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LETTER FROM THE EDITORS

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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*.

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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

INCOME SMOOTHING: MANAGEMENT CONSEQUENCES AND AUDITOR RESPONSIBILITES IN THE CASE OF BEAZER HOMES

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Aamer Sheikh, Quinnipiac University
Kathleen Simione, Quinnipiac University

CASE DESCRIPTION

The primary subject matter of this case concerns auditor responsibilities when their clients engage in earnings management to achieve income smoothing. Secondary issues examined include internal controls, the accounting for sale-leaseback transactions, the impact of Sarbanes-Oxley (SOX), and the role of industry-level risk assessment in audit planning. The case requires students to access and review U.S. Securities and Exchange Commission (SEC) documents filed by and regarding Beazer Homes USA, Inc. The case has a difficulty level of four or five and can be used in either undergraduate or graduate auditing courses. The case can also be used in advanced financial accounting, financial statement analysis, or accounting research courses in accounting masters degree programs. The case is designed to be taught in two class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

This case provides students with a real world example of alleged income smoothing and its consequences. Students learn how earnings were allegedly manipulated, why they were allegedly manipulated, and what the ultimate results of these alleged tactics were for the company. They are asked to analyze the earnings management techniques used and identify ways in which the auditors might have identified the activity and how their audit planning could have been modified given the industry-specific risks and the requirements of SOX. The case raises issues related to internal controls, auditor responsibility and professional and ethical principles and standards.

INTRODUCTION

Beazer Homes USA, Inc. (Beazer Homes) has been accused of using specific earnings management techniques to smooth income. Income smoothing is the result of carefully managing earnings (net income) to show a smooth, steady growth in earnings each year rather than dramatic ups and downs. Companies with volatile earnings are considered to be more risky and therefore less valuable than companies with stable patterns of income growth. Earnings management practices include understating income during good periods by deferring income or accelerating expenses and overstating income during bad business years by accelerating income or deferring expenses. In this case, you will learn about Beazer Homes, the home building industry in general, and income smoothing in general. Then you will learn how Beazer Homes allegedly used specific earnings management practices to smooth its income. You will then be asked to answer questions about the actions and responsibilities of Beazer Homes' top management team and its independent auditor.

BEAZER HOMES

Beazer Homes builds and sells predominately single-family residences in 17 states across the United States. In recent years, the company has been ranked consistently as one of the top ten residential home builders in the country, based on number of homes built and sold (Beazer Homes, 2002; Beazer Homes, 2005; Beazer Homes, 2008).

Beazer has grown continually since its 1985 entry into the U.S. residential housing market. The company has followed a strategy of doing business primarily in communities that have higher than average population growth and builds homes in a price range that appeals to first-time home buyers or buyers making their first move to a better home. Beazer also sells title insurance in some markets and, until February of 2008, offered home mortgage loans through a finance subsidiary. Beazer's success has led to its many homebuilding honors and awards and its listings as one of *Forbes 400 Best Big Companies* in 2005 and 2006 and as one of the *Forbes Global 2000* in 2005, 2006 and 2007 (Funding Universe, 2009; Hoover's, 2009).

The company started as Beazer PLC, a home builder in the United Kingdom. Beazer Homes entered the U.S. residential housing markets in 1985 with the purchase of Atlanta home builder, Cohn Communities. Shortly thereafter the company acquired two more home builders in the Southeast. The company continued its expansion with the purchase of additional home builders and a number of other related companies in the building industry, including Gifford-Hill, a Dallas cement producer; Tidewater Construction, a heavy construction contractor; and Koppers, a major producer of construction materials in Pittsburgh. The Koppers acquisition was a hostile takeover which led the company into several court battles with Kopper's management and investors. However, Beazer eventually raised its offer price enough to pacify the objections and acquired the company in 1988 (Williams, 1988).

The Koppers acquisition, financed completely with bank loans, gave Beazer Homes a strong presence in the U.S. construction market, but saddled the company with substantial debt just in time to face the declining housing markets in both the United Kingdom and the United States in the early 1990s. After several years of negotiating with banks regarding repayment plans for this debt, the company was acquired by Hanson PLC, a British company. Hanson PLC spun off Beazer homes in 1994 and the company went public later that year as an independent, U.S.-only home construction conglomerate (Lurz, 1994; *New York Times*, 1994).

As the U.S. real estate markets improved, Beazer Homes made additional acquisitions were made that expanded Beazer Homes into new regions in the Southeast, Mid-Atlantic, and West. By 2000 the company was selling about 8,000 homes each year and by 2005 they were selling more than 18,100. However, the real estate crisis, the general recession, and the near-collapse of the financial markets hit all major home builders hard. Beazer Homes was not immune to these industry trends and the company's sales dropped dramatically to 7,700 homes in 2008 (Funding Universe, 2009).

THE RESIDENTIAL HOME BUILDING INDUSTRY

The U.S. residential home building industry has gone through several dramatic business cycles in the last two decades. In the early 1990s, the industry was at a low point. The 1990-1992 recession had battered home builders and house prices in many local markets were at ten-year lows. The market took several years to recover, but as the economy grew in the 1990s, home builders participated in that growth. Areas of the country that saw rapid increases in population, especially parts of the Southeast and the Southwest saw equally rapid growth in the home building industry. Las Vegas and Phoenix were notable growth areas for home builders (Joint Center for Housing Studies, 2000).

The economic slowdown of 2000-2002 caused a temporary pullback in home construction, but as that recession ended and the Federal Reserve Bank held interest rates at an historically low level to increase the pace of economic recovery, home building was one of the prime beneficiaries. When the economy strengthened and interest rates increased, the housing markets continued to grow because changes in the structure of mortgage lending industry made money readily available to borrowers who were not well qualified by historical lending standards (Joint Center for Housing Studies, 2009).

When house prices began to decline in 2007, borrowers struggled to make payments on loans, many of which had payment escalation features, that they could no longer afford. Consequently, the number of loan foreclosures climbed rapidly (Joint Center for Housing Studies, 2009). As the credit markets and the economy deteriorated, home prices fell precipitously. This caused a significant drop in home building activity. According to the U.S. Census Bureau, housing starts in May, 2009 were down by more than 37% and completions decreased by almost 27% over the previous year (U.S. Department of Commerce, 2009). The downturn in home building has forced many companies in the industry to cut back construction, hiring, and investment. A growing number of these companies have entered bankruptcy proceedings or gone out of business. Although the survivors look forward to increases in housing starts in the future, that future still looks uncertain today (Professional Builder, 2009).

INCOME SMOOTHING AND EARNINGS MANAGEMENT

Companies with volatile earnings are considered by investors to have higher degrees of inherent risk than companies that report earnings that grow in a steady pattern, showing regular increases every year. Because of the increased level of risk perceived as inherent in companies with volatile earnings increases and decreases, the stock of those companies trades at a discount relative to the stock of companies with smooth and steady earnings growth (Brigham and Ehrhardt, 2007). Income smoothing is the result of carefully managing earnings (net income) to show a smooth, steady growth in earnings each year rather than volatility (Buckmaster, 2001).

Earnings management has received a great deal of scrutiny over the years. Researchers often focus on the factors that motivate earnings management. Many studies (see, for example: Bergstresser and Philippon, 2006; Cheng and Warfield, 2005; Cohen et al, 2008; Cornett et al, 2008; Dikolli et al., 2009; Laux and Laux, 2009; Skousen et al, 2007; and Weber, 2006) have examined the relationship between managers' compensation (in the form of both salary and stock options), and earnings management. The results of these research studies indicate that managers of these firms cause the firms frequently to report manipulated earnings numbers that meet earnings targets (which gives the managers bonuses or other incentive compensation) or the expectations of financial analysts.

Earnings management can also be used to understate earnings in good years and overstate earnings in bad years. This income smoothing strategy reduces variability in reported earnings. Revenues and expenses are shifted between accounting periods. Firms report higher revenues and/or expenses in some periods and lower in other periods, effectively shifting net income from successful periods to less successful periods. Firms use income smoothing to temper income volatility and reporting very good or very bad earnings in any given year. Reporting a stable income is more likely to instill and maintain the confidence of stakeholders (Healy and Whalen, 1999) particularly investors (Fogarty et al, 2008), lead to higher market valuations (Bitner and Dolan, 1996) and gives managers a way to meet bonus or incentive compensation plan targets when the company's actual performance would leave them short (Goel and Thakor, 2003). It follows then that the average rate on return on stockholder equity for smoothing firms is significantly less than the returns of non-smoothing firms (Tseng and Lai, 2007). Although the incidence of earning management appears to have declined in the wake of the enactment of laws, such as SOX, that make managers specifically responsible for the veracity of their financial statements (Cohen et al, 2008), the combination of the pressure to report better earnings every year and the discretion that generally accepted accounting principles (GAAP) provide, it is not surprising that many managers engage in this behavior.

GOVERNMENT INVESTIGATIONS OF BEAZER

The investigations of Beazer Homes began with a series of investigations by the U.S. Department of Housing and Urban Development, the civil division of the U.S. Department of Justice, and the North Carolina Real Estate Commission into irregularities in its mortgage lending business. These investigations ultimately alleged that Beazer Mortgage Corp. engaged in fraudulent mortgage origination activities (Kendal and Lynch, 2009). These included requiring purchasers to pay interest discount points at closing, but then keeping the cash and failing to reduce the loan interest rates; providing cash gifts to borrowers to use as down payments through charities it controlled, assuring the borrowers the gifts would not need to be repaid, then increasing the homes' purchase prices to offset the amounts of the gifts.

To settle these charges, Beazer agreed to close its mortgage lending business and pay $5 million in fines to the government. It also agreed to pay up to $48 million in damages to the victimized borrowers (*National Mortgage News*, 2009).

SEC Investigations and Actions

Shortly after the investigations of Beazer's mortgage business were announced, the SEC began an informal inquiry into violations of Federal securities laws at Beazer Homes. In 2007, the SEC inquiry became a formal order of investigation (*Wall Street Journal*, 2007).

The alleged accounting irregularities stemmed from abusive earnings management that resulted in fraudulent misstatements of net income over a multi-year period. Specifically, the SEC alleged that improper recording of Beazer's cost of goods sold for land development and house costs and improper revenue recognition in accounting for sale-leaseback transactions caused a material and fraudulent misstatement of net income (Corkery, 2008).

By the time the SEC had completed their investigation, Beazer found itself charged with submitting materially false company filings for years 2001 through 2007. Specifically, Beazer was charged with the fraudulent misstatement of net income for the purpose of improperly managing its quarterly and annual earnings. Although never admitting or denying the SEC allegations, Beazer Homes did reach a settlement with the government. As part of that settlement, Beazer adjusted and restated its financial statements for the fiscal years 1998 through 2006 and the first two quarters of fiscal year 2007 (Corkery, 2008). The company also consented to the entry of a cease and desist order for future violations. The SEC noted both Beazer's remedial actions and its cooperation as factors in reaching the settlement (SEC, 2008).

The consequences for Beazer Homes of these problems have been significant, especially when combined with the general malaise in the home building industry. Beazer's stock price reached a high of $79.12 on January 13, 2006; in 2009, the stock consistently traded below one dollar per share, hitting a low of $0.25 on March 9, 2009. Beazer Homes announced that its chief accounting officer (CAO), Michael T. Rand, was terminated as a result of his alleged efforts to destroy documents related to the SEC investigation. The SEC filed a separate complaint against Rand after settling the charges with Beazer Homes (SEC, 2009). The SEC alleges that Rand's misconduct led to inflated reserves and other accrued liabilities in earlier periods. Further, the complaint alleges that Rand's conduct was intended to maximize bonuses and meet or exceed analysts' expectations. In effect, the SEC in this complaint is holding Rand accountable for all of the charges made against the company.

Specific Alleged Accounting Irregularities

According to SEC (2009), Rand's scheme to manage the earnings of the homebuilder was multi-faceted. The first part of the scheme involved manipulation of the land inventory accounts. As Beazer constructed its subdivisions, costs accumulated in the land inventory accounts were allocated to individual home lots. When the home was later sold, the allocated costs in the account were expensed as a cost of sale.

From 2000 to 2005 Beazer over-allocated land inventory costs in material amounts that gave it excessive reserves and other accrued liabilities in violation of GAAP. This caused Beazer to understate income by a cumulative total of $42 million between 2000 and 2005. Beginning in 2006, the over-allocations were reversed, causing an overstatement of income of $17 million in 2006 and the first two quarters of 2007 (SEC, 2008; 2009).

In another part of the scheme, the "house cost to complete" reserves were manipulated in a similar manner. The company established a reserve for completed homes to cover minor expenses such as small repairs or final cosmetic touchups. Typically, the reserve was $2,000 to $4,000 per home. Within nine months after a sale, Beazer would close out that house's reserve with any remaining amounts taken to income. From 2000 to 2005 the reserve was over-allocated, which resulted in an understatement of income. Beginning in 2006, the scheme was reversed; amounts over-reserved in earlier periods were taken into income, which created an overstatement of income. The cumulative result was an understatement of net income of $6 million between 2000 and 2005. After the reversal of the scheme in 2006, Beazer overstated net income by $1.2 million. In the first two quarters of 2007, Beazer overstated its net loss by $1 million (SEC, 2008; 2009).

Yet another part of the alleged earnings management scheme involved sale-leaseback transactions. In a sale-leaseback transaction, a property owner sells the property and then leases it back from the buyer. The seller receives cash and retains possession and use of the property. The buyer generally benefits by acquiring the property at a price lower than market value. The buyer also receives periodic payments as well as any tax benefits of ownership.

In the time under investigation that preceded 2006, Beazer owned most (70-80%) of its model homes. The models it did not own were financed using sale-lease back arrangements with third parties. Revenue on these transactions was recognized in full at the beginning of the lease term. Near the end of 2005, however, Beazer entered into several sale-leaseback transactions that included written side agreements in which Beazer retained the right to a percentage of the appreciation on the home up through the time of its eventual sale. Beazer's independent auditor advised Beazer that the substance of these transactions outweighed their form and that Beazer would have to account for them as financing transactions, which would preclude Beazer from recording the sales as revenue at the beginning of the lease term. To avoid this accounting treatment, Beazer is alleged to have included the appreciation rights in oral side agreements, which it allegedly did not disclose to its auditors. The alleged resulting overstatement of revenues was $117 million and net income was allegedly overstated by $14 million (SEC, 2008; 2009).

Section 404 of the Sarbanes-Oxley Act of 2002

The various SEC filings summarized above tell us what type of earnings management is alleged to have occurred, why it happened and the specifics of how it is alleged to have happened. However, these documents do not tell us how this could have occurred given Beazer Homes' system of internal controls, particularly after the implementation of SOX Section 404. Section 404 calls for public companies' annual reports to include both "(1) a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) management's assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting" (SEC, 2003).

Section 404 also requires "the company's auditor to attest to, and report on management's assessment of the effectiveness of the company's internal controls and procedures for financial reporting in accordance with standards established by the Public Company Accounting Oversight Board" (SEC, 2003).

QUESTIONS

Most of these questions will require that you do research beyond reading the case. You can use the resources of your library and the Web, especially the SEC Web site, to conduct this research. Your instructor might recommend specific resources for particular questions.

1. Did any of the officers of Beazer Homes, other than the CAO, face consequences as a result of the company's settlement with the SEC?

2. Why did Beazer Homes' management fire their CAO for destruction of documents rather than for carrying out the alleged accounting irregularities?

3. Most auditing textbooks outline procedures for identifying accounting irregularities that overstate income, such as recording revenue from fictitious sales. How are the alleged earnings manipulation schemes at Beazer different from the irregularities you have discussed in your auditing classes?

4. What are the most likely reasons that Beazer engaged in the alleged accounting irregularities?

5. Is it possible to identify a pattern of earnings management in Beazer's restated earnings?

6. Did the passage of the Sarbanes-Oxley Act of 2002 appear to have any impact on the alleged accounting manipulations at Beazer Homes?

7. Why did Beazer's independent auditor raise concerns over the accounting for the sale-leaseback transactions that had written side agreements giving Beazer an interest in the appreciation of the model homes it sold and leased back?

8. What could the independent auditors have done to detect the alleged earnings management at Beazer Homes?

9. What specific audit standards apply to earnings management and what is the auditor's responsibility under those standards?

10. What were the specific effects on the financial statements of the restatements to which Beazer agreed?

11. Some accounting researchers have argued that companies in some industries might be more likely than companies in other industries to engage in income smoothing. Do you believe that companies in the home building industry would be more likely tempted to engage in income smoothing? If so, explain why. Also outline how a higher likelihood of firms engaging in income smoothing should affect audit planning.

DISCLAIMER

This case was written using publicly available information to provide a setting for student learning. It is not intended to provide commentary on or evaluation of the effectiveness or appropriateness of any party's handling of the situation described.

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CAUTIONS WHEN USING WORKING CAPITAL METRICS TO ASSESS FIRMS' FINANCIAL HEALTH

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Martin L. Gosman, Quinnipiac University

CASE DESCRIPTION

The primary subject matter of this case explores expectations regarding short-term liquidity across different industries. Secondary issues examined include working capital management and signals of working capital efficiencies. The case requires students to interpret varying working capital and liquidity ratio levels across companies. This case has a difficulty level of two, three, or five; the case is appropriate for financial accounting principles, introductory financial management, intermediate accounting, and introductory financial accounting for MBAs. This case is designed to be taught in one hour of class time and is expected to require one hour of outside preparation by students.

CASE SYNOPSIS

Using data from Bon Ton Stores, TJX Companies, Wal-Mart Stores, Brinker International (Chili's) and Southwest Airlines, students learn about basic liquidity analysis. Students will observe significant differences in key liquidity metrics both within and across industries. Students will consider the overall liquidity positions of the firms by comparing their working capital levels and their current ratios. Students will identify the driver of the differences in the current and quick ratios, and will explore issues in managing working capital. In the process, they will uncover some surprising findings. Some working-capital metrics may look good while hiding deficiencies that can be revealed by further analysis. Similarly, working-capital metrics may look bad, but further digging uncovers efficiencies. The case also highlights the interesting tension that exists between a lender's perspective about liquidity (more is better) versus a company's desire to increase profitability, which necessitates efficiently managing its working capital.

INTRODUCTION

Liquidity refers to an entity's ability to meet its short-term financial obligations with cash and near-cash assets as those obligations become due. The downturn in the global economy and the recent distress in the financial markets have resulted in volatility in the capital markets and diminished liquidity and credit availability. Retailers may find that this macroeconomic decline affects consumer confidence, and consequently impacts sales and cash flows from operations. In response, retailers must continue to focus on maintaining a strong balance sheet with adequate liquidity. Dwindling liquidity can lead to greater risk for creditors and investors and increase the chance of bankruptcy.

Business viability relies on effective working capital management. Working capital is the difference between current assets and current liabilities. Current assets include cash and resources that a company expects to convert to cash, sell, or consume during the next 12 months (or within the normal operating cycle if that is longer than a year). Similarly, current liabilities include accounts payable and other commitments for which resources must be sacrificed within the next year. Conventional wisdom suggests that current assets can give rise to the cash needed to pay current liabilities, so the relationship between current assets and current liabilities is important. Business success relies on the effective management of cash, receivables, inventory, and payables (the primary components of working capital). Working capital management is a key aspect of corporate finance and accounting since it affects the profitability and liquidity of a company. In industries where current assets are a relatively high percentage of the total assets of the organization, the management of these short-term resources is particularly critical.

Working capital has limitations as a measure of a firm's ability to pay its bills. First, the absolute difference between current assets and current liabilities is not a meaningful metric when comparing companies of different sizes. Second, it conveys nothing about the composition of the current assets, some of which may not be quickly converted to cash. Finally, firms that generate sizable cash from operations are able to settle their current liabilities without liquidating non-cash current assets.

The current ratio is the most frequently used measure of liquidity and it allows for comparison of firms of different size (Hitchner, 2006). The current ratio is calculated as current assets divided by current liabilities. It indicates the ability of a company to pay its short-term creditors from the realization of its current assets. A 2002 study found the current ratio to be the financial covenant most often included in loan agreements (Dichev and Skinner, 2002).

Other things being equal, the higher the current ratio, the more assurance creditors have that they will be paid in full and on time. Many decades ago, the rule of thumb for a desirable current ratio was at least 2.0, indicating $2 of current assets for each $1 of current liabilities. However, firms have increasingly come to realize that excessive investments in working capital can tie up funds that could be used profitably to invest in new products, corporate acquisitions, or other expansion projects. Also, firms' successful efforts in achieving inventory efficiencies and delaying payments to suppliers have allowed many firms to operate satisfactorily with less of an excess of current assets over current liabilities. A firm with a current ratio of less than 1.0 is one that operates with negative working capital (current liabilities in excess of current assets).

The quick ratio (acid-test ratio) addresses the second limitation associated with working capital. As compared to the current ratio, the quick ratio excludes inventory and potentially other less liquid assets such as prepaid expenses from the numerator of the ratio. This reduces the risk of drawing inferences about liquidity that may be misleading due to slow moving or excessive inventory. Thus, essentially the quick ratio divides the sum of cash, marketable securities (short-term investments that are intended to be quickly converted to cash), and receivables by current liabilities. So it examines the availability of assets that can convert to cash typically within 90 days relative to current liabilities.

In part, analysis of working capital is engaging because of the possible mixed signals that the balance sheet data can convey. Inventory may grow in order to meet an increase in demand by customers. Alternatively, inventory may grow if sales have slowed but the firm has not adjusted quickly to the declining sales. Holding too much inventory leads to excessive carrying costs for the inventory (storage, insurance, and financing) and an increased chance for obsolescence. So the analysis of working capital involves reflection rather than simply a superficial application of rules of thumb.

Further complicating the analysis is the tension between the perspectives of different entities that care about an organization's liquidity. Creditors to whom a firm owes money are likely to view measures of liquidity from a perspective of "the more, the better" since a greater cushion may reflect higher credit quality or a lower risk of non-repayment. But managers within a firm seek a beneficial balance between each of the working capital components so as to balance risk and efficiency (Eljelly, 2004). A high level of current assets may reduce liquidity risk (the inability to meet short term obligations as they become due). But an excessive level of current assets reduces a firm's return on investment or profitability. Thus, determining an appropriate level of working capital may be very difficult. But a helpful starting point is to learn to anticipate how the nature of a firm's operations will affect the sufficiency of its working capital and its current ratio or quick ratio. Analysis and discussion of the data for firms featured in Table 1 will help develop an understanding of those factors that are important to equity and credit analysts. Balance sheet data are as of year-end unless labeled as an average for the year.

Table 1: Selected Financial Data – Fiscal Year 2010
Bon Ton Stores, TJX, Wal-Mart, Brinker International, and Southwest Airlines

Company	BON TON	TJX	WAL-MART	BRINKER (CHILI'S)	SOUTHWEST
Line of business	Discount Department Store	Discount Department Store	Discount Department Store	Restaurant	Airline
Quick assets	$16,339,000	$2,018,159,000	$12,484,000,000	$389,764,000	$3,733,000,000
Inventory	$682,324,000	$2,765,464,000	$36,318,000,000	$26,735,000	Not applicable
Current assets	$777,081,000	$5,099,527,000	$51,893,000,000	$501,067,000	$4,279,000,000
Current liabilities	$413,871,000	$3,133,121,000	$58,484,000,000	$449,877,000	$3,305,000,000
Working Capital	$363,210,000	$1,966,406,000	($6,591,000,000)	$51,190,000	$974,000,000
Current ratio	1.88	1.63	0.89	1.11	1.29
Quick (acid-test) ratio	0.04	0.64	0.21	0.87	1.13
Net sales	$2,980,479,000	$21,942,193,000	$418,952,000,000	$2,858,498,000	$12,104,000,000
Cost of goods sold	$1,860,182,000	$16,040,461,000	$315,287,000,000	$816,015,000	Not applicable
Cash flow from perations	$141,135,000	$1,976,481,000	$23,643,000,000	$297,402,000	$1,561,000,000
Average inventory	$670,861,500	$2,648,891,000	$34,515,500,000	$30,290,000	Not applicable
Average current liabilities	$406,974,500	$3,014,053,500	$57,013,500,000	$434,189,500	$3,000,000,000

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ACCOUNTING FOR REVENUE AND THE FASB/IASB CONVERGENCE PROJECT: A CASE STUDY EXPLORING THE NEW EXPOSURE DRAFT

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CASE DESCRIPTION

The primary subject matter of this case concerns significant changes to revenue recognition that are proposed under the joint exposure draft issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) as part of their convergence efforts. The case focuses on fundamental changes to the revenue recognition model and potential changes to the timing and measurement of revenue and related transactions such as product or service warranties, merchandise returns, uncollectible accounts, and multiple deliverables.

Secondary, strategic business and ethical considerations that companies and accounting professionals should consider are explored. This case has a difficulty level of three to four and can be taught in about 40 minutes. Approximately two hours of outside preparation are needed for students to address every question. The case can be used in an Intermediate Accounting course to help students understand the expected changes to revenue recognition and the financial reporting issues that may arise, but can also be utilized in a more advanced course by focusing on the strategic business issues. The case has technical, analytical, and research aspects. Utilizing this case may enhance students' communications skills.

CASE SYNOPSIS

Accounting for revenue and sales/service related transactions will change significantly. In June of 2010, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly issued an exposure draft that will change accounting for revenue and related transactions under both U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The exposure draft, which introduces a five-step performance obligation model, proposes significant changes to the measurement, classification, and potentially, the timing of recognition of revenue and related transactions, such as warranty costs, returns and allowances, provisions for uncollectible accounts, and multiple deliverables. This case focuses on the key issues that are common and important to most business entities.

Because of the importance of revenue and the expected significant changes to revenue recognition, accounting students must begin to learn about these changes, understand the potential effect on financial reporting, and become aware of the business and ethical issues that may arise. Educators play an important role in helping students accomplish these goals. This case focuses on the new revenue recognition model, provides an overview of key changes to *current requirements that are proposed under the new exposure draft, and explores strategic business as well as ethical considerations.*

This case can be utilized in an Intermediate Accounting course focusing primarily on the technical accounting, financial reporting and ethical issues, or in an advanced course focusing primarily on the strategic issues. The case includes questions that can be addressed using the case specific information, but also includes questions that require research. Using this case can enhance students' critical thinking, research, analytical, and communications skills.

INTRODUCTION AND BACKGROUND

Recognition of revenues and related issues will soon be changing. On June 24, 2010, the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly issued an exposure draft (ED) entitled, "Revenue from Contracts with Customers" (FASB & IASB, 2010). The changes proposed in the ED will significantly affect revenue recognition and the recognition of sales and service related issues and transactions for many entities in the U.S. as well as in the nearly 120 nations that currently utilize International Financial Reporting Standards (IFRS).

The revenue recognition ED was issued as part of the FASB/IASB convergence project. The primary objective of the convergence project is to eliminate differences between U.S. GAAP and IFRS and to facilitate the development of high quality global financial reporting standards. (FASB & IASB, 2002). The Boards identified revenue recognition as one their priority projects (FASB & IASB, 2010) and intend to issue a final standard during 2011. Once a final standard becomes effective, it will supersede all revenue related standards under both U.S. GAAP and IFRS.

A target effective date, on which companies must start applying the new requirements, has not yet been announced. However, because of the critical importance of revenue, the significant changes proposed in the ED, and the potential effect on companies' financial statements, accounting educators should already start preparing their students for the expected changes. Educators should focus on the conceptual differences between the current and the expected revenue recognition rules and explore the proposed requirements for transactions and events that are common to many business entities and industries.

This case deals with a hypothetical telecommunication company and has several important aspects. The case introduces students to the fundamental changes to revenue recognition, compares current and proposed accounting treatments, and explores strategic as well as ethical considerations that companies and accounting professionals must consider.

Case-specific as well as research-based questions are included in the case. Each question is independent and can be assigned without loss of related context or continuity. The case has technical accounting, critical thinking, analytical, research, ethical, and communications aspects.

THE CASE*

Company Background

Margot Johansson is the Controller of Vielfalt Corporation, a global telecommunication company that is headquartered in the U.S. The consolidated entity holds majority ownership in fourteen consolidated subsidiaries; nine of these subsidiaries are located in Europe, two in Asia, and three in the U.S. All of the company's European and Asian subsidiaries prepare their financial statements consistent with International Financial Reporting Standards (IFRS). As the head of the accounting department, Margot is responsible for the reliability of the financial accounting and reporting system and the preparation of the consolidated financial statements. Preparation of the consolidated financial statements is a complex process, involving foreign currency translation of the subsidiaries' financial statements, conversion of the subsidiaries' IFRS-based financial statements to U.S. GAAP, and completion of the complex consolidation process.

Margot is very aware of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board's (IASB) convergence project. She keeps abreast of new developments and consistently disseminates new information available on the Boards' project links such as discussion memorandums, exposure drafts, and project updates. She also regularly participates in related web seminars sponsored by the large public accounting firms and in FASB and IASB podcasts.

Margot's management strategy is to delegate responsibility to her senior and midlevel staff as see deems appropriate. She also is committed to helping her junior accounting staff develop their professional knowledge. She has nurtured an environment of high ethical conduct, which allows her to delegate effectively. Every few months, Margot holds seminars on new accounting issues for her accounting staff. Her objective in holding these seminars is to inform and instruct her staff on new issues and also to reinforce the importance of ethical financial reporting. All members of the accounting staff are encouraged to participate in her seminars.

Margot knows that the proposed requirements of several recent exposure drafts that were issued jointly by the FASB and IASB may significantly affect Vielfalt Company's financial accounting and reporting, and potentially its financial results once a final standard is issued and implemented. After careful consideration, she believes that the FASB/IASB exposure draft entitled, "Revenue Recognition - Revenue from Contracts with Customers" will have the most pervasive impact on the company's financial accounting and reporting system. She decides to hold a seminar on revenue recognition for her staff on April 6, 2011.

The purpose of the seminar is to: (1) summarize the most important provisions of the FASB/IASB revenue recognition ED and identify the differences to current accounting practice, (2) explore the effect of some of the provisions on Vielfalt Company's timing and measurement of revenue, and (3) explore accounting issues and potential ethical considerations that may arise in applying the provisions set forth in the ED.

Selected Financial Information

The following information is extracted from Vielfalt Corporation's 2010 financial statements:

- Total assets: $ 25.5 billion
- Total liabilities: $15.2 billion
- Net Revenue: 12.8 billion
- Operating income: 920 million
- Controlling share of net income: 880 million

Business Environment and Strategies – Revenue Recognition

Contracts with Customers – Sales Channels

Vielfalt Corporation derives approximately 70% of its revenue from providing telecommunication services and 30% from the sale of telecommunications equipment. The majority of its revenue involves bundling of service and equipment. Sales and service contracts originate though two channels. Approximately 60% of the company's contracts involve direct contact with customers through internet or telephone order, or the company's many stores. The remaining 40% of the sales are originated indirectly through third party authorized dealers.

Returns and Cancellations

Customers can return or exchange equipment for a full refund within 30 days of purchase. Service contracts typically range from one to two years. If customers cancel their service prior to the expiration of their contract, the customer is charged an average cancellation fee of $185. In the past, returns and allowances were approximately six percent of sales revenue. Returned equipment typically can be used as replacement for effective equipment.

Product Warranties

Equipment typically is sold with a one-year limited warranty. Under this warranty, the company will replace or repair equipment that fails to perform as promised because of either latent or subsequent defects; the warranty specifically precludes coverage of defects resulting from accidental damage. In the past, repair and replacement of defective equipment covered by the warranty were between four and five percent of sales revenue.

Uncollectible Accounts

The company's strong accounts receivable department allows the company to minimize its risk of losses from unpaid customer accounts. In the past, uncollectible accounts were approximately three percent of net sales and service revenue.

