>57.7%</td>
<td>17.8%</td>
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<tr>
<td>Equity/total assets employed</td>
<td>69.2%</td>
<td>66.6%</td>
<td>69.3%</td>
<td>57.5%</td>
<td>54.7%</td>
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<tr>
<td>Interest cover (times)*</td>
<td>7.7</td>
<td>9.3</td>
<td>29.0</td>
<td>6.1</td>
<td>6.6</td>
</tr>
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* Excludes non recurring items.

could only sit and observe as their advertising revenues came under attack, hit a point of ‘maturity’ and then start to decline. To overcome this problem, he suggested, ‘TVNZ must position itself to offer new services and new value’. Ellis believed that new revenue streams could be created by exploiting digital technology to the advertiser and the viewer.

When observed globally, TVNZ had been historically more commercially driven and more dependent on commercial and advertising revenue than any other public service television broadcaster in the world. The New Zealand government spent on average approximately NZ$3 a head annually on public service television compared to Australia, which spent NZ$30, and the United Kingdom which spent NZ$122 per person. Would New Zealand government agree with this level of subsidisation? In 2002 the government allocated only NZ$12 million, which was less than 5 per cent of TVNZ’s annual operational revenue, in order to assist TVNZ in its implementation of the charter. It was also unclear whether TVNZ would still be subject to dividend demands from the Treasury. Fraser believed that this would not be realistic in the current situation. This opinion was rejected by the Broadcasting Minister Steve Maharey who had different views. He expected TVNZ to still operate profitably, with an estimated surplus of NZ$19.3 million for 2004 and to pay dividends to the shareholders – the government.

Furthermore, NZ On Air had already announced that it would need up to NZ$20 million more to buy programs necessary to meet TVNZ’s new Charter obligations. It also faced an NZ$8 million shortfall because of the changeover to Crown financing. July 2000 saw the end of NZ On Air. The Ministry for Culture and Heritage now took over the responsibility of NZ On Air. NZ On Air continued to operate with the same responsibilities and at the same net level of funding, but which was now provided directly by the government.

On a competitive front, ACNielsen research showed that TVNZ’s main competitor TV3 was increasingly able to hold its own position against TVNZ in the race for ratings. In 2001, for example, TV3 made significant gains in terms of audience levels compared to 2000 (see Exhibit 6). Meanwhile TV One and TV2 struggled to keep viewers, with both TVNZ channels recording a drop in performance. Nevertheless while TV3’s audience share remained about 28 per cent, TVNZ (TV One and TV2) still dominated with a 70 per cent of the channel market. This was regarded as success, on the basis that in most world markets when a free-to-air operator is introduced to pay TV competition (for example, Sky TV) a rapid erosion of market share results. Moreover, TVNZ still held on to some of the biggest contracts with major providers of programming; for example, the rights for major sporting events.

In terms of programming for TVNZ’s two channels, the Charter would require additional funding to cover the increase of New Zealand indigenous programming (that is, local content). In general, the relative expense of producing locally made programming was higher than importing overseas made programs. These costs would reduce returns on investment and, as discussed above, may be exacerbated by a downturn in advertising expenditure across the TV industry. To compound this, TV3 was expected to grow market share by taking advantage of TVNZ’s Charter obligations.

Moreover, TVNZ’s broadcasting arm was historically financially supported by its subsidiaries (for example, BCL). In 2000, they helped TVNZ’s two channels to report a NZ$10 million profit in only six months, handing over a dividend of almost NZ$7 million to the government. However, TVNZ annual results for 2001 stated that revenues relating to their transmission arm had ‘offset increased costs and a decline in advertising revenue, which at [NZ$]284.7 million for the year, was a decrease of [NZ$]11.1 million (3.7 per cent) on the previous year’.

THE FUTURE

Under the TVNZ Act 2003, the company now had the dual remit of meeting its Charter objectives while at the same time maintaining commercial performance. This made TVNZ a unique public broadcaster, as few networks globally are charged with the task of balancing these two objectives. Fraser felt that this delicate balancing act of accommodating commercial and social objectives would be difficult but achievable. “The charter does not give us a licence to bore’ he said. ‘And maintaining commercial performance means that we cannot afford to bore.’ Thus, it was of immense importance that the charter-related content was to be commercially attractive because TVNZ could not afford to hope on New Zealand government providing funding for public television.

Those that criticised the Labour government and opposed the Charter were questioning what the prime responsibility of TVNZ was. What was its strategic
CASE NINE:

TELEVISION NEW ZEALAND: BALANCING BETWEEN COMMERCIAL AND SOCIAL OBJECTIVES

objective? Was it to be a successful business which was to be as profitable and as efficient in comparison to businesses not owned by the Crown, or was it to reflect New Zealand’s identity and culture and encourage New Zealand programs? Some saw that the TVNZ Charter fell between two stools. If the government wanted TVNZ to become the national talent quest, it was probably going to have to accept a decline in quality, audience, and advertising revenue.61 On the other hand, the new Broadcasting Minister Steve Maharey said that TVNZ ‘should be under no illusions that Government wants a return. Because if we don’t get a return then our concern will be that the company is not running in a commercially successful way’.62 However, Maharey also added that ‘we have a Charter now and we expect to see a different kind of television channel’.63

Fraser and his team were faced with a difficult time ahead. If TVNZ fully embraced the Charter it would likely become dependent on the taxpayers in a very short time. And once it ceased to be a self-supporting operation its chances of keeping pace with the looming developments in its industry looked very dim indeed.64 The Charter was also silent on how the channel was supposed to strike the balance and, crucially, how profitable it was supposed to be.65

According to Fraser, the projections under the Charter would be difficult to achieve ‘if advertising demand falls away or the cost of producing the diverse programmes necessary to achieve TVNZ’s Charter objectives balloons’.66 On the other hand, the Broadcasting Minister, Maharey, was confident that the Charter would be good for advertisers. ‘Delivering a wider range of audiences to advertisers is critical to the industry’s success and it also fulfils the government’s objective’.67

The other challenge for Fraser related to splitting off those parts of TVNZ that were not directly concerned with the making of broadcast programs. The most important of these was BCL, a transmission company that distributed the signal for television and radio programs around the country. The main problem here was that BCL was the financial engine for TVNZ. Without the profits derived from BCL in 2004, the new restructuring would reveal just how profitable TVNZ really was. Consequently the split would have possible adverse effects on TVNZ television. TV2, with its diet of American sitcoms, had made money in the past, but TVOne, with its news and current affairs, documentaries and local programs, just managed to break even. When the additional demands of the Charter were to be introduced, and some advertising revenue possibly taken out, TVOne might find itself in a difficult position.68 Recently, Maharey was quoted saying that ‘both companies have strong and viable futures as separate stand-alone businesses, operating with clear mandates’.69

EXHIBIT 6 Average audience analysis

![Average Audience Analysis 2000 vs 2001](chart)

*Peak time: 6:30pm–10pm; Date range: 1 January – 29 August 2000 and 2001.

Source: Adapted from S. Shaw, 2001, ‘The rise & rise of TV3’, AdMedia, 16(8): 33 (from original material provided by ACNielsen Media International: Dataline Service).
While the above statement could certainly hold true for the transmission business, Fraser was wondering if the same could be said for TVNZ. As a highly visible media organisation, external pressures on TVNZ were perhaps greater than they were for most other commercial companies. It remained to be seen whether TVNZ could withstand these pressures in reality and find the balance between commercial and social objectives.
NOTES

5 ‘Treasury, Scoping report on Television New Zealand’.
6 ‘Treasury, Scoping report on Television New Zealand’.
16 Foreman, ‘New web site zooms off to cyberspace’.
18 A computer company.
19 ‘Tapsell, TVNZ’s transformer’.
27 P. Norris, 2000, ‘TVNZ goes digital but who’s being served’, New Zealand Herald, 21 November.
29 P. Norris, 2002, ‘Ian Fraser will need to be one out of the box’, New Zealand Herald, 19 April.
33 Maharey, ‘Current issues in New Zealand television’.
34 Cleave, ‘Ghost of Hawkesby seen as TVNZ swings axe again’: A2
44 Calder, ‘Kiwi channel changing’.
45 Tapsell, ‘TVNZ’s Transformer’: 21.
47 Maharey, ‘Current issues in New Zealand television’.
48 P. Thompson, 2005, ‘Calling the tune without paying the piper?’, Paper presented at the Annual Meeting of the Australian and New Zealand Communication Association, Christchurch, New Zealand, 4–7 July.
49 Thompson, ‘Calling the tune without paying the piper?’.
53 Shaw, ‘The rise & rise of TV3’: 33.
54 Shaw, ‘The rise & rise of TV3’: 33.
55 Tapsell, ‘TVNZ’s Transformer’.
56 Tapsell, ‘TVNZ’s Transformer’.
57 Calder, ‘Kiwi channel changing’.
58 Calder, ‘Kiwi channel changing’.
62 O’Sullivan, ‘Fraser in the hot seat’.
63 O’Sullivan, ‘Fraser in the hot seat’.
64 2001, NZ Herald, Editorial, 3 May.
65 NZ Herald, Editorial.
66 O’Sullivan, ‘Fraser in the hot seat’.
The tenth anniversary of the start of teaching was an opportune time to reflect on the years of progress at the University of the Sunshine Coast (USC). It had been the first ‘greenfield’ university established in Australia for more than 20 years and it had enjoyed the fastest growth of any Australian university during the 10 year period of its operations. It had grown from a simple organisation with a handful of staff and no students to a complex organisation of more than 400 staff and more than 5000 students in a little over a decade. This growth is all the more remarkable given that the main funding agency, the federal government, did not wish it to be established as an independent campus.

