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LETTER FROM THE EDITORS

Welcome to the *Journal of the International Academy for Case Studies.* The International Academy for Case Studies is an affiliate of the Allied Academies, Inc., a non profit association of scholars whose purpose is to encourage and support the advancement and exchange of knowledge, understanding and teaching throughout the world. The purpose of the IACS is to encourage the development and use of cases and the case method of teaching throughout higher education. The *JIACS* is a principal vehicle for achieving the objectives of both organizations. The editorial mission of this journal is to publish cases in a wide variety of disciplines which are of educational, pedagogic, and practical value to educators.

The cases contained in this volume have been double blind refereed, and each was required to have a complete teaching note before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies. The Instructor's Note for each case in this volume will be published in a separate issue of the *JIACS.*

If any reader is interested in obtaining a case, an instructor's note, permission to publish, or any other information about a case, the reader must correspond directly with the author(s) of the case.

The Academy intends to foster a supportive, mentoring effort on the part of the referees which will result in encouraging and supporting writers. We welcome different viewpoints because in differences we find learning; in differences we develop understanding; in differences we gain knowledge and in differences we develop the discipline into a more comprehensive, less esoteric, and dynamic metier.

The Editorial Policy, background and history of the organization, and calls for conferences are published on our web site. In addition, we keep the web site updated with the latest activities of the organization. Please visit our site and know that we welcome hearing from you at any time.

Inge Nickerson, Barry University
Charles Rarick, Barry University

CASES

JOJA'S DELI: GREAT FRANCHISE OPPORTUNITY? (PART II)

Shelley Morrisette, Shippensburg University
Louise Hatfield, Shippensburg University

CASE DESCRIPTION

The subject matter of this case addresses the problems and opportunities for a young family wanting to become entrepreneurs. This case would be most appropriate for undergraduate courses in entrepreneurship, small business management, franchise management, and strategic management, as a written assignment—and graduate courses as a class discussion. The case is designed to be discussed in one to one and one-half hours and should take students no more than three hours of outside preparation.

CASE SYNOPSIS

This case follows a young couple making their first attempt at becoming franchisees, and the inherent risks and challenges of being a small business owner. It also illustrates the difficulties of finding the right "fit" for any budding entrepreneur.

SITUATION

Dan Baylor looked up from the dining room table as Liz walked into the room.
"How is he sleeping?" Dan asked.

"He's dead to the world, without a care. I wish we slept as well as he does" Liz replied. Dan smiled and took Liz's hand as she sat down at the table to look at all of the information they had assembled. It looked like a huge pile of trash, along with a computer blinking, and a calculator humming.

"I think JoJa's is the right business for us" Dan finally exclaimed.

"Yeah, but do we have enough money?" questioned Liz.

"We're close and it is so much better than all of the other possible deals that we have to find a way to make it work. We just have to. We know the perfect spot --- right in the middle of the financial district, it is the right fit for us, and we're really close on the money. We just need to make this deal".

Liz nodded her head and said, "Let's do it".

DAN AND LIZ BAYLOR: POTENTIAL FRANCHISEES LOOKING FOR A BETTER LIFE

Dan and Liz (Walker) Baylor grew-up in the Pittsburg suburbs. Both were born in 1971, attended different high schools, and graduated from different liberal arts colleges in 1993. Both came from close middle-class families and wanted to stay in the Pittsburg area. In 1995 both joined US Airways and met for the first time in the required flight attendant training classes. Soon they were dating and having the times of their lives as they worked and traveled extensively together. Two years later Daniel Baylor and Elizabeth Walker were married and they continued to make Pittsburg their home and US Airways their career.

In early 2003 David Walker Baylor was born to proud and happy parents and extended families. Dan and Liz Baylor had worked for USAir for nearly eight years and were beginning to question their career decisions. The problems were many --- USAir had been in and out and back in to bankruptcy, their union seemed powerless to stop downward pressure on pay, benefits, and working conditions, and both were unsure of their prospects for the future. With the arrival of Davy, both seemed to realize that they needed to look for new careers. They decided to try to find new positions in the travel, hospitality, or restaurant industries. After several interviews with various companies they became extremely frustrated. While there was no shortage of employment in these industries, they realized that service workers were not unionized and, therefore, had poor pay and benefits. To make a living wage would require the Baylors to become managers and work 65 or more hours per week. This type of career did not appeal to either Dan or Liz.

By 2004 Dan and Liz began to think about starting their own business. Both had worked in restaurants in high school and college. Both had spent eight years at USAir, working with customers. Both were "people-people" and liked to interact with customers. They began an extensive search of possible businesses they could launch. They talked to friends, family, and business contacts and decided that a sandwich franchise business might be the best route for the would-be entrepreneurs. After investigating several franchise concepts they became somewhat disillusioned. The reason was simple --- although the sandwich market is huge --- estimated to be a $17 billion industry, everyone is in it and the competition can be brutal. Besides that, for many franchise concepts the hours are outrageous and the return is often meager. Newspaper and magazine articles such as "Buying a Hard, Low Paying Job" and "Franchise Opens Two Stores On the Same Block Without Knowledge of Two Different Franchisees" underscore the problems with many franchise sandwich shop opportunities.

Dan and Liz were not afraid of hard work, but wanted to make sure that they had a really good chance to be successful given that they planned to invest practically all that they owned in this new business. They also knew what type of sandwich shop they wanted to operate. First, they wanted to have limits on hours of operation. Working endless late nights and weekends did not appeal to them. This seemed like blasphemy to most of their friends and family, as well as to all industry insiders --- most felt that night and weekend operations were essential to sandwich shop success. Next, they had limited capital to invest --- about $110,000 from all of their savings, including a second mortgage on their home. This limited their options dramatically. For example, franchises' such as Atlanta Bread Company or Panera's Bread required franchisees to invest at least $1.5 million for each unit. Even upscale franchised delis, such as Jason's required franchisees to invest $650,000 per operation. Subway Sandwich Shops required $100,000 or more per unit, but with nearly 14,000 locations nationwide this concept seemed "overdone" to Dan and Liz. Additionally, all of these concepts required late night and weekend operation. Finally, they wanted to stay in Pittsburg because both have deep roots in the community.

After researching hundreds of franchise concepts the Baylor's finally stumbled on JoJa's Deli, Inc. At first glance it seemed like a perfect fit for the Baylor's. After a visit to the company's headquarters, the Baylor's were confident that they had found their opportunity. JoJa's had everything that the Baylor's required. First, it required no late night or weekend work. Next, the investment was very reasonable. Third, the Pittsburg area was wide open for possible franchises. Finally, the upside looked fantastic. JoJa's provided a 2003 Income and Expense Overview for all locations broken down by upper quartile, median, and lower quartile performing stores (see Exhibit 1). Although the Overview Statement did not contain total sales numbers (only percentages) the Baylor's were able to determine that the top performing JoJa's averaged $830,000 in yearly sales. The median units had total sales of $650,000, with the worst performing stores averaging $575,000 in yearly sales.

After making some quick calculations, the Baylors determined that the best performing JoJa's retuned $120,000 EBT to owners ($830,000 x .145 = $120,000). Additionally these units carried manager salaries of $80,000, which would be paid to Dan and Liz because they would be managing the business. Yet, even an average performing store would provide more money than they had hoped to make ($650,000 x .085 = $55,000 plus $75,000 in management salaries totaled $130,000). The risk would come if their JoJa's was not successful ($575,000 x .015 = $8,600 plus $68,000 in management salaries to total just $76,600). Both agreed that there was some risk in investing in a JoJa's, but it also was the best "fit" for Dan and Liz and offered considerable upside potential to the budding entrepreneurs. The only potential problem was the lack of support JoJa's offered its franchisees. Because it was a young company and the owners had little experience running a franchise operation, franchisees were more or less on their own. This would be especially true for the Baylor's because they would be 600 miles from the nearest JoJa's.

THE JOJA'S CONCEPT: OPEN ONLY WHEN AND WHERE IT IS BUSY FOR LUNCH.

The beauty of the JoJa's concept is its simplicity. Provide the absolute best deli sandwiches, meats, salads, stews, soups, desserts, and gourmet items to customers at a reasonable price, in a clean, convenient location, and operate the business when and where sandwiches are sold most often --- work lunches. Consequently, the company had developed the franchise to run like a clock, if franchisees follow this set of rules:

1. Locate the store on busy urban street corners with lots of foot traffic. Franchisees had further refined this rule --- locate the stores near the financial districts of urban areas where the JoJa's can cater business lunches. This represented another revenue stream. In fact, the two top performing JoJa's received 30% of their revenues from business catering --- almost three times the norm, and this business stream has the highest profit margin.
2. Have multiple streams of income. Besides the deli, JoJa stores should also cater business lunches, sell corporate gift baskets, and provide gourmet foods and novelty items. The corporate gift basket business provides 10% of total sales on average, but during the Thanksgiving/Christmas holiday season this percentage jumps to 24%. Here is an average breakdown of all possible revenue stream percentages averaged across all JoJa's:

Corporate/gift baskets	*10%*
Corporate lunch catering	*12%*
Breakfast	*5%*
Gourmet/specialty foods	*7%*
Lunch	*66%*
Total	*100%*

3. Kitchen and food preparation areas should be organized as outlined in the franchise manual. Additionally, all equipment specified by the manual should be purchased. All franchisees agree that the company knows how to create and equip an efficient production platform. The franchise manual has detailed specifications for all equipment and supplies.
4. Provide customers with all items on the JoJa's menu. Additionally, follow all recipes, portions, and specs for all menu items. The food and service is what brings people back. The food has won awards in every new location --- so do not mess with success.
5. Remember all JoJa's depend on repeat business. Most JoJa's customers work and shop close to each store and buy lunch everyday. It is important that each customer is completely satisfied. Additionally, it is imperative that each JoJa's offers a wide selection of quality soups, sandwiches, salads, meats, desserts, and other gourmet items. The main marketing appeal is to attract as many customers as possible and offer something new, appealing, and different for every customer visit.

The JoJa's concept has been very successful. The stores generally open at 7 a.m. for a simple breakfast offering of self-serve gourmet coffees and pastries, assorted fruits, and such. In the morning catering and large lunch orders are created and packed. By 11:00 the delivery services pick up the catering and delivery lunches. Walk-in customers begin arriving around 11:30 and both eat-in and take-out traffic continues until 2:00. From 2:00 until 3:00 the deli is closed, cleaned, re-stocked, and night delivery orders are prepared. At 3:00 the delivery services pick-up the orders and the team leaves for the day. Sales per customer seat, square foot, and per hour of operation are extremely high and the operation is one of the most efficient concepts of its type (see Exhibit 1).

Besides the high margins, clearly identified market niche, and limited hours of operation, a JoJa's franchise is a real bargain to launch. Start-up costs are around $150,000 for a "super" deli and $118,000 for the stand-alone deli (see Chart). This puts owning a JoJa's within the reach of many potential entrepreneurs. Additionally after speaking with several franchisees, the Baylors found out that most only paid between $10,000 to $15,000 for their franchise fee --- far below the stated price of $35,000. The Baylors wanted to open a "super" deli in a financial district of Pittsburg. They felt confident that they had all the bases covered --- the only problem was their slight lack of capital.

Types of Expenses	Stand alone JoJa's	Full-service JoJa's
Rent and deposit	3,000	3,500
Equipment	60,000	60,000
Computer	1,500	1,500
Office supplies	500	500
Fixtures	7,000	10,000
Opening inventory	6,000	10,000
Business insurance	2,000	3,000
Administrative expenses	5,000	7,000
Signage	3,000	5,000
Working cash	10,000	20,000
Sub-total	98,000	120,500
Franchise fee	20,000	35,000
Total	**$118,000**	**$155,500**

WHAT SHOULD THE BAYLORS DO?

Dan and Liz Baylor both feel that a JoJa's in Pittsburg would be a huge hit. Although there is no brand knowledge or equity, the young couple feels that they can build sales without national franchiser advertising, by using their great location, positive word of mouth, direct marketing (i.e., couponing), and personal selling. Their biggest worry is money. The Levins estimate (and prior store data supports) --- it takes $120,000 to launch and equip a store (i.e., this estimate is based on the premise that the location is leased). Additionally, the Baylors must pay the franchise fee. Currently, that fee is $35,000 for a full service JoJa's and $20,000 for just a deli JoJa's. The Baylors desire to operate a full service franchise but they only have $110,000 to invest --- $45,000 short of the total price ($120,000 start-up and $35,000 franchise fee).

BLUEGRASS WEDDING CENTER

Richard C. Becherer, The University of Tennessee at Chattanooga
J. Howard Finch, Florida Gulf Coast University
Marilyn M. Helms, Dalton State College

CASE DESCRIPTION

The primary subject matter of this case is the formation of a comprehensive wedding center in Kentucky. The case is positioned to present the business formation process and the search for partners and financing for a new business venture. It also involves turning a number of fragmented product and service providers in the wedding industry into a one-stop center, representing a new product/service combination. More specifically, the case deals with the human issues and challenges in selecting among a number of disparate partners and determining their potential equity stake, investment, and obtaining funding for the business.

Secondary issues examined in the case include assessing the new venture idea based upon actual narrative among the potential founders and excerpts from their business plan. Students should be able to directly identify with the wedding industry and the young couple in the case. Family business challenges also emerge into the case and the owners struggle to make the decisions necessary to turn their business idea into a reality.

The case has a difficulty level of two or three, and is best utilized in a junior or senior-level entrepreneurship, small business, strategic management, marketing of services or product/service development course. This case is very appropriate for undergraduate courses as: 1) students can relate to this industry, 2) the human issues demonstrate the challenges involved in starting a business, 3) and the financial analysis is fundamental and straightforward. It is an excellent case for in-class discussion in a 50 to 75-minute class period and should include debate of alternative issues, particularly when parts B and C of the case (included) are used to follow-up on the main case decisions and actions in the following class meeting. It lends itself to role- playing of the key participants involved, particularly the discussion with the various potential partners over options for structuring the business. The case requires two hours of preparation.

CASE SYNOPSIS

Julie had long dreamed of starting a wedding center. In her business plan, she wrote: "*Anchored by an attractive wedding chapel capable of seating 350 people, the complex will include retail shops that offer floral, catering, dresses and tuxes, photography and video, accessories and possibly even a travel agency, beauty salon and jeweler. To complete the offerings, a large* *expandable reception hall with a complete commercial kitchen and bar will allow the complex to provide every need associated with a complete wedding. Landscaping will be designed to accommodate outdoor weddings, as well as, create a garden setting to the surroundings." With her husband's support and the help of his entrepreneurship professor and her wedding planning colleagues, her dream might become a reality.*

This case involves a couple's efforts to turn a home-based wedding planning business into a one-stop shopping center offering customers every aspect needed for a complete wedding event. It represents an effort by a recent business graduate to take a business plan developed in an entrepreneurship course from a class project to reality. The proposed center will include wedding planning services, dresses and formal wear, photography, florist and catering services, as well as a wedding chapel and reception facilities. By offering customers the opportunity for one-stop shopping for their wedding, the involved businesses should have a competitive advantage over established concerns that only offer individual components. The case provides a first-hand account of the excitement and frustrations involved in developing an entrepreneurial idea and obtaining financing to turn the dream into an actual business venture.

Careful discussion of the case should enable the business students to better understand (1) structuring the "deal" for a new venture, (2) weighing the pros and cons of both debt and equity financing, (3) vertically and horizontally integrating a fragmented industry, (4) searching for appropriate and acceptable venture partners, (5) personality challenges in running a family business, (6) the personal decisions involved in starting a business, (7) analyzing market potential and assessing a new business venture, and (8) understanding the consequences of poor credit and the importance of conducting due diligence on all potential acquisitions.

INTRODUCTION

Chad Compton approached Dr. Bentler after the first night of the graduate entrepreneurship class fall semester, 1998, at Central Kentucky State University. "Would it be okay if I did my business plan on an idea my wife has for a business?" asked Chad. Dr. Bentler said, "Sure, I would like you to focus on a real business opportunity if possible, but be sure you think big enough. You should plan a business that will have at least $500,000 in sales by the end of the second year." Chad was surprised, as $500,000 in revenue was more than Julie had ever earned in her present wedding planning business. But perhaps her new idea had that kind of revenue potential.

The idea began when Julie was only 17 years old. Her sister and a friend were making corsages for Mother's Day as a sorority fundraiser. They had orders for over 300 corsages, but the friend became ill. Julie's sister agreed to give her one dollar for each corsage she made. Julie ended up making all the corsages in one night and cleared $300. Thinking "This is too easy," she studied library books on floral arrangement and decided to create her own floral fundraiser. During her senior year of high school, this resulted in corsages for the prom, Valentine's Day, and Mothers Day. She sold the flowers for triple the materials cost.

During college, Julie arranged the flowers for several weddings. Having succeeded there, she posted flyers on campus, and people started to hire Julie for their weddings. Her prices were low: "seventy-five cents for a boutonniere that my competitors sold for $3." she later said. "When you are cheap you get business," Julie recalled, and she earned enough to pay for college.

LATER THAT EVENING

"Julie, I would like to use that one stop wedding center idea of yours for my business plan in Dr. Bentler's class," said Chad. Julie was surprised since Chad had always thought her business was a bit of a "pain". Since she had expanded the business to wedding planning, it had begun to crowd their weekends and create extra obligations for Chad, who was already stressed from his work as a quality control specialist at the local General Electric facility. Julie remembered how frustrated Chad became when had had to watch their children for hours while Julie met with potential clients in their living room.

"Chad, you'll get your assignment done, but I don't want someone to steal my idea for a one-stop wedding center," Julie said. Julie's vision was for a all-encompassing location where a bride could make all of her wedding decisions including her dress, flowers, photography package, catering selections, and accessories for the chapel. On the day of the wedding the wedding planner would pull it all together with all involved on site, including a beauty salon and day spa for the bridal party.

Julie was operating her current wedding planning business, "The Bridal Party", from a $200 per month storefront. She and Chad had endured a number of different setbacks, including some undisclosed debts inherited when they assumed a wedding dress inventory, landlord problems, and lost business when they changed locations. They argued over the merits of just shutting down the business since it barely broke-even and the cash flow problems had destroyed the couple's personal credit history. Despite the financial pressures, Julie loved planning weddings and felt she had the potential to succeed on a larger scale.

Julie had always been ambitious, but she was just an average student when she was an undergraduate at the University of Kentucky. While she was in school she managed, however, to be a mom to two kids and still work on weddings part-time. Now the two oldest, James and Mari-Lynn, were old enough to help care for the youngest, Conrad. She had a degree in marketing, but the only work experience she ever had was her wedding business. Now perhaps she was ready for a bigger challenge.

THE BUSINESS PLAN

While Julie thought all she needed was money to implement her idea, Chad convinced her that preparing the formal business plan and class feedback would be valuable. Julie finally agreed for Chad to use her one-stop-wedding-shop idea as a business plan for his entrepreneurship class.

Together they gathered the financial information and market/industry trends. They also "mystery shopped" other wedding facilities to gather ideas.

Gradually, Chad became encouraged because everyone Julie spoke to about the business idea was enthusiastic. However, as the planning progressed, Julie and Chad became more polarized in their views. "She has a bad habit of being completely optimistic. She's got a vision of how it's going to work and I have to force her to look at things in a more negative or realistic way," Chad said.

From an Internet search of wedding-related sites, Chad learned wedding planning was a full-fledged industry, with many small independent operators loosely tied to national organizations such as the Association of Bridal Consultants and Weddings Beautiful Worldwide. The organizations reported industry data and Chad learned the average wedding in the United States costs $28,000. Wedding planners serve as consultants to the engaged couple, handling details using their list of contacts for caterers, bakeries, bridal shops, printers, florists, hotels, musicians, and photographers. Planners either bill by the hour or charge a percentage of the total wedding cost. Hourly rates range from $40 to $100 and the typical percentage charge of ten percent ranged from $2,880 to $4,320 per wedding. While spring and summer weddings are the most popular for first time brides, with weddings peaking in June, the industry is less seasonal for second weddings, though second weddings are typically smaller in size and budget. Wedding planners typically promote their business at Bridal Fairs, Yellow Page advertising, and rely extensively on word-of-mouth referrals.

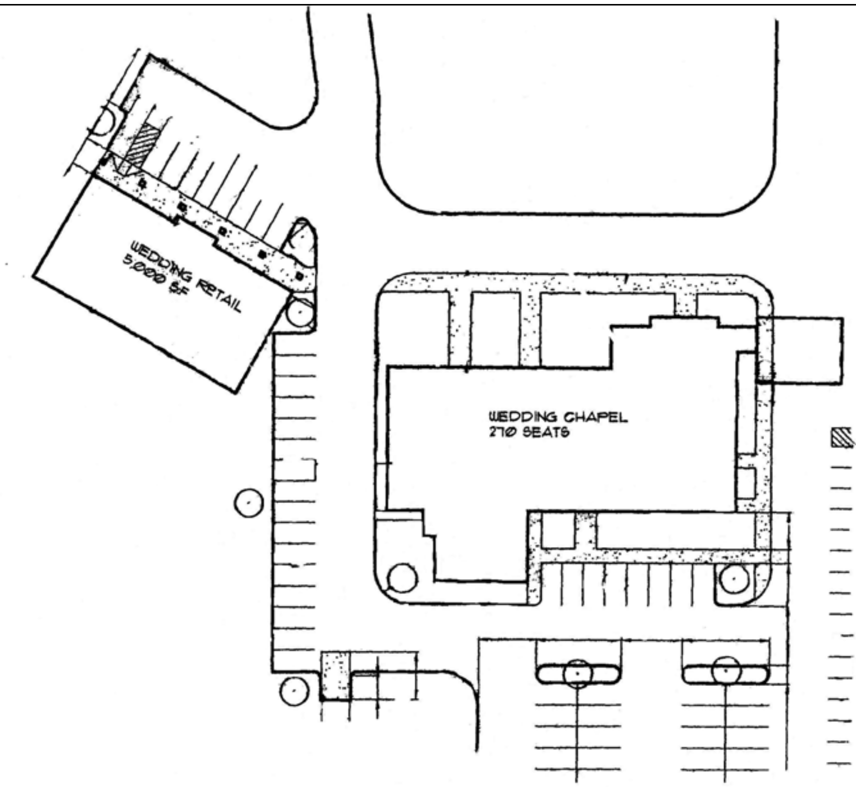
The business plan Julie and Chad wrote described their concept and the competition in the Lexington, KY market. The business plan was based on a three to four acre site that could be purchased for $200,000. The building and improvements were projected to cost $470,000, so the total required investment for the project was $735,000 which included working capital. In planning for first year operations, Chad developed the following projections. After looking at Julie's own business volume from the past several years and talking with their industry contacts from the formal wear, catering, floral and photography businesses, Chad decided he could conservatively forecast a five percent share of the estimated total wedding market (approximately $16 million) in the greater Lexington area. Chad talked to a number of wedding planners in the area and assessed what customers normally wanted and balanced this with their capacity, both in terms of the dates available and what the facility could accommodate. Based upon this information, Chad forecast 90 Quick Weddings with catering at $600 each, 90 Quick Weddings, with chapel rental only, at $200 each, and 80 Large Weddings at $6,000 each. These projections made sense given the Wedding Center capacity, the seasonality of the business, and Julie's past experience in the wedding planning business. Floral arrangements, men's and women's formal wear, photography and other services should generate an additional $264,000 in revenue. This would result in a first year sales projection of $816,000. Figure 1 details the floor plan of the Bluegrass Wedding Center Complex. Based on Julie's business experience, Chad anticipated an inventory equivalent to 24% of sales and he projected operating expenses to be 31% of sales. When he prepared the financial projections for the first year's operating results, Chad was optimistic.

First Year Operating Forecast (Jan.-Dec.)	
Sales	$816,000
Less Cost of Goods Sold	$195,840
Gross Profit	$620,160
Less Operating Expenses	$252,960
Operating Profit	$367,200
Assumptions: First year inventory = 24% of sales	
Operating expenses = 31% of sales	

Chad believed the one-stop wedding center idea could make money, but first they had to arrange funding to get started. As the concept originators, their goal was to attract the start-up capital needed without losing control of the business. To attract the capital and specialists they needed to launch the venture, Julie and Chad offered an equity position to their acquaintances in the wedding planning business. Chad and Julie decided to retain 52% of the equity in the C-corporation. They would offer stock to Wendy Smith, who had a wedding dress business, her sister Mary McMann, who ran a florist and assisted with wedding planning, and Jack Richards, a photographer they had worked with in the past. The proposed financial structure was:

Investor	Contribution	Ownership
Chad and Julie Compton	20,000	52.00%
Wendy Smith	20,000	6.00%
Mary McMann	20,000	6.00%
Jack Richards	15,000	3.00%
Outside investor/bank loan	660,000	33.00%
Total	**$735,000**	**100.00%**

Figure 1: Floor Plan of the Bluegrass Wedding Center Complex



Note that the Wedding Chapel building includes the chapel, catering and reception. Also, the Wedding Retail building includes space for the following vendors: Dresses and formal wear (new, resale, and rental), photography and video, florist, travel agency, salon and day spa, and jeweler.

The proposed ownership percentages reflect not only the financial contribution of each individual, but also their expertise, experience, and energy. If the couple could locate an angel investor, they were willing to give 33% ownership of the business in exchange for the large capital infusion. If they borrowed the money instead, they proposed increasing the ownership of Smith, McMann and Richards equally, resulting in respective ownership of 19.2%, 19.2%, and 9.6%. In this way, Julie and Chad retained majority ownership regardless of whether they raised most of their funds using debt or equity sources.

While Dr. Bentler was impressed with Chad's business plan, he was unsure how Chad and his wife could raise over $600,000 from an investor. He recommended they create a scaled down, yet expandable plan to require less initial capital. From Julie's perspective, the only thing she heard was that Dr. Bentler thought it was a good plan. As Chad puts it, "as soon as she heard that it was like a green light to her."

To accumulate additional seed monies, Julie expanded her current business, often working non-stop Fridays and Saturdays. "It was difficult getting her to forego some of the profit and get help," said Chad, and between helping Julie out on the weekends and taking care of the children, his free time disappeared as well.

RAISING THE CAPITAL

The business plan evolved. As Chad and Julie obtained more accurate cost estimates, they realized some additional expenses would be required. They developed new ideas for the facility and the budget section of the business plan grew. Chad was discouraged by the scope of the revised plan requiring over $1,000,000 in total capital. Julie, however, forged ahead; driven by her conviction the business would "make big numbers".

The couple had "team" meetings with potential investors including others Julie had worked with at weddings in the past. They discussed the status of the project, made plans, and organized to work together at the upcoming bridal show. A local investor with $20,000 emerged; Chad had another friend in Augusta, GA who said he would put in $20,000. They began to explore a second mortgage and talked to relatives in Canada about investing in the business. "The bottom line, however," said Chad, was "we had interest but no checks."

Julie was aggressively searching for property for the facility. The tentative building plan needed a three-acre minimum lot size to construct the proposed chapel and retail structure. The only parcels available were $500,000 -- double what they budgeted. Just as they began to believe the project was out of reach, Julie called Chad and said, "I just found 14 acres of land for $325,000 and half of it is wooded enough to do several honeymoon cabins!" While Chad thought the land was a good price, he could not help but think, "Now honeymoon cabins too!" Julie executed a purchase offer on seven acres, with an option on the other seven acres, contingent on obtaining financing.

Several months later, Julie approached the bank she and Chad had used for years to borrow some of the needed money. The bank immediately declined due to the couple's poor credit history. By the time they approached a small bank branch in neighboring Frankfort, Kentucky, Julie's increased efforts had paid off. Her business was now profitable and they had made real progress in reducing their personal debt. When Julie contacted the bank in Frankfort, they suggested she work with Katy Barnes, a Small Business Administration Loan specialist. The Frankfort bank thought the business concept had possibilities and agreed to fund the business with a $1.0 million loan at an 11% annual interest rate, provided the SBA would guarantee the loan, backed by the collateral of the land, buildings, and fixtures of the business. The only requirement was Julie and Chad needed 20% equity in the business, $200,000 cash. This was considerably more than the $75,000 the couple originally proposed to prospective investors.

First Year Income Statement (Jan.-Dec.)	
Sales	$816,000
Less Cost of Goods Sold	$195,840
Gross Profit	$620,160
Less Operating Expenses	$252,960
Operating Profit	$367,200
Less Interest Expense	$110,000
Pre-tax earnings	$257,200
Less Taxes @30%	$ 77,160
Net income	$180,040

A solid business plan to attract equity investors was essential to their success. By applying the techniques he had learned during his MBA program, Chad constructed pro-forma financial statements based on the proposed financing. His original forecast called for reinvesting all of the first year profits back into the business to fund growth and second year operations.

"Well Chad," Julie said, "If the bank believes in us, we should be able to find enough investors to come up with the down payment." That afternoon Julie's realtor called and indicated the seller was anxious to close. To secure the property and set a closing date, Julie and Chad would have to put down some earnest money. They needed $15,000, which was $10,000 more than their current liquid savings. The only option would be a loan against Chad's 401K accounts. Julie began to think, "When should I approach Chad about this…?"

BLUEGRASS WEDDING CENTER (B)

Two weeks later, Chad pulled $15,000 out of his 401K and extended the purchase agreement on the land another 120 days. "You realize, Julie, if we don't put $200,000 together for the down payment on the loan, we'll have to walk away from this $15,000," said Chad. "With Wendy, Mary, and Jack involved, we have a third of the money we need and we haven't talked to my uncle in Canada yet," she replied.

During the next two months Julie asked her friends and relatives to help. Many were interested, but no one committed checks. Julie's aunt in Canada disapproved of her uncles' offer to help, so after waiting three weeks all she got was "no". Her old boss who owned the McDonald's franchise in Lexington, KY also declined. Julie began to sense friends were avoiding her phone calls.

Pro-forma Balance Sheet for Bluegrass Wedding Center End of First Year of Operations			
ASSETS			
Current Assets			
	Cash and Marketable Securities	$230,040	
	Inventory	$616,000	
	Accounts Receivable	$150,000	
Total Current Assets			$ 996,040
Fixed Assets			
	Land	$325,000	
	Buildings and Equipment	$470,000	
Total Fixed Assets			$ 795,000
Total Assets			***$1,791,040***
LIABILITIES AND EQUITY			
Liabilities			
	Current Liabilities	$411,000	
	Long-term debt	$1,000,000	
Total Liabilities			$1,411,000
Shareholders equity			
	Common Stock ($10 par)	$10,000	
	Paid-in Capital in excess of par	$190,000	
	Retained Earnings	180,040	
Total Shareholders equity			$ 380,040
Total Liabilities and Shareholders equity			***$1,791,040***
Assumptions: Financing sources include $ 1 million SBA loan, $200,000 equity contributions from Chad and Julie and other outside investors. 10,000 shares of common stock issued at $10 par value. First year earnings reinvested into firm.			

Finally, she went to the Lexington Kentucky Commercial Development Enterprise (LCDE), a non-profit agency designed to stimulate are economic development. The LCDE pledged $100,000 to supplement the $75,000 Julie and Chad raised from their partners. When they returned to Frankfort to see if the bank would agree to the deal with $175,000 down, the bank told them they would need to be reconsidered for approval since so many changes had taken place in the structure of the Wedding Center.

That night, Julie and Chad brought Wendy and Mary together for a meeting and relayed the discouraging news from the bank. Wendy spoke up and said, "I just don't think this is going to fly. The project is just too big for us and we need to look at how we can do it on a smaller scale." Chad began to agree with them, but Julie jumped in and assured everyone they were just too close to throw it the towel.