Diversification Strategies

The company's board of directors recently decided to approve a proposed acquisition of a struggling commercial construction company. This acquisition is consistent with the company's planned diversification. Based on an analysis, the board believes that the construction company's stock is currently undervalued. Vielfalt's strong financial performance over the past decade and its positive cash flows allows the company to finance the acquisition by paying 45% of the acquisition price in cash and by issuing additional shares of Vielfalt's common stock for the remainder. The construction company currently is using the percentage of completion method for recognizing revenue.

Margot's Staff Seminar

During the seminar, Margot summarizes key points of the revenue recognition ED. An outline of the information presented during the seminar, which is based on the ED (FASB & IASB, 2010, 2011) is provided below.

<u>Background</u>

- Joint FASB/IASB Project
- Exposure draft (referred to as proposed Accounting Standards Update in the U.S.)
    - Issued June 24, 2010
    - Comment period ended Oct 22, 2010
- Boards plan to issue final standard by end of 2nd quarter of 2011
- Expected to replace IAS 18, IAS 11, and several interpretations
- Expected to supersede many different U.S. GAAP standards as codified in Accounting Standards Codification Topic 605

<u>Basic principle – model</u>

- Revenue recognized when contract asset increases (or liability decreases) in response to fulfillment of performance obligation
- Performance obligation model

<u>Five step performance obligation model</u>

1. Identify contract
2. Identify any separate performance obligations
3. Determine the transaction price
4. Allocate the transaction price
5. Recognize the revenue when the performance obligation is satisfied

<u>Step one – identify contract</u>

Contract may be:

- Written
- Verbal
- Implied

<u>Step two – identify any separate performance obligations</u>

- Separate performance obligations may be explicit or implied
- A separate performance obligation exists if it has a:
  - Distinct profit margin
  - Distinct function

Step three – determine the transaction price

- This is the amount of consideration expected to be received
- Includes several considerations
  - Probability of collectability
  - Time value of money
  - Any non-cash considerations
  - Consideration payable to the customer or client
  - Contingent and variable considerations

Step four – allocate the transaction price

- Allocate to separate performance obligations
- Use the respective stand-alone selling prices of each performance obligation
- Stand-alone selling prices can be estimated

Step five – recognize revenue

- Performance obligation must be satisfied
- Requires the transfer of control

Special Considerations

- Rights of return
- Product warranties and other contingencies
- May require significant estimation and judgment
- May result in differences (compared to current GAAP)

Right of Return

- Not considered a separate performance obligation
- Revenue recognized:
  - Only for goods or services not expected to be returned
  - i.e., excludes amount relating to return estimate
- Return estimate recognized as liability
- Related inventory cost is recognized as right of return asset (related cost of goods sold is recognized when return period expires)

Warranties

- Latent (existing) defects
  - Not a separate performance obligation
  - Revenue and cost of goods sold exclude estimated defective products
- Subsequent defects
  - Separate performance obligation
  - Allocate contract price

Uncollectible Accounts

- Estimate at time of sale

- Exclude estimated amount from revenue

To reinforce and assess their understanding and to qualify for continuing professional education credit, the seminar participants are asked to answer several questions. Some of the participants decide to further investigate the issues by conducting their own research.

ASSIGNMENTS

Pretend that you are a staff accountant working for Vielfalt Corporation. Your daily responsibilities include accounting for the revenue and receivable cycle. Answer the questions assigned by your instructor.

CONCLUSION

Because of the critical importance of revenue to business entities, significant changes to the recognition and measurement of revenue and related transactions are extremely important to accounting professionals and company executives. Accounting students must become familiar with the expected changes and understand the implications of these changes. This case can be used by accounting educators to accomplish these goals.

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AUTHOR'S NOTE

This is a fictitious case. Any similarities with real companies, individuals, and situations are solely coincidental.

SOCIAL MARKETING AND ROCK'N'ROLL: THE POWER OF THE U2 BRAND

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CASE DESCRIPTION

The primary goal of this case is to demonstrate an applied example of social marketing, covering topics of brand positioning, global targeting and positioning, global sponsorships, and social media. It is therefore targeted towards a Buyer Behavior or Global Marketing course at the undergraduate or graduate level, or a Principles of Marketing course at the graduate level. This case has a difficulty level 3-5. Students should be able to identify U2's product mix and brand image. Given the current shifts in the economy, students will be able to discuss strategic initiatives for U2, both on touring and social media avenues as they are planning the upcoming 30 year anniversary of their first album. Students appreciate the opportunity to study a popular rock band that works hard at promoting social causes. At the same time, there is room for effective class discussion and argument given the extraordinary operating costs and environmental impact of their current tour.

CASE SYNOPSIS

This case was written to demonstrate the power of social marketing in adding to the success of the band U2. The case first reviews the history of the Irish band up to their 2010-2011 360° tour and their rise to fame and concludes with questions on future decisions to be made. Keys to their success have been their focus on the U.S. market, their touring choices and their close relation to fans. From their early beginning, the band also chose to support various social causes, from fighting AIDS devastation, malaria and famines in poor developing Africa to the defense of human rights in Burma, to the protection of the environment. The case explains how U2 communicated about the causes they support via their web site and how they were integrated in their product delivery. Finally, choices of sponsors, whether global or local, are discussed. The conversation between Paul McGuinness, U2's manager, and the band demonstrates that all band members are involved in the planning process, marketing strategies, and are aware of the environmental impact and high cost of tour operations. The case ends with a conversation between the band and their manager as they are discussing future strategies.

INTRODUCTION

"I can't believe the news today
Oh, I can't close my eyes and make it go away
How long, how long must we sing this song?
How long, how long
Cause tonight
We can be as one tonight

Broken bottles under children's feet
Bodies strewn across the dead end street
But I won't heed the battle call
It puts my back up
Puts my back up against the wall

Sunday, bloody Sunday…"

> Paul McGuinness caught himself tapping his feet to the tune as he looked out to a crowd of more than 60,000 people dancing and singing in the rain. U2 was playing their third to last song on the set list before their encore at Luzhniki Stadium in Moscow, Russia the evening of August 25, 2010. He smiled in appreciation as he watched Bono and The Edge bring the crowd to a thunderous roar with their energy.
>
> "The Claw" stage with its video screen was an impressive site as well as a technological feat and the fans were having a great time. Paul was proud of their work on the *360°* Tour. There were still a number of concerts left on the European program before they moved on to Australia and then back to North America for the final leg in 2011.
>
> Paul remembered the release of "Sunday, Bloody Sunday" from the 1983 *War* album. At the time, he only had hopes that these lyrics would be an indicator of the future greatness of the band, not only for its musical talent but also for its stance against the ills of society.

Over the last 30 years, U2 has created an international community of fans through effective targeting strategies in their tours and a sophisticated social marketing approach. Songs such as "With or without you", "New Year's Day," "War," "I still haven't found what I'm looking for," "Pride (In the Name of Love)" and "Beautiful Day" have withstood several decades of change in the music industry and an ever evolving global marketplace.

While other bands and musicians from the same era have come and gone (most not breaking national barriers), "U2 is known for being super smart…Their rise was meteoric, but together they've carefully planned every step of the band's evolution, keeping all elements (stage show, videos, promo, packaging and PR—as well as the actual music) relevant" (Sampson, 2008).

> Paul was not a stranger to the entertainment industry, since, in his earlier years, he was the assistant director to John Boorman's "Zardoz". He was 26 years old when he met the members of the U2 band. He remembered, "I was the only one who could drive" (Olsen, 2005). "Sure we've made mistakes along the way but the lineup hasn't changed in 31 years. They are as ambitious and hardworking as ever, and each time they make a record and tour, it's better than the last time. They are doing their best work now" (McGuinness, 2008). Paul is also well known for his speech on digital music and the relationship that needs to exist between the technology and music industries. On numerous occasions, he has called on the music industry to protect the music distribution (illegal downloading) and fair contracts for musicians.
>
> Paul could hear the fans cheering as one as he made his way back to the staging area. He would let Bono rest before their debriefing session tomorrow. As he pulled on his jacket, Paul quickly added up the costs and benefits of the *360°* tour. Just tonight, the show was only 75% filled as Luzhniki stadium could hold over 80,000 people (www.stadiumguide.com). Paul was concerned over the growing costs of this extraordinary tour.

U2's History

The band U2, originally known as "Feedback," was formed in 1978 in Dublin, Ireland. Back then, and today, U2 consisted of four members:

- Paul Hewson (stage name 'Bono') on vocals
- Dave Evans (stage name 'The Edge') on guitar
- Adam Clayton on bass guitar
- Larry Mullen Jr. rounded out the percussion section.

The band hired Paul McGuinness as their band manager in 1979. After several failed attempts, it was McGuinness who managed to sign U2 with Island Records, whose artists included Bob Marley and the Wailers, Roxy Music, Jimmy Cliff, Robert Palmer, Melissa Etheridge, and Nine Inch Nails (U2 A De-Lux Excursion[c], 2009). Island Records continues to be U2's label today.

Paul McGuinness recognized early on the importance of cracking the American market (The Escape Pod, 2009). To ignore the UK market was unorthodox at the time, but McGuinness understood that America was the key strategy to mass marketing the newly created band. This approach was not unknown territory since it worked earlier for “super-groups” like the Rolling Stones and The Beatles. Table 1 shows performance locations for U2’s early years.

Table 1: U2 Early Performance Locations 1978 – 1989

Country	Performances
Australia	2
Belgium	1
England	56
Ireland	83
Japan	2
Netherlands	2
New Zealand	1
Scotland	3
Spain	1
USA	36
Grand Total	**187**
Source: http://www.u2gigs.com	

U2 was labeled “The Band of the 80’s,”and "Rock's Hottest Ticket" (Rock's Hottest Ticket, 1987). U2 has maintained its pop status through the years and recently was named as one of Rolling Stone’s eight “Artists of the Decade” in 2009. The group's tours were also ranked second in total concert grosses for the decade, following The Rolling Stones. Table 2 identifies the top city performances. Their success is well reflected in the number of awards earned by the band, both at national and global levels, as illustrated in Table 3. U2’s discography includes 12 studio albums not counting the numerous B-sides, live or compilation albums. As reflected in Table 4, U2’s albums have received worldwide success.

Sales of these albums were fostered by constant worldwide touring. By 2010, U2 had 14 multi-national world tours under its belt, and continued this trend with the latest, “U2 *360°* Tour.”

TOURING

For any band or artist, touring is one of the most important aspects of becoming a household name. Through touring, a band can make connections through venues, artists, and labels. Touring also does the obvious, it connects the band with the main objective, the fans that buy the music and support the artist. “Acts like Iggy Pop and Sonic Youth, which never had radio hit singles, are making more money than they did 20 years ago because they have been faithful to their audience (through touring)"(Goldburg, 2008). Bands that have historically toured furiously for the benefit of their fans have inevitably created a longer run in the industry. As the music industry grows and artists are signed and dropped in order to find the next "big hit," it is hard for a band to find support from the record industry. "Tour support is not an option in today's music economy. There is a serious crisis about how to construct pathways for the next generation of superstars and what business structures can help create such careers." (Goldburg, 2008) Many concert series and venues have turned to brand sponsorships to gain financial support for touring needs.

Table 2: Top 25 Performed Locations (City)

City	Shows	City	Shows
Dublin	120	Rotterdam	19
London	104	Washington	19
New York	77	Atlanta	18
Los Angeles	49	Glasgow	17
Chicago	30	Birmingham	16
Boston	26	Denver	15
East Rutherford	25	Houston	13
Toronto	25	Manchester, England	13
Sydney	24	Montreal	13
Paris	23	Amsterdam	12
Melbourne	19	San Diego	12
Philadelphia	19	Tokyo	12
		Vancouver	12

Source: http://www.u2gigs.com

Table 3: Awards Received by U2 (partial listing)

Album-Specific Awards	Other Awards
22 Grammys (USA) 15 Meteor Music Awards (Ireland) 8 BRIT Awards (UK) 4 MTV Video Music Awards (USA) 3 National Musical Express Award (UK) 2 Juno (Canada) 2 World Music Awards (Global) 1 Billboard Music Award (USA)	12 Pollstar Concert Industry Awards (Global) 10 Q Awards (Global) 2 People's Choice Awards (USA) 1 Golden Globe (USA) 1 American Music Award (USA) Ambassador of Conscience Award – Amnesty International (Global) Rock and Roll Hall of Fame – 2005 (Global)

Source: http://wwwU2.com

Table 4: U2's Discography			
Year	**Title**	**Certifications**	
1980	Boy	US: Platinum UK: Gold	CAN: Platinum FRA: Gold
1981	October	US: Platinum UK: Platinum	FRA: Gold
1983	War	US: 4 times Platinum UK: Twice Platinum CAN: 3 times Platinum	FRA: Twice Platinum GER: Gold
1984	The Unforgettable Fire	US: 3 times Platinum UK: Twice Platinum	CAN: 3 times Platinum FRA: Gold
1987	The Joshua Tree	US: Diamond UK: 6 times Platinum CAN: Diamond	FRA: Twice Platinum GER: Twice Platinum Worldwide: 25,000,000+
1988	Rattle and Hum	US: 5 times Platinum UK: 4 times Platinum CAN: 7 times Platinum	FRA: Platinum GER: Platinum
1991	Achtung Baby	US: 8 times Platinum UK: 4 times Platinum AUS: 5 times Platinum CAN: 9 times Platinum	FRA: Twice Platinum GER: Platinum Worldwide: 18,000,000+
1993	Zooropa	US: Twice Platinum UK: Platinum CAN: 4 times Platinum	FRA: Platinum GER: Gold
1997	Pop	US: Platinum UK: Platinum AUS: Platinum CAN: 3 times Platinum	EU: Twice Platinum FRA: Platinum GER: Gold
2000	All That You Can't Leave Behind	US: 4 times Platinum UK: Twice Platinum AUS: 4 times Platinum CAN: 5 times Platinum	EU: 4 times Platinum FRA: Platinum GER: Platinum Worldwide: 12,000,000+
2004	How to Dismantle an Atomic Bomb	US: 3 times Platinum UK: 4 times Platinum AUS: 4 times Platinum CAN: 5 times Platinum EU: 3 times Platinum	FRA: Platinum GER: Platinum JAP: Platinum Worldwide: 9,000,000+
2009	No Line on The Horizon	US: Platinum UK: Platinum AUS: Platinum CAN: Twice Platinum	EU: Platinum GER: Platinum JAP: Gold Worldwide: 5,000,000+
Source: Wanderer, 2009			

U2 Tours America

In a 2008 speech given at Marché International du Disque et de l'Edition Musicale (MIDEM), the music industry mega-conference that takes place yearly in Cannes, France, Paul McGuinness gave credit to the label Island Records for tour support to build an audience for U2. From the very beginning, U2 understood the importance of touring as a marketing strategy, and as mentioned already, they understood the importance of focusing first on the U.S. market. In 1980, U2 attempted its initial live U.S. target by launching its first multinational tour, *Boy,* promoting the album of the same. The tour started in its European homeland but then branched out into an American leg before returning home. Afterwards, for every new album release, U2 created another international tour, expanding its dates in the U.S. faster than in other countries.

U2 and Live Aid

In the beginning of their career, U2 participated in several festivals and multi-act concerts. The Live Aid concert for Ethiopian famine relief was held at Wembley Stadium in July 1985. "U2's performance in front of 82,000 fans was a pivotal point in the band's career. During a 14-minute performance of the song 'Bad,' Bono leapt down off the stage to embrace and dance with a fan, showing a television audience of millions the personal connection that Bono could make with audiences" (Kaufman, 2005).

Live Aid opened U2 to a global socially-conscious audience who would appreciate their human rights efforts. From that moment at Live Aid, Bono, and U2 would be known for making personal connections at all of their concerts. Two years after Live Aid, U2 produced another album and created a tour of the same name, *The Joshua Tree.* For *The Joshua Tree* tour, McGuinness would deploy U2 on their largest tour yet, covering more geographical locations than ever. U2 would also keep to their U.S. market dominance strategy by beginning and ending the tour in America. Table 5 illustrates U2's tour performance timeline.

Connecting on Tour

Throughout its 14 tours, U2 always provided an enjoyable and interactive tour opportunity. It was during the band's *Elevation* Tour in 2001 that much of U2's American sentiment would pay off. After the terrorist attacks of 9/11, U2 continued their *Elevation* Tour through the U.S.

U2 audience participation always plays a factor in the band's success, and now it was America's turn. During songs such as "Sunday, Bloody Sunday" peace signs, along with American and Irish flags intertwined, as Bono sympathized with the crowds. Fans and critics alike bragged about the uplifting and almost spiritual performances introducing slogans like, "U2, more necessary than ever" (Kot, 2001). Even in a time when U2's music may not have kept them on top, their concerts and tours made sure the band remained relevant to their audience.

Table 5
U2 Performance Timeline

Year	Tour	Continent / Country	# Performances
1980	*Boy Tour*		
		Europe	88
		North America	78
1981	*October Tour*		
		Europe	47
		North America	55
1982	*War*		
		Europe	55
		North America	48
		Japan	6
1984	*Unforgettable Fire*		
		Europe	44
		North America	50
		New Zealand	4
		Australia	15
1986	*Conspiracy of Hope*	North America	6
1987	*Joshua Tree*		
		Europe	30
		North America	79
1989	*Lovetown*		
		Europe	14
		New Zealand	4
		Australia	23
		Japan	6
1992	*Zoo Tv*		
		North America	79
		Europe	69
		New Zealand	2
		Japan	2
		Australia	6

Year	Tour	Continent / Country	# Performances
1997	*PopMart*		
		North America	46
		Europe	32
		Latin America	7
		Australia	4
		Japan	2
		South Africa	2
2000	*All that You Can't Leave Behind*		
		Europe	13
		North America	6
		South America	1
2001	*Elevation Tour*		
		North America	80
		Europe	33
2004	*How To Dismantle an Atomic Bomb*		
		North America	3
		Europe	4
2005	*Vertigo*		
		North America	80
		Europe	32
		Latin America	8
		Australia	7
		New Zealand	2
		Japan	3
2009	*No Line on the Horizon*		
		North America	10
		Europe	16
2010-2011	*U2 360*		
		North America	36
		Europe	47
		Australia	5
		New Zealand	1

Source: http://www.u2gigs.com/all-u2-tours.html Accessed 9/2/2010

U2 360° Tour

In 2009, U2 launched its biggest and most elaborate tour yet. The *U2 360° Tour* is the band's largest international tour, spanning over one hundred cities and still finding new ways to engage their audience. U2's idea of connecting with their fans has hit a new level; the band plays in stadiums on a giant circular stage fully surrounded by the crowd. U2 performs under a structure known as "The Claw" which features a 14,000 square foot 360-degree video screen, complete with a satellite link up to space (Farragher, 2009). (See Figure 1).

A highlight of the show includes an actual conversation with the International Space Station via satellite where Bono asks "Commander can you see (us)?" and the astronaut replies, "Right now the most beautiful sight is the blue planet Earth," segueing into the song "Beautiful Day." This experience provides a connection unlikely to be created at any other concert.

Figure 1: U2's *360°* Tour Set-Up

Source: http://www.U2.com

As U2 was finishing the song "MLK," Paul thought about how U2's music and stance on social justice and climate change was a tribute to their passion and hardworking nature, making each tour and record better than the last. Everything certainly was becoming more high tech and digital. Just earlier today, The Edge had captured video from fans that greeted the band at the Moscow airport on his cell phone and posted it to the U2.com website. Paul was very proud of the band and felt that they were far from being finished with their work. He wondered how they were going to top the *360°* performances.

SOCIAL MARKETING

The *U2 360°* tour would not be complete without a cause to support. It is perhaps the causes they support that have created the U2 loyal fan base found around the world. *Cause marketing* is sometimes used interchangeably with *social marketing* and refers to the planning and implementation of programs designed to support social causes using concepts from commercial marketing (Hawkins et al, 2010). Social marketing seeks to influence social behaviors not to benefit the marketer, but to benefit the target audience and the general society. U2 and its lead singer, Bono, have taken on many causes and used the band's fame and marketing techniques to promote these causes. U2's approach to bring about social change is to use their tours as platforms. While it is not believed that U2 promotes these social campaigns to further their success but for the greater good, it can be argued that it has had the inverse effect as well.

Captive Audience

Following the leadership of Bono, who has already made the list of potential Nobel Peace Prize nominees, U2 has consistently linked itself to global causes. Maybe one of U2's lead singer's most important acts is the call for the cancellation of debts owed by a number of Third World countries to the world's richest countries. He has become a leading advocate for global health, directly involved in raising money for The Global Fund. In 2006, Bono co-founded (PRODUCT) RED; select products from popular brands, such as The Gap, that are designed to invest consumer dollars directly into HIV and AIDS programs in Africa. "We can win the fight against the three diseases," Bono stated. "We can turn the tide on TB [tuberculosis] … We have the tools to prevent and treat malaria. Death by mosquito bite?- No! Not in the 21st century, we're not having that!" (The Global Fund, press release, 2010).

While all of the band members do their part off the road to promote their social causes, it is during tours that they can have the most influence on their captive target audience. The band's social marketing efforts have had a snowball effect for the band's tours. Fans have been known to say that "using his celebrity to drive important issues is why I don't mind paying a lot of money for his shows" (Memmott, 2001). The band goes out to promote and create social awareness through specific campaigns and concerts and in turn they create a larger committed audience. This larger audience then goes out and promotes the social causes connected to U2, bringing yet newer prospective fans to the group as a result.

The *U2 360°* tour's set list includes the song "Walk On," which Bono dedicates to Aung San Suu Kyi, the democratically elected leader of Burma and Nobel Peace winner, who has been under house arrest for most of the time since her election (Farragher, 2009). Along with the dedication of the song, the band has created support for Burma and Aung San Suu Kyi with creative flair. U2 has created a web page on their website, U2.com, that is dedicated strictly to Aung San Suu Kyi. On the web page, fans can cut out masks of Aung San Suu Kyi's face and provide support by wearing them to the band's concerts. U2 also encourages its fans to take pictures across the world with the masks on and submit them to the website to be posted. The Aung San Suu Kyi page on U2.com has been flooded with such pictures, creating a support group larger than could be connected by individual efforts.

Internet and Social Media

The global connection does not stop at the concert level but extends to the internet. The band's elaborate website contains an entire section labeled "Heart + Mind," listing and describing social causes and organizations that U2 supports (U2 A De-Lux Excursion[b], 2009). These campaigns include: Music Rising, The Angiogenesis Foundation, (RED), ONE, Free Burma!, Greenpeace, Amnesty International and The Chernobyl Children's Project (see Table 6 for details). These organizations are not centered on one geographical region but are scattered throughout the world in turn creating a larger market. U2 has been recognized by organizations for their outstanding work. The band and their manager have received the "Ambassador of Conscience Award" from Amnesty International (Kagan, 2002).

Social media have also been part of U2's communication strategy.U2's main concern is connecting with its global fan base. With the help of U2.com, Facebook, and Twitter as media, this task has been accomplished. The band's website, managed by Live Nation, a large global marketer with resources that an individual artist could not manage on their own, contains a "Community" tab that connects a global audience not only to the band, but to each other (Datamonitor, 2009). Members of the page can post photos, messages, forums, links or any other information they would like to share with the U2 community.

Table 6: Current Causes Supported by U2

Cause	Description
Music Rising	Launched to rescue the musical culture of the Central Gulf region of the United States from the destruction caused by the catastrophic hurricanes of the summer of 2005 by replacing musical instruments lost or destroyed in the deluge.
The Angiogenesis Foundation	Nonprofit organization dedicated to conquering disease using a new approach based on angiogenesis, the growth of new blood vessels in the body.
(Red)	Delivering a sustainable flow of private sector money to the Global Fund to Fight AIDS, Tuberculosis and Malaria
One	Fighting against extreme poverty and preventable disease, particularly in Africa
Free Burma!	Dedicated to empowering grassroots activists around the world to rally for human rights and to bring an end to the military dictatorship in Burma.
Greenpeace	Core principle is to prevent harm to the environment using the concept of non-violent direct action.
Amnesty International	A worldwide movement of people who campaign for internationally recognized human rights for all. *Demand Dignity* campaign launched in May 2009 aims to end the human rights violations that drive and deepen global poverty.
The Chernobyl Children's Project	Aims to help alleviate the suffering and to offer hope to those most affected by the Chernobyl nuclear explosion, namely the children of Belarus, Western Russia and the Ukraine.
Source: http://www.U2.com	

The U2 website provides direct connections to other social sites such as Facebook, Ilike, and MySpaceMusic. An interesting and rewarding part of the website is the band's interaction with the fans. In fact, on Facebook, there are more than 7 million followers that "Like U2." Their website, U2.com, has created a home where U2 enthusiasts they can gather and bond. Social media has become a huge trend for marketing and U2 has committed to provide a network that includes the world, with the help of partners such as Live Nation, who has a reputation for providing assistance and results in the international music industry. On the subject of the new partnership Bono stated, "We want a closer, more direct relationship between the band and its audience and Live Nation has pledged to help us with that" (PR Newswire, press release, 2009).

Environmentally Conscious Tour

Live Nation has also used U2.com and the *U2 360°* Tour to promote the band's own social causes. Live Nation has committed to "producing the largest concert tour in history in an environmentally responsible manner with a goal of balancing the Tour's direct carbon footprint through a comprehensive reduction and offset strategy" (Flynn, 2009). The band known for its social responsibility has taken a new effort in social marketing by creating a type of "green concert." Live Nation has hired MusicMatters as the tour's Environmental Advisor to work with production, venues and fans to reduce the environmental impact of the tour without compromising the quality of the fan experience. This involves recycling stations, access to filtered water in concerts to reduce plastic bottle waste. The "*U2 360°* Tour Environmental Impact Strategy" will be the new standard for touring artists trying to differentiate themselves (U2 A De-Lux Excursion[a], 2009).

SPONSORSHIPS

U2 has also been extremely successful in selecting the right sponsors. Artists turn to sponsorships to support a tour they could not manage on their own, but also to reach their target demographics (Enterntainment 3Sixty, 2010). Artists choose a brand that reflexes their image or can add value to their concert experience. Ray Waddell, Billboard's Executive Director has stated, "Today sponsorships are as much a part of the concert experience as service charges. For artists, they've become not just a payday, but an important marketing tool" (Waddell, 2007). Successful sponsorships will not only offset ticket prices, but create a partnership in shared objectives on what to offer consumers and provide a more personal experience (Peters, 2009).

Global Sponsorship

U2 has also made a major shift in selecting the *U2 360°* Tour sponsors. U2 has had several successful sponsorships in the past, including a very memorable Apple campaign.

However, in 2009, U2 partnered with Research in Motion (RIM) and RIM's Blackberry became the global sponsor for the *360°* Tour (Sorkin, 2009). According to statement made by McGuinness, "this marks the first stage of a relationship and shared vision between RIM and U2 that we expect will lead to new and innovative ways to enhance the mobile music experience on the BlackBerry platform for U2 fans." (www.U2tours.com) The collaboration is an effort to market to a global audience of BlackBerry users and U2 fans. One of the slogans seen around concert sites is "BlackBerry loves U2." It will take time to see if the socially conscious U2 audiences love BlackBerry as much in return.

Regional Sponsorship

While U2 is working on marketing its tour with an international sponsor, the band also uses smaller brands at the local level. For instance, Absolute Radio is co-promoting the UK leg of the *360°* Tour in an effort to ramp up its support of live music (Media: Absolute's commitment, 2009). BBC has sponsored a day of programming tied in with U2's album, "No Line on the Horizon" promoted by the *360°* Tour. The highlight of the event was a 'surprise' gig played by the band on the roof of Broadcasting House (Andrews, 2009). The goal for BBC was to show the two big names in media and entertainment together, as displayed on the BBC website on a page titled 'U2=BBC'. These local partnerships provide credibility and a sense of local pride to a global tour. When a customer goes to a concert that is part of a global tour, it is a connection point to bring in local sponsorships. U2's combination of global sponsor clout and smaller local partnerships provide financial and marketing benefits for all.

U2 *360°* DEBRIEFING SESSION

> The next morning, during a very late breakfast, Paul started the debriefing by saying "U2 has reached global fame. We never set our sights on being a local "indie" (independent) band, but on the bigger picture of becoming a household name in every country."
>
> Bono responded by saying "You have consistently pushed for innovation and new experiences for us. Our focus from the very beginning has been to create relationships and build connections with our fans and to play music that can change the world."
>
> "I agree," Paul continued, "The concept of touring often and making it a personal experience provided a marketing tool in itself. Our "Claw" stage with its video screen is a perfect example. When we used to play "in the round," we would not be able to fill an entire stadium. Under this current set up, we can."

Paul, taking a bite of blini, a traditional Russian thin pancake, continued, “We found a niche as a socially responsible band in support of worldwide campaigns. U2 has turned a passion for music and human nature into a profitable business that does not have any market boundaries.”

He paused, letting Bono and the band enjoy their moment of success before continuing. “We have some concerns. Our daily overhead, whether we play or not, is about $750,000. Environmentalists are questioning our “carbon footprint” since it takes about 200 trucks to move the production from one venue to the next. Just the stage requires about 120 trucks. Our engineering problems are enormous and costly. We will log about 70,000 air miles alone.”

“Paul,” Dave Evans (The Edge) interrupted, “we are spending the money on our fans. I don’t think there is a better way to spend it.”

Standing up to stretch, Bono chimed in, “Also, we are setting ticket prices to allow fans to come see us. At least 10,000 tickets at each performance are priced around $30 and the close section of seats we set up as the “Red Zone” is designed solely to support The Global Fund. Even though last night’s performance was not sold out, many of our shows are.”

“Exactly!” Paul, stated, excitedly. “Which is why we need to start thinking about what is next. The 30 year anniversary of your first record is coming up. Our strong and growing relationship with Live Nation offers many promises as does social media networking.”

“Well, boys,” Bono piped up, “hold on to your hats…we are off and running again!” Bono and the band members grinned and continued enjoying their breakfast before leaving to catch the flight for Australia.

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STARBUCKS: MAINTAINING A CLEAR POSITION

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CASE DESCRIPTION

The primary subject matters of this case are Marketing and Branding. Secondary issues examined include brand equity and brand positioning. This case has a difficulty level of three (appropriate for junior level courses or higher). This case is designed to be taught in one and one half class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

When Starbucks originated in Seattle, Washington in 1971 as a purveyor of dark roasted coffee beans and coffee merchandise, its founding owners didn't anticipate the extraordinary brand evolution to come. Under the direction of Howard Schultz, who became sole proprietor in 1987, Starbucks transformed into a beverage provider that mirrored the experience of Italian coffee houses including espresso drinks, and elegant camaraderie. This strategy, as part of Starbucks' brand positioning as the consumer's "Third Place" to spend his/her time between home and work, ignited a period of extraordinary expansion.

By the 1990s, however, Starbucks had begun offering specialty coffee-based drinks (such as its trademarked Frappuccino® drinks, etc.) through mass retail stores. The company also licensed Sodexho to operate Starbucks on naval bases that, despite being traditional Starbucks stores, served a wide variety of other products including pastries, sandwiches, salads, and various merchandise.

As higher-end competitors began serving gourmet coffees, Starbucks reacted by increasing its product offerings. By 2005, many Starbucks locations offered a variety of pastries, deserts, and lunch items. Additionally, many Starbucks had begun offering customers drive-through service. Each of these new additions (both the food and the drive-through additions) was successful in increasing immediate sales and profits and, therefore, in pleasing Starbucks investors.

In 2007, Starbucks executives received a memo from Schultz expressing significant concerns that Starbucks was weakening its brand image with these ongoing modifications. Questions arose regarding a decision-making bias towards brand extensions that increased profitability in the short-term, but that threatened Starbucks' long-term brand equity. By 2008, Starbucks executives worried about the company's financial declines.

