To broaden the range of products offered, eBay developed new product categories, introduced specialty sites, and developed eBay stores. Over 2,000 new categories were added between 1998 and 2000, and by 2003 eBay offered over 27,000 categories of items (greatly expanded from the original 10 categories in 1995). Ten of these categories had gross merchandise sales of over $1 billion, including eBay Motors ($7.5 billion), Consumer Electronics ($2.6 billion), Computers ($2.4 billion), Books/ Movies/Music ($2.0 billion), Clothing and Accessories ($1.8 billion), Sports ($1.8 billion), Collectibles ($1.5 billion), Toys ($1.5 billion), Home and Garden ($1.3 billion), and Jewelry and Gemstones ($1.3 billion).

Significant new product categories and specialty sites developed since eBay's early days included:

- eBay Motors, which began as a category and was developed when eBay noticed that an increasing number of automobile transactions were taking place on its site. In 2002, eBay Motors sold more than $3 billion worth of vehicles and parts and was the largest online marketplace for buying and selling autos as of mid-2003. According to Meg Whitman, "One month, we saw the miscellaneous category had a very rapid growth rate, and someone said we have to find out what's going on. It was the buying and selling of used cars. So we said, maybe what we should do is give these guys a separate category and see what happens. It worked so well that we created eBay Motors."[8] In partnership with AutoTrader.com this category was later expanded to a specialty site.
- The LiveAuctions specialty site, which allowed live bidding via the Internet for auctions occurring in brick-and-mortar auction houses around the world. Through an alliance with Icollector.com, eBay users had access to more than 300 auction houses worldwide. Auction houses that participated in this agreement were well rewarded, as more than 20 percent of their sales went to online bidders. One auction broadcast on the LiveAuctions site, held in February 2001, featured items from a rare Marilyn Monroe collection including a handwritten note from Monroe that listed her reasons for divorcing her first husband.

[8]"Q&A with eBay's Meg Whitman," *BusinessWeek E.Biz*, December 3, 2001.

- The eBay Business marketplace, launched in 2002, which allowed business-related items to be sold in one location. Items such as office technology, wholesale lots, and marketplace services were offered at this destination. By the end of 2002, over 500,000 items were listed in eBay Business each week and more than $1 billion in annualized gross merchandise sales occurred across these categories.
- eBay's Real Estate category, launched to foster eBay's emerging real estate marketplace. The offerings within this category were significantly enhanced by eBay's August 2001 acquisition of Homesdirect, which specialized in the sale of foreclosed properties owned by government agencies such as Housing and Urban Development and the Department of Veterans Affairs (formerly known as the Veterans Administration). The company estimated that a parcel of land was sold through the Real Estate category every 45 minutes during 2002.

Other notable moves to broaden the platform included the following:

- The Application Program Interface (API) and Developers Program was launched to allow other companies to use eBay's commerce engine and technology to build new sites.
- Starting in 1999, eBay launched over 60 regional sites to offer a more local flavor to eBay's offerings. These regional sites focused on the 50 largest metropolitan areas in the United States. Regional auction sites were intended to encourage the sale of items that were prohibitively expensive to ship, items that tended to have only a local appeal, and items that people preferred to view before purchasing. To supplement the regional sites, in mid-2001 eBay began offering sellers the option of having their items listed in a special seller's area in the classified sections of local newspapers. Sellers could highlight specific items, their eBay store, or their user ID in these classifieds.
- In June 2001 eBay introduced eBay stores to complement new offerings, to make it easier for sellers to build loyalty and for buyers to locate goods from specific sellers and to prevent sellers from driving bidders to the seller's own Web site. In an eBay store the entirety of a seller's auctions would

be listed in one convenient location. These stores could also offer a fixed-price option from a seller and the integration of a seller's Half.com listings with their auction listings. While numerous sellers of all sizes moved to take advantage of eBay stores, the concept was especially appealing to large retailers such as IBM, Hard Rock Café, Sears, and Handspring that were moving to take advantage of eBay's reach and distribution power.

- In May 2002 eBay reached an agreement with Accenture to develop a service intended to allow large sellers to more efficiently sell their products. These sellers were able to use a wide range of tools, such as high-volume listing capabilities, expanded customer service and support, and payment and fulfillment processes.
- A fixed-price format was established through the acquisition of Half.com and allowed eBay to compete more directly with online sellers such as Amazon.com. Half.com was a fixed-price, person-to-person format that enabled buyers and sellers to trade books, CDs, movies and video games at prices starting at generally half of the retail price. Like eBay, Half.com offered a feedback system that helped buyers and sellers to build a solid reputation. eBay intended to eventually fully integrate both Half.com's listings and the feedback system into eBay's current site.

Fostering eBay Community Affinity

From its founding, eBay considered developing a loyal, vivacious trading community to be a cornerstone of its business model. This community was nurtured through open and honest communication and was built on five basic values that eBay expected its members to honor:

> We believe people are basically good.
>
> We believe everyone has something to contribute.
>
> We believe that an honest, open environment can bring out the best in people.
>
> We recognize and respect everyone as a unique individual.
>
> We encourage you to treat others the way that you want to be treated.[9]

The company recognized that these values could not be imposed by fiat. According to Omidyar,

> As much as we at eBay talk about the values and encourage people to live by those values, that's not going to work unless people actually adopt those values. The values are communicated not because somebody reads the Web site and says, "Hey, this is how we want to treat each other, so I'll just start treating people that way." The values are communicated because that's how they're treated when they first arrive. Each member is passing those values on to the next member. It's little things, like you receive a note that says, "Thanks for your business."[10]

Consistent with eBay's desire to stay in touch with its customers and be responsive to their needs, the company flew in 10 new sellers every few months to hold group meetings known as Voice of the Customer. The company noted that 75–80 percent of new features were originally suggested by community members.

An example of eBay values in action took place when eBay introduced a feature that referred losing bidders to similar auctions from other eBay sellers, eliciting a strong outcry from the community. Sellers demanded to know why eBay was stealing their sales, and one longtime seller went so far as to auction a rare eBay jacket so that he could use the auction as a forum to complain about "eBay's new policy of screwing the folks who built them."[11] This caught the attention of Omidyar and Whitman, who met with the seller in his home for 45 minutes. After the meeting eBay changed its policy.

Recognizing that many new users might not get the most out of their eBay experience, and hoping to introduce new entrepreneurs to the community, the company created eBay University in August 2000. The university traveled across the country to hold two-day seminars in various cities. These seminars attracted between 400 and 500 people, who each paid $25 for the experience. Courses offered ranged from freshmen-level classes that introduced buying and selling on eBay to graduate-level classes that taught the intricacies of bulk listing and competitive tactics. eBay University was so successful that the company partnered with Evoke Communications to offer an online version of the classes. While community members gained knowledge from these classes, so did eBay. The company kept careful track of questions and concerns

[9]http://pages.ebay.com/help/community/values.html, January 1, 2002.

[10]"Q&A with eBay's Meg Whitman."

[11]Ibid.

and used them to uncover areas that needed improvement.

A second important initiative to make the eBay community more inclusive was aimed at the fastest-growing segment of the U.S. population, adults 50 and older. In an effort to bridge the digital divide for seniors, eBay launched the Digital Opportunity Program for Seniors and set a goal of training and bringing online 1 million seniors by 2005. Specific elements of this plan included partnering with SeniorNet, the leading non-profit computer technology trainer of seniors, and donating $1 million to this organization for training and establishing 10 new training facilities by 2005, developing a volunteer program for training seniors, and creating a specific area on eBay for Senior Citizens (www.ebay.com/seniors).

To foster a sense of community among eBay users, the company employed tools and tactics designed to promote both business and personal interactions between consumers, to foster trust between bidders and sellers, and to instill a sense of security among traders. Interactions between community members were facilitated through the creation of chat rooms based on personal interests. These chat rooms allowed individuals to learn about their chosen collectibles and to exchange information about items they collected.

To manage the flow of information in the chat rooms, eBay employees went to trade shows and conventions to seek out individuals who had knowledge about and a passion for either a specific collectible or a category of goods. These enthusiasts would act as community leaders or ambassadors; they were never referred to as employees but were compensated $1,000 a month to host online discussions with experts.

Although personal communication between members fostered a sense of community, as eBay's community grew from "the size of a small village to a large city" additional measures were necessary to ensure a continued sense of trust and honesty among users.[12] One of eBay's earliest trust-building efforts was the 1996 creation of the Feedback Forum, described earlier.

Unfortunately, the Feedback Forum was not always sufficient to ensure honesty and integrity among traders. eBay estimated that far less than 1 percent of the millions of auctions completed on the site involved some sort of fraud or illegal activity, but some users, like Clay Monroe, disagreed. Monroe, a Seattle-area trader of computer equipment, estimated that "ninety percent of the time everybody is on the up and up . . . [but] . . . ten percent of the time you get some jerk who wants to cheat you." Fraudulent or illegal acts perpetrated by sellers included misrepresentation of goods; trading in counterfeit goods or pirated goods that infringed on others' intellectual property rights; failure to deliver goods paid for by buyers; and shill bidding, whereby sellers would use a false bidder to artificially drive up the price of a good. Buyers could manipulate bids by placing an unrealistically high bid on a good to discourage other bidders and then withdraw their bid at the last moment to allow an ally to win the auction at a bargain price. Buyers could also fail to deliver payment on a completed auction.

Recognizing that fraudulent activities represented a significant danger to eBay's future, management took the Feedback Forum a step further in 1998 by launching the SafeHarbor program to provide guidelines for trade, provide information to help resolve user disputes, and respond to reports of misuse of the eBay service. The SafeHarbor initiative was expanded in 1999 to provide additional safeguards and to actively work with law enforcement agencies and members of the trading community to make eBay more secure. New elements of SafeHarbor included:

- Free insurance, with a $25 deductible for transactions under $200 and further protection for buyers and sellers who used PayPal.
- Cooperation with local law enforcement agencies to identify and prosecute fraudulent buyers and sellers.
- Enhancements to the Feedback Forum such as listing whether the user was a buyer or a seller in a transaction.
- A partnership with SquareTrade, an online dispute resolution service.
- A partnership with Escrow.com to promote the use of escrow services on purchases over $500.
- A new class of verified eBay users with an accompanying icon.
- Easy access to escrow services.
- Tougher policies relating to nonpaying bidders and shill bidders.
- Clarification of which items were not permissible to list for sale (such as items associated with Nazi Germany, the Ku Klux Klan, or other groups that

[12] Tristram, " 'Amazoning' Amazon."

glorified hate, racial intolerance, or racial violence).

- A strengthened antipiracy and anti-infringement program known as the Verified Rights Owner program (VeRO), and the introduction of dispute resolution services.

The use of verified buyer and seller accounts was viewed as especially significant because it allowed eBay to ensure that suspended users did not open new eBay accounts under different names. User information was verified through Atlanta-based Equifax, Inc. To further ensure that suspended users didn't register new accounts with different identities, eBay partnered with Infoglide to use a similarity search technology to examine new registrant information.

To implement these new initiatives, eBay increased the number of positions in its SafeHarbor department from 24 to 182, including full-time employees and independent contractors. It also organized the department around the functions of investigations, community watch, and fraud prevention. The investigations group was responsible for examining reported trading violations and possible misuses of eBay. The fraud prevention group mediated customer disputes over such things as the quality of the goods sold. If a written complaint of fraud was filed against a user, eBay generally suspended the alleged offender's account, pending an investigation. Despite all of these initiatives, innovative thieves were developing new ways to cheat honest bidders and sellers as quickly as eBay could identify and ban them from the system, and many eBayers still viewed this as one of the most significant threats to the eBay community.

The community watch group worked with over 100 industry-leading companies, ranging from software publishers to toy manufactures to apparel makers, to protect intellectual property rights. To ensure that illegal items were not being sold and sale items listed did not violate intellectual property rights, this SafeHarbor group automated daily keyword searches on auction content. Offending auctions were closed and the seller was notified of the violation. Repeated violations resulted in suspension of the seller's account.

As eBay expanded its categories to include Great Collections and the new automobile categories, new safeguards were introduced to meet the unique needs of these areas. In the eBay Great Collections category, the company partnered with Collector's Universe to offer authentication and grading services for specific products such as trading cards, coins, and autographs. In the automobile area, one of eBay's fastest-growing segments, eBay partnered with Saturn to provide users with access to a nationwide automobile brand and offered a free limited one-month or 1,000 mile warranty, free purchase insurance up to $20,000 with a $500 deductible, and a special escrow service (Secure Pay) designed for the needs of automotive buyers and sellers.

Expanding Value-Added Services Since its earliest days, eBay had realized that to be successful, its service had to be both easy to use and convenient to access. Recognizing this, the company continuously sought to add services to fill these needs by offering a variety of pre- and post-trade services to enhance the user experience and provide an end-to-end trading experience.

Early efforts in this direction included alliances with:

- Leading shipping services (USPS and UPS).
- Two companies that helped guarantee that buyers would get what they paid for (Tradesafe and I-Escrow).
- The world's largest franchiser of retail business, communications, and postal service centers (Mailboxes, Etc.).
- The leader in multicarrier Web-based shipping services for e-commerce (iShip.com).

To facilitate person-to-person credit card payments, eBay acquired PayPal, a company that specialized in transferring money from one cardholder to another, in October 2002. Using the newly acquired capabilities of PayPal, eBay was able to offer sellers the option of accepting credit card payments from other eBay users. At the end of 2002, PayPal was available to users in 38 countries, including the United States. eBay's objective was to make credit card payment a "seamless and integrated part of the trading experience."[13] The company expected that net revenues from the payments segment of PayPal would be approximately $300 to $310 million in 2003.

[13]eBay press release, May 18, 1999.

Developing U.S. and International Markets As competition increased in the online auction industry, eBay began to seek growth opportunities in international markets in an effort to create a global trading community. While international buyers and sellers had been trading on eBay for some time, there were no facilities designed especially for the needs of these community members. In entering international markets, eBay considered three options: it could build a new user community from the ground up, acquire a local organization, or form a partnership with a strong local company. In realizing its goals of international growth, eBay employed all three strategies.

In late 1998, eBay's initial efforts at international expansion into Canada and the United Kingdom relied on building new user communities. The first step in establishing these communities was creating customized home pages for users in those countries. These home pages were designed to provide content and categories locally customized to the needs of users in specific countries, while providing them with access to a global trading community. Local customization in the United Kingdom was facilitated through the use of local management, grassroots and online marketing, and participation in local events.[14] In February 1999 eBay partnered with PBL Online, a leading Internet company in Australia, to offer a customized Australian and New Zealand eBay home page. When the site went live in October, 1999 transactions were denominated in Australian dollars and, while buyers could bid on auctions anywhere in the world, they could also search for items located exclusively in Australia. Further, local chat boards were designed to facilitate interaction between Australian users, and country-specific categories, such as Australian coins and stamps as well as cricket and rugby memorabilia, were offered.

To further expand its global reach, eBay acquired Germany's largest online person-to-person trading site, Alando.de AG, in June 1999. eBay's management handled the transition of service in a manner calculated to be smooth and painless for Alando.de AG's users. While users would have to comply with eBay rules and regulations, the only significant change for Alando.de AG's 50,000 registered users was that they would have to go to a new URL to transact their business.

To establish an Asian presence, in February 2000 eBay formed a joint venture with NEC to launch eBay Japan. According to the new CEO of eBay Japan, Merle Okawara, an internationally renowned executive, NEC was pleased to help eBay in leveraging the tried-and-trusted eBay business model to provide Japanese consumers with access to a global community of active online buyers and sellers. In customizing the site to the needs of Japanese users, eBay wrote the content exclusively in Japanese and allowed users to bid in yen. The site had over 800 categories ranging from internationally popular categories (such as computers, electronics, and Asian antiques) to categories with a local flavor (such as Hello Kitty, Pokémon, and pottery). The eBay Japan site also debuted a new merchant-to-person concept known as Supershops, which allowed consumers to bid on items listed by companies.

In 2001, eBay expanded into South Korea through an acquisition of a majority ownership position in the country's largest online trading service, Internet Auction Co. Ltd., and into Belgium, Brazil, Italy, France, the Netherlands, Portugal, Spain, and Sweden through the acquisition of Europe's largest online trading platform, iBazar. Further expansion in 2001 included the development of a local site in Singapore, and an equity-based alliance with the leading online auction site for the Spanish and Portuguese-speaking communities in Latin America, MercadoLibre.com, that would give eBay access to Argentina, Chile, Colombia, Ecuador, Mexico, Uruguay, and Venezuela.

At the end of 2003 eBay had a presence in 28 countries, including Australia, Austria, Belgium, Canada, China (through an investment in the Chinese company Eachnet), France, Germany, Ireland, Italy, the Netherlands, New Zealand, Singapore, South Korea, Spain, Sweden, Switzerland, Taiwan, Great Britain, and Latin America (through an investment in MercadoLibre.com) and held the top online auction position in every country except Taiwan, where it was a close number two to Yahoo. eBay perceived this rapid international expansion as one of the keys to attaining its goal of having $3 billion in annual revenues by 2005. Growth opportunities were especially appealing in Asia (due to rapid increases in Internet access) and Europe. The company's international business grew by 165 percent in 2002, and its largest international markets were Germany (where 75 percent of eBay users were classified as active users), the United Kingdom,

[14]eBay 10K, filed March 30, 2000.

and South Korea. At the end of 2002, the company said:

> [We are] going to invest heavily in international expansion, to tap the huge potential that appears to be the hallmark of Germany, the UK, and Korea and so many of the other markets that we've entered. And we're going to do all of this with the same financial discipline we have always shown by staying true to our strategy of balancing returns with appropriate investment to capitalize on the company's long-term opportunities.[15]

HOW eBAY'S AUCTION SITE COMPARED WITH THOSE OF RIVALS

Auction sites varied in a number of respects: their inventory, the bidding process, extra services and fees, technical support, functionality, and sense of community. Since its inception eBay had gone to great lengths to make its Web site intuitive, easy to use by both buyers and sellers, and reliable. Efforts to ensure ease of use ranged from narrowly defining categories (to allow users to quickly locate desired products) to introducing services designed to personalize a user's eBay experience. Two specific services developed by eBay and launched in 1998 to increase personalization were My eBay and About Me. My eBay gave users centralized access to confidential, current information regarding their trading activities. From his or her My eBay page a user could view information pertaining to his or her current account balances with eBay; feedback rating; the status of any auctions in which he or she was participating, as either a buyer or a seller; and auctions in favorite categories. In October, eBay introduced the About Me service, which allowed users to create customized home pages that could be viewed by all other eBay members and could include elements from the My eBay page such as user ratings or items the user had listed for auction, as well as personal information and pictures. This service not only increased customer ease of use but also contributed to the sense of community among the traders; one seller stated that the About Me service "made it easier and more rewarding for me to do business with others."[16] New features and services added in 2000 included new listing functions that could make an auction stand out, including Highlight and Feature Plus, as well as a feature that allowed sellers to cross-list their products in two categories, a tool to set prequalification guidelines for bidders, a new imaging and photo hosting service that made it easier for sellers to include pictures of their goods, and the introduction of the Buy It Now tool.

Throughout its history eBay had struggled to balance its explosive growth with its technological infrastructure. To counter several significant service outages the company had faced in its early days, eBay hired Maynard Webb, a premier software engineer and troubleshooter who was working at Gateway Computer. Webb took swift action, forming alliances with key vendors such as Sun, IBM, and Microsoft, and outsourcing its technology and Web site operations to Exodus Communications and Abovenet. These outsourcing agreements were intended to allow Exodus and Abovenet to "manage network capacity and provide a more robust backbone" while eBay focused on its core business.[17] While eBay still experienced minor outages when it changed or expanded services (for example, a system crash coincided with the introduction of the original 22 regional Web sites), system downtime decreased. However, the stability of the system under eBay's explosive growth and continuous introduction of new features was a continuing management concern.

In 2003 Empirix conducted a benchmark study of online auction site performance that measured key performance metrics for six leading auction sites. This study included three customer experience metrics: efficiency (how long transactions were in seconds), consistency (how much the transaction lengths varied), and reliability (how often transactions were completed successfully). Results indicated that Amazon.com had the best performance, BidVille had the shortest transaction length, and eBay's Web applications were slower and more error prone than rivals' (see Exhibit 7).

eBay's Main Competitors

eBay considered the ability to attract buyers, the volume of transactions and selection of goods, customer service, and brand recognition to be the most important competitive factors in the online auction industry. In addition to these principal factors, eBay was also attempting to

[15]2002 eBay annual report.

[16]Ann Pearson, in an eBay press release dated October 15, 1998.

[17]eBay press release, October 8, 1999.

exhibit 7 Performance Metrics for Online Auction Firms

	Customer Experience Metrics				
	Reliability	Efficiency			Consistency
	Percent Error Rate	Average Transaction Length (seconds)	Minimum Transaction Length (seconds)	Maximum Transaction Length (seconds)	Variability of Transaction Length (seconds)
Amazon Auctions	0.52	5.68	3.39	47.1	3.6
BidVille	0.82	3.90	.05	71.1	3.77
eBay	3.97	13.20	7.34	97.5	6.01
ePier	1.02	7.29	4.7	83	5.98
uBid	11.76	5.95	3.05	185	8.39
Yahoo Auctions	2.38	10.94	2.97	112	4.37

Source: Benchmark Study of Online Auction Performance August–September 2003, www.empirix.com.

compete along several other dimensions: sense of community, system reliability, reliability of delivery and payment, Web site convenience and accessibility, level of service fees, and quality of search tools.[18]

Early in eBay's history the company's main rivals could be considered classified advertisements in newspapers, garage sales, flea markets, collectibles shows, and other venues such as local auction houses and liquidators. As eBay's product mix and selling techniques evolved, the company's range of competitors did as well. The broadening of eBay's product mix beyond collectibles to include practical household items, office equipment, toys, and so on brought the company into more direct competition with brick-and-mortar retailers, import/export companies, and catalog and mail order companies. Further, with the acquisition of Half.com, the introduction of eBay stores, and the growing percentage of fixed-price and Buy It Now sales as a percentage of eBay's revenue, eBay considered itself to be competing in a broad sense with a number of other online retailers, such as Wal-Mart, Kmart, Target, Sears, JCPenney, and Office Depot. In competing with these larger sellers, eBay began to adopt some of their tools, such as the use of gift certificates. The company also felt that it was competing with a number of specialty retailers, such as Christie's (antiques), KB Toys (toys), Blockbuster (movies), Dell (computers), Foot Locker (sporting goods), Ticketmaster (tickets), and Home Depot (tools).[19] In 2003 eBay begin experiencing competition from new sources, including portals (such as Yahoo) and search providers (such as Google and Overture) that sought to become primary launch pads for online shopping. Exhibit 8 displays eBay's customer service rankings as compared to a variety of rivals' customer service rankings.

eBay management saw traditional competitors as inefficient because their fragmented local and regional nature made it expensive and time-consuming for buyers and sellers to meet, exchange information, and complete transactions. Moreover, the competitors suffered from three other deficiencies: (1) They tended to offer limited variety and breadth of selection as compared to the millions of items available on eBay, (2) they often had high transaction costs, and (3) they were information inefficient in the sense that buyers and sellers lacked a reliable and convenient means of setting prices for sales or purchases. By the same token, eBay's management saw its online auction format as competitively superior to these rivals because (1) it facilitated buyers and sellers meeting, exchanging information, and conducting transactions; (2) it allowed buyers and sellers to bypass traditional intermediaries and trade directly, thus lowering costs; (3) it provided global reach to greater selection and a broader base of participants; (4) it permitted trading at all hours and provided continuously updated information; and (5) it fostered a sense of community among individuals with mutual interests.

[18]Ibid.

[19]eBay 10Q annual report, November 14, 2001.

exhibit 8 Customer Service Rankings (scores out of 100)

Sector/Company	1999	2000	2001	2002
E-commerce				
E-commerce retail	NA	78	77	83
Yahoo, Inc.	74	73	76	78
Amazon.com, Inc.	NA	84	84	88
Online Auctions Overall	NA	72	74	77
eBay	NA	80	82	82
uBid, Inc.	NA	67	69	70
Portals/search engines				
Yahoo, Inc.	74	73	76	78
Google, Inc.	NA	NA	80	82
Retail				
Overall retail	73.3	72.9	74.8	74.6
Target	74	73	77	78
Sears	71	73	76	75
Wal-Mart	72	73	75	74

Source: American Customer Satisfaction Index, www.theacsi.org.

Even with the strengthening competition, analysts estimated that eBay controlled approximately 85 percent of the consumer-to-consumer online auction market and 64 percent of total online auction revenue share. The most significant competitors to eBay's auction business included Amazon Auctions, Yahoo Auctions, and uBid. Two of the smaller competitors in the online auction industry included BidVille (an auction site with no listing fees and no final value fees) and ePier (60,000 members as of January, 2004). Both of these had closely copied eBay's look and fee structure and touted themselves as "alternatives to eBay."

Amazon.com Auctions Amazon.com's business strategy was to "be the world's most customer-centric company where customers can find and discover anything they may want to buy online."[20] With its customer base of 35 million users in over 150 countries and a very well-known brand name, Amazon.com was considered the closest overall competitive threat to eBay, especially as eBay expanded its business model beyond its traditional auction services. Analysts estimated that Amazon.com had a 5–7 percent share of all online retail sales, but Hitwise, an Internet competitive intelligence service, found that for the week ending September 20, 2003, eBay had a 93.6 percent share of all Web traffic to auction sites while Amazon.com had only a 1.1 percent share.

Amazon was created in July 1995 as an online bookseller and had rapidly transitioned into a full-line, one-stop-shopping retailer with a product offering that included books, music, toys, electronics, tools and hardware, lawn and patio products, video games, software, and a mall of boutiques (called z-shops). Amazon.com was the Internet's number one music, video, and book retailer. One of the distinctive features customers appreciated about Amazon.com was the extensive reviews available for each item. These product reviews were written both by professionals and by regular users who had purchased a specific product. The company's 2003 net sales were estimated between \$6.2 and \$6.7 billion, up almost 58.9 percent from 2002. In 2002 the company showed its first income from operations—\$64.1 million—and the 2003 operating revenue increased substantially from 2002 (as seen in Exhibit 9). One significant weakness analysts noted in Amazon's financials was that the company's free shipping policies, put in place to draw more customers, had a significant, negative impact on net income.

[20] 2000 Amazon annual report.

exhibit 9 Operating Results

Year	Income or (Loss) from Operations (in millions)
1996	$(6.2)
1997	(31.0)
1998	(124.5)
1999	(720.0)
2000	(863.9)
2001	(412.3)
2002	64.1
2003	400.0 (est)

By 2003 Amazon's management felt that it was in a position that would allow it to balance demands of both cost control and growth in executing a strategy intended to enhance Amazon's position as leader in retail e-commerce. As an indication of the company's success in executing its strategy, its customer base rose from 14 million to 20 million during 2000 and to 35 million by 2003. The company invested more than $300 million in infrastructure in 1999 and opened two international sites, www.amazon.co.uk (the United Kingdom) and www.amazon.de (Germany), and later added www.amazon.ca (Canada), www.amazon.co.jp (Japan) and www.amazon.fr (France). These sites, along with Amazon.com, were among the most popular online retail domains in Europe. By 2004 international sales had grown to over $2 billion from just $168 million in 1999 and accounted for 38 percent of all Internet sales.

Some analysts felt that in expanding its position both internationally and abroad Amazon had conceded the top spot in online auction to eBay and was looking to explore other avenues. Amazon often used strategic alliances to support its innovative expansion initiatives. For example, the company had agreements with Borders Books to allow customers to pick up Amazon.com book orders in-store, as well as e-commerce partnerships with Ashford.com, Drugstore.com, CarsDirect.com, and Sotheby's (a leading auction house for art, antiques, and collectibles), and opened a co-branded toy and video game store online with Toysrus.com. During 2003, the company announced an agreement with the band Pearl Jam to sell the group's music directly to fans through Amazon's Advantage program. By 2003 Amazon.com had over 550,000 active third-party sellers on its site and 350 branded sellers, most of them selling through shops rather than auctions. These third-party sellers accounted for over 22 percent of U.S. sales. To further expand the company's reach, in September 2003 Amazon established an independent unit called A9 that was charged with creating the best shopping search tool for Amazon's use and for use by other companies and third-party Web sites. To compete with eBay's fixed-price formats, Amazon began including links on product pages that allowed customers to view identical new and used items from third-party sellers.

uBid.com uBid's mission statement was to "be the most recognized and trusted business-to-consumer marketplace, consistently delivering exceptional value and service to its customers and supplier partners."[21] According to the company, "uBid delivers to the customer both the cost savings of an auction and the customer care of popular brand name retail e-commerce sites, making uBid a destination point for consumer share of wallet as they capitalize on the benefits of this high performance hybrid business model."[22] As such, uBid considered itself to be in direct competition with eBay, although a distant second, especially to that portion of eBay's business that was derived from large corporations and smaller companies wanting to sell their products through an auction format. The company's business model centered on offering brand-name, often refurbished and closeout, merchandise at a deep discount in a relatively broad range of categories from leading brand-name manufacturers such as Sony, Hewlett-Packard, IBM, Compaq, AMD, Minolta, and over 1,000 other suppliers. Categories included Computer and Office; Consumer Electronics; Music, Movies & Games; Jewelry & Gifts; Travel & Events; Home & Garden; Sports; Toys & Hobbies; Apparel; Collectibles; and Everything Else. The merchandise was offered in both an online auction format in which prices started at $1.00 and through uBid's fixed-price superstore. The merchandise was sourced from corporate partners and from uBid's own operations, which included a 400,000-square-foot warehouse and refurbishment center, and their current parent company Petters Group Worldwide, and from small and medium-sized companies who were members of uBid's Certified Merchant Program. Although uBid had offered consumer-to-consumer

[21]www.ubid.com/about/companyinfo.asp.

[22]Ibid.

auctions at one time, the company had discontinued this option as of 2002 due to the costs associated with policing fraud and concerns over product quality.

Founded in April 1997, uBid offered an initial public offering on the Nasdaq in December 1998. The company had experienced significantly increased revenues every year since its inception through 2000, but it had never captured the share of the auction market that its founders hoped was possible, although it at one time had a 14.7 percent share of revenues in the online auction market. In mid-2000 uBid was sold to CGMI Networks, and then it was sold again to Petters Group Worldwide in 2003. With each sale the number of workers employed by uBid fell and the product mix was changed in an attempt to find a niche market that would insulate the company from the competitive power of eBay.

Yahoo Auctions Yahoo.com, the first online navigational guide to the Web, launched Yahoo Auctions in 1998. Yahoo.com offered services to nearly 200 million users every month in North America, Europe, Asia, and Latin America. The Web site was available in 24 countries and 12 languages. Yahoo reported net revenues of $1.11 billion in 2000 (up 88 percent from 1999) and net income of $290 million. Yahoo's user base grew from 120 million to over 180 million during 2000. In December 2000 Yahoo's traffic increased to an average of 900 million page views per day (up 94 percent from 1999). Yahoo had entered into numerous alliances and marketing agreements to generate additional traffic at its site and was investing in new technology to improve the site's performance and attractiveness.

Its auction services were provided to users free of charge in the early days, and the number of auctions listed on Yahoo increased from 670,000 to 1.3 million during the second half of 1999. However, when Yahoo decided to start charging users a listing fee in January 2001, listings fell from over 2 million to about 200,000.[23] Yahoo Auctions also offered many extra services to its users. For example, the Premium Sellers Program was designed to reward the sellers that were consistently at the top of their category. These Premium Sellers were allowed enhanced promotions, premium placement, and direct access to customer support. In recognition of the fall in listings due to the listing fee instituted in January, Yahoo Auctions announced a revamped performance-based pricing model for its U.S. auctions in November 2001. In this system, which was relatively similar to eBay's, listing fees were reduced and sellers were charged according to the value of an item sold. In response to this change the number of listings rose to more than 500,000 by December 7, 2001.

While Yahoo had significant reach throughout the world, including over 25 local auction sites internationally, by 2004 Yahoo Auctions had reduced its international operations from 16 countries to 7 (Brazil, Canada, Hong Kong, Japan, Mexico, Singapore, and Taiwan). In 2002 alone Yahoo conceded its auction sites in France, Germany, Italy, Spain, and the United Kingdom and Ireland and promoted eBay's sites in each of those countries via banner ads and text links. In 2003 Yahoo sold its Australian site as well. However, in 2004 Yahoo began offering auctions in China through a joint venture with a dominant Chinese Web portal, Sina, indicating that it had not completely abandoned the international auction market. Further reinforcing Yahoo's commitment to online retail, in July 2003 Yahoo acquired Overture, which was the leading provider of commercial search as of the end of the first quarter of 2003 with more than 88,000 advertisers globally as well as an extensive affiliate distribution network. Many of the sellers who advertised on Overture also advertised on eBay, and some analysts estimated that the amount of sales by merchants through the combination of Yahoo's and Overture's offerings would total between one-half to two-thirds of that available on eBay.

eBAY'S NEW CHALLENGES

Heading into 2004 eBay was the undisputed leader in the online auction industry. To reach this enviable position, eBay had to overcome a number of hurdles. Throughout its history, eBay faced each new challenge with an eye on its founding values and an ear for community members. Omidyar said, "What we do have to be cautious of, as we grow, is that our core is the personal trade, because the values are communicated person-to-person. It can be easy for a big company to start to believe that it's responsible for its success. Our success is really based on our members' success. They're the ones who have created this, and they're the ones

[23]Troy Wolverton , "eBay Seeks to Sail into New Territory," CNET News.com, July 19, 2001.

who will create it in the future. If we lose sight of that, then we're in big trouble."[24] The company applied this perspective in response to significant customer concerns regarding the growing presence of corporate sellers on eBay.

Omidyar and Whitman recognized the importance of eBay's culture and were aware of the potential impact rapid growth and the evolution of the product line could have on this valued asset. When asked about the importance of the culture Omidyar said, "If we lose that, we've pretty much lost everything."[25] Whitman agreed with the importance of eBay's culture, but she did not see the influx of larger retailers and liquidators as a significant problem. Even as these sellers grew to account for 5 percent of eBay's total business in 2004 (from 1 percent in 2001), these large sellers received no favorable treatment. Whitman stated, "There are no special deals. I am passionate about creating this level playing field."[26] While this view was applauded by the smaller sellers, some larger sellers viewed these policies as overly restrictive.

Heading into 2004, eBay faced two fundamental challenges:

1. How could eBay continue to grow at its current pace given the maturing of its domestic market?
2. As eBay's business model evolved to include more fixed-price sales, could it transfer its competitive advantage in the online auction industry into the more general area of online retail?

Continued Growth

By virtually any measure, eBay's growth had been outstanding. However, this impressive track record, coupled with the progress they had made in reaching their stated goals had created high expectations among investors. These lofty expectations began to cause some concern among analysts as eBay's domestic core market of online auction sales began to show some warning signals. For example, in 2003 the average conversion rate (the number of auctions that were completed successfully) was approximately 51 percent, a rate that had held steady over the last two years. However, supply imbalances threatened this key metric. In many categories, as the number of sellers grew, supply was beginning to outstrip demand. One of the few categories in which demand outstripped supply was eBay Motors, which had an average of 11 bids from seven unique users for each sale. Further, almost half of eBay's registered users were from the United States and represented almost one-third of all U.S. Internet users. With the U.S. online auction market maturing and eBay maintaining the dominant market share, analysts were concerned with how much more penetration eBay could achieve.

In response to these concerns, eBay cited new trends indicating that even in the United States the company was reaching new customers and had room to grow. One of the trends eBay saw as particularly promising was the increasing use of eBay's 28,000 registered Trading Assistants and the emergence of drop-off eBay consignment services. Trading Assistants were experienced eBay sellers who, for a fee, would help users sell their items on eBay. Extending this service, drop-off consignment services began to spring up as early as 2000. These consignment services, such as AuctionDrop, QuickDrop, and Picture-It-Sold, would take physical possession of a customer's items, typically those with an eBay value of over $50, and sell them on eBay for a fee equal to between 30 and 40 percent of the item's final sale price. The company was encouraged by these activities because they reached sellers who would not normally use the Internet.

eBay also challenged the theory that the maturity of its markets was based on the company's total market penetration in key categories. For example, eBay argued that it had significant market opportunity in areas such as eBay Motors, where its $6.7 billion in gross merchandise sales accounted for less than 1 percent of the value of all vehicles sold in the United States. Based on this model, none of eBay's largest categories had a market penetration of 5 percent (see Exhibit 10).

Evolution of the Business Model

There was little concern that anyone would seriously threaten eBay in its core auction business in the near

[24]"Q&A with eBay's Pierre Omidyar," *BusinessWeek E.Biz,* December 3, 2001.
[25]"The People's Company," *BusinessWeek E.Biz,* December 3, 2001.
[26]"Queen of the Online Flea Market," Economist.com, December 30, 2003.

exhibit 10 **eBay's Largest Auction Categories, by Annualized Gross Merchandise Sales, as of Fourth Quarter 2003 (in millions)**

	Fourth-Quarter 2003	Market Penetration
Motors	$7,500	<1%
Consumer electronics	2,600	1–4%
Computers	2,400	1–3%
Books, movies, music	2,000	~3%
Clothing and accessories	1,800	<1%
Sports	1,800	2–5%
Collectibles	1,500	2–3%
Toys	1,500	~5%
Home and garden	1,100	<1%

Source: Corporate reports, Lehman Brothers estimates, www.lehman.com.

future, but with the increasing use of tools such as gift certificates, the growing importance of fixed-price sales, the purchase of Half.com, and the growing popularity of Buy It Now, eBay came into more direct competition with retailers such as Amazon.com, with e-commerce solutions, and with the likes of Microsoft. Some analysts also thought that search engines such as Google that were directing customers to clients who paid to have their sites prominently featured in the search engine's results would also become a competitor in the near future, but Meg Whitman dismissed this possibility, saying, "We see Google and Yahoo search and MSN search . . . as actually enablers of our business," she said. "We think both natural search and paid search are allies of ours."[27] When asked about how the evolution of their business model influenced their sphere of competition, Whitman said,

> If we were a retailer, we'd be the 27th-largest in the world. So our sellers are competing [with retailers] for consumer dollars. If you're thinking about buying a set of golf clubs or a tennis racket or a jacket or a pair of skis, you decide whether you're going to do that at eBay, at Wal-Mart, a sporting-goods store, or Macy's. I would define our competition more broadly than ever before.[28]

The threat of these competitors increased as fixed-price sales comprised an ever-increasing percentage of eBay's total sales and growth. By the end of 2003, fixed-price trading accounted for 28 percent of eBay's gross merchandise sales (the dollar value of merchandise sold) and was expected to experience continued growth throughout the foreseeable future.