Two additional weeks of waiting went by before the bank asked for a revised business plan and informed them the $100,000 from LCDE would not count toward the down payment. "It's not a real contribution of equity capital," said the bank official, "You need to get real investors." They did agree, however, the $100,000 would make the plan much stronger in terms of working capital. It looked like they could still get the $1,000,000 if they could come only up with the $200,000.

The following week Wendy and Mary showed up at the door unexpectedly with two-dozen fresh donuts. Julie and Chad were a little taken back. Chad remembered something he had heard years ago, "beware of Greeks bearing gifts". The sisters wanted to talk with them about another option.

"We showed your business plan to our half-brother Carl, and he liked the concept and the attractive profit margins. He is interested in financing the deal if we each contribute $25,000 and revise our plans a bit," said Mary. "Rather than build a new facility, he suggests we renovate the old courthouse to put a chapel on the first floor and a reception hall downstairs. Jack (the photographer) has already agreed to join us."

Chad and Julie were taken totally by surprise, particularly when Wendy said, "What we are suggesting is that if you want to join us, we'll give you 25% of the equity for your $25,000. We know it's not exactly what you wanted to do, but maybe it's better than nothing." Chad and Julie just looked at one another in amazement….

BLUEGRASS WEDDING CENTER (C)

"I can't believe you used my business plan to get your brother to invest in your business," said Julie. Wendy responded, "We knew you wouldn't be happy Julie, but at least we are willing to include you." Julie told them that she and Chad would talk it over and get back to them. She still planned to pursue the Wedding Center, however, even if she did agree to join their new venture.

Julie was discouraged, and hurt that people they had trusted had turned on them. Even Jack, who Julie only included in the team to be nice, had let her down. In addition to being let down by their friends, Julie and Chad had no idea of where to start recruiting new businesses. "When their half-brother used our business plan to show them how attractive this business is, I guess they decided they had to have it all to themselves," said Chad. Julie looked at him and said, "It's time to regroup."

Julie and Chad were reluctant to opt out of Wendy and Mary's deal for the Chapel at the courthouse, because it still might be a good business opportunity. A $25,000 investment in the courthouse project, however, would make it even harder to come up with the money they needed for the Wedding Center. Their dilemma only lasted a few days, however, because Wendy called and said she and Mary decided that they didn't want Julie as part of the team after all. The Wedding Center would just be a "big conflict of interest". What Julie would soon learn is that in addition to Jack, Wendy and Mary were quickly contacting everyone Julie had planned to do business with. In effect, Julie had set them up in business!

During the next two months, Julie had a renewed spirit when it came to finding investors. She attended an Entrepreneur of the Year banquet and took copies of her business plan with her. She set up a booth at the annual Women in Entrepreneurship dinner. In addition to the half dozen business plans she handed out to various business professionals in Lexington, KY she got an appointment with the wealthiest man in Lexington, John Lincoln, and pitched her idea to him. He was somewhat interested in the project, but he wanted a very large ownership position if she partnered with him. That night Julie told Chad," I just didn't like his attitude; I would be a little leery of being in business with him." Her concerns ended her desire to keep in contact with Mr. Lincoln.

A couple of weeks later Chad and Julie were invited to hear a friend play with a local bluegrass band. While they were there, Julie noticed an older gentleman sitting alone. She noticed that he was enjoying the music, but did not seem to know anyone there. Julie said to Chad, "Let's sit there near that man; I think he needs some company." Between sets, they struck up a conversation and he and Julie became fast friends. She told him what business she was in, and about her plan for the Wedding Center. He seemed interested and gave her his card, and he told Julie to send him her business plan.

Julie was surprised to learn that the man was Frank Baxtor, whose commercial real estate signs were all over town. Two weeks later Mr. Baxtor called and said, "I think you have a great concept here, and I might be interested in helping you. Why don't you come to my office this afternoon? I have some suggestions for you." Julie was surprised by his interest and enthusiasm. She told him that she could not get a baby sitter for her three children on such short notice. Mr. Baxtor just said, "Bring them along, I'd love to meet them."

When Julie got there Mr. Baxtor welcomed them in and set the kids up in the corner with some paper and pencils. He told Julie, "I like your idea, but I think you will need at least another $200,000 to have enough inventory and working capital to pull it off." She told him about the $1,000,000 bank loan and the $200,000 down payment they would need. He responded, "Julie, forget the bank, I will fund the whole project, but I want 50% of the equity. You and Chad will have the other 50%. When we get this one up and running we'll go to Atlanta or Birmingham with the next one, and maybe we'll end up franchising these things." Julie didn't know how to react. Imagine having a chain of Wedding Centers… but it was her idea…. did she want to give up half of her company?

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E. M. MAPALAD AND THE MAPALAD BUS LINERS, INC.: THE BUSINESS ENDED DESPITE A TALENTED ENTREPRENEUR

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CASE DESCRIPTION

The primary subject matter of this case is entrepreneurship. Secondary issues examined in the case include strategies involved in family business startup, growth, and decline, including profit-maximizing strategies (revenue maximization in particular), as well as international business environments and their impact on businesses, in general, and family businesses, in particular. This case has a difficulty level of three and up, appropriate for junior level and beyond. The case is designed to be taught in two to three class hours in a management or an entrepreneurship or international business course, and is expected to require about three hours of outside preparation for students, consisting mainly of reading the case and familiarizing themselves with the business implications of a Martial Law regime.

CASE SYNOPSIS

The case is about Eustacio Marino Mapalad, an entrepreneur, and the successful transportation business he created in the Philippines after World War II and operated for more than 50 years. The case traces through the history of his business, from its beginning as a surplus U.S. Army jeep that was leftover from the war to a fleet of thirty five full-sized buses at its peak in 1965-1972. In doing so, the case illustrates an example of how a highly motivated and very talented entrepreneur started his businesses from limited resources, and how his skillful management of these and additional resources and his ability to identify and pursue opportunities made him the number one bus operator in Manila twenty years after he started his business. The case also shows how a drastic change in the political environment adversely affected his businesses and drove this once motivated, dedicated and successful entrepreneur to give up on the business that he created.

This case secondarily provides a glimpse of the transportation industry in the Philippines between 1945 and the 1980s for which no explicit study exists and for which data are generally not available. It also gives a personal account of the political, economic and cultural environments faced by the entrepreneur and how these environments affected a number of his major business decisions.

START OF THE BUSINESS

The Entrepreneur

Eustacio Marino Mapalad first got involved in the public transportation sector in the Philippines in 1937 in his home province of Batangas, located 110 kilometers south of Philippines' capital city of Metro Manila (then one of 50 provinces in the country; at present, one of 79 provinces, National Statistical Coordination Board, latest reports). At the age of 19, he worked as a bus driver for Silva Transportation, which was later bought by the country's number one provincial bus lines, BT Co. (presently, BLTB Co.).[1] Six years later, his employment at BT Co., along with everything else, was interrupted by World War II, during which the U.S. and Philippines (then a U.S. colony of commonwealth status) combined their military force to fight against Japanese invasion in the Philippines and the rest of Asia. During the war, Mapalad used his driving experience to drive ambulance vehicles into battlegrounds and transport wounded soldiers to care centers.

The Business Environment

The Philippines ceased as a U.S. colony and gained her political independence in July 1946, following the Japanese surrender in 1945 to U.S.-coordinated military efforts in Asia (under the leadership of General Douglas MacArthur). To help with post-war rehabilitation and reconstruction in Batangas and other parts of the Philippines, the U.S. kept their military base in Batangas open until 1947, after which they relocated to Japan.[2] During these two years, the U.S. military base continued to be a major employer in the area, thereby creating and even increasing demand for public transportation. In addition, many roads and bridges were damaged during the war. Many of them could not handle the weight of large vehicles such as passenger buses. Passengers traveled using smaller modes of transportation such as horse-drawn carriages or passenger jeeps (many of which were surplus U.S. Army jeeps able to transport up to 12 passengers at a time). (Here is a little trivia: "jeep" evolved from the initials "G.P.", which stood for "general purpose", one-ton vehicles, invented in 1941 and used by the U.S. Army.)

The Business Strategy

In response to these conditions, Mapalad's brother Hugo bought a U.S. Army jeep, asked Mapalad to fix it (i.e., Mapalad was a mechanic), and employed Mapalad to drive it as a passenger jeep. The route was short (less than 1 km.), the fare was 0.50 Philippine Peso (Php, hereafter, then at par with the U.S. dollar), and most passengers were "shuttled" back and forth of the U.S. military base. In exchange, Hugo paid Mapalad a generous (you might say "brotherly") share of 50% of gross revenue.

Mapalad drove his brother Hugo's passenger jeep for six months until it reached the end of its service life and was then retired. However, while it was operational, this endeavor was profitable to his brother and beneficial for Mapalad, who was able to save 2000 Php, from which he would start his own business. Using 300 Php from his saving, Mapalad purchased his own surplus U.S. Army jeep, fixed it up and drove it for one and a half years until the closure of the U.S. military base in Batangas in 1947. His route was 5 km. between Ibaan and Sabang or 12 km. between Ibaan and Batangas City. The fare was a flat amount (0.50Php) charged to each passenger, regardless of the distance.

The First Business Success

Although Mapalad's business was small (he operated it as a "one-man band", serving as its sole owner, driver and mechanic), it was very successful. A reconstruction of his typical daily cashflow shows that he generated a daily profit of 35-40 Php, representing a profit rate of around 50%. This was calculated based on gross revenue of 70-80 Php, which represented service to 140-160 passengers (at the fare of 0.50 Php). His major expenses was fuel of 5 gallons per day, bought from a black market (the only market that existed at the time) where gasoline was supplied by U.S. Army soldiers at 5 Php per 5-gallon container. His other expenses (for example, for maintenance and repair were minimal as, with his skill and experience as mechanic, he fixed his passenger jeep himself. He also went to the Army surplus yard to purchase spare parts for his passenger jeep at low prices (e.g., he paid 2 Php for a clutch). He purchased spare parts as he found them during his surplus yard visits and maintained an inventory. Also, he was able to operate his business without a business license during most of this period.

Other ways of looking at his profitability continue to highlight his business success. For one, with his profit rate of 50% and profit of 35-40 Php per day, he was able to recover his start-up capital of 300 Php (used to purchase the surplus jeep) in less than 10 days. One may also put this in comparative terms. For example, with restaurant meal (a luxury item at the time) at 0.50Php, his profit of 35-40 Php provided a good level of comfort for him, his wife and two children. This would be true even if the above calculation were corrected by imputing wages paid to the driver and the mechanic, roles that he himself performed.

Aside from those already mentioned, there were other factors that contributed to Mapalad's business success at this time. Despite sufficient competition in the passenger jeep business from other owner-operators, including that from another brother Roque, Mapalad fared well. Passengers preferred to ride his jeep because of his reputation as an experienced driver (a signal for a safe driver) and a skilled mechanic (a signal for a well-maintained, i.e., safe, vehicle). The same was true for his brother Roque, who effectively was his only real competition.

The overall macroeconomic conditions following World War II were also favorable for Mapalad's business. The economy was strong, there were plenty of jobs, and the Philippine peso was at par with the U.S. dollar. The political climate was also conducive to his business. Corruption was low and politicians came from prominent, wealthy families who did not run for political office for personal material gain.

Mapalad's business success up to this point allowed him to gain more experience and knowledge in the public transportation sector, as well as to accumulate the funds he would later use to pursue opportunities to expand his business and to build personal assets. One of these opportunities arose in 1947 when, while driving his passenger jeep, he was pulled over by policeman Pua for continuing to operate his passenger jeep (also referred to as "public utility jeep", PUJ, hereafter) without a permit after a requirement was put in place. Courteously, Pua provided Mapalad with information on how to obtain a PUJ permit that would be valid for one year, would specify the line or route that the PUJ could serve, and cost 150 Php every year.

When Mapalad received his permit (a sticker that was affixed to the windshield of his jeep), he noticed that it did not specify the route that his PUJ was to serve. He saw a business opportunity from this: he would move his business from Batangas to the capital city of Manila and run his PUJ in Manila using his current PUJ permit. This decision was also motivated by the planned closing of the U.S. military base in Batangas in 1947, which led to reduced local jobs and hence reduced ridership on his PUJ. Before Mapalad could begin serving his Manila route, he had to convert his U.S. Army jeep into what became known as a passenger "jeepney", which continues to be a major mode of transportation throughout the Philippines. Wikipedia provided an interesting etymology of the term "jeepney" as commonly believed to be a conflation of "jeep" and "jitney", or "jeep" and "knee", the latter referring to the jeepney's crowded face-to-face seating." Similar versions of this vehicle, known as jitney, are also used in other parts of the world, including the Hamptons in New York and Atlantic City in New Jersey, while jitney buses are used in the Bahamas. The term "jitney" is a North American English term that refers to a "small-capacity vehicle that follows a rough service route, but can go slightly out of its way to pick up and drop off passengers" (Wikipedia).

When Mapalad moved his family and business to Manila, he first acquired a lot in the Pasay area in Manila, used some of his saving for down payment and took out a mortgage for the remaining balance. He built a home and office/garage on half of the lot and rented out the other half for an amount that allowed him to meet his mortgage payments. In his own garage, he also maintained other relatives' PUJs for no money in exchange but one could say it was good from a relational aspect.

GROWTH OF THE BUSINESS

Between 1947 and 1955, his PUJ business in Manila expanded from the one original U.S. Army jeep he converted to a passenger jeepney in 1947 to a total of five jeepneys by 1955. He had a staff of 12-16 drivers who rotated on their schedules to drive his jeepneys. He continued to work as the main mechanic in charge of maintaining these jeepneys and hired an assistant mechanic. He would use some of his business profits, supplemented by a loan from the Development Bank of the Philippines (formerly RFC, Rehabilitation Finance Corp.) to acquire land and build structure on it, such as his property in Makati, now a city but, at the time, an undeveloped area of Manila. Such a strategy of building up personal assets (which could be used as collateral) and a credit history would prove crucial in the next stage of his business.

A Business Opportunity

Mapalad's business was transformed when, in 1960, then Manila mayor Lacson announced that PUJs would be replaced by buses (PUBs). Shortly thereafter, he bought two PUBs on installment and initially operated them on his former PUJ route for which he had permit. It was by accident or sheer luck that he would discover what would prove to be the most lucrative bus route in all of Manila.

Like before, Mapalad acquired more land, most of them in Makati, with one in particular located near the city hall. One day in 1960, he went to the real estate office to make his mortgage payment, only to find out that the real estate office had moved to Ayala Avenue (a private road owned by one of Philippines' wealthiest family, the Ayalas). He first thought that this was strange and said to himself, "why would the real estate move to the 'boonies'"? Only later, he found out that the real estate agent was very optimistic about the Ayala area replacing Manila as the primary business area in the capital city. The same real estate agent told him that these empty lots or fields would soon be sites of new buildings and that the landowner (Ayala) had strict buildings codes, including a minimum of six floors for every building, that people or businesses who would buy land from Ayala would have two years after acquiring their land to develop it by constructing buildings, otherwise Ayala would repossess the land and not return their down payments.

While standing at his real estate agent's office, Mapalad saw a great business opportunity: He envisioned that the Ayala area (and Ayala Avenue in particular) would develop and would need transportation. He did a quick "mental" project study to evaluate the costs and benefits of applying for a franchise on the Ayala-Quiapo route (Quiapo then and now is the old business district while Ayala would become the commercial and financial center in the capital city). He used his personal connections to pursue this business opportunity: Through the help of a cousin who knew the Public Service Commissioner, he was able to set up a meeting with the commissioner. During the meeting, he convinced the commissioner that the Ayala area would boom and employ thousands of personnel, many of whom would rely on public transportation. He also expressed his interest in obtaining a franchise on the Ayala area, which would give him exclusive use of Ayala Avenue. In exchange for this exclusive use, Ayala required that Mapalad stand ready to meet what was expected to be a rapidly growing ridership (i.e., that he would not have capital and other constraints and would be able to add more PUBs to his existing fleet as demand increased). Following this meeting, he hired a lawyer to file his franchise application, which took three years to get approved by the commissioner. In 1963, he was awarded a 25-year franchise to service what would be the most profitable PUB route in Manila. This franchise effectively created a barrier to entry for potential PUB competitors (the main ones were JD Transit and MD Transit, both of whom tried to block his application for the franchise).

After receiving his franchise, Mapalad went directly to Mantrade, the Ford dealer in Manila. His years of skillful financial management, careful building up of credit, and accumulation of personal assets (real estate in particular) allowed him to be approved, with no down-payment, for 10 bus units. Each unit was worth 200,000 Php and came with the bus frame, a UK-made diesel engine (with a brand name of Fortune), and other parts. The bus' body was made by a separate manufacturer at a cost of 4,000 Php for each bus.

Mapalad was actively involved in the preparation of his buses, not only in their financial and mechanical aspects but also in their design. By carefully choosing the color scheme, he made sure that his buses attracted attention and also portrayed a cheerful appearance. He painted his buses fire-engine red and put two yellow stripes on each side, which ran from whole length of the bus. He also designed his company logo by embedding his initial "E. M." in a circle.

With a fleet of 10 buses, Mapalad was ready to take his transportation business (by this time, a PUB business) to a new height. It was also at this point that he adopted the business name "Mapalad Liners, Inc."

Revenue Maximization Strategy

Mapalad's business strategy centered on revenue maximization, and he considered his franchise on an excellent PUB route to be the most critical factor in his business success. What made his PUB route most attractive in generating revenues was that his PUBs would be filled to capacity all day in both directions of the route. Other competitors' routes would fill their PUBs in one direction and run them empty when heading the opposite direction (in this case, experiencing low revenues while incurring costs from, among other things, the use of fuel). This implied that, roughly estimated, his revenues were twice those of his competitors.

In addition, Mapalad knew that an idle bus (i.e., a bus that was in the garage for maintenance and repair or because its driver and/or conductor was absent for the day) represented forgone revenue. For this reason, he was dedicated to keeping his PUBs in excellent condition by setting up a complete inventory of spare parts and assemblies (e.g., engine assemblies) so that parts or assemblies could be swapped quickly, thereby minimizing downtime. In his own words, “minimizing downtime is the secret to the transportation business”. (As a side comment, because Mapalad’s PUBs were excellently maintained, they generated less air pollution than did his competitors).

Mapalad also knew that the ability to generate maximum revenues would allow him to attract the most talented personnel, especially drivers and conductors, whose earnings were calculated as percentages of revenue (15% and 10%, respectively). In essence, Mapalad had a semi-monopsonistic position in the hiring of drivers and conductors, as they preferred to work for his company before considering working for his competitors. This advantage made it easier for Mapalad to encourage good and honest work from his employees and to discipline them when the situation warranted such an action. These personnel would also be more dedicated to their jobs (if, for nothing else, the fear of losing their jobs), thus reducing potential problems with absenteeism.

Mapalad’s strategy of revenue maximization was helped by a number of decisions that focused on keeping his costs down. One of these was his decision to install diesel engines on his PUBs instead of gasoline engines. With diesel cost being two-thirds of that for gasoline (i.e., 0.14 Php per liter compared to 0.21 Php per liter), this decision saved him money—literally--every time his PUBs operated. In addition, his PUBs experienced few and minor accidents, partly due to their excellent maintenance. In his own words, Mapalad attributed this to “God’s will” in his favor, quite “appropriate” for someone whose last name means “blessed” in the Pilipino language-Tagalog dialect.

PEAK OF THE BUSINESS

1965 was the year when Mapalad’s business reached its peak, only two years after receiving his franchise in the Ayala area. The rapid growth of the past two years reflected itself in the size of his fleet, which increased from 10 PUBs in 1963 to 35 PUBs from 1965 to 1972. By that point, his business organization consisted of himself as owner-manager, one accountant named Bilar, family members (whose contributions to the business was not explicitly or formally paid), and more than 100 drivers, conductors, mechanics, inspectors, and dispatchers. Unfortunately, there was insufficient information to approximate his business costs. The revenue side of the business’ financial status would be easier to reconstruct, using a few reasonable assumptions, as illustrated below.

As above noted, Mapalad had a fleet of 35 PUBs at the peak of his business in 1965, with each PUB having an approximate sitting capacity of 60 passengers but would often run on “standing room only” capacity, with approximately 100 passengers. On a typical day, each PUB was able to make twelve roundtrips. Bus fares were three-tiered, depending on the distance covered, and were 0.10 Php, 0.15 Php, or 0.20 Php. Apply the following assumptions on the above information: at any time, 10% of PUBs were idle, mostly for maintenance and repair reasons; PUBs operated 5 days per week (although it was likely they ran for 6 days per week on their regular route and some of them were rented out on Sundays for excursions, funerals and other purposes); the average fare was 0.15 Php; and the average capacity per trip per PUB was 80 passengers. All of these would yield an approximate annual revenue of 2.36 million Php or almost $600,000 at the prevailing exchange rate of 4 Php per U.S. dollar.

To get an idea of the magnitude of Mapalad's business success, it might be useful to look at these figures in relative terms. At its peak, Mapalad's business profit, which could be conservatively estimated at 25%, was the main source of his household income, This would translate to a household income of 589,600 Php or $147,420, which was quite high, even when compared to the average household income in the U.S. at present. Of course, this figure becomes more impressive when comparisons are made during the relevant time period (around 1965) and with the relevant population (i.e., when compared with the average Filipino household). Indeed, one could say "not bad for someone with a third-grade education".

Mapalad's business was on all accounts successful throughout the period 1963 to 1972, with its peak reached and maintained since 1965. It was number one among PUB businesses that served the capital city of Manila. Perhaps less important for his business success during this period and hence simply described as a backdrop were the overall macroeconomic and political conditions that were favorable to his business as well as many other businesses. The economy under President Macapagal (in office from 1960 to 1965) was strong, and political corruption continued to be low. This economic and political status carried over to the next presidential term from 1966 to 1972 under Marcos.

DECLINE OF THE BUSINESS

The political climate drastically changed in the second half of 1972, when then President Marcos suspended the Philippine Congress and declared a Martial Law on September 21, 1972. After staging an ambush of the car of his principal political adviser and then senator, Enrile, Marcos justified his shift from a highly democratic to a Martial Law regime, forcefully arguing that Martial Law was necessary in order to restore national security and personal safety.

This political regime shift brought about a number of changes that significantly and adversely affected Mapalad's business success, as well as his business strategy and vision. First and more general in nature, Martial Law penalized successful business by making them targets for confiscation by the dictatorial president. Hence, the more successful was the business, the more likely it was to be confiscated. In response, the appropriate business strategy would have been to keep a low profile (which was difficult to do when the dictator and his entire political machine could easily gather any information they needed). To avoid confiscation, many businesses chose to become smaller operations and thus purposely slowed down or even reversed expansion plans they adopted prior to Martial Law. This was true for Mapalad who allowed his fleet to decrease by selling his PUBs to other operators (e.g., he sold 15 bus units to JD Transit) or by using older or less reliable bus units as spare parts for other units (a practice referred to "cannibalizing").

A second factor that had a particular adverse effect on Mapalad's business and others in the transportation business was the loss of independence of the Public Service Commissioner, who previously decided all matters concerning transportation (e.g., Mapalad sought the commissioner's approval of his franchise application). Of particular interest were PUB businesses' petitions to adjust bus fares to compensate for rising cost, especially fuel costs (note that these events were taking place during the period of worldwide oil price hikes in 1973 and 1979).

Before Martial Law, public transportation operators, mostly PUBs and PUJs owners (yes, PUJs were not phased out in the 1960s) would petition the Public Service Commissioner for fare increases, a court-like hearing would be held with affected parties in attendance, the Commissioner would grant periodic fare increases that approximately compensated operators for rising costs. As a PUB owner, Mapalad attended and was active in these meetings. In particular, he was instrumental in getting the lowest tier of bus fare increased from 0.10Php (as noted in the revenue calculation in the previous section) to 0.15Php. He was also active in business networks, through which he was able to establish business contacts and personal relationships (even friendships with his competitors). Through networking, he was invited by his competitor Eras (owner of JD Transit) to serve as a director in the board for the Bus Owners' Association.

After Martial Law, petitions to the Public Service Commissioner required the dictatorial president's approval. Because Marcos was consolidating political support during this time, he rejected fare increase petitions, which would always be viewed as unpopular as they increase the cost of living for the working population. By keeping fares constant despite rising PUB businesses' costs, Marcos was hoping to "neutralize" the undemocratic impact of a Martial Law regime or, better yet, endear himself to the Filipino mass. As a result, for the period between 1972 and 1985, all petitions for fare increases were denied, despite the rising costs of fuel, tires, and spare parts. It was not until 1986 under the new president Aquino, who took office after a people's revolution overthrew Marcos, that fares were finally adjusted. This fare increase came too late for Mapalad who, after years of financial losses and other business hardships, gave up on his business. It was also at this time that he decided to migrate permanently to the U.S. to join some members of his family.

A third factor that ended his business success concerned his exclusive right to then-private road Ayala Avenue, which allowed him to generate large revenues. Under Martial Law, this road was made into a public road. Soon thereafter, other PUB and PUJ operators, including his former competitors, were given permits to service this road, thereby nullifying his exclusive 25-year franchise on Ayala Road and the rest of his PUB route. With developing and intensifying corruption in government, anyone who was able to bribe employees at the Land Transportation Office (the equivalent of DMVs in the U.S.), Public Service Commission, or the dictatorial president himself would be granted "temporary permits" or "special permits" to operate PUBs or PUJs in any route.

Although temporary, these permits could be renewed multiple times and for an indefinite time period. As if this added competition on Ayala Avenue and throughout Mapalad's former route was not bad enough, the dictatorial government then competed directly with private PUB and PUJ operators by introducing its own bus company, Metro Manila Transit Corp. (MMTC), in the early 1980s. With large resources to draw from and unlimited influence on business networks through personal relations or coercion, MMTC had the advantage over any private PUB and PUJ operator, including Mapalad.

The period of Martial Law represented the time when, figuratively speaking, Mapalad's business died. Worse yet, in a desperate attempt to generate revenues to cross-subsidize his PUB business and to supplement his rapidly declining personal and family income, Mapalad made mistakes in his business decisions after more than 30 years of business experience. Part of this reflected the level of desperation and pressure for business survival that he and other businesspeople experienced during Martial Law. It also, in part, could be attributed to the decline in a businessperson's confidence after years of experiencing financial losses in his business while facing day-to-day challenges and frustrations as he continued to operate his business and witnessing how the business for which he worked so hard diminish day after day. It was regretful that his business success was prematurely ended because, if not for Martial Law, he would have expanded his PUB business interest (e.g., by considering provincial routes, with trip between Manila and the outlying provinces much like BT Co., which was noted in the earlier section. His plan was for his buses to serve as far as the Bicol region, approximately 250 km. southeast of Manila).

One major business mistake he made was when he diversified into a different line of business by converting a part of the bus garage into an open-air marketplace (named Mapalad Market). His original idea was to keep the project in a smaller scale that could be financed using previously accumulated savings. At this smaller scale, this project would have been financially feasible. Unfortunately, when the project proposal was presented for approval by government authorities, Mapalad found out that a larger scale project would be required. With no other attractive business opportunity available to him during Martial Law (as Marcos and his cronies already "reserved" the best ones available for themselves), he proceeded with the construction of a larger scale market, financed by bank loans that were collateralized by all of his remaining personal assets (including his family's home). This business endeavor proved to be a failure so that, after only two years of operating the market, Mapalad closed it down and sold the site at a substantial loss, if only to save his family's home.

What remained of Mapalad's PUB business was dragged out and operated at a loss by second and third generation family members until the 25-year franchise ended in 1998. By 1995, the fleet consisted of only 7 buses, only one-fifth of what it was at the peak of the business. By 1998, a mere 3 buses remained and were retired, marking the official end of the once successful business Mapalad created.

ENDNOTES

[1] "BT" stood for Batangas and Tayabas, two cities that are located in the province of Batangas. These cities represented the main areas served by the company's public utility buses with routes to and from Manila. Buses with these routes are usually referred to as "provincial" buses (i.e., they run from the capital city to the provinces). Later, the company's service area was extended to include the province of Laguna, as indicated by the change in the company's name to "BLTB Co.", which stands for Batangas-Laguna-Tayabas Bus Co.

[2] The U.S. maintained two other bases (Clark Air Base and Subic Naval Base), both located in the province of Pampanga, approximately 80 km. north of Manila. Clark Air Base was closed on November 1991, months after the eruption of Mount Pinatubo. Subic Naval Base was closed in October 1992.

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CHICAGO FOOD AND BEVERAGE COMPANY: THE CHALLENGES OF MANAGING INTERNATIONAL ASSIGNMENTS

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CASE DESCRIPTION

The primary subject matter of this case concerns the management of expatriate managers with a particular focus on their recruitment and compensation. Secondary issues examined include the internationalization strategies of a multinational company and particularly the alignment of international strategy and headquarters' orientation regarding the international human resource management policy. The case has the difficulty level of six (appropriate for second year graduate level). The case is designed to be taught in three class hours and is expected to require five hours of outside preparation by students.

CASE SYNOPSIS

The Chicago Food and Beverage Company (CFB Co.) is an American multinational with subsidiaries in North America, Europe and Asia. The case is about the alignment of CFB Co. internationalization strategy and the orientation of the head office in regard to its international human resource management (IHRM) policy and management of international assignments, with an emphasis on expatriates' recruitment and compensation. The case describes the international development of the company and the subsequent expatriation of Paul Fierman, the head of the Vietnam subsidiary. Paul's three-year mandate includes the preparation and execution of the strategy to synergize the three Asian subsidiaries (Singapore, Hong Kong, Vietnam) with the collaboration of the head of the Pacific Rim, which should allow CFB Co. to conquer the Asian market. Six months after his arrival, Paul Fierman is disappointed by the financial conditions of his contract and by his relationships with local colleagues, not to mention the difficulties his wife has been having adapting to this new environment. The discussion of this case in class allows introducing and illustrating the theoretical concepts related to the following topics: 1) internationalization strategies and international human resource management policies; 2) strategic management of international postings; and 3) advantages and disadvantages of different international compensation methods.

EVOLUTION OF CHICAGO FOOD AND BEVERAGE COMPANY FROM 1960 TO 1998

Chicago Food and Beverage Company (CFB Co.) is an American multinational which was established in Chicago in 1963. The company is specialized in the production of all kinds of fruit jams, canned fish, meat, vegetables, and non-alcoholic beverages. CFB Co. is primarily an American company and until 1985, it concentrated exclusively on the U.S. market. Due to its reputation as a high-technology intensive company and its capacity to adjust to the changing market demands, CFB Co. grew rapidly. It expanded all over the U.S. through its five national subsidiaries based in Chicago, New York, Atlanta, Los Angeles and Portland. In 1985, CFB Co. became the fifth largest American producer in the food and beverage sector. In 2003 its revenues amounted to several billion U.S. dollars (US$).

Since the long U.S. recession of the 1980s, CFB Co.'s management wanted to expand abroad so that the company wouldn't be so dependent on the already saturated domestic market. However, Mr. Brandon Long, CEO of the company since it was established, stubbornly opposed the idea. In late 1984 Mr. Long retired and was replaced by Mr. Bill Stevens who always dreamed of CFB Co. becoming a global power. With top management's approval, CFB Co.'s foreign expansion plans finally started and at the beginning of 1985, the company went international. The foreign expansion plans included two growth strategies: the company would either purchase small foreign enterprises operating in the same sector or establish joint ventures with foreign food and non-alcoholic beverage producers. CFB Co. expanded to Europe first, and between 1985 and 1990, the company acquired three local enterprises in Belgium, France, and Germany.

