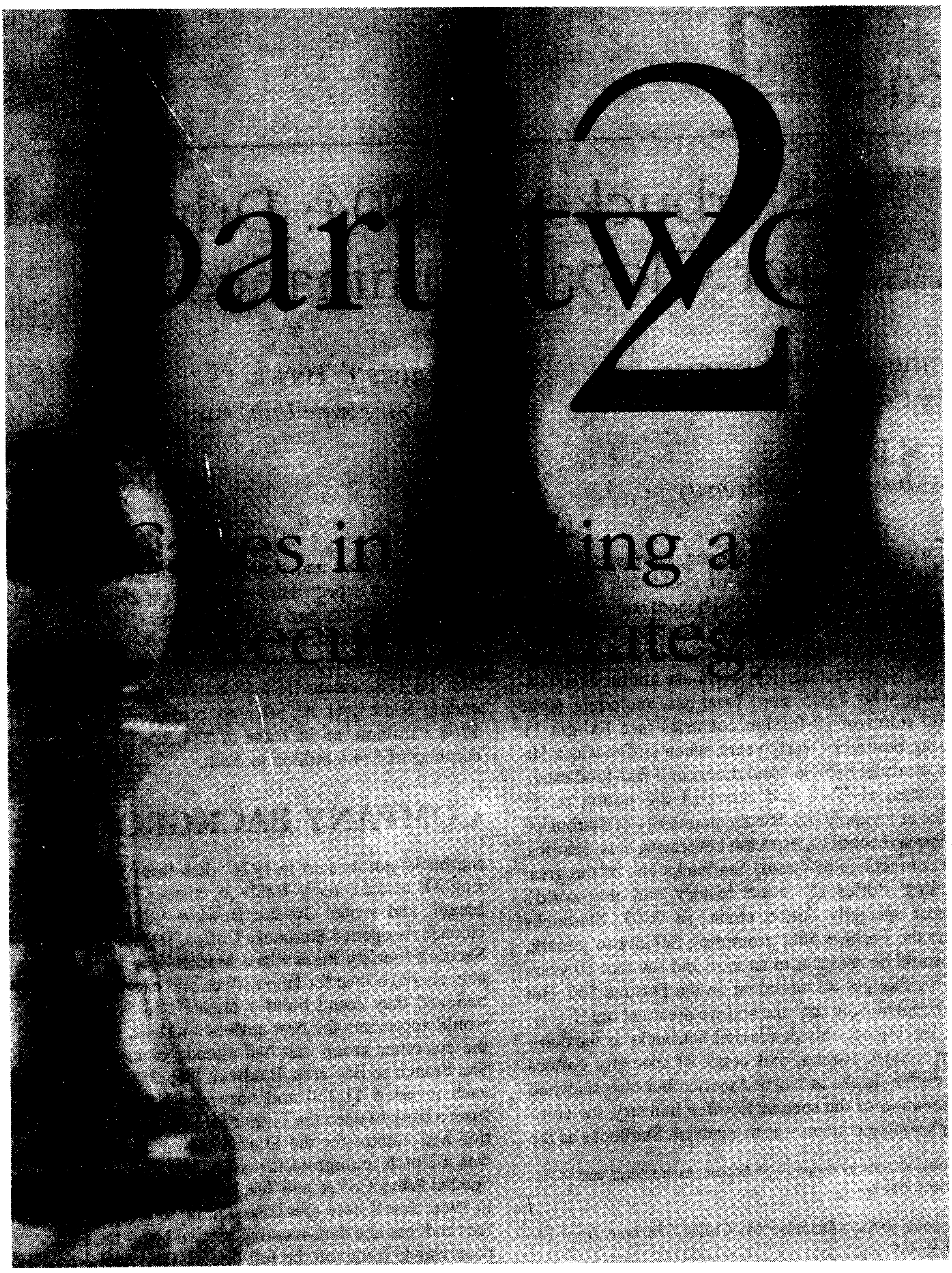
2. Go to the careers section at www.qualcomm.com and see what Qualcomm, one of the most prominent companies in mobile communications technology, has to say about "life at Qualcomm." Is what's on this Web site just recruiting propaganda, or does it convey the type of work climate that management is actually trying to create? If you were a senior executive at Qualcomm, would you see merit in building and nurturing a culture like what is described in the section on "life at Qualcomm"? Would such a culture represent a tight fit with Qualcomm's high-tech business and strategy? (You can get an overview of the Qualcomm's strategy by exploring the section for investors and some of the recent press releases.) Is your answer consistent with what is presented in the "Awards and Honors" menu selection in the "About Qualcomm" portion of the Web site?
3. Go to www.jnj.com, the Web site of Johnson & Johnson and read the "J&J Credo," which sets forth the company's responsibilities to customers, employees, the community, and shareholders. Then read the "Our Company" section. Why do you think the credo has resulted in numerous awards and accolades that recognize the company as a good corporate citizen?


part two
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case 1

Starbucks in 2004: Driving for Global Dominance

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In early 2004 Howard Schultz, Starbucks' founder and chairman of the board, could look with satisfaction on the company's phenomenal growth and market success. Since 1987, Starbucks had transformed itself from a modest nine-store operation in the Pacific Northwest into a powerhouse multinational enterprise with 7,225 store locations, including some 1,600 stores in 30 foreign countries (see Exhibit 1). During Starbucks' early years, when coffee was a 50-cent morning habit at local diners and fast-food establishments, skeptics had ridiculed the notion of \$3 coffee as a yuppie fad. But the popularity of Starbucks' Italian-style coffees, espresso beverages, teas, pastries, and confections had made Starbucks one of the great retailing stories of recent history and the world's biggest specialty coffee chain. In 2003, Starbucks made the Fortune 500, prompting Schultz to remark, "It would be arrogant to sit here and say that 10 years ago we thought we would be on the Fortune 500. But we dreamed from day one and we dreamed big."[1]

Having not only positioned Starbucks as the dominant retailer, roaster, and brand of specialty coffees and coffee drinks in North America but also spawned the creation of the specialty coffee industry, the company's strategic intent was to establish Starbucks as the most recognized and respected brand in the world. Management expected to have 15,000 Starbucks stores by year-end 2005 and 25,000 locations by 2013. In 2003, new stores were being opened at the rate of three a day. Starbucks reported revenues in 2003 of \$4.1 billion, up 128 percent from \$1.8 billion in fiscal 2000 ending September 30; after-tax profits in 2003 were \$268.3 million, an increase of 184 percent from net earnings of \$94.6 million in 2000.

COMPANY BACKGROUND

Starbucks got its start in 1971 when three academics, English teacher Jerry Baldwin, history teacher Zev Siegel, and writer Gordon Bowker—all coffee aficionados—opened Starbucks Coffee, Tea, and Spice in Seattle's touristy Pikes Place Market. The three partners shared a love for fine coffees and exotic teas and believed they could build a clientele in Seattle that would appreciate the best coffees and teas, much like the customer group that had already emerged in the San Francisco Bay area. Baldwin, Siegel, and Bowker each invested \$1,350 and borrowed another \$5,000 from a bank to open the Pikes Place store. The inspiration and mentor for the Starbucks venture in Seattle was a Dutch immigrant named Alfred Peet, who had opened Peet's Coffee and Tea, in Berkeley, California, in 1966. Peet's store specialized in importing fine coffees and teas and dark-roasting its own beans the European way to bring out the full flavors. Customers were

[1]As quoted in Cora Daniels, "Mr. Coffee," *Fortune*, April 14, 2003, p. 139.

exhibit 1 Number of Starbucks Store Locations, 1987–2003

Year	Number of Store Locations	Year	Number of Store Locations
1987	17	1996	1,015
1988	33	1997	1,412
1989	55	1998	1,886
1990	84	1999	2,135
1991	116	2000	3,501
1992	165	2001	4,709
1993	272	2002	5,886
1994	425	2003	7,225
1995	676		

Licensed Locations of Starbucks Stores Outside the Continental United States, 2003

Asia-Pacific		Europe–Middle East–Africa		Americas	
Japan	486	Saudi Arabia	29	Canada	53
China	116	United Arab Emirates	27	Hawaii	36
Taiwan	113	Germany	25	Mexico	17
South Korea	75	Kuwait	20	Puerto Rico	3
Philippines	54	Spain	15	Chile	3
Malaysia	37	Switzerland	15	Peru	1
New Zealand	35	Greece	12		
Singapore	35	Lebanon	9		
Indonesia	17	Austria	8		
		Qatar	5		
		Bahrain	4		
		Turkey	4		
		Oman	3		
Total	968		176		113

Source: Company records and reports.

encouraged to learn how to grind the beans and make their own freshly brewed coffee at home. Baldwin, Siegel, and Bowker were well acquainted with Peet's expertise, having visited his store on numerous occasions and listened to him expound on quality coffees and the importance of proper bean-roasting techniques.

The Pikes Place store featured modest, hand-built classic nautical fixtures. One wall was devoted to whole-bean coffees, while another had shelves of coffee products. The store did not offer fresh-brewed coffee sold by the cup, but tasting samples were sometimes available. Initially, Siegel was the only paid employee. He wore a grocer's apron, scooped out beans for customers, extolled the virtues of fine, dark-roasted coffees, and functioned as the partnership's retail expert. The other two partners kept their day jobs but came by at lunch or after work to help out. During the start-up period, Baldwin kept the books and developed a growing knowledge of coffee; Bowker served as the "magic, mystery, and romance man."[2] The store was an immediate success, with sales exceeding expectations, partly because of interest stirred by a favorable article in the *Seattle Times*. For most of the first year,

[2]Howard Schultz and Dori Jones Yang, *Pour Your Heart Into It* (New York: Hyperion, 1997), p. 33.

Starbucks ordered its coffee beans from Peet's, but then the partners purchased a used roaster from Holland, set up roasting operations in a nearby ramshackle building, and came up with their own blends and flavors.

By the early 1980s, the company had four Starbucks stores in the Seattle area and had been profitable every year since opening its doors. But then Zev Siegel experienced burnout and left the company to pursue other interests. Jerry Baldwin took over day-to-day management of the company and functioned as chief executive officer; Gordon Bowker remained involved as an owner but devoted most of his time to his advertising and design firm, a weekly newspaper he had founded, and a microbrewery that he was launching known as the Redhook Ale Brewery.

Howard Schultz Enters the Picture

In 1981, Howard Schultz, vice president and general manager of U.S. operations for a Swedish maker of stylish kitchen equipment and coffeemakers, decided to pay Starbucks a visit—he was curious about why Starbucks was selling so many of his company's products. The morning after his arrival in Seattle, he was escorted to the Pikes Place store by Linda Grossman, the retail merchandising manager for Starbucks. A solo violinist was playing Mozart at the door, his violin case open for donations. Schultz was immediately taken by the powerful and pleasing aroma of the coffees, the wall displaying coffee beans, and the rows of coffeemakers on the shelves. As he talked with the clerk behind the counter, the clerk scooped out some Sumatran coffee beans, ground them, put the grounds in a cone filter, poured hot water over the cone, and shortly handed Schultz a porcelain mug filled with freshly brewed coffee. After taking only three sips of the brew, Schultz was hooked. He began asking the clerk and Grossman questions about the company, about coffees from different parts of the world, and about the different ways of roasting coffee.

A bit later, he was introduced to Jerry Baldwin and Gordon Bowker, whose offices overlooked the company's coffee-roasting operation. Schultz was struck by their knowledge about coffee, their commitment to providing customers with quality coffees, and their passion for educating customers about the merits of dark-roasted coffees. Baldwin told Schultz, "We don't manage the business to maximize anything other than the quality of the coffee."[3] The company purchased only the finest arabica coffees and put them through a meticulous dark-roasting process to bring out their full flavors. Baldwin explained that the cheap robusta coffees used in supermarket blends burned when subjected to dark roasting. He also noted that the makers of supermarket blends preferred lighter roasts because it allowed higher yields (the longer a coffee was roasted, the more weight it lost).

Schultz was also struck by the business philosophy of the two partners. It was clear that Starbucks stood not just for good coffee but also for the dark-roasted flavor profiles that the founders were passionate about. Top quality, fresh-roasted, whole-bean coffee was the company's differentiating feature and a bedrock value. It was also clear to Schultz that Starbucks was strongly committed to educating its customers to appreciate the qualities of fine coffees. The company depended mainly on word of mouth to get more people into its stores, then built customer loyalty cup by cup as buyers gained a sense of discovery and excitement about the taste of fine coffee.

On his trip back to New York the next day, Howard Schultz could not stop thinking about Starbucks and what it would be like to be a part of the Starbucks enterprise. Schultz recalled, "There was something magic about it, a passion and authenticity I had never experienced in business."[4] The appeal of living in the Seattle area was another strong plus. By the time he landed at Kennedy Airport, he knew in his heart he wanted to go to work for Starbucks. At the first opportunity, Schultz asked Baldwin whether there was any way he could fit into Starbucks. Although the two had established an easy, comfortable personal rapport, it still took a year, numerous meetings at which Schultz presented his ideas, and a lot of convincing to get Baldwin, Bowker, and their silent partner from San Francisco to agree to hire him. Schultz pursued a job at Starbucks far more vigorously than Starbucks pursued hiring Schultz. There was some nervousness about bringing in an outsider, especially a high-powered New Yorker who had not grown up with the values of the company.

[3]Ibid., p. 34.
[4]Ibid., p. 36.

Nonetheless, Schultz continued to press his ideas about the tremendous potential of expanding the Starbucks enterprise outside Seattle and exposing people all over America to Starbucks coffee. Schultz argued that there had to be more than just the few thousand coffee lovers in Seattle who would enjoy the company's products.

At a meeting with the three owners in San Francisco in Spring 1982, Schultz once again presented his ideas and vision for opening Starbucks stores across the United States and Canada. He thought the meeting went well and flew back to New York thinking a job offer was in the bag. However, the next day Jerry Baldwin called Schultz and indicated that the owners had decided against hiring him because geographic expansion was too risky and they did not share Schultz's vision for Starbucks. Schultz was despondent, seeing his dreams of being a part of Starbucks' future go up in smoke. Still, he believed so deeply in Starbucks' potential that he decided to make a last ditch appeal; he called Baldwin back the next day and made an impassioned, reasoned case for why the decision was a mistake. Baldwin agreed to reconsider. The next morning Baldwin called Schultz and told him the job of heading marketing and overseeing the retail stores was his. In September 1982, Schultz took over his new responsibilities at Starbucks.

Starbucks and Howard Schultz: The 1982–1985 Period

In his first few months at Starbucks, Howard Schultz spent most of his waking hours in the four Seattle stores—working behind the counters, tasting different kinds of coffee, talking with customers, getting to know store personnel, and learning the retail aspects of the coffee business. By December, Jerry Baldwin concluded that Schultz was ready for the final part of his training, that of actually roasting the coffee. Schultz spent a week getting an education about the colors of different coffee beans, listening for the telltale second pop of the beans during the roasting process, learning to taste the subtle differences among Jerry Baldwin and Gordon Bowker's various roasts, and familiarizing himself with the roasting techniques for different beans.

Schultz made a point of acclimating himself to the informal dress code at Starbucks, gaining credibility and building trust with colleagues, and making the transition from the high-energy, coat-and-tie style of New York to the more casual, low-key ambience of the Pacific Northwest (see Exhibit 2 for a rundown on Howard Schultz's background). Schultz made real headway in gaining the acceptance and respect of company personnel while working at the Pike Place store one day during the busy Christmas season that first year. The store was packed and Schultz was behind the counter ringing up sales of coffee when someone shouted that a shopper had just headed out the door with some stuff—two expensive coffeemakers it turned out, one in each hand. Without thinking, Schultz leaped over the counter and chased the thief up the cobblestone street outside the store, yelling, "Drop that stuff! Drop it!" The thief was startled enough to drop both pieces he had carried off and ran away. Howard picked up the merchandise and returned to the store, holding the coffeemakers up like trophies. Everyone applauded. When Schultz returned to his office later that afternoon, his staff had strung up a banner that read: "Make my day."[5]

Schultz was overflowing with ideas for the company. Early on, he noticed that first-time customers sometimes felt uneasy in the stores because of their lack of knowledge about fine coffees and because store employees sometimes came across as a little arrogant or superior to coffee novices. Schultz worked with store employees on customer-friendly sales skills and developed brochures that made it easy for customers to learn about fine coffees. However, Schultz's biggest inspiration and vision for Starbucks' future came during the spring of 1983 when the company sent him to Milan, Italy, to attend an international housewares show. While walking from his hotel to the convention center, Schultz spotted an espresso bar and went inside to look around. The cashier beside the door nodded and smiled. The barista behind the counter greeted Howard cheerfully and moved gracefully to pull a shot of espresso for one customer and handcraft a foamy cappuccino for another, all the while conversing merrily with those standing at the counter. Schultz thought the barista's performance was "great theater." Just down the way on a side street, he went in an even more crowded espresso bar where the barista, whom he surmised to be the

[5]As told in ibid., p. 48.

exhibit 2 Biographical Sketch of Howard Schultz

- Schultz's parents both came from working-class families residing in Brooklyn, New York, for two generations. Neither completed high school.
- Schultz grew up in a government-subsidized housing project in Brooklyn, was the oldest of three children, played sports with the neighborhood kids, developed a passion for baseball, and became a die-hard Yankees fan.
- Schultz's father was a blue-collar factory worker and taxicab driver who held many low-wage, no benefits jobs; his mother remained home to take care of the children during their preschool years, then worked as an office receptionist. The family was hard pressed to make ends meet.
- Schultz had a number of jobs as a teenager—paper route, counter job at luncheonette, an after-school job in the garment district in Manhattan, a summer job steaming yarn at a knit factory. He always gave part of his earnings to his mother to help with family expenses.
- He saw success in sports as his way to escape life in the projects; he played quarterback on the high school football team.
- He was offered a scholarship to play football at Northern Michigan University (the only offer he got) and took it. When his parents drove him to the campus to begin the fall term, it was his first trip outside New York. It turned out that he didn't have enough talent to play football, but he got loans and worked at several jobs to keep himself in school. He majored in communications, took a few business courses on the side, and graduated in 1975 with a B average—the first person in his family to graduate from college.
- He went to work for a ski lodge in Michigan after graduation, then left to go back to New York, landing a sales job at Xerox Corporation. He left Xerox to work for Swedish coffee equipment maker Hammarplast U.S.A., becoming vice president and general manager in charge of U.S. operations and managing 20 independent sales representatives.
- He married Sheri Kersch in July 1982; the couple had two children.
- His father contracted lung cancer in 1982 at age 60 and died in 1988, leaving his mother with no pension, no life insurance, and no savings.
- Schultz became a principal owner of Seattle SuperSonics NBA team in 2001; also a principal owner of Seattle Storm of WNBA.
- He owned about 16 million shares of Starbucks in early 2003 and had an estimated net worth of $700 million.

Source: Howard Schultz and Dori Jones Yang, *Pour Your Heart Into It* (New York: Hyperion, 1997).

owner, was greeting customers by name; people were laughing and talking in an atmosphere that plainly was comfortable and familiar. In the next few blocks, he saw two more espresso bars. That afternoon when the trade show concluded for the day, Schultz walked the streets of Milan to explore more espresso bars. Some were stylish and upscale; others attracted a blue-collar clientele. Most had few chairs, and it was common for Italian opera to be playing in the background. What struck Schultz was how popular and vibrant the Italian coffee bars were. Energy levels were typically high, and they seemed to function as an integral community gathering place. Each one had its own unique character, but they all had a barista who performed with flair and maintained a camaraderie with the customers.

Schultz remained in Milan for a week, exploring coffee bars and learning as much as he could about the Italian passion for coffee drinks. Schultz was particularly struck by the fact that there were 1,500 coffee bars in Milan, a city about the size of Philadelphia, and a total of 200,000 in all of Italy. In one bar, he heard a customer order a caffe latte and decided to try one himself—the barista made a shot of espresso, steamed a frothy pitcher of milk, poured the two together in a cup, and put a dollop of foam on the top. Schultz liked it immediately, concluding that lattes should be a feature item on any coffee bar menu even though none of the coffee experts he had talked to had ever mentioned them.

Schultz's 1983 trip to Milan produced a revelation: the Starbucks stores in Seattle completely missed the point. There was much more to the coffee business than just selling beans and getting people to appreciate grinding their own beans and brewing fine coffee in their homes. What Starbucks needed to do was serve fresh brewed coffee, espresso, and cappuccino in its stores (in addition to beans and coffee equipment) and try to create an American version of the Italian coffee bar culture. Going to Starbucks should be an experience, a special treat, a place to meet friends and visit. Re-creating the authentic Italian coffee bar culture in the United States could be Starbucks' differentiating factor.

Schultz Becomes Frustrated

On his return from Italy, Howard Schultz shared his revelation and ideas for modifying the format of Starbucks' stores with Jerry Baldwin and Gordon Bowker. But instead of winning their approval for trying out some of his ideas, Schultz encountered strong resistance. Baldwin and Bowker argued that Starbucks was a retailer, not a restaurant or coffee bar. They feared that serving drinks would put them in the beverage business and diminish the integrity of Starbucks' mission as a purveyor of fine coffees. They pointed out that Starbucks had been profitable every year and there was no reason to rock the boat in a small, private company like Starbucks. But a more pressing reason not to pursue Schultz's coffee bar concept emerged shortly—Baldwin and Bowker were excited by an opportunity to purchase Peet's Coffee and Tea. The acquisition was finalized in early 1984; to fund it, Starbucks had to take on considerable debt, leaving little in the way of financial flexibility to support Schultz's ideas for entering the beverage part of the coffee business or expanding the number of Starbucks stores.

For most of 1984, Starbucks managers were dividing their time between operations in Seattle and the Peet's enterprise in San Francisco. Schultz found himself in San Francisco every other week supervising the marketing and operations of the five Peet's stores. Starbucks employees began to feel neglected and, in one quarter, did not receive their usual bonus due to tight financial conditions. Employee discontent escalated to the point where a union election was called. The union won by three votes. Jerry Baldwin was shocked at the results, concluding that employees no longer trusted him. In the months that followed, he began to spend more of his energy on Peet's operation in San Francisco.

It took Howard Schultz nearly a year to convince Jerry Baldwin to let him test an espresso bar. Baldwin relented when Starbucks opened its sixth store in April 1984. It was the first of the company's stores designed to sell beverages, and it was the first one located in downtown Seattle. Schultz asked for a 1,500-square-foot space to set up a full-scale Italian-style espresso bar, but Baldwin agreed to allocating only 300 square feet in a corner of the new store. The store opened with no fanfare as a deliberate experiment. By closing time on the first day, some 400 customers had been served, well above the 250-customer average of Starbucks' best-performing stores. Within two months the store was serving 800 customers a day. The two baristas could not keep up with orders during the early-morning hours, resulting in lines outside the door onto the sidewalk. Most of the business was at the espresso counter, while sales at the regular retail counter were only adequate.

Schultz was elated at the test results, expecting that Baldwin's doubts about entering the beverage side of the business would be dispelled and that he would gain approval to pursue the opportunity to take Starbucks to a new level. Every day he went into Baldwin's office to show him the sales figures and customer counts at the new downtown store. But Baldwin was not comfortable with the success of the new store, believing that it felt wrong and that espresso drinks were a distraction from the core business of marketing fine arabica coffees at retail. Baldwin rebelled at the thought that people would see Starbucks as a place to get a quick cup of coffee to go. He adamantly told Schultz, "We're coffee roasters. I don't want to be in the restaurant business . . . besides, we're too deeply in debt to consider pursuing this idea."[6] While he didn't deny that the experiment was succeeding, he didn't want to go forward with introducing beverages in other Starbucks stores. Schultz's efforts to persuade Baldwin to change his mind continued to meet strong resistance, although to avoid a total impasse Baldwin finally did agree to let Schultz put espresso machines in the back of possibly one or two other Starbucks stores.

Over the next several months, Schultz made up his mind to leave Starbucks and start his own company. His plan was to open espresso bars in high-traffic downtown locations, serve espresso drinks and coffee by the cup, and try to emulate the friendly, energetic atmosphere he had encountered in Italian espresso bars. Jerry Baldwin and Gordon Bowker, knowing how frustrated Schultz had become, supported his efforts to go out on his own and agreed to let him stay in his current job and office until definitive plans were in place. Schultz left Starbucks in late 1985.

[6]Ibid., pp. 61–62.

Schultz's Il Giornale Venture

With the aid of a lawyer friend who helped companies raise venture capital and go public, Howard Schultz began seeking out investors for the kind of company he had in mind. Ironically, Jerry Baldwin committed to investing $150,000 of Starbucks' money in Schultz's coffee bar enterprise, thus becoming Schultz's first investor. Baldwin accepted Schultz's invitation to be a director of the new company and Gordon Bowker agreed to be a part-time consultant for six months. Bowker, pumped up about the new venture, urged Howard to take pains to make sure that everything about the new stores—the name, the presentation, the care taken in preparing the coffee—be calculated to lead customers to expect something better than competitors offered. Bowker proposed that the new company be named Il Giornale Coffee Company (pronounced *il jor NAHL ee*), a suggestion that Schultz accepted. In December 1985, Bowker and Schultz made a trip to Italy, where they visited some 500 espresso bars in Milan and Verona, observing local habits, taking notes about decor and menus, snapping photographs, and videotaping baristas in action.

About $400,000 in seed capital was raised by the end of January 1986, enough to rent an office, hire a couple of key employees, develop a store design, and open the first store. But it took until the end of 1986 to raise the remaining $1.25 million needed to launch at least eight espresso bars and prove that Schultz's strategy and business model were viable. Schultz made presentations to 242 potential investors, 217 of whom said no. Many who heard Schultz's hour-long presentation saw coffee as a commodity business and thought that Schultz's espresso bar concept lacked any basis for sustainable competitive advantage (no patent on dark roast, no advantage in purchasing coffee beans, no ways to prevent the entry of imitative competitors). Some noted that coffee couldn't be turned into a growth business—consumption of coffee had been declining since the mid-1960s. Others were skeptical that people would pay $1.50 or more for a cup of coffee, and the company's unpronounceable name turned some off. Being rejected by so many of the potential investors he approached was disheartening for Schultz (some who listened to his presentation didn't even bother to call him back; others refused to take his calls). Nonetheless, Schultz maintained an upbeat attitude and displayed passion and enthusiasm in making his pitch. He ended up raising $1.65 million from about 30 investors, most of which came from nine people, five of whom became directors.

The first Il Giornale store opened in April 1986. It had 700 square feet and was located near the entrance of Seattle's tallest building. The decor was Italian, and the menu had some Italian words. Italian opera music played in the background. The baristas wore white shirts and bow ties. All service was stand-up—there were no chairs. National and international papers were hung on rods on the wall. By closing time on the first day, 300 customers had been served, mostly in the morning hours. But while the core idea worked well, it soon became apparent that several aspects of the format were not appropriate for Seattle. Some customers objected to the incessant opera music, others wanted a place to sit down, and many did not understand the Italian words on the menu. These "mistakes" were quickly fixed, but an effort was made not to compromise the style and elegance of the store. Within six months, the store was serving more than 1,000 customers a day. Regular customers had learned how to pronounce the company's name. Because most customers were in a hurry, it became apparent that speedy service was essential.

Six months after the first Il Giornale opened, a second store was opened in another downtown building. A third store was opened in Vancouver, British Columbia, in April 1987. Vancouver was chosen to test the transferability of the company's business concept outside Seattle. Schultz's goal was to open 50 stores in five years, and he needed to dispel his investors' doubts about geographic expansion early on to achieve his growth objective. By mid-1987 sales at the three stores were running at a rate equal to $1.5 million annually.

Il Giornale Acquires Starbucks

In March 1987 Jerry Baldwin and Gordon Bowker decided to sell the whole Starbucks operation in Seattle—the stores, the roasting plant, and the Starbucks name. Bowker wanted to cash out his coffee business investment to concentrate on his other enterprises; Baldwin, who was tired of commuting between Seattle and San Francisco and wrestling with the troubles created by the two parts of the company, elected to concentrate on the Peet's operation. As he recalls, "My wife and I had a 30-second conversation and decided to keep Peet's. It was the original and it was better."[7]

Schultz knew immediately that he had to buy Starbucks; his board of directors agreed. Schultz and his newly hired finance and accounting manager drew up a set of financial projections for the combined operations and a financing package that included a stock offering to Il Giornale's original investors and a line of credit with local banks. While a rival plan to acquire Starbucks was put together by another Il Giornale investor, Schultz's proposal prevailed. Within weeks, Schultz had raised the $3.8 million needed to buy Starbucks, and the acquisition was completed in August 1987. The new name of the combined companies was Starbucks Corporation. Howard Schultz, at the age of 34, became Starbucks' president and CEO.

STARBUCKS AS A PRIVATE COMPANY: 1987–1992

The Monday morning following the completed acquisition, Howard Schultz returned to the Starbucks offices at the roasting plant, greeted all the familiar faces, and accepted their congratulations. Then he called the staff together for a meeting on the roasting plant floor:

> All my life I have wanted to be part of a company and a group of people who share a common vision . . . I'm here today because I love this company. I love what it represents . . . I know you're concerned . . . I promise you I will not let you down. I promise you I will not leave anyone behind . . . In five years, I want you to look back at this day and say "I was there when it started. I helped build this company into something great."[8]

Schultz told the group that his vision was for Starbucks to become a national company with values and guiding principles that employees could be proud of. He indicated that he wanted to include people in the decision-making process and that he would be open and honest with them.

[7]As quoted in Jennifer Reese, "Starbucks: Inside the Coffee Cult," *Fortune,* December 9, 1996, p. 193.

[8]Schultz and Yang, *Pour Your Heart Into It,* pp. 101–2.

Schultz believed it was essential, not just an intriguing option, to build a company that valued and respected its people, that inspired them, and that shared the fruits of success with those who contributed to the company's long-term value. His aspiration was for Starbucks to become the most respected brand name in coffee and for the company to be admired for its corporate responsibility. In the next few days and weeks, Schultz came to see that the unity and morale at Starbucks had deteriorated badly in the 20 months he had been at Il Giornale. Some employees were cynical and felt unappreciated. There was a feeling that prior management had abandoned them and a wariness about what the new regime would bring. Schultz decided to make building a new relationship of mutual respect between employees and management a priority.

The new Starbucks had a total of nine stores. The business plan Schultz had presented investors called for the new company to open 125 stores in the next five years—15 the first year, 20 the second, 25 the third, 30 the fourth, and 35 the fifth. Revenues were projected to reach $60 million in 1992. But the company lacked experienced management. Schultz had never led a growth effort of such magnitude and was just learning what the job of CEO was all about, having been the president of a small company for barely two years. Dave Olsen, a Seattle coffee bar owner whom Schultz had recruited to direct store operations at Il Giornale, was still learning the ropes in managing a multistore operation. Ron Lawrence, the company's controller, had worked as a controller for several organizations. Other Starbucks employees had only the experience of managing or being a part of a six-store organization. When Starbucks' key roaster and coffee buyer resigned, Schultz put Dave Olsen in charge of buying and roasting coffee. Lawrence Maltz, who had 20 years' experience in business, including 8 years as president of a profitable public beverage company, was hired as executive vice president and charged with heading operations, finance, and human resources.

In the next several months, a number of changes were instituted. To symbolize the merging of the two companies and the two cultures, a new logo was created that melded the designs of the Starbucks logo and the Il Giornale logo. The Starbucks stores were equipped with espresso machines and remodeled to look more Italian than Old World nautical. Il Giornale green replaced the traditional Starbucks brown.

The result was a new type of store—a cross between a retail coffee bean store and an espresso bar/café—that eventually became Starbucks' signature.

By December 1987, the mood of the employees at Starbucks had turned upbeat. They were buying into the changes that Schultz was making, and trust began to build between management and employees. New stores were on the verge of opening in Vancouver and Chicago. One Starbucks store employee, Daryl Moore, who had started working at Starbucks in 1981 and who had voted against unionization in 1985, began to question the need for a union with his fellow employees. Over the next few weeks, Moore began a move to decertify the union. He carried a decertification letter around to Starbucks stores and secured the signatures of employees who no longer wished to be represented by the union. He got a majority of store employees to sign the letter and presented it to the National Labor Relations Board. The union representing store employees was decertified. Later, in 1992, the union representing Starbucks' roasting plant and warehouse employees was also decertified.

Market Expansion Outside the Pacific Northwest

Starbucks' entry into Chicago proved far more troublesome than management anticipated. The first Chicago store opened in October 1987, and three more stores were opened over the next six months. Customer counts at the stores were substantially below expectations. Chicagoans did not take to dark-roasted coffee as fast as Schultz had hoped. The first downtown store opened onto the street rather than into the lobby of the building where it was located; in the winter months, customers were hesitant to go out in the wind and cold to acquire a cup of coffee. It was expensive to supply fresh coffee to the Chicago stores out of the Seattle warehouse (the company solved the problem of freshness and quality assurance by putting freshly roasted beans in special FlavorLock bags that used vacuum packaging techniques with a one-way valve to allow carbon dioxide to escape without allowing air and moisture in). Rents were higher in Chicago than in Seattle, and so were wage rates. The result was a squeeze on store profit margins. Gradually, customer counts improved, but Starbucks lost money on its Chicago stores until, in 1990, prices were raised to reflect higher rents and labor costs, more experienced store managers were hired, and a critical mass of customers caught on to the taste of Starbucks products.

Portland, Oregon, was the next market the company entered, and Portland coffee drinkers took to Starbucks products quickly. By 1991, the Chicago stores had become profitable and the company was ready for its next big market entry. Management decided on California because of its host of neighborhood centers and the receptiveness of Californians to high-quality, innovative food. Los Angeles was chosen as the first California market to enter. L.A. was selected principally because of its status as a trendsetter and its cultural ties to the rest of the country. L.A. consumers embraced Starbucks quickly, and the *Los Angeles Times* named Starbucks as the best coffee in America even before the first store opened. The entry into San Francisco proved more troublesome because San Francisco had an ordinance against converting stores to restaurant-related uses in certain prime urban neighborhoods; Starbucks could sell beverages and pastries to customers at stand-up counters but could not offer seating in stores that had formerly been used for general retailing. However, the city council was soon convinced by café owners and real estate brokers to change the code. Still, Starbucks faced strong competition from Peet's and local espresso bars in the San Francisco market.

Starbucks' store expansion targets proved easier to meet than Schultz had originally anticipated, and he upped the numbers to keep challenging the organization. Starbucks opened 15 new stores in fiscal 1988, 20 in 1989, 30 in 1990, 32 in 1991, and 53 in 1992—producing a total of 161 stores, significantly above the 1987 objective of 125 stores.

From the outset, the strategy was to open only company-owned stores; franchising was avoided so as to keep the company in full control of the quality of its products and the character and location of its stores. But company-ownership of all stores required Starbucks to raise new venture capital to cover the cost of new store expansion. In 1988 the company raised $3.9 million, in 1990 venture capitalists provided an additional $13.5 million, and in 1991 another round of venture capital financing generated $15 million. Starbucks was able to raise the needed funds despite posting losses of $330,000 in 1987, $764,000 in 1988, and $1.2 million in 1989. While the losses were troubling to

Starbucks' board of directors and investors, Schultz's business plan had forecast losses during the early years of expansion. At a particularly tense board meeting where directors sharply questioned Schultz about the lack of profitability, Schultz said:

> Look, we're going to keep losing money until we can do three things. We have to attract a management team well beyond our expansion needs. We have to build a world-class roasting facility. And we need a computer information system sophisticated enough to keep track of sales in hundreds and hundreds of stores.[9]

Schultz argued for patience as the company invested in the infrastructure to support continued growth well into the 1990s. He contended that hiring experienced executives ahead of the growth curve, building facilities far beyond current needs, and installing support systems laid a strong foundation for rapid, profitable growth on down the road. His arguments carried the day with the board and with investors, especially since revenues were growing by approximately 80 percent annually and customer traffic at the stores was meeting or exceeding expectations.

Starbucks became profitable in 1990, and profits increased every year thereafter except for fiscal year 2000. Exhibit 3 provides a financial summary for 1998–2003.

HOWARD SCHULTZ'S STRATEGY TO MAKE STARBUCKS A GREAT PLACE TO WORK

Howard Schultz deeply believed that Starbucks' success was heavily dependent on customers having a very positive experience in its stores. This meant having store employees who were knowledgeable about the company's products, who paid attention to detail in preparing the company's espresso drinks, who eagerly communicated the company's passion for coffee, and who possessed the skills and personality to deliver consistent, pleasing customer service. Many of the baristas were in their 20s and worked part-time, going to college on the side or pursuing other career activities. The challenge to Starbucks, in Schultz's view, was how to attract, motivate, and reward store employees in a manner that would make Starbucks a company that people would want to work for and that would generate enthusiastic commitment and higher levels of customer service. Moreover, Schultz wanted to send all Starbucks employees a message that would cement the trust that had been building between management and the company's workforce.

One of the requests that employees had made to the prior owners of Starbucks was to extend health care benefits to part-time workers. Their request had been turned down, but Schultz believed that expanding heath care coverage to include part-timers was the right thing to do. His father had recently passed away with cancer and he knew from his own past experience of having grown up in a family that struggled to make ends meet how difficult it was to cope with rising medical costs. In 1988 Schultz went to the board of directors with his plan to expand the company's heath care coverage to include part-timers who worked at least 20 hours a week. He saw the proposal not as a generous gesture but as a core strategy to win employee loyalty and commitment to the company's mission. Board members resisted because the company was unprofitable and the added costs of the extended coverage would only worsen the company's bottom line. But Schultz argued passionately that it was the right thing to do and wouldn't be as expensive as it seemed. He observed that if the new benefit reduced turnover, which he believed was likely, then it would reduce the costs of hiring and training—which equaled about $3,000 per new hire; he further pointed out that it cost $1,500 a year to provide an employee with full benefits. Part-timers, he argued, were vital to Starbucks, constituting two-thirds of the company's workforce. Many were baristas who knew the favorite drinks of regular customers; if the barista left, that connection with the customer was broken. Moreover, many part-time employees were called on to open the stores early, sometimes at 5:30 or 6:00 AM; others had to work until closing, usually 9:00 PM or later. Providing these employees with health care benefits, he argued, would signal that the company honored their value and contribution.

The board approved Schultz's plan, and starting in late 1988 part-timers working 20 or more hours were offered the same health coverage as full-time

[9]Ibid., p. 142.

exhibit 3 **Financial and Operating Summary for Starbucks Corporation, 1998–2003 (dollars in 000s)**

	Fiscal Years Ending[a]					
	September 30, 2003	September 29, 2002	September 30, 2001	October 1, 2000	October 3, 1999	September 27, 1998
Results of operations data						
Net revenues						
Retail	$3,449,624	$2,792,904	$2,229,594	$1,823,607	$1,423,389	$1,102,574
Specialty	625,898	496,004	419,386	354,007	263,439	206,128
Total net revenues	$4,075,522	$3,288,908	$2,648,980	$2,177,614	$1,686,828	$1,308,702
Cost of sales and related company costs	1,685,928	1,350,011	1,112,785	961,885	741,010	578,483
Store operating expenses	1,379,574	1,109,782	867,957	704,898	543,572	418,476
Other operating expenses	141,346	106,084	72,406	78,445	51,374	43,479
Depreciation and amortization expenses	237,807	205,557	163,501	130,232	97,797	72,543
General and administrative expenses	244,550	234,581	179,852	110,202	89,681	77,575
Income from equity investors	38,396	33,445	27,740	20,300	—	—
Merger expenses[b]	—	—	—	—	—	8,930
Operating income	$ 424,713	$ 316,338	$ 280,219	$ 212,252	$ 156,711	$ 109,216
Internet-related investment losses			2,940	58,792		
Gain on sale of investment		13,361				
Net earnings	$ 268,346	$ 212,686	$ 180,335	$ 94,564	$ 101,693	$ 68,372
Net earnings per common share—diluted	$ 0.67	$ 0.54	$ 0.46	$ 0.24	$ 0.27	$ 0.19
Cash dividends per share	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Balance sheet data						
Current assets	$ 924,029	$ 772,643	$ 593,925	$ 459,819	$ 386,500	$ 337,280
Current liabilities	608,703	462,595	445,264	313,251	251,597	179,475
Working capital	$ 315,326	$ 310,048	$ 148,661	$ 146,568	$ 135,303	$ 157,805
Total assets	$2,729,746	$2,214,392	$1,846,519	$1,491,546	$1,252,514	$ 992,755
Long-term debt (including current portion)	$ 4,354	$ 5,076	$ 6,483	$ 7,168	$ 7,691	$ 1,803
Shareholders' equity	$2,082,427	$1,723,189	$1,375,927	$1,148,399	$ 961,013	$ 794,297

exhibit 3 **(concluded)**

	Fiscal Years Ending[a]					
	September 30, 2003	September 29, 2002	September 30, 2001	October 1, 2000	October 3, 1999	September 27, 1998
Store operations data						
Percentage change in comparable store sales[c]						
United States	9%	7%	5%	9%	6%	5%
International	7%	1%	3%	12%	8%	n.a.
Consolidated	8%	6%	5%	9%	6%	5%
Systemwide retail store sales[d]	n.a.	$3,796,000	$2,950,000	$2,250,000	$1,633,000	$1,190,000
Systemwide stores opened during the year						
United States						
Company-operated stores	506	503	498	388	394	352
Licensed stores	315	264	268	342	42	39
International						
Company-operated stores	96	111	149	96	53	35
Licensed stores	284	298	293	177	1,239	48
Total	1,201	1,177	1,208	1,003	612	474
Systemwide stores open at year end[e]						
United States						
Company-operated stores	3,779	3,209	2,706	2,208	1,820	1,622
Licensed stores	1,422	1,033	769	501	159	133
International						
Company-operated stores	767	671	580	411	315	66
Licensed stores	1,257	973	674	381	204	65
Total	7,225	5,886	4,709	3,501	2,498	1,886

[a]The company's fiscal year ends on the Sunday closest to September 30. All fiscal years presented include 52 weeks, except fiscal 1999, which includes 53 weeks.