THE FUTURE

Heading into 2004, eBay was almost certain to reach the aggressive growth targets it had set for itself in 2000—and its stock price reflected this belief (see Exhibit 11). In fact, most analysts forecast that eBay would meet these goals a year early. The main question that plagued investors was, How would the company continue its phenomenal growth rate? In considering future moves eBay had a few issues to address. First, how should it prioritize its efforts? Was additional expansion in the international markets the highest priority? If so, where? Alternatively, should eBay focus on further broadening its offerings to include more categories, more specialty sites, and more sellers? How much emphasis should be put on fixed-price options? If the company chose to continue expanding its fixed-price offerings, how could it position itself vis-à-vis established online retailers, and how could it defend itself against new, more diverse competitors such as paid search engines?

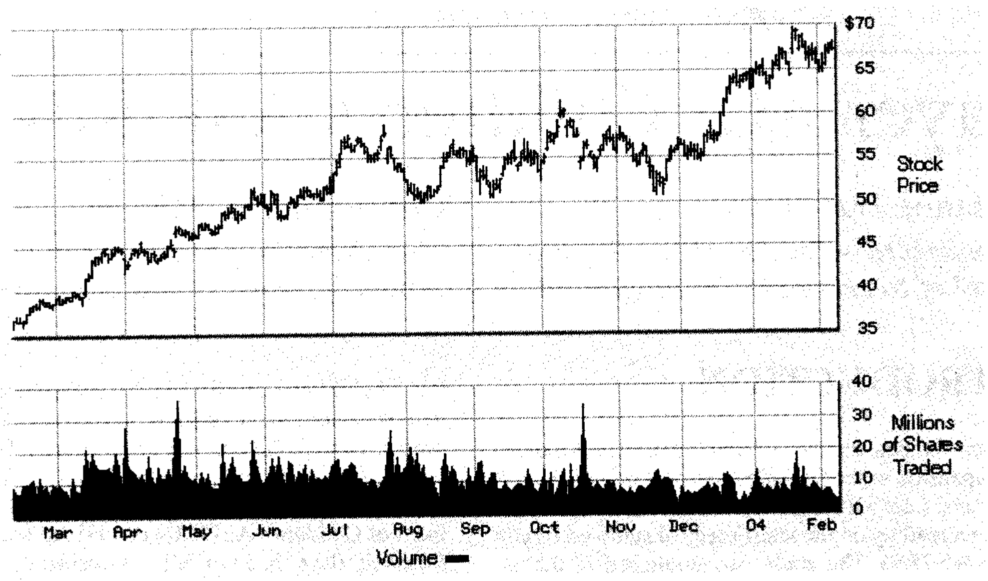
Finally, eBay was facing increasing dissatisfaction by some of its largest corporate sellers. Some corporate sellers were experiencing significant difficulty with selling a large volume of goods on the site while maintaining a sufficient profit margin. According to Walt Shill, the former chief of Return-Buy, a company that liquidated unsold merchandise for electronics retailers and manufacturers, eBay didn't have enough buyer demand to absorb significant quantities of a single good, such as a specific brand and model of a digital camera, in a short period of time, as eBay was "two inches deep and miles wide."[29] Whitman acknowledged this

[27]Ben Berkowitz, "eBay to Experiment Again with Local Auction Sites," www.usatoday.com, February 24, 2004.

[28]"Meg Whitman on eBay's Self-Regulation," *Business Week Online*, August 18, 2003.

[29]Nick Wingfield, "As eBay Grows, Site Disappoints Some Big Vendors," *The Wall Street Journal*, February 26, 2004.

exhibit 11 eBay's Stock Price Performance, March 2003–February 2004



Source: www.bigcharts.com, February 9, 2004.

problem and stated that, for sellers wishing to "move a thousand of the same computer in a day, eBay may not be one of the most effective channels."[30] This problem, coupled with eBay's fairness policy, was causing many large sellers such as Motorola and Circuit City to abandon selling on eBay and to search for additional sales outlets. According to Scott Wingo, CEO of ChannelAdvisor, a leading provider of auction and marketplace management software that was partially owned by eBay, eBay would need to reconsider its level-playing-field policy, which prohibited giving special perks or fee discounts to big sellers if it wanted to attract large businesses and keep growing at its current rate.[31]

[30]Ibid.

[31]Ibid.

When eBay posted its 2003 results in early 2004, it was apparent to most industry observers that it would easily reach its stated goals a year early. Perhaps the only significant concern among analysts and investors was whether eBay could continue its growth without stretching itself too thin, especially given Meg Whitman's philosophy, as evinced in the following statement:

> You really need to do things 100 percent. Better to do 5 things at 100 percent than 10 things at 80 percent. Because the devil in so much of this is in the detail and while we have to move very, very fast, I think you are not well served by moving incredibly rapidly and not doing things that well.[32]

[32]"What's Behind the Boom at eBay?" *Business Week Online,* May 21, 1999.

case 5

Bayer AG: Children's ASPIRIN

Lauranne Buchanan
Thunderbird—The American Graduate School of International Management

Christopher K. Merker
Thunderbird—The American Graduate School of International Management

INTRODUCTION

Joachim Zander, director of brand equity and modernity expansion in the Global Strategy Group of Bayer's Consumer Care Division, looked up from articles he had been reading on the latest medical study on Reye's Syndrome (RS). The study was published in the esteemed *New England Journal of Medicine*, a journal written primarily by and for the American medical community. One of the articles had a headline that read, "Children's Reye's Syndrome Now Rare."[1] He rubbed his eyes as he thought to himself, "This is surely the final nail in the coffin of Children's ASPIRIN."[2]

Bayer's Children's ASPIRIN business had been declining ever since the early '80s when the US medical community alleged a link between the consumption of children's aspirin and the occurrence of a dangerous condition in children known as Reye's Syndrome. Though the link was never proven, Bayer acted responsibly to the public relations crisis by self-imposing a worldwide ban on all promotion and advertisement of Children's ASPIRIN in 1988. In the years that followed, Bayer had not fully reconsidered its strategy for Children's ASPIRIN, nor had it considered introducing other analgesic products for children.

For years, Zander had wanted to conduct a brand audit to determine the future of ASPIRIN in the children's segment. But the project always fell behind something more pressing; given this new wave of publicity, it seemed like the time for the audit was now or never. Zander had recently hired a new intern, Chris Merker, from Thunderbird, The American Graduate School of International Management, and Merker was interested in conducting a study of the product market. Dividing up the work would make the task of examining and assessing the world market more manageable.

As Zander reflected on Children's ASPIRIN, his mind turned to other developments in the overall aspirin market and how it related to the little 100 mg. tablet. Concurrent with the decline within the children's segment, there had been new discoveries opening other business opportunities. In 1985, the medical profession revealed that aspirin is effective in the prevention of heart attacks and strokes. As the prevention market developed, Zander and other managers at Bayer realized that an increasing percentage of Children's ASPIRIN sales went to prevention. This was due, in part, to its lower cost but also to the lower dosage recommended for prevention (81–100 mg. compared to 325–500 mg. in adult aspirin). The percentage of sales of Children's ASPIRIN accounted for by the prevention market, however, was unclear.

THUNDERBIRD
THE AMERICAN GRADUATE SCHOOL OF INTERNATIONAL MANAGEMENT

Copyright © 2002 Thunderbird, The American Graduate School of International Management. All rights reserved. This case was prepared by Professor Lauranne Buchanan and Christopher K. Merker, MIM candidate, for the purpose of classroom discussion only, and not to indicate either effective or ineffective management.

[1] *The Associated Press,* May 5, 1999, at 16:58 EDT, Copyright 1999, File: h0505165.900; see also Belay, Bresee, Holman, Khan, Shahriari, Schonberger, "Reye's Syndrome in the United States from 1981 through 1997," *New England Journal of Medicine,* May 6, 1999, Vol. 340, No. 18, pp. 1377–1382.

[2] ASPIRIN is a brand name owned by Bayer in many countries; therefore to avoid confusion, this case will refer to the brand name as ASPIRIN (upper case) and to the substance aspirin as ASA or aspirin (lower case).

From worldwide sales data, it appeared that Children's ASPIRIN was growing. Total sales of Children's ASPIRIN had increased at a compounded annual growth rate (CAGR) of 13.34% over the five-year period from 1994 through 1998. Yet the growth in sales could have been driven completely by the growth in the prevention market.

With the new Thunderbird intern on his staff, Zander was determined to get to the bottom of the issues surrounding Children's ASPIRIN. He wondered to himself, "How much of these sales are attributable to the children's market and how much to prevention? And, what are the implications not only for the Consumer Care (CC) Division of Bayer, but for Pharma, the division which handles other prevention brands?"

BACKGROUND

Industry Dynamics

Throughout the 1990s, the pharmaceutical industry underwent several major changes. One of these changes was a strategic movement away from the concentration of dollars on Research & Development (R&D) within the value chain to greater attention and resources being devoted to marketing and advertising. Another change was the way marketing dollars were allocated. Historically, the sales force had been the center of the marketing program, and they had focused on direct selling to doctors, the gatekeepers of prescription drugs.

As government regulations, particularly in the US, loosened within the area of direct-to-consumer (DTC) advertising, more of the marketing dollars shifted to advertising. In DTC ads, consumers are made aware of a drug product available only by prescription and are told to "ask their doctor about" the drug. As marketing research established the effectiveness of these ads, more and more firms turned to DTC advertising as a source of sustainable competitive advantage. These trends were expected to continue:

> . . . pharmaceutical makers launched new advertising programs to raise awareness of products among consumers. In 1994, the amount spent on drug advertising was about $240 million, a 50% increase over 1993 expenditures. Expenditures were forecast to double by 1997. By 1995, manufacturers advertised more than two dozen prescription drugs on television, radio, and printed material. A 1995 survey indicated that 10% of consumers had some knowledge about 13 of the 17 most heavily advertised drugs. In contrast, only one drug received a similar response rate in 1989. Survey results also indicated that 99% of physicians surveyed—as opposed to 84% in 1989—would prescribe or consider prescribing a specific drug if a patient asked for it by name.[3]

Not only does creating awareness of a pharmaceutical generate additional sales, but it also prepares the market for transfer of the ethical drug to over-the-counter (OTC) status.[4] Converting ethical drugs to OTCs is a strategy to increase market share and sales over the product life cycle of the drug. This strategy is one means of prolonging—and possibly increasing—sales revenues of the drug as generic copycats arrive on the market upon patent expiration. The value of the brand to the consumer differentiates otherwise identical and competing products.

DTC advertising, deemed by many authorities as inappropriate, is more prevalent in the US than in other parts of the world such as Europe. Europe historically has taken a much more conservative approach with regard to advertising claims in general. For example, comparative advertising was permitted by EU law for the first time in the spring of 2000, while it had been permissible for decades in the US. A study commissioned by Bayer in the late 1990s indicated that DTC advertising in Europe would not occur for at least five to ten years. Nonetheless, a combination of direct selling to doctors and direct advertising to consumers is expected to become the predominant global strategy of pharmaceutical companies in both ethical and OTC categories in the future. The official regulatory status of products is expected to become less important, blurring the lines between ethical and OTC drugs.

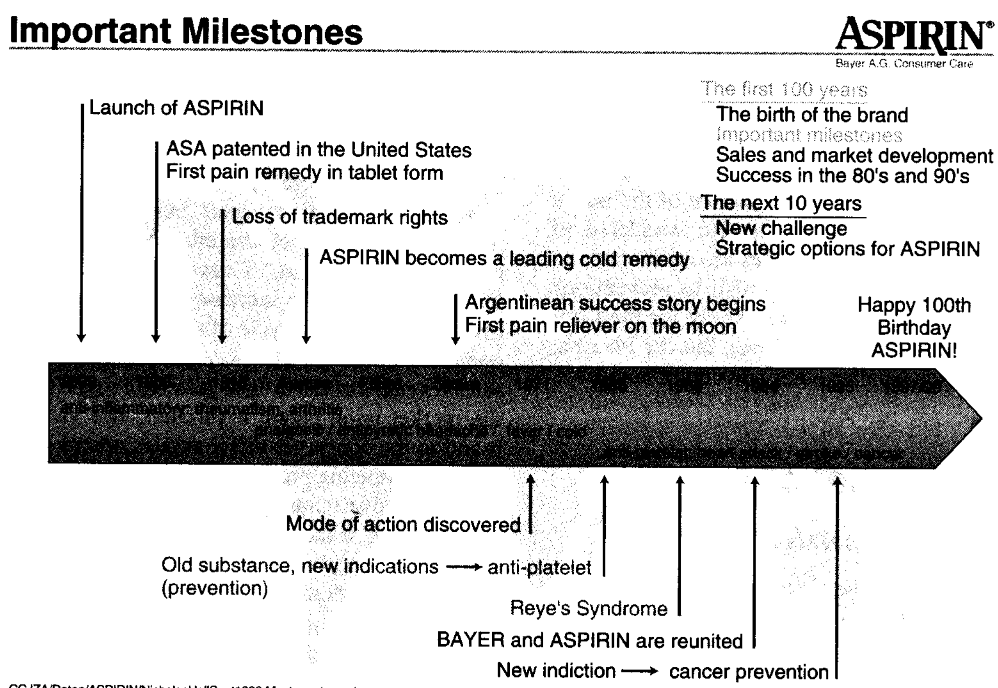
The Company

Bayer is a pharmaceutical and chemical company headquartered in Leverkusen, Germany with about 20 different business units that research, develop, and

[3]McGahan, Coxe, Keller, and McGuire, "The Pharmaceutical Industry in the 1990s," Harvard Business School Case 9-796-058 (1995), pp. 9–10.

[4]Ethical drugs are drugs sold only with a doctor's prescription; over-the-counter (OTC) status means that a drug may be sold without a doctor's prescription.

exhibit 1 **ASPIRIN Milestones**



manufacture products in the life sciences, polymers and specialty chemicals areas. Employing 120,400 people worldwide, the group has operations in nearly all countries of the globe and a portfolio of about 10,000 products. With annual worldwide sales of DM 54.9 billion and an operating result of DM 6.15 billion (1998), it is considered a world leader in its sector.[5]

The jewel at the very center of the Bayer crown is the brand ASPIRIN, and it is without question the most successful over-the-counter drug in history. In fact 1999 marked the 100th anniversary of ASPIRIN (see Exhibit 1 for a timeline of ASPIRIN milestones over the last 100 years). Felix Hoffman, a Bayer chemist, invented the drug in 1897, and the drug was brought to market two years later. The brand ASPIRIN is still the number two analgesic drug in the world with net sales in 1998 of DM1.1 billion (US$654.8 million). Only Tylenol exceeds ASPIRIN in sales, but 95% of Tylenol's sales are in the US; in the rest of the world, Bayer is still number one (see Exhibit 2 for sales and market development).

[5]All facts and figures, unless otherwise stated, are provided by Bayer AG.

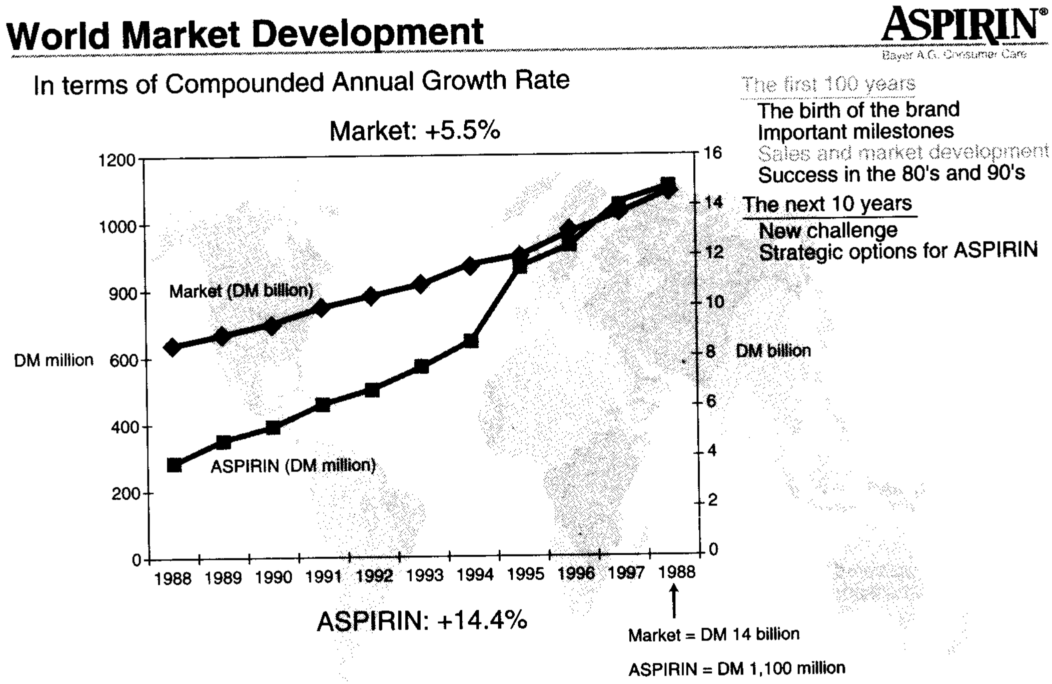
Consumer Care is the division of Bayer charged with the management of ASPIRIN and other OTCs, as well as other consumer products. In 1998, Pharma, Bayer's pharmaceutical division, was given control of the ASPIRIN prevention business since aspirin is typically prescribed by doctors for this indication.[6]

The ASPIRIN Family

ASPIRIN is a family of well-known brands and products, which includes Children's ASPIRIN, ASPIRIN-Protect®, ASPIRIN Direct®, ASPIRIN+C®, and many others. All are geared for specific uses such as cough and cold, headache and pain, stroke and heart attack prevention. Many have unique delivery systems such as granules, effervescent tablets, and chewable forms. Of the US$654.8 million in total worldwide net sales of all ASPIRIN products in 1998, US$37.5 million (5.8%) came from the sale of Children's ASPIRIN.

[6]A drug's indication simply means what the drug is used/prescribed for. The indication will typically be printed on the drug's packaging label, and is in almost all cases closely controlled by the government.

exhibit 2 **Market Development**



CCJZA/Daten/ASPIRIN/NicholasHallSept1999.Master.pptpage1

Brand

Originally, the brand name ASPIRIN was coined by Bayer as the tradename for acetylsalicylic acid (ASA). Bayer continues to hold a trademark on the brand name in many countries of the world, but has lost that right in several key countries like the United States (see Exhibit 3 for more information on where Bayer sells aspirin and continues to hold a trademark). The Bayer trademark was lost initially in the US at the end of World War I to Sterling Drug, Inc. as the result of the US government's retaliatory practice of confiscating and then auctioning off the property of German companies with holdings in the United States.[7] It wasn't until 1994, 76 years after the expropriation of the trademark Bayer ASPIRIN, that Bayer Group finally reacquired the brand (with a few other Sterling Drug OTC businesses in North America such as Phillip's Milk of Magnesia®) for US$1 billion.

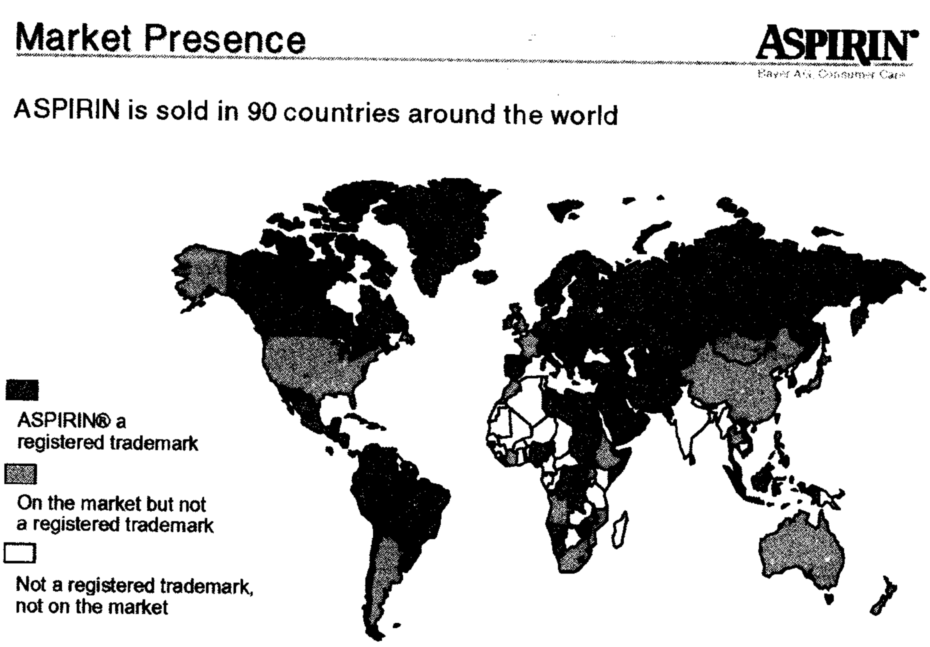
Despite regaining the name Bayer, Bayer Group cannot recoup the trademark on aspirin in the United States. In 1920, the US Patent Office cancelled the exclusive right of Sterling Drug, Inc., which held the Bayer ASPIRIN trademark, to sell ASA exclusively under the name ASPIRIN. A judge later supported this decision arguing that people knew ASA by the term "aspirin," and therefore any company should be permitted to sell the product under what had become the generic name.[8] There are significant economic implications of losing the right to market ASA exclusively under the name ASPIRIN, and Bayer has fared better in countries where it still retains that right.

In terms of Children's ASPIRIN, some OTC marketers at Bayer believe that a children's product is essential to the overall brand in two ways. One, it conveys a message of safety to the consumer; and, two, it fosters brand loyalty in future adult ASPIRIN customers.

[7]For more information about the history of the trademark, see Mann and Plummer's fascinating and comprehensive history of aspirin in *The Aspirin Wars: Money, Medicine and 100 Years of Rampant Competition,* pp. 32–38.

[8]Ibid., p. 66.

exhibit 3 **Market Presence**



CCJZA/Daten/ASPIRIN/NicholasHallSept1999.Master.pptpage4

REYE'S SYNDROME

History

In June 1986, the US Food and Drug Administration (FDA) mandated that all manufacturers of aspirin include this warning in their labeling:[9]

> Children and teenagers should not use this medicine for chicken pox or flu symptoms before a doctor is consulted about Reye's Syndrome, a rare but serious illness.[10]

In 1963, the Australian pathologist Reye described a very rare disease in children, the exact cause of which remains unknown. Reyes' Syndrome (RS) is an acute, noninflammatory disease of the brain and liver, usually seen following a viral infection. Some of the symptoms include frequent vomiting, seizures, episodes of disorientation, and coma. The disease can result in death.

In the late 1970s, epidemiologists began to review studies of RS that were conducted over two decades. They acted on a suspicion that aspirin could have been a contributing factor in the cause of the disease. The source of that suspicion was that most of the children in the initial RS studies were given aspirin—a known antipyretic (fever reducer)—to reduce fever in the early stages of a viral infection, which preceded the onset of RS. The ruling by the FDA was the culmination of the series of epidemiological studies conducted in the United States that alleged a connection between aspirin and the occurrence of Reye's Syndrome in children.

Since the ruling, the occurrence of RS has declined. Many in the US medical community argue that this has been a direct result of the information campaign launched in the US by the Center for Disease Control (CDC) and the FDA labeling requirement. This view is widely accepted, as indicated by an article in

[9]The label will contain the brand name, directions and indications, ingredient information, and any possible warnings on usage, such as conflicts with other drugs or, as in the case of Reye's Syndrome, any potential side effects of the drug. In most cases, labeling is strictly controlled by the government. Governments are typically involved in every step of the development and marketing of a new drug. Consequently, a large percentage of an R&D budget for developing a new drug is allocated toward regulatory affairs.

[10]See the back of any bottle of aspirin sold in the US.

the popular press citing research published in the prestigious medical journal, the *New England Journal of Medicine:*

> Reye's Syndrome, a rare but deadly disorder usually caused by giving aspirin to children with flu or chickenpox, has almost disappeared, thanks to a public education campaign and changes in treatment, a study found . . . In 1980, when the connection between aspirin and Reye's Syndrome was discovered, the CDC began warning doctors and parents not to give aspirin to children with viral infections . . . the study appears in Thursday's *New England Journal of Medicine.*[11]

Dissenting medical opinion and, of course, manufacturers of aspirin, claim that the evidence linking aspirin to RS lacks scientific validity. (See Appendix A for a rebuttal Bayer made to the *New England Journal of Medicine* study cited above; the rebuttal was circulated widely to the international press.)

To support this position, they cite empirical evidence from countries like Argentina, where children's consumption of aspirin remains strong, yet the occurrence of Reye's Syndrome is very low. The same is true in the seven major markets for Children's ASPIRIN, including Spain, Italy, Turkey, and several Latin American countries.

These groups also suggest that it is improvements in diagnostics that have made RS a much rarer condition, i.e. what in the past looked like RS might not have been RS at all, and thus not the result of taking aspirin for a viral infection. In other words, there has been no real decrease in the disease known as RS; rather there has been a decline in what is diagnosed as RS.

Finally, this side argues that there are many other factors present in genes or within the environment that could be responsible for causing RS, and that evidence isolating aspirin as a primary, contributing factor is still lacking. The reason alternative causes of the disease have not been identified and ruled out is that the biochemistry involved in explaining RS, which is a metabolic disorder, is extremely complex.

Unfortunately, the debate and the hundreds of studies, white papers and articles written on RS have done little to resolve these issues. But in this case, perception is everything. The debate within the health sciences that has gone on for over 20 years has had no impact on the conclusion reached by the public or by an influential medical community (specifically in the US) that there is a high risk in using aspirin to medicate children.

The regulation of aspirin for children is not without its downside. At a minimum, it limits consumer choice in the market and discourages both innovation and price declines associated with a competitive market. More importantly, however, it has reduced the use of aspirin among young consumers who could have benefited from the product for other indications.

Regulatory Issues, Public Opinion, and Bayer's Response

Initially, with allegations that aspirin caused death in children, the Bayer company was obviously greatly concerned about the threat to children. But they also wondered what it would mean for the future of the business. Some of the managers believed that the future viability of the entire brand was in question.

The first regulation came in 1984 when the German food and drug authority, the Bundesgesundheitsamt (BGA), mandated a warning on the label of all children's aspirin products. The warning indicated that, while there was a correlation between aspirin and RS, a direct relationship had not been established. In 1989, a revised BGA ruling dropped the disclaimer that the relationship had not been established. Bayer fully complied with both rulings just as it did in the United States with the FDA's 1986 decision.

In compliance with FDA standards, Bayer placed warnings on labels of Children's ASPIRIN worldwide, regardless of whether it was required by the host country's government. In 1988, Bayer took the additional step of invoking a worldwide ban on all advertising or promotion of ASPIRIN for children. In many ways, this was an extraordinary measure since Bayer AG, like many German companies, has a loose affiliation with its subsidiaries, and rarely engages in worldwide policymaking. Most subsidiaries are independent entities and operate as such. Nonetheless, virtually all affiliates complied with the ban.

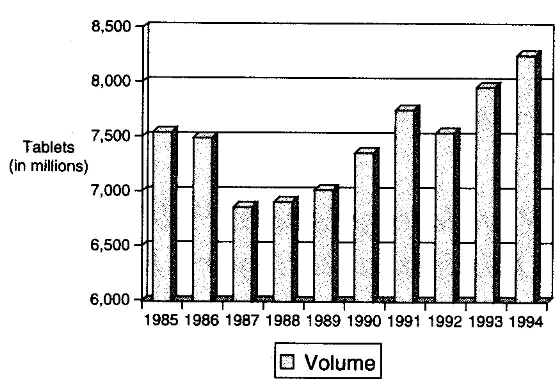
Bayer's policy of no promotion and advertising was developed, in part, to satisfy its constituency of customers, policymakers, and shareholders at home. Bayer had already pulled ASPIRINJunior® to satisfy

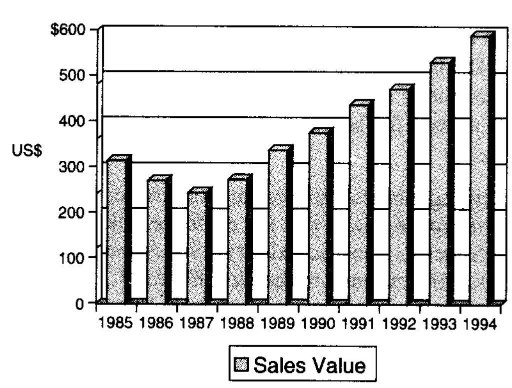
[11] *The Associated Press,* May 5, 1999, at 16:58 EDT, Copyright 1999, File: h0505165.900; see also Belay, Bresee, Holman, Khan, Shahriari, Schonberger, "Reye's Syndrome in the United States from 1981 through 1997," *New England Journal of Medicine,* May 6, 1999, Vol. 340, No. 18, pp. 1377–1382.

exhibit 4 **Effect of Reye's Syndrome on Sales of ASPIRIN (all products)**

Has Reye's Syndrome negatively impacted the overall sales performance of the ASPIRIN brand ?

CC-EU-NB/MR





the German public. It could not continue promoting the product in developing markets without being accused of exploiting consumers and taking advantage of the ambivalence of their government's regulatory bodies.

Despite these measures, Children's ASPIRIN remains a viable brand in many markets in southern Europe, e.g., Spain, Italy, Turkey, and in Latin America. In these countries, it is still prescribed by doctors and purchased by consumers. In Argentina, for example, where Bayer has an extremely strong brand presence, ASPIRINETAS continues to be the number one seller in the children's segment. Children's ASPIRIN is, therefore, managed in countries like Argentina as a cash cow. With virtually no monies set aside for advertising and promotion, the profit margins on the 100 mg. tablet are naturally higher.

Throughout the rest of the world, the publicity surrounding the association of aspirin with RS, the lack of any advertising and promotional support from Bayer, and aggressive competitive reaction lead to a dramatic decline in market share. For decades the number one children's analgesic, in 1998 Children's ASPIRIN accounted for 2.3% of total world market share for children's analgesics, which was valued at approximately US$865 million annually.[12]

While the Children's ASPIRIN business declined in many countries, the overall sales performance of the ASPIRIN brand (all products) continued to grow. During the crisis, there was a drop in the sales of all ASPIRIN products, but this can be attributed to other factors including huge price increases in Latin America and inadequate promotion in Asia and Africa. In fact, directly following the Reye's Syndrome crisis, ASPIRIN rebounded and experienced the highest growth rates in years (see Exhibit 4 for sales and volume performance of ASPIRIN during and after the crisis).

PREVENTION

At the same time that Bayer faced the crisis over Children's ASPIRIN and RS, there was some good news for Bayer. In October 1985, eight months before FDA imposed its labeling requirement for the children's indication, Margaret Heckler, then-US Secretary of Health and Human Services, held up a bottle of Bayer ASPIRIN at a press conference. She announced to the world that scientific studies had shown that first-time heart attack sufferers taking an aspirin a day could significantly reduce their chances of having a second heart attack.[13] In the battle against one of the leading causes

[12]IMS, Inc.; PADDS database (Bayer and IMS); IRI, Inc.; Bayer subsidiaries.

[13]*The Aspirin Wars*, p. 309.

exhibit 5 ASPIRIN's Three Distinct Indications and Three Distinct Markets

Therapeutic Quality	Indication	Product Markets OTC/Ethical	Competing Brands/ Substances	ASPIRIN's Market Share Worldwide
Analgesic Anti-inflammatory Antipyretic	Pain	Adult and children analgesics (OTC)	Tylenol/ acetaminophen (paracetamol) Advil/ibuprofen	8.2%
	Cough and cold	Cough, cold, anti-flu (OTC)	Nyquil, Contact, Theraflu, Robitussin	4.2
Anti-platelet	Prevention—heart attack	Anti-platelets and anti-coagulants (ethical)	Platel Cleartab, Heparin	9.1

of death in the developed world, the significance of this medical breakthrough could not be over-emphasized. It was wonderful news to scores of people at risk, for it meant that thousands of lives could be saved annually.

As a drug, aspirin not only has the properties of an analgesic or painkiller, it is also an antipyretic (anti-fever), an anti-inflammatory and an anti-platelet (see Exhibit 5). The first three qualities make it a headache, cold, and flu medication, but it is the fourth quality that makes ASPIRIN a preventive medication.

Interestingly, the anti-platelet effects of aspirin occur at a surprisingly low dosage: 30–50 mg. or so, and Children's ASPIRIN is one of the lowest dose aspirin products on the market. It also happens to be the cheapest among the ASPIRIN family of products. The significance of these two characteristics gave Children's ASPIRIN a new market, as doctors around the world started recommending and prescribing Children's ASPIRIN to their middle-aged patients as a means of prevention.

Bayer and their competitors have capitalized on the anti-platelet quality of aspirin by developing a whole battery of sophisticated—and more expensive—dosage and delivery systems intended for the at-risk-of-a-heart-attack user. Some, such as Bayer CardioASPIRIN®, are designed for persons with sensitive stomachs and are coated for enteric digestion. The tablet of aspirin is encased by a high-tech outer layer that allows the tablet to be digested and absorbed in the intestines rather than in the stomach. Others, such as ADIRO®, are microencapsulated and feature sustained release of the active ingredient over time, ensuring bioavailability and mucosa protection.

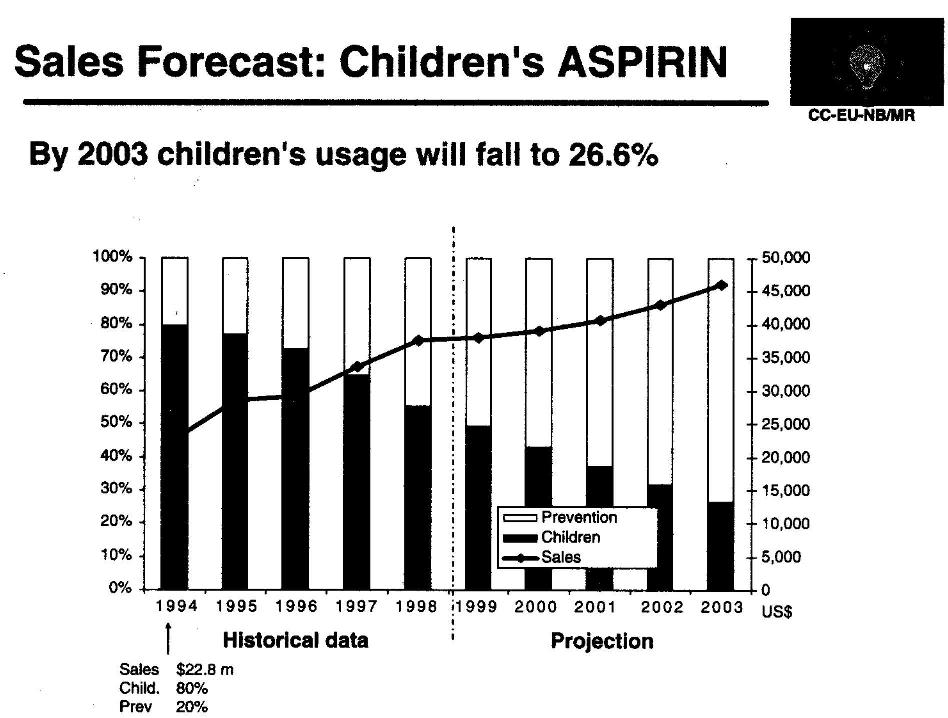
But for customers who don't require any special features of the medication, a lower dosage is all that's needed, and Children's ASPIRIN fills that role well. Almost half of all Children's ASPIRIN sales in 1998 were to prevention users, and the proportion was expected to increase rapidly.

A TALE OF TWO MARKETS

With the history of the Children's ASPIRIN brand in mind, Zander and Merker wondered how much prevention demand was driving the 13.34% CAGR in total sales. To answer this question, they began polling the country managers in the major market countries: Spain, Italy, Turkey, Argentina, Venezuela, Chile, Colombia, Brazil, Guatemala, Honduras, Nicaragua, Panama, Costa Rica, and El Salvador. They wanted to know the split in sales of Children's ASPIRIN between children and the adult prevention market. Country managers had a very good feel for the numbers, and they were able to go back five years to describe the development of the split in their respective countries of business. Exhibit 6 shows the splits in terms of total worldwide sales from 1994 to 1998 and with a five-year forecast through 2003. (White represents the prevention portion of sales, and gray, the children portion.)

In 1998, total sales of Children's ASPIRIN were US$20.8 million and US$16.8 million in the children's and prevention markets, respectively. Sales forecasted to the children's market decline to US$12.3 million by 2003.

The results further indicated that prevention customers had been rapidly replacing children customers over the five years from 1994 through 1998. Forecasts *exhibit 6* **Sales Forecast**



indicated that by 2003 approximately 27% of Children's ASPIRIN sales would be for children and 73% for prevention customers, effectively reversing the 80% / 20% split, respectively, from 1994.

From this, Zander and Merker realized that Children's ASPIRIN was naturally evolving into a low-cost, low-dosage prevention product. And it looked as if the combination of the rapid growth in the prevention market and the decline of the children's market would be the death of the Children's ASPIRIN brand.

This raised the following questions in their minds:

- What was the point of keeping Children's ASPIRIN on the market at all if the majority of sales went to prevention customers? Or, was Children's ASPIRIN meeting an implicit market demand that would be lost to competitors if Bayer left the market?
- And what impact was Children's ASPIRIN having on CardioASPIRIN® and ADIRO®, the preventive products managed by Pharma, Consumer Care's sister division? Was Children's ASPIRIN cannibalizing these brands, and if so, to what extent?

Based on these questions, Zander and Merker summarized the two possible directions Bayer could take in protecting and developing its prevention business:

1. Retract Children's ASPIRIN, pulling it off the market altogether and concentrating on pursuing the prevention market with the current high-end, enteric-coated CardioASPIRIN® and microencapsulated ADIRO® products.[14]

   Pulling the product off the market altogether would take care of the risk of cannibalizing Pharma's products. And it could lead to higher sales of CardioASPIRIN®, assuming the strength of the Bayer ASPIRIN brand ensured a commitment from doctors and customers to the high-end CardioASPIRIN® products, even though they were

[14]Financials on ADIRO were not included in the team's analysis because its share of the prevention business was not deemed significant. Therefore, the team chose to analyze prevention only in terms of CardioASPIRIN®'s projected performance.

twice as expensive. If not, it could replace the risk of cannibalization with one of losing the entire low-end prevention business to a competitor.

2. Reintroduce Children's ASPIRIN worldwide as a prevention product and rename it under the brand ASPIRIN 100®.

   This would require repackaging, relabeling, and reindicating the brand. While the new brand might accelerate the cannibalization of Pharma's sales, it could also attract users from competitive brands.

Whatever the outcome, the decision had to be balanced with respect to the growth (38% CAGR for five years of Children's ASPIRIN sales to prevention customers) of a product whose customers were not even being targeted.

Zander and Merker discussed the implications of each decision in an effort to develop some assumptions to model the outcomes of each.

Zander: If we retract Children's ASPIRIN to solve our cannibalization problem, we could at best keep 75% of our current prevention customers of Children's ASPIRIN and transfer them to our high-end products. We may transfer more than 75%, but to be conservative in our approach, let's assume we lose 25% to the competition.