The establishment and development of the university required agreement and cooperation between a number of stakeholders. Since the mid-1970s control of the regulatory environment for higher education has been shared between state and federal governments. The state governments are responsible for, among other things, the establishing legislation, appointments to university governing bodies and external audits. The federal government allocates operating and capital funding and negotiates the educational portfolio for each institution. Local governments also have an important part to play, being responsible for the development of physical infrastructure such as roads and services. The local community also needs to be engaged in the process – after all, they would need to be convinced of the quality of the new university in order to choose to attend it and to encourage others to do so. However, getting these diverse stakeholders to work towards a common goal would not be easy.

**ESTABLISHMENT**

The establishment of the University of the Sunshine Coast was a long and difficult task. Discussions on a university campus on the Sunshine Coast had commenced over 20 years earlier when a local interest group was formed, coinciding with the federal government’s adoption of direct responsibility for higher education funding. Although there were doubts that the population within the region at that time merited a full university campus, projections suggested that the Sunshine Coast region would be an area of significant population growth.

Concerns were also expressed that without a local university to meet their needs, a population drain would occur as the youth of the region left to further their educational knowledge elsewhere. On this basis, and recognising the multiplier effects that a local university can have on a regional economy, the local interest group was able to garner both community as well as local political support. However, the discussions were not conclusive and, as national economic conditions became less favourable, no firm plans for the establishment of a Sunshine Coast university emerged.

In the late 1980s the federal government adopted a policy of no new higher education institutions, refusing to provide the capital and operating funding necessary for the establishment of a new university. It preferred that existing institutions develop additional campuses. In response to the change of federal policy the Queensland government offered the Sunshine Coast campus to the Queensland University of Technology (QUT) which declined the offer so that it could concentrate on the development of its Brisbane campuses. QUT’s decision may have been influenced by its limited operation as part of a Sunshine Coast TAFE campus. The QUT operation had not been as successful as it had hoped and it was intending to close this campus down in the near future. This left the Queensland government with the sole option of establishing a new institution over the objections of the federal government.
In order to accomplish the establishment of the university, the Queensland government would need to broker an arrangement with the federal government. The parties agreed that the new institution would be named as a ‘university college’, suggesting that it was something less than a university. However, the establishing legislation would convey that the institution had all the rights of a university. The parties also agreed that the federal government would not directly fund the new institution. Rather, its funding would be provided through an existing higher education institution. The Queensland government obtained the agreement of the Queensland University of Technology (QUT) to act as an agent for the new institution and to undertake a mentoring role. This arrangement would continue until the new university gained formal membership of the national higher education system. QUT also agreed to oversee the establishment of the university, including all buildings and academic functions and to provide advice and assistance where required. The QUT campus on the Sunshine Coast would be closed down once the independent university was established.

THE PLANNING PHASE

Further to the arrangement between the Queensland government and QUT, a committee was created to oversee the initial planning phase for the new institution. Apart from its chair, the QUT vice-chancellor, Professor Dennis Gibson, the planning committee comprised three nominees of QUT plus four appointees of the Queensland Minister for Education. The planning president would join the committee once that position had been filled.

The planning committee addressed such issues as the name of the institution, the appointment of a planning president, and the appointment of a campus master planner. The committee appointed QUT’s Professor Paul Thomas as the planning president with the expectation that he would hold office until a vice-chancellor was appointed. All these issues were substantially resolved by the time that the committee handed over responsibility to the new university governing body.

THE UNIVERSITY COUNCIL

The planning committee continued operation for nearly 12 months prior to the formal creation of the university. The university legislation was endorsed by the planning committee and passed by the Queensland parliament. The informal arrangements gave way to statutory authority as the planning committee was replaced by the first governing body, the University Council.

The momentum developed by the planning committee could easily have been lost in the changeover to the University Council. However, five of the eight members of the planning committee, including the planning president and all four ministerial nominees, became members of the first University Council. This provided continuity in the governance of the organisation and ensured an understanding of its immediate history and strategic objectives. The first University Council included three members nominated by QUT (who, although not a requirement, had not been members of the planning committee), six members appointed by the Governor-in-Council, a nominee of the Chief Executive of the Queensland Department of Education and a student studying at the QUT Sunshine Coast campus. Some categories of membership, such as an academic staff member of the University, were not filled at that time. One of the Governor-in-Council appointees, Justice Tony Fitzgerald, was elected as the first Chancellor. The Chancellor is an honorary position in Australian universities that acts as the presiding officer at University Council meetings. At the time of his election as Chancellor, Justice Fitzgerald was President of the Queensland Court of Appeal and, more importantly, he was a well-known figure in Queensland as the former head of a committee of inquiry into police misconduct. Fitzgerald’s election as its Chancellor provided the new university with an individual who had extensive contacts in the state government and a national reputation for fairness and honesty. Other members of the first University Council were also eminent people with strong connections to the community. Thus, the new university had credibility drawn from the calibre of individuals who agreed to be associated with it.

The same day the Act became operational the University Council held its first meeting. It was determined that the first students would be admitted to the new campus in just 18 months time. Establishing every component of a new university with minimal start-up costs, very few staff and in such a short time had never before been accomplished.

THE SUNSHINE COAST REGION

By the mid-1990s the projections of substantial population growth had proved to be correct. The Sunshine Coast region experienced rapid expansion with nearly
31 per cent growth between the population census in 1991 and the population census in 1996. The population growth has continued with the Queensland Department of State Development noting that the Sunshine Coast region has experienced a 3.3 per cent annual growth rate in population between 1998 and 2003 (the state average was 1.9 per cent for the same period) and now contains around 7 per cent of the total population of Queensland. The trend is expected to continue with a projected 2.6 per cent annual growth rate in the regional population through to 2026.

Part of the original rationale for the establishment of a university on the Sunshine Coast was its economic impact. This became a central concern to the new university that continues to consider its engagement with the Sunshine Coast region and recognises its potential impact within its mission statement. At the time of the university’s establishment the local economy, once based around agricultural products, was in the process of change. It has increasingly diversified into service-based industries (retail, accommodation, restaurants and professional services). During the period 2001–05 the local economy expanded at a rate of 7 per cent (more than the state average rate of 6 per cent) and this high rate of economic growth is expected to continue. One emergent driver of the local economy during this time has been the construction industry, which has expanded substantially in response to population growth.

### STUDENTS

Notwithstanding the economic growth within the Sunshine Coast region, many population centres are still considered to be at the lower end of the socio-economic status scale. Indeed, the University of the Sunshine Coast has had the second highest rate of students drawn from low socio-economic status areas of any higher education institution in the nation. This presents particular difficulties for students, most of whom must undertake paid work in order to support themselves during their studies. The pressures of making a living are a major contributing factor to the attrition in student numbers which, at an average of 30 per cent per annum for the past five years, places the university in a high attrition category. Another factor has been the age of students at University of the Sunshine Coast, which has been consistently higher than the national average. Older students are more likely to have financial and family commitments and are, therefore, more susceptible to withdraw from their studies.

Despite these difficulties, the university has managed to achieve laudable growth. Exhibit 1 shows the performance of the university against other universities in Queensland from 1998 through to 2007 in terms of attracting applicants’ first preference through the Queensland Tertiary Admissions Centre (QTAC) system. The university has steadily increased its overall share of first preferences from 1.8 per cent in 1998 to 4.3 per cent in 2007. The majority of the growth in recent years has come from an expansion in the range of degrees offered rather than substantial increases in student numbers in existing degrees. Perhaps of greater interest is the university’s performance against the previous year, particularly when viewed against the overall trend in Queensland. With the exception of 2001 and 2002, the University of the Sunshine Coast has performed better than the Queensland average.

### EXHIBIT 1 Performance of USC within the QTAC admissions system

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<td>% of total 1st preferences for universities</td>
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<td>2.4</td>
<td>2.9</td>
<td>2.8</td>
<td>2.5</td>
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<td>2.7</td>
<td>2.9</td>
<td>3.6</td>
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<tr>
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<td>+19.5</td>
<td>+22.9</td>
<td>–7.5</td>
<td>–5.6</td>
<td>+3.6</td>
<td>+6.5</td>
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<td>+30.1</td>
<td>+16.9</td>
</tr>
<tr>
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<td>+6.2</td>
<td>+0.1</td>
<td>–0.5</td>
<td>–6.2</td>
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<td>–1.5</td>
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Source: USC QTAC data in January of the relevant year
MISSION AND VISION

Perhaps one of the strengths of the university over the period of its operation has been the consistency of mission and vision. Early in its foundation the University Council stated the university mission as:

The Sunshine Coast University College aspires to become the major focus for the academic, cultural and economic development of the Region; a higher education organisation which is responsive to its community but also pursues high international standards of scholarship in teaching and research, including their application to regional issues.

The mission statement has been revised on only two occasions since that time. In neither case has the core direction of the university been changed. In its tenth year of operation the mission was revised and now reflects that the University of the Sunshine Coast seeks:

To be the major catalyst for the innovative and sustainable economic, cultural and educational advancement of the region, through the pursuit of international standards in teaching, research and engagement.