[b]Merger expenses relate to the business combination with Seattle Coffee Holdings Limited.

[c]Includes only company-operated stores open 13 months or longer.

[d]Systemwide retail sales include sales at company-operated and licensed stores and are believed by management to measure global penetration of Starbucks retail stores.

[e]Systemwide store openings are reported net of closures.

Source: 10-K reports for 2003, 2002, 2000, and 1999 and company press releases (for 2003 data).

employees. Starbucks paid 75 percent of an employee's health care premium; the employee paid 25 percent. Over the years, Starbucks extended its health coverage to include preventive care, crisis counseling, dental care, eye care, mental health, and chemical dependency. Coverage was also offered for unmarried partners in a committed relationship. Since most Starbucks' employees were young and comparatively healthy, the company had been able to provide broader coverage while keeping monthly payments relatively low. The value of Starbucks' health care program struck home when one of the company's store managers and a former barista walked into Schultz's office and told him he had AIDS:

> I had known he was gay but had no idea he was sick. His disease had entered a new phase, he explained, and he wouldn't be able to work any longer. We sat together and cried, for I could not find meaningful words to console him. I couldn't compose myself. I hugged him.[10]
>
> At that point, Starbucks had no provision for employees with AIDS. We had a policy decision. Because of Jim, we decided to offer health-care coverage to all employees who have terminal illnesses, paying medical costs in full from the time they are not able to work until they are covered by government programs, usually twenty-nine months.
>
> After his visit to me, I spoke with Jim often and visited him at the hospice. Within a year he was gone. I received a letter from his family afterward, telling me how much they appreciated our benefit plan.

In 1994 Howard Schultz was invited to The White House for a one-on-one meeting with President Bill Clinton to brief him on Starbucks' health care program.

The Creation of an Employee Stock Option Plan

By 1991 the company's profitability had improved to the point where Schultz could pursue a stock option plan for all employees, a program he believed would have a positive, long-term effect on the success of Starbucks.[11] Schultz wanted to turn all Starbucks employees into partners, give them a chance to share in the success of the company, and make clear the connection between their contributions and the company's market value. Even though Starbucks was still a private company, the plan that emerged called for granting stock options to all full-time and part-time employees in proportion to their base pay. In May 1991, the plan, dubbed Bean Stock, was presented to the board. Though board members were concerned that increasing the number of shares might unduly dilute the value of the shares of investors who had put up hard cash, the plan received unanimous approval. The first grant was made in October 1991, just after the end of the company's fiscal year in September; each partner was granted stock options worth 12 percent of base pay. Each October since then, Starbucks has granted employees options equal to 14 percent of base pay, awarded at the stock price at the start of the fiscal year (October 1). When the Bean Stock program was presented to employees, Starbucks dropped the term *employee* and began referring to all of its people as *partners* because everyone, including part-timers working at least 20 hours per week, was eligible for stock options after six months. At the end of fiscal year 2003, Starbucks employee stock option plan included 39 million shares in outstanding options; new options for about 10 million shares were being granted annually.[12]

Starbucks became a public company in 1992; its initial public offering (IPO) of common stock in June proved to be one of the most successful IPOs of 1992 and provided the company access to the capital needed to accelerate expansion of its store network. Exhibit 4 shows the performance of the company's stock price since the 1992 IPO.

Starbucks' Stock Purchase Plan for Employees

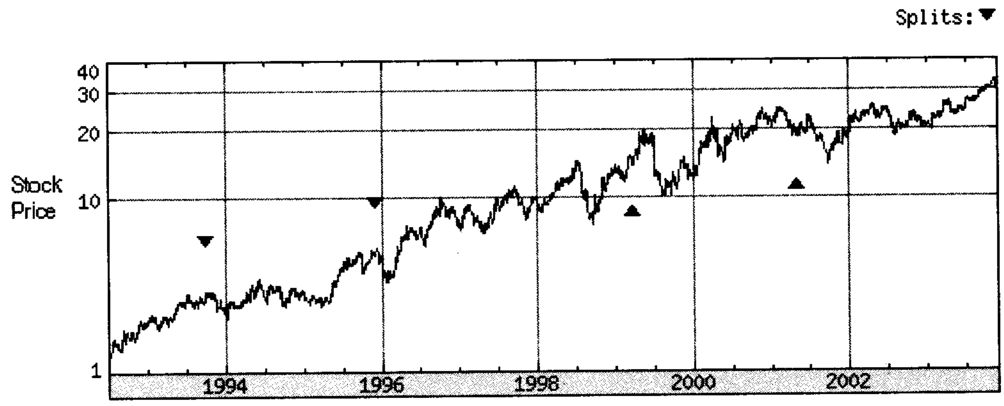
In 1995, Starbucks implemented an employee stock purchase plan. Eligible employees could contribute up to 10 percent of their base earnings to quarterly purchases of the company's common stock at 85 percent of the going stock price. As of fiscal 2003, about 5.7 million shares had been issued since inception of the plan, and new shares were being purchased at a rate close to 1 million shares annually by some 11,184 active employee participants (out of almost 35,000 employees who were eligible to partici-

[10] Ibid., p. 129.

[11] As related in ibid., pp. 131–36.

[12] Starbucks annual report, 2002, p. 32.

exhibit 4 **The Performance of Starbucks' Stock, 1992–2003**



Source: www.finance.yahoo.com.

pate).[13] An employee stock option plan for eligible United Kingdom employees was established in 2002.[14]

The Workplace Environment

Starbucks' management believed that the company's pay scales and fringe benefit package allowed it to attract motivated people with above-average skills and good work habits. Store employees were paid around \$9–\$12 an hour, several dollars above the hourly minimum wage. Whereas most national retailers and fast-food chains had turnover rates for store employees ranging from 150 to 400 percent a year, the turnover rates for Starbucks' baristas ran about 65 percent. Starbucks' turnover for store managers was about 25 percent, compared to about 50 percent for other chain retailers. Starbucks' executives believed that efforts to make the company an attractive, caring place to work were responsible for its relatively low turnover rates. One Starbucks store manager commented, "Morale is very high in my store among the staff. I've worked for a lot of companies, but I've never seen this level of respect. It's a company that's very true to its workers, and it shows. Our customers always comment that we're happy and having fun. In fact, a lot of people ask if they can work here."[15]

Starbucks' management used annual "Partner View" surveys to solicit feedback from its workforce of over 74,000 people, learn their concerns, and measure job satisfaction. In the latest sample survey of 1,400 employees, 79 percent rated Starbucks' workplace environment favorably relative to other companies they were familiar with, 72 percent reported being satisfied with their present job, 16 percent were neutral, and 12 percent were dissatisfied. But the 2002 survey revealed that many employees viewed the benefits package as only "average," prompting the company to increase its match of 401(k) contributions for those who had been with the company more than three years and to have these contributions vest immediately.

Exhibit 5 contains a summary of Starbucks' fringe benefit program. Starbucks was named by *Fortune* magazine as one of the "100 Best Companies to Work For" in 1998, 1999, 2000, and 2002. Still, in 2003, Starbucks' management was concerned by field reports of stores that were suffering from slumping employee morale and store manager burnout.

STARBUCKS' CORPORATE VALUES AND BUSINESS PRINCIPLES

During the early building years, Howard Schultz and other Starbucks' senior executives worked to instill some key values and guiding principles into the

[13]Ibid.

[14]Ibid.

[15]Ben van Houten, "Employee Perks: Starbucks Coffee's Employee Benefit Plan," *Restaurant Business,* May 15, 1997, p. 85.

exhibit 5 Elements of Starbucks' Fringe Benefit Program

- Medical insurance
- Dental and vision care
- Mental health and chemical dependency coverage
- Short- and long-term disability
- Life insurance
- Benefits extended to committed domestic partners of Starbucks employees
- Sick time
- Paid vacations (first-year workers got one vacation week and two personal days)
- 401(k) retirement savings plan—the company matched from 25% to 150%, based on length of service, of each employee's contributions up to the first 4% of compensation
- Stock purchase plan—eligible employees could buy shares at a discounted price through regular payroll deductions
- Free pound of coffee each week
- 30% product discounts
- Stock option plan (Bean Stock)

Source: Compiled by the case researchers from company documents and other sources.

Starbucks culture. The cornerstone value in the effort "to build a company with soul" was that the company would never stop pursuing the perfect cup of coffee by buying the best beans and roasting them to perfection. Schultz remained steadfastly opposed to franchising, so that the company could control the quality of its products and build a culture common to all stores. He was adamant about not selling artificially flavored coffee beans—"We will not pollute our high-quality beans with chemicals"; if a customer wanted hazelnut-flavored coffee, Starbucks would provide it by adding hazelnut syrup to the drink rather than by adding hazelnut flavoring to the beans during roasting. Running flavored beans through the grinders would leave behind chemical residues that would alter the flavor of beans ground afterward; plus, the chemical smell given off by artificially flavored beans was absorbed by other beans in the store. Furthermore, Schultz didn't want the company to pursue supermarket sales because it would mean pouring Starbucks' beans into clear plastic bins where they could get stale, thus compromising the company's legacy of fresh, dark-roasted, full-flavored coffee.

Starbucks' management was also emphatic about the importance of employees paying attention to what pleased customers. Employees were trained to go out of their way, and to take heroic measures if necessary, to make sure customers were fully satisfied. The theme was "Just say yes" to customer requests. Further, employees were encouraged to speak their minds without fear of retribution from upper management—senior executives wanted employees to be vocal about what Starbucks was doing right, what it was doing wrong, and what changes were needed. Management wanted employees to be involved in and contribute to the process of making Starbucks a better company.

A values and principles "crisis" arose at Starbucks in 1989 when customers started requesting skim (i.e., nonfat) milk in making cappuccinos and lattes. Howard Schultz, who read all customer comments cards, and Dave Olsen, head of coffee quality, conducted taste tests of lattes and cappuccinos made with nonfat milk and concluded they were not as good as those made with whole milk. Howard Behar, recently hired as head of retail store operations, indicated that management's opinions didn't matter; what mattered was giving customers what they wanted. Schultz took the position that "We will never offer nonfat milk. It's not who we are." Behar, however, stuck to his guns, maintaining that use of nonfat milk should at least be tested—otherwise it appeared as if all the statements management had made about the importance of really and truly pleasing customers were a sham. A fierce internal debate ensued. One dogmatic defender of the quality and taste of Starbucks' coffee products buttonholed Behar outside his office and told him that using nonfat milk amounted to "bastardizing" the company's products. Numerous store managers maintained that offering two kinds of milk was operationally impractical. Schultz found himself in a quandary, torn between the company's commitment to quality and its goal of pleasing customers. One day after visiting one of the stores in a residential neighborhood and watching a customer leave to go to a competitor's store because Starbucks did not make lattes with nonfat milk, Schultz authorized Behar to begin testing.[16] Within six months all 30 stores were offering drinks made with nonfat milk. Currently, about half the lattes and cappuccinos Starbucks sells are made with nonfat milk.

Schultz's approach to offering employees good compensation and a comprehensive benefits package was driven by his belief that sharing the company's success with the people who made it happen helped everyone think and act like an owner, build positive long-term relationships with customers, and do things in an efficient way. He had vivid recollection of his father's employment experience—bouncing from one low-paying job to another, working for employers who offered few or no benefits and who conducted their business with no respect for the contributions of the workforce—and he had no intention of Starbucks being that type of company. He vowed that he would never let Starbucks employees suffer a similar fate, saying:

> My father worked hard all his life and he had little to show for it. He was a beaten man. This is not the American dream. The worker on our plant floor is contributing great value to the company; if he or she has low self-worth, that will have an effect on the company.[17]

The company's employee benefits program was predicated on the belief that better benefits attract good people and keep them longer. Schultz's rationale was that if you treat your employees well, that is how they will treat customers.

STARBUCKS' MISSION STATEMENT

In early 1990, the senior executive team at Starbucks went to an off-site retreat to debate the company's values and beliefs and draft a mission statement. Schultz wanted the mission statement to convey a strong sense of organizational purpose and to articulate the company's fundamental beliefs and guiding principles. The draft was submitted to all employees for review, and several changes were made on the basis of employee comments. The resulting mission statement, which remained unchanged in 2003, is shown in Exhibit 6.

exhibit 6 **Starbucks' Mission Statement**

Establish Starbucks as the premier purveyor of the finest coffee in the world while maintaining our uncompromising principles while we grow.

The following six guiding principles will help us measure the appropriateness of our decisions:

- Provide a great work environment and treat each other with respect and dignity.
- Embrace diversity as an essential component in the way we do business.
- Apply the highest standards of excellence to the purchasing, roasting, and fresh delivery of our coffee.
- Develop enthusiastically satisfied customers all of the time.
- Contribute positively to our communities and our environment.
- Recognize that profitability is essential to our future success.

Source: www.starbucks.com, November 2003.

Following adoption of the mission statement, Starbucks' management implemented a "Mission Review" to solicit and gather employee opinions about whether the company was living up to its stated mission. Employees were urged to report their concerns to the company's Mission Review team if they thought particular management decisions were not supportive of the company's mission statement. Comment cards were given to each newly hired employee and were kept available in common areas with other employee forms. Employees had the option of signing the comment cards or not. Hundreds of cards were submitted to the Mission Review team each year. The company promised that a relevant manager would respond to all signed cards within two weeks. Howard Schultz reviewed all the comments, signed and unsigned.

STARBUCKS' STORE EXPANSION STRATEGY

In 1992 and 1993 Starbucks developed a three-year geographic expansion strategy that targeted areas that not

[16]As related in Schultz and Yang, *Pour Your Heart Into It,* p. 168.

[17]As quoted in Ingrid Abramovitch, "Miracles of Marketing," *Success* 40, no. 3, p. 26.

only had favorable demographic profiles but also could be serviced and supported by the company's operations infrastructure. For each targeted region, Starbucks selected a large city to serve as a "hub"; teams of professionals were located in hub cities to support the goal of opening 20 or more stores in the hub in the first two years. Once stores blanketed the hub, then additional stores were opened in smaller, surrounding "spoke" areas in the region. To oversee the expansion process, Starbucks created zone vice presidents to direct the development of each region and to implant the Starbucks culture in the newly opened stores. All of the new zone vice presidents Starbucks recruited came with extensive operating and marketing experience in chain store retailing.

Starbucks' strategy in major metropolitan cities was to blanket the area with stores, even if some stores cannibalized another store's business.[18] While a new store might draw 30 percent of the business of an existing store two or so blocks away, management believed that its "Starbucks everywhere" approach cut down on delivery and management costs, shortened customer lines at individual stores, and increased foot traffic for all the stores in an area.

Starbucks' store launches grew steadily more successful. In 2002, new stores generated an average of $1.2 million in first-year revenues, compared to $700,000 in 1995 and only $427,000 in 1990. The steady increases in new-store revenues were due partly to growing popularity of premium coffee drinks and partly to Starbucks' growing reputation. In more and more instances, Starbucks' reputation reached new markets even before stores opened. Moreover, existing stores continued to post sales gains in the range of 2–10 percent annually. In 2003, Starbucks posted same-store sales increases averaging 8 percent (Exhibit 3), the 12th consecutive year the company had achieved sales growth of 5 percent or greater at existing stores. Starbucks' revenues had climbed an average of 20 percent annually since 1992. In a representative week in 2003, about 20 million people bought a cup of coffee at Starbucks; a typical customer stopped at a Starbucks about 18 times a month—no U.S. retailer had a higher frequency of customer visits.[19]

One of Starbucks' core competencies was identifying good retailing sites for its new stores. The company was regarded as having the best real estate team in the coffee bar industry and a sophisticated system for identifying not only the most attractive individual city blocks but also the exact store location that was best; it also worked hard at building good relationships with local real estate representatives in areas where it was opening multiple store locations. The company's site location track record was so good that as of 1997 it had closed only 2 of the 1,500 sites it had opened; its track record in finding successful store locations was still intact as of 2003 (although specific figures were not available).

Exhibit 7 shows a timeline of Starbucks' entry into new market areas, along with other accomplishments, milestones, key events, and awards.

International Expansion

In markets outside the continental United States (including Hawaii), Starbucks had a two-pronged store expansion: either open company-owned and company-operated stores or else license a reputable and capable local company with retailing know-how in the target host country to develop and operate new Starbucks stores. In most countries, Starbucks used a local partner/licensee to help it recruit talented individuals, set up supplier relationships, locate suitable store sites, and cater to local market conditions. Starbucks looked for partners/licensees that had strong retail/restaurant experience, had values and a corporate culture compatible with Starbucks, were committed to good customer service, possessed talented management and strong financial resources, and had demonstrated brand-building skills.

Starbucks had created a new subsidiary, Starbucks Coffee International, to orchestrate overseas expansion and begin to build the Starbucks brand name globally via licensees. (See Exhibit 1 for the number of licensed international stores and Exhibit 7 for the years in which Starbucks entered most of these foreign markets.) Starbucks' management expected to have a total of 10,000 stores in 60 countries by the end of 2005. The company's first store in France opened in early 2004 in Paris. China was expected to be Starbucks' biggest market outside the United States in the years to come. Thus far, Starbucks products were proving to be a much bigger hit with consumers in Asia than in Europe. Even so, Starbucks was said to be losing money in both Japan and Britain; moreover, the Starbucks Coffee International division was only marginally

[18]Daniels, "Mr. Coffee," p. 140.
[19]Ibid.

profitable, with 2003 pretax earnings of only $5.5 million on sales of $603 million.

Going into 2004, Schultz believed the company's long-range goal of 25,000 store locations by 2013 was achievable. He noted that Starbucks had only a 7 percent share of the coffee-drinking market in the United States and a 1 percent share internationally. According to Schultz, "That still leaves lots of room for growth. Internationally, we are still in our infancy."[20] Although coffee consumption worldwide was stagnant, coffee was still the second most consumed beverage in the world, trailing only water.[21] Starbucks maintained that it would not franchise, although its foreign stores were frequently opened in partnership with local companies.

Employee Training

To accommodate its strategy of rapid store expansion, Starbucks put in systems to recruit, hire, and train baristas and store managers. Starbucks' vice president for human resources used some simple guidelines in screening candidates for new positions: "We want passionate people who love coffee . . . We're looking for a diverse workforce, which reflects our community. We want people who enjoy what they're doing and for whom work is an extension of themselves."[22]

All partners/baristas hired for a retail job in a Starbucks store received at least 24 hours training in their first two to four weeks. The training topics included coffee history, drink preparation, coffee knowledge (four hours), customer service (four hours), and retail skills; there was also a four-hour workshop titled "Brewing the Perfect Cup." Baristas spent considerable time learning about beverage preparation—grinding the beans, steaming milk, learning to pull perfect (18- to 23-second) shots of espresso, memorizing the recipes of all the different drinks, practicing making the different drinks, and learning how to customize drinks to customer specifications. There were sessions on cash register operations, how to clean the milk wand on the espresso machine, explaining the Italian drink names to customers, selling home espresso machines, making eye contact with customers, and taking personal responsibility for the cleanliness of the store. Everyone was drilled in the Star Skills, three guidelines for on-the-job interpersonal relations: (1) maintain and enhance self-esteem, (2) listen and acknowledge, and (3) ask for help. And there were rules to be memorized: milk must be steamed to at least 150 degrees Fahrenheit but never more than 170 degrees; every espresso shot not pulled within 23 seconds must be tossed; never let coffee sit in the pot more than 20 minutes; always compensate dissatisfied customers with a Starbucks coupon for a free drink.

Management trainees attended classes for 8 to 12 weeks. Their training went much deeper, covering not only coffee knowledge and information imparted to baristas but also the details of store operations, practices and procedures as set forth in the company's operating manual, information systems, and the basics of managing people. Starbucks' trainers were all store managers and district managers with on-site experience. One of their major objectives was to ingrain the company's values, principles, and culture and to pass on their knowledge about coffee and their passion about Starbucks.

When Starbucks opened stores in a new market, it launched a major recruiting effort. Eight to 10 weeks before opening, the company placed ads to hire baristas and begin their training. It sent a Star team of experienced managers and baristas from existing stores to the area to lead the store opening effort and to conduct one-on-one training following the company's formal classes and basic orientation sessions at the Starbucks Coffee School in San Francisco.

Real Estate, Store Design, Store Planning, and Construction

Starting in 1991, Starbucks created its own in-house team of architects and designers to ensure that each store would convey the right image and character. Stores had to be custom-designed because, unlike McDonald's or Wal-Mart, the company bought no real estate and built no freestanding structures; rather, each space was leased in an existing structure, meaning that each store differed in size and shape. Most stores ranged in size from 1,000 to 1,500 square feet and were located in office buildings, downtown and suburban retail centers, airport terminals, university campus areas, and busy neighborhood shopping areas convenient for

[20]Starbucks annual report, 2002, Letter to Shareholders.

[21]Ibid.

[22]Kate Rounds, "Starbucks Coffee," *Incentive* 167, no. 7, p. 22.

exhibit 7 Timeline of Starbucks' Accomplishments, Milestones, Key Events, and Selected Awards, 1987–2003

Year	Accomplishments/Milestones/Key Events/Awards
1987	• Il Giornale acquires the assets of Starbucks Coffee, Tea, and Spices and changes the company's name to Starbucks Corporation.
	• First stores outside of Seattle are opened in Chicago and Vancouver, British Columbia.
1988	• Starbucks introduces a mail order catalog, with service to all 50 states.
1990	• Starbucks expands Seattle headquarters and builds a new coffee bean roasting plant in Seattle.
1990	• Starbucks' first licensed airport location is opened at Sea-Tac International Airport in partnership with HMS Host.
	• Horizon Air begins serving Starbucks coffee on its flights.
1991	• Starbucks becomes first privately owned U.S. company to offer a stock option program that includes part-time employees.
1992	• Starbucks completes an IPO and becomes a public company trading on the Nasdaq National Market under the symbol SBUX.
1993	• Starbucks enters into an alliance with Barnes & Noble to have Starbucks coffee stores inside B&N's bookstores.
	• Starbucks opens a second roasting plant in Kent, Washington.
1994	• Starbucks wins contract for its coffees to be served at all Sheraton Hotels.
	• Starbucks expands to Minneapolis, Boston, New York, Atlanta, and Dallas.
1995	• Starbucks begins selling compact discs of music played in Starbucks stores.
	• United Airlines begins serving Starbucks on its flights.
	• A new $11 million state-of-the-art roasting facility is opened in York, Pennsylvania.
	• A joint venture is formed to open Starbucks stores in Japan.
	• Starbucks expands to Philadelphia, Pittsburgh, Las Vegas, Cincinnati, Baltimore, San Antonio, and Austin.
1996	• First Starbucks locations are opened in Japan, Hawaii, and Singapore.
	• Starbucks wins an account for Westin Hotels.
	• Starbucks' coffee-flavored ice creams are introduced in partnership with Dreyer's Grand Ice Cream.
	• Starbucks-PepsiCo venture begins selling a bottled version of Starbucks Frappuccino.
	• First Starbucks locations are opened in Rhode Island; Idaho; North Carolina; Arizona; Utah; and Ontario, Canada.
	• Starbucks receives 1996 Corporate Conscience Award for International Human Rights from Council on Economic Priorities.
1997	• First Starbucks locations are opened in Florida, Michigan, Wisconsin, and the Philippines.
	• Canadian Airlines begins serving Starbucks coffee on its flights.
	• Starbucks Foundation is established to help support local literacy programs in communities where Starbucks has coffeehouses.
	• Starbucks named one of the "Best Companies to Work for in America for People with Disabilities" by *We* magazine.
1998	• Starbucks enters into an alliance with Kraft Foods to handle the distribution of packaged Starbucks coffee in supermarkets.
	• First Starbucks locations are opened in New Orleans, St. Louis, Kansas City, Portland (Maine), Taiwan, Thailand, New Zealand, and Malaysia.
	• Starbucks enters Great Britain by acquiring 60 Seattle Coffee locations.
	• Starbucks acquires Pasqua, a San Francisco–based coffee retailer.
	• Company Web site, www.starbucks.com, is launched.

exhibit 7 (concluded)

Year	Accomplishments/Milestones/Key Events/Awards
1999	• First Starbucks locations are opened in Memphis, Nashville, Saskatchewan, China, Kuwait, South Korea, and Lebanon. • Tazo, a Portland, Oregon, tea company is acquired, and sales of Tazo teas at Starbucks locations begins. • Starbucks forms an agreement with Albertson's to open more than 100 Starbucks locations in Albertson's supermarkets beginning in 2000.
2000	• Howard Schultz transitions from chairman and CEO to chairman and chief global strategist; Orin Smith is promoted to president and CEO. • Starbucks enters into agreement with Host Marriott International to open locations in select properties. • First Starbucks locations are opened in Dubai, Hong Kong, Shanghai, Qatar, Bahrain, Saudi Arabia, and Australia. • Starbucks begins marketing Fair Trade Certified coffees. • Starbucks acquires Hear Music, a San Francisco music company. • *Interbrand Magazine* names Starbucks as one of the "75 Great Global Brands of the 21st Century."
2001	• Starbucks adopts coffee sourcing guidelines developed in partnership with Conservation International and commits to purchase at least 1 million pounds of Fair Trade Certified coffee. • Starbucks offers $1 million in support to coffee farmers. • Starbucks begins to offer high-speed wireless Internet access in stores. • Starbucks begins offering a reloadable Starbucks Card for customers to use in making purchases at Starbucks stores. • Starbucks opens 300th location in Japan and first stores in Switzerland, Austria, and Israel. • Howard Schultz is named one of the "Top 25 Best Managers" by *Business Week.*
2002	• Starbucks begins selling Fair Trade Certified coffees in select foreign locations. • Starbucks opens first stores in Oman, Indonesia, Germany, Spain, Puerto Rico, Mexico, Greece, and southern China. • *Fortune* magazine names Starbucks as one of the "100 Best Companies to Work For" (as it also did in 1998, 1999, and 2000). • *Business Ethics Magazine* names Starbucks as one of "100 Best Corporate Citizens" (as it also did in 2000 and 2001).
2003	• The company introduces the Starbucks Duetto Visa card, which combines Visa card functionality with the reloadable Starbucks Card functionality. • Starbucks acquires Seattle Coffee Company, consisting of 129 company-operated and franchised Seattle's Best Coffee locations, 21 company-operated Torrefazione Italia locations in the United States and Canada, and distribution of Seattle Coffee in some 12,000 supermarket and retail food locations. • Starbucks opens its 1,000th store in the Asia Pacific region and its first stores in Turkey, Chile, and Peru; it also announces plans to open stores in France in 2004. • Starbucks decides to end venture in Israel (a total of six stores) due to challenging operating conditions. • *Brandweek* ranks Starbucks eighth on its "Super Brand List." • Starbucks named as one of the "Ten Most Admired Companies in America" in *Fortune* survey.

Source: www.starbucks.com, accessed November 4, 2003.

pedestrian foot traffic and/or drivers. Only a select few were in suburban malls.

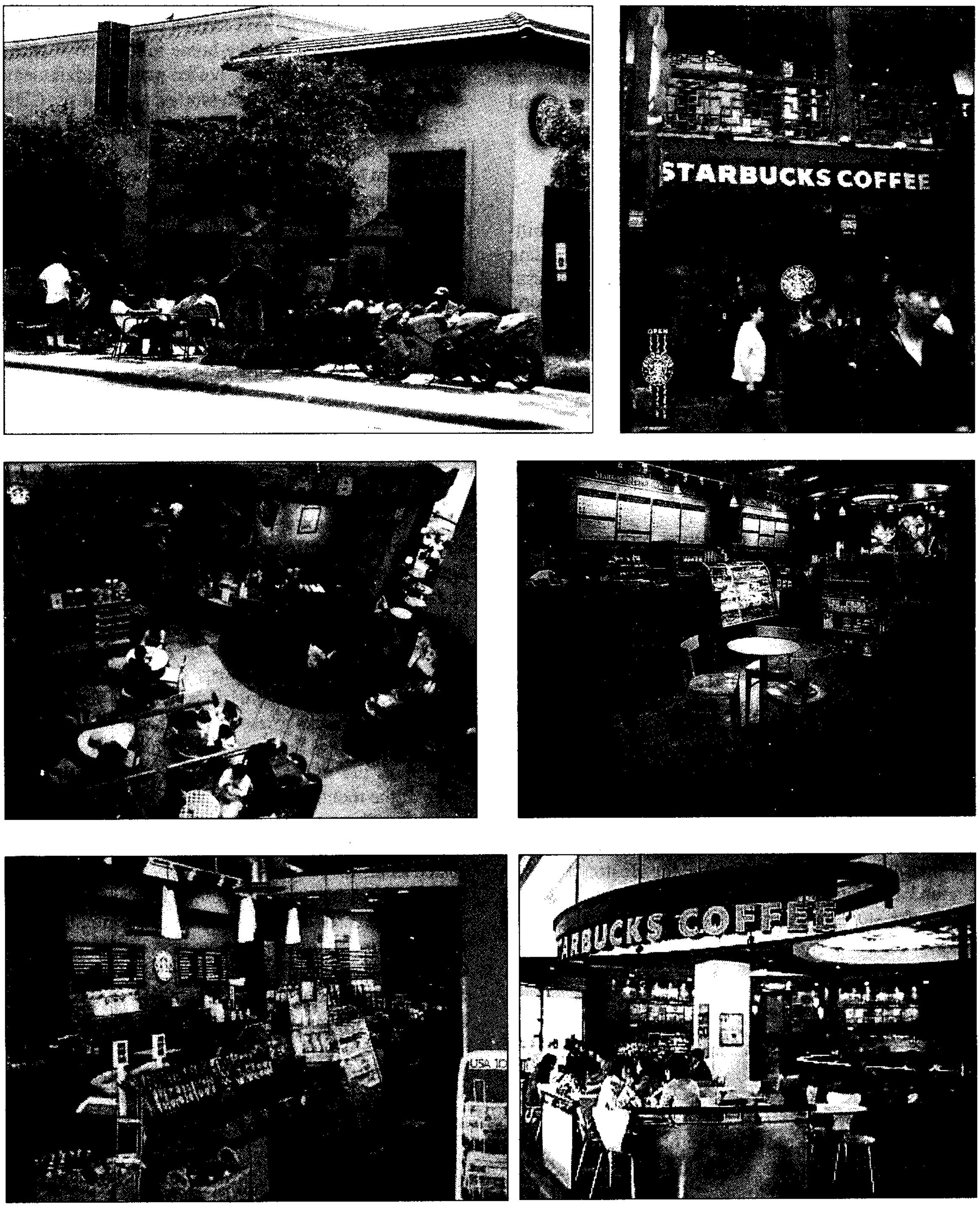
Over the years, Starbucks had experimented with a broad range of store formats. Special seating areas were added to help make Starbucks a desirable gathering place where customers could meet and chat or simply enjoy a peaceful interlude in their day. Flagship stores in high-traffic, high-visibility locations had fireplaces, leather chairs, newspapers, couches, and lots of ambience. The company also experimented with drive-through windows in locations where speed and convenience were important to customers and with kiosks in supermarkets, building lobbies, and other public places.

A "stores of the future" project team was formed in 1995 to raise Starbucks' store design to a still higher level and come up with the next generation of Starbucks stores. The vision of what a Starbucks store should be like included such concepts as an authentic coffee experience that conveyed the artistry of espresso making, a place to think and imagine, a spot where people could gather and talk over a great cup of coffee, a comforting refuge that provided a sense of community, a third place for people to congregate beyond work or the home, a place that welcomes people and rewards them for coming, and a layout that could accommodate both fast service and quiet moments. The team researched the art and literature of coffee throughout the ages, studied coffee-growing and coffee-making techniques, and looked at how Starbucks' stores had already evolved in terms of design, logos, colors, and mood. The team came up with four store designs—one for each of the four stages of coffee making: growing, roasting, brewing, and aroma—each with its own color combinations, lighting scheme, and component materials. Within each of the four basic store templates, Starbucks could vary the materials and details to adapt to different store sizes and settings (downtown buildings, college campuses, neighborhood shopping areas). In late 1996, Starbucks began opening new stores based on one of the four formats and color schemes. But as the number of stores increased rapidly between 2000 and 2003, greater store diversity and layout quickly became necessary. Exhibit 8 shows the diverse nature of Starbucks stores in 2003.

To better control average store opening costs, the company centralized buying, developed standard contracts and fixed fees for certain items, and consolidated work under those contractors who displayed good cost-control practices. The retail operations group outlined exactly the minimum amount of equipment each core store needed so that standard items could be ordered in volume from vendors at 20 to 30 percent discounts, then delivered just in time to the store site either from company warehouses or the vendor. Modular designs for display cases were developed. And the whole store layout was developed on a computer, with software that allowed the costs to be estimated as the design evolved. All this cut store opening costs significantly and reduced store development time from 24 to 18 weeks.

In August 2002, Starbucks teamed up with T-Mobile USA, the largest U.S. carrier-owned Wi-Fi service, to experiment with providing Internet access and enhanced digital entertainment to patrons at over 1,200 Starbucks locations. Customers using a Wi-Fi notebook computer while at Starbucks locations equipped with wireless broadband Internet service could surf the Web or take advantage of special Starbucks-sponsored multimedia promotions (e.g., classic blues performances by Howlin' Wolf and Muddy Waters, an array of great blues tunes, and videos of noteworthy musicians sharing how blues music and artists influenced them). The objective was to heighten the "third place" Starbucks experience, entice customers into perhaps buying a second latte or espresso while catching up on e-mail, listening to digital music, putting the finishing touches on a presentation, or accessing their corporate intranet. Since the August 2002 introduction of Wi-Fi at Starbucks, wireless Internet service had been added at 1,200 more stores and the number of accesses was in the millions; internal research showed that the average connection lasted approximately 45 minutes and more than 90 percent of T-Mobile HotSpot accesses were during the off-peak store hours, after 9:00 AM. In October 2003, Starbucks announced that it was expanding Wi-Fi capability to additional locations and would have 2,700 stores equipped with wireless Internet access by year-end.

During the early start-up years, Starbucks avoided debt and financed new stores entirely with equity capital. But as the company's profitability improved and its balance sheet strengthened, Schultz's opposition to debt as a legitimate financing vehicle softened. In 1996 the company completed its second debt offering, netting $161 million from the sale of convertible debentures for use in its capital construction program. This debt was *exhibit 8* **Scenes from Starbucks Stores**



successfully converted into common stock in 1997. Over the next seven years, strong internal cash flows allowed Starbucks to finance virtually all of its store expansion with internal funds; the company had less than $6 million in long-term debt on its balance sheet despite having invested some $1.3 billion in facilities and equipment.

Store Ambience

Starbucks' management viewed each store as a billboard for the company and as a contributor to building the company's brand and image. Each detail was scrutinized to enhance the mood and ambience of the store, to make sure everything signaled "best of class" and reflected the personality of the community and the neighborhood. The thesis was "Everything matters." The company went to great lengths to make sure that the store fixtures, the merchandise displays, the colors, the artwork, the banners, the music, and the aromas all blended to create a consistent, inviting, stimulating environment that evoked the romance of coffee, that signaled the company's passion for coffee, and that rewarded customers with ceremony, stories, and surprise. Starbucks was recognized for its sensitivity to neighborhood conservation with Scenic America's award for excellent design and "sensitive reuse of spaces within cities."

To try to keep the coffee aromas in the stores pure, Starbucks banned smoking and asked employees to refrain from wearing perfumes or colognes. Prepared foods were kept covered so that customers would smell coffee only. Colorful banners and posters kept the look of Starbucks stores fresh and in season. Company designers came up with artwork for commuter mugs and T-shirts in different cities that were in keeping with each city's personality (peach-shaped coffee mugs for Atlanta, pictures of Paul Revere for Boston and the Statue of Liberty for New York). To make sure that Starbucks stores measured up to standards, the company used "mystery shoppers" who posed as customers and rated each location on a number of criteria.

THE PRODUCT LINE AT STARBUCKS

Starbucks stores offered a choice of regular or decaffeinated coffee beverages, a special "coffee of the day," an assortment of made-to-order Italian-style hot and cold espresso drinks, and hot and iced teas. In addition, customers could choose from a wide selection of fresh-roasted whole-bean coffees (which could be ground or not on the premises for take-home in distinctive packages), fresh pastries, juices, coffee-making equipment, coffee mugs and other accessories, and music CDs. From time to time, stores ran special promotions touting Starbucks' special Christmas Blend coffee, shade-grown coffee from Mexico, organically grown coffees, and various rare and exotic coffees from across the world. In 2003, Starbucks began offering customers a choice of using its exclusive Silk soymilk, specifically designed to accentuate its handcrafted beverages using espresso roast coffee and Tazo Chai teas; the organic, kosher soymilk appealed to some customers as a substitute for milk or skim milk in various coffee and tea beverages.

The company's retail sales mix in 2002 was 77 percent beverages, 13 percent food items, 6 percent whole-bean coffees, and 4 percent coffee-making equipment and accessories.[23] The product mix in each store varied according to the size and location of each outlet. Larger stores carried a greater variety of whole coffee beans, gourmet food items, teas, coffee mugs, coffee grinders, coffee-making equipment, filters, storage containers, and other accessories. Smaller stores and kiosks typically sold a full line of coffee beverages, a limited selection of whole-bean coffees, and a few hardware items.

The idea for selling music CDs (which, in some cases, were special compilations that had been put together for Starbucks to use as store background music) originated with a Starbucks store manager who had worked in the music industry and selected the new "tape of the month" Starbucks played as background in its stores. The manager had gotten compliments from customers wanting to buy the music they heard and suggested to senior executives that there was a market for the company's music tapes. Research through two years of comment cards turned up hundreds asking Starbucks to sell the music it played in its stores. The Starbucks CDs, initially created from the Capitol Records library, proved a significant seller and addition to the product line; some of the CDs were specific collections designed to tie in with new blends of coffee that the company was promoting. In 2000, Starbucks acquired Hear Music, a San Francisco–based company, to give it added capability in enhancing its music CD offerings.

[23]Starbucks fiscal 2002 annual report, p. 15.

In 2003, in an average week, about 22 million customers patronized Starbucks stores in North America, up from about 5 million in 1998. Stores did about half of their business by 11:00 AM. Loyal customers patronized a Starbucks store 15 to 20 times a month, spending perhaps \$50–\$75 monthly. Some Starbucks fanatics came in daily. Baristas became familiar with regular customers, learning their names and their favorite drinks. Christine Nagy, a field director for Oracle Corporation in Palo Alto, California, told a *Wall Street Journal* reporter, "For me, it's a daily necessity or I start getting withdrawals."[24] Her standard order was a custom drink: a decaf grande nonfat no-whip no-foam extra-cocoa mocha; when the barista saw her come through the door, Nagy told the reporter, "They just say 'We need a Christine here.'" Since its inception in 2001, 20 million Starbucks customers had purchased the reloadable Starbucks Card that allowed them to pay for their purchases with a quick swipe at the cash register and also to earn and redeem rewards.