Merker: But, don't we also run the risk of losing the low-end prevention business altogether, if that's what we see developing before us: a market for low-end prevention aspirin? Won't a competitor come in and offer a low-cost 100 mg. aspirin geared toward prevention?

Zander: Maybe, so let's look at this in terms of best and worst possible outcomes, with a middle scenario assuming that we keep 50% of the prevention customers, and transfer them to the higher end.

Merker: Now, let's consider what might happen if instead of retracting the product, we, instead, give into this low-end demand, and we reintroduce Children's ASPIRIN as ASPIRIN 100® completely geared toward the prevention customer. We exit the children's market, but we keep essentially the same product on the market, just under a different name.

Zander: In that case, I see two scenarios. Under the first scenario, we essentially create attention for ourselves and the market reacts. As a result, Pharma's high-end product, CardioASPIRIN®, loses 10% of its sales due to our cheaper alternative. However, we also appropriate incremental sales of 10% from the competition. Beyond that, by keeping the product on the market, though in a new form, we are able to keep 20% of the children's ASPIRIN customers.

Under the second scenario, I envision that the market does the opposite and reacts very little to our product change. Thus, Pharma doesn't lose any volume, and Consumer Care is unable to gain any incremental volume from the competition. Either way, we still keep 20% of the children's ASPIRIN customers.

The decisions and their assumptions are summarized in Exhibit 7. Also refer to Exhibits 8 through 10 to understand the quantitative forecasts modeled under each scenario.

Of course, the implied third option was to do nothing, but with the numbers looking as they did, how could Bayer not take any action?

EVALUATING THE OPTIONS

1. Given the respective scenarios and the projections described in the exhibits for each option, evaluate and choose the alternative that best optimizes Bayer's prevention *and* children's businesses. Explain.
2. Do you agree with the quantitative assumptions used to develop the forecasts? Why or why not?
3. What other nonquantitative factors should be considered as part of this decision, such as brand or strategic implications? Is this simply an economic decision or are there other factors not captured by the numbers that should be considered before deciding on a course of action?

exhibit 7 Market Development

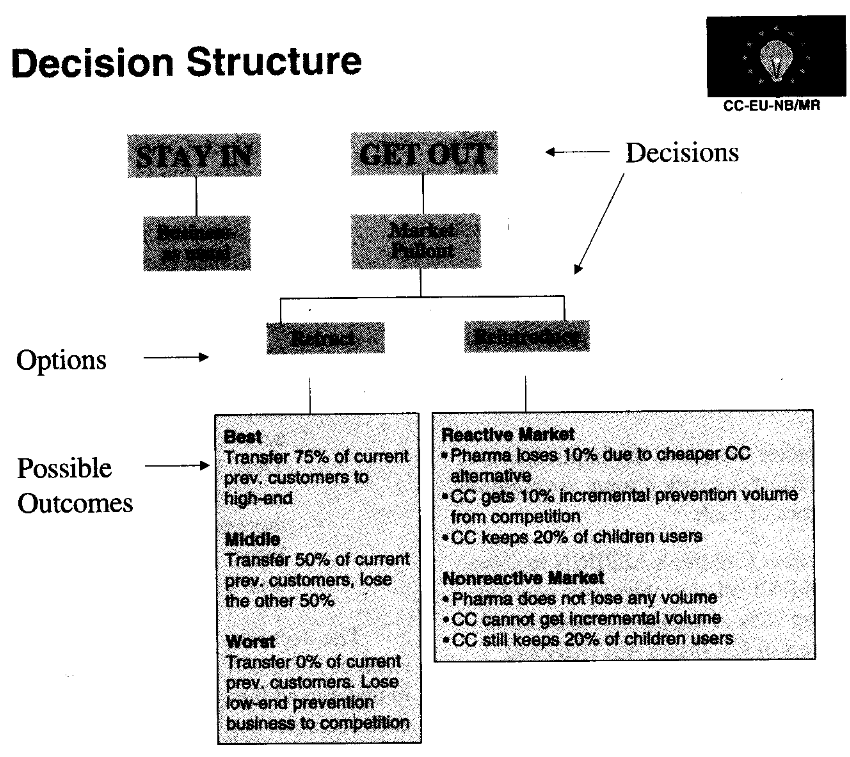


exhibit 8 Children's ASPIRIN Business Forecast, 1998* (US$ in 000s)

	1998 (Actual)	1999	2000	2001	2002	2003	Cumulative
Children's ASPIRIN (based on current business model)							
Children's share of sales (forecast)	55%	49%	43%	37%	32%	27%	
Sales forecast (combined sales from children and prevention)	$37,547	$37,989	$39,016	$40,664	$42,980	$46,021	$244,216
Children sales	20,761	18,685	16,816	15,135	13,621	12,259	97,277
Prevention sales	16,786	19,304	22,199	25,529	29,359	33,762	146,939
Net margin	$11,264	$11,397	$11,705	$12,199	$12,894	$13,806	$ 73,265
Margins							
Children's ASPIRIN	30%						
CardioASPIRIN®	20%						

*All numbers are disguised.

exhibit 9 Option One: Retract ($US in 000s)*

	1998 (Actual)	1999	2000	2001	2002	2003	Cumulative
Incremental business transferred to Pharma							
Best case—total	$18,881	$21,713	$24,970	$28,716	$33,023	$37,977	$165,281
Net margin	3,776	4,343	4,994	5,743	6,605	7,595	33,056
Middle case—total	12,587	14,476	16,647	19,144	22,016	25,318	110,187
Net margin	2,517	2,895	3,329	3,829	4,403	5,064	22,037
Worst case—total	6,294	7,238	8,323	9,572	11,008	12,659	55,094
Net margin	1,259	1,449	1,665	1,914	2,202	2,532	11,019
Net effect (incremental sales—sales forecast, based on current business model)							
Sales gain/loss Bayer (CC/Ph)							
Best	−$18,666	−$16,275	−$14,045	−$11,948	−$9,957	−$8,045	−$78,936
Middle	−24,859	−23,513	−22,369	−21,520	−20,964	−20,704	−134,029
Worst	−31,253	−30,751	−30,692	−31,092	−31,972	−33,363	−189,123
Net effect (incremental margins—margin forecast, current business model)							
Net margin gain/loss Bayer (CC/Ph)							
Best	−$7,488	−$7,054	−$6,711	−$6,456	−$6,289	−$6,211	−$40,209
Middle	−8,747	−8,501	−8,375	−8,370	−8,491	−8,743	−51,227
Worst	−10,005	−9,949	−10,040	−10,285	−10,692	−11,275	−62,246

*All numbers are disguised.

exhibit 10a Option Two: Reintroduce, Reactive Market ($US in 000s)*

Scenario I	
Pharma loses 10% volume due to cheaper CC alternative	10%
CC gets 10% incremental prevention volume from competition	10%
CC can keep 20% of children users	20%

		1998 (Actual)	1999	2000	2001	2002	2003	Cumulative
Pharma (forecast based on current business model)	Sales	$21,104	$27,230	$34,265	$37,272	$40,335	$42,150	$202,356
	Margin	4,221	5,446	6,853	7,454	8,067	8,430	40,471
Pharma (forecast, scenario assumptions)	Sales	18,993	24,507	30,839	33,544	36,302	37,935	182,120
	Margin	3,799	4,901	6,168	6,709	7,260	7,587	36,424
Pharma gain / loss (net effect)	Sales	−2,110	−2,723	−3,426	−3,727	−4,034	−4,215	−20,236
	Margin	−422	−545	−685	−745	−807	−843	−4,047
CC (forecast, current business model)	Sales	37,641	37,989	39,016	40,684	42,880	46,021	244,219
	Margin	11,262	11,397	11,705	12,199	12,894	[illegible]	[illegible]
CC (forecast, scenario assumptions)	Sales	22,613	24,871	27,782	31,109	35,019	39,590	181,085
	Margin	4,523	4,894	5,556	6,222	7,009	7,919	36,217
CC gain / loss (net effect)	Sales	−14,828	−13,018	−11,233	−9,565	−7,661	−6,431	[illegible]
	Margin	−6,740	−6,402	−6,149	−5,977	[illegible]	[illegible]	[illegible]
[illegible] gain / loss (net effect)	Sales	−17,938	−15,741	−14,660	−13,292	−11,695	−10,646	[illegible]
	Margin	−7,162	−6,947	−6,833	−6,723	−6,697	−6,731	[illegible]

*All numbers are disguised.

exhibit 10b Option Two: Reintroduce, Nonreactive Market ($US in 000s)*

Scenario II		
Pharma doesn't lose volume due to cheaper CC alternative		0%
CC doesn't get incremental prevention volume from competition		0%
CC can keep 20% of children users		20%

		1998 (Actual)	1999	2000	2001	2002	2003	Cumulative
Pharma (forecast based on current business model)	Sales	$21,104	$27,230	$34,265	$37,272	$40,335	$42,150	[illegible]
	Margin	4,221	5,446	6,853	7,454	8,067	8,430	[illegible]
CC (forecast, current business model)	Sales	37,541	37,989	39,016	40,664	42,980	46,021	[illegible]
	Margin	11,262	11,397	11,705	12,199	12,894	13,806	[illegible]
CC prevention (forecast, prevention portion only)	Sales	16,783	19,304	22,199	25,529	29,359	33,762	[illegible]
CC + 20% of children users	Sales	4,152	3,737	3,363	3,027	2,724	2,452	[illegible]
CC total	Sales	20,935	23,041	25,563	28,556	32,083	36,214	[illegible]
	Margin	4,187	4,608	5,113	5,711	6,417	7,243	33,275
CC gain / loss (net effect)	Sales	−16,606	−14,948	−13,453	−12,108	−10,897	−9,807	[illegible]
	Margin	−3,321	−2,990	−2,691	−2,422	−2,179	−1,961	[illegible]

*All numbers are disguised.

appendix | A

Gisela Latta, M.D. May 20, 1999
CC-EU-PDC-Med

Medical Comment on the Publication
by Belay, Breese, Holman, Khan, Shahriari, and Schonberger:
"Reye's syndrome in the United States from 1981 through 1997"
(*New England Journal of Medicine* 340:1377–82, 1999)

In the aforementioned paper, the authors, all from the Division of Viral and Rickettsial Diseases, National Center for Infectious Disease, Center for Disease Control and Prevention (CDC), Atlanta, present an analysis of national surveillance data collected from December 1981 through November 1997 on the incidence of Reye's Syndrome (RS) in the USA. The surveillance system was based on voluntary reporting by practicing physicians and hospital personnel with the use of a standard case-report form.

Belay and colleagues focus on the decline of RS and correlate this observation with the reduction in the use of acetylsalicylic acid (ASA) in children. They claim that some reports of a possible relation between RS and ASA were causal for the decline from 555 cases of RS in 1980 to no more than 36 cases per year since 1987. A close look at the literature cited as proof for this statement reveals that just one of the five publications derives from 1980, the others were published in 1982, 1985, and 1987! It appears more than improbable that these few papers published in scientific journals were sufficient for not only drawing public attention to this subject but even influence the attitude of parents concerning the use of anti-pyretic drugs for their children. Should this be the reason for the substantial reduction of RS in the following years (1981: 297 cases, 1982: 213, 1983: 198, 1984: 204, 1985: 93, 1986:

101, 1987: 36, 1988: 25, 1989: 25) ? As another point, the authors mention the "surgeon general's advisory" in 1982 (see figure 1, p. 1379). The official warning of RS on ASA products, however, the most important source of information for consumers, was only demanded by the FDA in 1986!

So what could really be the cause for the decline of RS in these years? One important answer is the discovery of so-called "inborn errors of metabolism," hereditary enzyme defects of infants and small children resulting in symptoms very similar to RS. The existence of these metabolic diseases is just mentioned in the text by Belay et al., but they do not say that this increase in diagnostic possibilities due to progress in medical and biochemical research occurred at the same time as the decline of RS as well: the more inborn errors of metabolism were discovered (today nearly thirty entities can be differentiated!), the fewer "true" cases of RS were diagnosed!

According to the CDC's definition, RS is an "exclusion diagnosis": only if all other possible explanations for the clinical symptoms have been ruled out, the diagnosis "RS" is correct! Has this always been the case? A reappraisal of diagnosis in 49 presumptive cases of RS suggests the opposite (Gauthier et al., 1989): the original diagnosis was considered certain in 1 case (2%), probable in 11 (22%), unlikely in 21 (43%), and excluded in 15 (31%)! However, this study derives from Canada, not the US! Belay et al. do not express any doubts about the validity of the data their assumptions are based on. There were certainly no such things like selection bias, recall bias, data collection bias, or categorization bias.

In this publication, the authors report that antecedent illness was reported in 93% of children and detectable blood salicylate levels in 82%. However, do "detectable" salicylate blood levels prove any causal relationship between the drug and the disease? In a study of 130 biopsy-proven cases of RS, Partin et al. (1982) measured serum salicylate concentrations; they came to the conclusion that "it is impossible to determine from this data whether salicylates are involved in the etiology of or in determining the outcome of Reye's disease. Increased concentrations of salicylates at admission could be the result of excessive dosage because of a greater severity of the prodromal illness; or to diminished excretion because of impaired hepatic metabolism." Even if the authors' statement were correct, then RS occurred in 18% of all cases in spite of the absence of ASA! Moreover in other countries, this percentage is much higher: 73% in South Africa, 80% in Germany, and 89% in Hong Kong; in a report from the Mayo Clinic, again 80% of the patients had not been given ASA (Smith, 1996). In Australia, not ASA but paracetamol/acetaminophen was found to be linked to RS (Orlowski, 1987).

To summarize, there is nothing new in this publication: it is just the repetition of well-known prejudices! Belay and co-workers only create the appearance of accuracy but they do not question the validity of the data they handle. Moreover, as the authors do not mention any argument in favor of ASA (as e.g. the time point when the inborn errors of metabolism were discovered!), it becomes obvious that for the CDC, ASA is still the culprit causing RS—although this has never been proven in any study!

However, from an international perspective, things look different. Professor David Stumpf from the Northwestern University Medical School, Chicago, wrote in 1995: "In the United States, epidemiological studies noted an association of Reye's syndrome with aspirin. This led to promulgation of professional and government guidelines that essentially eliminated the use of aspirin in children. Most Americans believe that the subsequent decline in Reye's syndrome is related to this change in practice pattern. However, the experiences in other countries suggest otherwise. In Japan there was no change in aspirin use. In Australia and India, aspirin was not in wide general use. Yet the decline in Reye's syndrome was equally dramatic in America, Japan and Australia. Clearly other factors were involved in the disappearance of Reye's syndrome."

Nothing further . . .

Gisela Latta, M.D.

Literature:

Gauthier M, Guay J, Lacroix J, Lortie A:
Reye's syndrome—A reappraisal of diagnosis in 49 presumptive cases.
AJDC 143:1181–1185, 1989

Orlowski JP, Campbell P, Goldstein S:
Reye's syndrome: a case control study of medication use and associated viruses in Australia.
Cleveland Clin J Med 57:323–329, 1990

Partin JS, Partin JC, Schubert WK, Hammond JG:
Serum salicylate concentrations in Reye's disease—A study of 130 biopsy-proven cases.
Lancet I:191–194, 1982

Smith TCG:
Reye's syndrome and the use of aspirin.
Scot Med J 41:4–9, 1996

Stumpf DA:
Reye syndrome: an international perspective.
Brain & Development 17:77–78, 1995

appendix | B

Joachim Zander

Education	
10/1976–02/1980	University of Cologne Business Economics; focus: Marketing
Work Experience	
01/1982–05/1986	Marketing Controller Bayer; Business Group: Pharma Leverkusen, Germany
06/1986–06/1989	Financial Controller Bayer—Miles; Business Group: Biotechnology Paris, France

07/1989–04/1990	Product Manager Bayer; Business Group: Selfmedication Leverkusen, Germany
05/1990–12/1995	Head of International Brand Management ASPIRIN Bayer; Business Group: Consumer Care Leverkusen, Germany
01/1996–12/1997	Regional Country Management Southeast Asia Bayer; Business Group: Consumer Care; Region: Asia/South America Leverkusen, Germany
01/1998–02/1999	Team Leader within the Global Strategy Group Analgesics Bayer; Business Group: Consumer Care Leverkusen, Germany
03/1999–present	Head of New Business and Marketing Research Bayer; Business Group: Consumer Care; Region: Europe Leverkusen, Germany

Extracurricular Activities

Travelling throughout the world; wine tasting; jogging

case 6

Harley-Davidson

John E. Gamble
University of South Alabama

Roger Schäfer
University of South Alabama

Harley-Davidson's management had much to be proud of as the company wrapped up its Open Road Tour centennial celebration, which had begun in July 2002 in Atlanta, Georgia, and ended on the 2003 Memorial Day weekend in Harley's hometown of Milwaukee, Wisconsin. The 14-month Open Road Tour was a tremendous success, drawing large crowds of Harley owners in each of its five stops in North America and additional stops in Australia, Japan, Spain, and Germany. Each stop along the tour included exhibits of historic motorcycles; performances by dozens of bands as diverse as Lynyrd Skynyrd, Earl Scruggs, and Nickelback; and hundreds of thousands of Harley enthusiasts who came together to celebrate the company's products. The Ride Home finale brought 700,000 biker-guests from four points in the United States to Milwaukee for a four-day party that included concerts, factory tours, and a parade of 10,000 motorcycles through downtown Milwaukee. The company also used the Open Road Tour as a platform to support its association with the Muscular Dystrophy Association (MDA)—raising $7 million for the MDA in the process. Photos from the Open Road Tour are presented in Exhibit 1, along with a photo of the company's new V-Rod model.

Also in its centennial year, Harley-Davidson was named to *Fortune*'s list of "100 Best Companies to Work For" and was judged third in automotive quality behind Rolls-Royce and Mercedes-Benz by Harris Interactive, a worldwide market research and consulting firm best known for the Harris Poll. Consumer loyalty to Harley-Davidson motorcycles was unmatched by almost any other company. As a Canadian Harley dealer explained, "You know you've got strong brand loyalty when your customers tattoo your logo on their arm."[1] The company's revenues had grown at a compounded annual rate of 16.6 percent since 1994 to reach $4.6 billion in 2003—marking the 18th consecutive year of record revenues and earnings. In 2003, the company sold more than 290,000 motorcycles, giving it a commanding share of the 651+ cubic centimeter (cc) motorcycle market in the United States and the leading share of the market in the Asia/Pacific region. The consistent growth had allowed Harley-Davidson's share price to appreciate by more than 15,000 percent since the company's initial public offering in 1986.

In January 2004, the company's CEO, Jeffrey Bleustein, commented on the centennial year and the company's prospects for growth as it entered its second century:

> We had a phenomenal year full of memorable once-in-a-lifetime experiences surrounding our 100th Anniversary. As we begin our 101st year, we expect to grow the business further with our proven ability to deliver a continuous stream of exciting new motorcycles, related products, and services. We have set a new goal for the company to be able to satisfy a yearly demand of 400,000 Harley-Davidson motorcycles in 2007. By offering innovative products and services, and by driving productivity gains in all facets of our business, we are confident that we can deliver an earnings growth rate in the mid-teens for the foreseeable future.[2]

However, not everyone was as bullish on Harley-Davidson's future. Analysts pointed out that the company had achieved its record growth during the 1990s and early

Copyright ©2004 by John E. Gamble.

[1]As quoted in "Analyst Says Harley's Success Had Been to Drive into Buyers' Hearts," *Canadian Press Newswire*, July 14, 2003.

[2]As quoted in a January 21, 2004, press release.

exhibit 1 **Photos from Harley-Davidson's Open Road Tour and Its VRSC V-Rod**

2000s primarily through the appeal of its image with baby boomers in the United States. Some questioned how much longer boomers would choose to spend recreational time touring the country by motorcycle and attending motorcycle rallies. The company had yet to develop a motorcycle that appealed in large numbers to motorcycle riders in their 20s or cyclists in Europe who both preferred performance-oriented bikes rather than cruisers or touring motorcycles. Another concern of analysts watching the company was Harley-Davidson's short-term oversupply of certain models brought about by the 14-month production run for its 100th anniversary models. The effect of the extended production period shortened the waiting list for most models from over a year to a few months and left some models on showroom floors for immediate purchase. The combined effects of a market focus on a narrow demographic group, the difficulty experienced in gaining market share in Europe, and short-term forecasting problems led to a sell-off of Harley-Davidson shares going into 2004. Exhibit 2 presents a summary of Harley-Davidson's financial and operating performance for 1994–2003. Its market performance for 1994 through January 2004 is presented in Exhibit 3.

COMPANY HISTORY

Harley-Davidson's history began in 1903 when 20-year-old Arthur Davidson convinced his father to build a small shed in their backyard where Davidson and 21-year-old William Harley could try their hand at building a motorcycle. Various types of motorized bicycles had been built since 1885, but the 1901 development of a motorcycle with an integrated engine by a French company inspired Davidson and Harley to develop their own motorcycle. The two next-door neighbors built a two-horsepower engine that they fit onto a modified bicycle frame. At first the motorcycle could not pull itself and a rider up a steep hill, but after some additional tinkering, the first Harley-Davidson motorcycle could run as fast as 25 miles per hour. Milwaukee residents were amazed as Harley and Davidson rode the motorcycle down local streets, and by the end of the year they were able to produce and sell three of their motorcycles. Walter Davidson joined his brother and William Harley during the year to help assemble and race the company's motorcycles. In 1905 a Harley-Davidson motorcycle won a 15-mile race in Chicago with a time of 19:02, and by 1907 the company had developed quite a reputation in motorcycle racing with numerous wins in Milwaukee-area races. In 1907 another Davidson brother, William, joined the company and the company began adding dealers. Harley-Davidson's dealers helped the company sell 150 motorcycles in 1907.

In 1909, to keep its edge in racing, Harley-Davidson developed a more powerful seven-horsepower motorcycle engine that turned out to define the look of the company's motorcycles. The engine's twin cylinders joined at a 45-degree angle became a trademark Harley-Davidson design characteristic and created a distinctive "potato-potato-potato" sound. Harley designed his V-twin engine with two pistons connected to a single crankpin, whereas later designs used crankpins for each piston. The single-crankpin design has been called inferior because it causes the pistons to come into firing positions at uneven intervals, which produces an uneven cadence in sound and excessive vibrations. Nevertheless, the vibrations and distinctive rumble of a Harley engine were accepted by the market in the early 1900s and continued to appeal to motorcyclists in the early 2000s.

The stronger engine allowed the company not only to produce 17,000 motorcycles for the U.S. military during World War I but also to become the largest motorcycle producer in the world by 1920, with 2,000 dealers in 67 countries. A number of features that make up Harley-Davidson's image originated during the 1920s, including the teardrop gas tank, its "Hog" nickname, and its "Flathead" engine design. By relying on exports and sales to police departments and the U.S. military, Harley-Davidson became one of two U.S. motorcycle companies (the other being Indian) to survive the Great Depression. The 1930s saw Harley-Davidson win more races and develop additional elements of its differentiated image, including the art deco eagle design painted on its gas tanks, three-tone paint, and the "Knucklehead" engine rocker boxes. Harley-Davidson's 1936 EL model, or Knucklehead, became its first highly styled motorcycle and formed the foundation of style elements that remained present in the highly demanded 2004 Softail Fat Boy. The company suspended production of civilian motorcycles in 1941 to produce almost 90,000 motorcycles for the U.S. military during World War II.

The recreational motorcycle market grew dramatically after World War II, as ex-GIs purchased motorcycles and led enthusiasm for riding. Harley-Davidson introduced new models for enthusiasts, including the Hydra-Glide in 1949, the K-model in 1952, the Sportster in 1957, and the Duo-Glide in 1958. The combination of racing success—Harley-Davidson riders won 18 of 24 races and set six new racing records in 1950 alone—and innovative new Harley-Davidson models led to Indian's demise in 1953. Harley-Davidson would remain the sole U.S. manufacturer of motorcycles until 1998, when the Indian brand was revived.

Harley-Davidson continued to win races throughout the 1960s, but its reputation began to erode soon after its acquisition by American Machine and Foundry Company (AMF) in 1969. Harley-Davidson under *exhibit 2* **Summary of Harley-Davidson's Financial Performance, 1994–2003 (in thousands, except per share amounts)**

	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994
Income statement data										
Net sales	$4,624,274	$4,090,970	$3,406,786	$2,943,346	$2,482,738	$2,087,670	$1,762,569	$1,531,227	$1,350,466	$1,158,887
Cost of goods sold	2,958,708	2,673,129	2,253,815	1,979,572	1,666,863	1,414,034	1,176,352	1,041,133	939,067	800,548
Gross profit	$1,665,566	$1,417,841	$1,152,971	$ 963,774	$ 815,875	$ 673,636	$ 586,217	$ 490,094	$ 411,399	$ 358,339
Operating income from financial services	167,873	104,227	61,273	37,178	27,685	20,211	12,355	7,801	3,620	—
Selling, administrative and engineering	(684,175)	(639,366)	(551,743)	(485,980)	(427,701)	(360,231)	(328,569)	(269,449)	(234,223)	(204,777)
Income from operations	$1,149,264	$ 882,702	$ 662,501	$ 514,972	$ 415,859	$ 333,616	$ 270,003	$ 228,446	$ 180,796	$ 153,562
Gain on sale of credit card business	—	—	—	18,915	—	—	—	—	—	—
Interest income, net	23,088	16,541	17,478	17,583	8,014	3,828	7,871	3,309	96	1,682
Other income (expense), net	(6,317)	(13,416)	(6,524)	(2,914)	(3,080)	(1,215)	(1,572)	(4,133)	(4,903)	1,196
Income from continuing operations before provision for income taxes and accounting changes	$1,166,035	$ 885,827	$ 673,445	$ 548,556	$ 420,793	$ 336,229	$ 276,302	$ 227,622	$ 175,989	$ 156,440
Provision for income taxes	405,107	305,610	235,709	200,843	153,592	122,729	102,232	84,213	64,939	60,219
Income from continuing operations before accounting changes	$ 760,928	$ 580,217	$ 437,746	$ 347,713	$ 267,201	$ 213,500	$ 174,070	$ 143,409	$ 111,050	$ 96,221
Income (loss) from discontinued operations, net of tax	—	—	—	—	—	—	—	22,619	1,430	8,051
Income before accounting changes	$ 760,928	$ 580,217	$ 437,746	$ 347,713	$ 267,201	$ 213,500	$ 174,070	$ 166,028	$ 112,480	$ 104,272
Cumulative effect of accounting changes, net of tax	—	—	—	—	—	—	—	—	—	—
Net income (loss)	$ 760,928	$ 580,217	$ 437,746	$ 347,713	$ 267,201	$ 213,500	$ 174,070	$ 166,028	$ 112,480	$ 104,272

(continues)

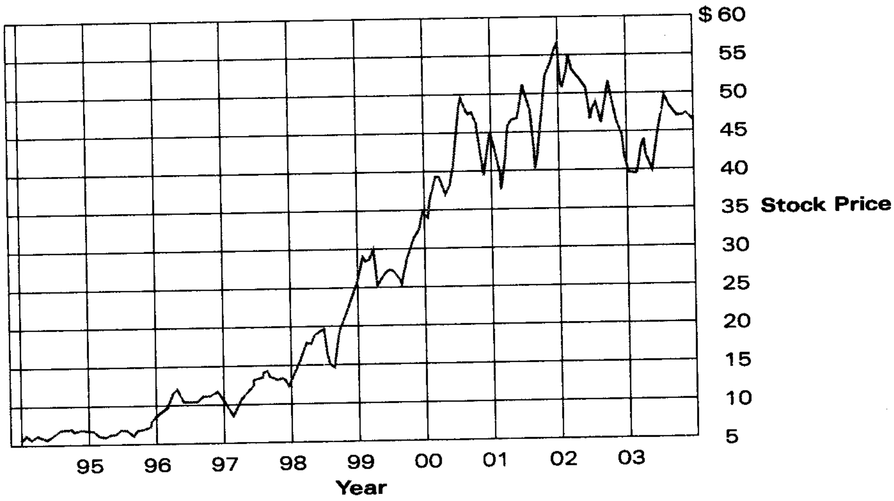
exhibit 2 **(concluded)**

	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994
Weighted average common shares:										
Basic	302,271	302,297	302,506	302,691	304,748	304,454	151,650	150,683	149,972	150,440
Diluted	304,470	305,158	306,248	307,470	309,714	309,406	153,948	152,925	151,900	153,365
Earnings per common share from continuing operations:										
Basic	$2.52	$1.92	$1.45	$1.15	$0.88	$0.70	$1.15	$0.95	$0.74	$0.64
Diluted	$2.50	$1.90	$1.43	$1.13	$0.86	$0.69	$1.13	$0.94	$0.73	$0.63
Dividends paid	$0.195	$0.135	$0.115	$0.098	$0.088	$0.078	$0.135	$0.110	$0.090	$0.070
Balance sheet data										
Working capital	$1,773,354	$1,076,534	$ 949,154	$ 799,521	$ 430,840	$ 376,448	$ 342,333	$ 362,031	$ 288,783	$ 189,358
Current finance receivables, net	1,001,990	855,771	656,421	530,859	440,951	360,341	293,329	183,808	169,615	—
Long-term finance receivables, net	735,859	589,809	379,335	234,091	354,888	319,427	249,346	154,264	43,829	—
Total assets	4,923,088	3,861,217	3,118,495	2,436,404	2,112,077	1,920,209	1,598,901	1,299,985	980,670	676,663
Short-term finance debt	324,305	382,579	217,051	89,509	181,163	146,742	90,638	8,065	—	—
Long-term finance debt	670,000	380,000	380,000	355,000	280,000	280,000	280,000	250,000	164,330	—
Total debt	994,305	762,579	597,051	444,509	461,163	426,742	391,572	285,767	185,228	10,452
Shareholders' equity	$2,957,692	$2,232,915	$1,756,283	$1,405,655	$1,161,080	$1,029,911	$ 826,668	$ 662,720	$ 494,569	$ 433,232

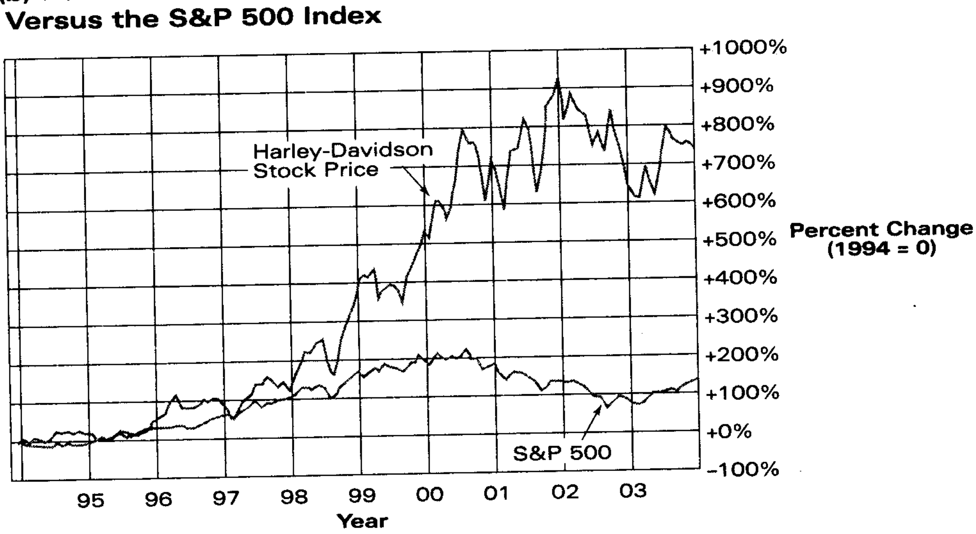
Source: Harley-Davidson, Inc., 2003, 2002, and 1998 10-Ks.

exhibit 3 Monthly Performance of Harley-Davidson, Inc.'s Stock Price, 1994 to January 2004

(a) Trend in Harley-Davidson, Inc.'s Common Stock Price



(b) Performance of Harley-Davidson, Inc.'s Stock Price Versus the S&P 500 Index



AMF was known for its leaking engines, unreliable performance, and poor customer service. At one point during AMF's ownership of the company, more than one-half of its bikes had to be repaired before leaving the factory. The company attempted to offset its declining sales of road bikes with the introduction of dirt bikes and snowmobiles in the early 1970s, but by the late 1970s AMF lost faith in the acquisition and slated it for divestiture. When no buyers for the company emerged, 13 executives engineered a leveraged buyout of Harley-Davidson in 1981. Harley-Davidson struggled under a heavy debt load and came within four hours of bankruptcy in 1985, before then-CEO Richard Teerlink was able to convince new creditors to step in and restructure Harley with less costly financing terms. Teerlink also launched a restructuring program that updated manufacturing methods, improved quality, and expanded the model line. U.S. tariffs imposed on 651+ cc Japanese motorcycles also aided Harley-Davidson in gaining financial strength and competitiveness in the heavyweight segment of the U.S. motorcycle industry.

Harley-Davidson completed an initial public offering in 1985 and petitioned the International Trade Commission to terminate tariffs on Japanese heavyweight motorcycles in 1987 when its market share in the U.S. heavyweight category had improved to 25 percent from 16 percent in 1985. The company purchased Wisconsin-based Buell Motorcycle in 1998, a performance brand using Harley-Davidson engines that began as a venture between Erik Buell and Harley-Davidson in 1992. Harley-Davidson opened its 358,000-square-foot Kansas City, Missouri, plant in 1998 to produce Sportster, Dyna Glide, and V-Rod models and built an assembly plant in Brazil in 1999 to aid in its Latin American expansion. The new capacity allowed Harley-Davidson to set production records each year during the early 2000s to reach 290,000 units by year-end 2003.

OVERVIEW OF THE MOTORCYCLE INDUSTRY

Demand for motorcycles in developed countries such as the United States, Germany, France, Spain, and Great Britain grew dramatically after World War II as veterans who enjoyed riding motorcycles during the war purchased their own bikes upon return to civilian life. Groups of enthusiasts began to form motorcycle clubs through which they socialized and participated in rallies and races. Two of the earliest motorcycle rallies in the United States were the Daytona Bike Week in Florida and the Sturgis Rally in South Dakota. The first Daytona 200, held during Bike Week, was run in 1937 on a 3.2-mile beach and road course. The first Sturgis race took place in 1938 when nine participants raced a half-mile track and performed such stunts as jumping ramps and crashing through plywood walls. These two and other such events grew dramatically in popularity beginning in the 1970s; the Daytona Bike Week and the Sturgis Rally each drew over 200,000 bikers in 2003. The Sturgis Rally was said to be among the most raucous motorcycle rallies in the United States—plenty of public drunkenness and lewd behavior accompanied the seven days of races. Such behavior was common enough that the rally Web site (www.sturgis.com) listed the fines and bonds associated with such offenses as indecent exposure, disorderly conduct, possession of open containers in public, and possession of controlled substances.

The rowdy and rebellious image of bikers can be traced to some of the motorcycle clubs that began after World War II. The outlaw image of cyclists first developed in 1947 when *Life* magazine photographers captured images of an impromptu rally at Hollister, California, by a motorcycle group calling themselves the Boozefighters. The group became quite rowdy during their motorcycling exhibition, but *Life* reporters embellished the story significantly, claiming the Boozefighters descended on the town and proceeded to terrorize its residents by drag-racing down the main street, tossing beer bottles, and riding motorcycles through the front doors of the town's saloon. The imagery of the drunken Fourth of July attack on the town became etched deeper into the minds of the world when the story became the subject of *The Wild One*, a 1954 movie starring Marlon Brando. When asked by a local resident what he was rebelling against, Brando's character Johnny replied, "Whaddya got?"[3]

If the general public came to dislike bikers because of incidents like the one in Hollister and because of the Hollywood treatment of the event, Hells Angels made many people fearful of bikers and put motorcycle gangs under the close scrutiny of law enforcement at local, state, and federal levels. The Hells Angels Motorcycle Club was established in 1948 in Fontana, California, by a group of young cyclists who had read of the Hollister rampage and wished to start their own outlaw biker group. The club, which took its name and symbols from various World War II flying units, became notorious during the 1960s when it became linked to drug trafficking and other organized crime activities. Sonny Barger, a founder of the Oakland, California, chapter in the late 1950s, became the United States' most infamous biker after organizing a disastrous security effort for the 1969 Rolling Stones concert in Altamont, at which one concertgoer was stabbed to death by Hells Angels members. Barger, who after the event was convicted of attempted murder, posses-

[3]As quoted in "Wings of Desire," *The Independent*, August 27, 2003.

sion of narcotics with intent to sell, and assault with a deadly weapon, commented in a 2000 interview with BBC that he had pressed a pistol into Rolling Stones guitarist Keith Richards' ribs and ordered him to continue to play after threatening to end his band's show because of Hells Angels' rough tactics with the fans.[4]

Hells Angels and rival motorcycle clubs like the Pagans, Banditos, and Outlaws, rode only Harleys, which hurt Harley-Davidson's image with the public in the 1960s and beyond. Honda successfully exploited Harley's outlaw image with the slogan "You meet the nicest people on a Honda" to become the largest seller of motorcycles in the United States during the late 1960s and early 1970s.[5] The Hells Angels image spilled over to the entire industry and contributed to declines in motorcycle demand in the United States and Europe before a new Hollywood film resurrected interest in motorcycles. When it premiered in 1969, *Easy Rider* portrayed bikers as less villainous rebels and appealed greatly to young people in the United States and Europe. The movie eventually gained cult status and helped charge a demand for motorcycles that continued through 2003. The red-white-and-blue 1951 Harley "Captain America" chopper ridden in the movie by Peter Fonda's Wyatt character helped Harley-Davidson break the outlaw image and come to represent less malevolent rebellion.

Industry Conditions in 2003

In 2003, there were more than 950,000 motorcycles sold in the United States and 28 million in operation worldwide. The industry was expected to grow by approximately 5 percent annually through 2007, with light motorcycles, mopeds, and scooters accounting for most of the expected growth. A rising income level in such emerging markets as China, India, and Southeast Asia was the primary force expected to drive industry growth. Demand growth for the heavyweight motorcycle category had outpaced smaller motorcycles in the United States during the 1990s and into 2003, but analysts projected that demand for larger motorcycles would decline as the population aged and became less able to travel on two-wheelers. In 2002, demand for heavyweight motorcycles in the United States grew by 17 percent compared to an industrywide growth rate of 10 percent.

The industry was segmented into various groups according to engine size and vehicle style. Mopeds, scooters, and some small motorcycles were equipped with engines having displacements of 50 cc or less. These motorbikes were best suited for urban areas where streets were narrow and parking was limited or for developing countries in which personal incomes were limited and consumers could make only small investments in transportation. Motorcycles used for basic transportation or for motocross events were typically equipped with engines ranging from 125 to 650 cc. Larger street bikes required more power and usually had engines over 650 cc. Large motorcycles with engine displacements greater than 651 cc accounted for the largest portion of demand in North America and Europe as riders increasingly chose motorcycles with more horsepower and better performance. Exhibit 4 presents registrations of 651+ cc motorcycles in the United States, Europe, and Asia/Pacific for 1998–2003. Even though it had fewer registrations of 651+ cc motorcycles than the United States, Europe was the world's largest market for motorcycles, with 1.1 million registrations of 125+ cc motorcycles in 2002. Registrations of motorcycles with engine displacements greater than 125 cc in the largest European markets are presented in Exhibit 5.