One of the reasons for so little alteration of the mission over time may be the clear rationale for the creation of the university. The community and government support received was based on this rationale and any substantial departure from it may have weakened the university’s standing. Another likely reason for the consistency of mission is the longevity of the chief executive officer and other senior officers. First as planning president and then as the university’s first Vice-Chancellor, Professor Paul Thomas’ involvement with the university stretched back more than a decade. Likewise, the university’s second Chancellor, Ian Kennedy, had been a member of the planning committee and Deputy Chancellor in earlier councils. The consistency in the mission of the university encouraged acceptance by staff of the changes that came through growth. Although the pace of change was perhaps faster than expected, nonetheless, the change was expected and, in some cases, seen as a measure of success.

STAFFING AND ORGANISATIONAL STRUCTURE

The first University Council was cautious in its arrangements for staffing. It determined that all full-time staff would be appointed on one-, three- or five-year fixed term contracts. This provided a measure of flexibility should the organisational structure need to be varied as a result of some teaching areas being discontinued or some administrative functions being outsourced or the organisational structure varied. There was a risk, in an environment where ongoing employment was standard, that many experienced staff in the higher education sector would be turned off by the fixed-term contracts offered by the university. To succeed the university needed to attract a core of experienced staff. Fixed-term contracts would, however, not be an obstacle to all potential applicants. It was possible that this approach of providing less-secure employment would attract individuals who were prepared to take risks, would back their own abilities and focus on outcomes. Certainly these qualities would be necessary if the university was to open its door on time.

The first University Council determined that, as a planning president was in place, there was little need in the early stages to pursue the appointment of a chief executive officer. However, in the light of the immediate work to be undertaken, a senior university administrator would be appointed to support the planning president. With 12 months to go before the commencement of teaching, Paul Corcoran was appointed as the foundation Registrar. At the time of his appointment Corcoran had nearly 20 years’ experience in higher education and had overseen a number of major change projects, including two institutional amalgamations in higher education. His role was to ensure that the facilities were ready on time, that the necessary administrative support services were operational, that recruitment and selection processes were undertaken and that the necessary regulatory infrastructure (policies and rules) was in place.

The process of structuring and re-structuring the organisational environment requires significant resources and can also be expensive in terms of both staff time and staff morale. These conditions meant that the University College administrative structure would need to be responsive to a rapidly changing organisational environment and, yet, provide a measure of stability and security for staff.

Corcoran’s stated aims in the development of the administrative staffing structure were the:

- development of an administration structure which would meet the needs of a developing institution
- development of a management framework which could direct, and adapt to, rapid organisational change
- creation of positions which would be sustainable beyond the initial establishment period.
Most university administrations are structured along functional lines with some large institutions adopting a hybrid functional–divisional structure. Following his appointment Corcoran prepared a functional analysis of a university administration based on his previous experience. One of the key issues to be determined was which functions the university administration would provide, which would be outsourced to the Queensland University of Technology and which would be outsourced to other organisations. In some cases, the functions might be performed in-house but outsourced initially if it was going to take some time to become fully operational, for example, the creation of a plant nursery. Some of the functions identified would not be performed in the early stages of the university’s development. The analysis provided a basic framework of what needed to be done and provided a basis to extrapolate growth in both positions as well as organisational units.

In the case of the Sunshine Coast University Corcoran opted for a functional structure, identified the likely positions in the first few years and recommended the order in which positions were to be filled. A flat structure was believed to be most appropriate, particularly in the early stages of foundation. A flat structure would allow for growth, particularly at middle management level, and would also allow higher level control over decision-making. This approach also provided little disruption in reporting lines and job scope as the organisation grew. Over time this highly centralised approach to decision-making was expected to give way to distributed decision-making.

While the administrative functions to be performed were fairly clear, the teaching areas were not. Accordingly, the initial staff advertisements for academic positions were doubly problematic – they were fixed-term and they did not provide detail of the teaching areas desired. Notwithstanding this the initial academic staff advertisements attracted a large number of applicants with over 800 applications being received for just 20 academic appointments to be made in the first year of teaching.

In spite of the planning undertaken the university was cautious in its implementation of an academic staff structure. A flexible organisational structure would allow the university an opportunity to address any flaws in its planning and also to respond to changed circumstances as it grew. In most universities discipline expertise is grouped into semi-autonomous departments which are, in turn, grouped within schools or faculties. In recent times larger universities have created super-faculties – groupings of organisational units which, previously, had been faculties in their own right.

It was determined that no faculties would be founded in order to facilitate a broad multidisciplinary approach to the degrees that would be offered. Likewise, no faculty deans would be appointed. Rather, coordinators who were responsible for specific degree programs would be engaged. However, these approaches soon gave way to a more traditional university structure. Concerns about not having individual faculties were raised and, in contrast to the innovative direction the college first strove to produce, separate faculties were formed. In order to be accepted within the higher education system the belief emerged that the Sunshine Coast institution needed to reflect the norms and structures of other Australian universities.

From three full-time staff in the early months of its establishment, by the start of teaching the university had grown to 57 full-time staff with a further 32 staff employed on a casual basis. The majority of these were administrative, professional and technical staff, including a near complete complement of managerial-level staff. The early appointment of managers enabled specialised input into institutional planning and facilitated the development of university policies and operational level structures and processes. By the 10-year mark many of these staff were still with the university, albeit some were in different positions. The changes in position have not been due to organisational structure changes, rather, they are due to downshifting by the individual. Growth in staff numbers over the 10 years of operation has been substantial. Currently there are nearly 400 full-time staff and nearly 100 sessional teaching (casual) staff. One possible problem, created by further growth in the next few years, is the continuing ability of the university to source appropriately qualified and experienced casual staff.

The potential problem of recruiting casual staff does not appear to arise in relation to full-time staff. Unusual for a university is that all staff, whether teaching and research staff or administrative, professional and technical staff, enjoy the same working conditions. This includes access to a competitive professional development program that provides successful applicants with six months’ leave on full pay to undertake agreed development activities. Some tensions were experienced in the introduction of this benefit with teaching and research staff concerned that the availability of the program somehow diminished their standing within the university. Administrative, professional and technical staff made little use of the program in the early years of its availability largely due to the unfamiliar requirements of the process.

The early concerns over the ability of the university to attract high quality academic staff were not realised.
Careful selection of academic staff each step of the university’s journey was recognised with a number of staffing reports identifying the University of the Sunshine Coast as having a very high proportion of full-time academic staff with higher degrees. Over a number of years, the university placed second or third on this basis in the list of Queensland universities. The quality of the staff was supported by the quality of human resource practice. In 2005 and 2006, the federal government’s Equal Opportunity for Women in the Workplace Agency (EOWA) recognised the university’s employment practices by listing the University of the Sunshine Coast as an Employer of Choice for Women.

THE CHALLENGES AHEAD

The 10-year anniversary of the commencement of teaching operations has provided an opportunity to consider the accomplishments associated with the University of the Sunshine Coast. Perhaps the greatest accomplishment is the fact of its existence as an independent, fully-fledged Australian university. With few financial or human resources the University of the Sunshine Coast has developed into a high quality institution recognised for its teaching and human resource practices. The staffing and decision-making structures are still highly centralised and this is likely to provide a challenge for the next generation of managers, particularly as the university continues to grow. Continuing growth itself is also an issue. It will be tempting to seek a period of minimal growth to give staff a breathing space during which current systems and structures can be evaluated and, if necessary, changed.

As system level quality and performance measures become more important the university will need to address the high student attrition rate. This is generally considered, perhaps wrongly, as a key indicator of student satisfaction and the current rate may impede the further development of the university. The employment rate of graduates, particularly within the region, is also a key indicator which will need to be monitored. The local economy, while growing, tends to be in areas which do not require university graduates. As a result, the rate of graduate employment is lower than the national average.

Apart from these challenges there is good reason for optimism. The university has come a long way in a relatively short period of time with substantial support from its local community and from its staff. The next 10 years promise to be just as exciting.
Reflecting about his three decades of experience in the grocery business, John Mackey smiled to himself over his previous successes. His entrepreneurial history began with a single store which he has now grown to become the nation’s leading natural food chain. While proud of the past, John had concerns about the future direction in which the Whole Foods Market chain should head. Whole Foods Market was an early entrant into the organic food market and it has used its early mover advantage to solidify its position and continue its steady growth.

With the changing economy and a more competitive industry landscape, John Mackey is uncertain about how to meet the company’s aggressive growth targets. Whole Foods Market’s objective is to reach US$10 billion in revenue with 300-plus stores by 2010 without sacrificing quality and its current reputation. This is not an easy task and John is unsure of the best way to proceed.

COMPANY BACKGROUND

Whole Foods carries both natural and organic food offering customers a wide variety of products. ‘Natural’ refers to food that is free of growth hormones or antibiotics, and ‘certificated organic’ food conforms to the standards as defined by the US Department of Agriculture in October 2002. Whole Foods Market is the world’s leading retailer of natural and organic foods, with 172 stores in North America and the United Kingdom. John Mackey, cofounder and current president of Whole Foods, opened Safer Way natural grocery store in 1978. The store had limited success as it was a small location allowing only for a limited selection, focusing entirely on vegetarian foods. John joined forces with Craig Weller and Mark Skiles, founders of Clarksville Natural Grocery (founded in 1979), to create Whole Foods Market. This joint venture took place in Austin, Texas, in 1980 resulting in a new company, a single natural food market with a staff of 19.