The authors have received positive responses from upper level undergraduate students and from graduate students in analyzing this case. Invariably, students' affinity for or against Starbucks' products increases their interest in the case and their satisfaction in the analysis.

INTRODUCTION

In early 2008, mixed emotions swirled among the executives of Starbucks. In light of the company's plummeting stock price, Howard Schultz' memo from the previous year seemed almost prophetic.

Starbucks had been enjoying the benefits of a relatively new concept: offering breakfast, lunch, and other food items outside of the traditional offerings of coffee, pastries, muffins, and biscotti that had become the Starbucks Experience. Through strong initial sales this newly implemented strategy had begun offering positive returns very quickly. Schultz, the company's founder and current chairman, commented, however that "over the past ten years, in order to achieve growth, … we have had to make a series of decisions that, in retrospect, have lead to the watering down of the Starbucks experience, and, what some might call the commoditization of the brand. Many of these decisions were probably right at the time, and on their own merit would not have created the dilution of the experience; but in this case, the sum is much greater and, unfortunately, much more damaging than the individual pieces." (See Appendix 5 for entire quote.)

ORIGINS OF AN AMERICAN ICON

Jerry Baldwin, Gordon Bowker, and Zev Siegel opened the original Starbucks (a precursor to Schultz' subsequent company that took the same name) in 1971 after having frequently visited Peet's Coffee and Tea in Berkeley, California. They had become hooked on the dark-roasted coffee Alfred Peet advocated over the light-roasted coffee found in most large stores. Peet had encouraged their desires to bring dark-roasted coffee to the Seattle, Washington marketplace. He taught them that the fullest flavor is from a very dark roasting of the coffee beans (Schultz, 1997).

The First Starbucks

The three partners initially disagreed over naming their new coffee company. Gordon consulted with a creative business associate, artist Terry Heckler, about naming the store "Pequod" after the ship in Herman Melville's *Moby Dick*. Terry told him, "You're crazy! No one's going to drink a cup of Pequod!" (Schultz, 1997). Eventually, the Starbucks name was chosen as a derivative of "Starbo," the name of a Mt. Rainier mining camp in the 1930s (Skoog, 2002). Baldwin liked the additional connection to Starbuck, a character from *Moby Dick*.

The first store opened in Pike's Place Market in Seattle. Consistent with locating in such a key port city, the first Starbucks had nautical décor. The one employee, Siegel, wore a white apron. The store sold 30 varieties of coffee beans (direct from Peet's) as well as other coffee-related merchandise but no ready-to-drink beverages.

The original Starbucks logo was based on a 15th century wood carving of a two-tailed siren, or mermaid. (See Figures 1, 2, 4, and 5 for the evolution of the Starbucks logo) In the wood carving, the siren wore a crown, was bare-chested with breasts exposed, and held the end of one of her two tails in each outstretched hand. The logo encircled this image with the words: "Starbucks" at the top, "Coffee · Tea · Spices" at the bottom. The main colors in the logo were brown and white (Krakovskiy, 2007).

Figure 1: Original Starbucks Logo
1971-1987

Peet's roasted its own beans, and remained Starbucks' coffee supplier until the company purchased its own roasting equipment after the first year of operations. Starbucks soon grew to four stores within the Seattle area (Schultz, 1997).

Early Growth

Like many Starbucks suppliers, Hammarplast, a manufacturer of drip coffee makers among other items, began receiving consistently increasing orders from Starbucks. Intrigued by the growing orders, Howard Schultz, a Hammarplast vice president, decided to visit Seattle in 1981. One year later Schultz joined Starbucks as the director of marketing and operations.

While on a business trip to Italy in 1983, Schultz discovered what he described as the "coffeehouse culture." Italian coffee houses (or "espresso bars") were neighborhood gathering places that brought people together over espresso-based drinks and camaraderie. Schultz was enamored with the way the baristas (the coffee house servers) pulled each shot of espresso artfully while making casual and comfortable conversation with the customers. The baristas knew most of the customers by name and they even knew some personal history of the regular customers. Music was often provided by a classical instrumentalist who would be playing in or near the coffee house. With no chairs, the customers stood and mingled freely with the baristas and with each other. It was more than a cup of coffee. It was an experience. Schultz determined to bring this experience back with him to Starbucks.

> "I wanted to blend coffee with romance, to dare to achieve what others said was impossible, to defy the odds with innovative ideas, and to do all this with elegance and style."
> (Schultz, 1997 p. 11)

Starbucks purchased the assets of Peet's Coffee and Tea in 1984. That same year, Jerry Baldwin allowed Schultz the opportunity to offer espresso in the newest (the sixth) Starbucks store, in downtown Seattle. Despite only a small percentage of space in the store (300 square feet) dedicated to espresso, sales of the freshly brewed drinks accounted for a significant portion of the store's revenue. Schultz was thrilled as he shared the positive results with the ownership almost daily.

Baldwin, however, believed the Starbucks' brand was best developed in selling fine, dark-roasted, whole-bean coffees. He told Schultz he didn't want to be in the restaurant business, and felt the selling of "coffee drinks" detracted from the selling of the dark-roasted whole-bean coffees. Coffee drinks were allowed, however, in four of the six stores, but always in the back of the store.

As the beverage business proved increasingly lucrative and popular in the stores, Schultz quickly became frustrated with the owners of Starbucks. He saw a great business opportunity in providing customers dark-roasted coffee drinks in every coffee store.

Il Giornale: A New Brand Offering

Desiring to bring the Italian espresso bar experience to America, Schultz opened Il Giornale Coffee Company with the goodwill and financial backing of Starbucks. Il Giornale offered dark-roasted fine coffee along with live music and no chairs. The beans were purchased from Starbucks, and the business became a rapid success.

Il Giornale was branded differently from Starbucks in noticeable ways. The aprons at Starbucks were brown – at Il Giornale a welcoming green was chosen. Starbucks carried a nautical theme, and everything about Il Giornale was Italian. Starbucks focused on selling dark-roasted whole-bean coffees. Il Giornale focused on selling espresso and espresso-based beverages. Figure 2 shows the logo for Il Giornale.

Figure 2: Il Giornale Logo
1986-1987

In 1987, the Starbucks founders decided to sell their interests in the company. In August of 1987 Schultz, who owned three Il Giornale locations, purchased each of Starbucks' six locations and adopted the Starbucks name for all nine stores.

CREATING AN INTEGRATED BRAND

After the acquisition, the Starbucks brand became a blend of the two concepts. No longer relegated to the back of the stores with minimal space, the beverage counter was placed prominently in all stores. The new format had the feel both of an espresso bar and a fine coffee purveyor, thereby serving customers seeking either or both product types.

Schultz' objective was to target young and middle aged professionals, particularly those in middle to high social classes. He desired to create a clearly differentiated brand image that would foster a personal connection between these customers and Starbucks. Schultz envisioned customers viewing Starbucks as their "Third Place" (both physically and emotionally) – first home, then the workplace, then Starbucks. In so doing, Starbucks sought to provide an inviting and refined place for these individuals to relax despite their demanding schedules.

As such, every detail of the Starbucks' experience had to provide a high class atmosphere where individuals would feel the same sophistication as a true coffee aficionado. The baristas would enhance this sophistication effect by always smiling pleasantly and by knowing each customer by name. This affordable luxury became highly appealing to America's vast middle class (Adegoke, 2007).

The high end coffee was served in a very relaxing, appealing atmosphere that invited the consumer to unwind while enjoying a fine coffee experience. This strategy differed from the approach used by traditional fast food restaurants, which offered inexpensive products and sought to maximize volumes of customers by minimizing the customers' time spent at a table. Fast food restaurants such as McDonald's (the industry leader) touted convenience in designing a quick customer experience that allowed for greater traffic capacity (Kowalski, 2006). The perceptual map shown in Figure 3 demonstrates how Starbucks' positioning set it apart from all other quick-service competitors in providing a "high-end" product in a relaxing "high-end" atmosphere. Without significant competitors in the quick-service industry directly positioned against Starbucks on these key attributes, the company enjoyed extraordinary success.

With the company strategically so well positioned, Starbucks grew from 9 locations to 17 by the end of 1987.

The logo for this newly revised Starbucks was also modified. (See Figure 4.) It was similar to the original Starbucks logo, but encircling the siren were the words "Starbucks Coffee." The siren's hair was longer than before, covering the exposed breasts but leaving the exposed navel. The art was more stylized, no longer looking like a 15th century carving. The brown was replaced with the green of Il Giornale for a more "affirming" look to customers (Moore, 2005).

Rapid growth continued for the next several years. Starbucks could be found in 33 locations by the end of 1988. (See Appendix 2 for annual store counts from 1987 through 2006.)

1990s – Embracing Growth

In 1992, the logo changed again. (See Figure 5). This time the siren was brought closer to the viewer, eliminating the navel. Otherwise, it was very similar to the 1987 logo.

Figure 3: 1987 Perceptual Maps

Figure 4: Starbucks Logo After Integration with Il Giornale
1987-1992

Figure 5: Current Starbucks Logo
1992-

Looking to maintain its high growth rates, Starbucks installed a drive-through window in a test store in Southern California in 1994. Prior to this test, the company had consistently resisted installing any drive-through windows. (Gillespie, 2006). Consumers clearly appreciated the convenience of purchasing Starbucks products without ever leaving their cars. Positive sales results led to a rapidly increasing number of stores with drive-through windows. The challenge became implementing the "3rd Place" atmosphere via the drive-through.

In 1998, Starbucks launched www.starbucks.com, the company web site. Starbucks considered expanding its corporate image by merchandising coffee, furniture, videocassettes, and more through its web site, and invested in several online retailers. In mid-1999 the stock price dropped over 20% which indicated that investors wanted Starbucks to refocus (Antlers, 2001). By 2001 online and catalog purchases combined for less than 2% of revenues. Starbucks divested itself of many of the online retailers in subsequent months.

COMPETITION

McDonald's

The competitive environment soon began to change. Quick-service restaurants began developing coffee offerings to compete directly against Starbucks. In May 2001, hamburger giant McDonald's reinvigorated a concept called McCafé that it had originally started in Australia in the 90s (Adamy 2008). Within the fast food industry, McDonald's had traditionally positioned itself with an Americana-oriented family image. This concept, however, called for a McDonald's-run coffee counter inside of McDonald's stores, offering espresso drinks as well as teas and pastries. Starbucks considered McCafé as merely an indirect competitor since McDonald's competed in a lower-end marketplace. This concept, however, had the potential to alter McDonald's image more toward expensive coffee. In May 2007, Starbucks executives couldn't have been happy when Consumer Reports magazine rated McDonald's regular coffee as better tasting than Starbucks as well as other national competitors (Consumer Reports 2007).

In January 2008, McDonald's announced it would begin installing coffee bars with "baristas" throughout its US stores over the next two years. McDonald's estimated that its baristas (who were easily identifiable since they wore aprons) would add an annual $1 billion in sales of cappuccinos, lattes, mochas, and "frappes" to its previous revenues of $21.6 billion. McDonald's priced these drinks between $1.99 and $3.29 (Adamy, 2008). By comparison, Starbucks' comparable drink versions were priced between $2.65 and $4.15, a premium of approximately one-third.

Dunkin Donuts

Throughout its history, Dunkin Donuts was known for quick, inexpensive no-frills donuts. Doughnuts, not coffee, was the primary focus of Dunkin Donuts' positioning (Manning-Schaffel, 2008). Like McDonald's, Starbucks viewed Dunkin Donuts as an indirect competitor that competed only within the lower-end convenience-oriented fast-food market.

Throughout the decade of the 00s, however, Dunkin Donuts pursued an aggressive growth strategy that shifted its positioning to coffee. In the midst of rapid store expansion, Dunkin Donuts began a promotional campaign entitled, "America Runs on Dunkin" (Dunkin Donuts Press Release, 2006), a direct reference to its coffee products. By 2006, Dunkin Donuts was the top selling retailer of coffee-by-the-cup in America at 2.7 million cups a day, close to one billion cups a year (Dunkin Donuts, Press Release 2006).

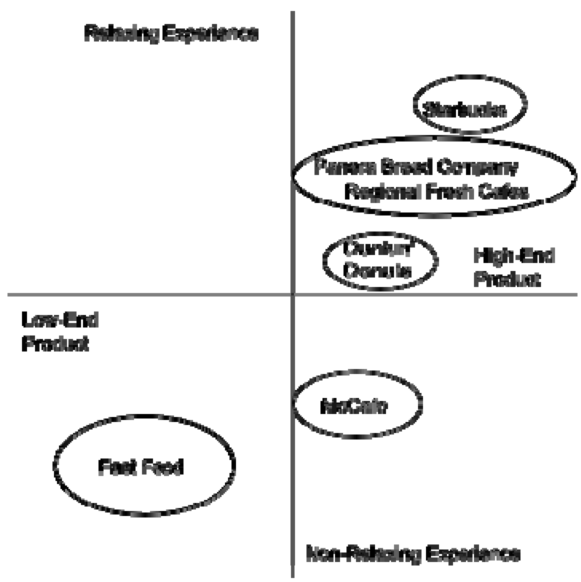
Although Dunkin Donuts didn't introduce a vast array of new coffee offerings with fancy names to rival Starbucks, it did introduce sandwiches that were similar to paninis in look and feel. The company also began offering free Wi-Fi and piped-in music. These changes increased the warmth within the retail stores (Manning-Schaffel, 2008).

Panera Bread Company

Competition also began increasing dramatically within the higher-end segments of quick-service food offerings, some of whom included high-end gourmet style coffees. Early in the 2000s, Panera Bread Company became a nationwide provider of quick-serve food and high-end coffee with a pleasant, relaxing atmosphere. Panera Bread also began offering free wireless internet connections in most of its stores. Other regional fresh café-style restaurants also began growing rapidly throughout the 2000s with no slowdown in expansion for the foreseeable future.

Over time, consumers perceived less brand differentiation between Starbucks and other options. The perceptual map in Figure 6 displays how Starbucks was perceived on its own two key attributes as compared to other quick-service providers as of 2007.

Figure 6: 2007 Perceptual Maps



2000S -- EVOLVING STRATEGY MODIFICATIONS

As competition intensified, Starbucks sought new ways to increase revenues. To complement its store expansion and leverage its loyal customer base (Restaurants, 2005), Starbucks chose to focus on two strategies for additional revenue growth.

Licensing and Joint Ventures

In the early 2000s, Dreyer's (ice cream) began producing a Starbucks-branded ice cream through a licensing agreement with the growing coffee company. Concurrently, Starbucks also began distributing Frappuccino® and DoubleShot® beverages through the mass retail segment throughout the US.

Hyatt Hotels announced in September of 2005 that room service coffee would be Starbucks in a personal pot with a French press (a traditional and popular style of coffee maker in which the grounds are added directly to hot water, then a filter is "pressed" through the water, removing the spent grounds). The program was to roll out to all Hyatt properties in the United States. The personal pot of Starbucks was also to be offered at all Hyatt Hotels restaurants.

In late 2005, Sodexho (a giant in the food distribution industry) and Starbucks announced that Sodexho would operate up to 30 Starbucks stores on U.S. naval bases. In response to demands for full-service Starbucks Coffee operations, the ten-year Navy contract required stores to operate as traditional Starbucks stores complete with coffees, teas, and other beverages, as well as pastries, sandwiches, salads, and even select merchandise (Elan, 2005; Sodexo Press Release, 2005).

Expanding Product Offerings

The expanded menu in the Navy contract reflects the changes Starbucks had been making in its product strategy. Throughout the '00s decade Starbucks had been accelerating its product line to include a variety of food offerings such as sandwiches, pastries, and candies. (See Appendix 3 for a timeline of product changes.) To drive food sales Starbucks had also begun offering wireless Internet connectivity in its stores for a fee in 2001. The goal was to bring customers back to Starbucks to use the Internet for work or play while enjoying an afternoon snack or coffee (Antlers, 2001).

With food offerings accounting for approximately 12% of company sales by 2003 (Matthews and Braitman, 2004), Starbucks decided to focus ever increasing attention on its non-core product offerings. In September 2003, shareholders in Starbucks Coffee Japan even approved the sale of alcohol in its stores. The Kobe, Japan store began offering coffee-themed mixed drinks. Starbucks Coffee Japan also planned to offer hot foods starting in October of the same year. Starbucks was encouraged by the favorable reviews these concepts received in US publications such as *Datamonitor*, which noted in 2003 that "ideas such as the introduction of more extensive menus and hot foods could easily find their way into US Starbucks outlets."

Confirming the *Datamonitor* prediction, by mid-2005 Starbucks had rolled out several new US offerings. Black Apron, a higher-end exclusive coffee, was introduced. New flavored drinks and teas were also introduced. *Restaurants & Institutions*, a leading industry magazine, wrote on its web site: "New pastries, desserts, and lunch items were launched to appeal to diners beyond the morning day-part crowd. But it's not only the menu that keeps customers so rabidly devoted to the brand. Starbucks locations are being reinvented with music and Wi-Fi connectivity."

Steve Forbes lauded Starbucks in 2005 for execution and marketing in a commodity market. He was impressed that Starbucks remained a high margin brand, and that the customer experience was well-executed and consistent across the stores (Forbes, 2005). He also was impressed with the naming of the drink sizes: a small is a "tall," a medium is a "grande," and a large is a "venti."

During the Christmas season in 2006, Starbucks announced it would begin selling a limited number of books in its stores. The rollout began with a single title: For One More Day by Mitch Albom, a well-known contemporary author. Drinking coffee and reading a book seemed a natural combination upon which Starbucks could capitalize (Nawotka, 2006). Some stores were also equipped with Hear Music (Starbucks' music label) areas for customers to create custom CDs for purchase. Appendix 4 provides a list of Starbucks product offerings.

EFFECTS OF STRATEGY CHANGES

By the end of 2007 more than two-thirds of company-owned US Starbucks locations were serving lunch items such as sandwiches. Some Starbucks baristas began expressing concerns, however, that their managers had begun instructing them to ask customers if they would like a breakfast sandwich with their coffee. This technique for upgrading a customer's order, however, had long been popular within the fast-food industry (Adamy, 2008). Starbucks even began considering expanding its menu to include more beverages aimed directly at children and teens (Linn 2007).

Overall, Starbucks appeared to be profiting from its strategic changes (see Starbucks' operating results in Table 1). The company's changes in product strategy seemed well aimed at the American culture's desires for convenience, even if they may not have been perfectly true to Schultz' original "Third Place" branding concept.

In February 2007, Schultz wrote an internal memo to CEO Jim Donald entitled "The Commoditization of the Starbucks Experience." (See Appendix 1 for entire memo). In the email, Schultz noted two specific trade-offs that had been made to gain efficiency and scope of operations: manual pulling of espresso shots was replaced by machine; and beans were shipped in special packaging instead of being stored in bins in sight of the customer. His message further stated that "some people even call our stores sterile, cookie cutter, no longer reflecting the passion our partners feel about our coffee." After the e-mail was eventually leaked to the media, it became national news and it triggered many articles speculating the future direction of Starbucks.

Table 1: Starbuck's Operating Results						
$Millions (except per share data)	2007	2006	2005	2004	2003	2002
Total Revenue	9411.50	7786.94	6369.30	5294.25	4075.52	3288.91
Total Operating Expense	8357.55	6892.99	5588.78	4687.75	3654.67	2974.68
Operating Income	1053.94	893.95	780.52	606.49	420.85	314.23
Income Before Tax	1056.36	906.24	796.35	620.63	432.47	336.89
Net Income	672.64	564.26	494.37	388.88	265.36	211.39
Income Available to Common Incl. Extra Items	672.64	564.26	494.37	388.88	265.36	211.39
Diluted Normalized EPS	0.87	0.73	0.61	0.47	0.33	0.27

POTENTIAL CROSSROADS

One year later, Schultz' memo still posed a potential dilemma for Starbucks. Many of Starbucks' product and branding evolutions were generating profitable returns. While the majority of Starbucks' revenues were still driven by sales of coffee drinks, these newer revenue sources offered some interesting advantages:

- Licensing sales represented margins that were close to 100% contribution.
- Merchandising sales were closely correlated with customer traffic within the stores, which Starbucks believed to be a positive sign.
- Sales for sandwiches and other food products were going well
- Drive-through service windows were making a dramatic difference in sales almost everywhere they were opened. Stores with drive-through service, now more than 30% of company-owned stores (Rothbort, 2007), derived a majority of their sales from the drive-through window as opposed to walk-in sales.

Total company sales were at or near historical highs and still increasing. In many regards, the company's decisions appeared to be working.

However:

- Food sales offered much lower contribution margins than did sales of coffee. Consistently, company profit margins had dropped each year from approximately

8.7% in 2004 (Palmer, 2007) to approximately 7.1% in 2007 (Hoovers, 2008) and were a mere 3% in the first quarter of 2008 (Hoovers, 2008).
- Although food products added an average of roughly $35,000 to a store's sales volumes in 2006, same store sales only rose 7% that year. By comparison, same store sales had grown at a rate of 10% in 2004 (Palmer, 2007).
- Same store sales had grown only 1% in the final quarter of 2007 (Goldman, 2008).

Such news was particularly alarming to a company with approximately 85% of all revenues derived from the company-owned stores (Valuecruncher, 2007). Investors seemed alarmed as well: Starbucks stock price dropped roughly one third in 2007 to end the year around $20 per share. It closed the first quarter 2008 around $17.50 per share, approximately half its value of late 2006. By comparison, the Dow Jones Industrial Average had risen in 2007, but closed the end of 2008 near its ending 2006 level. Panera Bread's stock price had dropped significantly in 2007, but it gained in the first quarter 2008 to close at approximately two-thirds its ending 2006 level. McDonald's stock price rose in 2007 and ended the first quarter 2008 significantly higher than its 2006 value. (See Appendix 5). Dunkin Brands was not publically traded.

Some industry forecasters foresaw Starbucks' disappointing performance as an early indicator of a weakening economy (Adegoke, 2007), arguing that a slowing economy could have been leading consumers to resist high priced lattes in favor of less expensive offerings from Starbucks' competitors. Starbucks' internal research, however, indicated that the company had not been losing customers to competitor brands due to a slowing economy (Stelter, 2008). This research demonstrated that Starbucks customers continued to purchase at Starbucks, but unlike America's previous economic downturn of the early 1990s (when US sales of specialty coffee drinks actually increased significantly (Maxwell, 1993)), the slowing economy might have led customers to purchase fewer of the more expensive coffee drinks such as lattes and cappuccinos in favor of other Starbucks offerings (Stelter, 2008). These findings indicated that a weakening economy was not likely the primary cause of the company's disappointing performance.

Starbucks appeared to be facing a potential trade-off between extending the brand to increase immediate short-term profitability vs. potentially moving away from the brand name at the expense of its long-term competitive distinction. The value of Starbucks to its customers; to its partners; and to its shareholders; hung in the balance.

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APPENDIX 1
"THE COMMODITIZATION OF THE STARBUCKS EXPERIENCE"

Text of an internal email from Howard Schultz on February 14, 2007. Recorded at Starbucks Gossip web site:

From: Howard Schultz

Sent: Wednesday, February 14, 2007 10:39 AM PST

To: Jim Donald

CC: Anne Saunders; Dave Pace; Dorothy Kim; Gerry Lopez; Jim Alling; Ken Lombard; Martin Coles; Michael Casey; Michelle Gass; Paula Boggs; Sandra Taylor

Subject: The Commoditization of the Starbucks Experience

As you prepare for the FY 08 strategic planning process, I want to share some of my thoughts with you.

Over the past ten years, in order to achieve the growth, development, and scale necessary to go from less than 1,000 stores to 13,000 stores and beyond, we have had to make a series of decisions that, in retrospect, have lead to the watering down of the Starbucks experience, and, what some might call the commoditization of our brand.

Many of these decisions were probably right at the time, and on their own merit would not have created the dilution of the experience; but in this case, the sum is much greater and, unfortunately, much more damaging than the individual pieces. For example, when we went to automatic espresso machines, we solved a major problem in terms of speed of service and efficiency. At the same time, we overlooked the fact that we would remove much of the romance and theatre that was in play with the use of the La Marzocca machines. This specific decision became even more damaging when the height of the machines, which are now in thousands of stores, blocked the visual sight line the customer previously had to watch the drink being made, and for the intimate experience with the barista. This, coupled with the need for fresh roasted coffee in every North America city and every international market, moved us toward the decision and the need for flavor locked packaging. Again, the right decision at the right time, and once again I believe we overlooked the cause and the affect of flavor lock in our stores. We achieved fresh roasted bagged coffee, but at what cost? The loss of aroma -- perhaps the most powerful non-verbal signal we had in our stores; the loss of our people scooping fresh coffee from the bins and grinding it fresh in front of the customer, and once again stripping the store of tradition and our heritage? Then we moved to store design. Clearly we have had to streamline store design to gain efficiencies of scale and to make sure we had the ROI on sales to investment ratios that would satisfy the financial side of our business. However, one of the results has been stores that no longer have the soul of the past and reflect a chain of stores vs. the warm feeling of a neighborhood store. Some people even call our stores sterile, cookie cutter, no longer reflecting the passion our partners feel about our coffee. In fact, I am not sure people today even know we are roasting coffee. You certainly can't get the message from being in our stores. The merchandise, more art than science, is far removed from being the merchant that I believe we can be and certainly at a minimum should support the foundation of our coffee heritage. Some stores don't have coffee grinders, French presses from Bodum, or even coffee filters.

Now that I have provided you with a list of some of the underlying issues that I believe we need to solve, let me say at the outset that we have all been part of these decisions. I take full responsibility myself, but we desperately need to look into the mirror and realize it's time to get back to the core and make the changes necessary to evoke the heritage, the tradition, and the passion that we all have for the true Starbucks experience. While the current state of affairs for the most part is self induced, that has lead to competitors of all kinds, small and large coffee companies, fast food operators, and mom and pops, to position themselves in a way that creates awareness, trial and loyalty of people who previously have been Starbucks customers. This must be eradicated.

I have said for 20 years that our success is not an entitlement and now it's proving to be a reality. Let's be smarter about how we are spending our time, money and resources. Let's get back to the core. Push for innovation and do the things necessary to once again differentiate Starbucks from all others. We source and buy the highest quality coffee. We have built the most trusted brand in coffee in the world, and we have an enormous responsibility to both the people who have come before us and the 150,000 partners and their families who are relying on our stewardship.

Finally, I would like to acknowledge all that you do for Starbucks. Without your passion and commitment, we would not be where we are today.

Onward

APPENDIX 2 STORE COUNT		
End of Year	**Total number of Starbucks stores**	**% increase from prior year**
1987	17	
1988	33	94.11%
1989	55	66.66%
1990	84	52.73%
1991	116	38.10%
1992	165	42.24%
1993	272	64.85%
1994	425	56.25%
1995	677	59.29%
1996	1015	49.93%
1997	1412	39.11%
1998	1886	33.57%
1999	2498	32.45%
2000	3501	40.15%
2001	4709	34.50%
2002	5886	24.99%
2003	7225	22.75%
2004	8569	18.60%
2005	10241	19.51%
2006	12440	21.47%
Source: Company web site, “Company Timeline,” accessed May 2007		

APPENDIX 3 PRODUCT DEVELOPMENT OVER TIME			
1971	Coffee beans Coffee equipment	2000	Fair Trade Certified coffee program extended
1982	Coffee provided to fine restaurants and espresso bars	2001	Starbucks stored-value card Hyatt Hotels agreement
1984	Caffe Latte Christmas Blend	2002	Ready-to-drink Starbucks Double-Shot espresso Commitment to Origins coffees Crème, non-coffee blended beverage T-Mobile wireless rollout begins

APPENDIX 3
PRODUCT DEVELOPMENT OVER TIME

1986	Eggnog Latte (Il Giornale)	2003	Starbucks Card Duetto (Visa & Starbucks card in one) Acquires Seattle's Best Coffee Iced Shaken Refreshments (iced coffee drinks)
1991	First licensed airport store	2004	In-store CD burning service Tazo® teas introduced to grocery stores Hear Music music bars launched Seattle's Best in Borders bookstores Black Apron exclusives 100% Kona coffee
1993	Starbucks in Barnes & Noble bookstores	2005	Starbucks Coffee Liqueur Starbucks Cream Liqueur Acquires Ethos Water (bottled water company) Ready-to-drink beverages introduced overseas
1995	CDs Frappuccino® Starbucks located in Chapters bookstores Starbucks Super-Premium Ice Cream (Dreyer's) First Starbucks in Japan	2006	Starbucks DoubleShot® Light espresso Rwanda Blue Bourbon Black Apron Exclusives Pomegranate Frappuccino® juice blend Strawberries & Crème Frappuccino® (non-coffee, bottled) Tangerine Frappuccino® juice blend Plans to roll out hot vending machines announce
1996	JV with Pepsico to sell bottled Frappuccino® in stores		
1997	Starbucks home espresso machine Frappuccino® Lowfat Ice Cream Bars		
1998	Milder Dimensions (lighter and milder than original roasts) Agreement with Kraft through grocery channels www.Starbucks.com Doonesbury Starbucks (playing cards, etc.) Doonesbury Starbucks discontinued		
1999	Acquires Tazo® tea company: adds Tazo® tea to Starbucks product offerings Shade-grown Mexican coffee Acquires Hear Music (music company) Starbucks Barista Aroma Solo coffeemaker Starbucks in Albertsons grocery stores		

APPENDIX 4
PRODUCTS

Coffee:
More than 30 blends and single-origin coffees.

Handcrafted Beverages:
Fresh-brewed coffee, hot and iced espresso beverages, coffee and non-coffee blended beverages, and Tazo® teas.

Merchandise:
An exclusive line of Starbucks Barista® home espresso machines, coffee brewers and grinders, a line of premium chocolate, coffee mugs and coffee accessories, and assorted gift items.

Fresh Food:
Baked pastries, sandwiches and salads.

Starbucks Entertainment:
A selection of the best in music, books and film from both emerging and established talent, offering Starbucks customers the opportunity to discover quality entertainment in a fun, convenient way.

Global Consumer Products:
Line of bottled Starbucks Frappuccino® coffee drinks, Discoveries™ Coffee Drinks (in Japan and Taiwan), Starbucks DoubleShot® espresso drinks, Starbucks® Iced Coffee drinks, whole bean coffees and Tazo® teas at grocery, Starbucks™ Coffee Liqueurs and a line of superpremium ice creams.

Starbucks Card:
Starbucks Card, a reloadable stored-value card, surpassed the $2.5 billion mark for total activations and reloads since its introduction in 2001. With more than 120 million cards activated to date, the Starbucks Card has continued to grow as a percentage of tender used in Starbucks stores. Due to its success in North America, Starbucks Card programs have launched in other international markets, including Australia, Greece, Hong Kong, Japan, Spain, Thailand and the United Kingdom.

Brand Portfolio:
Starbucks Entertainment, Starbucks Hear Music, Tazo®, Ethos Water, Seattle's Best Coffee and Torrefazione Italia Coffee.

Source: Company website, "Company Fact Sheet" accessed May 2007

APPENDIX 5 STOCK PERFORMANCE				
SELECTED YEAR-END ADJUSTED CLOSE SHARE / INDEX PRICES 2002-2007 (ADJUSTED FOR DIVIDENDS / SPLITS)				
	McDonald's MCD	**Panera Bread PNRA**	**Starbucks SBUX**	**Dow Jones Industrial Average DJIA**
2002	$13.17	$34.81	$10.05	8341.63
2003	$20.66	$39.52	$16.36	10,453.92
2004	$27.17	$40.32	$30.76	10,783.01
2005	$29.16	$65.68	$29.60	10,717.50
2006	$39.27	$55.91	$34.94	12,463.15
2007	$53.56	$35.82	$20.19	13,264.82
FIRST QUARTER (MARCH 31) 2008 CLOSE SHARE / INDEX PRICES				
1st Q 2008	$51.06	$41.89	$17.50	12,262.89

Source: Yahoo! Finance (2010), accessed December 30th, 2010

TO BREW, OR NOT TO BREW—THAT IS THE QUESTION: AN ANALYSIS OF COMPETITIVE FORCES IN THE CRAFT BREW INDUSTRY

Jack Kleban, Barry University
Inge Nickerson, Barry University

CASE DESCRIPTION

The primary subject matter of this case is a competitive analysis of the craft brewing industry in the U.S. The case is appropriate for courses in strategic management and entrepreneurship. The case has a difficulty level of three or four. The case is designed to be taught in 1 – 2 class hours.