Segmentation within the 651+ cc Category

Motorcycles in the 651+ cc segment were referred to as heavyweights and were grouped into four categories: standard, performance, custom, and touring. Standard heavyweight motorcycles were designed for low-cost transportation and lacked many of the features and accessories of more expensive classes of heavyweights. Performance bikes had streamlined styling, low-profile fairings, and seat and handlebar configurations that required the rider to lean forward; they were characterized by responsive handling, rapid acceleration, and high top-end speeds. Custom motorcycles ranged from motorcycles with a custom paint scheme to highly personalized bikes painted with murals or other designs, chrome frames and other components, and accessories not found on stock motorcycles. Among the more unusual custom styles was the

[4]As quoted in "Born to Raise Hell," *BBC News Online*, August 14, 2000.

[5]"Wheel Life Experiences," *Whole Pop Magazine Online*.

exhibit 4 Market Shares of the Leading Producers of Motorcycles by Geographic Region for the Heavyweight Segment, 1998–2003 (Engine Displacement of 651+ cc)

	2003	2002	2001	2000	1999	1998
New U.S. registrations (thousands of units)						
Harley-Davidson	228.4	209.3	177.4	155.1	134.5	109.1
Buell	3.5	2.9	2.6	4.2	3.9	3.2
Total company new registrations	231.9	212.2	180.0	159.3	138.4	112.3
Total market new registrations	461.2	442.3	394.3	340.0	275.6	227.1
Percentage market share						
Harley-Davidson	49.5%	47.5%	45.0%	45.6%	48.8%	48.1%
Buell	0.8	0.7	0.7	1.2	1.4	1.4
Total	50.3%	48.2%	45.7%	46.8%	50.2%	49.5%
Honda	18.4	19.8%	20.5%	18.5%	16.4%	20.3%
Suzuki	9.8	9.6	10.8	9.3	9.4	10
Kawasaki	6.7	6.9	8	9	10.3	10.1
Yamaha	8.5	8.9	7.9	8.4	7	4.2
Other	6.3	6.6	7.1	8	6.7	5.9
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
New European registrations (thousands of units)						
Total market new registrations	323.1	303.5	292.1	293.4	306.7	270.2
Total Harley-Davidson new registrations	26.3	20.1	19.6	19.9	17.8	15.7
Percentage market share						
Total Harley-Davidson	8.1%	6.6%	6.7%	6.8%	5.8%	5.8%
Honda	16.7	21.0	17.4	21.8	22.2	24.1
Yamaha	16.0	17.7	16.4	17.3	18.0	16.3
BMW	15.3	15.1	15.1	13.0	13.0	13.4
Suzuki	15.5	14.8	16.5	14.3	15.4	17.2
Other	28.4	24.8	27.9	26.8	25.6	23.2
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
New Asia/Pacific registrations (thousands of units)						
Total market new registrations	58.9	63.9	62.1	62.7	63.1	69.2
Total Harley-Davidson new registrations	15.2	13.0	12.7	12.2	11.6	10.3
Percentage market share						
Total Harley-Davidson	25.8%	21.3%	20.4%	19.5%	18.5%	14.8%
Honda	17.8	19.1	17.3	20.4	22.4	28.0
Kawasaki	13.8	15.8	15.6	18.9	19.0	22.1
Yamaha	11.4	13.6	15.8	17.0	19.0	16.0
Suzuki	10.7	10.1	12.8	10.4	9.3	7.9
Other	20.5	20.1	18.1	13.8	11.8	11.2
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Harley-Davidson, Inc., 10-Ks and annual reports.

exhibit 5 Registrations of New Motorcycles in Major European Markets, 1998–2002 (Engine Displacement of 125+ cc)

Country	1998	1999	2000	2001	2002
Germany	175,937	187,192	170,636	158,270	145,369
Italy	79,400	103,800	122,085	126,400	129,261
France	88,500	109,105	103,900	106,802	113,852
Great Britain	84,500	98,186	93,634	91,543	93,557
Spain	35,600	39,200	38,052	31,829	35,252

Sources: Association des Constructerus Europèens de Motocycle, Brussels; Industrie-Verband Motorrad Deutschland e.V.

chopper, limited only by designers' imaginations but typically featuring extended forks, high handlebars, a narrow front tire, and a rigid "hardtail" frame design that lacked rear shocks and was stretched longer than that of normal motorcycles. Another notable feature of custom choppers was that they were almost always built from stock Harley-Davidson motorcycles, sometimes retaining only the engine.

Custom bikes were the largest segment of the U.S. heavyweight market for motorcycles and had become a curiosity for noncyclists in the United States. The Discovery Channel regularly aired two programs dedicated to the topic of choppers and other custom vehicles. The names of two custom motorcycle shops, West Coast Choppers (WCC) and Orange County Choppers, frequently made the Internet search engine Lycos's list of 50 most-searched terms. Jesse James, a descendant of the famous American Old West outlaw and owner of West Coast Choppers, also made Lycos's list of most-searched terms. WCC charged between $60,000 and $150,000 for its custom motorcycles, which were usually sold to celebrities such as movie stars, professional athletes, and rock musicians.

Touring bikes were set apart from other categories by creature comforts and accessories that included large fairings, storage compartments, CD players, cruise control, and other features typically found on cars rather than on motorcycles. Touring bikes were popular in the United States since many baby boomers wished to enjoy biking in comfort. Comfortable saddles, upright riding positions, and other features found on touring bikes were especially welcomed by those who took cross-country or other long-distance journeys. Custom and touring motorcycles were less popular outside the United States since cyclists in other countries were more likely to travel only short distances and did not necessarily identify with the individualist or outlaw image associated with heavyweights in the United States. The largest segment of the heavyweight motorcycle category outside the United States was the performance bike category since most riders in other countries preferred sleek styling and were more interested in speed and handling rather than comfort and tradition. In addition, motorcyclists in Europe and Asia tended to choose performance bikes over motorcycles in the custom and touring category because of the high relative prices of such motorcycles. Exhibit 6 presents a regional comparison of motorcycle registrations by heavyweight category for 1998 through 2002.

Competition in the Global Motorcycle Industry

Rivalry in the motorcycle industry centered on performance, styling, breadth of product line, image and reputation, quality of after-the-sale service, and price. Most motorcycle manufacturers had good reputations for performance and styling, with the greatest variance between brands occurring in pricing, variety of models, and quality of dealer service. Most cyclists preferred not to purchase specific brands, even if they were attracted to specific models, if the company's dealers did not have trained mechanics or had a reputation for shoddy workmanship or poor parts availability. There was also a great degree of price variability in the industry with comparable models of Japanese motorcycles typically carrying retail prices far below that of U.S.- or European-made motorcycles.

exhibit 6 Regional Comparison of the 651+ cc Motorcycle Market by Segment, 1998–2002 (percent of units registered)*

	1998	1999	2000	2001	2002
United States					
Custom	58.4%	57.7%	56.6%	58.9%	60.3%
Touring	20.4	21.7	21.1	20.3	20.2
Performance	19.4	18.9	20.4	19.1	17.3
Standard	1.8	1.8	2.0	1.7	2.2
	100.0%	100.0%	100.0%	100.0%	100.0%
Europe					
Custom	22.8%	20.2%	17.6%	17.8%	13.8%
Touring	5.3	5.5	5.2	5.2	4.8
Performance	59.8	58.0	61.7	59.8	61.2
Standard	12.1	16.3	15.5	17.2	20.2
	100.0%	100.0%	100.0%	100.0%	100.0%
Asia/Pacific					
Custom	18.3%	28.6%	26.7%	23.9%	n/a
Touring	3.9	4.7	3.7	7.2	n/a
Performance	76.1	64.5	66.2	65.5	n/a
Standard	1.7	2.2	3.5	3.4	n/a
	100.0%	100.0%	100.0%	100.0%	n/a

*Category definitions:

Custom: Characterized by "American styling." Often personalized by accessorizing.

Touring: Designed primarily for long trips, with an emphasis on comfort, cargo capacity, and reliability. Often have features such as two-way radios (for communication with passenger), stereo, and cruise control.

Performance: Characterized by quick acceleration, top speed, and handling. Commonly referred to as "sport bikes."

Standard: A basic, no-frills motorcycle with an emphasis on low price.

Source: Harley-Davidson, Inc., 2003 and 2002 10-K reports.

Exhibits 7 and 8 illustrate the difficulty U.S. and European manufacturers had experienced in attracting price-sensitive buyers in Europe. The Japanese producers were able to offer high-performance motorcycles at prices below those of Harley-Davidson, Ducati, Triumph, or Moto Guzzi. BMW had achieved considerable success in Europe, especially in Germany, because of exceptional performance and reputation, a strong dealer network, and regional loyalty to the brand.

Motorcycle manufacturers, like automobile manufacturers, maintained relationships with suppliers to produce or assemble components such as upholstery, tires, engine parts, brake parts, wiring harnesses, shocks, and rims. Almost without exception, the manufacturer designed and manufactured its engines and frames. Design and assembly of motorcycles took place in the manufacturer's home country, and completed motorcycles were exported to country markets where dealer networks had been established.

Consumers typically evaluated brands by talking to other cyclists, reading product reviews, perusing company Web sites, noting ads in print and other media, and noting a manufacturer's performance in competitive events. Typically, consumers had some ability to negotiate prices with dealers, but most did prefer to buy from dealers with good service departments, large parts inventories, and attractive financing programs. Similarly, strong motorcycle dealers preferred to represent manufacturers with good reputations and strong consumer demand, responsive customer service and parts delivery, formal training programs for service technicians, and financing divisions that offered competitive rates and programs.

exhibit 7 **Market Shares of the Leading Sellers of Motorcycles in Germany, 2001–2003 (Engine Displacement of 125+ cc)**

Brand	2001	2002	2003*
Suzuki	21.7%	20.3%	19.2%
BMW	16.0	18.1	18.8
Honda	16.8	17.3	15.6
Yamaha	16.3	16.0	16.1
Kawasaki	11.1	10.7	10.8
KTM	3.1	3.8	4.4
Harley-Davidson	3.6	3.7	4.2
Ducati	2.8	2.8	2.9
Triumph	2.5	1.8	2.0
Aprilla	1.7	1.5	1.4
Moto Guzzi	0.6	0.7	0.9
Buell	0.4	0.3	0.7
MV/Cagiva	1.2	0.8	0.6
MZ	0.5	0.4	0.3
Sachs	0.3	0.2	0.2
Other	1.4	1.6	1.9
Total	100.0%	100.0%	100.0%

*Based on registrations occurring between January and November 2003.

Sources: Kraftfahrtbundesamt; Industrie-Verband Motorrad Deutschland e.V.

Consumers purchased motorcycles for various reasons. Some individuals, especially in developing countries, were looking for low-cost transportation. Lightweight motorcycles, mopeds, and scooters were priced inexpensively compared to cars and used far less gasoline. However, most riders also owned a car and used motorcycles for fair-weather transportation. In the United States and Europe, most consumers preferred to travel by motorcycle on weekends or other times they were not working. Some in Europe did choose to commute to and from work on motorcycles when weather permitted because of limited parking available in large European cities and the high cost of fuel. Many motorcycle owners, particularly those in the United States, looked at riding as a form of recreation and had given up other sports or hobbies to spend time touring on motorcycles. Many middle-aged bikers in the United States had purchased motorcycles after giving up sports and activities requiring more athleticism or endurance.

Regulation and Legal Challenges

The motorcycle industry was subject to laws and regulations in all countries in which motorcycles were operated. The European Parliament and the European Council included motorcycles in their agreement to reduce exhaust-gas values during their March 2002 meeting. The agreement required producers of motorcycles and scooters to reduce pollutants by 60 percent for all new cycles produced after April 2003. A further 60 percent reduction would be required for motorcycles produced after January 2006. Demand for motorcycles in Europe was impacted to a great degree by the implementation of the euro in 2002; prices of motorcycles increased substantially in some countries when the currency exchange took effect. For instance, because Germany's currency was much stronger than that of many other European Union countries, prices of most products and services increased in Germany after the change to the euro since the euro attempted to equalize the differences between currencies. The difficulty in obtaining a driver's license for motorcycles in some European countries also affected demand for motorcycles. Germany required separate automobile and motorcycle licenses for anyone born after 1980, and France required those applying for motorcycle licenses to have first held an automobile license for two years. Austria's licensing laws were the most restrictive—requiring applicants to first hold an automobile license for five years and to complete six training sessions prior to obtaining a motorcycle license. Motorcycles that produced excessive noise were also under attack in most European countries.

In the United States, motorcycle producers were subject to certification by the Environmental Protection Agency (EPA) for compliance with emission and noise standards, and agencies in some states imposed more stringent noise and emission standards. The California Air Resources Board (CARB) had outlined new tailpipe emission standards that would go into effect in 2004 and 2008. The EPA developed new emission standards that would go into effect in 2006 and 2010 to match national standards with those in California.

exhibit 8 Best-Selling Motorcycle Models in Germany, November 2003

Rank	Brand	Model	Manufacturers' Recommended Price (USD)	Year-to-Date 2003 Registrations	Heavyweight Classification
1	BMW	R 1150 GS	$14,500	6,100	Performance
2	Suzuki	GSF 1200 (KL)	7,399	3,963	Performance
3	Suzuki	SV 650	6,299	3,433	Standard
4	BMW	F 650 GS	8,190	3,304	Standard
5	Yamaha	FZS 600	6,499	3,230	Standard
6	Suzuki	GSF 600	6,299	3,175	Performance
7	Suzuki	GSX-R 1000	10,599	2,830	Performance
8	Kawasaki	Z1000	8,499	2,813	Performance
9	BMW	R 1150 RT	16,290	2,505	Touring
10	BMW	R 1150 R	9,990	2,469	Performance

Sources: Krafftfahrtbundesamt; Company Web sites.

Motorcycle producers in the United States were also required to meet the product safety standards imposed by the National Highway Traffic Safety Administration (NHTSA).

Also in the United States, many motorcyclists found that their health insurance providers excluded coverage for any injuries sustained while on a motorcycle. The American Motorcyclists Association (AMA) had successfully petitioned the U.S. Senate to pass a bill in October 2003 that would prohibit insurance companies from denying coverage to someone hurt while riding a motorcycle, snowmobile, or all-terrain vehicle. Insurance companies had based their policies on NHTSA statistics that found motorcycling to be much more dangerous than traveling by car. While traffic fatalities per 100 million vehicle miles traveled hit a historic low in 2002, motorcycle fatalities had increased for a fifth consecutive year to reach 3,244 deaths. There were 42,815 traffic fatalities in 2002 involving occupants of automobiles. Fatalities involving motorcyclists ages 50 and older increased by 26 percent during 2002—a higher rate of increase than any other age demographic. Legislatures in states where helmets were optional had attempted to force motorcyclists who chose not to wear helmets to become mandatory organ donors. However, the AMA and its membership had successfully stopped all such attempts to pass mandatory organ donor laws.

HARLEY-DAVIDSON'S STRATEGY FOR COMPETING IN THE MOTORCYCLE INDUSTRY

Harley-Davidson was reincorporated in 1981 after it was purchased by 13 of its managers through a leveraged buyout (LBO). The management team's main focus at the time was to preserve jobs, but managers soon realized that the company would need to be rebuilt from the ground up to survive. The company's market share in the United States had fallen to 3 percent, primarily because its products were unreliable and had poorer performance relative to less-expensive Japanese motorcycles. In addition, its network of dealers ran greasy, run-down shops that many people didn't feel comfortable visiting. Upon assessing the company's situation, the management team concluded that a strong allegiance to the Harley brand by many bikers was the company's only resource strength. However, when management began to meet with customers, they found that long time Harley riders felt cheated by the company and were angry about the lack of attention to product quality and customer service under AMF ownership. Some of the most loyal Harley riders refused to call models produced in the 1970s Harleys, preferring to label them as AMFs. After the LBO, Harley management tried to win over previous customers by attending any function at which motorcyclists congregated. The company's director of communications commented in a 2003 interview with a trade publication, "At first we found that our customers didn't like us, and they didn't trust us."[6] However, the distrust subsided when Harley owners saw their suggestions being implemented by the company.

Harley-Davidson's turnaround strategy including improving product quality by adopting Japanese management practices, abandoning a reliance on advertising in favor of promotions at motorcycle rallies, and improving its dealer network to broaden its appeal to new customers. After hearing complaints about dealers from Harley riders at rallies and other bike events, Harley-Davidson conducted a pilot program with two dealers in Milwaukee that called for the dealers to build clean, attractive stores to showcase Harley's improved motorcycles and display apparel and other merchandise that cyclists might wish to purchase. The two dealerships recaptured their investments within 18 months, while other dealers struggled. The pilot program led to new or remodeled dealerships across the Harley-Davidson network and helped the company enter into a new product category. Harley showrooms offered a large assortment of clothing items and such accessories as helmets, boots, leather jackets, and T-shirts in addition to new motorcycles. In 2003 Harley-Davidson introduced 1,200 new clothing items and licensed its name to more than 100 manufacturers making everything from Harley-Davidson Edition Ford F-150 pickups to Harley Barbie dolls. Apparel and accessories were so important to the company and its dealers that in 2003 every dealership had a fitting room.

Cultivating Loyalty through HOG Membership

After Harley-Davidson's product quality issues had been resolved, the company focused on cultivating the mystique of Harley ownership. The company formed Harley Owners Groups (HOGs) in 1983 to provide Harley owners with local clubs where they could socialize and ride with other owners. Harley-Davidson established HOGs in cities where dealers were located but did not interfere with HOGs' operations or try to use the organization in a self-serving way. The company's primary interest in setting up the chapters was to give motorcycle buyers a sense of community. Management understood that once new owners came to feel they belonged to the Harley community, they would bring new buyers to the company without any encouragement from Harley-Davidson.

The company provided each new Harley buyer with a free membership to a HOG, through which they could not only meet other area bikers but also learn the ins and outs of the biker world. HOGs also organized rides, raised money for charities, and participated in nationwide HOG events. Owners were required to renew their free memberships each year to ensure that only active participants would be on chapter rolls. The HOG organization started with 33,000 members in 1983 and had grown to 793,000 members in 1,200 chapters in 2003. The company sponsored about 100 HOG rallies in 2003, with thousands of additional events organized by local chapters.

Harley's Image and Appeal with Baby Boomers

Even though Harley-Davidson sold many motorcycles to construction workers, mechanics, and other blue-collar workers, Harley riders included a great many accountants, lawyers, bankers, and corporate executives. In 2003, Harley-Davidson's typical customer was 46-year-old male earning $78,000 a year. The company had successfully added upscale consumers to its list of customers without alienating the traditional biker. Some of the more traditional bikers did complain about the new breed of "bean counter" Harley owners, sometimes calling them "rubbers"—rich urban bikers. Such concern had been calmed to some degree by William G. Davidson's continuing involvement with the company. "Willie G." was the grandson of the company's cofounder and, as chief designer, had designed every motorcycle for the company since the 1960s. Willie G. was an "old-school" biker himself and rationalized the company's alliance with upscale baby boomers with comments

[6]As quoted in "Will Your Customers Tattoo Your Logo?" *Trailer/Body Builders*, March 1, 2003, p. 5.

such as "There's a lot of beaners, but they're out on the motorcycles, which is a beautiful thing."[7]

Part of the appeal of HOG membership was that new motorcyclists could experience freedom of the open road, much like a Hells Angel might, if only during occasional weekends when the weather was nice. Some middle-aged professionals purchased Harleys because riding was an opportunity to recreate and relax without being reminded of their daily responsibilities. Belonging to a HOG or other riding group was different from joining a country club or other club dominated by upper-income families. The CEO of a Fortune 500 company explained, "Nobody cares what anybody else does. We share a common bond of freedom on a bike"; he also claimed after a few hours of riding, he forgets he's a CEO.[8] Another affluent Harley owner suggested that Harley owners from all walks of life shared the brotherhood of the open road: "It doesn't matter if you make $10,000 a year or $300,000."[9] Others suggested that Harley ownership gave them an identity and provided them with a close group of friends in an increasingly anonymous culture.

However, other Harley owners were lured to the appeal of Harley-Davidson's outlaw image. The editor of *AARP Magazine* believed that baby boomers purchased Harleys because of a desire to feel "forever young."[10] The *AARP Magazine* editor said that riding a Harley helped take boomers back to a time when they had less responsibility. "You saw 'Easy Rider.' As a kid, you had a bit of a wild period in the '70s and you associate the motorcycle with that. But you got married. You had kids and a career. Now you can afford this. It's a safe way to live out a midlife crisis. It's a lot safer than running off with a stewardess."[11] In fact, many of Harley-Davidson's competitors have claimed that Harley sells lifestyles, not motorcycles. Harley-Davidson's CEO, Jeffrey Bleustein, commented on the appeal of the company's motorcycles by stating, "Harley-Davidson stands for freedom, adventure, individual expression and being a little on the edge, a little bit naughty. People are drawn to the brand for those reasons."[12]

The desire to pose as a Hells Angel, Peter Fonda's Wyatt character, or Marlon Brando's Johnny helped Harley-Davidson sell more than 290,000 motorcycles and over $200 million in general merchandise in 2003. Many of Harley-Davidson's 1,400 dealers dedicated as much as 75 percent of their floor space to apparel and accessories, with most suggesting that between 25 and 40 percent of their annual earnings came from the sale of leather jackets, chaps, boots, caps, helmets, and other accessories. One dealer offered her opinion of what drove merchandise sales by commenting, "Today's consumer tends to be a little more affluent, and they want the total look."[13] The dealer also said that approximately 5 percent of the dealership's apparel sales were to nonbike owners who wanted the biker image. Even though some high-income baby boomers wanted to be mistaken from a distance for Hells Angels' "1 percenters"—the most rebellious 1 percent of the population—for most it was all show. When looking out at the thousands of leather-clad bikers attending Harley-Davidson's 2003 Memorial Day centennial celebration in Milwaukee, a Harley owner said, "The truth is, this is mostly professional people . . . People want to create an image. Everybody has an alter side, an alter ego. And this is a chance to have that."[14]

Another Harley owner who had ridden his Heritage Softail from his home in Sioux Falls, South Dakota, to attend the centennial event commented on his expectations for revelry during the four-day celebration by pointing out, "Bikers like to party pretty big. It's still a long way to go before you forget the image of the Hells Angels."[15] However, most weekend bikers were quite different from the image they emulated. Hells Angels continued to be linked to organized crime into 2003, with nine Hells Angels members being convicted in September 2003 of drug trafficking and murdering at least 160 people, most of whom were from

[7]As quoted in "Will Harley-Davidson Hit the Wall?" *Fortune,* July 22, 2002.

[8]As quoted in "Even Corporate CEOs Buy into the Harley-Davidson Mystique," *Milwaukee Journal Sentinel,* August 24, 2003.

[9]As quoted in "Harley-Davidson Goes Highbrow at Annual Columbia, S.C., H.O.G. Rally," *The State,* September 26, 2003.

[10]As quoted in "Even Corporate CEOs Buy into the Harley-Davidson Mystique."

[11]Ibid.

[12]As quoted in "Milwaukee-Based Harley-Davidson Rides into Future with Baby Boomers Aboard," *Milwaukee News-Sentinel,* August 5, 2003.

[13]As quoted in "Harley-Davidson Fans Sport Motorcycle Style," *Detroit Free Press,* August 28, 2003.

[14]As quoted in "Bikers Go Mainstream 100 Years On," *Global News Wire,* September 11, 2003.

[15]Ibid.

rival gangs.[16] Similarly, Hells Angels organizations in Europe had been linked to drug trafficking and dozens of murders.[17] Fifty-seven Hells Angels in the United States were arrested in December 2003 for crimes such as theft of motorcycles, narcotics trafficking, and firearms and explosives trafficking following a two-year investigation of the motorcycle club by the Bureau of Alcohol, Tobacco, Firearms and Explosives.[18]

Harley-Davidson balanced its need to promote freedom and rebellion, while distancing the company from criminal behavior. Its Web site pointed out that "the vast majority of riders throughout the history of Harley-Davidson were law-abiding citizens," and the company archivist proposed, "Even those who felt a certain alienation from society were not lawless anarchists, but people who saw the motorcycle as a way to express both their freedom and their identity."[19] When looking at the rows of Harleys glistening in the sun in front of his Southern California roadside café, the longtime proprietor of one of the biggest biker shrines in the United States commented, "There used to be some mean bastards on those bikes. I guess the world has changed."[20] A Harley-Davidson dealer commented that dealers considered hard-core bikers 1 percenters because they made up less than 1 percent of a dealer's annual sales. The dealer found that very affluent buyers made up about 10 percent of sales, with the remainder of customers making between $40,000 and $100,000 a year.[21]

Harley-Davidson's Product Line

Unlike Honda and Yamaha, Harley-Davidson did not produce scooters and mopeds or motorcycles with engine displacements less than 651 cc. In addition, Harley-Davidson did not produce dirt bikes and performance bikes like those offered by Kawasaki and Suzuki. Of the world's major motorcycle producers, BMW offered a product line that most closely resembled Harley-Davidson's traditional line of bikes, although BMW also offered a large number of performance bikes. In 2004, Harley-Davidson's touring and custom motorcycles were grouped into five families: Sportster, Dyna Glide, Softail, Touring, and the VRSC V-Rod. Sportsters, Dyna Glide, and VRSC models were manufactured in the company's Kansas City, Missouri, plant, while Softail and Touring models were manufactured in York, Pennsylvania. Harley-Davidson considered Sportsters, Dyna Glide, and VRSC models custom bikes, while Softails and Touring models fell into the touring industry classification. Sportsters and Dyna Glides each came in four model variations, while Softails came in six variations and touring bikes came in seven basic configurations. The VRSC V-Rod came in two basic styles. Harley-Davidson produced three models of its Buell performance bikes in its East Troy, Wisconsin, plant. In 2004, Harley-Davidson Sportsters carried retail prices ranging from $6,495 to $8,675; Dyna Glide models sold at price points between $11,995 and $16,580; VRSC V-Rods sold for $16,895 to $17,995; Softails were offered for $13,675 and $17,580; and the Road King and Electra Glide touring models sold at prices between $16,995 and $20,405. Consumers could also order custom Harleys through the company's Custom Vehicle Operations (CVO) unit, started in 1999. Customization and accessories added to CVO models could add as much as $10,000 to the retail price of Harley-Davidson motorcycles. Images of Harley-Davidson's five product families and CVO models can be viewed at www.harley-davidson.com.

Honda, Kawasaki, Suzuki, and Yamaha had all introduced touring models that were very close replicas of Harley Sportsters, Dyna Glides, Road Kings, and Electra Glides. The Japanese producers had even copied Harley's signature V-Twin engine and had tuned their dual crankpin designs in an attempt to copy the distinctive sound of a Harley-Davidson engine. However, even with prices of up to 50 percent less on comparable models, none of the Japanese producers had been able to capture substantial market share from Harley-Davidson in the United States or in their home markets. Indian Motorcycle Corporation had experienced similar difficulties gaining adequate market share in the U.S. heavyweight

[16]"Nine Montreal Hells Angels Sentenced to 10 to 15 Years in Prison," *CNEWS*, September 23, 2003.

[17]"Hells Angels: Easy Riders or Criminal Gang?" *BBC News*, January 2, 2004.

[18]"Feds Raid Hells Angels' Clubhouses," *CBSNews.com*, December 4, 2003.

[19]As quoted in "Wings of Desire," *Global News Wire*, August 27, 2003.

[20]Ibid.

[21]Interview with Mobile, Alabama, Harley-Davidson dealership personnel.

segment and ceased its operations for a second time in September 2003.

Harley-Davidson's difficulties in luring buyers in the performance segment of the industry was similar to challenges that Japanese motorcycle producers had encountered in their attempts to gain market share in the custom and touring categories of the U.S. heavyweight motorcycle segment. Harley-Davidson had co-developed and later purchased Buell to have a product that might appeal to motorcyclists in the United States in their 20s who did not identify with the *Easy Rider* or Hells Angels images or who did not find Harley-Davidson's traditional styling appealing. Harley management also believed that Buell's performance street-racer-style bikes could help it gain market share in Europe, where performance bikes were highly popular. The Buell brand competed exclusively in the performance category against models offered by Honda, Yamaha, Kawasaki, Suzuki, and lesser-known European brands such as Moto Guzzi, Duccati, and Triumph. Buell prices began at $4,595 for its Blast model to better compete with Japanese motorcycles on price as well as performance and styling. Buell's Lightning and Firebolt models were larger, faster motorcycles and retailed between $9,000 and $11,000. The VSRC V-Rod—with its liquid-cooled, Porsche-designed engine—was also designed to appeal to buyers in the performance segment of the industry, both in the United States and Europe.

As of 2004, Harley-Davidson had not gained a significant share of the performance motorcycle segment in the United States or Europe. Some industry analysts criticized Harley-Davidson's dealers for the lackluster sales of V-Rod and Buell models since most dealers did little to develop employees' sales techniques. Demand for Harleys had exceeded supply since the early 1990s and most dealers' sales activities were limited to taking orders and maintaining a waiting list. In addition, most Harley-Davidson dealers had been able to charge $2,000 to $4,000 over the suggested retail price for new Harley-Davidson motorcycles, although most dealers had begun to sell Harleys at sticker price in 2003. The number of Harley-Davidson and Buell motorcycles shipped annually between 1998 and 2003 is presented in Exhibit 9. Harley-Davidson's revenues by product group are shown in the following table:

Harley-Davidson Revenues by Product Group (in millions)

	2003	2002	2001
Harley-Davidson motorcycles	$3,621.5	$3,161.0	$2,671.3
Buell motorcycles	76.1	66.9	61.7
Total motorcycles	$3,697.6	$3,227.9	$2,733.0
Motorcycle parts and accessories	712.8	629.2	509.6
General merchandise	211.4	231.5	163.9
Other	2.5	2.4	0.3
Net revenue	$4,624.3	$4,091.0	$3,406.8

Source: Harley-Davidson, Inc., 2002 and 2003 annual reports.

Distribution and Sales in North America, Europe and Asia/Pacific

Harley-Davidson's dealers were responsible for operating showrooms that allowed customers to examine and test-ride motorcycles; for stocking parts and accessories that existing owners might need; for operating service departments; and for selling biking merchandise such as apparel, boots, helmets, and various Harley-Davidson branded gift items. Some Harley owners felt such strong connections to the brand that they either gave or asked for Harley gifts for birthdays, weddings, and anniversaries. Some Harley owners had even been married at Harley-Davidson dealerships or at HOG rallies. Harley-Davidson dealers were also responsible for distributing newsletters and promoting rallies for local HOGs. The 10,000-member Buell Riders Adventure Group (BRAG) was also supported by Harley-Davidson dealers.

Harley mechanics and other dealership personnel were trained at the Harley-Davidson University (HDU) in Milwaukee, where they took courses in such subjects as retail management, inventory control, merchandising, customer service, diagnostics, maintenance, and engine service techniques. More than 17,000 dealership employees took courses at the company's university in 2002. Harley-Davidson also provided in-dealership courses through its Web-based distance learning program. In 2002, HDU held 665 instructor-

exhibit 9 Annual Shipments of Harley-Davidson and Buell Motorcycles, 1998–2003

	2003	2002	2001	2000	1999	1998
Harley-Davidson						
Sportster	57,165	51,171	50,814	46,213	41,870	33,892
Custom*	151,405	141,769	118,303	100,875	87,806	77,434
Touring	82,577	70,713	65,344	57,504	47,511	39,492
	291,147	263,653	234,461	204,592	177,187	150,818
Domestic	237,656	212,833	186,915	158,817	135,614	110,902
International	53,491	50,820	47,546	45,775	41,573	39,916
	291,147	263,653	234,461	204,592	177,187	150,818
Buell						
Buell (excluding Blast)	8,784	6,887	6,436	5,043	7,767	6,334
Buell Blast	1,190	4,056	3,489	5,416	—	—
	9,974	10,943	9,925	10,189	7,767	6,334

*Custom includes Softail, Dyna Glide, and VRSC.

Source: 2002 and 2003 Harley-Davidson, Inc., annual reports

led classes and 115 online classes; 96 percent of the company's dealers participated in HDU courses that year.

The company also held demo rides in various locations throughout the United States, and many Harley dealers offered daily rentals for novices to decide if they really wanted a motorcycle. Some dealers also rented motorcycles for longer periods of time for individuals who wished to take long-distance trips. Harley-Davidson motorcycles could also be rented from third parties like EagleRider—the world's largest renter of Harleys, with 29 locations in the United States and Europe. Harley-Davidson's Riders Edge motorcycle training courses were also offered by quite a few dealers in North America, Europe, and Asia/Pacific. The company had found that inexperienced riders and women were much more likely to purchase motorcycles after taking a training course. Harley-Davidson management believed that the 25-hour Riders Edge program had contributed to the company's increased sales to women, which had increased from 2 percent of total sales prior to the adoption of the program to 9 percent in 2003.

In 2003, Harley-Davidson motorcycles were sold by 644 independently owned and operated dealerships across the United States. Buell motorcycles were also sold by 436 of these dealers. There were no Buell-only dealerships, and 81 percent of Harley dealers in the United States sold Harley motorcycles exclusively. The company also sold apparel and merchandise in about 50 nontraditional retail locations such as malls, airports, and tourist locations. The company's apparel was also available seasonally in about 20 temporary locations in the United States where there was significant tourist traffic. The company also had three nontraditional merchandise outlets in Canada, where it had 76 independent dealers and one Buell dealership. Thirty-two of its Canadian Harley dealers also sold Buell motorcycles.

Harley-Davidson had 161 independent dealers in Japan, 50 dealers and three distributors in the Australian/New Zealand market, and 7 other dealers scattered in smaller East and Southeast Asian markets. Only 73 of Harley-Davidson's Asia/Pacific dealers also sold Buell motorcycles. The company also had two dealers that sold Buell but not Harley-Davidson motorcycles. Harley-Davidson motorcycles were sold in 17 Latin American countries by 32 dealerships. The company did not have a dealer for its Buell motorcycles in Latin America, but had *exhibit 10* **Harley-Davidson's Net Revenues and Long-Lived Assets by Business Group and Geographic Region, 2000–2003**

	2003	2002	2001	2000
Motorcycles net revenue				
United States	$3,807,707	$3,416,432	$2,809,763	$2,357,972
Europe	419,052	337,463	301,729	295,372
Japan	173,547	143,298	141,181	148,684
Canada	134,319	121,257	96,928	93,352
Other foreign countries	89,649	72,520	57,185	57,966
	$4,624,274	$4,090,970	$3,406,786	$2,953,346
Financial services income				
United States	$ 260,551	$ 199,360	$ 172,593	$ 132,684
Europe	8,834	[illegible]	1,214	685
Canada	10,074	[illegible]	7,738	6,766
	$ 279,459	$ 211,500	$ 181,545	$ 140,135
Long-lived assets				
United States	$1,400,772	$1,151,702	$1,021,946	$ 856,746
Other foreign countries	41,804	36,138	33,234	27,844
	$1,442,576	$1,187,840	$1,055,180	$ 884,590

Source: Harley-Davidson, Inc., 2002 and 2003 10-Ks.

13 retail stores carrying only apparel and merchandise in the region.

The company's European distribution division based in the United Kingdom served 32 countries in Europe, the Middle East, and Africa. The European region had 436 independent dealers, with 313 choosing to also carry Buell motorcycles. Buell motorcycles were also sold in Europe by 10 dealers that were not Harley dealers. Harley-Davidson also had 26 nontraditional merchandise retail locations in Europe.

Exhibit 10 presents the company's revenues by geographic region along with the division of assets in the United States and abroad and a breakdown of financial services revenues by region. The company's financial services unit provided retail financing to consumers and wholesale financial services to dealers including inventory floor plans, real estate loans, computer loans, and showroom remodeling loans.

CHALLENGES CONFRONTING HARLEY-DAVIDSON AS IT ENTERS ITS SECOND CENTURY

As Harley-Davidson entered its second century in 2004, the company celebrated not only a successful centennial that brought more than 700,000 of Harley's most loyal customers to Milwaukee but also a successful year with record shipments, revenues, and earnings. New capacity had allowed the company's shipments to increase to more than 290,000 units, which drove annual revenues to $4.6 billion and net earnings to nearly $761 million. The company's planned 350,000-square-foot expansion of its York, Pennsylvania, plant would allow the company to increase production to 400,000 units by 2007.

However, there was some concern that the company may not need the additional capacity. Some market analysts had begun to believe Harley-Davidson's stock was approaching its apex because of the aging of its primary baby boomer customer group. Between 1993 and 2003, the average age of the company's customers had increased from 38 to 46. The average age of purchasers of other brands of motorcycles in 2003 was 38. Some analysts suspected that, within the next 5 to 10 years, fewer baby boomers would be interested in riding motorcycles and Harley's sales might begin to decline. Generation X buyers were not a large enough group to keep Harley's sales at the 2003 level, which would cause the company to rely on Generation Y (or echo boomer) consumers. However, most Generation Y motorcyclists had little interest in the company's motorcycles and did not identify with the *Easy Rider* or outlaw biker images that were said to appeal to baby boomers. The company's V-Rod motorcycle had won numerous awards for its styling and performance, but its $17,000-plus price tag kept most 20-year-olds away from Harley showrooms. Similarly, Buell motorcycles were critically acclaimed in terms of performance and styling but had been unable to draw performance-minded consumers in the United States or Europe away from Japanese street-racing-style bikes to any significant degree.

Europe was the largest market for motorcycles overall, and the second largest market for heavyweight motorcycles, but Harley-Davidson had struggled in building share in the region. In some ways the company's 6+ percent market share in Europe was impressive since only 4.8 percent of motorcycles purchased in 2002 were touring cycles and custom cycles accounted for only 13.8 percent of motorcycles sold in Europe during 2002. The V-Rod's greatest success was in Europe, but neither the V-Rod nor any other Harley-Davidson model had become one of the top 10 best-selling models in any major European market.

There was also some concern that Harley-Davidson's 14-month production run had caused an unfavorable short-term production problem since the company's waiting list, which required a two-year wait in the late 1990s, had fallen to about 90 days beginning in mid-2003. The overavailability of 2003 models had caused Harley-Davidson's management to adopt a 0 percent down payment financing program that began at midyear 2003 and would run through February 2004. When asked about the program during a television interview, Harley-Davidson's CEO, Jeffery Bleustein, justified the program, noting that "it's not zero percent financing, as many people understood it to be, it's zero dollars down, and normal financing. The idea there was to get the attention that some of the people who aren't riding Harleys and are used to a world of other motorcycles where there's always a financing program of some sort going on. We just wanted to get their attention."[22] By year-end 2003, dealer inventories had declined to about 2,000 units and many dealers again began charging premiums over list price, but not the $2,000–$4,000 premiums charged in prior years.