In addition to the supermarkets, Whole Foods owns and operates several subsidiaries. Allegro Coffee Company was formed in 1977 and purchased by Whole Foods Market in 1997; it now acts as Whole Foods’ coffee roasting and distribution centre. Pigeon Cove is Whole Foods’ seafood-processing facility, which was founded in 1985 and known as M&S Seafood until 1990. Whole Foods purchased Pigeon Cove, located in Gloucester, Massachusetts, in 1996. The company is now the only supermarket to own and operate a waterfront seafood facility. The last two subsidiaries are Produce Field Inspection Office and Select Fish, which is Whole Foods’ West Coast seafood-processing facility, acquired in 2003. In addition to the above, the company has eight distribution centres, seven regional bake houses, and four commissaries.

‘Whole Foods Market remains uniquely mission driven: The Company is highly selective about what they sell, dedicated to stringent quality standards, and committed to sustainable agriculture. They believe in a virtuous circle entwining the food chain, human beings and Mother Earth: each is reliant upon the others through a beautiful and delicate symbiosis. The message of preservation and sustainability are followed while providing high-quality goods to customers and high profits to investors.'
Whole Foods has grown over the years through mergers, acquisitions, and several new store openings. Today, Whole Foods Market is the largest natural food supermarket in the United States. The company employs over 32,000 people who are operating 172 stores in the United States, Canada, and the United Kingdom with an average store size of approximately 3000 square metres. While the majority of Whole Foods locations are in the United States, the company has made acquisitions expanding its presence in the United Kingdom. European expansion provides enormous growth because of the large population, and it holds ‘a more sophisticated organic-foods market . . . in terms of suppliers and acceptance by the public’. Whole Foods targets its locations specifically by an area’s demographics. The company targets locations where 40 per cent or more of the residents have a college degree, as they are more likely to be aware and supportive of nutritional issues.

WHOLE FOODS MARKET’S PHILOSOPHY

The company’s corporate website defines the company philosophy as follows:

Whole Foods Market’s vision of a sustainable future means our children and grandchildren will be living in a world that values human creativity, diversity, and individual choice. Businesses will harness human and material resources without devaluing the integrity of the individual or the planet’s ecosystems. Companies, governments, and institutions will be held accountable for their actions. People will better understand that all actions have repercussions and that planning and foresight coupled with hard work and flexibility can overcome almost any problem encountered. It will be a world that values education and a free exchange of ideas by an informed citizenry; where people are encouraged to discover, nurture, and share their life’s passions.

While Whole Foods recognises it is only a supermarket, it is working toward fulfilling its vision within the context of its industry. In addition to leading by example, it strives to conduct business in a manner consistent with its mission and vision. By offering minimally processed, high quality food, engaging in ethical business practices and providing a motivational, respectful work environment, the company believes it is on the path to a sustainable future.

Whole Foods incorporates the best practices of each location back into the chain. This can be seen in the company’s store product expansion from dry goods to perishable produce, including meats, fish and prepared foods. The lessons learned at one location are absorbed by all, enabling the chain to maximise effectiveness and efficiency while offering a product line that serves its customers’ needs. Whole Foods carries only natural and organic products. The company believes that the best tasting and most nutritious food available is found in its purest state – unadulterated by artificial additives, sweeteners, colourings and preservatives.

Whole Foods continually improves customer offerings, catering to its specific locations. Unlike business models for traditional grocery stores, Whole Foods products differ by geographic regions and local farm specialties.

EMPLOYEE AND CUSTOMER RELATIONS

Whole Foods encourages a team-based environment, allowing each store to make independent decisions regarding its operations. Teams consist of up to 11 employees and a team leader. Each store employs anywhere from 72 to 391 team members. The manager is referred to as the ‘store team leader’. The store team leader is compensated by an economic value added (EVA) bonus and is also eligible to receive stock options.

Whole Foods tries to instil a sense of purpose among its employees and for six years, it was named one of the ‘100 Best Companies to work for in America’ by Fortune magazine. In employee surveys, 90 per cent of its team members stated that they always or frequently enjoy their job.

The company strives to take care of its customers, realising they are the ‘lifeblood of our business’, and the two are ‘interdependent on each other’. Whole Foods’ primary objective goes beyond 100 per cent customer satisfaction with the goal to ‘delight’ customers in every interaction.

COMPETITIVE ENVIRONMENT

At the time of Whole Foods’ inception, there was almost no competition, with less than six other natural food stores in the United States. Today, the organic foods industry is growing and Whole Foods finds itself competing hard to maintain its elite presence. As the population has become increasingly concerned about its eating habits, natural foods stores such as Whole Foods are flourishing. Other successful natural food grocery chains today include Trader Joe’s Co. and Wild Oats Market (see Exhibits 1 and 2).
EXHIBIT 1  Natural product sales top US$45 billion in 2004

American shoppers spent nearly $45.8 billion on natural and organic products in 2004, according to research published in the “24th Annual Market Overview” in the June issue of The Natural Foods Merchandiser. In 2004, natural products sales increased 6.9 percent across all sales channels, including supermarkets, mass marketers, direct marketers, and the Internet. Sales of organic products rose 14.6 percent in natural products stores. As interest in low-carb diets waned, sales of organic baked goods rose 35 percent. Other fast-growing organic categories included meat, poultry and seafood, up 120 percent; coffee and cocoa, up 64 percent; and cookies, up 63 percent.

EXHIBIT 2 Sales (US$ million)

<table>
<thead>
<tr>
<th>Company</th>
<th>2000</th>
<th>2001</th>
<th>% Growth</th>
<th>2002</th>
<th>% Growth</th>
<th>2003</th>
<th>% Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Whole Foods Marketa</td>
<td>$1,838.60</td>
<td>$2,272.20</td>
<td>23.60%</td>
<td>$2,690.50</td>
<td>18.40%</td>
<td>$3,148.60</td>
<td>17.00%</td>
</tr>
<tr>
<td>Trader Joe's Companyb</td>
<td>$1,670.00</td>
<td>$1,900.00</td>
<td>13.80%</td>
<td>$2,200.00</td>
<td>15.80%</td>
<td>$2,500.00</td>
<td>13.60%</td>
</tr>
<tr>
<td>Wild Oats Marketc</td>
<td>$838.10</td>
<td>$893.20</td>
<td>6.60%</td>
<td>$919.10</td>
<td>2.90%</td>
<td>$969.20</td>
<td>5.50%</td>
</tr>
</tbody>
</table>


Trader Joe’s, originally known as Pronto Markets, was founded in 1958 in Los Angeles by Joe Coulombe. By expanding its presence and product offerings while maintaining high quality at low prices, Trader Joe’s has found its competitive niche. The company has 215 stores, primarily on the west and east coasts of the United States. The company ‘offers upscale grocery fare such as health foods, prepared meals, organic produce and nutritional supplements’. A low cost structure allows Trader Joe’s to offer competitive prices while still maintaining its margins. Trader Joe’s stores have no service department and average just under 1000 square metres in store size. A privately held company, Trader Joe’s enjoyed sales of US$2.5 million in 2003, a 13.6 per cent increase from 2002.

Wild Oats was founded in 1987, in Boulder, Colorado. Its founders had no experience in the natural foods market, relying heavily on their employees to learn the industry. Acknowledging the increased competition within the industry, Wild Oats is committed to strengthening and streamlining its operations in an effort to continue to build the company. Its product offerings range from organic foods to traditional grocery merchandise. Wild Oats, a publicly owned company on Nasdaq, is traded under the ticker symbol of OATS and is the third largest natural foods supermarket chain in the United States in terms of sales. Although it falls behind Whole Foods and Trader Joe’s, the company enjoyed US$1 048 164 in sales in 2004, a 7.5 per cent increase over 2003. Wild Oats operates 100 full-service stores in 24 states and Canada.

Additional competition has arisen from grocery stores, such as Stop ’N Shop and Shaw’s, which now incorporate natural foods sections in their conventional stores, placing them in direct competition with Whole Foods. Because larger grocery chains have more flexibility in their product offerings, they are more likely to promote products through sales, a strategy Whole Foods rarely practices.

Despite being in a highly competitive industry, Whole Foods maintains its reputation as ‘the world’s #1 natural foods chain’. As the demand for natural and organic food continues to grow, pressures on suppliers will rise. Only 3 per cent of US farmland is organic, so there is limited output. The increased demand for these products may further elevate prices or result in goods being out of stock, with possible price wars looming.

THE CHANGING GROCERY INDUSTRY

Before the emergence of the supermarket, the public was largely dependent on specialty shops or street vendors for dairy products, meats, produce and other household items. In the 1920s, chain stores began to threaten independent retailers by offering convenience and lower
prices by procuring larger quantities of products. Appel explains that the emergence of the supermarkets in the 1930s was a result of three major changes in society:

- the shift in population from rural to urban areas
- an increase in disposable income
- increased mobility through ownership of cars. 29

Perhaps the earliest example of the supermarket as we know it today is King Kullen, ‘America’s first supermarket’, which was founded by Michael Cullen in 1930. ‘The essential key to his plan was volume, and he attained this through heavy advertising of low prices on nationally advertised merchandise.’ As the success of Cullen’s strategy became evident, others such as Safeway, A&P, and Kroger adopted it as well. By the time the United States entered World War II, 9000 supermarkets accounted for 25 per cent of industry sales.30

Low prices and convenience continue to be the dominant factors driving consumers to supermarkets today. The industry is characterised by low margins and continuous downward pressure on prices made evident by coupons, weekly specials and rewards cards. Over the years firms have introduced subtle changes to the business model by providing additional conveniences, such as the inclusion of bakeries, banks, pharmacies and even coffee houses co-located within the supermarket. Throughout their existence, supermarkets have also tried to cater to the changing tastes and preferences of society such as healthier diets, the Atkins diet and low carbohydrate foods. The moderate changes to strategy within supermarkets have been imitated by competitors, which are returning the industry to a state of price competition. Supermarkets themselves now face additional competition from wholesalers such as Costco, BJ’s and Sam’s Club.

