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LETTER FROM THE EDITORS

Welcome to the *Journal of the International Academy for Case Studies.* The editorial content of this journal is under the control 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 *JIACS* is to encourage the development and use of cases and the case method of teaching throughout higher education. Its editorial mission 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.

We intend 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, Purdue University-Calumet

SUBPRIME MORTGAGES: A CASE PROVIDING THE PERSPECTIVES OF A HOME BUYER AND A CDO TRADER

Michael Tucker, Fairfield University

CASE DESCRIPTION

The case provides two levels of understanding the subprime mortgage crisis. The first level is from the perspective of home buyers worried about being closed out of an overheated housing market. The second level is from the perspective of investment firms trading exotic securities created by investment banks out of the subprime mortgages. The case could be used with undergraduate or graduate financial management students as well as in case courses. The calculations are straightforward and there are ethical issues. The case could be used in a business ethics course with the calculations provided the discussion ensuing would be on the home buyers' decisions, the mortgage lenders behavior, the investment bank's fiduciary responsibilities, and the moral hazards of any proposed legislation to remedy the crisis.

CASE SYNOPSIS

A couple buys a new home in 2006 in the Atlanta suburbs where prices have been rising. Lacking a down payment but with passable credit they purchase the home with a subprime mortgage that has the added complication of negative amortization on a six month interest only mortgage. When the mortgage resets at a rate pegged to the constant maturity T-Bill rate, the payments are much greater and they have difficulty making them. Their mortgage is one of many rolled up into Collateralized Debt Obligations (CDOs) created by investment banks. An investment company trading in CDOs has been making money using highly leveraged positions on what have been investment grade securities. When interest payments suddenly cease, the investment company is faced with a liquidity crisis. The case returns to the couple holding the subprime mortgage as they confront foreclosure with the added possibility of having to pay taxes on the difference between the sale price of their home and the amount they owe.

INTRODUCTION

In early 2006 Bill and Mary Wilkes, both just past 30 years old had been living in an Atlanta apartment for five years. Bill works in Atlanta's city administration and Mary is a receptionist at a mid-sized corporation in an office park outside Atlanta. They have looked for a house on and off for two years. A major impediment was that they had not been particularly successful in saving a down payment. Mary was fond of winter vacations and Bill was easily persuaded to buy the latest in high tech gadgetry, including a 50-inch HDTV and three high-end computers. He justified the computers since his job involved software services.

In 2005 Atlanta suburban housing prices continued an upward trend. In early 2006 Bill suggested to his wife that they have another look at the market. Kim Mitchell, a twenty-something broker with an easy smile, agreed to show them house listings in the suburbs.

The Wilkes' joint income is $75,000. Among their expenses is a car payment of $300 per month, which would be factored into any calculations a traditional mortgage broker would perform to see if they qualified for a mortgage, i.e., had sufficient income remaining after fixed expenses to make the payments. Monthly homeowners insurance and property taxes would also count toward their fixed expenses against which their income would be compared.

Mitchell took Bill and Mary on a tour of a selection of three bedroom homes. They weren't very excited about older homes so she steered them toward a new development. The model house was attractively decorated and they were sold on it at once.

"But can we afford it?" Bill wondered aloud.

Mary voiced a different problem. "And it is a further commute for us."

Kim turned up the sales pitch. "There aren't too many of these houses left. I know you saw the $319,000 price out front, but my company has a deal with the builder. We can get it for $300,000." With that, she took out her cell phone and said she was calling her office. When she hung up she said, "There are two left in this development at that special price. One of them is a corner lot and will probably go first."

Bill and Mary looked at each other and nodded. "What about the down payment?"

"Our mortgage broker can work that out with you," Kim responded. "He's very flexible. You can probably get the house without spending a dime until your first payment." She took out a contract. "All I need is a $500 binder." Binders were usually 10% of the price, but Kim already understood this couple didn't have that kind of money and she was eager to make her commission.

Bill and Mary went into the house's kitchen to confer privately. They were both excited and quickly decided they should try to buy the house. "Prices are going up so fast, if we don't jump at this there might not be anything so nice and new again," Mary said.

Bill agreed. "But we don't have $500 in our checking account."

"Kim will take our credit card. I'm sure of it." And she did. Mitchell also had them sign the binding agreement. Bill read through it quickly and noticed there was something about commissions in it. Kim told him, "In this case because we are offering the home to you below market, you have to split the commission with the seller. That 3% will just be added to the price and will be part of your mortgage. You don't have to come up with the money or anything." Buyers paying a commission were not typical of home purchases. Gallagher did not mention that he earned a higher commission on subprime loans.

The following day the Wilkes met with Henry Gallagher, a mortgage broker Kim provided. Gallagher advised them to go for a no documentation mortgage. "It's faster, less paperwork and I can get you one with no down payment. They even have an introductory interest only mortgage of just 2% per month for the first six months. Very affordable"

"I thought rates were about 6%," Mary said.

"That's for 30-year fixed mortgages and they want a hefty down payment as well as all kinds of documentation," Gallagher explained.

"Do we qualify for the 2% mortgage?" Bill asked.

"You are both employed?"

"Yes."

"And you don't have any major debts?"

"There's the $300 car payment."

"All my lender requires is a credit check. As long as there are no skeletons in the closet . . ." and Gallagher laughed heartily, handing Bill a pen and mentioning some terms Bill was unfamiliar with. He recalled negative amortization later but couldn't pinpoint what it meant. Besides, they were getting a 2% mortgage. Gallagher did warn them that the rate was adjustable and the payments would go up. He didn't say what the payments would be because he couldn't know what the reset rates would be in six months. But they would own the house and if they couldn't make the payments they could always sell it for more than they paid for it. That was obvious with the way the housing market had been in the last year or two.

Two days later Gallagher called to tell them their mortgage had been approved. After hearing that, Mary attempted to review the loan papers but the language was not always clear and there were many terms with which she was unfamiliar. She saw they had agreed to an adjustable rate mortgage (ARM) for which they would pay two points. Two points is 2% of the mortgage as a fee that effectively increases the loan amount by $6,000. This would be added to the principal. The rate was what Gallagher had told them, 2% interest only for the first six months. Then there was something about the difference between their six months of reduced payments and what their payment would be at the current ARM rate of 5.17%. That difference in payments was to be added to the initial principal amount for each of the six months during the interest only 2% teaser rate mortgage. The principal at closing would also be increased above the house purchase price of $300,000 by various charges that would be noted at the closing. Adding on these charges would avoid any out-of-pocket expenses for the Wilkes. The increased principal owed at the end of the six month interest only rate would constitute the principal on the loan when rates reset. The new ARM interest rate to be determined at that time would be used to calculate new monthly payments for the remainder based on the then 29 ½ year term. The newly reset rate would be 350 basis points greater than the constant maturity Treasury bill rate. The ARM would then reset every year from that date in the same way. The phone rang, Mary was glad to get away from the contractual language and enter into a long conversation with her sister. When Bill came home they went out to celebrate their approval. While they were out they did some shopping for the new home.

At the closing on January 15, 2006 Gallagher supplied an attorney. “Just a formality,” he said. They had not previously met the woman. She was all business when she presented them with a stack of papers to sign. Mary recalled later that everything went by very fast as they signed page after page. “There was no time to read anything and I wasn’t really interested in reading it any way. I tried with that other agreement. Mr. Gallagher assured us this was how it was done and Kim said the same thing. We were just excited and busy packing, arranging for the movers, the electricity. There was a long list of things to get done.” As promised, all fees were rolled into the principal including the two percentage points for the mortgage, legal fees of $1,000, the 3% realtor commission on the sale and another $1,000 in fees. Their initial $500 binder deposit was even refunded at their request. They didn’t have to write a single check.

February 15, 2006, the date of their first official mortgage payment at which time they paid interest only on the loan outstanding. They moved into their new home. Bill was pleased with the low monthly payments. “We got a deal,” he was fond of telling Mary. In the first few months they had two house warming parties and thought nothing of adding to their credit card debt when spending to fix up the house. Monthly mortgage payments were much less than their rent had been.

Table 1

	Monthly Cost
Autos (Gas & Maintenance)	350
Utilities	350
Car Payment	300
Food & Dining	800
Cable Etc	175
Clothing	200
Credit Card Debt	500
Monthly Federal Tax	510
Monthly Property Tax & Insurance	400
Social Security Tax	477
Total	**4,062**

In mid June a letter came from the mortgage company advising the Wilkes that the mortgage was due for adjustment with their August 15, 2006 payment. The baseline T-bill rate was 5.27% making mortgage interest rate 8.57% which was applied to the ballooned principal amount. Since this was an ARM, each time it payments reset they did so based upon the remaining term which was now 29½ years. Mary was shocked at the new payment figure. Every month the 2% teaser rate was in effect, the difference between what would have been the 5.17% ARM payment and their payment was added to the principal. Now the principal was more than when they started. She took out her calculator, gathered up credit card statements and tried to come up with their monthly expenditures (Table 1). She added the new mortgage payment to that figure, compared it to their pre-tax monthly income, and was shocked.

WHITEWATER INVESTMENTS

Whitewater Investments (WI) is a hedge fund that has come to specialize in leveraged debt instrument. WI returns have been nothing short of spectacular in the past two years. Kent Reynolds who has been at Whitewater for three years describes the money-making situation as an arbitrage opportunity. WI has been investing in collateralized debt obligations (CDOs) backed by residential mortgages. They have been buying CDOs from a New York investment bank. CDOs are packaged in tranches, i.e., mortgages with similar credit risk are in the same tranche. Mortgages with higher risk of default pay higher interest rates. "But you have to have some inside information in order to understand the pricing," Kent is fond of saying. He implied he had that inside information. After all, he was making plenty of money.

Many CDOs have good credit ratings, often as high as triple A. Part of the way investment banks soften the credit risk is by mixing bonds with low correlations together. Exactly how an investment bank calculates the correlation between mortgages is more art than mathematics since none of these debts have a credit history. The borrowers themselves do have FICO credit scores. FICO scores are a compilation of a borrower's payment history, amounts owed, length of credit history and other credit related information. Historically, borrowers with reasonably good credit typically paid off their mortgages before paying other debts so that credit scores above a specific level had been reasonable indicators that the borrower would pay his/her mortgage.

Credit rating agencies such as Moody's, Standard and Poor's and others are compensated for providing credit ratings by bond or security issuers. Information about the underlying security is provided by the borrower or in the case of a CDO by the investment bank doing the packaging. The mathematics of the CDO is not transparent but the issuer can do a good job of explaining or marketing them to buyers. That was the case while buyers were making money. To all appearances, these bonds were low risk. There was firm collateral behind the debts; home equity bolstered by rising prices.

There are higher and lower interest paying tranches among the CDOs. If the risk is similar then the interest spread should be minimal. But, according to Kent, risk, at least as he understands it, is often mispriced among CDOs presenting an arbitrage opportunity. WI can buy one and sell another tranche locking in a return at no investment of capital. Besides taking advantage of some of these spreads, many of which were seized upon quickly by hedge funds seeking such opportunities, WI also borrowed at low short term rates and invested in the higher paying CDOs. Kent provided an example of the "killing" the firm made last year buying $1 billion of 7.5% CDOs with an investment of only $100 million. "We borrowed at 5% and raked in the difference. And that's just one investment. As I said, we had a good year with CDOs." Kent also scored a large bonus of several million dollars last year.

Bill and Mary's mortgage was among the mortgages in a CDO tranche that Kent and Whitewater just took a long position on. It was classified as subprime even though their FICO report indicated the Wilkes were lower risk than average for missing payments.

MORTGAGE OVERLOAD

Bill was the first to admit he did not have a clear understanding of things financial. Through a friend of a friend he was able to contact a financial planner. He took his mortgage statements and the new payment information to the planner who had agreed to have a quick look pro bono.

"I've seen these big hikes in payments before," said Mike Hutchins, the financial planner, as he went through the pile of papers. After a few minutes of studying the documents the planner said, "You may owe more for your house than the house is worth."

Bill expressed surprise when Mike told him that housing prices had hit a plateau lately. "They may even be coming down. In your case with all these other costs and the negative amortization tacked onto the original $300,000, if the value of your house hasn't increased substantially then you'd be what we call 'underwater,' the value of your home is less than the principal on your mortgage.

But the developer was still putting up homes right next to his own subdivision, Bill protested. Surely there must be demand for them.

"I know the developer you're talking about. He's building on speculation that the buyers are out there. Those homes aren't sold. Keep an eye on the billboard out front and see if the prices of those new homes don't come down in the next couple of months."

Bill and Mary made the first two higher mortgage payments making ends meet with their credit card which was approaching its limit. Mary's sister pointed out that the 18% interest on the credit card was a good signal that Visa was not the place to be borrowing. "Why don't you call the bank and see if you can work something out?"

In this case, the bank was Henry Gallagher. "That loan is probably sold," Henry told Bill when he called. "The mortgage company securitizes all these loans. They're packaged and sold to investors. This isn't like your daddy's bank. It's not a local deal. That's why the rates are so low and why you got the loan in the first place."

"The rate we're paying now isn't low. It's higher than the fixed rate," said Bill. Henry told him that was the risky part of adjustable rate mortgages. "But we can't afford it," Bill protested. Gallagher gave him the name of the mortgage originator and Bill called their office.

This phone call proved to be extremely frustrating. After going through a series of telephone tree choices, Bill was put on hold for 40 minutes and then disconnected. He went online and searched for the name of the mortgage company. The first story that came up summarized the financial difficulty the company was in. They could no longer raise capital to finance new mortgages. There was speculation that they would be sued by an investment bank that bought their mortgages on the grounds that they were riskier than the company had portrayed them. Possible bankruptcy was described in another story.

Bill called again and, after a long wait, got through to a customer service representative who told him that their mortgage had been sold to another institution. He was given the name of an investment bank in New York that sounded familiar. "Does that mean I have to call them for some help with my payments?" The customer service representative provided another toll free number.

Navigating the annoying telephone tree and arriving at another cheerful customer service representative, Bill was asked if he wanted to refinance. "No, I want to do something about these high payments. This isn't what we agreed to." He told her he had paid much less for the first six months and she countered that the contract stipulated that the introductory rate was only for six months. It was all in the contract. Didn't he read the contract? It sounded as if she asked this question frequently. "Okay, I want to refinance at a lower fixed interest rate. I saw that those rates are much lower than the ARM." She explained he would have to go through the application process again but not with her. She provided a different number and said it was a mortgage company that dealt in refinancing.

By the time Bill was finished speaking to the refinance company, he had learned that refinancing would be costly even in the unlikely event he was approved. Since taking out the mortgage, Bill and Mary's expenses had risen, which would mean he could not qualify for the refinancing. "They're using a formula to see if 30% of our income less expenses will cover the mortgage. It won't. Gallagher didn't do that calculation."

"Let's sell the house," Mary said, trying to sound decisive. She was angry and depressed. Bill should have read the contract and understood the situation in the first place.

A quick phone call to Kim Mitchell confirmed that she would list the house. "But I'm not optimistic. Unless you price it aggressively, you won't have much chance of even getting anyone to look at it. The developer hasn't had a sale on the houses he's building next to you in the last two months. It's like sales have just dried up. I don't understand it. I can tell you I'm not meeting my expenses either."

Bill and Mary assessed their situation. They had spent quite a bit of money moving and fixing up the new house. The first six payments had been much less than the rent they had been paying, but the last two payments were well above rent they could afford for a nice place. Mary had gone through the rental real estate section of the Sunday paper and there was no shortage of nice homes and apartments. "We wouldn't get the tax deduction we get on taxes and interest on the mortgage," Bill countered.

"We'll only get those deductions if we can pay the mortgage. And if the only way we can pay it is to add to our credit card debt at 18% that's a bad deal."

Neither Bill nor Mary was familiar with foreclosure. They looked it up and discovered that it took at least six months for a lender to foreclose on a house. After much hand wringing and some research, they agreed that they would just stop paying the mortgage and instead focus on reducing their other debts, particularly the 18% credit card debt. In their research they had learned that if they defaulted and the house was later sold for less than their mortgage, the difference would be viewed by the IRS as a debt forgiven and as such subject to taxes. That would mean a sizable tax bill but there was nothing they could do about that.

PROBLEMS AT WHITEWATER

Kent had taken a large long position on $1.3 billion in CDOs yielding 7.8% with 15:1 leverage. The monthly interest payment was due on the loans. The 6% interest rate WI was paying had looked attractive when he took out the loan. "A very profitable spread," he had explained to the CEO of the company. The problem was that now 35% of the CDO tranche was not paying interest. He was concerned and considering borrowing further money to cover the interest on what he had borrowed to take the highly leveraged position. He called the insurance company that had been lending him the money on the CDOs. They balked about providing additional money and expressed concern about their principal. If WI missed a loan payment they would consider the debt in default triggering principal repayment.

There were stories about mortgages being underwater and borrowers simply not paying or walking away from their loans. Kent decided to call New York and find out what was going on in the market.

He was immediately told CDOs were not doing well. "As a matter of fact, we're no longer in that business," the New York investment banker told him.

"You can't just leave me hanging out here with these nonperforming loans," Kent protested.

"You knew the risk," the New York banker responded.

"But these were double A."

"There have been triple A tranches in some trouble lately so this is not unheard of."

Kent realized the conversation was going nowhere and hung up. He would try to sell the CDOs in the international market. The CDOs that were still performing would probably fetch a good price. As for the losers, the company would have to deal with those later.

After working the phones for four hours the best price he was offered for the "good" CDOs for 89 cents on the dollar. That would be a huge loss but small compared to the nonperforming CDOs. "They're maybe worth 60 cents on the dollar at best," he offered as an excuse to the CEO.

After a long pause during which the CEO stared out the window. "We're cooked," the CEO said. "Call Ted and let's start bankruptcy proceedings."

During the bankruptcy proceedings, several million dollars of the performing CDOs originally held by WI did sell and underwent another transformation. The interest payments were stripped out and one year of those payments were sold as a safe investment to a Norwegian municipality funding its upcoming annual budget. The municipality never did receive any interest payments. The townspeople tried to sue the investment broker in Oslo who had sold this American monster to them but it was unclear if the town would see any money or, if it did, how long the process would take.

BAILOUT PLAN?

Bill and Mary got ever more threatening notices until they finally received a foreclosure notice with an offer to negotiate. Bill called the lender and explained how the reset interest rate on the mortgage had put the payment out of reach of their budget.

“When we tried to refinance at a fixed rate we were told we wouldn’t qualify.

The lender offered to roll the six missed payments into the principal and drop the interest rate by 100 basis points. The mortgage would still be an ARM but would be reissued at 2.5% above the constant maturity T-bill rate which was 4.97%. “That’s the best we can do,” she said. But when she calculated what the new payment would be on the new 30-year mortgage, Bill said he would have to get back to her.

Bill and Mary now felt like victims. They had been betrayed by the complexity of their loan and by Gallagher. He hadn’t adequately explained it. “We could tell them we’ll take the new payment and then just not pay or pay for one month. They’d have to start foreclosure proceedings again,” said Mary.

There was really nothing the lender could do to them other than foreclosing again if they took the new offer and then didn’t pay. Housing values were dropping. The newly built homes just like their own didn’t even sell for $249,000. The developer had gone bankrupt leaving behind several unfinished projects including the promised community pool. Weeds grew up around the never occupied houses. There were several vacant homes in their own development as a result of foreclosure. One even had a broken picture window that he and another neighbor had boarded up. Another one had new residents – bees!

SUBS BY DESIGN: THE CASE OF A FAMILY BUSINESS IN TRANSITION

Barbara K. Fuller, Winthrop University

CASE DESCRIPTION

This case focuses on the growth of a family-owned franchise from its inception in 1987 to 12 stores in 2008. The patriarch is now 70 years old and the succession planning for the business is just beginning. The background of the family and history of the company create a portrait of the current situation and provide the environment for making future decisions. The case first concentrates on the issue of growth by providing students with an opportunity to develop a profit and loss statement for a new store offered to the franchisee. All of the key figures available to the entrepreneur are provided allowing students to put themselves into the role of the decision-maker. Secondly the patriarch of the family, Ryan, is thinking about retirement. The case develops Ryan's personality as well as the characteristics and behaviors of his two children over the 20 years of the business. As the founder, Ryan must now decide what is best for the business as well as the family as he becomes less active and the business moves to the next generation. The case provides students with a unique perspective by extensively quoting Ryan and Greg Smith, the founder and his son, thus giving them insight into the thoughts of the individuals involved in the decision making. All of the events in the case are based on a true entrepreneurial experience, but the names have been disguised to provide privacy to the owner. The profit and loss statement uses actual figures and depicts the situation as it existed at the time the offer was made. The case has a difficulty level appropriate for junior to senior level undergraduate students. It is suitable for use near the end of an introductory course in entrepreneurship which is where small business growth is usually covered in entrepreneurial textbooks or in a separate entrepreneurship course that has more of an emphasis on growing the business and succession planning. Although not developed for a finance class, it could be use by emphasizing the purchase decision associated with the Rock Crest location. Depending on the emphasis at least some basic accounting background would be helpful. The case is designed to be taught in two class hours and is expected to required four hours of outside preparation by students. However, there is a lot of latitude provided to the instructor as to what direction to take the case.

CASE SYNOPSES

Ryan Smith, laid off from his position as plant manager for a textiles firm, begins a new career as the franchise owner of a group of sandwich shops doing business as Smith Enterprises.

The case covers Ryan's startup of Subs by Design with the help of his family and the trials and tribulations of growing a family business. Startup financing came from some unique sources including from a fellow franchisee in a nearby territory. Early family support came from his daughter Bree who gave Ryan the confidence he needed to open the first two franchises. Bree and her husband, Brad, helped Ryan grow the business during it early days. Greg, Bree's younger brother, was not interested in the business, until an injury kept him from pursuing his first love, professional baseball. After the injury his father urged him to join the company. The case looks at the interaction among Ryan, Greg, and Brad as they continue to grow Smith Enterprises. The triangular relationship eventually results in Brad leaving to pursue a career in real estate.

After Brad and Bree's departure, the company continued to grow. Smith Enterprises is now looking forward to operating 12 stores which include two stores currently under construction. However, recently Ryan was presented with an interesting offer from the franchisor for a prospective store in a potential hot growth area. Ryan must make a decision on the offer within the next three weeks. If he doesn't accept the offer, the franchisor will offer the location to someone else. The case ends with Ryan who is now 70 looking at his retirement and planning for the succession of the business. He has to decide how to divide his estate and what to do with the business as it moves to a second generation of ownership.

INTRODUCTION

> "I never planned to be an entrepreneur, but it's been an interesting 20 year detour. When you work for a corporation for practically a life time, you don't realize how much your identity as a person is anchored by the corporate experience. Being layoff at 50 years old was a devastating experience. But it opened up a new chapter in my life and provided me with a chance to build and grow a business of my own. Sure there were hard time, but now the business is thriving and I have people coming to me with new locations and opportunities. The biggest issue now is deciding which of the opportunities makes the best sense for the business as I become less involved and it moves to the next generation of leadership. Now that I'm 70, the thought of retirement does wander into my mind every once in a while. I'm still not sure when and under what conditions I'll retire, but I would like to slow down at least a little."

These are the words of Ryan Smith, CEO of Smith Enterprises. In 2008 Ryan is the owner of 12 sub sandwich shops doing business as Subs by Design in Stansberry GA, a town with a population of just over 50,000. Smith had purchased his first two Subs by Design franchises twenty years ago in 1987. At the time, the experience was both exhilarating and frightening. He was 50 years old and moving into the restaurant industry. What frightened Ryan the most was the fact that he knew nothing about restaurants and had no past experience upon which to draw. How had he gotten here after spending 30 years in the textiles industry? He remembers vividly the day he was laid off from Phoenix Textiles. He had worked for the company for 24 years and made his way up to general manager before he was terminated to make room for the owner's eldest son to take the top spot at the company. Although he understood how family businesses worked, he was left without a job in an industry that was seeing continued movement off shore and to Asian countries with lower labor costs. Thinking that textile industry was all he knew, Ryan was devastated. As he pondered his future he wasn't sure which direction to go. He had always wanted to start his own company, but had never found the right business or the timing was off. He felt this certainly was not the right time with children in college. But fate had put Ryan and his wife, Vicki in the job market with some very serious decisions before them.

> Ryan: "I wanted my own business, but we were scared. I had written away for franchise information many times over the years, but we were afraid because of the family. We had two kids in college. Where would we get the money to start a franchise even if we were able to find a business we liked? We thought going into business meant we would have to go a year or two without making any money. You know that's what everyone tells you. We would have to live on Vicki's salary and if we moved to a new city to open a franchise, we didn't know if Vicki would be able to get a teaching job."

FRANCHISE OPPORTUNITY

As chance would have it while traveling on an interview in Calhoun GA, Ryan stopped in a Subs by Design Sandwich Shop for lunch. The product was so impressive that he located the franchise owner to discuss the business. The owner convinced Ryan to inquire further, which he did. The franchisor was just starting to grow and the product was not really proven in the south. But, Ryan had a very positive gut feeling about the business. In July 1986, he purchased two franchises and opened the first one in April of 1987 and the second one six months later. Today, he has 10 stores with two under construction. An additional two are run by his daughter Bree and her husband Brad. But he remembers trying to get the courage and the resources to start the first store.

> Ryan: "We had a little bit of savings plus I borrowed money from anybody I could find. I coaxed a friend of mine who was in the banking business to help put together a business plan. When I went to the bank they said it was a good plan, but I didn't have experience in the restaurant business and 80% of the restaurants fail in the first year. If I had some collateral, they were willing to give me a loan against assets. But, I didn't have assets, my home wasn't paid for and I didn't have other property."

However, back on the job front, the prospects didn't look good. Ryan had several interviews, but nothing interesting. The small nest egg he and Vicki had saved was dwindling. They were going to have to make a decision soon. Ryan gathered his courage and sat down to talk with his wife, Vicki.

> Ryan: "I told Vick that this was a good opportunity that would work. I had studied it very carefully and had spent a lot of time with the store owner in Calhoun, GA. He convinced me Subs by Design was an up and coming franchise and it was going well for him. He even offered to loan me $5000.00 to get started. Once Vicki was on board we got the whole family together and said, look this is what we want to do. It means moving to Stansberry, GA. Much to our surprise my 19 year old daughter Bree who was in college said fine, I'll drop out of school for a while and help out with the startup. Even with everyone's support, my gut was still churning, especially about the financing. I thought nothing is black and white and there is always risk involved in starting a business. The next step was to visit the franchisor. Bree agreed to accompany me to the national headquarters of Subs by Design. After several hours of talking with the franchisors, we both felt it was a really good opportunity. They were a new company and we would be getting in on the ground floor. Bree convinced me right there on the spot that it was the thing to do. So we bought two franchises that day and Smith Enterprises was formed."

Subs by Design provided two weeks of training for new owners to learn to operate and manage the store. Ryan completed his training at the end of 1986. In January of 1987, with the help of Bree he opened the first store and six months later a second store across town. They both worked in the first store for six months along with Michael, a young man that Ryan hired as manager because he had some experience in the restaurant industry. When the second store opened Michael took over as its manager. Bree stayed at the first store with Ryan. Ryan and Vicki's youngest son, Greg, was in the ninth grade when the stores opened so he helped out after school and in the summer.

> Ryan: "When I went to school they taught me to calculate profit weekly. From the very first week, I took all the monthly overhead times 12 and divided by 52 weeks and had a formula for all my fixed costs (rent, power, water, debt service, gas, phone, labor). I determined after the first week I had made a $30.00 profit, so I paid my self $30.00. The second week, I made even more profit and it just kept growing."

The reality of his decision was beginning to set in and Ryan realized that he was now in the sandwich business. During his corporate years he had relied on standardized procedures that had been established through years of experience in the textiles industry. He had always felt safe under the protective umbrella of the company. If he needed something, there was a department somewhere in the corporation that could help solve the problem. But being an entrepreneur was different.

> Ryan: "As an entrepreneur you have to do everything. At least with a franchise, I had an operation manual, but in effect I was now out there on my own and I was responsible for making all of the decisions. There was nobody who could help. I knew that I could get opinions from people, and everyone had an opinion. I could call other franchisees all over the United States, but I still had to make the final decisions myself. I soon found I needed to be pretty calculating because there were consequences of my decisions. This was true especially in the beginning. When I started Subs by Design was a concept that had not been proven and I had to figure out if Southern folks would warm up to submarine sandwich which had mainly been sold in the north. At the same time, I was responsible for setting up my own business including administrative, operations, banking, legal, and accounting functions. I had to hire people and make sure they were paid every week. I had to deal with the IRS, as well as state and local government regulation and ordinances. It was a little overwhelming. In the beginning, I did it all myself until I understood how to do it. I paid all of my accounts payable and wrote checks for payroll every week. Within 6 months I found a CPA to help with the financials. He now helps me with all of the financial aspects of the business and stands behind me with the IRS if I have any problems."

LESSONS LEARNED YEAR ONE

Ryan learned a lot that first year in business. This is how he described his thoughts at the end of that first year as an entrepreneur.

> Ryan: "You have to be a little cocky and have a lot of self-confidence. Those traits will tide you over when things start to go wrong, which they inevitable will at some point in the business. In other words, you have to feel like if thing don't work and you do get into a mess, you can work your way out of it. You can't be perfect all the time, you're going to slip. You also have to have folks that can serve as mentors that you can call and ask and hope they have been in the same spot or one similar to it. There are three people you have to have as friends: your banker, your lawyer, and your CPA. That doesn't mean you use them a lot other than your CPA. But you have to have some folks you can call on that you are comfortable with. In addition, you have to be the kind of person who doesn't mind asking questions that may make

you feel a little foolish. I don't care if you have a master's degree in business; there are questions that you will never know the answer to unless you ask somebody. You have to have the drive and perseverance within you to find answers that are not available in textbooks, yet are extremely important to the future success of your business. Knowing the facts and doing your due diligence are important in creating a comfort level with your daily decisions that will eventually lead to the success of your venture."

Ryan was also aware that he had made a number of mistakes that first year that were costly to the company. Because of his inexperience many decisions felt right at the time but ended up costing the company in the long-run.

Ryan: "Early on we were too cheap with our money because we were trying to make a profit. We paid minimum wage, which is what others were paying. But, people cannot live on minimum wage. We had so much debt we could not provide any benefits. We grew so fast it was hard to keep up. In the beginning if somebody didn't do their job, I would let them go. Then I didn't have anybody to help me. I was too firm and expected too much of people. You have to understand if you're an entrepreneur, nobody is going to work as hard as you do. You can't expect your people to work half as hard as you do because they don't have any vested interest in the business. They are thinking about day to day when you are looking out five to ten years. My impatience caused a lot of turnover. I also made some bad moves with some managers. I hired people that probably could have done the job, but they didn't want too. I soon found that education was important, but so was motivation. Some of the early hires came to the job with vim and vigor for the first few weeks, but then decided that work was something they just didn't want to do and they would leave. As I got more experience in the industry, things got better. Now we have such a good benefit package that our managers never leave us. To help them understand our expectations, we put together a training program with the help of the local technical college. The program required them to do some role playing and learn how to hire, fire, and motivate people. The course was sixteen hours over a four week period and each manager receives a certificate of completion. After the training program, managers are responsible for hiring and firing, employee evaluations, giving raises, training and all daily operations. Every store is managed the same way. There is a little bit of difference in the personalities of store managers, but basically I delegate as much responsibility for daily operations as possible to the managers so that I can concentrate on the overall operations and growth of the business."

EXPANSION

The lessons that first year where many, but Ryan's goal was to grow the business beyond two individual stores. So when both of the original stores became profitable, he was ready to move on to a third store. He never saw himself making sandwiches for the rest of his life. He had bigger plans.

> Ryan: "I didn't get in this business to make sandwiches, I got in this business to grow and manage the business and let employees make the sandwiches. I made sandwiches in the beginning, but that was not the master plan. I started in the store because I needed to know how to do every aspect of the business from the ground up."

Ryan knew that most of Subs by Design franchisees had three to four stores. They made a nice living, but were tied to the daily operations of the business. Ryan had run a large textile plant and knew how to manage people on a larger scale. His dream was to own multiple stores and he knew he would need assistance. He would need to hire one additional management person and arrange financing before Smith Enterprises could increase in size.