Following that, from 1991 to 1998, CFB Co. turned toward the Asian market, installing three joint ventures in that region. According to CFB Co.'s managers, there was a huge potential for food processing and distribution in the Asian market because firstly, it accounted for over 60% of total world population, and secondly, Asian consumers' expenditures were increasing three times more rapidly than those of North Americans. Therefore, the company's expansion to this region was thought to be of crucial importance for its economic health. Thus, the first joint venture specializing in Asian fruit-based jam production was established in 1991 in Singapore. The second joint venture which was created in 1995 in Hong Kong produced canned fish, meat and vegetables. The third joint venture, started in 1998 with a Vietnamese subsidiary based in Haiphong, specialized in the production of all kinds of non-alcoholic drinks, fruit juices, and sodas. Although some of their clients are based in the neighbouring countries, each joint venture produces its own products which are basically distributed on the local market. There is no cooperation between subsidiaries since they are considered as completely independent entities from each other.

CREATION OF CFB VIETNAM JOINT-VENTURE IN 1998

CFB Vietnam, created one year after the beginning of the Asian economic crisis, is a joint-venture between CFB Co. (which owns 49% of capital) and a local state-owned enterprise (which owns 51% of capital). It was CFB Co.'s largest investment in Vietnam. The joint venture formula was chosen due to the mutual advantages it offered to the parties involved. On the one side, CFB Co. was gaining rapid access to the Vietnamese market, benefiting from the lands, buildings, and other infrastructure of the local enterprise and from the cheap national labour costs. On the other hand, the Vietnamese counterpart was benefiting from the accrued capital, high technology transfers, and American know-how. Therefore, the joint venture was rapidly granted with the licence to produce and distribute non-alcoholic drinks in the Vietnamese market. During its first year of functioning, the multinational invested more than US$ 2 million in bottling equipment. In three years, the subsidiary became the second biggest non-alcoholic beverage producer in Vietnam. It had only one competitor in the market: Vietnam Drinks Company, which was the national producer of all kinds of drinks and had its headquarters in Ho Chi Minh City.

The subsidiary is located in Haiphong, the third largest city in Vietnam after Ho Chi Minh and capital city of Hanoï. Haiphong is one of the three cities of the Northern economic triangle (Hanoi - Haiphong - Quangninh) and is very popular among foreign investors. CFB Co. management had chosen Haiphong for its economic dynamism and its accessibility to the sea, rail and air transport. Haiphong represents a main gateway by the sea to the Northern provinces of Vietnam, facilitating fluvial commercial exchanges not only with the whole country but also with neighbouring countries. The subsidiary's activities, its production, bottling factory, and administrative buildings, are all concentrated in one site situated at the Northern periphery of Haiphong. CFB Vietnam's primary mission was to produce exclusively for the national market, with an objective to export its products to neighbouring Asian countries over the next three years.

CFB CO. RESTRUCTURING IN 2000

At the end of 1999, CFB Co. started to lose money in all of its foreign operations. National and international competition grew in all markets and consumers became quality-oriented. Even though the company's main operations in the U.S were still profitable, the figures were declining significantly as compared to the 1998 levels. The modest profits from the U.S. plants were not enough to offset the losses reported abroad.

In 2000, U.S. headquarters analysed the situation and decided to undertake a radical strategic change. In order to reduce costs and achieve greater profits, the company's management decided to regroup its food and beverage production activities into three regional zones: United States, having its center in Chicago; Europe, with its regional center in Brussels; and Asia, with its center in Singapore. In other words, the subsidiaries which previously enjoyed exclusive rights in their respective local markets had to be integrated into "three regional networks: United States, Europe, and Asia".

This strategy was expected to allow CFB multinational to find synergies within these three regional zones and thus to assure a significant increase in revenues per region. For instance, CFB Co.'s management wants the Vietnamese subsidiary to export its non-alcoholic drinks to the whole Asian zone, helped by the distribution systems of other regional subsidiaries from Hong Kong and Singapore. It is therefore necessary to create and implement common distribution and communication strategies. The main objectives are to reduce costs, to increase revenues and to promote CFB Co.'s activities in the whole Asian region.

CHANGES IN EXPATRIATES' COMPENSATION POLICY IN 2002

Back in 1985, when CFB Co. started its international expansion, the company did not have any experience in the field of expatriation management. Since the initial stage of foreign growth strategy, only a small number of expatriates were used. Therefore, the Chicago management team opted for a flexible expatriate compensation approach: the negotiation method. According to this method, each expatriate is handled case by case; the components included in the compensation package represent the final outcome of negotiations between the expatriate and the company. Moreover, this compensation formula is beneficial due to its administrative simplicity, requiring little information on costs of living and tax issues in host countries. Over the years, however, the multinational company penetrated several European and Asian markets and, therefore, the number of its expatriates increased considerably. Hence, starting in 1998 CFB Co. employed constantly about 25 American expatriates. With increasing expatriation development, the negotiation method became less effective, more time consuming, and rather expensive. In order to keep its costs under control, CFB Co.'s senior management decided that a significant change in its current expatriate compensation philosophy would be needed.

In 2002, Chicago human resources department (HR), which manages the company's expatriates, adopted a new and mixed compensation approach. In light of this approach, different compensation systems are proposed to senior and junior expatriates. Seniors, expatriates having more than six years of international experience, are compensated according to the international method. In this case, a specific international scale is applied to all senior expatriates. During their expatriation period, senior expatriates are compensated using the international compensation scale and once they are back in their home countries, they reintegrate the standard national compensation scale. Expatriate juniors, having less than six years of international experience, are compensated in line with the home country method, which uses the balance sheet approach. According to this method, the parent company allows it's expatriate to make the same expenditures in terms of accommodation, goods and services in the host country as those that would have been incurred in the home country had the employee remained at home. Moreover, the company commits to maintain the purchasing power of its expatriates in the host country, making some adjustments to the home compensation package in order to balance additional expenditures in the host country due to a higher cost of living index. The key purpose of this approach is to ensure that expatriate employees are no better or worse off as a result of an international assignment.

The summary of important events in the evolution of CFB Co. is presented in table 1.

Table 1: Summary of important events in the evolution of CFB Co.

Year	Important event
1963	Creation of Chicago Food and Beverage Co., Chicago, United States
1963-1985	Expansion in United States, five American subsidiaries based in Chicago, New York, Atlanta, Los Angeles and Portland
1985	Beginning of the international adventure
1985-1990	Acquisition of three European local companies: Belgium, France, Germany
1991-1998 1991 1995 1998	Conquest of the Asian market: Joint venture Singapore; Joint venture Hong Kong; Joint venture Vietnam
1999	CFB Co.'s economic slowdown
2000	CFB Co.'s strategic change and restructuring: creation of three regional networks: United States – Europe – Asia
2002	Introduction of the new expatriates' compensation policy: the mixed compensation method
2004	Recruitment and expatriation of Paul Fierman to Haiphong (Vietnam)

PAUL FIERMAN'S EMPLOYMENT WITH CFB CO. AND HIS EXPATRIATION TO VIETNAM IN 2004

Paul Fierman, a 34-year-old American, was appointed General Director of CFB Vietnam at the end of March 2004, with a mission to lead the subsidiary and to implement the new organizational strategy.

Obtaining this expatriate position was not a difficult endeavour for Paul. In 1995 he earned his bachelor's degree in marketing from Johnson Business School, at Cornell University in New York. After graduation, Paul took a position as product vice-manager in the marketing department at the New York subsidiary of CFB Co. Three years later, he became carbonated non-alcoholic beverages' manager for the Eastern American region. After two years in this position, Paul was put in charge of both carbonated and non-carbonated non-alcoholic drinks in the U.S. market. As a country manager, he was paid US$ 300.000 annual base salary and 10% to 15% commission on sales. Although Paul was satisfied with his job, he wanted to reorient his career towards general management positions in this company. Therefore, in 2002 he decided to undertake a full-time Master in Business Administration studies in international management at Harvard Business School in Boston. After completing his MBA, Paul wanted to come back to CFB Co., but in order be able to reach the pinnacle of his career, he thought he needed to acquire some international professional experience. The only international experience he had so far was a year spent in Oxford, Great Britain, as an exchange program student.

Paul Fierman's employment for CFB Co. is summarized in table 2.

Table 2: Paul Fierman's professional evolution

Year	Professional evolution
1995	Bachelor's Degree in Marketing, Johnson Business School, Cornell University, New York; Recruitment by CFB Co., New York subsidiary, product vice-manager
1998	Regional product manager: Eastern U.S. markets, carbonated non-alcoholic beverages
2000	Country brand manager: U.S. markets, carbonated and non-carbonated non-alcoholic beverages
2002-2004	Master of business administration in international management, Harvard Business School, Boston
2004	Expatriation to Haiphong, Vietnam

During his M.B.A. studies, Paul kept in touch with his former supervisor at his first position within CFB Co., Allan Roger, marketing director of the New York subsidiary. Just before graduating from his M.B.A., Paul called Allan to discuss about his potential return to the company. Allan, very enthusiastic about this perspective, told him:

"Mike Shannon, the expatriate Managing Director of CFB Vietnam, has just returned to the U.S. unexpectedly due to health problems. Since Mike's departure was not planned, the headquarters are desperate to replace him as soon as possible. If you are interested, you can send me your application for the position of Managing Director in Haiphong, and I will forward it to the General Manager in Chicago. In my opinion, Paul, you have a high professional potential in this company. Your lack of international experience is a problem…, but it does not mean that you would not be able to prepare and implement, in collaboration with the regional director of Pacific Rim, the new strategy aiming at integrating the three Asian subsidiaries. This expatriation would be an exceptional training experience for you, preparing you for a higher level managing position within the Chicago headquarters on your return to the U.S., three years later."

With his experience within CFB Co. and his high recommendations, Paul Fierman was a good candidate for this three-year expatriate position. He was perceived as a promising young manager due to his excellent academic background and the outstanding professional results he achieved during his employment within the company.

At that point, things went very fast. In March 2004, thanks to Allan's intervention and contacts, Paul met directly with the General Manager in Chicago. Two weeks later, a notice of approval had been sent to Paul from the Chicago HR department, officially confirming his managing position within CFB Vietnam. Robert Greenberg, managing director in charge of the Pacific Asia region, had been informed about Paul's nomination by Chicago's General Manager himself. One month later, in April 2004, Paul began his new position in Haiphong. Before his departure he spent a couple of weeks preparing his move and organizing the rental of his house in New York. His wife Carrie and their seven-year-old daughter Rachel joined him two months later in Haiphong. These two extra months gave Carrie enough time to have her dismissal accepted by her employer. In the meantime, Paul settled into their new Vietnamese house and enrolled their daughter at Haiphong international school. Before his departure, Paul bought three books on Vietnam in order to get some preliminary knowledge about the general business context of the country. However, his readings on culture and the economic and political history of Vietnam seemed to be too disconnected from today's business reality.

One week before his arrival in Vietnam, Paul had a three hour meeting with Robert Greenberg in New York. Robert showed him the outlines of the corporate strategy aiming at creating synergies among the three Asian subsidiaries. Since then, they never spoke to each other directly anymore.

PAUL AND ARRIE'S FRUSTRATION SIX MONTHS AFTER THEIR ARRIVAL IN HAIPHONG

Six months after his arrival in Vietnam, Paul was feeling extremely frustrated. Sadly, he begins to explain to his wife Carrie:

"I have two big problems. My first one is related to the financial conditions of my expatriation contract. When I applied for this expatriation position in Vietnam, I expected to benefit from an excellent compensation offer, as all the other expatriates I had met before in the CFB Co. internal conferences had enjoyed. Although the final result of negotiations with the HR manager from headquarters varied from one expatriate to another, all of them were generally managing to negotiate at least double their previous salaries and lots of mobility, protection of purchasing power, accommodation, and hardship allowances. I thought that this expatriation to Vietnam would be not only a springboard for my career but also a good financial move. Unfortunately for me, the expected financial gain did not materialize. I am one of the five expatriates out of 25 who have less than six years of international experience. My compensation is therefore calculated according to the balance sheet approach. Of course, the cost of living in Haiphong is significantly lower than in New York and the company had provided me with a nice house and a good company car. Nevertheless, I feel upset and frustrated. The expatriates from other multinational companies that I met in Hanoi and Ho Chi Min City enjoy better living conditions. In addition, they live in far more attractive cities than Haiphong. As I am the only American expatriate in CFB Vietnam, I feel isolated and frustrated. Since my arrival in Haiphong, I have practically worked alone in order to make the things work. The expatriates from CFB Hong Kong and CFB Singapore subsidiaries are all seniors, they are paid according to a far more advantageous compensation scale, plus they are living in very modern cities where all the usual distractions Americans are accustomed to are available. Furthermore, these two Asian subsidiaries employ several expatriates who are all collaborating closely in order to achieve their objectives together. Between Hong Kong and Singapore, the expatriates are used to pay each other regular friendly visits. My own salary does not allow me to enjoy the week-ends that my counterparts from Hong Kong and Singapore are enjoying."

Carrie was not surprised. She had many times noticed the sad mood of her husband in the past few months… She encouraged him to continue. "What is your other problem?"

"My second problem is related to my work. I feel very frustrated by the results of my work in the subsidiary and the relationships I have with my Vietnamese colleagues. The financial situation of the subsidiary six months after my arrival is very bad: declining revenues, decreasing motivation of Vietnamese plant workers and staff, lack of cooperation on behalf of local management, etc. The implementation of the new organizational strategy is far from even getting off the ground! I have to handle all these problems alone. I have the impression that my work does not produce any of the expected results… What about you, Carrie, how do you feel?"

Carrie's situation was hardly encouraging. Carrie seemed to be getting more and more depressed and irritated. Before their departure from U.S., she had been starting her fourth year of employment at the New York Stock Exchange as a financial analyst. Even though she liked her job and had good prospects for advancement in her career, she seemed enthusiastic to accompany her husband to Vietnam for the entire expatriation period. Thus, she could spend more time with their daughter. Carrie collected her thoughts and her courage and replied to Paul:

"To me, who have never left the North American continent, Vietnam seemed to be an exotic country… and I thought, before our departure, that your expatriation would be a very new, enriching experience. However, this experience turns out to be hard to get through. Life here in Haiphong is not what I had imagined. Being used to work, I am getting bored staying home all day long. I also miss my family and friends whom we were used to visiting regularly in New York. Besides that, I have to admit that Haiphong's heat and humidity are really unbearable for me… And finally, I am also very worried for Rachel. The fact that she has arrived in the middle of the school year in the local Anglophone school prevents her from making any friends, as her classmates do not speak English outside the classroom. Rachel no longer wants to do her homework and cries every morning before going to school… We definitely cannot go on like this! What will we be doing, Paul? I hardly recognize our family, which is normally so happy."

SELECTED QUESTIONS FOR CASE DISCUSSION

Topic 1: Alignment of International Strategy and Headquarters' Orientation Regarding the International Hrm Policy

1. Which internationalisation strategies do you recognise in this case study?
2. What is the HRM orientation adopted by the headquarters? What comments can you make concerning this choice? What can you recommend to the company's headquarters in this sense?

Topic 2: Expatriation Management

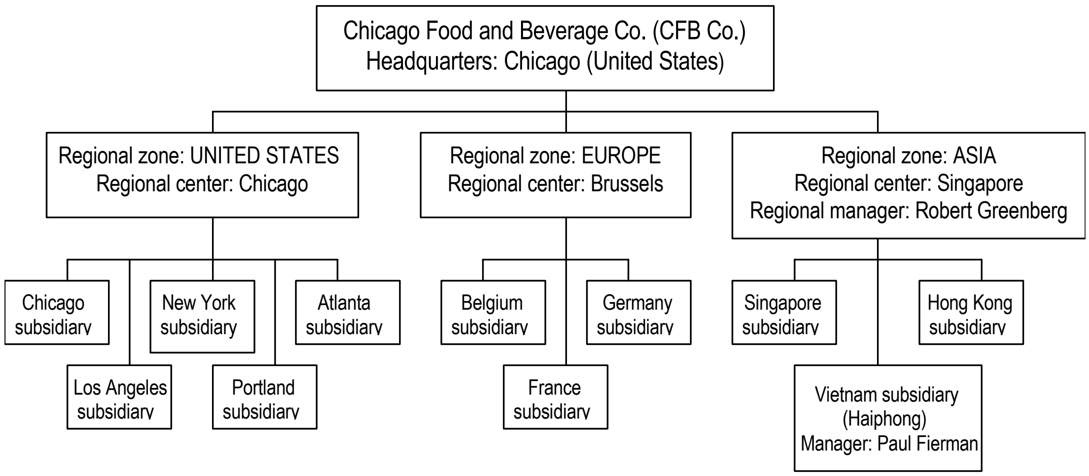
1. Is Paul Fierman a good candidate for this expatriation position?
2. What comments can you make on the expatriation management in general? And what comments can you make on the expatriate recruitment policy in particular?

Topic 3: Compensation of International Staff

1. What are the different expatriate compensation methods you recognised in the text? What are the advantages and disadvantages of these different expatriate compensation methods?
2. What do you suggest to the U.S. headquarters' human resources manager in order to improve the expatriate satisfaction / compensation?

Appendix 1
Map of South-East Asia

Appendix 2
Chicago Food and Beverage Co. organizational chart



Appendix 3
Compensation packages

Table 1: Annual compensation package of a junior expatriate employee: balance sheet approach

Employee: Paul Fierman
Position: General manager of CFB Vietnam
Country: Vietnam
Reason for relocation: New assignment
Effective date of change: 5April 2004

Item	Total amounts US$	Paid in US$	Paid in local currency VN dong
Base salary:	320,000	160,000	2602240000
Hardship allowance (20%)	64,000	64,000	
Trip allowance	25,000	25000	
Housing deduction	- 22,000	- 22,000	
Car deduction	- 5,000	- 5,000	
Tax equalization	- 43,200	- 43,200	
TOTAL	338,800	178,800	2602240000

Cost of leaving allowance index: Haiphong: 84; New York: 100
Exchange rate: US$ 1 = 16,264 VN dong

Table 2: Annual compensation package of a senior expatriate employee: international method

Employee:
Position: General manager
Country: Hong Kong
Effective date of change:

Item	Total amount (US$)	Paid in US$	Paid in local currency HK$
Base salary	400000	200000	1560000
Cost of living allowance	25000		195000
Overseas service premium (20%)	80000	80000	
Trip allowance	35000	35000	
Schooling allowance	10000	10000	
Taxprotection	50200	50200	
Housing and car provided			
TOTAL	600200	375200	1755000

Cost of living allowance index: Hong Kong: 110; New York: 100
Exchange rate: US$ 1 = HK$ 7.8

GETTING STARTED IN THE THOROUGHBRED HORSE BUSINESS: A REVIEW OF SOME BASIC ACCOUNTING PRINCIPLES

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CASE DESCRIPTION

This case, for beginning accounting students, reinforces some common accrual accounting concepts in an interesting setting. The body of the case is also available in CD version with a dramatized story and summaries of the data for students to refer to while answering the questions (to get a CD, contact the author directly). The key concepts include revenue and capital expenditures, product and period costs, profit and loss, cash flows, fixed assets and depreciation, inventory costing, indirect costs, cost allocation and cost of goods sold. Due to the concepts covered, it is appropriate to use during the second half of the course after students have been exposed to fixed assets, inventory, profit and loss and cash flow reporting. The case should take about 30 to 45 minutes of class time with about two hours of out-of-class preparation for each of the three sets of discussion questions.

CASE SYNOPSIS

The case centers on the breeding and racing operations of a small Thoroughbred horse business whose owner has little business or accounting knowledge. The business has two distinct operations, racing and breeding. Students discover that the Thoroughbred breeding industry is primarily a manufacturing business with the mares serving as production equipment and the foals serving as inventory. Racing operations are similar to many other businesses with fixed assets (racing stock) and operating costs (board, transportation, vets, race entry fees, jockey purses, etc.). In this case, the owner financed her operations with a large bank loan so the concept of cost allocation and indirect costs for interest are also introduced. Students are asked to identify the cash flows, list the product and period costs, recommend a depreciation policy for each operation and reconcile the cash flow to income.

Instructors are given sufficient background information on accounting and reporting issues in the Thoroughbred industry to allow adequate feedback and guidance to the students. Since most Thoroughbred horse business are not public companies, they primarily report on an income tax basis. Some basic, relevant tax issues are presented as background for instructors. Short summaries of the history of the Thoroughbred breed, naming foals and the Triple Crown of racing are provided for interest.

The case is also available on CD with a dramatized story line and appropriate data summaries for use by students (contact the author directly to obtain the CD from which copies can be made).

GETTING STARTED IN THE THOROUGHBRED HORSE BUSINESS: A REVIEW OF SOME BASIC ACCOUNTING PRINCIPLES

Over dinner, Carol and her former college roommate Gina were discussing their lives and interests since college. Both had grown up in the Bluegrass Region of central Kentucky. Carol had pursued her CPA career in Chicago and had recently returned to Lexington to take another accounting job. Gina, meanwhile, had worked in advertising for a local agency while trying to pursue her real interest – Thoroughbred horses. She already owned several Thoroughbreds and had been doing some limited breeding and racing. In January 2005, Gina was seriously considering leaving her marketing career and becoming a full time Thoroughbred breeder and trainer.

"Gina, why did you want to get involved in the horse business? I thought that your interest was advertising." asked Carol.

"Carol, if I have to tell you, you probably won't understand anyway" teased Gina. "Really, though, the satisfaction comes from daily interaction with high-strung and sensitive animals plus seeing the beauty and grace of one of the world's fastest animals. All Thoroughbreds are descended from Arabian and Turkish racing breeds. Even though they can only hold their top speed for about one-quarter of a mile, they can exceed 40 miles per hour for a mile or more. There's a reason why The Kentucky Derby is called the fastest two minutes in sports!" [See Appendix B: History of the Thoroughbred Horse]

"And", continued Gina, "The business aspects of it are also a challenge since a lot of people can't make it in this industry. There's a saying in the Thoroughbred business: The only way to end up with $1 million in the Thoroughbred horse business is to start with $10 million! With boarding costs running from $30 to $40 per day and training costs averaging $75 a day, you can see that you need a lot of money just for daily operations. Also, vet costs average about $300 a month even for healthy horses and I'm paying around $100 a month to the blacksmith for each horse."

"So your goal is to win the Kentucky Derby and make a lot of money?" quizzed Carol.

"No, on either count", laughed Gina. "Only a few big-time, select breeders and trainers reach the performance level of the Kentucky Derby although everybody hopes to breed the next Secretariat. That's very expensive company to keep. Although every breeder and owner secretly hopes that will happen, realistically, it won't. Many Thoroughbreds never race at a distance beyond one mile and all of the Triple Crown races are longer than that." [See Appendix D: The Triple Crown of Racing]

"My racer, Rockin' Robin's best distance is about eight furlongs, which is one mile. Actually, he did quite well at that distance in 2004 which was his first racing season. Although his previous owner did some training, we didn't start our training until early January. He raced for the first time in May and finished first or second in all five of his starts. Here's a list of his finishes and purse amounts. [See Appendix A: Race Results]. Race payoffs are called "purses" since, in the very early days of racing, the winning money was hung in a purse at the finish line and the winning jockey took it all. In modern racing, the winner gets about 60% of the purse, 2nd place gets 20%, 3rd gets 12%, 4th gets 6% and 5th gets about 2%."

"Let's see if I understand all of this" interjected Carol. "'TR' must mean 'track' and I'm guessing that CD means Churchill Downs and KEE means Keeneland. Right?"

"You know more about racing than you've admitted", laughed Gina.

Carol continued: "He's raced at distances from 6 ½ to 8 furlongs. Since you said that 8 furlongs is a mile, his best distance is between three-fourths and one mile. 'TR Cond' must mean track conditions. What do 'FP' and 'TF' mean?"

Gina explained: "FP means finish position and TF means total horses in the field. Look at September 4. Robin finished first out of seven horses. The total purse was $56,000. As winner, we got 60% of that amount. You can see that with his five first or second place finishes last year, we've gotten a pretty good return on our $200,000 investment."

"One last explanation here", said Carol. "I don't understand the lingo under 'Race type'."

"That's one of the most confusing parts of this business since there are so many different race types. It takes a trainer with a lot of experience to know what's best for your horse," explained Gina. "Horses who have never won a race are called Maidens and there are special races for them. As you can see, Robin's first two races were Maiden races."

Gina continued: "Allowance races permit some horses to carry less weight than others based on their racing history. Colts (males) can't carry over 126 pounds and fillies (females) can't carry over 121 pounds including the jockey's weight. Stakes races are the most prestigious ones and, as a result, pay the most money and attract the best horses. We were really lucky to win that stakes race in December. Everything broke right for us that day!"

"How big can the race purses get?" asked Carol.

"As your horse improves, you want to move up in class to race for larger purses. Last year Robin moved up from a purse of $47,000 in May to $100,000 in December" replied Gina. "That's probably about as high as we'll get. But, if you're talking about the highest levels of racing, the Preakness and Belmont Stakes are over $1 million and the Kentucky Derby purse is now well over $2 million."

"It looks like you made some good money in racing last year" observed Carol.

Gina countered: "Well, we had five good payoffs but there are a lot of expenses involved with racing beyond the training costs. It's common in this business for the trainer and jockey to split 20% of the winnings and the stable where Robin boards gets 3%. Also, we paid about $2500 in race entry fees and spent about $1200 on transportation to the races."

"When's Robin's next race?" asked Carol. "I can't wait to see him in action!"

"Well, there may not be another race for Robin. I'm considering selling him and concentrate on the breeding operations", replied Gina. "It's a different type of business that I find more satisfying and I also think it's where I can make the most money. We've been lucky with Robin's racing career; he's done well as a two-year old. But, generally, there's as much as a five-year lag before you get any racing revenue if you breed and train your own racing stock. Most Thoroughbreds don't do a whole lot of racing until they are three-year olds."

"Oh, I didn't know that you were also doing some breeding. That sounds intriguing. Tell me about it" said Carol.

"In late 2003, I bought a four-year old mare, Lady Delight, for $300,000. She was 'in-foal' which means she was pregnant. The foal, Dan D Dancer, was born in March 2004 and he's now a yearling. I bred Lady Delight again last year and that foal is due in March", explained Gina.

"Can you explain the age designations for Thoroughbreds? I've never understood that whole thing" asked Carol.

"For racing and breeding, all thoroughbreds have the same birthday – January 1", explained Gina. "At birth (called foaling), all thoroughbreds are called foals until they're weaned at about four to five months. They're then called weanlings until their first January 1 when they become yearlings. After their second January 1, they are called two-year olds and so forth. Breeders time their mares to give birth early in the year which is why breeding season is February through April. They want the foals to be as old as possible by their first January 1. For example, The Kentucky Derby is the premiere race for three-year olds. For that race, colts and fillies born in January (three years earlier) will have three to four extra months of maturing and training over foals born later in the spring of that year. That's a big advantage!"

"What stallion did you breed to Lady Delight? And, isn't that expensive?" asked Carol.
"Very successful stallions, like Empire Maker (winner of the 2003 Belmont Stakes), get a $100,000 breeding fee. Storm Cat, one of the strongest sires in history gets $500,000! Obviously, I had to spend a lot less than that and paid $26,500 for a decent, local stallion. Most breeding contracts guarantee that the foal will be born alive, stand on its own and nurse or else the fee is waived." explained Gina.

"Okay, you own a pregnant mare and a foal, oh sorry! a yearling. I guess the vet bills go up during foaling, right?" queried Carol.

"Yes, but not as much as you might think. If everything goes okay, which ours did, you can get by for about an extra $500. But, of course, now you have another horse incurring daily boarding fees and monthly vet costs", continued Gina. "The only break here is that before they're weaned, daily boarding costs are only $15 since the foals share a stall with their mother."

She continued: "We'll take Dan D to this summer's auctions. In March, we'll start the whole process over again when the second foal is due. The goal is to make enough money on one or two foals to expand the breeding operation by buying more mares. Eventually, if you do really well, you can buy your own farm and expand the breeding even more. Many farms board other people's horses to pay the bills while they wait for the bigger payoffs from breeding. As you've figured out, I'm boarding my horses on someone else's farm since I don't own a farm yet!"

Carol returned to an earlier topic: "So, you need to make enough from selling Rockin' Robin and Dan D Dancer to finance another mare. Is that possible? How much can you get for Robin and Dan D?"

"Since the auctions aren't always predictable, I really wasn't counting on Dan D so much. I was hoping to make enough on Robin to pay back part of the loan and buy a new mare", replied Gina. "Based on early conversations with other owners, we think he'll bring around $750,000".

"Wow, you're rich!" exclaimed Carol. "Do you need a partner?"

"Not so fast" cautioned Gina. "From that price I've got to pay a 10% agent's commission, a 5% trainer's commission and sales entry and prep fees of about $3000. I don't get to keep all of it."

"Now that I know a little more about Thoroughbred horses, let's talk about you making money in this business", said Carol. "You said you wanted to get out of racing and concentrate on breeding. So, you must have run the numbers on each activity and picked the one with the biggest return. Right?"

"Okay, you caught me" laughed Gina. "I didn't keep very good records but I think that I did okay overall. At least I was able to pay my bills every month."

"Thank you for not asking" continued Gina, "But as you know, I didn't really have the kind of money needed to get started in this business. It helps to have relatives in the banking business and to have good co-signers for a loan. I borrowed $500,000 early last year to finance my horse operations. The previous owners of Rockin' Robin and the mare let me delay payment to them until the loan came through."

"You're making payments on debt of $500,000?" asked Carol. "You have to be making a lot of money!"

"Actually, it's a demand loan so I'm only paying the interest right now" countered Gina. "The interest is prime plus 4%, payable quarterly."

"You know, Gina, if you knew a good CPA, they'd be able to tell you whether you made or lost money on your breeding and racing operations. Yes, if you only knew a CPA that could help you" mused Carol.

Discussion Questions – Part I: Racing Operations – cash flows, profit/ loss, capital expenditures, depreciation, gross profit, net profit.

You are a CPA advisor helping Gina determine her financial success in the racing part of her business. Provide complete responses to the following items.

1. Discuss, in general, the different ways that a business owner might determine how well their business has performed.

2. Compute Gina's cash inflows and outflows from the racing operations for last year (2004). Show each inflow and outflow separately.

3. Using accrual accounting, identify the types of revenues and costs related to Gina's racing operations. Classify each of the costs as either a capital expenditure or revenue expenditure (expense). Explain your answers.

4. Explain how the capital expenditures identified in answer I-3 would be treated for accounting purposes in the current and future years. Include an estimate of how much of each of the capital expenditures should be expensed in 2004. Be specific

5. Compute Gina's accrual accounting income or loss from the racing operations for last year. Prepare a detailed income statement. Present any supporting calculations that are needed.

6. In general, do cash flows equal accounting income or loss? Why or why not? Reconcile (explain the differences) your answers from questions I-2 and I-5.

7. If Gina sells Rockin' Robin in July 2005 for $750,000, compute her gross and net profit on the sale. Show any supporting calculations.

Discussion Questions – Part II: Breeding Operations – cash flows, profit/ loss, capital expenditures, depreciation, gross profit, net profit.

1. Compute Gina's cash inflows and outflows from the breeding operations for last year (2004). Show each inflow and outflow separately.

2. Using accrual accounting, identify the types of revenue and costs related to Gina's breeding operations. Classify each of the costs as either a capital expenditure or revenue expenditure (expense). Explain your answers.

3. Explain how the capital expenditures identified in answer II-2 would be treated for accounting purposes in the current and future years. Include an estimate of how much of each of the capital expenditures should be expensed in 2004. Be specific.

4. Compute Gina's accrual accounting income or loss from the breeding operations for last year. Prepare a detailed income statement. Present any supporting calculations that are needed.

5. Reconcile (explain the differences) between your answers in 1 and 4.

Discussion Questions – Part III: Combined Operations – profit/ loss, expense classification.