Upon entering a Whole Foods supermarket, it becomes clear that the company attempts to sell the consumer on the entire experience. Team members (employees) are well trained and the stores themselves are immaculate. There are in-store chefs to help with recipes, wine tastings and food sampling. There are ‘Take Action food centers’32 where customers can access information on the issues that affect their food such as legislation and environmental factors. Some stores offer extra services such as home delivery, cooking classes, massages and valet parking.33 Whole Foods goes out of its way to appeal to the above-average-income earner.

Whole Foods uses price as a marketing tool in a few select areas, as demonstrated by the 365 Whole Foods brand name products, priced less than similar organic products that are carried within the store. However, the company does not use price to differentiate itself from competitors.34 Rather, Whole Foods focuses on quality and service as the competitive dimensions on which it is differentiated from competitors.

Whole Foods spent only 0.5 per cent35 of total sales from fiscal year 2004 on advertising; the company relies on other means to promote its stores. The company relies heavily on word-of-mouth advertising from its customers to help market itself in the local community. Whole Foods is also promoted in several health-conscious magazines and each store budgets for in-store advertising each fiscal year.

Whole Foods also gains recognition via its charitable contributions and the awareness that it brings to the treatment of animals. The company donates 5 per cent of after-tax profits to not-for-profit charities.36 The company is also very active in establishing systems to make sure that the animals used in its products are treated humanely.

A DIFFERENT SHOPPING EXPERIENCE

The set-up of the organic grocery store is a key component to Whole Foods’ success. The store’s set-up and its products are carefully researched to ensure that it is meeting the demands of the local community. Locations are primarily in cities and are chosen for their large space and heavy foot traffic. According to Whole Foods’ 10K, ‘approximately 88 percent of our existing stores are located in the top 50 statistical metropolitan areas’.31 The company uses a specific formula to choose its store sites that is based on several metrics, which include but are not limited to income levels, education and population density.
This shift in demographics has created an expansion in the gourmet store group, while slowing growth in the discount retail market. To that end, there is a gap in supermarket retailing between consumers who can afford to shop only at low cost providers, like Wal-Mart, and the population of consumers who prefer gourmet food and are willing to pay a premium for perceived higher quality. ‘The Baby Boomers are driving demand for organic food in general because they’re health-conscious and can afford to pay higher prices,’ says Professor Steven G. Sapp, a sociologist at Iowa State University who studies consumer food behaviour.

The perception that imported, delicatessen, exotic and organic foods are of higher quality, therefore commanding higher prices, continues to bode well for Whole Foods Market. As John Mackey explains, ‘We’re changing the [grocery-shopping] experience so that people enjoy it . . . It’s a richer, [more fun], more enjoyable experience. People don’t shop in our stores because we have low prices.’ The consumer focus on a healthy diet is not limited to food. More new diet plans emerged in America in the last half of the twentieth century than in any other country. This trend has also increased the demand for nutritional supplements and vitamins.

In recent years, consumers have made a gradual move toward the use of fresher, healthier foods in their everyday diets. Consumption of fresh fruits and vegetables and pasta and other grain-based products has increased. This is evidenced by the aggressive expansion by consumer products companies into healthy food and natural and organic products. ‘Natural and organic products have crossed the chasm to mainstream America.’ The growing market can be attributed to the acceptance and widespread expansion of organic product offerings, beyond milk and dairy. Mainstream acceptance of the Whole Foods offering can be attributed to this shift in consumer food preferences as consumers continue to identify taste as the number one motivator for purchasing organic foods.

With a growing percentage of women working outside of the home, the traditional role of home-cooked meals, prepared from scratch, has waned. As fewer women have the time to devote to cooking, consumers are giving way to the trend of convenience through prepared foods. Sales of ready-to-eat meals have grown significantly. ‘The result is that grocers are starting to specialize in quasi-restaurant food.’ Just as women entering the workforce has propelled the sale of prepared foods, it has also increased consumer awareness of the need for the one-stop shopping experience. Hypermarkets such as Wal-Mart that offer non-food items and more mainstream product lines allow consumers to conduct more shopping in one place rather than moving from store to store.

The growth in sales of natural foods is expected to continue at the rate of 8–10 per cent annually, according to the National Nutritional Food Association. The sale of organic food has largely outpaced traditional grocery products because of the consumer perception that organic food is healthier. The purchase of organic food is perceived to be beneficial to consumer health by 61 per cent of consumers, according to a Food Marketing Institute/Prevention magazine study. Americans believe organic food can help improve fitness and increase the longevity of life. Much of this perception has grown out of fear of how non-organic foods are treated with pesticides for growth and then preserved for sale. Therefore, an opportunity exists for Whole Foods to contribute to consumer awareness by funding non-profit organisations that focus on educating the public on the benefits of organic lifestyles.

**OPERATIONS**

Whole Foods purchases most of its products from regional and national suppliers. This allows the company to leverage its size in order to receive deep discounts and favourable terms with its vendors. The company still permits stores to purchase from local producers to keep the stores aligned with local food trends and is seen as supporting the community. The company owns two procurement centres and handles the majority of procurement and distribution itself. Whole Foods also owns several regional bake houses, which distribute products to its stores. The largest independent vendor is United Natural Foods, which accounted for 20 per cent of Whole Foods total purchases for fiscal year 2004. Product categories at Whole Foods include but are not limited to:

- produce
- seafood
- grocery
- meat and poultry
- bakery
- prepared foods and catering
- specialty (beer, wine and cheese)
- whole body (nutritional supplements, vitamins, body care, and educational products such as books)
- floral
- pet products
- household products.

While Whole Foods carries all the items that one would expect to find in a grocery store (and plenty that one would not), its ‘heavy emphasis on perishable foods...
is designed to appeal to both natural foods and gourmet shoppers'.  
Perishable foods accounted for 67 per cent of its retail sales in 2004 and are the core of Whole Foods' success. This is demonstrated by the company’s own statement: ‘We believe it is our strength of execution in perishables that has attracted many of our most loyal shoppers.’

Whole Foods also provides fully cooked frozen-meal options through its private label Whole Kitchen, to satisfy the demands of working families. For example, the Whole Foods Market located in Woodland Hills, California, has redesigned its prepared foods section more than three times in response to a 40 per cent growth in prepared foods sales.

Whole Foods doesn’t take just any product and put it on the shelves. In order to make it into the Whole Foods grocery store, products have to undergo a strict test to determine if they are ‘Whole Foods material’. The quality standards that all potential Whole Foods products must meet include:

- foods that are free of preservatives and other additives
- foods that are fresh, wholesome and safe to eat
- promote organically grown foods
- foods and products that promote a healthy life.

Meat and poultry products must adhere to a higher standard:

- no antibiotics or added growth hormones
- an affidavit from each producer that outlines the whole process of production and how the animals are treated
- an annual inspection of all producers by Whole Foods Market
- successful completion of a third party audit to attest to these findings.

Also, because of the lack of available nutritional brands with a national identity, Whole Foods decided to enter into the private label product business. The company currently has three private label products with a fourth program called Authentic Food Artisan, which promotes distinctive products that are certified organic. The three private label products: (1) 365 Everyday Value: A well-recognised and trusted brand that meets the standards of Whole Foods and is less expensive than the regular product lines; (2) Whole Kids Organic: Healthy items that are directed at children; and (3) 365 Organic Everyday Value: All the benefits of organic food at reduced prices.

When opening a new store, Whole Foods stocks it with almost US$700 000 worth of initial inventory, which its vendors partially finance. As with most conventional grocery stores, the majority of Whole Foods’ inventory is turned over fairly quickly; this is especially true of produce. Fresh organic produce is central to Whole Foods existence and turns over on a faster basis than other products.

## FINANCIAL OPERATIONS

Whole Foods Market focuses on earning a profit while providing job security to its workforce to lay the foundation for future growth. Interested in serving the needs of all stakeholders, the company is determined not to let profits deter the company from providing excellent service to its customers and quality work environment for its staff. Its mission statement defines its recipe for financial success.

Whole Foods, Whole People, Whole Planet – emphasizes that our vision reaches far beyond just being a food retailer. Our success in fulfilling our vision is measured by customer satisfaction, Team Member excellence and happiness, return on capital investment, improvement in the state of the environment, and local and larger community support.

Whole Foods also caps the salary of its executives at no more than 14 times that of the average annual salary of a Whole Foods worker; this includes wages and incentive bonuses as well. The company also donates 5 per cent of its after-tax profits to non-profit organisations.

Over a five-year period from 2000 through 2004, the company experienced an 87 per cent growth in sales, with sales reaching US$3.86 billion in 2004. Annual sales increases during that period were equally dramatic: 24 per cent in 2001, 18 per cent in 2002, 17 per cent in 2003, and 22 per cent in 2004 (see Exhibit 3). This growth is perhaps more impressive, given the relatively negative economic environment and recession in the United States.

Whole Foods’ acquisition strategy as a means of expanding has fuelled growth in net income since the company’s inception. This is particularly evident when looking at the net income growth in 2002 (24.47 per cent), 2003 (22.72 per cent) and 2004 (27.94 per cent).