> Ryan: "Although I did have a lot of debt, the second store doubled our profits and the financials were looking pretty good. The Subs by Design franchisors were pressing me to open more stores. If I didn't do it, they would give the new locations to somebody else. So I went to the bank and showed them the profit and loss statement and said I wanted to open a third store. This time the bank was more agreeable and loaned me some of the money to finance the third store."

Money as with any startup was tight in the beginning. All of Ryan's money and everything he had been able to borrow from friends and family was tied up in the business. With the desire to expand and Subs by Design encouraging even pushing him to open another store, he used every financial option available to him.

> Ryan: "For the first three stores Subs by Design leased the equipment to me. The lease was for a 5 year period and at the end of the lease period, for one dollar, I would own the equipment. This method of financing was expensive, but I had to bite the bullet on leasing because I had no other way of financing the equipment. One of my goals was to pay off the leases early on all three stores and own them outright. Within 3 years of each stores opening, I had reached this goal. After the third store I was able to borrow enough from the bank to finance both the building and

equipment. I now had a track record and the interest I paid at the bank was half of what Subs by Design charged."

FAMILY ISSUES

Two years had passed since the first store opened and Bree, Ryan's daughter, wanted to go back to college. She had a boyfriend who lived near the college that she had previously attended in Bradshaw, Georgia and their long distance relationship was becoming strained. So, Ryan and Bree investigated properties around the college with the intent of building a store in Bradshaw that Bree could run while she attended college. They found a suitable property and opened a store the following year. Bree returned to school and was responsible for running the store in Bradshaw. Ryan returned to Stansberry and initiated plans for two additional stores in the nearby town of Landburg, GA. He had scoped out a couple of locations that he felt would be profitable. However, he was experiencing skepticism from family and friends and hadn't been able to find the right person to help manage the expansion.

> Ryan: "Everyone told me I was foolish. Landburg could only support one store. Their strong opposition created some doubt in my mind, but my gut instincts told me to go ahead with two. I truly felt that there were two distinctly different communities based on the geography and demographic characteristics of the city. There was the uptown section towards the bypass and a more rural community to the west of Highway 603. The city was growing and a developer was building a new shopping center near the bypass, so I thought I'm going to gamble on two. I was beginning to get a feel for this business and my past experience gave me a pretty good feeling about these locations. I convinced the franchisor that the locations would be profitable and opened two stores in 1989. Both stores have done extremely well."

Ryan now had five stores, plus the one Bree operated in Bradshaw. With six stores, Smith Enterprises was stretched to its capacity and Ryan needed additional management help at the corporate level. So in 1994 Ryan convinced Bree and her new husband, Brad, to come back to Stansberry and help him build the business. By this time Brad and Bree had a new baby four months old. The solution was for Brad, Bree and the new baby to return to Stanberry and move in with Ryan and Vicki. Brad became the general manager at Smith Enterprises helping with the overseeing of the franchises.

The first few years were an adjustment period for Ryan and Brad. Ryan came from the old school and managed his business accordingly. He ran a tight ship and those around him had to adjust to his management style, including Brad. This is how Ryan described his management style.

Ryan: "Employees look up to me more as a fatherly type figure. I know the business and demand respect. I want things done my way throughout the organization from the top to the bottom. In the corporate office as well as the stores there are procedures that must be followed. I insist that store employees work hard and take care of themselves personally. I don't put up with any shenanigans going on during business hours. I don't care what they do with their personal lives as long as they don't bring it to the store. When I walk into a store everyone knows they better snap to. I start checking the store. I want everybody in uniform. I want everything done properly. They will also tell you, I am very benevolent. If they do a good job, they get rewarded for it."

Within the next couple of years, Brad adjusted to his new environment and helped Smith Enterprises open another store in a newly developing section of Stansberry. A strip center with the right combination of retail space, a convenience store and some specialty shops, created what Ryan thought was an ideal location for another "Subs by Design" location in the city. With this addition Smith Enterprises now had eight stores.

In the mean time Ryan's son, Greg, came back from college. Up until this point Greg had little interest in or contact with Smith Enterprises except for the few summers he had worked behind the counter at the original Subs by Design location.

Greg: "I was away at school on an athletic scholarship and wanted nothing to do with the business. I hoped to play professional baseball some day. However, because of some injuries, in the spring of 1995 I returned home. The business was growing and doing phenomenally well. So, I decided to join dad and my brother-in-law, Brad, in the business. The company owed a lot of money, but they were paying off the debt earlier than required by the bank and there were plans for further expansion. I knew that I would need to learn the business from the ground up, so I agreed to work as a manager in one of the stores for the first year."

With his son's decision to enter the business Ryan's thoughts again moved towards expansion. Once Greg got experience at the store level, he would be able to join Brad and help with overseeing additional stores. Ryan decided to begin looking in Longville, a small but thriving community located just outside of Stansberry.

Ryan: "We went to Longville, but we couldn't find available property suitable for developing a franchise. The only option was a convenience store. I ask the owner if I could put a Subs by Design shop inside of his convenience store. Creating partnerships with existing convenience stores was a new business model for Subs by

> Design but the co-branding concept had become a popular trend with a number of well known franchises as well and independent companies. So we made a deal, and built a store inside the local convenience mart. The store is still there today and doing quite well."

The success in Longville leaded to the opening of three additional stores within close proximity to Stansberry. Smith Enterprises was also able to purchase a store in Springfield, GA. Although the Springfield store was run down and losing money at the time of purchase, Ryan and his new management team was able to turn it into a profitable store within six months.

MANAGEMENT STYLES

For the past four years, Greg had been away at college and pretty much on his own. Now he has back working in the family business under his father. The first year he managed a store and was left pretty much on his own. But, the second year he moved into the corporate offices of Smith Enterprises with his father and Brad. He immediately had to learn to deal with his father's management style.

> Greg: "The biggest thing with dad is that he is always so serious. When it comes to business he is all business. He tells it like it is and never beats around the bush with any niceties. He always wants more. That's his style. It got him to where he is today, so I have to respect him. However, he's tough to work for not only for me but for other people. Let me give you an example of how it was back then. He would walk into a store any day of the week at 6 to 7 o'clock in the evening. When he walked in, if the employees were playing around or the store was dirty or he just wasn't happy about something he would fire everybody right on the spot. Then he would call Brad and me and we would have to come down and run the store and close up. He's gotten better over the years. Now when he gets upset, he bites his lip and calls me. We talk and he lets me take care of the problem. Before he was the chief, and he would handle it his way. I'm not saying it was right or wrong, but it was tough. I didn't understand a lot of decisions he made, but we had to deal with them, and just keep going. There is nothing else we could do."

As Greg was learning about the family business and his father's management style, everyone especially the store managers and employees were testing Greg. What type of a manager would he be? Would they be able to walk all over him or was he a chip off the old block with the same hard-nosed tactics as his father? Ryan described his son's management style as follows.

> Ryan: "When Greg walks into a store, the employees just love to see him. They think he's a great guy. They are very comfortable, not nervous at all. When he finally starts looking around the store, he points out a few things and slaps them on the back. He asks how they are doing, or says it's good to see them. Eventually he'll get around to saying; you know we need to get that corrected because what the customer sees is important. He explains why they need to make the corrections. He goes on back through the store and talks to them about their families and gets really involved. In the beginning when I observed this type of behavior, I was very nervous. I thought he was too lax, and they were going to take advantage of him."

It took several years for father and son to appreciate each other's management style and conflicts still occur, as with most family businesses. Ryan confesses that he was very surprised that his son's laid back management style worked. After many arguments and reconciliations Ryan eventually gave in and let Greg try it his way.

> Greg: "My philosophy is 'There are two ways to skin a cat.' What I mean by that is Dad wanted things to be done in a certain way, but the managers wanted to do things their way. Dad would argue with the managers and insist that everyone do it his way. But I've helped him to understand that if the end result is the same, then we need to be happy with the results and not worry about how the manager got to that result. Sometimes, it was stressful on everyone trying to make the transition."

> Ryan: "We had some pretty strong arguments for a couple of years, arguments about Greg not being firm enough. I thought he should fire someone, but he chose to keep them. Or I thought he didn't follow up closely enough to find out who was taking money from the register. But, almost every time I got upset, I had to later back off because he had already quietly followed through. That was just his personality. During this time Greg made some mistakes, but I gritted my teeth and kept my eye on the situation to keep him from getting into major problems. He learned from making those mistakes and never made the same ones twice. That's what you are looking for in a good manager. If you have a person who repeats the same mistake from a different perspective then you have a person that you have to get rid of because they aren't going to do any better. With each new experience, Greg was growing with the company. He did tell me one time that he finally realized that it wasn't my job anymore to look after him. It was his job to look after himself and the business. Once he realized that, he seemed ready to take on more responsibility. Maybe it was only a mind set, but it made a big difference in our relationship. "

FAMILY ADJUSTMENTS

In 2003 after spending 10 years in the business, Brad decided he wanted to leave Smith Enterprise to move into the real estate business. Although Smith Enterprises had been able to thrive and prosper, the relationship between the Ryan, Greg and Brad had become somewhat strained.

> Greg: "When I first moved into management and started overseeing the stores, I would go to Brad for advice. He had more knowledge. We were doing the same job, but he had been around longer and had more knowledge. However, it was not long before my relationship with Brad became more strained. Looking back I was somewhat naïve. I thought we would all be doing Subs by Design together forever. There were days when Brad couldn't say or do anything right in dad's eyes. You've seen the movie – "Meet the Parents." It wasn't quite that bad, but dad was constantly on him. A guy in town presented Brad with a business opportunity in real estate. He decided to take it. From my perspective it was strange being the person in the middle. I always hoped that I would be playing ball somewhere, and didn't really want to come back to Smith Enterprises. However, when the ball thing didn't work out and dad needed some help, I decided to come on board. I didn't think about my role as opposed to Brad or any of that type of stuff. Looking back there were so many signs, but I was too young and naive to understand the family issues."

At the time that Bree and Brad left the company, Ryan deeded over two stores to them - Bree's original store in Bradshaw and the one in Springfield, GA, which was only 19 miles away. The two stores were worth $1.2 million at the time.

> Ryan: "On the one hand, I was hard and let Brad and Greg compete to see who would be the strongest leader at Smith Enterprises, but on the other side when Brad & Bree decided to leave I gave them two stores. The two stores would provide them with income until they got their other business up and running. I felt like Bree and Brad helped to me get the business going when I needed them."

Brad moved into the real estate business and Bree took over the two Subs by Design stores. With Brad gone, Greg began to take over more of the responsibility at Smith Enterprises and became the president in 2005. Ryan still remains as the CEO.

> Greg: "The business is open seven days a week and we now have 8 stores with two more close to completion. There is always something happening. If someone breaks in I have to go down to the store in the middle of the night. In the beginning, I saw

> myself as an employee working for dad. Now I'm looking more from the perspective of an owner. That has helped me. If a problem arises I used to just jump and handle it. Now I try to get people to take care of the problem for me. One day I woke up and said I can't keep putting out fires all the time. It used to be if someone failed to show up for lunch or there was no one to close at the end of the day, I would jump and go do the work. Corporate planning and development would have to wait and I would get all backed up. I just said I can't keep going on like this not getting anything done, so I delegated more responsibility to our managers. Now I have people that have been in place for a number of years and they are at the point where they can handle more decision making at the store level. That gives me more time to think about the future of the business."

As Smith Enterprises grew, Greg learned how to manage his time more efficiently by delegating more of the responsibility for day to day operation to the store managers. A few years ago, around 2006 he began handling the opportunities and challenges presented by the business in a much more professional manner. This allows him more time for his personal life and family responsibilities. He cherishes the flexibility that he has to spend time with his daughters at after school activities or dance recitals, but understands he is responsible if something goes wrong in the business.

> Greg: "I have two children 5 and 3 years old. I feel lucky that I can attend a lot of their school activities. It all comes back to having good people to run the business. Today ninety percent of the store's issues can be handled over the phone. But there will always be issues to resolve. Keeping my wife involved somewhat in the business helps her to understand if I have to go to the store on a Saturday night because of an emergency. It doesn't happen often, but it probably will never completely go away. Entrepreneurs are always on call. Our biggest disappointment was a trip to Hawaii that we planned a year in advance, and at the last minute I had to let a manager go. It was a situation where I couldn't wait. The family was really disappointed. That was really tough for all of us."

Ryan also comments on Greg's development over the past few years. He gives credit to Greg when he talks about having ten franchises rather than the average three or four held by most Subs by Design franchisees.

> Ryan: "We have learned a lot about operations over the years and have really good people in place. Greg is good at what he does. He handles ten stores like I handled four and has plenty of time let over. Greg's management style is very laid back, and

> he gives employees a lot of leeway. He's not liberal, but he is very understanding. He has a lot of credibility with the employees and knows how to deal with people. He also knows everything there is to know about the business and can make a sandwich faster than anyone I know."

CONTINUED EXPANSION: AN OPPORTUNITY AT ROCK CREST VILLAGE

Now in 2008, the business is growing and Smith Enterprise has two additional stores under construction.

> Ryan: "The two new locations are good sites with heavy traffic counts, beautiful visibility, good rent, and different markets from our current stores. We are capitalizing on the benefits these locations offer. You always have to be aware of what your competition is doing in the marketplace. Right now we have at least four other sub franchises in town so we have to stay ahead of the game and know where expansion is occurring within the city. One of our new locations is north of the city, where we are seeing a lot of growth and increased traffic. We plan to put another store along this corridor before long. I already have a site in mind. You're in a much better position if you're ahead of the competition. Growth requires that you to look at the market and evaluate where you have opportunities to take advantage of the market.
>
> How large we decide to grow the business depends on Greg. He says maybe 20 or it might be more than that. Greg is currently 34, so he's got a lot of years ahead of him. We are also looking into the commercial real estate business. We own some office space and strip centers. We are starting to diversify a bit. Putting all of your eggs in one basket is dangerous. However, Subs by Design is our bread and butter. If you can run 10 stores, you can run 100 stores. You just apply the same principles and procedures, and then follow them."

Although most of Ryan's expansion has been self initiated, there were times when the franchisor found an interesting opportunity in a particular geographic area and presented it to the franchisee for consideration. Subs by Design recently found such an opportunity and approached Ryan with a prospectus for a new store. The Rock Crest section of Stansberry had experienced significant growth with the completion of a regional mall two years ago. Numerous retailers moved into the area and residential growth was forming. Ryan outlines a call he received from Subs by Design.

Ryan: “Subs by Design will find a location and if it is in my general geographic area, they will call me to see if I’m interested. When they called I said, yes I’ve been watching that location. Let me see the lease and I’ll work up some numbers. Having worked with Subs by Design over the years, I knew that the franchisor wouldn’t appreciate my turning down an offer in my geographic area, but I needed to look at the figures. A lot of owners would take anything to keep competition out of their area, but I’m in this business to make a profit. I was certain rent would be high because of the type of development in the area, but I wanted to see the overall package.”

Since day one Subs by Design had trained Ryan to look at the Profit and Loss Statement (P&L). So Ryan’s first instinct when he looks at any new site is to develop a Weekly P&L for the store. (A copy of the P&L Form that Ryan uses in evaluating stores is provided in Appendix A of the case.) He received the following lease terms for a 1500 square foot site from the Rock Crest Village landlord.

Ryan estimates that sales in the new location would be between $7,000 and $10,000 per week. He did his first calculation using a $10,000/week sales volume since his costs were generally related to $10,000 per location in sales. If he needed to make adjustments he would have the established fixed expenses and make adjustments for the cost of goods, royalty fees and advertising cost. Ryan’s expenses included the following: gas .05%, electric 1.75%, telephone .15%, garbage .25%, insurance .40%, labor and taxes 22%, repair and maintenance .8%, and miscellaneous expenses .8%. Cost of goods sold usually ran near 31% of sales. And of course, he would have to pay the franchise royalties of 8%, advertising expenses of 4.5%, and payback his loan for the purchase of equipment which was $500 per week to the bank. All Ryan needed now was to put the figures from the lease agreement plus his cost estimates into the weekly profit and loss statement. This would give him a picture of the potential profit or loss for the new location. The net profit margins for his current stores ranged from a low of 10% to a high of 20%. Ryan knew that a store would be opened in this location whether or not he decided to accept the offer. If he declined the offer, Subs by Design would offer the location to another franchisee, and he would have competition in the territory. If he opened the store it meant that he would be adding an additional store to the two he currently had under construction north of Stansberry.

As Ryan pondered expansion into the Rock Crest Village location he thought about the past and was proud of his accomplishments over the years at Smith Enterprises. Money was no longer the issue it had been in the early days when he was just getting started. With a good track record behind him, Ryan found he had the backing of the bank and could borrow money whenever he needed it. On the other hand, he felt that the decision as to whether or not to open the store in Rock Crest Village had to stand on its own. Would the Rock Crest Village store make a reasonable profit for Smith Enterprises? The location was great, but the developer had a reputation for very high rents. In addition, several national chain restaurants had already committed to the location including Cracker Barrel, The Olive Garden, Panera Bread, McDonalds, McAlisters Deli, Outback Steakhouse, and Applebees. There were also rumors of additional competition moving into the area as the development grows. This meant the competition would be pretty tough.

Table 1: Lease for Rock Crest Village Terms of the Deal	
Lease Terms:	Commencing on the "Commencement Date" and ending Sixty (60) months thereafter except that in the event the Commencement Date is a date other than the first day of a calendar month, said term shall extend for said number of months in addition to the remainder of the calendar month following the Commencement date.
"Estimated Completion Date":	November 2005
Permitted use"	Full Service, with a drive through, Subs by Design Restaurant.
Minimum Guaranteed Rental:	\$3700.00 per month (\$29.60 per square foot per year) in Years 1-5.
Initial Common Area Maintenance Charge per month:	\$125.00 per month (\$1.00 per square foot per year).
Initial Insurance Escrow Payment per month:	\$18.75 per month (\$.15 per square foot per year).
Initial Tax Escrow Payment per month:	\$62.50.00 per month (\$.50 per square foot per year).
Security Deposit:	Two (2) monthly payment totals to be applied to the 1st and 36th month of the lease term. \$11,100.00
Summary:	Initial Minimum Guaranteed Rental (\$3700/month) + Initial Common area Maintenance Charge (\$125/month) + Initial Insurance Escrow Payment (\$18.75/month) + Initial Tax Escrow Payment (\$62.50/month) = Monthly Payment Total (\$3906.25/month)

There were two other issues that Ryan and Greg thought were important to consider before making a decision on Rock Crest Village. One dealt with the size and configuration of the current management structures. Greg felt that Smith Enterprises had reached it capacity without the addition of another layer of management.

> Greg:" At Smith Enterprises, Subs by Design is our bread and butter. The franchise has come a long way in twenty years. I have talked with dad about the possibility of having fifteen to twenty stores in the next few years. That would require moving two or three of our current store managers to regional positions. We could give each

of them four to five individual stores to manage. Fifteen to twenty stores would be over my head. I'm 34 years old now. It is six years until I'm 40. I've started to think about where I want to be at 40 and what's going to be going on at Smith Enterprises in six years."

Would a management structure change have to occur before the addition of the Rock Crest Village store or could they absorb an additional store now? Another issue Greg needed to take into consideration was the fact that his father has just turned 70 and was starting to be less active in the daily operations of the business. In the past couple of years he has helped mainly with new store negotiations and openings.

Greg: "Dad is trying to take a lesser role in the operation of the business. I don't think he will ever be totally out, which is fine with me. Even today, I get a lot of advice from him. We'll go out to lunch and talk about different things. The last few years we have had a really nice relationship. We still talk about the business as well as him giving me personal advice. My role now is in operations. I handle all the managers and the employees. Dad has taken over the role of building out the new stores. We have to deal with corporate headquarters and negotiating lease agreements with landlords. Dad loves confrontation. He feeds off of the competitive environment. I wish I had more of those qualities in me. I'm more of a push over, but I can be strong if I need to be. So today dad basically handles building the stores and I take over the operations when their complete."

Based upon their calculation and knowledge about the area as well as the position of Smith Enterprises, Greg and Ryan must make a decision about whether to accept the proposal presented by Subs by Design or turn it down and allow someone else to open a store at Rock Crest Village.

SUCCESSION PLANNING

As with any family business when the patriarch begins to think about retirement, the succession of leadership in the business begins to become an important issue. Ryan is in the process of talking with his family and getting legal advice from his attorney on issues related to succession planning for the business and his estate. He wants to be fair to both Bree and Greg, but he is not exactly sure how to approach the subject. Death and estate planning are such difficult topics to discuss.

Greg: "Dad turned 70 this year and in the last few months he has been talking about his will. I don't want to think about all that. I'll be fine with whatever mom and dad decide to do with the business. I feel dad is trying to understand what Bree and I want and where we're coming from."

Appendix 1: Student Worksheet			
Rock Crest Village Weekly Proforma Profit & Loss Statement Comparison of Sales Volume at $10,000 and $7,000			
	$	%	$
Net Sales	$10,000		$7,000.00
-Cost of Goods			
= Gross Margin			
Expenses			
-Gas			
-Electric			
-Telephone			
-Garbage			
-Insurance			
-Labor-Taxes			
-Repair/Maintenance			
-Miscellaneous			
-Rent and other contractual costs associated with lease			
-Royalty			
-Advertising			
=Total Operating Expenses			
-Loans/Administration			
Net Profit/Loss			

Ryan: “I have approached an estate planning attorney and have begun the process of putting together the paperwork to transfer the ownership of the business. The process is more complicated than I had imagined. There are many options with gifting, family limited partnerships, self-cancelling installments, private annuities, and grantor-retained annuity trusts. Not only do I have to decide on how to divide the estate but also the best way to pass it on taking advantage of all of the IRS rules associated with business succession.”

KING OF THE HILL: COMPETING FOR FOREIGN DIRECT INVESTMENT IN 'DIXIE'

Patricia C. Borstorff, Jacksonville State University
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CASE DESCRIPTION

The primary subject matter of this case concerns foreign direct investment (FDI) in the southern U.S., specifically automobile FDI in Alabama. Secondary issues concern the aggressive competition, using incentives and state-specific features, of southern states in recruiting foreign investment and the employment opportunities that FDI brings. This case has a difficulty level of three. It is suitable for a junior level course and can be taught in a 90 minute class with two hours of preparation by students outside of class. The case could also be used in a senior-level international management class to illustrate the reach of globalization into our corner of the world. This case can be used as a template for professors in other states in illustrating the proximity of FDI in their state and the consequences of that FDI. We propose that there is international activity in the form of FDI here or abroad as well as exporting and importing in virtually all states. A professor can use this case as is or as a template to reflect international activity in his/her local geographical area. Students should relate to the importance of international business as they see its relevance to their lives.

CASE SYNOPSIS

This case is designed to illustrate the concepts of foreign direction investment, job creation, state incentives as a factor in FDI, and the unique features that a foreign investor wants from a state. The case can be used in its entirety or in part as appropriate. For example, one could investigate recruiting methods used by U.S. states in the pursuit of FDI and the results of that pursuit. Or one could investigate the facets of employment, such as a non-union environment, educational development, and tax policies, that are particularly attractive to foreign investors. Or one could compare the incentive packages offered by various southern states and determine the return on their investment.

Countries are faced with numerous challenges as they compete for the same Foreign Direct Investment (FDI) dollars. FDI is increasing as the world evolves into a global marketplace for industry. The U.S. government continually adjusts its policies and tax procedures in order to be a viable player in the world market. The southern U.S. has become more aggressive in recruiting *foreign investment by providing incentives to attract industries and communicating the unique advantages they offer to foreign companies interested in a U.S. presence. Many southern states, including Alabama, have been successful in improving their economies and providing new employment opportunities by offering the incentives required to attract FDI and industries to the area.*

INTRODUCTION

Colleges and universities have tremendous interest in foreign direct investment today. FDI provides well paying jobs and internship opportunities for students as well as consulting ventures for faculty. Some students are involved in finding out more about how southern states have been so successful in attracting FDI to “Dixie,” as the southeastern states are known at home. The students introduced here are MBA students who are hoping that their advanced research will give them a competitive advantage over their peers. Their names are Mary, Tom, Zack, and Sue. Go with them as they unravel the intricacies of FDI. They are assisted by employees from various economic development offices in the south who are enthusiastic about the students’ quest.

Neal Wade, head of the Alabama Development office, started the students with a little background information. Let’s listen in for what Neal shared with them about FDI, different countries’ motives, and the major Southern United States’ FDI inflow players.

In today’s global marketplace, governments increasingly must compete aggressively to attract multinational companies. Companies engage in foreign direct investment (FDI) for the purpose of actively controlling property, assets, or companies located in a host country. International business competition among multinational companies frequently involves fiscal incentives. Due to the elimination of barriers to capital movements, governments must compete for Foreign Direct Investment (FDI) in global markets. FDI patterns have significantly changed over the past twenty years. Relative to the GDP of all developed countries, in 1980, the amount of inward FDI was 4.7 percent and outward FDI was 6.4 percent. These figures had tripled to 14.5 percent and 19 percent respectively by 1999 (Zitta & Powers, 2003).

Industries have several different motives for expanding their operations abroad. If a firm possesses unique capabilities, they may conduct FDI abroad in order to expand their capabilities to achieve higher returns. Often firms expand abroad in order to obtain capabilities that are not available in their home country. Some fear protectionism and others move close to their customers to reduce costs and better capture what their customers want (Alcacer & Chung, 2002).

Countries vary in the importance of issues that affect their FDI. There are similarities between the U.S. and Japanese investments, even though the two groups of investors vary in their responsiveness to factors such as low wage inflation, labor quality, and corporate tax rates. Japanese investors are more influenced by factors such as infrastructure, wage inflation, elementary school enrollment, and country risk, described as economic and social uncertainty of the host country

(Mody & Srinivasan, 1998). The United States is the largest foreign direct investor country with 1,953 foreign direct investment projects since 2002 (www.locomonitor.com 2005). The U.S. also hosts the largest inflow of FDI in the world, which offers foreign multinational companies substantial market opportunity (Cooke, 2001). U.S. FDI net financial inflows were $17.6 billion in the second quarter of 2005 (www.bea.gov.)

During the 1990's, the U.S. experienced a sharp growth in FDI generated by the booming economy. During 2004, FDI capital investments reached $13.90 billion U.S. dollars. The United Kingdom, Netherlands, Japan, Germany and Canada provided the largest amounts of direct investment in the U.S., and these countries also received large amounts of investment from the U.S. (Country Profile, 2005). For example, in 2003, there were 589 FDI projects with a capital investment of U.S. $11.61 billion. In 2004, 580 FDI projects resulted in U.S. $14.26 billion. In the first half of 2005, there were 370 projects with a capital investment of U.S. $10.99 billion. The countries investing in the U.S. since 2002 were Japan (328 projects), Germany (258), UK (241), Canada (180), and France (95). (www.locomonitor.com).

The top five multinational companies investing in the U.S. ranked by the number of FDI projects in the U.S. since 2002 are Toyota (16), DHL (15), Honda (12), Daimler Chrysler (9), and Infineon Technologies (7) (http://www.locomonitor.com";www.locomonitor.com). It is important to note the number of automobile companies.

Mary and Zack were astounded at what they heard from Mr. Wade. They knew that they had seen a lot of television reports about foreign automotive groups visiting in the south. However, they did not realize why they were here, and they were a little unsure about what the various states would deliver to them. Mary did some research and found out about the fierce competition for FDI among local and national governments. She filed her summary on what southern states bring to the table for the foreign companies. Her report is below.

SOUTHERN STATES AND COMPETITION FOR FDI

Many foreign countries choose the southern section of the U.S. as a desirable location for their FDI. Despite the escalating costs of incentives packages, southern states continue to invite large industrial employers in order to continue the evolution from an agricultural economy to a manufacturing economy. In the first quarter of 2004, "Relocate America" named the top five places to live in the U.S., and they were all located in the South. In 2005, Policom Corporation ranked their top metros for economic strength, and seven of the top ten were in the South (Randle, 2005).

National and local governments face fierce competition for foreign direct investment as they recognize the impact to their economies of foreign business and industry locating in their area. Attracting multinational companies is no easy task but the state economic results are quite impressive. In today's global economy, companies expect their new facilities to be profitable immediately, and this requires a trained labor pool and cooperation within local governments. The southern U.S. tax policies have changed within recent years to impact FDI decisions. Infrastructure improvements, business incentives, and job training programs are part of the incentives offered to foreign investors as competition among states takes place.

FDI AND SOUTHERN STATES

As states are forced to compete for FDI, large manufacturers reap the benefits of shopping around for prime locations and the best deals or incentives offered by states. The southern U.S. has been very aggressive in recruiting international companies. Economic development is one of the first job priorities of southern politicians. Tennessee, Alabama, Georgia, Kentucky, South Carolina, and Texas have been eager to grow their manufacturing bases and have welcomed foreign automakers with numerous incentives, many industrial sites, a skilled work force and a non-union environment (Krizner, 2005). Each state has adopted a unique strategy to attract FDI because they realize they are competing for the same limited investments. The following section discusses what Texas, South Carolina, Mississippi, and Alabama are willing to offer in their pursuit of international investment.

Our student, Zack, was no slacker and he came up with a short report on FDI in Texas, South Carolina, and Mississippi. Here he was helped by the friendly staff in the respective development offices of these states. The Economic Development Offices' mission is to have every imaginable bit of information at their finger tips for any group looking over their state as possible investment projects. Tom Blackburn and Barry Mintone gave a lot of time to helping Zack learn more about what individual states do to attract FDI.

TEXAS, FDI AND INCENTIVES

Tom Blackburn is an acquaintance of Zack's dad. He previously lived in Alabama where he worked for the Economic Development Partnership of Alabama, so he has a vast knowledge of FDI. He recently retired and moved to the state of Texas. When he first moved to the state, Governor Rick Perry offered him a job, but he did not take it since he was retired. He gets bored now and then, so he has been pondering on how he can get involved with FDI projects in Texas. He would like to contact Governor Rick Perry, but he is not sure if he should. In the middle of his thoughts, his phone rang. When he picked up the phone, Zack was on the other end of the line. Zack asked Tom if he had any information on FDI in Texas. Tom told Zack that he currently did not have that information, but that he would be glad to call the governor and see what he could get. Tom was very relieved that Zack had called because now he had a reason to contact Governor Perry.

A few minutes later, Tom contacted Governor Perry's office. The Governor was not available, but Tom left a message. When the Governor returned his call, Tom explained his past experience with FDI and that he was helping a student from Alabama with a project about FDI in

Texas. Tom asked Governor Perry to explain what the state has done and is currently doing to bring Foreign Direct Investment into the state of Texas. As a response to Tom's inquiry, Governor Rick Perry explained that he has made job creation and economic development a foundation of his administration. With the legislature's help, he established a $295 million dollar Texas Enterprise Fund to allow the state to respond quickly and aggressively to opportunities to bring jobs and employers to Texas (www.governor.state.tx.us). This fund merged all economic development and tourism functions into the governor's office (fDi Magazine, 2005). This provides state's leaders with a "deal-closing fund" that has the flexibility and financial resources to help strengthen the state's economy. The fund may be utilized for a variety of economic development projects, including infrastructure development, business incentives, community development, and job training programs. This enables the governor's office to tailor incentive packages to best meet the needs of local communities and businesses. The fund focuses on ways to attract new business to the state or assist with a substantial expansion of an existing business as part of a competitive recruitment situation (www.governor.state.tx.us). The Governor's and legislature's reform of the state's workers' compensation system is also an example of the state's commitment to successful partnership (www.toyota.co.jp.2003).

An additional economic incentive Texas utilizes to attract FDI is the Texas Industry Development (TID) Loan Program, which provides capital to Texas communities at favorable market rates. Also, the Texas Leverage Fund (TLF) provides an additional source of financing to communities that have adopted an economic development sales tax (www.governor.state.tx.us). Texas ranks forty-eighth within the fifty states in per capita taxes which makes its tax burden one of the lowest in the U.S. (www.fdimagazine.com).

Governor Perry ended his explanation by telling Tom that Texas recently acquired a new Toyota Motor Manufacturing North America (TMMNA) plant in San Antonio and that it involved an additional $50 million dollar investment by Toyota within the state.