[22]As quoted in a CNNfn interview conducted on "The Money Gang," June 11, 2003.

case | 7

Hero Honda Motors (India) Ltd.: Is It *Honda* that Made It a *Hero*?

Kannan Ramaswamy
Thunderbird—The American Graduate School of International Management

Rahul Sankhe
Thunderbird—The American Graduate School of International Management

Hero Honda Rides Splendor to Become World's No. 1

India has finally got a world leader in manufacturing with "no problem." Hero Honda Motors Ltd. (HHM) has attained the distinction of being the largest two-wheeler company in the world in volume terms. With a new factory on the anvil, it is gearing itself for Operation One Billion, targeting $1 billion revenues in 2002-03. "Next year, we will enter the (dollar) billionaire's club (in revenues). After Operation Million for volumes in 2001-02, our slogan for the next year is Operation One Billion," said Mr. Pawan Munjal, Director & CEO, HHM. The distinction of being the largest two-wheeler company in the world came in calendar 2001, with sales rocketing past the one million mark in the first nine months of the current fiscal year. This performance was in conjunction with Splendor, launched in 1995, becoming the world's largest-selling bike.

—*Business Standard*, January 2002

THUNDERBIRD
THE AMERICAN GRADUATE SCHOOL OF INTERNATIONAL MANAGEMENT

Copyright © 2003 Thunderbird, The American Graduate School of International Management. All rights reserved. This case was prepared by Professor Kannan Ramaswamy and Mr. Rahul Sankhe (MBA Class of 2002, ISB) for the purpose of classroom discussion only, and not to indicate either effective or ineffective management. Mr. Anuj Rastogi, Mr. Ravi Yadavalli, and Ms. Divya Ramachandran, from the MBA Class of 2002 at the Indian School of Business, prepared the first draft of this case.

Things could not have possibly looked any better for Mr. Brijmohan Lal Munjal, the Chairman and Managing Director of Hero Honda Motors (HHM). Quarter after quarter, and year over year, HHM had continued to grow, delivering superb performance in India's two-wheeler marketplace. The company had come from nowhere to whiz past Bajaj Auto Ltd., the traditional leader of the pack in two-wheelers. Mr. Munjal had not only earned the crowning title of heading the largest two-wheeler company in the world, but also the personal glory of having presided over one of the most successful joint ventures in the country. Having built a storied legacy, he could rest easy. Or could he?

The spectacular track record of the company was being threatened by predatory moves made by its Japanese partner, Honda Motor Company. The first dark clouds appeared on the horizon in August 1999. Honda Motor Company Ltd. (HMC), HHM's joint venture partner, announced that it would be setting up a 100% subsidiary, Honda Motorcycle & Scooter India (HMSI) to initially make scooters and later, motorcycles as well. HHM's stock plummeted by 30% on the day of the announcement. It was apparent that the investors were no longer optimistic about the company's ability to continue its sterling performance record, especially in the face of competition from Honda. Was this a portent of things to come? Adding another dimension to an arena already fraught with significant complexity, reports from the marketplace clearly showed increasing intensity of rivalry. Not only were domestic rivals getting better equipped to challenge HHM for supremacy, there were foreign interlopers as well who seemed determined on giving HHM a run for its money. It was definitely not a time to rest on past laurels.

THE TWO-WHEELER INDUSTRY IN INDIA

History and Background

India had the largest population of two-wheelers (around 41.6m vehicles) in the world.[1] They accounted for almost 70% of the country's automobile market in volume terms. India was the second largest manufacturer of two-wheelers in the world. Exhibit 1 provides comparative financial and operating statistics for the major two-wheeler manufacturers in India.

The birth of the Indian two-wheeler industry can be traced to the small beginnings that it made in the early 1950s when Automobile Products of India (API) started manufacturing scooters in the country. Although API initially dominated the scooter market with its Lambrettas, Bajaj Auto Ltd., a company that later became a legend in the global scooter industry, overtook it fairly quickly. Although a number of government and private enterprises also entered the scooter segment, almost all of them had disappeared from the market by the turn of the century. Bajaj Auto Ltd. stood the test of time perhaps due to its initial association with Piaggio of Italy (manufacturer of Vespa) that provided the technological know-how for the venture.

The *license raj* that existed prior to economic liberalization (1940s–1980s) in India did not allow foreign companies to enter the market, making it an ideal breeding ground for local players. Local players were subject to a very stringent capacity licensing process, and imports were tightly controlled. This regulatory maze created a seller's market, with customers often forced to wait 12 years just to buy a scooter from companies such as Bajaj. In 1980 Bajaj had a waiting list that was equal to about thirteen times its annual output, and by 1990 this list had doubled. Clearly, there was no incentive to implement proactive strategies to woo the customer. In a 1980 interview with a local magazine, Mr. Rahul Bajaj, the CEO of Bajaj Auto, observed, "My marketing department? I don't require it. I have a dispatch department. I don't have to go from house to house to sell." The motorcycle segment was no different; with only three manufacturers—Royal Enfield, Ideal Jawa, and Escorts—there was hardly any significant competition for the customer. While this segment was dominated by Enfield's 350cc Bullet, the only motorcycle with a four-stroke engine at the time, Jawa and Escorts also had a fair share of the middle and lower end of the market.

The winds of change began to take hold in the mid-'80s when the Indian government started permitting foreign companies to enter the Indian market through minority joint ventures. Under these relaxed regulations, the two-wheeler market witnessed a veritable boom with four Indo-Japanese joint ventures; namely, Hero Honda, TVS Suzuki, Bajaj Kawasaki, and Kinetic Honda all lining up to target the Indian consumer market for motorcycles. The simultaneous entry of four players into this underserved market helped boost motorcycle revenues to stratospheric heights. For the first time, the market dynamics changed in favor of the Japanese players in both two-stroke and four-stroke vehicles, and the Indian manufacturers who had held sway for such an extended period of time were suddenly cornered. The entry of these new foreign companies transformed the very essence of competition from the supply side to the demand side. Confronted with a larger array of choices, the consumers were regaining their influence over the products that they bought. In keeping up with these higher customer expectations, the industry accelerated the launch of new models, and every company was trying to outdo the other in terms of styling, price, and fuel efficiency. The technological expertise that the foreign companies brought to the marketplace helped increase the overall quality and reliability of the products quite significantly. The old-guard companies soon found themselves under pressure to improve their offerings and bring their products on par with their global counterparts.

The Indian Consumer

Two-wheelers had become the standard mode of transportation in many of India's large urban centers. Increasing urbanization, saturation of cities, and the lack of adequate roads helped to propel demand for two-wheelers. The two-wheeler was typically a prized possession

[1]Two-wheelers include all motorized vehicles using a two-wheel chassis (e.g., motorcycles, scooters, and mopeds).

exhibit 1 **Comparative Financial and Operating Statistics for the Major Two-Wheeler Manufacturers in India**

	Kinetic Honda					Hero Honda		
	1990	1993	1996	1999	2001	1990	1993	1996
Sales (gross)	132.1	157.7	315.2	321.1	423.1	149.8	301.5	632.7
Sales (net)	110.4	126.8	257.8	264.9	350.8	149.3	300.3	630.8
Cost of goods sold	77.6	124.2	236.4	238.2	291.2	134.0	266.8	515.5
R&D expenditure	0.0	0.0	1.5	0.2	4.1	0.0	0.0	2.0
Advertising and sales expenditure	0.9	2.6	6.2	13.4	32.7	4.0	9.5	28.3
Capital expenditure	0.6	2.4	9.3	2.2	10.1	10.7	10.4	30.8
Imports (imported materials)	22.7	15.2	54.6	44.7	19.8	18.0	35.7	66.8
Imported materials (% of COGS)	0.3	0.1	0.2	0.2	0.1	0.1	0.1	0.1
Current assets	20.3	44.3	69.8	88.6	98.0	34.1	83.2	146.2
Current liabilities	15.4	24.1	55.6	63.1	72.7	57.1	59.3	145.6
PBDIT (operating profit)	10.7	5.6	11.5	16.4	34.6	12.4	32.4	59.7
Net income (PAT)	4.4	0.4	5.2	3.5	15.6	−0.2	16.7	26.8
Return on sales	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Return on investment (ROI)	0.3	0.1	0.1	0.1	0.2	0.1	0.2	0.2
Return on average equity	1.0	0.0	0.1	0.1	0.3	0.0	0.4	0.3
Total debt	16.9	17.0	22.0	40.1	21.8	50.8	63.3	50.0
Net fixed assets	17.7	20.2	29.2	46.9	52.1	60.2	67.0	103.9
ROCE (% pre-tax)	40.3	16.0	27.3	23.3	45.7	46.6	34.7	55.5

in the average Indian household. It was normally used to transport both people and goods, substituting for a car that was prohibitively expensive. While a two-wheeler normally cost around Rs. 40,000 [1 U.S. $ = 49 Rupees (Rs.)], an entry-level car was priced around Rs. 300,000. Two-wheelers had long road lives, and were often used for even 15 years, passed down from one generation to the next. However, in global terms the market was far from mature. Industry watchers reported that India had a penetration rate of 10% as of the late 1990s (107 two-wheelers for every 1,000 adults), far below the penetration rates of other developing countries. It was clear that the manufacturers had a lot of ground to cover.

There were indeed visible signs that the companies were gearing up to address this growing market. While the production and sales of motorcycles grew substantially (CAGR of 22% between 1996 and 2001), the performance of the other two segments of two-wheelers was poor. Scooter production grew by only 0.5%, while the production of mopeds fell by 29% during 2001–02.

THE LEGEND OF HERO HONDA

The Hero Group

The Munjals, owners of the Hero Group and promoters of HHM, had made a modest beginning as suppliers of bicycle components in the early '40s. Currently, the group's bicycle company, Hero Cycles, manufactured over 16,000 bicycles a day and had sold over 86 million bicycles in aggregate as of 2002. It had been acknowledged as the world's largest bicycle manufacturer in 1986 when it overtook the U.S. manufacturer, Huffy. Despite the lack of significant process automation, the company had been able to achieve among the highest levels of employee productivity and efficiency on a global basis. Although a publicly traded company, the family was extensively involved in day-to-day management of operations, as well as setting strategic direction.

Much of the company's strategy was anchored to the fundamental principle of providing products of

Hero Honda		TVS Suzuki					Bajaj Auto				
1999	2001	1990°	1993	1996	1999	2001	1990	1993	1996	1999	2001
1536.4	3177.2	143.1	186.1	618.3	1018.6	1821.0	1019.1	1246.0	2742.9	3604.7	3628.7
1532.8	3171.2	141.6	182.9	606.1	1000.2	1781.6	814.7	1011.3	2309.9	3039.0	3052.9
1240.9	2533.5	120.5	150.9	484.9	770.3	1517.6	686.7	891.5	1687.2	2303.5	2596.4
3.5	5.1	0.0	0.8	6.1	15.5	16.1	4.5	9.2	22.7	31.4	51.0
64.4	122.3	4.5	8.7	25.4	78.8	119.0	13.2	28.6	106.0	169.6	[illegible]
106.2	121.2	11.5	2.3	58.9	85.0	74.2	75.2	59.6	292.5	[illegible]	[illegible]
238.6	420.6	19.4	10.3	60.3	80.4	179.3	111.8	84.1	215.8	255.3	[illegible]
0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.2	0.1	0.3	0.1	0.1
328.1	963.8	49.1	58.5	144.2	257.8	969.2	364.2	505.8	1425.0	2364.1	2938.7
308.7	460.1	76.9	77.8	150.9	160.3	322.9	315.1	350.1	871.3	1570.8	1647.4
220.4	489.8	9.9	18.2	74.8	144.8	149.0	181.3	186.3	666.9	838.6	474.4
120.1	250.1	−5.6	3.8	35.2	66.5	63.1	58.1	32.8	405.9	481.6	298.9
0.1	0.1	0.0	0.0	0.1	0.1	0.0	0.1	0.0	0.1	0.1	0.1
0.3	0.4	0.1	0.2	0.3	0.3	0.2	0.3	0.2	0.3	0.2	0.1
0.5	0.5	−0.4	0.3	0.5	0.4	0.2	0.2	−0.1	0.3	0.2	0.1
78.2	69.2	36.5	41.5	38.5	142.4	225.2	159.8	184.4	197.2	351.2	527.3
308.6	463.9	54.1	51.0	97.6	187.5	436.1	301.4	291.9	559.2	921.8	1362.4
122.3	78.6	64.3	52.2	86.8	61.2	29.8	51.4	38.4	46.8	91.1	14.2

superior value at reasonable prices to the consumer. This basic belief was reflected in the company's approach to product innovation, quality, and reliability. Over time, the group had nurtured an excellent network of dealers to serve India's expansive markets. This network was not just focused on the high-density urban centers, but also encompassed rural outlying regions that typically did not attract the attention of large manufacturers. The company truly believed in its mission of bringing transportation to the masses.

Over the years, the Hero Group had entered multiple business areas, largely related to the transportation industry. The group evolved into a fairly integrated set of operations that spanned multiple areas of raw material processing, such as steel rolling, to the manufacture of subassemblies and components. Many of these ventures were owned and controlled by members of the Munjal family or operated by very close friends and associates. Thus, the company had seemingly established control over all facets of production and marketing. Exhibit 2 shows the portfolio of Hero Group businesses.

Honda Motor Company of Japan

Honda Motor Company had surprisingly similar origins like its counterpart in India. Founded in 1946 as the Honda Technical Institute by Mr. Soichiro Honda, the company produced its first bicycle engine a year later. There had been no looking back from that time on as the company grew to dominate the global automotive market, with over 100 plants in 33 countries selling 11 million product units as of 2002. The engine was the centerpiece of Honda's global expansion. It had parlayed this expertise into a wide range of products such as lawnmowers, generators, scooters, motorcycles, and cars.

Honda called its global strategy "glocalization" to signify its approach of building plants locally to meet local demand. Within this web of localized operations, the company had been able to leverage synergies in R&D and manufacturing by regionalizing its operations, consolidating local strategy at the regional level. It had worked quite well. The reach of wholly owned

exhibit 2 Portfolio of Hero Group Businesses

Business: [illegible]	*Hero Cycles Limited* Established in 1956 Product: Bicycles *Hero Honda Motors Limited* Established in 1984 [illegible] Product: Motorcycles Collaboration: Honda Motor Co., Japan	*Hero Cycles Limited (Unit II)* Established in 1989 Product: Bicycles *Majestic Auto Limited* Established in 1978 Product: Mopeds and fitness equipment	*Gujarat Cycles Limited* Established in 1989 Product: Bicycles *Hero Motors* (A division of Majestic Auto Limited) Established in 1988 Product: [illegible] Collaboration: Steyr Daimler Puch, Austria Product: Scooters Collaboration: Malaguti, Italy
Business: [illegible]	*Rockman Cycle Industries Limited* Established in 1960 Products: Automotive and bicycle chains, steel and aluminum hubs	*Highway Cycle Industries Limited* Established in 1971 Products: Freewheels and special machine tools	*Munjal Showa Limited* Established in 1985 Product: Shock absorbers Collaboration: Showa Manufacturing Co., Japan
Business: Castings and steel	*Munjal Castings* Established in 1981 Product: Nonferrous castings	*Sunbeam Castings* Established in 1987 Product: Nonferrous castings	*Hero Cycles-Cold Rolling Division* Established in 1990 Product: Cold rolled steel sheets and coils
Business Services	*Hero Exports* Established in 1993 Product: International trading company dealing in commodities and engineering items	*Hero Corporate Services* Established in 1995 Product: Corporate services in finance, HRD, IT, and strategic planning	*Munjal Sales Corporation* Established in 1975 Product: Sole selling agents of bicycles and bicycles parts for India

subsidiaries was augmented through astute management of select joint ventures, although not a preferred mode of entry for the company. In many cases, the company was motivated to enter into joint ventures either because of regulatory constraints or because of a desire to access local market knowledge that was not easily available.

Forging a Par%tnership with Honda Motor Company

Given the impending liberalization of India's markets, HMC had come looking for suitors. Initial plans called for entry both into the two-wheeler market and the electric generator market. HMC identified a short list of Indian companies that it felt would make good partners. Topping the list in the two-wheeler category was Bajaj Auto, a company that traced its reputation to the storied history of Piaggio of Italy and the chic-yet-egalitarian brand of transportation it offered through its series of Vespas. When that first choice did not work out for HMC, it moved on to its second choice, the Firodia group, an automotive products conglomerate based in the prosperous western Indian state of Maharashtra. Kinetic Engineering Ltd. (KEL), the group's flagship company, manufactured the first mopeds in India. Hugely popular in the late '70s and early '80s, KEL had a 44% share of the Indian moped market and about 15% of the entire two-wheeler market. It seemed to hold much promise at the time, and thus attracted the attention of HMC. KEL and HMC entered into a 50/50 joint venture, Kinetic Honda Motors Ltd., with the express objective of launching a line of scooters in India. It was widely reported that KEL was offered a choice between scooters and motorcycles and chose scooters based on prevailing trends that favored scooters. Honda was already close to signing on another partner for its other venture in power products, and hence its bid for a motorcycle JV was all that was left in play.

HMC came to the Hero group as the last choice for its motorcycle venture. The market for motorcycles was not booming in any sense of the term in the early '80s. Many Indian consumers still believed that motorcycles were more accident prone and less safe for Indian roads. The market had been largely carved among three Indian firms with various levels of old imported technology. It was against this backdrop that the Hero group sought to throw its hat into the ring as a means of consolidating its position in the two-wheeler market. Since it had a flourishing bicycle business and a fairly strong moped business as well, the Munjals felt that entering into a joint venture with a company that enjoyed a worldwide reputation would help them achieve their goal of dominating the two-wheeler market in India. It was indeed a golden opportunity for Mr. Brijmohan Lal Munjal to achieve the distinction of "beating Bajaj," a seldom-vocalized desire that he had harbored.

The Deal Is Done

The negotiations between HMC and the Hero group had by all accounts gone quite smoothly. Although there had been some lingering resentment that HMC had come to Hero as a last resort, Mr. Brijmohan Lal Munjal had tried to maintain the enthusiasm amongst the members of the Munjal family, emphasizing the benefits of the alliance they were about to enter. The negotiations culminated in an agreement that was signed in June 1984 creating a joint venture firm called Hero Honda Motors Ltd.

Honda agreed to provide technical know-how to HHM and assist in setting up manufacturing facilities. This included providing the design specifications and responsibility for future R&D efforts relating to the product lines that the company would offer. For these services, HHM agreed to pay Honda a lump-sum fee of $500,000 and a 4% royalty on the net ex-factory sale price of the product. Both partners held 26% of the equity with another 26% sold to the public and the rest held by financial institutions. HHM became a public company listed on the Bombay Stock Exchange (BSE).[2]

A 13-member board was formed to oversee the governance of the company. Honda had four key appointees including the Joint Managing Director, a particularly powerful position in Indian companies. The Hero group was represented by four family members and appointed the chairman of the company. Honda brought in its staff of technical experts to run the engineering and quality support functions. Hero brought in local talent to manage all other functions including marketing, finance, and HR. A seven-member top management team drawn almost exclusively from local ranks took charge of the daily operations of the venture. Both partners agreed to review the terms and relevance of the agreement in 1994 when the current joint venture arrangement would lapse. Time was short, and it was clear that HHM would have to act very quickly to build a foothold in the motorcycle business.

Rubber Hits the Road

The manufacturing plant which was established in Dharuhera in the state of Haryana started manufacturing the CD-100 model motorcycle in 1985. The CD-100 was powered by India's first four-stroke engine, the unique selling point that put Hero Honda in the driver's seat in the marketplace. Soon, the CD-100 set the standards for fuel efficiency, pollution control, and quality. Perhaps the most appealing characteristic of the CD-100 was its fuel efficiency (approximately 80 km/litre), an attribute highly valued by the Indian consumer. As the CD-100 was the only one with a four-stroke engine at the time, it became a runaway success. Interestingly, it was Mr. Munjal who persuaded HMC to launch the 100cc vehicle instead of the 70cc version that HMC had originally planned to offer. Given his long experience with the manufacture of bicycles and mopeds, he really understood the intricacies of the Indian marketplace very well. "Our bicycle and moped manufacturing background gave us insights into the

[2]Bombay Stock Exchange is one of the two biggest stock exchanges in India. http://www.bseindia.com

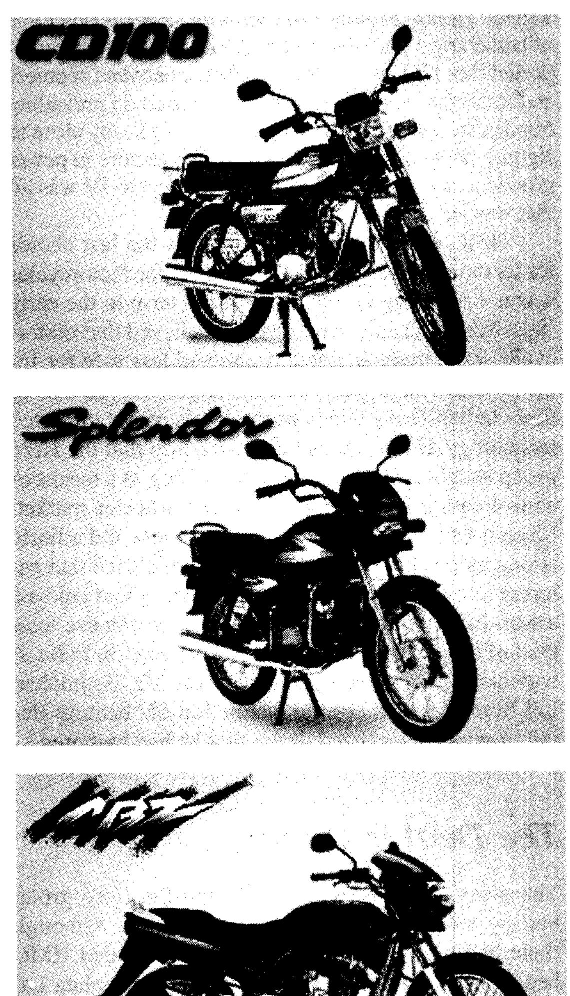
customer psyche that the running cost of the vehicle had to be low," he recalled in a press interview focusing on the rationale behind the CD-100. The organization had since spearheaded many "firsts" for the auto sector in India, being the first two-wheeler manufacturer to implement an ERP across the functions, and the first to implement initiatives such as six-sigma.

Under the stewardship of Mr. Munjal, HHM had grown consistently, earning the title of the world's largest motorcycle manufacturer after having churned out 1.3 million vehicles in 2001. Its motorcycle volumes nearly quadrupled during the period 1997–2001, a feat unparalleled in the Indian two-wheeler industry. While the motorcycle market grew at an average 21.74% per annum between 1997 and 2001, Hero Honda averaged a growth rate of 35.46% a year. In 2001–02, it again doubled volumes from 0.76 million in 1999–2000 to 1.3 million. However, there were several significant bumps on the road along the way.

The CD-100 had captivated the Indian consumer when it was first launched, but the uniqueness soon wore off. Exhibit 3 illustrates some of the product offerings from HHM. Competitors such as TVS-Suzuki and Bajaj-Kawasaki were introducing feature-rich models that were vying for the attention of customers. Many of these vehicles boasted comparable fuel efficiency and some were priced much lower than the CD-100. However, Mr. Munjal was boxed in by the relationship with HMC. His dependence on Honda for all product innovation inputs hobbled HHM's ability to respond to emerging changes in the market. Honda had decided to consolidate all its R&D activities worldwide in three countries, and India was not one of them. Therefore, Hero Honda was forced to wait its turn before getting any changes vetted by Honda's R&D. New product designs did not materialize as fast as the market demands dictated. It was quite difficult to sustain customer interest when all HHM could do was to release newer models that were only variations of the CD-100 platform. This was particularly costly for the company, since it did not have any new products, when competitors were releasing new products to ride the boom in demand from 1993 to 1996, when industry sales grew at a cumulative average rate of 31% per year.

HHM managed to dampen some of the negative impact of these years through astute marketing and by leveraging its knowledge of customers and markets. It had built an expansive network of dealers who were extremely loyal to the company. Much of this network was culled from Hero Group's bicycle operations. The company instituted modern programs and incentives to motivate its dealer network. The best dealers were chosen to visit the Japanese operations of Honda each

exhibit 3 Some Offerings from the Hero Honda Stable



year. They formed an extended family and HHM was perceived as being very supportive of its dealers. As of 2000, the company had close to 400 dealers across the country. It was this well-penetrated dealer network that allowed the firm to actively market its products in rural India, a significant departure from other firms that concentrated solely on the urban market. The challenge of rural marketing would have been quite difficult without intimate knowledge of the dramatic differences, not only between the urban and rural consumer, but also the various shades of gray that differentiated rural consumers in one region from another.

The dealers were strongly supported through major advertising campaigns. HHM retained the best advertising agencies to execute its campaigns. Its "fill it, shut it, forget it" campaign promoting the maintenance-free nature of its motorcycles was a major hit with the Indian public. These campaigns also leveraged the Honda name to maximum advantage. Capitalizing on Honda's reputation for the quality of its engines, HHM ran advertisements that proclaimed, "It is the Honda that makes it a Hero." Exhibit 4 provides an illustration from this advertising campaign.

Hero Honda was among the first manufacturers to understand the impact of product differentiation and market segmentation on sales revenues. While the differentiated positioning brought price premiums, the customer got a much more fuel-efficient and reliable product in exchange. The mantra of fuel economy formed the core of all HHM's product launches. On a single platform (CD-100 series), it devised three models catering to different market segments. The CD-100 bike was an excellent pick for the rural and semi-urban customer for whom cost was critical consideration. The CD-100 SS was a basic model for the urban market. Splendor catered to the middle-class, office-going segment. Since all these products came from a single platform, product development costs were spread over higher volumes, and after-sales service quality was maintained, thereby reducing costs and increasing margins.

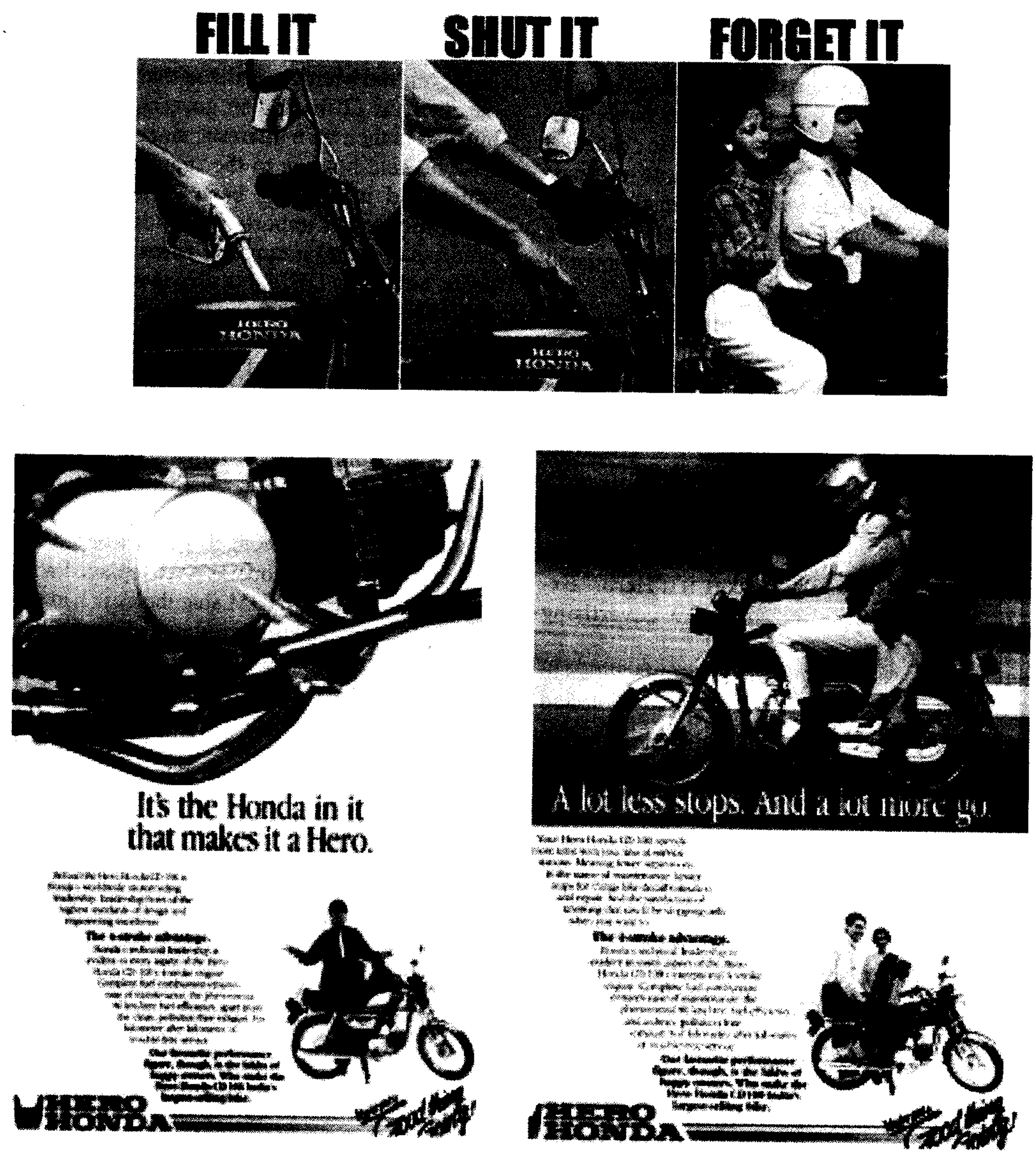
The influence of the Hero group was quite visible in the way the supply chain was organized at HHM. The company had built an extensive network of primary and secondary suppliers for components and subassemblies. Since the Indian government had stipulated that the joint venture must indigenize production within a fairly short period of time, developing the supplier network was deemed crucial. By 1996, over 95% of the motorcycle was manufactured from locally procured parts, a rate of localization that even Honda at times thought would be difficult to achieve. However, the Munjals realized that it was not only in the interests of the Indian government to indigenize but also in their own interests, since they would otherwise be held hostage to the rupee-yen exchange rate which had historically been unfavorable to Indian firms relying on imported components. The Munjal family had set up a range of firms to supply components, not just to HHM, but also to other buyers. These operations ranged from the manufacture of shock absorbers and wheel rims, to aluminum castings and plastic products. Munjal family interests ran seven of its crucial supplier firms. HMC had also helped establish some of these ventures, and HHM had a controlling shareholding in Munjal Showa, for shock absorbers, and Sunbeam Castings and Munjal Castings, both of which supplied castings.

Honda did not seem to be concerned about the rate at which foreign sources were replaced with Indian suppliers. However, HHM shareholders had expressed some concerns. The preferred provider network of suppliers was filled with either Hero family companies or firms that were run by promoters who were closely aligned with Munjal family interests, and this posed a potential conflict of interest. Since HHM was a publicly traded company, it was felt that the profitability impact of outsourcing to allied firms would affect shareholder returns. The flip side of this sourcing approach was the reliability of the network and its ability to respond quickly to environmental change. There was very little inventory in process or waste due to supply chain bottlenecks, which resulted in better margins. Of course, this also ensured that many among the Munjal family were gainfully engaged.

Renegotiating the Venture in 1994

As 1994 rolled around, the sentiments amongst the Munjal family were mixed but largely negative. Some felt that while Hero had ploughed a lot into making HHM a success, HMC had not contributed as much. There was a lack of new product innovation and much uncertainty surrounded the negotiations at that time. Even routine design changes were taking too long, and

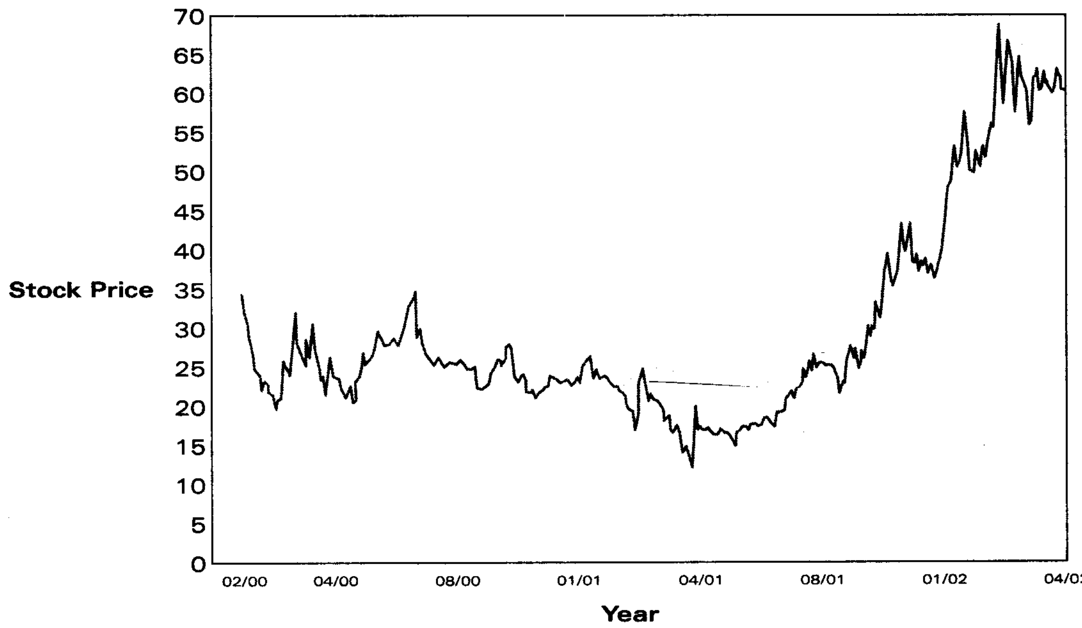
exhibit 4 **Advertisement of Hero Honda**



HMC's R&D engineers did not appear cooperative on this count at all. The impending negotiations paralyzed HHM, and it had to sit on the sidelines while its competitors roared past. Archrival Bajaj had introduced a new four-stroke engine for its motorcycle line and usurped the lead that HHM had carefully nurtured. In the meantime, HMC had negotiated new ventures with other Indian partners for manufacturing automobiles and power equipment. Mr. Munjal would have liked very much to have been part of the automobile venture, but did not allow this disappointment to color the relationship.

Perhaps in protecting its own destiny, Hero had been evaluating alternative product lines and market approaches right from 1986. It entered into a collaboration agreement with Steyr Daimler Puch, an Austrian sub-

exhibit 5 Hero Honda Stock Performance Chart, Feb., 2000–April, 2002



Source: indiainfoline.com.

sidiary of Daimler A.G., to manufacture motorcycles in the 50cc–65cc range. This business was organized under the Hero Motors banner and targeted both Indian and foreign markets. Hero Motors was successful in exporting completely knocked-down (CKD) kits for assembly in Spain, Iran, Mauritius, Vietnam, Bangladesh, and Egypt. Bolstered by these initial successes, Hero Motors even entered into discussions with BMW of Germany to manufacture 650cc bikes. Although these talks eventually fizzled out, they could hardly have inspired any trust or confidence at Honda headquarters.

It was 1995 by the time the joint venture agreement was renegotiated and extended until 2004. HHM was able to negotiate far more attractive terms from HMC with respect to royalties. They were able to persuade HMC to accept a paltry Rs. 200 per vehicle in 1995. Licenses to manufacture future models were dealt with on a case-by-case basis using a mix of lump sum payments and royalties. By 1999, the proportion of royalty payments to sales revenues had declined considerably from a high of 4% at founding to about 0.5%. Honda displayed new willingness to share its R&D and product suites in a more timely fashion. Subsequent to the 1995 contract renewal, Honda licensed HHM to manufacture Street, a model that was based on Honda's recent global hit called the Dream, which had sold over 25 million worldwide. In addition to the reduced royalties and fast-track transfer of technology, HMC agreed to increase the extent of components and subassemblies purchased from Hero's supplier network.

With the emergence of significant competition from similarly positioned offerings from Bajaj and TVS-Suzuki, Hero Honda had become more aggressive in terms of its marketing with new product launches and market segmentation. The company had announced new product launches (two every year) to continue this effort. This phenomenal rate of new product introductions was, of course, solely dependent on HMC's continuing its R&D support, since HHM had not explored setting up R&D facilities in India. HHM had also undertaken significant expansion of its distribution network.

The going was good for HHM, and the financial results followed. The company had reported flawless quarter-on-quarter growth for 18 consecutive quarters between 1997 and 2001. Hero Honda's quarterly sales during the period grew 303.28% and its net profit jumped from Rs. 16.28 crore[3] to Rs. 98.34 crore. HHM hardly required any incremental working capital over the seven-year period following the renegotiation. In fact, its working capital was lower in 2001 than in 1994 by Rs. 1160m, despite sales having grown by approximately 7X during this period. Return on average capital employed (ROACE) at 65% was among the highest in the country. Hero Honda was among the few Indian companies that enjoyed the distinction of generating a positive economic spread for an extended period of time. Between 1995 and 2001, the economic spread (difference between WACC and ROIC) expanded from 16.5% to 65.4%. This performance had not been lost on the investors who helped the share rise among the ranks of established blue chips. Exhibit 5 (page C-405) charts the performance of HHM shares. However, just as things appeared to be set for a smooth sailing, storm clouds appeared.

STORM CLOUDS AND SILVER LININGS

Competition began to intensify in the late '90s as many of the foreign joint ventures in the Indian motorcycle industry reached maturity. Players such as Kawasaki and Yamaha were helping their local companies mount a credible assault on Hero Honda. Closer to home, HHM partner HMC was forced to dissolve Kinetic Honda Ltd., the venture it set up with Kinetic Engineering to manufacture scooters. This left a void in HMC's product suite in India and it was poised to enter the scooter market on its own. Both of these developments were cause for significant alarm.

The Competition Revs Up

The competitors for HHM were Kawasaki-Bajaj, TVS-Suzuki, and Yamaha Motors, a familiar bevy of powerhouses from Japan. Exhibit 6 shows the key competitors by two-wheeler category in the Indian marketplace. Refer to Exhibit 7 for recent sales and production figures for these players in the two-wheeler market.

[3]1 Crore = 10 million

exhibit 6

Subsegment	Major Players
Motorcycles	Hero Honda, Bajaj Auto, Yamaha Motors Escorts, TVS Suzuki, Eicher
Scooters	Bajaj Auto, LML, Kinetic Motor Co., Maharastra Scooters, TVS Suzuki
Mopeds	TVS Suzuki, Kinetic Engineering, Majestic Auto, Bajaj Auto

Bajaj Auto

Bajaj Auto Limited was one of India's largest two- and three-wheeler (three-wheelers, also known as auto-rickshaws, are unique to the South Asian region) manufacturer. The Bajaj group came into existence in 1945 and got a start by importing scooters and three-wheelers from Italy for sale in India. In 1960, it struck a technical know-how agreement with Piaggio of Italy, and the company became a public corporation the same year. Scooter production commenced in 1961 and three-wheeler production was followed in 1962. The Piaggio collaboration expired in 1991. Since then, the company's scooters and three-wheelers were sold under the brand name of Bajaj. As of 2001, Bajaj had become a market leader in scooters with annual production in excess of 1.34 million units. It offered products in all segments such as mopeds, scooters, motorcycles, and three-wheelers.