ABSTRACT

This case analyzes the craft brewing industry in the U.S. It encompasses a description of what defines craft brewers, the different categories of craft breweries depending on size in the U.S. and the major competitors in the industry according to annual volume output of craft beer. Recent growth in the craft beer industry compared to the general U.S. beer industry is detailed.

In addition to craft beer brewer characteristics, the case outlines market structure, competition, and business strategies of craft breweries. Also considered are branding and social media marketing and social responsibility considerations, followed by distribution, and regulation and taxation of the craft brewing segment of the beer and beverage industry .

INTRODUCTION

Craft breweries' operations are small, and they are considered to be traditional and independent. Traditional in the sense that they produce a malt flagship or brew full- bodied beers which many are made from recipes taken from German or English brewing origins. The malt is high grade, the brewing process is relatively slow and the production is small scale. The main differentiating factors of craft brewers are their unique styles of brewing which can lead to enhanced flavor and taste (www.craftbrewersassociation.org).

The craft brewery industry in the U.S. is experiencing rapid growth. In 2008, craft breweries sold a combined 8.5 million barrels of beer, and in 2009 they sold over 9 million barrels of beer. Although the general beer sales in the U.S. experienced a decline in sales by volume of 2.7% in the first half of 2010, and sales of imported beer were down by 9.8%

in 2009, craft breweries were able to increase their sales by volume in the U.S. by 9%. In 2006, the reported number of craft breweries in the U.S. was 1370, and in 2010, 1625 craft breweries were reported. This represents a growth of over 18% in less than five years, the highest growth rate in U.S. history since before the prohibition era (www.craftbreweresassociation.org).

As evidenced, craft beer production and its consumption in the U.S. is on the rise. This case provides an in-depth look at the industry and its potential for growth in the near future. We also provide information about the industry's market structure, including competition within the sector.

Market Definition

Since 2006, the craft beer industry has been able to outperform the normal beer industry segment on both percentage margins and percentage growth because of their unique product characteristics, organizational structure and different marketing approach.

Craft breweries tend be small in size, typically producing less than 6 million barrels of beer (BBL) per year. They are *independent*, as less than 25% of the breweries are owned or controlled by an alcoholic beverage industry member that is not themselves a craft brewer, and *traditional*, as at least 50% of its volume is in either all malt beers or utilizes enhancers in order to create full-flavored beers (www.breweresassotiation.org).

Craft brewers focus on differentiation. Their value derives from utilizing both traditional styles such as using malted barley, combined with their own unique formulas by adding non-traditional ingredients, hence developing new styles that have no precedent.

Craft brewers tend to operate locally not only on the production side but, as well, they are very involved with the communities they serve. They are participate in a number of corporate social responsibility programs such as product donations, volunteerism, sustainable development, sponsorships, and other philanthropic endeavors (www.breweresassotiation.org).

Craft breweries are horizontally differentiated and have a limited number of substitutes. The main differentiating factor between the craft beers and other normal beers is the brewing styles and distinctive flavors. Craft beers have their unique taste and likeness, which come from the traditional slow brewing styles and recipes that have been perfected over the years. This is how craft beers differentiate themselves horizontally based on the taste and quality.

Craft type of beers appeal to consumers who are seeking a "taste revolution." For this particular consumer group, the increase in product features enhances their economic benefit, thus giving them more satisfaction. Due to this unique feature, the price elasticity of demand for craft beers is much lower than for regular beers. Because of the economic benefit provided by craft beers, they can demand higher prices, thereby capturing higher margins. The craft brewers are also geographically differentiated. A particular geographical area boasts a unique type of craft brew (i.e. Boston Beer Company, located in Boston, Massachusetts). The success of the craft brew industry and its appeal to the general population is based on two main factors: the higher perceived economic value consumers get and the very experience of drinking craft beer (http://www.stumptown.com/articles/mgmtbeer.html).

The Craft Beer Making Process: Where Differentiation Begins

The primary natural ingredients for making beer are hops, yeast, malted grain and water. Craft breweries traditionally select only the finest quality of all these ingredients – particularly barley malt, with strains having two rows of grain in each ear. Hops are chosen according to the need of a specific flavor or taste. Some hops impart slight bitterness to the beer, while others are used to bring out distinctive aromas. The most commonly used yeasts for the fermentation process are *Saccharomyces Cerevisiae* used in production of ale, and *Saccharomyces Uvarum* used to produce lagers. There are many different strains of these yeasts and craft breweries carefully choose the correct combination of these ingredients according to their in-house recipes.

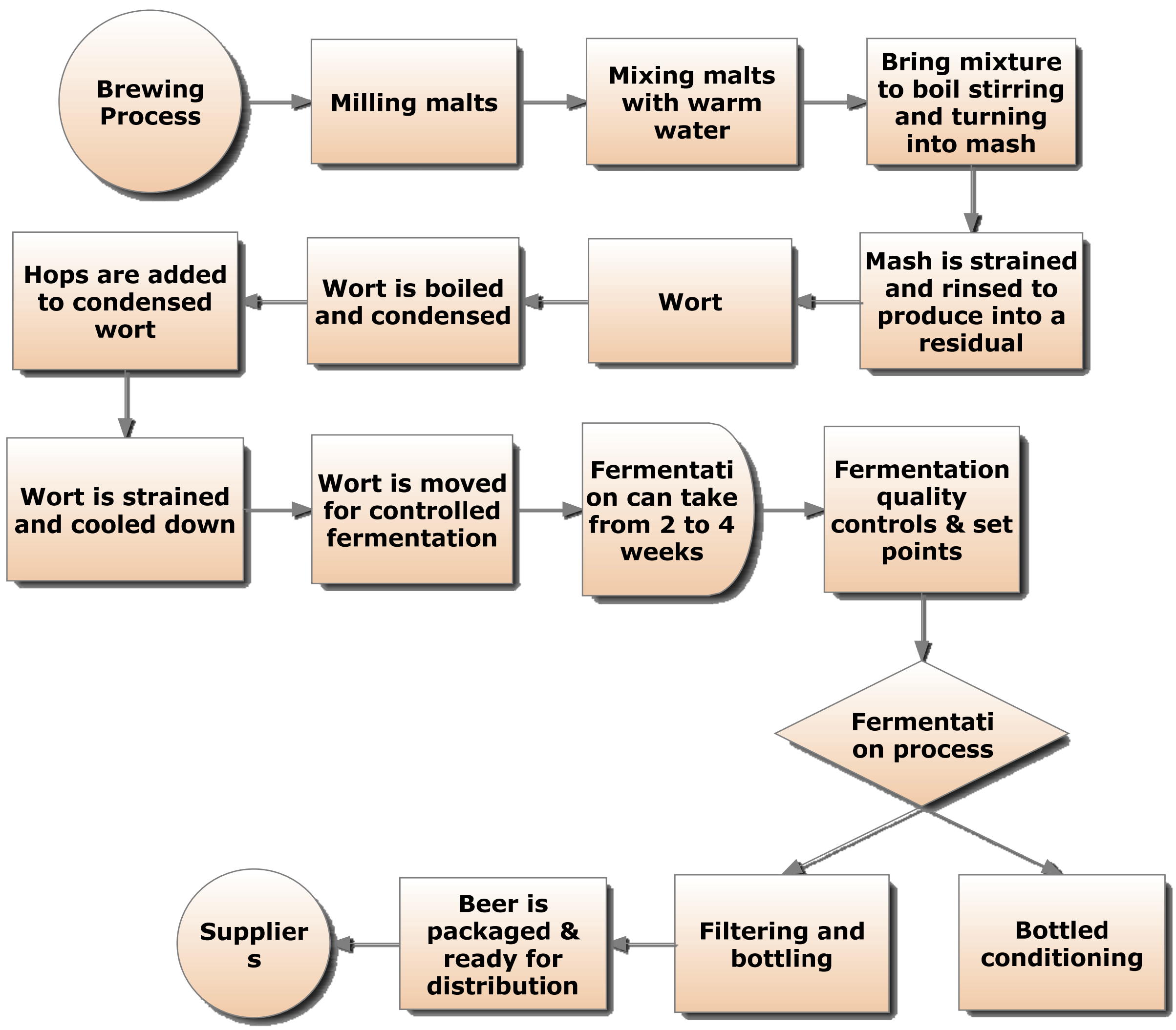
The brewing process starts with milling specific strains of malts and then mixing them with warm water. A mash tun is used to stir and heat the mixture, converting simple carbohydrates and sugars into fermentable sugars with the help of naturally occurring enzymes. This mash is then strained and rinsed in the *lauter tun* to produce a residual liquid dense in fermentable sugars called *wort*. Wort is then boiled and condensed in a brew kettle, and hops are introduced in intervals to not only act as natural preservatives for the beer but, as well, to reach the adequate bitterness and aroma according to the recipe.

Sometimes a mixture of different varieties of hops is used to create a distinct flavor and taste. After the boil, the wort is strained and cooled down before it is moved to the fermentation cellar, where the internally cultivated specific yeast is added to induce the fermentation. Yeast metabolizes worts' sugars to produce alcohol and CO_2. CO_2 is partially captured and absorbed by beer, providing a natural source of carbonation. After the fermentation is over, the beer is cooled for several days during which beer gets clarified and develops a full-flavor. The unwanted yeast is removed from the beer by filtration, which is completed in roughly 14 to 21 days.

The fermenters and other necessary equipment required for the brewery are easily available for purchase in the market. Different breweries employ different styles and types of equipment. Once the beer is ready, it is generally packed in kegs and bottles. Most of the microbreweries and nanobreweries have manually operated bottling equipment. To enhance shelf life, the bottling operations are done under maximum CO_2 concentrations to ensure that minimal amount of O_2 gets dissolved in the beer. Craft breweries are known for their environmentally conscious practices and utilize lighter- weight glass bottles, tins or bigger (1/2 liter) size bottles to serve beer.

Quality assurance (QA) is a key factor in order to maintain the consistency required in craft beer quality and flavor. QA for small breweries is generally done by tasting beer randomly within different batches. Large breweries, like the Boston Beer Co., maintain a separate Quality Assurance Department which oversees microbiology, brewing chemistry, sensory evaluations, and packaging quality and integrity. These subdivisions within the Quality Assurance Department oversee qualitative and quantitative analysis of the batches to ensure superior product quality. Each new product is thoroughly tested and retested before it is mass-produced and sold in the market. Larger breweries allocate extensive amount of their budget to QA departments (http://www.redhook.com/Default.aspx?p=21).

The Craft Beer Making Process



Scope of Craft Breweries

Craft breweries can be separated into different categories according to production output in barrels of beer (BBL) per year. (Where 1 BBL = 339 12 oz bottles of beer or 235 half-liter bottles of beer.) Craft beer production for all categories can range anywhere between less than 30 BBL and up to 6 million BBL per year. It is within this range of volume output that craft breweries get their name categorization.

- *Nanobreweries:* Nanobreweries operate at a slower rate than traditional microbreweries, with a volume output of less than 30 barrels of beer per year. They are not a good choice for long-term setup as the effort/profit ratio is very narrow.

- *Microbreweries:* Microbreweries produce less than 15 thousand barrels of beer per year. More than 75% of its beer production is sold outside the brewery. Microbreweries sell to the public in three different methods:

  Brewery → Wholesaler → Retailer → Consumer
  Brewery as Wholesaler → Retailer → Consumer
  Brewery (As a Bar/On-site Tap sale)→ Consumer

- *Brewpub*: Brewpubs are restaurant-based breweries where more than 25% of beer is sold on the same floor. Restaurants maintain these breweries and beer is dispensed from the storage tanks. Many laws and regulations have to be taken into consideration for these brewpubs; and, if allowed by law, it is possible to sell beer to offsite places or offer "beer to go." The majority of restaurants that operate a Brewpub are located in the northeast sector of the U.S. This is due to the fact that the local population in the northeast demands locally brewed beers.

- *Contract Brewing Company:* They comprise brewing companies that outsource their production to other already established breweries. The main brewery provides the exact specifications for brewing the beer. The contract brewing company is responsible for the marketing, distribution and selling aspects of the business, while the brewery provides the space, apparatus and infrastructure for brewing. Examples of these breweries include Pete's Brewing Co. and Boston Beer Co. Boston Beer Co. is the largest brewery with its flagship products Samuel Adams (SA) Boston Lager, Boston Ale, SA Octoberfest, SA Wheat, and SA Winter Lager, etc.

- *Regional Craft Brewery:* Regional craft breweries produce anywhere between 15 thousand and 2 million barrels of beer per year, and over 50% or more of their volume production focuses on all-malt beers and/or their malt flagship. Regional craft breweries are typically known for adding flavor-enhancers in order to produce strong-tasting beers. Examples include Sierra Nevada Brewing Co., Red Hook Ale Brewery and Anchor Brewing Co.

- *Large Brewery*: These breweries have an annual production capacity of up to 6 million barrels of beer. The only craft brewery that comes close to this definition is the Boston Beer Company with annual production of 1,841,348 barrels per year.

Leading Companies and Market Share

<u>Boston Beer Co.</u>

- *ANNUAL SALES: 1,841,348 BARRELS*
- *SEGMENT MARKET SHARE: 20.20%*

Headquartered in Boston, Massachusetts, the Boston Beer Co. is the largest craft brewery in the U.S. They produce the widely popular Samuel Adams brand, and they also produce a diversity of craft beer types. Boston Beer Co. is also known as the largest Contract Brewing Company. Although the most popular brew is their Boston Lager, the company is also popular for their seasonal and specialty beers, such as the high-priced Utopias, which contain 27% alcohol by volume and are aged over 16 years.

Following the acquisition of Anheuser-Busch by InBev, the Boston Beer Company is the largest American-owned brewery, producing over 1.8 million barrels annually. The Boston Beer Co. was founded by Jim Koch and uses the original recipe from his ancestor's pre-prohibition formula.

<u>Sierra Nevada Brewing Co.</u>

- *ANNUAL SALES: 723,880 BARRELS*
- *SHARE OF SEGMENT: 7.94%*

Established in 1980 by Ken Grossman and Paul Camusi, Sierra Nevada Brewing Co. is the second largest craft brewery in the U.S. and is located in Chico, California. It produces over 723,000 barrels of beer annually, and its most popular brew is the company’s pale ale. Sierra Nevada has a wide range of seasonal brews, porters, stouts and special releases.

New Belgium Brewing Co.

- *ANNUAL SALES: 583,160 BARRELS*
- *SHARE OF SEGMENT: 6.40%*

Located in Fort Collins, Colorado, New Belgium Brewing Co. is the third largest craft brewery in the U.S. Founded in 1991, the brewery began when Jeff Lebesch decided to take his passion for home brewing to a commercial level. Fat Tire, the company's flagship beer, originated from a bicycle trip Lebesch took across Belgium from brewery to brewery, and the icon of a bicycle is also displayed in company logos and labels. The company's beers are distributed in 19 different U.S states.

Spoetzl Brewing Co.

- *ANNUAL SALES: 409,000 BARRELS*
- *SHARE OF SEGMENT: 4.49%*

Located in Shiner, Texas, and known as the "little brewery in Shiner," was founded in 1909. Spoetzl is the oldest brewery in Texas and is distributed across 41 states across the U.S. Brewed since 1913, Spoetzl's flagship beer is the Shiner Bock.

Pyramid Breweries, Inc.

- *ANNUAL SALES: 192,199 BARRELS*
- *SHARE OF SEGMENT: 2.11%*

Headquartered in Seattle, Washington, Pyramid Breweries was acquired by North American Breweries, Inc. in August 2010. With the introduction of its Apricot Ale in 1994, Pyramid has been known as a leader in the fruit beer category. They operate several alehouses and restaurants in Washington, Oregon and California.

Deschutes Breweries, Inc.

- *ANNUAL SALES: 186,783 BARRELS*
- *SHARE OF SEGMENT: 2.05%*

Located in Bend, Oregon, Deschutes Brewery produces a range of beers, including Black Butte Porter and Mirror Pond Pale Ale as well as a specialty brew called The Abyss, which is an imperial stout with 11% alcohol by volume. Aged in bourbon barrels, "The Abyss" has won numerous awards since its 2007 release and is considered to be one of the finest beers in the country.

Matt Brewing, Co.

- *ANNUAL SALES: 171,700 BARRELS*
- *SHARE OF SEGMENT: 1.88%*

Matt Brewing Co. brews Saranac Beers, and is the third largest craft brewery in the U.S. Located in Utica, New York, this family-owned brewery also produces soft drinks and is primarily available on the East Coast.

Magic Hat Brewing, Co.

- *ANNUAL SALES: 154,236 BARRELS*
- *SHARE OF SEGMENT: 1.69%*

Located in South Burlington, Vermont, Magic Hat brews four year-round beers, and four seasonal beers, with “#9” as its flagship beverage. In August 2010, Rochester based North American Breweries, Inc., along with several other brewers, acquired Magic Hat.

Boulevard Brewing, Co.

- *ANNUAL SALES: 138,954 BARRELS*
- *SHARE OF SEGMENT: 1.52%*

Boulevard is a regional brewery located in Kansas City, Missouri. When Anheuser-Busch was sold to InBev, Boulevard became the largest independent American brewery in Missouri. Their beers are primarily available in 20 states across the Midwest and Great Plains. Boulevard has recently completed an expansion of their brewing facility that gives them the capacity to produce up to 700,000 barrels per year.

Harpoon Brewing, Co.

- *ANNUAL SALES: 130,516 BARRELS*
- *SHARE OF SEGMENT: 1.43%*

Headquartered in Boston, Massachusetts, Harpoon Brewery is known best for its India Pale Ale, but also has a range of beers, including award-winning Munich Dark, 1636 brew and four seasonal beers.

The U.S. Beer Market and its Performance Compared to Craft Beer

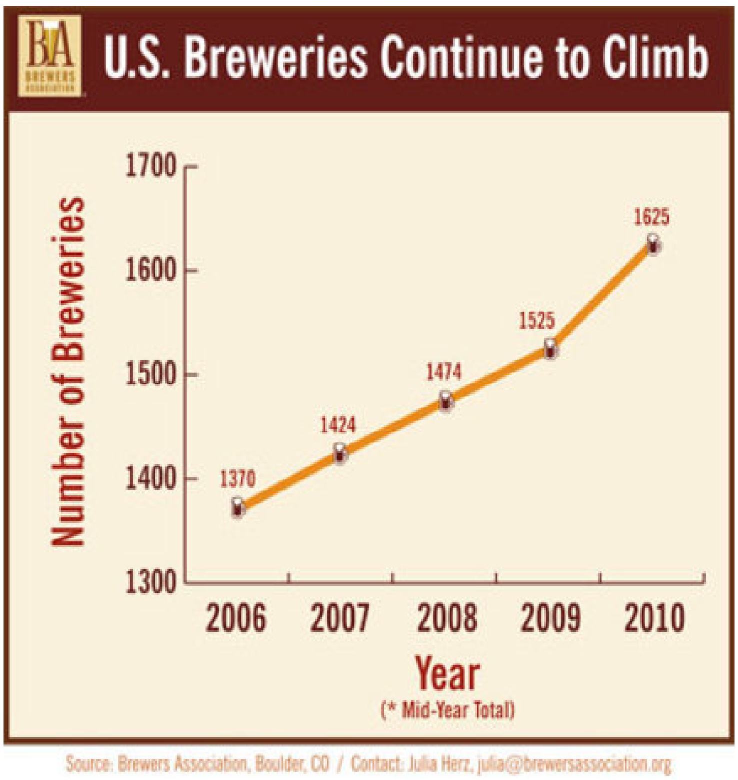
The U.S. beer sales market has experienced a downturn in recent years. Beer sales by volume were down an estimated 2.2% in 2009 and 2.7% in the first half of 2010. Imported beers have also experienced a downturn in sales of 9.8% in 2009 (equivalent to 2.8M barrels). Conversely, the craft beer brewing industry has experienced sales growth in recent years. Craft beer sales by volume in 2009 were 7.2%, and 10.3% by dollars compared to growth in 2008 of 5.9% by volume and 10.1% by dollars. This transfers into a 4.3% by volume and 6.9% by dollars of craft brewing sales share as of 2009. (www.brewersassociation.org).

2009 Craft Beer Industry Production Volume	
Regional craft breweries	7,053,996 bbl
Contract brewing companies	365,132 bbl
Microbreweries	989,644 bbl
Brewpubs	706,863 bbl
Domestic Craft Beer Sales	
2009	9,115,635 barrels
2008	8,501,713 barrels
US Breweries July 31, 2010	
Brewpubs	994
Microbreweries	534
Regional Craft Breweries	71
Total US Craft Breweries	1,599
Large Non-Craft Breweries	20
Other Breweries	21
Total US Breweries	1,640

US Breweries Operating in 2009		US Breweries Operating in 2008	
68	Regional Craft Breweries	62	Regional Craft Breweries
486	Microbreweries	447	Microbreweries
998	Brewpubs	995	Brewpubs
1,552	Total Craft Breweries	1,504	Total Craft Breweries
20	Large Breweries (Non-Craft)	20	Large Breweries
23	Other Non-Craft Breweries	23	Other Non-Craft Breweries
1,595	Total US Breweries	1,547	Total US Breweries
2009 US Openings		**2008 US Openings**	
47	Brewpubs	66	Brewpubs
63	Microbreweries	58	Microbreweries
0	Regional Craft Brewery	1	Regional Craft Brewery
2009 US Closings		**2008 US Closings**	
34	Brewpubs	45	Brewpubs
16	Microbreweries	15	Microbreweries
2	Regional Breweries (non-craft)	0	Regional Breweries (non-craft)

SOURCE: BREWERS ASSOCIATION, http://www.brewersassociation.org/

Craft brewers sold an estimated 9,115,635 barrels of beer in 2009, up from 8,501,713 in 2008. Craft brewer retail dollar value in 2009 was an estimated $6.98 billion, up from $6.32 billion in 2008.



Business Strategies Employed by Craft Brewers

As craft breweries grow and continually plan to expand their operations throughout the U.S., they combine a precise set of strategies that prove to be effective within their industry. Table 1 explains them and the tactics used to achieve them.

Market Structure and Competition

Because craft breweries differentiate themselves from the regular beer producers by focusing on quality, their organizational structure is consequently different. Furthermore, craft breweries cannot compete with large breweries on price due to their advantages with higher economies of scale.

Competition within the domestic craft beer segment and other high quality beer categories is based on product quality, consistency, freshness and taste. Craft breweries must also be keen in their ability to differentiate products by utilizing a variety of methods, mainly: promotional tactics, customer satisfaction programs, distribution costs and price. In order for craft breweries to maintain their identity, they must follow their differentiation strategy (by using a combination of the methods mentioned). Otherwise, they would be considered as part of a regular beer product category and, hence, would compete with beer, wines, spirits and other flavored alcohol beverages.

Table 1: BUSINESS STRATEGIES EMPLOYED BY CRAFT BRWERERS

Strategy	Tactic
Superior quality of beers	World-class beer production machinery, and utilizing only the best ingredients available (barley, hops, etc.). Most brewers get their product Kosher certified by the orthodox union. Producing their products in sustainable environment and help reduce the total carbon footprint by improvising on brewing mechanisms.
Diversified product lines	Brand loyalty can be difficult to attain in industry. In order to attract and retain loyal customers, craft brewers offer a variety of beers under the same flagship brand. For example, seasonal, or festive brews.
Strategic partnerships with distributors	Most of the craft brews are location-based and serve a limited area. They lack the necessity manpower to distribute the beer themselves, thus forging strategic relationships with the local successful distributors.
Control of production	By doing this, craft brewers maintain operational efficiency, and consistency in product quality and taste. Employee productivity is also optimized.
Targeted sales and marketing efforts	Craft brewers usually target local restaurants, bars, clubs and liquor stores. They also engage in the creation of different families of products under the same brand. Advertising is done to boost sales in a variety of ways. Breweries engage in training wholesalers and retailers about their brand to secure loyalty. They also engage in promotional events at festivals, venues, sponsorships, etc. The relationships with wholesalers and retailers are key, as they also serve as the promoters of the brand and the different product.
http://www.annualreports.com/HostedData/AnnualReports/PDFArchive/hook2009.pdf	

The craft beer segment has become highly competitive in recent years due to easy availability of funds to finance the startup operations, which has led to the explosive growth in the number of craft breweries operational in US market. Competition varies with the regional markets, depending upon the local market preferences and distribution techniques.

Within the craft brewing industry, microbreweries experience the most competition. This is due to the fact that there are many of them and their market shares are noticeably small. Due to their wider distribution zones, national craft brewers have the financial backing necessary to support their products with expensive promotions. On the other hand, microbreweries possess the competitive advantages of being even more unique than national craft breweries and highly appealing to local consumers.

Craft brewers also compete with imported craft brews such as Dark Ales, Pale Ales, Lagers and other alcoholic segment products from Belgium, France, Germany, and other countries. The imported beer segment has a large market share in US and is economically stronger than most of the local craft brewers. However, due to the growth in the craft brew market in the U.S., the imported beer segment has lost some market share. Craft brewers are taking advantage of several factors, such as lower transportation costs, quality and flavor of beers, proximity and familiarity with local consumers, federal and state tax incentives, higher degree of product freshness and crispness.

Competition for craft beers is also present from the wine and spirits segment. The regular beer segment has lost about 1% of their market share to wine and spirits segment every year since 2003. However, this trend is declining due to the recent economic downturn. As the numbers indicate, the craft beers segment has shown growth despite the economic crisis, indicating a bright future and potential for further growth in this industry. The Pacific Northwest and California are said to be the most competitive craft beer markets in the U.S. in both number of breweries and consumer awareness. The market is currently healthy and competitive, but specialists believe that soon this competition will be based on price, leading to a drastic decline in the quality and integrity of the products. This in turn can potentially damage the image of the industry as the industry is primarily based on differentiation via quality of product(s). Craft brewers attempting to capture more market share are focusing on consumer awareness, redesigning their brands and aligning their product lines (http://www.konabrewingco.com/uploads/CBA_Kona_Partner.pdf).

Market Concentration

<u>Producers:</u>

The market concentration in the industry is high, with two distinctive sets of trends that set the competition in the market. The positive acceptance of craft brews by the U.S. population has led to the extensive growth in the industry. This acceptance, in turn, has led to growth in the number and diversity of craft brewers. Consequently, large breweries are either acquiring or are being acquired by other national or foreign brewers in order to gain more market share in the expanding craft brew market.

SABMiller and Molson Coors came together in joint venture, merging their U.S. operations as Miller-Coors to compete head on with market leader Anhauser-Busch. Miller-Coors was then momentarily the world's largest brewer by volume until InBev's acquisition of Anhauser Busch in the fourth quarter of 2008. According to industry statistics, Anhauser Busch and Miller-Coors have accounted for roughly 80% of total beer shipped in the United States, including imports, since 2008. While in the craft brew segment, Boston Beer Co. became the largest brewer of craft brews. The U.S. beer market is similarly and increasingly concentrated in a small number of microbrewers, nanobrewers and brewpubs.

The largest four have established a combined market share estimated at just over 50% of the world market. Budweiser-brewer, AB-InBev, had beer volumes of around 350 million hectoliters in 2009, Miller-brewer SABMiller at just under 250 million, Heineken at just over 200 million, and Carlsberg around 125 million, while Tsingtao trailed at just over 50 million hectoliters a year (http://www.sabmiller.com/index.asp?pageid=1878&blogid=45).

Consumers:

The majority of craft beer drinkers are Caucasian (90%), male (70%), urban (65%) who have household incomes of at least $50,000 per year (75%), are college educated (65%) and are between ages 21 to 50 (90%). The national market for craft brewers has an eight-firm concentration ratio of 53.4%. The largest of this share goes to Boston Beer Co., which holds a market share of 25.1%. Thus, the craft brewing industry has a large untapped market, which is made up of small to very small brewers.

Most of the larger brewers are trying to gain market share in the craft brew segment. The Chicago based Miller-Coors have established a separate division named Tenth and Blake Beer Co. which will focus on the domestic and imported craft beer segment, and it carries beers like Blue Moon, Peroni and Pilsner Urquell. The trend is supporting this move, as most of the current consumers are choosing flavored, innovative, full-bodied and diversified beers over regular beers. Guinness has also started concentrating on the craft brew industry with the launch of Guinness Black Lager, designed for Guinness drinkers who are looking for a taste revolution (http://articles.chicagotribune.com/2010-09-21/business/ct-biz-0922-craft-beers-new-20100921_1_craft-beer-craft-segment-craft-brewers).

The Branding of a Craft Beer Brand

Building successful beer brands is a step-by-step process that takes into consideration various factors such as quality of beers, availability in the marketplace, competitive pricing, marketing and promotions, etc.

The balanced combination of ‘Push’ and ‘Pull’ in the marketplace creates brand recognition and attracts both new and repeat customers. Push strategies utilize the resourcefulness of distributors to put the brands on retailers’ shelves, while Pull strategies create a liking for the brands in the minds of consumers. Creating this pull strategy is highly essential for the creation of a successful brand, as it focuses on consumers, their interests, and strategically aligns the brands to meet them.

Identify your customers:

Identifying your target market is important. Every craft brewer should know the demographics of the market but at the same time should understand the age groups, income levels, and other key attributes of their consumers who are buying their product. Sellers should know why a particular age group is buying their product, who their repeat customers are, what other age groups are drinking and why. The craft brewer should try and reach for a dedicated niche market based on product quality and pricing. Once a loyal base has been established, craft brewers can expand further by creating targeted marketing campaigns.

Craft a dedicated brand message:

Every craft brewer needs to establish a clear communication channel with the consumer. The message should be clear, concise and appealing. It should be repeated until it becomes second nature to every level throughout the organization from the brewers to distributors to retailers and to consumers. Brands packaging and accessory materials should reiterate the message, (i.e. Boston Beer Co.: The leading brewer of handcrafted and full-flavored beers).

The brand message should take into consideration the vision and mission for the brand. The strategy behind building a message is customers will then be able to identify your brands based on the unique message.

Creating image of the brand:

Creating an image or reputation is essential. This is usually done through designing unique logos or images that will make a craft brew brand stand out from the rest. Reputation is also dependent on the quality of beer and customer service provided.

Providing consistent quality:

Quality can be conveyed in many ways, but for a craft brewer the most important factor is product consistency. The freshness and crispness of the beer should be same in every batch, every bottle should bear the same logo and brand message and every product packaging should be identical. Every brewery regardless of its size should have a basic level of quality control. Quality Control programs are very costly, but each brewery should have at least the following:

- A program that measures the quality of the beer before it sets out for sale.
- A well calculated and defined shelf life for each type of beer and a technique to identify age of the product at retail outlets ("best before" date stamp).
- A consistent way to randomly sample the products to enforce consistency in products.

- Sufficient budget to remove the expired beer from the shelves and returning it to the brewery.

Brand recognition

Making your brand recognizable is most important. Breweries that are dominating the market have recognized the need for establishing brand recognition by getting more shelf space for their products. The more customers see a particular brand and begin remembering it, the more chances there are for its consumption and demand. This can be achieved by simple steps such as hanging a sign outside the door, creating accessories such as pouches for beer bottles, t-shirts, pens, mouse pads, etc. These are excellent means to spread the brand name.