1. Compute Gina's overall, combined income or loss from her Thoroughbred horse operations for last year (2004). Prepare a detailed income statement showing the separate types of revenue and expenses (e.g. operating, non-operating, etc). Present any supporting computations that are needed.

2. Make a recommendation to Gina concerning the future of her racing and breeding operations. Make suggestions as to which activities to continue pursuing versus those activities to stop doing. Consider other criteria besides cash flows and profit or loss.

APPENDIX A

Race Results – Rockin' Robin 2004

Horse	Race	Date	TR	Race type	Dist	TR Cond	Jockey	FP/TF	Purse
Rockin' Robin (2002) b.c. Into training oct 03	1	04 May 02	CD	Maiden-Special Weight	6.5f	Fast	K. Rider	2/6	47,000
	2	06 July 02	CD	Maiden-Special Weight	8f	Fast	K. Rider	1/7	47,000
	3	04 Sept 02	TP	Allowance	8f	Fast	K. Rider	1/7	56,000
	4	15 Oct 02	KEE	Listed Race	8f	Fast	K. Rider	2/8	65,000
	5	01 Dec 02	CD	Stakes Race	8f	Fast	K. Rider	1/8	100,000

b. c. – bay colt
Tracks: CD – Churchill Downs; TP – Turfland Park; KEE – Keeneland
Distance: f – furlong (1 furlong = 1/8 mile)

APPENDIX B
History of the Thoroughbred Horse

The Thoroughbred breed of horse traces its ancestry back more than 300 years to three foundation stallions - the Darley Arabian, the Godolphin Arabian and the Byerly Turk. These stallions were imported to England from the Mediterranean Middle East around the turn of the 17th century and bred to the stronger, but less precocious, native mares. The result was an animal which could carry weight with sustained speed over extended distances.

In height, the Thoroughbred averages a little over 16 hands (1 hand = 4 inches) to the withers and weighs approximately 1,000 pounds. The Thoroughbred's conformation, or physical makeup, enables it to reach speeds up to 40 miles per hour. At that rate, the Thoroughbred covers nearly 60 feet per second.

The Thoroughbred's rear legs act much like springs as they bend and straighten during running. This tremendous "spring power" helps thrust the Thoroughbred forward as its front legs provide "pull." The head and long neck also help to make running smooth and rhythmic. The neck moves in synchrony with the forelegs, aiding the Thoroughbred in its forward motion and extending the "arc of flight" - the time the Thoroughbred literally is airborne.

Blessed with agility, grace, speed, stamina and courage, Thoroughbreds are ideally suited for any number of disciplines beyond the racetrack. Thoroughbreds compete at the highest levels of international competition in eventing, show jumping and dressage, and also make outstanding hunters, steeplechasers, barrel racers and polo mounts. They are also used by mounted police patrols and recreational riders who appreciate their intelligence and versatility. (Source: The Jockey Club).

APPENDIX C
Naming Thoroughbreds

Before choosing a name, owners send their proposed names to the Jockey Club. The name is checked for similarity against their registry of over 430,000 names and compliance with the 15 rules governing names including such rules as less than 18 characters and no business or suggestive meanings.

Many names are derived from personal and pop culture connections. However, the most popular naming technique is through incorporating name combinations or some other reference to the foal’s pedigree. For example: Alphabet Soup (out of the mare Illiterate), Flat Fleet Feet (by Afleet out of Czar Dancer) and Prenup (by Smarten out of Homewrecker). (Source: The Jockey Club).

APPENDIX D
Triple Crown of Racing

This series of three premiere races for three-year old Thoroughbreds begins with the Kentucky Derby which is run over 1 ¼ miles at Churchhill Downs on the fist Saturday in May. The second leg is the Preakness Stakes which is run two weeks later over the 1 3/16 mile course at Pimlico. Three weeks later is the final leg, the Belmont Stakes run over a 1 ½ course at Belmont Park. This final race is referred to as "the test of champions" since this is the longest distance that Thoroughbreds will ever race.

Sir Barton (1919) was the first of 11 triple-crown winners. The most recent winner, Affirmed, accomplished that difficult feat in 1978.
(Source: The Bloodhorse).

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. DEVELOPING A STRATEGIC NEGOTIATION PLAN: TOYOTA HIGHLANDER

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CASE DESCRIPTION

The primary subject matter of this case concerns the evaluation of gathered information to develop a negotiation plan prior to a consumer's purchase of a sport utility vehicle. Secondary issues examined include the sales process and the increasing role of the Internet in consumers' information search activities. The case has a difficulty level of one (appropriate for freshman level courses) although it may be used through level five (appropriate for first year graduate level) depending on the amount and complexity of background reading assigned. The case is designed to be taught in as little as one class hour, but may be expanded to as many as three class hours depending on the amount of theoretical material discussed by the instructor, if role-play negotiations are carried out, and whether any out-of-class preparations are assigned. The case is expected to require from zero to approximately four hours of outside preparation by students.

CASE SYNOPSIS

Introducing students to the topic of sales negotiation is always challenging. While it is typically a significant part of business-to-business purchases and many higher-ticket priced consumer goods, negative word-of-mouth and uncomfortable personal experiences leave many students apprehensive. Presenting the topic in the context of purchasing an automobile, or in this case study, negotiating the purchase of two sport utility vehicles, students will draw on their own experiences, those of their friends and family members, and any assigned readings. The overall goals of the case are to defuse the anxiety many students associate with negotiation, underscore the importance of analysis and planning prior to face-to-face encounters, and better prepare students for future business and personal purchase situations where negotiation is a factor. Specifically, in this case students examine collected price and non-price information, and develop a negotiation plan. Through this task the instructor may explore various fundamental aspects of negotiation (e.g., agenda analysis, concession strategies) and the distributive bargaining model (e.g., aspiration targets, reservation points, buyer and seller surplus).

INTRODUCTION

As Michelle Tipton read through the brochure for what seemed the tenth time she found herself nodding in agreement. "The new Highlander. An unexpected bit of comfort in the rugged world of the SUV. Breaking new ground is nothing new to Toyota, but this time around, we've built a vehicle that boldly redefines everything you've come to expect from a sport utility vehicle. Highlander gives you uncommon comfort and unparalleled smoothness in an unmistakable form. It's designed for those drivers who crave the versatility and space of an SUV, but aren't willing to sacrifice a refined, comfortable ride. With exceptionally smooth handling, clean, unique styling and a spacious interior, Highlander is the civilized ride you've been looking for." (Toyota Internet Website and Highlander brochure).

After months of investigating, Michelle knew that this was the vehicle she wanted. Sifting through piles of Car and Driver, Auto Week, and Consumer Reports magazines, visiting websites for Acura, Subaru, BMW, and Honda brands among others, convinced her that this was the vehicle for her. Now the question was how to get the best deal from one of the local Toyota dealerships in the Louisville metropolitan area. Located in the city were Toyota of Louisville and Oxmoor Toyota. Just across the river in Southern Indiana was Green Tree Toyota. Because of negative comments and stories she had heard about Oxmoor Toyota, Michelle decided to limit her dealership choice to either Toyota of Louisville or Green Tree Toyota.

An unexpected twist in Michelle's deliberations came when one of her colleagues at work, Ashley Lacey, dropped by her office one day and told her that she and her husband Robert were also looking for a new sport utility vehicle for their family, which included their nine year-old daughter Alex and one good size Labrador retriever. After talking for a while concerning what Michelle had discovered in her research, and about a week after she loaned Ashley all of the information she had collected on various models, Ashley came back and told her that she and Robert were convinced the Highlander was the vehicle that was right for them.

Further discussions between the two parties discovered that with the exception of the choice of exterior color, they both wanted virtually identical models and accessories. Both Michelle and the Lacey family wanted the 6-cylinder, four wheel drive model, with a significant number of options. In Michelle's case she would be able to purchase the vehicle outright, trading in her low mileage 1992 Honda Accord LX. With the Lacey's however, they would be keeping their current car and financing the purchase beyond a $5,000 down payment.

Both Ms. Tipton and the Lacey's knew that if they went to the dealerships together with the intent of buying two vehicles as a package deal, it would be a different, or at least unusual, situation that the salespeople didn't see too often. They hoped that it would allow them to get a better overall price.

Through various online sources, Michelle has been able to find not only the Manufacturer's Suggested Retail Price (MSRP), which typically served as the high end or full price benchmark for consumers, but also wholesale prices. These wholesale prices represent the amount the car dealership paid for the vehicle, excluding any givebacks or other incentives provided by the manufacturer. Michelle's further investigation indicated that there were no other incentives provided to the dealerships for sales of the Highlander model. As she sat at the kitchen table with the Lacey's and with the financial information spread out before them, they knew they had a number of decisions to make and questions to answer in putting together their negotiation plan before they approached the dealerships.

Exhibit 1		
Used car information for 1992 Honda Accord LX		
Source	Trade-in to dealer	Retail price sold by dealer
Kelley Blue Book	$4,575	$7,600
Edmunds	$4,977	$6,708
Consumer Reports	$4,775	$7,365

Exhibit 2				
Toyota Highlander – Base Vehicle Costs and Options				
MSRP	Wholesale	Model and Engineering Options	Michelle Tipton	Lacey Family
$24,390	$21,761	4 door sport utility with base engine	No	No
25,790	23,007	4 door, 4 wheel drive sport utility with base engine	Yes	Yes
1,580	1,407	3.0 Liter, 6 cylinder 220 hp	Yes	Yes
650	559	Vehicle skid control	Yes	Yes
MSRP	Wholesale	Exterior Options	Michelle Tipton	Lacey Family
$699	$455	Fender Flares	No	No
310	248	Glass, deep tinted	No	No
102	61	Hood protector	Yes	Yes
220	176	Luggage rack	Yes	Yes
80	64	Mud guards	Yes	Yes
625	405	Running boards	No	Yes
334	200	Rear spoiler	Yes	Yes

Exhibit 2				
Toyota Highlander – Base Vehicle Costs and Options				
MSRP	Wholesale	Model and Engineering Options	Michelle Tipton	Lacey Family
900	720	Power sunroof	Yes	Yes
MSRP	Wholesale	Interior, Security, Safety, and Miscellaneous Options	Michelle Tipton	Lacey Family
$379	$235	Molded wood dash	No	No
90	58	All weather floor mats	Yes	Yes
$147	$88	Glass breakage sensor	No	No
309	185	VIP security system	No	No
250	215	Side impact air bags	Yes	Yes
40	32	Daytime running lights	Yes	Yes
30	24	Outside heated mirrors	Yes	Yes
400	352	Heated seats	Yes	Yes
200	150	Premium sound package with CD changer	Yes	Yes
520	416	16” aluminum wheels	Yes	Yes

QUESTIONS TO ANSWER

1. What should Michelle and the Laceys' negotiation strategy be? (e.g. how much information to share concerning where they are in the buying process, that there is a vehicle trade-in, that they are looking at other dealerships as well, that they have wholesale price information from Internet sources, whether and how much deception is ethical/allowable, etc.)
2. What do you expect the behavior of the sales people to be when Michelle and the Laceys visit the Toyota dealerships?
3. Develop a negotiation plan (i.e. characteristics of opening offer, reservation price, tactics, tradeoffs they should make, how to react if the seller brings up issues before you are ready to discuss them, e.g. whether you have a trade in vehicle, etc.). What would your Plan B be if your original plan becomes untenable?
4. What do you believe the salespersons' negotiation plan will be? How can you determine what their plan is?

CONFLICT MANAGEMENT: THE TEAM NEW ZEALAND CASE

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CASE DESCRIPTION

The primary subject matter of this case is the effectiveness of risk management strategies associated with the staging of a major international sporting event. A secondary issue examined in the case concerns the proprietary rights of employers to the intellectual capital and skills acquired by employees. The case requires an understanding of strategic risk management and good corporate governance principles.

This case has a difficulty level that makes it most suitable for senior level students in a Corporate Governance/Business Ethics course. The case is designed to be taught in three class hours and would require about eight hours of out-of-class time which includes reading the case material and the articles listed in the references.

CASE SYNOPSIS

Team New Zealand (TNZ) is a syndicate that specialised in defending the title to a major international sporting event, the America's Cup Yacht Challenge (America's Cup). The America's Cup is on a comparable level with Formula One motor racing. Title to the America's Cup is usually challenged and defended in the home waters of the title-holder nation. The implications for the title-holder's national economy are significant and positive, particularly for its tourism and boat-building industries. In early March 2000, TNZ successfully defended its title to the America's Cup. By the end of March the contracts of all TNZ team members had expired and the sailors and boat designers were facing an uncertain future. The yacht skipper, the tactician, and four other long-time sailors, all unbeaten in two America's Cup Yacht Challenges, joined a competitor syndicate, the Swiss challenger, Alinghi. As well as their considerable crewing ability, these ex-TNZ team members took with them considerable knowledge of the design of the 2000 America's Cup winning boat. TNZ was left without an overall leader responsible for balancing the needs of boat development and sailing. The TNZ syndicate failed in its defense of the America's Cup in the 2003 Challenge, losing all races in a series of five to Alinghi.

This case focuses on some of the many challenges encountered by management of the TNZ syndicate in mounting their defense in a highly competitive environment, and their ability to choose the appropriate organisational structure and personnel necessary to meet those challenges. The *initial task for the student is to review the current organisational structure of the managing syndicate along with the challenges and opportunities it faces. Students can then use the details provided in the case information and references to develop risk management and corporate governance strategies for success in an environment characterised by uncertainty.*

BACKGROUND

Since the America's Cup challenge commenced in 1851, it has been traditional that the defender faces the challenger in its own home waters. In 1995, the Team New Zealand (TNZ) syndicate successfully competed in the America's Cup Yacht Challenge held in San Diego, USA. This resulted in the transfer of the challenge to the new title-holder's home waters – the Waitemata Harbour in Auckland, New Zealand, where the home team successfully defended the title in 2000. The economic implications for the title-holders' national economy of mounting the America's Cup defense are generally considered to be positive. For instance 160 cities responded to the request for proposals to host the America's Cup defense on behalf of Switzerland which does not have an appropriate site to stage the open water ocean sailing matches that make up America's Cup racing (http://www.cupinfo, 2005). The economic implications may not be so positive for the owners of the defender rights. Mounting a defender series is an expensive undertaking as it involves many challenge races over a prolonged period of time. It has the potential to 'divide resources, tax sponsors and create division in a small country' (The National Business Review, 2003). Further, the beneficial ownership of the TNZ syndicate (a Trust) was not clear, and whether the trustees actually desired to hold a defender series was questioned and debated vigorously in the popular press (The National Business Review, 2003).

The following are a series of events and strategic decisions that shaped the planning and organisation for the 2003 America's Cup defense by TNZ.

CONFLICT OF INTEREST

Following the win by TNZ in 2000, protracted discussions about management succession for the 2003 America's Cup Yacht Challenge failed. Two key team members - the skipper of the yacht Russell Coutts, and the race tactician Brad Butterworth, had been negotiating for the transfer to them, from outgoing syndicate trustees, of control of companies connected with match events. Butterworth subsequently repeated claims that TNZ trustees and sponsors were to blame for the departure of him and Coutts. He said that a 12-month moratorium imposed on signing new sponsors after TNZ's win in 2000 was "one of the parts of the deal we found impossible to live with" (The New Zealand Herald, 9 March 2003).

"As you've seen with this Cup there's a lot of excitement and corporate interest around and that's the time to forge these relationships and get these companies that see they could get a bang for their buck out of it. But when you don't have the facility to move and you don't have any rights it's impossible. You can talk to them but you've got nothing to sell." (The New Zealand Herald, 9 March 2003).

Butterworth also said that the sponsors and trustees "did us a great favour by pushing us out into the world" as they (Butterworths and Coutts) hadn't realised they could earn such good money by leaving TNZ. The trustees were in disbelief according to Butterworth. He said of the trustees "they even thought several weeks later that we wouldn't go through with it and that was the arrogance of them."

By the end of March 2000, the contracts of all team members had expired and the TNZ managing syndicate abruptly changed the access of the team members to the yacht-base. All team members found themselves locked out of the base and facing an uncertain future. As a result of the conflict the TNZ managing syndicate failed to secure the existing team as an ongoing operation. Coutts, Butterworth and four other highly experienced sailors, all of whom were unbeaten in two previous America's Cup challenges decided to join a competitor syndicate, the Swiss team, Alinghi. Thus, TNZ was left without an overall leader responsible for balancing the demands of boat development and sailing needs.

Subsequently Dean Barker, also a team member in the successful 2000 challenge, skippered the TNZ sailing crew in the 2003 defense. Barker's crew comprised a number of very experienced sailors, but they generally lacked experience in successful America's Cup challenges. The TNZ syndicate failed in its defense of the America's Cup in the 2003 challenge, losing all races in a series of five to Alinghi.

Conflicts are a common facet of life in many organisations. The key to successful conflict management is the strategies and systems that are put in place to manage and resolve conflict, to determine the nature of disclosures made, and to make judgments when balancing competing interests (Jennings, 2004).

STRATEGIC MANAGEMENT AND CORPORATE GOVERNANCE

In assessing the strategic management of risk and corporate governance principles, a number of important issues need to be considered by the student. These include the organisation's management structure, the personalities involved and their accumulated experience, and the management strategies put in place.

A charitable trust structure (Team New Zealand Trust) controlled all TNZ entities. These included two separate companies; one responsible for defending the America's Cup and another company responsible for organising the America's Cup Yacht Challenge. Team members Coutts and

Butterworth wanted to take over responsibility for running the company involved with the America's Cup defense but could not reach agreement with the existing trustees. Legal counsel engaged by Coutts and Butterworth was unable to make significant progress with the TNZ trustees. The trustees "would not agree to any arrangement which involved the existing trustees being replaced… and that a new structure would have to be established, existing assets sold to it and several million dollars of discretionary debt paid to the existing sponsors" (Sailing World, 2003 (Ed.)). After more than two years of, at times acrimonious discussion, and a matter of weeks after TNZ won the America's Cup in 2000, the negotiations failed. Subsequently Coutts and Butterworth left TNZ and joined the competitor team, Alinghi (Switzerland).

The TNZ trust structure remained intact after the departure of Coutts and Butterworth and a number of new trustees were appointed in place of some outgoing trustees. Three individuals with specific, self-contained areas of operational responsibility (for sailing, administration, and boat design) were appointed. These individuals reported to a four-person board of directors. A critical missing element in this structure was a managing director with overarching knowledge and responsibility for organising and financing the match and defending the Cup.

The inability of TNZ management to successfully resolve a conflict of interest with two key personnel (the experienced skipper Russell Coutts, and the tactician Brad Butterworth), was a significant factor in Team New Zealand's failure to defend the America's Cup in the 2003 challenge matches. The presence of these two in the ranks of the winning team Alinghi (the Swiss competitor) was a crucial difference in Alinghi building a cup-winning team from a zero-base, in the same preparation time that team New Zealand had. The personnel departures also played a part in Team New Zealand believing that it had to take a major step forward in boat design.

Shortly after the loss of the America's Cup in 2003, TNZ released a report on the Trust's unsuccessful management of the event. In many respects the report was damning of the management strategies that were adopted and a clear link was drawn between management failure and the loss of the America's Cup. "Team New Zealand has admitted that the management structure they adopted after the sudden departure of Coutts and Butterworth cost them the America's Cup" (The New Zealand Herald, 6 May 2003). The manager's decision-making world is most often imperfect and is subject to limitations on information processing capacity, risk and uncertainty. Faced with a complex environment managers often use simplifying strategies (heuristics) for decision-making. An awareness of heuristics and their potential biases can help to improve decision-making capabilities. The TNZ report said that the most critical weakness was that no single individual had a total overview of where the team was at, or final responsibility and authority over decision making. An overarching management structure that ensured the transparency and transfer of vital information, and an overall understanding of project risk were missing elements in the TNZ 2003 cup defense.

"Corporate governance refers to the method by which an organisation is governed, administered, directed or controlled, and the goals for which it is governed" (Dellaportas et al., 2005). A good corporate governance structure such as that envisaged under the Sarbanes-Oxley Act, outlines the rules and responsibilities of participants involved in governing an organisation, improves the accuracy and reliability of disclosures made, and should lead to goal congruence between managers and stakeholders. Corporate governance models introduce controls designed to reconcile conflicts of interest between managers and stakeholders. If TNZ had a sound corporate governance structure in place, management objectives would have been transparent and the prolonged conflict with key personnel may have been avoided. A sound corporate governance system may have aided in retaining the experienced crew and avoided a clearly flawed design-led, uncoordinated and unclear management strategy.

A DESIGN-LED DEFENSE STRATEGY

Shortly after the 2000 win of the America's Cup the employment contracts of TNZ personnel expired. Some sailors and designers began accepting contracts with other organisations. Two months later the yacht skipper and the tactician also formally left TNZ to join a competitor syndicate, the Swiss challenger, Alinghi. Thus not only did TNZ adopt a weak management structure, it also lost critical talent who took with them their considerable crewing ability and invaluable intellectual capital by way of their knowledge of the design of the 2000 America's Cup winning boat.

TNZ was left with the need to have a faster boat to counter the loss of intellectual capital. The TNZ design team determined that to be competitive in 2003 they had to take a major step forward in boat design. They worked on a number of revolutionary concepts and eventually chose a radically new design for the team's 2003 training and racing boats. Thus TNZ mounted a design-led campaign for the 2003 challenge. The process of becoming design-led was gradual and design was able to dominate through the absence of an overall leader responsible for balancing the demands of boat development and sailing needs.

The TNZ boat-builder Mick Cookson, who also built TNZ's 2000 cup-winning yacht, warned the trustees of flaws in the structures of their America's Cup boats months before the 2003 races series commenced, but was ignored. Cookson twice raised his concerns about the structural elements of the boats with TNZ designers. Problems with the training boat were experienced during pre-match testing, and the boat suffered crippling hull and deck structural damage, in the areas that Cookson had predicted, in the months leading up to the races. The damage to the *training* boat meant that TNZ had nothing to trial their *race* boat against and this undermined their confidence in the race boat. It was clear that the crew had little confidence in their boat especially after the crippling structural damage to the training boat in the two months prior to the races comprising the 2003 challenge.

Furthermore, the delivery of the boats was late (possibly due to the complexity of the design). This meant the testing and training period was severely reduced and race preparation was inadequate. A consequence of the equipment failure on the training boat was that the race boat was never tested in the extreme conditions that prevailed during the five races comprising the actual match. As a result the TNZ boat failed to finish two of the five match races through equipment failure.

SUMMARY

The conflict of interest between the TNZ management syndicate and key team members was critical. Acknowledgment of the conflict, and early, clear and on-going disclosure of management intent may have been useful in resolving the conflict. Such a process is an integral component of good corporate governance. Poor management of the conflict meant that the interests of the two parties became too much at variance and eventually irreconcilable. Subsequent risk management action including the adoption of a design-led strategy stemmed from the inability of the two parties to resolve their conflict.

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RYANAIR (2005): SUCCESSFUL LOW COST LEADERSHIP

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CASE DESCRIPTION

The primary subject matter of this case concerns strategic management in the airline industry in Europe. Secondary issues examined include international marketing, operations management and business ethics. The case has a difficulty level of four or five, and the case is designed to be taught in one 90-minute class session. It is expected that students will need to devote three to four hours of outside preparation for the class discussion.

CASE SYNOPSIS

Ryanair is a 20-year-old international air carrier based in Dublin, Ireland. It is now the largest low cost airline in Great Britain and Europe and has modeled its operations (since 1991) on the very successful Southwest Airlines Low Cost Leadership model. Ryanair's CEO, Michael O'Leary, is an accountant by training but a combative entrepreneur by inclination. He has angered trade unions, government officials and competitors with his "bare knuckle" tactics but has achieved dramatic growth and profitability in the very competitive airline industry.

As of the end of the year 2004, Ryanair was flying 25 million passengers annually with a staff of less than 2,500 personnel. Ryanair flies only Boeing 737s and is rapidly transitioning to the newest 737 models – the 737-800. Challenges to the airline at the end of 2004 included escalating fuel costs, intensity of competition and the sometimes less than favorable attitude of the regulatory bodies in Great Britain, Ireland and the EU.

INTRODUCTION

On Thursday, May 26, 2005, Ryanair Holdings, PLC (Ryanair) celebrated its 20th birthday in a central Dublin hotel with a birthday cake and a party. At the celebration, Ryanir's CEO – Michael O'Leary – confidently predicted that Ryanair would overtake British Airways by carrying 3.5 million passengers a month in 2005. He went on to say, "The very fact that a Mickey Mouse Irish airline can start in a field in Waterford 20 years ago, and in 20 years, overtake the world's self-styled, self-proclaimed favourite airline is testament to the demand for low-airfare travel around Europe" (Business Ticker, 2005).

EARLY HISTORY OF RYANAIR

Ryanair was founded in July, 1985, by Cathal and Declan Ryan with the financial backing of their father, Tony Ryan. The elder Ryan had, for many years, been Aer Lingus' leasing manager and had gone on to found Guinness Peat Aviation, which eventually became the largest aircraft leasing company in the world. Aer Lingus is Ireland's national airline – principally owned by the Irish government. Ryanair began operations with a staff of 25 and a single 15-seat Bandeirante turbo-prop, flying between Waterford and London. In 1986, Ryanair received permission from the regulatory authorities to begin flying four flights a day on the Dublin-London route with two 46-seat BAE748 turbo-props. In doing so, they challenged the high-cost monopoly of British Airways and Aer Lingus with fares that were set at half the prevailing fare of £209. Ryanair's strategy (initially) was to offer simple, low-cost fares and exemplary customer service. In 1986 (the first full year of operations), they flew 82,000 passengers and began negotiations to acquire their first jet aircraft and additional routes.

During the later part of the 1980s, Ryanair continued to compete vigorously with British Airways and Aer Lingus while adding additional routes and jet aircraft. By the end of 1989 Ryanair had six BAC-111 jets and three ATR 42 turbos. In 1990, Ryanair suffered a £20 million loss and was forced to completely restructure. A new, brash CEO – Michael O'Leary – was brought in to manage the turnaround and the Ryan family invested an additional £10 million. O'Leary, at the suggestion of Tony Ryan, visited Southwest Airlines in Dallas, TX, to learn the fundamentals of Low Cost Leadership in the airline industry. Southwest, of course, was by far the most profitable of the American carriers, and their business model was quite different from the traditional flagship carriers.

Gulf War I (Desert Storm) broke out in January of 1991, and airline traffic around the world collapsed. Despite the decline in overall airline traffic, Ryanair made a profit of £293,000 for the year and carried 651,000 passengers with a total workforce of 477 people. In May 1991, Ryanair switched its London base from Luton Airport to Stansted Airport in Essex. By 1999, Ryanair had added a number of European destinations, had switched the aircraft fleet to Boeing 737s, and had carried over 5 million passengers, profitably.

INTO THE 21ST CENTURY

In January 2000, Ryanair introduced Europe's largest travel website, www.ryanair.com. Within three months, the site was recording 50,000 bookings per week. The website also facilitated car and hotel rentals, rail services and travel insurance, all at low prices. In September, the first new base since 1991 was established at Glasgow Prestwick (Scotland), and three new Boeing 737-800s were stationed there. The base provided Scots customers direct flights to Paris, Frankfurt, Dublin and London. In 2000, Ryanair carried over seven million passengers with a workforce at year end of 1,262 people. Ryanair had, by the end of 2000, formalized its business model to include:

- All Boeing aircraft (primarily 737-800s).
- No "free" amenities such as snacks and drinks.
- Non-reclining seatbacks.
- Quick flight turnarounds – averaging 45 minutes.
- An in-flight magazine that was really a catalog for food, beverage and a multitude of duty free products – sold at a considerable profit by the cabin attendants.
- Minimum baggage allowances.

In 2001, Ryanair opened its first European base at Brussels' Charleroi Airport with five more new Boeing 737-800s. Service was provided from Charleroi to Dublin, London, Glasgow, Shannon, Venice, Paris and Carcassonne (France). The agreement at Charleroi was negotiated with airport authorities at a considerable savings in landing fees and gate charges in addition to subsidies for Ryanair. Despite the cost advantages, many predicted failure for Ryanair because the airport is located so far (about 65 km) from the capital (Brussels). This, however, was not the case. Despite the industry- wide downturn in airline traffic due to the terrorist attack of September 11 and an increase in operating costs resulting from the upward spike in the price of oil and petroleum products, Ryanair performed very well. For example, in August, the airline carried more than one million passengers, more than the total passengers carried in the year 1993. By year-end, Ryanair had carried over nine million passengers with a staff of 1,477.

Frankfurt (Hahn) was selected as the second European base in 2002. It was necessary to prevail in the German courts to overturn Lufthansa's high price monopoly of German aviation, and customers responded enthusiastically. During this year, Ryanair increased an order at Boeing from forty-five to 125 737-800s with an option for an additional 125 aircraft. In 2003, Ryanair acquired Stansted-based Buzz Airlines from KLM and as a result of the acquisition, got access to an additional eleven French regional airports. By the end of 2004, Ryanair was the largest low-cost airline in Europe, flying almost 25 million passengers with a staff of only 2,288.

RYANAIR'S VISION AND MISSION

Ryanair does not publish a formal vision or mission statement, but in accordance with Jack Welch's advice, "Strategy, then, is simply finding the big aha and setting a broad direction…" Michael O'Leary's broad direction, communicated in public statements, is to simply continue to be the largest Low Cost Leader in the European airline industry and to carry 50 million passengers by 2009. Implementing this vision is a function of many individual tactics, including an absolute dedication to low cost performance in every element of the value chain, quick gate turnarounds, non-union operations, performance-based incentive compensation plans, standardization on one type of aircraft, and flying (in most cases) to secondary airports, which provides significant savings for Ryanair.

BUSINESS PRACTICES

Despite its remarkable success, Ryanair, and particularly Michael O'Leary, have been criticized on a number of issues involving business practices. One of the areas of concern is human resource management. Ryanair is a non-union operation based in Dublin, Ireland. Ireland, of course, is a strongly pro-union environment. Taoiseach (head of the Irish government) Bertie Ahern described O'Leary's orientation toward labor as "tooth and claw capitalism" during the baggage handler's strike at Dublin Airport in 1999. In addition, compensation for pilots and flight attendants is comprised partly of salary and partly based on efficiency issues such as number of flight segments flown and, for flight attendants, amount of revenue generated from sales of items in the in-flight magazine.

O'Leary has also been a harsh critic of government officials in Ireland and Europe. He is particularly disdainful of officials at Aer Lingus (www.aerlingus.com) and officials at the airline authority (Aer Rianta). As a result of the fees imposed by the Irish government, Ryanair has actually reduced the number of flights in its home country over the last four years.

A recent criticism of Ryanair was its refusal to supply wheel chairs for disabled passengers at Stansted airport. The airline argued that this provision was the responsibility of the airport authority, and that 87 of the 93 airports that they fly to provide wheelchairs for those requiring them. In 2004, a judge ruled that the responsibility should be shared by the airline and the airport owners.

Perhaps the most significant (potentially costly) criticism of Ryanair was the deal they negotiated for landing rights at Charleroi. In February 2004, the European Commission ruled that €4 million of the €15 million in incentives paid to Ryanair constituted illegal state aid. In October, Ryanair agreed to put €4 million in an escrow account pending its appeal of the ruling.

In fairness, we must say that although Ryanair can be criticized for a number of their business practices involving human resource management, governmental relations, treatment of passengers and negotiated costs at Charleroi, these practices, in part, constitute Ryanair's business model. Their very successful strategy -- what Porter calls Low Cost Leadership – is undoubtedly responsible for the profits generated in a remarkably competitive industry.