In the fall of 2003 Starbucks, in partnership with Bank One, introduced the Duetto Visa card, which added Visa card functionality to the reloadable Starbucks Cards. By charging purchases to the Visa account of their Duetto card anywhere Visa credit cards were accepted, cardholders earned 1 percent back in Duetto Dollars, which were automatically loaded on their Starbucks Card account after each billing cycle. Duetto Dollars could be used to purchase beverages, food, and store merchandise at any Starbucks location. The Duetto card was the latest in an ongoing effort by Starbucks' management to introduce new products and experiences for customers that belonged exclusively to Starbucks; senior executives drummed the importance of always being open to reinventing the Starbucks experience.

So far, Starbucks had spent very little money on advertising, preferring instead to build the brand cup by cup with customers and depend on word of mouth and the appeal of its storefronts.

Joint Ventures

In 1994, after months of meetings and experimentation, PepsiCo and Starbucks entered into a joint venture to create new coffee-related products for mass distribution through Pepsi channels, including cold coffee drinks in a bottle or can. Howard Schultz saw this as a major paradigm shift with the potential to cause Starbucks' business to evolve in heretofore unimaginable directions; he thought it was time to look for ways to move Starbucks out into more mainstream markets. Cold coffee products had historically met with poor market reception, except in Japan, where there was an \$8 billion market for ready-to-drink coffee-based beverages. Nonetheless, Schultz was hoping the partners would hit on a new product to exploit a good-tasting coffee extract that had been developed by Starbucks' recently appointed director of research and development. The joint venture's first new product, Mazagran, a lightly flavored carbonated coffee drink, was a failure; a market test in southern California showed that some people liked it and some hated it. While people were willing to try it the first time, partly because the Starbucks name was on the label, repeat sales proved disappointing.

Despite the clash of cultures and the different motivations of PepsiCo and Starbucks, the partnership held together because of the good working relationship that evolved between Howard Schultz and Pepsi's senior executives. Then Schultz, at a meeting to discuss the future of Mazagran, suggested, "Why not develop a bottled version of Frappuccino?"[25] Starbucks had come up with the new cold coffee drink in the summer of 1995, and it had proved to be a big hot-weather seller; Pepsi executives were enthusiastic. After months of experimentation, the joint venture product research team came up with a shelf-stable version of Frappuccino that tasted quite good. It was tested in West Coast supermarkets in the summer of 1996; sales ran 10 times over projections, with 70 percent being repeat sales. Sales of Frappuccino reached \$125 million in 1997 and achieved national supermarket penetration of 80 percent. Starbucks' management believed that the market for Frappuccino would ultimately exceed \$1 billion.

In October 1995 Starbucks partnered with Dreyer's Grand Ice Cream to supply coffee extract for a new line of coffee ice cream made and distributed by Dreyer's under the Starbucks brand. The new line, featuring such flavors as Dark Roast Expresso Swirl, JavaChip, Vanilla MochaChip, Biscotti Bliss, and Caffe Almond Fudge, hit supermarket shelves in April 1996, and by July 1996 Starbucks coffee-flavored ice cream was the best-selling superpremium brand in the coffee segment. In 1997, two new low-fat flavors were added to

[24]David Bank, "Starbucks Faces Growing Competition: Its Own Stores," *The Wall Street Journal,* January 21, 1997, p. B1.

[25]As related in Schultz and Yang, *Pour Your Heart Into It,* p. 224.

complement the original six flavors, along with two flavors of ice cream bars; all were well received in the marketplace.

In 2003, Starbucks' partnerships with PepsiCo and Dreyer's generated revenues of about $6 million.

Licensed Stores and Specialty Sales

Starbucks had a licensing agreement with Kraft Foods to market and distribute Starbucks' whole-bean and ground coffees in grocery and mass-merchandise channels across the United States. Kraft managed all distribution, marketing, advertising, and promotions and paid a royalty to Starbucks based on a percentage of net sales. Two-thirds of all coffee was sold in supermarkets. Starbucks coffee sold in supermarkets featured distinctive, elegant packaging; prominent positions in grocery aisles; and the same premium quality as that of coffee sold in its stores. Product freshness was guaranteed by Starbucks' FlavorLock packaging, and the price per pound paralleled the prices in Starbucks' retail stores. Flavor selections in supermarkets, however, were more limited than those at Starbucks stores. Starbucks executives recognized that supermarket distribution entailed several risks, especially in exposing Starbucks to first-time customers. Starbucks had built its reputation around the unique retail experience in its stores, where all beverages were properly prepared—it had no control over how customers would perceive Starbucks when they encountered it in grocery aisles. A second risk concerned coffee preparation at home. Rigorous quality control and skilled baristas ensured that store-purchased beverages would measure up, but consumers using poor equipment or inappropriate brewing methods could easily conclude that Starbucks packaged coffees did not live up to their reputation.

Going into 2004, Starbucks coffees were available in some 19,500 supermarkets and warehouse clubs (such as Sam's and Costco) and generated 2003 revenues close to $160 million.

Starbucks had also entered into a limited number of licensing agreements for store locations in areas where it did not have ability to locate its own outlets. The company had an agreement with Marriott Host International that allowed Host to operate Starbucks retail stores in airport locations, and it had an agreement with Aramark Food and Services to put Starbucks stores on university campuses and other locations operated by Aramark. Starbucks received a license fee and a royalty on sales at these locations and supplied the coffee for resale in the licensed locations. All licensed stores had to follow Starbucks' detailed operating procedures and all managers and employees who worked in these stores received the same training given to Starbucks managers and store employees. As of 2003, there were 1,422 licensed or franchised stores in the United States and 1,257 licensed stores internationally. Royalty and license fee revenues from domestic stores generated close to $150 million in revenues in fiscal 2003, with international licensed retail stores accounting for about $250 million in revenues.

Starbucks had a specialty sales group that provided its coffee products to restaurants, airlines, hotels, universities, hospitals, business offices, country clubs, and select retailers. One of the early users of Starbucks coffee was Horizon Airlines, a regional carrier based in Seattle. In 1995, Starbucks entered into negotiations with United Airlines to serve Starbucks coffee on all United flights. There was much internal debate at Starbucks about whether such a move made sense for Starbucks and the possible damage to the integrity of the Starbucks brand if the quality of the coffee served did not measure up. After seven months of negotiation and discussion over coffee-making procedures, United Airlines and Starbucks came up with a mutually agreeable way to handle quality control on 500-plus planes having varying equipment, and Starbucks became the coffee supplier to the 20 million passengers flying United each year. Since then, Starbucks had entered into an agreement to have Starbucks coffee served on Canadian Air flights.

In recent years, the specialty sales group had won the coffee accounts at Sheraton and Westin hotels, resulting in packets of Starbucks coffee being in each room with coffee-making equipment. Starbucks had entered into an agreement with Wells Fargo to provide coffee service at some of the bank's locations in California. A 1997 agreement with U.S. Office Products gave Starbucks an entrée to provide its coffee to workers in 1.5 million business offices. In addition, Starbucks supplied an exclusive coffee blend to Nordstrom's for sale only in Nordstrom stores, operated coffee bars in Barnes & Noble bookstores, and, most recently, had begun coffee bar operations for

Chapters, a Toronto book retailer that had sites throughout Canada. In fiscal 2003, Starbucks had approximately 12,800 food-service accounts that generated revenues of about $175 million. Starbucks was in the process of partnering with SYSCO to service the majority of its food-service accounts.

Mail Order Sales

The original Starbucks had begun a small mail order operation in the 1970s to serve travelers who had visited a Seattle store or former store customers who had moved away from Seattle. Sales were solicited by mailing out a simple brochure. In 1988, Starbucks developed its first catalog and began expanding its mail order base to targeted demographic groups. In 1990 a toll-free number was set up. Sales grew steadily as the company's name and reputation began to build. The company's market research indicated that its average mail order customer was a connoisseur, well educated, relatively affluent, well traveled, interested in the arts and cultural events, and usually a loyal buyer of the company's products. As time went on, the cities and neighborhoods where the company's mail order customers were located became beacons the company used to decide where to open new stores.

Starbucks published a mail order catalog that was distributed six times a year and that offered coffee, a selection of candies and pastries, and select coffee-making equipment and accessories. A special gift-giving catalog was mailed to business accounts during the 1997 Christmas holiday season; this practice carried over into 2002. The company also had an electronic store on America Online. In 1997, sales of this division were about $21.2 million, roughly 2 percent of total revenues; almost 50,000 mail order customers were signed up to receive monthly deliveries of Starbucks coffee as of late 1997. The number of mail order consumers steadily increased thereafter, as did sales revenues from online marketing. Starbucks' management believed that its direct response marketing effort helped pave the way for retail expansion into new markets and reinforced brand recognition in existing markets.

However, in 2001–2002 catalog sales fell off as the number of retail stores expanded and as Starbucks coffee began to be sold in supermarkets. The company discontinued its catalog operations in early 2003, along with sales via the company's Web site (online customers could buy selected Starbucks coffees at Amazon.com and several other Web sites).

COFFEE PURCHASING STRATEGY

Starbucks personnel traveled regularly to coffee-producing countries—Colombia, Sumatra, Yemen, Antigua, Indonesia, Guatemala, New Guinea, Costa Rica, Sulawesi, Papua, Kenya, Ethiopia, Java, Mexico—building relationships with growers and exporters, checking on agricultural conditions and crop yields, and searching out varieties and sources that would meet Starbucks' exacting standards of quality and flavor. The coffee-purchasing group, working with personnel in roasting operations, tested new varieties and blends of beans from different sources.

Coffee was grown in 70 tropical countries and was the second most traded commodity in the world after petroleum. The global value of the 2000–2001 coffee bean crop was about $5.6 billion. By World Bank estimates, some 25 million small farmers made their living growing coffee. Commodity-grade coffee, which consisted of robusta and commercial-quality arabica beans, was traded in a highly competitive market as an undifferentiated product. Coffee prices were subject to considerable volatility due to weather, economic and political conditions in the growing countries, new agreements establishing export quotas, and periodic efforts to bolster prices by restricting coffee supplies. Starbucks used fixed-price purchase commitments to limit its exposure to fluctuating coffee prices in upcoming periods and, on occasion, purchased coffee futures contracts to provide price protection. In years past, there had been times when unexpected jumps in coffee prices had put a squeeze on Starbucks' margins, forcing an increase in the prices of the beverages and beans sold at retail.

Starbucks sourced approximately 50 percent of its beans from Latin America, 35 percent from the Pacific Rim, and 15 percent from East Africa. Sourcing from multiple geographic areas not only allowed Starbucks to offer a greater range of coffee varieties to customers but also spread the company's risks regarding weather, price volatility, and changing economic and political conditions in coffee-growing countries.

During 2002, a global oversupply of more than 2 billion pounds drove the prices of commodity coffees to historic lows of $0.40–$0.50 per pound. The specialty coffee market, which represented about 10 percent of worldwide production, consisted primarily of high-quality arabica beans. Prices for specialty coffees were determined by the quality and flavor of the beans and were almost always higher than prevailing prices for commodity-grade coffee beans. Starbucks purchased only high-quality arabica coffee beans, paying an average of $1.20 per pound in 2002. Its purchases represented about 1 percent of the world's coffee-bean crop.

Believing that the continued growth and success of its business depended on gaining access to adequate supplies of high-quality coffees on a year-in, year-out basis, Starbucks had been a leader in promoting environmental and social stewardship in coffee-origin countries. Starbucks' coffee-sourcing strategy was to contribute to the sustainability of coffee growers and help conserve the environment. In sourcing green coffee beans, Starbucks was increasingly dealing directly with farmers and cooperatives, and its policy was to pay prices high enough to ensure that small coffee growers, most of whom lived on the edge of poverty, were able to cover their production costs and provide for their families. About 40 percent of Starbucks' purchases were made under three- to five-year contracts, which management believed enabled the company to purchase its future coffee-bean requirements at predictable prices over multiple crop years. Coffee purchases negotiated through long-term contracts increased from 3 percent in 2001 to 36 percent in 2002. Farmers who met important quality, environmental, social, and economic criteria—which Starbucks had developed with the support of Conservation International's Center for Environmental Leadership in Business—were rewarded with financial incentives and preferred supplier status.

Fair Trade Certified Coffee

A growing number of small coffee growers were members of democratically run cooperatives that were registered with Fairtrade Labelling Organizations International; these growers could sell their beans directly to importers, roasters, and retailers at favorable guaranteed "fair-trade" prices. Buyers of Fair Trade Certified coffee beans had to pay a minimum of $1.26 per pound for nonorganic green arabica coffee and $1.41 for organic green arabica coffee. According to TransFair USA, an independent nonprofit organization that licensed Starbucks to sell Fair Trade coffee imported into the United States, the guaranteed prices for Fair Trade coffees boosted earnings for small coffee growers enough to allow them to afford basic health care, education, and home improvements. In 2003, Starbucks marketed Fair Trade Certified coffee at most of its retail stores and through some 350 university and hotel locations that were licensed to sell Starbucks coffees.

Environmental Best Practices

Since 1998, Starbucks had partnered with Conservation International to promote coffee cultivation methods that protected biodiversity and maintained a healthy environment. A growing percentage of the coffees that Starbucks purchased were grown without the use of pesticides, herbicides, or chemical fertilizers; organic cultivation methods resulted in clean ground water and helped protect against degrading of local ecosystems, many of which were fragile or in areas where biodiversity was under severe threat. Another environmental conservation practice involved growing organic coffee under a natural canopy of shade trees interspersed with fruit trees and other crops; this not only allowed farmers to get higher crop yields from small acreages but also helped protect against soil erosion on mountainsides.

COFFEE-ROASTING OPERATIONS

Starbucks considered the roasting of its coffee beans to be something of an art form, entailing trial-and-error testing of different combinations of time and temperature to get the most out of each type of bean and blend. Recipes were put together by the coffee department once all the components had been tested. Computerized roasters guaranteed consistency. Each batch was roasted in a powerful gas oven for 12 to 15 minutes. Highly trained and experienced roasting personnel monitored the process, using both smell and hearing to help check when the beans were perfectly done—coffee beans make a popping sound when ready. Starbucks' standards were so exacting that roasters tested the color of the beans in a blood-cell analyzer and discarded the entire batch if the reading wasn't on target. After roasting and cooling, the coffee was immediately vacuum-sealed in one-way valve bags that let out gases naturally produced by fresh-roasted beans without letting oxygen in—one-way valve technology extended the shelf life of packaged Starbucks coffee to 26 weeks. As a matter of policy, however, Starbucks removed coffees on its shelves after three months and, in the case of coffee used to prepare beverages in stores, the shelf life was limited to seven days after the bag was opened.

In 2003, Starbucks had roasting plants in Seattle and Kent, Washington; York, Pennsylvania; Minden, Nevada; and the Netherlands. In addition to roasting capability, the Kent, Minden, York, and Netherlands plants also had additional space for warehousing and shipping coffees. The roasting plants and distribution facilities in Kent and Seattle supplied stores west of the Mississippi and in the Asia Pacific region. The newly constructed Minden plant/distribution center was used to supply stores in the Mountain West and Midwest. The roasting and distribution facility in York, which could be expanded to 1 million square feet, supplied stores mainly east of the Mississippi. The 70,000-square-foot facility in the Netherlands supplied stores in Europe and the Middle East.

STARBUCKS' CORPORATE SOCIAL RESPONSIBILITY STRATEGY

Howard Schultz's effort to "build a company with soul" included broad-based initiatives to contribute positively to the communities in which Starbucks had stores and to the environment. The guiding theme of Starbucks' social responsibility strategy was "Giving back to our communities is the way we do business." The Starbucks Foundation was set up in 1997 to orchestrate the company's philanthropic activities. Since 1991 Starbucks had been a major contributor to CARE, a worldwide relief and development organization that sponsored health, education, and humanitarian aid programs in almost all of the third world countries where Starbucks purchased its coffee supplies. Stores featured CARE in promotions and had organized concerts to benefit CARE. A second major philanthropic effort involved providing financial support to community literacy organizations. In 1995 Starbucks began a program to improve the conditions of workers in coffee-growing countries, establishing a code of conduct for its growers and providing financial assistance for agricultural improvement projects. In 1997, Starbucks formed an alliance with Appropriate Technology International to help poor, small-scale coffee growers in Guatemala increase their income by improving the quality of their crops and their market access; the company's first-year grant of $75,000 went to fund a new processing facility and set up a loan program for a producer cooperative.

Starbucks had an Environmental Committee that looked for ways not only to reduce, reuse, and recycle waste but also to contribute to local community environmental efforts. A Green Store Task Force looked at how Starbucks stores could conserve on water and energy usage and generate less solid waste. Customers who brought their own mugs to stores were given a 10-cent discount on beverage purchases (in 2002, customers used commuter mugs in making purchases about 12.7 million times). Coffee grounds, which made up a big portion of the waste stream in stores, were packaged and given to customers, parks, schools, and plant nurseries as a soil amendment. Company personnel purchased paper products with high levels of recycled content and unbleached fiber to help Starbucks minimize its environmental footprint. Stores participated in Earth Day activities each year with in-store promotions and volunteer efforts to educate employees and customers about the impacts their actions had on the environment. Suppliers were encouraged to provide the most energy-efficient products within their category and eliminate excessive packaging; Starbucks had recently instituted a Code of Conduct for suppliers of noncoffee products that addressed standards for social responsibility, including labor and human rights. No genetically modified ingredients were used in any food or beverage products that Starbucks served, with the exception of milk (U.S. labeling requirements do not require milk producers to disclose the use of hormones aimed at increasing the milk production of dairy herds).

Starbucks stores participated regularly in local charitable projects of one kind or another, donating drinks, books, and proceeds from store-opening benefits. Employees were encouraged to recommend and apply for grants from the Starbucks Foundation to benefit local community literacy organizations.

exhibit 9 Starbucks' Environmental Mission Statement

Starbucks is committed to a role of environmental leadership in all facets of our business.

We fulfill this mission by a commitment to:

- Understanding of environmental issues and sharing information with our partners.
- Developing innovative and flexible solutions to bring about change.
- Striving to buy, sell, and use environmentally friendly products.
- Recognizing that fiscal responsibility is essential to our environmental future.
- Instilling environmental responsibility as a corporate value.
- Measuring and monitoring our progress for each project.

On the Fourth of July weekend in 1997, three Starbucks employees were murdered in the company's store in the Georgetown area of Washington, D.C.; Starbucks offered a $100,000 reward for information leading to the arrest of the murderer(s). The company announced that it would reopen the store in early 1998 and donate all future net proceeds of the store to a Starbucks Memorial Fund that would make annual grants to local groups working to reduce violence and aid the victims of violent crimes.

Starbucks felt so deeply about its responsibilities that it even developed an environmental mission statement to expand on its corporate mission statement (see Exhibit 9). In 2002 Starbucks also began issuing an annual "Corporate Social Responsibility Report" (the reports for recent years can be viewed in the Investors section at www.starbucks.com). Going into 2004, Starbucks had received 20 awards from a diverse group of organizations for its philanthropic, community service, and environmental activities.

STARBUCKS' EXCURSION INTO DOT-COM BUSINESSES

In the late 1990s, Howard Schultz became enamored with the potential of the Internet and pushed Starbucks into a series of dot-com investments:

- Cooking.com—a Santa Monica–based e-tailer of kitchenwares, which was still operating in late 2003, although it had not yet earned a profit.
- Living.com, Inc.—an online retailer of furniture and home products in which Starbucks invested $20.3 million. Living.com filed for bankruptcy in mid-2000, even though it had recently been rated as the best online retailer of furniture by e-commerce analyst Gomez.com. Living.com had allied with Amazon.com (which was also an investor) to market its products under the "Home" tab on Amazon's Web site.
- Kozmo.com, Inc.—an Internet start-up that offered fast and free delivery of products such as video games, movies, snacks, and magazines. Starbucks and Kozmo entered into a joint marketing pact in early 2000 that called for Kozmo.com to pay Starbucks $150 million over the next five years for prominent placement in Starbucks shops. Under the terms of the deal, Kozmo would locate "drop boxes" for the return of videos and other items in Starbucks stores throughout the cities where Kozmo operated. Kozmo also agreed to deliver packaged Starbucks coffees, teas, and other products, and look into opportunities to deliver hot beverages. The agreement was a crucial part of Kozmo's planned expansion to 21 U.S. cities by the end of 2000; Kozmo currently offered one-hour delivery of videos, books, magazines, meals, snacks and beverages in the New York, San Francisco, Boston, Seattle, and Washington, D.C., markets. Kozmo, which began operations in March 1998 to deliver videos in the Greenwich Village section of Manhattan, had secured $28 million in venture capital funding in 1999 and reportedly received $60 million from Amazon.com and an additional $30 million from Japanese Internet investor Softbank in January 2000. After burning through some $280 million in capital and getting little interest from consumers, Kozmo closed down operations in April 2001.
- Talk City, Inc.—a 1996 start-up founded by former Apple employees to create chat rooms and online communities on its own Web site as well as for other sites. Starbucks had invested in a $20 million pre-IPO offering of Talk City stock in 1999. Talk City generated most of its revenue from advertising and sponsorships on its sites. Howard Schultz planned to promote Talk City's Web chats at

Starbucks stores offering Internet access to patrons. Talk City shut down its Web site and filed for Chapter 7 bankruptcy in August 2002, after changing its name to LiveWorld in 2001 and then selling its assets to MyESP.com in late 2001. LiveWorld's customers included the Internal Revenue Service, Cisco Systems, Eastman Kodak, Coca-Cola, and Costco; its revenues reached a peak of about $14.8 million, but the company was never profitable, with annual losses running as high as $42 million.

In the fourth quarter of 2000, Starbucks wrote off the full amount of its equity investment in Living.com and the majority of its equity investments in Cooking.com, Kozmo.com, and Talk City—a total of $58.8 million.

THE SPECIALTY COFFEE INDUSTRY

While the market for traditional commercial-grade coffees had stagnated since the 1970s, the specialty coffee segment had expanded as interested, educated, upscale consumers became increasingly inclined to upgrade to premium coffees with more robust flavors. Whereas retail sales of specialty coffees amounted to only $45 million in 1969, by 1994 retail sales of specialty coffees had increased to $2 billion, much of which stemmed from sales in coffee bars or the shops of coffee-bean retailers (like Peet's). The increase was attributed to wider consumer awareness of and appreciation for fine coffee, the emergence of coffee bars featuring a blossoming number of premium coffee beverages, and the adoption of a healthier lifestyle that prompted some consumers to replace alcohol with coffee. Coffee's image changed from one of just a breakfast or after-dinner beverage to a drink that could be enjoyed anytime in the company of others. Many coffee drinkers took to the idea of coffee bars where they could enjoy a high-caliber coffee beverage and sit back and relax with friends or business associates.

Some industry experts expected the gourmet coffee market in the United States to be saturated by 2005. But the international market was much more wide open as of early 2004. The United States, Germany, and Japan were the three biggest coffee-consuming countries.

Competitors

In 2003, there were an estimated 14,000 specialty coffee outlets in the United States, with some observers predicting there would as many as 18,000 locations selling specialty coffee drinks by 2015. Starbucks' success was prompting a number of ambitious rivals to scale up their expansion plans. No other specialty coffee rival had even as many as 250 stores, but there were at least 20 small local and regional chains that aspired to compete against Starbucks in their local market arenas, most notably Tully's Coffee (98 stores in 4 states), Gloria Jean's (280 mall locations in 35 states and several foreign countries), New World Coffee (30 locations), Brew HaHa (15 locations in Delaware and Pennsylvania), Bad Ass Coffee (about 30 locations in 10 states and Canada), Caribou Coffee (241 locations in 9 states), Second Cup Coffee (the largest chain based in Canada), and Qwiky's (India). While it had been anticipated in the late 1990s that local and regional chains would merge to better position themselves as an alternative to Starbucks, such consolidation had not occurred as of 2003. But numerous retail entrepreneurs had picked up on the growing popularity of specialty coffees and opened coffee bars in high-pedestrian-traffic locations to serve espresso, cappuccino, lattes, and other coffee drinks.

In late 2003, McDonald's announced it would begin opening a new type of store called McCafe featuring premium coffee and made-to-order specialty drinks in a café-style setting, with Internet access also available. Krispy Kreme Doughnuts had recently upgraded the number and quality of the coffee drinks it offered at its locations.

Starbucks also faced competition from nationwide coffee manufacturers such as Kraft General Foods (the parent of Maxwell House), Procter & Gamble (the marketer of Folger's and Millstone brands), and Nestlé, all of which distributed their coffees through supermarkets. There were also dozens of specialty coffee companies that sold whole-bean coffees in supermarkets—brands like Green Mountain, Allegro, Peaberry, Brothers, and Millstone. Because many consumers were accustomed to purchasing their coffee supplies at supermarkets, it was easy for them to substitute whatever specialty coffee brand or brands were featured in their local supermarkets for Starbucks. But despite the upsurge of interest in specialty coffees, the National Coffee Association reported that regular coffee still accounted for 87 percent of all coffee consumed in the United States in 2002; some industry experts believed that this statistic signaled that the gourmet coffee segment was still emerging.

Growing numbers of restaurants were upgrading the quality of the coffee they served. And both General Foods and Procter & Gamble had introduced premium blends of their Maxwell House and Folger's coffees on supermarket shelves, pricing them several dollars below Starbucks' offerings.

Future Challenges

In fiscal 2004, Starbucks planned to open approximately 1,300 new stores worldwide and to have comparable store sales growth of 3 to 7 percent. Top management believed that it could grow revenues by about 20 percent annually and net earnings by 20–25 percent annually for the next three to five years. To sustain the company's growth and make Starbucks one of the world's preeminent global brands, Howard Schultz believed that the company had to challenge the status quo, be innovative, take risks, and adapt its vision of who it was, what it did, and where it was headed. He was pushing Starbucks executives to consider a number of fundamental strategic questions. What could Starbucks do to make its stores an even more elegant "third place" that welcomed, rewarded, and surprised customers? What new products and new experiences could Starbucks provide that would uniquely belong to or be associated with Starbucks? How could Starbucks reach people who were not coffee drinkers? What new or different strategic paths should Starbucks pursue to achieve its objective of becoming the most recognized and respected brand in the world?

case 2

Dell Computer in 2003: Driving for Industry Leadership

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In 1984, at the age of 19, Michael Dell founded Dell Computer with a simple vision and business concept—that personal computers (PCs) could be built to order and sold directly to customers. Michael Dell believed his approach to the PC business had two advantages: (1) Bypassing distributors and retail dealers eliminated the markups of resellers, and (2) building to order greatly reduced the costs and risks associated with carrying large stocks of parts, components, and finished goods. While at times between 1986 and 1993 the company struggled to refine its strategy, build an adequate infrastructure, and establish market credibility against better-known rivals, Dell Computer's strategy started to click into full gear in the late 1990s. Going into 2003, Dell's sell-direct and build-to-order business model and strategy had provided the company with the most efficient procurement, manufacturing, and distribution capabilities in the global PC industry and given Dell a substantial cost and profit margin advantage over rival PC vendors. Dell's operating costs ran about 10 percent of revenues in 2002, compared to 21 percent of revenues at Hewlett-Packard (HP), 25 percent at Gateway, and 46 percent at Cisco Systems (considered the world's most efficient producer of networking equipment). Dell's low-cost provider status was powering its drive for market leadership in a growing number of product categories.

Dell Computer was solidly entrenched as the market leader in PC sales in the United States, with nearly a 28 percent market share in 2002, comfortably ahead of Hewlett-Packard (16.8 percent) and Gateway (5.7 percent). Dell had moved ahead of IBM into second place during 1998 and then overtaken Compaq Computer as the U.S. sales leader in the third quarter of 1999. Its market share leadership in the United States had widened every year since 2000. Worldwide, Dell Computer was in a neck-and-neck race for global market leadership with HP, which acquired Compaq Computer in May 2002. Dell was the world leader in unit sales in the first and third quarters of 2002, and HP was the sales leader in the second and fourth quarters. Dell had overtaken Compaq as the global market leader in 2001. But when HP, the third-ranking PC seller in the world, acquired Compaq, the second-ranking PC vendor, Dell found itself in a tight battle with HP for the top spot globally. Exhibit 1 shows the shifting domestic and global sales and market share rankings in PCs during the 1996–2002 period.

Since the late 1990s, Dell had also been driving for industry leadership in servers. In 2002 Dell was the number one domestic seller of entry-level servers and high-performance workstations (used for applications with demanding graphics). It was number two in the world in server shipments and within striking distance of global market leadership. In the mid-to-late 1990s, a big fraction of the servers sold were proprietary machines running on customized Unix operating systems

exhibit 1 Leading PC Vendors Worldwide and in the United States, Based on Factory Shipments, 1996–2002

A. U.S. Market Shares of the Leading PC Vendors, 1998–2002

		2002		2001		2000	
2002 Rank	Vendor	Shipments (in 000s)	Market Share	Shipments (in 000s)	Market Share	Shipments (in 000s)	Market Share
1	Dell	13,324	27.9%	10,817	23.5%	[illegible]	[illegible]
	Compaq*	—	—	5,341	11.6	[illegible]	[illegible]
2	Hewlett-Packard*	8,052	16.8	4,374	9.5	[illegible]	[illegible]
3	Gateway	2,725	5.7	3,219	7.0	[illegible]	[illegible]
4	IBM	2,531	5.3	2,461	5.3	[illegible]	[illegible]
5	Apple	1,693	3.5	1,665	3.6	n.a.	[illegible]
	Others	19,514	40.8	23,509	51.0	18,959	[illegible]
	All vendors	47,839	100.0%	46,051	100.0%	48,900	[illegible]

B. Worldwide Market Shares of the Leading PC Vendors, 1996–2002†

		2002		2001		2000	
2002 Rank	Vendor	Shipments (in 000s)	Market Share	Shipments (in 000s)	Market Share	Shipments (in 000s)	Market Share
1	Dell	20,672	15.2%	17,231	12.9%	[illegible]	[illegible]
	Compaq*	—	—	14,673	11.0	[illegible]	[illegible]
2	Hewlett-Packard*	18,432	13.6	9,309	7.0	10,327	[illegible]
3	IBM	7,996	5.9	8,292	6.2	[illegible]	[illegible]
4	Fujitsu Siemens	5,822	4.3	6,022	4.5	6,582	[illegible]
5	NEC	4,533	3.3	4,702	3.5	n.a.	[illegible]
	Others	78,567	57.8	73,297	54.9	80,840	[illegible]
	All vendors	136,022	100.0%	133,466	100.0%	139,057	[illegible]

*Compaq was acquired by Hewlett-Packard in May 2002. The 2002 data for Hewlett-Packard include both Compaq-branded and Hewlett-Packard-branded PCs for the last three quarters of 2002, plus only Hewlett-Packard-branded PCs for Q1 2002. Compaq's worldwide PC shipments during Q1 2002 were 3,367,000; its U.S. PC shipments during Q1 2002 were 1,280,000 units.

†Includes branded shipments only and excludes original equipment manufacturer (OEM) sales for all manufacturers; shipments of Compaq PCs for last three quarters of 2002 are included in 2002 figures for Hewlett-Packard.

Source: International Data Corporation.

and carrying price tags ranging from $30,000 to $1 million or more. But a seismic shift in server technology, coupled with growing cost-consciousness on the part of server users, produced a radically new server market during 1999–2002. In 2003 about 8 out of 10 servers sold were expected to carry price tags below $10,000 and to run on either Windows or the free Linux operating system rather than more costly Unix systems. The overall share of Unix-based servers shipped in 2003 was expected to be about 10 percent, down from about 18 percent in 1997. Dell's domestic and global market share in low-priced and midrange servers was climbing rapidly. Dell had over a 30 percent share of the 2002 world market for servers, up from 2 percent in 1995.

In addition, Dell was making market inroads in other product categories. Its sales of data storage devices were growing rapidly, aided by a strategic alliance with EMC, a leader in the data storage. In 2001–2002, Dell began selling low-cost, data-routing switches—a product category where Cisco Systems was the

1999		1998	
Shipments (in 000s)	Market Share	Shipments (in 000s)	Market Share
7,492	16.6%	4,799	13.2%
7,222	16.0	6,052	16.7
3,955	8.8	2,832	7.8
4,001	8.9	3,039	8.4
3,274	7.2	2,983	8.2
n.a.	n.a.	n.a.	n.a.
19,248	42.6	16,549	45.6
45,192	100.0%	36,254	100.0%

1999		1998		1997		1996	
Shipments (in 000s)	Market Share	Shipments (in 000s)	Market Share	Shipments (in 000s)	Market Share	Shipments (in 000s)	Market Share
11,883	10.5%	7,770	8.5%	4,684	5.8%	2,996	4.3%
15,796	14.0	13,266	14.5	10,064	12.6	7,211	10.4
7,577	6.7	5,743	6.3	4,468	5.6	2,984	4.3
9,287	8.2	7,946	8.7	7,239	9.1	6,176	8.9
n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
5,980	5.3	5,976	6.5	4,150	5.2	4,230	6.1
62,254	55.2	50,741	55.5	49,333	61.7	45,727	66.0
112,725	100.0%	91,442	100.0%	79,938	100.0%	69,324	100.0%

dominant global leader. In late 2002 Dell introduced a new line of handheld PCs—the Axim X5—to compete against the higher-priced products of Palm, HP, and others; the Axim offered a solid but not trendsetting design, was packed with features, and was priced roughly 50 percent below the best-selling models of rivals. Starting in 2003, Dell planned to begin marketing Dell-branded printers and printer cartridges, product categories that provided global leader HP with the lion's share of its profits. In January 2003, Dell announced that it would begin selling retail-store systems, including electronic cash registers, specialized software, services, and peripherals required to link retail-store checkout lanes to corporate information systems. Since the late 1990s, Dell had been marketing CD and DVD drives, printers, scanners, modems, monitors, digital cameras, memory cards, Zip drives, and speakers made by a variety of manufacturers.

So far, Dell's foray into new products had proved to be profitable; according to Michael Dell, "We believe that all our businesses should make money. If a business doesn't make money, if you can't figure out how to make money in that business, you shouldn't be in that business."[1] In 2002, more than half of Dell's profits came from products other than desktop computers, and the percentage from nondesktop computing was growing.

Moreover, Dell was the world's leading Internet retailer. Dell began Internet sales at its Web site (www.dell.com) in 1995, almost overnight achieving sales of $1 million a day. By early 2003, over 50 percent of Dell's sales were Web-enabled—and the percentage was increasing. Dell's Web site sales exceeded $50 million a day in 2002, up from $35 million daily in early 2000 and $5 million daily in early 1998. The company averaged over 3 million visits weekly at its 80 country-specific sites in 2002. Dell products were sold in more than 170 countries, but sales in 60 countries accounted for 97 percent of total revenues.

In its fiscal year ending January 31, 2003, Dell Computer posted revenues of $35.4 billion, up from $3.4 billion in the year ending January 29, 1995—an eight-year compound average growth rate of 34.0 percent. Over the same period, profits were up from $140 million to $2.1 billion—a 40.5 percent compound average growth rate. A $100 investment in Dell's stock at its initial public offering in June 1988 would have been worth about $28,500 in February 2003. Dell Computer was one of the top 10 best-performing stocks on the New York Stock Exchange and the Nasdaq during the 1990s. Based on 2001 data, Dell ranked number 53 on the Fortune 500, number 131 on the Fortune Global 500, and number 23 on the Fortune Global "most admired" list.

COMPANY BACKGROUND

At age 12, Michael Dell was running a mail order stamp-trading business, complete with a national catalog, and grossing $2,000 a month. At 16 he was selling subscriptions to the *Houston Post,* and at 17 he bought his first BMW with money he had earned. He enrolled at the University of Texas in 1983 as a premed student (his parents wanted him to become a doctor), but he soon became immersed in computers and started selling PC components out of his college dormitory room. He bought random-access memory (RAM) chips and disk drives for IBM PCs at cost from IBM dealers, who at the time often had excess supplies on hand because they were required to order large monthly quotas from IBM. Dell resold the components through newspaper ads (and later through ads in national computer magazines) at 10–15 percent below the regular retail price.

By April 1984 sales were running about $80,000 per month. Michael decided to drop out of college and form a company, PCs Ltd., to sell both PC components and PCs under the brand name PCs Limited. He obtained his PCs by buying retailers' surplus stocks at cost, then powering them up with graphics cards, hard disks, and memory before reselling them. His strategy was to sell directly to end users; by eliminating the retail markup, Dell's new company was able to sell IBM clones (machines that copied the functioning of IBM PCs using the same or similar components) about 40 percent below the price of IBM's best-selling PCs. The discounting strategy was successful, attracting price-conscious buyers and generating rapid revenue growth. By 1985, the company was assembling its own PC designs with a few people working on six-foot tables. The company had 40 employees, and Michael Dell worked 18-hour days, often sleeping on a cot in his office. By the end of fiscal 1986, sales had reached $33 million.

During the next several years, however, PCs Limited was hampered by growing pains—specifically, a lack of money, people, and resources. Michael Dell sought to refine the company's business model; add needed production capacity; and build a bigger, deeper management staff and corporate infrastructure while at the same time keeping costs low. The company was renamed Dell Computer in 1987, and the first international offices were opened that same year. In 1988 Dell added a sales force to serve large customers, began selling to government agencies, and became a public company—raising $34.2 million in its first offering of common stock. Sales to large customers quickly became the dominant part of Dell's business. By 1990 Dell Computer had sales of $388 million, a market share of 2–3 percent, and an R&D staff of over 150 people. Michael Dell's vision was for Dell Computer to become one of the top three PC companies.

Thinking its direct sales business would not grow fast enough, in 1990–93, the company began distributing its computer products through Soft Warehouse

[1]Quoted in "Dell Puts Happy Customers First," *Nikkei Weekly,* December 16, 2002.

Superstores (now CompUSA), Staples (a leading office products chain), Wal-Mart, Sam's Club, and Price Club (now Price/Costco). Dell also sold PCs through Best Buy stores in 16 states and through Xerox in 19 Latin American countries. But when the company learned how thin its margins were in selling through such distribution channels, it realized it had made a mistake and withdrew from selling to retailers and other intermediaries in 1994 to refocus on direct sales. At the time, sales through retailers accounted for only about 2 percent of Dell's revenues.

Further problems emerged in 1993. In that year Dell reportedly had $38 million in second-quarter losses from engaging in a risky foreign-currency hedging strategy, quality difficulties arose with certain PC lines made by the company's contract manufacturers, profit margins declined, and buyers were turned off by the company's laptop PC models. To get laptop sales back on track, the company took a charge of $40 million to write off its laptop line and suspended sales of laptops until it could get redesigned models into the marketplace. The problems resulted in losses of $36 million for the company's fiscal year ending January 30, 1994.

Because of higher costs and unacceptably low profit margins in selling to individuals and households, Dell Computer did not pursue the consumer market aggressively until sales to individuals at the company's Internet site took off in 1996 and 1997. It became clear that PC-savvy individuals, who were buying their second and third computers, wanted powerful computers with multiple features; did not need much technical support; and liked the convenience of buying direct from Dell, ordering exactly what they wanted, and having it delivered to their door within a matter of days. In early 1997, Dell created an internal sales and marketing group dedicated to serving the individual consumer segment and introduced a product line designed especially for individual users.

By late 1997, Dell had become a low-cost leader among PC vendors by wringing greater and greater efficiency out of its direct sales and build-to-order business model. The company was a pioneer and an acknowledged world leader in incorporating e-commerce technology and use of the Internet into its everyday business practices. The goal was to achieve what Michael Dell called "virtual integration"—a stitching together of Dell's business with its supply partners and customers in real time such that all three appeared to be part of the same organizational team.[2] The company's mission was "to be the most successful computer company in the world at delivering the best customer experience in the markets we serve."[3]

In early 2002, Dell Computer had 34,600 employees in 34 countries, up from 16,000 at year-end 1997; approximately 42 percent of Dell's employees were located in countries outside the United States, and this percentage was growing. During fiscal years 2001 and 2002, Dell had eliminated some 5,700 employee positions worldwide to better align its cost structure with slowdowns in industrywide PC sales, business cutbacks on information technology (IT) expenditures, and stiffer competitive pressures. The company's headquarters and main office complex was in Round Rock, Texas (an Austin suburb).