The ticker for Whole Foods, Inc. is WFMI. A review of the performance history of Whole Foods stock since its IPO reveals a mostly upward trend. The 10-year price trend shows the company increasing from under US$10 per share to a high of over US$100 per share, reflecting an increase of over 1000 per cent.
past year, the stock has been somewhat volatile, but with a mostly upward trend. The current price of US$136 with 65.3 million shares outstanding gives the company a market valuation of US$8.8 billion (as of August 2005). Details about Whole Foods’ financial performance are shown in Appendices 1, 2, and 3.

THE CODE OF CONDUCT

From its inception, the company has sought to be different from conventional grocery stores, with a heavy focus on ethics. Besides an emphasis on organic foods, the company has also established a contract of animal rights, which states the company will only do business with companies that treat their animals humanely. While Whole Foods realises that animal products are vital to its business, it opposes animal cruelty.

The company has a unique 14-page Code of Conduct document that addresses the expected and desired behaviour for its employees. The code is broken down into the following four sections:

- potential conflicts of interest
- transactions or situations that should never occur
- situations where you may need the authorisation of the ethics committee before proceeding
- times when certain actions must be taken by executives of the company or team leaders of individual stores.

This Code of Conduct covers, in detail, the most likely scenarios a manager of a store might encounter. It includes several checklists that are to be filled out on a regular, or at least an annual, basis by team leaders and store managers. After completion, the checklists must be signed and submitted to corporate headquarters and copies retained on file in the store. They ensure that the intended ethical practices that are part of Whole Foods are being followed by everyone. The ethical efforts of Whole Foods do not go unrecognised; the company recently was ranked number 70 out of the ‘100 Best Corporate Citizens’.

POSSIBLE SCARCE RESOURCES: PRIME LOCATIONS AND THE SUPPLY OF ORGANIC FOODS

Prime store locations and the supply of organic foods are potential scarce resources and could be problematic for Whole Foods Market in the future.

Whole Foods likes to establish a presence in highly affluent cities, where its target market resides. The majority of Whole Foods customers are well-educated, thereby yielding high salaries enabling them to afford the company’s higher prices. Whole Foods is particular when deciding on new locations, as location is extremely important for top and bottom line growth. However, there are limited number of communities where 40 per cent of the residents have college degrees.

Organic food is another possible scarce resource. Organic crops yield a lower quantity of output and are rarer, accounting for only 3 per cent of US farmland usage. Strict government requirements must be satisfied; these are incredibly time consuming, more effort intensive and more costly to adhere to. With increased demands from mainstream supermarkets also carrying organics, the demand for such products could exceed the limited supply. The market for organic foods grew from US$2.9 billion in 2001 to US$5.3 billion in 2004, an 80.5 per cent increase in the three-year period.

Whole Foods recognises that the increased demand for organic foods may adversely affect its earnings and informs its investors as such.

Changes in the availability of quality natural and organic products could impact our business. There is no assurance that quality natural and organic products will be available to meet our future needs. If conventional supermarkets increase their natural and organic product offerings or if new laws require the reformulation of certain products to meet tougher standards, the supply of these products may be constrained. Any significant disruption in the supply of quality natural and organic products could have a material impact on our overall sales and cost of goods.
NOTES

1  www.organicconsumers.org/organic/most071904.cfm.
4  Boorstin, ‘No Preservatives, no unions, lots of dough’: 127.
15 Boorstin, ‘No Preservatives, no unions, lots of dough’: 127.
23 Hoovers Online.
24 Hoovers Online.
26 Hoovers Online.
27 Hoovers Online.
31 Whole Foods 10K-Q: 8.
32 Whole Foods 10K-Q: 8.
33 Whole Foods 10K-Q: 8.
34 Whole Foods 10K-Q: 8.
39 Gapper, ‘Organic food stores are on a natural high’.
40 Gapper, ‘Organic food stores are on a natural high’.
APPENDIX 1 UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
INFORMATION FOR THE FISCAL YEAR ENDED 26 SEPTEMBER 2004

<table>
<thead>
<tr>
<th></th>
<th>FIRST QUARTER</th>
<th>SECOND QUARTER</th>
<th>THIRD QUARTER</th>
<th>FOURTH QUARTER</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FIRST YEAR 2004</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Sales</strong></td>
<td>$1,118,148</td>
<td>$902,141</td>
<td>$917,355</td>
<td>$927,306</td>
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<tr>
<td><strong>Cost of goods sold and occupancy costs</strong></td>
<td>733,721</td>
<td>582,597</td>
<td>600,691</td>
<td>606,537</td>
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<tr>
<td><strong>Gross profit</strong></td>
<td>384,427</td>
<td>319,544</td>
<td>316,394</td>
<td>320,769</td>
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<tr>
<td><strong>Direct store expenses</strong></td>
<td>282,596</td>
<td>229,995</td>
<td>232,649</td>
<td>240,800</td>
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<tr>
<td><strong>General and administrative expenses</strong></td>
<td>35,869</td>
<td>28,783</td>
<td>27,551</td>
<td>27,597</td>
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<tr>
<td><strong>Pre-opening and relocation costs</strong></td>
<td>4,073</td>
<td>4,040</td>
<td>4,966</td>
<td>5,569</td>
</tr>
<tr>
<td><strong>Operating income</strong></td>
<td>61,889</td>
<td>56,726</td>
<td>51,228</td>
<td>46,803</td>
</tr>
<tr>
<td><strong>Other income (expense)</strong></td>
<td>(2,478)</td>
<td>(1,859)</td>
<td>(1,319)</td>
<td>(1,593)</td>
</tr>
<tr>
<td><strong>Interest expense</strong></td>
<td>1,464</td>
<td>1,503</td>
<td>1,782</td>
<td>1,707</td>
</tr>
<tr>
<td><strong>Investment and other income</strong></td>
<td>60,875</td>
<td>59,370</td>
<td>51,691</td>
<td>46,917</td>
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<tr>
<td><strong>Income before income taxes</strong></td>
<td>24,350</td>
<td>22,548</td>
<td>20,676</td>
<td>18,767</td>
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<tr>
<td><strong>Provision for income taxes</strong></td>
<td>36,525</td>
<td>33,822</td>
<td>31,015</td>
<td>28,150</td>
</tr>
<tr>
<td><strong>Basic earnings per share</strong></td>
<td>$0.61</td>
<td>$0.55</td>
<td>$0.50</td>
<td>$0.45</td>
</tr>
<tr>
<td><strong>Diluted earnings per share</strong></td>
<td>$0.57</td>
<td>$0.52</td>
<td>$0.47</td>
<td>$0.43</td>
</tr>
<tr>
<td><strong>Dividends per share</strong></td>
<td>$0.15</td>
<td>$0.15</td>
<td>$0.15</td>
<td>$0.15</td>
</tr>
</tbody>
</table>
### APPENDIX 2  \textbf{WHOLE FOODS MARKET BALANCE SHEET FOR FISCAL YEAR ENDING 26 SEPTEMBER 2004}

<table>
<thead>
<tr>
<th>PERIOD ENDING</th>
<th>SEPTEMBER 26, 2004</th>
<th>SEPTEMBER 28, 2003</th>
<th>SEPTEMBER 29, 2002</th>
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<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and Cash Equivalents</td>
<td>221,537</td>
<td>165,779</td>
<td>12,646</td>
</tr>
<tr>
<td>Short-Term Investments</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Net Receivables</td>
<td>94,421</td>
<td>61,554</td>
<td>42,356</td>
</tr>
<tr>
<td>Inventory</td>
<td>152,912</td>
<td>123,904</td>
<td>108,189</td>
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<tr>
<td>Other Current Assets</td>
<td>16,702</td>
<td>12,447</td>
<td>8,950</td>
</tr>
<tr>
<td><strong>TOTAL CURRENT ASSETS</strong></td>
<td>485,572</td>
<td>363,684</td>
<td>172,141</td>
</tr>
<tr>
<td>Long Term Investments</td>
<td>—</td>
<td>2,206</td>
<td>4,426</td>
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<tr>
<td>Property Plant and Equipment</td>
<td>904,825</td>
<td>718,240</td>
<td>644,688</td>
</tr>
<tr>
<td>Goodwill</td>
<td>112,186</td>
<td>80,548</td>
<td>80,548</td>
</tr>
<tr>
<td>Intangible Assets</td>
<td>24,831</td>
<td>26,569</td>
<td>22,889</td>
</tr>
<tr>
<td>Accumulated Amortization</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Other Assets</td>
<td>20,302</td>
<td>5,573</td>
<td>11,159</td>
</tr>
<tr>
<td>Deferred Long-term Asset Charges</td>
<td>—</td>
<td>—</td>
<td>7,350</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td>1,547,716</td>
<td>1,196,820</td>
<td>943,201</td>
</tr>
<tr>
<td><strong>LIABILITIES</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>328,977</td>
<td>233,778</td>
<td>170,509</td>
</tr>
<tr>
<td>Short-/Current Long-Term Debt</td>
<td>5,973</td>
<td>5,806</td>
<td>5,789</td>
</tr>
<tr>
<td>Other Current Liabilities</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>TOTAL CURRENT LIABILITIES</strong></td>
<td>334,950</td>
<td>239,584</td>
<td>176,298</td>
</tr>
<tr>
<td>Long-Term Debt</td>
<td>164,770</td>
<td>162,909</td>
<td>161,952</td>
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<tr>
<td>Other Liabilities</td>
<td>1,581</td>
<td>2,301</td>
<td>3,774</td>
</tr>
<tr>
<td>Deferred Long-Term Liability Charges</td>
<td>77,760</td>
<td>15,850</td>
<td>12,091</td>
</tr>
<tr>
<td>Minority Interest</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Negative Goodwill</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>TOTAL LIABILITIES STOCKHOLDERS’ EQUITY</strong></td>
<td>579,061</td>
<td>420,644</td>
<td>354,115</td>
</tr>
<tr>
<td>Misc. Stocks Options Warrants</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Redeemable Preferred Stock</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Common Stock</td>
<td>535,107</td>
<td>423,297</td>
<td>341,940</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>431,495</td>
<td>351,255</td>
<td>247,568</td>
</tr>
<tr>
<td>Treasury Stock</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Capital Surplus</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Other Stockholder Equity</td>
<td>2,053</td>
<td>1,624</td>
<td>—422</td>
</tr>
<tr>
<td><strong>TOTAL STOCKHOLDER EQUITY</strong></td>
<td>968,655</td>
<td>776,176</td>
<td>589,086</td>
</tr>
<tr>
<td><strong>NET TANGIBLE ASSETS</strong></td>
<td>$831,638</td>
<td>$669,059</td>
<td>$485,649</td>
</tr>
</tbody>
</table>