Tom was satisfied with Governor Perry's explanation of what Texas is doing to bring FDI into the state, and he told Governor Perry that he was interested in helping with FDI projects for the state of Texas. Tom called Zack and relayed all of the facts that he learned from Governor Perry. Using the information Tom gathered, Zack sat down at his computer and started typing his report on Texas.

SOUTH CAROLINA, FDI AND INCENTIVES

To obtain information on FDI in South Carolina, Zack contacted Barry Mintone, a member of the South Carolina Economic Developers' Association. This organization is devoted to increasing the effectiveness of individuals involved in the practice of economic development in South Carolina by encouraging cooperation, exchange of information, and promotion of professional skills. Barry informed Zack that Carl Tanning from the state's economic development board would be speaking about South Carolina's current and past experience in attracting FDI to the state at the next meeting. He invited Zack to attend the meeting.

At the meeting, Zack attentively listened to what Carl had to say. Carl explained that South Carolina started its modern Foreign Direct Investment (FDI) program in 1988, which resulted in the securing of Fujifilm Medical in Greenwood and the BMW Plant in Greer (1992). Since this program started, South Carolina has continued to reap success in the development of jobs through in-sourcing or FDI. According to the Organization for International Investment, South Carolina ranks first in the nation in the share of its private sector workforce supported by U. S. subsidiaries of companies headquartered abroad. FDI employment accounts for some 127,000 jobs in South Carolina or 8.4 percent of its private industry employment. 10,000 jobs were created in the period of 1999-2004 (9 % increase), with 51 percent being in the manufacturing sector; which has a tendency to produce a greater rate of spin-off employment opportunities. With 604 foreign owned companies operating in South Carolina, 1 in 12 of the state's jobs can be attributed to FDI. South Carolina ranks fifteenth nationwide in its number of in-sourced jobs.

Carl continued his presentation by introducing the state's most current FDI project, the 1992 BMW package. He informed the audience that the BMW project was thought to be the most costly state supported economic initiative ventured at the time. The state offered incentives totaling $155 million in return for the promise of 1900 jobs for a ratio of $81,479 per employee (adjusted to 2001 dollars). These dollars came in the form of property tax abatements, labor training, income tax credits, revenue bonds, a 900 acre plant site, road and airport improvements, and a $6 million dollar local county contribution. While raising dire doubts among politicians and some economist concerning government's direct support of foreign owned private business, the economic impact has been beyond even the most aggressive projections.

Carl concluded his presentation by describing how BMW has effected the state's economic position. He explained that the result of South Carolina's initial investment has been BMW's return investment of $1.9 billion and direct employment of 4300 employees. This foundation supports an additional 16,700 jobs producing $691 million in wages. The total impact associated with BMW's annual economic activities exceeds $4.1 billion. Given the above data, South Carolina's venture capital was obviously put to good use. The prudent use of state monies in the pursuit of FDI continues, as in 2004, the state approved a $103.5 million incentive package for BMW in return for a promised $400 million additional direct investment and the creation of 400 new jobs.

After listening to Carl speak, Zack packed up his things, went home, and wrote his report on South Carolina. After finishing the report, he realized that he was almost finished with the project. One more state and he would be finished with his research.

MISSISSIPPI, FDI AND INCENTIVES

Zack was very excited about researching the state of Mississippi because his family is originally from there. He brainstormed about how he would gather the information. His options were to contact the economic development board in Mississippi or to find the information on the board's website. He decided to do the research on the website since it was the quickest way to access the information. Below are the facts that he found while completing his research.

FDI by U.S subsidiaries of foreign-based companies in Mississippi play a vital role in the state's economy. They employ almost 3% of the private sector workforce, totaling 25,500 Mississippians, which represents an increase of 29% in the last five years. This increase is largely due to the arrival of Japan's number three automobile manufacturer, Nissan.

Mississippi was slow in realizing the worth of recruiting foreign capital. However, it launched a serious effort the late 1990's, which resulted in a major catch; Nissan came to Canton in 2000. Mississippi held special secessions of the state legislature which resulted in cutting the time frame for incentive decisions from the normal eighteen months to five. The package included $295 million of direct incentives in return for a promise of 4,000 jobs paying an average of $23 per hour. In addition to the state's effort, Mississippi went one step further when its United State's Senator, Trent Lott, sponsored special federal tax reduction legislation for the Canton area. It is ironic, in light of the state's lethargy in getting into the game, that the facility was expanded by forty percent a full year before it was scheduled to open.

The final incentive package totaled $363 million with the corresponding job numbers jumping to 5,300 and a promised direct investment of $1.4 billion. Using what has become a standard measurement of the soundness of the investment for the state, these figures compute to an incentive/job ratio of $68,490. This compares favorably with Mississippi's neighbors of Alabama and South Carolina whose ratios were $82,857 and $81,479, respectively. A state funded economic impact study projected the investment to break even by 2007, in large part because of the economic multiplier effect showing the overall job creation to be 16,212.

As in South Carolina for BMW, many of the dollars in the incentive package were devoted to infrastructure improvements, employee training, and tax credits. Nissan Vice-President, Emil Hassan, reflected in his statement, "The partnership between local firms and Tier 1 automotive suppliers demonstrate a win-win scenario that will be good for the smaller firms, for Nissan, and for Mississippi."

After Zack finished his research on the internet, he took a short break to eat dinner and think about his research a little. After dinner, he began writing his report. Soon he would be finished with his portion of the project.

ALABAMA, FDI, AND INCENTIVES

Mary Jones, Tom Russell, and Sue Hensley focused their research on Alabama's economic incentive plan, particularly its competitive position in the solicitation of Foreign Direct Investment (FDI). On the second day of their internship, they were a little apprehensive as they waited outside the governor's office at the Alabama State Capital in Montgomery. After they all said hello, they headed inside, so they could get started on their research project.

After a brief introduction to the governor and a one-half hour visit with the Chief of Economic Development, they were escorted to their offices, better descried as cubicles, and basically told to "Get on with it". After settling in, getting their personal items arranged, computer pass words approved, and security badges, they all agreed a 1:00 pm "Brain Storming" was an appropriate first step. Tom, who was getting his MBA from Ole Miss, was informally selected as the leader of the team, with equal participation encouraged by all.

All agreed the mission-goal for their project was to evaluate available data on the history and economic impact of FDI in Alabama and competitive states; and give recommendations as how to apply this information in the making of future decisions.

The effort was further categorized into three general areas:

1. A comparison of the tax incentive packages offered by various southern states. Mary's had an undergraduate degree in accounting from Jacksonville State, so the group thought she would be the best equipped to handle this section. Mary was very comfortable assessing how tax incentives would influence the companies to look hard at Alabama.
2. The desired employment environment and infrastructure, particularly as it relates to human resources: i.e., education demographics, state sponsored training programs, and union presence. Given Sue's undergraduate degree in human resources from Auburn, she seemed a natural for this role.
3. Financial Incentives and return on the state's investment. With Tom's undergraduate degree in finance he was deemed the best suited for this category.

When Mary began her research in the area of tax incentives she was somewhat surprised to discover that Alabama offers substantial advantages for companies seeking a business location that will contribute to long-term success. It has a labor pool of more than two million skilled workers, and it offers a work force training system that has been ranked best in the nation. The transportation infrastructure can meet the demands of companies in any sector. It has a competitive overall cost structure that is one of the country's lowest, and it is a prime location in the heart of the fast-growing U.S. South. All these factors have a major impact on a company's bottom line.

As Mary's research developed, she was awed by Alabama's success of being in the forefront of offering incentives packages and deriving a considerable benefit from the industries relocating in the state. For example, Alabama's auto industry has generated 30,180 direct jobs, creating another 53,530 indirect jobs, for a total of 83,710. These job totals translate to $1.4 billion in direct payroll and $1.62 billion for indirect payroll as of the end of 2002. It is estimated that 5 to 6.2 spin off jobs are associated for every single assembly job. Alabama possesses many natural resources that make it attractive to foreign multinational corporations. Among these natural resources are attractive climate, accessible ports and rivers, excellent infrastructure including a good transportation system, and reserves of natural gas, coal, and marble. Other areas that Alabama emphasized in their quest for automotive FDI were tax incentives, union sentiment, education development activities, and state training programs.

ALABAMA AND TAX INCENTIVES

Due to Alabama's commitment to the promotion and maintenance of a competitive business climate, the state has developed one of the most aggressive tax incentive programs in the nation for new and expanding industry. The Alabama Department of Revenue governs several tax incentives for existing industries, expanding industries, and new industries locating to Alabama. The tax incentives offered by Alabama are created and administered under the Alabama Constitution of 1901 and the Code of Alabama 1975. Since the Alabama tax incentives have a statutory basis, industries in the state have a stable framework for long-term investment.

The most substantial tax incentive offered by Alabama is the Capital Investment Tax Credit program. This program allows new and expanding companies up to five percent of their initial capital costs of qualifying projects as a credit. This credit is offered each year, for twenty years, beginning in the year the qualifying project is placed into service. This credit is available to all types of entities, including but not limited to: C corporations, S corporations, limited liability corporations, partnerships, trusts, and sole proprietorships.

In addition to the Capital Investment Tax Credit, it offers the Alabama Enterprise Zone Credit and the Employer Education Credit to companies locating or expanding in Alabama. The Alabama Enterprise Zone Credit was established to stimulate growth in depressed areas of the state. It offers businesses a package of incentives which includes some of the most favorable arrangements in the country. In order for a company to receive this credit, it must locate in one of the twenty seven areas of Alabama that are designated as an "enterprise zone." The credit can be applied against the income tax liability or the business privilege tax liability and cannot exceed $2,500 per new permanent employee each year. In addition to the maximum $2,500 credit, employers may also receive an exemption from Alabama sales and use tax on the purchase of materials used in the construction of a building or any addition or improvement for the zone business or any machinery and equipment used in the business. The Employer Education Credit is available to employers who provide basic skills education programs to Alabama resident employees. The credit is twenty percent of the actual costs and is limited to the employer's income tax liability.

Since Mary was puzzled by Alabama's ability to offer such concessions, she inquired about the topic with Alabama's Chief Revenue Officer, Clyde Romer. Mr. Romer explained that most tax incentives are booked against future anticipated tax liabilities instead of cash outlays; relieving the pressure on current revenues. Mr. Romer also discussed how Alabama is favored for its corporate income tax rate of 6.5%. The state allows corporations to deduct their federal income taxes, which makes the net effective rate of 4.42% one of the lowest in the nation. Unlike many other states, Alabama does not levy property tax on inventory that is held for sale or materials that are held to be compounded or manufactured and are stocked at plants for manufacturing purposes.

Mary was quite intrigued by the fact that the Alabama legislature took the initiative to pass The Tax Incentive Reform Act 1992. This act gives the cities, counties, industrial development boards, and other public bodies the power to grant property tax exemptions of up to ten years to companies that are engaging in new projects or major additions to existing projects. There is no minimum investment for new projects, but an addition to an existing project must be the lesser of 30% of the cost of the existing facility or $2 million to qualify for the exemption.

Alabama is ranked nationally among the lowest electricity costs for industrial users. In addition, utilities used in certain types of manufacturing and compounding processes qualify for an exclusion from the utility gross receipts tax and utility service tax for utility services used in Alabama.

Mr. Romer's interview concluded the Alabama portion of her research, so Mary left the meeting confident she had the data to compare Alabama's tax incentives with other southern states.

FDI AND INFRASTRUCTURE

In her effort to evaluate the importance of the employment environment and infrastructure, Sue sought an appointment with the state Human Resources Director, Helen James. Gracious with her time, Mrs. James explained that competition for FDI is influenced by government policies. While offering tax incentives is often effective in attracting foreign investors, improving the quality of a country's infrastructure appears to have a longer lasting impact. Countries must focus on the basics that make them attractive to the foreign investors: de-regulation, simplification of processes, reduced corruption, education of the labor force for long-term benefit, and expanded infrastructure (www.iabd.org/res/publications, 2001).

Sue remembered her courses in international business and began nodding in agreement as Mrs. James further elaborated that human resources (for example, wage levels, unionization, labor politics, and skills of the workforce) are important factors in most firms' decisions regarding FDI. Findings indicate that U.S. and European multinational companies' decisions regarding investment abroad are strongly influenced by comparative location advantages, especially the differences in union penetration, collective bargaining contexts, and government workplace regulations (Cooke, 2001). German-owned DaimlerChrysler Corporation, in its Alabama operations, has been aggressive in its efforts to rid itself of union representation by Bridgestone/Firestone who is Japanese owned. DaimlerChrysler wishes to operate as a union-free enterprise. Studies by Bartik (1985) and Woodward (1992) show that foreign multinational companies strive to minimize the likelihood of their company being unionized by their location decision in the U.S. A study by Shaver (1998) indicates that foreign-owned manufacturers are more negatively influenced by union penetration rates than U.S. manufacturers in making location investment decisions (Cooke, 2001).

When questioned about state sponsored training, Mrs. James responded by saying that Alabama offers several unique first class training programs. Alabama Industrial Development Training (AIDT) is among the most highly rated workforce-training program in the U.S. (Expansion Management, 2003). They provide state-of-the-art industrial training and support services for new and expanding industries. AIDT has several training centers located statewide. For example, the AIDT center in Lincoln continually assists the Honda Manufacturing plant located nearby with employee training and support as they expand their processes. They provide mobile training units, an experienced staff paid by AIDT and on-site production facilities at no cost to the business client. AIDT often works in partnership with the local community colleges in their training center areas to coordinate customized training for their clients.

Sue was pleased to discover, through Mrs. James' orientation, that the state has 12 Alabama Technology Network (ATN) Training Centers located throughout the state that work with businesses and industries to increase the competitiveness of companies through a network of service providers. This network merged under the umbrella of the Department of Postsecondary Education in 2005, in order to fully partner with the College system to enhance workforce-training capabilities. Future plans call for increasing the number of ATN center locations in the state within the next two years in order to meet the increased technology training needs of the future Alabama workforce. ATN's administer the Manufacturing Extension Partnership (MEP), which provides a network of increased services to manufacturers. ATN's assist businesses that have lost jobs or are forced to revamp their processes due to foreign competition. They offer applications for the Federal Incumbent Worker Grants that enable manufacturers to retrain their employees with a fifty percent match of grant funds for training costs.

Wow! With this treasure trove of information Sue began organizing her research data to reflect Alabama's competitive position among the state's peers in the ongoing FDI competition.

FINANCIAL INCENTIVES AND RETURN ON INVESTMENT IN ALABAMA

Having been given the responsibility to perform the financial analysis on the southern FDI phenomena, Tom started his investigation into its cost effectiveness by contacting the state Treasurer's Office. While he visited with the state's Chief Finicial Officer, Gene Downs, Tom learned that more than 300 foreign-based manufacturers from more than 30 nations currently operate in Alabama. Of these foreign-based companies, three are major automobile manufacturers, Honda, Hyundai, and Mercedes. Another foreign-based automobile manufacturer, Isuzu, just announced that it will be expanding its operations into Alabama in the near future. The state is also the home of a Toyota engine plant that produces V6 and V8 engines.

Mr. Downs explained that, in 1993, when Mercedes announced that it would be moving the assembly of the M-Class outside of Germany, Alabama was not anywhere near the top of the list of possible locations. However, Alabama ended up being the state of choice because of its generous incentives package. It granted huge subsidies to Mercedes in exchange for Mercedes building its plant in Vance that would employ 1,500 people. The incentives package included $253 million in free acreage, tax abatements, donations, infrastructure, improvements, and work force training. Based on the incentives offered, those 1,500 jobs cost Alabama taxpayers $168,000 per job. The Mercedes plant manufactures the M-Class sport-utility vehicle (SUV), the Grand Sports Tourer, and the GL-Class luxury SUV at the plant in Vance. After its $600 million expansion in 2005, Mercedes' total capital investment in the plant increased to $1 billion with 4,000 employees. The number of vehicles assembled each year rose to 160,000 while the total square footage for the plant increased to $3 million. Mercedes' investment in Alabama has also created thirty five auto suppliers. Although it cost a substantial amount of money to get Mercedes to locate in Alabama, it put Alabama on the automotive map which led to future investments from other foreign auto makers. In light of this scenario, it is Mr. Downs' belief that the assessment of the financial soundness of these FDI endeavors, especially this first one, cannot be made on a strictly financial analysis alone.

Looking further, Tom was able to produce real numbers as to individual incentive packages' total cost in terms of tax incentives and actual cash outlays. And, return on investment can be approximated in terms of economic impact and jobs gained. In 1999, the state was not as generous to Honda as it was to Mercedes in 1993, but Honda still received $102 million in direct incentives that included site preparation grants, preparation for the construction site, free employee training programs, industrial access programs, and the biggest thing of all: enough affordable land to accommodate its 3.25 million square foot manufacturing facility. They also received an additional $55.6 million in tax breaks. Honda expanded its operations in 2004 with the addition of a second assembly line. Along with this expansion came an additional $89.7 million dollars in incentives from the state. This incentives package included: $45.1 million from the state for employee training, and road, sewer and water improvements, $33.1 million from the state and local levels for various tax breaks, and $11.5 million from the city of Talladega and Talladega County for site preparation, and sewer and water improvements. The Honda assembly plant produces the Honda Odyssey Minivans, the Honda Pilot SUVs, and V-6 engines to power the vehicles they assemble. After the expansion in 2004, Honda has a $1.2 billion investment in its plant in Lincoln and employs approximately 4,500 worked. Honda produces more than 300,000 Odyssey minivans, Honda Pilot sport utility vehicles, and V-6 engines each year at its plant in Lincoln. It is Honda's largest light truck production source in the world.

In 2002, Alabama gave Hyundai an incentive package worth $252.8 million to locate in Montgomery. This package included $76.7 million in tax breaks; $61.8 million in training grants; and $34 million in land purchase assistance, road and bridge development, and water and sewer improvements. Hyundai assembles the Santa Fe SUV, the Sonata sedan, and the Lambda 3.3L V6 engine at its plant in Montgomery. It employs 2,500 workers and has an annual production capacity of 300,000 units. Hyundai has invested $1 billion in its 2 million square foot plant and has created an additional 5,500 jobs through its 34 suppliers in Alabama.

As Tom processed this information, he looked forward to meeting with the team to discuss his findings, along with what they found, as to Alabama's competitive position in the solicitation of FDI.

After several weeks of hard and interesting work, they reconvened with the following findings. At the last minute, they heard the announcement from the Economic Development Office about Isuzu coming to Alabama. They also reported on this new bonanza for Alabama.

ISUZU COMES TO ALABAMA

Isuzu Manufacturing Services of America Inc., a subsidiary of Japan-based Isuzu Motors Ltd., purchased a three hundred square foot former Del Monte Corp. distribution center for $7.8 million in Birmingham, AL, according to 2007 public records. Isuzu Manufacturing Services provides research, development, engineering and manufacturing services for Isuzu in North America. It also owns Isuzu Diesel Services of America Inc., an engine development and manufacturing subsidiary. Isuzu plans to invest several million dollars into the distribution center and turn it into a manufacturing facility for its commercial medium and full-size trucks. Isuzu plans to employ approximately 1,000 workers.

The project will qualify for incentives from the city and the state based on the extent of Isuzu's investment and the number of jobs to be created, using a formula spelled out by state law. It is possible additional incentives could be offered. The negotiations with the state of Alabama and Birmingham have been secret and Isuzu has not set a date for production to begin.

Chip Letzgus, a spokesman with Isuzu Motors America Inc. in Cerritos, Calif., declined to confirm recent reports that the company would build a commercial truck plant in the city. He said the company is likely to make an official announcement of its plans for the site within the next two to six months. Isuzu Motors America, headquartered in California, serves as the distribution arm for Isuzu sport-utility vehicles and pickup trucks in the U.S.

Sam Addy, director of the University of Alabama Center for Business and Economic Research, said news that Isuzu is coming to town is "great, because I think it's saying that we are on the map. We are being recognized as far as manufacturing is concerned." Addy said the new plant would help to diversify Birmingham's economy, which has been limited in the past by Environmental Protection Agency regulations from landing new manufacturing operations. It also would diversify the automotive products that Alabama has to offer, he said. "We've been offering cars, SUVs, sedans, and now we have a truck."

In October, Gov. Bob Riley said he had a "very enthusiastic" meeting in Japan with executives for truck maker Isuzu. The company has not made a formal announcement and Governor Riley declined to elaborate on the details of his meeting with Isuzu executives. He would only say that the meetings went very well and the meeting was very positive. Throughout the year, reports have varied on Isuzu's plans. For example, last month, Automotive News said Isuzu has delayed breaking ground on the project because it is considering the possibility of putting the operation in Mexico instead. In April, Japan's Nikkei newspaper said Isuzu would open a plant in Alabama with a production capacity of 5,000 trucks per year by 2010.

"With the growing and significant Japanese investment in Alabama, it's incredibly important for us to continue our business ties with Japan," says Neal Wade, head of the Alabama Development Office, the state's chief industrial recruiting agency. Wade, Governor Riley and other Alabama officials attended the Southeast U.S./Japan Association conference on how those ties can be expanded throughout the region.

The trip is at a critical time when Alabama is aggressively pursuing foreign investment. With plans unannounced and rumors of Isuzu looking at Mexico for manufacturing opportunities, Alabama officials are reaching out to Isuzu on their trip.

Others traveling to Japan have broader goals. Birmingham City Councilman Steven Hoyt, who heads the panel's economic development committee, says he wants to boost the city's profile. "When international companies think of Alabama, I want them to know about Birmingham, our resources, assets and amenities," he said in a press release last week. "As this message spreads, it will lead to economic expansion, jobs and enhanced prosperity."

Without a doubt, Japanese investment in Alabama during the past few years has helped fuel prosperity - and explains why the state group is making the trip. Carl Ferguson, director emeritus and senior research fellow at the UA center, said Alabama's existing automakers, Mercedes-Benz U.S. International Inc., Honda Manufacturing of Alabama LLC , Hyundai Motor Manufacturing Alabama and Toyota Motor Manufacturing Alabama Inc., "have all demonstrated that they can operate very, very profitably in Alabama." Labor is productive, and Alabama is well-positioned as a transportation hub, enabling raw materials to flow easily into plants and finished products to flow easily out, he said.

The smallest investment dealing with automotive industry is Toyota. The Toyota engine plant started production in Huntsville, Alabama in 2003. It produces V8 and V6 engines and employs 800 workers. The plant produces 270,000 V8 engines and 130,000 V6 engines annually. Toyota’s investment in Alabama totals to $490 million.

CONCLUSIONS

Alabama has invested millions of dollars into the automotive industry. As a result, their existing automakers, Mercedes, Honda, Hyundai, and Toyota have demonstrated that they can operate efficiently and profitably in Alabama. With deals like these, its no wonder foreign automakers have stepped up production in the U.S. States continue to offer attractive incentives, hoping that these will solve some of the problems facing them at home. For example, in early 2007, Louisiana and Alabama are in a bidding war for a German steel company. It is reported that the incentive package offered by both has exceeded $1 billion.

QUESTIONS

1. What percent of FDI to the US is in the southern states?

2. What caused this increase in FDI to the southern area?

3. What tax incentives does Alabama offer companies in FDI?

4. What part does unionization sentiment in a state have on FDI decisions?

5. Why do countries engage in foreign direct investment (FDI) in Alabama and other southern states? What unique things does Alabama offer? See www.ado.state.al.us

6. What is the impact of Alabama Investment Development Training (AIDT)?

7. What is the Alabama Technology Network and what is its influence on FDI?

8. What was the incentive package Alabama gave Honda?

9. What was the incentive package Alabama gave Hyundai?

10. What are the aggregate benefits of FDI to Alabama?

11. What makes Alabama and its infrastructure attractive to foreign investors?

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BELGROVE FARMS INC.

Richard Tontz, California State University, Northridge
Leonard Rymsza, California State University, Northridge
Leah Marcal, California State University, Northridge

CASE DESCRIPTION

The primary subject matter of this case focuses on the calculation and use of comparative advantage in the allocation of resources within the firm. Secondary issues involve the use of accounting techniques and statistics to complete the business decision analysis of a profit opportunity. The case also presents strategic thinking and ethical issues related to business conduct in a family firm and the effects on consumers.

The case has a difficulty of level three, appropriate for junior level courses. The case is intended to be taught in three class hours, including a class presentation by student teams. The case is expected to require a minimum of three hours of outside preparation by student teams that present a report.

This case is designed for use in an upper-division, inter-disciplinary business course. The purpose of the course is to enable students to utilize the knowledge they have gained in their lower-division core business courses that include one economics course in microeconomics and two accounting courses (one course in financial accounting and one course in managerial accounting) and one statistics course.

Specifically, the case incorporates the understanding of comparative advantage, opportunity cost and how prices affect the allocation of resources, how cost data should be used in decision making, and the calculation of expected value.

CASE SYNOPSIS

Students are faced with a factual setting that presents practical business and ethical issues. The client, Belgrove Farms, is considering changing production from standard yellow corn to genetically modified corn. The farm has four sub-divisions that vary in production of the new product. Cost data is provided by an existing proposal. Future pricing of the genetically modified corn is uncertain. Using the concept of comparative advantage, the student must choose the appropriate allocation of production among the four sub-divisions, and calculate the anticipated change in profits. Students must also consider the nature of a family firm and any strategic or ethical issues associated with the proposed change in production.

BELGROVE FARMS INC.

As a junior analyst for Benderson Consulting (Benderson), you were looking forward to an exciting career. You imagined assignments evaluating new technologies in far-off, exotic locations. As your bus traveled through the heartland of U.S. cornfields, you wondered about your job choice. Your background research, however, has changed your first impression of being assigned to an agricultural consulting engagement. You have discovered that farming is no longer a small potatoes operation. Perhaps, given the changes in the size of farming businesses in the U.S., agribusiness might be a lucrative consulting specialty.

Belgrove Farms Inc. (hereinafter referred to as Belgrove Farms) is an old, family-owned business that has acquired various smaller farms over the years and has managed to maintain a profitable business enterprise through economies of scale. So far, the firm has specialized in the production of Grade AA yellow corn. Kevin Thorp, Operations Manager for Belgrove Farms, has proposed replacing the current production of AA yellow corn with a new genetically modified (GM) variety of yellow corn (see Exhibit 1).

Robert Belgrove, CEO of Belgrove Farms, engaged Benderson to evaluate Mr. Thorp's proposal and make recommendations. Marna Kim, the Senior Financial Analyst at Benderson, has assigned your team the task of evaluating the Thorp proposal. Ms. Kim has sent your team a memo (see Exhibit 4) outlining the major points she would like your team to consider.

The firm's research staff has pulled together information regarding the new product (see Exhibit 2) and the past two year's income statements for Belgrove Farms (see Exhibit 3). Your team has a few days to review the materials and prepare its preliminary analysis before meeting with the client

Required:

Using the memo from Marna as a guide, prepare a business report to the client setting forth your team's analysis and recommendations. Be sure to answer the questions found in the memo. In the report, address any risks associated with the recommendations. The team will also deliver its analysis and recommendations in a formal, personal presentation to the client.

ACKNOWLEDGMENT

Our thanks to Dr. Janice Bell for her assistance with the accounting aspects of the case.

Exhibit 1: Thorp Proposal Letter

Belgrove Farms Inc. 17342 Mendow Circle, San Jose, CA 95129 Phone (408) 555-CORN

January 10, 20xx[1]

Mr. Robert Belgrove
124 East Ocean Ave.
Santa Barbara, CA 93105

Dear Uncle Bob:

As we discussed last fall, I have been looking into switching the company's output from Grade AA yellow corn to a new strain of Genetically Modified (GM) yellow corn. I think you will be pleased with the following results of my analysis and the potential impact on our profitability.

Output and Revenue Analysis:

Based on our output from last year, if we plant Grade AA yellow corn again we can anticipate:
Total Revenue (TR) = $ 1,450,000 (290,000 x $ 5.00)
If we switch to the new GM yellow corn:
Total Revenue (TR) = $ 2,653,750 (482,500 x $ 5.50)

As you can see, our output would increase and the GM yellow corn is of somewhat higher quality generating a higher anticipated price. This change would increase output by 192,500 bushels or 66% and increase TR by $ 1,203,750.

Cost Analysis:

Our average production cost was $ 2.48 per AA yellow corn bushel this past year. We estimate it will be $ 2.70 per AA yellow corn bushel this year. If we switch to GM yellow corn, our processing, overhead and planting expenses will not change, but the increased price of GM yellow corn seed will raise average production cost per bushel to $ 3.25.

AA yellow corn Cost: 290,000 x $ 2.70 = $ 783,000.
GM yellow corn Cost: 482,500 x $ 3.25 = $ 1,568,125.
Increased Cost: $ 785,125.

Profit Analysis:

Increased total revenue = $ 1,203,750
Increased cost = $ 785,125
Increased profit: $ 418,625
Total Profit: $ 1,085,625

I hope you are as excited about this potential as I am. There has been some bad press about the genetically modified products in Europe, but I think that's just the usual fear of new technologies.

Sincerely,

Kevin
Kevin P. Thorp
Operations Manager
Belgrove Farms Inc.

[1] Let 20xx = current year.

Exhibit 2: Estimated Production by Farm			
Projected Year 20xx: Production Summary for AA Yellow Corn by Sub-division:			
1. Brookhurst Farm:	200 acres	20,000 bushels	(100 per acre)
2. Fordum Estates:	500 acres	50,000 bushels	(100 per acre)
3. Gatos Peligo:	300 acres	60,000 bushels	(200 per acre)
4. Sally's Place:	800 acres	160,000 bushels	(200 per acre)
5. Belgrove Farms Total:	**1,800 acres**	**290,000 bushels AA yellow corn**	
Projected Year 20xx: Production Summary for GM Yellow Corn by Sub-division:			
1. Brookhurst Farm:	200 acres	22,000 bushels	(110 per acre)
2. Fordum Estates:	500 acres	50,500 bushels	(101 per acre)
3. Gatos Peligo:	300 acres	90,000 bushels	(300 per acre)
4. Sally's Place:	800 acres	320,000 bushels	(400 per acre)
5. Belgrove Farms Total:	**1,800 acres**	**482,500 bushels GM yellow corn**	

Exhibit 3: Belgrove Farms: Income for the Two Years Preceding 20xx		
	1st Prior Year (Last Year)	2nd Prior Year (Year Before Last)
Sales and Changes in Value of Crop Inventories	$1,254,250	$1,160,181
Expenses and Losses		
Cost of Production	720,360	677,138
Selling, General, and Administrative Expenses	313,200	269,352
Technological Expenses	93,960	79,866
Other	11,745	10,336
Income From Continuing Operations Before Taxes	**114,985**	**123,489**
Income Taxes	32,196	34,577
Net Income	**$82,789**	**$88,912**
Basic Earnings Per Share	***$0.32***	***$0.35***

Exhibit 4: Marna Kim's Memorandum

Memo

To: All Student Teams, Benderson Consulting

From: Marna P. Kim, Senior Financial Analyst, Benderson Consulting MPK

Date: February 2, 20xx.

Re: Belgrove Farms Inc.

Please forgive my generality, but since I don't know at the moment which team will be doing this research, I have laid out a brief outline of the major points I think should be considered in evaluating the proposal of Mr. Kevin Thorp, the Operations Manager, at Belgrove Farms Inc.

Background: Robert Belgrove, a conservative older gentleman who founded the firm, is the client. He is very proud of the firm's commitment to quality. Kevin Thorp, a nephew of Mr. Belgrove, was hired by him two years ago. Kevin is 27 and recently graduated from a state university with a business degree.

Q. 1. Belgrove Farms has four sub-divisions (four different farms it has previously acquired). Since the farms have different relative productive abilities (AA yellow corn vs. GM yellow corn), and production can be shifted by farm, consideration must be given to the best combination of outputs to maximize the economic profit.

a. Calculate the output of each farm for AA yellow corn or GM yellow corn. From this data, calculate the economic cost of AA yellow corn in terms of GM yellow corn (ratio) and the economic cost of GM yellow corn in terms of AA yellow corn (ratio) [i.e., 1 AA = ? GM; or 1GM = ? AA.]

b. Our marketing division has put together a projection of expected selling prices (see Exhibit 5). Apparently there are some consumer issues about the new corn. These issues may affect the expected selling price of GM yellow corn. Evaluation of some alternative prices for GM yellow corn may be in order.

c. Combine the relative output ratios from Q.1.a. with the selling prices from Q.1.b. to determine an optimal output table at each selling price of GM yellow corn.