Subsequent to the opening up of the two-wheeler sector to foreign technology and equity participation in the mid '80s, Bajaj Auto entered into a technical collaboration agreement with Kawasaki of Japan. It started production of Kawasaki 100cc motorcycles in 1986. Bajaj became a key manufacturing base for Kawasaki and accounted for 60% of the latter's global sales. The company had chalked out a strategy for coexistence with Kawasaki, wherein Bajaj would concentrate on developing products in the price range of Rs 30,000–60,000 and Kawasaki would offer a wider choice of products priced from Rs 35,000 up to Rs 250,000. Though the company planned to introduce some high-tech motorcycles from the Kawasaki range, it was fighting an uphill battle trying to shed its image of a "screwdriver" company (assembler as opposed to manufacturer) by developing its own range of motorcycles.

exhibit 7 Comparative Sales and Production Figures for Two-Wheeler Manufacturers, (April 2001 to February 2002)

	Production		Sales	
	Number	% Change	Number	% Change
Motorcycles	2,866,456	33.7	2,850,822	36.4
Hero Honda	1,288,933	37.7	1,289,838	38.8
Bajaj Auto	654,051	29.2	649,920	32.9
TVS Motor Co.	399,151	20.0	395,494	22.8
Yamaha Motor	212,954	29.6	210,568	40.0
LML	40,380	15.6	42,115	44.6
Kinetic Engg	48,992		40,937	
Eicher	21,995	10.6	21,950	11.7
Scooters	808,185	9.5	808,768	−1.6
Bajaj Auto	347,997	10.0	347,785	7.0
TVS Motor Co.	138,070	2.8	135,492	1.8
LML	119,183	−24.6	121,857	−23.8
Kinetic Motor Co.	103,253	−7.8	103,292	−10.7
Mah Scooters	54,532	−35.9	53,601	−39.8
Honda Motorcycle	47,170		46,801	
Mopeds	454,680	−29.2	451,784	−28.8
TVS Motor Co.	246,317	−28.6	247,136	−27.6
Kinetic Engg	96,606	−31.8	91,467	−32.5
Majestic Auto	76,997	−23.7	77,014	−24.3
Bajaj Auto	35,760	−36.4	36,167	−35.2

TVS-Suzuki

A leading producer of automotive components, the TVS group was formed as a transport company in 1911. Originally incorporated in 1982 as Indian Motorcycles Pvt. Ltd to produce motorcycles in collaboration with Suzuki, Japan, the company later went public under the banner Ind-Suzuki Motorcycles Limited, which was later renamed TVS-Suzuki Limited. The perfect blend between the best design engineers and the latest technology made TVS-Suzuki one of the leading two-wheeler manufacturers in the country.

However, the relationship between Suzuki and TVS was far from amicable. A divorce was in the cards for nearly a decade. In August 2001, TVS bought out the 25.97% stake of the Japanese partner in August 2001, increasing its equity holding to 32%. The parting also meant that Suzuki would not be allowed to enter India for a 30-month period. The decision to buy out Suzuki was prompted by the fact that the partners felt it was in their own long-term interests to pursue their own interests separately rather than through the joint venture.

The TVS Group wanted to promote the TVS brand, grow their revenues, and develop products indigenously. Further, they wanted to export TVS-made vehicles to the rest of the world, a proposition Suzuki Motors opposed. From Suzuki's point of view, its contribution to the joint venture was shrinking. With the exception of the two-stroke Suzuki Max 100R, an evolution of the original Ind-Suzuki, none of the company's fast-selling two-wheelers had a major Suzuki contribution. TVS-Suzuki's bread-and-butter product, the moped, was fully Indian. The hugely successful TVS Scooty was also a non-Suzuki product. It was only in two-stroke motorbikes that TVS-Suzuki had to rely on the Japanese parent. However, with the decline of two-stroke motorcycles in India, and with the recent launch of the all-Indian TVS Victor, it was clear that the Indian partner could do without the Japanese collaborator.

As per the terms of the joint venture agreement, there was to be a 30-month licensing arrangement, during which time the joint venture would continue to pay royalties to Suzuki. After this period, TVS was free to sell the four licensed vehicles (Samurai, Max 100, Max 100R, and Fiero) as TVS vehicles. As it turned out, TVS had localized production ahead of schedule and voted to terminate the agreement before the 30-month period could lapse.

Escorts-Yamaha (EYML)

EYML was a joint venture between Escorts Ltd., the flagship company of the Escorts Group, and the global giant, Yamaha Motors Co. Ltd of Japan. Ever since signing the first technical assistance agreement between the two companies in 1985, Yamaha Motor Company Limited (YMC) and Escorts Limited had built a cooperative relationship dedicated to the manufacture and sales of Yamaha-brand motorcycles. In November 1995, the two companies established the joint venture company, Escorts Yamaha Motors Limited, based on a 50-50 capital investment. In June 2000, that investment ratio was changed to 74% for YMC and 26% for Escorts Limited, and YMC assumed managerial control of the company with the name being changed to Yamaha Motors Escorts Limited (YMEL). It then undertook numerous measures to build the company's motorcycle manufacturing and marketing operations. In June 2001, an agreement was reached between YMC and Escorts Ltd. under which YMC acquired the remaining 26% of the stock held by Escorts. The stated aims of this move to make YMEL a 100% YMC subsidiary were to increase the overall speed of managerial and business decisions, to improve product development capabilities and production efficiency, while also strengthening the marketing organization.

Kinetic Honda Ltd.

Kinetic Engineering Ltd. (KEL), one of the leading manufacturers and exporters of two-wheelers for over 20 years, came into existence in 1970. It manufactured scooters, motorcycles, and mopeds that were all well known for their fuel economy and quality. KEL was the beneficiary of Honda's advances when the Japanese company first came to India shopping for partners. They set up a 50-50 joint venture called Kinetic Honda Ltd. (KHL) to manufacture and market scooters. Unfortunately, the terms of the agreement specified that KHL could not enter the motorcycle business. KHL seemed to be doing an excellent job in cornering the market and was within striking distance of a leadership spot in the race for market share. When the two-wheeler business began to boom in the early 1990s, Honda wanted to take charge, an idea that was welcomed by the Indian partner. KEL felt that such a move might motivate Honda to bring in new products more quickly to India. Strangely, Honda began to lose interest in the venture and decided to turn off the spigot, putting the brakes on R&D spending, which was a paltry 0.31% of sales when Indian competitors were spending 1.5%. It also decelerated its advertising spending significantly when the competition was blitzing the consumer with new campaigns. All these actions hurt the sustainability of the company, and soon the personal relationship started to sour and culminated in a KEL buyout of Honda's interests. This effectively released Honda to pursue its own agenda in the scooters segment.

Other Challengers

In addition to domestic competition, another competitive threat took shape in the form of cheap Chinese imports when import restrictions were lifted in 2001. A relatively unknown company named Monto Motors in Alwar (Rajasthan[4]) was the first to import Semi-Knocked-Down (SKD) kits from one of the top motorcycle manufacturers in China. A 72cc motorbike from China cost the customer Rs. 27,000 on road, a 125cc would cost Rs. 33,000, and a 250cc motorbike would cost Rs. 36,000. The Indian models seemed frightfully expensive in comparison. In early 2002, a moped cost around Rs. 22,000, a 100cc motorbike cost around Rs. 45,000, and a 125cc motorcycle cost around Rs. 50,000. The domestic two-wheeler industry was bound to feel the pinch, especially in the mid and lower price segments of the motorcycle, scooter, and moped segments.

The Other Shoe Drops

HMC, having extricated itself from the KHL venture, announced plans to set up a new company, Honda Motor Scooters India Ltd., for the sole purpose of

[4]Rajasthan is one of the states in West India.

manufacturing scooters for the Indian market. At that time, it also announced that it intended to enter the motorcycle market in 2004, ominously the very year when the HHM joint venture agreement would come up for its next revalidation. This announcement shocked the top brass at Hero Group. Mr. Munjal put on a brave face and announced that Honda had made its plans public only after Hero signed off on its plans. This led to further speculation as to why Mr. Munjal would give his blessings to a venture that would place the destiny of HHM in peril.

HMSI was indeed a troubling development for the Munjal family and the shareholders of HHM. However, Mr. Munjal was looking for the silver lining in what was apparently a huge storm cloud brewing. He announced that HHM had negotiated three key concessions from Honda. First, Honda agreed to delay entry into the motorcycles segment until 2004. It also agreed to form a four-person committee with two members from HHM to examine any new motorcycles that it would release post-2004. Lastly, it offered an opportunity to HHM to share in the equity as a minority holder in HMSI. These assurances were followed by a visit by Mr. Yoshino, the CEO of Honda from Japan, for the launch of Honda's first scooter in India. At the launch ceremony, he addressed the simmering problems that were perceived by HHM and its investors. He observed, "By 2003 the two companies will together be selling 25% of the world's projected seven million market for two-wheelers."[5] The President and CEO of HMSI, Mr. Takiguchi painted a similar scenario in his interview with a leading news magazine. He said, "The discussion in 2004 will not be on whether to continue with the joint venture. We will sit and discuss about the products which both the companies—Hero Honda and HMSI—should build on."[6] However, in the same breath, he also observed, "Our strategy will be to offer motorcycles which keep up with the overall market trend in the post-2004 scenario."[7] It was anybody's guess what that statement truly meant.

Honda was already bolstering its dealership network and had plans to set up over 100 dealerships by the end of 2002. It was also spending Rs. 1 billion to set up a manufacturing plant that would double HMSI's existing capacity.[8] Given the rate of growth of scooters that was in the 4% range, it was difficult to imagine how Honda would be able to use the capacity effectively without stepping onto HHM's turf.

Mr. Munjal seemed to be reassured about the situation, however. After Mr. Yoshino's visit, he proclaimed, "His visit has made a lot of difference to the outlook at Hero Honda."[9]

ARE THERE ROAD HAZARDS AHEAD?

Mr. Munjal sifted through the various options he had in front of him. While the investors were sated with the flurry of announcements and reassurances for now, what would the future hold for HHM? How should the company arm itself for the post-2004 marketplace? How would the competitors, especially the Japanese companies, respond to the uncertainties that faced HHM? What if HMSI, despite all its assurances, saw the potential marketplace in 2004 and decided to push HHM to the periphery and engineer a frontal assault on the motorcycle business? Would HMC go back to its old ways of withholding R&D now that it had plans to make motorcycles in India post-2004? The joint venture had been in existence for a very long period of time by international standards. Perhaps its time had come. Would HHM have to be dismantled in the same way its competitors in India had been? These were troubling questions, but nevertheless very critical ones. Charting the future strategy of HHM would undoubtedly require clear answers to all these questions. These were indeed the best of times and the worst of times for HHM.

bibliography

http://www.herohonda.com/web/index.htm

www.yamaha-motor.co.jp

http://www.indiainfoline.com

www.securities.com

http://www.expressindia.com/ie/daily/19980823/23550444.html

http://www.businessworldindia.com/archive/7Jan99/corpo3(1420).html

[5] *Business Standard*, Entrepreneur of the Year issue, 2001.

[6] Hindu, *Businessline*, June 19, 2001.

[7] Ibid.

[8] moneycentral.com, July 25, 2002.

[9] *Business Standard*, Entrepreneur of the Year issue, 2001.

Transcript of interview with Ms. Sulajja Firodia Motwani, Joint Managing Director of Kinetic Engineering, February 22, 2002

Business World, January 28, 2002

Report on TVS Motor Company Limited—ICICI Securities, January 18, 2002

Business Line, Sunday, Sept 30, 2001

Business Line (International Edition), Tuesday, June 19, 2001

Reports on Hero Honda Motors Limited:

HSBC, March 28, 2002

HSBC, September 21, 2001

Merrill Lynch, June 20, 2001

CSFB (Hong Kong), July 6, 2000

Probity, December 16, 1998

Dresdner Kleinwort Benson Research, May 8, 1998

Morgan Stanley, May 31, 1996

Reports on Automotive Sector in India

LKP Shares & Securities Limited, February 2002

Scope Marketing, September 2001

case | 8

Unilever's Path to Growth Strategy: Is It Working?

Arthur A. Thompson
The University of Alabama

Throughout 2003, Niall FitzGerald and Antony Burgmans, Unilever's co-chairmen, expressed confidence that the company's five-year Path to Growth strategy was on track. The two co-chairmen had fashioned the strategy initiative in early 2000, following several years of sluggish performance, to rejuvenate the company and restructure its wide-ranging portfolio of food, home, and personal care businesses, which included some 1,600 brands and sales and marketing efforts in 88 countries across the world. Prior to the launch of the Path to Growth strategy, company critics characterized Unilever as burdened by lack of a coherent corporate strategy and an array of lesser-known, low-volume brands; comparatively few Unilever brands had global standing or qualified as "power" brands in 1999. In emerging-country markets, where there was the greatest potential to grow sales of food and household products, Unilever's performance was said to be lackluster.

The key elements of Unilever's Path to Growth strategy involved cutting the size of the company's portfolio from 1,600 brands down to 400 "core" brands, concentrating R&D and advertising on the company's leading brands, divesting underperforming brands and businesses, relying more on product innovation to boost internal growth, and making new acquisitions. The key strategic targets were to achieve top-line sales growth of 5–6 percent annually and to increase operating profit margins from 11 percent to over 16 percent—both to be accomplished by year-end 2004. FitzGerald and Burgmans expected the Path to Growth strategy to produce double-digit earnings per share growth and better position Unilever in the global food and household products industry against such giants as Nestlé, Procter & Gamble, Kraft, Group Danone, Campbell Soup, and General Mills. Moreover, focusing on key brands was expected to allow Unilever to concentrate its advertising and marketing efforts on higher-margin businesses and to build brand value, thus gaining increased pricing power with supermarket retailers.

The five-year initiative was expected to cost a total of some 5 billion euros (€), entail closing or selling 100 factories and laying off some 25,000 employees (10 percent of Unilever's workforce) so as to consolidate production at fewer plants, and ultimately produce annual savings of €3.9 billion through better strategic fits, a streamlined supply chain, and greater operating efficiencies. In addition, Unilever executives believed that the Path to Growth initiative would rectify the company's lagging sales per employee relative to other food companies—Unilever had sales per employee of around $160,000 in 2000, compared with $205,000 for Nestlé, $360,000 for Procter & Gamble, $458,000 for Kellogg's, and $605,000 for General Mills.

Following the announcement of its Path to Growth strategy in February 2000, which was met with considerable skepticism on the part of industry analysts, Unilever undertook a series of actions over the next 12 months. By March 2001 the company had:

- Made 20 new acquisitions worldwide, including SlimFast diet foods; Ben & Jerry's ice cream; Bestfoods (whose major brands included Hellmann's mayonnaise, Skippy peanut butter, Mazola corn oil and margarines, and Knorr packaged soup mixes—Bestfoods had 1999 sales of $8.6 billion

Copyright © 2004 by Arthur A. Thompson. All rights reserved.

across 110 countries); Corporacion Jaboneria Nacional (an Ecuadorian company that had strong market positions in detergents, toilet soaps, skin creams, dental care, margarine, and edible oils and sales of approximately €114 million); Grupo Cressida (a leading consumer products company in Central America); and Amora-Maille (a French maker of mustards, mayonnaises, ketchups, pickles, vinegars, spices, and cooking sauces with 1999 sales of about $365 million).

- Cut the company's brand portfolio from 1,600 brands to 970. To reach the 2004 corporate goal of focusing on about 400 core brands, Unilever's brand reduction strategy called for letting certain brands wither and decline without active promotion and support, selling those brands that no longer fit in with Unilever's future strategy, and discontinuing the rest. An additional 250–300 brands had been targeted for pruning by 2002, and yet another 200 designated for "merger and migration" into the product families of the top 400 brands. According to Niall FitzGerald, "This [migration] is a complex process. No one else has [done it] on this scale. It is easy to change a name—the marketing challenge is to bring the consumer with you."[1]
- Launched 20 internal initiatives to deliver additional sales of €1.5 billion on an annualized basis.
- Divested 27 businesses, including the company's Elizabeth Arden cosmetics business; the Elizabeth Taylor and White Shoulders fragrances brands; the company's European bakery business, the Bestfoods Baking Company (a U.S. bakery business inherited from the acquisition of Bestfoods); most of its European dry soups and sauces businesses, and an assortment of small businesses that produced and marketed lesser-known European grocery brands. The European dry soups and sauces businesses that Unilever divested (via a sale to Campbell Soup Company) had combined sales of €435 million in 2000 and had grown at 1 percent annually over the last three years. (The divestiture was undertaken to alleviate market power concerns in packaged soups expressed by the European Commission and gain the commission's approval of Unilever's acquisition of Bestfoods—the Knorr packaged soup business that was part of the Bestfoods acquisition had global sales of $3 billion.)
- Reorganized the company into two roughly equal-sized global divisions, one including all of the company's food products and the other including all of its household and personal care products.
- Started two new businesses—Cha, a chain of tea houses, and Myhome, a laundry and home-cleaning service test-marketed in Britain in 2000 and in the United States and India in 2001.

In the fall of 2003, some three and a half years after launching the Path to Growth strategy, FitzGerald and Burgmans claimed that Unilever's operating results showed "significant progress" toward delivering top-line growth of 5–6 percent and operating margins of 16 percent or more. In their report on third-quarter 2003 results, Unilever's two co-chairmen cited several accomplishments to indicate that Unilever was "on track or ahead on all key elements" of the five-year plan:

- Unilever's leading brands (which included Dove soaps and shampoos; Knorr soups; Lipton teas; Hellman's mayonnaise; Bertolli's olive oil; Ragú sauces; Country Crock margarine; SlimFast; and Heart, Breyers, and Ben & Jerry's ice creams) accounted for almost 92 percent of the company's nearly €50 billion in revenues (up from 75 percent of total revenues in 1999) and sales of leading brands had grown 5.4 percent over the past 12 months.
- The company's businesses and brand lineup had been reshaped and enhanced through acquisitions and the divestiture of 110 businesses (proceeds from the sales of these businesses had generated over €6.8 billion).
- The company's restructuring of its businesses and brands had produced savings of €3.4 billion out of the €3.9 billion total targeted by year-end 2004.
- Net debt had been reduced from €26.5 billion at the end of 2000 to €16 billion and was expected to fall further to €12–€15 billion by year-end 2004.
- Annual free cash flow of €4 billion was up by €1 billion since 1999.

[1]As quoted in "Unilever Unveils 'Big Hit' Innovations, Brand Cull Progress," *Euromarketing via E-mail* 4, no. 3 (February 9, 2001).

Nonetheless, there were several troubling signs at Unilever in late 2003. Whereas Nestlé's revenues had grown by 5.5 percent in the first half of 2003, Unilever's revenues were up by only 1.7 percent (after stripping out the effects of fluctuating exchange rates). On two occasions in 2003 Unilever had cut its revenue growth forecasts—indicating on its second announcement in the fall of 2003 that companywide revenues for 2003 would likely increase by less than 2 percent over 2002. Management said a sharp deceleration of growth in sales in frozen foods, household care, fine fragrances, and SlimFast had restrained the growth of its leading brands in the third quarter of 2003 to just 3.2 percent and that full-year 2003 growth in sales of leading brands would be below 3 percent. Several analysts indicated that the Path to Growth strategy lacked the punch to produce 5–6 percent revenue growth. One analyst said, "Clearly their program has failed. The worst-case scenario is happening."[2] Another said, "Management needs to give up on the top-line [sales revenue] targets and do some more restructuring."[3]

Exhibit 1 shows Unilever's product and brand portfolio in late 2003. Exhibit 2 shows the 2003 slowdown in the sales growth of Unilever's leading brands.

COMPANY BACKGROUND

Unilever was created in 1930 through the merger of Margarine Unie, a Dutch margarine company, and British-based Lever Brothers, a soap and detergent company. Margarine Unie had grown through mergers with other margarine companies in the 1920s. Lever Brothers was founded in 1885 by William Hesketh Lever, who originally built the business by establishing soap factories around the world. In 1917, Lever Brothers began to diversify into foods, acquiring fish, ice cream, and canned foods businesses. At the time of their merger, the two companies were purchasing raw materials from many of the same suppliers, both were involved in large-scale marketing of household products, and both used similar distribution channels. Between them, they had operations in over 40 countries.

Searching for Focus and Identity

Over the next decades, Unilever continued acquiring companies and brands, gradually moving into more food and household products categories in more and more countries. Still, as late as the mid-1970s, more than half of Unilever's profits came from its West African plantations, which produced bulk vegetable oils for margarine and washing powders. In the 1970s and early 1980s, Unilever diversified beyond food and household products into specialty chemicals, advertising, packaging, market research, and a UK-based franchise for Caterpillar heavy equipment. The specialty chemicals business transformed products from some of the company's plantations into ingredients for food and household products; Unilever also had shipping lines that transported Unilever products. However, during the late 1980s and 1990s, the specialty chemicals, advertising, packaging, shipping, and market research businesses were divested in an attempt to shed the company's image as a conglomerate and focus resources on the company's core businesses.

Unilever's broad-based product and geographic diversification in foods, personal care products, and household products spawned a complex management structure that gave considerable decision-making power to country managers to set their own priorities and to tailor products to local tastes. From time to time, executives at Unilever's headquarters had launched new initiatives and reorganization plans aimed at giving the company more focus as a multinational marketer of food, personal care, and household products. Still, in 2000 when the Path to Growth strategy was launched, the company had 1,600 brands of food, personal care, and household products, with 1999 sales of €41.2 billion and operations in 88 countries.

In 2003, Unilever had pared its brand portfolio to 500–600 brands and reported 2002 sales of about €48.8 billion. A number of Unilever brands had either the highest or second highest share in their respective markets. Unilever was one of the world's five largest food and household products companies and had been ranked among the top 60 of *Fortune*'s Global 500

[2]Deborah Ball, "Unilever Cuts Its Growth Target Again," *The Wall Street Journal*, October 21, 2003, p. A3.

[3]Ibid., p. A7.

exhibit 1 **Unilever's Business and Product Line Portfolio in Late 2003**

Unilever Foods Group		
Product Category	**Brands**	**Comments**
Margarines, spreads, and cooking oils	I Can't Believe It's Not Butter, Country Crock, Imperial, Take Control, Promise, Brummel & Brown, Rama, Flora/Becel, Dorina, Doriana, and Blue Band spreads and cooking products; Bertolli olive oils; Skippy peanut butter	The world leader in margarine and related spreads and olive oil, with sales in more than 100 countries. Rama was the world's largest margarine brand; Country Crock was the number one U.S. margarine, and Doriana and Dorina were leading margarine brands in Latin America. The Rama, Country Crock, Blue Band, and Flora/Becel brands had 2002 sales of €2.4 billion. Bertolli was the world's leading brand of olive oil, with 2002 revenues of €500 million. Unilever had significant oil plantations in the Democratic Republic of Congo, Côte d'Ivoire, Ghana, and Malaysia.
Frozen foods	Birds Eye (sold in the United Kingdom), Findus (sold in Italy), and Iglo (sold in most other European countries)	Unilever was the biggest marketer of frozen foods in Europe; this product category had an inconsistent growth record but produced a 30% return on capital employed.
Ice cream and frozen novelties	Heart, Breyers, Ben & Jerry's, Magnum, Solero, Wall's, Langnese, Ola, Streets, Cornetto, Carte de'Or, Kibon, Viennetta, Popsicle, Klondike, and Good-Humor ice cream products	Unilever was the world leader in sales of ice cream, with global revenues of €5 billion, a 17% global market share, and sales in over 90 countries. The Heart family of ice cream brands had sales of €3.5 billion across 40 countries; the Breyers and Ben & Jerry's brands generated €1.5 billion in sales.
Tea-based beverages	Lipton, Lipton Ice Tea and Lipton Brisk (ready-to-drink teas), Brooke Bond, and Beseda teas	Lipton was the world's most popular tea brand and the third largest beverage brand worldwide based on volume; Lipton products were sold in 110 countries. Unilever had extensive tea plantations in India, Tanzania, and Kenya that supplied tea for its own brands and the tea market in general.
Culinary products	Knorr soups; Hellman's mayonnaise; Ragú and Five Brothers pasta sauces; Colman's, Amora, and Maille mustards and condiments; Lawry's seasonings; Wishbone and Calvé salad dressings; Calvé peanut butter; Slotts and Klocken mustards, ketchup, and seasonings; Sizzle & Stir sauces	Knorr was Unilever's biggest selling brand with sales of over €2.3 billion; Hellman's was Unilever's third biggest selling brand. Ragú was Unilever's third biggest selling brand in the culinary products group; Amora was the best-selling mustard brand in France.
Health and wellness	SlimFast, AdeS (a soy-based beverage), Maizena	SlimFast was the number one weight management brand in the United States.

largest corporations since 1995. According to Niall FitzGerald, "We're not a manufacturing company any more. We're a brand marketing group that happens to make some of its products."[4]

Exhibit 3 provides a summary of Unilever's financial performance for the 1992-2002 period.

[4]As quoted in *The Financial Times*, February 23, 2000, p. 27.

Organization and Management

To preserve the company's Dutch and British heritage, Unilever maintained two headquarters—one in Rotterdam and one in London—and operated under two co-chairmen. The company's headquarters group in Rotterdam, headed by Antony Burgmans, was in

exhibit 1 (concluded)

Unilever Home and Personal Care Group (operations in 60-plus countries)		
Product Category	**Brands**	**Comments**
Prestige fragrances	Calvin Klein, Eternity, Escape, Chloé, Cerruti, Valentino, Obsession, Lagerfeld, Nautica, Vera Wang, and BCBG	Unilever's prestige fragrances division was one of the largest fragrance businesses in the world.
Deodorants and toiletry products	Rexona/Sure, Axe/Lynx, Dove, Degree, Brut, Suave, and Impulse	Rexona/Sure was the world's number one deodorant brand.
Hair care	ThermaSilk, Sunsilk, Seda, Finesse, Suave, Caress, Dove, Salon Selectives, Timotei, and Organics shampoos; AquaNet and Rave hair care products	
Oral care and oral products	Aim, Pepsodent, Mentadent, and Close-up (Asia-Pacific, United States), Signal (Europe), Zhonghua (China) toothpastes; Signal and Mentadent chewing gums	
Soaps, lotions, and skin care products	Dove, Lux, Degree, Caress, Lever 2000, Lifebuoy, and Shield's soap bars; Pond's, Vaseline, and Fair & Lovely skin care products; Hazeline shampoos and skin care products (sold in China); Q-tips cotton swabs and balls	Dove was the world's number one brand of soap.
Laundry detergents and fabric conditioners	Wisk, Omo, Omo, Surf, Ala, Persil, All, Radiant, and Skip detergents; Snuggle, Cajoline, and Comfort fabric conditioners	Unilever was a distant number two to Procter & Gamble in North America, a close number 2 behind P&G in Europe, and the clear leader in the developing and emerging country markets with an estimated 55 percent share. The Omo, Surf, and Radiant brands all had annual sales in the €1–€2 billion range.
Household care and cleaning products	Domestos surface cleaners, Cif household cleaners, Sunlight dish detergents, and Solvol (a heavy-duty hand cleaner marketed in Australia and New Zealand)	Domestos was marketed in 48 countries, and Cif was marketed in 53 countries.

Source: Compiled by the case researcher from a variety of company sources.

charge of food products, while the London headquarters group, under Niall FitzGerald, was in charge of personal care and household products. FitzGerald had been chairman of the London-based portion of Unilever since 1996 and was said to have been instrumental in reorganizing Unilever's 1,600-brand portfolio around 14 groups as opposed to the former 57 groups. Company observers regarded FitzGerald as one of the most able and innovative Unilever chairmen in decades. Officially, the two co-chairmen had equal status and responsibilities. Each had offices in both Rotterdam and London, shuttling between the two headquarters' locations every couple of weeks. They kept in contact via phone daily.

To complement its unique dual headquarters, dual chairperson approach, the company had a dual holding company structure whereby Unilever's ownership was divided into two classes—some shareholders owned Unilever NV stock (based largely on food products), which traded on the Dutch stock exchange, and some shareholders owned Unilever PLC stock (based largely on personal care and household products), which traded on the Financial Times and the London Stock Exchange (London FTSE) and was included as part of the FTSE 100 Index. Since Unilever stock was also traded on the New York Stock Exchange, the company reported its financial results in euros, British pounds, and U.S. dollars. The two companies, Unilever NV and

exhibit 2 Growth in Sales of Unilever's Leading Brands, by Category, 2000–2003

	Growth Rate in Sales of Leading Brands				
Category	2000	2001	2002	January–September 2003	July–September 2003
Margarines, spreads, oils, and cooking products	(1.5)%	5.5%	4.3%	(0.4)%	(0.7)%
Frozen foods	3.0	0.3	0.9	(0.2)	0.8
Ice cream	1.2	2.9	4.0	4.0	5.6
Tea-based beverages	4.5	3.3	3.3	4.9	11.6
Soups, dressings, and culinary products	6.0	4.2	5.1	3.4	2.0
Health and wellness	17.0	25.4	9.1	(14.5)	(29.5)
Total foods	1.9%	4.1%	4.4%	1.7%	1.6%
Personal care	7.5%	9.0%	10.8%	8.6%	9.6%
Fragrances	2.8	(7.2)	1.3	(8.0)	(25.[illegible])
Laundry	3.2	5.3	1.9	1.3	2.9
Other household products	2.0	7.1	2.6	(3.6)	4.2
Total home and personal care	5.3%	6.5%	6.7%	4.8%	5.1%
Overall Unilever average	3.8%	5.3%	5.4%	3.1%	3.2%

Source: Unilever press release, October 29, 2003.

Unilever PLC, operated as nearly as practicable as a single entity; a series of intercompany agreements ensured that the position of shareholders in both companies was virtually the same as having shares in a single company.

Unilever's food businesses had traditionally been organized around countries, with each country having its own factories engaged in making products for mostly national and sometimes regional geographic markets. Some countries had multiple brands of the same product—for example, in 2001 American shoppers could choose from six Unilever brands of margarine (Promise, Imperial, Country Crock, Brummel & Brown, Take Control, and I Can't Believe It's Not Butter!); in the United Kingdom there were nine Unilever margarine brands, although only three were supported by advertising. The strategy in margarine was to cater to a wide range of tastes—from a German preference for lighter-colored spreads to British preferences for spreads with a higher fat content to American tastes for flavorful and healthier spreads.

Longtime company analysts regarded Unilever management as a slow-moving, unwieldy, and inherently conservative Anglo-Dutch bureaucracy—one that operated in a staid manner resembling the civil service approach of government agencies. As one analyst put it, "Historically, Unilever has been a very inbred business. People used to join the company from college and leave it when they were carried out in a box. It was a cradle-to-grave company."[5] In 2001 about 90 percent of the company's managers were locally recruited and trained.

To stimulate more innovation and entrepreneurial thinking, Unilever had begun stepping up efforts to attract talented managers from outside the company. In addition, Unilever had revised its incentive compensation system. In the old system, the top 300–400 managers could earn an annual bonus worth up to 40 percent of their salaries, with the average bonus rate being 15 to 25 percent. Under the recently introduced system, outstanding managers who hit exacting growth and earnings targets could earn up to 100 percent bonuses. A further move was to alter the award of stock options from giving equal amounts to all managers at a

[5] Quote attributed to David Lang, consumer industry analyst at brokerage firm Investec Henderson Crosthwaite, in an article by John Thornhill in the *Financial Times*, London Edition, August 5, 2000, p. 12.

exhibit 3 **Selected Financial and Operating Highlights for Unilever, 1992–2002**

	1992	1994	1996	1998	2000	2001	2002
Sales revenues (in millions)	€34,746	€37,478	€39,840	€40,639	€48,066	€52,206	€48,760
Operating profit, BEIA* (in millions)	3,099	3,266	3,693	4,323	5,794	7,269	7,260
Operating profit margins, BEIA*							
By product area							
Foods	8.7%	7.9%	8.0%	9.6%	11.6%	14.4%	14.8%
Personal care	9.9	11.0	11.6	12.8	16.2	18.0	18.2
Home care and cleaning	7.8	7.7	8.2	10.2	8.9	8.5	11.1
By geographic area							
Europe	8.9%	8.5%	9.3%	11.4%	12.7%	14.7%	15.3%
North America	8.0	8.5	9.2	10.9	12.8	14.2	16.1
Africa, Middle East, Turkey	10.5	9.6	9.2	8.8	10.0	11.0	11.0
Asia and Pacific	9.4	8.9	8.6	8.8	11.2	13.4	14.2
Latin America	10.0	9.7	10.4	10.6	10.8	13.2	13.9
Overall	8.9%	8.7%	9.3%	10.6%	12.0%	13.9%	14.9%
Research and development expenditures (in millions)	€ 649	€ 686	€ 714	€ 830	€ 1,187	€1,178	€1,166
Expenditures for advertising and promotions (in millions)	3,846	4,224	4,499	5,188	6,545	6,648	6,839
Capital expenditures (in millions)	1,560	1,804	1,389	1,329	1,356	1,513	1,298
Cost of new acquisitions (in millions)	543	789	1,892	361	24,728	120	53
Funds received from divestitures (in millions)	713	165	541	736	586	3,233	1,703
Number of acquisitions/divestitures	43	40	50	44	47	34	38
Average number of employees	287,000	304,000	306,000	267,000	261,000	279,000	258,000

*BEIA = Before exceptional items and amortization of goodwill and intangibles.

Source: Unilever records posted at www.unilever.com, accessed December 30, 2003.

particular level (based on the company's overall performance) to making awards of shares based on individual performance.

INDUSTRY ENVIRONMENT

The food and household products industry was composed of many subsectors, each with differing growth expectations, profit margins, competitive intensity, and business risks. Industry participants were constantly challenged to respond to changing consumer preferences and to fend off maneuvers from rival firms to gain market share. Competitive success started with creating a portfolio of attractive products and brands; from there success depended largely on product line growth through acquisitions (it was generally considered cheaper to buy a successful brand than to build and grow a new one from scratch) and on the ability to continually grow sales of existing brands and improve profit margins. Advertising was considered a key to increasing unit volume and helping drive consumers toward higher margin products; sustained volume growth also usually entailed gaining increased international exposure for a company's brands. Improving a company's profit margins included not only shifting sales to products with higher margins but also boosting efficiency and driving down unit costs.

In 2000, there was a wave of megamergers involving high-profile food and household products companies (see Exhibit 4). Three factors were driving consolidation pressures in the food industry—slower growth rates in the food sector, rapid consolidation among retail grocery chains (which enhanced the buying power of the major supermarket chains and enhanced their ability to demand and receive lucrative "slotting fees" for allocating manufacturers favorable shelf space on their grocery aisles), and fierce competition between branded food manufacturers and private-label manufacturers.

Growth prospects for many food companies had been bleak for several years, and the trend was expected to continue. In the United States, for example, sales of food and household products were, on average, growing 1–2 percent annually, just slightly higher than the 1 percent population growth. More women working outside the home, decreasing household sizes, and greater numbers of single-person and one-parent households were causing a shift of food and beverage dollars from at-home outlays to away-from-home outlays. The growth rate for food and household products across the industrialized countries of Europe was in the 2 percent range, with many of the same growth-slowing factors at work as in the United States. Food industry growth rates in emerging or less-developed countries were more attractive—in the 3–4 percent range—prompting most growth-minded food companies to focus their efforts on markets in Latin America, Asia, Eastern Europe, and Africa, where about 85 percent of the world's population was concentrated. The household and personal care business (excluding food products) was a €21 billion market, with sales of €5 billion in North America, €6 billion in Europe, €5 billion in the Asia-Pacific region, €3 billion in Latin America, and €2 billion in Africa and the Middle East.

Since 1985 the share of private-label food and beverages sold in the United States had risen steadily, accounting for roughly 25 percent of total grocery sales in 2000, up from 19 percent in 1992. Growing shopper confidence in the leading supermarket chains and other food retailers like Wal-Mart (which was selling a full line of grocery and household items at its Supercenters and had become the largest supermarket retailer in the world during the past five years) had opened the way for retail chains to effectively market their own house-brand versions of name-brand products, provided the house brand was priced attractively below the competing name brands. Indeed, with the aid of checkout scanners and computerized inventory systems, retailers knew as well or better (and more quickly) than manufacturers what customers were buying and what price differential it took to induce shoppers to switch from name brands to private-label brands. These developments tilted the balance of power firmly toward retailers. Thus competition between private-label goods and name-brand goods in supermarkets was escalating rapidly, since retailers' margins on private-label goods often exceeded those on name-brand goods. The battle for market share between private-label and name-brand goods was expected to continue as private-label manufacturers improved their capabilities to match the quality of name-brand products while also gaining the scale economies afforded by a growing market share.