Exhibits 2 through 4 provide Dell Computer's recent financial statements and geographic operating performance.

Michael Dell

Michael Dell was widely considered one of the mythic heroes within the PC industry, having been labeled "the quintessential American entrepreneur" and "the most innovative guy for marketing computers in this decade." In 1992, at the age of 27, Michael Dell became the youngest CEO ever to head a Fortune 500 company; he was a billionaire at the age of 31. Once pudgy and bespectacled, in 2003, 38-year-old Michael Dell was physically fit, considered good-looking, wore contact lenses, ate only health foods, and lived in a three-story 33,000-square-foot home on a 60-acre estate in Austin, Texas, with his wife and four children. In early 2003 Michael Dell owned about 11.8 percent of Dell Computer's common stock, worth about $8.5 billion.

In the company's early days Michael Dell hung around mostly with the company's engineers. He was so shy that some employees thought he was stuck up because he never talked to them. But people who worked with him closely described him as a likable young man

[2]This was the term Michael Dell used in an interview published in the *Harvard Business Review*. See Joan Magretta, "The Power of Virtual Integration: An Interview with Dell Computer's Michael Dell," *Harvard Business Review*, March–April 1998, p. 75.

[3]Information posted on www.dell.com, February 1, 2000.

exhibit 2 **Dell Computer's Consolidated Statements of Income, Fiscal Years 1997–2003 (in millions, except per share data)**

	Fiscal Year Ended	
	January 31, 2003	February 1, 2002
Net revenue	$35,404	$31,168
Cost of revenue	29,055	25,661
Gross margin	6,349	5,507
Operating expenses:		
Selling, general and administrative	3,050	2,784
Research, development and engineering	455	452
Special charges	—	482
Total operating expenses	3,505	3,718
Operating income	2,844	1,789
Investment and other income (loss), net	183	(58)
Income before income taxes, extraordinary loss, and cumulative effect of change in accounting principle	3,027	1,731
Provision for income taxes	905	485
Income before extraordinary loss and cumulative effect of change in accounting principle	2,122	1,246
Extraordinary loss, net of taxes	—	—
Income before cumulative effect of change in accounting principle	2,122	1,246
Cumulative effect of change in accounting principle, net	—	—
Net income	$ 2,122	$ 1,246
Basic earnings per common share (in whole dollars):		
Income before extraordinary loss and cumulative effect of change in accounting principle	$0.82	$0.48
Extraordinary loss, net of taxes		
Income before cumulative effect of change in accounting principle	$0.82	$0.48
Cumulative effect of change in accounting principle, net		—
Earnings per common share	$0.82	$0.48
Diluted earnings per common share (in whole dollars)	$0.80	$0.46
Weighted average shares outstanding:		
Basic	2,584	2,602
Diluted	2,644	2,726

Source: Dell Computer Corporation annual reports and press release on February 13, 2003.

who was slow to warm up to strangers.[4] He was a terrible public speaker and wasn't good at running meetings. But Lee Walker, a 51-year-old venture capitalist brought in by Michael Dell to provide much-needed managerial and financial experience during the company's organization-building years, became Michael Dell's mentor, built up his confidence, and was instrumental in turning him into a polished executive.[5] Walker served as the company's president and chief operating officer during the 1986–1990 period; he had a fatherly image, knew everyone by name, and played a key role in implementing Michael Dell's marketing ideas. Under Walker's tutelage, Michael Dell became intimately familiar with all parts of the business, overcame his

[4]"Michael Dell: On Managing Growth," *MIS Week*, September 5, 1988, p. 1.

[5]"The Education of Michael Dell," *Business Week*, March 22, 1993, p. 86.

Fiscal Year Ended				
February 2, 2001	January 28, 2000	January 29, 1999	February 1, 1998	February 2, 1997
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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shyness, learned to control his ego, and turned into a charismatic leader with an instinct for motivating people and winning their loyalty and respect. When Walker had to leave the company in 1990 because of health reasons, Dell turned to Morton Meyerson, former CEO and president of Electronic Data Systems, for advice and guidance on how to transform Dell Computer from a fast-growing medium-sized company into a billion-dollar enterprise.

Though sometimes given to displays of impatience, Michael Dell usually spoke in a quiet, reflective manner and came across as a person with maturity and seasoned judgment far beyond his age. His prowess was based more on an astute combination of technical knowledge and marketing know-how than on being a technological wizard. By the late 1990s, he was a much-sought-after speaker at industry and company conferences—he received 100 requests to speak in 1997; 800 in 1998; and

exhibit 3 Dell Computer's Consolidated Statements of Financial Position, Fiscal Years 1999–2003 (in millions of dollars)

	February 1, 2003	February 1, 2002	February 2, 2001	January 28, 2000	January 29, 1999
Assets					
Current assets:					
Cash and cash equivalents	$ 4,232	$ 3,641	$ 4,910	$ 3,809	$1,726
Short-term investments	406	273	525	323	923
Accounts receivable, net	2,586	2,269	2,424	2,608	2,094
Inventories	306	278	400	391	273
Other	1,394	1,416	1,467	550	791
Total current assets	8,924	7,877	9,726	7,681	5,807
Property, plant and equipment, net	913	826	996	765	523
Other investments and noncurrent assets	5,633	4,832	2,948	3,025	547
Total assets	$15,470	$13,535	$13,670	$11,471	$6,877
Liabilities and stockholders' equity					
Current liabilities:					
Accounts payable	$ 5,989	$ 5,075	$ 4,286	$ 3,538	$2,397
Accrued and other	2,944	2,444	2,492	1,654	1,298
Total current liabilities	8,933	7,519	6,778	5,192	3,695
Long-term debt	506	520	509	508	512
Other	1,158	802	761	463	349
Total liabilities	10,597	8,841	8,048	6,163	4,556
Stockholders' equity:					
Preferred stock and capital in excess of $.01 par value; shares issued and outstanding: none	—	—	—	—	—
Common stock and capital in excess of $.01 par value; shares authorized: 7,000; shares issued and outstanding: 2,654, 2,601, 2,543 and 2,575, respectively		5,605	4,795	3,583	1,781
Treasury stock, at cost, 52 shares and no shares, respectively		(2,249)	—	—	—
Retained earnings		1,364	839	1,260	606
Other		(26)	(12)	465	(66)
Total stockholders' equity	4,873	4,694	5,622	5,308	2,321
Total liabilities and stockholders' equity	$15,470	$13,535	$13,670	$11,471	$6,877

Source: Dell Computer Corporation annual reports and press release, February 13, 2003.

exhibit 4 **Geographic Area Information, Dell Computer, Fiscal 2000–2003 (in millions of dollars)**

	Fiscal Year Ended			
	January 31, 2003	February 1, 2002	February 2, 2001	January 28, 2000
Net revenues				
Americas				
Business	$19,394	$17,275	$18,969	$15,160
U.S. consumer	5,653	4,485	3,902	2,719
Total Americas	25,047	21,760	22,871	17,879
Europe	6,912	6,429	6,399	5,590
Asia-Pacific-Japan	3,445	2,979	2,618	1,796
Total net revenues	$35,404	$31,168	$31,888	$25,265
Operating income				
Americas				
Business	$ 1,945	$ 1,482	$ 1,999	$ 1,800
U.S. consumer	308	260	253	204
Total Americas	2,253	1,742	2,252	2,004
Europe	388	377	347	359
Asia-Pacific-Japan	203	152	169	94
Special charges	—	(482)	(105)	(194)
Total operating income	$ 2,844	$ 1,789	$ 2,663	$ 2,263

Source: Dell Computer Corporation annual reports.

over 1,200 in 1999. His views and opinions about the future of PCs, the Internet, and e-commerce practices carried considerable weight both in the PC industry and among executives worldwide. His speeches were usually full of usable information about the nuts and bolts of Dell Computer's business model, the compelling advantages of incorporating e-commerce technology and practices into a company's operations, and developments in the IT industry.

Michael Dell was considered a very accessible CEO and a role model for young executives because he had done what many of them were trying to do. He delegated authority to subordinates, believing that the best results came from turning "loose talented people who can be relied upon to do what they're supposed to do." Business associates viewed Michael Dell as an aggressive personality, an extremely competitive risk taker who had always played close to the edge. He spent about 30 percent of his time traveling to company operations and meeting with customers. In a typical year, he would make two or three trips to Europe and two trips to Asia.

DELL COMPUTER'S STRATEGY

The core of Dell Computer's strategy in 2002–2003 was to use its strong capabilities in supply chain management, low-cost manufacturing, and direct sales capabilities to expand into product categories where it could provide added value to its customers in the form of lower prices. Its standard pattern of attack was to identify an IT product with good margins; figure out how to build it (or else have it built by others) cheaply enough to be able to significantly underprice competitive products; market the new product to Dell's steadily growing customer base; and then watch the market share points, incremental revenues, and incremental profits pile up.

Dell management believed it had the industry's most efficient business model. The company's strategy was built around a number of core elements: a cost-efficient approach to build-to-order manufacturing, partnerships with suppliers aimed at squeezing cost savings out of the supply chain, direct sales to customers, award-winning customer service and technical support, pioneering use of the Internet and e-commerce technology, and product-line expansion aimed at capturing a bigger share of the dollars its customers spent for IT products and services.

Cost-Efficient Build-to-Order Manufacturing

Dell built its computers, workstations, and servers to order; none were produced for inventory. Dell customers could order custom-equipped servers and workstations based on the needs of their applications. Desktop and laptop customers ordered whatever configuration of microprocessor speed, random-access memory, hard disk capacity, CD or DVD drives, fax/modem/wireless capabilities, graphics cards, monitor size, speakers, and other accessories they preferred. The orders were directed to the nearest factory. In 2003 Dell had assembly plants in Austin, Texas; Nashville, Tennessee; Limerick, Ireland; Xiamen, China; Penang, Malaysia; and El Dorado do Sul, Brazil. At all locations, the company had the capability to assemble PCs, workstations, and servers; Dell assembled its data storage products at its Austin, Limerick, and Penang plants. In 2002, typical orders were built and delivered in three to five days.

Until 1997, Dell operated its assembly lines in traditional fashion with workers performing a single operation. An order form accompanied each metal chassis across the production floor; drives, chips, and ancillary items were installed to match customer specifications. As a partly assembled PC arrived at a new workstation, the operator, standing beside a tall steel rack with drawers full of components, was instructed what to do by little red and green lights flashing beside the drawers. When the operator was finished, the drawers containing the used components were automatically replenished from the other side, and the PC chassis glided down the line to the next workstation. However, Dell had reorganized its plants in 1997, shifting to "cell manufacturing" techniques whereby a team of workers operating at a group workstation (or cell) assembled an entire PC according to customer specifications. The shift to cell manufacturing reduced Dell's assembly times by 75 percent and doubled productivity per square foot of assembly space. Assembled computers were first tested and then loaded with the desired software, shipped, and typically delivered five to six business days after the order was placed.

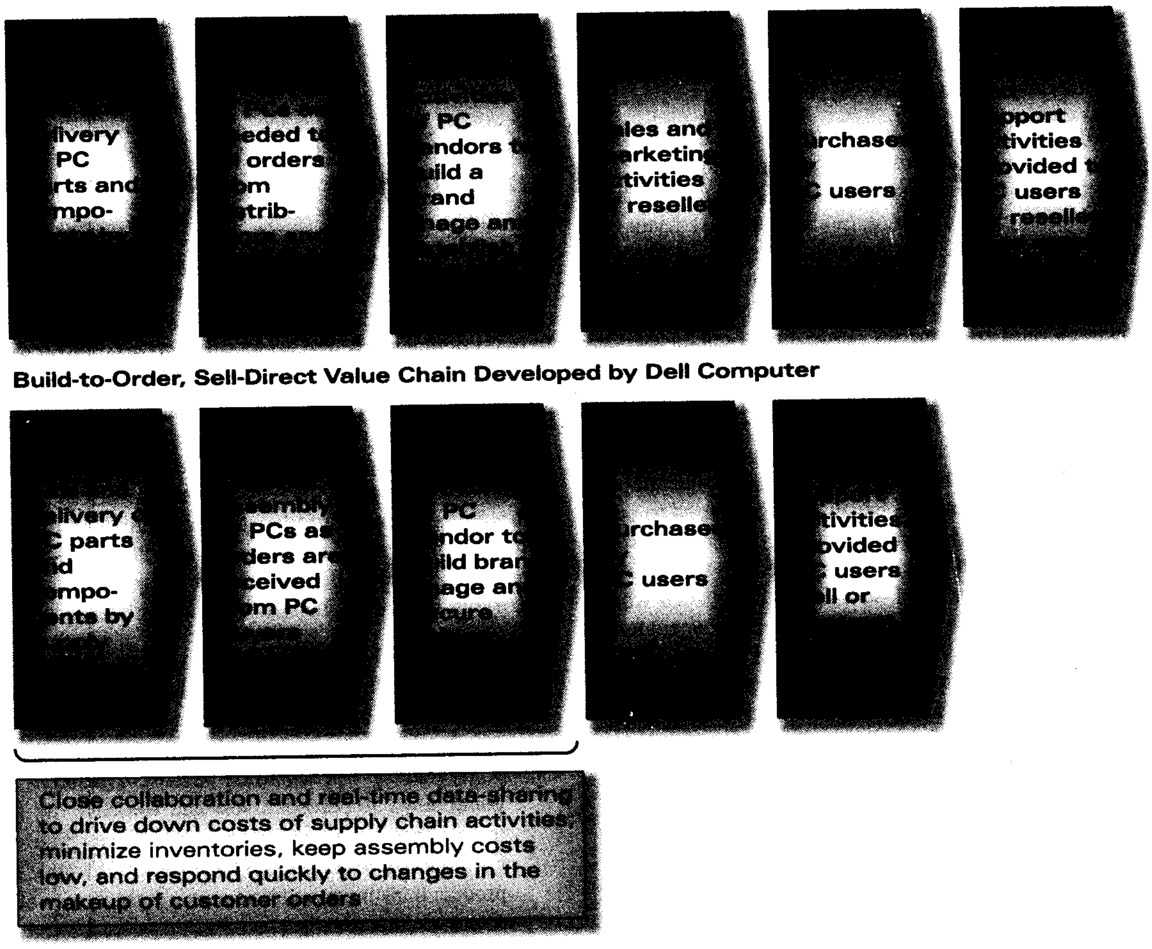
At Dell's newest plant in Austin, the cell manufacturing approach had been abandoned in favor of an even more efficient assembly-line approach. Workers at the new plant in 2002 could turn out about 700 desktop PCs per hour on three assembly lines that took half the floor space of the now-closed cell manufacturing plant in Austin, where production had run about 120 units per hour. Although the new Austin plant was designed for production of 400 units per hour, management believed that it would be able to improve operations enough to boost hourly production from the current 700 units to 1,000 units per hour. The gains in productivity had been achieved partly by redesigning the PCs to permit easier and faster assembly, partly by innovations in the assembly process, and partly by reducing the number of times a computer was touched by workers during assembly and shipping by 50 percent. At both Dell's Austin plant and its plant in Ireland, workers could assemble a PC in two to three minutes. Moreover, just-in-time inventory practices that left pallets of parts sitting around everywhere had been tweaked to just-in-the-nick-of-time delivery by suppliers of the exact parts needed every couple of hours; double-decker conveyor belts moved parts and components to designated assembly points. Newly assembled PCs were routed on conveyors to shipping, where they were boxed and shipped to customers the same day.

Dell was regarded as a world-class manufacturing innovator and a pioneer in how to mass-produce a customized product—its methods were routinely studied in business schools worldwide. Most of Dell's PC rivals—notably, IBM and HP/Compaq—had given up on trying to produce their own PCs as cheaply as Dell and shifted to outsourcing their PCs from contract manufacturers. Dell management believed that its in-house manufacturing delivered about a 6 percent cost advantage versus outsourcing.

Dell's build-to-order strategy meant that the company had no in-house stock of finished goods inventories and that, unlike competitors using the traditional value chain model, it did not have to wait for resellers to clear out their own inventories before it could push new models into the marketplace—resellers typically operated with 30 to 60 days inventory of prebuilt models (see Exhibit 5). Equally important was the fact that

exhibit 5 Comparative Value Chain Models of PC Vendors

Traditional Build-to-Stock Value Chain Used by Hewlett-Packard, IBM, Sony, and Most Others



customers who bought from Dell got the satisfaction of having their computers customized to their particular liking and pocketbook.

Quality Control

All assembly plants had the capability to run testing and quality control processes on components, parts, and subassemblies obtained from suppliers, as well as on the finished products Dell assembled. Suppliers were urged to participate in a quality certification program that committed them to achieving defined quality specifications. Quality control activities were undertaken at various stages in the assembly process. In addition, Dell's quality control program included testing of completed units after assembly, ongoing production reliability audits, failure tracking for early identification of problems associated with new models shipped to customers, and information obtained from customers through its service and technical support programs. All of the company's plants had been certified as meeting ISO 9002 quality standards.

Partnerships with Suppliers

Michael Dell believed that it made much better sense for Dell Computer to partner with reputable suppliers of PC parts and components than to integrate backward and get into parts and components manufacturing on its own. He explained why:

> If you've got a race with 20 players all vying to make the fastest graphics chip in the world, do you want to be the twenty-first horse, or do you want to evaluate the field of 20 and pick the best one?[6]

Dell evaluated the various makers of each component; picked the best one or two as suppliers; and then stuck with them as long as they maintained their leadership in technology, performance, quality, and cost. Management believed that long-term partnerships with reputable suppliers had at least five advantages. First, using name-brand processors, disk drives, modems, speakers, and multimedia components enhanced the quality and performance of Dell's PCs. Because of varying performance among different brands of components, the brand of the components was quite important to customers concerned about performance and reliability. Second, because Dell partnered with suppliers for the long term and because it committed to purchase a specified percentage of its requirements from each supplier, Dell was assured of getting the volume of components it needed on a timely basis even when overall market demand for a particular component temporarily exceeded the overall market supply. Third, Dell's long-run commitment to its suppliers made it feasible for suppliers to locate their plants or distribution centers within a few miles of Dell assembly plants, putting them in position to make deliveries daily or every few hours, as needed. Dell supplied data on inventories and replenishment needs to its suppliers at least once a day—hourly in the case of components being delivered several times daily from nearby sources.

Fourth, long-term supply partnerships facilitated having some of the supplier's engineers assigned to Dell's product design teams and being treated as part of Dell. When new products were launched, suppliers' engineers were stationed in Dell's plants; if early buyers called with a problem related to design, further assembly and shipments were halted while the supplier's engineers and Dell personnel corrected the flaw on the spot.[7] Fifth, long-term partnerships enlisted greater cooperation on the part of suppliers to seek new ways to drive costs out of the supply chain. Dell openly shared its daily production schedules, sales forecasts, and new model introduction plans with vendors. Dell also did a three-year plan with each of its key suppliers and worked with suppliers to minimize the number of different stock-keeping units of parts and components in its products and to identify ways to drive costs down.

Commitment to Just-in-Time Inventory Practices

Dell's just-in-time inventory emphasis yielded major cost advantages and shortened the time it took for Dell to get new generations of its computer models into the marketplace. New advances were coming so fast in certain computer parts and components (particularly microprocessors, disk drives, and wireless devices) that any given item in inventory was obsolete in a matter of months, sometimes quicker. Moreover, rapid-fire reductions in the prices of components were not unusual—for example, Intel regularly cut the prices on its older chips when it introduced newer chips, and it introduced new chip generations about every three months. Michael Dell explained the dramatic economics of minimal component inventories as follows:

> If I've got 11 days of inventory and my competitor has 80 and Intel comes out with a new chip, that means I'm going to get to market 69 days sooner.
>
> In the computer industry, inventory can be a pretty massive risk because if the cost of materials is going down 50 percent a year and you have two or three months of inventory versus eleven days, you've got a big cost disadvantage. And you're vulnerable to product transitions, when you can get stuck with obsolete inventory.[8]

For a growing number of parts and components, Dell's close partnership with suppliers was allowing it to operate with no more than two hours of inventory.

Dell's supplier of monitors was Sony. Because the monitors Sony supplied with the Dell name already imprinted were of dependably high quality (a defect rate of fewer than 1,000 per million), Dell didn't even open up the monitor boxes to test them at its Reno, Nevada, monitor distribution center.[9] Utilizing sophisticated data exchange systems, Dell arranged for its shippers

[6]Quoted in Magretta, "The Power of Virtual Integration," p. 74.

[7]Magretta, "The Power of Virtual Integration," p. 75.

[8]Ibid., p. 76.

[9]Ibid.

(Airborne Express and United Parcel Service) to pick up computers at U.S. assembly plants, then pick up the accompanying monitors at its Reno distribution center and deliver both to the customer simultaneously. The savings in time and cost were significant.

Dell had been working hard for the past several years to refine and improve its relationships with suppliers and its procedures for operating with smaller inventories. In fiscal year 1995, Dell averaged an inventory turn cycle of 32 days. By the end of fiscal 1997 (January 1997), the average was down to 13 days. The following year, it was 7 days, which compared very favorably with Gateway's 14-day average, Compaq's 23-day average, and the estimated industrywide average of over 50 days. In fiscal year 1999 and 2000, Dell operated with an average of six days' supply in inventory; the average dropped to five days' supply in fiscal year 2001 and to four days' supply in 2002 and 2003.

Dell's Direct Sales Strategy and Marketing Efforts

With thousands of phone, fax, and Internet orders daily and ongoing field sales force contact with customers, the company kept its finger on the market pulse, quickly detecting shifts in sales trends, design problems, and quality glitches. If the company got more than a few of the same complaints, the information was relayed immediately to design engineers who checked out the problem. When design flaws or components defects were found, the factory was notified and the problem corrected within a few days. Management believed Dell's ability to respond quickly gave it a significant advantage over PC makers that operated on the basis of large production runs of variously configured and equipped PCs and sold them through retail channels. Dell saw its direct sales approach as a totally customer-driven system, with the flexibility to transition quickly to new generations of components and PC models.

Dell's Customer-Based Sales and Marketing Focus Unlike technology companies that organized their sales and marketing efforts around product lines, Dell was organized around customer groups. Dell had placed managers in charge of developing sales and service programs appropriate to the needs and expectations of each customer group. Up until the early 1990s, Dell operated with sales and service programs aimed at just two market segments—high-volume corporate and governmental buyers and low-volume business and individual buyers. But as sales took off in 1995–97, these segments were subdivided into finer, more homogeneous categories that by 2000 included global enterprise accounts, large and midsize companies (over 400 employees), small companies (under 400 employees), health care businesses (over 400 employees), federal government agencies, state and local government agencies, educational institutions, and individual consumers. Many of these customer segments were further subdivided—for instance, within the federal category, Dell had formed separate sales forces and marketing programs for the army, navy, and air force; in education, there were separate sales and marketing programs for K–12 schools; higher education institutions; and personal-use purchases by faculty, staff, and students. Dell's largest global enterprise accounts were assigned their own dedicated sales force—for example, Dell had a sales force of 150 people dedicated to meeting the needs of General Electric's facilities and personnel scattered across the world.

Dell's sales to individuals and small businesses were made by telephone, fax, and the Internet. It had call centers in the United States, Europe, and Asia with toll-free lines; customers could talk with a sales representative about specific models, get information faxed or mailed to them, place an order, and pay by credit card. The Asian and European call centers were equipped with technology that routed calls from a particular country to a particular call center. Thus, for example, a customer calling from Lisbon, Portugal, was automatically directed to a Portuguese-speaking sales rep at the call center in Montpelier, France.

Dell in Japan While NEC, Toshiba, Fujitsu, and Hitachi had the leading shares of the $20 billion PC market in Japan for 2002, Dell was fifth, with a 7.7 percent dollar share, and IBM ranked sixth. Other competitors included Sony, Sharp, and Matshusita. Counting units sold, however, Dell was number one in business desktop computers and was number two in entry-level and midrange servers, with a 19.1 percent share in mid-2002. Dell's 2002 sales in Japan were up about 20 percent, in a market where overall sales were flat. Dell's technical and customer support was ranked the best in Japan in 2002 by *Nikkei PC,* an industry trade magazine. Dell had 200 full-time personnel at its call center in Japan and was tracking Japanese buying habits and preferences with its proprietary software. The head of Dell's consumer PC sales group in Japan had installed 34 kiosks in leading electronics stores around Japan, allowing shoppers to test Dell computers, ask questions of staff, and place orders—about half the sales were to people who did not know about Dell prior to visiting the kiosk.

Dell believed that it was more profitable than any other PC-server vendor selling in the Japanese market. Dell's profit margins in Japan were higher than those in the U.S. market, and sales were rising briskly. Dell overtook NEC in servers to become the second-ranking seller of servers in the fourth quarter of 2002. Japan ranked 20th worldwide in personal computers per capita, with a rate of 31.5 computers per 100 people; the United States ranked 1st, with 58.5 computers per 100 people.[10]

Dell in China Dell Computer entered China in 1998 and achieved faster growth there than in any other foreign market it had entered. The market for PCs in China was the third largest in the world, behind the United States and Japan, and was on the verge of being the second largest. Unit volume was expanding 20–30 percent annually and with a population of 1.4 billion people (of which some 400 million lived in metropolitan areas where computer use was growing rapidly), the Chinese market for PCs was expected to become the largest in the world by 2010. The market leader in China was Legend, a local company; other major local PC producers were Founder and Great Wall. IBM, Hewlett-Packard, Dell, Toshiba, Acer, and NEC Japan were among the top 10 market share leaders in China. All of the major contenders except Dell relied on resellers to handle sales and service; Dell sold directly to customers in China just as it did elsewhere.

Dell's primary target market in China consisted of large corporate accounts. Management believed that many Chinese companies would find the savings from direct sales appealing, that they would like the idea of having Dell build PCs and servers to their requirements and specifications, and that—once they became a Dell customer—they would like the convenience of Internet purchases and the company's growing array of products and services. Dell recognized that its direct sales approach put it at a short-term disadvantage in appealing to small business customers and individual consumers. According to an executive from rival Legend, "It takes two years of a person's savings to buy a PC in China. And when two years of savings is at stake, the whole family wants to come out to a store to touch and try the machine."[11] But Dell believed that over time, as Chinese consumers became more familiar with PCs and more comfortable with making online purchases, it would be able to attract growing numbers of small business customers and consumers through Internet and telephone sales. In 2002, about 40 percent of Dell's sales in China were over the Internet.

Dell's sales in Asia were expected to surpass those in Europe by year-end 2003 and to become Dell's biggest region outside the United States by 2005.

Dell in Latin America In 2002 PC sales in Latin America exceeded 5 million units. Latin America had a population of 450 million people. Dell management believed that in the next few years PC use in Latin America would reach 1 for every 30 people (one-tenth the penetration in the United States), pushing annual sales up to 15 million units. The company's plant in Brazil, the largest market in Latin America, was opened to produce, sell, and provide service and technical support for customers in Brazil, Argentina, Chile, Uruguay, and Paraguay.

Using Dell Direct Store Kiosks to Access Individual Consumers In 2002 Dell began installing Dell Direct Store kiosks in a variety of retail settings. The kiosks did not carry inventory, but customers could talk face-to-face with a knowledgeable Dell sales representative, inspect Dell's products, and order them on the Internet while at the kiosk. The idea for using kiosks had begun in Japan, where Dell sales reps were encountering resistance to Dell's direct sales approach from individual buyers—Japanese consumers were noted for wanting to touch and feel a product before committing to purchase it. When kiosks were installed in Japanese retail settings, they proved quite popular and helped generate a big boost in Dell's share of PC sales to consumers in Japan. The success of kiosks in Japan had inspired Dell to try them in the United States. About 60 kiosks were in place at U.S. locations during the 2002 holiday sales season. In January

[10]According to figures cited in Ken Belson, "How Dell Is Defying an Industry's Gravity in Japan," *New York Times*, December 8, 2002, Section 3, p. 4.

[11]Quoted in Neel Chowdhury, "Dell Cracks China," *Fortune*, June 21, 1999, p. 121.

2003, Dell announced that it would begin placing Dell Direct Store kiosks in selected Wal-Mart and Sears stores.

Customer Service and Technical Support

Service became a feature of Dell's strategy in 1986 when the company began providing a year's free on-site service with most of its PCs after users complained about having to ship their PCs back to Austin for repairs. Dell contracted with local service providers to handle customer requests for repairs; on-site service was provided on a next-day basis. Dell also provided its customers with technical support via a toll-free phone number and e-mail. Dell received close to 40,000 e-mail messages monthly requesting service and support. Bundled service policies were a major selling point for winning corporate accounts. If customers preferred to work with their own service provider, Dell supplied the provider of choice with training and spare parts needed to service customers' equipment. Recently, Dell had instituted a First Call Resolution initiative to strengthen its capabilities to resolve customer inquiries or difficulties on the first call; first call resolution percentages were made an important measure in evaluating the company's technical support performance.

Value-Added Services Dell kept close track of the purchases of its large global customers, country by country and department by department—and customers themselves found this purchase information valuable. Dell's sales and support personnel used their knowledge about a particular customer's needs to help that customer plan PC purchases, to configure the customer's PC networks, and to provide value-added services. For example, for its large customers Dell loaded software and placed ID tags on newly ordered PCs at the factory, thereby eliminating the need for the customer's IT personnel to unpack the PC, deliver it to an employee's desk, hook it up, place asset tags on the PC, and load the needed software from an assortment of CD-ROMs and diskettes—a process that could take several hours and cost \$200–\$300.[12] While Dell charged an extra \$15 or \$20 for the software-loading and asset-tagging services, the savings to customers were still considerable—one large customer reported savings of \$500,000 annually from this service.[13]

Premier Pages Dell had developed customized, password-protected Web sites called Premier Pages for over 40,000 corporate, governmental, and institutional customers worldwide. These Premier Pages gave customers' personnel online access to information about all Dell products and configurations the company had purchased or that were currently authorized for purchase. Employees could use Premier Pages to (1) obtain customer-specific pricing for whatever machines and options the employee wanted to consider, (2) place an order online that would be electronically routed to higher-level managers for approval and then on to Dell for assembly and delivery, and (3) seek advanced help desk support. Customers could also search and sort all invoices and obtain purchase histories. These features eliminated paper invoices, cut ordering time, and reduced the internal labor customers needed to staff corporate purchasing and accounting functions. Customer use of Premier Pages had boosted the productivity of Dell salespeople assigned to these accounts by 50 percent. Dell was providing Premier Page service to thousands of additional customers annually and adding more features to further improve functionality.

www.dell.com At the company's Web site, which underwent a global redesign in late 1999 and had 50 country-specific sites in local languages and currencies, prospective buyers could review Dell's entire product line in detail, configure and price customized PCs, place orders, and track orders from manufacturing through shipping. The closing rate on sales at Dell's Web site was 20 percent higher than that on sales inquiries received via telephone. The company was adding Web-based customer service and support tools to make a customer's online experience pleasant and satisfying.

In February 2003, over 50 percent of Dell's technical support activities were being conducted via the Internet. Dell was aggressively pursuing initiatives to enhance its online technical support tools and reduce the number and cost of telephone support calls (which totaled about 8 million in 2000). Management believed that enhancing www.dell.com to shrink transaction and order fulfillment times, increase accuracy, and provide more personalized content resulted in a higher degree of

[12]Magretta, "The Power of Virtual Integration," p. 79.

[13]"Michael Dell Rocks," *Fortune*, May 11, 1998, p. 61.

"e-loyalty" than traditional attributes like price and product selection.

On-Site Services Corporate customers paid Dell fees to provide technical support, on-site service, and help with migrating to new IT technologies. Services were one of the fastest growing part of Dell, accounting for almost $4 billion in sales in 2002. Dell's service business was split about 50–50 between what Michael Dell called close-to-the-box services and management and professional services—but the latter were growing faster, at close to 25 percent annually. Dell estimated that close-to-the-box support services for Dell products represented about a $50 billion market, whereas the market for management and professional services (IT life-cycle services, deployment of new technology, and solutions for greater IT productivity) was about $90 billion. IT consulting services were becoming more standardized, driven primarily by growing hardware and software standardization, reduction in on-site service requirements (partly because of online diagnostic and support tools, growing ease of repair and maintenance, increased customer knowledge, and increased remote management capabilities), and declines in the skills and know-how that were required to perform service tasks on standardized equipment and install new, more standardized systems.

In a fall 2002 speech, Michael Dell explained the company's move into services:

> We developed a couple of years ago an organization we originally called Dell Technology Consulting, and what they do is the kind of technical consulting, the SAN [storage area network] installation and design, the Microsoft Exchange implementation, the Oracle 9i rack, the cluster installation and design. Last year we did about 2000 engagements with Dell Technology Consulting.
>
> We acquired a company called Plural, which is totally focused on the Microsoft application environment, and have combined those resources together to create what we now call Dell Professional Services . . . Our focus here is, first and foremost, to support our thrust into enterprise products. And we know that as customers require those products, you can't have a 70 percent increase in SAN shipments year over year, you can't have a billion dollar external storage business unless you can design and install those products.[14]

Dell's strategy in services, like its strategy in hardware products, was to bring down the cost of IT consulting services for its large enterprise customers. The providers of on-site service, technical support, and other types of IT consulting typically charged premium prices and realized hefty profits for their efforts. During 2001–2002, according to Michael Dell, customers who bought the services being provided by Dell saved 40 to 50 percent over what they would have paid other providers of IT services. Going into 2003, Dell had some 8,000 employees in its services group and top management foresaw services as playing an expanding role in the company's growth. Kevin Rollins, Dell's president, indicated the company's business model "isn't just about making cheap boxes, it's also about freeing customers from overpriced relationships" with such vendors as IBM, Sun Microsystems, and Hewlett-Packard.[15]

While a number of Dell's corporate accounts were large enough to justify dedicated on-site teams of Dell support personnel, Dell generally contracted with third-party providers to make the necessary on-site service calls. Customers notified Dell when they had problems; such notices triggered two electronic dispatches—one to ship replacement parts from Dell's factory to the customer sites and one to notify the contract service provider to prepare to make the needed repairs as soon as the parts arrived.[16] Bad parts were returned so that Dell could determine what went wrong and how to prevent such problems from happening again. Problems relating to faulty components or flawed components design were promptly passed along to the relevant supplier for correction.

Customer Forums In addition to using its sales and support mechanisms to stay close to customers, Dell periodically held regional forums for its best customers. The company formed Platinum and Gold Councils composed of its largest customers in the United States, Europe, Japan, and the Asia-Pacific region; regional meetings were held every six to nine months.[17] Some regions had two meetings—one for chief information officers and one for technical personnel. At the meetings, which frequently included a

[14]Speech to Gartner Fall Symposium, Orlando, FL, October 9, 2002.

[15]Quoted in Kathryn Jones, "The Dell Way," *Business 2.0*, February 2003.

[16]Kevin Rollins, "Using Information to Speed Execution," *Harvard Business Review*, March–April, 1998, p. 81.

[17]Magretta, "The Power of Virtual Integration," p. 80.

presentation by Michael Dell, Dell's senior technologists shared their views on the direction of the latest technological developments, what the flow of technology really meant for customers, and Dell's plans for introducing new and upgraded products over the next two years. There were also breakout sessions on topics of current interest. Dell found that the information gleaned from customers at these meetings assisted the company in forecasting demand for its products.

Pioneering Leadership in Use of the Internet and E-Commerce Technology

Dell Computer was a leader in using the Internet and e-commerce technologies to squeeze greater efficiency out of its supply chain activities, to streamline the order-to-delivery process, to encourage greater customer use of its Web site, and to gather and utilize all types of information. In a 1999 speech to 1,200 customers, Michael Dell said:

> The world will be changed forever by the Internet . . . The Internet will be your business. If your business isn't enabled by providing customers and suppliers with more information, you're probably already in trouble. The Internet provides a dramatic reduction in the cost of transactions and the cost of interaction among people and businesses, and it creates dramatic new opportunities and destroys old competitive advantages. The Internet is like a weapon sitting on a table ready to be picked up by either you or your competitors.[18]

Dell Computer's use of its Web site and various Internet technology applications had proved instrumental in helping the company become the industry's low-cost provider and drive costs out of its business. Internet technology applications were a cornerstone of Dell's collaborative efforts with suppliers. The company provided order-status information quickly and conveniently over the Internet, thereby eliminating tens of thousands of order-status inquiries coming in by phone. It used its Web site as a powerful sales and technical support tool. Few companies could match Dell's competencies and capabilities in the use of Internet technology to improve operating efficiency and gain new sales in a cost-efficient manner.

Expansion into New Products

Dell's recent expansion into data storage hardware, switches, handheld PCs, printers, and printer cartridges represented an effort to diversify the company's product base and to use its competitive capabilities in PCs and servers to pursue revenue growth opportunities. Dell had expanded its product line to include storage devices designed to handle a variety of customers' needs for high-speed data storage and retrieval; management saw storage devices as a growth opportunity because the computing systems of corporate and institutional customers were making increasing use of high-speed data storage and retrieval devices. Dell's PowerVault line of storage products had data protection and recovery features that made it easy for customers to add and manage storage and simplify consolidation. Because it relied on standardized technology and components (which were considerably cheaper than customized ones) as building blocks for its storage products, Dell had been able to drive down storage prices for its customers by about 50 percent during 2001–2002.

Dell began selling its own data-routing switches in 2001. As sales of these switches accelerated and as Dell mulled whether to expand into other networking products and Internet gear, Cisco elected to discontinue supplying its switches to Dell for resale as of October 2002. Dell's family of PowerConnect switches—simple commodity-like products generally referred to as layer 2 switches in the industry—carried a price of $20 per port, versus $70–$100 for comparable Cisco switches and $38 for comparable 3Com switches. Most of Dell's sales of switches were to customers who were in the process of buying Dell servers. Michael Dell used Dell's entry into data networking switches to explain the logic behind the company's strategy to expand into products and services that complemented its sales of PCs, workstations, and servers:

> In the United States, Dell has about a 46 percent share of the market for small computer systems sold to large corporations, which does not mean that we sell to 46 percent of corporations; it means we sell to about 90 percent of corporations and one out of two of the products they buy is Dell. So we have pretty profound access and coverage within large corporations.

[18]Keynote speech given on August 25, 1999, in Austin, Texas, at Dell's DirectConnect Conference.

> Every computer that we sell to businesses is attached to a network. So you buy a PC, you buy a server, you attach them with switches, layer 2 and layer 3, into a WAN [wide-area network], into some fiber optic backbone or something that connects out to the broader Internet or intranet or whatever the network may be.
>
> So it's a fairly logical adjacency to say, okay, you're buying PCs from Dell, how about switches from Dell. And it turns out that that's a fairly easy thing for us to sell.[19]

Some observers saw Dell's 2003 entry into the printer market as another deliberate attack on Hewlett-Packard—going after HP's biggest and most profitable business segment at a time when HP management was busy tackling the challenges of merging its operations with those of Compaq and trying to make its acquisition a success. Dell's Axim line of handheld PCs was priced at about 50 percent less than HP's popular iPaq line of handhelds, and Dell's storage and networking products also carried lower prices than comparable HP products. Dell management, however, indicated the company's entry into the printer market was driven by a desire to add value for its customers. Michael Dell explained, "We think we can drive down the entire cost of owning and using printing products. If you look at any other market Dell has gone into, we have been able to significantly save money for customers. We know we can do that in printers; we have looked at the supply chain all the way through its various cycles and we know there are inefficiencies there. I think the price of the total offering when we include the printer and the supplies . . . can come down quite considerably."[20]

When Dell announced it had contracted with Lexmark to make printers and printer and toner cartridges for sale under the Dell label beginning in 2003, HP immediately discontinued supplying HP printers to Dell for resale at Dell's Web site. Dell had been selling Lexmark printers for two years and since 2000 had resold about 4 million printers made by such vendors as HP, Lexmark, and other vendors to its customers. Lexmark designed and made critical parts for its printers but used offshore contract manufacturers for assembly. Gross profit margins on printers (sales minus cost of goods sold) were said to be in single digits in late 2002, but the gross margins on printer supplies were in the 50–60 percent range—brand-name ink cartridges for printers typically ran $25 to $35.