OPERATIONS

In 2004, Ryanair achieved a number of important milestones. They launched two new European bases (Rome and Barcelona) and added 73 new routes, bringing their total to 150 routes. They took delivery of 18 new Boeing 737-800s and acquired a competitor – Buzz Airlines from

KLM. In July 2003, they carried a record number of passengers – two million --and for the year out-carried British Airways in the UK/European market.

At the end of the year, they had 2,300 employees and an industry leading 10,049 passengers per employee.

FINANCIAL DATA

Table 1		
Income Statement (all amounts € 000)	Year 2004	Year 2003
Total operating revenues	1,074,224	842,508
Total operating expenses	(803,373)	(579,034)
Operating profit	270,851	263,474
Profit for the year after adjustments	206,611	239,398
Source of data: Ryanair (2004) Annual Report		

Table 2		
Balance sheet information (all amounts € 000)	Year 2004	Year 2003
Fixed assets	71,994	71,994
Current assets	533,859	526,910
Total assets	605,853	598,904
Other liabilities	35,172	35,172
Equity	570,681	563,732
Total liabilities and equity	60,5853	598,904
Source of data: Ryanair (2004) Annual Report		

It should be noted that the operating expenses (as a percentage of income) rose from about 68% in 2003 to almost 75% in 2004. This relative increase in operating expenses attributes to the dramatic increase in fuel costs – approximately 52% for calendar year 2004. Offsetting the fuel price increase was the delivery of newer Boeing 737 – 800s which consume less fuel per mile than the older 737-200s. It is likely that the high cost of fuel will continue to plague all airlines for the next several years.

INDUSTRY COMPETITORS

Aer Lingus Group Plc (AL) is owned (85%) by the Irish government. They fly about seven million passengers per year to 50 destinations in Ireland, the UK, the US and Europe. In 2004, they generated $1,236, 900,000 in revenues with 3,906 employees. AL began flight operations in 1936 with a single De Haviland biplane, flying between Dublin and Bristol, England. In 1958, AL bought Aerlinte Eireann and began Atlantic service to New York City. The airline grew rapidly until 1993, when revenues and profits eroded substantially. A restructuring plan was introduced, and the Irish government invested an additional € 222.2 million in equity. Following the financial crisis related to the September 11, 2001 terrorist attacks, AL implemented a survival plan, which included a staff reduction of over 2,000 employees, a pay freeze and sales of non-essential assets. The airline also adopted a new lower fare strategy which has resulted in significant increases in revenue and profits.

British Airways Plc (BA) is a very large, full-service airline based in Hammondsworth, England. It traces its history back to 1919 when its predecessor, Aircraft Transport and Travel, launched air service from London to Paris. Today, BA flies to 154 destinations in 75 countries with a fleet of 300 aircraft. In 1998, BA invested $25 million in a new, low-cost airline subsidiary named Go. Go was headed by an American woman, Barbara Cassinni, and had an eventful five-year history till it was sold (in 2003) to Stelios Haji-Ioannou, owner of easyJet, for $375 million. Interestingly, the market cap of BA is slightly less than the market cap of Ryanair, a much smaller airline.

easyJet Plc (EJ) is primarily owned by Stelios Haji-Ioannou and began operations in 1995 when Stelios – as he likes to be called – was 28 years old. EJ began as a low cost airline, although it does offer some amenities not offered by Ryanair. In 1998, Stelios founded easyGroup to extend the low-cost concepts used at easyJet. easyGroup is invested in hotels, car rentals, internet cafes and credit cards and is constantly exploring additional opportunities. EJ flies 100 Airbus aircraft to 70 destinations and expects to fly 30 million passengers in 2005 in Europe and the UK.

Other competitors include Sir Richard Branson's Virgin Express, Lufthansa (Germany's flagship airline), Air France and the 60 or so small airlines in Europe that have been created since the EU deregulated the airline industry in 1998.

CONCLUSION

It was March 17, 2005: the start of the four day national holiday honoring St. Patrick, Ireland's patron saint, and Michael O'Leary was stretched out on a couch watching an old rugby match being replayed on the telly. On a yellow legal pad, O'Leary had jotted down issues that needed consideration at Ryanair: fuel prices, expansion to Eastern Europe, his future at Ryanair, and the regulatory battles with Irish politicians and the EU.

MICHAEL EISNER AND HIS REIGN AT DISNEY

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CASE DESCRIPTION

Topics addressed in this case include management conflict, corporate governance, shareholder value, and CEO succession. It may be used in an undergraduate, upper-level classroom, and is particularly appropriate for a capstone course in strategic management. It will also work well in any number of graduate business courses, including general management, leadership , and organizational behavior. Prerequisites for this case include some understanding of prevailing corporate governance topics, as well as familiarity with The Walt Disney Company's diversified portfolio of businesses. As a result, no outside readings should be necessary to understand the case, but some outside research will be necessary in order to address the assigned questions. The case should prove to be an easy read, taking no more than 20 to 30 minutes and then allowing 1 ½ to 2 hours to address the questions that follow.

CASE SYNOPSIS

This is a story of the triumphs and challenges of one of the most notable executives in corporate American history, Disney Chairman and CEO Michael Eisner. The purpose of this case is to highlight the impact of corporate governance from a shareholder perspective. In particular, two problems are addressed – (i) Disney's reputation for weak governance, whether justified or not, and (ii) dissention among the top ranks of the organization. While it is difficult to determine which came first, the case shows how each of these issues perpetuates the other, and that removing the source may be the only way to recover. As CEO, Michael Eisner was blamed for both, and thus the board was divided into two camps. There were those who supported Eisner and his actions over the years and those who did not. The question remained as to which side would prevail.

The case begins with a description of the situation facing Eisner at the close of 2003. Two long-standing Disney board members had called for his resignation from both positions, in letters rife with criticism of Eisner and his management team. Eisner's many options are presented and revisited later in the case.

In order to help the reader analyze Eisner's situation, the case provides a brief history of The Walt Disney Company, as well as biographical descriptions of the CEO and the two dissenting *board members, Roy Disney and Stanley Gold. Coverage includes company milestones under Eisner's leadership, and comparisons are made between the company's financial performance and Eisner's highly criticized compensation package. We then describe the conflict that arose between the parties and offer some discussion of the governance practices that come under attack in the letters.*

As there are usually two sides to every story, voices in favor of Eisner's management are also heard. The case then discusses what transpired as shareholders met and voted on a key governance issue with clear implications for the future – both for Eisner and for the company and its shareholders.

EISNER'S SITUATION

At the start of the Christmas season in 2003, Michael Eisner had more to think about than yuletide treasures. Roy E. Disney, founder Walt Disney's nephew, and his financial advisor Stanley Gold, had called for Eisner's replacement as both CEO and Chairman of the Board. After 20 years of managing the entertainment giant, Eisner had to make a decision that would affect not only the world's largest entertainment company, but his own destiny as well. Given the reasons that Mr. Disney and Mr. Gold allege for his ouster, should he leave, either by resigning or retiring? Alternatively, should he wait for a response from the board regarding his removal? He could also consider resigning one post but not the other, eliminating any concerns associated with filling the dual roles. Might it be time to retire and enjoy the fruits of his labors? There may also be other alternatives available to Eisner, which may serve to minimize dissention at the top of the organization and restore confidence in investors and other stakeholders alike. With the annual shareholder's meeting coming up in March, Michael Eisner and Disney shareholders had less than four months to contemplate their options. Regardless of the decision, this era would prove to be one of strain at The Walt Disney Corporation.

COMPANY OVERVIEW

Disney is a diversified company in the entertainment and leisure industries, operating its own film studios, theme parks, resorts, cruise ships, and retail outlets, all based on the animated Disney characters that have evolved over the past 80 years. It all started in 1923 when 21-year-old Walter Elias Disney boarded the train from Kansas City to Los Angeles with forty dollars and his cartoon about a little girl named Alice. Walt soon found a distributor for the "Alice Comedies" and formed Disney Brothers Cartoon Studio with brother Roy. Walt then created and subsequently gave up the rights to Oswald the Lucky Rabbit but was wiser and more protective with his next creation, Mickey Mouse. Mickey rose to stardom when he appeared in Steamboat Willie, his third cartoon and his first with synchronized sound. The image of the legendary mouse appeared on merchandise from stationery to toothbrushes, giving the Disney brothers an added source of revenue. In 1937, the company, renamed Walt Disney Studio, made its first animated feature film, *Snow White*, followed by *Pinocchio* and *Fantasia*. The move into television came in 1954 with the "Disneyland" anthology series, followed by *The Mickey Mouse Club* in 1955. With success on both the big and small screens, Walt set his sights on amusement parks, opening the first of five Disney theme parks in Anaheim, California, in 1955. In the years to follow, the company was run by Roy O. Disney (Walt died in 1966) and then by an executive team trained by the Disney brothers. The team executed Walt's plans for EPCOT and restructured the film segment to include Touchstone Pictures and Hollywood Pictures. In 1984, new management was brought in, with Michael Eisner as chairman and CEO and Frank Wells as the president and Chief Operating Officer. The duo found ways to maximize Disney's assets and continued to gain the respect of leaders in the industry until Wells' untimely death in 1994. Eisner endured, and the company's portfolio has undergone many changes during his reign. Its Anaheim ties, for example, led to its ownership of the Anaheim Angels, although divested in 2003, and the Mighty Ducks. Most recently, Disney began competing in the network and cable television markets, with stations such as the Disney Channel and Toon Disney, again capitalizing on Disney animation or airing original Disney programs, as well as others, such as Lifetime and A&E, acquired along with the ABC package in 1996. All told, under Eisner's 's leadership, Disney opened Disneyland Paris; expanded the Walt Disney theme parks; acquired Capital Cities/ABC, which included the ABC television network and equity ownership in ESPN, The History Channel, Lifetime, A&E, and E!; developed such leading Internet sites as Disney.com, ESPN.com, ABCNews.com, ABC.com, and Family.com; acquired Miramax Pictures; created Walt Disney Theatrical, which produced *Beauty & the Beast*, *Aida*, and *The Lion King*; developed the Disney Cruise Line; and acquired the Fox Family Channel (now ABC Family). In September, the 11th Disney theme park will open in the world's most populous nation - Hong Kong Disneyland.

THE CHARACTERS IN CONFLICT

Michael Eisner

Michael Eisner was born in Mount Kisco, New York, on March 7, 1942, to an affluent family. His father was a lawyer and investor who had also served as administrator of the Department of Housing and Urban Development, and his mother was the president of a medical research institute. Eisner grew up in his parent's Park Avenue apartment in New York City and graduated from Denison University in 1964 with a B.A. in English literature and theater. In the space of just a few years, Eisner had worked at all three of the then-existing television networks. While still in college, he found summer employment as a page at NBC, and then worked there for a few weeks following graduation as an FCC logging clerk. Eisner then took a position in the Programming Department at CBS, but his dissatisfaction with his job prompted him to send out hundreds of resumes. His only response came from Barry Diller in the programming department at ABC. Diller hired him as Assistant to the National Programming Director, a position Eisner held from 1966 to 1968. Eisner proceeded to advance at ABC, producing his first television special in 1967, and by 1976 he was ABC's Senior Vice President for Prime Time Production and Development, involved with hit programs such as *Happy Days, Welcome Back Kotter*, and *Starsky and Hutch*. ABC moved from its long-held number three position to the number one spot during Eisner's tenure in programming there.

In 1976, Eisner accepted another offer from Barry Diller, who had moved from ABC two years earlier to become Paramount Pictures' Chairman of the Board. Eisner's new position was that of President and Chief Operating Officer at Paramount, where he remained until 1984. Eisner's attention to the creative aspect of filmed entertainment led Paramount to enjoy the same dramatic turnaround that ABC had experienced earlier, as Paramount moved from last to first of the six major studios during that time. A few of the hits produced during those years include *Raiders of the Lost Ark, Marathon Man, Saturday Night Fever, Grease, Terms of Endearment, An Officer and a Gentlemen*, and *Beverly Hills Cop*.

In 1984, at the request of Roy E. Disney, the nephew of Walt Disney, Eisner became Chairman and Chief Executive Officer of The Walt Disney Company. The company at that time was far from an industry leader in film, performing poorly overall and relying primarily on its theme parks. Eisner initiated major strategic changes, and revenues grew from $1.7 billion to $25.3 billion in his first ten years at the helm. For example, in early 1996, Disney completed its acquisition of Capital Cities/ABC for $20 billion, securing Disney's place as one of the most important players in the entertainment industry.

Roy E. Disney

Roy Edward Disney was born January 10, 1930, to Edna and Roy O. Disney, who was Walt Disney's older brother and co-founder of the Disney Company. Roy E. attended Harvard School and Pomona College, from which he graduated in 1951. At the age of 24 he began working at The Walt Disney Company as an assistant editor on the True-Life Adventure film (Schutt, 2004). In the following years, he worked in numerous capacities on Disney productions: camera operator, writer (e.g., the "Zorro" television series in 1957), television program host, film director, and producer of television programs and films (e.g., "The Wonderful World of Disney" and "Fantasia/2000"). He joined the Disney board of directors in 1967 and in 1984 became Vice Chairmen as well as the head of Disney's animation department, which was his first full-time position at Disney.

Roy E. Disney continues to serve as Chairman of the Board of Shamrock Holdings, Inc., a Disney-family business he founded in 1978, which operates in real estate development and investments. He is a member of the board of directors of the United States Committee for UNICEF, as well as a member of the board of trustees of the Ronald McDonald charities, along with other civic organizations. He has received honorary doctorates of Fine Arts from Pomona College, Mercy College, and the California Institute of Arts. He and his wife, Patricia, have four children and thirteen grandchildren.

Stanley Gold

Stanley Gold is a native of Los Angeles and received his A.B. degree from the University of California in L.A. He attained his J.D. from the University of Southern California Law School in 1967 and continued on with postgraduate work at Cambridge University in England. In 1968 he joined a Los Angeles law firm and eventually became a managing partner, practicing primarily in the areas of corporate acquisitions, sales and financing. Mr. Gold is currently President and CEO of Shamrock Holdings, Inc., and Shamrock Capital Advisors. He has served on the Disney board for 15 years, as well as on the boards of several other business and civic organizations, including the University of Southern California.

THE CONFLICT

At the close of the century, The Walt Disney Company had come under intense scrutiny for its governance practices. The Board of Directors, for example, was criticized for insider-domination and lack of independence, ultimately appearing on *Business Week*'s list of Worst Boards two years running. In September 2002, Michael Eisner began traveling the country to meet with powerful investors and shareholder rights groups in an attempt to shore up the company's reputation. He also sought the advice of Ira Millstein, a leading authority on corporate governance, and began making a variety of changes to Disney's governance structure. There is evidence in this case, however, that at least two board members questioned the timing and perhaps the reasons behind these governance initiatives. In fact, there remained a lack of confidence in the CEO himself.

Those Opposed to Eisner

Known for an aggressive management style, Eisner failed to befriend many who crossed his path. Included among those were Roy E. Disney and Stanley P. Gold. In a dramatic public move, on November 30, 2003, Roy E. Disney resigned from the Board. In his resignation letter to Mr. Eisner, he argued that Eisner had lost momentum and creative energy in the past seven years. Specific areas of concern included the low ratings with ABC programming, Eisner's micromanagement style, the building of new theme parks 'on the cheap' and the perceptions among stakeholders that Disney was seeking a quick profit rather than long-term growth, significant loss of key creative employees over the years, weakening partnerships with Pixar and Miramax, and Eisner's refusal to establish a clear succession plan. To Eisner he wrote, "You well know that you and I have had serious differences of opinion about the direction and style of management in the company in recent years. For whatever reason, you have driven a wedge between me and those I work with even to the extent of requiring some of my associates to report my conversations and activities back to you. I find this intolerable." Roy accused Eisner of omitting his name from the ballot for re-election to the board as being in retaliation for Roy's expressed concerns that the CEO was "no longer the best person to run The Walt Disney Company." While saluting Eisner for success during his first 10 years at the company, he stated that the past seven suffered from failed leadership. He concludes as follows: "…it is my sincere belief that it is you who should be leaving and not me. Accordingly, I once again call for your resignation or retirement…"

The next day, Stanley Gold resigned, in a letter to the Board which began as follows: "It is with regret that I resign effective immediately from the Board of Directors of The Walt Disney Co. and second Roy Disney's call for the removal of Michael Eisner as chairman and chief executive." He, too, expressed disgust over the failure to include Roy Disney on the election ballot. While the board had explained that he had reached the expected retirement age, Mr. Gold believed otherwise – that Roy had become increasingly vocal in his criticism of Eisner and his board, and that the omission was an attempt to "squelch dissent by hiding behind the veil of 'good governance'". He questioned the ouster of board members who disagreed with or even criticized Michael Eisner, and objected to Eisner's bonus of $5 million in Disney shares given poor organizational performance. See Table 1 for information on CEO compensation and the company's financial performance for the 20 years under Eisner's leadership.

Issues that may have led to the dissention include a board of directors allegedly packed with cronies or individuals otherwise beholden to Michael Eisner. This lack of independence has manifested itself in several conflicts of interest. For example, Father Leo O'Donovan, currently serving on the board, is President Emeritus of Georgetown University, the alma mater of one of Eisner's sons and recipient of more than $1 million from Eisner. And Reveta Bowers, who served on the Board from 1993 to 2003, runs the school attended by another of his sons. Further, Mrs. Bowers, along with directors Stanley Gold and Raymond Watson, had children employed by The Walt Disney Company within one year of their directorships, and thus were not to be considered independent board members according to the NYSE's new governance recommendations. In 2001, Craig Bowers worked for Disney's internet operations, earning $81,863. Jennifer Gold worked for the consumer products division, earning $85,111. And David Watson worked for Disney Channel, where he earned $152,608.

As evidenced in their full resignation letters, both Disney and Gold also blame Eisner for debauched relationships with both internal and external studio heads. Although The Walt Disney Company acquired Miramax in 1993, Eisner continues to butt heads with founders Bob and Harvey Weinstein, who maintain creative control over the studio. Historically, large budget projects and pay scales had been at the heart of these disagreements. Most recently, however, Eisner refused to distribute Michael Moore's Farenheit 9/11 but did sell the film to the Wiensteins, who then formed a separate company in order to distribute the film. Further, while Eisner claimed that Miramax had been unprofitable, he was not willing to sell the studio back to its original owners. Externally, Eisner is said to have clashed with Pixar Animation Studios CEO Steve Jobs, and in 2004, Pixar walked away from the negotiating table. In particular, the computer animation powerhouse felt that the existing contract -- whereby the two companies co-finance movies, split the profits, and Disney distributes the films in exchange for 12.5 percent of the box office gross ticket sales – is tilted heavily in Disney's favor.

EXHIBIT 1
CEO Compensation and Organizational Performance

	Eisner's Compensation			Organizational Performance				
Year	Salary	Bonus (Cash & or Stock)	Total Compensation	Revenues (in millions)	Net Income (in millions)	Stock Price		
						High	Low	Splits
1984				1,656.0	978.4	67.75	45.62	
1985				2,015.4	173.5	113.50	59.37	
1986				2,470.9	247.3	143.50	31.62	4 for 1 on 3/5
1987				2,876.8	444.7	82.00	44.87	
1988				3,438.2	552.0	68.00	54.25	
1989	750,000	8,839,360	9,589,360	4,594.3	703.3	134.62	65.75	
1990	750,000	10,483,229	11,233,229	4,418.2	824.0	134.50	87.37	
1991	750,000	4,691,543	5,441,543	6,182.4	636.6	127.37	94.00	
1992	764,423	6,694,558	7,458,981	7,504.0	816.7	159.00	32.87	4 for 1 on 5/15
1993	750,000	-	750,000	8,529.2	299.8	47.37	33.75	
1994	750,000	7,268,807	8,018,807	10,055.1	1,110.4	46.62	42.50	
1995	750,000	8,024,707	8,774,707	12,112.1	1,380.1	62.87	46.00	
1996	750,000	7,900,000	8,650,000	18,739.0	1,534.0	73.87	53.37	
1997	750,000	9,900,000	10,650,000	22,473.0	1,886.0	97.62	67.37	
1998	764,423	5,000,000	5,764,423	22,976.0	1,850.0	127.12	23.50	3 for 1 on 7/9
1999	750,000	-	750,000	23,402.0	1,368.0	38.00	23.43	
2000	813,462	8,500,000	9,313,462	25,402.0	920	43.31	27.87	
2001	1,000,000	-	1,000,000	25,256.0	(158.0)	34.50	16.98	
2002	1,000,000	5,000,000	6,000,000	25,360.0	1,236.0	25.00	13.77	
2003	1,000,000	6,250,000	7,313,656	27,061.0	1,267.0	22.56	15.02	
2004	1,000,000	7,250,000	8,307,473	30,752.0	2,345.0	25.50	20.36	

Source: Disney 10-K Filings and Proxy Statements.
[A] Includes category for "other" annual and long-term compensation

Those in Favor of Eisner

The Board of directors responded in support of Michael Eisner, categorically rejecting the requests made by Disney and Gold. In fact, the board credited Michael Eisner with changes in corporate governance that resulted in a board dominated by independent directors, one of which involved renaming the Nominating Committee to what is now the Governance and Nominating Committee. While the process by which directors are named to the board remains the same, the committee is now charged with monitoring Disney's Corporate Governance Guidelines, which was adopted in 1996. The board continues to allow shareholders, as well as the board itself, to nominate candidates deemed qualified. Shareholders must submit their recommendations in writing to the Company's Secretary and must provide confirmation that the nominee is willing to serve. Elections for board membership take place at the annual shareholders' meeting, at which time directors are elected or re-elected for one-year terms. Shareholders are granted one vote for each board candidate. This is in contrast to cumulative voting, whereby a shareholder is given a number of votes consistent with the number of candidates on the roster and then has the option of casting all of his or her votes for a single director or apportioning the votes among the candidates. When voting is cumulative, minority stockholders could gain representation on the board, even at the objection of powerful investors. Without cumulative voting, Disney's board is likely to persist as it was assembled under Eisner's leadership.

The board cited Eisner's commitment to governance and transparency, which has led to the company exceeding the corporate governance guidelines set by the NYSE. A guest column, written by independent producer David Kirkpatrick, appeared in Variety magazine and began with, "I am writing today to celebrate a man's creativity and managerial skill. This man has gotten a bit banged up lately, and I am saddened by all the cascading public and media assassination of Michael Eisner, especially when so much of it has been coming from our own creative community." Kirkpatrick praised the Eisner's accomplishments while underscoring his mistreatment at the hands of Stanley Gold and Roy Disney.

Shortly before the annual meeting, the Board communicated with the company's shareholders.

> *You may have heard recently about the attack being waged by two former directors against the chief executive officer and certain members of the Board of Directors of your company. You should be disturbed by this attack, which comes at a time when your company is achieving very positive results. We, as the continuing directors of the company, want to provide you with some perspective on Disney's performance and to set the record straight . . . shareholders have every reason to question the actions of Stanley Gold and Roy Disney and to wonder how the best interests of all shareholders are served*

by trying to distract the Board and management at a time when all energy and resources should be devoted to forwarding the company's momentum. You should be concerned that Messrs. Gold and Disney are putting their own interest ahead of yours.

At this crucial time, with Eisner's future hanging in the balance, the board called to the attention of the Disney shareholders the many accomplishments of the company and its current management team and also used its annual letter as a forum to address the criticisms brought forth by Mr. Disney and Mr. Gold. The board of directors, which includes Michael Eisner, held that both men completely ignored the impressive long-term performance record of their CEO, who, as one of the company's largest individual shareholders, is fundamentally focused on the shareholders' interests.

NOTHING LASTS FOREVER

The issue of role duality was certainly a key one at the shareholders' meeting. The meeting took place in Philadelphia on March 3, 2004, followed by an announcement from the Board of Directors that it would be separating the positions of CEO and Chairman in response to the shareholder vote. While the Board stated that it continued to have complete confidence in Mr. Eisner and the senior management team, it formalized the division of CEO and Chairman responsibilities in April, created the stand-alone position of Chairman of the Board, and unanimously elected former U.S. Senator George Mitchell to serve in that non-executive capacity. The new chairman vowed to work diligently to fulfill his responsibilities and stated that Eisner, the continuing CEO, would have full support from the board and would have the same authority to manage the operations of the company as he had previously held.

While the two may have worked well together, their time together at the helm will be brief. On September 9, Michael Eisner submitted a letter to the Disney board, indicating his plans to retire as CEO when the term of his employment agreement concludes on September 30, 2006. He will be replaced by Robert Iger, Disney's President and Chief Operating Officer since 2000. Upon resigning, Eisner offered the following sentiment:

It is with a considerable amount of satisfaction and even pride that I approach the end of my term as CEO of this company. By every financial and creative measure, Disney is performing at its peak. I have enjoyed virtually every moment of my tenure and want to express my appreciation to the phenomenal colleagues with whom I have been privileged to work. I believe Disney is now poised for its brightest days in the years ahead under the able and insightful leadership of Bob, who has not only the qualities to succeed, but also has a keen sense of the Disney brand and how to maintain its leadership position and grow it on a worldwide scale.

ASSIGNMENT QUESTIONS

1. Who served on Disney's board of directors in 2003? Describe the characteristics and backgrounds of each board member.

2. Why do you suppose the Board of Directors was so unwavering in its support of Michael Eisner?

3. Evaluate the options that were available to Eisner. What factors do you think he considered when weighing his alternatives?

4. Compare Michael Eisner's current compensation package to the company's recent performance. Was his pay justified? Why or why not? In answering this question, consider the following:

    a. How have other CEO's been compensated in relation to their company's performance? Look at CEO's of competitor companies or of similarly diversified firms.
    b. Based on your finding for (a) above, would you say that there is some minimum level of compensation that is necessary to attract and retain high-quality corporate leadership?

5. Evaluate the conflict among the board members from a shareholder's perspective. What impact might the conflict have on investor confidence?

6. Evaluate the conflict among the board members from a stakeholder perspective. What impact might the conflict have on claimants other than the shareholders?

7. Describe the leadership characteristics of Robert Iger, Michael Eisner's successor. How might certain stakeholders view Iger, as compared to the long-reigning Eisner? (HINT: Consider relationships with the Walt Disney Company that may have deteriorated during Eisner's tenure).

8. Roy Disney and Stanley Gold criticized Michael Eisner for his lack of a clear succession plan. Under Iger, has one been established? If so, what does it state?

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INTERNATIONAL MARKETING AND DELIVERY OF BANKCARD PROCESSING SERVICES (TSYS)

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CASE DESCRIPTION

This case depicts a US-based firm that painstakingly but successfully markets its bankcard processing services to international prospects. The case intends to enable the student to assess how TSYS' success in the European market entry has taken place. Following this assessment, students will study strategic considerations related to the present market attained by TSYS in the United Kingdom and Ireland and the possibility of further expansion of operations internationally. The basic modes of supply are a combination of services supplied from one country to another, corporate subsidiary setup of operations and local personnel recruitment. Prior to the establishment of operations, an extensive discovery, sales and marketing process leading to contract negotiation takes place. The case describes the strategic challenges facing a services firm and the integration requirements necessary for successful market penetration. The case concludes with an overview of the successes enjoyed by TSYS as a result of these efforts and decisions to be made regarding subsequent actions. Although TSYS has developed operations in several regions internationally, the case concerns service delivery to the European market and the potential of further expansion in that market. A firm embarking on such exportation must be cognizant of and form entry strategies bearing in mind the longer sales cycle and a need for direct in-country representation to achieve product awareness. This case is designed for a junior level undergraduate course in International Business, International Marketing or International Strategy in which the above topics may be covered.

The exercise is designed to be taught in a one hour class and is expected to require two hours of outside preparation. The author endeavors to provide an enhanced understanding of bankcard services marketing and delivery with the corporate objective of long-term growth, increased revenue generation and improved market share. Study of the proliferation of services is notably important in light of the continuous augmentation of this type of business endeavor versus manufacturing. According to the 2004 World Investment Report published by the United Nations Conference on Trade and Development, future economic growth improvements will be patent particularly in "the case of services, which make up the largest economic sector in many countries, and which dominate foreign direct investment" (UNCTAD World Investment Report, 2004).

CASE SYNOPSIS

Service industry exportation entails a certain marketing-related complexity not similarly encountered with the export of manufactured goods. TSYS, a processor of bankcard transactions, boasts top notch sales, technical and project management expertise that has effected success in the services marketplace. Having thoroughly penetrated the United States bankcard services market, TSYS set out to explore new and international opportunities through a customized sales approach of bankcard processing service offerings. Just as regulations and other compliance issues vary from country to country, so do processing requirements, rules and other idiosyncrasies of the industry on an international level. The solution to ensure ultimate delivery is shaped by several elements "unique to a services solution that differentiate it from a [tangible] product solution" (Hill, 2003). Speed to market is greatly affected in comparison with that of tangible product offerings. Additionally, estimation and control of the timeliness of deliverables tend to be more elusive thus requiring increasingly skilled management of the process. TSYS' marketing with regards to cross-border service bankcard provision involved dealing with factors such as intangibility, customization requirements, lack of inventory, time sensitivity and change and quality management. The case is instructional in terms of the challenges such service firms may face and how to respond.

COMPANY BACKGROUND AND INFORMATION

TSYS' foundations date back to 1959 as a division of Columbus Bank and Trust Company (CB&T) in Columbus, GA. Named Total System Services after going public in 1983, the company was one of the first institutions to offer a revolving credit card product in the United States. Further innovation in the mid 1970's led to the electronic movement of transactions among bankcard issuing institutions. TSYS, as Total System Services began to be called starting in 2002, has become a prominent third party processor (TPP) of "non-domestic accounts with a global presence that spans countries, regions and continents" (TSYS website, 2005). TSYS' client base consists of bankcard issuers (cardholder bank processors) and acquirers (merchant bank processors) for credit, debit, commercial, private-label, prepaid, and chip card product processing. This clientele is located around the world on "three continents, in seven languages and 16 currencies" (TSYS website, 2005).

Within a decade after going public, TSYS turned its attention to specific research and development of an enhanced, "option-driven" processing platform known as TS2® which was implemented in the mid 1990's. The TS2® data processing system has been a reliable source of competitive advantage for TSYS since this time and is upgraded as required to continue meeting the market needs. To the average consumer, these "options" that TS2 enables include a great deal of the offers that many individuals see arriving in their mailbox in the form of introductory rates, promotional interest-free purchase periods, incentive programs that accumulate "points" toward airline miles or toward further personal consumption purchases and, recently, a consumer savings account program allowing cardholders to channel a certain percentage of purchases into a special account set up by their bank. These options are in demand both in the United States and in abroad. As a result of its technological innovation, TSYS enjoys increased international growth due to "cost savings, improved customer service, unsurpassed speed to market and efficient workflow" (TSYS website, 2005). TSYS' revenues have continually increased during its existence in part due to decisions to internationalize and assertively target markets outside of the United States The company has continued to portray success in financial, technological and innovative terms. Internationally, the company has faced the challenges of differing environments. TSYS generates revenues for electronic payment processing services principally from:

> *Charges based on the number of accounts on file, transactions and authorizations processed, statements mailed, credit bureau requests, credit cards embossed and mailed, and other processing services for cardholder accounts on file. Cardholder accounts on file include active and inactive consumer credit, retail, debit, stored value and commercial card accounts*.(TSYS Annual Report 2003-p. F-11)

The business has evolved within a highly competitive market domestically and abroad. TSYS maintains strong relationships with clients and the bankcard associations. The key to the international expansion efforts is due to the research and sales teams that take on tasks of discovering the potential markets, analyzing the environment and establishing and maintaining relationships with prospects. TSYS' adaptation to continuous change is an essential skill set required in light of the ambiguities faced when exploring international opportunities. The United Kingdom proved to be a good choice due to the lack of a language barrier, large established banks such as Royal Bank of Scotland Group and National Westminster Bank as well as the Irish bank Allied Irish, and a demand for the products and options provided by the TSYS processing system. The banking centers of the United Kingdom, in spite of the similarity in language, have quite particular processing rules in comparison to most other European nations. Entry into the Irish market allowed TSYS the chance to prove its ability with processing of the Euro beginning in 2002 since the United Kingdom does not utilize this currency. This strategic entry into Ireland is intended to have the additional benefit of attracting the attention of banks from other Euro-zone countries. The European clients' processing began in the spring of 2001. Nonetheless, negotiations had begun as early as 1997 which evidences the long sales process involved in the marketing of bankcard processing services.