Most food and household products manufacturers were trying to counteract the bargaining power of large

exhibit 4 Selected Major Acquisitions in the Food and Household Products Industry, 2000–2002

Companies Involved	Value of Deal	Principal Products and Brands of Acquiring Company	Brand /Products Acquired
2002 transactions Nestlé acquired a majority ownership of Dreyer's Grand Ice Cream, Inc.	$2.4 billion in stock	• Chocolates, candies, candy bars (Nestlé Crunch, KitKat, Smarties, Butterfinger, Lifesaver, Milkybar, Baci, Lion, Rolo, Aero, Wonderball, Wonka, PowerBar) • Dairy (Carnation, Coffee-Mate, Yoco, LC1, Munch Bunch, Gloria, Bärén Marke) • Beverages (Nescafé, Nesquik, Nestea, Juicy Juice, Milo) • Bottled water (San Pellegrino, Perrier, Poland Spring, Contrex, Panna, Vittel, 24 others) • Prepared foods (Stouffer's, Maggi, Buitoni, Lean Cuisine, Herta, Libby's) • Ice cream (Dreyer's, Extreme, Maxibon, 3 others) • Pet care (Friskies, Fancy Feast, Alpo, Mighty Dog, Purina, Tidy Cat, Felix, 8 others) • Baby foods (Alete, Beba, 6 others)	• Dreyer's ice creams and sherbets
Del Monte Foods acquired the pet foods, tuna, soup, and infant feeding businesses of the H. J. Heinz Company	$2.8 billion in stock	• Del Monte canned fruits and vegetables • Contadina canned tomato products • S&W canned fruits and vegetables	• Heinz steak sauces and other condiments • Ore Ida potatoes • Wyler's bouillon and soup mixes • Weight Watchers dinners • StarKist tuna • Pet Foods (9 Lives, Kibbles and Bits, Meaty Bone, Skippy) • Baby foods (Heinz, Nature's Goodness, Plasmon, Farley's, tinytums)
Nestlé acquired Chef America	$2.6 billion in cash	See above	• Chef America frozen stuffed sandwiches
Associated British Foods PLC acquired 19 brands from Unilever	$360 million in cash	• Silver Spoon sweeteners (United Kingdom) • Allinsons, Kingsmill, Ryvita, and Speedibake breads (United Kingdom) • Ovomaltine malt beverage (Europe, China, Thailand) • Twinings and Jackson of Piccadilly teas	• Mazola cooking oil • Argo and Kingsford's cornstarches • Karo and Golden Griddle syrups • Henri's salad dressing • A number of related Canadian brands

(continues)

exhibit 4 **(continued)**

Companies Involved	Value of Deal	Principal Products and Brands of Acquiring Company	Brand /Products Acquired
2001 transactions			
Sara Lee acquired The Earthgrains Company	$1.8 billion in cash	• Sara Lee deli lunch meats, sliced and packaged meats, fresh and frozen bakery products, and frozen foods • Coffee and coffee systems (Douwe Egberts and Superior) • Meats (Hillshire Farms, Aoste, Bryan, Ball Park, Jimmy Dean) • Kiwi shoe products • Apparel (Champion, Playtex, Hanes, DIM, Wonderbra, Loveable, Bali, Just My Size, Nurdie, L'eggs)	• Earth Grains, IronKids, Rainbo, Colonial, and Grant's Farms breads
Nestlé acquired Ralston Purina Company	$10.3 billion in cash	See list of Nestlé brands earlier in table	• Ralston Purina pet food and pet care brands—Purina Dog Chow, Purina Puppy Chow, Felix, Purina One, T Bonz, Beggin' Strips, Pro Plan, Puppy Chow, Tidy Cats, Tender Vittles
2000 transactions			
General Mills acquired the Pillsbury unit of Diageo (a UK-based company with a wide-ranging portfolio of wines and alcoholic beverage brands and the then parent of Burger King and Pillsbury)	$10.5 billion in cash	• Wheaties, Cheerios, Total, Lucky Charms, Trix, Chex, Golden Grahams, and Kix cereals • Betty Crocker desserts and side dishes, Gold Medal flours, Bisquick, and Hamburger Helper • Lloyd's barbeque meats • Yoplait and Colombo yogurts • Pop Secret, Chex Mix, Nature Valley, and Bugles snack foods	• Pillsbury and Martha White flours, baking mixes, and baking products, and Hungry Jack pancake mix • Häagen-Dazs ice cream and frozen yogurt • Green Giant frozen and canned vegetables • Old El Paso Mexican foods • Totinos and Jenos pizzas • Progresso soups
Phillip Morris (the parent of Kraft Foods prior to Kraft's 2001 IPO) acquired Nabisco	$19 billion in cash, stock, and debt	• Kraft cheeses, mayonnaise, salad dressings, barbeque sauces, and dinners • Post cereals • Jell-O • Kraft, Velveeta; Cheez Whiz; Cracker Barrel, and Hoffman's cheeses • Maxwell House, Yuban, and Sanka coffees • Minute rice • Claussen pickles • Louis Rich and Oscar Mayer meats • Others: Shake 'N Bake, Breakstone, Cool Whip, Planters nuts, Kool-Aid, Stove Top, Altoids, Tobler and Toblerone chocolates	• Nabisco cookies, crackers, and snacks • Grey Poupon French mustards

exhibit 4 **(continued)**

Companies Involved	Value of Deal	Principal Products and Brands of Acquiring Company	Brand /Products Acquired
Kellogg's acquired Keebler	$4.4 billion	• Kellogg's cereals • Eggo, Nutri-Grain, Pop-Tarts • Kashi cereal and breakfast bars • Rice Krispies Treats • Snack'Ums	• Keebler and Murray cookies • Keebler snack foods (Cheez-It, Wheatables, Toasteds, Munch'ems, Harvest Bakery, Snax Stix) • Krispy and Zesta saltine crackers, Club crackers, Hi Ho crackers • Ready Crust pie shells
ConAgra acquired International Home Foods	$2.9 billion	• Armour, Banquet, Butterball, Eckrich meats • Blue Bonnet and Parkay margarines • Chun King and La Choy Chinese foods • Orville Redenbacher's and Act II popcorns • Peter Pan and County Line cheeses • Morton prepared foods • Fleischmann's, Egg Beaters • Healthy Choice foods • Hunt's ketchup, tomatoes, and tomato sauces	• Chef Boyardee sauces • Pam cooking spray • Louis Kemp/Bumblebee seafood products • Libby's canned meats • Gulden's mustard
PepsiCo acquired Quaker Oats	$12.4 billion in cash and stock	• Pepsi and Mountain Dew soft drinks • Frito-Lay snack foods • Tropicana juices	• Gatorade • Quaker Oats cereals • Rice a Roni • Aunt Jemima mixes and syrups • Near East food products • Golden Grain-Mission pastas
Cadbury Schweppes acquired the Snapple Beverage Group from Triarc, Inc.	$1.45 billion	• Schweppes and Canada Dry tonics, sodas, and ginger ales; 7Up, Dr Pepper, and A&W soft drinks; Mott's and Clamato juices; Cadbury chocolates and confectionery items; and Trebor, Pascall, Cadbury Éclair, and Bassett candies	• Snapple ready-to-drink teas and beverages

supermarket chains and the growth of private-label sales by building a diverse lineup of strong brands—the thesis being that retailers, fearful of irritating shoppers by not carrying well-known brands, would be forced to stock all of the manufacturer's name-brand products and, in many cases, award them favorable shelf space. At the same time, because they faced pressures on profit margins in negotiating with retailers and combating the competition from both name-brand and private-label rivals, manufacturers were trying to squeeze out costs, weed out weak brands, focus their efforts on those items they believed they could develop into global brands, and reduce the number of versions of a product they manufactured wherever local market conditions allowed (to help gain scale economies in production).

Exhibit 5 provides a brief profile of Unilever's main competitors. Other competitors included Sara Lee, H. J. Heinz, Kellogg's, and well over 100 regional and local food products companies around the world. Many of the leading food products companies had a food-service division that marketed company products to restaurants, cafeterias, and institutions (such as schools, hospitals, college student centers, private country clubs, corporate facilities) to gain access to the growing food-away-from-home market.

UNILEVER'S BUSINESSES AND BRAND PORTFOLIO

Analysts familiar with the household products business and with Unilever were skeptical that there were meaningful strategic and resource fits between food products and household/personal care products. Some saw Unilever's reorganization into a foods group and a home and personal care group as a possible precursor to the breakup of Unilever, an outcome denied by Unilever executives.

The foods division, known as Unilever Bestfoods following the 2000 acquisition and integration of Bestfoods, was organized around six product categories: spreads, culinary, and cooking products; savory (soups and sauces) and dressings; beverages; health and wellness; frozen foods; and ice cream. The foods division, which had consistently generated 50–52 percent of Unilever's corporate-wide revenues from 1992 to 2000, accounted for 55 percent of revenues in 2001 and 56 percent in 2002—chiefly because of the Bestfoods acquisition. The Home and Personal Care (HPC) division consisted of eight categories: deodorants, hair care, household care, laundry, mass skin care, oral care, personal wash, and fragrances and cosmetics. HPC generated about 43 percent of Unilever's corporatewide revenues.

Unilever Bestfoods and HPC were each headed by a director who had global profit responsibility and executive authority for aligning brand strategy with operations worldwide.[6] Underneath the division heads were directors for each product category and regional presidents who were responsible for profitability in their respective regions. Both divisions had an executive committee—composed of the division director (acting as chairperson), the directors for each product category, and the regional presidents—that was responsible for the overall results and performance of Unilever. Most research and new product development activities were integrated into the divisional structure, but the company formed a small number of "global innovation centers" to interlink with R&D at the division level and the company's worldwide brand innovation organization. Unilever's local companies were to remain as the key interface with customers and consumers, responding to local market needs. Unilever executives saw the formation of two global divisions as having three benefits:

- Improving the company's focus on foods and HPC activities regionally and globally.
- Accelerating decision making and execution through tighter alignment of brand strategy with operations.
- Strengthening innovation capability through more effective integration of R&D into the divisional structure and the creation of global innovation centers.

Some analysts had criticized Unilever for paying too much for several of its acquisitions. For example, Unilever paid a purchase price of €715 million to acquire Amora Maille (equal to 16.6 times Amora Maille's 1999 operating earnings of €43 million)—a price well above the earnings multiples commanded by other food businesses and an amount said to be double what the present owners paid to acquire Amora Maille from Group Danone in 1997. Unilever paid 14.1 times earnings before interest, taxes, depreciation, and amor-

[6]Company press release describing the realignment of the senior management structure at Unilever, August 3, 2000.

exhibit 5 Profile of Selected Unilever Competitors

Company (Headquarters)	Sales (in billions)	Profits (in billions)	Scope of Operations and Key Facts
Nestlé (Swiss)	2002: SFr89.2 2001: SFr84.7 2000: SFr81.4 1999: SFr74.7 1998: SFr71.7 1997: SFr70.0 1996: SFr60.5	2002: SFr7.56 2001: SFr6.81 2000: SFr5.76 1999: SFr4.72 1998: SFr4.20 1997: SFr4.18 1996: SFr3.59	World's largest food company with sales in almost every country of the world; 508 factories; 254,000 employees.
Procter & Gamble (U.S.)	2003: $43.4 2002: $40.2 2001: $39.2 2000: $40.0 1999: $38.1 1998: $37.2 1997: $35.8 1996: $35.3	2003: $5.19 2002: $4.35 2001: $2.92 2000: $3.54 1999: $3.76 1998: $3.78 1997: $3.42 1996: $3.05	Sales in over 140 countries; on-the-ground-operations in more than 70 countries, 98,000 employees; and 300 brands (13 with sales of over $1 billion). P&G believed it was the global sales leader in its four core product categories: fabric care, hair care, feminine care, and baby care products. P&G had 5 global business units: • Fabric and home care—2003 sales of $12.6 billion and 32 key brands, including Tide, Ariel, Downy, Lenor, Dawn, Fairy, and Joy. • Beauty care—2003 sales of $12.2 billion and 38 key brands, including Pantene, Olay, Head & Shoulders, Clairol, Secret, and Tampax. • Baby and family care—2003 sales of $9.9 billion of such brands as Pampers, Luvs, Kandoo, Charmin, Bounty, Tempo, and Puffs. • Health care—2003 sales of $5.8 billion; key brands include Crest, Pepto-Bismol, Vicks, Metamucil, and 2 pet health and nutrition brands (Iams and Eukanuba). • Snacks and beverages—2003 sales of 43.2 billion; brands included Pringles, Folgers, Millstone, Sunny Delight, Punica, and Torengos. Tide's market share was over 4 times larger than its nearest competitor; Ariel laundry detergent was sold in 115 countries (with the highest or second highest share in 25 countries). Tide and Ariel had combined sales greater than any other P&G brand.
Kraft Foods (U.S.)	2002: $29.7 2001: $29.2 2000: $26.5 1999: [illegible] 1998: $27.3 1997: [illegible] 1996: [illegible]	2002: $3.39 2001: $1.88 2002: $6.28* 2001: $5.04* 2000: $4.62* 1999: $4.25* 1998: $4.18* 1997: $4.20* 1996: $3.98*	Kraft had 60 major brands in its business lineup, sales in over 150 countries, 218 manufacturing plants (118 outside the U.S.), 5 R&D technology centers, 109,000 employees, and operating units in 68 countries. Kraft brands held the number one share position in 21 of the top 25 categories in the U.S. In international markets, Kraft brands were number one based on unit volume in one or more countries in 10 product categories. Kraft was committed to innovation, with more than $1.1 billion of 2002 revenue generated from new products. In 2003, Kraft planned to launch more than 100 new products.

(continues)

exhibit 5 **(concluded)**

Company (Headquarters)	Sales (in billions)	Profits (in billions)	Scope of Operations and Key Facts
Groupe Danone (France)	2002: €13.4 2001: €14.5 2000: €14.3 1999: €12.9 1998: €13.5 1997: €12.8 1996: €12.1	2002: €1.28 2001: €0.13 2000: €0.72 1999: €0.60 1998: €0.56 1997: €0.51 1996: €0.32	Sales in 120 countries (38% outside the European Union); 148 production plants, 86,000 employees. Four brands represented more than 50% of sales: • Danone yogurts (the world leader in yogurt with a 15.1 global share). • LU (the world's second largest cereal biscuit and snack crackers brand). • Evian and Volvic bottled waters (2 of the 4 biggest bottled water brands worldwide). Other key brands include Actimel and Galbani in dairy products; Brio Fountain, and Fontvella in bottled waters; Prince and Tiger in biscuits and crackers; Lea & Perrins; and Amoy Asian products.
Campbell's Soup (U.S.)	2003: $6.7 2002: $6.1 2001: $6.6 2000: $6.3 1999: $6.4 1998: $6.7 1997: $6.0 1996: $7.7	2003: $0.60 2002: $0.52 2001: $0.65 2000: $0.71 1999: $0.72 1998: $0.66 1997: $0.71 1996: $0.80	Campbell's products were sold in 120 countries and included such brands/products as Campbell's soups, tomato juice, and Super Bakes; Batchelors, Erasco, Leibig, McDonnells, and Oxo soups (Europe); Homepride sauces (Europe); Franco American and Prago in culinary foods and sauces, Pepperidge Farm, Swanson canned meats and soups; Pace salsas, and Godiva chocolates. Campbell's was the number one wet soup brand in the world; Arnott's was the market leader in biscuits and crackers in Australia and was the number two brand in New Zealand.
General Mills/ Pillsbury (U.S.)	2003: $10.5 2002: $7.9 2001: $5.5 2000: $6.7 1999: $6.2 1998: $6.0 1997: $5.6 1996: $5.4	2003: $0.92 2002: $0.46 2001: $0.66 2000: $0.61 1999: $0.54 1998: $0.42 1997: $0.44 1996: $0.48	General Mills/Pillsbury products were manufactured in 17 countries and distributed in over 100 countries. However, about 95% of sales were in the United States. The company's internationally recognized products were Häagen-Dazs ice creams, Old El Paso Mexican foods, Green Giant vegetables, Pillsbury dough products and mixes, Betty Crocker mixes, and Bugles snacks.

*Operating earnings—Philip Morris (the former parent of Kraft) did not report net income separately for its business divisions.

Source: Compiled by the case researcher from company Web sites and company documents.

exhibit 6 **Selected Financial Performance Statistics for SlimFast, 1997 through the First Quarter of 2000 (dollars in millions)**

	1997	1998	1999	Q1 2000
Sales revenues	$390	$505	$611	$194*
Advertising and promotional expenditures	87	102	142	n.a.
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	78	117	139	
Earnings before interest and taxes (EBIT)—operating profits	76	112	125	39†
EBIT % (operating profit margin)	19.4%	22.2%	20.5%	20.1%

*Up 21% over Q1 1999.
†Up 28% over Q1 1999.
Source: www.unilever.com, April 17, 2001.

tization (EBITDA) for Bestfoods—a record high for a foods company and above the 12.8 times EBITDA that Philip Morris/Kraft paid for Nabisco and the 12.1 times EBITDA that PepsiCo paid for Tropicana in 1999. Unilever defended its price for Amora Maille, saying it was justified based on the superior growth prospects the business would deliver relative to other grocery products and on the 19.3 times earnings before interest and taxes (EBIT) that PepsiCo paid for Tropicana in 1999.

THE SLIMFAST ACQUISITION

Two months after announcing the new Path to Growth strategy in February 2000, Unilever negotiated an agreement to acquire SlimFast diet foods for $2.3 billion cash. SlimFast, a privately held company headquartered in Miami, Florida, was the U.S. market leader in the $1.3 billion North American weight management and nutritional supplement industry, with a 45 percent market share. The company's nearest competitor had a market share of just over 25 percent. SlimFast had sales of $611 million in 1999, up 20 percent over 1998 (see Exhibit 6); the company's net assets totaled $160 million at the time of acquisition. SlimFast's ready-to-drink selections (72 percent of total sales), powders (16 percent), and bars (12 percent) all had the leading positions in their category segments. An estimated 2 million U.S. consumers used SlimFast products daily, and an additional 5 million used SlimFast products occasionally. About 94 percent of SlimFast's sales were in North America. Studies showed the SlimFast brand name had an unaided 89 percent recognition rate among U.S. consumers. SlimFast produced a portion of its products at a company-owned manufacturing facility in Tennessee and sourced the remainder from contract suppliers. It had a strong sales and distribution network, having been successful in gaining shelf space in most supermarkets and drugstores, and had spent over $400 million on advertising and promotion during the past four years.

SlimFast products were made from "natural ingredients" supplemented with added vitamins and minerals to provide a strong nutritional profile—no appetite suppressants were used. Promotional efforts centered on the themes of good health, balanced nutrition, great taste, and convenient product formats (ready-to-drink products, powders, and bars). SlimFast had conducted extensive clinical trials to validate the performance of its products. The company had a strong physician education program and enjoyed good relationships with the U.S. Food and Drug Administration (FDA) and other regulatory agencies.

Unilever was attracted to SlimFast because the company was growing by about 20 percent annually and because people all across the world were increasingly interested in living a longer, healthier, and more vital life. Market research indicated that in the United States, Germany, and the United Kingdom nutrition was the number one dietary concern and that weight was number three. In the United States, Western Europe, Australia, and the largest cities in the rest of the world, between 40 and 55 percent of the population were overweight and 15 to 25 percent were obese. According to the World Health Organization, the number of people who were either overweight or obese was increasing at an alarming rate.

Unilever management saw opportunities to use the company's global distribution capabilities to introduce SlimFast in Europe, Australia, and cities in developing countries, perhaps doubling SlimFast's sales within two or three years. According to independent market research, the world market for diet products and nutritional foods was about $31.7 billion annually and was growing annually at 11.3 percent. Unilever executives believed that SlimFast products would appeal to weight-conscious Europeans; according to co-chairman Antony Burgmans, "Europe at the moment is underdeveloped. We are in a perfect position to boost the presence of this brand."[7] Company projections at the time of the acquisition indicated that SlimFast would begin to contribute positively to Unilever's cash flows in 2002 and to earnings in 2003. Unilever believed that SlimFast had a strong management team.

But Unilever's SlimFast acquisition, which looked so promising in 2000–2001, showed signs of being in deep trouble in 2003. Sales growth of SlimFast products slowed to about 9 percent in 2002, and then unit volume plummeted in 2003, chiefly due to growing consumer infatuation with low-carbohydrate diets and a mushrooming number of new diet and nutrition bars that competed directly against SlimFast products and that had gained highly visible shelf space in supermarkets, convenience stores, and drugstore chains. SlimFast's revenues, which were €1 billion in 2002, were down 23 percent in the first nine months of 2003.

THE BEN & JERRY'S ACQUISITION

After considering offers from Unilever, Diageo (at the time the parent company of archrival Häagen-Dazs), Nestlé, Roncadin (an Italian company), and Dreyer's (a rival maker of superpremium ice cream products and a longtime distributor of Ben & Jerry's products), the board of directors of Ben & Jerry's Homemade, Inc., in April 2000 agreed to accept Unilever's offer of $43.60 a share for all of the company's 7.48 million shares, resulting in an acquisition price of $326 million. The $43.60 price represented a premium of 23 percent over the closing price the day prior to the announcement of the agreement and was well above the $15.80–$20.00 range the stock traded in prior to the five buyout offers becoming public knowledge in December 1999. Exhibit 7 shows Ben & Jerry's financial highlights for years prior to the acquisition. The Ben & Jerry's acquisition put Unilever in the high-end superpremium segment of the ice cream market for the first time and made Unilever the world's largest marketer of ice cream products.

Company Background

Ben & Jerry's began active operations in 1978 when Ben Cohen and Jerry Greenfield, two former hippies with counterculture lifestyles and very liberal political beliefs, opened a scoop shop in a renovated gas station in Burlington, Vermont. Soon thereafter, the cofounders decided to package their ice cream in pint cartons and wholesale them to area groceries and mom-and-pop stores—their sales slogan became "Vermont's Finest All Natural Ice Cream" and the carton design featured a picture of the cofounders on the lid and unique hand-style lettering to project a "homemade" impression. The cartons were inscribed with a sales pitch by Ben and Jerry:

> This carton contains some of the finest ice cream available anywhere. We know because we're the guys who made it. We start with lots of fresh Vermont cream and the finest flavorings available. We never use any fillers or artificial ingredients of any kind. With our specially modified equipment, we stir less air into the ice cream, creating a denser, richer, creamier product of uncompromising high quality. It costs more and it's worth it.

A *Time* magazine article on the superpremium ice cream craze appeared in August 1981 with the opening sentence, "What you must understand is that Ben & Jerry's in Burlington, Vermont, makes the best ice cream in the world." Sales at Ben & Jerry's took off, rising to $10 million in 1985 and to $78 million in 1990. By 1994 Ben & Jerry's products were distributed in all 50 states, the company had 100 scoop shops, and it was marketing 29 flavors in pint cartons and 45 flavors in bulk cartons.

[7]As quoted in an article by Mark Bendeich, "Unilever Buys U.S. Health Foods Firm for $2.3 Billion," April 12, 2000, and posted at www.economictimes.com.

exhibit 7 **Financial Performance Summary, Ben & Jerry's Homemade, Inc., 1994-1999 (in thousands, except per share data)**

	1999	1998	1997	1996	1995	1994
Income statement data						
Net sales	$237,043	$209,203	$174,206	$167,155	$155,333	$148,802
Cost of sales	145,291	136,225	114,284	115,212	109,125	109,760
Gross profit	$ 91,752	$ 72,978	$ 59,922	$ 51,943	$ 46,208	$ 39,042
Selling, general, and administrative expenses	78,623	63,895	53,520	45,531	36,362	36,253
Special charges*	8,602	—	—	—	—	6,779
Other income (expense)—net	681	693	(118)	(77)	(441)	228
Income (loss) before income taxes	5,208	9,776	6,284	6,335	9,405	(3,762)
Income taxes	1,823	3,534	2,388	2,409	3,457	(1,869)
Net income (loss)	$ 3,385	$ 6,242	$ 3,896	$ 3,926	$ 5,948	$ (1,869)
Net income (loss) per share—diluted	$ 0.46	$ 0.84	$ 0.53	$ 0.54	$ 0.82	$ (0.26)
Shares outstanding—diluted	7,405	7,463	7,334	7,230	7,222	7,148
Balance sheet data						
Working capital	$ 42,805	$ 48,381	$ 51,412	$ 50,055	$ 51,023	$ 37,456
Total assets	150,602	149,501	146,471	136,665	131,074	120,296
Long-term debt and capital lease obligations	16,669	20,491	25,676	31,087	31,977	32,419
Stockholders' equity†	89,391	90,908	86,919	82,685	78,531	72,502

*The special charge in 2000 concerned a writedown of Springfield plant assets and employee severance costs associated with outsource novelty ice cream products. The 1994 charge stemmed from early replacement of certain software and equipment installed at the plant in St. Albans, Vermont, and included a portion of the previously capitalized interest and project management costs.

†No cash dividends had been declared or paid since the company's formation in 1978. Earnings were retained and reinvested in growing the business.

Source: Company annual reports.

Products and Operations in 2000

At the time it was acquired by Unilever, Ben & Jerry's produced and marketed over 50 superpremium ice cream flavors, ice cream novelties, low-fat ice cream flavors, low-fat frozen yogurts, and sorbets, using Vermont dairy products and high-quality, all-natural ingredients. Like other superpremium ice creams, Ben & Jerry's products were high in calories (about 300 per serving), had a fat content equal to 40 to 55 percent of the recommended daily allowance for saturated fat per serving, and were high in cholesterol content (20 to 25 percent of the recommended daily allowance). About 35 of the flavors were packaged in pint cartons for sale in supermarkets, grocery stores, and convenience stores; the rest were packaged in bulk tubs for sale in about 200 franchised and company-owned Ben & Jerry's scoop shops, restaurants, and food-service accounts. To stimulate buyer interest, the company came up with attention-getting names for its flavors: Chunky Monkey, Bovinity Divinity, Cherry Garcia, Chubby Hubby, Double Trouble, Totally Nuts, and Coffee Olé. Many of the flavors contained sizable chunks of cookies or candies, a standout attribute of the company's products. Retail prices for a pint of Ben & Jerry's were around $3.25 in May 2001.

At year-end 1999, Ben & Jerry's had 164 franchised scoop shops, 8 PartnerShop franchises (not-for-profit organizations that operated scoop shops), 19 Featuring Franchises (scoop shops within airports, stadiums, college campus facilities, and similar venues), 12 Scoop Station franchises (prefabricated units that operated within other large retail establishments), and 9 company-owned scoop shops (4 in Vermont, 2 in Las Vegas, and 3 in Paris, France). Internationally, there were 9 franchised Ben & Jerry's scoop shops in Israel, 4 in Canada, 3 in the Netherlands, 1 in Lebanon, and 1 in Peru. The company began exporting from its Vermont plants to Japan in 1997, selling single serve containers through an exclusive arrangement with 7-Eleven Japan. In 1999, it established a wholly owned subsidiary in Japan for the purpose of importing, marketing, and distributing its products through Japanese retail grocery stores. Beginning in January 2000, Ben & Jerry's imported all products into Japan through an agreement with a Japanese trading company.

Distribution Ben & Jerry's products were distributed throughout the United States and in several foreign countries. Company trucks, along with several local distributors, handled deliveries to retailers in Vermont and upstate New York. In the rest of the United States, Ben & Jerry's relied on distribution services provided by other ice cream manufacturers and marketers. It was the distributor's job to sell retailers on stocking a brand, deliver supplies to each retail location, and stock the freezer cases with the agreed-on flavors and number of facings. Until 1998, Ben & Jerry's used two primary distributors, Sut's Premium Ice Cream for much of New England and Dreyer's Grand Ice Cream for states in the Midwest and West. To round out its national coverage, the company had a number of other distributors that serviced limited market areas. In 1994, distribution through Dreyer's accounted for 52 percent of Ben & Jerry's net sales. The arrangement with Dreyer's was somewhat rocky, and in 1998 Ben & Jerry's began redesigning its distribution network to gain more company control. Under the redesign, Ben & Jerry's increased direct sales calls by its own sales force to all grocery and convenience store chains and set up a network where no distributor had a majority percentage of the company's sales. Starting in 1999, much of the distribution responsibility in certain territories was assigned to Ice Cream Partners (a joint venture of Nestlé and Pillsbury, the parent of Häagen-Dazs); the balance of U.S. deliveries was assigned to Dreyer's and several other regional distributors, but Dreyer's territory was smaller than before and entailed Ben & Jerry's receiving a higher price than formerly for products distributed through Dreyer's.

Manufacturing Ben & Jerry's operated three manufacturing plants, two shifts a day, five to seven days per week, depending on demand requirements. Superpremium ice cream and frozen yogurt products packed in pint cartons were manufactured at the company's Waterbury, Vermont, plant. The company's Springfield, Vermont, plant was used for the production of ice cream novelties and ice cream, frozen yogurt, low-fat ice cream, and sorbets packaged in bulk, pints, quarts, and half-gallons. The St. Albans, Vermont, plant manufactured superpremium ice cream, frozen yogurt, frozen smoothies, and sorbet in pints, 12-ounce, and single-serve containers. Beginning in October 1999, in order to reduce costs and improve its profit margins, the company ceased production of ice cream novelties at its Springfield plant and began outsourcing its requirements from third-party co-packers.

Competitors

Ben & Jerry's two principal competitors were Dreyer's/Edy's (which had introduced its Dreamery and Godiva superpremium brands in 1999) and Häagen-Dazs (part of Pillsbury, which was formerly a subsidiary of Diageo but which was acquired by General Mills in 2000—see Exhibit 4). Other significant frozen dessert competitors were Colombo frozen yogurts (a General Mills brand), Healthy Choice ice creams (a ConAgra brand), Breyers ice creams and frozen yogurts (Unilever), Kemps ice cream and frozen yogurts (a brand of Marigold Foods), and Starbucks (whose coffee ice cream flavors were distributed by Dreyer's). In the ice cream novelty segment, Ben & Jerry's products (S'Mores, Phish Sticks, Vanilla Heath Bar Crunch pops, Cookie Dough pops, Cherry Garcia frozen yogurt pops, and several others) competed with Häagen-Dazs, Dove bars (made by a division of Mars, Inc.), Good Humor bars (a Unilever brand), an assortment of Nestlé products, and many private-label brands.

Häagen-Dazs was considered the global market leader in the superpremium segment, followed by Ben & Jerry's. Ben & Jerry's had only a negligible market share in ice cream novelties and a low single-digit share of the frozen yogurt segment. Whereas close to 90 percent of Ben & Jerry's sales were in the United States, Häagen-Dazs was represented in substantially more foreign markets, including markets in Europe, Japan, and other Pacific Rim countries. Like Ben & Jerry's, Häagen-Dazs marketed several ice cream flavors using pieces of cookies and candies as ingredients.

Management and Culture

Since 1988 Ben & Jerry's had formalized its business philosophy by adopting and pursuing a three-part mission statement:

- *Product mission*: To make, distribute, and sell the finest-quality all-natural ice cream and related products in a wide variety of innovative flavors made from Vermont dairy products.
- *Economic mission*: To operate the company on a sound financial basis of profitable growth, increasing value for our shareholders, and creating career opportunities and financial rewards for our employees.
- *Social mission*: To operate the company in a way that actively recognizes the central role that business plays in the structure of society by initiating innovative ways to improve the quality of life of a broad community—local, national, and international.

Pursuing the Company Mission The three parts of the mission were deemed equally important, and management strived to integrate their pursuit in its day-to-day business decision making. Starting in 1988, the company's annual report had contained a "social report" on the company's performance during the year, with emphasis on workplace policies and practices, concern for the environment, and the social mission accomplishments. To support its social mission activities, Ben & Jerry's had a policy of allocating 7.5 percent of pretax income (equal to $1.1 million in 1999) to support various social causes through the Ben & Jerry's Foundation, corporate grants made by the company's Director of Social Mission Development, and employee community action teams. In addition, the company made a practice of sourcing some of its ingredients from companies that gave jobs to disadvantaged individuals who would otherwise be unemployed, and it strived to operate in an environmentally friendly manner, frequently partnering with environmentally and socially conscious organizations that were trying to make the world a healthier and more humane place. Over the years, Ben & Jerry's had been actively involved with hundreds of grassroots organizations working for progressive social change, such as Greenpeace, the Children's Defense Fund, National Association of Child Advocates, the Coalition for Environmentally Responsible Economies, the Environmental Working Group, and the Institute for Sustainable Communities. It had contributed to efforts to save the rain forests in Brazil. One day each year, the company hosted a Free Cone Day at its scoop shops as a way of thanking customers for their patronage.

Ben & Jerry's had selected Vermont communities with high unemployment rates for all three of its plants. It had created a blueberry ice cream so it could buy blueberries exclusively from a tribe of Maine Indians and help support their economy. In 1991, Ben & Jerry's had entered into an agreement with St. Albans Cooperative Creamery (a group of Vermont dairy farmers) to pay not less than a specified minimum price for its dairy products in order to bring prices up to levels the company deemed fair and equitable. In 1994, this agreement was amended to include, as a condition of paying the premium price, assurance that the milk and cream purchased by the company would not come from cows that had been treated with recombinant bovine growth hormone (rBGH), a synthetic growth hormone approved by the FDA. The company quit selling a handmade brownie-and-ice-cream sandwich upon discovering that workers' hands were developing repetitive strain injuries. In 1999, Ben & Jerry's became the first U.S. ice cream company to convert a significant portion of its pint containers to a more environmentally friendly unbleached paperboard (bleaching paper with chlorine to make it whiter was said to be one of the largest causes of toxic water pollution in the United States).

Company Culture The work environment at Ben & Jerry's was characterized by informality, casual dress, attempts to make the atmosphere fun and pleasurable, and frequent communications between employees and management. Ben Cohen was noted for not owning a suit. Efforts were made to treat employees with fairness and respect; employee opinions were sought out and given serious consideration. Rank and hierarchy were viewed with distaste, and until the late 1990s executive salaries were capped at no more than seven times the pay for entry-level jobs. Compensation levels were above average, compared to pay scales in the Vermont communities where Ben & Jerry's operated. Ben & Jerry's had instituted a very liberal benefits package for its nearly 850 employees that included health benefits for the gay or lesbian partners of employees, parental leave for fathers as well as mothers, leave for the parents of newly adopted children, $1,500 contributions toward adoption costs, on-site cholesterol and blood pressure screening, smoking cessation classes, tuition reimbursement for three classes a year, a profit-sharing plan, a 401(k) plan, an employee stock purchase plan that allowed employees to buy shares at 15 percent below the current market price, a housing loan program, a sabbatical leave program, free health club access, and free ice cream. Nonetheless, there had been occasions on which vocal employees had expressed dissatisfaction with various aspects of their jobs; the periodic meetings management held to discuss issues and concerns with employees had often provoked hot debates.

Ben & Jerry's had long prided itself on treating workers so fairly that they did not need and would not want to be represented by a union. But in late 1998 the company became embroiled in a union controversy at its St. Albans plant, where the International Brotherhood of Electrical Workers (IBEW) was trying to organize a group of 19 maintenance workers. Management refused the IBEW's request to recognize the union voluntarily. Company lawyers, appearing before the National Labor Relations Board, opposed the IBEW organizing attempt, arguing that the vote should be held among all workers at the plant, not just among the 19 maintenance workers. Production workers, who made up the majority of the plant's workforce, did not support the union's organizing effort as strongly. In early 1999, following an NLRB ruling that the maintenance workers at the St. Albans plant were an appropriate bargaining unit, the 19 maintenance workers voted narrowly for representation by the IBEW. Even though the 19 workers constituted less than 3 percent of the company's full-time workforce, top management at Ben & Jerry's was concerned that the voting outcome raised questions about the quality of employer–employee relations at Ben & Jerry's.

Management Changes When Ben Cohen, the creative driving force in the company from the beginning, decided to step down as CEO in 1994, the search for a replacement included an essay contest in which anyone wishing to be considered for the CEO position was asked to state in 100 words or less "why I want to be a great CEO for Ben & Jerry's." Robert Holland, a former consultant at McKinsey & Company, was selected to become the company's CEO in February 1995; he helped transition the company from a founder-led to a professional management structure and begin the company's ventures into international markets. Holland resigned in October 1996, partly because of growing disagreements with the founders over how the company was being operated; he was replaced by Perry Odak, who had held senior management positions at Armour-Dial, Atari, Jovan, Dellwood Foods (a dairy products company), and, most recently, at U.S. Repeating Arms Company (the maker of Winchester firearms) and Browning, a manufacturer of firearms and other sporting goods.

Company Image and Events Leading Up to the Acquisition Ben & Jerry's counterculture values, unconventional policies, and passionate commitment to social causes were widely known and, in many respects, had emerged as the company's biggest brand asset. Frequent and usually favorable stories in the New England and national press describing Ben & Jerry's proactive approach to "caring capitalism" had fostered public awareness of the company and helped mold a very positive image of the company and its business philosophy. Indeed, substantial numbers of the company's customers patronized Ben & Jerry's ice cream products because they were suspicious of giant corporations, shared many of the same values and beliefs about how a company ought to conduct its business, and wanted to support Ben & Jerry's efforts and good deeds. So strong was the anti-big-business feeling of some customers, employees, and shareholders that, when the press reported that Ben & Jerry's was considering various acquisition offers, there were protest rallies at company facilities in Vermont and a Save Ben & Jerry's Web site sprang up for followers to express their displeasure and to help mount a public relations campaign to block a sale. Hundreds of messages were posted at the site—one message said, "My friend and I will not buy Ben & Jerry's again if you sell out. It would not taste the same." Most messages conveyed concerns that Ben & Jerry's would lose its character and social values, ceasing to be a model for other businesses to emulate. Vermont's governor told Reuters, "This company has really come to symbolize Vermont to the country and the world. It would be a shame if it were sucked into the corporate homogenization that's taking over the planet."[8]

Reportedly, neither Ben Cohen nor Jerry Greenfield was enthusiastic about selling the company; both had publicly expressed their desires for the company to remain independent. But the company's languishing stock price and the attractive offers of interested buyers forced the board of directors to consider being acquired. To counter an offer of $38 per share from Dreyer's, Ben Cohen had entered into negotiations with Meadowbrook Lane Capital (one of the company's large shareholders) and others to take the company private. This fell through when Unilever made its offer of $43.60 per share. In agreeing to accept Unilever's price, Cohen netted over $39 million for his controlling interest in the company, while Odak received over $16 million and Greenfield got $9.6 million. A substantial fraction of Ben & Jerry's 11,000 shareholders were Vermont (or former Vermont) residents.

Developments Following the Acquisition

To win approval for the acquisition from Ben & Jerry's cofounders and the board, Unilever agreed to keep the company's headquarters in Vermont, to operate it separately from Unilever for a period of time, to maintain employment at current levels for at least two years, to hold employee benefits at current levels for at least five years, and to contribute 7.5 percent of pretax income annually to the Ben & Jerry's Foundation. (Historically, the foundation had been managed by a nine-member employee board of directors that considered proposals relating to children and families, disadvantaged groups, and the environment.) Unilever further agreed to form an independent 11-member board of directors for Ben & Jerry's to monitor how well these conditions were being met, with eight of the board members to be named by Ben & Jerry's management, one by Unilever, and two by Meadowbrook Lane Capital. Ben Cohen and Jerry Greenfield were also to continue to have active roles in management.

In a joint statement announcing the acquisition, Unilever's co-chairmen said, "Ben & Jerry's is an incredibly strong brand name with a unique consumer message. We are determined to nurture its commitment to community values." Ben Cohen said, "The best and highest use for Ben & Jerry's is to try to influence what goes on at Unilever. It's a gargantuan task. Who knows how far we'll get? Who knows how successful we'll be?"

[8]Article by Mike Mills in *The Vermont Post*, December 9, 1999.

In November 2000, Unilever announced that Yves Couette had been appointed CEO of Ben & Jerry's, to succeed Perry Odak. Couette, a native of France, was one of the top executives in Unilever's ice cream group and had worked in the United States, Mexico, Indonesia, and the United Kingdom. Couette had recently been managing director of Unilever's ice cream business in Mexico, where he had turned Unilever's Helados Holanda business into a solid success with distinctive local brands and scoop shops. In commenting on his appointment, Couette said,

> Ben & Jerry's is a unique company, with highly professional and committed people from whom I look forward to learning and connecting to Unilever's world-class knowledge of ice cream. In addition, I am determined to deliver on Ben & Jerry's social mission commitment.

Perry Odak remained with the company until January 2001 to assist Yves Couette in the transition.