Dell's Entry into the White-Box PC Segment

In 2002 Dell announced it would begin making so-called white-box (i.e., unbranded) PCs for resale under the private labels of retailers. PC dealers that supplied white-box PCs to small businesses and price-conscious individuals under the dealer's own brand name accounted for about one-third of total PC sales and about 50 percent of sales to small businesses. According to one industry analyst, "Increasingly, Dell's biggest competitor these days isn't big brand-name companies like IBM or HP, it's white-box vendors." Dell's thinking in entering the white-box PC segment was that it was cheaper to reach many small businesses through the white-box dealers that already served them than by using its own sales force and support groups to sell and service businesses with fewer than 100 employees. Dell believed its low-cost supply chain and assembly capabilities would allow it to build generic machines cheaper than white-box resellers could buy components and assemble a customized machine. Management expected that Dell would achieve $380 million in sales of white-box PCs in 2003 and would generate profit margins equal to those on Dell-branded PCs. Some industry analysts were skeptical of Dell's move into white-box PCs because they expected white-box dealers to be reluctant to buy their PCs from a company that had a history of taking their clients. Others believed this was a test effort by Dell to develop the capabilities to take on white-box dealers in Asia and especially in China, where the sellers of generic PCs were particularly strong.

Going into 2003, Dell Computer had a war chest of over $9 billion in cash and liquid investments that it could deploy in its pursuit of attractive revenue growth opportunities. Management had expressed a desire to grow the company revenues to around $60 or $65 billion annually by 2006. The company wanted such products as servers, storage devices, switches and routers, printers, and other peripherals to account for 50 percent of revenues within four or five years. According to Michael Dell, whereas Dell's unit shipments, revenues,

[19]Remarks by Michael Dell, MIT Sloan School of Management, September 26, 2002; posted at www.dell.com.

[20]Quoted in the *Financial Times* Global News Wire, October 10, 2002.

and profits were all up at double-digit rates in the second quarter of 2002, "on average, the rest of the industry was down 4 percent in shipments, down 10 percent in revenue and lost money."[21]

Other Elements of Dell's Business Strategy

Dell's strategy had two other elements that assisted the company's drive for industry leadership: R&D and advertising.

Research and Development Dell's R&D focus was to track and test new developments in components and software, ascertain which ones would prove most useful and cost-effective for customers, and then design them into Dell products. Management's philosophy was it was Dell's job on behalf of its customers to sort out all the new technology coming into the marketplace and help steer customers to options and solutions most relevant to their needs. The company talked to its customers frequently about "relevant technology," listening carefully to customers' needs and problems and endeavoring to identify the most cost-effective solutions.

Dell was a strong advocate of incorporating standardized components in its products so as not to tie either it or its customers to one company's proprietary technology and components, which almost always carried a price premium and increased costs for its customers. Dell actively promoted the use of industrywide standards and regularly pressed its suppliers of a particular part or component to agree on common standards. Michael Dell and other company officials saw standardized technology as beginning to take over the largest part of the $875 billion spent annually on IT—standardization was very much evident in the areas of servers, storage, networking, and high-performance computing. One example of the impact of standardized technology was at the University of Buffalo, where Dell had installed a 5.6 teraflop cluster of about 2,000 Dell servers containing 4,000 microprocessors that was being used to decode the human genome. The cluster of servers, which were the same as those Dell sold to its business customers, had been installed in about 60 days at a cost of a few million dollars and represented the third most powerful supercomputer in the world. High-performance clusters of PCs and servers were replacing mainframe computers and custom-designed supercomputers because of their much lower cost. Amerada Hess, attracted by Dell's use of standardized and upgradable parts and components, installed a cluster of several hundred Dell workstations and allocated about $300,000 a year to upgrade and maintain it; the cluster had replaced an IBM supercomputer that cost $1.5 million a year to lease and operate. Studies conducted by Dell indicated that, over time, products incorporating standardized technology delivered about twice the performance per dollar of cost as products based on proprietary technology.

Dell's R&D group included over 3,000 engineers, and its annual R&D budget was $450 to $500 million. The company's R&D unit also studied and implemented ways to control quality and to streamline the assembly process. About 15 percent of Dell's 800 U.S. patents were ranked "elite."

Advertising Michael Dell was a strong believer in the power of advertising and frequently espoused its importance in the company's strategy. His competitive zeal resulted in the company's being the first to use comparative ads, throwing barbs at Compaq's higher prices. Although Compaq won a lawsuit against Dell for making false comparisons, Michael Dell was unapologetic, arguing that the ads were very effective: "We were able to increase customer awareness about value."[22] Dell insisted that the company's ads be communicative and forceful, not soft and fuzzy.

The company regularly had prominent ads describing its products and prices in such leading computer publications as *PC Magazine* and *PC World,* as well as in *USA Today, The Wall Street Journal,* and other business publications. In the spring of 1998, the company debuted a major multiyear, worldwide TV campaign to strengthen its brand image using the theme "Be Direct." Most recently, Dell had been successful in gaining sales to consumers with a popular ad campaign featuring Steven, the "Dude, You're Gettin' a Dell" guy, enthusiastically pitching Dell products. A second popular campaign featured a group of young Dell interns working their way through Dell's operations and talking with workers about their jobs.

[21]Quoted in *Investor's Business Daily,* September 6, 2002.

[22]"The Education of Michael Dell," p. 85.

DELL'S PERFORMANCE IN 2002 AND EARLY 2003

In 2001–2002 Dell added about 16,000 new business customers in North and South America alone—in the United States, Dell had gained about 1,500 new business customers each quarter since mid-2001. In its largest accounts, the portion of revenue coming from new customers had increased 50 percent above 2001 levels, and revenues from existing corporate accounts were up by about 20 percent. The company believed that close to $6 billion of its fiscal 2003 revenues could be attributed to market share gains in the past eight quarters. Management believed that its strategy to acquire new customers, keep its customers satisfied, and sell them a growing array of IT products and services was working well.

According to data compiled by Dell management, in the second quarter of 2002, Dell generated operating income of $75,000 per employee, versus $15,000 for Hewlett-Packard, $10,000 for IBM, and −$1,000 for Sun Microsystems. Whereas Dell's revenues were running close to or above record levels on a quarterly basis in mid-2002, the revenues of its chief competitors were averaging about 62 percent of their all-time peak-quarter revenues—and most were not expected to exceed their previous quarterly peak for at least two years. From the third quarter of 1997 through the first quarter of 2002, Dell's unit worldwide market share had risen 158 percent; during the same period, HP's worldwide unit market share had dropped by 23 percent and IBM's unit share was down 19 percent. From 1998 through the second quarter of 2002, Dell had increased its U.S. share of entry-level and midrange servers from about 12 percent to an industry-leading 29.9 percent, edging out Hewlett-Packard, whose share had dropped from 43 percent in 1998 to 29.8 percent in mid-2002; third-ranked IBM's share had remained relatively constant at around 11 percent. Dell's market share in fiscal 2003 was higher than in fiscal 2002 in all regions of the world.

Dell's strategy was also generating good cash flows. Statistics compiled by Dell indicated that its free cash flow (defined as cash flow from operations minus capital expenditures) had averaged just over 12 percent of revenues during 1997–2002; this compared very favorably with free cash flows at Sun Microsystems (about 9 percent), IBM (about 6 percent), and Hewlett-Packard (nearly 3 percent). Going into 2003, Dell had $9.9 billion in cash and investments, a company record.

During the November 2002–January 2003 period (the fourth quarter of Dell's 2003 fiscal year), the company posted its best-ever quarterly product shipments, revenues, and operating profits. Management indicated that Dell's global market share in PCs in the last quarter of fiscal 2003 was almost 3 points higher than in its fiscal 2002 fourth quarter, and its U.S. share was 5 points higher—in servers, Dell's market share was over 3 points higher. Unit shipments were up 25 percent, and shipments in China, France, Germany, and Japan increased a combined 39 percent, with server sales in those countries up 47 percent. Despite steadily eroding average selling prices of $1,640 in fiscal 2003; $1,700 in 2002; $2,050 in 2001; $2,250 in 2000; and $2,600 in 1998, Dell's revenues were climbing as the company gained volume and market share in virtually all product categories and geographic areas where it competed.

MARKET CONDITIONS IN THE INFORMATION TECHNOLOGY INDUSTRY IN EARLY 2003

Analysts expected the $875 billion worldwide IT industry to grow roughly 5 percent in 2003, following a 2.3 percent decline in 2002 and close to a 1 percent decline in 2001—corporate spending for IT products accounted for about 45 percent of all capital expenditures of U.S. businesses. From 1980 to 2000, IT spending had grown at an average annual rate of 12 percent and then flattened. The recent slowdown in IT spending reflected a combination of factors: sluggish economic growth worldwide that was prompting businesses to delay upgrades and hold on to aging equipment longer; overinvestment in IT in the 1995–99 period; declining unit prices for many IT products (especially PCs and servers); and a growing preference for lower-priced, standard-component hardware that was good enough to perform a variety of functions using off-the-shelf Windows or Linux operating systems (as opposed to relying on proprietary hardware and customized Unix software). The selling points that appealed most to *exhibit 6* **Actual and Projected Worldwide Shipments of PCs, 1980–2004**

Year	Volume of PC Shipments (millions)
1980	1
1985	11
1990	24
1995	58
1996	69
1997	80
1998	91
1999	112
2000	140
2001	134
2002	136
2003	147*
2004	164*

*Forecast.
Source: International Data Corporation.

customers were standardization, flexibility, modularity, simplicity, economy of use, and value.

Exhibit 6 shows actual and projected PC sales for 1980–2004 as compiled by industry researcher International Data Corporation. According to Gartner Research, the billionth PC was shipped sometime in July 2002; of the billion, an estimated 550 million were still in use. Nearly 82 percent of the 1 billion PCs that had been shipped were desktops, and 75 percent were sold to businesses. With a world population of 6 billion, most industry participants believed there was ample opportunity for further growth in the PC market. Computer usage in Europe was half of that in the United States, even though the combined economies of the European countries were a bit larger than the U.S. economy. Growth potential for PCs was seen as particularly strong in China, India, several other Asian countries, and portions of Latin America. Many industry experts foresaw a time when the installed base of PCs would exceed 1 billion units, and some believed the total would eventually reach 1.5 billion—a ratio of one PC to every four people in the world.

Forecasters also predicted that there would be a strong built-in PC replacement demand as microprocessor speeds continued to escalate. A microprocessor operating at 450 megahertz could process 600 million instructions per second (MIPS); Intel had forecast that it would be able to produce microprocessors capable of 100,000 MIPS by 2011. Such speeds were expected to spawn massive increases in computing functionality and altogether new uses and applications not only for PCs but also for computing devices of all types. At the same time, forecasters expected full global buildout of the Internet, which would entail the installation of millions of servers.

Currently, there was growing interest in notebook computers; many businesses were turning to notebooks equipped with wireless data communications capability to improve worker productivity and keep workers connected to important information. The emergence of Wireless Fidelity (Wi-Fi) networking technology was fueling the trend—Wi-Fi systems were being used in businesses, on college campuses, in airports, and other locations to link users to the Internet and to private networks. Another next-generation PC, the tablet PC, used a penlike stylus for writing notes on text documents and e-books. The media center PC combined a full-function PC with such consumer electronic devices as a DVD player, music jukebox, and personal video recorder. Two other devices—flat-panel LCD monitors and DVD recorder drives—were also stimulating sales of new PCs.

The Server Market

In the server market, a sea change from proprietary servers running Unix operating systems to much lower-cost Intel/Windows/Linux server technologies was generating a slowdown in dollar revenues from server sales despite rapidly increasing unit volume. Dell was the market leader in the number of low-end and midrange servers shipped but because of its low prices trailed far behind Hewlett-Packard, IBM, and Sun Microsystems in total revenues from server sales. The rapid inroads that Dell was making into the server market had greatly intensified competition in servers in the past three years. In late 2002, HP, IBM, and Sun were in a dead heat for market share leadership based on dollar volume.[23] In the third quarter of 2002, IBM overtook HP as the overall revenue leader in servers, with 30.0 percent

[23]Based on data compiled and reported by International Data Corporation.

of the market versus HP's 27.2 percent. However, HP edged out Sun for the lead in Unix-based servers, with a revenue share of 32.9 percent versus Sun's 30.4 percent.

The Unix share of the server operating system market (based on unit shipments) was said to have decreased by 50 percent over the past five years compared to Windows and Linux, which had almost tripled in use—Dell estimated that Unix-based servers accounted for about 17 percent of unit volume and 55 percent of dollar volume in mid-2002. A number of industry observers believed that Linux was the "new Unix" and that the days of using expensive, proprietary Unix systems were numbered.

COMPETING VALUE CHAIN MODELS IN THE GLOBAL PC INDUSTRY

When the personal computer industry first began to take shape in the early 1980s, the founding companies manufactured many of the components themselves—disk drives, memory chips, graphics chips, microprocessors, motherboards, and software. Subscribing to a philosophy that mandated in-house development of key components, they built expertise in a variety of PC-related technologies and created organizational units to produce components as well as handle final assembly. While certain noncritical items were typically outsourced, if a computer maker was not at least partially vertically integrated and an assembler of some components, then it was not taken seriously as a manufacturer.

But as the industry grew, technology advanced quickly in so many directions on so many parts and components that the early personal computer manufacturers could not keep pace as experts on all fronts. There were too many technological innovations in components to pursue and too many manufacturing intricacies to master for a vertically integrated manufacturer to keep its products on the cutting edge. As a consequence, companies emerged that specialized in making particular components. Specialists could marshal enough R&D capability and resources to either lead the technological developments in their area of specialization or else quickly match the advances made by their competitors. Moreover, specialist firms could mass-produce the component and supply it to several computer manufacturers far cheaper than any one manufacturer could fund the needed component R&D and then make only whatever smaller volume of components it needed for assembling its own brand of PCs.

Thus, in the early 1990s, computer makers began to abandon vertical integration in favor of a strategy of outsourcing most components from specialists and concentrating on efficient assembly and marketing their brand of computers. Recall Exhibit 5, which shows the value chain model that such manufacturers as Compaq Computer, IBM, Hewlett-Packard, Sony, Toshiba, and Fujitsu-Siemens used in the 1990s. It featured arm's-length transactions between specialist suppliers, manufacturer/assemblers, distributors and retailers, and end users. However, Dell, Gateway, and Micron Electronics employed a shorter value chain model, selling directly to customers and eliminating the time and costs associated with distributing through independent resellers. Building to order avoided (1) having to keep many differently equipped models on retailers' shelves to fill buyer requests for one or another configuration of options and components, and (2) having to clear out slow-selling models at a discount before introducing new generations of PCs. Direct sales eliminated retailer costs and markups (retail dealer margins were typically in the range of 4 to 10 percent).

Because of Dell's success in using its business model and strategy to become the low-cost leader, most other PC makers in 2003 were endeavoring to emulate various aspects of Dell's strategy, but with little notable success. Nearly all vendors were trying to cut days of inventory out of their supply chains and reduce their costs of goods sold and operating expenses to levels that would make them more competitive with Dell. In an effort to cut their assembly costs, several of the leading PC makers (including IBM and Hewlett Packard) had begun outsourcing assembly to contract manufacturers and refocused their internal efforts on product design and marketing. Virtually all vendors were trying to minimize the amount of finished goods in dealer/distributor inventories and shorten the time it took to replenish dealer stocks. Collaboration with contract manufacturers was increasing to develop the capabilities to use a build-to-order model and be able to deliver orders to customers in 7 to 14 days, but this was complicated by the use of offshore contract manufacturers.

While most PC vendors would have liked to adopt Dell's sell-direct strategy for at least some of their *exhibit 7* **Dell's Principal Competitors and Dell's Market Share, by Product Category, 2002**

Product Category	Dell's Principal Competitors	Estimated Worldwide Market Size in 2003 (in billions)	Dell's Worldwide Share, 2002
PCs and workstations	Hewlett-Packard (maker of both Compaq and HP brands), IBM, Gateway, Apple, Acer, Sony, Fujitsu-Siemens (in Europe and Japan), Legend (in China)	$162	~16%
Servers	Hewlett-Packard, IBM, Sun Microsystems, Fujitsu	$50	~9
Data storage devices	Hewlett-Packard, IBM, EMC, Hitachi	$31	~6
Networking switches and related equipment	Cisco Systems, Enterasys, Nortel, 3Com	$58	<1
Handheld PCs	Palm, Sony, Hewlett-Packard, Toshiba, Casio	$4	<1
Printers and printer cartridges	Hewlett-Packard, Lexmark, Canon, Epson	$35–$45	0
Cash register systems	IBM, NCR, Wincor Nixdorf, Hewlett-Packard, Sun Microsystems	$4 (in North America)	0
Services	Accenture, IBM, Hewlett-Packard, many others	$350	~2

Source: Compiled by the case authors from a variety of sources, including International Data Corporation and www.dell.com.

sales, they were reluctant to push direct sales hard for fear of alienating the dealers on whom they depended for the bulk of their sales. Dealers saw sell-direct efforts on the part of a manufacturer whose brand they represented as a move to cannibalize their business and to compete against them. So far, other than Dell and Gateway, the remaining PC vendors had elected, for the most part, to market their products through independent dealers who were responsible for handling sales and service to customers. However, Dell's success in gaining large enterprise customers with its direct sales force had forced growing numbers of PC vendors to supplement the efforts of their independent dealers with direct sales and service efforts of their own. Going into 2003, several of Dell's rivals were selling 15 to 25 percent of their products direct.

PROFILES OF SELECTED COMPETITORS IN THE PC INDUSTRY

This section presents brief profiles of four of Dell's principal competitors. Exhibit 7 summarizes Dell's principal competitors in the various product categories where it competed and the sizes of these product markets.

Hewlett-Packard

In one of the most contentious and controversial acquisitions in U.S. history, Hewlett-Packard shareholders voted by a narrow margin in early 2002 to approve the company's acquisition of Compaq Computer, the world's second largest full-service global computing company (behind IBM) and a company with 2001 revenues of $33.6 billion and a net loss of $785 million. Compaq had passed IBM to become the world leader in PCs in 1995 and remained in first place until it was overtaken by Dell in late 1999. Compaq acquired Tandem Computer in 1997 and Digital Equipment Corporation in 1998 to give it capabilities, products, and service offerings that allowed it to compete in every sector of the computer industry.[24] When Compaq purchased it, Digital was a troubled company with high operating costs, an inability to maintain technological leadership in high-end computing, and a nine-year

[24] "Can Compaq Catch Up?" *Business Week,* May 3, 1999, p. 163.

string of having either lost money or barely broken even.[25] The acquisitions gave Compaq a product line that included PCs, servers, workstations, mainframes, peripherals, and such services as business and e-commerce solutions, hardware and software support, systems integration, and technology consulting. In 2000, Compaq spent $370 million to acquire certain assets of Inacom Corporation that management believed would help Compaq reduce inventories, speed cycle time, and enhance its capabilities to do business with customers via the Internet.

Carly Fiorina, who became HP's CEO in 1999, explained why the acquisition of Compaq was strategically sound:

> With Compaq, we become No. 1 in Windows, No. 1 in Linux and No. 1 in UNIX . . . with our combined market position in servers, we will be able to engage the software community in building the applications that will drive demand for [Intel's] Itanium systems.
>
> Compaq is the leading provider of storage systems in the world on a revenue basis. With Compaq, we become the No. 1 player in storage, and the leader in the fastest growing segment of the storage market—storage area networks.
>
> With Compaq, we double our service and support capacity in the area of mission-critical infrastructure design, outsourcing and support. And while support is frequently considered the boring part of the services business, it produces mid-teens operating margins quarter after quarter. It's like the supplies business—more is better.
>
> Compaq is No. 1 today in high-performance computing as a result of their Tandem acquisition. Between Himalaya, their fault-tolerant computing systems, and our own super-fast Superdome, we will have an incredibly powerful position at the high end of the server market. And we gain access to new customers and markets where fault-tolerant computing is required: national security, the military and the world's largest stock exchanges, for example.
>
> Let's talk about PCs . . . Compaq has been able to improve their turns in that business from 23 turns of inventory per year to 62—100 percent improvement year over year—and they are coming close to doing as well as Dell does. They've reduced operating expenses by $130 million, improved gross margins by three points, reduced channel inventory by more than $800 million. They ship about 70 percent of their commercial volume through their direct channel, comparable to Dell. We will combine our successful retail PC business model with their commercial business model and achieve much more together than we could alone.
>
> With Compaq, we will double the size of our sales force to 15,000 strong. We will build our R&D budget to more than $4 billion a year, and add important capabilities to HP Labs. We will become the No. 1 player in a whole host of countries around the world—HP operates in more than 160 countries, with well over 60 percent of our revenues coming from outside the U.S. The new HP will be the No. 1 player in the consumer and small- and medium-business segments. And in the enterprise space, this company will be able to compete for every single customer's business.
>
> We have estimated cost synergies of $2.5 billion by 2004 . . . By 2003, the PC and personal devices business will earn 3 percent operating margin, which more than returns its cost of capital and generates substantial cash. Our enterprise business will earn 9 percent, and our services business will earn 14 percent. All in all, the company will generate $1.5 billion of cash flow net of capital expenditures every quarter.
>
> It is a rare opportunity when a technology company can advance its market position substantially and reduce its cost structure substantially at the same time. And this is possible because Compaq and HP are in the same businesses, pursuing the same strategies, in the same markets, with complementary capabilities.

However, HP's acquisition of Compaq was met with considerable skepticism from both industry analysts and investors. Opponents pointed out that no large mergers of technology companies had proved successful and delivered the promised benefits. The PC businesses of both companies were unprofitable, and skeptics doubted that combining the two would produce a profitable business capable of competing effectively with Dell. In 2001–2002, Compaq was struggling to make a success of several prior acquisitions and was losing market share in many market categories—its revenues in 2001 were almost $9 billion below revenues in 2000. Many also saw the merger as likely to divert management attention and resources away from HP's core imaging and printing business, which generated the bulk of HP's profits.

HP completed its acquisition of Compaq on May 3, 2002, producing a company with combined annual revenues close to $82 billion and transforming HP into a company with four major business groups: imaging and printing; personal computing systems (desktop and notebook PCs, workstations, handheld PCs, and DVD drives); enterprise systems (composed primarily of

[25]More information on Digital's competitive position can be found in "Compaq-Digital: Let the Slimming Begin," *Business Week,* June 22, 1998.

exhibit 8 **Performance of Hewlett-Packard's Four Major Business Groups, Fiscal Years 2000–2002 (in billions of dollars)**

	Printing and Imaging	Personal Computing Systems*	Enterprise Systems†	HP Services
2002 (fiscal year ending October 31)				
Net revenue	$20,324	$14,733	$11,400	$9,095
Operating income (loss)	3,249	(401)	(968)	1,022
Inventories	3,136	843	1,188	629
2001 (fiscal year ending October 31)				
Net revenue	$19,426	$10,117	$ 8,395	$6,124
Operating income (loss)	1,849	(412)	(291)	647
Inventories	3,433	602	843	342
2000 (fiscal year ending October 31)				
Net revenue	$20,346	$12,008	$ 9,628	$5,730
Operating income (loss)	2,523	335	660	578
Inventories	3,475	685	1,080	337

*Includes desktop and notebook PCs, workstations, handheld PCs, and DVD drives.

†Primarily composed of servers and storage devices.

Note: The figures for 2002 include data for Compaq Computer only for the period May 3 through October 31, 2002, the end of HP's fiscal year.

Source: HP's 2002 10K report.

servers and storage devices); and IT services—see Exhibit 8 for the performance of these four segments. As of December 2002, HP management had moved aggressively to cut the size of the combined workforces by 17,900 employees (versus a previously announced cut of 15,000) and expected to achieve cost savings of $3 billion in 2003, a year ahead of initial plans. Going into 2003, HP management believed the integration was solidly on track, beating or meeting all its integration milestones to date. Outsiders, however, had heard anecdotal reports of infighting among the various camps in the new company.[26]

HP reported total revenues of $56.6 billion and losses of $903 million for fiscal 2002, versus revenues of $45.2 billion and net profits of $408 million for fiscal 2001. HP had sales of $48.9 billion and net profits of $3.9 billion in 2000. The combined revenues of HP and Compaq in 2002, however, were running close to 10 percent below comparable 2001 levels, indicating that HP and Compaq products were losing ground in the marketplace.

In the fourth quarter of 2002, HP had an estimated 16.1 percent worldwide share of PC sales, versus 15.7 percent for Dell, 5.8 percent for third-place IBM, 4.3 percent for Fujitsu Siemens, and 3.3 percent for NEC. In the United States, HP had a 20.8 percent share, versus 29.2 percent for Dell. Analysts believed that HP retook the top spot in the 2002 fourth quarter because HP's strong presence in retail stores gave it an advantage over Dell in selling to holiday shoppers and because it had aggressive promotions and price cuts. An HP marketing official said, "HP is attacking Dell on price and beating them with new and innovative products. We're growing faster than the market and gaining share across all regions and categories. [Dell] can no longer claim price as a competitive advantage. The momentum is clearly with HP."[27]

While it was true that HP's performance in the fourth quarter of 2002 was better than in the third quarter and might reflect growing momentum on HP's part, its fourth-quarter 2002 revenues for its Personal Computing Systems group were still about 8 percent below

[26]"HP Blames Economy, Not Merger, for Its Soft Sales," *Houston Chronicle,* August 28, 2002, Business section, p. 1.

[27]Quoted in *Investor's Business Daily,* January 17, 2003, p. A1.

what HP and Compaq had achieved in the fourth quarter of 2001. Statistics released by both International Data Corporation and Gartner Research showed HP losing market share in the fourth quarter of 2002 compared to what HP and Compaq enjoyed in the fourth quarter of 2001, with Dell's fourth-quarter 2002 share about 20 percent higher than its fourth-quarter 2001 share. What was most encouraging about HP's fourth-quarter performance was management's report that the company had been able to narrow its losses in Personal Computing Systems by year-end 2002 to a -1.7 percent operating margin, reduce total channel inventories to 4.3 weeks, and improve distribution efficiency.

Going into 2003, Hewlett-Packard was

- Number one globally in imaging and printing.
- Number one globally in personal computers (based on fourth-quarter 2002 statistics reported by Gartner Research).
- Number one globally in Unix, Windows, and Linux servers.
- Number one globally in enterprise storage (with revenues about 35 percent greater than the number two vendor as of mid-2002).
- Number one globally in management software.
- Number three globally in IT services.

HP management saw IBM, not Dell, as its biggest competitor.

In an effort to gain market momentum and prove that the Compaq acquisition was going to prove successful, HP had recently introduced a number of new products, including a tablet PC, a media center PC, new iPAQ Pocket PC designs, new monitors, a first-ever mobile workstation, and two Intel Itanium 2–based workstations that would support Unix, Windows, and Linux.

In January 2003, Carly Fiorina provided her take on developments in the world IT market and HP's future strategy and prospects:

> The value proposition for IT has to change . . . This industry has been focused on a cyclical economic environment. And we all know that the cyclical economic environment means that there have been substantial declines in growth rates; that smaller start-up players have been struggling to survive; and that in fact, consolidation in the IT industry is happening.
>
> . . . The market trends that we are seeing today are not being driven by cyclical economics, although clearly that's going on. I believe what we're really seeing in the IT industry today is being driven as much by changes in customer requirements . . . customer requirements are no longer simply about the fastest, hottest box. Customer requirements are no longer simply about the latest killer app. They are no longer about what's the next big thing, or the next coolest piece of technology. Customers are focused on something much more fundamental and much more practical, and that is: How do I get a better return on my technology investment? How do I get real value? How do I make sure that I can live with, not only the initial costs, but the ongoing costs of owning and operating technology?
>
> And just as important, you want to know: do I as a customer, have freedom? Can I choose the pieces I want? Can I make sure that I stay in control of my environment and in control of my investment? How do I stay in control of what is core to my business, because in fact the last thing I want to do as a customer is to hand the keys of the kingdom over to someone else? How do I make sure I have freedom of choice?
>
> So, in the midst of all this change, and in the face of those fundamental, practical, and profound requirements, what is it that HP is focused on?
>
> Our strategy—our investment—our commitment, are focused around four fundamental principles; first, that we will be the company that provides the best return on information technology (RoIT). And by the best return on information technology, we deliver on that commitment through our products, our people, our services, and importantly, our partners. And by return on information technology, what we mean is lowest total cost of ownership, improved productivity, better manageability, better interoperability, reduced complexity, improved reliability, and security.
>
> And we think we come to the table with a portfolio that differentiates us from our competitors and uniquely positions us to meet those goals. Today, we [are] the number one company in supercomputing; number one in network management capability through our OpenView platform and professional services; number one in servers—in Windows and Linux and UNIX; number one in storage; number one in imaging and printing at a time when imaging and printing are critical to [customers'] infrastructure as [they] digitize [their] processes; number one in laptops and PCs; and a leader in IT services.
>
> Our portfolio today runs from desktop to print shop; from palmtop to nonstop computing systems; from printers that sell for \$49.99—and by the way, those \$49.99 printers have 100 patents associated with them and drop 18 million drops of ink a second, proving that hi-tech and low cost can go together—

everything from $49.99 printers to multimillion dollar commercial publishing systems.

That portfolio has helped us become the number one consumer IT company in the world; the number one small- and medium-business technology company in the world; and the number one or two enterprise IT technology company in the world—depending on how you count . . . We believe it is factually accurate to say that we are the leading technology company in the world.

For a company that does 60 percent of its business outside the United States . . . we believe it is an advantage for our partners and for our customers that we have capabilities in 160 countries, that we do business in 43 currencies and 15 languages around the world . . . More than one billion people around the world use HP technology every day.

For our consumer customers, as our second principle, we're focused on providing what we would call simple, rewarding experiences—technology and solutions that are simple to own, simple to buy, simple to operate, and provide rewarding experiences that make consumers' lives more productive, more communicative, more fun, and more valuable.

Our third principle is to deliver world-class cost structures and world-class capabilities. We believe we are the company that provides the best technology at the lowest cost with the best total customer experience.

. . . In the last six months of 2002, we introduced more than one hundred new products and added 1,400 patents, bringing our patent portfolio to over 17,000 worldwide. This happens to be the fastest rate of innovation as measured by product introduction and patent generation in HP history.

We believe that open, standards-based modular building blocks are the surest way to lower acquisition costs. And that is why you have seen us—and will continue to see us—invest heavily to make sure that our product line is the most modular, the most standards-based in the industry, because we think modularity and openness gives you flexibility and choice.

You'll also see us stick to an engineering paradigm that bets on heterogeneity and a diverse technology environment . . . [Customers] are going to see us continue to invest in being the leading platform provider for NT, for UNIX and Linux platforms. Because we think all three are critical in building out an IT infrastructure.

We . . . have a standards-based building block approach to systems design in engineering—again, in everything from computing to storage.

We're focused on providing the best price/performance curve—hi-tech, low cost.

HP ships more Linux servers than anyone else in the world. Our Linux business is now a $2 billion business annually inside HP. We partner with Oracle as well as SAP on Linux. And we think we have a lead in Linux for sure in the high-performance technical computing realm. Importantly, we have the most comprehensive set of service offerings in Linux, and frankly, we think it is the service offerings as well as our technology that set us apart when we are competing on Linux opportunities. We don't see a company like Dell, for example, in the competition really at all because of the importance of the service and support offerings.

. . . We have been a leader in standards for many, many years, and have about 700 people who work in about 300 different standards organizations around the world, and we think we clearly have one of the largest and most effective standards programs in the industry. We are really focusing our standards efforts and the participation in these standards bodies in areas like improved compatibility and interoperability, because it is compatibility and interoperability that is critical to giving you the flexibility and adaptability and economic benefit that you're looking for.

We at HP are very excited about where we are today. Fundamentally, we think we have a very different set of investments and approaches to the marketplace than our competitors, and we believe that freedom of choice, adaptability, and the best return on information technology is what [customers] want and where we have an advantage.

We want to be the company that gives [customers] the best technology, at the lowest cost with the best total customer experience. That is the strategy that HP is focused on. That is the value we are delivering today in the marketplace.

IBM

IBM was seen as a "computer solutions" company and had the broadest and deepest capabilities in customer service, technical support, and systems integration of any company in the world. IBM's Global Services business group was the world's largest information technology services provider. IBM had 2002 sales of $81.2 billion and earnings of $3.6 billion versus 2001 revenues of $83.1 billion and profits of $7.7 billion. Its two biggest and best-performing businesses were software and services (see Exhibit 9). Once the world's undisputed king of computing and information processing, IBM was struggling to remain a potent contender in PCs, servers, storage products, and other

exhibit 9 IBM's Performance by Business Segment, 2001–2002 (in billions of dollars)

Business Segment	External Revenues	Pretax Income (Loss) from Continuing Operations
2002		
Global services	$36,360	$3,657
Enterprise systems	12,646	1,561
Personal and printing systems	11,049	57
Technology	3,935	(1,057)
Software	13,074	3,556
Global financing	3,203	955
Enterprise investments	1,022	(293)
2001		
Global services	$34,956	$5,161
Enterprise systems	13,743	1,830
Personal and printing systems	11,982	(153)
Technology	5,149	177
Software	12,939	3,168
Global financing	3,407	1,143
Enterprise investments	1,118	(317)

Source: IBM press release, January 16, 2003.

hardware-related products. Since the early 1990s, IBM had been steadily losing ground to competitors in product categories it had formerly dominated. Its recognized strengths—a potent brand name, global distribution capabilities, a position as the longtime global leader in mainframe computers, and strong capabilities in IT consulting services and systems integration—had proved insufficient in overcoming buyer resistance to IBM's premium prices. Many of its former customers had turned to lower-priced vendors—the old adage "No one ever got fired for selecting IBM products" no longer applied. IBM's revenues had been essentially flat to down for the past five years.

Believing that open architectures and common standards were inevitable in the years to come, IBM management had begun turning the company away from dependence on its proprietary products and technology, where it had made its name and reputation, and toward standardized products and technologies in the mid-1990s. Even so, no cohesive strategic theme really stood out at IBM during the 1995–2002 period beyond that of growing its revenues from services and software as the company's business in hardware products eroded. To offset its declining share of PC and server sales, in 1998 and 1999 IBM moved to boost its R&D and manufacturing efforts to become a leading global supplier of computing components (hard drives and storage devices) and microelectronics products. It signed a long-term agreement with Dell to supply over $7 billion in components in 1999 and had increased its sales of parts and components to other PC makers as well.

IBM's Troubles in PCs IBM's market share in PCs was in a death spiral—it had lost more market share in the 1990s than any other PC maker. Once the dominant global and U.S. market leader, with a market share exceeding 50 percent in the late 1980s and early 1990s, IBM was fast becoming an also-ran in PCs, with a global market share under 6 percent in 2002. Its last stronghold in PCs was in laptop computers, where its ThinkPad line was a consistent award winner on performance, features, and reliability. The vast majority of IBM's laptop and desktop sales were to large enterprises that had IBM mainframe computers and had been long-standing IBM customers. IBM's PC group had higher costs than rivals, making it virtually impossible to match rivals on price and make a profit.

IBM distributed its PCs, workstations, and servers through reseller partners, but used its own sales force to market to large enterprises. IBM competed against rival hardware vendors by emphasizing confidence in the IBM brand and the company's long-standing strengths in software applications, IT services and support, and systems integration capabilities. IBM had responded to the direct sales inroads Dell had made in the corporate market by allowing some of its resellers to economize on costs by custom-assembling IBM PCs to buyer specifications.

Gateway

Gateway, a San Diego–based company (recently relocated from South Dakota), had 2002 revenues of $4.2 billion (down from $6.1 billion in 2001) and a net loss of $309 million (an improvement over the loss of $1.03 billion in 2001). Gateway's all-time peak revenues were $9.6 billion in 2000 and its peak-year profits were $428 million. Founder, chairman, and CEO Ted Waitt, 41, owned over 30 percent of the company. Waitt had dropped out of college in 1985 to go to work for a computer retailer in Des Moines, Iowa; after nine months, he quit to form his own company. The company, operating out of a barn on his father's cattle ranch, sold add-on parts by phone for Texas Instruments' PCs. In 1987, the company, using its own PC design, started selling fully equipped PCs at a price near that of other PC makers. Sales took off, and in 1991 Gateway topped the list of *Inc.* magazine's list of the nation's fastest-growing private companies. The company went public in 1993, achieving sales of $1.7 billion and earnings of $151 million. The company had differentiated itself from rivals with eye-catching ads; some featured black-and-white-spotted cows, while others featured company employees (including one with Waitt dressed as Robin Hood). Gateway, like Dell, built to order and sold direct.

Gateway entered the server segment in 1997. In 1999, the company became the first PC maker to bundle its own Internet service with its PCs. To promote the Gateway name in the retail marketplace, the company had opened 280 Gateway Country Stores—227 in the United States, 27 in Europe, and 26 in the Asia-Pacific region—that stocked Gateway PCs and peripheral products and that conducted classes for individuals and businesses on the use of PCs. It had also launched an online software and peripheral Web store with more than 30,000 products.

Gateway's strength had traditionally been in the consumer segment. Going into 2000, Gateway was the number one seller of PCs to consumers, but it lost its lead over the next two years to Dell Computer. In 2001–2002, Gateway's top management began a series of initiatives to reverse the company's deteriorating market position; the company had:

- Closed its retail stores in Canada, Europe, the Middle East, Africa, and the Asia-Pacific region, along with 70 underperforming U.S. retail locations.
- Combined its consumer and business sales organization into a single unit.
- Focused its sales and marketing efforts on consumers, small and medium-sized businesses, educational institutions, and government.
- Consolidated its manufacturing operations and call center operations, paving the way for a 50 percent cutback in its workforce in 2001. Manufacturing operations in Ireland and Malaysia were closed, and all production was moved to the company's two existing plants in South Dakota and Virginia. Further cutbacks to reduce the workforce from 14,000 to 11,500 employees were announced in early 2002.
- Supplemented its sell-direct distribution strategy by stocking a limited inventory of prebuilt Gateway PCs in its retail stores that customers could take home immediately.
- Improved its offering of digital cameras, music, and videos and actively marketed broadband Internet services to its customers via alliances with a number of cable broadband Internet access providers.
- Worked with third-party financing partners to provide financing for businesses and consumers to purchase gateway PCs.
- Introduced a sleek new line of desktop and notebook PCs with industry-leading features. Gateway's notebook sales in 2002 outpaced the U.S. market, growing by approximately 16 percent. Gateway's desktop PCs earned numerous awards, including *Computer Shopper*'s "Best PC Line of the Year" in 2002 for the Gateway 700 Series, *PC World*'s "Best Buy" in the office PCs value cate-

gory for the Gateway 500S, and *PC Magazine*'s "Editor's Choice" in a round-up of value PCs for the Gateway 300S Value.

- Refreshed its spotted-cow box logo used since 1998.
- Expanded and improved its e-support, local support, and call centers—moves that boosted the company's already leading customer satisfaction rankings by 5 percentage points, according to Alliance Research.
- Started selling consumer electronics products made by other manufacturers in its retail stores, including digital cameras, MP3 players, and high-end plasma-screen TVs.

Going into 2003, it was unclear whether Gateway could become a strong contender in the domestic PC market. Its fourth-quarter 2002 results were disappointing: revenues of $1.06 billion (versus a best-case scenario of $1.2 billion) and shipments of only 720,000 PCs despite heavy advertising and aggressive pricing during a holiday-season quarter when its sales had typically been highest (Gateway had shipped 729,000 units in the traditionally weaker third quarter). Analysts believed that the company's retail stores were a "relatively expensive channel" that added about 10 percent to the company's cost structure.

Sun Microsystems

Sun's strength was in technical computing—it was the leader in high-end workstations and high-performance servers. But the Silicon Valley company, headed by pugnacious chairman and CEO Scott McNealy, was mired in difficulty in early 2003. Sales had nose-dived to $12.5 billion in fiscal 2002 (ending June 30) from an all-time high of $18.3 billion in fiscal 2001, and gross profit margins had dropped 20 percent. Fiscal 2002 losses were $587 million, down from record profits of $1.85 billion in fiscal 2000; in the first six months of fiscal 2003, Sun reported net losses of nearly $2.3 billion, partly due to write-offs and restructuring charges. Sun's stock price had fallen from its all-time high of $64 to around $3 per share in February 2003. According to a *Business Week* article:

> A fearsome posse of competitors, from Dell Computer to Microsoft and Intel, is battering its way into Sun's core market for computer servers, selling low-cost machines at a fraction of Sun's price. A few years ago, servers powered by Microsoft Windows software and Intel chips couldn't perform in the same league with Sun. Now they can. Worse, Linux's open-source software is making inroads into McNealy's market. It's created by legions of volunteers, and it's free—a price that's hard to beat. McNealy finds himself selling the tech equivalent of a Mercedes in a market of Honda buyers.[28]

Sun customer E*Trade Group had recently replaced 60 Sun servers costing $250,000 each with 80 Intel-powered Dell servers running Linux that cost $4,000 each.