## APPENDIX 3  WHOLE FOODS MARKET INCOME STATEMENT FOR FISCAL YEAR ENDING 26 SEPTEMBER 2004

<table>
<thead>
<tr>
<th>PERIOD ENDING</th>
<th>SEPTEMBER 26, 2004</th>
<th>SEPTEMBER 28, 2003</th>
<th>SEPTEMBER 29, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL REVENUE</strong></td>
<td>$ 3,864,950</td>
<td>$ 3,148,593</td>
<td>$ 2,690,475</td>
</tr>
<tr>
<td><strong>Cost of Revenue</strong></td>
<td>2,523,816</td>
<td>2,067,939</td>
<td>1,757,213</td>
</tr>
<tr>
<td><strong>GROSS PROFIT</strong></td>
<td>1,341,134</td>
<td>1,080,654</td>
<td>933,262</td>
</tr>
<tr>
<td><strong>Operating Expenses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Research Development</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Selling General and Administrative</td>
<td>1,107,797</td>
<td>893,229</td>
<td>771,631</td>
</tr>
<tr>
<td>Non Recurring</td>
<td>11,449</td>
<td>12,091</td>
<td>12,485</td>
</tr>
<tr>
<td>Others</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total Operating Expenses</strong></td>
<td>1,119,246</td>
<td>905,320</td>
<td>784,116</td>
</tr>
<tr>
<td><strong>OPERATING INCOME OR LOSS</strong></td>
<td>221,888</td>
<td>175,334</td>
<td>149,146</td>
</tr>
<tr>
<td><strong>Income from Continuing Operations</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Other Income/Expenses Net</td>
<td>6,456</td>
<td>5,593</td>
<td>2,056</td>
</tr>
<tr>
<td>Earning Before Interest and Taxes</td>
<td>228,344</td>
<td>180,927</td>
<td>151,202</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>7,249</td>
<td>8,114</td>
<td>10,384</td>
</tr>
<tr>
<td>Income Before Tax</td>
<td>221,095</td>
<td>172,813</td>
<td>140,818</td>
</tr>
<tr>
<td>Income Tax Expense</td>
<td>88,438</td>
<td>69,126</td>
<td>56,327</td>
</tr>
<tr>
<td>Minority Interest</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Net Income from Continuing Ops</strong></td>
<td>132,657</td>
<td>103,687</td>
<td>84,491</td>
</tr>
<tr>
<td><strong>Nonrecurring Events</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discontinued Operations</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Extraordinary Items</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Effect of Accounting Changes</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Other Items</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>NET INCOME</strong></td>
<td>132,657</td>
<td>103,687</td>
<td>84,491</td>
</tr>
<tr>
<td>Preferred Stock and Other Adjustments</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>NET INCOME APPLICABLE TO COMMON SHARES</strong></td>
<td>$ 132,657</td>
<td>$ 103,687</td>
<td>$ 84,491</td>
</tr>
</tbody>
</table>

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 per cent, amounting to US$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 US$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 centre 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.

All was not well within the Wal-Mart family either. Some employees had filed a 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 among the biggest in the realm of employment law in recent years. A similar case in Oregon was decided in favour 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 per cent of Wal-Mart associates were women, they represented only 15 per cent 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 US 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’. Although Wal-Mart had systematically decimated the negative projections of analysts in the past, it was once again the subject of doubt and nay saying. 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 US and counterparts such as Carrefour, Ahold, Metro, Tesco and others worldwide, global discount chains had cornered a significant chunk of the global retail business (see Exhibit 1). 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 favourable volume-based contracts with manufacturers, many of whom were themselves global. Coupled with sophisticated information systems that optimised 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 made – a selection of merchandise that was unrivalled at prices that were unequalled.

EXHIBIT 1 The world’s five leading global retailers, 2002

<table>
<thead>
<tr>
<th>Rank</th>
<th>Retailer</th>
<th>Sales ($bn)</th>
<th>Earnings ($mil)</th>
<th>Stores (#)</th>
<th>Nationality</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Wal-Mart</td>
<td>244.5</td>
<td>8,039</td>
<td>4,688</td>
<td>US</td>
</tr>
<tr>
<td>2</td>
<td>Carrefour</td>
<td>86.3</td>
<td>1,440</td>
<td>9,725</td>
<td>French</td>
</tr>
<tr>
<td>3</td>
<td>Ahold</td>
<td>81.7</td>
<td>n/a</td>
<td>8,800</td>
<td>Dutch</td>
</tr>
<tr>
<td>4</td>
<td>Metro</td>
<td>57.9</td>
<td>464</td>
<td>2,310</td>
<td>German</td>
</tr>
<tr>
<td>5</td>
<td>Tesco</td>
<td>45.8</td>
<td>1,178</td>
<td>2,291</td>
<td>British</td>
</tr>
</tbody>
</table>

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. Simultaneously 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 (see Exhibit 2). Given the significantly higher growth rates that these markets promised, the early entrants were sure to profit.
EXHIBIT 2  Global market penetration by international retailers, 2004

<table>
<thead>
<tr>
<th>Country</th>
<th>Global Retailers (no.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>14</td>
</tr>
<tr>
<td>Poland</td>
<td>13</td>
</tr>
<tr>
<td>Spain</td>
<td>12</td>
</tr>
<tr>
<td>Germany</td>
<td>11</td>
</tr>
<tr>
<td>USA</td>
<td>11</td>
</tr>
<tr>
<td>Belgium</td>
<td>11</td>
</tr>
<tr>
<td>UK</td>
<td>10</td>
</tr>
<tr>
<td>Thailand</td>
<td>10</td>
</tr>
<tr>
<td>Taiwan</td>
<td>10</td>
</tr>
<tr>
<td>China</td>
<td>10</td>
</tr>
<tr>
<td>Portugal</td>
<td>10</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>10</td>
</tr>
<tr>
<td>Denmark</td>
<td>8</td>
</tr>
<tr>
<td>Netherlands</td>
<td>7</td>
</tr>
<tr>
<td>Italy</td>
<td>7</td>
</tr>
</tbody>
</table>


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 realised 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 5000 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 US$245 billion. The company was widely seen as the beacon of shareholder value, the darling of investors and the customer’s champion.

Wal-Mart capitalised on its rural locations to establish important competitive advantages during its infancy. Many rural markets were characterised 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 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 labour 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. Because 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.
CASE TWELVE: WAL-MART STORES INC.: DOMINATING GLOBAL RETAILING

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 conceptualising 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 standardised layouts. The stores did not carry any backroom inventory and this helped maximise 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 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

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’. ‘The buyers were tough negotiators and demanded a wide array of price and service concessions. For example, Mr Katzenberg, chief executive officer (CEO) of DreamWorks, one of the world’s leading movie companies, was requested by Wal-Mart to produce a customised 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’. 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 US was individually responsible for selling 35 per cent of all pet food, 24 per cent of all toothpaste, the largest volume of jewellery, 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 favourable 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 (see Exhibit 3).

### Exhibit 3 Wal-Mart's Influence over its Suppliers

<table>
<thead>
<tr>
<th>Supplier Company</th>
<th>Main Products</th>
<th>% of Sales from Wal-Marts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dial Corporation</td>
<td>Toilet soaps</td>
<td>28</td>
</tr>
<tr>
<td>Clorox Corporation</td>
<td>Liquid bleach</td>
<td>23</td>
</tr>
<tr>
<td>Mattel Corporation</td>
<td>Toys</td>
<td>23</td>
</tr>
<tr>
<td>Revlon</td>
<td>Perfumes/cosmetics</td>
<td>22.5</td>
</tr>
<tr>
<td>Procter &amp; Gamble Co.</td>
<td>Toilet soaps, detergents</td>
<td>17</td>
</tr>
<tr>
<td>Energizer Holdings Inc.</td>
<td>Batteries</td>
<td>16.3</td>
</tr>
<tr>
<td>Kraft Foods</td>
<td>Packaged foods</td>
<td>12.2</td>
</tr>
<tr>
<td>Gillette Co.</td>
<td>Shavers, batteries</td>
<td>12</td>
</tr>
<tr>
<td>Kellogg Co.</td>
<td>Breakfast cereals</td>
<td>12</td>
</tr>
</tbody>
</table>

Source: Company annual reports.

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. Because 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 per cent 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.