(Remember opportunity cost and comparative advantage analysis from economics, and contribution margin from accounting?)

Q. 2. Using the client's production cost data (Exhibit 1), demonstrate the change in profits expected from the above production recommendation for the alternative potential selling prices of GM yellow corn.

Q. 3. Assuming the probabilities of alternative prices for GM yellow corn are as stated in Exhibit 5, calculate the expected change in profits from adopting our recommendation. (This is important since it can be used to justify our consulting fees.)

Q. 4. Okay, that's the economic analysis, but consider the nature of a family business and any strategic and ethical issues that might be important, and check with me. We want to make the right recommendation for the client.

Exhibit 5: Marketing and Price Analysis

Benderson Consulting Group - Marketing Division

Background:

The Marketing Division was asked to analyze the expected prices and probabilities for AA yellow corn and Genetically Modified (GM) yellow corn for the summer harvest.

Analysis:

Estimating the future demand and supply of the commodity derives the projected market prices. The factors considered in the demand portion of this analysis include population growth, consumer preferences, and income. Relative prices of substitutes and complements were considered as static or unchanged. The supply portion of the analysis considered current input prices, existing technology, existing stocks on hand (domestic and foreign), and government policies (domestic and foreign). Exchange rate estimates were taken from our International Division's current forecast.

Price Forecast:

AA Yellow Corn (domestic): Price per bushel: $ 5.00.

GM Yellow Corn (domestic):

Two alternative price scenarios should be considered. The demand acceptance of GM products in general is in question. There have been numerous reviews by governments all over the world, but particularly in Europe.

1. Scenario #1: Price of GM Yellow Corn (domestic): $ 5.50. Europe adopts few restrictions on the importation of GM products, but prohibits European production.

2. Scenario #2: Price of GM Yellow Corn (domestic): $ 4.70. Europe adopts heavy restrictions on the importation of GM products.

At this time, we consider the probabilities to be: Scenario #1: 60%; and Scenario #2: 40%.

The futures markets will have determined which price will occur before it is time to plant the summer crop.

THE MISSING INVENTORY AT ZENITH INTERNATIONAL TRUCKS, INC.

Barry Armandi (deceased), SUNY-Old Westbury
Herbert Sherman, Long Island University-Brooklyn Campus
Daniel J. Rowley, University of Northern Colorado
Advar Dinur, Long Island University-Brooklyn Campur

CASE DESCRIPTION

This case was primarily developed for undergraduates taking a course in business ethics, although the case does include issues in accounting (inventory control) and the legal environment of business (corporate theft). The case specifically deals with how a firm handles the discovery of possible corporate theft and students should therefore have been exposed to material on white-collar crime. The case also deals with possible conspiracy to commit a crime (the RICO act) since one might wonder why and how the inventory control system did not indicate missing inventory prior to this time period. The case has a difficulty level appropriate for sophomore level or above. The case is designed to be taught in one class period (may vary from fifty to eighty minutes depending upon instructional approach employed, see instructor's note) and is expected to require between two to four hours of outside preparation by students (again, depending upon instructor's choice of class preparation method).

CASE SYNOPSIS

Derived from observation and field interviews, this case centers on Bob Harris, the new Assistant Controller of Zenith's parent company, United Truck Corporation, and Dave Manning, the Service Manager of the Yonkers facility. Bob Harris had been brought into Zenith by United Truck Corporation because the old operation, Magnum International Trucks, was losing money and United wanted the renamed firm (Zenith) attractive enough for a sale to another International dealership. Dave Manning first came to Bob Harris' attention when Dave was paid a bonus incentive for the month yet the Yonkers Service Department only contributed $ 2,484.42 to the firm's profit margin. Bob spoke with Dave and explained that Dave's bonus would in the future be based upon the facility's profits rather than gross sales. This would avoid the impact of heavy sales at the end of the month and returns the following week. Dave remained silent on this topic. The second time Dave Manning was confronted by Bob Harris was when there was a short fall in inventory at the Yonkers facility based upon a misplaced transmission. Bob confronted Dave in-person with this discrepancy and therein Dave resigned. Students are left wondering what actions should or would

Bob Harris take in light of this missing inventory and Dave's obvious attempts to avoid be held accountable for said items.

INTRODUCTION

"You know Bob, I really don't want this job anymore, and so I am giving you my formal resignation. I quit." Dave Manning, Zenith's Yonkers New York Branch Service Manager of the United Truck Corporation[1], spoke these words into his phone which he left off the receiver as he went back to his office to clear out his belongings. Bob Harris was stunned and speechless. As Assistant Controller of Zenith's parent company sitting in Chicago, he actually heard Dave's footsteps through the phone as Dave walked out of his office and out of the building. Bob had just recently asked Dave about some discrepancies concerning invoices and inventory and was expecting a report on Dave's investigation; this was certainly not the reply he was expecting or hoping for.

Bob Harris shook his head as he then closed the door to his office to get some privacy so he could think. He reflected back on everything he had been through the last year, all the events that brought him to this point, every plane flight between Chicago to New York, every encounter he had with his subordinates, every encounter with his superiors, all of it. "What a mess!" he thought to himself. "More importantly, what do I do now?"

ZENITH'S BACKGROUND

United Truck Corporation, headquartered in Chicago, owned and operated a New York subsidiary, Magnum International Trucks. Magnum was a truck dealership in the New York metropolitan area that sold International, UD, and Hino brand name trucks. It had five locations in Maspeth, Yonkers, Brooklyn, the Bronx, and Newark, New Jersey.

In September 2002, Magnum lost its International brand franchise from its major manufacturer due to sales problems. Magnum decided to close its Maspeth and Yonkers locations. It would keep the other three locations and continue with the UD and Hino brands. To prevent being closed out of selling International brand trucks, United Truck Corporation formed Zenith International trucks in October 2002. The sole purpose was to keep a New York market presence to be attractive for another International dealership. Zenith occupied the former magnum locations in Maspeth and Yonkers. Along with them taking these facilities over, they also kept all the employees that worked at the two locations.

The main headquarters of Zenith International was the Maspeth location, which consisted of a corporate accounting department, a sales department, a parts department, and a service department (See Appendix A). The accounting department consisted of an accounts receivables clerk, an accounts payable clerk/payroll administrator, and an office secretary. The Sales Department consisted of a Sales Manager, a truck salesman, and a truck parts salesman. The parts department consisted of a Parts Manager, two parts countermen, a parts deliveryman, and a receiving clerk. The Service Department consisted of a Service manager, an Assistant manager, a warranty administrator and ten mechanics. The Yonkers facility was much smaller with only a parts and service department. The parts department consisted of a parts manager and a parts deliveryman. The Service Department consisted of a Service Manager and five mechanics. International Truck and Engine Corporation sent two of its Operations Managers from their main headquarters in Chicago to oversee all the operations of the two locations. Their names were Sid Wohl and Bob Harris.

Sid Wohl was an older man in his mid-sixties. He had been with United for twenty-one years and was well schooled in United's practices. A proud man, he walked with utmost confidence as he had been in take over situations before with United. Sid indicated that, "This is just another dealership that I have been sent to in the country to look over until the next one. At least I can get some great New York City pizza to eat. And of course there is Peter Luger's Steak House." You could see from Sid's physique his love for great food. "Besides, I will be at this New York dealership very little. This assignment is more for Bob than me."

Bob Harris was a married 32-year-old man from Chicago and considered himself Sid's apprentice. Bob was a very calm, low-keyed individual, with a cautious hesitation with everything he did. Every sentence that came out of his mouth started with, "Ummm," followed by this clicking noise he made with his mouth. Although, he missed his wife back home in Chicago, he was excited about this incredible assignment. "Wow, New York City…what a way to make a name for myself as a leader at United Truck Corporation," Bob said. "If I succeed in New York, I can be sent anywhere in the country to help dealerships."

The schedule set up for Bob by his superiors was primarily to fly into New York every Tuesday at around noon. If everything went well at the baggage claim and there was not too much traffic, he would get to the Maspeth location at around 2 PM. Bob would stay at the dealership until about noon on Friday and then return to Chicago for the weekend.

BOB HARRIS' FIRST DAY AT ZENITH

Bob called a meeting with the employees the first day he was there. He advised all the employees at the Maspeth branch and the service and parts manager from the Yonkers facility to attend the meeting at the Maspeth site. The agenda was, first and foremost, to introduce himself to the employees and explain the situation the company was in. He wanted them to know that it was a new company, not an extension of Magnum, and how everyone started with a clean slate. He ensured them of their job security as well as motivated them to succeed in their positions.

The introductory meeting went without a hitch. Although he was nervous and a bit hesitant, he felt all the employees accepted him favorably by smiling at his comments, or laughing at his jokes along the way of his oral presentation. Bob closed his meeting by saying, "I would like to thank all of you for your time. Over the next week, I will be calling each employee privately into my office to get a better feel for your backgrounds and to speak on a more personal level with each of you. I will be listening to your suggestions, problems, and concerns regarding the Company." He figured he would speak to the two employees that were from the Yonkers facility, so they could return to their branch as soon as possible. Then he would meet with the Maspeth employees.

The first employee he met was Dave Manning, the Service Manager of the Yonkers facility. Dave was 28 years old, who was a most likeable sweet-talker. He had great self-confidence, which Bob noticed right away. Bob also knew that Dave's father, Charles Manning, was a former management consultant of Magnum International and was well respected in the industry. Bob knew that Dave was very knowledgeable of the industry having learned much from his father. Bob and Dave spoke for about fifteen minutes laughing and talking about everything from the Yonkers facility to the nightlife that can be enjoyed in New York. Also, that day he was able to speak to the parts manager of the Yonkers facility. Between arriving at around 2:15PM from Chicago, settling in his office, making a few important calls, calling the general meeting, and speaking to the Yonkers employees, it was already the end of his first day. These two employees were the only people he had time to speak with on the first day.

Over the course of his first week, Bob met with every employee at the Maspeth branch. The two employees who made an impression were Dave Manning and June Wyman. June was a forty-eight year old woman, who was crude and brash. She worked at Magnum for fifteen years and she had a 21 year-old son who was the receiving clerk for the Maspeth Parts Department. Bob noticed that when they met she had something to say about every single person in the company. He felt like he knew more about everybody from speaking to June as compared to speaking with each employee. She knew personal information about every employee in the company and had no problem sharing any of that information with Bob, whom she just met.

THE NOVEMBER NUMBERS

November ended, which represented the first full month that Zenith International was in business. Bob was happy with the progress he made with all the employees. Everybody seemed to be getting along with him as well as each other. The environment around the office seemed to be light-hearted and laid back. Bob was pleased with all the employees' eagerness to perform their jobs in the Maspeth office. He felt the same about the Yonkers office, though he hadn't been to the site yet. This feeling was based on phone conversations he had with Dave regarding the flow of operations in Yonkers. At around 5:30 PM one evening in early December, Bob decided to review the November financial numbers. It was quiet enough to read and analyze the figures without interruption since most of the employees had already gone home for the day. He quickly leafed through the figures and, upon reaching the Net Income/Loss line on the income statement, paused for a second. He excitedly commented, "How could we have operated at a net loss of $51,270." He was perplexed! "Wait a minute," Bob said out loud. He started turning the pages with more conviction and attentiveness. The section that really caught his eye was the Yonkers Service Department. Their contribution margin was ($2,484.42). He also noticed that the Service Manager, Dave, was paid a bonus incentive for the month, even with the Department's performance being so poor. Bob said, "My bosses are not going to be happy about this. I better get this turned around fast!"

THE CONVERSATION WITH DAVE

The next day, after getting off the phone and experiencing a less than wonderful conversation with Sid, Bob decided to call Dave about the financials of his department. He spoke with Dave and conveyed to him the disappointment he had with the numbers for November. He tried to get an explanation for such poor performance.

Bob: Hello Dave, its Bob. I just wanted to discuss with you the financial numbers for November.

Dave: Sure Bob, What's up?

Bob: Well Dave, to be honest they are not that good.

Dave: Well how bad could they have been, I received a bonus incentive. Isn't that for good performance?

Bob: Well, I wanted to speak to you about that as well. To be honest, I'm going to have to change the parameters that encompass your bonus incentive. You operated at a loss in your department and received a bonus. That can't happen anymore. From now on bonuses will be paid based on verifiable profits.

Dave remained silent for the rest of the conversation as Bob outlined the new parameters of his bonus incentive, which relied on a gross margin as opposed to just sales figures (Bob had already received approval for this change from Sid). Bob did notice that there were a lot of returns and credits issued at the beginning of each month which perhaps suggested hard sales tactics were employed at the end of the month; this may have resulted in numerous sale returns at the beginning of the month. Once he finished speaking, Bob hung up. He was happy that the conversation went with no resistance, and hoped that Dave would strive to reach his new defined goals.
Another Bump in the Road

Over the course of the next eight months the financials did not get any better. As a matter of fact, they got noticeably worse. Zenith International operated at a loss consistently each month, and none of the departments in the Yonkers branch were reaching their goals.

One day June walked into Bob's office with an invoice from a vendor that had to be paid. She informed Bob that there was no record of receiving the part into the Yonkers inventory account. She was able to spot this discrepancy because of the large dollar amount for the part. It wasn't some washer or light bulb; it was a three thousand dollar transmission. Bob decided to investigate the situation himself. He discussed the matter with the Parts Manager and came to the conclusion that they never received the item. Bob decided to call the vendor and dispute the invoice. The vendor told him that the item was delivered and that they would provide a copy of the signed delivery form. Bob had a stack of these types of invoices sitting on his desk, but because of their small amounts, he never really got into the reasons for the discrepancies, until this invoice. He grabbed the invoice from the fax machine and read the signature "Dave Manning" at the bottom. After seeing the signature, he thumbed through the other invoices on his desk and all of them read the same name, "Dave Manning". Dave hoped that this was merely a discrepancy, something that could easily be cleared up in a few minutes. Bob called Dave to discuss the missing inventory and asked him to come down to the Maspeth Office and meet with him at 8AM the following morning.

THE END OF THE LINE

The following morning Dave arrived at the Maspeth facility around 7:45AM and walked into Bob's office. After exchanging a few pleasantries, Bob went straight to the point of the meeting.

Bob: Dave, the reason why I asked to meet you is we have a situation with some vendors regarding parts bills and I need your help to resolve it. The vendors say we owe them money for parts we seem to have misplaced and/or not accounted for. I verified this with the parts manager. When I gave the vendor this information, they provided me with documentation showing that you signed the invoices as the parts being received. Please look this over and verify the signature …. Perhaps someone in the department signed your name for you? Or worse, perhaps the vendors are trying to scam us? It has happened to our parent firm already and I wouldn't be surprised if your suppliers are trying the same tricks to boost their sales.

Dave sat quietly, and looked at the invoices and the signature. Seconds ticked away slowly and Bob was wondering if he would ever get an answer to his question. It seemed a simple enough question and he expected that Dave would act indignantly about one of his subordinates who goofed up. Bob's silence seemed to stretch on for an eternity as Dave's mind continued to wonder what the possible explanations were. In terms of inventory control, does the branch have a history of parts being mislaid? If so, what percentage of inventory? Is this a "normal" inventory loss for the firm or industry? Or, are parts perhaps being used but not being accounted for and therefore just appear to missing? What is the "checks and balances" that make sure that parts are being recorded when received or used?

Dave shrugged his shoulders several times and did not even try to hazard an explanation. Bob thought that perhaps he was as shocked as himself about these discrepancies and was also examining the possible alternative explanations. This made sense since Bob would hate to see Bob jump to an erroneous conclusion. This stillness gave Dave a chance to think of other alternatives – perhaps accounts payable was not processing suppliers' invoices in a timely fashion and suppliers were therefore trying to pad their bills as a sort of revenge to make up for this lag in payment? Or worse, perhaps the firm had bounced some checks with their suppliers and the suppliers were trying to get back at them? Bob decided that rather than torture himself and Dave any further by sitting in mutual silence, that Dave should investigate this matter and get back to him.

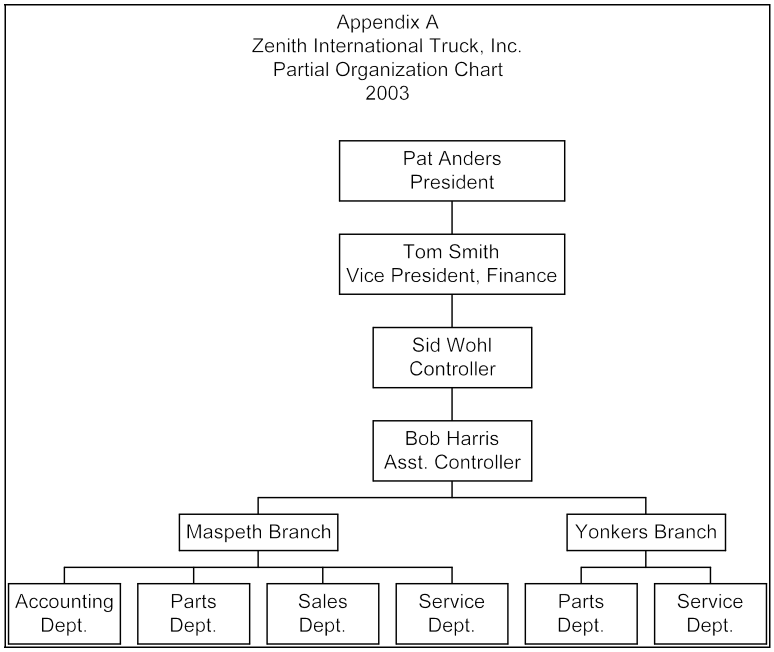
Bob: You know Dave, perhaps some of these invoices you can explain, some of the others you cannot. Why not give yourself some time to investigate the matter and inform me of yoru findings.

Dave nodded in agreement and slowly walked out of Bob's office. Perhaps Dave suspected one of his employees of forging his signature and then stealing from the firm. Or perhaps Dave knew more about the vendors then was saying and wanted to talk with them himself before accusing anyone. In the interim, Bob would check the signatures on the invoices against Dave's previous signatures as well as recent paychecks. If forgery was at work here he would need proof, otherwise he could at least rule out this possibility.

With that, Dave left. A week later Dave resigned without an explanation.

ENDNOTE

1 The names of the characters and the firm have been disguised.


Appendix A
Zenith International Truck, Inc.
Partial Organization Chart
2003
Pat Anders
President
Tom Smith
Vice President, Finance
Sid Wohl
Controller
Bob Harris
Asst. Controller
Maspeth Branch
Yonkers Branch
Accounting Dept.
Parts Dept.
Sales Dept.
Service Dept.
Parts Dept.
Service Dept.

SOUTHWEST AIRLINES: THE NEXT FIGHT BEGINS

William T. Jackson, University of South Florida St. Petersburg
Mary Jo Jackson, University of South Florida St. Petersburg

CASE DESCRIPTION

This case was developed through the use of secondary research material. The case has a difficulty level of five and is appropriate to be analyzed and discussed by advanced undergraduate and graduate students in a strategic management class.

The case allows the instructor the flexibility of concentrating on one strategic issue, or as a means of examining the entire strategic management process. The major focus within the strategic analysis as well as excellent stand alone modules is in the area of legal/political influence, economic, leadership succession, or the ability to survive in an unattractive industry. The instructor should allow approximately one class period for each element addressed. Using a cooperative learning method, student groups should require about two hours of outside research on each element researched. The case also provides an impetus to explore a very successful company during the current extreme economic downturn.

CASE SYNOPSIS

This case is a library, popular press and internet case which examines Southwest Airlines—a frequently examined company, yet one facing new challenges in the current economy. The review of annual reports, trade journals, government documents and proposed and enacted regulations must be accomplished carefully. While most students have a general understanding of the airline industry, few have the current knowledge to compare this industry against more traditional operations. A review of these resources should lead students in determining the future of the company and the current CEO, Gary Kelly.

INTRODUCTION

Gary Kelly sat staring blankly out of the board room's windows overlooking Love Field pondering the inevitable questions regarding the current year's annual report. Sure, the company had just achieved the unprecedented feat of 36 consecutive years of profitability in the never tranquil airline industry. He could not help but ask, to no one in particular, when this industry would ever draw a break. Gary wasn't feeling sorry for himself—he had been a part of this company long enough to know that nothing came easy, and if he wanted the mundane he had other choices.

I guess what worried him the most, was the potential that he would be the one (it was his watch) when the unthinkable would occur—a year when Southwest Airlines finally did not make a profit. Herb had outsmarted and outmaneuvered every obstacle that was thrown his way from taking that initial investment of $500,000 to start a new intra-state airline in an era of high regulation and fierce established competitors through recessions and fuel shortages. Then Coleen stepped right in to 9/11 and the fallout that accompanied that disaster in the years to follow. So why should he be afraid to tackling the worse economic downturn since the depression—maybe because so many members of the Southwest family were counting on him not to let that happen.

COMPANY HISTORY

The early years provided numerous challenges to Southwest, and set the stage for what has followed over the last thirty-six years of operations. As management of the company insists today, this is when the *Southwest Spirit* was born.

In 1996, Rollin King, a well-respected businessman of San Antonio, came to Herb Kelleher with an idea too preposterous to ignore. As Herb sat in his law office where he had been practicing for several years, he listened to King's vision of starting a Texas airline that would serve Dallas, San Antonio, and Houston using heavy jet equipment.

Although this idea was novel for Texas, it had already proven itself in California (a state very similar in regard to geographic separation of major cities within a state) through PSA and Air California. Both of these carriers had been extremely successful with intrastate coverage, even during a period of high government involvement.

Because of his legal prowess (not to mention his entrepreneurial spirit), Herb Kelleher was an ideal candidate to assist in getting the carrier off the ground. It took over three years from the time that Herb filed the initial application to fly these routes before the first airplane took off at Love Field in downtown Dallas in June of 1971. This period involved considerable legal positioning to counteract the activity of other competitors that were flying these routes—Braniff, Texas International and Continental. Numerous suits were filed against Southwest, and the early years involved standing up against these giants in the courts. These battles finally culminated with the U.S. Supreme Court refusing to hear the complaints of the other carriers, and Southwest was finally free to fly the skies of Texas.

The battle was not over yet though. The next two years of striving to become profitable was the next hurdle to clear. Then, just when the black ink was hardly dry, Southwest was again taken back to court by the cities of Dallas and Fort Worth for refusing to move their operations to DFW International Airport. Once again the fight went all the way to the U. S. Supreme Court. As before, Southwest emerged victorious.

Through these hardships, as well as those encountered after the implementation of the Airline Deregulation Act of 1978, Southwest developed its personality of doing things unconventionally.

This maverick attitude continues to permeate throughout the company to this day as the company faces new obstacles in dealing with the national and world economy.

As the most recent annual report states, the company has just completed their thirty-six year of profitable performance. Southwest has grown each year from a regional carrier with four airplanes to one with over 500 airplanes today, and serving a substantial part of the country through a route structure that includes 64 cities in 32 states.

THE AIRLINE INDUSTRY

The U.S. commercial airline industry has been dominated by a few major players in the market (even prior to the Airline Deregulation Act of 1978). In 2008 the industry was dominated by seven major companies (firms with revenues in excess of $1 billion). These seven companies account for over 80 percent of the industry's total market share. While there are numerous national airlines (32 firms with revenues between $100 million and $999 million) as well as regional and commuter airlines (89 firms with revenues less than $100 million) the landscape of air travel is controlled by these seven firms.

Table 1: Airline Market Share Leaders

2008 Rank	Company	2008 %	1998 %
1	American	16.8	17.4
2	United	14.2	19.8
3	Delta	13.4	16.6
4	Continental	10.7	8.6
5	Southwest	9.3	5.0
6	Northwest	9.2	10.6
7	U.S. Airways	7.8	6.6
	Others	18.6	15.4

Source: Aviation Daily

As has been the case over the last thirty years since the passage of the Airline Deregulation Act of 1978, the last seven years has been especially difficult for the airline industry. The landscape his been scattered with the remains of numerous smaller airlines after their failed attempts to compete against the imperfect oligopoly found in the airline industry. In addition, many of the larger more respected firms in the industry found themselves in bankruptcy as well.

The year 2001 gave some forbearance to the impact the environment was having on even the larger firms in the industry. In July of 2001 the Department of Justice blocked the proposed merger between US Airways and United Airlines. After the deal did not materialize, both firms ended up in bankruptcy court. Finally in 2005 after filing for bankruptcy again in 2004, US Airways completed a merger with American West Airlines. Further consolidation within the industry is currently underway with the approved merger in late 2008 of two of the industry giants—Northwest Airlines and Delta. Both firms had filed in 2005 for bankruptcy.

The merger of Delta and Northwest (scheduled to be implemented over a 12-24 month period) created the world's largest airline. The combined company, after taking into consideration capacity reductions, would have a near 23 percent market share in the industry. The total city pairs to be served by the merger would be over 1,000 with only 12 pairs served by both companies prior to the merger. Many authorities in the industry see the plans of increased revenue with potential cost savings as being a realistic goal for the new company.

TABLE 2: Airline Bankruptcies 2004-2008

Airline	Date	Chapter	Airline	Date	Chapter
Primaris	10/08	11	Sun Country	10/08	11
Gemini Air	8/08	7	Vintage	7/08	11
Gemini Air	6/08	11	Champion Air	5/08	7
Air Midwest	4/08	7	Eos	4/08	11
Frontier	4/08	11	Skybus	4/08	11
ATA	4/08	11	Aloha	3/08	11
Big Sky	1/08	7	MAXjet	12/07	11
Kitty Hawk	10/07	11	Florida Coastal	2/06	11
Independence	1/06	7	ERA	12/05	11
Independence	11/07	11	Mesaba	10/05	11
TransMeridian	9/05	7	**Delta**	9/05	11
Northwest	9/05	11	Aloha	12/04	11
Southeast	10/04	7	ATA	10/04	11
US Airways	9/04	11	Atlas Air	1/04	11
Great Plains	1/04	11			

The end on 2008 was not as many expected. Instead of a rebound of the struggling economy, the overall health of the economy on almost all fronts continued to plummet. This continued downturn was in spite of numerous attempts by the government to bolster economic growth through various bailouts and stimulus packages. The results within the airline industry for the last quarter of 2008 reflected the same general trends seen in most sectors.

There are numerous other concerns facing firms within the industry within the environment; none more precarious than the price of fuel. On October 25, 2007, oil prices hit an all time high of $92.22 per barrel. According to Air Transport Association (ATA), an industry trade group, it is estimated that fuel costs will equal around 29% of total airline revenue in 2007.

Just as critical as the base price of oil is the "crack spread"—the cost difference between a barrel of oil and a barrel of jet fuel. The differential has historically hovered between $5 and $10 per barrel. Immediately after Hurricanes Katrina and Rita this spread reached as high as $60 and during 2006 the spread averaged $16.64 a barrel.

According to the U.S. Energy Information Administration, the average price of West Texas crude oil rose sharply from 2001 to 2006. As seen in Table xx below, this increase amounted to over a 100% increase. Preliminary results in 2008 through September further exasperate the problem—jet fuel averaged $3.35 a gallon, up 55% over the average price paid of $2.16 a gallon for all of 2007.

Table 3: Crude Oil prices

Year	Crude Oil Price ($ per Barrel)
2000	30.30
2001	25.92
2002	26.10
2003	31.14
2004	41.44
2005	56.48
2006	66.02
2007	61.52

Source: U.S. Energy Information Administration

COST STRUCTURE

When evaluating an airline, a greater consideration regarding performance needs to be applied to the cost structure within that firm. The secret to success generally hinges on the ability of the airline to manage growth and costs simultaneously. In the airline industry, the three primary areas of cost involve fuel, labor, and airframes. Each of these must be examined in context of the firm to understand the competitive position of that firm.

Labor:

Labor costs dropped to the second highest expense category due to recent increases in fuel costs. When examining this area of costs, three broad areas must be taken into consideration—pilots and engineers, flight attendants, and ground services. In most of the industry, much of the costs in each category is impacted by the high level of unionization.

Fortunately, there have been few rehabilitating strikes in the industry over the past several years. This is primarily due to the prescribed procedures that must be followed prior to a strike. The procedures mandated include submission of disputes to a mediation board, declaring an impasse, and then sitting through a "cooling-off" period. In addition, many of the failures throughout the industry have prompted a much more conservative approach by the unions in making unreasonable demands on management.

Fuel:

As previously mentioned, fuel costs have historically been the second largest cost for air carriers, but recently moved into the number 1 position. These costs represented 25.7% of total revenues within the industry for both 2006 and 2007 for the 10 largest carriers. Fuel efficiency has naturally become a major concern for these firms. In considering efficiency levels firms have to take a concerted look at both the age and type of aircraft as well the number of landings. Another tool being deployed by most carriers are long-term contracts with suppliers as well moving into the futures market. Some firms have been much more successful in this approach than others.

Airframes:

Many options exist today to lower the costs associated with airframes. As an example, carriers can adjust the percentage of leased equipment rather than outright purchases. Typically this can result in considerable savings in interest expense through the bulk purchasing capabilities of the leasing company.

Other costs savings associated with airframes can be achieved through a younger fleet with lower maintenance costs. Standardization within a company's fleet can also result in substantial savings.

Reservation Systems:

Most carriers today have most of their bookings in one of three ways. Flights can be booked through computer reservation systems (CRSs) requiring payments to the operator of between $2.50 and $3.00, through the firm's won website, or through intermediaries specializing in multiple access schedules. Clearly, bookings through the firm's own resource results in considerable savings with greater control for adjusting fares when necessary.

Security:

The Aviation and Transportation Security Act of 2001 created in response to the events of 9/11 federalized the airport security industry and resulted in the creation of the Transportation Security Agency (TSA). While the federal government assumed the responsibility of paying the more than 40,000 screeners used in all commercial airports, the cost has been passed on to the carriers at a rate of $5.00 per passenger per segment. In addition, costs for the equipment used in screening are the responsibility of the carriers. More sophisticated equipment has been mandated for enhanced screening of possible incendiary devices and will add further costs in this area in the near future.

In addition to the added costs, with increased security measures, getting in and out of some airports can require significant time. On sort-haul trips this may result in a significant reduction in any value added by the speed of air travel. As an example, a trip from New York to Boston by car is approximately 220 miles and takes about four hours to drive. When you factor in travel to and from the airport along with addition time for security, flying may actually take longer.

THE ECONOMY

Firms in the airline industry have not dealt well with the impact of the economy at the end of 2008 and into 2009 as was the case in other sectors. However, since leisure travel is directly impacted by disposable income, and to a lesser extend business travel, the airlines were especially impacted.

Another major concern in the economic environment is the Federal Funds Rate issued by the Federal Reserve. This rate has increased steadily since 2004 reaching 5.25% in 2006. Recently, the Federal Reserve has taken actions to lower the rate based on fears of an impending recession. Unfortunately, the deteriorating economy has eliminated most of the benefits of these reductions.

A further concern is eroding consumer confidence as measured by the Consumer Confidence Index (CCI). The index peaked in 2000 at 144.7 but fell to a disturbing 99.8 in September 2007. This measure is closely tied to disposable personal (DPI) income as well which often drives leisure travel. DPI as adjusted for inflation rises and falls with the economic cycle—rising each year after the recession of 1991. The recent economic downturn has only eroded confidence further.

Although airlines within the industry target the business traveler as their ideal passenger, the *Domestic Travel Market Report* (2006 Edition) recognizes that approximately 59% of the 164.6 million domestic person-trips by airplane in 2005 were taken primarily for leisure purposes. As leisure travelers are more cost conscious than their business traveler counterparts, they are more likely to consider substitutes to air travel.

SOUTHWEST TODAY

SWA has always pursued the business traveler. From its very beginning, the ability to have breakfast in Dallas, a business lunch in Houston, an afternoon meeting in San Antonio and back home by that evening was an important element of their business model. Recently, in an attempt to capture an even greater percentage of business travelers, the company has offered a new "Business Select" fare product that guarantees for $10-30 more per seat; preferred seating, extra credit in SWA's frequent flier program, preferential seating, and a free drink. The company has also taken a new approach to boarding (their old method had often been seen as a "cattle call"). In lieu of standing in three separate lines awaiting boarding, customers are now called by actual check-in order.