Sun designed its own chips and wrote its own server software (called Solaris). It spent close to 18 percent of revenues on R&D, aiming at outcompeting rivals by having Sun servers and Sun software run superefficient networks better than rival brands of servers and software. It had cash and cash equivalents of close to $5 billion and had recently bought back $500 million worth of common stock, paid down its debt by $200 million (leaving it with long-term debt of $1.5 billion), and shaved about $600 million out of its supply chain (boosting its gross margins by about 5 percent). It had also begun outsourcing servers that ran on Linux, which Sun was selling at prices starting about $2,700. McNealy's goal was for Sun to have a 30 percent share of what was expected to be a $6.5 billion market for Linux-based servers in 2004. Sun's strategy was also to move bigger into services; the company had tripled the size of its service staff to 13,000 employees. In January and February 2003, Sun announced a blitz of new, high-performing server products at very competitive prices.

MICHAEL DELL'S VIEW OF DELL COMPUTER'S PROSPECTS AND CHALLENGES

In a February 2003 article in *Business 2.0*, Michael Dell said, "The best way to describe us now is as a broad computer systems and services company. We have a pretty simple system. The most important thing is to satisfy our customers. The second most important thing is to be profitable. If we don't do the first one well, the second one won't happen."[29] For the most

[28]"Will Sun Rise Again?" *Business Week*, November 25, 2002, p. 120.

[29]Kathryn Jones, "The Dell Way," *Business 2.0*, February 2003; posted at www.business2.com.

part, Michael Dell was not particularly concerned about the efforts of competitors to copy many aspects of Dell's build-to-order, sell-direct strategy. He explained why:

> The competition started copying us seven years ago. That's when we were a $1 billion business. Now we're [$36] billion. And they haven't made much progress to be honest with you. The learning curve for them is difficult. It's like going from baseball to soccer.[30]
>
> I think a lot of people have analyzed our business model, a lot of people have written about it and tried to understand it. This is an 18½ year process . . . It comes from many, many cycles of learning . . . It's very, very different than designing products to be built to stock . . . Our whole company is oriented around a very different way of operating . . . I don't, for any second, believe that they are not trying to catch up. But it is also safe to assume that Dell is not staying in the same place. You know, this past year we've driven a billion dollars of cost out of our supply chain, and certainly next year we plan to drive quite a bit of cost out as well.[31]

In a presentation at the University of Florida in the fall of 2002, Michael Dell explained how the company decided to move into new areas, usually in an effort to get a bigger share of its customer's expenditures on IT:

> We tend to look at what is the next big opportunity all the time. We can't take on too many of these at once, because it kind of overloads the system. But we believe fundamentally that if you think about the whole market, it's about an $800 billion market, all areas of technology over time go through a process of standardization or commoditization. And we try to look at those, anticipate what's happening, and develop strategies that will allow us to get into those markets. In the server market in 1995 we had a 2 percent market share, today we have over a 30 percent share, we're number 1 in the U.S. How did that happen? Well, first of all it happened because we started to have a high market share for desktops and notebooks. Then customers said, oh yes, we know Dell, those are the guys who have really good desktops and notebooks. So they have servers, yes, we'll test those, we'll test them around the periphery, maybe not in the most critical applications at first, but we'll test them here. [Then they discover] these are really good and Dell provides great support . . . and I think to some extent we've benefited from the fact that our competitors have underestimated the importance of value, and the power of the relationship and the service that we can create with the customer.
>
> And, also, as a product tends to standardize there's not an elimination of the requirement for custom services, there's a reduction of it. So by offering some services, but not the services of the traditional proprietary computer company, we've been able to increase our share. And, in fact, what tends to happen is customers embrace the standards, because they know that's going to save them costs. Let me give you an example . . . about a year ago we entered into the data networking market. So we have Ethernet switches, layer 2 switches. So if you have PCs and servers, you need switches; every PC attaches to a switch, every server attaches to a switch. It's a pretty easy sale, switches go along with computer systems. We looked at this market and were able to come up with products that are priced about 2½ times less than the market leader today, Cisco, and as a result the business has grown very, very quickly. We shipped 1.8 million switch ports in a period of about a year, when most people would have said that's not going to work and come up with all kinds of reasons why we can't succeed.[32]

On another occasion, Michael Dell spoke about the size of the company's future opportunities:

> When technologies begin to standardize or commoditize, the game starts to change. Markets open up to be volume markets and this is very much where Dell has made its mark—first in the PC market in desktops and notebooks and then in the server market and the storage market and services and data networking. We continue to expand the array of products that we sell, the array of services and, of course, expand on a geographic basis.
>
> The way we think about it is that there are all of these various technologies out there . . . What we have been able to do is build a business system that takes those technological ingredients, translates them into products and services and gets them to the customer more efficiently than any company around.
>
> We only have about a 3 percent market share in the $800 billion-plus IT market, so we think . . . we've got a lot more opportunity going forward . . . It's a pretty exciting time to be in our industry and the opportunities are pretty awesome.[33]

[30]Comments made to students at the University of North Carolina and reported in the *Raleigh News & Observer,* November 16, 1999.

[31]Remarks by Michael Dell, Gartner Fall Symposium, Orlando, Florida, October 9, 2002; posted at www.dell.com.

[32]Ibid.

[33]Remarks by Michael Dell, MIT Sloan School of Management, September 26, 2002, and posted at www.dell.com.

case 3

McDonald's: Polishing the Golden Arches

Lou Marino
The University of Alabama

Katy Beth Jackson
The University of Alabama

When Ray Kroc built on the work of Dick and Maurice McDonald to form the McDonald's franchising system in 1955, he had a vision of building a restaurant chain that served a "low-priced, value-oriented product fast and efficiently in clean and pleasant surroundings."[1] In building McDonald's he probably never dreamed that it would become the world's largest burger chain, and one of the world's best-known brands, with over 30,000 stores worldwide, 46 million customers a day, and $41 billion in sales. Unfortunately, he probably also never foresaw that his beloved company would one day receive a customer service ranking that was not only the lowest among all national fast-food chains, an unenviable rank it has held since 1994, but also lower than any of the U.S. domestic airlines and, perhaps most notably, even lower than the U.S. Internal Revenue Service (based on the University of Michigan's American Customer Satisfaction Index).[2]

The fortunes of McDonald's have changed so drastically over the last two decades that David Sires of *Fortune* wrote, "If you hear of a 'Big Mac Attack' these days, it comes with chest pains. At least at McDonald's headquarters in Oak Brook, Ill., where the bad news tends to be super-sized."[3] Indeed, McDonald's posted its first ever quarterly loss—$343.8 million—in January 2003, revenue growth has been in decline, and same-store sales fell for 12 straight months prior to April 2003. The company's current situation has been attributed to a number of factors, including increased competition, poor management and marketing, and a failure to respond to the changing needs of customers and franchisees.

In the midst of these challenges, James Cantalupo came out of retirement in January 2003 to take the reins of the foundering Fortune 500 company, which he admitted was "in serious need of improvement." Cantalupo immediately announced an aggressive, broad-ranging turnaround plan designed to add customers instead of units. The purpose of this plan was to refocus McDonald's on its mission by increasing focus on internal operations, slowing store expansion (opening 640 fewer units than in 2002), enhancing the relevancy of McDonald's to its customers, and making the consumer the new boss at McDonald's.

By December 2003 McDonald's had begun to show signs of a successful turnaround, with three consecutive months of double-digit comparable sales growth. October sales were up by 10.2 percent, and November 2003 sales increased by 14.9 percent, as compared to November 2002. Analysts applauded these activities, and McDonald's stock price rose from a low of $12.50 in March 2003 to $25.28 as of December 23, 2003. While these changes have been substantial, the question remains of whether McDonald's series of missteps has allowed competitors to entrench themselves so firmly that the company will be unable to regain its prominent position in the global fast-food industry.

[1]Ray Kroc, with Robert Anderson, *Grinding It Out: The Making of McDonald's* (Chicago: H. Regnery, 1977).

[2]Grainger David, "Can McDonald's Cook Again?" *Fortune*, March 30, 2003.

[3]David Sires, "McDonald's Fallen Arches," *Fortune*, April 14, 2002.

THE FOUNDING AND DEVELOPMENT OF McDONALD'S CORPORATION

In 1937 brothers Dick and Maurice "Mac" McDonald opened a tiny drive-in east of Pasadena, California, where they worked cooking hot dogs, mixing shakes, and waiting on customers.[4] The success of this location led the brothers to open a much larger drive-in at 14th and E streets in San Bernardino, California. The new restaurant employed 20 car hops and served a menu with 25 items ranging from pork sandwiches and ribs to barbequed beef and hamburgers. The operation was wildly successful. By 1948 the brothers were wealthy beyond their expectations but were growing tired of running their operation in the face of increased competition, a labor shortage, and increasingly complex operations.

To address these issues they decided to overhaul their operations. In analyzing their sales they discovered that hamburgers accounted for 80 percent of their business. This revelation led the brothers to close their business for three months in 1948 to allow themselves to introduce a revolutionary new business model based on their new "Speedy Service System." This system featured a self-service restaurant instead of car hops, a limited menu with only nine items (a 15-cent hamburger, a cheeseburger, potato chips, pie, and five beverages), a kitchen that was redesigned to use an assembly-line layout, and an all-male staff.[5] The 15-cent price was important since it made eating out on a regular basis affordable for families, an element of the company's strategy that McDonald's still follows today. Initially the innovations were not well received, and sales fell to one-fifth of their previous level. However, the brothers believed in their business model and persisted.

By 1952 the operations were so successful that they were featured as a cover story for *Restaurant* magazine, and McDonald's signed its first franchisee, Neil Fox. Fox redesigned his own drive-in restaurant in Phoenix, Arizona, with the red-and-white tile building and Golden Arches on the sides that became the prototype for McDonald's restaurants. While Fox's operations were successful, the McDonald brothers did not aggressively pursue franchising because they were satisfied with their current income and did not want the headaches associated with building a national chain. Further, by his own admission, Dick McDonald was a "lousy franchise salesman."[6] However, the success of the McDonald brothers did not go unnoticed. They received numerous franchise inquiries and were offered financial backing by Carnation Corporation, which they turned down. By 1953 the brothers realized they were missing a significant opportunity and hired a franchise agent, William Tansey, to further their operations. Tansey, however, was forced to resign after a few months due to a heart ailment. Unfortunately, as the McDonald brothers were foundering in their franchising operations, counterfeit McDonald's began to crop up throughout California largely because of the brothers' willingness to give in-depth tours of their operations.

One of the numerous businessmen who came to observe the McDonald brothers' success firsthand was the vendor who supplied them with the Multimixer machines they used to mix milkshakes: a Mr. Ray Kroc. Kroc had heard about the business from his West Coast sales representative in 1953. By 1954 the store had purchased 10 Multimixers (a large operation would normally only need 2) and Kroc's curiosity was piqued. When Kroc visited the store, he was impressed with the volume of customers (about 150 at lunch), the speed of service (orders were filled in 15 seconds), the quality of the food, and the number of milkshakes sold (estimated at 20,000 a month). Initially Kroc only wanted a sales agreement to supply Multimixers to new franchisees, but he was told that he would have to wait until a new franchise agent was hired to replace William Tansey. After a week of reflection, Kroc called the McDonalds and became their exclusive franchise agent in the United States. The initial franchise deal included the brothers' retention of full control over the operations, with Kroc being prohibited from making changes in operations without their approval, as well as the establishment of a low franchise fee ($950 and 1.9 percent of sales, 1.4 percent to Kroc and 0.5 percent to the McDonald brothers). On March 2, 1955, Kroc formed the new franchising company named McDonald's System, Inc., and about six weeks later, on

[4]John F. Love, 1986. *McDonald's Behind the Arches* (Toronto: Bantam Books).

[5]Ibid.

[6]Ibid.

April 15, 1955, Kroc's prototype McDonald's restaurant opened for business in Des Plaines, Illinois.

By 1956, McDonald's System, Inc., had 14 restaurants with total sales of $1.2 million. In selling the franchises Kroc treated his franchisees as partners but insisted both on uniformity of operations so that customers would get the same food experience at every McDonald's and on keeping the establishments very clean. Franchisees who adhered to these policies and shared Kroc's commitment to quality, service, and cleanliness were well supported, and Kroc viewed his role as one of facilitating their success.

In 1960 Kroc and Harry Sonneborn, head of McDonald's finances, sought a $1.5 million loan to expand operations. In securing this loan, McDonald's Corporation was formed with Kroc acting as chairman of the board of directors and Sonneborn as the president and chief executive officer. (While Sonneborn was president and CEO in name, Kroc still ran the show.) Both men agreed that a top priority was negotiating a new franchise contract with the McDonald's brothers, as the current one was due to expire in a few years and Kroc was chafing under the restrictions placed on him by the McDonald bothers—he was beginning to become frustrated with what he saw as the brothers' naiveté toward business.[7] The contract was successfully renegotiated, but Kroc soon became dissatisfied again and it became apparent that for Kroc to have the level of control he felt he needed, McDonald's Corporation would have to buy out the franchise from the brothers. When Kroc made the offer, the brothers asked for $2.7 million (enough for each brother to have $1 million after taxes) and refused to include the original San Bernardino store in the deal. Both of these conditions infuriated Kroc, especially since the brothers wanted the $2.7 million immediately, not in deferred payments, and the San Bernardino store was one of the most profitable in the chain.

With the help of Sonneborn, Kroc was able to secure the necessary funding in 1961. Interestingly, Sonneborn sold the concept to investors primarily on the basis of McDonald's real estate operations and its model of buying property and leasing it to franchisees rather than on the company's fast-food operations. These real estate operations were to become a key to McDonald's business model—as the company would make more money from locating, building and opening more stores than any other chain in the business, spurring McDonald's to open more outlets than rivals.[8] Purely out of spite, Kroc went to San Bernardino as soon as the deal was signed, and opened a location one block away from the location he was denied; he also forced the brothers to remove their name and the McDonald's golden arches from the location.

In that same year a key element of McDonald's business model, the Hamburger University training program for McDonald's franchise owners and store managers, was established. The year 1963 was a banner one for McDonald's as the company reached two significant milestones. First, McDonald's was selling 1 million hamburgers a day. Ray Kroc sold McDonald's 1 billionth hamburger to Art Linkletter on Linkletter's national television show. Second, McDonald's had its first national meetings with its franchise holders. Then, in 1965, under the leadership of Kroc and Sonneborn, McDonald's became a public company, selling shares for $22.50 each in its initial public offering. About a year later, on July 5, 1966, McDonald's was listed on the New York Stock Exchange.

McDonald's reached another first in 1967 when the first price increase in its hamburgers occurred—going from 15 cents to 18 cents. That year also saw the resignation of Sonneborn after numerous disputes with Kroc and the installment of Fred Turner in his place. Turner had been with McDonald's since the early years, joining McDonald's System, Inc., in 1956 to work with Kroc on company operations as Kroc's protégé. The year 1967 also marked McDonald's initial involvement in international expansion with a new franchise that opened in Canada on June 1, 1967. In 1968, the 1,000th restaurant was opened in Des Plaines, not far from Kroc's original location, and the Big Mac was introduced systemwide. Soon the corporation began generating sales profits on a huge scale, and in 1970 a Minnesota restaurant became the first to reach $1 million in annual sales. The company also branched out in other ways that year, as a restaurant in Hawaii was the first to serve breakfast. New ideas occurred to company executives and franchisees often, and in 1971 the first McDonald's Playland opened in California; that feature has since become a regular one in many restaurant locations. That same year, the first Japanese, German, and

[7]Ibid.

[8]David, "Can McDonald's Cook Again?"

Australian McDonald's opened. By the end of the 1970s McDonald's had over 5,000 restaurants.

In 1984 two important events occurred: McDonald's served its 50 billionth hamburger, earning over $10 billion in sales with a new restaurant opening somewhere in the world every 17 hours, and its founder, Ray Kroc, passed away. Over the ensuing years McDonald's continued its international expansion and even opened a new restaurant in Moscow on January 31, 1990. This opening broke the record for the most people ever served by a single restaurant as more than 30,000 people lined up to visit the new restaurant.

In 1990, Fred Turner stepped down and was replaced by Michael Quinlan. During Quinlan's tenure McDonald's began to experience a number of challenges that would plague the company for years. First, customer preferences began to change due to technological advances such as the microwave oven and increasing health consciousness that led to decreased consumption of fried food and red meat. To further complicate matters, as the number of customers began to decline, the competition increased from other quick-service restaurants as well as from nontraditional outlets for reheatable prepared foods, including grocery and convenience stores. In response to customer desires for healthier fare, McDonald's experimented with new menu items such as the McLean Deluxe hamburger, a low-fat alternative to the Big Mac that was introduced in 1992 and that failed to ever become a solid menu item; a low-fat frozen yogurt; fat-free apple bran muffins; and the salad shaker, another failed product.

Increasing competition led McDonald's to continue aggressive store expansion in the United States; to seek new outlets, including partnerships with Walt Disney and Wal-Mart; and to further focus on international expansion. Increased domestic expansion led to cannibalization in existing franchises and caused increased tension between McDonald's and it franchisees. To ease these tensions, McDonald's discontinued its Quality, Service, Value, Cleanliness (QSVC) store evaluation system.

Increased domestic competition also led to an increased focus on McDonald's international expansion efforts. On April 23, 1992, McDonald's opened a location in Beijing, China, that drew a crowd of more than 40,000 customers that quickly swamped the location's 29 cash registers. As McDonald's increased its international expansion, the menus of international locations received a more local flavor. For example, the first kosher restaurant opened in Jerusalem in 1995; it did not serve dairy products, and it closed on Saturday, the Jewish Sabbath day. By the end of 1995, McDonald's foreign store count had expanded by over 100 percent, to more than 4,700 units from only 2,000 outlets in 1987. Despite these efforts, McDonald's continued to struggle and posted its first ever quarterly decline in annual earnings. In response to this, the board of directors ousted Quinlan in early 1999 and chose Jack Greenberg over Jim Cantalupo to be the new president, CEO and chairman of the board.

Greenberg took over the reins of the embattled fast-food giant at one of the most challenging times in the company's history. Competition among the largest fast-food rivals was increasing on multiple fronts, including an intense price war, rapid product innovation, and the addition of new stores. Internally, McDonald's customer service rankings had dropped considerably, quality was beginning to become inconsistent throughout the system, and store decor in many locations was considered dated. In response to these challenges, Greenberg announced a plan that he estimated would boost profits by 10 to 15 percent. Two of the key elements of this plan were continued store expansion efforts and diversification away from the hamburger segment through the acquisition of other quick-service restaurants (QSRs), including Boston Market, Chipotle, Donato's Pizzeria, Pret a Manger, and Fazoli's.

To combat rivals' product innovations, McDonald's introduced 40 new menu items, though none of these was particularly successful, as well as a new "Made for You" cooking system designed to allow customers to order and receive their food in 90 seconds. This initiative cost McDonald's $420 million ($20 million of which was in R&D), and each franchisee between $18,000 and $100,000 in kitchen upgrades. Unfortunately, "Made for You" did not produce the desired results and led to further tension between McDonald's and its franchisees. To resolve internal issues such as inconsistent quality and service, in 2001 McDonald's reinstituted its comprehensive restaurant review operation that included Quality, Service, Cleanliness (QSC) inspections, mystery shoppers, and a toll-free number for customers to provide feedback. The company also streamlined operations, reducing the number of regions from 37 to 21 (each region had a general manager and a team reporting to him or her that included a vice president of quality, service, and cleanliness), laid off 700 corporate employees, and announced the closure of 175 underperforming overseas outlets. Finally, Greenberg announced a plan to refurbish older stores at a cost of approximately $150,000 per store. Before Greenberg could fully implement all of these plans, in the fourth quarter of 2002 McDonald's posted its first loss since going public in 1965. Critics argued that Greenberg had launched too many initiatives simultaneously and had failed to properly implement any of them. The initiatives never produced the 10 to 15 percent increases in net profit Greenberg had promised. Taking full responsibility for McDonald's poor performance, Greenberg resigned in December 2002. At this critical juncture, the company called on Jim Cantalupo to come out of retirement, which he had entered after being passed over in favor of Greenberg in 1999, to lead a company that was one of the most recognizable brands in the world serving millions of customers daily in an increasingly complex environment in more than 120 countries.

THE QUICK-SERVICE SANDWICH INDUSTRY

In 2003 sales for the U.S. consumer food-service market totaled approximately $408 billion. While there were tens of thousands of fast-food outlets in the United States, including all of the regional and local outlets, the 10 largest chains in 2003 ranked by U.S. Systemwide Foodservice Sales accounted for about 14 percent of the total sales (see Exhibit 1).

Analysts generally segment the consumer food-service market into eight categories according to the type of food served and the concept on which operations are based: sandwich, pizza, chicken, family, grill-buffet, dinner house, contract, and hotel. In 2003 the top 30 sandwich chains had U.S. systemwide sales of approximately $64 billion. Of this amount, McDonald's accounted for almost 33 percent of the sales, the top 5 chains accounted for 71.70 percent of sales, and the top 10 chains 88.88 percent. Systemwide sales for the top 17 sandwich chains are shown in Exhibit 2, market share data is provided in Exhibit 3, and the top 10 sandwich chains based on number of U.S. units in Exhibit 4. Future growth in the sandwich segment was expected to be only around 2 percent annually for the foreseeable future.

exhibit 1 10 Largest Chains Based on 2003 Systemwide Sales

Chain	Sales (millions)
McDonald's	$20,305.7
Burger King	8,350.0
Wendy's	6,953.0
Aramark Global Food	5,334.0
Subway	5,230.0
Taco Bell	5,200.0
Pizza Hut	5,100.0
KFC	4,600.0
Applebee's Neighborhood Grill	3,182.6
Domino's	2,826.7
Total	$67,382.0

Source: Nation's Restaurant News.

Trends in the Quick-Service Sandwich Industry

Several trends were impacting the quick-service food industry. First, customers were increasingly focusing on value. In response to this trend most of the sandwich companies—including McDonald's, Burger King, Wendy's, Hardee's, and Jack in the Box—had implemented a version of a low-cost menu. Items on these menus were offered at the lowest possible competitive price, most commonly around 99 cents. When McDonald's was considering whether to implement a value menu in 2001, the company believed that its menu was "conceptually similar to the one that Wendy's, the nation's no. 3 burger chain, has relied on for years."[9] Wendy's introduced its value menu, with seven items, in late 1989, long before most other national chains even considered doing so; Hardee's began offering a value meal in 1996. Of the major competitors, only Sonic has refrained from following this trend; it offers regular-priced menu items but no specific "value" items.

[9]Amy Zuber, *Nation's Restaurant News* 35, no. 5 (December 10, 2001), p. 1.

exhibit 2 Systemwide Sales in the United States, 1998–2002 (Millions)

	2002	2001	2000	1999	1998
Top 100 chains	$152,523.8	$144,094.8	$136,512.0	$130,362.7	$122,733.7
Top 17 sandwich chains	61,049.2	58,840.9	56,559.7	54,814.6	51,736.8

exhibit 3 Market Shares for Fast-Food Sandwich Chains, 1998–2002

	1998		1999		2000		2001		2002	
	Rank	Market Share*	Rank	Market Share*	Rank	Market Share*	Rank	Market Share*	Rank	Market Share*
McDonald's	1	35.08%	1	34.92%	1	34.43%	1	33.74%	1	33.26%
Burger King	2	15.94	2	15.55	2	15.29	2	14.85	2	13.68
Wendy's	3	9.65	3	9.98	3	10.22	3	10.50	3	11.39
Taco Bell	4	9.66	4	9.55	4	8.97	4	8.24	5	8.52
Subway	5	5.99	5	5.88	5	6.66	5	7.54	4	8.57
Arby's	6	4.01	6	4.15	6	4.24	6	4.32	6	4.41
Dairy Queen	7	3.89	7	3.94	7	3.91	7	3.72	9	3.59
Hardee's	8	4.63	8	3.93	8	3.57	8	3.37	10	2.78
Jack in the Box	9	2.81	9	3.23	9	3.38	9	3.57	7	3.67
Sonic Drive-In	10	2.58	10	2.92	10	3.13	10	3.32	8	3.61
Carl's Jr.	11	1.52	11	1.63	11	1.76	11	1.86	11	1.67
Whataburger	12	0.93	12	0.92	12	0.98	12	1.03	12	1.09
White Castle	13	0.81	13	0.81	13	0.83	13	0.79	14	0.80
Schlotzsky's Deli	14	0.66	14	0.72	14	0.74	14	0.70	17	0.63
Blimpie Subs and Salads	15	0.75	15	0.70	15	0.68	18	0.59	Not ranked	—
Krystal	16	0.64	16	0.63	16	0.63	16	0.63	15	0.64
Del Taco	17	0.60	17	0.53	17	0.58	17	0.60	16	0.64
Quizno's	Not ranked	—	Not ranked	—	Not ranked	—	15	0.65	13	1.06

*Market shares are based on McDonald's estimates of the size of the entire market.

Source: Nation's Restaurant News.

Consistent with the increased focus on value, major competitors, especially McDonald's and Burger King, had been willing to use price cuts to attract customers. Both of those companies marketed their signature sandwiches, the Big Mac and Whopper, respectively, for only 99 cents in 2002. However, the use of price cuts as a competitive weapon had abated as McDonald's and Burger King shifted tactics in an attempt to curb deep discounts. Both chains have shifted their competitive tactics to focus on building customer loyalty by updating menu items, increasing efficiency, and improving service. A Burger King spokesperson said, "If McDonald's wants to price its product at 99 cents, then they should do that. But the Whopper is a premium deluxe sandwich and . . . Burger King believes it is worth far more than 99 cents."[10]

While customers were focused on price, they were also concerned with quality. In addition, health-conscious consumers were increasing their demands. Although several chains had been aware of a need to offer healthier fare for years, a recent lawsuit brought by

[10]Kim Miller, quoted in ibid.

exhibit 4 **Top 10 Sandwich Chains Ranked by Number of U.S. Units, 2002**

Chain	Units
Subway	14,522
McDonald's	13,491
Burger King	8,146
Taco Bell	6,165
Wendy's	5,549
Dairy Queen	4,870
Arby's	3,250
Sonic Drive-In	2,533
Hardee's	2,229
Jack in the Box	1,862

Source: Nation's Restaurant News.

eight teens against four fast-food chains for causing obesity caused many of these restaurants to renew efforts to offer healthier menu items ranging from salads and soup to healthier hamburgers such as veggie or turkey burgers. The lawsuit was later dismissed by the court, but it had a far-reaching impact. One response to this change in customer demands was the introduction of gourmet salads. Wendy's was the first nationally franchised quick-service restaurant to sell gourmet salads, beginning in 2002, and was generally considered the market leader in that area. In fact, according to one source, "30 percent of those who have bought [Wendy's] Garden Sensations salads came just for that."[11] Since their first appearance on the market, salads had become a regular feature of most fast-food restaurants' menus because they appealed to a wide range of consumers looking for a fast, healthier alternative to burgers and fried foods. Other companies had begun offering other low-fat options: Burger King was acknowledged as the first and only chain that offered customers a veggie burger, and the slogan for a new ad campaign was "Flavor from fire-grilling . . . not from fat," while Jack in the Box was one of the only fast-food restaurants where consumers could find a turkey burger.

As an extension of this trend, several fast-food companies were testing new ideas and menu items on kids' menus to determine a reaction and to show parents that they were concerned for their children's health. For example, Subway had begun replacing cookies and soft drinks in its kids' meals with fruit roll-ups and fruit juice, Wendy's was trying to substitute milk for soft drinks in kids' meals in North Carolina, and in a few select locations McDonald's was replacing french fries in Happy Meals with apple slices. Many of these hamburger chains were concerned that if they did not introduce more appealing, healthy fare, consumers would begin turning toward chains that were intrinsically healthier, such as deli sandwich chains like Subway. Indeed, by 2003, there were more Subway restaurants in the United States than McDonald's and sandwich outlets had become part of the fastest-growing segment of the quick-service restaurant industry—the "other sandwich" was growing at a rate of 12.8 percent, compared to a 2.8 percent growth rate in the hamburger segment.

Another developing trend in the industry involved broadening the customer focus to include younger, hipper consumers as well as more sophisticated customers. One way McDonald's was attempting to achieve this was by hiring Justin Timberlake and other popular singers to be the singing voices of some of its new advertisement schemes, such as the "I'm lovin' it" campaign. Many of the changes made in the area of health had a side benefit by appealing to consumers who were looking for fast food that was slightly classier and more "gourmet." Items such as grilled chicken and premium chef's salads came across as more tasteful fare than a plain hamburger and french fries. Chains that offered items other than hamburgers were also following the trend to include more gourmet offerings in their food. Several of Arby's Market Fresh sandwiches included thick-sliced pepper bacon, smoked mozzarella cheese, roasted red peppers, and baguette-type bread. The young and hip today would be the mothers and fathers of the next generation, and fast-food restaurants of all types were attempting to firmly establish a loyal customer base now for improved long-run security.

The International Quick-Service Restaurant Industry

According to Euromonitor, the global food-service industry was expected to grow by more than $200 billion between 2002 and 2006. Many of the trends affecting

[11]Gregory Richards, *Knight Ridder Tribune Business News,* October 18, 2003, p. 1.

exhibit 5 Systemwide Outlets for the Top Five Fast Food Hamburger Chains, 2002

	Domestic Outlets	Foreign Outlets	Total Systemwide Outlets	Number of Countries
McDonald's Corporation	13,491	16,534	31,108	120
Burger King Corporation	8,146	3,309	11,455	58
Wendy's International	6,273	2,538	8,811	22
CKE Restaurants (Hardee's)	3,101	194	3,295	15
Jack in the Box	2,000	0	2,000	1

Source: Nation's Restaurant News.

the domestic fast-food industry were evident in the wider international market. For example, due to their success in the United States and Canada, many companies were introducing value-priced menus overseas to test consumer reactions. Another trend was increased offerings of healthy foods and premium products in overseas markets. For example, McDonald's had introduced the McChicken Premiere, a zesty chicken breast filet served on a focaccia bun, in the United Kingdom, France, Italy, and Belgium, as well as Le 280, a premium sandwich, in France. McDonald's had had a continuous struggle recently between offering value-priced items and offering more expensive products: "We offer a variety of price and taste options designed to attract price-sensitive consumers, as well as those who are willing to pay more for premium products."[12]

McDonald's and Burger King, especially, were the earliest and most aggressive hamburger chains to begin to expand internationally (see Exhibit 5). For McDonald's the first store outside the United States opened in Canada in June 1967. That company's first store openings in new countries had consistently drawn huge crowds of people, sometimes upward of 40,000 consumers on the opening day. Burger King's first international restaurants opened in 1963 in Puerto Rico; the first European Burger King opened in 1975 in Madrid, Spain.

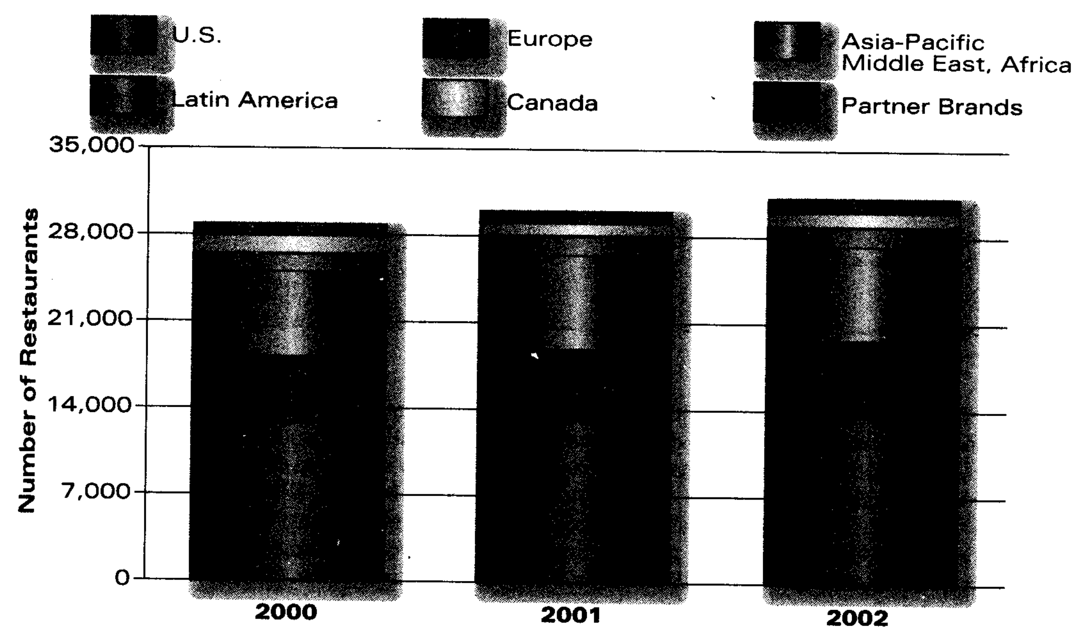
In foreign countries both McDonald's and Burger King had traditionally offered menu items with a distinctively local flavor. For example, in Chile, Burger King offered the Broiled Salmon Fish Sandwich, the breakfast burrito in Mexico, and other seasonal dessert items throughout Central and South America. McDonald's Le 280, offered in France, was a sandwich with a distinctive sauce designed especially to appeal to the French palate; the stores in Jerusalem offered only kosher menu items, and no dairy products.

Wendy's had also experimented with international expansion, but with slightly less success than the top two hamburger chains. Two factors that may have influenced Wendy's struggle internationally were that it was a relatively new company and that it had been much slower to begin expanding overseas. When the crisis over bovine spongiform encephalopathy (mad cow disease) occurred in Europe and the financial crisis occurred in the Far East during the 1990s, the company became hesitant to aggressively expand internationally; it even closed seven stores in the United Kingdom and all stores in Hong Kong. Furthermore, in 2001, Wendy's was forced to abandon its Argentinean operations altogether because of that country's deep financial problems. Wendy's International simply lacked a strong enough foothold in any international market to support these failing ventures. Instead, the company was forced to turn to improving domestic operations and continuing growth through acquisitions.

All of the fast-food chains had consistently reported steady international expansion and growth of sales in international markets. In fiscal year 2003, Burger King had 55 new store openings in the Latin American/Caribbean region alone. In that same fiscal year and region, Burger King reported sales of $594 million, more than 10 percent growth in system sales over the prior year. In fact, every fiscal year since 2001, Burger King had reported decreased numbers of U.S. stores but increased numbers of international locations. However, McDonald's had represented the strongest international presence and greatest amount of worldwide sales since the beginning of overseas expansion. In 2002, the U.S. sector of the company was beginning to comprise less than half of total systemwide

[12]McDonald's company report, "Revitalization Plan," 2003.

exhibit 6 **McDonald's Systemwide Restaurants by Segments, 2000–2002**



Source: www.mcdonalds.com.

restaurants (see Exhibit 6); the rest of the world housed more than half of all McDonald's restaurants. Those numbers were expected to grow wider apart because the U.S. fast-food market was rapidly becoming saturated. The fast-food chains were recognizing the saturation of the industry and beginning to see the crucial importance of international expansion; growth in other countries was expected to be one of the only sources of growth for many of the top hamburger chains in future years.

McDONALD'S MAIN COMPETITORS

Burger King Corporation

Next to McDonald's, Burger King was the second largest hamburger fast-food chain in the world. Headquartered in Miami, Florida, the company had locations in 58 countries, with almost 11,400 Burger King stores across the globe, and derived 55.3 percent of its revenues from drive-through operations. Although McDonald's revenues in 2002 were significantly higher than those of Burger King—$15.4 billion and $1.72 billion, respectively—McDonald's revenues represented only a 4 percent increase over the past year, whereas Burger King's revenues had increased by almost 17 percent in the same period. In 2002, the company was put up for sale by its parent company, Diageo, because of its declining market share, and was purchased by a coalition formed by Texas Pacific Group, Bain Capital, and Goldman Sachs Capital Partners. Exhibit 7 provides information on the number of Burger King outlets and total sales from 1998 to 2003.

Founded in 1954 in Miami, Burger King offered quality food at affordable prices, much like any other fast-food hamburger chain. The Whopper was first introduced in 1957 and became an immediate success and a trademark menu item of Burger King. In advertising, the company noted both the Whopper's unique charbroiled taste and the company's policy of preparing the hamburger any way the customer wanted it. Burger King's early achievements made it a natural candidate for franchises, and so a natural competitor of McDonald's corporation, which was also being franchised and expanded during that time.

Even early on, the company sought to distinguish itself in a rapidly growing industry by providing its customers with a unique fast-food experience. One way it *exhibit 7* **Burger King Outlets and Sales, 1998–2003**

	Fiscal Year					
	2003	2002	2001	2000	1999	1998
Outlets						
United States	7,904	8,146	8,306	8,293	8,020	7,691
International	3,431	3,309	3,066	2,868	2,506	2,144
Total	11,335	11,455	11,372	11,161	10,526	9,835
Sales (in billions)						
United States	$ 7.9	$ 8.6	$ 8.5	$ 8.7	$ 8.5	$ 8.2
International	3.2	2.7	2.7	2.7	2.4	2.1
Total	$11.1	$11.3	$11.2	$11.4	$10.9	$10.3

achieved this was by enclosing its patio seating in 1957, thereby offering customers an indoor dining experience for the first time in fast-food history. Another example occurred in 1975, when Burger King began to install and operate drive-through windows at its restaurants. Now customers who were busy with family, jobs, and children could buy a quality meal in a hurry without ever leaving the car. Burger King's menu also offered a few items that set it apart from other fast-food restaurants. For breakfast, it offered the popular Crois-san'wiches and french toast sticks, and for lunch and dinner the menu included a veggie burger and the chicken Caesar salad.

Like McDonald's and virtually every other burger chain in the world, however, Burger King was being forced to respond to a shift in consumer preferences from high-calorie burgers and fries to less fatty, more health-conscious offerings such as deli sandwiches and baked potatoes. All fast-food hamburger chains, Burger King included, were expected to be struggling for several years to come to meet new consumer health expectations without compromising the menu items on which the companies were founded.

Wendy's International, Inc.

Wendy's Old-Fashioned Hamburgers was considered the third largest fast-food hamburger business in the world, although it reported higher revenues in 2002 than did Burger King. The company as a whole generated $2.73 billion in revenues in 2002, up 14.2 percent from the previous year. With headquarters in Dublin, Ohio, the corporation operated over 9,000 restaurants in 33 countries worldwide.

General menu items were similar to those of McDonald's and Burger King—hamburgers, chicken sandwiches, and fries—but Wendy's also offered several unique products such as Frostys and Spicy Chicken Sandwiches, as well as many healthy alternatives like salads, baked potatoes, and even chili. One very important innovation contributed by Wendy's was a special value menu that consisted of about 10 items that could be purchased for 99 cents. Since its initiation in Wendy's stores, the value menu had also been implemented in McDonald's and Burger King's restaurants in order to compete with Wendy's.

Founded in 1969 in Ohio by David Thomas, Wendy's Old Fashioned Hamburgers was incorporated and in 1976 had its first public offering of 1 million shares at $28 per share. By 1981 the company had been listed on the New York Stock Exchange and had built its 2,000th restaurant. Unlike a few of its competitors, Wendy's faced difficulties with international expansion (as noted earlier in this case). Despite these failures, the corporation had grown by acquiring several smaller companies such as Tim Horton's and Baja Fresh Mexican Grill.

Wendy's possessed several strengths and weaknesses in the fast-food business. The company's Super Value Menu was definitely one of its strongest assets, although the concept had been picked up by other major companies. Also, in 2002, most fast-food chains were desperately slashing prices in a bid to go increasingly lower. However, Wendy's chose that year as a time to focus on product quality and product expansion by offering its Garden Sensations, a new selection of fresh, healthy salads. One weak point in Wendy's business plan was the lack of an easily recognizable product comparable to McDonald's Big Mac or Burger King's Whopper.