INDUSTRY AND COMPETITORS

Background of the Bankcard Industry

Before the Great Depression of the 1930's, several "charge" cards without a revolving credit feature issued by individual hotels, oil companies and department stores were in existence as early as pre-World War I. (Mandell, 1972) Other entities issued charge cards during the early 1950's such as Diners Club, Carte Blanche and American Express. The innovative feature with the product issued by these latter entities was the capacity to use at different merchant locations instead of being restricted to one, which was the case with the prior cards. Joseph Nocera refers to a watershed event that took place in 1958 in Fresno, CA as the "drop". (1994) The California-based Bank of America issued and sent via mass mailings, 60,000 live and unsolicited "revolving" credit cards. From the "drop" of 1958, the more recent technological innovations have enabled further proliferation of credit cards and continued acceptance. The different transactional methods such as mail order to telephone order to internet transactions bring about increasingly higher purchase volumes. On a domestic and global level there is an ever-increasing cardholder base as well as universal acceptance and recognition of brands such as Visa and MasterCard.

Unsolicited live card distribution was outlawed by 1970. The years between 1958 and 1970 entailed the trial-and-error beginnings of the nascent credit card industry. Over 100 million cards were mailed as part of the BankAmericard program from 1958-1970. These revolutionary financial products were a radical change from the checking and savings accounts; the principle financial "products" available to the majority of the United States population prior to the credit card, money market and subsequent mutual fund boom. A side-effect was the resultant consumer debt which started as a trickle in the first decade after 1958 evolved into an inundation by the 1980's in terms of consumer credit. In what has become an era of expansive dissaving, credit cards have simply made it too easy to purchase items that the consumer may not really want or need or otherwise could not afford.

> *Credit cards became popular due to the user-friendliness of the product and due to the decreasing of post depression aversion to financial risk and the markets. There was decreasing influence of the post-depression logic of "going without until enough saved to purchase"* (Nocera, 1994). *There was a growing concept of "spending money not yet in one's possession" and from the years 1945-1970, consumer credit growth was strong with consumer credit increasing from $2.6 billion to $105 billion.* (Nocera, 1994)

In the following table are the card industry achievements 10 years after the introduction of the BankAmericard (Nocera, 1994):

Table 1: BankAmericard – First decade (ending 1968)

Year	Cards in use	Sales	Consumer debt	Bank profit
1960	233,585	$ 59 million	$ 28 million	$ 179,000
1968	>1,000,000	$400 million	$252 million	$12.7 million

In the late 1960's, banks began to discover their ability to use credit cards to reach out and lure new customers and possibly avoid state and federal regulations. In 1966, BankAmericard as the beginning of the Visa association and an organization known as Interbank Card Association (ICA) as the beginning of what is now MasterCard were separate entities that worked with member banks in which directorships were established in order to "establish rules for authorization, clearing and settlement [as well as] marketing, security and legal aspects of running the organization" (MasterCard, 2005). These two associations still maintain a vibrant rivalry. As a first-mover in Europe, MasterCard formed an alliance with a clearing and settlement entity known as Eurocard in 1968. MasterCard and Eurocard have recently merged into one global organization. Nonetheless, the major historical industry trends for this credit product are rooted in the United States processing environment.

The efforts at establishing a nationwide bank in the United States, started by the Bank of America, continued in the mid 1970's. In 1977, Citibank conducted a "drop" of 26 million credit card solicitations across the country which very quickly resulted in 3 million Visa accounts. A burning question was how could a bank go "national" and still be within legal limits. The answer seemed to be via credit cards. Just as before with the drop of the actual live cards with the BankAmericard, these solicitations acted as lures into the national pool of potential customers. This was a major step in nationwide and global banking.

From a regulation standpoint, a few key decisions in the last few decades have brought about explosive growth and competition in the global credit card industry. An issue brought up by consumer advocacy groups is the aggressive fee structure imposed by the credit card companies. The legislation that presaged these issues included two key United States Supreme Court cases. (Lazarony, 2005) In 1978, Marquette vs. First Omaha Service Corp was a decision that a national bank could charge the highest interest rate allowed in their home state to customers living anywhere in the United States, including states with restrictive interest caps. In essence, it didn't matter what kind of rate cap existed in a customer's state. This was essentially the deregulation of rates for unsecured loans which was a boon for the credit card issuing banks. In South Dakota in 1979, Governor Bill Janklow allowed higher rates to be charged, thus inviting Citibank and other entities to do business in their state. Mr. Janklow's lifting of usury laws caused a catalytic event in the credit card industry. Walt Wriston, then CEO of Citibank, went to South Dakota because at the time, Citibank had a large number of cardholders due to the aforementioned card solicitation "drop" of 1977 which resulted in a large number of accounts. With the high interest rates in the late 1970's, Citibank was losing money basically because of the 12% cap on card rates in New York State and a cost of funds of around 20%. (Frontline, 2004) An additional round of decisions resulted from the 1996 Smiley vs. Citibank Supreme Court case which lifted state restrictions on fees credit card issuers could charge. This same principle applies to credit card late fees. As Smiley vs. Citibank in 1996, the Supreme Court gave national banks free rein on credit card fees. (Lazarony, 2005) Before the Smiley ruling, the typical late fees were from \$5-\$10. After the Smiley decision, those late fees rose to as high as \$29 or even \$39. In addition to late payment assessments, other fees were imposed as well such as over-the-limit or returned check fees.

Credit cards are used for a variety of expenditures such as discretionary spending, convenience and, in some cases, basic needs. Banks issue credit cards due to the potential profitability with interest rates that climb as high as 25-30% and due to the increasing consumer credit usage over the last 50 years. In 2003, lucrative profits of more than "$30 billion before taxes" were generated by more than 641 million cards issued in the United States alone. (Frontline, 2004) During the last 10 years, bankcards have become a common item in consumers' possession in developed and developing regions. From the 1983 to the mid 1990's, there was a real increase of 179% in consumer borrowing. "Credit rose from $291 1983 dollars to $812 1983 dollars based on household data" (King, 2004).

The bankcard product treated in this case has the following characteristics:

- *The product is called a bankcard – a card issued by a bank that extends credit to the cardholder.*
- *All cards substitute for cash or checks in transactions.*
- *Most cards have similar payment plans; generally a month's charges will be billed to the credit cardholder in one statement.*
- *If payment is made promptly, there is no interest assessed against the cardholder.*
- *Finance charges on credit card debt are similar for most cards. Generally the debt is treated as a revolving type of account in which payment must be at least a specified portion of the outstanding balance but can be larger if the cardholder wishes.* (Mandell, 1972)

Characteristics of all cards imply that they may potentially have similar effects on the economy. Since all cards substitute for cash and checks, this may enable the economy to be moving toward a "cashless" or "checkless" society. (Mandell, 1972)

The primary regulatory forces in the United States that can effect necessary change to the credit card industry include state entities and the Office of the Comptroller of the Currency (OCC). The OCC is a federal agency that regulates and supervises national banks to ensure a safe and competitive banking system that supports the citizens, communities and economy of the United States. Growing consumer debt and consumer spending is a central issue associated with the ubiquity of credit cards. There is no EU equivalent of the OCC. Each of the European countries has its own bank regulatory agency which in some cases may be co-located in the central bank. The European Union's supervisory equivalent is covered by the European Central Bank, based in Frankfurt, in coordination with the National Central Banks of the EU Member States. The National Central Banks, in turn, monitor and supervise the commercial banks operating in their areas of jurisdiction. The European Commission also plays a role in monitoring and advising Member States in developing policies for managing their financial markets.

The key participants in the world of bankcard processing include the cardholders, card acceptor locations, acquiring banks, issuing banks, bankcard associations such as Visa and MasterCard and third party processors (TPPs). The acquiring bank represents the card acceptor location which may be a merchant, mechanical card reader, a touchless sensor or the internet. The issuing bank represents the cardholder and this bank name along with the association is clearly visible on the physical card. The TPP can provide outsourced transaction processing services to acquiring and issuing banks. TSYS falls into the category of third party processor or TPP. The bankcard associations, such as Visa and MasterCard, essentially serve as an extremely sophisticated conduit for the transaction and information flow as well as a financial settlement engine. The association "identifies buyer to seller and seller to buyer [and] acts as a guarantor for payment" (Visa, 2004). Associations utilize global networks that facilitate global acceptance of bankcards. To familiarize the reader with the various stages of the transmission of data, the table below provides a high level overview of the clearing transaction, which transports the transactional data in the processing cycle for the various stages of a transaction leading directly to the information printed on a cardholder statement:

As technological innovations continue to improve, so does the pipeline through which greater numbers of cardholders are reached on a global level. Other key technological breakthroughs have been made in the area of internet transaction processing, chip or smart cards, mobile phone transactions, and touchless credit card transaction all of which further the omnipresence of bankcards. The following statistics from the MasterCard corporate website provide an indication of the steady growth of card users and global acceptance over the past two years. The following 2 tables include all programs except online debit programs:

Table 2: Transaction flow of a credit card clearing (post authorization*) transaction			
ACQUIRER = Acquiring bank that represents the merchant location ISSUER = Issuing bank that represents the cardholder			
Stage 1	ACQUIRER submits to➜	MC/VISA then submits to➜	ISSUER receives
PRESENTMENT	The ACQUIRER transmits a presentment as a result of a cardholder purchase at a merchant location pending an approval authorization result. Presentment: A data message with the original purchase data. All subsequent data messages submitted have mostly the same transaction data	The transaction is approved for quality, quantity and timeliness. Quality implies appropriate formatting, quantity implies amount of information and timeliness deals with the amount of the fee assessed. Usually, transactions submitted quickly result in a lower MC/Visa fee to the ACQUIRER	ISSUER posts the transaction to the cardholder statement. If there is no dispute, the process ends with the cardholder paying the balance. If there is a dispute, then the presentment is submitted back to the ACQUIRER. This is called a chargeback

Table 2: Transaction flow of a credit card clearing (post authorization*) transaction			
Stage 2	ISSUER submits to➜	MC/VISA then submits to➜	ACQUIRER receives
CHARGEBACK	ISSUER forwards the same transaction back to the ACQUIRER for a specific valid reason. The different reasons range from account number was not on file to duplicate processing to credit posted as purchase etc.	Similar approval process as above. However the issuer usually has about 180 days to submit this type of transaction.	If the ACQUIRER does not have sufficient documentation or other evidence to re-transfer the transaction to the ISSUER, then the ACQUIRER accepts financial responsibility. If, however, the ACQUIRER does find sufficient evidence to return the transaction to the ISSUER, then this takes place in the form of a representment (see below) to the ISSUER.
Stage 3	ACQUIRER submits to➜	MC/VISA then submits to➜	ISSUER receives
REPRESENTMENT	If, however, the ACQUIRER does find sufficient evidence to return the transaction to the ISSUER, then this takes place in the form of a representment to the ISSUER.	Similar approval process as above. However the issuer usually has about 180 days to submit this type of transaction.	ISSUER will again post the transaction to the cardholder statement. If there is no dispute, process ends with cardholder paying balance.
Stage 4	ISSUER submits to➜	MC/VISA then submits to➜	ACQUIRER receives
ARBITRATION CHARGEBACK	If there is a dispute, then the PRESENTMENT is submitted back to the ACQUIRER.		Albeit costly, the transaction can still be disputed by the ACQUIRER. Once the process reaches this point it can become more costly to proceed. Continuation at this point would usually be due to larger dollar volume items that justify the efforts dedicated to resolution.

* For a credit card transaction, authorization services generally refer to the process in which the card issuer indicates whether a particular credit card is authentic and whether the impending transaction value will cause the cardholder to exceed defined limits. Basics results of these transactions are either approval or decline of a transaction.

Table 3 - Number of bankcards per MasterCard region (millions)				
	FY2004	Growth	FY2004	Growth
Worldwide Cards (Millions)	679.5	8.6%	625.5	5.8%
South Asia, Middle East, Africa	12.7	29.8%	9.8	26.4%
Asia Pacific	131.8	8.4%	121.6	8.5%
Europe	111.6	11.6%	100.0	14.9%
Latin America	57.0	19.5%	47.7	7.4%
Canada	28.5	7.1%	26.6	9.7%
United States	337.8	5.6%	319.8	1.3%

Table 4 - Acceptance locations per region per MasterCard region (millions)				
	FY2004	Growth	FY2004	Growth
Worldwide Cards (Millions)	24.6	9.8%	22.4	12.7%
South Asia, Middle East, Africa	0.5	15.1%	0.5	14.1%
Asia Pacific	8.8	13.6%	7.7	12.4%
Europe	7.1	3.4%	6.9	13.8%
Latin America	1.9	8.4%	1.7	9.8%
Canada	0.7	13.5%	0.6	-0.2%
United States	5.6	12.0%	5.0	14.2%
*Acceptance Locations include Merchant Locations, ATMs and Manual Cash Locations.				

From the Visa perspective, the picture of growth is no different. As Visa endeavors to "change the way the world pays", the increases in cards and sales volumes have also been robust in the past few years thus confirming the continuing role of bankcard products in the economy. The total card sales volume for Visa was recently reported as follows:

Table 5 – Visa – Total global card sales volume		
Year	Total Card Sales Volume (in billions USD)	Year-Over-Year Growth
2002	$2,400	17%
2003	$2,900	11%
2004	$3,190	13%

The number of cards has also dramatically increased:

Table 6 – Visa – Total global card sales volume		
Year	Total Cards (in millions)	Year-Over-Year Growth
2002	960	10%
2003	1,050	10%
2004	1,190	13%

The growth of the presence of bankcards enables a greater number of personal expenditures to be conducted with these financial instruments thus affecting consumer behavior in terms of spending. The Visa Annual report provides the following insight regarding the "Personal Consumption Expenditure (PCE)":

> *Personal Consumption Expenditure represents the market value of all goods and services purchased by households and non-profit institutions, excluding the purchase of homes. […] Today, global PCE is valued at US$24 trillion and is composed primarily of cash and cheque payments.* (Visa, 30)

In spite of the majority of PCE being conducted with cash and checks, the growth of PCE share has been steadily increasing over the years as is portrayed in the following table:

Table 7: Visa – Growth of personal consumption expenditure		
Year	Growth of PCE Share with use of only Visa products	Growth of PCE Share with use of Visa, MasterCard, Discover and American Express
2002	7.1%	12.1%
2003	7.6%	13.0%
2004	8.4%	14.4%

Competition and the European Market

The bankcard processors such as TSYS, Certegy, First Data, Nova, and Global Payments continue to be greatly influenced by the merger and acquisition activity of the larger banks of the world. In many cases, this activity has resulted in bank changes in TPPs for the processing service. There is presently a trend towards consolidation of the market share among the major processors. The problem for some processing firms, however, is the overall pieces of the pie are becoming larger and fewer as the banking industry consolidates under fewer and fewer roofs. Consider the merger and acquisition activities of JP Morgan Chase as well as Bank of America and Fleet Bank. Such consolidation among large banking corporations with sizeable bankcard portfolios implies that in the near future there will be some processing firms with greatly reduced market share and possibly some acquisitions or takeovers of the weakened firms.

Table 8: Principal International Competitors in Bankcard processing

Company Name	Primary product offering	Global presence	# of cardholder accounts (millions)	High level SWOT analysis
TSYS	-Cardholder processing -Merchant processing	-United States - Europe -Mexico -Caribbean -Canada -Honduras	430	S-Highly flexible systems that can be customized to meet variety of requirements W-New ventures into certain areas may not allow for continued economies of scale advantages O-Exploration in the Chinese market offers chance to develop market for bankcards in China T-Continuous merger and acquisition activity causes uncertainty regarding the bigger banks choices regarding who will process their cardholder transactions
Certegy	-Cardholder processing -Merchant processing	-United States -United Kingdom -Ireland -France -Chile -Brazil -Australia -New Zealand -Thailand -Caribbean	52.4	S-Smaller semi-focused operations W-Not as specialized or flexible as the TSYS systems O-Several markets covered by present operations allow easier further penetration to those markets T-Since Certegy is a smaller operation, larger firms such as TSYS and FirstData have potential cost advantages due to economies of scale
FirstData	-Cardholder processing -Merchant processing	- Latin America & Canada (LAC) -Australia, New Zealand & South Asia (ANZSA) -Europe, Middle East & Africa (EMEA) -China & North Asia (CNA)	406	S-Very large conglomerate wielding market power in various areas of data processing W-Older less flexible processing systems O-Global reach through current established presence in 5 regions T-TSYS has recently overtaken FirstData in terms accounts on file and has momentum

Table 8: Principal International Competitors in Bankcard processing				
Company Name	Primary product offering	Global presence	# of cardholder accounts (millions)	High level SWOT analysis
Global Payments	-Cardholder processing -Merchant processing	-United States, -Canada -Europe -Latin America	1	S-Solid relationships with existing client base W-Smaller clients mean less experience with the top issuing banks. Tough to penetrate that market O-Global payments' specialization in recent processing compliance enhancements may help with new smaller client acquisition T-The larger processors such as TSYS and FirstData that have economies of scale advantage

The global reach of the different TPPs varies. TSYS has clients in Europe, Mexico, the Caribbean, Canada and Honduras. The other processors all have clients in Europe as well. Certegy also has global extension in Chile, Brazil, Australia and New Zealand while First Data actually partitions their global presence into 5 different regions: Latin America/Caribbean, Australia/New Zealand/South Asia, Europe/Middle East/Africa and China/North Asia. In general, the competitors' weakness is the use of legacy systems that are not as flexible in terms of customization as the more advanced TSYS processing software. FirstData, for example, has lost a few clients to TSYS in recent years. One of the banks with whom TSYS started European processing, the United Kingdom bank Royal Bank of Scotland, is an example. The strengths of the competition are their existing client base and global reach. The preceding table provides a high level summary of the competition faced by TSYS internationally:

Less ability to customize to particular client needs means less opportunity to take advantage of economies of scale with the processing platforms. The basis for competition is usually price, ability to comply and process per local rules and options and flexibility provided by the systems used to easily introduce changes or add new product offerings such as affinity programs or incentive interest rates for an introductory period as mentioned previously.

INTERNATIONAL APPROACH

TSYS entered the international arena as a market seeker to increase market share, as an efficiency seeker to take advantage of economies of scale and to hedge by diversification of the "portfolio" of clients. The 2003 TSYS annual report states:

> *TSYS' revenues are derived from providing electronic payment processing and related services to financial and nonfinancial institutions, generally under long-term processing contracts. TSYS' services are provided primarily through the Company's cardholder systems, TS2 and TS1, to financial institutions and other organizations throughout the United States, Mexico, Canada, Honduras, the Caribbean and Europe.* (F-23)

The business concept defined above entails highly specific technology solutions outsourced by bankcard issuers and acquirers worldwide. The TS2 processing system is an option driven software engine for bankcard processing that handles transactions for issuing banks. TS1 is an earlier version that is not quite as robust but there are still clients using that lower priced offering. These two systems represent the core competency of TSYS' processing of bankcard transactions for issuing banks. The competitive advantage that TSYS has enjoyed in recent years is attributed to the TS2 system which has been very popular in winning an ever-increasing client base. The basic units of revenue generation in the bankcard industry are cardholders conducting transactions around the globe. The processing compliance requirements set forth on a continuous basis by the bankcard associations, principally Visa and MasterCard, have increased in quantity and complexity over the last decade. Today, there are more data transmitted per transaction than previously. While the additional data adds value to an individual transaction such as consumer behavior tracking or purchase type categorization for business accounting purposes, there are technical and resource costs involved in maintaining the capacity to send and receive the additional data.

The European countries in which TSYS has had initial success include the United Kingdom and Ireland. These countries use different currencies, have different nuances in terms of domestic processing rules per the bankcard associations and entail regulatory issues requiring specific market entrant research, investment and planning. For example, the United Kingdom legal system requires that sensitive bankcard data be stored within the United Kingdom. This requires foreign direct investment in either the form of leasing or purchase of property such as a data center. TSYS, as the processor, would not outsource this further. A direct result of such regulations is the latest related maneuver for TSYS which has been a "greenfield" investment in a new data center in the United Kingdom to "accommodate client growth and the company's expansion throughout the continent" (TSYS Press Release, 6 Oct 2004).

CHALLENGES OF SUCCESSFUL PROVISION OF SERVICES OUTSOURCING

Exploring other markets entails the research of key channels, potential markets, and areas in which to benefit from economies of scale or strategically enhancing and customizing processing platforms to efficiently handle multiple smaller markets. Frequently the larger potential clients observe the results of the processing of smaller entities and engage in a "wait-and-see" approach. A successful observation phase implies higher possibility for an organization such as TSYS of signing on the bigger clients. The sales cycle involves lengthy contractual discussions and agreements as well as highly coordinated turning over of clients known as the deconversion/conversion process. That is, when a bank changes processor, there is a deconversion (from previous in-house or other vendor processing) and a subsequent conversion (in this case, to TSYS) of the live cardholder accounts. The processing of these accounts cannot be placed on hold while outsourcing changes are underway thus the meticulous and time sensitive nature of this process.

There are numerous discrete elements unique to a services solution that TSYS, as an internationally expanding enterprise, faced regarding its market offering:

- *Intangibility of services*
- *Inseparability of buyer and provider*
- *Lack of inventory*
- *Sensitivity to time*
- *High degree of risk*
- *Customization requirements* (Hill, 2003, 2, Magrath, 1986, 3)

TSYS has faced this array of challenges in its international endeavors. The services offered by TSYS, such as card issuance, transaction authorization, transaction clearing, statement generation, dispute resolution, financial settlement and associated reporting all lack physical substance not including the bankcard itself. The sales cycle in securing a client base for delivery of these services tends to be longer, "with cycles of 12 months or more [being] the norm rather than the exception" (Hill, 2003, 3). Of particular interest was the raising of potential market consciousness of the values and benefits of the product. TSYS' approach in the United Kingdom and Ireland primarily entailed the following activities:

- *Market research*
- *Prospect discovery*
- *Initial high level discussions*
- *Functional site analysis and gap determination*
- *Contract negotiation and pricing*
- *Conversion and deconversion activities*

This particular process lasted longer than a year and was labor intensive in terms of the provider and the buyer coming to an agreement on each aspect of change related to the conversion of accounts from one processor to another. Note that the initial discovery and contact with a prospective client until the actual implementation can be from two to five years. Therefore, a manifold-like pipeline is an important strategy for TSYS because having multiple prospects in the pipeline enables TSYS a greater diversification in terms of time and size of the prospects that finally reach a decision.

The gap determination analysis included uncovering of operational differences and ever-changing association (Visa/MasterCard) compliance differences. Such a gap analysis is used to examine the "gap" or "difference" between what the customer requires and what the processor can provide through current offerings or via customization, thus the importance of a flexible system. For example, the clients in the United Kingdom processes certain bankcard transaction types that adhere to domestic rules of that country such as transaction rate structure, dispute reasons, specific ATM fees etc. The gap analysis may reveal that the present "off-the-shelf" version of the TSYS software system does not meet all of these requirements. If this is the case, special ad hoc project work and software configuration is conducted in order to "close" such gaps in order to comply with the client needs. The specific gaps are discussed between the project management team for TSYS and the project representative of the client so that a specific project plan can be developed to resolve processing differences. Operational differences may vary from adding a field to a system screen to developing a new report or database function as required by the association or as requested by the client. The key is to add value and this was not possible with a "vanilla" or "off-the-shelf" offering of TSYS products due to customization needs and requirements. An additional factor was the necessity for the continuity of the business process upon changing of service provider. Not only was the processor faced with the complexities of a different processing environment encountered in Europe compared with the United States region, but it was imperative that the transition on implementation day of conversion be conducted with as few interruptions as possible. As previously mentioned, the cardholders do not cease card usage for a specific period to accommodate a conversion/deconversion. Thus, the coordination among the winning firm (conversion), the losing firm (deconversion) and the bankcard associations must be precise and timely.

The management of change in light of such requirements or requests is a TSYS competitive advantage that sets the company apart from rivals as is apparent by the growth in accounts on file, especially in terms of international clients as seen in Table 9:

After initial market research and prospect discovery were concluded, the company invested heavily in infrastructure to support global expansion. Cost for labor and capital factors were incurred in the establishment of an international processing center in Harrogate, England. This center preceded the Knaresborough location completed in the third quarter of 2004 as mentioned above. This "greenfield" investment in Knaresborough, England was decided upon in order to meet the potential demands of other prospects on the European continent. Such investment was a risky endeavor with major costs. However, with long-term projections of "20% of total revenue [to be] derived from international sources," TSYS was aggressive toward entering the profitable United Kingdom and Irish markets and planned to continue throughout the rest of the continent.

Table 9: TSYS accounts on File 2001-2003 (in millions)

Accounts on file	2001	% increase	2002	% increase	2003	% increase
Domestic	190.4	6.6%	215.4	13.1%	229.8	6.7%
International	28.1	66.9%	30.5	8.6%	44.1	44.8%

Source: *TSYS 2003 Annual Report*

Additional comments on data: The upward trend of 66.9% in 2001 was due to the United Kingdom accounts opened during that period and the 44.8% increase indicates very strong international "organic" growth of accounts already on file.

Pricing the product proves a daunting challenge as the pricing in the bankcard processing arena is rarely based on a standard worldwide price due to the factors in the negotiation process and the level of customization that each client requires. In the credit card processing services industry, there are not necessarily price increases due to distance as may be the case when a physical product must be shipped or direct investment in assets within the target market is a factor. The objectives of TSYS as well as market conditions have greatly affected prior pricing decisions. This case depicts a firm using, in certain initial phases of a particular market entry, a market-differentiated price-setting strategy based on client-specific demand and potential rather than actual cost of the sales process, establishment of operations and project management. This can imply different foreign and domestic pricing. One of TSYS' objectives with the choice of the United Kingdom and Ireland was to take advantage of economies of scale as related to the processing platforms. As this turned out possible, the outlook from a capital budgeting project had a favorable outlook. The following table provides an illustration of the cash flow factors for entry into the United Kingdom and Ireland market includes the following capital outlays and operating cash flows.

Expansion into other countries that may reduce the advantages of economies of scale is carefully considered as such a maneuver may become detrimental if the different platforms on which processing takes place are not managed properly and either cause reduced economies or data processing issues which can potentially damage the company's reputation. There are specific challenges posed by the processing environment in other countries. The business processes in France are extremely unique and have been relatively difficult for acquiring processors to master. In Germany, the debit bankcard product is less compelling due to lower margins. These three areas, the United Kingdom, France and Germany represent the majority of the bankcard processing volumes in Europe.

Table 10: Various cash flow factors in TSYS' European expansion

Year	Capital outlay	Factors related to [future] cash flows
2000	Opening of headquarters in York, England. Cost = $13 million**	In the 2000 annual report a 15% per year market growth is predicted for the European expansion area.
2000	During 2000, the Company ceased development of two software projects. The projects were evaluated to determine their utilization in a new design plan that included expanded international functionality. Based on its review, the Company expensed $6.1 million of costs as employment and other expenses that were originally capitalized on those projects.*	
2001	Decline in cash flows from operating activities from prior year. The amount of the decline = $77 million due to outlay without full year of processing revenues. (entails net operating expenses related to European expansion = $16.4 million)	
2001		$121,967 currency translation gain related to financing of European operations
2002		$9.44 million segment operating cash flows
2002		$3 million currency translation gain related to financing of European operations
2003	On July 30, 2003, the Company announced the groundbreaking for a new TSYS data center in Knaresborough, England. The 53,000 square-foot facility and n October 6, 2004, the Company announced the completion of the new data center. The Company invested approximately £16.6 million, or approximately $30.2 million, in the new building, land and equipment.**	$15.43 million segment operating cash flows
2004		$15.16 million segment net income

Note: The figures above are actual figures extracted from annual report financial data. The outlay and inflows are to provide an idea of the costs involved, not to serve as a projection of what costs may be as is the case in basic capital budgeting. The source of the above data is the corresponding year TSYS Annual Report.

* Software development costs: In accordance with Statement of Financial Accounting Standards No. 86, ''Computer Software to be Sold, Leased or Otherwise Marketed,'' software development costs are capitalized once technological feasibility of the software product has been established. Costs incurred prior to establishing technological feasibility are expensed as incurred. Technological feasibility is established when the Company has completed a detailed program design and has determined that a product can be produced to meet its design specifications, including functions, features and technical performance requirements. The Company did not successfully achieve technological feasibility.

** To be capitalized

In Spain there is a barrier of a national consortium of banks known as Sistema 4B. This is a consortium of banks that cooperates as the Spanish transaction processing authority.
From a technical standpoint, an additional challenge deals with association processing regulations which must be adhered to by all interfacing banks or processors. For example, MasterCard of Europe will be fully integrated with MasterCard international from a business and technical processing standpoint by the end of 2006. This implies that banks that process in-house and smaller interbank shops will need to go to the required lengths to meet the demands of the technical system and data format changes that will internationally standardize MasterCard processing. TSYS' competitive advantage is that they presently operate in both environments.

Euro currency processing

The euro currency came into effect financially on 1 January 1999 becoming the defined currency for monetary policy in the Economic and Monetary Union of the European Union. The subsequent physical circulation of the Euro, beginning in January 2002, posed no problems for TSYS. From TSYS' perspective, the European client adoption of the euro varied as is noted in a related passage in TSYS' 2001 Annual Report covering "Euro Conversion Readiness":

> *The Company converted the account portfolios of RBS [Royal Bank of Scotland] and AIB [Allied Irish Bank] in 2001. The United Kingdom is not a participating country with respect to January 1, 1999, "Euro" currency conversion and it currently is not known when or if the United Kingdom will elect to convert to the Euro. However, Ireland is a participating country. As of October 2000, TSYS' TS2 processing system is capable of processing Euro-denominated transactions. TSYS' costs in connection with the Euro conversion were not material. The European Union officially converted to the Euro currency on January 1, 2002. TSYS has not experienced any difficulties in processing Euro-denominated transactions.* (F-12)

Having successfully converted United Kingdom and Irish clients, TSYS was able to display its technical and project management skills to other potential client prospects in the euro –zone. While the British Isles constitute a major share of the processing volume, there still remain other key potential large volume processing areas in which to expand.