Consumer Ownership

People choose a particular brand because they feel a sense of attachment with the brand. Most of the brands try to create an aura around them which makes them attractive to targeted customers. For craft brews, it can be the taste revolution which most of the customers are seeking nowadays which can instantly attach a peculiar taste with a brand, or a visit to the brewery which has gone really well and consumers establish an attachment towards the brewery and its brands. Craft brewers should give the necessary attention to each and every consumer who demonstrates interest in their product, as these people then act as brand ambassadors to the brand. A customer centric approach must be a priority when creating a brand image in the craft brew industry.

Packaging

Packaging conveys how the consumer perceives your brand. If consumers are going to pay a special price to buy a craft brew, the package must reflect the consumer's perception. Good packaging should not only stand out but, as well, fit in. It should be compelling, interesting and comfortable. Most craft breweries re-evaluate their packaging every time they make changes in their package designs, logo changes, etc. They allow their packaging to evolve as the brand matures. The subtle changes in brand packaging can be easily understood if famous brands from successful craft breweries such as The Sierra Nevada Brewing Co., and The Boston Beer Co. packaging from last 15 years are studied (http://www.probrewer.com/resources/library/brand_building.php).

Some craft breweries like the Oskar Blues Brewery in Colorado, despite criticism from the craft brewing community, have packaged their products in tin cans. Packaging in tin cans is more affordable and easier to recycle. Aficionados expressed concern that such a package affects the integrity of the taste and quality of the product, claiming that UV rays and oxidation occur easier with tin cans. It has been proven that the taste and integrity of beer in tin cans is just as good as glass, and currently less than 1% of the craft beers are canned. Some 52 breweries in the U.S. now offer canned beers. The point of view towards canned beer in the craft beer industry is changing, especially after larger craft breweries are shifting to green initiatives. It is estimated that in a few years canning of craft beer will increase multifold as more customers realize its true advantages (http://www.inc.com/ss/canned-beer-renaissance?nav=related).

Contingency Planning

Contingency planning is essential to building a successful craft beer portfolio. Craft breweries need to watch individual brands' sales records very carefully, and adapt accordingly. There can be several reasons why a brand might not be selling as well as expected, including sudden drop of demand, lower production volumes, difficulties in accessing the raw materials, etc. On the other hand, through contingency planning, craft breweries can focus on their main products in the scenario of an increase in competition in other segments. The craft beer industry is currently a niche market and limited to the people who are following the taste revolution. But as it is growing exponentially every year, large beer companies like Miller-Coors, A-H, etc. are trying to gain market access, and also every year many new microbreweries are staring up. Thus, in face of rapidly changing scenarios in the craft beer industry, contingency planning is highly important (http://www.bplans.com/brewery_business_plan/controls_fc.cfm#ixzz10BxMSyeU).

Social Media Marketing for Craft Breweries

Craft brewers have picked up on the scent of this new marketing platform. They are using social media to send and receive instantaneous feedback about their existing and upcoming products. In the world of beer makers, it has always been the case that a company with more financial resources to spare had an upper hand because of their extensive marketing expenditure. But the situation is changing, as social media has brought microbreweries, nanobreweries and large breweries to a common battlefield; and the one who will strategically utilize these networking resources, will prevail.

The giants of the social media stream are Facebook, Twitter and YouTube. Every company/brand or product is marking its presence on these social media websites. On Facebook they create a fan page, on Twitter they create an official Twitter account which allows its followers to stay on top of the brand, and on YouTube they have company- dedicated channels through which they share their videos about the brand, best practices, etc.

There are some common strategies that are used by craft brewers. Most of the craft brewers create a Facebook fan page and make users aware of it. Some even give out free beer samples or pints once customers become fans. This is a strategy to increase the sphere of influence on Facebook. The more followers the brand has, the more chances there are that a new user will consider checking the brand out once he/she stumbles onto the page.

The second strategy is creating an official account on Twitter. Twitter allows users to follow the brands and celebrities they like. The sphere of influence on Twitter is roughly calculated by how many followers a brand will have plus how far a message posted by brand/company travels.

The third most commonly used strategy is by creating a dedicated video stream on YouTube. The videos included by craft brewers will focus on their best practices, fun to make beer videos, etc.

After marking the presence of the brands and companies on various social media platforms, companies then need to pay attention to what customers are saying about them, how their competitors are interacting with their customers and how effective their influence on social media is.

Nano and microbreweries can easily gather information about their current customers and spread the word to their potential customers with a very low marketing budget. The social media network is a boon for small breweries that cannot dedicate much of their finances to specialize and engage in costly marketing practices.

After the generation of followers, there are specialized online tools which are available for the companies through which they can determine the level of influence the company has, how many new followers the company/brand have gathered, how effective their social media strategy was, etc. The return on investment of a Social Media Marketing plan for a craft brewer is an increase in its sphere of influence, which can be directly translated to more effective pull for his/her products by the market (http://www.bplans.com/brewery_business_plan/controls_fc.cfm; http://craftbeer.us/2010/02/14/film-it-and-they-will-watch/).

Corporate Social Responsibility

Craft brewers are seen as revolutionaries, who are more localized, green and typically adopt socially responsible business models with focus on quality and diversity over mass-produced beer. In his book, *Fermenting Revolution: How to Drink Beer and Save the World*, author and beer activist Chris O'Brian, states that "American craft brewers are the country's unlikely revolutionaries, and their adoption of sustainable business practices helps fight globalization and break the market control of major beer companies."

Microbreweries are fighting in the smaller markets but with larger players, they are supporting their communities by using fresh local ingredients for their brews; they understand their customers and they have the ability to develop and respond to the needs of the local markets. They are building loyal followers, giving back to the society by promoting various events, something that has not been done by the beer giants.

From the bigger craft beer breweries like The New Belgium Brewing Co., The Boston Beer Co., and Red Hook Ale to small microbreweries, such as The Main Beer Company http://mainebeercompany.com/About_the_Trainer.html and brewpubs, an overwhelming number of craft brewers have embraced green technology to run their businesses. But maintaining a sustainable modern-day brewery involves more than just buying local ingredients and following a protocol. Eco-friendly brewers need to be aware of things like the type of energy used to power their operations, the sources of raw materials, the equipment used to build the brewery, the packing and distribution materials used and how to dispose of the waste products.

Vermont has highest breweries per capita in the U.S, where there is a craft brewery for every 32,698 people. Vermont also boasts the first certified organic brewery in the nation: Wolaver's Brewery. Wolaver's believe that people are attached to a particular type of Craft beer because they feel a connection for that brewery. And part of building and nurturing that connection is through implementing local, sustainable business practices. They have the vision: "local, organic, collective, green and background." Every step of their beer-making process has been well defined to be sustainable.

The Alaskan Brewing Company in Juneau is the first beer producer who has started recycling the CO_2 naturally created during the fermentation process. The Alaskan Brewing Company tries to tie in their location and environment to their brewing process. They state that if a consumer is enjoying their product, he/she is not only supporting the environment and helping the local community become sustainable but also supporting a business that is consciously trying to make a difference.

Sedibeng Breweries are actively involved in a wide range of social responsibility engagement programs, which aim to invest back into the community. Through their social responsibility program they are trying to assist in improving people's lives. They contribute to development in a sustainable way and they support projects that communities need. They study the community requirements, rather than strictly creating solutions for our communities. This works because then they can spread their resources widely on various sustainable projects. However, before the company commits to a project, it ensures that skills will be transferred, communities are involved and the projects will be able to become self-sustaining. Wherever it can, the company assists and sometimes forms partnerships to increase capacity.

Small brewpubs are also paving the way for environmentally sustainable business in America. Salt Lake Brewing Company in Utah was awarded the 2006 Environmental Company of The Year award by the Recycling Coalition of Utah, while Kona Brewing Company in Hawaii employs a full-time sustainability coordinator.

The ultimate sustainable brewpub in the country is the Hopworks Urban Brewery in Portland, Oregon. Formed by award-winning Laurelwood brewmaster Christian Ettinger, Hopworks considers sustainability its primary motto. It uses biofuel made from oil used in the deep fryers to run its trucks and uses pizza ovens to heat the brewing water. The brewery is cleaned with collected rainwater caught from the roof, and the entire brewery building is built from reclaimed or recycled materials.

Local, sustainable beer is infusing the American beer market. According to the Organic Trade Association (OTA), organic craft beer sales increased 40 percent in 2005, tying only with organic coffee as the fastest-growing organic beverage segment in the country. The big companies are also starting to notice the glitter produced by the organic beers. Anheuser-Busch released two organic beers to the market named Wild Hop Lager and Stone Mill Pale Ale. Since then A-B have dedicated separate sustainable development departments to improve their social corporate responsibility rating. In 2008 the Molson Coors Brewing Co. set the rolling global target to reduce water-use efficiency by four percent. And, according to a 2008 promo video, Miller claims to now be recycling 99.9% of all packaging waste.

Most of the larger players in beer business have taken up environmental initiatives, which have resulted in reductions of carbon footprints, and in less water and energy usages. But these sly larger players are going green for better PR, the proof lies in the lobbying of the U.S. Department of Agriculture by Anheuser Busch to drop the hops as the item on the list of organic beers' ingredients which doesn't have to actually be organic. According to the USDA, for a product to be considered organic, it must be made with at least 95 percent organic ingredients. The company now claims to be using 100% organic hops in its organic beer (http://www.bplans.com/brewery_business_plan/strategy_and_implementation_summary_fc.cfm #ixzz10BwnF1Yy; http://www.triplepundit.com/2011/01/green-brewhaha-craft-beer-makers-green/).

Distribution Channels

Distributors are very important personnel in the craft beer industry. They are responsible for transportation, cold storage requirements and maintenance of perishable beer from the time it leaves the brewery till the time it arrives for sale at restaurants, bars or retailers. Distributors add value in the beer distribution channel in many ways. Particularly, distributors provide the necessary infrastructure for small brewers so that their products can reach a wide network of retailers. The consumers of the beers benefit by having a wide variety of choices of famous brands, from large domestic or international breweries to specialty craft microbreweries. Because of the economic efficiencies of the distribution system, retailers can offer hundreds of choices of beers at a great price.

<u>Storage and Transportation</u>

Each distributor is equipped with state of art cold storage facilities. They secure the beer from a variety of breweries and preserve it until it is delivered with the utmost freshness. They are the face of the beer brands to the retailers, employing skilled sales and marketing crews to market the products they carry to different retailers. Distributors have a variety of trucks, and they employ many drivers who deliver a customized inventory to a vast network of small and large retailers, which include different retailers, restaurants, pubs, bars and neighborhood stores.

Chain of Custody

The distributors work with a “chain-of-custody” method in the sale of beer. This system makes it very easy to enforce state laws and local ordinances. The same system also regulates the sales to the retailers ensuring that they hold the correct licenses, do not sell to the underage, pay the required state and local taxes and comply with the state and local alcohol beverage laws.

The same regulations that check for the accountability in beer sales also allow the states to effectively collect the taxes on the sale of alcoholic products. Distributors monitor the data of the sales from the point where the beer leaves the brewery till it arrives at the licensed retail outlet, thus they have all the necessary information to collect taxes. Many states find it much easier to collect the taxes from a limited number of federally- and state-licensed beer distributors than from thousands of individual retail outlets.

Market Access

Distributors are spread throughout different states across the country. For craft breweries, selling the beer through distributors allows them to get their product to diverse markets, and it provides the small scale retailers the opportunity to offer a broad range of beer under one roof. The system provides the same level playing field for all the breweries regardless of their size. Distributors facilitate a healthy competition among the breweries.

STATE ALCOHOL CONTROL

Due to the nature of alcoholic drinks, the rules and regulations for alcohol are different across the states. Alcoholic beverages are unique and can have negative consequences if consumed illegally by underage teens or abused by adults. The 21st amendment gives states the total control to design and implement their own rules and regulations for the sale of alcoholic beverages. This regulatory system allows states the flexibility to deal with the local circumstances (www.centraldistributors.com; www.probrewer.com/resources/distribution/specialty.php; http://nbwa.org/industry-tech/craft-beer-distributor-of-the-year-award).

INVESTORS FOR CRAFT BREWERY STARTUPS

Many investors are lining up to support the exploding growth in the craft beer industry. But investors are being very careful in selecting the breweries they want to invest in. There are many factors that influence their investment decisions in craft breweries, mainly:

- Increased competition in the craft brew industry

- A petition is currently filed against craft brewers with the U.S Treasury Department Bureau of Alcohol, Tobacco and Firearms on behalf of Anheuser – Busch, Red Hook Ale and several other breweries, demanding that craft brewers add names of who actually brewed their beer on their bottles.
- The growth of the craft beer industry is mainly because customers think craft brews give them added value.
- The outsourcing of craft beer production, also known as contract brewing (i.e. Boston Beer Co.).
- Investors' fear that craft brewers are expanding based on hype created by bigger players, and one missed step can hurl the industry into downward direction.

Microbreweries on the other hand are looking forward to the lawmakers' tax cuts for the craft beer industry. Craft brewers have different sets of tax burden even if they fall in the broad category of small businesses. For these brewers the tax is levied on the production rather than on the actual sales. The tax cut bill will reduce this $7 per barrel for first 60,000 barrels of beer to nearly $3.50 per barrel. And for breweries producing more than 60,000, it will reduce tax from $18 to $16 per barrel. If the bill is passed, it will bring the small breweries on the same playing field as the small business owners. A Harvard study shows that, if the bill is passed, it will create 2,700 new jobs within 18 months and 375 new jobs will be created every year throughout the next four to five years.

Thus, as most of the investors are trying to figure out which upcoming breweries in which to invest, microbreweries are hopeful that more investors will line up as the craft brew market explodes in terms of market share and total beer sales (www.inc.com/magazine/20101001/a-craft-beer-stimulus-plan.html; www.cnbc.com/id/39232270/Craft_Beer_Business_Is_Booming).

Taxation and Regulations that Pertain to Alcoholic Beverages

All of the Craft breweries are highly regulated at the federal, state and local level. These levels govern the production and distribution of the beer, including permitting, licensing, labeling, marketing, trade practices, distributor agreements, advertising, and more. There are different entities at federal, state and local level that collect various taxes, licensing fees and other similar charges. They also make sure each brewery is adhering to the laws and regulations.

All the breweries that sell beer commercially are subject to licensing and permit approvals by a number of governmental authorities at the Federal, state and local level. At the Federal level, the Alcohol and Tobacco Tax and Trade Bureau of the U.S Treasury Department ("TTB") is responsible for administration and enforcement of the related Federal laws and tax codes to production and taxation of alcoholic products. A Federal brewer's notice is required by each brewer in order to brew beer for public consumption, and an amended brewer's notice is to be filed if there is any change in material processing, brewing equipment, brewing or warehousing locations, brewery ownership or change in management team. Similar types of TTB permits are required when a brewery is entering into a contract brewing agreement or into an alternating proprietorship agreement. These are very important permits and they can be revoked, cancelled or suspended in case the brewery does not comply with the correct protocol and standards, thereby directly affecting the companies' production and reputation. Also TTB can inspect or audit any brewery at any time.

At the local and state levels, the level of regulation varies widely. Some of the breweries distribute their products in areas where just a notice to the authorities regarding the change in the operations, management, materials or ownership is sufficient, but in other areas an advance notice and approval is required. State and local laws and regulations, which govern the sale of the craft beers within a particular state, especially for an out-of-state brewing company, vary from locale to locale.

Taxation by production numbers:

Breweries producing less than 60,000 barrels of beer pay taxes of $7 per keg in taxes, while large breweries brewing more than 60,000 barrels pay $18 per keg in taxes. The tax is on production and applies as soon as a keg is moved out as a finished product. The individual states in which the breweries operate also impose excise taxes on beer and other alcoholic beverages, which may vary depending on state.

ENVIRONMENTAL REGULATIONS

The environmental regulations differ at a federal and state level. There are special environmental permits required by the federal and state authorities. These requirements consider permissions for air emissions, water discharges from the brewery, and handling and proper disposal of hazardous waste materials. The established protocols need to be strictly followed by the breweries, and violation of such protocols can lead to adverse effects on breweries' credibility.

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THE LITTLE BEE THAT COULD: JOLLIBEE OF THE PHILIPPINES V. MCDONALD'S

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CASE DESCRIPTION

The primary subject matter of this case concerns the growth of a Filipino fast food chain. It started from a single ice cream store, which later moved into hamburgers, Filipino style. Over the years Jollibee, a multi-national corporation in the restaurant industry, expanded its operation both in the Philippines and in neighboring countries. At the end of 2010 it operated 2316 stores in eight countries including the Philippines, China, Brunei, Vietnam, Spain, Indonesia, Dubai and the United States. It is now facing increased competition and a dilemma as to what direction it should go. A secondary issue examined in this case is Jollibee's unique business strategies. The case is written at a difficulty level of three, appropriate for junior level courses. The case is designed to be taught in one class hour and is expected to require 2-3 hours of outside preparation by students.

CASE SYNOPSIS

The Filipino Company, Jollibee, is imitating McDonald's in some ways but has its own twist on offering unique products that emphasize local spices and local taste preferences. This fast growing restaurant chain has benefited from the increased demand for fast food in Southeast Asia and has developed a unique business strategy. This case examines Jollibee's success and how the company is successfully competing with McDonald's. With its rapid growth, the company is now ready to expand with new concept restaurant to the rest of the world.

INTRODUCTION

Jollibee Foods Corporation (JFC), known distinctively by its red and yellow bumble bee mascot, operates a number of concept restaurants in the Philippines and beyond. From its core business, a McDonald's-like restaurant, Jollibee has expanded into a pizza chain, fast food Chinese restaurants, bakeries, breakfast bars, and a tea house. The company competes well with multinationals in the Philippines, and has begun a large expansion into the international market, including China and the United States. Jollibee, the original flagship brand, together with its additional product concepts, dreams of becoming a global powerhouse in the restaurant industry.

Jolibee's dreams will be challenging given the economic uncertainties that surfaced in 2009 and the 0.6% contraction in the world economy. With sound planning and leadership, however, the company is taking active steps to effectively manage its business. JFC's system-wide sales grew by 9.6% amidst weakened consumer spending in the Philippines and throughout most of the world. In 2009 Jollibee opened 168 new stores worldwide and even more impressively, opened 434 in 2010.

THE PHILIPPINES

The Republic of the Philippines is a country in Southeast Asia consisting of over 7,000 islands. The Philippines was "discovered" by Ferdinand Magellan in 1521, who claimed the islands for Spain. While Magellan met his death soon after arriving in the Philippines, the country was under Spanish control for almost 400 hundred years. The Philippines came under the rule of the United States in 1898 when Admiral Dewey defeated the Spanish and Spain ceded the islands under the Treaty of Paris. While Tagalog, or Filipino, is the official language of the Philippines, English is widely spoken, especially among educated Filipinos. In 1935 the US government decided that the Philippines should become a self-governing commonwealth and the country gained complete independence in 1946. After a number of different political administrations, strongman Ferdinand Marcos ruled the country from 1965 to 1986, maintaining close ties with the United States. With increasing discontent among Filipinos over its government, citizens in the opposition movement organized a "people's revolution" in 1986, and Marcos was forced to leave the country. Political instability ensued for a short time, but democracy quickly took a firm hold in the Philippines. The newly-formed democracy could be described as somewhat fragile, having been forced to endure the stresses of political corruption and attempted coups.

The population of the Philippines is approximately 98 million, with an estimated population growth rate of slightly less than 2% per year. The Filipino people have a rich ancestral heritage that can be traced to populations from Malaysia, Indonesia, Spain, and China. The ethnic Chinese have been very influential in the Filipino economy. Filipino culture is rooted in Asian, Spanish, and American values.

Total GDP for the Philippines in 2009 was $161.2 billion, with a growth rate of 1.1%, as compared with the U.S. GDP growth rate of -2.4% for the same period. In 2010 the estimated GDP for the Philippines was $189.1 billion with a growth rate of 7.0%, as compared with an estimated U.S. GDP growth rate of 2.7%. Per capita GDP was $1886 in 2009 and $2077 in 2010. The currency of the Philippines is the peso (PHP), trading at 43.9 PHP in December 2010 and ranging between 40 and 53 PHP per U.S. dollar over the past five years.

HISTORY AND MISSION OF JOLLIBEE

What would eventually become Jollibee Foods was once an ice cream parlor named Magnolia, started by Tony Tan in 1975 as a family-based business in the Philippines. Over time the company began offering hot meals and sandwiches. From this humble operation the concept of a fast food hamburger business was developed and Jollibee has expanded in terms of revenue and concentric diversification. In 1978 the company began a bakery and by 1986 it was operating its first international eatery in Taiwan. With the acquisition and development of additional restaurant concepts, Jollibee catapulted itself into an array of food service businesses including pizzerias, breakfast cafes, Chinese fast food chains, and a teahouse. Much of this diversification has come in recent years. While mostly known for its Jollibee hamburger franchise, the company has ventured into many additional fast food areas, significantly expanding its number of outlets and geographical coverage.

The mission of Jollibee Foods is simple: *To serve great tasting food, bringing the joy of eating to everyone.* Jollibee has a vision statement that expresses not only its values, but also its aspirations.

VISION

We are the best QSR...
The most endearing brand ...
that has ever been ...
We will lead in product taste at all times ...
We will provide FSC excellence
in every encounter
Happiness in every moment ...
By year 2020, with over 4,000 stores worldwide,
Jollibee is truly a GLOBAL BRAND

Jollibee has strategically established its brand by focusing on quality and customer service. It is committed to sustainability as a quality requirement, making Forest Stewardship Council (FSC) excellence a corporate priority. Its vision statement positions the company to be the best quick service restaurant (QSR) that has ever existed. JFC is concerned with consumer perceptions and actively manages them through extensive advertising, hiring of celebrity endorsers with wholesome images, and engagement in charitable works.

STRATEGIC BUSINESS UNITS AND EXPANSION

Jollibee Foods Corporation (JFC) consists of a number of SBUs that cut across different food groups. Its system-wide retail sales for 2010 were 70.3 billion PHP ($1.6 billion USD), representing a 10.2% increase over 2009. Net income in 2010 was 3.1 billion PHP ($70.6 million USD), which grew by 16.3% over 2009 income.

At the core of JFC is Jollibee, the McDonald's-like hamburger restaurant. The unit sells a standard fare of lunch and breakfast items, but adds a local touch with products such as the Amazing Aloha Burger (slice of pineapple on top of a burger), the Jolly Hotdog Taco Style, Chickjoy with Rice, and Palabok (noodles with a spicy sauce, boiled egg, shrimp, and ground pork). Jollibee competes with McDonald's on the basis of price, local product offerings, and national identity. JFC also owns Chow King, a Chinese fast food restaurant chain with operations in a number of countries. The firm has a pizza restaurant chain called Greenwich and a bakery chain called Red Ribbon.

Table 1

Financial Summary 2007 - 2010
Jollibee Foods Corporation

	2007	2008	2009	2010
Gross revenue	38,693,662	43,891,559	47,957,693	53,352,870
Net income	2,388,358	2,321,817	2,666,900	3,100,629
Return on equity	18.9%	16.4%	16.4%	18.1%

(Above amounts are in PHP 000, except for return on equity)

Number of Stores by Chain

	2007	2008	2009	2010
Jollibee	652	700	743	784
Chowking	402	418	431	438
Greenwich	245	231	226	223
Red Ribbon	212	239	242	259
Yonghe King	99	141	160	200
Delifrance	26	26	24	-
Chun Shui Tang	1	2	-	-
Manong Pepe's	2	9	15	12
Hong Zhuan Yuan	-	38	41	52
Caffé Ti-Amo	-	-	-	3
Mang Inasal	-	-	-	345
Total	**1,639**	**1,804**	**1,882**	**2,316**

Source: Jollibee Annual Report, 2009, page 34 and Jollibee 4th quarter 2010 report.

JFC is looking internationally to increase sales and recently acquired Yonghe King, a "contemporary Chinese fast food" restaurant chain in China. It operates restaurants in the Philippines, China, Brunei, Vietnam, Saipan, Indonesia, Dubai, and the United States. The units in the U.S. are located in areas with large Filipino-American populations. JFC feels that international expansion is important not only to grow the company, but because it believes that "Being open to different cultures widens one's spectrum of tastes, style, and ways of seeing food." JFC's management feels that international expansion provides for organizational learning, and the leveraging of this learning into new markets. JFC is always searching for new product concepts, including its new pilot store called Tio Pepe Karinderia. This new restaurant concept serves very low-priced typical Filipino dishes and seeks to compete with street vendors by offering a more hygienic and cost-efficient alternative.

Financial data and the number of stores by chain are summarized in Table 1.

LOOKING AHEAD

As Jollibee looks to the future it seeks greater expansion opportunities. The company plans on opening more stores, and in more markets, including the Indian market. Jollibee has experienced great success in its relatively short history, but it now faces a number of challenges. Rising food and fuel costs are putting pressure on the company to raise prices. Consumer spending in the Philippines is starting to weaken, especially among lower income consumers as their disposable income has declined. In addition, the flagship brand is coming under attack from McDonald's as it continues to open more new stores in the Philippines. According to a 2007 report by Tony Lopez in the *Manila Times*, McDonald's beats Jollibee in revenue per store, and has been gaining ground through better customer service, better kid's meals, and better cost and supply chain management.

Undeterred by these developments, Jollibee continues to look ahead by opening restaurant chains in new markets. In 2010 alone it opened 434 additional stores worldwide, representing a 23% increase over the number of stores in 2009. While JFC expands its profitable chains, it has eliminated some marginally performing, mostly aging stores. According to a February 2011 statement, JFC Chairman and CEO Tony Tan Caktiong said, "Practically all our brands in all countries where we operate achieved growth...We were able to preserve and even slightly improve our profit margins despite the fast rising cost of labor, power and raw materials….We look forward to continued robust sales and profit growth in the Philippines and abroad in the years ahead." It appears that the same pioneering spirit that enabled Mr. Caktiong to establish the first ice cream shop in 1975 lives on.

DISCUSSION QUESTIONS

1. What advantages does a domestic firm have over a MNC in its local market?

2. Can Jollibee Foods Corporation continue to successfully leverage its brands and products in other geographic markets, including the United States? Explain.

3. In what way should Jollibee expand? Which countries are likely to be profitable markets?

4. What strategic direction would you suggest for Jollibee Foods Corporation?

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CHANGES IN THE GLOBAL MOBILE MARKET AND NEW CHALLENGES FOR LG MOBILE

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CASE DESCRIPTION

The primary subject of this case study falls within the scope of strategy. The secondary issues examined in this case study include globalization, marketing, decision-making, growth management strategy, industry structure attractiveness analysis, and understanding competitive advantage. The case has a difficulty level of four out of five, and is appropriate for the senior level. The case is designed to be taught in one hour, and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

The global mobile phone market has long maintained a double-digit growth rate, and its total sales volume has reached 1.24 billion. Today, the global market is dichotomized into developed markets and developing markets; alternative demands dominate the former, and new demands dominate the latter. The rise of smartphones is one of the hottest issues in developed markets. Recent changes in the global market landscape, initiated by the arrival of smartphones, is bringing to an end the market domination by the top five companies—Nokia, Samsung Electronics, LG Electronics, Motorola, and Sony-Ericsson. The decline of Motorola and Sony-Ericsson, and the sudden rise of smartphone specialists such as RIM, Apple, and HTC are disrupting the market structure, and causing increasing uncertainty within the wireless business.

Despite increasing market uncertainty, LG Electronics (LGE) managed to become the third-largest global mobile phone manufacturer by 2009. However, it might be too early to celebrate, as no one can guarantee the sustainability of LGE's growth in today's highly uncertain environment. Inadequate distribution channels are preventing LGE from catching up with Nokia in the developing markets, and competition in the developed markets among high-end manufacturers is becoming fiercer by the day. Moreover, LGE lacks competitive advantage in the smartphone market, which is the only market with high growth potential. LGE's smartphone manufacturing capacity falls behind that of RIM and HTC, and LGE has to depend on Microsoft and Google for the operating system software. LGE's application store (app store) is still in a nascent stage, and its growth potential is yet to be proved. In this context, this case study will *lead the discussions on how LGE can survive in this challenging new environment as a late mover in the smartphone market. Besides, with the app store—a disruptive innovation that is rearranging how digital contents are distributed—expanding its territory, discussions about LGE's strategies and its future prospects will provide meaningful suggestions not only for the mobile phone industry but also for other IT industries.*

INTRODUCTION

> *LG Electronics will achieve global market share of 10% and sales of a hundred million units by the end of 2009. By 2012, we will become the second-largest mobile phone manufacturer in the world.*
>
> *Mr. Seung-Kwon Ahn of LGE, at the Mobile World Congress in February 2009*

In February 2009, when global economies were experiencing the aftermath of the financial crisis initiated by the sub-prime mortgage loans, the Mobile World Congress (MWC) of 2009 opened its first session at Barcelona, Spain. Mr. Seung-Kwon Ahn, the chief of the mobile communication division of LG Electronics Corporation (LGE), declared his future strategies with strong confidence to the attendants from all over the world. However, most of the audience was not convinced about the feasibility of his plans in the short term.

It did not take long to prove the detractors wrong. At the end of the fourth quarter of 2008, LGE claimed third position in the mobile phone market, and its market share exceeded 10% for the first time in its corporate history. These surprising performances in fact reflected the goals promised by Mr. Ahn nearly half a year earlier. The double digit global market share of the LGE mobile division gains even more significance since the global economy was yet to recover from the crisis, and LGE acquired only a few top mobile telecommunication carriers. These numbers effectively killed possible concerns about the future of LGE and other related questions.

Although initial doubts about the capability of LGE and its top management team had died down, LGE knew that it still had a long way to go. The volatile global mobile phone market made it difficult to look into the future, and situations could turn against them at any moment. As can be seen from the history of the market, a significant change in a mobile phone technology or product has always been followed by an acute change in market competition. As the core technology shifted from analog to digital, Motorola experienced a downfall while Nokia emerged a winner; LGE and Samsung Electronics Corporation (SEC) joined the top five brands when the mobile phone evolved from a simple gadget for voice communication to a complex multimedia device. These changes were just a beginning compared to the market transformation that the current mobile phone market is experiencing. With smartphones on the rise, the competition in the mobile phone market is entering a whole new phase.

LG Electronics began to experience difficulties in such a business environment, with the market share in the smartphone market remaining modest, at best. In early September 2009, Mr.

Ahn said to the executives of the Mobile Communications Business Division in a concerned tone:

> *We must put the success achieved so far behind us. Now we are facing a serious crisis in terms of future competition centered on smartphones. The entire company needs to contemplate on how to overcome this situation. I want to ask each department to establish plans to acquire competitiveness for our smartphones.*

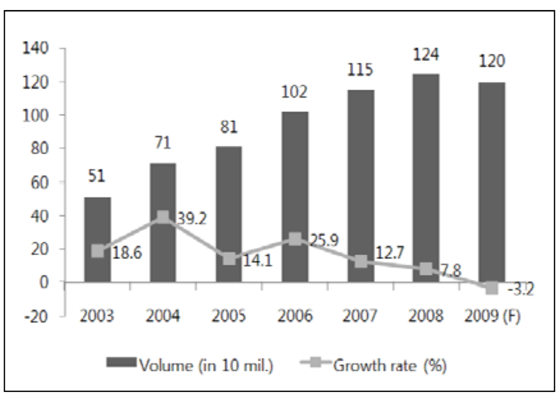
GLOBAL MOBILE PHONE MARKET

OVERVIEW OF THE MOBILE PHONE MARKET

The global mobile phone market in 2008 was predicted to be 1.24 billion in total volume, which reflects a 7.6% growth from 1.15 billion in 2007. This showed that the growth rate of mobile phone markets, which remained in double digits for the past several years, was falling, mainly due to the maturing global market and the effects of the financial crisis that originated in the US. Moreover, the market in 2009 was expected to drop to 1.2 billion, dropping 3.2% from 2008, due to decreased demand in the stagnating economy.