As Wendy's moved into the future without founder Dave Thomas, who passed away in 2002, it planned to add between 2,000 and 4,000 new Wendy's locations in the next decade and to focus its international expansion in Latin America. However, the company's chief executive officer and chairman, Jack Schuessler, stated that the company planned to increasingly use acquisitions of smaller brands and joint ventures as the primary driver of future growth. In selecting potential acquisition targets, Wendy's was avoiding concepts that directly competed with core Wendy's offerings and looking to the fast casual segment and to concepts that involved offering high-quality food without table service.

Hardee's

Headquartered in St. Louis, Missouri, Hardee's was the fourth largest fast-food hamburger chain and a subsidy of the parent company CKE Restaurants. There were about 2,400 Hardee's restaurants in 32 states and 11 countries, and the company brought in $1.8 billion in 2002. The company was founded in 1960 in North Carolina, and its original menu featured charbroiled hamburgers and cheeseburgers for 15 and 20 cents, respectively.

The greatest strength of the company lay in its breakfast menu, which accounted for about 35 percent of Hardee's total revenues, and its new Thickburgers, which had been well received among hamburger eaters. CKE Restaurants as a whole had experienced many difficulties in recent years due to company debt and underperformance of several of its stores, including many Hardee's restaurants. In 2000, CKE sold almost 500 Hardee's stores and began working to revamp the chain's brand image. All of the restaurant buildings were being remodeled inside and out into Star Hardee's, and the menu was being expanded to include several premium offerings such as the Angus beef Thickburger. Because of the company's recent troubles, its efforts had been focused less on low prices and hardball competition and more on the mere survival and revitalization of the company. One notable product innovation was the Six Dollar Burger. According to Andrew F. Puzder, CEO and president of Hardee's Food Systems, Inc. (Hardee's management), the success of this product had demonstrated that customers were willing to pay more for quality and exceptional taste and had led Hardee's to position itself as the "premium burger specialist among quick-service restaurants."[13] Building on this success and consumer feedback, Hardee's had eliminated 40 menu items from the lunch and dinner menus and introduced a burger line featuring one-third-pound, half-pound and three-quarter-pound hamburgers.

Jack in the Box

The Jack in the Box drive-through hamburger chain was headquartered in San Diego and operated over 1,850 restaurants in 17 states. Jack in the Box, Inc., also owned Qdoba Mexican Grills and Quick Stuff Convenience Stores. In fiscal year 2002, the company's sales totaled $2.2 billion, a 4.7 percent increase over the past year's sales of $2.1 billion. Jack in the Box was subsidized in 1968, but in 1985 its managers succeeded in buying out their business and going private. In 1992, the company went public with a stock offering of 17.2 million shares and was listed on the NYSE as JBX.

Although other fast-food chains had focused on children as well as adults for a healthy percentage of their income, Jack in the Box menu items were geared toward adult consumers only and included hamburgers, Mexican food, and specialty sandwiches. The restaurant's traditional signature items included the Jumbo Jack, the Sourdough Jack, and the Ultimate Cheeseburger, while its more innovative offerings included a teriyaki chicken bowl and a chicken fajita pita. Like most of the other competitors, Jack in the Box also offered a value menu.

The company experienced a difficult year in 2002 due to several factors. An overall weaker economy damaged the company to some extent, and larger competitors were heavily involved in cutthroat price wars. The company did not wish to engage in those price wars and instead turned to improving the quality of its product as well as to initiating efforts to attract women, despite the fact that the company regards young men as its primary focus.

Jack in the Box, like its competitors, noted the necessity in the future of broadening its product offerings in order to compete with fast-food chains as well as grocery stores, which now offered many complete, healthy, cheap meals that the consumer could heat up at

[13]Company press release, "Hardee's Breaks Ranks from Competition," January 21, 2003.

home in a few minutes. In 2003, Jack in the Box's CEO, Robert Nugent, announced that his company would undertake a fast, casual systemwide makeover intended to reduce the company's reliance on its core market of males ages 18 to 34, and attract more women and older men. According to Nugent, "The fast-food hamburger segment of the quick-serve restaurant category has been crowded and mature."[14] Nugent estimated that the renovation would take between three and five years and involve a smaller menu, simplified restaurant kitchen operations, and the introduction of "premium items." Nugent also announced a decreased emphasis on value pricing, stating, "People seeking 99-cent deals probably will go elsewhere."[15] By the end of 2003, Jack in the Box had introduced new main-course salads (Asian Chicken, Southwest Chicken, and Chick Club), roasted turkey and club sandwiches on hearth-baked rolls (Jack's Classics), a chicken taco, and a turkey burger. As customers responded favorably to these innovations, fourth-quarter sales rose 18 percent over the same period the previous year.

Sonic

Sonic Corporation, whose motto was "Service with the speed of sound," was founded by Troy Smith in 1953 in Shawnee, Oklahoma, as a hamburger and root-beer stand called Top Hat.[16] The first location to bear the Sonic name, changed from Top Hat to avoid copyright infringement, was located in Stillwater, Oklahoma in 1956; the company was headquartered in Oklahoma City. By 2003 Sonic had grown to over 2,700 locations (approximately 80 percent of which were franchises) and systemwide sales of almost $2.4 billion. Although Sonic was significantly smaller than the major players in the fast-food industry, it operated the largest American drive-in restaurant business. Sonic had been listed as one of *Forbes*'s 200 best small companies for the last 10 years, as one of *Business Week*'s Hot Growth Companies in 2002 and 2003, and as one of the top franchise opportunities by *Entrepreneur* magazine.

Sonic's relatively broad menu and atmosphere attempted to emulate those of a bygone era for the consumer. Top 40 Oldies usually played over the speakers, carhops could be found serving the customers, and popular menu items included foot-long cheese coneys, toaster sandwiches, onion rings, tater tots, specialty soft drinks, and frozen shakes and malts. Sonic had a very good relationship with its franchisees, who developed many of the new menu items. In adopting new products for systemwide sales, Sonic tried to focus on items that were fun and novel. To compete with other fast-food businesses, Sonic began offering a breakfast menu in 1999 and rolled it out systemwide by the end of 2003.

Since its founding the company had experienced almost nonstop growth. The company's first public offering occurred in 1991, raising $52 million in capital that Sonic used to buy out some investors, pay off debt, and increase its working capital. The recent addition of a breakfast menu continued that trend of almost continuous growth in the fast-food industry. For the fiscal year 2004, Sonic expected earnings per share to grow between 16 and 17 percent through the addition of franchises and, to a lesser extent, company-owned drive-ins as well as by driving higher same-store sales through increased advertising designed to build brand awareness. Sonic opened 194 new drive-ins in fiscal 2003 (159 franchised and 35 company owned) and planned to open 190–200 new locations in fiscal 2004, 165–170 of these owned by franchisees. In the first quarter of fiscal 2004, which ended on November 30, 2003, systemwide same-store sales increased by 6.2 percent and net income increased by 20 percent over the same period the previous year. Sonic expected systemwide same-store sales to grow at a rate of 1–3 percent for fiscal 2004.

McDONALD'S CURRENT SITUATION

Management Team

Jim Cantalupo became chief executive officer and chairman of McDonald's Corporation on January 1, 2003. Cantalupo was a 28-year veteran of the company and had recently served as president and vice chairman of

[14]Susan Spielberg, "Jack in the Box Brand Renovation Could Aim to Tap Fast-Casual Allure," *Nation's Restaurant News* 37, no. 39 (September 29, 2003).

[15]Richard Gibson, "Jack in the Box CEO: 'We Went into the Southeast Too Quickly,'" *The Wall Street Journal,* September 17, 2003.

[16]Sherri Daye, "Sonic's First Fifty," *QSR Magazine,* September 30, 2003.

McDonald's. He first joined the company in 1974 as controller; a year later he was promoted to vice president and then senior vice president in 1981. Cantalupo also served on the board of directors of Sears, Roebuck, and Company; Illinois Tool Works, Inc.; World Business Chicago; and the Chicago Council on Foreign Relations. After stepping to the McDonald's helm, Cantalupo faced many challenges and problems, with the company suffering from recent profit losses, poor decisions, and poor management. He had begun taking steps to bring the company out of a downturn, but only time would tell whether or not his maneuvers were effective.

As chief operating officer and president of McDonald's Corporation, Charlie Bell was responsible for more than 30,000 McDonald's restaurants in over 120 countries. His immediately prior position had been as president of the European sector of the company, but he started as a regular restaurant worker in Sydney, Australia, at the age of 15. Bell's job was to be sure that the orders from the board of directors were carried out in all restaurants and countries. Matthew Paull was an executive vice president and chief financial officer of McDonald's as of 2001. Unlike the first two team members, Paull did not begin his career very early in the company; he joined in 1993, after an 18-year career with Ernst & Young. At McDonald's, Paull was responsible for all financial matters of the company and directly responsible for the reporting for information systems, accounting, facilities and systems, tax, treasury, and investor relations.

Michael Roberts was president of the U.S. sector of McDonald's Corporation. As such, he oversaw the functioning of the more than 13,000 restaurants. In 1977, Roberts joined the McDonald's team as a regional purchasing manager. He worked his way up through the ranks and also served as an advisory director to the corporation's board of directors. Russ Smyth was the president of the European segment of McDonald's Corporation; he oversaw 6,000 restaurants in over 51 countries. Beginning his career in 1984, and for the next 13 years, Smyth served in the financial arena of McDonald's; in 1987, he began to become involved in the international segment as well, with his appointment as staff director of the Europe group of the International Accounting Group. In 1988, Smyth became the first employee to receive the McDonald's President's Award, which was given to the company's top performing employees annually.

Fred Turner was senior chairman of McDonald's Corporation and a member of the board of directors. When Turner first became involved with McDonald's, he hoped to become a franchisee but instead became one of the first employees of McDonald's Corporation in 1956. By 1967, he was an executive vice president of the company. Turner became CEO of McDonald's in 1973 and then also chairman in 1977. That same year, Ray Kroc, McDonald's founder, became senior chairman; Turner had taken that position by 1990. After a long career with McDonald's, Turner was still actively involved with the company. Finally, Jim Skinner was vice chairman of McDonald's Corporation; his duties had recently been extended to include management of McDonald's Japan Limited, the company's second largest market, with more than 4,000 restaurants. Before this promotion, Skinner was president and chief operating officer of the company. Skinner's career began in 1971, when he became a restaurant manager trainee; he quickly advanced in the company and went on to hold numerous positions in the United States and international segments of the corporation.

McDonald's Business Model and Sources of Revenue

McDonald's income was provided by a variety of sources, including the company's restaurant operations (McDonald's and its partner brands), its vast real estate holdings and the retail sales of merchandise, a category that was potentially growing as a percentage of total revenue.

McDonald's restaurant operations included revenue from company-operated, franchised, and affiliated restaurant outlets in domestic as well as international markets. Over the past 10 years, franchised restaurants typically had accounted for approximately 60 percent or more of McDonald's total systemwide sales, while the company's own restaurants brought in just less than 30 percent of its sales revenue (see Exhibits 8 and 9). Globally, the combined markets in the United States and Europe accounted for the majority of the company's sales. Although the lion's share of existing McDonald's outlets were franchises, the profit of the company-owned restaurants comprised a fairly significant portion of the total income because the company kept and applied 100 percent of those profits rather *exhibit 8* **McDonald's Systemwide Sales by Type of Outlet 1992–2002 (sales in millions)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Franchised stores											
Sales	$14,474	$15,758	$17,146	$19,123	$19,969	$20,863	$22,330	$23,830	$24,463	$24,838	$25,692
Outlets	9,237	9,918	10,944	12,186	13,374	14,197	15,086	15,949	16,795	17,395	17,846
Company owned											
Sales	$5,103	$5,157	$5,793	$6,863	$7,571	$8,136	$8,895	$9,512	$10,467	$11,040	$11,500
Outlets	2,551	2,733	3,216	3,783	4,294	4,887	5,433	6,059	7,625	8,378	9,000
Affiliated stores											
Sales	$2,308	$2,674	$3,048	$3,928	$4,272	$4,639	$4,754	$5,149	$5,251	$4,752	$4,334
Outlets	1,305	1,476	1,739	2,330	3,216	3,844	3,994	4,301	4,260	4,320	4,244
Total	$21,885	$23,587	$25,987	$29,914	$31,812	$33,638	$35,979	$38,491	$40,181	$40,630	$41,526

Source: www.mcdonalds.com, December 1, 2003.

exhibit 9 **McDonald's Sales by Type of Outlet as a Percentage of Total Systemwide Sales, 1992–2002**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Franchised	66.13%	66.80	65.98	63.93	62.77	62.02	62.06	61.91	60.88	61.13	61.87
Company-operated	23.32	21.86	22.29	22.94	23.80	24.19	24.72	24.71	26.05	27.17	27.69
Affiliated	10.55	11.34	11.73	13.13	13.43	13.79	13.21	13.38	13.07	11.70	10.44

Source: www.mcdonalds.com, December 1, 2003.

than the much smaller portion of the franchises' profits it received. The affiliated restaurants segment had begun to bring in more profits within the past few years, as McDonald's acquired Boston Market in 2000, as well as Chipotle Mexican Grill and Donato's Pizza.

Franchises continued to play a significant role in McDonald's Corporation, as they had since the very first franchise was opened in Des Plaines, Illinois, in 1955 by Ray Kroc himself. The franchising process was extensive. When an individual financially qualified for a franchise and was approved, McDonald's searched for possible locations for the proposed restaurant, and after a franchisee had undergone extensive training, McDonald's purchased the most appropriate site. The franchisee was then assigned to the property and paid rent on that land in addition to typical franchise fees. Franchisees had two options: (1) They could either purchase an existing McDonald's restaurant from the company or from another franchisee and pay a down payment equal to 25 percent of the purchase price of the building and land, or (2) they could open a brand-new McDonald's, paying a 40 percent down payment on the property. The former option was the more common one, and although there was a stated down payment of 25 percent, McDonald's typically required a person to contribute a minimum of $175,000 in personal, nonborrowed funds. After that initial payment, McDonald's did not act as a finance corporation; the franchisee was responsible for obtaining financial assistance for the remainder of the purchase price.

After the franchise was established, there were several ways in which McDonald's continued to receive an income from each restaurant. First, a monthly service fee was charged to each franchisee, determined as a percentage of total monthly sales; in 2002, the service fee was 4.0 percent. The second revenue stream was provided by the rent the company charged for the property on which each franchise was located. From early in its history, McDonald's had recognized the value of real estate, and almost from the very beginning the company's policy had been to own all property on which a McDonald's outlet was built, regardless of whether that location was franchised or company-owned. This strategy, first conceived by Harry Sonneborn, had been a key element of McDonald's strategy since. Rent income varied from property to property, but it was estimated that McDonald's "generates more money from its rent than from its franchise fees."[17]

McDonald's real estate holdings and rent generated from these holdings had become an increasingly important component of the company's value and income. According to a *Wall Street Journal* article, "McDonald's is unique in the fast-food industry in that it owns much of its real estate, . . . giving the company more control over what it can do on the land."[18] McDonald's real estate holdings were significant in both their quantity and quality. In the vast majority of cases, McDonald's restaurants were located on prime high-traffic real estate that is highly visible and easily accessible. In fact, when McDonald's stipulated its conditions for a franchise location, requirements included a corner lot with at least 35,000 square feet of land whose entrance and exit were facilitated by a traffic light. While McDonald's did accrue a good bit of income from renting out the property to franchisees, that was certainly not the only way the company made money from its real estate—it also marketed excess land, property, and buildings on www.loopnet.com. Between rents and profits from land sales, McDonald's vast real estate holdings represented a significant portion of the company's value.

As McDonald's looked to the future, it was experimenting with several new methods of earning income. In the past, the company's initial public offerings in the United States and Japan had met with success, and if the company could grow enough, that option would be available to raise revenue in many of the other 120 countries where McDonald's had a presence. The company was also tentatively testing new methods of raising revenue, such as offering retail merchandise for sale in certain stores. There had been wide speculation about the exact nature of the products McDonald's could or would offer for sale to the public, ranging from watches to toys. Evidence that the company was moving into the age of computer technology could be found in its collaboration with Freddie Mac, a mortgage finance company, to install computers in certain

[17]Beverly Vasquez, "McDonald's Takes Bite from Its Land Holdings," *Denver Business Journal* 50, no. 8 (October 23–October 29, 1998), p. B9.

[18]Shirley Leung. "At McDonald's, Will 'Extension' Join the Menu?" *The Wall Street Journal,* Eastern edition, May 29, 2002, p. B1.

restaurants in order to provide customers with information about home ownership, courtesy of the Freddie Mac Web site. McDonald's past successes with franchises and real estate, combined with its new ventures in earning income, would allow McDonald's to remain a successful and, hopefully, profitable company for many years to come.

The recent recovery in McDonald's performance and stock price had been largely attributed to Cantalupo's implementation of the company's new strategy, known as McDonald's Plan to Win.

McDonald's Plan to Win

McDonald's Plan to Win focused on what the company had identified as its five key drivers of success: people, products, place, price, and promotion. The company expected that it would take between 12 and 16 months to implement this plan but believed that by focusing on these five key drivers the company would:

> fortify the foundation of [its] business through operations excellence and leadership marketing and lay the pipeline for long-term innovation . . . [by aligning] . . . the system around McDonald's plan to win—revitalizing the brand and becoming more relevant to a broader group of people by consistently delivering on the drivers of exceptional customer experiences allowing the company to attract new customers, encourage existing customers to visit [McDonald's] more often, build brand loyalty and, ultimately, creating enduring profitable growth for the company, the System and [its] shareholders.[19]

The first driver of exceptional customer experiences that McDonald's would focus on was people—that is, employees who were considered instrumental in delivering exceptional customer service. Accordingly, the company vowed to "do a better job of staffing our restaurants during busy periods and of training and rewarding our people to deliver outstanding service."[20] Specific initiatives the company intended to launch in this area included speeding up service by using more visual menu boards and reducing the menu, employing hospitality training to ensure the employees were friendly and focused on customer service, and using an interactive e-learning program to cost-effectively train restaurant staffs worldwide in customer service attitudes and skills. In Latin America, McDonald's was focusing on customer service by reinstituting hostesses to help carry trays and attend to customers' service needs. McDonald's would measure its success in this area through a reduction in complaints related to service and increases in friendliness scores and speed of service.[21]

The second driver of exceptional customer experiences McDonald's chose to focus on was its products. The company planned to be responsive to changing taste preferences and the growing interest in wholesome food choices and premium products.[22] Examples of premium products included the new McGriddles sandwiches introduced in the United States and Canada, as well as the McChicken Premiere, a chicken sandwich introduced in the United Kingdom, France, Italy and Belgium. McDonald's responsiveness to changing customer preferences was reflected in new white-meat Chicken McNuggets offered in the United States and Canada, expanded Happy Meal offerings in the United Kingdom that included no-sugar-added fruit drinks, and fruit slices that could be added for an extra fee, as well as the Premium Salads being offered in the United States and the Salads Plus Menu offered in Australia that included eight products, all of which had 10 grams of fat or less. McDonald's planned to judge its success in this area through improvements in its hot and fresh food scores.

The third driver was place, which involved making McDonald's a customer destination by making its restaurants cleaner, more relevant, and more modern. Consistent with this goal the company intended to "make McDonald's a place customers seek out because it serves the food they want in a contemporary, welcoming environment they want to be in—whether dining alone, with friends or with family."[23] Improving the relevancy of the customer experience was to be achieved through initiatives such as installing wireless technology and creating wireless "hot spots" in restaurants in 28 countries, and adding coffeehouses (McCafe) in select restaurants that included premium coffee, muffins, and pastries at a value price to enhance adult appeal. To make the restaurants cleaner and more modern, McDonald's was renovating, rebuilding, and

[19]McDonald's Revitalization Plan, 2003, www.mcdonalds.com.
[20]Ibid.
[21]Ibid.
[22]Ibid.
[23]Ibid.

exhibit 10 Customer Service Rankings, Fourth Quarter 2002

Company	Quality Ranking*	Drive-Through Time†	Drive Through Accuracy†
Wendy's International	74	116.22	86.54%
KFC Corporation (Yum! Brands, Inc.)	69	172.73	88.50
Burger King Corporation	68	160.52	88.04
Taco Bell Corporation (Yum! Brands, Inc.)	67	159.12	90.14
U.S. Internal Revenue Service	62	NA	NA
McDonald's Corporation	61	156.92	84.86

*University of Michigan's American Customer Satisfaction Index (ASCI).
†"The Best Drive Thru in America '03," *QSR Magazine*, www.qsrmagazine.com.

even relocating some of its buildings; the goal was to create a fresh, sophisticated, but family-friendly atmosphere. To measure success in the place driver, McDonald's planned to use restaurants' cleanliness scores, with the goal of returning them to their all-time highs.

The fourth driver was price, with a focus on improving productivity and value. In offering value, McDonald's concentrated on offering a broad variety of products at a range of price points that would appeal to price sensitive customers, such as McDonald's dollar menu in the United States, as well as those willing to pay for premium products. Measuring the price driver involved improvements in value-for-money scores and restaurant margins.

The final driver of exceptional customer experiences was promotion, through which McDonald's hoped to build trust and brand loyalty. Initiatives to support this driver included "creating messages that reinforce [the] brand and connect with key customer segments—families and young adults . . . [while] continuing to forge bonds of trust with customers and the communities in which we do business."[24] Specific programs included the "I'm lovin' it" campaign launched worldwide in 2003; more general efforts included making McDonald's an easy choice for families by offering both premium salads and improved Happy Meals, giving Ronald McDonald a more prominent place in marketing and goodwill efforts, targeting young adults with relevant advertising featuring music from leading recording artists, using advertising media beyond television, and being a leader in social responsibility.[25] Goals in this area included increasing brand awareness and increasing the number of Happy Meals sold per unit to the previous all-time high.

In conjunction with the Plan to Win was an effort to further enhance McDonald's focus on its core business. In December 2003 McDonald's announced significant changes in its partner brand activities. Specific changes included the sale of Donato's Pizzeria back to its owner, entering into a letter of intent to exit its domestic joint venture activities with Fazoli's, the discontinuation of the development of non-McDonald's brands outside of the United States, and the discontinuation of the Pret a Manger chain in Japan.

McDonald's Current Performance

Through January 1, 2003, McDonald's performance was lackluster on several metrics, including customer service rankings, employee turnover, and order-processing time. As previously mentioned, its customer service ranking was the lowest in the fast-food industry and even lower than that of the IRS (see Exhibit 10).

Several elements contributed to this poor service ranking. One factor was employee turnover. Within the fast-food industry employee turnover typically ran 300 percent a year, but McDonald's turnover rate tended to be higher than its rivals'. Another factor contributing to poor service rankings was slow service at the drive-through window; McDonald's ranked the fifth best in the industry, with an average service time of 156.92 seconds. Ahead of McDonald's were Wendy's (average time of 116.2 seconds), Chick-Fil-A (146.38), Krystal Burger

[24]Ibid.
[25]Ibid.

(149.57), and Checkers (153.59). McDonald's generated approximately 60 percent of it sales from its drive-through operations, but its service times were about 40.67 seconds behind rivals such as Wendy's.[26] This may seem insignificant, but each six-second increment translated into 1 percent loss in sales. Based on average franchise sales of $1.44 million, this translated into an annual loss of almost $97,000. In terms of order accuracy McDonald's also performed poorly, fulfilling only 84.41 percent (Compared to Chick-Fil-A's 97.30 percent) of the orders correctly and ranking 19th.

By implementing the strategies and tactics detailed in its Plan to Win, McDonald's intended to realize a significant improvement in performance. Short-term financial objectives included cutting capital expenditures by 40 percent in 2003, a decrease of approximately $1.2 billion. McDonald's also intended to use cash from 2003 operations to pay off debt and return some cash to shareholders through repurchase of shares and increased dividends.

Long-term financial objectives the company intended to achieve by 2005 and beyond included annual systemwide sales growth of between 3 and 5 percent, with approximately 1 to 3 percent of this growth from increased sales at existing restaurants and up to 2 percent coming from new restaurants, and growth in operating income of 6 to 7 percent and annual returns on incremental invested capital in the high teens.[27]

As McDonald's began to implement its Plan to Win, performance improvements in some areas became readily apparent. For example, by January 2, 2004, the company's stock price had reached a price of $24.79, from an all-time low of approximately $12.50 in March 2003, with some analysts predicting a price of $34.00 by the end of 2004. While this was a significant improvement, it was still well below the $40.00 per share price the stock was bringing in the late 1990s and the early 2000s. Key financial metrics are provided in Exhibits 11, 12, 13, and 14.

[26]David, "Can McDonald's Cook Again?"

[27]McDonald's Plan to Win, 2003.

THE FUTURE

By January 1, 2004, McDonald's had begun to show positive progress in its turnaround strategy. The company had enjoyed 11 straight months of sales gains, with double-digit gains in October (15.1 percent) and November (10.2 percent) 2003. While this turnaround was impressive, some analysts, such as Coralie Witter, a restaurant analyst from Goldman Sachs, were withholding judgment. Witter stated, "While we expect McDonald's to maintain same-store sales momentum near-term, long-term we think it will be tough to sustain [that] growth and thus margin expansion without a substantial improvement in operations."[28] Dean T. Haskell, a securities analyst from JMP, agreed, stating, "We do not believe same-store sales growth at these double-digit rates to be sustainable."[29] Analysts' specific concerns included McDonald's ability to sustain its current level of product innovation and competitors' ability to imitate McDonald's successful new products. Analysts also questioned the extent to which McDonald's recent recovery was a reflection of the changes it had made as opposed to a reflection of a cyclical recovery in the fast-food sector and currency gains from a weak dollar. (McDonald's systemwide sales growth in October was 17.8 percent, compared to the previous October but only 10.2 percent in constant currency.)

While pleased with McDonald's recent performance, even the company's chairman and CEO, Jim Cantalupo, believed that McDonald's still had work to do. To remind his staff of this, he sent a memo to them stating, "We have come a long way in creating the kind of momentum we will need to deliver on our stated goal of sustaining increases in sales and operating income." But he said the journey was far from over and that 2004 would be a "pivotal year."[30] The most significant question that remained was whether the changes Cantalupo had made were sufficient to provide McDonald's with the core competencies necessary to build a sustainable competitive advantage in the global fast-food industry.

[28]Richard Gibson, "McDonald's Is Recuperating but a Full Recovery Is a Ways Off," *The Wall Street Journal,* December 9, 2003.

[29]Ibid.

[30]Ibid.

exhibit 11 McDonald's Condensed Consolidated Statements of Income, 1998–2003 (in millions except per share data)

	Q3 2003	Q2 2003	Q1 2003	2002	2001	2000	1999	1998
Revenues								
Sales by company-operated restaurants	$3,351.2	$3,189.7	$2,856.1	$11,500.0	$11,041.0	$10,467.0	$ 9,512.5	$ 8,894.9
Revenues from franchised and affiliated restaurants	1,153.4	1,091.1	943.6	3,906.0	3,829.0	3,776.0	3746.8	3,526.5
Total revenues	$4,504.6	$4,280.8	$3,799.7	$15,406.0	$14,870.0	$14,243.0	$13,259.3	$12,421.4
Operating costs and expenses								
Company-operated restaurant expenses	$2,840.6	$2,744.0	$2,509.4	$ 9,907.0	$ 9,454.0	$ 8,750.0	$ 7,829.6	$ 5,261.6
Franchised restaurants—occupancy expenses	236.0	231.0	223.3	840.0	800.0	772.0	737.7	678.0
Selling, general, and administrative expenses	456.3	466.4	396.4	1,713.0	1,662.0	1,587.0	1,477.6	1,458.5
Other operating (income) expense, net	7.8	13.2	(4.0)	833.0	257.0	(196.0)	(105.2)	261.4
Total operating costs and expenses	$3,540.7	$3,454.6	$3,125.1	$13,293.0	$12,173.0	$10,913.0	$ 9,939.7	$ 9,659.5
Operating income	$ 963.9	$ 826.2	$ 674.6	$ 2,113.0	$ 2,697.0	$ 3,330.0	$ 3,319.6	$ 2,761.9
Interest expense	93.8	101.7	101.8	374.0	452.0	430.0	396.3	413.8
Nonoperating expense, net	47.0	16.3	25.2	77.0	52.0	18.0	39.2	40.7
Income before provision for income taxes and cumulative effect of accounting changes	$ 823.1	$ 708.2	$ 547.6	$ 1,662.0	$ 2,330.0	$ 2,882.0	$ 2,884.1	$ 2,307.4
Provision for income taxes	275.7	237.3	183.4	670.0	693.0	905.0	936.2	757.3
Income before cumulative effect of accounting	$ 547.4	$ 470.9	$ 364.2	$ 992.0	$ 1,637.0	$ 1,977.0	$ 1,947.9	$ 1,550.1
Cumulative effect of accounting changes, net of tax benefits of $9.4 and $17.6	—	—	(36.8)	(99.0)	—	—	—	—
Net income	$ 547.4	$ 470.9	$ 327.4	$ 893.0	$ 1,637.0	$ 1,977.0	$ 1,947.9	$ 1,550.1
Per common share								
Income before cumulative effect of accounting changes	$ 0.43	$ 0.37	$ 0.29	$ 0.78	$ 1.27	$ 1.49	$ 1.44	$ 1.14
Cumulative effect of accounting changes	—	—	(0.03)	(0.08)	—	—	—	—
Net income	$ 0.43	$ 0.37	$ 0.26	$ 0.70	$ 1.27	$ 1.49	$ 1.44	$ 1.14
Per common share—diluted								
Income before cumulative effect of accounting changes	$ 0.43	$ 0.37	$ 0.29	$ 0.77	$ 1.25	$ 1.46	$ 1.39	$ 1.1
Cumulative effect of accounting changes	—	—	(0.03)	(0.07)	—	—	—	—
Net income	$ 0.43	$ 0.37	$ 0.26	$ 0.70	$ 1.25	$ 1.46	$ 1.39	$ 1.1
Dividends declared per common share	$ 0.40							
Weighted average shares	1,271.5	1,272.5	1,269.6	1,273.1	1,289.7	1,323.2	1,355.3	1,365.3
Weighted average shares—diluted	1,281.0	1,277.5	1,270.3	1,281.5	1,309.3	1,358.5	1,404.2	1,405.7

Source: Company reports.

exhibit 12 **McDonald's Condensed Consolidated Balance Sheets, 1998–2003 (in millions except per share data)**

	Q3 2003	Q2 2003	Q1 2003	2002	2001	2000	1999	1998
Assets								
Current assets								
Cash and equivalents	$ 647.4	$ 520.4	$ 488.0	$ 330.4	$ 418.1	$ 421.7	$ 419.5	$ 299.2
Accounts and notes receivable	703.0	807.1	816.7	855.3	881.9	796.5	708.1	609.4
Inventories, at cost, not in excess of market	116.2	111.5	103.7	111.7	105.5	99.3	82.7	77.3
Prepaid expenses and other current assets	471.9	465.0	433.4	418.0	413.8	344.9	362.0	323.5
Total current assets	$ 1,938.5	$ 1,904.0	$ 1,841.8	$ 1,715.4	$ 1,819.3	$ 1,662.4	$ 1,572.3	$ 1,309.4
Other assets								
Investments in and advances to affiliates	$ 1,092.2	$ 1,036.4	$ 1,050.7	$ 1,037.7	$ 990.2	$ 824.2	$ 1,002.2	$ 854.1
Goodwill, net	1,763.6	1,717.8	1,652.0	1,559.8	1,320.4	1,443.4	1,261.8	973.1
Miscellaneous	1,041.2	1,102.6	1,048.7	1,074.2	1,115.1	705.9	822.4	606.2
Total other assets	$ 3,897.0	$ 3,856.8	$ 3,751.4	$ 3,671.7	$ 3,425.7	$ 2,973.5	$ 3,086.4	$ 2,433.4
Property and equipment								
Property and equipment, at cost	$27,884.2	$27,586.5	$26,689.8	$26,218.6	$24,106.0	$23,569.0	$22,450.8	$21,758.0
Accumulated depreciation and amortization	(8,485.6)	(8,254.4)	(7,873.1)	(7,635.2)	(6,816.5)	(6,521.4)	(6,126.3)	(5,716.4)
Net property and equipment	$19,398.6	$19,332.1	$18,816.7	$18,583.4	$17,289.5	$17,047.6	$16,324.5	$16,041.6
Total assets	$25,234.1	$25,092.9	$24,409.9	$23,970.5	$22,534.5	$21,683.5	$20,983.2	$19,784.4
Liabilities and shareholders' equity								
Current liabilities								
Notes and accounts payable	$ 507.0	$ 533.4	$ 488.0	$ 0.3	$ 184.9	$ 960.4	$ 1,658.8	$ 1,308.1
Dividends payable	508.0	—	—	635.8	689.5	—	—	—
Income taxes	125.1	113.0	100.7	16.3	20.4	92.2	117.2	94.2
Other taxes	209.0	212.3	194.4	191.8	180.4	195.5	160.1	143.5
Accrued interest	172.4	189.9	197.0	199.4	170.6	149.9	131.4	132.3

(continued)

exhibit 12 **(concluded)**

	Q3 2003	Q2 2003	Q1 2003	2002	2001	2000	1999	1998
Accrued restructuring and restaurant closing costs	152.5	202.8	241.6	328.5	144.2	—	—	—
Accrued payroll and other liabilities	843.6	772.6	782.7	774.7	680.7	608.4	660.0	651.0
Current maturities of long-term debt	115.8	406.9	319.1	275.5	177.6	354.5	546.8	168.0
Total current liabilities	$ 2,633.4	$ 2,490.9	$ 2,323.5	$ 2,422.3	$ 2,248.3	$ 2,360.9	$ 3,274.3	$ 2,497.1
Long-term debt	$ 9,291.7	$ 9,447.1	$ 9,686.9	$ 9,703.6	$ 8,555.5	$ 7,843.9	$ 5,632.4	$ 6,188.6
Other long-term liabilities and minority interests	668.0	620.7	598.1	560.0	629.3	489.5	538.4	492.6
Deferred income taxes	992.4	930.2	979.7	1,003.7	1,112.2	1,084.9	1,173.6	1,081.9
Shareholders' equity								
Common stock, $01 par value; authorized—3.5 billion issued—1,660.6 million	$16.6	$16.6	$16.6	$16.6	$ 16.6	$ 16.6	$ 16.6	$ 16.6
Additional paid-in capital	$ 1,808.4	$ 1,787.6	$ 1,775.5	$ 1,747.3	$ 1,591.2	$ 1,441.8	$ 1,288.3	$ 989.2
Unearned ESOP compensation	(97.9)	(98.1)	(98.2)	(98.4)	(106.7)	(115.0)	(133.3)	(148.7)
Retained earnings	20,043.3	20,003.5	19,532.3	19,204.4	18,608.3	17,259.4	15,562.8	13,879.6
Accumulated other comprehensive income (loss)	(1,018.7)	(1,067.3)	(1,442.5)	(1,601.3)	(1,708.8)	(1,287.3)	(886.8)	(522.5)
Common stock in treasury, at cost; 391.5 and 392.4 million	(9,103.1)	(8,978.3)	(8,962.0)	(8,987.7)	(8,912.2)	(8,111.1)	(6,208.5)	(4,749.5)
Total shareholders' equity	$11,648.6	$11,664.0	$10,821.7	$10,280.9	$ 9,488.4	$ 9,204.4	$ 9,639.1	$ 9,464.7
Total liabilities and shareholders' equity	$25,234.1	$25,092.9	$24,409.9	$23,970.5	$22,534.5	$21,683.5	$20,983.2	$19,784.4

Source: Company reports.

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exhibit 13 McDonald's Revenues and Operating Income by Segment, 2002–2003 (in millions)

	Q3 2003	Q2 2003	Q1 2003	2002	2001	2000
Revenues						
United States	$1,593.5	$1,551.0	$1,316.1	$ 5,422.7	$ 5,395.6	$ 5,259.1
Europe	1,525.4	1,463.3	1,302.5	5,136.0	4,751.8	4,753.9
Asia/Pacific, Middle East and Africa	659.3	570.8	581.7	2,367.7	2,203.3	2,101.8
Latin America	221.3	212.7	186.4	813.9	971.3	949.3
Canada	213.8	196.7	151.1	633.6	608.1	615.1
Partner brands	291.3	286.3	261.9	1,031.8	939.9	563.8
Total	$4,504.6	$4,280.8	$3,799.7	$15,405.7	$14,870.0	$14,243.0
Operating income (loss)						
United States	$ 571.0	$ 503.3	$ 405.7	$ 1,673.3	$ 1,622.5	$ 1,795.7
Europe	382.6	329.8	268.4	1,021.8	1,063.2	1,180.1
Asia/Pacific, Middle East and Africa	91.4	47.9	69.4	64.3	325.0	451.2
Latin America	−20.2	2.8	2.2	−133.4	10.9	102.3
Canada	47.3	40.9	26.2	125.4	123.7	126.3
Partner brands	−0.2	−10.3	−12.9	−66.8	−66.5	−41.5
Corporate	−108.0	−88.2	−84.4	−571.7	−381.8	−284.4
Total	$ 963.9	$ 826.2	$ 674.6	$ 2,112.9	$ 2,697.0	$ 3,329.7

Source: Company reports.

exhibit 14 McDonald's Operating Margins by Segment, 2000–2003

	Q3 2003	Q2 2003	Q1 2003	2002	2001	2000
Company-operated						
United States	18.6%	18.5%	14.5%	15.9%	16.8%	17.0%
Europe	17.0	15.6	13.8	11.3	12.4	18.3
Asia/Pacific, Middle East and Africa	12.2	7.5	9.7	9.4	10.1	15.9
Latin America	5.7	8.0	7.8	13.7	15.6	12.4
Canada	17.1	14.4	10.9	14.4	15.1	15.4
Franchised						
United States	80.4%	80.5%	77.2%	76.7%	77.2%	78.3%
Europe	77.4	75.7	74.1	85.8	86.2	81.5
Asia/Pacific, Middle East and Africa	86.7	84.4	83.8	66.9	68.4	73.0
Latin America	64.7	64.0	66.0	79.2	80.4	80.2
Canada	79.3	78.8	75.8	78.5	79.1	79.5

Source: Company reports.

case 4

eBay: In a League by Itself

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On September 20, 2000, eBay's top management surprised the financial community by announcing ambitious objectives of $3 billion in annual revenues by year-end 2005, a gross margin target above 80 percent, and target operating margins of 30–35 percent. Given that eBay's 2000 annual revenues were only $400 million, the $3 billion annual revenue target implied a compound annual growth rate of 50 percent from the end of 2000 through 2005—an objective some analysts criticized as too aggressive. Other analysts, however, wondered if the revenue target was ambitious enough, since online auction sales were forecast to reach $54.3 billion by 2007 and since eBay was far and away the dominant player in the online auction market.

But in early 2004 eBay was well on its way to meeting the 2005 goals it set for itself in 2000. In January 2004, eBay reported 2003 revenues of $2.17 billion and a gross margin of 81 percent. If the company could grow its revenues by 40 percent in 2004, it could reach its $3 billion annual revenue goal a year ahead of the 2005 target date. However, analysts were becoming increasingly concerned about whether eBay could sustain its phenomenal growth (see Exhibit 1), given that almost one-third of all U.S. Internet users were already registered on eBay and that eBay could expect stiffening competition from other ambitious online auction sites and e-tailers as it pursued its growth initiatives.

Building on the vision of its founder, Pierre Omidyar (pronounced oh-*mid*-ee-ar), eBay was initially conceived as an online marketplace that would facilitate a person-to-person trading community based on a democratized, efficient market in which everyone could have equal access through the same medium, the Internet. Leveraging a unique business model and the growing popularity of the Internet, eBay had dominated the online auction market since its beginning in the mid-1990s and had grown its business to include over 94.9 million registered users from more than 150 countries heading into 2004. The auction site's diverse base of registered users in early 2004—which ranged from high school and college students looking to make a few extra dollars, to Fortune 500 companies such as IBM selling excess inventory, to large government

exhibit 1 **Selected Indicators of eBay's Growth, 1996–2003**

	1996	1997	1998	1999	2000	2001	2002	2003
Number of registered users (in millions)	0.041	0.341	2.2	10.0	22.0	42.4	61.7	94.9
Active users (in millions)	NA	NA	NA	NA	NA	18.0	27.7	41.2
Gross merchandise sales (in millions)	$7	$95	$745	$2,800	$5,400	$9,300	$14,900	$24,000
Number of auctions listed (in millions)	0.29	4.4	33.7	129	264	423	638	971

agencies like the U.S. Postal Service selling undeliverable parcels—differed greatly from its original user base of individuals and small companies.