RECENT RESULTS, ACTIVITIES AND FUTURE OPPORTUNITIES

As the background of the bankcard industry suggests, this business is complex and highly competitive. The competitive environment is active and the risks with international markets indeed exist. TSYS' approach has yielded solid results. As an outcome of the efforts made in terms of revenue, TSYS achieved the following operating outcomes over the 2001-2003 period:

Table 11: TSYS Total revenues and Net Income 2001-2003 Revenues			
Year	Domestic-based services	International-based services	% International
2003	$973,251,890	80,288,103	8.25%
2002	$890,830,320	64,948,732	7.3%
2001	$859,113,429	33,214,304	3.87%
Net income			
Year	Domestic-based services	International-based services	% International
2003	$133,859,727	7,113,240	5.31%
2002	$123,145,684	2,659,287	2.16%
2001	$114,604,567	(10,186,338)	-

Ireland and the United Kingdom appear to be a point of departure for TSYS' presence in Europe. The improving revenue and income figures above represent steps in the right direction for the company. Recently, TSYS has further opened up its opportunities with the pending reacquisition of the 50% equity stake that Visa USA holds in Vital Processing Services, an acquiring processor:

> *Following the closing of the transaction, Vital will become a wholly-owned subsidiary of TSYS. The purchase of the remaining 50% interest in Vital provides TSYS greater synergies for its clients that service merchants who accept cards as payments and issue credit to their customers. Vital is the second-largest processor of merchant accounts in the United States, serving more than one million merchant locations. Formed in 1996 as a joint venture between Visa U.S.A. and TSYS, Vital specializes in attractive, cost-effective, turn-key alternatives for acquirers that outsource their merchant business.*

As TSYS has mastered its bankcard processing skills in Europe to include quick response to association compliance changes, the future portends opportunity. Is there a cost effective option for pan-European bankcard processing? While processing in the United Kingdom and Ireland has posed some obstacles, there are the aforementioned additional barriers to further expansion to other larger volume areas of Europe such as in France, Germany, and Spain. Furthermore, a key potential development for the near future entails consolidation among larger third party processors such as TSYS, FirstData, Certegy and smaller interbank processors. There are many niches and peculiarities within the European bankcard processing environment. How will the processors deal with the challenge of these niches and differences among the European countries in terms of processing environment? In spite of the differences, with the advent of the euro and general attempts to harmonize various accounting and financial methodologies in Europe, standardization is starting to apply as well to the card processing market. Since larger processors such as TSYS already operate in both the European and non-European international environments, this provides a clear competitive advantage and particularly when faced with strict and continuous compliance requirements and deadlines set forth by the bankcard associations.

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AMERICAN RED CROSS: UNDER FIRE

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CASE DESCRIPTION

This case is directed towards undergraduates and graduate students in management classes and classes in non-profit organizations. Depending on the focus of the class, different case questions can be emphasized for students in management classes, leadership classes and those enrolled in non-profit classes.

CASE SYNOPSIS

The case deals primarily with the governance of the San Diego Imperial County Chapter of the American Red Cross in the early part of this decade during, after the debilitating Viejas fire. The chapter's CEO, Dodie Rotherham, seemingly cared more for raising donations to better the chapter than caring for the people in need and the community. Rotherham ignored the internal conflicts of the organization preferring to be out in the public to raise donations. She lost sight of the principal core values of the organization; provide relief to victims and help people prevent, prepare for and respond to emergencies. Because Rotherham and the organization lost touch with the community, the community rose up against the organization when it was discovered that the organization used the donations for the fire victims inappropriately. The organization had to change to survive. The key to its survival was the rebuilding of the trust of the community by removing all of the leaders (CEO and Board of Directors) and developing an organizational culture change that promoted openness, change and development.

The purpose of this case is to demonstrate the effects of leadership on a non-profit organization. Discussion of this case brings about the understanding of the problems that can arise when leadership abandons the organization's mission and goals. Students will have a better understanding of what can happen if management loses focus of the organization's goals and mission. Additionally, students will see that it is difficult to regain the confidence of community when the organization loses touch with the community. The student will learn the espoused values of the Red Cross, the values under Dodie Rotherham, and after Rotherham left the Red Cross, the values Jerry Sanders and Ronne Froman attempted to bring to the organization.

OUR MISSION

The American Red Cross, a humanitarian organization led by volunteers and guided by its Congressional Charter and the Fundamental Principles of the International Red Cross Movement, will provide relief to victims of disaster and help people prevent, prepare for, and respond to emergencies.

The fire came without warning. In the early morning hours of January 3, 2001, several families had to flee their homes with only the clothes on their back to escape the blaze that became known as the Viejas fire. The fire started on the Viejas Indian Reservation, east of Alpine, CA. Due to dry conditions and heavy winds, it burned for six days, where it charred more than 10,000 acres, destroying homes and vehicles, killing animals and livestock, and disrupting lives. Total damage estimates ranged from $1.8 million to $8 million. Victims of the fire started out their New Year in devastation and looked to the local chapter of the American Red Cross, an institution designed to assist in disasters, to help in their loss. Donations from the community streamed into the San Diego chapter of the Red Cross for use towards the fire victims. However, victims of the fire felt that they did not receive the level of comfort and support expected from this trusted non-profit organization. Their phone calls to the local chapter went unanswered. At a meeting, victims expressed their concern over the use of the funds collected on their behalf. Dodie Rotherham, the San Diego/Imperial County chapter CEO for the Red Cross, called the meeting a "bitchfest." Victims received very little financial support to restart their lives. Later, audits revealed that the Red Cross received over $400,000 in donations after the fire, but of that total, only $7,000 was used for the victims. How could this have happened? How could an organization whose values included humanitarianism, stewardship, helping others, respect and integrity, now also include fraud, distrust and lying? The blaze may have been put out, but the fire for the San Diego chapter of the Red Cross was just beginning.

"TOGETHER, WE CAN SAVE A LIFE"

The mission for the American Red Cross is to provide relief to victims of disasters and help people prevent, prepare for, and respond to emergencies. The Red Cross was modeled after the International Red Cross, which was created in Geneva, Switzerland to provide nonpartisan care to the wounded and sick in times of war. The first person to establish the American Red Cross was Clara Barton (1821-1912), and she created it to serve America in peace and in war, but also during times of disaster and national calamity. The Red Cross functions independently of the government, but works closely with government agencies, such as the Federal Emergency Management Agency (FEMA), during times of crisis. They are also responsible for giving aid to members of the U.S. Armed Forces and to disaster victims at home and abroad.

The San Diego chapter of the Red Cross was formed in 1898, as a result of assistance efforts during the Spanish-American War. Over the past 105 years, the chapter has achieved recognition for being the only chapter in the United States to have served on a battlefield; beginning the world's first mass antipolio inoculation of adults in 1957; and in 1978, assisting emergency officials during the aftermath of the deadly Pacific Southwest Airlines (PSA) crash. The San Diego and Imperial

County Red Cross chapters merged in 1983, where there are now 19 offices throughout the two counties and on military bases to deliver services locally. (Reference SD Red Cross Values in Attachment #1)

At the San Diego chapter, there is a volunteer board of directors, paid staff, $18 million dollar operating budget, and 5,000 local volunteers who donate an average of 500,000 hours of service each year. They have five major programs: Disaster Services, Armed Forces Emergency Services, Health and Safety, Transportation Services and the Women, Infants and Children (WIC) supplemental food program.

Despite its longevity and importance to the community, this organization has been through a very difficult period of turmoil. The Viejas fire that started the morning of January 3, 2001 may have burned homes, acreage and lives, but it also started a fire at the local San Diego chapter of the Red Cross, where several scandals, firings and resignations occurred in its aftermath.

"THE HOUSE OF CARDS BEGINS TO CRUMBLE"

The house of cards began to crumble for the San Diego chapter when Superior Court Judge Patricia Cookson, a victim of the Viejas fire, did not receive return calls from them when she needed assistance in locating grief counseling. She became further outraged when she discovered that the local Red Cross was using a picture taken of her during the fire to solicit money on their web site. She contacted other fire victims, where they compared notes and decided to enlist the help of their County Supervisor, Dianne Jacob, to raise questions about the assistance (or the lack of) provided to them. On January 30, 2001, Jacob requested that all contributions made to the American Red Cross as a result of the Viejas fire be spent in the community of Alpine to benefit the victims of the fire. Chapter CEO, Dodie Rotherham, stressed that the money raised needed to be saved for future disasters and that the Red Cross funds were not meant to take the place of property insurance. In response, Jacob launched her own investigation into the agency and its disbursement of funds. The chapter refused to open its books to Jacob, where she then took her case to the media. Public outrage grew, especially when it was revealed that Rotherham was paid more than $300,000 a year in salary and incentives. Donors were not pleased and monetary donations dropped so significantly that the chapter was forced to seek financial assistance from the National Red Cross. In a May 2001 meeting, Supervisor Jacob was supplied with a report on the use of funds from the disaster, which she found unacceptable. Jacob then requested that the national Red Cross president, Dr. Bernadine Healy, look into the fund-raising practices of the San Diego chapter and get a full accounting of the money spent in the Viejas fire relief effort.

In August of 2001, Rotherham defended the Red Cross' handling of the situation by producing an accounting for some of the money spent on the Viejas fire relief, and acknowledged that the remainder of donations went into a local disaster relief fund that pays for responses for smaller disasters, like house fires, throughout the year. Jacob believed that this was vague and incomplete.

"ALOOF AND ACCOUNTABLE TO NO ONE"

Under Rotherham's 19-year tenure as CEO, the San Diego chapter of the Red Cross was transformed into a consistent moneymaker and it was the lead chapter in California, finally taking the number one spot away from Los Angeles. Critics, including former employees, national executives, a former board member and elected officials, said "Rotherham and the chapter became aloof and accountable to no one." According to these critics, these traits were apparent throughout the chapter's dealings with its employees, the community and even the Red Cross national headquarters. They also said that "the chapter had lost its focus on its core Red Cross programs and became more interested in making money than serving people."

By September 2001, the national Red Cross office assured Jacob that an audit would be conducted on the San Diego chapter and the results would be made public. The national audit was completed in early September but never officially released. Information contained in the audit criticized the chapter for taking too much money for overhead – more than 60 percent – and giving too little to victims. The conclusions of the audit were covered up by Rotherham and her executive committee, and it wasn't shared with the chapter's Board of Directors. When Healy, the national Red Cross CEO, read the report, she was so outraged that she felt Rotherham should be removed. On the morning of September 11, 2001, Healy was set to fire Rotherham, but the terrorist events of that day intervened. Instead, it was Healy that was fired in October 2001 because of her insistence that Rotherham and other chapter CEOs be held more accountable. Because of her stand, she lost the support of the national Red Cross board, which is largely appointed by local chapters.

Rotherham may have remained, but the media, public and Supervisor Jacob would not allow her to. In November 2001, local San Diego media obtained a copy of the national audit on the San Diego chapter, which forced local chapter officials to confront the issue. In the meantime, the chapter quickly put together and released their own version of the audit, which they doctored to make themselves look more favorable. That version was later disputed by the national Red Cross. Later that month, Charles Duddles, the chairman of the San Diego Red Cross Board of Directors, apologized for the way his organization solicited and handled the funds collected during the Viejas fire. Although he heavily denied the augmented results of the national audit that was leaked to the press in an attempt to cover up their wrongdoing, he eventually released the correct and full version of the national audit, complete with the 14 failings found. A committee was formed at the request of the San Diego chapter to provide oversight and to review the chapter's community services.

In April 2002, the committee began its examination and was granted full access to the chapter's information. A preliminary report was promised in 8 to 12 weeks. It didn't take that long. By the end of April 2002, the committee recommended that Duddles, the Board Chair, step down and he did. In May 2002, the committee told Rotherham to retire or be fired. Rotherham refused and was fired. In June 2002, the national Red Cross removed the volunteer directors at the San Diego chapter. Due to the fallout of the Viejas fire, the committee felt that the board members had become paralyzed and could no longer provide effective leadership. An interim CEO and new Board of Directors were appointed. Further trouble plagued the organization when it was revealed that the San Diego chapter was under investigation by the State Attorney General for potential fraud in the transportation services sector. (They have since terminated the transportation services sector of their services).

"GIVE YOU THE SHIRT OFF THEIR BACK; BUT PUT A KNIFE IN YOURS"

An influential factor in the demise of Rotherham and her Board of Directors can be described as a cultural one. As part of a national organization, the local chapter was a reflection of the inconsistencies, poor oversight, and arrogance of the large entity. The former national president of the Red Cross, Dr. Bernadine Healy, has said that when she arrived at the Red Cross to assume her position as CEO, another executive told her that "Red Crossers will give you the shirt off their back, but will as easily put a knife in your back." According to the same article, Healy also describes the Red Cross as a "corporate culture steeped in silos, turf battles, gossip and very little teamwork. Management structure was almost militaristic … but unlike the military, there were few commonly understood performance measures, and almost no system of reward or consequences for performance." The chapters had always been allowed to operate autonomously, so the San Diego chapter felt justified in their handling of the Viejas fire. The chapters have been compared to "fiefdoms;" they developed their own subcultures, which allowed them to create their own philosophies, and in turn, they resisted direction from national.

The national-appointed CEO that followed Healy said that his first impression of the Red Cross organization as a whole was a "politburo." There was tension between the disaster relief and blood business components. The local chapters and national were often at odds; long-time veterans thought the "mission" was performing good deeds, while newcomers perceived that good management was the "mission." The national Board of Directors were also in conflict as the board of 50 directors, of which 30 were chapter representatives, viewed themselves as being in control of the organization and were the ones that were in charge.

Competing interests, conflicts and power struggles were what defined the Red Cross. County Supervisor Dianne Jacob stated that she considered national part of the problem, not the solution. Prior to her firing in October 2001, Healy wrote a memo to the General Counsel, Ron Lund, to express her concern regarding evaluating chapters that were suspected of problems. Healy found response about these matters from the national board to be troubling. She said that touching the chapters was like touching the "third rail." The "third rail" is a reference to the third rail in the subway system, which could cause serious harm and even electrocution. Given Healy's perception on the chapters, it is not surprising that Rotherham believed no harm or consequences would come from her actions. As a local chapter, it was a microcosm of the national Red Cross, and reflected the larger culture. When asked for information, Rotherham refused to disclose the information, which raised even more red flags. This choice of behavior served to only heighten the public's distrust of the organization and invited further scrutiny. When the time had come for Rotherham to step down, she refused. She had been an authority figure for the chapter for such a long period of time, and the Board and community had let her decisions go unquestioned. She could not see why the national leaders were pressuring the Board to terminate her employment. Although the organization needed to make drastic changes to insure its survival, the Board was impotent of even making that decision. It finally fell to national leaders that gave her the "retire or be fired." Rotherham chose the latter.

"WHERE DO WE GO FROM HERE?"

Since the removal of Rotherham and her Board, the San Diego chapter made strides to regaining public trust in the mission and services of the American Red Cross. They started off by appointing the chairman of the Board, a popular former San Diego police chief, Jerry Sanders. He wrote in an editorial to the local newspaper in October 2002, "Our local American Red Cross chapter responds to hundreds of disasters each year, roughly one every 29 hours. But it would not be a stretch of anyone's imagination to suggest that the biggest disaster the chapter has faced in its 104-year history in our community has been the loss of its own credibility and integrity." Sanders pledged that he and the new Board of Directors would make sure investigations into the Red Cross' activities would continue, that they would be cooperative and would be held accountable for their past actions as a catalyst for change.

The local chapter then selected a new chapter CEO, retired Navy rear admiral Veronica "Ronne" Froman, who Supervisor Jacob hailed as a "brilliant hire." Jacob said, "She's a no-nonsense, highly trusted person with a high level of integrity." Froman spent more than 31 years serving her country as a Naval Officer leading reform efforts around the globe and spent close to two years at the San Diego Unified School District as the chief of business and operations. Froman is also friends with the new national Red Cross CEO, Mary Evans. Evans, who retired from the Navy in 1997, was hired in the summer of 2002 to replace Healy.

When Froman took over the chapter, it was struggling to regain its footing in fundraising and disaster relief operations. The organization's fiscal year ended June 2003, and its revenues were $2 million less than the previous year. She and the new board had a lot of work ahead of them.

Froman and the new chapter Board were put to the test in October 2003, when wildfires across San Diego County devastated homes, lives and whole communities. Donors were hesitant to send donations to the local Red Cross for fear that the debacle that happened with the Viejas fire would occur again and that the money would be used partially for the victims and the rest for other

Red Cross purposes. Froman went to the media and strongly stressed that donations would remain in the local area and would directly benefit victims. The media reported, “Given the local chapter’s sensitivity to fundraising issues stemming from the scandals surround the 2001 Viejas fire, chapter officials have offered to establish a separate fund and track it.” Froman and Sanders had to fight the national Red Cross on this issue, as it is a violation of their usual policies. Sanders said in a local newspaper editorial, “Under Froman’s leadership, the Red Cross is responding on many fronts to the conflagration … donors can be confident the money they send to assist thousands of victims will be used for that purpose.”

They did just that when current chief financial officer for the local chapter, Jeff Weimann, released regular donation and account updates to the media. This allowed donors to see exactly where the money came from and what services are being supported with those funds. The key to rebuilding trust with the community is an organizational culture that promotes openness, change and development.

The American Red Cross and its chapters should never allow itself to deviate so far from their core mission – to help people. They must put the victims and donors first, not fundraising. They have to focus on the mission and not get bogged down in politics and bureaucracy of a vast organization. They became enveloped in a fire of their own creation and alienated the very people they were trying to help. At the San Diego chapter, they have appointed people that have backgrounds that should instill trust from the community, a former Navy rear admiral and a former San Diego police chief. The chapter knows they are under the watchful eye of the community, the local media and Supervisor Jacob. With their recent handling of the devastating wildfires of 2003, they are on their way to regaining the trust and integrity that burned in the fires of early 2001.

KMART-SEARS MERGER OF 2005

Noushi Rahman, Pace University
Alan B. Eisner, Pace University

"*Unless this new retail giant proves that it's capable of creating stronger customer connections, there will be no real value to this merger*" (William J. McEwen, *Gallup Management Journal*)

"*As a retailer, we really have not grown at all for the last 35 years*" (Alan Lacy, Vice Chairman of SHC, Ex-Chairman of Sears)

"*The idea is to form "one great culture*" (Edward Lampert, Chairman of SHC, Ex-Chairman or Kmart)

CASE DESCRIPTION

The primary subject matter of this case is corporate strategy. The subject matter is fleshed out in the context of a merger. This case is intended for an undergraduate or graduate corporate strategy section of a business strategy course. The case is designed to be taught in one class hour and is expected to require one hour of outside preparation by students.

CASE SYNOPSIS

In November 2004, retail giants Kmart and Sears announced plans to "merge" their operations. The "merger" was finalized in March 2005 and the combined entity was named Sears Holding Company. At the completion of the "merger," Sears Holding Company had revenues of more than $55 billion (in addition to $2.8 billion in debt), making it the third largest domestic retail company following Wal-Mart and Home Depot. The new organization would face three important issues: competition, synergy, and culture. Appropriate strategies, structures, and culture-blending initiatives must be developed to integrate these historic, disparate organizations to successfully perform as one unified business firm.

THE MERGER

In late 2004, two giant U.S. retail corporations—Sears, Roebuck and Co. and Kmart Holding Corporation—announced that they would merge operations to form the Sears Holding Company

(SHC). In terms of how the new entity's name was selected, the Sears name was apparently held in higher esteem by consumers than the Kmart name. Based on a survey conducted by Rivkin & Associates, Opinion Research Corp. (of 1,050 U.S. adults), 75% of Americans preferred the "Sears" name over "Kmart."

Under the terms of the merger, SHC became the third largest retailer in the U.S. with approximately $55 billion in annual revenues and 2,350 full-line and off-mall stores and 1,100 specialty retail stores in the U.S. Kmart shareholders received one share of SHC common stock for each Kmart share. Sears shareholders had the right to elect $50 in cash or 0.5 of a share of SHC for each share of Sears's common stock. At the time of the merger, it was estimated that the former shareholders of Kmart would have an approximate 63% interest in SHC and former shareholders of Sears would hold a 37% interest in SHC. On the morning of March 24, 2005, the merger approval date, Sears shares fell $6.06 (about 11%) to $50.74 (NYSE) and Kmart shares rose $1.19 (about 1%) to $126.02 (NASDAQ).

Twelve teams—comprised of members from both companies—were created to ease the merger process. According to Alan Lacy, former President and Chief Executive Officer of Sears and new Vice Chairman of SHC, one post-merger goal is that "Kmart will benefit from the planned cost sharing of several of Sears leading proprietary brands" as well as present opportunities "to capture significant revenue and cost synergies, including merchandise and non-merchandise purchasing, distribution and other SG&A expenses." Ultimately, the goal of the merger, according to Edward S. Lampert, former Chairman of Kmart and new Chairman of SHC, was to "seek to leverage the combined strengths of Sears and Kmart to obtain greater long-term value than either could have generated on a stand-alone basis. SHC plans to offer customers a new, more compelling experience with a differentiated and expanded product range" (*SHC Press Release*, 2005).

These changes are the first of many for these historic and somewhat disparate companies, both of which were founded in the late 1800's and are woven in American culture. The newly merged entity—SHC—will face challenges of marrying two distinct retail entities in terms of their unique cultures, in order to create requisite synergies to keep pace with (or surpass) the competition. Before looking on to the future, it is important to look at the historical evolution of Sears and Kmart to better understand the respective organizations' strategies and cultures.

BACKGROUND OF COMPANIES

Sears, Roebuck & Co.

Richard W. Sears found the R.W. Sears Watch Co. in 1886. The early days of the organization were filled with changes in structure and partnership—moving to Chicago, taking on Alvah Roebuck (an Indiana watchmaker) as a partner, and publishing the company's first mail order catalog (which comprised of 80 pages) in 1888. The watch business was sold in 1889 and by 1891

Sears had developed the nation's first mail-order business. In 1893, the company's name changed to Sears, Roebuck and Co. At that time, the company's sales had exceeded $400,000. By 1895, the 532-page Sears catalog offered a variety of merchandise, including apparel, shoes, china, saddles, musical instruments, firearms, buggies, wagons, fishing tackle, watches, jewelry, etc.

In 1911, when banks did not lend to consumers, Sears opted to offer credit services to its customers. Around this time, Sears also established a research lab to ensure product standards and conduct merchandise quality control checks. In February 1925, Sears opened its first retail store. In terms of retail history making, Richard Sears is credited with creating the modern department store; he also came up with the idea of "unconditional money back guarantee."

Like most other U.S. companies, Sears struggled during the great depression. After the depression, the company continued its growth in terms of number of retail locations, business line diversification (e.g., Sears introduced a line of tires, "Allstate," which was ultimately expanded into an automobile insurance and life insurance company), international expansion (e.g., early expansions included Cuba in 1942 and Mexico in 1947), acquisitions of several other organizations (e.g., Simpsons Ltd. of Canada, Coldwell Banker Co., etc.), and the erection of the Sears Tower in Chicago in the 1970's (i.e., at the time, the tallest building in the world). By 1963, Sears was the number-one retailer in the U.S. and one-in-five consumers shopped at Sears regularly.

Early success ultimately made Sears complacent. By the 1970's, competition became stiff and other discounters (S. S. Kresge Co., which later became Kmart) started cutting into Sears' profits. In 1974 alone, Sears experienced a $170 million drop in profits. In an effort to continue its growth, Sears attempted to further diversify its businesses. Despite diversification in the 1980's (e.g., purchase of Coldwell Banker, then the nation's largest real estate broker; Dean Witter Reynolds, a securities firm; the launch of Prodigy, an on-line service with IBM and CBS; the launch of the Discover Card; and ultimately the transformation of Sears into a collection of specialty stores), profits continued to decline through the 1990's. In 1992, Sears slashed jobs and suffered a year-end loss of almost $2.3 billion. This outcome prompted Sears to sell off several of its businesses (e.g., Coldwell Banker, Dean Witter Reynolds, etc.).

As a strategic response to declining revenue in the 1990's, Sears made an effort to target female consumers, introducing the "softer side of Sears." To support this strategy, Sears restructured its stores (i.e., moving appliances, hardware, and furniture were moved from mall stores to their own freestanding retail outlets). By 1995, profits hit $1 billion again; and in 1997, Sears stock reached an all time high of $65.25 per share. By 1998, however, Sears again saw downturns in business and many executives, including the chief executive officer, departed. In October 2000, current President Alan Lacy took the reins and created "The Great Indoors" store concept. Another strategic move made by Lacy was to transfer Sears account holders to MasterCard as Sears had come to rely too heavily on its credit card financing operations. This move resulted in many consumer defaults because of the higher interest rates. Sears in-store sales also continued to falter. In 2003 sales were slumping and staff layoffs were instituted again. In addition, the credit card business was sold for $3 billion to Citigroup. The "softer side of Sears" was ultimately considered to be too "soft" as witnessed by the eleven consecutive months of declining sales seen in 2004 (see Exhibits 1 and 2 for Sears' revenues and net income).

In general, Sears' retail business had been weak, consistent with its declining store sales. Sears' in-mall locations had been a major impediment to its sales of home-related categories because the majority of home goods are sold in off–mall locations. Indeed, Sears was able to retain some of its charisma in small-town America (i.e., where its off-mall stores were located).

Exhibit 1: Net Income of Kmart and Sears, 1995-2004

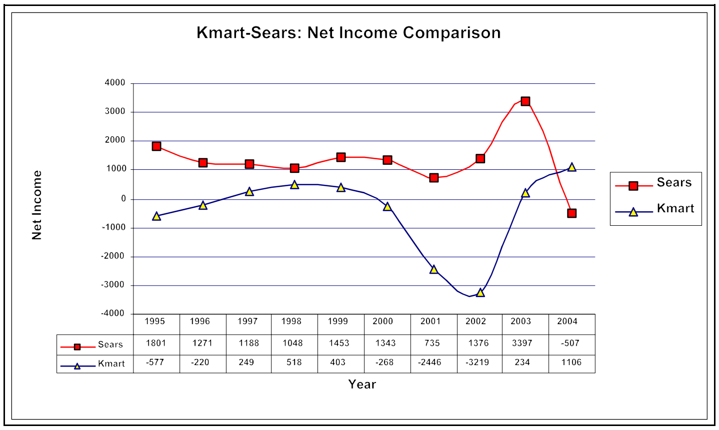
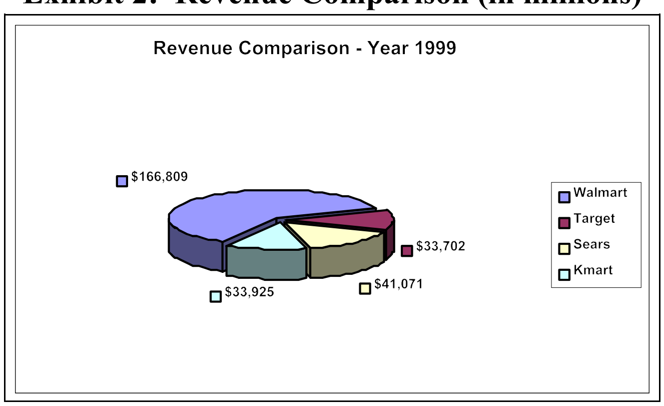
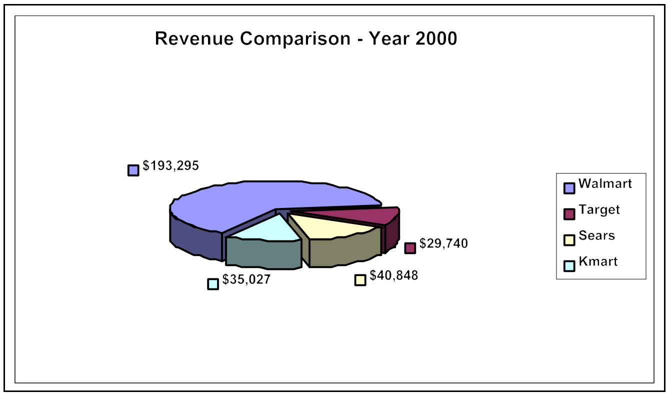
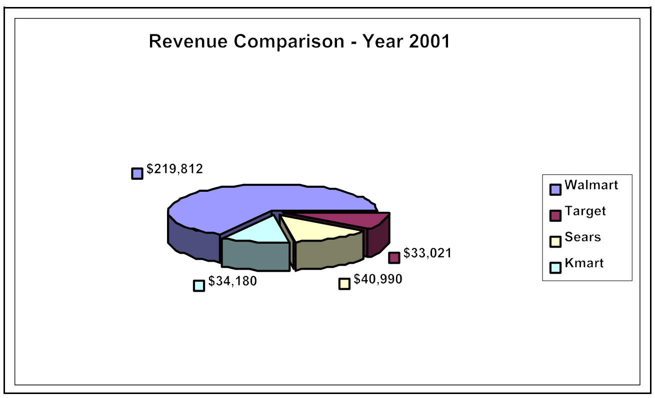


Exhibit 2: Revenue Comparison (in millions)




Revenue Comparison - Year 2000
$193,295
$29,740
$40,848
$35,027
Walmart
Target
Sears
Kmart


Revenue Comparison - Year 2001
$219,812
$33,021
$40,990
$34,180
Walmart
Target
Sears
Kmart

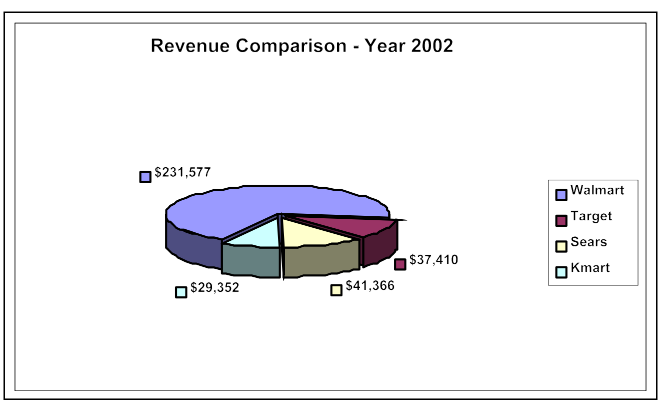
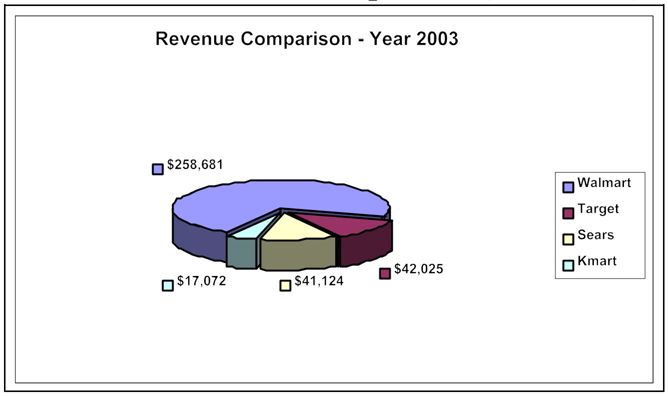
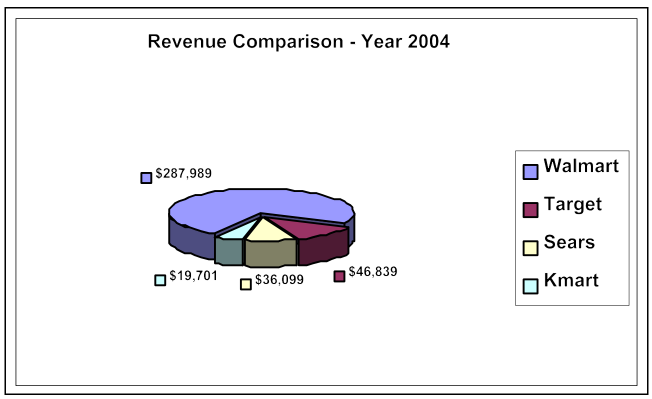

Revenue Comparison - Year 2002
$231,577
$37,410
$41,366
$29,352
Walmart
Target
Sears
Kmart

Exhibit 2: Revenue Comparison (in millions)





Kmart Holding Corporation

Kmart was founded as S. S. Kresge Co. in 1899 by Sebastian Spering Kresge as a five-and-dime retail store in Downtown Detroit. He then expanded into chain stores, similar to that of the Woolworth stores and ultimately acquired Mount Clemens Pottery (which manufactured inexpensive, popular dinnerware sold in the stores). By 1912, Kresge stores were the second largest five-and-dime chain in the U.S. with 85 stores and annual sales of over $10 million. By 1924, there were 257 stores with annual sales of $90 million.