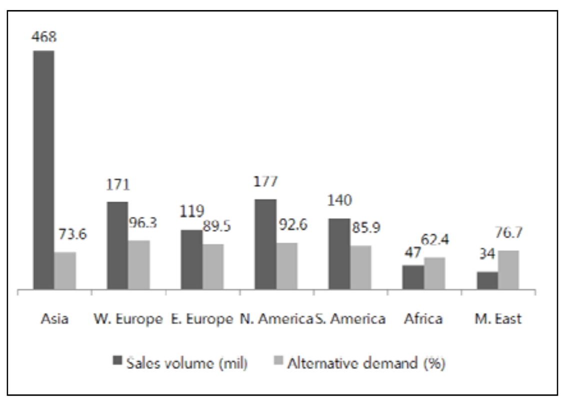
The uncertain global economy rapidly caused the domination of the mobile phone industry by the five major manufacturers to crumble. Motorola's prolonged slump in North America and Sony-Ericsson's weakened presence in Europe stimulated the restructuring of the global handset market. Nokia, SEC, and LGE formed the new triumvirate, dominating almost 70% of the global market in the second quarter of 2008. Motorola and Sony-Ericsson's market strength was quickly dwindling; the aggregated market share of the two companies was less than that of LGE alone.

<Global Mobile Phones Sales>



Source: Gartner

<2007 Regional Sales and Rates of Alternative Demand>

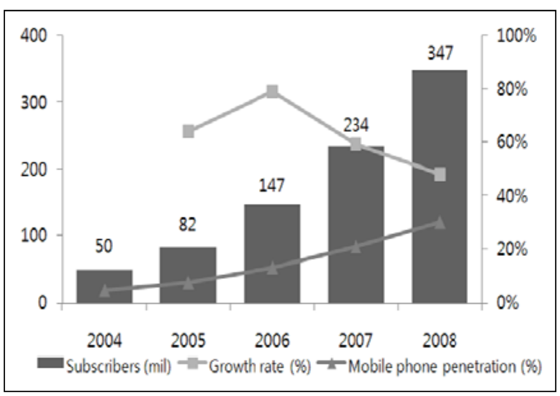


Source: Gartner

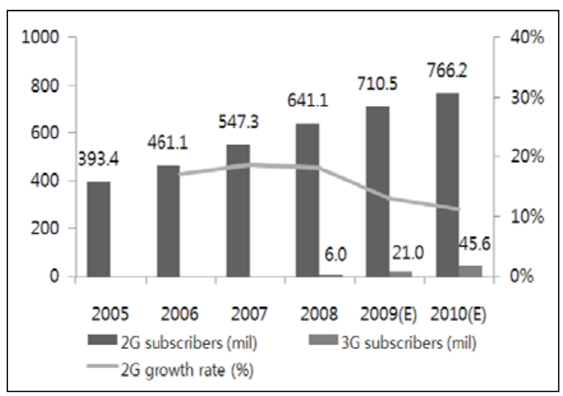
Although the growth rate of the mobile phone market is in a decline overall, there are a few promising segments where high growth rates can be observed. First of all, the markets in the emerging countries collectively referred to as the BRICs (Brazil, Russia, India, and China) show high growth potential. For instance, Brazil is currently the largest mobile phone market in Central America, accounting for 35% of the total Central American market. It also showed a drastic increase in growth rate: from 34.88 million in 2003, subscribers jumped to 86.21 million in 2005, 99.91 million in December 2006, and 1.7141 billion in January 2007. The Russian market, notorious for the massive distribution of smuggled mobile phones until the first half of 2005, is becoming more transparent with the help of strong governmental regulation imposed as part of the market transparency policy. The Russian government is strongly supporting the regulatory efforts to meet the qualifications that are required to join the WTO.

India and China, with even bigger opportunities for market expansion, are attracting manufacturers. Their vast population—easily over 35% of the world total—is expected to provide unprecedented market growth in the years to come. The number of mobile phone subscribers in India reached 100 million in April 2006, and the Indian mobile phone market recorded an annual growth rate of 47.3%. Since only 30% of the Indian population possesses a mobile phone, enormous potential for further growth still exists. China, whose population exceeds 1.3 billion, is an especially promising market for 3G mobile phones. The double-digit growth of mobile phone subscribers in China had mostly been centered on 2G services. In recent years, the growth rate of 2G subscribers gradually decreased as more customers signed up for 3G phones. In contrast to the Indian market, where low-end devices dominate, the Chinese market has demand for both high-end and low-end devices, and is also famous for its high preference for global brands. In short, the Chinese market wins a few points over India, and is perceived as one of the most attractive markets for global mobile phone manufacturers (Kim, 2008).

<Mobile Phone Market in India>



<Mobile Phone Market in China>



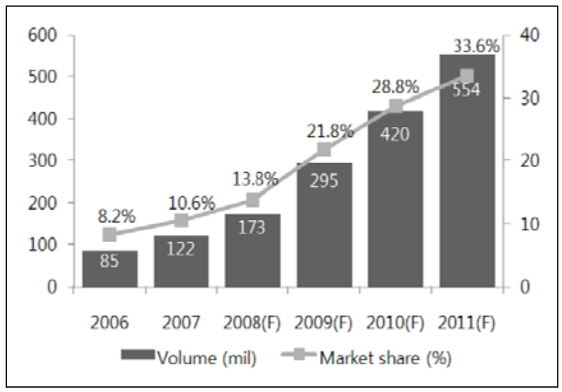
Source: Bank of America, Merrill Lynch, MMC Group analysis

Source: www.huawei.com

The developed markets, on the other hand, with subscription rates reaching nearly 100%, are showing stagnation in quantitative growth, reflected in the low number of new subscribers. Alternative demands for high functional devices constitute the strongest demand in these markets. The smartphone market in particular, which was once largely limited to North America, is growing at double-digit rates, and is leading to the rapid replacement of existing 2G and 3G mobile phones in the developed markets. According to Gartner, a market research institute, the overall mobile phone market in the second quarter of 2009 declined by 6.1% in sales volumes, while smartphone sales increased by 27%. The polarized state of the global mobile phone market, with smartphones at one end and low-end phones at the other, is expected to continue for a while. The demand for expensive smartphones is high in high-end markets, including North America, Europe, Japan, and Korea, while the demand in countries with less-developed economies is more for relatively cheap, low-end products.

<Smartphone Sales Volume and Market Share> <Global Handset Sales Portion by Price Range>

	2004	2005	2006	2007
Ultra low (~ USD 50)	0.2%	0.6%	1.9%	6.1%
Low end (USD 50 ~ 120)	54.0%	53.6%	51.8%	43.8%
Mid end (USD 120 ~ 190)	23.1%	23.7%	24.1%	24.3%
High end (USD 190 ~)	22.8%	22.1%	22.3%	25.8%



Source: Gartner Source: Strategy Analytics

RAPID GROWTH OF THE SMARTPHONE MARKET

The history of the smartphone market goes back to the launch by Palm of its first PDA 10 years ago. Although this device was more of a portable personal computer (PC) than a communication device, it was embedded with a communication module, which justifies its being treated it as the origin of the smartphone. However, the Palm PDA failed to succeed with the masses due to its limited communication functions and applications, and appealed only to a handful of early adopters. The first smartphone that really opened up the potential for a whole new market was the BlackBerry, introduced by the Canadian company Research In Motion (RIM).

Although the BlackBerry was successfully introduced into the market, RIM's growth was mostly confined to North America as it targeted corporate customers by providing solutions along with the product, such as the Instant Messenger service and an e-mail system linked with Enterprise Resource Planning (ERP). BlackBerry also adopted the QWERTY keypad, which is the standard keyboard layout, for easy utilization of its powerful computing functions. The mass market for smartphones began to grow at a much faster pace after Apple released the iPhone. The iPhone was first introduced to the public at the Macworld Conference & Expo held in San

Francisco on January 9, 2007. In the first week of its release, the iPhone became a million-seller, signaling the beginning of the smartphone era.

A smartphone is a mobile phone equipped with computing power similar to that of a PC. Mobile phone manufacturers, content providers, and customers all have their own reasons to covet smartphones, placing the product under the IT spotlight. Manufacturers can earn higher profit margins since smartphones are sold at higher prices; content developers are able to gain direct access to customers through the application stores (commonly referred to as app stores), without having to rely on other content providers or distributors; customers are drawn to smartphones as they increasingly wish to add mobility to their computing experience, such as by accessing e-mail, browsing the Internet, watching streaming videos, and so on. Smartphones, with their added computing power and faster network access, are considered to be the ideal choice to meet such needs.

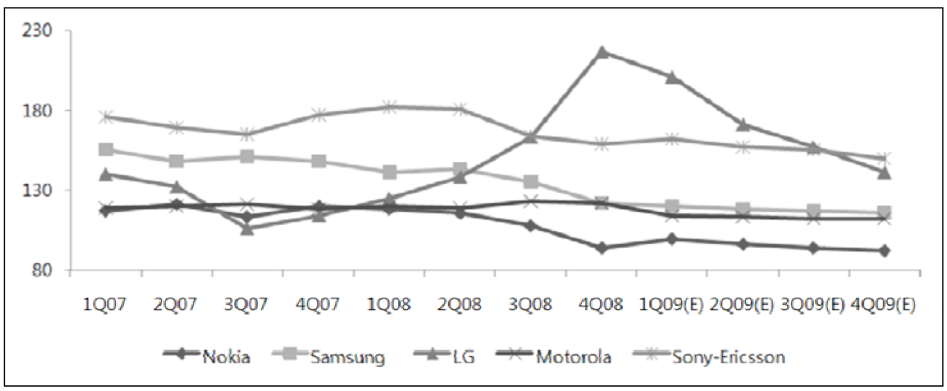
The recent boom of smartphones can be attributed to the advancement of technology, both inside and outside of smartphones. One of the reasons why early smartphones were not widely accepted was that they were simply not capable of executing the tasks the customers expected of them. Recently, the mobile CPU used in smartphones was upgraded to 1 GHz, which is almost up to the level of a PC, making the computing power of smartphones comparable to that of desktop or laptop computers. On the infrastructure front, HSPDA technology was applied to allow 14.4 Mbps of network speed when downloading data. Further, new touchscreen technologies allowed a more graceful and user-friendly UI, while full-browsing technology provided webpage screens identical to those on a PC. Smartphones are increasingly being perceived as a user-friendly device with convenient access to digital services, rather than as a special device for select corporate customers or early adopters.

The explosive growth of the smartphone market, which started around 2005, is not showing any signs of slowing down. The annual growth rate of the smartphone market touched 45% in 2006, and smartphones are forecasted to take up 33.6% of the total market in a few years. In Korea and Japan, where broadband Internet access is widely available throughout the country, a mass demand for smartphones has only begun to appear. In the case of Europe and the US, however, broadband Internet access is not as widespread as in Korea or Japan; this drove the need for devices with highly functional mobile Internet access in these markets. Moreover, the need for mobile devices with fast network access is also rising in emerging markets, which will create more demand in the near future. Subscribers to mobile communication services, numbering around 3 billion in 2007, are expected to increase to 5.5 billion by the end of 2013. Nearly a billion new subscribers are expected from China and India. After a few years, after the number of subscribers grows to a certain level, alternative demand is expected to become greater than new demand, even in emerging markets. This would be especially true for the BRICs if their continuous growth in GDP maintains its current pace. Alternative demand, which represents the demand to replace existing mobile devices with new ones, will result in increased demand for high-end devices over low-end devices. A few particularly fast-growing emerging markets, including India, are heading straight toward building a nationwide wireless Internet network instead of investing in costly broadband Internet infrastructure; such a move would trigger new demands for smartphone in these emerging markets, where traditional 2G and 3G phones have reigned.

ANALYSIS OF THE COMPETITION

Until recently, the global mobile phone market had remained mostly stable, with the dominance of the Big 5: Nokia, SEC, LGE, Motorola, and Sony-Ericsson. The Big 5 dominated more than 80% of the total market. However, the market is going through a major transformation due to the fall of Motorola and Sony-Ericsson, Nokia's slump, and the huge success of Samsung Electronics and LG Electronics, along with the rise of specialized smartphone manufacturers.

<Market Share Distribution of Big 5 Manufacturers> (%)



Source: Gartner

Comparison of the Major Handset Makers' Results in 2Q08 and 2Q09 (Unit: Thousand)								
	2Q09			2Q08			2Q09/2Q08	
	Sales	Market share	Return on Sales	Sales	Market Share	Return on Sales	Sales	Market Share
Nokia	105,413.3	36.8%	11.6%	120,353.3	40.4%	17.2%	-12.4%	-8.9%
Samsung	55,430.2	19.3%	10.0%	46,376.0	15.2%	12.8%	19.5%	27.0%
LG	30,497.0	10.7%	11.0%	26,698.9	9.3%	14.4%	14.2%	15.1%
Motorola	15,947.8	5.6%	-13.8%	30,371.8	9.2%	-10.4%	-47.5%	-39.1%
Sony-Ericsson	13,574.2	4.7%	-16.3%	22,951.7	8.1%	-0.1%	-40.9%	-42.0%

Source: LGE investor relation information & Gartner

FALL OF MOTOROLA AND SONY-ERICSSON

Motorola

Motorola originally started its business as a battery manufacturer in Chicago, and then boldly jumped into the radiotelegraph and wireless communication business. The new business proved to be an enormous success. Motorola tripled its earnings between 1990 and 1995, and became the leader among the first-generation mobile communication players. Motorola's dominance of the market came to an end when the second-generation mobile phones were introduced in the market. In 1998, the company lost its market leadership to Nokia, as it failed to secure the digital cellular technology that was critical to build second-generation mobile phones. In 2001 and 2002, Motorola recorded losses to the tune of USD 3.9 billion and USD 2.5 billion, respectively.

To turn the things around, Motorola hired Ed Zander, former chief operating officer (COO) of Sun Microsystems, as the new CEO. The first thing Zander wanted to do was to improve Motorola's new product development capability. The main office of Motorola was moved to a chic, modern-looking place in the urban area, which was meant to provide an innovative atmosphere to the organization. Zander also hired Geoffrey Frost, former Nike brand campaign master, as the chief marketing officer (CMO). These efforts immediately showed results, and the outcome was RAZR, an ultra-slim mobile phone, which became a megahit as soon as it was released.

Motorola's comeback, led by Ed Zander, unfortunately ended with RAZR. Its subsequent products failed to outperform the multimedia phones of its competitors such as LGE and SEC, and Motorola was back on the downward track. Motorola not only experienced a record-breaking loss of USD 4.2 billon in 2008 but also failed to effectively take on the emerging markets in Asia and Africa with its low-price handsets. It was not surprising when Motorola's global market share plummeted to 5%. Motorola also suffered in its main market, North America. Motorola's market share in North America dropped to 17%, and the first and second place went to SEC and LGE, respectively. In the second quarter of 2009, Motorola's operating profit fell to 13%. Motorola had announced several layoff plans since the second half of 2008 in an effort to improve its profitability that had remained in the red since 2007. In addition to the layoff plans, newly hired CEOs Greg Brown and Sanjay Jha (former COO of Qualcomm) have been concentrating fully on the smartphone market as their core strategy to put the company back on track. The results of their strategy were Droid and Click, which were released very recently. These Android-base smartphones were developed through collaborations with Google, and were very well accepted by the market. However, it remains to be seen whether the commercial success of these two models would be enough to restore Motorola's lost glory.

Sony-Ericsson

Sony-Ericsson was formed by a 50:50 joint venture of Sony (Japan) and Ericsson (Telefonaktiebolaget LM Ericsson, Sweden). With Sony's brand power and business know-how in the electronic devices market and Ericsson's mobile communications technology, the joint venture ranked third in the global market soon after its launch. Sony-Ericsson's differentiation strategy had mainly focused on emphasizing the superior multimedia performance of its products. However, Sony-Ericsson began to lose its competitive edge when other companies also introduced popular multimedia mobile phones. Sony-Ericsson's decline picked up speed due to stagnation in the western European market, which the company heavily relied on; this directly damaged the company's overall performance. To make matters worse, Sony-Ericsson had difficulties in entering emerging markets because its product portfolio was mainly composed of expensive high-end devices.

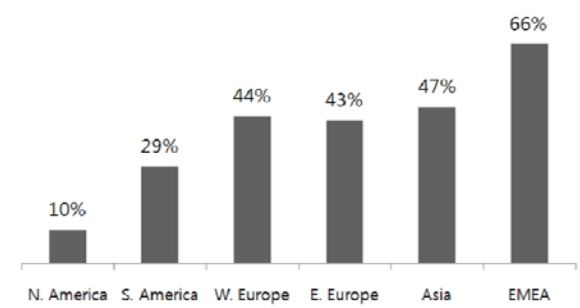
By the end of 2010, the objective of Sony-Ericsson was to save 880 million Euros from operating expenses to cover up the losses and to secure liquidity. To meet the objective, Sony-Ericsson has been undergoing a major restructuring process since 2008, and has replaced Hideki Dick Komiyama with Bert Nordberg, former head of Ericsson's US technology division, who took over as the new CEO and president. However, given the present conditions—Sony-Ericsson's global market share of 8.1% in the first quarter of 2008 dropped to 4.7% in one year, and its operating margin in the second quarter of 2009 marked only 16.2%—not too many people believe Sony-Ericsson will bounce back.

STAGGERING NOKIA

Nokia's history dates back to the nineteenth century. The Nokia Company (Nokia Aktiebolag), Finnish Rubber Works Ltd. (Suomen Gummitehdas Oy), and Finnish Cable Works Ltd. were established in 1865, 1898, and 1912, respectively. These companies merged in 1967, and the current Nokia group was established. When the group was first formed, Nokia engaged in very diverse business fields, including rubber, tires, electricity cables, paper pulp, and so on. Jorma Ollila, who was appointed CEO in 1992, saw this as a misuse of the group's resources and decided to focus on one business segment. This decision led Nokia to become the world's leading company in the mobile communications and multimedia sector. Nokia quickly overtook the market leader Motorola, and dragged them down to second place in 1998. Since then, Nokia has remained the undisputed leader in the mobile phone industry.

There are two driving forces behind Nokia's success. First, Nokia dominates not only the developed markets but also emerging markets such as Asia, the Middle East, and Africa. In fact, Nokia's presence is stronger in the emerging markets. Nokia's 2008 second-quarter market share of 47% in the Asian market and 66% in the African market indicate how much influence the company has in these markets. Unlike developed markets, which are mostly facing stagnation in the mobile phone industry, such emerging markets are expected to maintain an annual growth of over 4%. Successful market diversification helped Nokia keep its place as the market leader despite a strong euro and the economic crisis. One of the unique characteristics of the mobile phone market in the emerging countries is that the manufacturers are themselves responsible for distribution most of the time. Nokia already possesses its own distribution channels in the major emerging markets (100,000 in India, 120,000 in Africa, and 60,000 in China), while many other manufacturers are facing difficulties in even entering these emerging markets because they lack distribution channels.

<Nokia’s Regional Market Share in 2Q08>



	N. America	S. America	W. Europe	E. Europe	Asia	EMEA
Expected market size in 2010 (USD mil)	171.6	137.6	174.6	85.5	555.0	145.1
Expected growth rate (2008 ~ 2013)	1.3%	2.2%	1.7%	3.0%	4.8%	4.2%

Source: Son, M.-S. (2008), “Is Nokia Invincible?” LG Business Insight.

Second, Nokia’s superior manufacturing capabilities are also responsible for its success. According to Gartner, Nokia’s sales volume was 15 million in the second quarter of 2009; this was higher than the aggregated total of the other Big 5 companies, even though Nokia had lost 8.9% points of its market share in that quarter. This gap in sales volume provides much stronger economies of scale for Nokia, which in turn enables more cost reduction. Nokia applied the platform strategy to its manufacturing system from 2000, and is currently pushing toward the standardization of its hardware components by introducing the MIPI (Mobile Industry Processor Interface). Nokia also aims to standardize the software for its devices by building all operating platforms based on the Symbian operating system (OS). Nokia now possesses an even stronger manufacturing competence to supply a wide selection of devices at lower prices.

In August 2007, Nokia announced the launch of Ovi, its new service platform. Ovi was launched to extend Nokia’s reach, and to re-position itself as a web platform service provider rather than a simple device manufacturer. Further, Nokia restructured its existing four business groups (mobile phones group, multimedia group, enterprise solutions group, and networks group) into three new business units in January 2008: device unit, service & software unit, and market unit. This move was a clear indication of Nokia's determination to become a platform-based service and software provider. After restructuring internal organizations, Nokia went on to acquire companies such as NAVTEQ (a navigation software manufacturer) and Loudeye (the leading music content provider).

Until around 2005, Nokia's position as the market leader seemed unshakeable. However, the recent changes in the global market put Nokia in a difficult situation. Nokia's overall market share has been decreasing from the time when it recorded a high of 40.4% in 2007, and its disparity with SEC (which had been almost up to 30%) is also continuously decreasing. Nokia is losing market shares in high-end markets where manufacturers specializing in smartphones are cutting into Nokia's share of the market. Ironically, the problem lies with Nokia's platform strategy, which was the driving force of its strong manufacturing ability. The platform strategy enables the production of many different devices on a single platform, thus greatly reducing cost. However, when Nokia wants to produce a fundamentally new device, the company has to rebuild the whole platform, which could take more than two years to complete. A platform strategy lacks flexibility in unpredictable conditions. Despite all its market power and resources, Nokia was not the first to release the full touchscreen phone. In addition, the success of Apple's iPhone and App Store, together with the recent surge of Google's Android-based smartphones, made inroads into the potential customer base of Nokia as a web platform provider. As a result, both Nokia's year-to-year sales and market share decreased by 12.4% and 8.9%, respectively, in the second quarter of 2009. Symbian's market share in the OS market also experienced a significant decrease from 63.5% in 2007 to 52.4% in 2008. Nokia is taking various measures such as reducing production, announcing temporary layoffs, and increasing investments in high-end device developments, in an effort to turn the status around.

THRIVING SAMSUNG ELECTRONICS

Samsung Electronics Corporation (SEC) was the first Korean company to produce its own mobile phones. The company began its domination of the Korean domestic market in 1994 with the release of the Anycall brand of mobile phones. The company quickly extended its reach to the global market. It built up technological development and product design capability with amazing speed. With its accumulated capability, SEC is now accepted as a notable mobile phone manufacturer across the world.

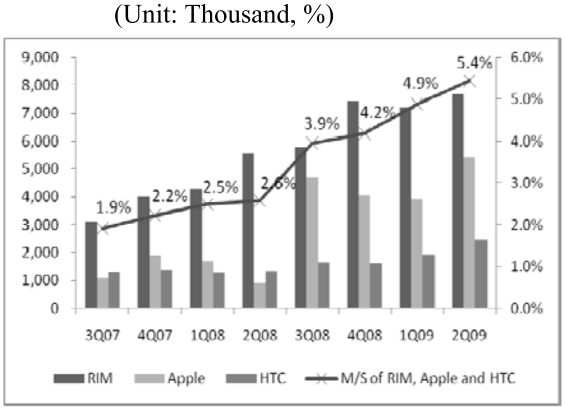
As the mobile phone business of SEC developed and its markets began to mature, the company actively transferred its factories overseas, in order to maintain the cost competitiveness of its products. Samsung moved most of its factories to locations where cheap labor was readily available, except for the one factory in Gumi, Korea, where SEC manufactured its premium products. The new factory locations included Tianjin, Shantung, and Xien Jien in China, and Haryana, India. The factories set up in China and India were specifically intended to manufacture low-price devices. The contribution of the Gumi plant to total production volume gradually decreased from 63.3% in 2006, to 52% in 2007, and then to 34.7% in 2008. Samsung also actively adopted the platform strategy of Nokia to further reduce costs. As a result, the average selling price of Samsung mobile phones constantly dropped, reducing the disparity between SEC and Nokia from USD 38 in 2007 to USD 24 in the fourth quarter of 2009.

Samsung, which had always aimed to overtake Nokia and become the global leader, is currently facing another challenge, as the market is shifting to smartphones. In the North American market, Samsung sold 2.5 million Black Jack handsets through AT&T and 1.5 million Instinct handsets through Sprint in 2008. According to Gartner, SEC had a market share of 4.2% in the smartphone market, selling 1.6 million devices in the fourth quarter of 2008. This was a 2.6% increase from 1.8% in the fourth quarter of 2007. One of SEC's most recent moves was the unveiling of the S8500 Wave handset at the Mobile World Congress (MWC). Wave is the first handset operating on the Bada OS that was developed by SEC. Bada and Wave were both part of SEC's initiative to develop its own set of unique standards encompassing handsets, operating system, and an app store. Samsung is currently aiming at sales of 10 million smartphones operating on Bada and developing at least 1,000 applications that could run on the platform by the end of 2010.

THE RISE OF SPECIALIZED SMARTPHONE VENDORS

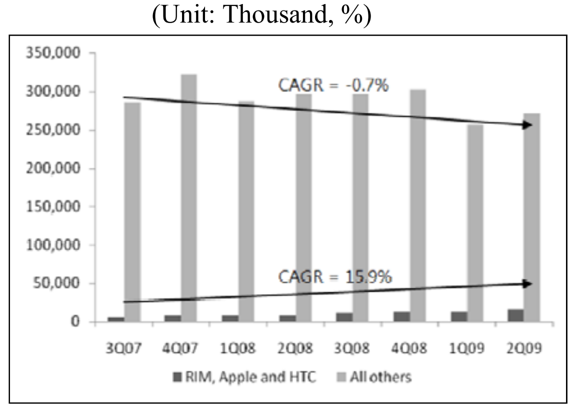
The sluggish economy seems to have had little effect on manufacturers specializing in smartphones. Even as the overall mobile phone market was slowing down, they showed impressive growth rates. Apple of the US, RIM of Canada, and HTC of Taiwan had the most outstanding results. Their market share tripled since the third quarter of 2007, adding up to 5.4% of the total mobile phone market in the second quarter of 2009. The average growth rate of these companies in the same period reached 15.9%.

<Growth of Smartphone Makers>
(Unit: Thousand, %)



Source: Gartner

<Sales and Growth of RIM, Apple, and HTC vs. Others>
(Unit: Thousand, %)



Source: Gartner

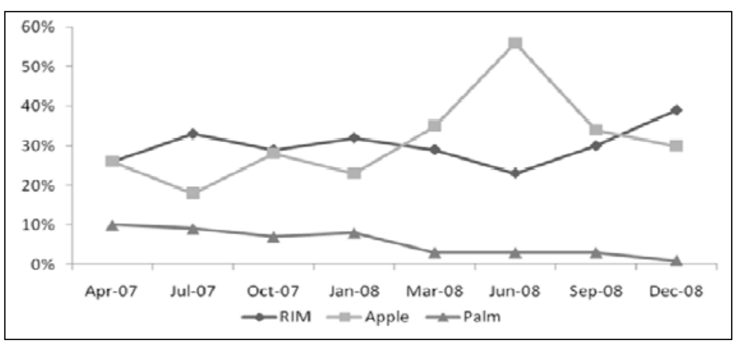
Research In Motion

The Canadian communication device manufacturer, Research In Motion (RIM), which was established in 1984, quickly became the leader in the smartphone market after it released the BlackBerry. The most significant feature of the BlackBerry was its e-mail solution. BlackBerry users can send and receive e-mails regardless of where they are, allowing them to deal with pressing business matters faster. Users can also easily manage their schedule through the Outlook program, and chat with other people using the instant messaging service installed on BlackBerry. The beauty of this device was that users could do all of these functions even as they were striding down the sidewalk, far from any desktop computer (Kim, 2008). BlackBerry adopted the QWERTY keypad, and there was a track-ball in the center of the device (which performs the same functions as a mouse does for a PC); these features were meant to provide as much of a PC-like environment as possible.

Fortune selected RIM as one of the world's 100 fastest-growing companies in 2009. Even as Apple's iPhone generated a buzz in the global market, Rim outperformed the iPhone in the North American market in the first half of 2009, reclaiming its dominance in the US smartphone market. The BlackBerry is most commonly used by business people in North America and Europe, which are advanced markets in B2B solutions. There are about 19 million users across more than 130 nations. During the last three years, RIM recorded an average increase of 84% in earnings per share, and a 77% annual sales growth.

<Market Share of the North American Smartphone Market>

(Unit: %)



Source: Changewave Research

Apple

Apple Computer Inc, established by Steve Jobs and Steve Wozniak, started as a computer manufacturing company in 1977. Apple literally led the world into an era of personal computers by successfully launching the world's first desktop computers with a keyboard and a monitor (i.e., Apple I and Apple II). Apple was also the first to introduce the concept of a graphic user interface (GUI) through its Macintosh products. Such accomplishments made Apple a symbol of innovation in the computer industry of the twentieth century. Apple did have some difficult times in the early years of the twenty-first century, when several of its new products failed in the market, and Steve Jobs was driven out of the company. When Jobs returned, Apple got a fresh lease of life, and started launching a series of innovative products from 2007, such as the iPod (a portable MP3 player), Apple TV (a multimedia device for households), the iPhone (a smartphone), and the iPad (a tablet computer). The iPod and iPhone especially were well received in the market.

Apple entered the mobile handset market, which had already been showing signs of saturation, for two reasons. First, the iPod was losing its initial glamour, and Apple was looking for a new growth engine. The sales of the iPod had been growing at a whopping annual rate of 200%, which was unquestionably the main driving force behind Apple's rapid growth. Since 2006, however, iPod's sales growth had slowed down to double-digit rates. Of course, this was only natural as the iPod had by then claimed more than 50% of the total MP3 player market. Nevertheless, Apple wanted to find its next growth engine that could replace the iPod in order to keep the company on the rise.

A more fundamental reason could be found in Steve Jobs's forecast of the IT market. At "All Things Digital," a conference hosted by the Wall Street Journal on May 30, 2007, Jobs stated that the future of IT lies in mobile phones. This was in sharp contrast to what Microsoft's Bill Gates had forecast; he had previously claimed that personal computers would become the black hole of other IT-related devices. Although seemingly contradictory, these remarks clearly indicate that the players in the mobile phone and PC industries would soon cross paths. Apple's entry into the mobile phone market was not simply about developing new products to secure a future growth engine, but was really about forming a foundation to build competitiveness in the future IT market.

The iPhone attracted a great deal of attention, causing a huge impact on the mobile phone market upon its release. The first iPhone was sold in the US at 6 p.m. on June 29, 2007. Customers formed endless lines at outlets to buy the new device. A million units were sold in the first week, and the hype continues with its share of ups and downs. One of the reasons for the iPhone's success was its good looks, of course. Apple's service model, designed to maximize the user experience, was another main reason behind the scene. The iTunes service, which had made the iPod so successful, was applied directly to the iPhone. This caused a large number of customers who had already experienced and loved using iPod to shift to the iPhone and Apple's App Store.

Despite its grand opening, the iPhone fell a little short of the groundbreaking results that iPod had shown initially. Apple only sold 6 million units of the second-generation iPhone; it had expected to sell 10 million. The most critical reason for the insufficient sales was its excessively high price (USD 499 for the 4 GB model and USD 599 for the 8 GB model) compared to the average price of other mobile phones (USD 130 in 2007). To increase the sales of the iPhone, Apple gave up its profit-sharing model. Apple stopped receiving part of the profit from the mobile communication service providers, and cut down the price to USD 199 (4 GB) and USD 299 (8 GB). iPhone's market share leaped to 10.7% in the fourth quarter of 2008, from 5.2% in the previous year. The iPhone is currently sold in about 80 countries, including the US, Canada, France, Germany, Japan, Taiwan, and Korea.