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 biggest selling dog food, outstripping such established giants as Ralston Purina and Nestlé. Nationally, the trend toward
store brands was gathering momentum. According to a study by A. C. Nielsen, national brands grew by 1.5 per cent in 2001 and 2002, but store brands grew by 8.6 per cent. 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. One analyst estimated that about 40 per cent 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.

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 modelling 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 (GE), once observed 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 per cent, 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 from Wal-Mart’s Roll Back settlement payments. Wal-Mart demanded full transparency. 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 labour 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
teams that specialised in each product line. Initially, across a range of price points. Newell had multiple sales to shop with multiple suppliers to fill out its offerings shelf space because the mass market retailer did not have points. This provided the important benefit of capturing product lines. Each line had options across the three price points. Newell adopted a good, better, best approach to managing its techniques, using its scale model of the store, before Wal-Mart store at its Bentonville office. It experimented invested a sizable sum in building a scaled version of a an extent that Wal-Mart began using Newell as the originator of the legendary supplier scorecard that new ways to improve retailer efficiency. Newell was highly flexible supplier, often taking the lead in proposing novel 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 optimisation 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 specialised 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 per cent lower than Duracell and Energizer, the competing battery brands. In some cases, it was able to offer 50 per cent 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 per cent) 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 per cent 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 globalisation effort.

LEVERAGING TECHNOLOGY AND LOGISTICS

Wal-Mart was a leader in the use of technology to maximise operational efficiency. Very early on, the company realised
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 that were the staging grounds for inventory management. 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 customise 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 centres. 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 400-kilometre radius. All of them had easy access from interstate roads 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 centres. Instead, the company designed them to use cross-docking, a practice that allowed the trans-shipment 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 10 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, minimised 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 set-up 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 rivalled even dedicated trucking fleets. Appendix 1 provides indicators of comparative efficiency for major US 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 (see Exhibit 4). Within the United States, the first three formats were referred to as Domestic One formats.

Appendix 2 provides comparative financial and operating statistics for major US-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 among 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 organisational 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 travelled on buying trips to manufacturer locations were expected to stay in a budget motel. Even executives stayed two to a room and 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
### EXHIBIT 4 Store formats, target markets and unique features

<table>
<thead>
<tr>
<th>Format</th>
<th>Size</th>
<th>Unique features</th>
</tr>
</thead>
</table>
| 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 tyre 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 urban 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 |

...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 on its founding. These tenets included a ‘10-foot rule’, which required every employee to greet a
customer who came within 10 feet (approximately 3 metres) of the employee. Mr Walton exhorted all his associates to practise ‘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 among the upper echelon had started on the shop floor or in the warehouses and had moved their way up the ladder. Roughly 65 per cent 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 gruelling program in the United States 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 360° 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 US$8.23 an hour in the case of sales clerks, according to Business Week. This amounted to US$13,861 per year, below the federal poverty line of US$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 per cent of the customer service managers, they accounted for only 15 per cent of store manager positions. This alleged unfair labour 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 labour costs low by leveraging its clout to force employees to work overtime without offering overtime pay. These transgressions were closely watched by the unions who had always wanted to bring Wal-Mart employees under their fold. The non-union 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 unionise 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 United States 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 1300 stores system-wide. By 2003, international operations accounted for close to 17 per cent of 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 United Kingdom, 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 its globalisation 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 per cent 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 United States, 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 rationalise 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 United States. After some initial hiccups, the Mexican operations became an important shot in the arm for Wal-Mart, contributing 26 per cent 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 United States and also pursue additional opportunities in other markets in the Wal-Mart empire (see Exhibit 5). 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

### Exhibit 5 Wal-Mart’s global empire

<table>
<thead>
<tr>
<th>Country</th>
<th>Mode of Entry</th>
<th>Store Population</th>
<th>Associates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Greenfield</td>
<td>11 Supercenters, 1 Distribution Center</td>
<td>4,000</td>
</tr>
<tr>
<td>Brazil</td>
<td>Greenfield</td>
<td>13 Supercenters, 9 Sam’s Clubs, and 2 Todo Dia Stores</td>
<td>6,000</td>
</tr>
<tr>
<td>Canada</td>
<td>Acquisition</td>
<td>213 Discount Stores</td>
<td>52,000</td>
</tr>
<tr>
<td>China</td>
<td>Joint venture</td>
<td>21 Supercenters, 5 Sam’s Clubs, and 2 Neighborhood Stores</td>
<td>15,000</td>
</tr>
<tr>
<td>Germany</td>
<td>Acquisition</td>
<td>92 Supercenters</td>
<td>15,500</td>
</tr>
<tr>
<td>Japan</td>
<td>Joint venture</td>
<td>400 Supermarkets</td>
<td>30,500</td>
</tr>
<tr>
<td>Korea</td>
<td>Acquisition</td>
<td>15 Supercenters</td>
<td>3,000</td>
</tr>
<tr>
<td>Mexico</td>
<td>Joint venture</td>
<td>124 Bodega Stores, 51 Sam’s Clubs, 78 Supercenters, and 457 other stores</td>
<td>96,000</td>
</tr>
<tr>
<td>Puerto Rico</td>
<td>Greenfield; acquired local</td>
<td>9 Discount Stores, 9 Sam’s Clubs, 2 Supercenters, and 33 other stores</td>
<td>11,000</td>
</tr>
<tr>
<td></td>
<td>chains after entry</td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Acquisition</td>
<td>247 Discount Stores, 21 Distribution Centers</td>
<td>125,000</td>
</tr>
<tr>
<td>United States</td>
<td></td>
<td>1,494 Discount Stores, 1,386 Supercenters, 56 Neighborhood Markets, and 532 Sam’s Clubs</td>
<td>More than 1 million</td>
</tr>
</tbody>
</table>
enter segments that were outside the scope of traditional retail operations. For example, it offered a money transfer service between the United States 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 manoeuvring 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 flyers 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 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 US 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, AG, 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’.

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 United Kingdom. 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-Martisation 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 US, South America and everywhere’. One 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 US 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 US. ‘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 non-foods 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.
that was readily visible, it was believed that the emergence of competitive front, although there was no obvious threat of variety of fronts, ranging from employee compensation. The company was increasingly coming under fire on a road that was not very clear. As Wal-Mart moved forward to assert its dominance as the world’s largest retailer, the road was not very clear.

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 multistorey format, with stores often encompassing six to eight storeys. 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 per cent of its products locally and even leveraged its Chinese supply network to export products worth US$12 billion to its US operations and close to US$20 billion by mid-2003. The company was China’s eighth largest trading partner, ahead of Russia and the UK. 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’.

BEING BIG ISN’T SO EASY

As Wal-Mart moved forward to assert its dominance as the world’s largest retailer, the 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 United States 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 homogenising the marketplace by letting smaller towns dictate popular culture. The same filtering effect was noticed in magazines and books. Publications such as *Maxim* 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 US 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’, 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 characterised it. The market was indeed sizable since 37 per cent of all US households earned less than US$25 000 per year. Interestingly, this was also one of the fastest growing segments of the population. The Dollar General store was about 632 square metres – roughly one-sixth the size of the smallest Wal-Mart store. It kept its inventory low by trimming the variety of products it offered. It carried about 3500 items on average, leaning more heavily on hard goods and non-perishables. It used an innovative pricing approach that comprised only 20 price points, ranging from US$1 to US$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 6000 stores in the US, most of them in communities of less than 25,000 or in low-income urban neighbourhoods. 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’. The company had almost doubled its sales revenue in the five-year period from 1999 to 2003. Although with over US$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.

NOTES

4 Useem, ‘One nation under Wal-Mart’.
7 Boyle, ‘Brand killers’.

APPENDIX 1 COMPARATIVE EFFICIENCIES OF LEADING US RETAILERS

<table>
<thead>
<tr>
<th>MERCHANDISER</th>
<th>SPF 2000</th>
<th>SPF 2001</th>
<th>SPF 2002</th>
<th>SQ. FT. BASIS</th>
<th>AVG. SQ. FT. PER STORE</th>
<th>SALES PER STORE</th>
<th>TOTAL STORES</th>
<th>TOTAL SALES ($000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costco</td>
<td>$763</td>
<td>$757</td>
<td>$771</td>
<td>gross</td>
<td>137,000</td>
<td>105,683,152</td>
<td>374</td>
<td>37,993,093</td>
</tr>
<tr>
<td>Sam’s Club</td>
<td>$469</td>
<td>$491</td>
<td>$497</td>
<td>gross</td>
<td>124,462</td>
<td>61,857,561</td>
<td>525</td>
<td>31,702,000</td>
</tr>
<tr>
<td>Wal-Mart</td>
<td>$387</td>
<td>$406</td>
<td>$422</td>
<td>gross</td>
<td>135,195</td>
<td>55,924,898</td>
<td>2,875</td>
<td>244,524,000</td>
</tr>
<tr>
<td>Target</td>
<td>$268</td>
<td>$274</td>
<td>$278</td>
<td>selling</td>
<td>122,28</td>
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<td>$212</td>
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<td>$148</td>
<td>gross</td>
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<td>$388</td>
<td>$370</td>
<td>gross</td>
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SPF = Sales per foot

### APPENDIX 2 COMPARATIVE STATISTICS FOR LARGE US-BASED DISCOUNT RETAILERS

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<td>962</td>
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<td>1,368</td>
<td>1,654</td>
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<td>11,937</td>
<td>13,644</td>
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<td>1.84%</td>
<td>1.56%</td>
<td>3.91%</td>
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<td>2.00%</td>
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<td>1.56%</td>
<td>3.91%</td>
<td>4.34%</td>
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