Similar to Sears, Kresge stores struggled through the Great Depression. Unlike Sears, Kresge stores did not offer "credit" to its customers in the early years. Although Kresge offered layaway payment plans, this approach hurt the company because customers were more attracted to credit offerings.

In the late 1950's, food grew into the single largest department in Kresge stores and in-store luncheonettes were created. Consequently, Kresge acquired various food companies (e.g., Furr's

Cafeterias, Bishop Buffets, etc.), created a fast food drive-through (i.e., Kmart Chef), and ultimately entered grocery retailing in 1970's. Kmart Chef was discontinued in 1974.

In 1962, Kresge's President Harry Cunningham conducted a research study on discounters and competition. Cunningham found that discount stores were the main competition for Kresge stores. As a strategic response, "Kmart" was born in Garden City, Michigan.

After the first year in business with Kmart, sales reached $483 million and plans were made to open 32 additional Kmart locations which were geographically isolated from the competition. Through the 1960's, Kmart and Kresge continued to evolve and older Kresge stores were converted to Jupiter Discount. By 1976, Kmart became the second largest general merchandise retailer in the U.S. with annual sales of $8.4 billion. The corporation held its shares tightly (1,206 out of 1,647) and maintained 271 stores. The S.S. Kresge name was officially changed to Kmart Corp. in 1977. In mid 1970's, Kmart expanded internationally into Australia. However, Kmart sold its stake in the Australian Kmart in 1978. In the 1980's, Kmart expanded to Mexico (stores operated by a prominent Mexican retailer); the company also formed a joint venture with Japan's top retailer.

By 1981, Kmart had 2,000 stores and continued expanding through acquisitions of Penske Auto, Walden Books, and Home Centers America (renamed Builders Square). By 1987, sales were up to $25.6 billion. In order to continue its growth, from 1980 through the 1990's, Kmart Corp. acquired Sports Authority, OfficeMax, and Borders Inc.; merged with Pay Less Drug Stores, launched the Jaclyn Smith Collection, and opened Super Kmart Centers (1,200 sites by 1997). During this time, Kmart also enjoyed the growth of its apparel business (i.e., Kmart's fastest growing business).

In 1994, Kmart streamlined operations in response to shareholder displeasure. The company closed 110 stores, laying off 6,000 staff members and managers. Furthermore, Kmart sold off several of its previously acquired businesses: OfficeMax, Borders/Walden bookstores, Payless Drugs, Penske Auto, and Sports Authority.

Facing tremendous competition from other major retailers (mainly Walmart and Target), Kmart continued to change throughout the 1990's by selling its stake in the Rite Aid Corp., partnering with Salton/Maxim Housewares (i.e., giving Kmart exclusive distribution rights Salton/Maxim's small electrical appliances, consumer electronics, kitchen housewares and personal care products and other White Westinghouse brands), introducing the highly successful Martha Stewart line (i.e., home fashion products that neared $1 billion in sales), creating BlueLight.com (i.e., an independent e-commerce company formed in 1999), and entering the food retailing segment. However, all these shuffling proved futile, as Kmart continued to lose market share (see Exhibits 1 and 2 for Kmart's revenues and net income). Kmart Corp. filed for Chapter 11 bankruptcy protection in January, 2002.

Edward Lampert, former Chairman of Kmart, turned around Kmart from bankruptcy in less than two years. By the end of 2004, Kmart reported three consecutive profitable quarters and operated 1,511 Kmart discount stores and SuperCenters. Such expedited recovery sent Kmart's stock price above $100 per share in late 2004. Despite the turnaround orchestrated by Lampert, Kmart's market share continued to shrink. Some criticized that Lampert pumped Kmart to generate cash rather than to build the business (Garbato, 2005).

THE NEW ENTITY: SEARS HOLDINGS CORPORATION

Exhibit 3: Pre-Merger Operations and Financial Comparisons of Sears and Kmart
(data as of 1/1/05)

Item	Sears	Kmart
1/1/05 Revenue	$36,099,000,000	$17,072,000,000
Full-time employees	247,000	158,000
# Shares outstanding	253,824	89,629
Dividends per share	$0.92	$0
Earnings per share	$1.53	$2.52
Price per share	52 Week High: $50.49 52 Week Low: $49.81	52 Week High: $99.64 52 Week Low: $97.35
Stockholder's equity	$6,092,000,000	$2,192,000,000
Long term debt	$3,473,000,000	$477,000,000
Total assets	$22,474,000,000	$6,084,000,000
Total liabilities	16,382,000,000	$3,892,000,000
Return on equity	5.45%	11.31%
Return on assets	1.48%	4.08%
Return on investment	(1.36)	106.77
Net profit margin	(1.40%)	1.45
Total debt to equity ratio	0.57	0.22
Fortune 2005 "America's Most Admired Companies"- General Merchandisers	Overall score: 6.67, ranked third behind Wal-Mart (7.86) and Kohl's (6.71) and moved from fourth to third place over last year	Overall score: 4.22, ranked tenth following Wal-Mart, Kohl's, Sears, J.C. Penney, Federated Dept. Stores, Target, Dollar General, May Dept. Stores and Dillard's and moved from eleventh to tenth place over last year
Number of stores in U.S.	873 full-line department stores, 1,307 specialty format stores (auto, neighborhood hardware) and 15 Lands' End retail stores.	1,511 (includes Puerto Rico, Guam and the U.S. Virgin Islands) and 60 Kmart Supercenters.

Exhibit 3: Pre-Merger Operations and Financial Comparisons of Sears and Kmart
(data as of 1/1/05)

Item	Sears	Kmart
Fortune 500	Ranked 32 in 2004, was 30 in 2003.	Ranked 67 in 2004, was 39 in 2003.
Analysis	In 2004, total revenue decreased 12.2% from 2003 (attributable to the decline in credit and financial products revenues as a result of the sale of the domestic Credit and Financial Products business). In 2003, total revenue decreased 0.6% from 2002.	In 2004, Kmart did not have a 10K filing. In 2003, Kmart was in the midst of reorganizing from its 2002 Chapter 11 filing, which resulted in the closing of 284 stores and the elimination of 22,000 jobs and a charge of more than $1 billion. In 2003, total revenue decreased 15.4% from 2002.
Business Description:	Home group: Includes appliances, electronics, home fashions, home improvement products (e.g., tools, fitness equipment, lawn and garden equipment) and includes the Kenmore, Craftsman and WeatherBeater brands. Apparel/Accessories: Includes apparel and footwear, jewelry and accessories and includes the Land's End, Covington, Canyon River Blues, Apostrophe and TKS Basics brands. Sears Auto Centers: includes automotive services and sales of tires and batteries including the DieHard brand. Sears has 1,000 specialty stores in off-the-mall locations, an internet retail site (sears.com), 792 dealer stores (which are primarily independently owned), 245 hardware stores (Sears Hardware and Orchard Supply Hardware), 18 The Great Indoors stores (specializing in home decorating and remodeling interiors), and 45 Sears Outlet stores (carrying overstocks and discount merchandise).	Home group: Includes appliances, electronics, home fashions, fitness and sports equipment and includes the Martha Stewart Everyday brand. Apparel/Accessories: Includes apparel and footwear, jewelry and accessories and includes the Disney, Jaclyn Smith, Joe Boxer, Route 66, Thalia Sodi, Sesame Street and Kathy Ireland brands. Kmart Supercenters: 60 stores that combine a grocery, deli and bakery along with general merchandise.

Exhibit 3: Pre-Merger Operations and Financial Comparisons of Sears and Kmart
(data as of 1/1/05)

Item	Sears	Kmart
Significant International Presence	Sears Canada: Similar to U.S. operations with 122 department stores, 42 furniture and appliance stores, 144 dealer stores, 14 outlet stores, 53 floor covering stores, 49 automotive centers, 110 travel offices and 2,200 catalog pick-up locations. Sells brands similar to those sold in the U.S.	No significant presence outside of the U.S.
Motto and Business Model	Motto: "Satisfaction guaranteed or your money back." Their vision is to be the preferred and most trusted resource for products and services that enhances its customers' home and family life. Business Model: To offer a compelling customer value proposition through the combination of high quality products and services at competitive prices. This is affected by low pricing and promotional activities, and minimization of product and service costs. This is achieved through economies of scale, centralized overhead expense structure, reinvestment of operating cash flows into capital projects, and quality improvements in proprietary brands. To return profits to shareholders, issue dividends, repurchase shares, and increase share price. Differentiation: By offering high quality national brands as well as Sears proprietary brands which enjoy high levels of consumer awareness, trust and integrity (Kenmore, Craftsman, DieHard and Land's End brands are offered exclusively at Sears stores) and retail-related services such as delivery, installation, product repair, product warranty, and protection services. Pre-merger challenges: Retail stores within a mall-based format are not preferred by consumers. Sears has been challenged by competitors that specialize in certain types	Motto: Unclear. No reference of a formal motto can be traced. Business Model: The historical core competency of Kmart is in designing and sourcing apparel and in its merchandising and marketing approach on quality brand names. Differentiation: By designing and sourcing its apparel. Pre-merger challenges: Kmart has been challenged by competitors like Wal-Mart and Target and was forced to close stores, eliminate jobs and declare Chapter 11

Exhibit 3: Pre-Merger Operations and Financial Comparisons of Sears and Kmart
(data as of 1/1/05)

Item	Sears	Kmart
	of consumer goods and Sears was focused on being the lowest cost provider in those categories.	Bankruptcy in 2002 due to a rapid decline in liquidity which resulted from below-plan sales and earnings performance in the 4th quarter of fiscal 2001, the evaporation of the surety bond market, erosion of supplier confidence, intense competition, unsuccessful sales and marketing initiative, and the continuing recession and capital market volatility. After emerging as Kmart Holding Corp., the focus was to generate profitable sales, control costs, streamline overhead, increase asset productivity, and improve customer service.

As indicated in the comparison chart (see Exhibit 3), there is common territory among the products offered by the Sears and Kmart stores—the primary overlaps being in the home goods and apparel arenas. Some major differences in product offerings exist too. On one hand, Sears sells lawn, garden, tools, large appliances, automotive, hardware and window/siding products, which are not offered by Kmart. On the other hand, Kmart's retail food line and pharmacy operations are not common to Sears. Differences in product lines need to be exploited by SHC, as the new entity "will feature a powerful home appliance franchise with strong positions in tools, lawn and garden, home electronics and auto repair and maintenance." The new company expects that these product lines, in addition to the combined strengths of the apparel lines previously offered by both Sears and Kmart, the strength of the Martha Stewart Home line and the predicted extra traffic generated by the retail food line, will result in a realization of approximately $200 million in incremental gross margin from revenue synergies capitalized by these cross-selling opportunities and by the conversion of off-mall Kmart stores to Sears. According to an SHC Press Release, "The company expects to achieve annual costs savings of $300 million principally through improved merchandising and non-merchandising purchasing scale as well as improved supply chain, administrative and other operational efficiencies" (*SHC Press Release*, 2004).

Lampert believes that the anticipated $200 million in additional revenue, the $300 million in cost savings, and Kmart's $3.8 billion in tax credits (which will shield profits for a number of years) would help SHC's per share price to rise. As a result, SHC should be able to accumulate cash and be in a strong market position. His vision for SHC is to build a broader customer base and to increase sales to achieve profits of 10% EBITDA-to-sales ratio (similar to successful retailers like The Gap and Home Depot). This will be accomplished by several strategies.

First, SHC will convert Kmart stores to the Sears name in "markets where existing Kmart stores better fit Sears' demographic of slightly higher-income shoppers. Second, given its huge real estate portfolio, SHC will benefit from the flexibility of switching stores between chains and selling stores as necessary (although this can be limited by mall owners, because 74% of mall owners followed by Merrill Lynch have a Sears store).

Third, SHC will expand on the Sears Grand concept (off-mall stores which carry consumables) to counter the "loss of consumers to savvier rivals." Plans are already in place to open 60 Sears Grand stores by 2006. Sears Grand expectations should benefit from Kmart's experience in the consumables and apparel markets. Consumables are viewed by the SHC as "traffic builders." Fourth, SHC will expand the Sears Essentials stores (relatively smaller convenience-driven stores) by converting approximately 400 existing Kmart locations. Sears Essentials will offer products such as appliances, lawn and garden tools, home electronics, apparel and home fashions as well as convenience goods such as health and beauty aids, a pharmacy, pantry items, household products, paper products, pet supplies, and toys. These stores will benefit from Kmart's position as one of the nation's largest pharmacy and health care retailers (i.e., 1,150 in-store pharmacies, 2,400 staff pharmacists, and significant expertise in disease management). The Kmart stores slated for conversion are located in key urban and high-density suburban markets with customer demographics and income levels matching those of the typical Sears shopper. The first 25 Sears Essential stores will open in Spring 2005.

Fifth, SHC will cross-sell products by having Kmart and Sears' carry each other's lines. For example, Kmart will carry Kenmore appliances, Craftsman tools, and diehard batteries; Sears will carry some of Kmart's brands in future.

Lastly, SHC will be able to emphasize on apparel labels that appeal to a multicultural audience. Latinos and African Americans make up a significant share of Sears' shoppers and this group also represents large share of the shoppers at Kmart's inner city locations.

Overall, management's strategy for the restructuring is aimed at better supporting existing Sears stores, although both stores will continue to operate separately under their respective names for quite some time after the merger. The new structure creates eight regions that cover 110 districts, each composed of six to nine stores. There will be a new position entitled "director of stores" to manage each district. This position will report to a regional vice president. Since SHC will operate under at least six different formats, a challenge for the new leadership will be to determine how the retail formats would fit in each market and how they should be named, e.g., Sears Grand, Sears Essentials, etc. Therefore, to avoid the inherent confusion that will result among stakeholders (e.g., consumers, SHC employees, shareholders, and analysts), it will be critical for the leadership of SHC to clearly define the organization's identity, image, and direction. This is even more important because, historically, both Sears and Kmart were accused of having an ill-defined media image, caused by frequently changing strategies. Both firms were also deficient in strategy execution and employee training. Because of this, the new SHC executive staff, in particular

Aylwin Lewis—former President and CEO of Kmart, is focused on team building and staff training (Berner & Weber, 2004; Guy, 2005).

Equally important in terms of strategy is retaining and building customer loyalty. A former Kmart executive, Gary Ruffing, who now serves as senior director of retail consulting for BBK, Ltd, has advice for the SHC management team: "You can fix a lot of things, but if you can't get the customer back, it doesn't matter …. My advice to the new CEO is to listen to the customer and keep the team focused on four or five critical points of the shopping experience … the keys are the in-stock position, the touch points at checkout, the friendly service and keeping the pricing within the value range." Ruffing also underscored the importance of strategically placing Aylwin Lewis. "[H]is ability to understand and bring brands and positions together to drive the success of Sears Holding Co. and Kmart's ability to fit outside of discounting … where they fit has always been an issue …. [E]ventual success could lie in the chains' combining of product lines rather than that of the retail brands. Many people say the retailers are two losers. The brand equity is not the Sears or Kmart name … brands are brands … you have to understand who they are and put together a marketing program and the ambient features that go with that. You need somebody who has done that." Aylwin Lewis is credited with the successful transformation of Kentucky Fried Chicken from a sleepy Southern brand touted by an aged colonel to the hip and urban KFC (Clark, 2004).

In terms of changes for stakeholders as a result of the merger, one glaring difference will be the loss of dividend payments to former Sears shareholders. Another change, which will directly affect employees, is the reduction by SHC of the number of employees eligible for stock options (Sears had already reduced the number from 17,000 to 2,000 in early 2004 and further reductions are expected) as well as the inherent management changes and organizational policy changes. According to a March 14, 2005 article in *Home Textiles Today*, "there will be seismic shifts among senior executives and middle managers immediately following the merger." Importantly, in April 2005 SHC announced the first of a series of staff lay-offs (which will directly affect employees and management at the Sears Chicago headquarters) as well as salary and benefits changes to take effect in 2006.

Management

The new Board of Directors consists of seven directors from the former Kmart Board and three directors from the former Sears Board. The executive team is also a blend of former Kmart and Sears staff members, as follows:

1. Edward S. Lampert, Chairman (formerly Chairman of Kmart)
2. Alan J. Lacy, Vice Chairman (formerly Chairman of Sears)
3. Aylwin B. Lewis, President of Sears Holdings and C.E.O. of Sears Retail (formerly President and C.E.O. of Kmart)

In addition, two other previous Sears executives and five Kmart executives were appointed to SHC. Current and previous employment positions of SHC's top management team is presented in Exhibit 4.

Exhibit 4: SHC's Top Management Team			
Sears Holding Corp. (SHC)			
Board Size: 11 (Chair, Vice Chair, CEO, CFO, and 7 Directors)			
Top Management Team			
Name	**Age**	**SHC Position**	**Background**
Edward S. Lampert	43	Chairman	Chairman, Kmart
Alan J. Lacy	51	Vice Chairman	Chair/CEO, Sears
Aylwin B. Lewis	50	Pres/CEO	CEO, Kmart
William C. Crowley	47	EVP/CFO	CFO, Sears
Maureen McGuire	N/A	EVP/Chief Marketing Officer	VP-Strategy/Marketing, IBM
Corwin Yulinsky	N/A	EVP-Customer Strategy	Consultant, McKinsey SVP-Customer Strategy, Chase
Lisa Schultz	50	EVP-Apparel Design	SVP/Chief Creative Officer, Kmart
Karen A. Austin	43	SVP/CIO	SVP/CIO, Kmart
Julie Younglove-Webb	35	SVP/GM-Sears Essentials and Sears Grand	VP-Space Planning, Kmart
Teresa Byrd	56	SVP/GM-The Great Indoors	VP/General Merchandise Manager-Sears Grand, Sears
Chris Shimojima	N/A	VP-Merchandising and Marketing, Customer Direct	VP/GM-Sears Customer Direct, Sears
Andrea L. Zopp	48	SVP/General Counsel	General Counsel, Sears Logistics
Edgar (Ted) McDougal	N/A	VP, Public Relations	SVP-Public Relations and Government Affairs, Sears

RETAIL INDUSTRY AND COMPETITION

Retail Industry

The retail industry is the second largest industry in the U.S. when ranked by number of establishments (20% of all establishments) and number of employees (18.3% of all employment covered by unemployment insurance). The retail industry expanded at unprecedented rates from the late 1990's to 2000, before the recession resulted in a manufacturing slowdown, job losses, high consumer debt, and retail bankruptcies. The industry was further plagued by the ".com bust," uncertainty following the September 11, 2001 terrorist attacks and global unrest. The rise of Wal-Mart and other big box discount retailers (or "mass merchandisers") and the economic recovery in the mid-2000's changed the retail landscape. Retailers responded to these market pressures by restructuring stores, reorganizing internal operations, and marketing patterns and by taking advantage of technology to assist with e-commerce, inventory issues, point-of-sale systems and data analysis. In 2004 (which is considered by analysts to be the most "stable" retail year in quite some time), the top ten U.S. general merchandise retailers based on 2004 sales figures were: (1) Wal-Mart ($285 billion), (2) Sears Holding Corp. (recently merged with a combined $55 billion), (3) Target ($48 billion), (4) Federated/May (recently merged with a combined $30 billion), (5) J.C. Penney ($18 billion) (6) Gap Inc. ($16 billion), (7) TJX Cos. ($15 billion), (8) Limited Brands ($9 billion), (9) Dillard's ($8 billion) and (10) Saks ($6 billion). Home Depot, the number two retailer in the U.S., is not considered a "department store." While retail sales were strong in the luxury and discount sector in 2004, department stores and other retailers struggled to make their numbers. In early 2005, the GDP had risen 4.4% which was the fastest pace in five years and was led by consumer and capital spending (Sway & Musselman, 2005).

The architecture of the retail industry has drastically changed from the introduction of catalogs and general trading stores, to department stores, to the rise of indoor malls, to the growth of discounters and big box stores, to internet based selling, to changing demographics (more single parent households, double income households, geographic shifts and increased catalog sales due to busy lifestyles). In addition, catalogs and e-commerce have globalized the retail market.

Several other notable changes took place in the 2000's. For example, as enclosed malls fall out of favor with consumers, new open air "lifestyle centers" are becoming increasingly popular. These centers have plenty of outdoor space—fountains, plazas, and walking paths—designed to attract customers and keep them there for longer periods of time. Because retailers generally pay less rent for these open air arenas, profits are higher. In addition, consumers can park very close to the store entrance, unlike traditional mall set-ups (Kennedy, 2005).

More mega-mergers (such as the Sears/Kmart combination, Federated/May stores) will result in the closing of more stores, which in turn will propel even more mergers and acquisitions (in retail and closely related industries). Because of this activity, suppliers may be forced to merge in order to survive the huge bargaining clout created by these mega-mergers. Suppliers potentially face fewer orders, higher pressure for markdowns, discounts and promotions from the shrinkage wave following these mergers. Ultimately, smaller suppliers will be swallowed up by larger, healthier entities as they will be unable "to meet the demands and prices of the newly emerging retail behemoths" (Ostroff, 2005).

Another recent trend is that clothing vendors are opening their own stores (e.g., Ralph Lauren, etc.), which has created somewhat of a backlash on major retailers. In retaliation, chain operators like Federated are opening series of mini stores (mini-Macys, mini-Bloomingdales and other specialty mini stores such as Charter Club and INC.) throughout the country to accommodate consumer's varied tastes (Ostroff, 2005).

In the current retail economy, consumer trends lean toward value and frugality, leading to a movement away from department stores and to the rise of discount retailers, warehouse and wholesale clubs (such as Costco and Sam's Club). Warehouse shopping outlets are currently growing at a rate of 10% per year—twice as fast as the rest of the retail industry. The long-term forecast for department stores in the U.S. suggests a continued slow growth rate into the next century as the industry continues to battle online retailing, direct marketing and home shopping networks.

Competition

Wal-Mart was established in 1962 in Arkansas and is currently the largest retailer in the U.S. and in the world. Wal-Mart is also considered to be the low-price leader. The company went public in 1970 and has 4,800 stores worldwide with 75% of those located in the U.S. Annual sales in the U.S. 2004 were $256.3 billion and their sales were higher than the combined total of the nine second largest stores (Target, Sears, Kmart, J.C. Penney, Federated, Mays, TJX, Kohl's and Dillards). Wal-Mart is planning to open 500 new stores by the end of 2005 that will result in an 8% expansion of total square footage (55 million square feet). Wal-Mart has also entered the grocery market, which has been strategic to its growth in recent years. In 2005, Wal-Mart will add 240-250 Supercenters (stores which sell both general merchandise and groceries), 30-40 Sam's Clubs (large warehouse stores) and 25-30 Neighborhood Markets (smaller grocery store formats designed to accommodate zoning in metropolitan areas).

Wal-Mart has significant power over its suppliers and has been accused of unfair labor practices for years (they maintain a strict anti-union position). It has a 44% turnover rate for their hourly workforce and, in 2001, the average Wal-Mart employee earned below the poverty level. Wal-Mart is also accused of putting many small town department stores and individual establishments out of business and has been criticized for limiting the public's choices by catering to conservative special interest groups. Wal-Mart accounts for 2.3% of the GNP. By comparison, General Motors was at 3% in 1955 and U.S. Steel was at 2.8% in 1917 at their respective peaks. In 2003, Wal-Mart was plagued by class-action employment suits (sexual discrimination against women with nearly 1.5 million potential plaintiffs, employees forced to work off the clock to avoid overtime payments) and use of illegal immigrants in cleaning companies.

Target, now the fourth largest retailer in the United States (due to the Sears/Kmart merger Target moved from third to fourth place) with 1,275 stores and 2004 annual U.S. sales of $48.16 billion. Target has its roots in the J.L. Hudson company established in 1881 in Michigan and the largest retailer of men's clothing by 1891. They opened their first Target store in 1962. Target is considered an "upscale" discounter with better brands and is very attractive to chic, hip, young consumers.

JC Penney's is ranked 5th in the retail category for 2004 with total revenues of $18 billion. JC Penney's stands to suffer from the Sears/Kmart merger because the move gives SHC an opportunity to grow off-mall at a rapid pace. Although it appears that SHC may be positioned more as a discount retailer, which would not directly compete with Penney's who are known for their value fashions for moderate consumers, the indirect result for JC Penney's could be problematic if SHC pulls their stores out of malls (the absence of Sears mall anchor stores would reduce foot traffic to malls which can ultimately hurt JC Penney's bottom line) (Howell, 2004).

Clearly, there is no shortage of retail competition between Wal-Mart, Target, Federated/May Department Stores, J.C. Penney and others. If SHC were to exclusively focus on the strength of the Sears brand lines of Kenmore, Craftsman, DieHard, and other home services, then their competitors would include Home Depot and Lowe's. At the moment, however, it appears that SHC may be aiming to become more of a mass merchandiser by cross-selling both hard and soft product lines in various formats such as Sears Grand, Sears Essentials and mall/off-mall locations. In this category, Wal-Mart is the undisputed leader. Competing head-on with Wal-Mart will prove to be a daunting task as noted by Howard Davidowitz, chairman of consulting and investment banking firm Davidowitz & Associates, "All the dead retailers had grandiose plans … there's been more than 100 casualties. Nobody has ever taken on Wal-Mart and lived."

The Future of the Sears Holding Company

In order to be successful, SHC's business strategy must specifically address the issues of competition, culture and synergy in a very focused way. "Four out of five companies that have attempted to change business strategies have failed to meet the new strategy's objectives" (Porter, 1996) and "employees resisting change may make implementing a strategic change difficult or impossible" (Lewin, 1952). In terms of competition, the mere combination of the Sears and Kmart retail empires does not propose any significant threat to competitors (e.g., Wal-Mart, Target, Home Depot, etc.) because their consumer messages are more consistent and they continue to grow by building market share. With regards to culture, both organizations come from distinct, historic and proud pasts—and it will be a challenge to combine these disparate entities to form one unique forward-driven culture. And, finally, while there are countless opportunities to combine brands, product lines, operations, and systems, corporate history books are filled with failed mergers (e.g., AOL-Time Warner) that underscore the difficulty to create synergies at such a large scale (Sway & Musselman, 2005).

It should be noted that 70% of mergers fall short when it comes to achieving their targets for revenue synergies, while 40% lead to cost-synergy disappointment. Other mergers are "dis-synergy disasters" such as the aforementioned AOL-Time Warner merger, which resulted in $99 billion in write-downs by January 2003. Miscalculations of revenue synergies can be attributed to unexpectedly high consumer defection levels, poor assumptions about market growth and competitive realities, and overly optimistic prospects for cross-selling opportunities in a deal's wake. It is also important to make efforts to retain employees from both companies. Bad assumptions (e.g., overly optimistic projections, simplistic predictions and assumptions, and poor time projections) "will lead to substantial over-estimates of synergy net present value by making cash flow accretion and other deal metrics look unrealistically positive" (Frieswick, 2005).

The question looming over the top management of Sears Holding Company is whether they can create a distinct brand image and identity to outperform fierce competitors like Walmart and Target. To take on the competition successfully, key obstacles would be to create a culture of success among the disparate organizations of Sears and Kmart, to generate consumer loyalty, and to appropriately position SHC, based on its identity, in the general merchandise market.

ANALYST REVIEWS

Analysts' reviews of the merger are mixed, ranging from optimism and faith in the leadership and vision of Lampert to ultimate failure of SHC (see Exhibit 5). There is, however, much speculation among analysts as to whether Lampert can successfully accomplish the stated goals without the selling off of real estate. Hailed by Business Week as the next Warren Buffet, Lampert closely mirrors Buffet's strategy of investing in cash rich old line companies and he stands to benefit enormously from the merger via his private investment fund, ESL Investments, which held 52.6% of Kmart and 14.6% of Sears (pre-merger). As of March 2005, many industry analysts and insiders remained skeptical as to Lampert's motives—whether they would build a successful retail empire or merely generate cash.

Exhibit 5: Analysts' Reviews

Date	Positive Reviews	Negative Reviews	Source
November 18, 2004		There are "two threats immediately for the merged firms: debt will be more expensive because bond-rating firms are downgrading Sears' credit-worthiness, and the power and growth of Web shopping are weak areas for both firms … neither Sears nor Kmart have strong Internet sales …. Walmart.com and Target.com have seen significant growth in sales but this merger is not likely to improve the internet presence for Kmart or Sears" (Cynthia Jeffrey, Associate Professor, Iowa State College of Business).	*Ascribe Newswire*, "Iowa State Sources Offer Expertise, Perspective on Sears/Kmart Merger

Exhibit 5: Analysts' Reviews			
Date	**Positive Reviews**	**Negative Reviews**	**Source**
November 22, 2004	They will provide a compelling power brand statement in both fashion and home categories that will drive shoppers to the stores. If they pool their war chest of brand names and become one, they may solve the "brand image" problem that has eluded both Sears Grand expectations should benefit from Kmart's experience in the consumables market.		*Retail Merchandiser*, "Consultants Question Success of Sears/Kmart Merger
November 22, 2004	Sears has long offered ethnic-specific programs…. Kmart has just begun to "officially" target Hispanics …. Perhaps bringing the benefits of big box retailing combined with these power brands to inner city, lower income, ethnic shoppers will provide the right niche for a still under served audience.		*Retail Merchandiser*, Consultants Question Success of Sears/Kmart Merger
November 22, 2004	"Long-term, the combined entity's success will hinge on execution, where neither company had a particularly good track record….In our view, neither management team brings a significant track record of operating success to the transaction….Still, better real estate locations will give them access to greater customer traffic, so we think it would be rash to discount the deal entirely" (Danielle Fox, Merrill Lynch analyst).		*Business and Industry, HFN,* "The Big Deal: S-Mart?", by Barbara Thau, pg. 1, ISSN: 1082-3010
November 22, 2004		"We do not believe that adding Sears appliances to Kmarts or Joe Boxer apparel to Sears will turn either company around" (George Strachan, Goldman Sachs analyst).	*Business and Industry, HFN,* "The Big Deal: S-Mart?", by Barbara Thau, pg. 1, ISSN: 1082-3010

Exhibit 5: Analysts' Reviews			
Date	**Positive Reviews**	**Negative Reviews**	**Source**
November 29, 2004	Overall, Kmart brings stronger soft home goods to the merger … the Martha Stewart brand will be re-energized and become the focus private-label brand for the merged chain.		*Business and Industry, HFN*, "Battle of the Brands for Kmart and Sears," pg. 4, ISSN: 1082-0310
November 30, 2004		Most analysts are skeptical the combination of two struggling retail brands that will continue to operate separately will thrive in a sector dominated by Wal-Mart.	*Retail Merchandiser*, "How Kmart-Sears Merger Affects Suppliers"
February 10, 2005		"You have two retailers who are doing badly right now … It's hard to fathom how combining them is suddenly going to produce a new entity that will do better" (Stephen Hoch, The Wharton School).	*Gallup Management Journal*, "Merger Myopia: Two retail giants join forces. But how will the customer benefit?" by William J. McEwen
March 24, 2005	"It's about profitability, not about sales. It may get smaller, but … it's going to be more profitable, more stable, with a better strategy. And it'll be more competitive with Wal-Mart and Target" (Richard Hastings, independent retail analyst).		*The Associated Press,* "Kmart Buyout of Sears Gets Final Approval; Changes Loom," by Dave Carpenter
March 24, 2005		"For the short term, it's very exciting. But for the long term, watch out." Davidoff forecasts a "bleak outlook" for Sears unless the move away from malls is successful (Howard Davidoff, Davidoff and Associates).	*The Associated Press,* "Kmart Buyout of Sears Gets Final Approval; Changes Loom," by Dave Carpenter

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