Even with these new changes, the pleasure-class customer still has the ability of taking advantage of the traditional "Gotta Get Away" no-frills options provided by the airline. While there are still no movies or meals served on the airline, the company continues to offer numerous options on flights that historically have maintained consistency in on-time departure and arrival. This has translated to

SWA has, from its inception, used the power of promotion to "gain attention" and "teach" its potential customers about the company's low fares and high customer service. This has been done with the use of unique advertisements infused with humor and a light-hearted approach to marketing. SWA kicked off its first marketing campaign in 1972 with a television commercial featuring a young, attractive female flight attendant, asking viewers to remember what it was like before hostesses in hot pants who "loved you." More recent campaigns have centered on the company's humorous "Wanna Get Away" campaign, featuring comical embarrassing situations in which people find themselves wanting to "get away."

The company entered the airlines industry with a penetration pricing strategy with the goal of capturing the largest possible volume at the lowest possible cost. In order to be successful over the long-haul, SWA needed to always pay very close attention to its costs. The approach continues to be on this focus. Southwest typically enters a market with fares that are two-thirds lower than competitors and they increase traffic three or four fold in these markets.

Southwest has constantly sought out new markets, but not just for growth sake. The company has remained cautious in examining the cost structure of any new city it has entered. Long-term growth potential along with sustainable low costs has driven their decision to serve limited markets. However, the company now serves 64 cities nation wide and only serving international locations with the use of international codeshare agreements. Its latest venture into this market is through a joint venture with WestJet to serve markets in Canada and Volaris to capture travel to Mexico.

The company's careful pricing strategy has placed Southwest in the enviable position of setting the prices for a large section of the industry. In strongly competitive markets, this pricing approach has led many competitors to be forced to match fares while usually not being able to match the cost efficiency of SWA.

Operations:

Known as the most efficient airline in the industry, Southwest Airlines continues to grow in spite of troubling times. From its humble beginnings of four airplanes serving three cities, SWA has made significant strides. Table 4 below details cities currently being served by the company while Table 5 highlights the largest markets for the carrier.. Even though the number of airports soliciting the airline to expand to their location has drastically increased, SWA has elected to make expansion decisions based upon finding underserved, overpriced markets, and has stayed steady in its course of selecting only profitable destinations.

TABLE 4: Cities Served by SWA: 2008

Albany	El Paso	Midland/Odessa	Reno
Albuquerque	Ft. Lauderdale	Nashville	Rio Grande Valley
Amarillo	Ft. Myers	New Orleans	Sacramento
Austin	Hartford	Norfolk	St. Louis
Baltimore/Washington	Houston	Oakland	Salt Lake City
Birmingham	Indianapolis	Oklahoma City	San Antonio
Boise	Long Island	Omaha	San Diego
Buffalo	Jackson, MS	Ontario, CA	San Francisco
Burbank	Jacksonville, FL	Orange County	San Jose
Chicago	Kansas City	Orlando	Seattle
Cleveland	Las Vegas	Philadelphia	Spokane
Columbus	Little Rock	Phoenix	Tampa
Corpus Christi	Los Angeles	Pittsburg	Tucson
Dallas	Louisville	Portland, OR	Tulsa
Denver	Lubbock	Providence, RI	Washington Dulles
Detroit	Manchester, NH	Raleigh-Durham	West Palm Beach

TABLE 5 SWA's Top Ten Airports—2008			
Cities	Daily Departures	# of Gates	Nonstop Cities Served
Las Vegas	238	21	55
Chicago Midway	214	29	47
Phoenix	194	24	42
Baltimore/Washington	162	26	38
Houston Hobby	144	17	29
Dallas	140	15	15
Oakland	134	13	21
Los Angeles	126	11	18
Orlando	106	14	33
San Diego	108	10	18

One unique feature regarding the company's fleet serving these cities is that the planes do not change. That is not to suggest that the company is using the same old planes. In fact, SWA continues to be one of the leaders in the industry in regard to the age of its fleet—9 years old on average. What it does suggest is that it uses only one model of airframe—the Boeing 737 aircraft. Table 6 below shows the makeup of the fleet.

TABLE 6: SWA's Fleet		
Type	Number	Seats
737-300	186	137
737-500	25	122
737-700	327	137

All carriers are being forced to consider cost savings measures and SWA is no different. Improvements in the fleet have remained at the forefront for the company. All of its new 737-700 aircraft arrive form Boeing with Blended Winglets installed significantly increasing the efficiency of the aircraft. In addition, over 48 percent of its 737-300 aircrafts (the oldest in its fleet) have added this technology.

SWA has dealt with this crippling increase by implementing one of the best fuel hedging programs in the industry. The company negotiated fuel derivative contracts for over 70% of its 2006 expected jet fuel needs at $36 per barrel. This decision saved the company over $675 million compared to spot markets. SWA also has adequate hedging positions over the next three years at approximately $50 per barrel. While this is a substantial increase over 2006 rates it remains significantly below market rates as well as rates negotiated by most competitors in the industry.

Going Green:

In response to the Federal Aviation Administration (FAA's) Next Generation Air Traffic Control System spearheaded by Required Navigation Performance (RNP) requirements, Southwest has committed $175 million over the next years for implementation. The RNP system unites the accuracy of GPS (Global Positioning Systems), advanced avionics and new flight procedures. This new way of looking at aviation will allow aircraft to fly more precise, direct, and accurate paths. It is estimated that by 2015, 156,000 metric tons of emissions will be eliminated as well as $25 million in fuel savings per year.

Human Resources:

The recently retired COO and President, Coleen Barrett, was quoted as saying, "After the employee…the company's second focus is the passenger, with shareholders coming in a distant third". To back up this claim, SWA's emphasis on employee happiness can be witnessed through the company's compensation practices. SWA's annual employee compensation is one of the highest in the industry. According to the *Bureau of Transportation Statistics*, "Southwest Airlines' average annual compensation of $90,669 was higher than all of the network airlines except Northwest."

The high compensation and benefits packages can be credited to SWA's low employee turnover rate. This rate is the lowest in the industry, approximately 4.5% a year. While pay and benefits may be higher, training costs are significantly reduced due to the low turnover rate.

Information Technology:

Southwest Airlines has consistently remained on the leading edge of information technology (IT), recognizing the cost savings that could be generated from the efficiencies of system processes. The company made a strategic decision to centralize its IT procurement on a selected number of vendors, where possible and practical. This decision allowed the firm to streamline its operations, improve resource utilization, avoid paying for redundant functionality, and more tightly integrate the systems that support is business and initiatives. In 2004, SWA announced that the company would be standardizing its mainframe management software to reduce IT costs even further.

Another technology solution implemented by the company was the GE Aviation Flight Management System for Boeing 737s. The flight management system gives Southwest the ability to consistently fly shorter routes and idle-thrust descents, thus offering significant cost savings through reduced fuel consumption.

Leadership:

The name Herb Kelleher and Southwest Airlines are synonymous to many. His reputation as a heavy smoking, hard drinking maverick are well known, not only in the company, but outside of the company as well.

One of the greatest concerns the company ever faced was upon his decision to step down as President and CEO. Many viewed that decision as the beginning of the end for the company. What other CEO would go to the maintenance hanger at 2:00 a.m. in a purple dress and a flower boa. While the question did not take long to be answered—Coleen Barrett and Gary Kelly might.

Coleen Barrett assumed the role of President and Gary Kelly CEO in 2001. Colleen joined the company in 1978 as a legal secretary. She quickly moved her way up through the management team, serving as vice president of both administration and customer relations. She was described as both den mother and a management guru and has been credited as an integral part of the famous SWA culture. As the company grew in size and geographic dimension, Barrett recognized the challenge of maintaining this strong culture. In response she created a culture committee whose purpose it was to enhance and preserve the culture established by Herb.

Gary Kelly started with the company as their internal auditor. In 1986 he took the position of controller and later became the Chief Financial Officer. He gained high praise and recognition with the successful fuel hedging strategies and upgrades in cost saving technology. He also defied pontiffs that speculated that SWA should inhibit its growth plans during the period after 9/11 and maintained the course in their controlled growth strategy. In 2008, Gary Kelly assumed all of the responsibilities of Chairman of the Board, CEO and President as both Coleen and Herb stepped away. And, although Gary might not dress in a purple dress, as many found out at a company party, he looked magnificent as Gene Simmors of KISS.

Finance:

A major difference between Southwest Airlines and its competitors revolves around the means of financing operations. In an industry well known for tremendously high levels of debt, SWA stands out in its conservative approach to maintaining its controlled growth. In 2006, SWA had the lowest debt-to-equity ratio in the industry, 25.2% compared to the industry average of 96.7%. This element of operations clearly gives the company a unique advantage during more troubling times.

Awards:

Based upon the many characteristics described above, it is not surprising that Southwest Airlines continues to garner headlines in the business and professional community. As usual 2008 was no different. Table 7 below highlights some of the awards the company achieved during the most recent year of operations.

TABLE 7: Awards in 2008	
Award	Presenter
Most Reliable Airline	*Forbes*
Friendliest Airline	*TIME*
Most Admired Airline	*Fortune Magazine*
Best Leisure Airline	*Recommend Magazine*
Best Blog	*PR News*
Quest for Quality Award	*Logistics Magazine*
Airline Customer Service Champs	*BusinessWeek*
Top Shareholder Friendly Companies	*Institutional Investor Magazine*
Best Domestic Airline Customer Service	*Executive Travel*
Top 500 Most Innovative Users of Technology	*Information Week*

Other SWA Facts:

Some other interesting facts about Southwest Airlines includes:

1. Average 2008 airfare was $124.38
2. Average passenger trip length 846 miles
3. Company is 86 percent unionized
4. Most supported charity was Ronald McDonald House
5. On line bookings reached 74% via Southwest.com
6. More than 6.6 million people subscribe to SWA's weekly Click'N Save emails
7. 70 percent of customers check in online or at a kiosk
8. SWABIZ, SWA's free online booking tool allowing business travelers to plan and track business travel, increased 19% in 2007
9. SWA was the first airline to establish a home page on the internet
10. In 2007, Southwest.com was the number 1 airline web site for online revenue
11. Fortune Magazine selected SWA as # 7 in the world's most admired companies

Financial and Operational Performance:

As mentioned, SWA just completed its 36 consecutive year of profitability. The financial statements provided below (unaudited at this time) represent the most recent results of operations for 2008—as can be seen, some areas have changed significantly for the company.

EXHIBIT 1: Southwest Airlines Co. Income Statement			
Southwest Airlines Co. Condensed Consolidated Statement of Operations (in millions, except per share amounts) (unaudited)	Year ended 12/31		
	2008	2007	% Change
Operating Revenues:			
Passenger	$10549	$9457	11.5
Freight	145	130	11.5
Other	329	274	20.1
Total Operating Revenue	11023	9861	11.8
Operating Expenses:			
Salaries, wages and benefits	3340	3213	4.0
Fuel and oil	3713	2690	38.0
Maintenance, materials and repairs	721	616	17.0
Aircraft rentals	154	156	(1.3)
Landing fees and other rentals	662	560	18.2
Depreciation and amortization	599	555	7.9
Other operating expenses	1385	1280	8.2
Total Operating Expenses	10574	9070	16.6
Operating Income	449	791	(43.2)
Other Expenses (Income)			
Interest Expense	130	119	9.2
Capitalized Interest	(25)	(50)	(50.0)
Interest Income	(26)	(44)	(40.9)
Other (gains) losses, net	92	(292)	n.a.
Total other expenses (income)	171	(267)	n.a.
Income (Loss) Before Income Taxes	278	1058	(73.7)
Provision (Benefit) for Income Taxes	100	413	(75.8)

EXHIBIT 1: Southwest Airlines Co. Income Statement

Southwest Airlines Co. Condensed Consolidated Statement of Operations (in millions, except per share amounts) (unaudited)	Year ended 12/31		
	2008	2007	% Change
Net Income (Loss)	$178	$645	(72.4)
Net Income (Loss) per share :			
Basic	$.24	$.85	
Diluted	$.24	$.84	
Weighted Average Shares Outstanding:			
Basic	735	757	
Diluted	739	768	

EXHIBIT 2: Southwest Airlines Co. Balance Sheet

Southwest Airlines Col Condensed Consolidated Balance Sheet (in millions) (unaudited)	December 31	
	2008	2007
ASSETS		
Current Assets:		
Cash and cash equivalents	$1368	$2213
Short-term investments	435	566
Accounts and other receivables	209	279
Inventories or parts and supplies, at cost	203	259
Fuel derivative contracts	-	1069
Deferred Income Taxes	365	-
Prepaid expenses and other current assets	313	57
Total current assets	2893	4443
Property and equipment, at cost:		
Flight Equipment	13722	13019
Ground property and equipment	1769	1515
Deposits on flight equipment purchase contracts	380	626
Less allowance for depreciation and amortization	(4831)	(4286)
Net Property and Equipment	11040	10874

EXHIBIT 2: Southwest Airlines Co. Balance Sheet		
Southwest Airlines Col Condensed Consolidated Balance Sheet (in millions) (unaudited)	December 31	
	2008	2007
Other Assets	375	1455
Total Assets	$14308	$16772
LIABILITIES & STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts Payable	$668	$759
Accrued liabilities	1012	3107
Air traffic liability	963	931
Current maturities of long-term debt	163	41
Total current liabilities	2806	4838
Long-term debt less current maturities	3498	2050
Deferred income taxes	1904	2535
Deferred gains from sale and leaseback of aircraft	105	106
Other deferred liabilities	1042	302
Total Long-term Liabilities	6549	4993
Stockholders' equity:		
Common stock	808	808
Capital in excess of par value	1215	1207
Retained earnings	4919	4788
Accumulated other comprehensive income	(984)	1241
Treasury stock, at cost	(1005)	(1103)
Total stockholders' equity	4953	6941
Total Liabilities and Stockholders' Equity	$14308	$16772

EXHIBIT 3: Southwest Airlines Co. Comparative Operating Statistics			
	Year Ended December 31		
	2008	2007	Change
Revenue passengers carried	88529234	88713472	(0.2)%
Enplaned passengers	101920598	101910809	0.0%
Revenue passenger miles (RPMs) (000s)	73491687	72318812	1.6%
Available seat miles (ASMs) (000s)	103271343	99635967	3.6%
Load factor	71.2%	72.6%	(1.4)pts
Average length of passenger haul (miles)	830	815	1.8%
Average aircraft stage length (miles)	636	629	1.1%
Trips flown	1191151	1160699	2.6%
Average passenger fare	$119.16	$106.60	11.8%
Passenger revenue yield per RPM (cents)	14.35	13.08	9.7%
Operating revenue yield per ASM (cents)	10.67	9.90	7.8%
CASM, GAAP (cents)	10.24	9.10	12.5%
CASM, GAAP excluding fuel & related taxes (cents)	6.64	6.40	3.7%
CASM, excluding special items (cents)	10.06	9.04	11.3%
CASM, excluding fuel & related taxes and special items (cents)	6.64	6.38	4.1%
Fuel costs per gallon, including fuel tax (unhedged)	$3.18	$2,26	40.7%
Fuel cost per gallon, including fuel tax (GAAP)	$2.44	$1.80	35.6%
Fuel cost per gallon, including fuel tax (economic)	$2.32	$1.77	31.1%
Fuel consumed, in gallons (millions)	1511	1489	1.5%
Fulltime equivalent employees at period-end	35449	34378	3.3%
Size of fleet at period-end	537	520	3.3%

KALTIM PLYWOOD: PRODUCTION IMPROVEMENT IN DEVELOPING COUNTRIES

Kuo-Ting Hung, Suffolk University
Gina Vega, Salem State College

CASE DESCRIPTION

This is a field researched case about a failing plywood plant in East Kalimantan, Indonesia during the plywood manufacturing boom in that region. The research team had full access to the plant manager. The purpose of this case is to introduce students to the considerations in decision making in operational process improvement in accordance with capacity constraints and market conditions. This case is intended for use in an upper-level undergraduate Operations Management course early in the term and can be used as a scenario for discussion of capacity management. Students are expected to spend 2 to 3 hours of outside preparation reviewing concepts of capacity analysis, reading the case materials and brainstorming process improvement options. The instructor should advise students to pay attention to the particular relevance and importance of the bottleneck step in process capacity. The case can be taught in one 75- minute class period.

CASE SYNOPSIS

The events in this case took place when many logging firms in Indonesia were venturing into plywood production business with little experience. Ching-Mia Hung, a Taiwanese veteran of the plywood production business, was asked to turn around a failing plywood plant in East Kalimantan, Indonesia. Ching-Mia accepted the challenge and studied the plant patiently for a month before taking any action. Among his observations of the plywood production operation, Ching-Mia noticed several anomalies in inventory and capacity management with respect to external market conditions. This case presents students with a complex plywood production process with realistic and hard-to-come-by details, including the composition design of different plywood products, their respective production steps, common production challenges, and market demand information. Students are challenged to analyze the scenario and identify operational process improvement opportunities. Embedded in the case information are clues on improving operation without requiring additional equipment investment or new hiring. The instructor should encourage students to formulate action plans that utilize current resources more efficiently to cater to existing market conditions.

KALTIM INDONESIA PLYWOOD PLANT

Eleven long hours from Taiwan to Singapore to Jakarta to East Kalimantan, Indonesia and the Samarinda plywood plant at last. Ching-Mia Hung was tired, but he stood at the entrance, ready to take his first stroll through this plant. Just three months earlier, in early April, Ching-Mia had agreed with Kaltim Indonesia (Kaltim) to take over the management of the plant in an attempt to reverse its four year losing streak.

Ching-Mia had managed many plywood plants before - he had been in the plywood industry since 1965. Since then, he had acquired extensive experience in different functions of the plywood industry ranging from sales to production engineering. He knew that new plywood plants often miss production targets initially. After all, it takes time to identify and solve production problems. But losing money for years? "Can I really help this one?" Ching-Mia wondered.

CHING-MIA HUNG

Ching-Mia grew up in a small northern city in post WWII Taiwan. Being from a large family, Ching-Mia learned the importance of hard work early in his life. After his national service in the Navy, he entered the National University of Taiwan and graduated with a Bachelor's degree in natural science in 1965. During the 1960s, Taiwan was going through an unprecedented economic boom. Many local industries, including logging and plywood manufacturing, were in their heyday. After graduation, Ching-Mia immediately joined Forest Product, a plywood company in southern Taiwan.

Ching-Mia had no experience in plywood production. But, being a hard working young man and one of the few with a college degree in the company, Ching-Mia moved up through the ranks. He started out in the Quality Control department. He soon became a division leader, and later the department director. In his eight years at Forest Products, Ching-Mia would later be the director of the planning department, then of the production department, and eventually plant manager. He would later recall this period as the time he learned the most about all the functions of the plywood business.

Ching-Mia left Forest Products in 1973. In the 1970s, he managed plywood plants for three other Taiwanese companies. However, the oil crisis of that decade devastated the Taiwanese export economy, and the plywood industry slowed down. Decades of over-logging pushed up the prices of the logs essential for plywood production. Suddenly, the Taiwanese plywood industry collapsed and Ching-Mia was laid off.

Ching-Mia had some time to reflect upon his experience with the Taiwanese plywood industry. He believed he had identified some common problems among the plants he had managed, and he believed he could help other plants, given the opportunity.

Through a referral from a friend in 1982, Ching-Mia found that opportunity with a failing Indonesian plywood plant. Within six months, he had turned around the plant completely. In the subsequent four years, Ching-Mia helped the company to set up two more plants in Indonesia and made millions for them. Ching-Mia had made a name for himself as well.

In early 1986, the director of another plywood company, Kaltim Indonesia, heard about Ching-Mia and his work in helping failing plywood plants, and decided to contact Ching-Mia.

KALTIM INDONESIA

Kaltim was established in 1980. The formation of Kaltim represented a transition of the Indonesian forestry industry from logging operations with a low profit margin to the more lucrative area of plywood manufacturing. In the 1970s, there had been a growing national concern over the efficient utilization of natural resources and the development of the Indonesian national economy. In response, the Indonesian government began to require logging businesses to develop the capability of producing plywood.

In the 1980s, the plywood industry bloomed. There was a huge demand for plywood all over the world including Japan, Hong Kong, America, Europe, and the Middle East. The price of plywood panels differed in each of these markets and the specifications differed as well (Refer to Appendix B: Global Plywood Markets). With the failing plywood industry in Taiwan, Southeast Asian countries including Indonesia, with its seemingly endless supply of logs, were eager to satisfy the demand.

In 1982, Kaltim launched operations at its first plywood plant, the Samarinda plant in East Kalimantan. The Samarinda plant had two factories: Unit I and Unit II. As a logging company, Kaltim had no experience operating a plywood production facility so they signed a technical service contract with Yamato Forestry Co., Ltd. (Yamato) prior to the start of production, to ensure a smooth production ramp-up. Yamato, a Japanese company with a long history in the timber industry, had had experience running plywood manufacturing facilities in Southeast Asia since the 1970s.

Yamato had a strong incentive to collaborate with Kaltim: Yamato would purchase most of Kaltim's plywood to be exported to the Japanese market as long as those panels met the standards set by the Japanese Agricultural Standard. Yamato agreed to send four of its Japanese technicians to the Samarinda plant to manage operations at Unit II, which would produce panels for the Japanese market exclusively. Yamato also agreed to refer Taiwanese plywood production technicians to help Kaltim to manage operations in Unit I, which would produce plywood panels for other markets.

These factories specialized in different markets because of the different panel specifications required by different markets. The plywood panels that Yamato wanted were Concrete panels and Floor Base (FB) panels in a few standard sizes. Plywood panels for other markets had much greater variety in size. They would also likely have different quality requirements. Specialization by size and market reduced the need to calibrate machines to switch back and forth between different panel specifications.

The Kaltim management decided to designate Unit II to produce Concrete and Floor Base (FB) panels specifically for the Japanese market. Unit I was designated to produce 4'x8' Moisture Resistance (MR) and Water Boil Proof (WBP) panels for the British market.

PROBLEMS OCCURRED ALMOST IMMEDIATELY

Production at the Samarinda plant did not proceed as expected. The equipment production capacity was 8,000 cubic meters of panels per month. Yet, the average of combined production from both units was only 7,000 cubic meters per month. Unit II performed well under the supervision of the Yamato technicians, generating about 4,000 cubic meters per month, but Unit I constantly missed its production target. Overall, the Samarinda plant was losing money.

By 1986, after four consecutive years of losing money, Kaltim desperately needed new financing to sustain its operations. Its bank introduced Kaltim to Mr. Widjaja of the IndoPacific group, a tycoon in the Indonesian forestry industry. Mr. Widjaja agreed to provide the necessary financing in exchange for a minority ownership of Kaltim. The new financing extended the life of the Samarinda plant, however, Kaltim management knew they had little time to save the Samarinda plant.

Ching-Mia was aware of all this history. Prior to accepting the assignment, he had met with Mr. Widjaja and talked extensively with the top management from Kaltim. The question was "Why was Unit I failing while Unit II was thriving?" Ching-Mia sighed and took a deep breath of the cool fresh morning air around him. "Here we go," he thought to himself and walked into the factory.

PLYWOOD PRODUCTION PROCESS

Ching-Mia decided to visit Unit II first. As he strolled through Unit II, he saw a process that was similar to that of the many plywood factories that he had managed before.

There were many steps involved in processing logs to make plywood panels (see Appendix C & D). Bark was first stripped from tree logs, and each log was then cut into segments of appropriate length for further processing. Each log segment was peeled (rotary cut) into long sheets of veneer using a rotary cut lathe. Veneers were then dried in dryers to reduce their moisture content. Dried veneers were layered, glued, and pressed to form plywood panels. These panels were then trimmed to appropriate sizes, sanded, graded, and inspected before being packed for shipping. A critical step in plywood production was the drying process. Moisture had to be removed from veneers before they could be glued together to produce plywood. Veneers in a plywood panel could become delaminated if too much moisture remained in the veneers. The duration of the drying process depended on many variables including the humidity in the environment and the original moisture content in the log. However, the two major factors in the drying duration were the thickness of the veneer and the thickness of the plywood panel (See Appendix E). It took much longer to remove moisture from thicker veneers. Also, thicker panels required lower moisture content in the veneers, which took longer to achieve.

Depending on the type of veneers, the drying step was achieved by continuous dryer or roller dryer. The continuous dryer was used to dry long grain veneers which included face veneers, back veneers and long core veneers. The continuous dryer had two to three decks with wire-net conveyors. The upper deck had both higher steam pressure and higher temperature. The long core veneers were dried on the upper deck because long core veneers were typically thicker than the face/back veneers and required higher drying temperatures. The face and back veneers were dried on the lower decks. The roller dryer was used to dry short core veneers.

QUALITY OF VENEERS AND PANELS

The quality of plywood panels was largely related to the quality of logs used to produce veneers. Incoming logs often contained wormholes. These holes were created by wood burrowing insects while the logs were waiting to be transported. After trees were harvested into logs, logs were piled on the ground or floated in canals before they were transported to processing plants. The longer the logs waited to be processed, the more likely insects would be to burrow into these logs. The resulting wormholes were usually discovered after the rotary cut lathe stripped away the tree bark from a log. When there were wormholes in a log, the sheet of veneer peeled from this log would also contain wormholes. Veneers with wormholes were of much poorer quality than blemish-free veneers. Such veneers could not be used as surface veneers (i.e., face or back veneers) in plywood panels for more stringent markets, such as the British market. However, there were ways to salvage these logs. When wormholes were found right after debarking, the log could be peeled into surface veneers for less stringent markets, such as the Hong Kong or US markets, if the wormholes were sparse and small. Alternatively, the log could be peeled into thicker veneers to be used as core veneers, which were not visible.

The problem was that wormholes sometimes were not noticed after debarking. Consequently, face and back veneers with wormholes were produced. If the wormholes were small, they could be repaired by filling with wood putty. Veneers with larger wormholes and other irreparable defects could not be used as surface veneers. However, they could be used as long core veneers because core veneers were not visible. In the worst case, defective veneers were scrapped.

Dried and repaired veneers were glued together and pressed to form plywood panels. These panels were inspected again for defects. Defective panels were repaired when possible. Others were rejected.

PERFORMANCE MEASURE OF PLYWOOD PLANTS

A commonly used high level performance measure for plywood plants was the output volume measured in cubic meters of plywood panels. Essentially, this was the volume of plywood panels produced. Higher volume was more desirable. However, high volume of production did not translate directly to profitability. Thinner panels (e.g., 3-ply panels) were priced higher and were more expensive to produce per cubic meter than thicker panels (e.g., 5-ply panels). One of the reasons was that thinner panels required more face veneers per cubic meter, which were of greater quality than core veneers (see Appendix B & C).

For example, Unit I was producing for the British market a 5-ply thick panel which consisted of two sheets of 0.9 mm long grain face and back veneers, two sheets of 2.4 mm short grain core veneer and one sheet of 2.8 mm long grain core veneer. The ratio of surface veneer to core veneer in thickness was about 20 percent. In contrast, a thin panel with similar construction could consist of two sheets of 0.9 mm long grain face and back veneers and one sheet of 1.2 mm short grain core veneer. The ratio of surface veneer to core veneer in thickness was 60 percent.

WHAT HAPPENED?

"Unit II seems to be chugging along just fine." Ching-Mia thought to himself. "That means the production capacity of Unit I is much lower than expected. Why?"

As Ching-Mia walked through Unit I, he immediately noticed something odd. The upper decks of the continuous dryers were always full, while the lower decks were often unutilized. Since the upper decks were used to process the long core veneers and the lower decks were used to process surface veneers, this suggested Unit I was producing lots of long core veneers but not much surface veneers. Since Unit I was set to produce thick plywood panels (5-ply panels), this might have been all right. "But this equipment is not fully utilized," he thought to himself.

He also noticed that there were considerable inventories of veneers after processing by the continuous dryers. It was common to have work-in-process in the operation, so Ching-Mia did not give it a second thought at first. But then he noticed that they were a mix of 0.9 mm and 1.2 mm surface veneers with wormholes and thought, "They probably won't cut it for the British market. So what are they for?" Ching-Mia decided to ask Hendra, one of the foremen in Unit I.

"These veneers are meant for the Hong Kong market." Hendra replied.

"Why? Doesn't Unit I produce for the British market?" Ching-Mia asked.

"Yes, they were meant to be the surface veneers for the thick panels for the British market. But these veneers were peeled before we realized the logs had wormholes. Once we realized they wouldn't meet the British standard, we decided to use them as the surface veneers for 5-ply thick panels for the Hong Kong market."

"Fair enough," Ching-Mia thought. The quality of a log was difficult to determine before it was debarked or even before it was peeled. The inventories would probably be cleared in a couple of days once they were matched up with the right core veneers.

But in the next two weeks, Ching-Mia kept passing by the same pile of inventory. In fact, the size of the inventory was increasing. By his estimate, there were probably 500 cubic meters of veneers. Ching-Mia decided to talk with Hendra again.

"Why are there still so many veneers here?" Ching-Mia asked Hendra.

"They are waiting for the core veneers to produce the thick panels for the Hong Kong market." Hendra replied.

"That was what you told me two weeks ago. But they are still here. In fact, there are more of them now. Shouldn't we just finish them up and sell them to Hong Kong?" Ching-Mia asked.

"Well, yes and no. We are busy trying to fill the orders from the British markets; we just don't have enough capacity to meet those orders on time so all the core veneers are used to produce British thick panels. That's why these surface veneers are waiting. Once we fill the British orders, we will work on these veneers. Besides, we don't have any orders from Hong Kong yet. So there is no hurry."

"This is interesting," Ching-Mia thought. According to the management, the plant was not producing up to its designed capacity. Yet Hendra clearly believed that they were short of capacity. "Where is the problem?"

Ching-Mia's observation concurred with what Hendra had told him. When a log was found to have wormholes right after it was debarked, it was peeled into thick (2.8 mm) long core veneers for the thick panels for the British market. Furthermore, since these veneers were to be used for MR and WBP panels, these veneers needed to have low moisture content. Consequently, the drying time of these veneers was much longer than other veneers, such as the thinner surface veneers. As a result, the continuous dryers were constantly working on drying out these thick veneers.

On the other hand, defective face and back veneers were produced from time to time. These surface veneers were typically 0.9 mm or 1.2 mm thick. They could not be used as long core veneers for the British market, which were much thicker, typically 2.8 mm for 5-ply thick panels. They also could not be used as short core veneers because they had the wrong dimension and wood grain alignment. Also, since the price of Hong Kong thick panels was much lower than that of the British thick panels, they were not the priority of Unit I. So, these defective surface veneers accumulated and waited indefinitely.

DECISION POINT

It was July 30th and Ching-Mia had been in this factory for a month. He had patiently observed the plant's operation, particularly that of Unit I, and believed he had learned all there was to learn about it. Kaltim had been eagerly awaiting his report. He needed to formulate a plan to turn around profitability.

He listed his observations and thoughts on a piece of paper.

Unit I had produced about 3,500 cubic meters of veneers during the month of observation. This was actually not too far from the expected capacity of 4,000 cubic meters per month. However, only 3000 cubic meters of plywood panels were produced. The remaining 500 cubic meters were never used.

He divided the internal operations of Unit II into five major steps, Peeling, Continuous Drying, Roller Drying, Glue Spreading & Press, Trimming & Sanding, and Grading & Packing. Ching-Mia noted many of these steps were only about 60 percent to 80 percent utilized. The roller dryers, with an expected capacity of 2,000 cubic meters, only processed about 1,600 cubic meters of short core veneers. On the other hand, by his estimate, the continuous dryers had processed about 1,900 cubic meters of long grain surface and core veneers during the month, which is fairly close to the expected capacity of 2,000 cubic meters per month.

Ching-Mia summarized his thoughts into two questions.

1. Even though the plant capacity should be 8,000 cubic meters, Unit I was really capacity constrained. What could be done to increase its capacity and profitability?
2. What could be done with the 500 cubic meters of surface veneers? Hendra believed that they should be made into thick panels for the Hong Kong market. But in the meantime, they had been sitting in the factory for a month. Unit I was still busy trying to meet existing orders from the British market. However, there was no order from the Hong Kong market. Could there be another way to deal with these inventories?

Ching-Mia pondered his course of action.