Unilever's Global Ice Cream Business in 2003 In late 2003, Unilever had the largest and most profitable ice cream business of any company in the world. In Europe Unilever had a 26 percent overall market share—and its lead over the number two competitor, Nestlé (with a 2002 share of 13 percent), was increasing. Top executives of Unilever's ice cream business were confident of achieving 5–6 percent annual revenue growth and saw ice cream as on the Path to Growth. Since acquiring Ben & Jerry's, Unilever had moved to:

- Grow the sales of its ice cream businesses from €4.3 to €5.0 billion.
- Unify the marketing of its 10 ice cream brands outside the United States under a single "heart" logo—in an effort to create an ice cream "powerbrand."
- Boost profitability in ice cream by exiting sales in 12 countries, consolidating production into 36 factories

(down from 53 in 1999), and reducing headcount by almost 8,800 employees.

Sales of ice cream worldwide were an estimated €55.4 billion in 2002, growing at 2.5 percent annually. North America was the biggest geographic market, with 2002 sales of €23 billion. Ice cream sales in Latin America were up 9.2 percent in 2002, the highest growth rate of any region in the world. Out-of-home consumption of ice cream accounted for about €37 billion of total sales in 2002 but was growing by only about 1.7 percent annually; 2002 ice cream consumption in the in-home segment grew by 5.2 percent in North America, 13.5 percent in Latin America, and about 2.5 percent in the rest of the world. Unilever management saw the global ice cream market as fragmented; in Europe there were some 200 brands of ice cream, many of which had different identities in different country markets.

THE BESTFOODS ACQUISITION

At the time of its acquisition by Unilever in mid-2000, Bestfoods was a global company engaged in manufacturing and marketing consumer foods. The company had offices and manufacturing operations in 60 countries and marketed its products in 110 countries. About 60 percent of Bestfoods' $8.6 billion in sales in 1999 came from outside the United States. Bestfoods employed approximately 44,000 people, of whom about 28,000 were at non-U.S. locations. Food industry analysts considered Bestfoods to be one of the best managed American food companies, and it was one of the 10 largest U.S.-based food products companies.

Exhibit 8 shows Bestfoods' lineup of products and brands in mid-2000. During the decade of the 1990s, Bestfoods had grown revenues at a 7.8 percent annual rate, operating earnings at a 10.5 percent annual rate, and earnings per share at a 12.1 percent annual rate; the company had increased its dividends for 14 consecutive years. Growth had slowed during the 1997–1999 period, however. In 1999, Bestfoods' sales were up 2.7 percent over 1998, unit volumes were up 4.1 percent, and operating income was up 9.0 percent (see Exhibit 9). Bestfoods' corporate strategy in 2000 had four core elements:

- *Globalization of the company's core consumer businesses*—the Knorr product line, salad dressings, and food-service operations.
- *Continual improvement in cost-effectiveness.*
- *Seeking out and exploiting new market opportunities* (via both new product introductions and extending sales of existing products to additional country markets).
- *Using free cash flow to make strategic acquisitions.* Since the 1980s, Bestfoods had made over 60 acquisitions to expand its lineup of products and brands and to position the company in new geographic markets.

Exhibits 10 and 11 show Bestfoods' performance and market positions in various country markets at the time it was acquired.

After several weeks of back-and-forth negotiations and increases in Unilever's offer price from the $61–$64 per share range to $66 per share to $72 per share and finally to $73 per share, Bestfoods in June 2000 agreed to be acquired by Unilever for what amounted to $20.3 billion in cash (equivalent to €23.6 billion), plus assumption of Bestfoods net debt (which amounted to $3.1 billion as of June 30, 2000). The $73 per share buyout agreement represented a price 44 percent higher than the nearly $51 price at which Bestfoods' shares were trading before Unilever's overtures became public and represented about a 20 percent premium over the $59–$62 range, in which Bestfoods shares were trading in late 1999. Bestfoods was by far the largest acquisition ever undertaken by Unilever and the largest combination of food companies in 12 years.

Unilever management believed that combining and integrating the operations of Bestfoods and Unilever would "result in pre-tax cost savings of approximately $750 million annually through combined purchase savings, greater efficiencies in operations and business processes, synergy in distribution and marketing, streamlining of general and administrative functions, and increased economies of scale." In addition, management said that the complementary nature of Unilever's and Bestfoods' product portfolios and geographic market coverage better positioned the combined company for faster revenue growth through:

- Creating a "more robust" combined business in the U.S. market.

exhibit 8 Bestfoods' Products and Brands, June 2000

Products/Brands	Comments
Hellmann's mayonnaise and salad dressings; Bestfoods, Lady's Choice, and Lesieur mayonnaise and salad dressings; Dijonnaise creamy mustard; and Henri's and Western salad dressings	Worldwide sales of about $2 billion, with the leading market share in mayonnaise in North America, Latin America, and many countries of Asia and Europe. In parts of the United States, Hellmann's products were marketed under the Bestfoods brand; Lesieur mayonnaise products were marketed in France and had the second highest market share in that country.
Knorr dry soups, sauces, bouillons, and related products	Worldwide sales of about $3 billion. Knorr products were sold in virtually all of the 110 countries where Bestfoods had a market presence. It was the number two soup brand, behind Campbell's.
Mazola corn and canola oils and Mazola margarine; Mazola No-Stick and Pro Chef cooking sprays; RightBlend oils	Marketed in 35 countries
Skippy peanut butter	One of the leading brands in the United States and also strong in parts of Asia
Karo and Golden Griddle syrups	
Argo, Kingsford's, Canada, Benson's, and Maizena corn starches	The Maizena brand of corn starch and other basic nutritional foods was marketed primarily in Latin America.
Mueller's pastas	
Rit dyes and laundry products	
Entemann's bakery goods; Thomas' English muffins; Arnold, Brownberry, Oroweat, and Freihofer's breads; and Boboli pizza crusts	The Bestfoods Baking division was the largest baker of fresh premium products in the United States; Entemann's was the number one brand of fresh bakery-style cakes and pastries in the United States; Boboli had a 57 percent share of the market for fresh pizza crusts; Bestfoods total sweet baked goods share was 19.2 percent in 1998.
Glaxose-D energy drinks	A newly acquired business in Pakistan
Globus dressings, condiments, and liquid sauces	A newly acquired brand in Hungary
Alsa and Ambrosia ready-to-eat desserts, dessert mixes, and baking aids	Marketed primarily in Europe; sales of about $280 milli on in 1999
AdeS soy beverages	Marketed throughout Latin America
Captain Cook salt	A packaged salt business in India
Bestfoods (in the United States) and Caterplan (outside the United States) food services	Provided food-service packs of company products, specially formulated products, and menu-planning and other unique services to support restaurants, cafeterias, and institutions in the growing global market for food prepared and consumed away from home—geographic coverage in virtually all of the countries where Bestfoods operated. The food-service division had worldwide sales of $1.4 billion in 1999.
Others: Pfanni potato products (Germany); Pot Noodle instant hot snacks (United Kingdom); Telma soups and instant foods products (Israel); Bovril bouillons; Marmite spread; Santa Rosa jams; Sahara pita breads; Goracy Kubek instant soups (Poland); Delikat seasonings (Central Europe); and Molinos de la Plata mayonnaise, ketchup, and mustard (Argentina)	

exhibit 9 Selected Financial Statistics for Bestfoods, 1997–1999 (in millions, except for per share amounts)

	1999	1998	1997
Selected income statement data			
Net sales	$8,637	$8,413	$8,438
Cost of sales	4,546	4,562	4,693
Gross profit	$4,091	$3,851	$3,745
Marketing expenses	996	976	978
Selling, general, and administrative expenses	1,765	1,655	1,859
Operating income	$1,330	$1,187	$ 866
Financing costs	183	166	162
Income from continuing operations before income taxes	1,147	1,021	704
Provision for income taxes	384	352	250
Net income	$ 717	$ 640	$ 429
Earnings per share of common stock (diluted)	$ 2.48	$ 2.09	$ 1.15
Selected balance sheet data			
Inventories	$ 792	$ 827	$ 818
Current assets	2,204	2,405	2,188
Plant, property, and equipment	1,964	1,965	1,941
Intangible assets, including goodwill associated with acquiring businesses at costs exceeding net assets	1,811	1,854	1,742
Total assets	$6,232	$6,435	$6,100
Current liabilities	2,368	2,312	2,347
Long-term debt	1,842	2,053	1,818
Total stockholders' equity	$ 938	$ 981	$1,042
Selected cash flow data			
Net cash flows from operating activities	$1,110	$ 819	$ 915
Capital expenditures	278	304	321
Payments for acquired businesses	225	121	298
Net cash flows used for investing activities	477	264	732
Repayment of long-term debt	153	94	99
Dividends paid on common and preferred stock	295	277	256
Net cash flows used for financing activities	697	440	267

Source: Company annual reports, 1998 and 1999.

- Maximizing the complementary strengths of Unilever and Bestfoods in Europe.
- Building on the strength of Bestfoods in Latin America to accelerate the growth of Unilever's brands.
- Using Unilever's distribution network strengths in the Asia-Pacific region to grow the sales of Bestfoods' brands.
- Utilizing Bestfoods' food-service channel to gain increased sales for Unilever's portfolio of spreads, teas, and culinary products.

According to a statement issued by Antony Burgmans and Niall FitzGerald, the Bestfoods acquisition would give Unilever "a portfolio of powerful worldwide and regional brands with strong growth prospects." Knorr, with $3 billion in annual sales, would become Unilever's biggest food brand.

To finance the $21.4 billion Bestfoods acquisition, *exhibit 10* **Summary of Bestfoods Worldwide Business Results, 1997–1999**

1999 Sales and Operations, by Geographic Region

Geographic Region	Sales Revenues (in millions)		Fixed Assets (in millions)		Areas of Operation, 1999	Number of Plants, 1999
Europe, Africa/ Middle East	1999	$3,596	1999	$1,568	Operations in 33 countries of Europe, Africa, and Middle East	59
	1998	3,490	1998	1,809		
	1997	3,539	1997	1,637		
North America	1999	$3,594	1999	$1,682	Operations in the United States, Canada, and the Caribbean	36
	1998	3,452	1998	1,507		
	1997	3,412	1997	1,547		
Latin America	1999	$1,071	1999	$ 277	Operations in 16 countries	19
	1998	1,149	1998	284		
	1997	1,105	1997	291		
Asia	1999	$ 374	1999	$ 124	Operations in 12 countries, including joint ventures in 7 countries	18
	1998	322	1998	120		
	1997	382	1997	101		

1999 Sales by Product Group

Product Group	Region	Sales (in millions)	% Change	Volumes
Knorr soups, sauces, bouillons, and related products	Europe	$2,091	+4.2%	+9.8%
	North America	470	+10.3	10.3
	Latin America	342	−9.0	−7.6
	Asia	185	+17.0	+25.0
	Total	$3,088	+4.1%	6.8%
Dressings	Europe	$ 464	+2.7%	+7.9%
	North America	1,001	+4.8	5.4
	Latin America	443	−5.7	+1.7
	Asia	96	+14.0	+10.2
	Total	2,004	+2.2%	5.4%
Baking	United States	$1,697		
Starches	Worldwide	$ 569		
Bread spreads	Worldwide	$ 406		
Desserts	Worldwide	$ 280		
All other sales	Worldwide	$ 593		
Bestfoods and Caterplan food services	Worldwide	$1,400 (distributed across several of the product groups above)	+8.4%	Included in the appropriate product groups above

Unilever arranged for a $20 billion line of credit from several banks, with annual interest costs that analysts expected to exceed $1 billion. It was anticipated that Unilever would ultimately finance the transaction with longer-term debt securities having a currency profile paralleling the geographic composition of the business.

exhibit 11 Market Positions of Bestfoods Products, by Country, 1999

1 Leader in Market Share 2 Second in Market Share • Present in the Market	Soups*	Sauces*	Bouillons*	Meal Kits*	Potato Products	Pasta/Pasta Dishes	Mayonnaise	Pourable Dressings	Corn Oil	Foodservice†	Peanut Butter	Starches	Desserts (Ambient)	Premium Baking
North America, Caribbean														
Canada	2	2	1				1		1	•	2	1		
Dominican Republic	2		2				•		•	•		1		
United States	•	•	2	•	•	•	1	•	1	•	2	1	•	1
Europe														
Austria	1	1	1	1	1				1	•		1		
Belgium	1	1	1	1						•		1		
Bulgaria	•	•	•		•					•				
Czech Republic	2	2	2	2	•		1	1		•				
Denmark	1	1	1	1	2			2	1	•		1	•	
Finland	1	1	1	2					1	•		2		
France	1	2	2				2	2		•		1	1	
Germany	2	2	2	2	1		•		1	•		1	•	
Greece	1	1	1		2	1	1	1		•		2	2	
Hungary	1	1	1	2	1		2			•			•	
Ireland	1	1	1	1	1	•	1	2	•	•		2	1	
Italy	1	•	2		1		•		•	•		1		
Netherlands	2	1	2	2	•				•	•		2		
Norway	•	2	•						•	•		1		
Poland	1	1	1	1	1		2			•			•	
Portugal	1	•	1		2		1	2		•		1	2	
Romania	1		1							•			•	
Russia	2	1	2		1		•		•	•	•			
Slovak Republic	2	•	•	•	•		1			•				
Slovenia														
Spain	2	•	2	•		•	•	•		•		1	2	
Sweden	1	2	1	1				•	1	•	1	1		
Switzerland	1	1	1	1	1			•	•	•		1	•	
United Kingdom	•	•	2	•		•	1	2	1	•		1	1	
Africa/Middle East														
Egypt														
Israel	1	2	2	1	•	•	1		1	•	1		2	
Jordan	2		2						•					
Kenya	1		2						•	•	2	1		
Morocco	1	•	1							•		1	1	
Saudi Arabia							2		2	•	•	•		
South Africa	1	2	1	1			•	1		•	•	1	•	
Tunisia	1	•	1				•			•		2	•	
Turkey	1		2	•						•		1	•	

exhibit 11 (concluded)

1 Leader in Market Share
2 Second in Market Share
• Present in the Market

	Soups*	Sauces*	Bouillons	Meal Kits*	Potato Products	Pasta/Pasta Dishes	Mayonnaise	Pourable Dressings	Corn Oil	Foodservice†	Peanut Butter	Starches	Desserts (Ambient)	Premium Baking
Latin America														
Argentina	1		1		1	1	1	1	2	•		1		
Bolivia	•		•				2			•		1		
Brazil	2		1			2	1	1	1	•		1		
Chile	•		•		2		1	1	1	•		1	•	
Colombia	•	2	2	2	•		1	•	•	•		1	1	
Costa Rica	2	1	•		•		1	1	1	•	•	1	•	
Ecuador	2	•	•	2			•		1			•		
El Salvador	•	•	•				•	•	1		•	1		
Guatemala	•	•	•		•		•	1	1	•	•	1		
Honduras		•					•		1			2		
Mexico	1	•	1	1		1	2	•	2	•		1	•	
Panama	•	•	•				•	•	•	•		1		
Paraguay	2		2		2	•	1		2	•		1		
Peru	2	•	2		2	2	1	2	1	•		1		
Uruguay	1		1		1	•	1		2	•		1		
Venezuela	2	•	2	1			•	•		•		1		
Asia														
China	•	•	•				•			•	•	•	•	
Hong Kong	•	•	1			•	2		•	•	1	1	1	
India	1			1								1	1	
Indonesia	1	•	•				2	2	1	•	1			
Japan	1	•	1	•			2	2	1	•	•			
Malaysia	1	•	2				1	1	1	•	1	1	2	
Pakistan	1	•	1	•			2		1	•		1	1	
Philippines	1	•	1			1	1	•	•	•	1	•	1	
Singapore	1		1				2	2	•	•	1	1	1	
Sri Lanka	2	1	2						2	•				
Taiwan	1		1				2	•	•	•	1			
Thailand	1	1	1	2		1	1		1	•	1	•	•	
Vietnam	2		1				•			•				

*Dehydrated products only.
†Bestfoods food-service (catering) products hold leading share positions in many of the categories in which they compete.
Source: Company annual report, 1999.

In February 2001, Unilever announced the sale of the Bestfoods Baking Company to George Weston, a Canadian food and supermarkets group, for $1.76 billion in cash. Unilever had announced its intention to divest Bestfoods Baking Company two weeks after closing its merger with Bestfoods on October 4, 2000, noting that the characteristics of the baking business did not fit other Unilever products and that bakery products was a category no longer in existence at Unilever. Bestfoods Baking was entirely U.S.-based, with 19 plants across the country, a strong management team, 12,000 employees, and one of the best distribution systems for delivering fresh-baked products directly to retail stores. In 1999, Bestfoods Baking had sales of $1.7 billion (up 2.3 percent over 1998) and an operating profit margin of 8 percent (good for the baking business).

In April 2002 Unilever announced an agreement to sell 19 former Bestfoods brands sold across North America to ACH Food Companies, a subsidiary of Associated British Foods, for €406 million ($360 million) in cash. The brands had combined sales of €350 million (U.S.$310 million) in 2001 and included Mazola cooking oil products, Argo and Kingsford's corn starches, Karo and Golden Griddle syrups, and Henri's salad dressing sold in the United States, Puerto Rico, and Canada, plus such Canadian brands as Benson's and Canada corn starches, St. Lawrence/St. Laurent corn oil, Crown and Bee Hive corn syrups, Old Colony maple syrup, and Old Tyme pancake syrup. The deal also included a cornstarch manufacturing facility in Argo, Illinois. Approximately 200 Unilever Bestfoods employees were transferred to ACH Food Companies.

By year-end 2003, Unilever management believed that it had successfully integrated the operations of Bestfoods with those of Unilever. Businesses of the two companies had been merged in 63 countries across 5 regions of the world, producing €790 million in cost-saving synergies and efficiencies and leading to increased operating margins (15.7 percent for the first nine months of 2003 versus 14.8 percent in 2002 and 14.4 percent in 2001). Unilever's entire food division was operating under the name Unilever Bestfoods (UBF).

UNILEVER IN 2003

Despite the obvious progress that Unilever had made as of the fall of 2003 in executing its Path to Growth strategy—most notably boosting its operating margins to over 15 percent (in striking distance of the 16+ percent target), the company's third-quarter 2003 report of a growth slowdown in the sales of its leading brands (Exhibit 2) raised questions among investors and analysts of whether the company's current lineup of businesses and brands could deliver 5–6 percent growth in revenues in the years to come. Did Unilever really have a "world-beating brand portfolio and unrivaled geographic coverage" as Niall FitzGerald and Antony Burgmans had claimed in the months following the company's acquisitions of SlimFast, Ben & Jerry's, and Bestfoods? Was the 2003 drop-off in the sales growth of leading brands just temporary or a sign of things to come? What options did Unilever have for addressing the underperforming parts of its business? How much confidence should be placed in the claim by FitzGerald and Burgmans that "higher levels of leading brands growth will resume"? What should be made of their statement that "good progress in the vast majority of our business is not yet sufficient to offset the weaknesses in a limited number of under-performing businesses"?

Exhibits 12, 13, and 14 present highlights of Unilever's performance for the first nine months of 2003, as compared to the first nine months of 2002.

exhibit 12 Summary of Unilever's Financial Performance Based on Constant Exchange Rates, First Nine Months, 2003 versus 2002 (in millions)

	First Nine Months		
	2003	2002	Percent Change
Income statement data			
Revenues	€35,559	€36,008	(1.25)%
Operating profit (BEIA*)	5,519	5,434	1.56
Operating profit	4,412	4,306	2.46
Net earnings	2,032	1,884	7.86
Balance sheet data			
Cash and short-term investments	€ 3,027	€ 4,476	(32.37)%
Net debt	14,363	18,846	(23.79)
Shareholders' equity	6,400	6,196	3.29

*BEIA = Before exceptional items and amortization of goodwill and intangibles.

Source: Unilever press release, October 29, 2003, accessed at www.unilever.com, January 9, 2004.

exhibit 13 Unilever's Financial Performance by Geographic Area at Constant Exchange Rates, First Nine Months, 2003 versus 2002 (euros in millions)

Geographic Area Performance	First Nine Months, 2003	First Nine Months, 2002	Percent Change
Revenues			
Europe	€14,273	€14,832	(4)%
North America	8,822	9,502	(7)%
Africa, Middle East, Turkey	2,516	2,373	6%
Asia and Pacific	6,000	5,781	4%
Latin America	4,164	3,899	7%
Total	€35,775	€36,367	(2)%
Operating profit—BEIA*			
Europe	€ 2,452	€ 2,183	12%
North America	1,310	1,550	(16)%
Africa, Middle East, Turkey	331	287	15%
Asia and Pacific	858	847	1%
Latin America	568	567	0%
Total	€ 5,519	€ 5,434	2%
Operating margin—BEIA*			
Europe	17.2%	14.7%	
North America	14.8%	16.3%	
Africa, Middle East, Turkey	13.1%	12.1%	
Asia and Pacific	14.3%	14.6%	
Latin America	13.6%	14.5%	
Total	15.4%	14.9%	

*BEIA = Before exceptional items and amortization of goodwill and intangibles.

Source: Unilever press release, October 29, 2003, accessed at www.unilever.com, January 9, 2004.

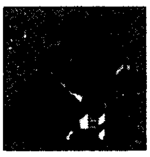
exhibit 14 Unilever's Financial Performance by Business Segment at Constant Exchange Rates, First Nine Months, 2003 versus 2002 (euros in millions)

Business Segment Performance	First Nine Months, 2003	First Nine Months, 2002	Percent Change
Revenues			
Foods	€20,059	€20,569	(2)%
Soups and dressings	6,892	6,654	1
Spreads and cooking products	3,954	4,521	(13)
Health and wellness and beverages	3,078	3,170	(3)
Ice cream and frozen foods	6,135	6,024	2
Home care and professional cleaning	6,000	6,529	(8)
Personal care	9,449	8,931	6
Other operations	267	358	(25)
Total	€35,557	€36,387	(2)%
Operating profit—BEIA*			
Foods	€ 3,154	€ 2,925	7%
Soups and dressings	1,084	967	12
Spreads and cooking products	627	676	(7)
Health and wellness and beverages	420	427	(1)
Ice cream and frozen foods	1,023	865	18
Home care and professional cleaning	752	766	(2)
Personal care	1,617	1,714	(6)
Other operations	(4)	19	(123)
Total	€ 5,519	€ 5,434	2%
Operating profit margin—BEIA*			
Foods	15.7%	14.3%	
Soups and dressings	15.7	14.1	
Spreads and cooking products	15.9	14.9	
Health and wellness and beverages	13.6	13.4	
Ice cream and frozen foods	16.7	14.4	
Home care and professional cleaning	12.5	11.7	
Personal care	17.1	19.2	
Other operations	(1.6)	5.4	
Overall	15.4	14.9	

*BEIA = Before exceptional items and amortization of goodwill and intangibles.

Source: Unilever press release, October 29, 2003, accessed at www.unilever.com, January 9, 2004.

case | 9



Robin Hood

Joseph Lampel
New York University

It was in the spring of the second year of his insurrection against the High Sheriff of Nottingham that Robin Hood took a walk in Sherwood Forest. As he walked he pondered the progress of the campaign, the disposition of his forces, the Sheriff's recent moves, and the options that confronted him.

The revolt against the Sheriff had begun as a personal crusade. It erupted out of Robin's conflict with the Sheriff and his administration. However, alone Robin Hood could do little. He therefore sought allies, men with grievances and a deep sense of justice. Later he welcomed all who came, asking few questions and demanding only a willingness to serve. Strength, he believed, lay in numbers.

He spent the first year forging the group into a disciplined band, united in enmity against the Sheriff and willing to live outside the law. The band's organization was simple. Robin ruled supreme, making all important decisions. He delegated specific tasks to his lieutenants. Will Scarlett was in charge of intelligence and scouting. His main job was to shadow the Sheriff and his men, always alert to their next move. He also collected information on the travel plans of rich merchants and tax collectors. Little John kept discipline among the men and saw to it that their archery was at the high peak that their profession demanded. Scarlock took care of the finances, converting loot to cash, paying shares of the take, and finding suitable hiding places for the surplus. Finally, Much the Miller's son had the difficult task of provisioning the ever-increasing band of Merrymen.

The increasing size of the band was a source of satisfaction for Robin, but also a source of concern. The fame of his Merrymen was spreading, and new recruits were pouring in from every corner of England. As the band grew larger, their small bivouac became a major encampment. Between raids the men milled about, talking and playing games. Vigilance was in decline, and discipline was becoming harder to enforce. "Why," Robin reflected, "I don't know half the men I run into these days."

The growing band was also beginning to exceed the food capacity of the forest. Game was becoming scarce, and supplies had to be obtained from outlying villages. The cost of buying food was beginning to drain the band's financial reserves at the very moment when revenues were in decline. Travelers, especially those with the most to lose, were now giving the forest a wide berth. This was costly and inconvenient to them, but it was preferable to having all their goods confiscated.

Robin believed that the time had come for the Merrymen to change their policy of outright confiscation of goods to one of a fixed transit tax. His lieutenants strongly resisted this idea. They were proud of the Merrymen's famous motto: "Rob the rich and give to the poor." "The farmers and the townspeople," they argued, "are our most important allies. How can we tax them, and still hope for their help in our fight against the Sheriff?"

Robin wondered how long the Merrymen could keep to the ways and methods of their early days. The Sheriff was growing stronger and becoming better organized. He now had the money and the men and was beginning to harass the band, probing for its weaknesses. The tide of events was beginning to turn against the Merrymen. Robin felt that the campaign must be decisively concluded before the Sheriff had a chance to deliver a mortal blow. "But how," he wondered, "could this be done?"

Copyright © 1991, by Joseph Lampel.

Robin had often entertained the possibility of killing the Sheriff, but the chances for this seemed increasingly remote. Besides, killing the Sheriff might satisfy his personal thirst for revenge, but it would not improve the situation. Robin had hoped that the perpetual state of unrest, and the Sheriff's failure to collect taxes, would lead to his removal from office. Instead, the Sheriff used his political connections to obtain reinforcement. He had powerful friends at court and was well regarded by the regent, Prince John.

Prince John was vicious and volatile. He was consumed by his unpopularity among the people, who wanted the imprisoned King Richard back. He also lived in constant fear of the barons, who had first given him the regency but were now beginning to dispute his claim to the throne. Several of these barons had set out to collect the ransom that would release King Richard the Lionheart from his jail in Austria. Robin was invited to join the conspiracy in return for future amnesty. It was a dangerous proposition. Provincial banditry was one thing, court intrigue another. Prince John had spies everywhere, and he was known for his vindictiveness. If the conspirators' plan failed, the pursuit would be relentless, and retributions swift.

The sound of the supper horn startled Robin from his thoughts. There was the smell of roasting venison in the air. Nothing was resolved or settled. Robin headed for camp promising himself that he would give these problems his utmost attention after tomorrow's raid.

case 10

Procter & Gamble: Organization 2005 and Beyond

Ravi Madapati
ICFAI Knowledge Center

In September 1998 Procter & Gamble (P&G) announced a corporate restructuring program called Organization 2005. The set of far-reaching initiatives involved comprehensive changes in organizational structure, work processes, and culture to make employees stretch themselves and speed up innovation. Organization 2005 also sought to leverage P&G's global presence. The program was intended to boost sales and profits by introducing new products, closing plants, and eliminating jobs. Spearheaded by Durk Jager, who became P&G's CEO in 1999, this initiative was to be a six-year, $1.9 billion effort. Jager believed that rapid restructuring was necessary to create new growth opportunities for P&G. While launching the program he expressed his optimism:

> Success is defined first and foremost in terms of growth. Unless a company grows at an acceptable rate—year in, year out—it can't sustain its organization. Success also means growing profitably. Otherwise, it can't produce the resources and capability to invest, take risks, or seize new opportunities. The program we lay out here today is designed to deliver that growth, at a consistently higher level. Just come back in a couple of years and take a look. I believe that the best way to accelerate growth is to innovate bigger and move faster consistently and across the entire company.[1]

Jager indicated that the cultural changes he planned to introduce would create an environment that produced bolder goals and plans, bigger innovations and greater speed. As part of the exercise, Jager redesigned the reward system to strengthen the link between executive compensation and results.

BUSINESS SEGMENTS

P&G was one of the best-known consumer goods companies in the world. For the year ended June 30, 2002, P&G reported revenues of $40.2 billion. The company was in the Fortune Global 50 list. It owned several well-known brands that were sold in over 140 countries to nearly 5 billion consumers (see Exhibit 1). P&G had operations in North America, Europe, the Middle East, Africa, Asia, and Latin America. Exhibits 2 and 3 highlight the company's recent financial performance.

P&G had five main business segments: Fabric and Home Care; Baby, Feminine, and Family Care; Beauty Care; Health Care; and Food and Beverage:

- Fabric and Homecare was the most important segment, accounting for nearly a third of P&G's total sales. The division dealt with cleaning products for clothes, surfaces, and dishes. Key brands included Bold and Tide laundry detergents, and Cascade dishwasher powder.
- The Baby, Feminine, and Family Care segment produced tissues and paper towels, feminine protection products, diapers, and baby wipes. Well-known brands in this category were Bounty paper towels and Tampax tampons.
- Beauty Care products included deodorants such as Old Spice, Sure, Cover Girl, and Max Factor cos-

Copyright © 2003 ICFAI Knowledge Center, Hyderabad, India. This case was written with the help of Asif Hasan, ICFAI, Knowledge Center.

[1]"Organization 2005 Drive for Accelerated Growth Enters Next Phase," P&G press release, June 9, 1999.

exhibit 1 **P&G Brands around the World**

Region	Shaving Products	Skin Care	Cleansing	Cosmetics
United States	Noxema Old Spice	Noxema Olay	Camay Ivory Moisture Care Olay Safeguard Zest	Cover Girl Max Factor Olay
Latin America	Old Spice	Noxema Olay	Camay Ivory Olay Old Spice Safeguard Zest	Cover Girl Max Factor
Europe, Middle East, Africa	Old Spice	Noxema Olay Rogé Cavaillès	Infasil Ivory Safeguard Zest	Cover Girl Ellen Betrix Max Factor
Asia		Olay	Camay Ivory Muse Safeguard Zest	Cover Girl Max Factor SK-II

Source: Collected from various sources.

metics. The segment also produced fragrances, shaving products, and shampoos such as the Head & Shoulders and Pantene brands.

- Health Care products ranged from prescription drugs to toothpastes such as Crest, over-the-counter remedies such as Pepto-Bismol, and pet foods.
- Food and Beverage produced cooking oil, Pringles snacks, and peanut butter. It also offered drinks like Sunny Delight and Folgers coffee.

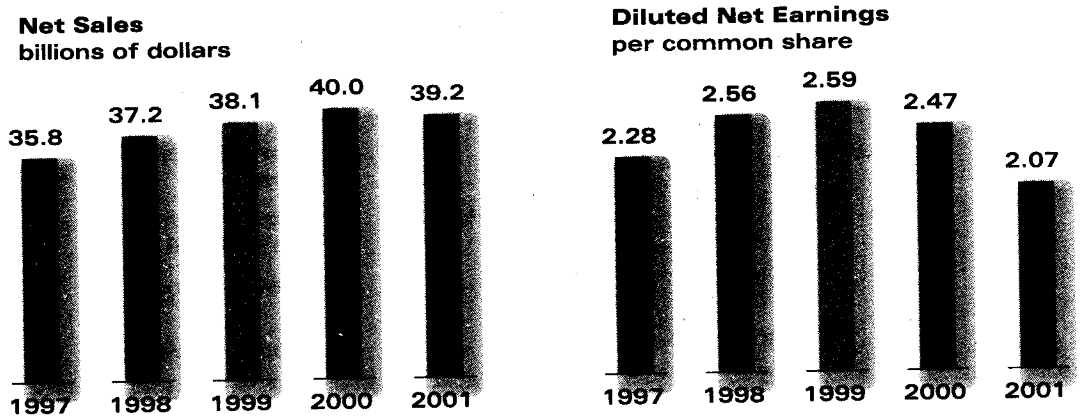
Exhibits 4 and 5 show recent earnings growth of these five groups, and Exhibit 6 presents each group's sales, profitability, and major brands.

CORPORATE HISTORY

William Procter and James Gamble founded P&G as a partnership in 1837 in Cincinnati, Ohio, by merging Procter's candle-making company with Gamble's soap business. The company grew to $1 million in sales by 1859. P&G's initial foray into branding was the Moon and Stars, a trademark that appeared on all company products starting in the early 1860s. In 1887, P&G became one of the first companies in the United States to offer a profit-sharing program for its employees. In 1924, P&G was one of the first companies to create a market research department to study consumer preferences and behavior. The company's marketing organization and brand management system began to evolve in the early 1930s. In 1933, P&G's Oxydol soap powder sponsored a serial radio program.

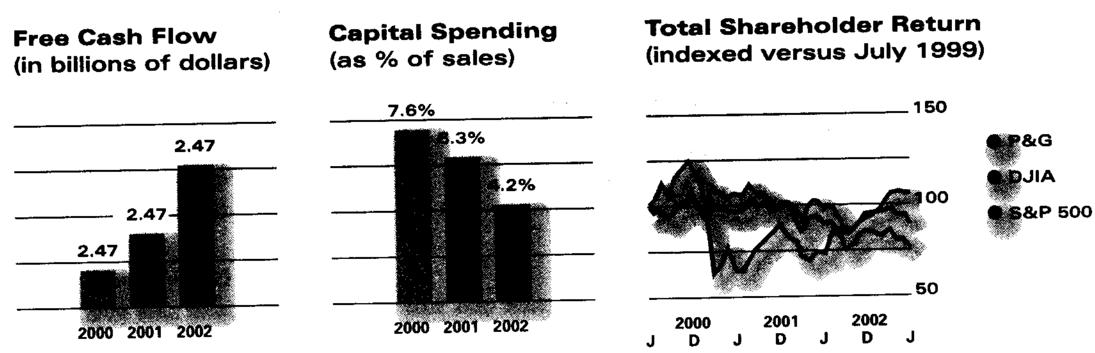
P&G had been a late globalizer. But after World War II, P&G began its international expansion in earnest. In 1948, it established an overseas division while setting up its first Latin American subsidiary in Mexico. P&G entered Europe in 1954, Saudi Arabia in 1961, and Japan in 1973. By 1980, P&G was operating in 23 countries and reporting over $10 billion in annual sales. By the mid-1990s, over half of the company's sales came from outside the United States. As its global expansion progressed, P&G continued to modify its

exhibit 2 Summary of P&G's Financial Performance, 1997–2001



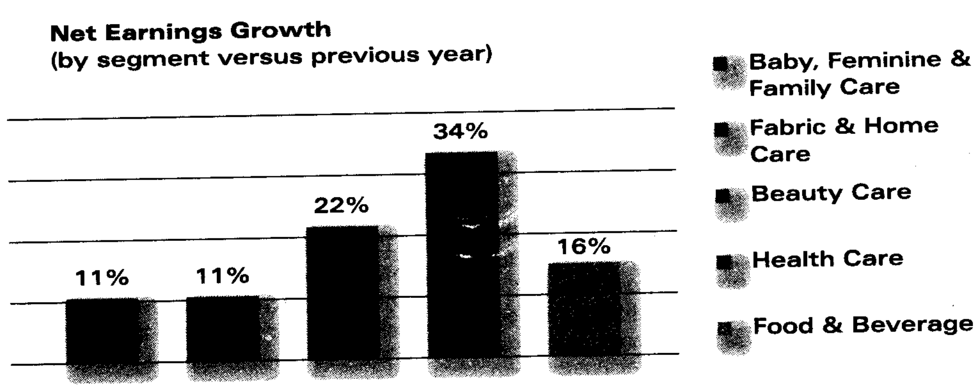
Source: P&G annual report, 2002.

exhibit 3 P&G's Performance in 2002



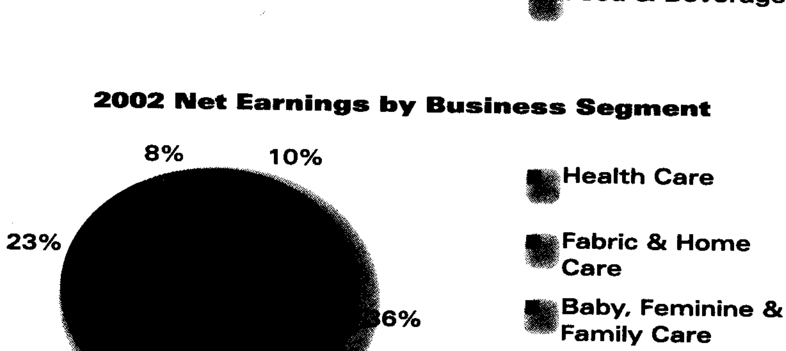
Source: P&G annual report, 2002.

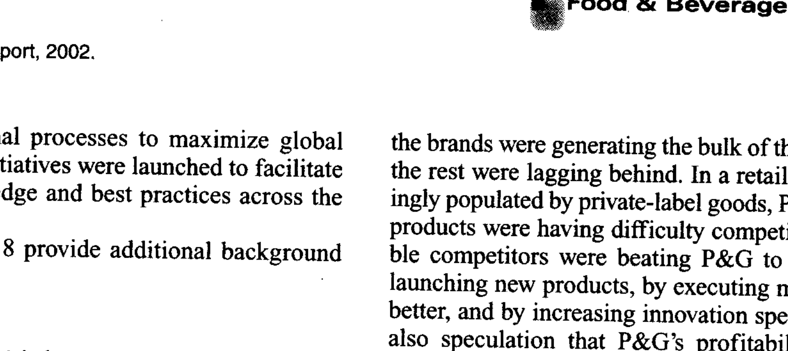
exhibit 4 P&G's Earnings Growth from Different Segments



Source: P&G annual report, 2002.

exhibit 5 P&G Net Sales and Net Earnings by Segment





Source: P&G annual report, 2002.

structure and internal processes to maximize global leverage. Various initiatives were launched to facilitate exchange of knowledge and best practices across the company.

Exhibits 7 and 8 provide additional background on the company.

ORGANIZATION 2005

In 1998, P&G's earnings per share (EPS) fell below the 14 to 15 percent that Wall Street had gotten used to. Revenue growth, which had varied between 1.4 and 5.5 percent between 1995 and 1999, was also well below P&G's internal target of 7 percent. Revenue growth was slowing down, particularly in developed markets, due to the maturity of the company's established brands. Half the brands were generating the bulk of the growth while the rest were lagging behind. In a retail world increasingly populated by private-label goods, P&G's premium products were having difficulty competing. More nimble competitors were beating P&G to the market by launching new products, by executing marketing plans better, and by increasing innovation speeds. There was also speculation that P&G's profitability was being eroded by the increasing dominance of retailers like Wal-Mart. With a turnover of about $160 billion in 1999, Wal-Mart was a particularly formidable player.

P&G's innovation track record had also been disappointing. New brands had the ability to add billions of dollars in incremental revenue, but P&G had not launched a major new brand in almost a decade.

The need to reinvigorate growth led P&G to conceive Organization 2005. The goal of the program was to improve P&G's competitive position and generate oper-