HTC

Established in 1997, Taiwan's HTC started its business as an original design manufacturer (ODM) for other companies in the mobile phone business. HTC pioneered the smartphone market hand in hand with major OS providers, such as Microsoft and Google. HTC also maintained strategic partnerships with Intel, Texas Instruments, Qualcomm, and other global communications service providers (such as Orange, T-Mobile, Vodafone, Verizon, and NTT Docomo). Having accumulated sufficient knowledge and experience, the company unveiled its own brand of smartphones in June 2006.

Before unveiling its own brand, HTC showed remarkable growth by releasing a series of well-accepted products for other companies: the Microsoft smartphone (2002), the first Microsoft 3G phone (2005), and the first Microsoft Windows 5.0 Smartphone (2006). Even after releasing its own brand of phones, HTC manufactured the first Google phone, Nexus One (2010). HTC was ranked number two on Business Week's Asian Top Information Technology companies in 2007, and number three among global IT companies in 2006. HTC annually invests 25% of its total profit for R&D and for developing its manufacturing capabilities.

PAST AND PRESENT OF LG ELECTRONICS

HISTORY OF LGE'S MOBILE PHONE BUSINESS

The history of LGE's mobile phone business can be traced back to 1995. On March 6, 1995, LGE held the launch of Hwa Tong, an analog handset. This event signaled LGE's entrance into the mobile phone industry. LGE initially organized their handset division under LG Information & Communications, Ltd, which merged with LGE in September 2000. LGE invested a substantial part of its retained earnings on information and communications throughout this process to build competence in a field with high growth potential. LGE's devotion toward the handset business began to produce concrete results by 2001. In the first quarter of 2001, the company recorded a 2.5% share in the global market, and joined the ranks of the global top ten for the first time. In the fourth quarter of 2001, LGE had sold 10 million handsets worldwide, and became one of the top eight global manufacturers.

With strong performance in 2001, we are now confident that the mobile handset business will be our core business in mid- and long-term perspective.

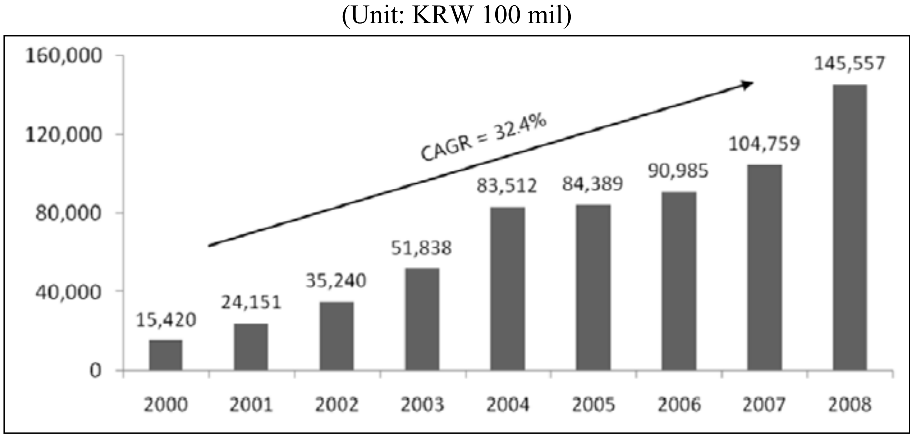
–LG Electronics Annual Report, Kim Jong-eun, Head of Mobile Communications Division

In August 2001, LGE decided to enter the European market, which primarily used the Global System for Mobile Communication (GSM). This indicated LGE's efforts to become a truly global company, as GSM accounted for 70% of the global market at the time. In the first quarter of 2003, LGE increased its market share to 5.2%, and jumped ahead of Sony-Ericsson to become the global number five. LGE achieved greater success in the third-generation WCDMA handset market. In the fourth quarter of 2004, its efforts to succeed in the future communications market paid off: LGE became the global leader in the third-generation WCDMA handset market. The capability to effectively embed multimedia technology into digital devices, which LGE had accumulated while manufacturing digital household appliances, made this possible. Its WCDMA handsets were ahead of those of its competitors in features such as visual communication and battery life.

The global success of the Chocolate Phone, introduced to the market in October 2005, proved LGE's global competitiveness. It became a global steady seller, with sales of 15 million units. LGE also became a pioneer in using touchscreen technology with the success of the Chocolate Phone. Since the Chocolate Phone was one of the earliest handsets with a full touchscreen, the phone's success made the technology popular in the mobile phone industry. Since then, LGE released many other highly successful handsets, such as the Shine Phone (with a stainless steel casing) and the Beauty Phone (with an aluminum case and a built-in 5-megapixel camera). All these helped to push LGE up to the third place in the global handset market in 2009.

<Sales Revenue of LG Electronics>

(Unit: KRW 100 mil)



Source: LG Electronics IR Report

LG Electronics' mobile phone business history	
1979	Established Goldstar Semiconductor
1986	Started developing handsets in partnership with US companies
1989	Started sales of handsets
1990	Changed name to Goldstar Information & Communication, and imported STAREX-TD to
1993	Vietnam
1994	Manufactured Vietnamese communication devices, and established a joint venture, VKX
1995	Operated Russian communication and established a joint venture, ROKOTEL
1996	Changed name to LG Information & Communication
1997	Released world's first CDMA handsets
1998	Commercialized CDMA PCS system, and supplied the equipment
1999	Developed world's lightest CDMA PCS phone
2000	Released world's first wireless Internet mobile phone
2003	Merged with LG Electronics
2004	Entered North and East European GSM markets
2005–	Released world's first mobile TV phone
2007	Became global number one in CDMA
2005–	Awarded "3G CDMA industry development award" four years in a row
2008	Successfully demonstrated LTE (Long-Term Evolution), the 4G mobile communication
2007	standard in mobile devices
	10 million Chocolate phones sold by April; 15 million Chocolate phones sold by December
2007	Applied 4G mobile communication standard (LTE) in mobile devices; developed world's
2008	first device modem chip
	Unveiled Touch Watch phone, which enables global visual calls
2009	Became one of the Top 3 in global handset sales
2009	

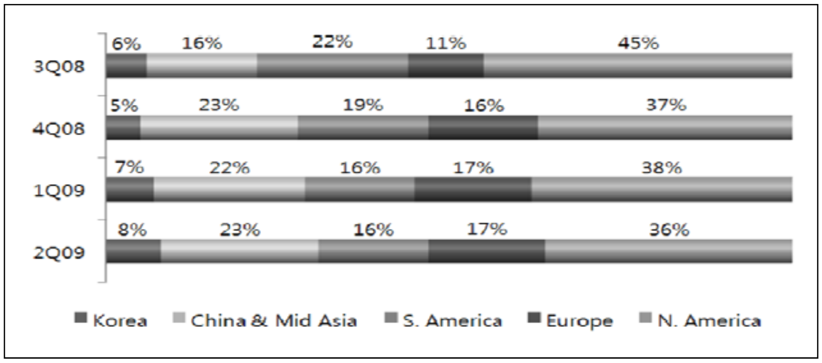
Source: LG Electronics official website (www.lge.co.kr)

BEHIND THE SUCCESS OF LG ELECTRONICS

LGE has frequently used a strategy that simultaneously targets the developed markets (i.e., US and Europe) and the developing markets (i.e., Central/South America and Asia). Emphasizing both sides of the global market resulted in the balanced sales of LGE mobile phone devices in both developed and developing markets.

As part of this strategy, LGE is planning to open about a hundred LG Mobile brand shops to expose customers in developing markets to LGE's high-end goods. This was an alternative solution intended to promote the sales of its premium devices, since existing shops in developing markets were not suitable for emphasizing LGE's prestigious image. LGE plans to maintain its profit margin to a reasonable level by focusing on the sales of its premium handsets, and by preventing the "chicken game" price war that can occur—especially when the product portfolio is focused only on low-end products.

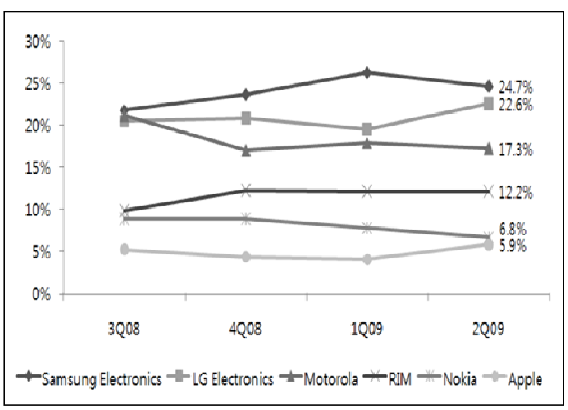
< Rate of LG Electronics' regional sales>



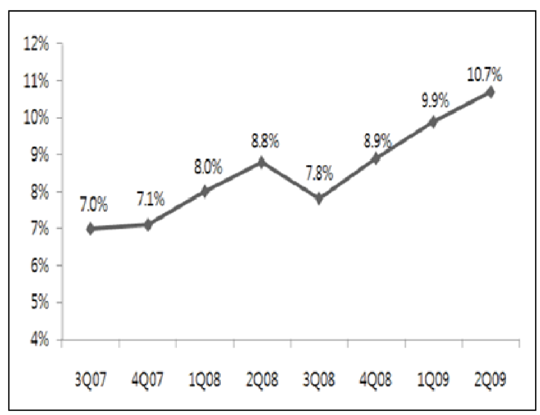
Source: LG Electronics IR Report

LGE performed particularly well in the North American market. A study of the North American market showed that SMS usage was more than doubling every year, along with the need to send e-mails using mobile phones. LGE took the findings of this study seriously, and released mobile phones equipped with QWERTY keypads to maximize messaging efficiency. The devices were dubbed Envy and Rumor. The Envy series generated sales of more than 8 million units in North America. Envy's successors such as Envy Touch and Xenon also became million-sellers. The success of these models in one of the most developed markets in the world contributed to LG's reputation, and increased its market share in the North American market to 22.6%. This was the biggest success for LGE so far, considering that LGE's global market share was marked at 10.7% in the second quarter of 2009.

<Market Share in North American Mobile Phone market> <LG Electronics' Global Mobile Phone Market share>



Source: Strategy Analytics



Source: LG Electronics IR Report

LGE's strategy of covering developed and developing markets simultaneously has another advantage: it increases the total supply, thus strengthening the economies of scale, and hedging the impact of various regional economic factors. In other words, diversifying the sales market reduced the risk of global operations. For example, LGE made up for the decrease in demand in the North, Central, and South American markets as well as the Korean market in 2008 (caused by the economic crisis) with the increase in sales in the Indian market. This contrasts with the strategies adopted by Motorola and Sony-Ericsson, which had either neglected developing markets or depended solely on a single market.

The strongest driving force behind LGE's success, however, was its capability in developing innovative products through the active adoption of new technology and hardware designs. Its innovative products are certainly the most important reason behind LGE's success in the developed markets. The Prada Phone, the Chocolate Phone, the Shine Phone, and the Voyager all used innovative technologies that stood out from the competition: touchscreen technology, QWERTY keypad, stainless steel casing that had not been used before due to signal disturbance caused by the metal, and so on. These products set the trend in the global market with innovative technology and excellent design, contributing to building LGE's presence as a premium brand.

LGE has its own channels of substantial scale to efficiently deliver key components; this fact had a favorable impact on LGE's positioning of itself as a premium brand. The cost and quality of the different modules, such as the MP3 player and camera, are decisive factors in the total price of a handset, as the costs for these components take up most of the production cost. Having these components supplied at a low cost is crucial for mobile phone makers in order to cut down the price (Pak & Kim 2007).

LGE is a conglomerate with a highly efficient, vertically integrated organizational structure. The core components can be sourced from internal suppliers like LG-Philips LCD and LG Chemicals, allowing efficient cost management. Efficiently managed intercompany transactions within the group enabled LG to eliminate unnecessary costs, and this enhanced the price competitiveness of LG's final products in the global market. The managers were able to accumulate know-how on effective intercompany dealings, and could strengthen the link between partner companies through repeated transactions. Transportation costs were also reduced because the locations were nearby. Another advantage of using internal suppliers is that suppliers tend to provide their best products, manufactured on the best infrastructure, without the need for too much tiresome negotiations or supervision, since a long-term relationship is assured (Williamson, 1975, 1983). Increased competitiveness derived from internal partnership (as in this case) is being successfully practiced in Korean conglomerates, where a top-down command approach is the norm; this makes it difficult for other companies with different cultural backgrounds to imitate this model (Barney, 1991). This is one of the factors behind the success of LGE and SEC that has enabled them to step ahead of their competitors in manufacturing complex multimedia handsets that require various modules with diverse embedded functions.

THE NEW ORDER IN THE SMARTPHONE MARKET

Smartphones, often referred to as the PC at your fingertips, require a whole new level of manufacturing capabilities compared to mobile phones. Hardware quality and distinguishable designs, which were the key success factors in the past, became less important. One of the key factors in making smartphones is to provide high-quality content services to the users. As most of the contents provided to smartphone users come in the form of various applications, this creates pressure on handset makers to supply an ample volume of useful applications. Applications, in turn, cannot operate by themselves. The need for a fast and reliable OS that can enhance the computing performances of smartphones has also greatly increased. The few companies with the capability to develop their own OS for smartphones gained a powerful voice in the transformed mobile phone market. All these new factors in the current smartphone market changed the competition, and made it much more complicated. In order to measure a company's competitiveness in the current smartphone market, a comprehensive evaluation is necessary that would encompass the hardware devices, OS, and applications offered by the company.

COMPETITION IN HANDSETS

The main contenders vying for excellence in the smartphone market include the traditional mobile phone manufacturers (Nokia, SEC, LGE, Motorola, and Sony-Ericsson) and the specialized smartphone manufacturers (RIM, Apple, and HTC). Nokia remains at the top among these players, with the highest market share, even though it is experiencing a sharp decrease in its market power. In order to overcome the situation, Nokia began to actively release smartphones in 2006, and upgraded its product portfolio to a higher level. Nokia's efforts to increase the portion of smartphone sales to over one-third of Nokia's total sales paid off. However, Nokia was a step behind its competitors in releasing smartphones, and had lost a substantial amount of market strength in North America, more than in other markets, where the demand for smartphones was increasing explosively.

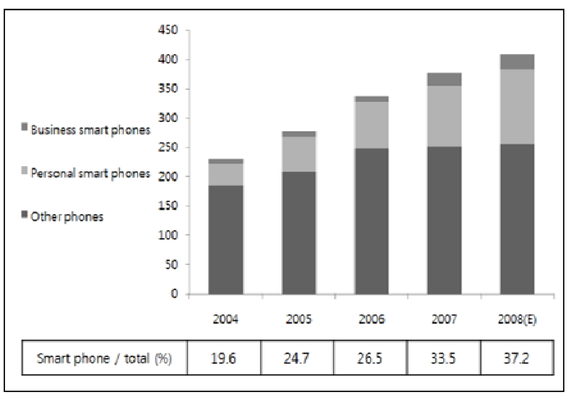
Comparison between 074Q and 084Q of the major smartphone makers (Unit: Thousand, %)

	4Q08		4Q07		4Q08/4Q07	
	Sales	Market share	Sales	Market Share	Sales	Market Share
Nokia	15,561.7	40.8%	18,703.3	50.9%	-16.8%	-19.8%
RIM	7,442.6	19.5%	4,024.7	10.9%	84.9%	78.9%
Apple	4,079.4	10.7%	1,928.3	5.2%	111.6%	105.8%
HTC	1,631.7	4.3%	1,361.1	3.7%	19.9%	16.2%
Samsung	1,598.2	4.2%	671.5	1.8%	138.0%	133.3%
Others	7,829.7	20.5%	10,077.3	27.4%	-22.3%	-25.2%
Total	38,143.4	100.0%	36,766.1	100.0%	-	-

Source: Gartner

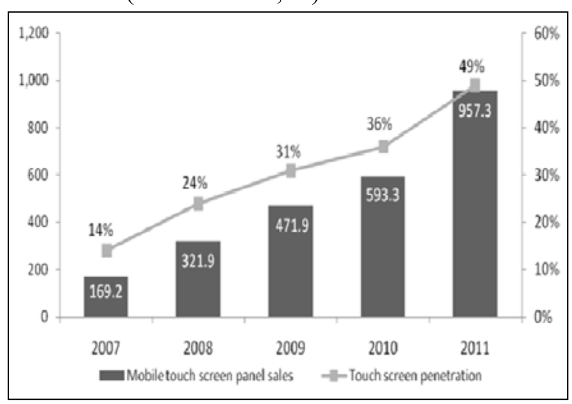
Among the specialized smartphone manufacturers, RIM and Apple are growing stronger in the smartphone market, with HTC following closely behind. RIM provides strong enterprise solutions, and is well known in the North American market, although its high reliance on the North American market could also be its weak point. Nearly 80% of RIM's total sales come from the North American market, and AT&T accounts for about half of these sales. Apple's remarkable growth is in part propelled by the Apple App Store, which is believed to be the most successful application store to date. The competence of the iPhone comes not only from the device itself, but also from the synergy created by its App Store. However, some worry that the closed architecture of Mac's OS and App Store, along with the iPhone's extremely limited hardware portfolio, will have a negative influence on the future growth of Apple. The Taiwanese smartphone maker HTC became more widely known to the public because of its Google Phone.

< Sales Breakdown of Nokia Handsets>
(Unit: EUR 100 mil)



Source: Garcha, K., Armaly, W., & Sultania, A.

<Touchscreen Panel in Mobile Phones>
(Unit: Million, %)



Source: DisplayBank (2008)

SEC and LGE, which are number two and three in the global mobile phone market, have released smartphones since the second half of 2008, and are currently holding on to relatively small market shares. Motorola and Sony-Ericsson, on the other hand, have kept from investing large sums in the smartphone market due to their ongoing restructuring.

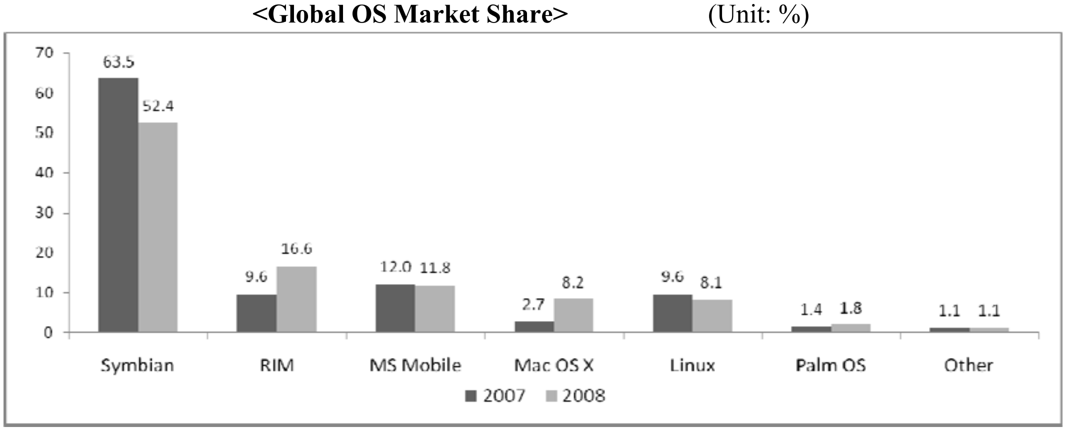
COMPETITION IN OPERATING SYSTEMS

Smartphone users are very sensitive when it comes to choosing which operating system (OS) to use; this decision is just as crucial as deciding on the device itself. They demand that the computing performance of the OS is close to that of a PC, and they expect their use of the smartphone to be an extension of their PC usage experience. Therefore, it is very important for smartphone companies to equip their devices with a fast and reliable OS that can support a certain amount of workload with minimum errors. Currently, Nokia's Symbian, Microsoft's Windows Mobile, and Google's Android operating systems are competing to be loaded on to various devices, while RIM and Apple had developed exclusive operating systems for their devices.

A recent trend in the smartphone OS industry is the emergence of open source OS. An open source OS allows users to develop applications, using the software development kit (SDK) provided by the OS developers. Leaving the source codes of the software open to other developers would ultimately enable the open source OS to be upgraded faster, and would provide a wider variety of applications to consumers than the closed-source systems would. This is essentially why many analysts predict that Google Android would be the most successful player in the future. Strategy Analytics, a US market research company, projected that Google Android would increase its OS market share to 4.4% by the end of 2009, from its current market share of 0.5%. The Android OS aspires to be an open source OS, and is based on the Linux system, promising broad potential for further service development. LGE, SEC, Motorola, and Sony-Ericsson, along with HTC, are planning to or are already actively releasing smartphones using the Android OS.

Nokia, while gradually losing market dominance due to the surge of Android and iOS (Apple's OS), still dominates the smartphone market with a 45% share, and is most likely to achieve the strongest economies of scale. Its decision to change from Symbian to an open source OS would certainly support its current strong market position. Nokia, however, has canceled its plans to release an Android handset due to fears of losing Symbian's market leadership.

<Global OS Market Share> (Unit: %)



Source: Gartner

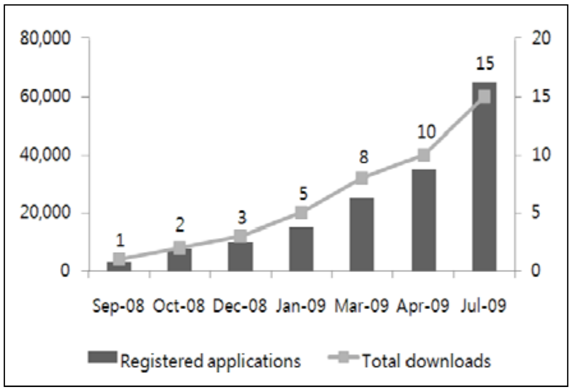
COMPETITION IN APPLICATIONS

As the hardware and operating systems of smartphones are improving rapidly, the competition to provide various applications that run on smartphones is also receiving new attention. An app store refers to an online space where various applications are sold or provided free to users. Application developers, varying from huge corporations to individuals, can upload their products to an app store, which is then sold directly to users. The applications that are downloaded by the users can be used without any further processes. The profit generated from the sales of applications is shared between the app store operator and the software developer according to the terms of their agreement. The most distinct characteristic of app stores is the openness in developing applications: app store operators disclose their software development kit (SDK) to the public, and anyone can utilize the SDK to develop a new application, and commercialize it.

The current app store competition was initiated by the success of Apple's App Store. Apple's App Store opened in July 2008, and accumulated 1.5 billion downloads and 65,000 applications by July 2009. Companies running app stores are not limited to manufacturers specializing in smartphones such as Apple, RIM, and Palm. Major handset makers (such as Nokia, Samsung, and LG), OS developers such as Google and Microsoft, and mobile communication service providers (such as Vodafone, T-Mobile, and Verizon) are all currently operating app stores, or have plans to open an app store in the future. Although an app store is generally characterized by its openness from the point of view of the developers, the consumer's perspective of the extent of this openness varies, depending on the providers. For instance, only customers with Apple devices can use Apple's App Store, and their devices do not have access to other app stores. On the other hand, companies without their own app stores or mobile OS do not prevent their users from downloading applications from other companies' app stores. The recently opened LGE app store has also adopted this format. In certain other cases, companies with their own OS do not allow access to other users, but do permit their customers to access other app stores.

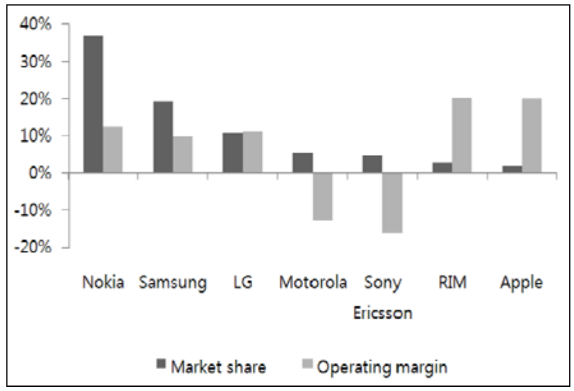
The importance of contents distribution can be clearly seen by comparing the market share and return on sales of the different mobile phone providers. The top three players of the market—Nokia, Samsung, and LG—had a total market share of 70% in the second quarter of 2009, but their return on sales was only about 10%. In contrast, RIM and Apple, with only 2.7% and 1.9% market share, respectively, had return on sales of over 20% each. These differences occur due to the disparity between the cost of sales, sales expenses, and operating expenses for the two groups. The profit of traditional mobile phone manufacturers is mostly generated by hardware sales; manufacturing hardware, unfortunately, involves high cost of sales, high sales expenses, and high operating expenses. RIM and Apple, on the other hand, generate their profit not only from selling hardware but also from selling contents, which requires extremely low fixed and variable costs.

<Growth of Apple App Store>



Source: Apple's published report

<2Q09 Market Share and Operating Margin>



Source: Each company's IR reports

COMPETITIVENESS OF LG ELECTRONICS IN THE SMARTPHONE MARKET

Based on its strength in hardware manufacturing, LGE leaped to third place in the global mobile phone market in terms of global market share. Nevertheless, LGE's competitiveness still remains insufficient to make it the top player in such a fast-evolving smartphone market. The OS for LGE phones are supplied by Google and Microsoft, and the LG Application Store is still in the early stages of development. The current conditions of LGE are well captured by the evaluation of the competitiveness of the smartphone makers in 2008 which showed that LGE was ahead of its competitors in hardware designs, WCDMA Chipset technology, and basic manufacturing capability. However, LGE was weak in areas such as software, intellectual property rights, and brand, signifying that the advantages of LGE in the smartphone market are limited to the capabilities the company already had in the traditional mobile phone market.

2008 Competitiveness Analysis of Smartphone Makers

Fields	Nokia	Samsung	Sony-Ericsson	Apple	RIM	HTC	LG	Motorola
Size	9	5.7	5.3	2.3	2.3	2.3	3.7	3.7
Supply	10	7	4	6	7.5	4.5	4.5	6.5
Product portfolio	8	7.3	6.7	3	4.7	5	3.7	2.3
WCDMA Chipset	10	6	8	2	2	6	6	2
Intellectual property rights	10	2	8	0	1	1	1	4
Service	6.7	4.3	4.7	5	7	4	3.3	4
Software	5.5	3.5	5	9.5	7	5.5	3	3
Brand	10	8	2	9	6	1	3	5
Management	7	4	5	8	7.5	10	4	1.5
Design	6	7	6	7	5	6	7	1
Total score	82.2	54.8	54.7	51.8	50	45.3	39.2	33
Rank	1	2	3	4	5	6	7	8
Source: Credit Suisse								

However, LGE has a few reasons to be optimistic about its future in the smartphone market. For instance, there are many ways to make up for the capabilities that are lacking, by cooperating with other companies. The success of Apple and HTC each gives inspiration, in rather contrasting ways. Apple had its strength in its OS and applications, but it had no previous handset manufacturing experience. Despite such circumstances, Apple achieved its success in the mobile phone market through its partnership with Hon Hai Precision Industry (an electronics manufacturing services company in Taiwan) that had mobile phone manufacturing ability. This was possible because providing fast computing experience is much more important for smartphones than simply providing good quality calls; this enabled the company to make up for the deficiencies in manufacturing capacity with OS and contents related capabilities. In contrast, Nokia, which enjoyed its cost competitiveness through the efficient platform strategy that no competitors could imitate, is currently struggling in the smartphone market.

On the other hand, HTC possessed competitiveness in hardware development and manufacturing, while being less competent in OS and application development capabilities. However, HTC was able to become number four in the global smartphone market as a result of its close ties with Microsoft since the beginning of its business. The cooperation with Microsoft strengthened its software competitiveness, which is a crucial element in developing smartphones. HTC learned to manufacture smartphone devices best suited for the OS provided by other companies, and supplied devices to companies (such as Sony-Ericsson and Palm) using Microsoft's OS. HTC currently manufactures devices under its own brand, using Google Android. While Apple's case indicates that software competitiveness is more important than manufacturing capacity, HTC's case indicates that a company with an excellent smartphone manufacturing capacity can thrive in the smartphone market through partnerships with software vendors.

Due to the multi-faceted competition in the smartphone market, it is hard for a single company to claim monopoly in all segments. A single company with all of the capabilities needed to create good smartphones—the capacity to manufacture high-quality handset devices, strong economies of scale in distribution, continuous innovation in hardware manufacturing capacity, the ability to develop and maintain a stable and user-friendly OS, and an attractive app store—is very unlikely to appear in the near future. It would be a much smarter move to find the right partners, as Apple and HTC did, in order to thrive in the smartphone market, rather than to try to cope with all of the problems single-handedly.

In this context, the recently initiated LG Enterprise Application Partnership Program to target the B2B smartphone market in North America is a notable initiative taken by LGE. The objective of this program is to provide differentiated software services to LGE's corporate clients, under close cooperation with thirteen partner companies, including Microsoft, Bloomberg, and Good Technology. Although this move shows that LGE is seeking to remove its weaknesses through partnerships, it does not imply that LGE will only focus on such a method. While LGE agreed to participate in creating the Wholesale Application Community (WAC) that will act as an open app store platform, it also clearly stated the commitment to expand its own LG Application Store. It is obvious that LG has chosen another direction when compared to Samsung, which is currently striving to create a standard of its own, and dreaming to foster its own mobile ecosystem. The future outcomes of these contrasting decisions by the two giants are already attracting interest.

EPILOGUE

Since launching its mobile phone business in 1995, LGE has recorded an annual growth rate of 32.4% in the first decade of the twenty-first century. LGE became the third-largest mobile phone manufacturer in the first half of 2009, with over 10% share in the global market. However, LGE cannot yet rest on its achievements in the highly uncertain environment of the global mobile phone market. As the smartphone rapidly expanded its presence in the mobile phone market, the structure of competition became more complex with handset devices, OS, and applications all coming into play. LGE suffered from low market share in smartphones due to the absence of competitive advantage in some of these areas. Competition among the participants is becoming fiercer as the global market landscape changes, along with the need to apply different strategies for manufacturing handset devices, developing OS, and providing applications.

LGE now needs to establish and effectively implement a new strategy in order to secure competitiveness in the smartphone market. Can LGE continue its success in the smartphone markets in North America and Europe with its current positioning? Maintaining LGE's success or realizing an even higher goal depends on its future strategies, and their implementation. Changes taking place in the mobile phone market has already led, and will continue to lead, to seismic shifts in the industry. Companies reluctant to change have always fallen behind in the new order of competition.

What strategic decisions should LGE make in order to secure competitiveness in a short period of time, when a new business model centered on the smartphone is being established in the market?

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INTEREST RATE SWAPS AT HOLOGEN INC

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CASE DESCRIPTION

The primary subject matter of this case is the use of interest rate swaps to lower capital costs and manage interest rate risk. Secondary issues include examining market efficiencies. The case requires students to have an introductory knowledge of accounting, statistics, finance and international business thus the case has a difficulty level of four (senior level) or higher. The case is designed to be taught in one class session of approximately 3 hours and is expected to require 3-4 hours of preparation time from the students.

CASE SYNOPSIS

Hologen Inc., a diversified medical technology company, currently operates in three business segments (Breast Health, GYN Surgical, and Skeletal Health). Hologen's CEO has suggested the company pursue an acquisition that would diversify its product line as well as increase its exposure in international markets. Hologen's vision is to become the world's largest pure-play women's health-care company. In order to achieve this status, Hologen would need to enter the diagnostic health-care segment of the industry and expand international sales.

Hologen felt the quickest and more cost effective way to accomplish these goals was through an acquisition of an existing diagnostic company with an international clientele. The company Hologen is interested in acquiring is a British firm, Cybertech. Cybertech, a publicly traded company listed on the London Stock Exchange, has a current market capitalization of about 252 million British pounds. In order to make a tender offer for Cybertech, Hologen will need to borrow the equivalent of about $200 million dollars and is exploring three different borrowing alternatives.