APPENDIX A
NAMES AND RESPONSIBILITIES OF KEY CHARACTERS

Table 1: Names and Responsibilities of Key Characters

Character Name	Title & Responsibility
Ching-Mia Hung	Plant Management
	Hired by Kaltim Indonesia to turn around a failing plywood plant in East Kalimantan, Indonesia.
Mr. Widjaja	A tycoon in the Indonesian forestry industry
	Recently provided the necessary financing to Kaltim Indonesia to rescue the failing Samarinda plant.
Hendra	Foreman in the Unit I factory of the Samarinda plant
	In charge of coordinating the operations among various production steps in Unit I.

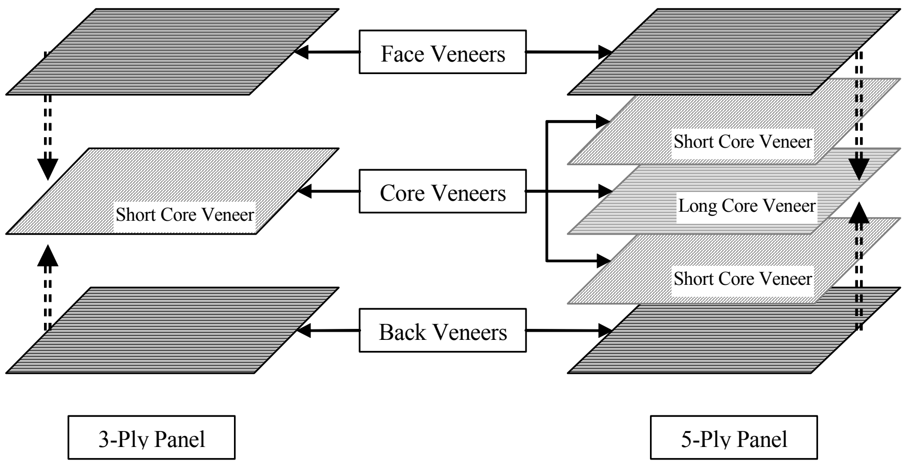
APPENDIX B
GLOBAL PLYWOOD MARKETS IN 1980S (IN US DOLLAR/CUBIC METERS)

	Plywood Thickness	
Market	Thin Panel (3-ply)	Thick Panel (5-ply)
Britain (European)	-	$230/cubic meters
America	$260/cubic meters	$190/cubic meters
Middle East	$230/cubic meters	$170/cubic meters
Hong Kong	-	$170/cubic meters

APPENDIX C
PLYWOOD BASICS

Each plywood panel is composed of three types of veneers; face, back and core veneers. Face and back veneers form the top and bottom surfaces of a plywood panel. Core veneers form the center part of plywood panels. Since the face veneer is the most visible part of any plywood panel to consumers, only the best quality veneers are used as top veneers. The back veneer may have equal or less quality than the top veneer depending on customer demand. The core veneers are not visible to consumers so the quality requirement is the lowest of the three.
The thickness of a plywood panel depends on the thickness of veneers and the number of layers of veneers used in constructing the panel. In general, core veneers are thicker than face and back veneers. While all plywood panels have only one layer of face and one layer of back veneer, the number of core veneer layers changes depending on plywood specification. For example, a 5-ply panel has one layer of face veneer, three layers of core veneer, and one layer of back veneer while a 3-ply panel has only one layer of core veneer.
To provide structural strength, the orientation of wood grain of layers of veneers in a plywood alternates. For example, in a 5-ply panel, the face veneer (first layer), long core veneer (third layer) and the back veneer (fifth layer) have wood grains running along the length of the panel. These are also known as long grain veneers. The core veneers at the second and the fourth layers (short core veneers) have wood grains running along the width of the panel. On the other hand, a 3-ply panel has only one short core veneer and no long core veneer.

Figure 1. Composition Difference between a 3-ply and a 5-ply plywood panels



Composition of a typical 3-ply plywood panel

A typical thin 3-ply plywood panel, e.g. 3 mm x 4' x8', may have a 0.9 mm thick top veneer, a 1.2 mm thick core veneer, and a 0.9 mm thick back veneer. These three layers are glued together, pressed, and sanded to form plywood panels with final thickness of approximately 2.9 mm.

SUMMARY COMPARISON OF TYPICAL 3-PLY AND 5-PLY PANEL COMPOSITIONS

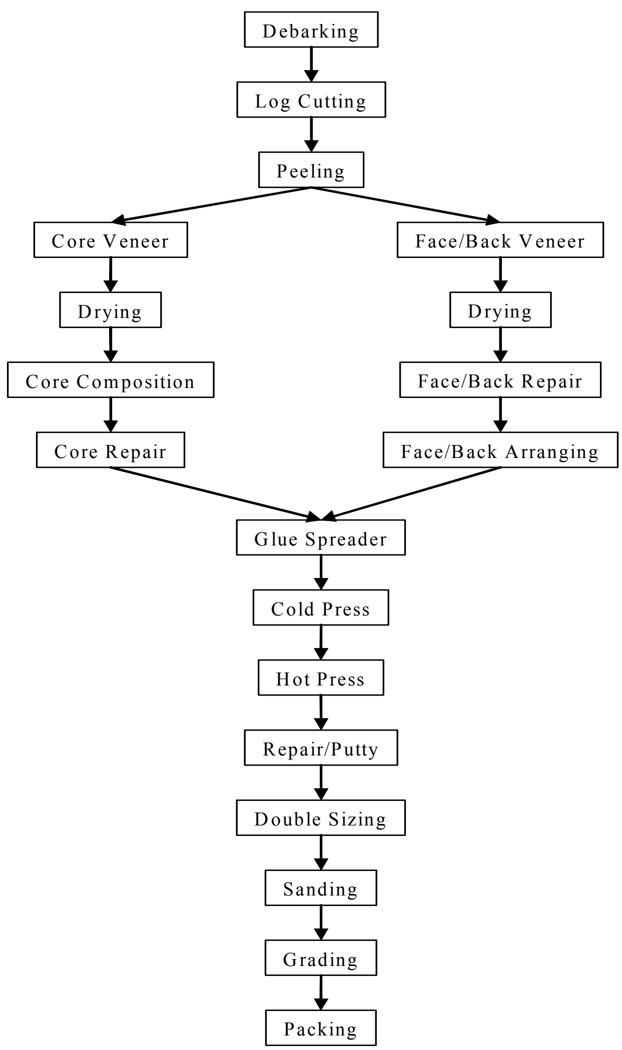
	3-ply panels		5-ply panels	
	Thin Veneer	Thick Veneer	Thin Veneer	Thick Veneer
Long Core	2 sheets	0 sheet	2 sheets	1 sheet
Short Core	0 sheet	1 sheet	0 sheet	2 sheets

Since the thicker veneers takes longer to dry (refer to Appendix E: Drying Time and Moisture Content), these differences in thin and thick veneers compositions have direct implications on capacity requirement on the continuous dryers for the long core veneers and roller dryers for the short core veneers.

As an example, suppose the thin veneer is 1 mm thick and the thick veneer is 3 mm thick. For simplicity, suppose it takes 1 unit of time to dry a sheet of thin veneer (1 mm thick). It will take more than 3 units of time to dry a sheet of thick veneer (3 mm thick). Let's assume that it takes 4 units of time. Thus, a 3-ply panel will require 2 units of drying time from the continuous dryer and 4 units of drying time from the roller dryer. In comparison, a 5-ply panel will require 6 units of drying time from the continuous dryer and 8 units of drying time from the roller dryer. Thus, in this example, the workload of a 5-ply panel on dryers is about 233% that of a 3-ply panel.

We can also take an additional step by evaluating the total workload per cubic meter of panels. There are about 91 5-ply panels in a cubic meter (assuming each panel is one square meter) and 200 3-ply panels in a cubic meter. Thus, in this example, the workload requirement per cubic meter is greater for the 5-ply panel.

APPENDIX D: PLYWOOD PRODUCTION PROCESS



APPENDIX E: DRYING TIME AND MOISTURE CONTENT

Veneers must be dried to required moisture content before they can be glued to form plywood panels. Otherwise, veneers may delaminate (separate into individual veneers) after plywood panels are formed. The required moisture content for a veneer differs based on several factors, such as the type of veneers, thickness of the plywood panel, and type of glue used, etc. For example, a thin panel requirement for moisture content is 8~12 % for face and back veneer, and 12~16% for core veneer (about 1.5mm). A thick panel will require core veneer to have moisture content at 10~12%. A water-proof type panel required very low moisture content in the veneers. A good example is the thick Water Boil Proof (WBP) panel for the British market, which requires moisture content at 6~8%.

It takes time to remove moisture from veneers. Thin veneers take much less time to dry than thick veneers. Thus, flow time of thin veneers through the Continuous Dryer is much shorter than that of thick veneers. For example, it takes an average of 200 seconds to dry a sheet of 0.64 mm veneer to 12% moisture content. In contrast, under the same equipment setup, it will take an average of 900 seconds to dry a 2.4 mm veneer to 10% moisture content.

In reality, drying time is influenced by moisture content, veneer thickness, type of tree, and temperature, steam pressure and capacity of dryers. For more detailed information, please consult a technical handbook for plywood production.

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THE EVALUATION OF A FLOATING-RATE SALE-LEASEBACK

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CASE DESCRIPTION

The primary subject matter of this case concerns the evaluation of a sale-and-leaseback arrangement. Secondary issues examined include differences in tax ramifications and financial reporting implications of the leasing arrangement, and simple scenario analysis. The case is intended for an introductory finance course delivered to juniors and seniors in a business program. Students should have prior familiarity with the structure of the balance sheet and the income statement, and discounted cash flow analysis, including the concept of net present value. The case will require approximately two hours of preparation outside of class, after which it can comfortably be discussed in a one-hour class. It is recommended that the instructor provide a ten-minute overview of the case in a prior class period.

CASE SYNOPSIS

Rockhill, Inc. is an electric utility operating in mid-western United States. The process of deregulation in electricity generation has transformed the utility's competitive landscape, prompting it to divest much of its generating assets, shift its focus to electricity transmission and distribution, and revise several of its financial policies. Among other things, the company has adopted the policy to lease, rather than purchase, any additions to its fleet of vehicles. While the vehicles it currently owns represent slightly over 40% of its entire fleet (with the remainder being leased), over time, its "lease-only" policy will eliminate owned vehicles altogether, since vehicles must eventually be replaced. In the meantime, though, it wishes to evaluate the economic advisability of speeding up the process of eliminating ownership by converting the owned vehicles into leased vehicles through a "sale and lease-back" arrangement with another party.

One of Rockhill's financial analysts has just been assigned the task of determining whether such a lease will add value to the firm. She must project the cash flow implications of the switch from ownership to leasing, and then estimate the present value of those incremental cash flows. Based upon her analysis, she needs to make a recommendation to management at the upcoming meeting. The estimation of incremental cash flows will require a careful consideration of the tax treatment of the leasing arrangement as well as a forecast of the floating interest rate that the utility will have to pay on its lease.

COMPANY BACKGROUND

Rockhill, Inc. is a regulated transmission and distribution utility that serves almost 1.2 million customers over three counties. The customers are primarily residents, rather than businesses, and, by national standards, enjoy an above-average per capita income. Over the past three years, Rockhill's customers have had the option to choose other suppliers of power, and to date about 10% of them have switched to alternative providers. While the service area is fairly stable, it is also mature, and growth is expected to be moderate for the foreseeable future; estimates of the growth rate range from 1.5% to 2.5% assuming normal weather conditions.

The utility has divested a large portion of its generating assets to Altisar Corporation, with whom it has a five-year, fixed-price contract to purchase the electricity needed to fulfill its standard service commitment to its customers. Altogether, its power purchase agreements and its remaining ownership interest in generating assets is very likely to meet the utility's supply needs for the next six years.

Rockhill recently acquired a smaller electricity distributor, Teslar, Inc., which cost approximately $3 billion. While the proceeds from the sale of generating assets to Altisar Corporation paid for more than half this amount, almost 45% of the funds needed for the acquisition of Teslar came from the issue of long-term debt. A favorable interest rate environment has made this bond issue an attractive source of financing, but it has also raised significantly the utility's debt ratio.

Like most utilities, Rockhill, Inc. operates a large fleet of vehicles, including a variety of trucks, vans, cranes, backhoes, and tractors. If purchased new, these vehicles would cost anywhere from $3000 to as much as $200,000. For a few years now, Rockhill's management has adopted a policy of leasing any additions to its existing fleet. Currently, the utility owns 200 vehicles, and an additional 250 are leased through the Dalton Leasing and Finance Corporation (DLFC).

THE REQUEST FOR LEASE ANALYSIS

By leasing rather than buying the new vehicles, the utility avoids large outlays of cash. As a corollary, it avoids booking a large amount of debt and depreciating vehicles over long periods, often beyond the original costs (which the rules of the Federal Energy Regulatory Commission, FERC, can engender). Thus, the utility can maintain its cash reserves and keep its debt and coverage ratios in a more desirable range. This is of particular concern in the face of some active credit downgrades currently occurring in the industry. Indeed, an industry that has traditionally been characterized by high payout ratios now finds many of its firms cutting back on their dividends in an effort to satisfy credit rating agencies and preserve their bond ratings.

In the case of Rockhill, conserving cash and reducing debt is of particular concern in the light of its recent acquisition of Teslar, Inc. As noted earlier, this purchase came at a cost of $3 billion, of which approximately 45% was financed by long-term debt. Not surprisingly, then, the utility's treasury department recently received a suggestion from management to evaluate the feasibility of converting the 200 owned vehicles to leased vehicles. The utility could consummate such a conversion by first determining the current market value of the owned vehicles and then establishing an amortization period and mutually agreeable value with the potential lessor, probably DLFC. DLFC would then reimburse the utility for the agreed-upon market value, and the latter would lease the same vehicles from DLFC. Management expects that such a sale-and-lease-back arrangement will significantly reduce fleet costs, since the annual amortization on the lease will be significantly less than the current depreciation on these vehicles. Of course, the transaction would also result in an upfront inflow of cash equal to the market value of the vehicles.

THE ANALYST GATHERS INFORMATION

Meg Hawkins, a financial analyst with Rockhill's treasury department, has been assigned the task of evaluating the sale-and-leaseback, and must report her recommendation to management within a week. She begins by contacting the Fleet Management department, which informs her that none of the vehicles is scheduled to be sold or salvaged for two years. It also estimates the market value of the 200 owned vehicles to be approximately $3,000,000. For financial reporting purposes, the vehicles currently have a book value of approximately $12,000,000, and the firm charges annual depreciation of $1,500,000 on the vehicles to the transportation clearing account. The depreciation amount is based on original costs, and continues at the same level as long as the company owns the vehicles. On the other hand, for tax purposes, these vehicles are almost fully depreciated at this point, and have a remaining tax basis of approximately $25,000. Thus, by the time the lease goes into effect, the owned vehicles would have a negligible depreciation tax shield.

Ms. Hawkins apprises the potential lessor, DLFC, of Rockhill's interest in a sale-and-leaseback transaction. DLFC also contacts Fleet Management at Rockhill, Inc., and obtains information pertaining to the vehicles involved in the leasing arrangement. DLFC concurs with Fleet Management's estimate of $3,000,000 for the value of the vehicles, and quotes Ms. Hawkins a spread of 125 basis points over the one-month LIBOR for a lease involving a 24-month amortization period. The current level of the one-month LIBOR is 2.5%, and this will determine Rockhill's initial finance cost. Any change in the LIBOR will be recognized at the end of the first year of the lease. According to the lease terms, the residual value of the vehicles will be $0, so the entire amount of $3,000,000 will be amortized over the 24-month period, at a rate of $125,000 per month. Payment will be made monthly, and, in addition to the $125,000 amortization payment, will include an interest payment calculated on the unamortized value at the beginning of the month. Rockhill has the option to terminate the lease at the end of the first year, but provides the lessor a "residual guarantee" of up to $1,150,000 if the equipment is sold for less than the unamortized lease balance. This amount can be looked upon as the utility's "maximum obligation", in addition to the first twelve monthly payments. Unless Rockhill terminates the lease at the end of the year, the lease will be remain in effect for another twelve months, with interest payments being determined at the reset LIBOR rate. At the end of the two-year period, Rockhill can repurchase the vehicles for the unamortized value, which is zero. Exhibit 1 shows DLFC's sample amortization schedule for the lease (some information has deliberately been hidden, and represented by Xs, since the reader will be asked to ascertain it). Note that this schedule is based on the assumption that the currently prevailing LIBOR of 2.5% will continue through the two years of the lease.

Ms. Hawkins knows that Rockhill's marginal tax rate is 38%, that its weighted average cost of capital is 9%, and that its cost of secured debt is 7% on a pre-tax basis. For the lease analysis, she will use the after-tax cost of secured debt, rather than the firm's weighted average cost of capital, as the discount rate. This is because the lease payments by the lessee are akin to debt service cash flows on secured debt rather than like operating cash flows; the lower discount rate reflects the lower risk of these incremental cash flows. Before she can ascertain the economic feasibility of the lease, however, the analyst needs two more pieces of information: a forecast of the LIBOR one year from now, and a clear determination of the tax treatment of the lease. Luckily, the former is readily available, since she just completed a project in connection with which she forecasted the following LIBOR rates for the next 4 years (beginning today), respectively: 2.5%, 2.6%; 2.35%; and 2.31%.

The tax treatment of the sale-and-leaseback, on the other hand, is a more complicated issue. Being somewhat less familiar with this aspect of leases, Ms. Hawkins decides to consult some textbooks pertaining to the accounting and tax classification of leases. In addition, she requests DLFC to provide its input on the matter.

CLASSIFICATION OF THE LEASE AGREEMENT

The analyst finds that the lease has different implications for financial reporting and reporting for tax purposes. Of course, she is interested in both the financial reporting and tax aspects of the sale-and-leaseback, even though only the tax treatment of the lease has an impact on cash flow. The results of the analyst's research and the opinion provided by a Vice President of DLFC *on the specific leasing arrangement proposed by Rockhill* can be summarized as follows. For financial accounting purposes, the sale-and-leaseback is looked upon as an operating lease. Therefore, the lessee (Rockhill) is not required to book the lease obligations as a liability and the leased property as an asset. For tax purposes, on the other hand, the same lease is viewed as a financing arrangement. The lessee maintains the operating control of the asset, and retains the tax benefits associated with the debt implied by the lease.

A few key features of the proposed lease agreement should be noted, which are relevant to the tax treatment summarized above. First, as mentioned earlier, under the proposed agreement, the lessee would have the option to purchase the leased vehicles at the end of the 24-month period for a fixed price equal to the unamortized lease balance, which in this case is zero. Thus, Rockhill would retain the right to any upside equipment value. Second, Rockhill would provide a residual guarantee in the form of additional rent, should the lease be terminated, and the equipment sold for less than the unamortized lease balance. There will be a cap on this guarantee, but the risk to the lessor (DLFC) would be less than 20% of the original cost. Third, a portion of each payment made by Rockhill would represent amortization; since the utility has the option to purchase the equipment at the expiration of the lease (at the unamortized balance), this portion of each payment essentially represents a build-up of equity for Rockhill. Finally, the remaining portion of each payment would represent interest, which would be computed on the basis of the unamortized value at the beginning of each month, as noted earlier.

These key features of the proposed lease indicate that all the benefits, and a substantial part of the risk of ownership are to be retained by Rockhill. For tax purposes, therefore, the utility can be treated as the owner of the equipment, and the lease may be treated as a financing arrangement. Indeed, the analyst obtained a copy of the IRS Field Service Advice on a similar lease, which deemed the lease to be a financing arrangement, or a "conditional sale agreement". Rockhill can thus reduce its taxable income by the amount of the interest involved in the lease. While it can also claim depreciation expense on the equipment by virtue of being treated as the owner of the equipment, the vehicles will have no depreciable basis by the time the lease is expected to go into effect. The analyst does not, therefore, need to consider any tax shield from depreciation in her evaluation of this leasing arrangement.

For financial reporting purposes, Meg Hawkins finds that the Financial Accounting Standards Board (FASB) Statement No.13 (FASB 13) sets out the criteria that determine whether a lease might be classified as an operating lease or a capital lease. Should the lease meet any one of four criteria specified by FASB 13, it would have to be classified as a capital lease. These criteria, and Meg Hawkins' assessment of whether the proposed lease meets any of those criteria, are provided in Exhibit 2. As reported there, the analyst finds that the proposed lease fails to meet each of the criteria defined by FASB 13, and concludes that the lease would in fact be classified as an operating lease rather than as a capital lease.

The classification of the sale-and-leaseback as an operating lease for financial reporting purposes implies that the vehicles will not appear as assets on the utility's balance sheet, nor will the required payments be reported as a liability. Meg Hawkins notes with some satisfaction that, should she find the lease to be sound on economic grounds, its "off-balance-sheet" classification will lead management to receive the sale-and-leaseback proposal with greater enthusiasm.

The analyst is curious to find out how the numbers will play out in the case of this lease. She organizes all the information she has gathered, starts up her spreadsheet program, and begins the process of arriving at some hard figures that will help her make a recommendation to management in the upcoming meeting.

Exhibit 1—Sample Amortization Schedule for Rockhill, Inc.
Dalton Leasing and Finance Corporation

Equipment Cost	$3,000,000
Payment Frequency	Monthly
Amortization Period	24
Expected Residual Value	0
Spread over LIBOR	1.25%
Indexed to LIBOR Rate	2.50%
Lease Rate	3.75%
PV of 12 payments:	
NPV of Total Payments	**$X,XXX,XX X**
As % of Fair Value	**XX.XX%**

End of Period	Unamortized Value	Amortization for the Month	Lease Rate	Total Payment	Lessee's Max. Obligation
0	$3,000,000	-	-		
1	2,875,000	$125,000	$9,375.00	$134,375.00	
2	2,750,000	125,000	8,984.38	133,984.38	
3	2,625,000	125,000	8,593.75	133,593.75	
4	2,500,000	125,000	8,203.13	133,203.13	
5	2,375,000	125,000	7,812.50	132,812.50	
6	2,250,000	125,000	7,421.88	132,421.88	
7	2,125,000	125,000	7,031.25	132,031.25	
8	2,000,000	125,000	6,640.63	131,640.63	
9	1,875,000	125,000	6,250.00	131,250.00	
10	1,750,000	125,000	5,859.38	130,859.38	
11	1,625,000	125,000	5,468.75	130,468.75	
12	1,500,000	125,000	5,078.13	130,078.13	$1,150,000.00
13	1,375,000	125,000	4,687.50	129,687.50	
14	1,250,000	125,000	4,296.88	129,296.88	
15	1,125,000	125,000	3,906.25	128,906.25	
16	1,000,000	125,000	3,515.63	128,515.63	
17	875,000	125,000	3,125.00	128,125.00	
18	750,000	125,000	2,734.38	127,734.38	
19	625,000	125,000	2,343.75	127,343.75	
20	500,000	125,000	1,953.13	126,953.13	
21	375,000	125,000	1,562.50	126,562.50	
22	250,000	125,000	1,171.88	126,171.88	
23	125,000	125,000	781.25	125,781.25	
24	0	125,000	390.63	125,390.63	

PV of First Year Payments	$X,XXX,XX X
PV of Residual Guarantee	$X,XXX,XX X

Exhibit 2—Classification Criteria for Capital Leases			
	FASB Criterion	Does Lease Meet Criterion?	Explanation
1	"The lease transfers ownership of the property to the lessee by the end of the lease term."	No	The lease provides a purchase option but not a predetermined transfer of ownership.
2	"The lease contains a bargain purchase option."	No	The lease does contain a purchase option, but the price is not a bargain.
3	"The lease term is equal to 75% or more of the estimated economic life of the leased property."	No	The estimated useful economic life of the property is more than 2.7 years, and therefore the lease term is less than 75% of the estimated useful life.
4	"The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90% of the fair value of the leased property at the inception of the lease."	No	The present value of the minimum lease payments, including the residual guarantee at the end of the first twelve-month term, is less than 90% of the fair value of the leased property at the inception of the lease.
Source for Criteria: *Financial Accounting Standards Board, Statement 13, "Accounting for Leases", Paragraph 7. The criteria are quoted from the FASB statement.*			

THE HAWTHORNE ORGANIZATION

Shelley Morrisette, Shippensburg University
Louise Hatfield, Shippensburg University

CASE DESCRIPTION

This case can be seen from many different angles -- pure strategy, small business management (including financing and cost accounting), family owned businesses, succession planning, international operations, leadership, entrepreneurship, or organizational change. The case traces the growth and progress of two entrepreneurial firms from creation to merger and beyond. This case would be most appropriate for undergraduate courses in entrepreneurship, small business 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

John Jones has been CEO of The Hawthorne Organization since 1990. During this time the firm has been on a roller coaster ride with plenty of ups and downs. The marketing research industry is savagely competitive and requires huge investments in technology, human resources, and sales and marketing. Unfortunately, The Hawthorne Organization has made a few bad bets along the way, for which it has paid a huge price. While The Hawthorne Organization is respected and considered one of the leaders in the industry, John has not been able to substantially differentiate its brand or products, or increase margins or profits. The numerous strategy and organizational changes have wrecked havoc on Hawthorne employees and operations. Now John Jones must decide what he should do next with his family-owned business.

INTRODUCTION

James Collins founded Hawthorne Research Company in 1939 in a small town along the soon to be constructed commuter train corridor between Princeton, NJ and New York City. This track has become known as "Research Row" because it is home to many of the nation's oldest and most recognized marketing research firms. Today Research Row is to survey research as Detroit is to automobiles, Hollywood is to movies, and Silicon Valley is to high tech. Jim migrated to Research Row after completing his graduate degree from the University of Wisconsin in 1933. This area was to become the research, public opinion polling, and household survey hothouse for advertising and PR industries concentrated in New York City during the pre-war years. Many young and talented social scientists gravitated to this area to take advantage of this new growth industry, which was on the cusp of a massive expansion, and Jim Collins would help shape and mold the growth and composition of the industry.

During the war years (i.e., 1941-1945) Hawthorne Research and the new industry "treaded water" as the United States and all of her institutions concentrated on winning the war against fascism. Once the war was over the US economy began the longest and greatest economic expansion ever. This expansion was driven by insatiable consumer demand for all types of goods -- cars, cosmetics, white-goods, furniture, clothing, electronics, etc. The age of mass-production and mass-advertising was underway and businesses needed information on the giddy and expanding new-middle class, who now possessed tremendous disposable income for the first time in nearly 20 years.

Hawthorne Research became one of the most prestigious research houses in the nation. The company's client list included a who's who of consumer-goods companies, advertising firms, and PR organizations. Its work and reputation was considered unassailable. Jim Collins was known as a great social scientist and researcher and his company grew at a healthy, if not spectacular rate, from 1946 through 1975. Jim Collins was not a great businessman and never tried to maximize the value of his company. Instead, he was thrilled to make a very good living, while working at something he loved. While the firm was well known and well regarded it never made huge profits even though it had the highest project rates and margins in the industry. This was due to Jim Collins' lack of business-side concern and attention.

Yet, until 1981 Hawthorne Research had always made a profit and its clients, employees, and other stakeholders were extremely happy and satisfied. The company had always been operated in a highly moral and ethical manner. Jim never took projects that dealt with harmful products such as beer, alcohol, tobacco products, or any other companies or products he considered outside his moral code. Additionally, he refused polling projects for all political candidates, organizations, and parties. Finally, he would not accept PR work from firms who represented clients or companies he felt were outside the mainstream of American values. Because of Hawthorne's reputation and quality work these practices had never hurt the company. In fact, they reinforced the reputation of Hawthorne Research as the "white-shoe" company of choice for consumer research and public polling.

By 1985 things had begun to spiral downward at Hawthorne. Jim Collins was now 76 and while still active in company operations, was suffering from health problems. Additionally, the company was beginning to show a lack of leadership and dynamism, because of Jim's age and health. For example, PCs and new statistical software were revolutionizing the research industry and Hawthorne was not investing in the new technology or the new breed of market researcher who thrived in this environment. Consequently, the firm was beginning to lose clients, projects, brand equity, and most importantly money. In 1986, revenues dropped to $37 million -- down nearly $6 million from its high water mark in 1982. Hawthorne lost $2 million for the year. Jim Collins realized that he needed to figure out what to do with the firm he had worked a lifetime to build and nurture. His children had no interest in taking over the reins of the company, but were very concerned that full-value be extracted from its sale or transfer. Because of these issues Jim Collins began an intensive search for a possible partner to help save his beloved company either via sale, merger, or investment. He had never thought about a succession plan, and now he was forced to determine the future of his company.

The suitors were numerous -- competitors, conglomerates, entrepreneurs without any industry experience, and even clients made pitches for Hawthorne. But Jim Collins could not find a partner that he felt fit his exemplar of what Hawthorne was and would be. He insisted that the partner still maintain Hawthorne's high ethical and industry standards, its high quality practice methods, and its old-school way of client engagement. He felt that this was the only way the new company could remain true to its character and stay the great company that it was. As Jim continued to field offers the firm continued to list badly and his family began to worry that the once valuable company might be forced under. In early 1987 Jim Collins suffered a minor stroke. Although mentally he was unaffected, he lost some mobility and his energy and vitality were greatly sapped. It was then that he realized that he must quickly deal with the fate of his company.

RESEARCH LEADERSHIP SELECTION CORPORATION

William Jones enrolled at the University of Iowa in the fall of 1941 with his heart set on becoming a history teacher. He had grown up on an Iowa farm and represented the dreams and hard work of his family. That fall as he walked the Iowa campus he felt that "he had died and gone to heaven". Little did he know that his life was about to be turned upside down. When the Japanese bombed Pearl Harbor in December 1941, Bill immediately enlisted in the Navy. He spent the war aboard a destroyer in the Atlantic -- hunting subs.

He returned to Iowa in the fall of 1945 a changed man. Gone were the dreams of becoming a history teacher. Instead, Bill decided that he could best serve mankind by helping organizations select, train, and develop leaders. He became fascinated by this idea as a young enlisted man in the Navy. He closely studied the officers and NCOs and their leadership abilities and problems. He felt that helping organizations of all kinds find and develop great leaders would be his life's work. Thus, he changed his major to psychology and began his journey.

1952 was a big year for Bill Jones and family. First, Bill finished his doctorate and joined the Iowa psychology faculty. Next, Mary Jones, Bill's wife and high school sweetheart gave birth to their second child -- a boy named John, who joined Karen who was born in 1950 (another daughter Linda was born in 1957). Finally, Bill launched Research Leadership Selection Corporation (RLSC). Bill Jones started RLSC as a way of realizing his dream of helping organizations select, train, develop, reward, and nurture leaders for all kinds of organizations. Bill had always been an entrepreneur at heart and his "basement" company allowed him to follow his dream. Within a year Bill was forced to lease office space and begin hiring employees to handle the increased business volume.

In 1967 Bill Jones left his teaching position at Iowa to focus entirely on RLSC. The company had annual revenues of $15 million and Bill felt that his company could make a huge difference and impact on society. The company's core expertise was providing selection expertise for all types of positions and organizations. In other words, RLSC scientists developed selection interviews (or instruments) for organizations to help them select, hire, promote, train, develop, and motivate individuals in all types of situations. Besides the normal types of selection projects -- managers of all types, sales people for all levels and products, supervisory personnel, executives, teachers, principals, and nurses -- RLSC worked with unusual organizations to help select clergy, professional athletes (i.e., NBA, NFL, and NHL), pilots, and even nuns and priests for the Catholic Church.

During the next 20 years RLSC continued to grow and prosper. Revenues topped $140 million in 1985. Bill Jones had expanded RLSC into many other areas of business and organizational research -- survey, consumer behavior, marketing, and advertising, to name a few. But RLSC's strength remained selection research, although it had successfully extended its core business into the lucrative areas of employee and customer satisfaction tracking. Bill Jones had also launched several other periphery businesses that had been failures. These included a software company, a mobile phone company, franchising child development centers, and a travel agency. These business failures drained capital from RLSC. Additionally, RLSC had failed in many research businesses such as syndicated research, consumer panels, and public polling.