THE GROWTH OF E-COMMERCE AND ONLINE AUCTIONS

The concepts underlying the Internet were first conceived in the 1960s, but it wasn't until the 1990s that the Internet garnered widespread use and became a part of everyday life. The *Computer Industry Almanac* estimated that by the end of 2002 there were approximately 665 million Internet users worldwide in over 150 countries and that number would grow to over 1 billion users worldwide by 2005.[1] While the top 15 countries accounted for more than 70 percent of the computers in use, slightly less than one-fourth of these Internet users (160.7 million) resided in the United States, and the United States' share as a percentage of total Internet users worldwide was falling. The highest areas of Internet usage growth were expected to be in developing countries in Asia, Latin America, and Eastern Europe with increasing access through new technologies such as Web-enabled cell phones. However, it was expected that total growth rates would not exceed 20 percent annually in the future.

Forrester Research forecast that worldwide e-commerce revenues would be $6.79 trillion in 2004 and that online retail would grow at a 19 percent annual rate between 2003 and 2008 to reach $229.9 billion, of which 25 percent, or $57.5 billion, was expected to come from online auction sales. It was also predicted that North America would account for 51.5 percent of total e-commerce sales in 2004, with the Asia-Pacific region accounting for 24.3 percent, Western Europe accounting for 22.5 percent, and Latin America accounting for 12.1 percent of total sales. Within the business-to-consumer segment, eBay's primary area of operation, U.S. e-commerce accounted for over 65 percent of all Internet transactions in 1999 but was expected to account for only about 38 percent in 2003 and potentially less in the future, due to rapid expansion in other parts of the world. Asia was expected to grow especially rapidly following the 2001 decision to include China in the World Trade Organization. In 2002, Germany, the United Kingdom, France, and Italy accounted for 70 percent of the e-commerce revenues in Western Europe, but this share was expected to decline as business-to-business e-commerce in Europe was expected to triple from 2003 to 2006. Exhibit 2 displays the expected total growth in worldwide e-commerce between 1999 and 2004.

[1]www.c-i-a.com, press releases, April 2001 and July 2001.

KEY SUCCESS FACTORS IN ONLINE RETAILING

It was relatively easy to create a Web site that functioned like a retail store; the more significant challenge was for an online retailer to generate traffic to the site in the form of both new and returning customers. To reach new customers, some online retailers partnered with search engines such as Google, MySimon, or StreetPrices that allowed customers to compare prices for a given product from many retailers. Other tactics employed to build traffic included direct e-mail, online advertising at portals and content-related sites, and some traditional advertising such as print and television advertising. For customers who found their way to a site, most online retailers endeavored to provide extensive

exhibit 2 **Estimated Growth in Global e-Commerce 1999–2004**

	1999	2000	2001	2002	2003	2004
Estimated value of e-commerce transactions	$170 billion	$657 billion	$1.23 billion	$2.23 trillion	$3.98 trillion	$6.79 trillion

Source: Forrester Research.

product information, include pictures of the merchandise, make the site easily navigable, and have enough new things happening at the site to keep customers coming back. (A site's ability to generate repeat visitors was known as *stickiness.*) For new Internet users, retailers had to help them overcome their nervousness about using the Internet itself to shop for items customers generally bought in stores. Web sites had to appease concerns about the possible theft of credit card numbers and the possible sale of personal information to marketing firms. Online retailing also had severe limitations in the case of those goods and services people wanted to see in person to verify their quality. From the retailer's perspective, there was the issue of collecting payment from buyers who wanted to use checks or money orders instead of credit cards.

ONLINE AUCTIONS

The first known auctions were held in Babylon around 500 BC. In AD 193, the entire Roman Empire was put up for auction after the emperor Pertinax was executed. Didius Julianus bid 6,250 drachmas per royal guard and was immediatelv named emperor of Rome. However, Julianus was executed only two months later, suggesting that he may have been the first-ever victim of the winner's curse (bidding more than the good would cost in a nonauction setting).

Auctions have endured throughout history for several reasons. First, they give sellers a convenient way to find a buyer for something they would like to dispose of. Second, auctions are an excellent way for people to collect difficult-to-find items, such as certain Beanie Babies or historical memorabilia, that have a high value to them personally. Finally, auctions are one of the "purest" markets that exist for goods, in that they bring buyers and sellers into contact to arrive at a mutually agreeable price. As technological advances led to the advent and widespread adoption of the Internet, this ancient form of trade found a new medium.

Online auctions worked in essentially the same way as traditional auctions, the only difference being that the auction process occurred over the Internet rather than at a specific geographic location with buyers and sellers physically present. There are three basic categories of online auctions:

1. Business-to-business auctions, typically involving equipment and surplus merchandise.
2. Business-to-consumer auctions, in which businesses sold goods and services to consumers via the Internet. Many such auctions involved companies interested in selling used or discontinued goods, or liquidating unwanted inventory.
3. Person-to-person auctions, which gave interested sellers and buyers the opportunity to engage in competitive bidding.

Since eBay's pioneering of the person-to-person online auction process in 1995, the number of online auction sites on the Internet had grown to well over 2,750 by the end of 2001. Forrester Research predicted that 6.5 million customers would use online auctions in 2002.

Online auction operators could generate revenue in four principal ways:

1. Charging sellers for listing their good or service.
2. Charging a commission on all sales.
3. Selling advertising on their Web sites.
4. Selling their own new or used merchandise via the online auction format.

More recently, however, online auction sites had also added a fifth revenue-generation option that allowed buyers to purchase the desired good without waiting for an auction to close:

5. Selling their own goods or allowing other sellers to offer their goods in a fixed-price format.

Most sites charged sellers either a fee or a commission and sold advertising to companies interested in promoting their goods or services to users of the auction site.

Online Auction Users

Participants in online auctions could be grouped into six categories: (1) bargain hunters, (2) hobbyist/collector buyers, (3) professional buyers, (4) casual sellers, (5) hobbyist/collector sellers and (6) corporate and power sellers.

Bargain Hunters Bargain hunters viewed online auctions primarily as a form of entertainment; their objective usually was to find a great deal. Bargain hunters were thought to make up only 8 percent of active online users but 52 percent of eBay visitors. To attract repeat visits from bargain hunters, industry observers said, sites must appeal to them on both rational and emotional levels, satisfying their need for competitive pricing, the excitement of the search, and the desire for community.

Hobbyist and Collector Buyers Hobbyists and collectors used auctions to search for specific goods that had a high value to them personally. They were very concerned with both price and quality. Collectors prized eBay for its wide variety of product offerings.

Professional Buyers As the legitimacy of online auctions grew, a new type of buyer began to emerge: the professional buyer. Professional buyers covered a broad range of purchasers, from purchasing managers acquiring office supplies to antiques and gun dealers purchasing inventory. Like bargain hunters, professional buyers were looking for a way to help contain costs; and like hobbyists and collectors, some professional buyers were seeking unique items to supplement their inventory. The primary difference between professional buyers and other types, however, was their affiliation with commercial enterprises. With the growth of online auction sites dedicated to business-to-business auctions, professional buyers were becoming an increasingly important element of the online auction landscape.

Casual Sellers Casual sellers included individuals who used eBay as a substitute for a classified ad listing or a garage sale to dispose of items they no longer wanted. While many casual sellers listed only a few items, some used eBay to raise money for some new project.

Hobbyist and Collector Sellers Sellers who were hobbyists or collectors typically dealt in a limited category of goods and looked to eBay as a way to sell selected items in their collections to others who might want them. Items ranged from classic television collectibles, to hand-sewn dolls, to coins and stamps. The hobbyists and collectors used a range of traditional and online outlets to reach their target markets. A number of the sellers used auctions to supplement their retail operations, while others sold exclusively through online auctions and in fixed-price formats such as Half.com.

Power and Corporate Sellers Power sellers were typically small to medium-sized businesses that favored eBay as a primary distribution channel for their goods and often sold tens of thousands of dollars' worth of goods every month on the site. One estimate suggested that while these power sellers accounted for only 4 percent of eBay's population, they were responsible for 80 percent of eBay's total business.[2] Individuals who were power sellers could often make a full-time job of the endeavor.

As with the evolution of buyers, commercial enterprises were becoming an increasingly important part of the online auction industry. These commercial enterprises generally achieved power-seller status relatively rapidly. On eBay, for example, some of the new power sellers were familiar names such as IBM, Compaq, and the U.S. Postal Service (which sells undeliverable items on eBay under the user name usps-mrc).

PIERRE OMIDYAR AND THE FOUNDING OF eBAY

Pierre Omidyar was born in Paris, France, to parents who had left Iran decades earlier. The family emigrated to the United States when Omidyar's father began a residency at Johns Hopkins University Medical Center. Omidyar attended Tufts University, where he met his future wife, Pamela Wesley, who came to Tufts from Hawaii to get a degree in biology. Upon graduating in 1988, the couple moved to California, where Omidyar, who had earned a bachelor of science degree in computer science, joined Claris, an Apple Computer subsidiary in Silicon Valley, and wrote a widely used graphics application, MacDraw. In 1991, Omidyar left Claris and cofounded Ink Development (later renamed eShop), which became a pioneer in online shopping and was eventually sold to Microsoft in 1996. In 1994 Omidyar joined General Magic as a developer services engineer and remained there until mid-1996, when he left to pursue full-time development of eBay.

Internet folklore has it that eBay was founded solely to allow Pamela to trade Pez dispensers with

[2]Claire Tristram, "'Amazoning' Amazon," www.contextmag.com, November 1999.

other collectors. While Pamela was certainly a driving force in launching the initial Web site, Pierre had long been interested in how one could establish a marketplace to bring together a fragmented market. Pierre saw eBay as a way to create a person-to-person trading community based on a democratized, efficient market where everyone could have equal access through the same medium, the Internet. Pierre set out to develop his marketplace and to meet both his and Pamela's goals. In 1995 he launched the first online auction under the name of Auctionwatch at the domain name of www.eBay.com. The name *eBay* stood for "electronic Bay area," coined because Pierre's initial concept was to attract neighbors and other interested San Francisco Bay area residents to the site to buy and sell items of mutual interest. The first auctions charged no fees to either buyers or sellers and contained mostly computer equipment (and no Pez dispensers). Pierre's fledgling venture generated $1,000 in revenue the first month and an additional $2,000 the second. Traffic grew rapidly, however, as word about the site spread in the Bay area and a community of collectors emerged, using the site to trade and chat—even some marriages resulted from exchanges in eBay chat rooms.[3]

By February, 1996 the traffic at Pierre Omidyar's site had grown so much that his Internet service provider informed him that he would have to upgrade his service. When Omidyar compensated for this by charging a listing fee for the auction, and saw no decrease in the number of items listed, he knew he was on to something. Although he was still working out of his home, Omidyar began looking for a partner and in May asked his friend Jeffrey Skoll to join him in the venture. While Skoll had never cared much about money, his Stanford master of business administration degree provided the firm with the business background that Omidyar lacked. With Omidyar as the visionary and Skoll as the strategist, the company embarked on a mission to "help people trade practically anything on earth."

Their concept for eBay was to "create a place where people could do business just like in the old days—when everyone got to know each other personally, and we all felt we were dealing on a one-to-one basis with individuals we could trust."

[3]Quentin Hardy, "The Radical Philanthropist," *Forbes*, May 1, 2000, p. 118.

In eBay's early days, Omidyar and Skoll ran the operation alone, using a single computer to serve all of the pages. Omidyar served as CEO, chief financial officer, and president, while Skoll functioned as copresident and director. It was not long until Omidyar and Skoll grew the company to a size that forced them to move out of Pierre Omidyar's living room, due to the objections of Pamela, and into Skoll's living room. Shortly thereafter, the operations moved into the facilities of a Silicon Valley business incubator for a time until the company settled in its current facilities in San Jose, California. Exhibits 3 and 4 present eBay's recent financial statements.

eBAY'S TRANSITION TO PROFESSIONAL MANAGEMENT

From the beginning Pierre Omidyar intended to hire a professional manager to serve as the president of eBay: "[I would] let him or her run the company so . . . [I could] go play."[4] In 1997 both Omidyar and Skoll agreed that it was time to locate an experienced professional to function as CEO and president. In late 1997 eBay's headhunters came up with a candidate for the job: Margaret (Meg) Whitman, then general manager for Hasbro, Inc.'s preschool division. Whitman had received her bachelor of arts degree in economics from Princeton and her master of business administration from the Harvard Business School; her first job was in brand management at Procter & Gamble. Her experience also included serving as the president and CEO of FTD, the president of Stride Rite Corporation's Stride Rite Division, and as the senior vice president of marketing for the Walt Disney Company's consumer products division.

When first approached by eBay, Whitman was not especially interested in joining a company that had fewer than 40 employees and less than $6 million in revenues the previous year. It was only after repeated pleas that Whitman agreed to meet with Omidyar in Silicon Valley. After a second meeting, Whitman realized the company's enormous growth potential and agreed to give eBay a try. According to Omidyar, Meg Whitman's

[4]"Billionaires of the Web," *Business 2.0*, June 1999.

exhibit 3 **eBay's Income Statements, 1996–2002 (in thousands, except per share figures)**

	1996	1997	1998	1999	2000	2001	2002	2003
Net revenues	$32,051	$41,370	$ 86,129	$224,724	$431,424	$748,821	$1,214,100	$2,165,096
Cost of net revenues	6,803	8,404	16,094	57,588	95,453	134,816	213,876	416,058
Gross profit	$25,248	$32,966	$ 70,035	$167,136	$335,971	$614,005	$1,000,224	$1,749,038
Operating expenses:								
Sales and marketing	$13,139	$15,618	$ 35,976	$ 96,239	$166,767	$253,474	$ 349,650	$ 567,565
Product development	28	831	4,640	24,847	55,863	75,288	104,636	159,315
General and administrative	5,661	6,534	15,849	43,919	73,027	105,784	171,785	304,703
Patent litigation expense	—	—	—	—	—	—	—	29,965
Payroll taxes on stock options	—	—	0	0	2,337	2,442	4,015	9,590
Amortization of acquired intangibles	—	—	805	1,145	1,443	36,591	15,941	50,659
Merger-related costs	—	—	0	4,359	1,550	0	0	0
Total operating expenses	$18,828	$22,983	$ 57,270	$170,509	$300,977	$473,579	$ 646,027	$1,119,797
Income (loss) from operations	$ 6,420	$ 9,983	$ 12,765	$ (3,373)	$ 34,994	$140,426	$ 354,197	$ 629,241
Interest and other income (expense), net	(2,607)	(1,951)	1,799	23,833	46,337	41,613	49,209	37,803
Interest expense	—	—	(2,191)	(2,319)	(3,374)	(2,851)	(1,492)	(4,314)
Impairment of certain equity investments	—	—	0	0	0	(16,245)	(3,781)	(1,230)
Income before income taxes and minority interest	$ 3,813	$ 8,032	$ 12,373	$ 18,141	$ 77,957	$162,943	$ 398,133	$ 661,500
Provision for income taxes	(475)	(971)	(4,789)	(8,472)	(32,725)	(80,009)	(145,946)	(206,738)
Minority interests in consolidated companies	—	—	(311)	(102)	3,062	7,514	(2,296)	(7,578)
Net income	$ 3,338	$ 7,061	$ 7,273	$ 9,567	$ 48,294	$ 90,448	$ 249,891	$ 447,184
Net income per share:								
Basic	$ 0.39	$ 0.29	$ 0.07	$ 0.04	$ 0.19	$ 0.34	$ 0.43	$ 0.69
Diluted	0.07	0.08	0.03	0.04	0.17	0.32	0.43	0.67
Weighted average shares:								
Basic	8,490	24,428	104,128	217,674	251,776	268,971	574,992	638,288
Diluted	45,060	84,775	233,519	273,033	280,346	280,595	585,640	656,657

Source: Company financial documents.

exhibit 4 **eBay's Consolidated Balance Sheets, 1997–2003 (in thousands)**

	Year Ended December 31						
	1997	1998	1999	2000	2001	2002	2003
Assets							
Current assets:							
Cash and cash equivalents	$3,723	$ 37,285	$219,679	$ 201,873	$ 523,969	$1,109,313	$1,381,513
Short-term investments	—	40,401	181,086	354,166	199,450	89,690	340,576
Accounts receivable, net	1,024	12,425	36,538	67,163	101,703	131,453	225,871
Funds receivable	—	—	—	—	—	41,014	79,893
Other current assets	220	7,479	22,531	52,262	58,683	96,988	118,029
Total current assets	$4,967	$ 97,590	$459,834	$ 675,464	$ 883,805	$1,468,458	$2,145,882
Long-term investments	—	—	—	—	286,998	470,227	934,171
Restricted cash and investments	—	—	—	—	129,614	134,644	127,432
Property and equipment, net	652	44,062	111,806	125,161	142,349	218,028	601,785
Goodwill	—	—	—	—	187,829	1,456,024	1,719,311
Investments	—	—	373,988	—	—	—	—
Deferred tax assets	—	—	5,639	—	21,540	84,218	—
Intangible and other assets, net	—	7,884	12,675	23,299	26,394	292,845	291,553
Total assets	$5,619	$149,536	$963,942	$1,182,403	$1,678,529	$4,040,226	$5,820,134
Liabilities and stockholders' equity							
Current liabilities:							
Accounts payable	$252	$ 9,997	$ 31,538	$ 31,725	$ 33,235	$ 47,424	$ 64,633
Funds payable and amounts due to customers	—	—	—	—	—	50,396	106,568
Accrued expenses and other current liabilities	—	6,577	32,550	60,882	94,593	199,323	356,491
Deferred revenue and customer advances	128	973	5,997	12,656	15,583	18,846	28,874
Debt and leases, current portion	258	4,047	12,285	15,272	16,111	2,970	2,840
Income taxes payable	169	1,380	6,455	11,092	20,617	67,265	87,870

exhibit 4 **(concluded)**

	Year Ended December 31						
	1997	1998	1999	2000	2001	2002	2003
Deferred tax liabilities, current	—	1,682	—	—	—	—	—
Other current liabilities	128	5,981	7,632	5,815	—	—	—
Total current liabilities	$1,124	$ 24,656	$ 88,825	$ 137,442	$ 180,139	$ 386,224	$ 647,276
Debt and leases, long-term portion	305	18,361	15,018	11,404	12,008	13,798	124,476
Deferred tax liabilities, long-term	—	—	—	—	3,629	27,625	79,238
Other liabilities	157	—	—	6,549	15,864	22,874	33,494
Minority interests	—	—	—	—	37,751	33,232	39,408
Total liabilities	$1,586	$ 48,998	$111,475	$ 168,643	$ 249,391	$ 483,753	$ 923,892
Series B redeemable convertible preferred stock and Series B warrants	3,018	—	—	—	—	—	—
	1,015	100,538	852,467	1,013,760	1,429,138	3,556,473	4,896,242
Total stockholders' equity	$5,619	$149,536	$963,942	$1,182,403	$1,678,529	$4,124,444	$5,820,134

Source: Company financial documents.

experience in global marketing with Hasbro's Teletubbies, Playskool, and Mr. Potato Head brands made her "the ideal choice to build upon eBay's leadership position in the one-to-one online trading market without sacrificing the quality and personal touch our users have grown to expect."[5] In addition to convincing Whitman to head eBay's operations, Omidyar had been instrumental in helping bring in other talented senior executives and in assembling a capable board of directors. Notable members of eBay's board of directors included Scott Cook, the founder of Intuit, a highly successful financial software company, and Fred D. Anderson, executive vice president and chief financial officer of Apple.

HOW AN eBAY AUCTION WORKED

eBay endeavored to make it very simple to buy and sell goods. In order to sell or bid on goods, users first had to register at the site. Once they registered, users selected both a user name and a password. Unregistered users were able to browse the Web site but were not permitted to bid on any goods or list any items for auction.

On the Web site, search engines helped customers determine what goods were currently available. When registered users found an item they desired, they could choose to enter a single bid or to use automatic bidding (called proxy bidding). In automatic bidding the customer entered an initial bid sufficient to make him or her the high bidder, and then the bid would be automatically increased as others bid for the same object until the auction ended and either the bidder won or another bidder surpassed the original customer's maximum specified bid. Regardless of which bidding method they chose, users could check bids at any time and either bid again, if they had been outbid, or increase their maximum amount in the automatic bid. Users could choose to receive e-mail notification if they were outbid.

Once the auction had ended, the buyer and seller were each notified of the winning bid and were given each other's e-mail address. The parties to the auction would then privately arrange for payment and delivery of the good.

[5]eBay press release, May 7, 1998.

Fees and Procedures for Sellers

Buyers on eBay were not charged a fee for bidding on items, but sellers were charged an insertion fee and a "final value" fee; they could also elect to pay additional fees to promote their listing. Listing, or insertion, fees ranged from 30 cents for auctions with opening bids, minimum values, or reserve prices of between $0.01 and $0.99, to $4.80 for auctions with opening bids, minimum values, or reserve prices of $500 and up. Final value fees ranged from 1.25 to 5 percent of the final sale price and were computed according to a graduated fee schedule in which the percentage fell as the final sales price rose. As an example, in a basic auction with no promotion, if the item had brought an opening bid of $200 and eventually sold for $1,500, the total fee paid by the seller would be $35.48—the $3.60 insertion fee plus $31.88. The $31.88 was based on a fee structure of 5 percent of the first $25 (or $1.25), 2.5 percent of the additional amount between $25.01 and $1,000 (or $24.38), and 1.25 percent of the additional amount between $1,000.01 and $1,500 (or $6.25). Auction fees varied for special categories of goods such as passenger vehicles in eBay Motors that were charged a $40 transaction fee when the first successful bid was placed and a $100 insertion fee for residential, commercial, and other real estate.

Sellers could also customize items by adding photographs and featuring their item in a gallery. Sellers could indicate a photograph in the item's description if they posted the photograph on a Web site and provided eBay with the appropriate Web address. Items could be showcased in the Gallery section with a catalog of pictures rather than text. A seller who used a photograph in his or her listing could have this photograph included in the Gallery section for 25 cents or featured there for $19.95. A Gallery option was available in all categories of eBay, but fees varied between categories and the prominence of the gallery. For example, a simple gallery listing cost 25 cents, whereas a featured gallery listing, which included a periodic listing in the featured section above the general gallery, cost $19.95. In the eBay Motors gallery, options could cost as much as $99.95.

To make doing business on eBay more attractive to potential sellers, the company introduced several features. To receive a minimum price for an auction, the seller could specify an opening bid or set a reserve price on the auction. If the bidding did not top the reserve price, the seller was under no obligation to sell the item to the highest bidder and could relist the item at no additional cost. For items with a reserve price between $0.01 and $49.99, the fee was $1.00; between $50.00 and $199.99, the fee was $2.00; and for over $200, the fee was 1 percent of the reserve price. If the seller wished, he or she could also set a Buy It Now price that allowed bidders to pay a set amount for a listed item. The fee for this service was $1.00. If the Buy It Now price was met, the auction would end immediately.

As of June 11, 2001, new sellers at eBay were required to provide both a credit card number and bank account information to register. While eBay admitted that these requirements are extreme, it argued that they helped protect everyone in the community against fraudulent sellers and ensured that sellers were of legal age and were serious about listing the item on eBay.

How Transactions Were Completed

Under the terms of eBay's user agreement, if a seller received one or more bids above the stated minimum, or reserve, price, the seller was obligated to complete the transaction, although eBay had no enforcement power beyond suspending a noncompliant buyer or seller from using the company's service. In the event the buyer and seller were unable to complete the transaction, the seller notified eBay, which then credited the seller the amount of the final value fee.

When an auction ended, the eBay system validated that the bid fell within the acceptable price range. If the sale was successful, eBay automatically notified the buyer and seller via e-mail; the buyer and seller could then either work out the transaction details independent of eBay or use eBay's checkout and payment services to complete the transaction. In its original business model, at no point during the process did eBay take possession of either the item being sold or the buyer's payment. In an effort to increase revenues, eBay expanded its offerings to facilitate buyers' payments by first offering services that accepted credit card payments and electronic funds transfers on behalf of the seller and then purchasing PayPal, the leading third-party online payment facilitator in 2003. To make selling easier, eBay also had alliances with two leading shippers, the U.S. Postal Service and United Parcel Service (UPS). Both of these shippers had centers on eBay that would allow sellers to calculate postage and to print postage-paid labels. However, the buyer and seller still had to independently arrange shipping terms, with buyers typically paying for shipping. Items were sent directly from the buyer to the seller unless an independent escrow service was arranged to help ensure security.

To encourage sellers to use eBay's ancillary services the company offered an automated checkout service to help expedite communication, payment, and delivery between buyers and sellers.

Feedback Forum

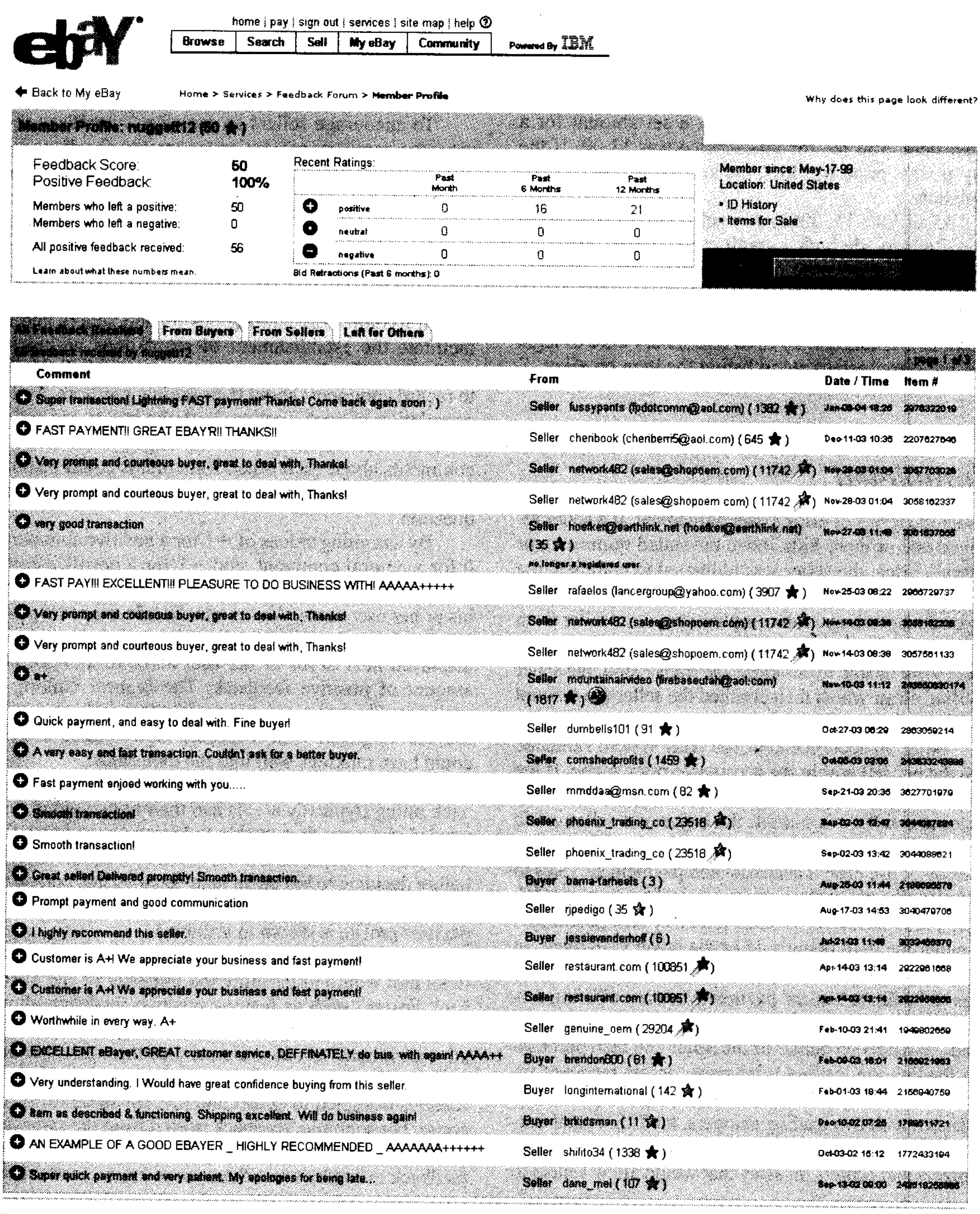
In early 1996 eBay pioneered a feature called Feedback Forum to build trust among buyers and sellers and to facilitate the establishment of reputations within its community. Feedback Forum encouraged individuals to record comments about their trading partners. At the completion of each auction, both the buyer and seller were allowed to leave positive, negative, or neutral comments about each other. Individuals could dispute feedback left about them by annotating comments in question.

By assigning values of +1 for a positive comment, 0 for a neutral comment, and −1 for a negative comment, each trader earned a ranking that was attached to his or her user name. A user who had developed a positive reputation over time had a color-coded star symbol displayed next to his or her user name to indicate the amount of positive feedback. The highest ranking a trader could receive was "over 100,000," indicated by a red shooting star. Well-respected high-volume traders could have rankings well into the thousands.

Users who received a sufficiently negative net feedback rating (typically a −4) had their registrations suspended and were thus unable to bid on or list items for sale. Buyers could review a person's feedback profile before deciding to bid on an item listed by that person or before choosing payment and delivery methods. A sample user profile is shown in Exhibit 5.

The terms of eBay's user agreement prohibited actions that would undermine the integrity of the Feedback Forum, such as leaving positive feedback about oneself through other accounts or leaving multiple negative comments about someone else through other accounts. The Feedback Forum had several automated features designed to detect and prevent some forms of abuse. For example, feedback posted from the same account, positive or negative, could not affect a user's net feedback rating by more than one point, no matter how

exhibit 5 A Sample Feedback Forum Profile



home | pay | sign out | services | site map | help

Browse | Search | Sell | My eBay | Community — Powered By IBM

Back to My eBay — Home > Services > Feedback Forum > Member Profile — Why does this page look different?

Member Profile: nugget12 (50)

Feedback Score:	50
Positive Feedback:	100%
Members who left a positive:	50
Members who left a negative:	0
All positive feedback received:	56

Learn about what these numbers mean.

Recent Ratings:

	Past Month	Past 6 Months	Past 12 Months
positive	0	16	21
neutral	0	0	0
negative	0	0	0

Bid Retractions (Past 6 months): 0

Member since: May-17-99
Location: United States
• ID History
• Items for Sale

All Feedback Received | From Buyers | From Sellers | Left for Others

Feedback received by nugget12 — page 1 of 3

Comment	From		Date / Time	Item #
Super transaction! Lightning FAST payment! Thanks! Come back again soon :)	Seller	fussypants (fpdotcomm@aol.com) (1382)	Jan-08-04 18:26	[illegible]
FAST PAYMENT!! GREAT EBAY'R!! THANKS!!	Seller	cheribook (cheriberri5@aol.com) (645)	Dec-11-03 10:36	2207627646
Very prompt and courteous buyer, great to deal with, Thanks!	Seller	network482 (sales@shopoem.com) (11742)	Nov-28-03 01:04	[illegible]
Very prompt and courteous buyer, great to deal with, Thanks!	Seller	network482 (sales@shopoem.com) (11742)	Nov-28-03 01:04	3058162337
very good transaction	Seller	hoefker@earthlink.net (hoefker@earthlink.net) (35) no longer a registered user	Nov-27-03 11:49	[illegible]
FAST PAY!!! EXCELLENT!!! PLEASURE TO DO BUSINESS WITH! AAAAA+++++	Seller	rafaelos (lancergroup@yahoo.com) (3907)	Nov-25-03 08:22	2966729737
Very prompt and courteous buyer, great to deal with, Thanks!	Seller	network482 (sales@shopoem.com) (11742)	Nov-14-03 08:38	[illegible]
Very prompt and courteous buyer, great to deal with, Thanks!	Seller	network482 (sales@shopoem.com) (11742)	Nov-14-03 08:38	3057561133
a+	Seller	mountainairvideo (firebaseutah@aol.com) (1817)	Nov-10-03 11:12	[illegible]
Quick payment, and easy to deal with. Fine buyer!	Seller	dumbells101 (91)	Oct-27-03 06:29	2963059214
A very easy and fast transaction. Couldn't ask for a better buyer.	Seller	cornshedprofits (1459)	[illegible]	[illegible]
Fast payment enjoed working with you.....	Seller	mmddaa@msn.com (82)	Sep-21-03 20:36	3627701979
Smooth transaction!	Seller	phoenix_trading_co (23518)	Sep-02-03 13:42	[illegible]
Smooth transaction!	Seller	phoenix_trading_co (23518)	Sep-02-03 13:42	3044088621
Great seller! Delivered promptly! Smooth transaction.	Buyer	bama-farheels (3)	Aug-26-03 11:44	[illegible]
Prompt payment and good communication	Seller	rjpedigo (35)	Aug-17-03 14:53	3040479706
I highly recommend this seller.	Buyer	jessievanderhoff (6)	Jul-21-03 11:49	[illegible]
Customer is A+! We appreciate your business and fast payment!	Seller	restaurant.com (100851)	Apr-14-03 13:14	2922981668
Customer is A+! We appreciate your business and fast payment!	Seller	restaurant.com (100851)	Apr-14-03 13:14	[illegible]
Worthwhile in every way. A+	Seller	genuine_oem (29204)	Feb-10-03 21:41	1949802659
EXCELLENT eBayer, GREAT customer service, DEFFINATELY do bus. with again! AAAA++	Buyer	brendon800 (61)	Feb-09-03 18:01	[illegible]
Very understanding. I Would have great confidence buying from this seller.	Buyer	longinternational (142)	Feb-01-03 18:44	2166940759
Item as described & functioning. Shipping excellent. Will do business again!	Buyer	brkidsman (11)	Dec-10-02 07:28	[illegible]
AN EXAMPLE OF A GOOD EBAYER _ HIGHLY RECOMMENDED _ AAAAAAA++++++	Seller	shilito34 (1338)	Oct-03-02 16:12	1772433194
Super quick payment and very patient. My apologies for being late...	Seller	dane_mel (107)	Sep-13-02 00:00	[illegible]

Source: www.ebay.com, February 4, 2004.

many comments an individual made. Furthermore, a user could make comments only about his or her trading partners in completed transactions. Prior to 2004, once a feedback comment was made, it could not be altered. However, as of February 9, 2004, the system was changed in response to suggestions by community members to all users to mutually withdraw feedback about each other. Withdrawn feedback would no longer impact a user's feedback rating.

The company believed its Feedback Forum was extremely useful in overcoming users' initial hesitancy about trading over the Internet, since it reduced the uncertainty of dealing with an unknown trading partner. However, there was growing concern among sellers and bidders that feedback might be positively skewed, as many eBayers chose not to leave negative feedback for fear of unfounded retribution that could damage their carefully built reputations.

eBAY'S STRATEGY TO SUSTAIN ITS MARKET DOMINANCE

Meg Whitman assumed the helm of eBay in February 1998 and began acting as the public face of the company. In an effort to stay in touch with her customers, Whitman hosted an auction on eBay herself. She found the experience so enlightening that she required all of eBay's managers to sell on eBay. Pierre Omidyar stepped back to become chairman of eBay's board of directors and focused his time and energy on overseeing eBay's strategic direction and growth, business model and site development, and community advocacy. Jeff Skoll, who became the vice president of strategic planning and analysis, concentrated on competitive analysis, new business planning and incubation, the development of the organization's overall strategic direction, and supervision of customer support operations.

The Move to Go Public

eBay's initial public offering (IPO) took place on September 24, 1998, with a starting price of $18 per share. The IPO exceeded that price and closed the day up 160 percent at $47. The IPO generated $66 million in new capital for the company and was recognized by several investing publications. The success of the September 1998 offering led eBay to issue a follow-up offering in April 1999 that raised an additional $600 million. As a qualification to the IPOs, eBay's board of directors retained the right to issue as many as 5 million additional shares of preferred stock with no further input from the current shareholders in case of a hostile takeover attempt.

eBay's Business Model

According to eBay's Meg Whitman, the company could best be described as a dynamic, self-regulating economy. Its business model was based on creating and maintaining a person-to-person trading community in which buyers and sellers could readily and conveniently exchange information and goods. The company's role was to function as a value-added facilitator of online buyer–seller transactions by providing a supportive infrastructure that enabled buyers and sellers to come together in an efficient and effective manner. Success depended not only on the quality of eBay's infrastructure but also on the quality and quantity of buyers and sellers attracted to the site; in management's view, this entailed maintaining a compelling trading environment, a number of trust and safety programs, a cost-effective and convenient trading experience, and strong community affinity. By developing the eBay brand name and increasing the customer base, eBay endeavored to attract a sufficient number of high-quality buyers and sellers necessary to meet the organization's goals. The online auction format meant that eBay carried zero inventory and could operate a marketplace without the need for a traditional sales force.

eBay's business model was built around three profit centers: the domestic business (auction operations within the United States), international business (auction operations outside of the United States), and payments (e.g., PayPal). It was estimated that, in 2003, U.S. operations accounted for 31.7 percent of revenue growth, international's share was 34.6 percent, and the remaining 33.8 percent was from payments (see Exhibit 6).

Specific elements of eBay's business model that the company particularly recognized as key to its success included:[6]

[6]Company 10-K filing with the Securities and Exchange Commission, March 3, 2001, pp. 4–6.

exhibit 6 Share of eBay Transaction Revenue Growth, 2001–2008

	2001(a)	2002(a)	2003(e)	2004(e)	2005(e)	2006(e)	2007(e)	2008(e)
U.S.	62.8%	48.0%	31.7%	39.1%	31.7%	32.5%	32.5%	32.7%
International	32.6	36.9	34.6	35.9	41.6	42.0	38.7	38.7
Payments	4.7	15.1	33.8	25.0	26.7	25.5	28.8	28.6
100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	

1. The fact that it was the largest online trading forum, with a critical mass of buyers, sellers, and items listed for sale.
2. Its compelling and entertaining trading environment, which had strong values, established rules, and procedures that facilitated communication and trade between buyers and sellers.
3. Established trust and safety programs such as Safeharbor. This program provided guidelines for trading, aided in resolving disputes, and warned and suspended (both temporarily and permanently) users who violated eBay's rules.
4. Cost-effective, convenient trading.
5. Strong community affinity.
6. An intuitive user interface that was easy to understand, arranged by topics, and fully automated.

In implementing its business model, eBay employed three main competitive tactics. First, it sought to build strategic partnerships in all stages of its value chain, creating an impressive portfolio of over 250 strategic alliances with companies such as America Online (AOL), Yahoo, IBM, Compaq, and Walt Disney. Second, it actively sought customer feedback and made improvements on the basis of this information. Third, it actively monitored both its external and internal environments for developing opportunities. One way eBay executives kept in touch with internal trends was by hosting online town hall meetings and by visiting cities with large local markets. The feedback gained from these meetings was used to adopt and adjust practices to keep customers satisfied.

eBay's Strategy

eBay's strategy to sustain growth rested on five key elements:[7]

1. *Broaden the existing trading platform* within existing product categories, across new product categories, through geographic expansion, both domestic and international, and through introduction of additional pricing formats such as fixed price sales.
2. *Foster eBay community affinity* by instilling a vibrant, loyal eBay community experience, seeking to maintain a critical mass of frequent buyers and sellers with a vested interest in the eBay community.
3. *Enhance features and functionality* by continually updating and enhancing the features and functionality of the eBay and Half.com Web sites to ensure continuous improvement in the trading experience.
4. *Expand value-added services* to include end-to-end personal trading service by offering a variety of pre- and post-trade services to enhance the user experience and make trading easier.
5. *Continue to develop U.S. and international markets* that employ the Internet to create an efficient trading platform in local, national, and international markets that can be transformed into a seamless, truly global trading platform.

Broadening the Existing Trading Platform Efforts intended to broaden the eBay trading platform concentrated on growing the content within current categories, broadening the range of products offered according to user preferences, and developing regionally targeted offerings. Growth in existing product categories was facilitated by deepening the content within the categories through the use of content-specific chat rooms and bulletin boards as well as targeted advertising at trade shows and in industry-specific publications.

[7]eBay company 10K, filed March 28, 2001.