Still RLSC was highly successful, and Bill felt that they needed to build or acquire broader skill and product sets if the company was to really grow beyond the core selection business. The selection business offered fabulous margins because once an instrument was created it could be sold many times to many different clients -- write once, sell many. This business model (i.e., the subscription model) was much different than the traditional research model -- write once, sell once (i.e., the client model). The problem was that the growth was in the client model businesses, while the greater margins were in the subscription model businesses. Unfortunately for both business models, competition was savage -- there are literally hundreds (sometimes thousands) of competitors for most types of research. Additionally, because the industry was reaching maturity, consolidation was the watch-word for survival. Size, scope, and efficient operations mattered in the industry because human resource, technology, and overhead costs were escalating and competition was holding down revenues. Industry growth rates were in the 3% range during the 1980s and early 1990s.

In October 1987, Bill Jones, his son John (i.e., President of RLSC) and Trey Kramer (i.e., Chief Legal Officer) traveled to Hawthorne Research headquarters to meet with Jim Collins and the investment firm that brokered the event. The rapport between Jim and Bill was instant, warm, and filled with admiration. Both were farm-boys who shared common values and were considered leaders in their fields. By the end of the day the broad outline of the purchase was established. Both gentlemen made personal commitments to ensure that the new company would include the best of both firms and would continue to uphold the highest standards of conduct and quality work. All concerned felt that the outcome was perfect for all stakeholders.

THE HAWTHORNE ORGANIZATION

Bill Jones knew that the Hawthorne brand had more equity than RLSC, so naming the new company The Hawthorne Organization was a no-brainer. Bill pleaded with Jim Collins to stay involved with the new company. He also encouraged many of the Hawthorne executives and key people to remain with the new company. All agreed that the transition, while painful for many, was accomplished with compassion, credibility, and excellence. The Hawthorne Organization hit the ground running and the future looked bright for all involved.

RLSC had a far superior (and larger) sales team than Hawthorne Research. Bill Jones had used all of his expertise to select, train, motivate, and nurture the finest group of account executives in the industry. Once this juggernaut took over and was encouraged to cross-sell Hawthorne products to RLSC clients and RLSC products to Hawthorne clients, revenues increased by 20%. In 1988 sales for the new company were $202 million. The next year they were $243 million. Although profits were disappointing, all felt that this was a temporary problem.

The financial structure and strategy of The Hawthorne Organization was all RLSC. The new company continued to be 100% employee owned. This made for great PR, but in reality Bill Jones owned 87% of the company. The remaining 13% belonged to employees who purchased stock through special plans and options. Bill Jones had no intention of taking the company public or pursuing other avenues of equity financing. Instead, he employed debt to finance growth and operations -- the company was highly leveraged, because he wanted control of The Hawthorne Organization. The debt situation only got worse with the purchase of Hawthorne Research. RLSC agreed to pay $35 million for the troubled company. For tax purposes RLSC paid the $35 million (plus interest) to the Collins family over the next ten years. Thus, cash flows would be severely constrained for the next decade and The Hawthorne Organization would be in a very risky financial situation (at least until the buyout was completed).

Additionally, RLSC (now The Hawthorne Organization) had poor accounting and control systems due to a lack of investment -- Bill perceived accounting as a necessary evil. Costs were not tracked to specific projects, but to divisions and then only on a yearly basis. Overhead was allocated to divisions based on the prior year's sales. This led to some creative sales, cost accounting, and divisional managing. Inside the firm it became known as "out running your fixed costs". Division managers executed the strategy because they made the most money, even though many times it hurt the bottom line of the firm. Because overhead costs were allocated to each division based on the prior years sales, it meant that if managers increased sales significantly the next year their division was only allocated overhead costs for last year's sales. Therefore, this year's additional sales were "overhead free" of charges (at least to the division). This meant that many sales were made that actually lost money for the company, even though they appeared profitable to the division. This behavior was a function of the lack of investment in accounting and control systems, and Bill's desire for growth and market share.

In early 1990, Jim Collins died a few months shy of his 81st birthday. All members of The Hawthorne Organization mourned his passing. Additionally, Bill Jones decided to step down as CEO of the company. Bill was now 67 and wanted to spend his remaining years writing, conducting research, and spending more time with friends and family. He remained Chairman of the Board of Directors, but gave up all executive duties and perks. He took a small, non-descript office in the Old Building at the Iowa City home office and began writing his first of four books. John Jones was named CEO & President of The Hawthorne Organization. All stakeholders felt a little uneasy with the three changes 1990 brought to the organizational structure of The Hawthorne Organization.

LEADERSHIP AT THE HAWTHORNE ORGANIZATION: A CASE OF TOO MUCH FAMILY?

All three of the Jones children were in key executive positions and many felt that they were not chips off the old block. Everyone realized that Bill Jones would be a difficult, if not impossible person to replace, but many felt his children were just average. All three were very nice young people, but not real leaders. Naturally, one did not make these comments publicly, unless one had another job lined up.

John Jones had always been the The Hawthorne Organization heir apparent. He was entertaining, self-assured, and someone that everyone immediately liked. John liked to socialize and loved being the center of attention. He enjoyed action much more than cognition or introspection. He had some natural leadership qualities and his parents had given him and his sisters a strong, loving, and secure childhood and outlook on life. Bill and Mary had provided their children everything and had been unconditionally supportive of them. John Jones (and his sisters to a lesser extent) grew-up believing that he would succeed at all things without having to try. This unrealistic view of life and his abilities sometimes backfired. For example, John was a terrible student and flunked out of the University of Iowa twice, and failed to graduate because he refused to work. He joined Hawthorne in 1975 as a junior account executive. He had tremendous sales skills, but was not known as a hard worker. His overall performance was only considered so-so and the watchword for John was talented, but lazy. Still he was promoted constantly through the ranks and was made President of the company at 32. Even with Bill Jones' mentoring and the help of other executives, John, while popular, was considered a very average executive and never extended his self.

Karen Jones was John's older sister, and was somewhat jealous of John's position as heir apparent. Karen, like all the Jones, was confident and secure. She graduated from the University of Iowa in 1972 with a degree in elementary education and immediately joined RLSC in the Selection Division. While she was considered bright she was not on the level of the numerous social scientists with doctorates and many years of experience. Still Karen was promoted to Director of the Leadership and Selection Division by the time she was 31. The job was too big for her and she enjoyed only token support from her subordinates. Along the way, Karen married a top account executive at Hawthorne and had a child (Emily, born 1977). Karen's marriage ended in a messy divorce in 1985 that caused deep division within the company. Her former husband left Hawthorne and launched his own consulting company. Karen Jones remained in her leadership position, but was not part of the inner circle of decision makers, although she was a member of the Board. Karen, while outgoing, was not as well-liked as her brother and was considered un-focused and a very poor manager. Most in the company felt that while John was not as bright as Karen, he was far more qualified to lead Hawthorne. Karen outwardly supported John, but those close to the situation felt her resentment of his leadership position.

Linda was the youngest of the Jones children. She graduated from the University of Iowa with a degree in elementary education in 1979 and immediately joined Hawthorne. Finding a spot for Linda was not easy. While she was outgoing and popular she did not like sales. While she was bright she did not have the talent or the inclination to become a social scientist. She luckily gravitated towards operations. She was placed in-charge of interviewing, project management, technology, HR, and regional offices. This was a fortuitous move because these aspects of the organization would grow the most over the next 20 years. By 1993, Linda would become COO of Hawthorne and the heir apparent to John. The trouble was, Linda much like Karen, did not have John's likeability or charm. While she was much more focused and organized than Karen, she was considered only an average administrator. Thus, Linda would be much like all of the Jones children -- too small for the job. She was a member of the Board and was involved in all company decisions. The rest of the executive team at Hawthorne can only be considered outstanding in every manner. Bill Jones had used all of his skill and abilities to find, select, and train individuals throughout the organization. The mantra for Hawthorne was -- select, train, and let people do what they do best. It was carried out to the fullest. Typical of this attitude was Tony Michaels, a young highly talented sales professional and manager. Tony joined RLSC in 1979 and became EVP of Sales and Marketing in 1989. Tony was considered a smart, savvy, hard-charging, businessman who led a group of talented sales professionals. He was one of only three non-family employees to sit on the Board of Directors.

Gary Anderson was Executive VP of Research and a wise, kind, smart, caretaker of the organization. He joined RLSC in 1967 the day after he completed his dissertation. Bill Jones was the Chair of his dissertation committee. Bill would have left Iowa in 1965 or 1966, but wanted to stay until Gary finished his doctorate. Both left the University of Iowa in 1967 to work full-time at RLSC. Gary was Bill's favorite student and both were incredibly close. Gary worked as a scientist in leadership, selection, and marketing research. While he was highly respected as a researcher, his true talents lay in his ability to inspire trust in others. He was a natural leader and everyone at The Hawthorne Organization felt that Gary was the salt of the earth. He was the most loved executive at The Hawthorne Organization and all members of the Jones family deservedly trusted him and his council. The research staff at The Hawthorne Organization was considered outstanding overall, but had special expertise and talent in leadership and selection research and consulting. Gary Anderson had been a Board member since 1980.

Trey Kramer joined RLSC in 1985 as Chief Legal Officer. Prior to this he was a corporate attorney with an Iowa City law firm. He received his bachelor's degree in history and his law degree from the University of Iowa. He was considered an excellent attorney and Bill Jones valued his insights and abilities. Besides all legal issues at The Hawthorne Organization, Trey was also responsible for accounting, finance, and international operations. Trey Kramer was considered an excellent manager and was respected within the organization. He became a Board member in 1988.

The Board of Directors had three outside members. The most important was Robert Darcy. Bob Darcy was President of M&T Bank and was considered an excellent businessman and banker. His company supplied much of the debt financing for The Hawthorne Organization. He had known Bill Jones for 20 years and they were good friends. Darcy's Board seat was a direct result of his bank's financial involvement with The Hawthorne Organization, but he was also a wonderful source of business knowledge and acumen. The other two outside members of the Board were long-time friends of Bill Jones. Randy Thomas was a local entrepreneur who had met Bill Jones in 1970. Peter Morris was a retired administrator from the University of Iowa. He met Bill Jones in graduate school. Both Peter and Bill had worked on research together and their families were very close. Thus, Randy Thomas and Peter Morris were very close to Bill James. While both were intelligent and able men, they were placed on the Board to offer their advice, but not to rock the boat.

There were many other talented and creative employees and managers at The Hawthorne Organization. Several members of the research staff were considered experts in their fields. Division managers were all strong performers. The IT, HR, and other support divisions were all filled with quality managers and staff. Thus, The Hawthorne Organization had many strengths -- a quality brand, great products, a strong, well trained, and motivated sales organization, leading-edge researchers, and an excellent and deep cohort of managers and employees. In 1990 the firm faced a bright if uncertain future. While the company was highly leveraged and operated in a mature industry with low-growth prospects, all members of the Board felt the company stood poised to dramatically expand its operations. The leadership of The Hawthorne Organization (i.e., the Board) would need to formulate a plan for growth and profits and then lead its execution.

IN SEARCH OF GROWTH AND CASH FLOWS

By 1990 John Jones had been President of The Hawthorne Organization for six years. Bill Jones gave his CEO position and the operation of the company to his son. While he was always available to help his son, he let it be known that the torch had been passed and that John was now in charge of The Hawthorne Organization. John knew that the company needed a growth strategy that would throw off enough cash to service the firm's substantial debt and also internally fund the desired growth.

After a series of meetings and strategy sessions John and the other Board members decided to launch a new and different customer service delivery model. It was called "expanding the footprint" and was a bold move. It would require creation of six, full-service regional offices to get closer to the customer. Both RLSC and Hawthorne Research had been stand-alone companies with a few account reps working out of home offices in distant areas of the country. John's new plan required The Hawthorne Organization to open large, full-service offices in Atlanta, Chicago, LA, Houston, Denver, and Washington, DC, along with the current home office in Iowa City (also called "the factory") and the New Jersey office (i.e., formerly Hawthorne Research). The new offices would have sales, research, IT, and support staff and three of them would have special call centers (i.e., Atlanta -- Afro-American, Houston -- Hispanic, and LA -- Asian). The rational for this plan was to cut down on travel and keep contact employees near the customers. It also raised the Hawthorne flag throughout America.

Although sales increased during the three-year implementation and many customers liked the idea of being close to Hawthorne's sales, consultant, and research staffs, the costs of the plan wiped out much of the profits and absorbed cash like a sponge. Each office had to have support, IT, and HR personnel (along with full-service sales, consultant, and research staffs). Also the cost for communications equipment and infrastructure links to the home office was expensive. Finally, rent and office start-up costs were pricey.

By 1992 John realized that he needed to augment the footprint strategy. Although sales would reach $340 million and EBIT would be $15 million -- this profit would not support interest, principal, taxes, and growth cash needs. The Hawthorne Organization had to continue to draw down on its line of credit. John Jones decided a new plan was necessary to break the firm's need to constantly borrow capital. This new plan was called "$1billion in sales by the end of the millennium". The plan called for The Hawthorne Organization to grow from $340 million to $1 billion in sales in eight years.

To accomplish this goal it would be necessary to pursue only big research projects, and that usually meant working with big national or international organizations. The tag-line for this strategy became "1,000 clients each spending a million dollars a year". It sounded so doable and non-threatening that Board members and most Hawthorne employees readily embraced the new policy.

But like all policies the devil is in the details, and this plan would shake the ethics and character of The Hawthorne Organization to its core.

The biggest problem with the new strategy was the change in scope of projects. Both companies (i.e., RLSC and Hawthorne Research) had always taken small projects from small to medium sized companies. "A small project with a high margin could be just as profitable as a large project with a small margin" had been a company mantra. Still this was just a saying and because the firm did not track project cost information, no one really knew if the statement was true or not. The Hawthorne Organization had numerous small to medium sized clients with research projects less than $75,000, many were less than $50,000. John Jones believed that these small projects (and the small companies) did not fit the expanded scope of The Hawthorne Organization. He felt that undertaking many small research projects (even with high margins) increased overhead costs dramatically and, thus, pulled down profits. His solution was to refuse to work on small client projects.

This change in policy had many exceptions and, thus, was confusing to the sales and marketing team. For example, a small job could be sold to a large non-client company to establish a relationship, but could not be sold to a former customer or small non-client because there was no potential for additional large projects (i.e., one-off projects greater than $500,000 were considered large). What was even more confusing was that large clients always expected The Hawthorne Organization to conduct their smaller research projects. For example, a major telecommunications company client might have a $4 million a year customer satisfaction track, and expect Hawthorne to conduct 20 small, one-off projects during the year. The Hawthorne Organization could not just take the huge track and refuse the small projects, thus, there was no way of ridding the company of small projects -- they are part of the business, and clients of all sizes need the flexibility to conduct small, specific, one-off research. At first this change caused a great deal of angst amongst the sales team, but they quickly adapted to a new incentive program that paid higher commissions for bigger projects.

The outcome of this change in policy and focus on large projects and clients was considerable. First, many of the firm's old, small clients were jettisoned. Next, the focus on large national and international organizations became complete. Third, the average size of a research project increased dramatically. Fourth, sales continued to increase, but at a decreasing rate. Next, sales person's salaries jumped dramatically and were the highest in the industry. Sixth, margins and profits collapsed. By 1994 it was apparent that although the new strategy was working in many areas, it was not producing greater profits and The Hawthorne Organization was still borrowing money.

John Jones felt that the only way to win this race was to push harder and expand the footprint to the world. Because of increasing globalization and the rise of multi-national firms John felt that the best position for Hawthorne was to become the only global research company in the world. This would give Hawthorne a competitive advantage with large, multi-national firms who needed to conduct research across national borders. Hawthorne would become the one-stop research store for all international companies. It could also guarantee quality and comparability across all research and have one point of contact. Thus, John decided to extend Hawthorne's focus to large companies that needed to conduct research across the world. This extended strategy was a direct break with the way research companies had operated in the past. Most large, established research firms were not global -- most relied on affiliate companies in other parts of the world. For example, a US research company would have an affiliate in the UK, France, Japan, Mexico, and so forth. If a client needed a project conducted in another country the US firm would contact the affiliate and structure the engagement and contract. The same was true for research firms in other countries. Thus, research companies did not have to invest in international offices, but could still service international clients. The problem with this situation was the lack of quality control and accountability.

John Jones' wanted to create 15 international Hawthorne offices. The plan called for acquisition where possible and building where needed. In the next two years Hawthorne offices opened in London, Frankfurt, Madrid, Santiago, Rio, Mexico City, Tokyo, Hong Kong, Singapore, Taipei, Toronto, Beijing, Sydney, Budapest, Warsaw, Seoul, and Delhi. While there were many success stories and clients appreciated Hawthorne's global reach, it was also a time of hard lessons learned. For example, Hawthorne opened an office in Moscow, but closed it after three months because mafia gangs threatened to injure or kill employees unless protection money was paid. Consequently, Hawthorne was forced to move its Russian office to an affiliate firm in Lithuania. Additionally, the firm had to learn to conduct marketing research in different cultures. Hawthorne understood phone survey research, but this methodology did not translate to countries like China and India. This brought on problems with sample design, such as how representative was the sample of the prescribed sample frame? Also Hawthorne had no competitive advantage over other research houses conducting research in many countries, because they had to adopt new and different data collection tactics. Another problem was that the Hawthorne brand did not translate to other countries -- even countries like Germany and Spain. For example, because of strong privacy laws, telephone research in Germany had to be conducted from the UK because it was too costly to conduct the interviews from Germany. Thus, Hawthorne had no brand equity outside the USA. Also, people in countries such as China and Russia were wary of being interviewed, due to government repression. Next, Hawthorne had to align itself with several partners that made operations difficult. For example, to open an office in China, Hawthorne entered into a partnership with the Chinese government where The Hawthorne Organization made all of the capital investments, but owned only 49% of the organization. Additionally, a government official was in charge of the operation and he knew nothing of marketing research and had to consult with government officials on every aspect of the business. The Chinese government officials did not care much about profits or cash flows (i.e., these concepts were alien to them), instead they focused on growth of the partnership and the number of workers employed. The Hawthorne Organization was naïve about international operations and paid a huge price.

By the end of 1996 The Hawthorne Organization was in drastic shape. Although the US economy was skyrocketing and domestic sales and profits were way up (i.e., overall firm sales were $501 and EBIT was $23 million) the international expansion had drained all cash flows and borrowing capacity. The firm was on the precipice of going under. John Jones called a Board meeting in December to discuss the short-term cash crunch. Bob Darcy was unable to secure additional credit financing and suggested bringing in equity investors. After considering several equity offers, Bill and John Jones decided to raise cash in a highly unusual manner -- they would invite executives and senior managers to become Hawthorne Partners. All executives and key employees would be allowed to purchase up to $500,000 of Hawthorne stock at a special price and the transaction would be financed via personal loans at M&T Bank.

This plan accomplished many objectives. It raised badly needed cash. It tied executives and key employees to Hawthorne's success. It kept the company 100% employee owned. It was quick and very inexpensive. It helped cleanup the balance sheet. Finally, while it diluted the Jones family ownership, it did not decrease their power within the organization. Given the situation, executives and key employees had little choice but to purchase the stock. To refuse this offer would have been a sign of sedition. Consequently, nearly all of the approached executives and key employees made the stock purchase (and the one's who did not, began looking for a new job). One manager said it was much like "Bill and John Jones asking their followers to drink the Cool Aide". The stock purchase plan raised $15 million and saved the company, but left hard feelings within the firm.

While The Hawthorne Organization had dogged a bullet, moral within the Board and the firm was plunging. It seemed that the company was not making progress even though the economy and industry were booming. Consequently, non-family members of the Board (i.e., Trey Kramer, Gary Anderson, and Tony Michaels) and Bob Darcy suggested that The Hawthorne Organization abandon its current strategy and focus entirely on cash flow generation and repairing the balance sheet. They approached Bill and John with a plan that included three objectives; 1) purchase and implement a project cost system and enterprise software, 2) close or consolidate non-profitable offices, and 3) reward sales and operations associates exclusively on profitability of projects.

FOCUS ON EFFICIENCY AND ACCOUNTABILITY

John Jones hated the idea of standing still -- focusing on margins. However, even he could see how close the company had come to bankruptcy. Thus, he agreed to let Trey hire a new CFO with the expressed goal of implementing a project cost system and complete accounting controls and reporting capabilities. Trey hired Steve Andrews who had prior experience with a large financial services firm. Steve Andrews demanded and was given carte blanche for the new system's implementation. Software consultants and accountants lived at Hawthorne headquarters for four months. Training took another three months, but by 1998 The Hawthorne Organization could track specific project costs, employee productivity, overhead allocation, and profits for the entire company. Reports allowed managers to spotlight problems with objective data. The system revealed many of the sales, pricing, and operation problems facing The Hawthorne Organization. For example, it was not the size of the project that determined its profitability, but how well it was managed to project specifics. In other words, a lot of projects were unprofitable because "scope creep" occurred. This meant that client extras were freely given away because they had not been tracked.

Given this information the company began to refocus its sales and marketing efforts. Sales and operations associates began to be rewarded based on profits and this caused salaries to drop by an average of 20%. The Hawthorne Organization had always paid its employees extremely well, but this new incentive plan caused many marginal performers to leave the company. It also tied performance to pay and that was the rub for many associates. The new plan was typical of compensation programs utilized in the industry and it forced Hawthorne employees to realize that the good old days of hiding were over. It was a blow to many in the organization. The Hawthorne Organization never had a retention problem. In fact, yearly, fewer than 2% of employees left the organization, but now the turnover rate reached 20% in the sales department (which is typical in the industry).

By the end of 1999 Hawthorne was financially stable. Sales for the year were $479 million and EBIT rose to $25 million. John Jones had elevated Trey Kramer to President of The Hawthorne Organization. Many believed that this move saved the company, but those close to the situation agreed that Steve Andrews had played a bigger role in bringing "sense" to executive decision making at The Hawthorne Organization. Steve Andrews was a financial and MIS whiz, but left The Hawthorne Organization in 2000 because he did not feel appreciated by the Jones family. He and John Jones constantly argued. Steve usually won the battles, but in the end lost the war.

John still launched new products and services -- education and training classes for executives, a benchmarking product, and a syndicated product for measuring advertising consumption in American newspapers. None of the new products was a home run, but all at least made money. Still John's dream of Hawthorne being a billion dollar company was dead and he chafed to again grow the company. Most members of the Board and many employees looked back at the last decade as one of lost opportunities.

The go-go 90s were a gold mine for the research industry. Many companies doubled their research capacity. Profits were generally extremely high. Most firms invested heavily in new interviewing technologies, the internet, software, new reporting methodologies, and computer data processing capabilities. Because The Hawthorne Organization had focused on international and domestic office expansion, it missed making needed infrastructure investments. All members of the Board agreed that The Hawthorne Organization needed to make major technology and human resource investments over the next two years to remain competitive. Additionally, it was agreed that the company must continue to focus on margins versus growth.

THO made major technology investments in 1999 and 2000. The company gained tremendous capacity and productivity, but the costs were high. Once again, cash flows were drained. However, by June 2000, the company was poised to begin growing again. Its debt situation was manageable, its internal control systems were first-rate, technology and human resource investments had increased productivity, its products and services were now competitively priced, and margins and profits were on the increase. John Jones announced a plan to once again pursue international clients with a very competitive set of services. Then a series of three events crushed the possibilities of the plan and nearly knocked The Hawthorne Organization out.

First, the high-tech market crashed. The NASDAQ market index dropped from nearly 5200 to 1200 and this caused business investment and confidence to evaporate. Marketing research is driven by business investment and confidence, thus, the industry went into a depression. Second, Bill Jones was diagnosed with cancer and only given three months to live. In November, he died and his passing was a terrible blow to everyone affiliated with The Hawthorne Organization. Luckily a financial succession and estate plan had been previously executed which included insurance, trusts, and gifts, so there was no financial hardship on the family or The Hawthorne Organization. Finally, the terrorist attack on the World Trade Center in September 2001 pushed the country (and the world) into a recession and further depressed the research industry.

Performance for 2001 reflected the impact of these three events -- sales slumped to $398 million and EBIT was just $9 million. Additionally, The Hawthorne Organization had to layoff employees for the first time in the company's history. In 1992 earnings had been $15 million, so this situation was a real blow to everyone at Hawthorne -- it seemed to many that the company was regressing. Although the company was not in the dire conditions of 1996, it still had substantial debt and the situation had to be managed carefully. During the next five years Trey worked hard to manage margins and costs. Tony Michaels tried to rally the sales and marketing team, but many top-performers left the company because of falling commissions. Tony left Hawthorne in 2003 to take the COO position at another research firm. Gary was faced with the toughest job since most of the layoffs were made in the research and operations areas -- not enough work to keep folks busy. The substantial layoffs demoralized the once very proud research company.

The period from 2001-2005 can best be described as "the blue period". Because of the industry slump, sales and profits cratered. The company was forced to become more efficient. This caused a complete shift in corporate culture. An example of this was the emphasis placed on project managers. Prior to 1998, the project manager position was considered a necessary, but not critical, function at The Hawthorne Organization. These individuals were responsible for taking projects from the sales team and steering them through the factory until data could be delivered to researchers and analysts for final report creation. The schedule included survey creation, computer piloting, interview slotting, quality assurance, data coding, file creation, cross-tab development, and data file delivery to researchers and clients. With the advent of the new cost accounting and control system this position was elevated to "Profit and Project Manager". In other words, project managers became the individuals that tracked costs and controlled projects. This was a complete departure from the prior power structure at The Hawthorne Organization where sales and research drove projects and the company culture. By 2005 project management and accountability drove the new culture at Hawthorne.

This situation would have never happened prior to the new cost accounting system. The sales team sold projects (and specified deliverables) and the researchers delivered the project. Project managers just made sure the trains ran on time. But now project managers make sure that just project deliverables are delivered. Thus, sales people cannot over-promise and researchers cannot over-deliver. This puts more pressure on both of these groups. Now selling is much tougher because the sales team cannot give client freebies to close a deal and researchers cannot pad their timesheets with extra analysis. Instead, project managers are given the authority to deliver to project specs and force both of these groups to be much more accountable and this has dramatically changed the culture at The Hawthorne Organization. It is no longer the self-assured, freewheeling, entrepreneurial company, where all things are possible. Instead, it is a more accountable, cautious, skeptical organization.

WHAT NOW?

Today John Jones is faced with many decisions. The Hawthorne Organization had an encouraging 2005 -- sales were $408 million and EBIT was $17 million. The International Division made a profit for the first time and did not need capital to finance operations. Sales for Pan-national projects were up by 40% since 2002 and all signs pointed to increased sales and profits from all international offices. The international plan looks to be finally ready to pay big dividends. Domestically, things are looking up as well. While 2006 will not be a great year for The Hawthorne Organization, there is every indication that it will be much better than 2005. So industry and economic conditions are improving. John and other Board members feel that there is tremendous unlocked value in the firm, but have not been able to figure out how to get to it.

Financially, The Hawthorne Organization is in very good shape. The firm has become very efficient and has total control of costs, pricing, margins, and employee productivity. Debt is manageable once again. Cash flows are positive and improving. Still the company has been mired in a decade of contraction and crisis. Company sales are down nearly $100 million from their peak in 1996 and EBIT are down $8 million from their peak in 1999. Still all executives feel that financially The Hawthorne Organization is better off than it has been since 1987.

Unfortunately, numerous real problems face The Hawthorne Organization. First, the firm has lost a great deal of brand equity. While the name Hawthorne still means quality and integrity, it no longer dominates the industry as it once did. Its products no longer lead the pack. For example, other research companies have focused their value chains and successfully differentiated their products -- Gallup, Harris, and Pew in public opinion and polling, Hewitt in selection and leadership, Forrester and Gartner in syndicated high-tech research, NPD and NFO in panel research and online panels, J.D. Powers in customer satisfaction, Mercer and Bain in benchmarking, and Maritz in employee satisfaction research. The The Hawthorne Organization brand and products are no longer considered cutting edge. The Hawthorne Organization is just one of many research companies that are not considered special or different.

Another problem facing the company is the lack of leadership talent. Gary Anderson is scheduled to retire in 2006. Trey Kramer will be 61 and has indicated that he would like to step down from the President's position. Linda Jones-Tyler is not considered a strong leader. Other key employees and managers either left the company during the last decade or are considered too near retirement to be effective. The once deep cohort of possible leaders has been depleted by lay-offs, turnover, or retirement. Due to a decade of contraction, new blood has not been brought in to keep things churning. Today the company needs an infusion of new talent with new ideas.

The final problem facing the company is the uncertainty of the industry. The future of the industry is impossible to predict. For example, what methodology(ies) will be employed to reach and survey consumers? The terrestrial phone system method is now becoming obsolete, because people screen calls or refuse to participate in surveys, or use cell phones exclusively. So what will replace phone survey research -- Internet, internet panels, TV set-top boxes, or something else? Because it is impossible to determine what technology or partner (i.e., ISPs, cable company, or platform) will win, all research companies must hedge their bets -- which is expensive. Additionally, competition will only get fiercer and capital investment in technology, human resources, and sales will continue to put pressure on margins.

John Jones must decide where he wants to take The Hawthorne Organization. At 54 he still has the desire to lead the company, but if he decides to continue he must rebuild management, develop new products and services, and re-create the "buzz" that once surrounded the Hawthorne brand. After 16 years of ups and downs, he still believes he can succeed at making the company great, but others are not so sure and feel he should look at all options.

This case is based on observations and knowledge the authors have gained about the research industry over the last 25 years. All of the facts, companies, characters, and incidents are fictitious and any similarity to events or persons living or dead is purely a coincidence.

PARTNERING WITH AN NGO TO START A MICROLOAN PROGRAM IN A GHANAIAN VILLAGE: A GLOBAL ORGANIC TRIPLE-BOTTOM-LINE SOCIAL ENTERPRISE IN THE MAKING

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CASE DESCRIPTION

The primary subject matter concerns social entrepreneurship which incorporates the triple bottom line. Secondary issues include financing new ventures, human resource development and motivation, globalization of collegiate curriculum with experiential/service learning methods, globalizing microenterprise, and entrepreneurship in a nonprofit. This could be used in for-profit or nonprofit management or entrepreneurship courses, developmental economics, and finance. It has a difficulty level of four, appropriate for senior level and five, appropriate for the first year graduate level. The case is designed to be taught in 1-3 class hours with two hours of outside preparation that can be done online.

CASE SYNOPSIS

The director of a student consulting program in a university hears about a way to globalize the program by partnering with an NGO in Wilmot, New Hampshire, WomensTrust, to start a microloan program in a Ghanaian Village. A meeting is called with interested colleagues, alumni, and students. There is support for the concept but several other possible scenarios are proposed. A go with Ghana decision is made somewhat unilaterally and without a business plan. Entrepreneurial enthusiasm abounds as in a typical start-up. The team must now quickly do its homework--get the buy in of the relevant stakeholders especially the Dean of the Business School, and the University Administration. The Dean would be concerned about the level of positive impact on students and alumni and mitigating possible increased overload on faculty. The University is concerned about liability and safety issues. There is a desire to make sure this is a triple-bottom-line social enterprise, which achieves desired outcomes of helping empower women to have more secure lives for themselves and their families. The people, profit, and planet aspects must be addressed. Is there someway of getting to Ghana without burning tons of carbon dioxide during a 14,000 mile round-trip flight? The model calls for investing $15,000 to begin a microloan program that charges interest to its peer lending group members and then becomes self-sustaining at 400 borrowers. How *are they going to raise the $15,000 to start the process? It is an organic development model which starts with microloans and may grow into providing help with education, health, and meeting other needs if the women feel that is what they want. How will that be financed? What if the team doesn't get the buy in? The reservations cannot be canceled.*

IT BEGINS WITH A TAXI RIDE TO THE AIRPORT

B. Barnsworth, in her seventh and final year as Endowed Chair of Entrepreneurship at Brandon University in Spokane, Washington, wanted to make a difference with this year to be a part of something meaningful. She had recently attended the Global Microcredit Summit in Nova Scotia. It had been an exciting conference following the announcement of Muhammad Yunus receiving the Nobel Peace prize for his highly successful efforts with the Grameen Bank and the peer-lending model in Bangladesh with microcredit and empowering very poor women with very small loans. B.B. had been in microenterprise endeavors using a model, the Small Business Institute, to have students in the senior capstone course work together on teams with microenterprises and small business owners to do in-depth analysis and business plan with the owner. She was hoping to be able to globalize the course with coverage of microenterprise as economic development model generating business plans that could compete in social enterprise track of business plan competitions. These two wishes were about to merge.

As she was waiting for van to take to airport, she met two other conference attendees who wanted to go to airport also. They were from Wilmot, New Hampshire, USA. The three of them agreed to split a taxi fare. From the minute the doors closed and during the half hour ride to the airport, B.B. learned about a unique program from Susan Kraeger, the Executive Director of WomensTrust and Dana Dakin, the founder. Dana Dakin had “adopted” a village in Ghana--Pokuase, close to Accra, where she started a microlending program to small groups of women. In the process, she had hired an Executive Director. They were now on a crusade to encourage others to start similar programs in any developing country on their own or it could be possibly contiguous to WomensTrust in Ghana and operate under WT’s 501(c)(3) umbrella.

The taxi ride ended too soon. Upon getting back to Spokane, B.B. checked out the WomensTrust.org web site www.womenstrust.org. It really sounded like this might be the answer. B.B. convened a group including an Econ-Finance faculty member who had recently proposed some innovative student involvement in investing funds and possibly investing in microenterprises, the Management Department Chair, the other senior capstone course instructor, a faculty person out of the Provost Office who runs a Global Student Internship program, a business law faculty member who had published a definitive work on social enterprise who had just put on a program on indigenous people, alumni from an MBA Social Enterprise/Triple Bottom Line course; a student in the Executive Masters in Nonprofit Leadership program, a Management faculty member who had interests in helping in villages, and a visiting professor in Econ and Finance who had indicated interest as well. It was billed as an exploration of the concept of adopting a village and hearing more about the WomensTrust program.

THE SOUNDING OUT MEETING

The following meeting occurred as recorded by the Entrepreneurship Center's administrative assistant, over a catered lunch.

December 8, 2006, 12-2 p.m., Smith 416, J.F. Scribe

Betsy Barnsworth, C.B., J.Q., C.W., D.M., M.E., G.L., C.C., Madhu R., D.L., Meena R., S.M., and Susan Kraeger, from WomensTrust, Inc. (via conference phone).

- Interest in Entrepreneurship Center is to find something to invest in locally
- It is exploring how to best utilize its anticipated $1 million endowment to support local microenterprise.
- However, as Endowed Chair of Entrepreneurship, Barnsworth is looking at a "partner with a village" model
- Can choose to serve a village and then get involved in a certain area of their development (AIDS, clean water, etc). You get to chose the village and determine how involved you want to be.
- Susan Kraeger enters conversation by teleconference to give the WomensTrust story:
- Background on WomensTrust: founded in 2003 by Dana D. Decided to at 60 she wanted to give back so traveled to Ghana in search of a village she could adopt and start a microlending program for the women. Dana D. found a village, met with the women and they were interested. She started a microlending with $1700 for 72 women ($20 each about), asked women to meet in groups, found someone to administer the program in Ghana, and she returned to the United States to oversee it. After a year, they lost site of the group lending concept, repayment rates were low and they were not meeting their full potential. Susan went over in 2005 and met with the women. They wanted larger loans, higher caps for reliable repayers. Currently have over 500 clients and over $30,000 portfolio on the ground working and two staff in the village that are covered by the interest. Discovered women need not only access to credit but also access to education and healthcare as well to individually sustain themselves above the poverty level. This larger picture is the goal now (not just microlending) (redefinition of sustainability). They look for women who have businesses – they are not trying to help women start businesses. Ask the women what they need and what would be helpful and then they work with the women to develop the programs and what they need. 85-90% repayment rate. The interest rate has been tied to the going rate of 39% in the local banking community (which the women are not qualified to access) with 13% for 4 months being the going rate for WomensTrust. 90% of clients sign their paperwork with a thumbprint and are illiterate. Loan program can run itself. They raise money for their education programs and other programs separately from the microlending.
- For $10 American year, Ghanaians can sign up for national healthcare and it includes their kids. For those women who repay their loans, they pay for the 1-year coverage (through another woman who gives $10,000/year).
- Women's Trust: provides umbrella services to other organizations that want to work with them in line with their goals and mission. They are also very happy to share their model and work with others in developing other microlending programs anywhere in the world.

- The women have shown an interest in learning more skills and there are a number of skill building classes they would like to have. One issue is that after dark, there are no lights so they can't do the programs at night and then the women work during the day so it's been hard to schedule these. Want to build a resource center, where there will be an electric generator, computer, space for classes, library. These are the kind of things they are looking at. They have been working with the poor and very poor – this is their primary target. Would also like to engage women a level or two up from that to look at new markets, small business planning, marketing, etc. Want to get everyone up to a certain level and then want to take the climbers further if they are willing to go.
- What's being done to help the community at large? Rotary Int. has a water program and builds wells in the developing world. Talking to community about implementing educational programs regarding wells. People don't want to use them because it's hard water and it doesn't taste like the river water. No running water in the community of 20,000 people. Interested in building latrines. People live to about 60 years old. Anything above that makes them a burden to their families.
- Potential for backlash by men as the women become more empowered? Women have always worked in West Africa and according to creationism, women were given the gift of productivism so it's not unusual for women to be involved in business. Have seen cases where men have sent wives to get a loan and then have taken the money and disappeared. That's why the group approach is so important in microlending. At this time, they are not hearing a lot about domestic violence as an outcome of this program. It's just an issue regardless.
- Critical mass for microlending program is 400-500 women (to support administration).
- Local government: they know they are there and WT keeps them updated on what they are doing but they do not work through the government. The government allows them to come and go when they please.
- Everyone in Ghana who is educated speaks English. Currently a college in the country that teaches computer training and technology to both young men and women. This is unusual because girls rarely get access to computers. They can't get computer time. The boys always get it. The college is 45 minutes from where this program is working.
- Working on building relationships with other organizations in Ghana that are already existing to help women.

Executive Director is thanked and leaves the meeting (hangs up phone).

What's the outcome of this meeting we are aiming for? Where are we going?

- Determine if there is any interest in (adopting) Partnering with a village?
- Is there a model we could bring forth?
- Is there something here that we want to pursue?

Thoughts?

- Maybe partner with the "computer university" in Accra and play on the Microsoft/NW connection.
- J.Q. – interested in partnering with a community that is being hard hit by AIDS. Grandmothers are prostituting themselves to take care of their grandkids because the mothers are dying of AIDS. In turn, the grandmothers are then dying of AIDS from prostituting themselves.
- MeenaR – Mentioned Clouds of Hope orphanage.

- MadhuR – What are we looking at Ghana? We have other connections in countries in Africa. Would we be interested in partnering with any of them? Ghana only or do we want to expand the idea?
- J.Q. – maybe partner with Catholic Relief Services? They are in 96-97 countries already and may be able to help facilitate our partnering with NGO's in those countries.
- B.B. – create a model that could conceivably be used within the Jesuit schools. Could build through internships within the university as well. The bottom line is that if we are located closer geographically to whichever country we choose to work, we will have a better chance of success and getting people involved.
- C.B. – W.T. was fortunate to pick that village. Feels their success was built on the fact that they started small. Concerned with the consortium approach. Don't over engineer grassroots.
- G.L. – the way to generate financial support at this school is to say that we could create a model that could be adopted by other Jesuit universities. We get more support that way.
- C.B. – we have to make sure whatever we do benefits the whole village, not just the micro lendees.
- C.W. – if we're serious then we need to go and learn from people already there, find out what they need and then begin to think about building a model and getting involved. We don't want to build a top down program with no information.
- J.Q. – would be nice to connect it to where some of the other Jesuit organizations are in Africa, which is the world-wide focus of the Jesuits right now. Need to look at Ghana but think we should keep our options open and look at the social justice issue since that's our mission.
- G.L. – maybe start a dialogue with all the countries we're interested in. Then divide it up and everyone looks at different areas and then come together and determine the next step.
- C.C./J.Q. – stake in the ground that we're interested in Africa.
- G.L. – very successful women organizations in Spokane that maybe we could tap into for funding, etc.

Thanks, J.F. for taking such great notes. Thank you all for coming and giving your inputs! I will be back in touch with you individually to discuss your interests. Great ideas. Excellent questions and insights.

The group seemed to want to do a bit of research and get more information before deciding on one program model or country.

However, B.B. was really sold on the WomensTrust model and was eager to get going. This one sounded like it would be a great one for the SBI to sponsor. It could be piloted here as a national model for globalizing the SBI programs. Shortly after, Susan Kraeger and Dana Dakin went for their regular twice a year trip from New Hampshire to Ghana. This one was to kick off the "World Class" program that a group of Skidmore College's Class of l971 was sponsoring.

They were giving circles of people "who share a passionate concern for human rights and poverty issues. It is particularly concerned with the plight of women and children in Africa, home to many of the world's 'poorest of the poor'

THE VILLAGE IN GHANA DECISION

Over the next few weeks, a core of the initial group had emerged as very enthused about partnering with a village and to work under the umbrella of the WomensTrust group rather than to go it alone or explore other partnerships in other places. They felt that the political stability and safety factors were more certain in Ghana plus it was deemed as a positive that English was the Ghana language though the villages would have their own languages. These villages outside of Accra were too small to be of interest to the large aid organizations such as Catholic Relief Services and the Grameen Bank and World Vision. B.B. sounded out WomensTrust about the availability of a contiguous village. As a matter of fact, they might have one in which WT was already running a women's literacy program staffed by a local village leader. There was indication that the village would be delighted to have a microloan program. They had also heard about the program's success in nearby Pokuase from word passed by some of the women in the peer lending groups. This was an appealing model to the core group.

The core 4-some has reservations for spring break to meet with WomensTrust Exec Director to get crash immersion course and possibly help vet a village where a microfinance program could be started. The Econ professor is going to build two modules into an economic development course on global and local microcredit and microenterprise and will follow the case as a live case for the class that will be offered once a year beginning spring.. The Executive Master's in Nonprofit Leadership student, D.M., is building her final project around this. B.B. is developing this case to present at a professional conference and added a module in the winter capstone class with this case. She is also seeing how long she can continue to finance this project with her own monies. There is no written plan. J.Q. is looking at possibility of placing an intern in Pokause during the summer of 2007 as part of program of placing global interns that she is in charge of out of the Provost's Office. The MBA alumni have started recruiting a core group to strategize. D.M. provides the first copy of a prospectus:

One village, two circles at a time
World Class Partnering

WomensTrust / Brandon University
Prospectus; 1/3/07

Our Story

Have you ever stopped and really thought about what it must be like to try to survive on less than $1 a day? Do you feel up to speed on the plights of women and children living in places like Africa? And in your deepest soul, have you ever stopped to contemplate the special vulnerability of our sister females enduring real human rights abuses daily?

Perhaps you'd like to do something – something tangible; something you can put your hands on and be a real part of. You believe you have the entrepreneurial skills and passions that could help make a difference, but then you stop and think to yourself "there must be a more efficient and satisfying way to plug in"; a better way to honor your education, your creativity, and the power of real collaboration towards helping our sisters and their villages achieve self-sufficiency and gain their basic human dignity. That's what B. Barnsworth thought too.

In her seventh and final year as Endowed Chair of Entrepreneurship at Brandon University, B.B. wanted to make a real difference. She had recently attended the Global Microcredit Summit in Nova Scotia; an exciting time following announcement of Muhammad Yunus receiving the Nobel Peace prize for his highly successful efforts with the Grameen Bank, peer lending model in Bangladesh, and microcredit – the successful empowering of very poor women with very small loans. Having been in microenterprise endeavors for many years using the Small Business Institute model, where students work in Capstone course teams with microenterprise and small business owners, B.B. hoped to globalize the course. She felt sure these two important things were about to emerge; she just wasn't clear how.

That same day in Nova Scotia, B.B. ended up sharing a riveting cab ride with two other conference attendees from the WomensTrust organization based in Wilmot, New Hampshire, USA; Susan Kraeger, the Executive Director and Dana Dakin, its founder. A few years back, Dana Dakin had begun partnering with a village in Ghana –Pokuase, where she had started a microlending program with a small group of women. Since then, she had hired an Executive Director. Together, the two were on a crusade to encourage others to start similar programs in any developing country on their own, and they were allowing for other nearby village partnerships to be operated under their WomensTrust 501(c)(3) umbrella. The taxi ride ended too soon. Upon arriving back to Spokane, B.B. checked out the WomensTrust.org web site, and it appeared she had found her answer. On 12/8/06, B.B. convened a group of potentially-interested business school facility and alumni, and one student from the executive masters in nonprofit leadership program. The idea was a hit for many reasons!

WHAT'S SO SPECIAL ABOUT THE WOMENSTRUST MODEL?

1. Starting in Africa – and its incredible problems with AIDS, poverty, and hunger
2. The village choice --right village factors and timing
3. The village circle's needs assessment process
    - Village initial needs --grassroots, focus-group assessment with interested women
    - Village matching – matching of the goals and hearts
    - Village ongoing needs – ongoing focus group assessment
4. Their World Class donor circle approach
    - Concerned folks coming together believing they can help solve this problem
    - A coming together that's dynamic in a grassroots learning and collaborative way
    - A way to scale organically its own microfranchise model to help get rid of poverty
5. Opportunity to make it our own
    - Unique and multiple donor circle compositions
    - Unique partnering opportunities
6. Opportunity to use it as rich collegiate learning model
7. Opportunity to get hands-on involvement in making a difference

OUR WORLD CLASS DREAM?

A core of Brandon University folks come together now in the spirit of learning and collaboration as well to build in tandem on the Skidmore College alumni team's World Class dream.

- ♦ To help empower women to help them help themselves secure the kind of life and livelihood they want for themselves and their families
- ♦ In support of Brandon University's mission -- a huge supporter of service learning and the education of whole person, as great champions of justice especially for the poor
- ♦ In collaboration within the Small Business Institute -- piloting a national model for globalization

- In support of promoting a triple-bottom-line and sustainability approach to economic development making sure not to do more damage than good; buying carbon offsets units offset carbon emissions from air travel
- In collaboration across schools –School of Business's "Entrepreneurship Center" with the College of Arts and Sciences' Center for Nonprofit and Social Enterprise Management
- In synergistic learning support of other efforts currently going on in Nicaragua, and in collaborative support with Catholic Relief Services and local Ghanaians
- For increased engagement among alumni
- In collaboration and/or exchange with other universities … promote adopt a village model
- In collaboration with the Ghanaian Association of Greater Spokane
- In support of Microenterprise and Environment Guiding Principles as developed by the participants at the Microenterprise and Environment Conference, Valley Forge, Pennsylvania, July 2004

WHAT IT TAKES?

First, the microlending. $15,000 is the amount currently estimated for starting up *a microlending operation in a new village*. Because WomensTrust is a "bottom up" model, one which honors the importance of working at the grassroots level, each donor circle would carry with it both the freedom and the responsibility of helping to develop market-driven programs based on relationships and dialogue with the women of the "village circle". Additional needs here could be tied to loan process, equipment, business expansion, or staffing. *The steps?*

Form a circle
Find a village match
Come back, organize, and raise money initially to find a microloan program ($15000)
Then consider an endowment and further fundraise to be able to grow the village and its needs

Next, what else? *Other needs* could be related to the women's microenterprise venture (business consulting, etc) or could be much more general and life-skills based. In Pokuase, they provided education for girls; a vital need and one easily taken for granted among those of us attending a school like BU. Other such needs that could come up for a giving circle to address might be: literacy classes for women, monthly stipends for the elderly, special resource centers for women offering access to computers, research and training. The beauty of the circle here-to-circle there relationship, is that each village partnership opportunity can be customized to needs, desires, and resource availability. And just as with the $15,000 funding example above, each new opportunity can become an entrepreneurial challenge to tackle. Just "be the circle", use your natural talents, and be creative about figuring it out!

One Village, Two Circles at a Time

It can seem overwhelming, but its not. Not if you consider the journey as one village at a time, supported by the partnering of two circles at a time – one circle here and one circle there for many women here and many women there.

THE FLIGHT LEAVES IN THREE WEEKS

To this point there has been no official sanctioning of this activity by the University. B.B. is faced with the reality that their core group has about three weeks to get the University's sanctioning of this activity so the team can be going to Ghana with that knowledge. They are meeting to strategize. How are they going to raise the initial $15,000 to say nothing of the possible need to raise many thousands more if their village determines it has needs further than just microlending. Is raising $15,000 in our role as members of a nonprofit different from raising $15,000 for a regular microenterprise start up in Spokane? How could the program in Ghana benefit the students and enhance the learning experience campus-wide for both undergrads and graduates? How will this affect the University's ability to communicate with alumni? How can B.B. show that globalizing microenterprise/microfinance should be a module in the senior capstone course--they already use local microenterprise cases for consulting in delivering the Small Business Institute program? Also the Triple Bottom Line and sustainability are major themes in the course. The loan fund is supposed to be self-sustaining at 400 borrowers. However, concern for the planet is questionable as soon as they board on the plane...so much for not harming the environment and planet. B.B. is concerned about overlooking a relevant stakeholder group. The Dean will be concerned about overloading the faculty even more taking something like this on. This should be a great service learning option but how do they convince others? Could it be scaled to have opportunity to help colleagues in other universities, start or partner in similar programs. How do you make a business plan for this type of venture? What would a viable business plan look like for this? How do you make a microcredit program self-sustaining? How do you deal with liability issues?

THE DAILY EXAMINER: STRATEGIC INITIATIVE 2013

Patricia Lapoint, McMurry University
Carrol R. Haggard, Fort Hays State University

CASE DESCRIPTION

The primary subject matter of this case concerns strategic decision making, outsourcing, and organizational politics. The case can be used to explore the intricacies of strategic planning in a strategic management course. Students are asked to analyze data in order to determine whether to adopt a new strategic plan for the company. Making such a determination requires the students to complete a cost/benefits analysis, an analysis which includes both financial as well as human elements. The case has a difficulty level of four. The case can be presented and discussed in two to four class periods depending on the number of issues considered. Students can be expected to spend about 8 hours of outside preparation to be fully prepared to complete the case.

CASE SYNOPSIS

CEO William Rogers is well aware that the internet poses a significant threat to traditional print newspapers like The Daily Examiner, a regional, employee-owned newspaper. Therefore, Rogers hired Skip Van Wart as CFO because of his reputation as a strategic change agent for staid industries. Although Van Wart has limited experience in the newspaper industry, he has initiated turnaround strategies in other companies. During his 10 months with the company, Van Wart conducted a study of all areas of operations as well as readership patterns. The study concluded that The Daily Examiner faced a strategic dilemma, determining that two major changes were strategically necessary: 1) the newspaper must develop an online newspaper segment; and 2) the current printing operation should be outsourced. The conclusions of the study are based on the increasing age demographic of the Daily Examiner readership, the growing online market, as well as the opportunity to reduce what could become excessive operational costs, i.e. capital outlays in replacing the printing presses. Immediate implementation of the plan is complicated by two major elements: (1) there are three years remaining on the lease of one of the printing presses and (2) outsourcing the printing operation would affect about 30% of the employees. Having worked in the printing area, Rogers has strong interpersonal ties with many of the employees there. In addition the printing employees, collectively, own 42% of the company's stock and include the single largest shareholder, Buck Johnson, who had served as Rogers' mentor. Rogers therefore, faces a tough decision: reject the initiative and stay true to the paper's historic roots and support the long *serving employees, or adopt the initiative and make radical changes in order to meet perceived future needs?*

THE DAILY EXAMINER: STRATEGIC INITIATIVE 2013

As he was putting a large stack of papers and documents into his briefcase at 6:15 on Friday, William "Bill" Rogers knew that it would be anything but a restful weekend. Rogers is CEO of *The Daily Examiner,* a regional newspaper. On Monday, Rogers has to submit the agenda and related materials for the upcoming quarterly board meeting. The most controversial issue on the agenda will be consideration of the strategic initiative. This weekend Rogers must decide on his vision for the future of the paper: do we reject the initiative and stay true to our historic roots and support our long serving employees, or do we adopt the initiative and make radical changes in order to meet perceived future needs?

The Daily Examiner is a small regional newspaper with a total readership of 60,000 adults. As is typical of most regional print newspaper organizations, *The Daily Examiner* faces a changing and uncertain future.

Industry-wide data indicates that income has always played an important role in segmenting newspaper audiences. Readership increases steadily with higher earnings. Among adults with household incomes of $75,000+, readership stands at 55% on weekdays and 65% on Sundays. Education and occupation have long been closely correlated with newspaper readership for both weekdays and Sundays. In fact, 57% of adults who graduated college or more read a weekday paper and 66% do so on Sundays. In general, people in occupations with more job responsibility also show stronger readership of newspapers. Fifty-four percent of adults in Management, Business and Financial Operations read a daily newspaper, and 64% do so on Sundays. Racial and ethnic groups differ in their reading levels. Forty-nine percent of whites read a daily newspaper, compared to 44% of African-Americans, 38% of Asians, and 31% of adults of Hispanic origin. On Sunday, the reach among racial/ethnic newspaper readers is white – 58%, African-American – 55%, Asian – 39%, and Hispanic – 37%. Table 1 shows the percentage of newspaper readership by age group for 2000-2005 (Mediamark Research, Inc. 2005). This national demographic data is of concern to all newspapers.

Table 1: Percentage Newspaper Readership by Age, 2000-2005

	18-24	25-34	35-54	55+
2000	39.9	40.9	56.6	69.5
2001	38.9	40.4	54.8	69.6
2002	40.9	42.0	56.3	69.2
2003	39.7	41.1	54.4	68.4
2004	39.0	38.8	53.0	67.4
2005	38.4	36.8	51.7	66.0

Table 1 illustrates a general declining trend in newspaper readership for all age groups. This declining trend is especially troubling since the older generation of print media readers is being replaced with a younger readership that is more technologically savvy and tends to prefer electronic-based media over print media.

Since 1993, the boom of online news organizations has been taking place at an unprecedented rate. Along with the emergence of many non-traditional news providers, the dawn of the twenty-first century continues to see a sharp upturn in the number of traditional news organizations migrating online. Online newspapers now reach nearly 37 percent of every American on the Web or nearly 54 million people, and these numbers have climbed steadily. Even with so much to do online, these users have made the online newspaper a daily habit in overwhelming numbers: 63 percent of online newspaper users say they check the Web daily for breaking news, compared with only 16 percent of non-users (Newspaper Association of America, 2008).

In such a context, the online news audience has been growing in both size and substance. In general, the Internet has reached or is reaching the status of a mainstream news medium. However, as the Internet is still in its relative infancy, factors influencing the current use and adoption of online news (including age, education, income, Internet experience, location of use, news habits and bandwidth) suggest a bright future of the Web as a major source of news in a near future.

In the United States, prolific research into online news provides more exhaustive evidence. Although a diversity of commercial and academic studies have resulted in some points of debate, there is a general agreement that the Web as a news medium has gone mainstream. In September 2001, the U.S. Census Bureau (2002) surveyed 57,000 households with more than 137,000 individuals to find that news, including weather and sports, was the third most dominant of the 15 listed activities, being used by 62% of Internet users (approximately equivalent to one-third of the population), just after e-mail (84%) and searching for products or services (67%). A year later in, September 2002, a Jupiter Research study of 4,341 Americans found news to be the sixth most popular activity on the Web, being consumed by 53% of the online audience (Greenspan, 2002). A study at the University of California at Los Angeles (UCLA) "Surveying the Digital Future" demonstrated that "reading news has consistently been in the third position of the most popular online activities with 55.6%, 47.6% and 51.9% of online users doing this in 2000, 2001 and 2002 respectively" (UCLA Center for Communication Policy, 2003).

The status of the Internet as a mainstream news medium in American life is incisively asserted in the Pew Research Center's influential biannual surveys on media usage, which have been conducted since 1994. The most recent survey (April 26 to May 12, 2002) of 3,000 American adults, shows that despite a general decline in American news usage between 2000 and 2002, online news consumption was up; 35% of the population (33% in 2000) logged on the Web for news at least once a week in 2002 (Pew Research Center, 2002). At the time of the survey, 15.5% of the American population received online news every day and an additional 10% examined online news three to five times a week — compared to 41% of the population reading a daily newspaper and only 13%

being readers of weekly news magazines. The picture is clear: The Internet as a news source, at the least, outpaces mainstream weekly magazines in the race for readers and is making inroads on print newspaper readership.

According to a survey of western industrialized nations, by July 2002, one in five Americans already felt that the Web was the "most essential" medium in their daily life — compared to 39% indicating television, 26% selecting radio and only 11% choosing newspapers (Rose and Rosin, 2002). More importantly, more than one-third of those aged 12-24 saw the Web as the most essential medium (while only 30% saw television and 27% radio); and nearly half of 12-to-34-years-olds viewed the Web as "the most cool and exciting" medium. In contrast, only two percent described newspapers in the same fashion (Rose and Rosin 2002). The implication is that this young generation, growing up with more skills, enjoyment and dependence in relation to computers and the Internet, will more and more rely on the Web as their source of news. The Internet is the news medium of the future in this sense. The print newspaper industry, therefore, faces a strategic dilemma; does it transition from a focus on print to on-line delivery (Sutel, 2006, July 15).

Although *The Daily Examiner* has been profitable over the recent past, there is concern by the Board of Directors that the 21st century demographic and technological changes have altered the traditional print media newspaper organizations. The results of a recent survey reveal the following *Daily Examiner* demographic readership statistics. Weekday readership stands at 47% of the total adult readership; Sunday readership stands at 55% of total adults.

Chief Executive Officer William “Bill” Rogers has been with the newspaper for 32 years, working his way from copy boy, print shop operator and supervisor, various other operational positions, then CEO for the last 8 years. Now that he is in the top leadership position in the company, Rogers is concerned about the future of the newspaper and its employees. In a recent meeting with his senior staff, Rogers stated “facing a challenge is one thing, but meeting it head-on is another. We are a well established regional newspaper, with modest growth. We find ourselves in a new millennium with technological changes occurring more rapidly than ever before. The industry in general, has experienced significant technological advances and we, too, must adapt to those changes if we are to survive in the 21st century.”

The new Chief Financial Officer (CFO), Stephen “Skip” Van Wart, is an unmarried, 37 year old, honors Wharton School M.B.A. graduate who specialized in Finance. CEO Rogers hired Van Wart because of his reputation as a strategic change agent for staid industries such as the newspaper industry. Although he has limited experience in the newspaper industry, Van Wart has initiated turnaround strategies in other companies. These turnaround strategies involved strategy revisions, selling off assets, cutting costs, or a combination of both. Since his arrival ten months ago, Van Wart conducted a study of all areas of the operation and analyzed the demographic trends in readership. The study concluded that *The Daily Examiner* faced a strategic dilemma, determining that two major changes were strategically necessary: 1) the newspaper must develop the online newspaper segment; and 2) the current printing operation should be outsourced. Tables 2 and 3 reflect the feasibility studies data**.**

Table 2: Feasibility Study for Maintaining In-House Printing Operation vs. Outsourcing	
Option A: To Maintain Printing Operation In-House	Percentage of Unit Cost ($.85/unit)
Materials	52%
Salaries, Benefits & Payroll Taxes	24%
Warehouse & Shipping	12%
Repair & Maintenance	5%
Equipment Lease	5%
Fixed Allocated Costs	2%
Option B: Outsource Printing Operation	Unit costs
Contract Fee @8MM-10MM units	$.88/unit
Contract fee @ 10MM-12MM units	$.80/unit
Unit sales price = $1.00	

Table 3: Feasibility Study for Continuing Printing Equipment Lease vs. Breaking the Lease Agreement	
Option A: Continue Printing Equipment Lease Agreement	Option B: Break Lease Agreement
5% of unit cost	Attorney's fees and court costs $65,000
	Negative Public Relations (estimated @ loss of 15% readership; 15% profit margin)

Skip calls the new company plan the Strategic Initiative 2013. The conclusions of the study are based on the increasing age demographic of the Daily Examiner readership, growing online market as well as the opportunity to reduce what are could become excessive operational costs, i.e. capital outlays in replacing the printing presses. While the two conclusions of the study are independent recommendations, they are also related. In order to create an online presence for the paper, resources will need to be diverted from other segments of the company. Any potential cost saving that might result could be allocated to the creation of an online presence.

Unlike previous downsizing efforts that targeted a percentage cut in each department, this time around, however, the 5-year strategic plan calls for actual restructuring of departments in an effort to impact product line expansion efficiency and costs savings. Due to aging equipment which would have to be replaced and a decline in the number of contracts for outside printing the study indicated that the printing operation should be eliminated. Therefore, the elimination of the printing department and the departments that support the printing operation are targeted for outsourcing within the first 18 months of the 5-year strategic plan. However, the plan has hit a snag—the lease agreement on one of the printing presses has 3 more years left. The company's attorney fears that breaking the lease would most likely cost more in both legal fees and negative public relations than the cost of the lease even though she believes that she can win the lawsuit.

Other issues face the company as well. Roughly 30% of the workers at the newspaper would be affected by the outsourcing of the printing operation. Many of these individuals have been with the newspaper a long time. Some of the most loyal and dedicated employees have been in the Print Shop for many years. In fact, the most senior worker, Bill "Buck" Johnson, continues to work in the Print Shop; he and CEO Rogers worked together in the Print Shop for over a decade where he apprenticed under Buck, who served as a mentor, thus starting a life long friendship. During those years, the print shop efficiencies increased at a compounded rate of 34% partly a result of newer technologies, but also because of worker productivity. The Print Shop has been recognized throughout the company as the unit with the highest, consistent worker productivity and morale/satisfaction levels. However, it is through the hard work of Buck and the staff that worker productivity is high, the overall productivity has declined due to the aging of the printing presses and their constant need for attention and repair. Those once state of the art technologies have now significantly aged and need replacement in order to maximize productivity. Regaining that high productivity will mean significant capital expenditures. As CEO Rogers reflects upon his years in the Print Shop, he remembers the strength of the interpersonal relationships among coworkers that continues to this day. He and Buck remain close personal friends; their families grew up together. Due to the company's profit sharing program, Buck is the largest single stockholder with 5% of the stock of the employee owned corporation. He has been with the newspaper for 39 years starting part-time as a runner, and then moved into the print shop holding several operational positions, and now serves as department manager. Buck has always been a strong advocate for the print shop. He is the one who advanced the proposal to purchase the new printing presses. Since he has spent his entire adult life in the Print Shop, it is likely that he will be devastated when he learns of the plans to dismantle the printing department.

It was a long, long weekend for CEO Rogers, as he weighed the options in finalizing a decision regarding his recommendations for the future of *The Daily Examiner*. After Rogers read and re-read the materials he brought home, he made his decision late Sunday night. However, he decided to sleep on it before he announced his decision. It is now 2 a.m. Monday morning and Bill Rogers can't fall asleep. He has been tossing and turning for the last two hours, as a number of thoughts keep running through his head. Among those thought are: While the movement to an online presence seems inevitable, must it be done now? If not, then when? Would an 18 month delay put the paper too far behind? Is there a way to establish an online presence for the paper without shutting down the printing department? Are the cost savings of outsourcing of the printing operations worth the potential negative consequences? The newspaper prides itself as an employee-friendly company and a community partner. How does the company downsize in a caring and compassionate way without alienating the entire employee group and creating a negative public image of the newspaper within the community, its readership, and its advertisers? Would any negative public image also affect the company's strategic plan to expand into the online newspaper segment? Could printers be retrained to work in the online environment? How would the employees react to the changes? How would the plan to eliminate the printing department affect his lifelong friendship with Buck? As an employee owned company, would Buck, who is the single largest stockholder and the other operations workers, who together own 42% of the stock initiate an internal fight to prevent the elimination of the printing operation? How would the act of presenting the initiative, even if he did not recommend it, affect his credibility? How would it affect Skip's credibility? Would the new CFO be targeted as the source of the changes? Would rumors about the initiative creative a negative public image? Although the company was financially strong, might consideration of downsizing start rumors of bankruptcy? Considering the impact of the implications of his impending decision, it is not surprising that Rogers was having difficulty sleeping.

While he finally dozed off, he was not at all certain of whether he would recommend the initiative or not: do we reject the initiative and stay true to our historic roots and support our long serving employees, or do we adopt the initiative and make radical changes in order to meet perceived future needs? That would be a decision he would make in the morning.