BACKGROUND

Hologen, Inc. is a diversified medical technology company that develops, manufactures, and distributes medical imaging systems and surgical products for serving the healthcare needs of women. The company currently operates in three segments: Breast Health, GYN Surgical, and Skeletal Health. The Breast Health segment offers breast imaging products. This segment also develops a breast imaging platform to produce 3D images. The GYN Surgical segment offers a minimally-invasive procedure that allows physicians to treat women suffering from excessive menstrual bleeding; and a form of permanent female contraception intended as an alternative to tubal ligation. The Skeletal Health segment assesses the bone density of fracture sites and the bone density of heels as well as an extremity MRI for detecting rheumatoid arthritis and orthopedics. Hologen, Inc. sells its products through a combination of direct sales and service force, and a network of independent distributors and sales representatives primarily in the United States and Asia. The company was founded in 1987 and is headquartered in San Francisco, CA.

The breast health segment is Hologen's largest division, contributing to about 60% of sales. The majority of revenues in the breast health division are derived from the sale of imaging devices, with digital imagining driving sales. Over the past few years, sales from the breast health division have been expanding due to a shift from analog to digital imaging by hospitals and clinics. Hologen's GYN surgical division has been performing steadily. The established sales force with strong connections to OB/GYN physicians has proven effective at delivering consistent 7%-8% revenue growth over the last 5 years. However, this division is the smallest in terms of revenue contribution (only about 15% of total sales). Hologen's skeletal health segment, which represents about 25% of total revenue, has come under pressure from lower reimbursement rates and the company is anticipating a decline in revenue growth from this division over the next few years.

Even though Hologen is well positioned in the digital mammography segment, with a market leading 65% share in the United States, the company is concerned this area of business is becoming saturated. Contributing to declining sales is the gap or extension of the replacement cycle by hospitals as they continue to cut capital spending on many big-ticket devices, such as digital imagers.

THE SITUATION

During the first week of 2011, Hologen's CEO John Rollins was reviewing the most recent fourth quarter financial statements. The results were disappointing. Revenues were down 8% for the quarter and this mirrored the full-year results in which sales were down almost 3%, mostly due to weaker results from the breast health segment.

To date, Hologen's current strategy for long-term growth has been focused on the breast health segment. Hologen has continued to invest in research and development to maintain a competitive advantage in the digital market. In addition, the company has focused heavily on 3-D imaging devices, which the company believes is the next frontier for digital mammography. This strategy has potential vulnerability as large conglomerates such as GE and Siemens also compete in this business segment. If either of these competitors decides to focus their vast research budgets on digital imaging, Hologen's superior technological advantage may be severely diminished. GE and Siemens could also use their broad product lines and large sales force to erode away Hologen's current leading market share position in this segment.

In response to the potential vulnerability to the breast health division, Rollins had suggested to Hologen's board that the company pursue an acquisition that would diversify its product line as well as increase its international exposure. Currently Hologen had very little access to developed markets such as Europe, which Rollins feels Hologen must penetrate in order to achieve consistent earnings growth over the long-run. Moreover, Rollins wants to position Hologen as a future player in emerging markets where the potential for growth is extremely promising. Rollins vision is for Hologen is to become the world's largest pure-play women's health-care company. In order to achieve this status, Hologen would need to become a participant in the diagnostic health-care segment and increase international sales. Rollins felt the quickest and more cost effective way to accomplish these goals was through an acquisition of an existing diagnostic company that had an international presence and ties to emerging markets.

The company Rollins is interested in acquiring is a British firm, Cybertech. Cybertech is a molecular diagnostic company whose main product line is T-Prep, the most widely used method for cervical cancer screening in both Europe and the United States. In addition, Cybertech had been expanding market penetration to include Asia, India and Brazil. Over the last year, they had seen some especially positive results from expansion into India. About a month ago, Rollins was at a major medical conference in Las Vegas where he met Jim Burns, the CEO of Cybertech. They had briefly met at a reception where both had been presenting new products for the upcoming year. Rollins remembered that he had really liked Burns' vision for Cybertech's role in the diagnostic screening procedure market. Burns had a philosophy for running a business that matched well with Rollins. The two had had dinner together and talked mostly about the challenges of the healthcare sector.

When Rollins had returned from the conference, he began to research Cybertech and found their sales were fairly predictable and the company had a number of other market leading products in the diagnostic segment in addition to the well-known T-Prep. Rollins had asked his CFO, Tim Scott to work with their investment bank and come up with a preliminary valuation for Cybertech. Rollins estimated that if Hologen were able to acquire Cybertech's existing diagnostic business and strong international sales force, it would provide Hologen an opportunity to realize additional revenue benefits from cross-selling existing Hologen products via Cybertech's sales network. Furthermore, Rollins expected net margins might also improve by eliminating some duplicate research and development expenditures and lowering other costs.

Tim Scott's initial reaction to the proposed acquisition was centered on the price they would have to pay for Cybertech. With Cybertech trading at around 420 pence, up from 220 pence a year ago, the current market capitalization is 252 million pounds. Furthermore, the pound is trading at around $1.60, up from $1.40 two years ago. In US dollars, Cybertech market value is a little over $400 million. Scott casually mentioned he wished Rollins had thought of acquiring Cybertech a year ago when the US dollar equivalent market capitalization for Cybertech was under $185 million. The pound has been strengthening and Cybertech's stock has almost doubled over the last year, partially due to the world economic recovery and partially due to Cybertech's recent success in India. Scott also noted that an acquisition of a public company would also have to include about a 15% to 35% premium in order to persuade the target's board of directors and current shareholders to approve the acquisition. Rollins, Scott, their investment banker and the board of directors had spent a few weeks performing due diligence on the Cybertech acquisition and had concluded Cybertech should move forward with an initial cash tender offer of 290 million pounds. Given Hologen's current financial position, the company would need to borrow an additional 125 million pounds (the equivalent of about $200 million) if Hologen wanted to make a cash offer to acquire Cybertech. Rollins instructed Scott to meet with their investment banker and determine the cost of borrowing an additional $200 million dollars.

THE TASK

The investment banker helping Hologen with the Cybertech acquisition had done some preliminary research and concluded that Hologen could raise $200 million dollars by issuing a 5% coupon bond (paid semi-annually) at face value with a maturity of 10 years. However, the investment banker also noted that at present, there was considerably more client interest in funding investment grade floating rate notes. Given Hologen's A-rated credit quality, they could borrow $200 million for 10 years at a floating rate of 6-month LIBOR plus 1.5% with interest paid semi-annually. Tim Scott suggested that the riskiness of the international acquisition would lead Rollins to prefer fixed rate debt, even if floating rate debt is relatively more attractive at the present time. The investment banker suggested Scott should seriously consider the floating rate debt and he would try to find an appropriate party for an interest rate swap in order to take advantage of the current high demand for floating rate debt. Scott was a little uncertain about interest rate swaps but his investment banker assured him that the interest rate swap is more common that he might think. He remarked that the notional principal for interest rate swaps have grown from $12.8 trillion in 1995, to $48.8 trillion in 2000, to $128 trillion in 2005, to about $347 trillion in 2010. As interest rate swaps become more and more common place in the financial markets, the investment banker suggested Scott should stronger consider this possibility.

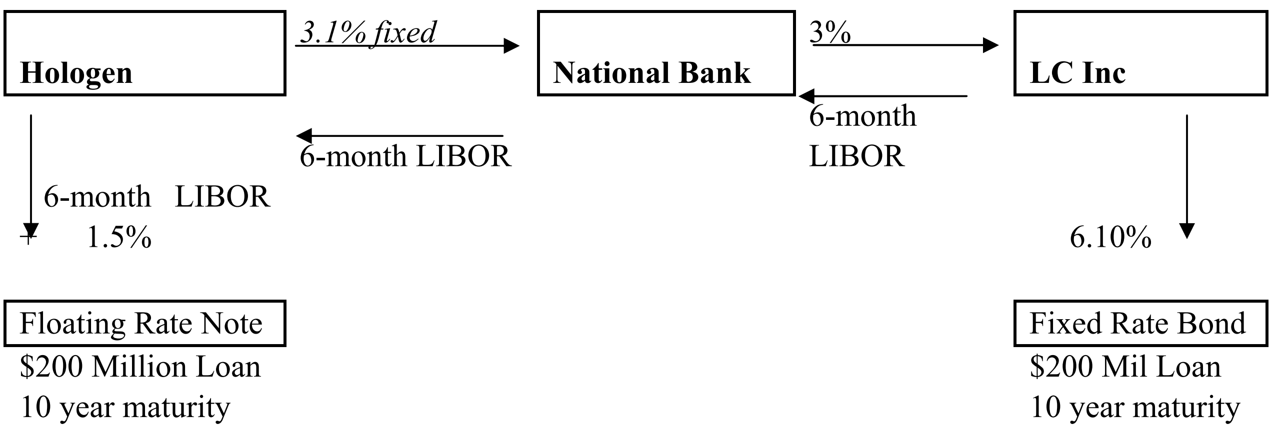
Two days later, the investment banker called Scott and reported that he found a company, LC Inc. who is able to borrow $200 million at a fixed rate of 6.1% for 10 years but prefers floating rate debt to take advantage of the steep upward sloping yield curve and initially lower interest payments. Unfortunately LC Inc. is just below investment grade in terms of credit quality and they are not able to fully take advantage of current favorable market conditions for floating rate debt. It would cost LC Inc. 6-month LIBOR plus 3.4% to borrow in the floating rate market.

The investment banker suggests Hologen and LC Inc enter into an interest rate swap that can be set up by National Bank who will act as a dealer in the interest rate swap. Hologen will pay National Bank a fixed 3.1% interest on $200 million dollars over 10 years in exchange for the 6-month LIBOR rate interest on $200 million. National Bank will also have an agreement with LC Inc. LC Inc will pay National Bank 6-month LIBOR rate interest on $200 million in exchange for a fixed rate of 3% interest. The cost of financing for Hologen and LC Inc as well as the swap terms are summarized below:

Table 1:
Cost of Financing for Hologen and LC Inc in both the Fixed Rate and Floating Rate Markets

Company Issuing Debt	**Fixed Rate Bond at Par**	**Floating Rate Note**
Hologen	5%	6-month LIBOR + 1.5%
LC Inc	6.1%	6-month LIBOR +3.4%

Figure 1: Proposed Interest Rate Swap between Hologen and LC Inc



Tim Scott went back to his office to prepare a presentation of the three different alternatives available to Hologen in terms of raising the $200 million needed for the acquisition. Scott must include the details of the fixed rate bond, floating rate note and interest rate swap in such a manner that Rollins and the Board would be able to make an informed decision. Scott listed a few major discussion points that needed to be covered in his presentation. Considering that Rollins and the Board would almost certainly want to borrow at a fixed rate, Scott had to make sure his presentation explained in some detail why it would be better for Hologen to issue a floating rate note and engage in an interest rate swap.

1) Why might investors prefer floating rate notes over a fixed rate bond?

2) Why might Hologen prefer to issue fixed rate bonds rather than floating rate notes?

3) What is the anomaly in current market conditions that makes an interest rate swap a viable option for both parties involved in the swap?

4) If Hologen issues a floating rate note and engages in the interest rate swap, what is the net cost of financing for Hologen after the interest rate swap? How does this compare to the cost of financing if Hologen issues a fixed rate bond?

5) If LC Inc issues a fixed rate bonds and engages in the interest rate swap, what is the net cost of financing for LC Inc. after the interest rate swap? How does this compare to the cost of financing if LC Inc issues a floating rate note?

6) What is National Bank's role in the interest rate swap and how much will they be compensated for their involvement in this transaction?

7) How does the interest rate swap reduce the cost of borrowing for both parties and allow the intermediary to be compensated?

Figure 2: US Treasury Yield Curve for Feb-2011

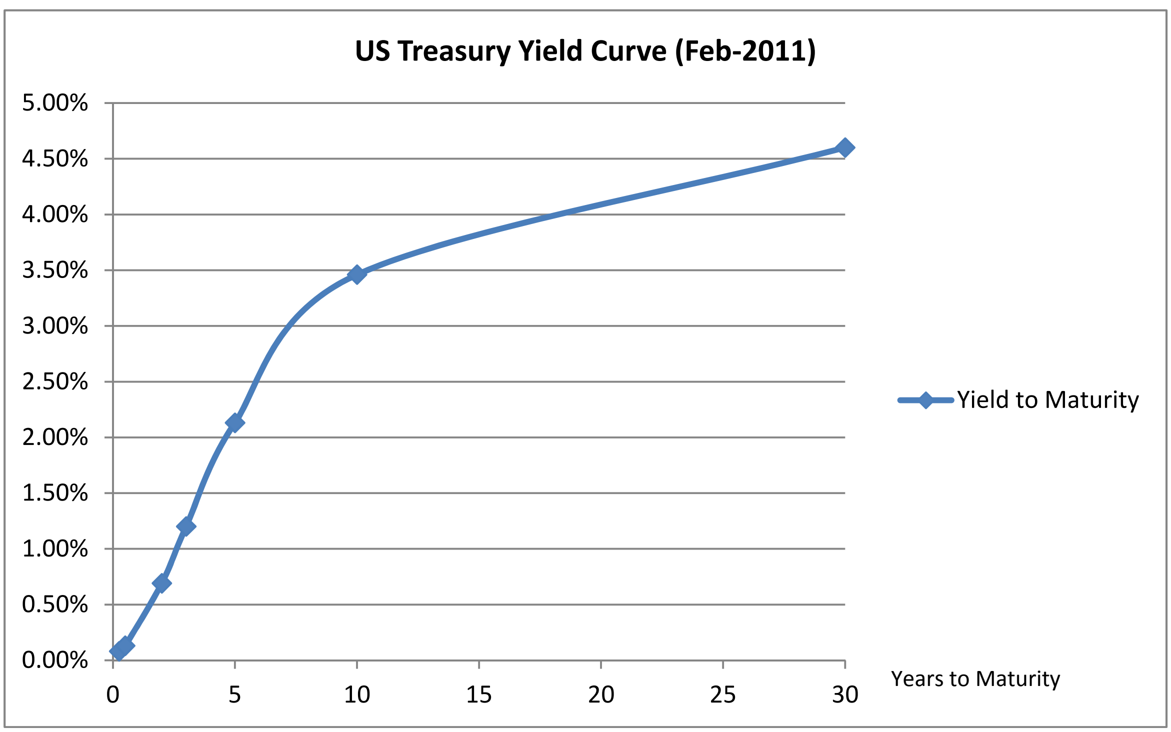


Figure 3: A-Rated Corporate Bond Yield Curve (Feb-2011)

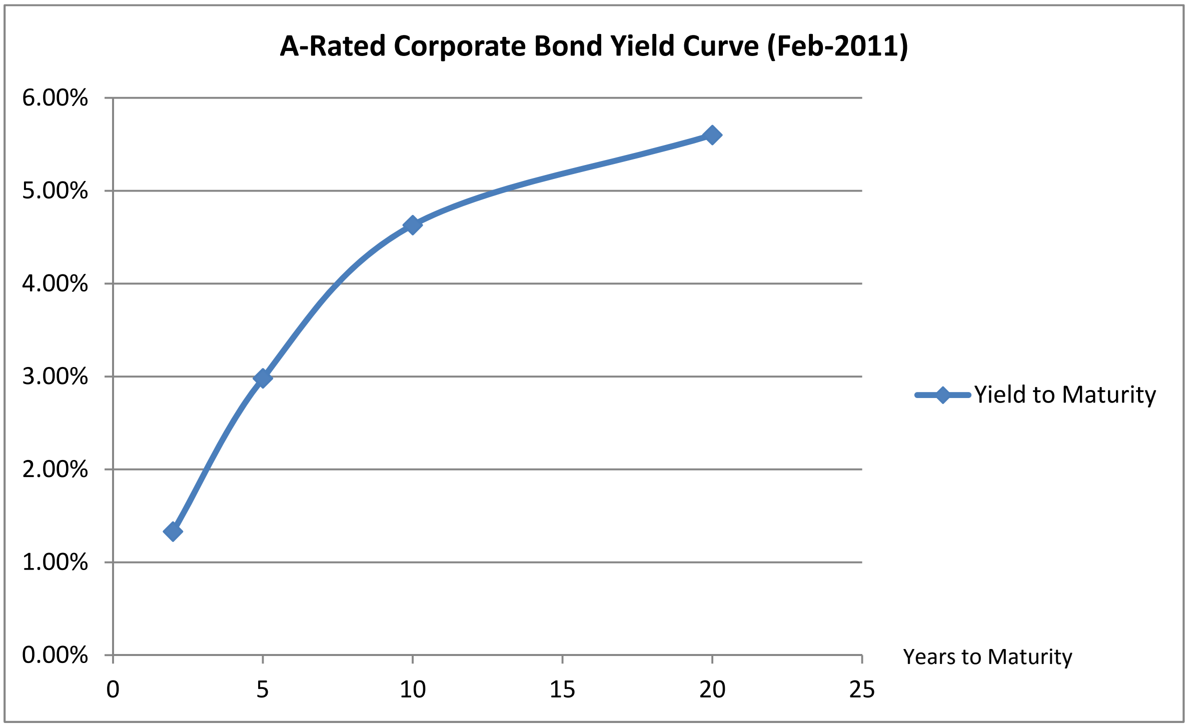
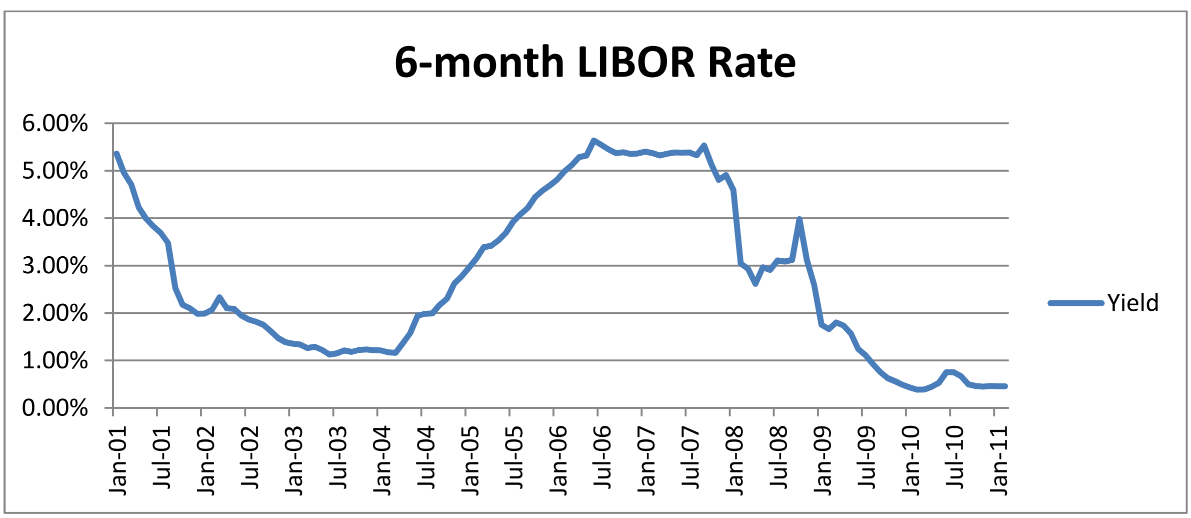


Figure 4: 6-month LIBOR rate Jan-2001 to Feb-2011



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MURPHY WAREHOUSE COMPANY

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CASE DESCRIPTION

The primary subject matter of this case concerns how sustainable business practices and increased profitability can go hand in hand. Making decisions that are both environmentally responsible and advantageous to the business often requires the assessment of a variety of tangible and intangible factors and the reconsideration of traditional decision making guidelines. Richard Murphy Jr., the CEO of Murphy Warehouse Company, has spent a great deal of time analyzing sustainable ways to conserve resources, reduce costs, improve the well-being of his employees, and promote his company as an environmentally responsible logistics provider. Murphy also realizes that the benefits of sustainable projects must be weighed against the costs and payback periods of these investments. The case has a difficulty level of three or four, appropriate for junior and senior level students. The case is designed to be taught in a one-hour class period, with two hours of outside preparation by students.

CASE SYNOPSIS

Imagine that you are Richard Murphy Jr., the CEO of Murphy Warehouse Company, a family-run company that began over 100 years ago. You feel the weight of responsibility to maintain the financial viability of the company that is now in its fourth generation of family ownership. One of your biggest challenges is to understand how the company should adapt to a changing business environment while conserving the company's financial resources and protecting the core business model that has sustained it for so long.

One major force in the current business environment is the sustainability movement, which focuses on the responsible use of natural resources. If you are Richard Murphy, you are trying to find the opportunities to adopt sustainable practices that also make financial sense to Murphy Warehouse Company. While you have successfully implemented several sustainable projects in your company, you are now faced with deciding to invest over a half million dollars in a stormwater project that presents an unusually long payback period. It is a complicated decision that involves high expense, multiple tangible and intangible variables, and a fair amount of risk that something might go wrong. What do you do?

INTRODUCTION

Richard Murphy Jr., CEO of Murphy Warehouse Company, sat at his desk and shook his head as he reviewed another stormwater bill from the City of Minneapolis for Warehouse 701.

The bill was significant for the 22-acre facility: $17,000 on average, every three months, or $68,000 per year. Murphy thought to himself, “I’m literally pouring money down the drain—or in this case, the storm sewer!”

Murphy Warehouse Company (MWC) is one of the Upper Midwest’s largest logistics companies. It is a family-owned private company that was founded in 1904. Richard Murphy Jr. represented the fourth generation of family leadership of the company. MWC operated twelve warehouses in the Twin Cities metropolitan area that together total 2.6 million square feet of space, of which four are Murphy owned totaling 1.1 million sq. ft.

In 1987, amendments to the Clean Water Act imposed a federal mandate on local governments to conduct stormwater quality management to protect against pollutants from stormwater entering rivers and lakes. The federal mandate provided no funds for local governments to build and operate the infrastructure to manage stormwater. To cover their costs, municipalities resorted to user fees to pay for their stormwater systems. In 2005, Minneapolis started assessing a stormwater fee on all property owners, including residential.

Warehouse 701 was the oldest of MWC’s four owned warehouses. Original buildings were constructed on the site in 1904, with several expansions over the decades leading to the present 550,000 square foot facility. MWC’s other three warehouses were built in the 1990s and included large on-site stormwater retention basins to hold stormwater and filter out pollutants as the water seeps slowly into the ground. These basins were built to conform to building codes and integrated into the site designs for the construction of the new warehouses. The newer warehouses could handle all of their stormwater and municipal stormwater fees were not assessed on these properties.

Warehouse 701 was a different situation. Ninety-five percent of the 22-acre site was comprised of water-impervious roof or pavement that generated tremendous volumes of stormwater runoff from a typical July thunderstorm. Most of this water was diverted into the Minneapolis storm sewer system, costing MWC tens of thousands of dollars per year.

Murphy did his research and found an engineer who could design and construct a stormwater system for Warehouse 701 at a cost of $580,000. It would include a large retention basin, three rain gardens to absorb water runoff, and modified roof outlets to manage stormwater surge.

The challenge for Murphy was determining whether the high cost of the project and the longer than normal payback period could be justified. Sure, the project would, for the most part, eliminate the quarterly storm sewer bills from the City of Minneapolis. And processing stormwater on-site also was the environmentally responsible thing to do. But spending well over a half million dollars was without a doubt a steep price to pay, especially when there were so many other ways to invest in MWC’s future. At what cost should Murphy say the project should be rejected?

BACKGROUND

Due to increased awareness of environmental issues over past few years, consumers are not only demanding environmentally friendly products and services but are also expecting that companies run their businesses by taking into account the environmental impact of their operations. Corporations are responding to this demand by evaluating ways to adopt the best practices in environmental sustainability. Increasingly, more companies are embedding environmental performance and other green values and measures into their core business goals, making their environmental sustainability plans and achievements public, and requiring that their suppliers incorporate green practices in their operations.

Recently, Wal-Mart announced a plan to develop a Sustainable Product Index that will measure sustainability of each product the company sells. This plan requires a Wal-Mart supplier to complete a self-assessment survey in four areas: energy and climate, natural resources, material efficiency, and people and community. The information from the suppliers will then be combined with the information about the lifecycle of the product (from raw materials to disposal) to create an index representing environmental sustainability of each product. The purpose of this index is to provide a rating system so that customers can understand environmental implications of the products they buy (Quinn, 2009).

Starbucks has taken a firm stand on environmental issues. Currently, Starbucks cups are recycled in Seattle and composted in San Francisco, but neither process is available in many locations. Starbucks aims to make its cups recyclable or compostable by 2012 in all locations. To understand relevant issues, Starbucks held a ‘cup summit’ in 2009 where attendees included the Starbucks task force, cup manufacturers, beverage partners, recyclers, local municipal governments, environmental non-governmental organizations (NGOs), and experts from academia (Yepsen, 2009).

Many companies that are much smaller than Wal-Mart and Starbucks want to make environmentally friendly changes to their business practices, but the high costs of many of these proposals require some difficult tradeoff decisions. This makes environmental sustainability especially difficult for small businesses that are struggling to survive in the competitive marketplace. Yet most of these companies can ill-afford to ignore the opportunities and competitive requirements that sustainable business practices present. The high cost of energy, industry trends, and direct pressure from customers are persuasive forces that push company leaders to think deeply and creatively about how sustainability fits with their future business strategies. This is especially true in the transportation/logistics industry. In the United States, transportation accounted for about 28% of energy consumption and 33% of carbon dioxide emissions in 2007 (www.eia.doe.gov; http://ftp.eia.doe.gov).

For this reason, focusing on business supply chains, particularly the management of warehouses and distribution networks, can yield significant progress in sustainability. This view is shared by many experts and corporate leaders, including Brian Walker, CEO of furniture maker Herman Miller, who asserts, “you are only as green as your supply chain” (Walker, 2008).

Warehouses are key players in the supply chain networks of countless businesses and industries. According to industry statistics for 2009, there is five billion square feet of warehousing space in the United States--sixteen square feet for every person in the country. The total annual cost of warehousing services in the United States is approximately $122 billion (or $407 per person).

Warehouses significantly impact the cost, efficiency, and environmental effects of supply chain systems. They occupy vast tracts of land that turn water-absorbing soil surfaces into water-impermeable roof and asphalt. They often feature acres of surrounding green space that require mowing, watering, fertilizing, and the application of herbicides and pesticides. Warehouses also are heavy users of energy to light, heat, and sometimes cool hundreds of thousands of square feet of interior space. They are often major contributors to the "urban heat island" effect where buildings and parking lots absorb and retain heat from the sun and raise the overall average temperature of metropolitan communities.

Increasingly, new warehouses are being built to comply with environmental standards developed by the U.S. Green Building Council (USGBC). For example, ProLogis, a global developer and manager of distribution facilities, wants all of its new developments in the U.S. to be built according to USGBC standards and to be considered for LEED (Leadership in Energy and Environmental Design) certification (Rizzo, 2008). Some existing warehouses are also being revamped to make them more efficient, with modifications such as additional insulation and long gridded windows to ensure ample natural light (Cohen, 2007).

SUSTAINABILITY PROJECTS AT MURPHY WAREHOUSE COMPANY

In the mid-1990s, Richard Murphy took a hard look at MWC's operations and saw several opportunities to capture cost and efficiency advantages for his company by investing in sustainable projects. Murphy knew he had a business to run, so he wasn't plunging headlong into just any sustainable or "green" idea that came along. Financial analysis of any investment proposal had to be a key driver for decisions that involved company resources. But for Murphy and MWC, financial analysis was accompanied by a strong culture of making decisions for the long-term, being a good corporate citizen, and doing the right thing. Just because a project didn't have a 2-3 year financial payback didn't necessarily exclude it from consideration.

CONVERSION OF LAWN TO PRAIRIE

In one of his first ventures into sustainable practices, Murphy looked at the costs of maintaining 10.19 total acres of lawn that would surround two of his new warehouse facilities in Fridley, Minnesota (Table 1).

Table 1
Annual Costs of Maintaining 10.19 Acres of Lawn

	Annual Costs
Mowing	$29,220.25
Watering	$20,988.00
Fertilizing	$ 2,444.14
Total	$52,652.39
Cost Per Acre	$5,167.06

Besides being MWC's CEO, Murphy was also formally trained as a landscape architect and taught design and business as an adjunct professor at the University of Minnesota's College of Design for over 23 years. He knew the advantages of replacing traditional Kentucky bluegrass acreage that was expensive to grow and maintain, and required wasteful sprinkler irrigation, with native prairie flowers and grasses. He contacted Prairie Restorations, a company that specializes in installing and maintaining native prairies. Together, Murphy and the people from Prairie Restorations replaced six acres of lawn with native prairie, with an installation cost of $6,575 per acre.

(To maintain aesthetic appearances, not all acreage can be converted from lawn to prairie. One of the drawbacks of prairie landscaping is the sometimes ragged and unkempt look it conveys to passersby along roadways, sidewalks, and driveways. Murphy and Prairie Restorations were careful to design the prairie space so that it was bordered by a flowing strip of lawn so the prairie would be defined, contained, and the public would understand that it's "supposed to be that way." Designing prairie areas in this way is called "enframing.")

The prairie landscape provided immediate cost savings to MWC. Although low maintenance, native prairie does require occasional attention, including prescribed burning, exotic species control, wildflower maintenance, and dormant mowing. The per-acre annual cost of maintaining MWC's prairie areas was $707—less than 14% of the cost of mowing, watering, and fertilizing Kentucky bluegrass.

In addition to this prairie project and two others, MWC captured several benefits by planting 732 trees on its warehouse campuses. The trees helped reduce the "urban heat island" effect by cooling the air through respiration and by shading the surrounding ground surfaces. They also provided attractive buffers between the warehouse operations and adjacent commercial properties and residential neighborhoods. The trees and the prairie plantings also attracted a variety of wildlife, including waterfowl, raptors, song birds, deer, and fox.

DOCK BLANKETS

Another sustainable practice at MWC was the adoption of dock blankets for covering steel dock plates that extend from the outdoor wall to ten feet inside the loading areas in the warehouses. The steel plates caused significant heat loss by 1) transferring winter's cold outdoor temperatures directly into the warehouses and 2) because steel on steel joints are impossible to keep tight against wind penetration. Murphy thinks of these steel dock plates as "ice cubes" sitting inside the building, cooling the space just like ice in a drink.

To combat the heat loss problem, the operations team custom-ordered insulated blankets of the type used by the furniture moving industry. The blankets were sized to fit the dock plates in the warehouse, and during winter the employees covered the dock plates whenever they weren't being used, even for only ten minutes. Immediately, MWC's heating costs fell by ten percent and the temperatures around the dock areas increased by ten or more degrees, a result which pleased the dock workers. The relatively minor investment in dock blankets was paid back within days by employee comfort and within a few months from heating bill savings.

LIGHTING

Lighting is an area where dramatic improvements in energy efficiency in the past fifteen years have prompted MWC to repeatedly invest in lighting upgrades to capture newly available savings. For example, MWC recently replaced lighting systems that were only five years old because the new "T-8" fixtures reduced lighting expense by nearly 20 percent over the old fixtures. (The five-year-old system was considered "state of the art" at the time it was installed.) The payback period on the new T-8 lighting systems was only 14-16 months, which reinforced Murphy's belief that it pays dividends to stay on top of new energy saving technologies.
Another important measure taken by MWC to improve lighting performance was painting warehouse ceilings white so light was reflected downward from the ceiling instead of being absorbed. Historically, warehouses were almost always built with dark grey ceilings.

HEATING SYSTEMS

A significant challenge in heating large high-ceilinged spaces is maintaining sufficient warmth near the floor because of the fact that warm air rises and cold air falls. In high-ceilinged warehouses where the air is not well circulated, the air temperature at the ceiling can be 8-10 degrees warmer than on the floor.

To save on heating costs, Murphy installed numerous "High Air Turnover" (HAT) furnace units on the floor of one warehouse. These HAT units differed significantly from conventional industrial ceiling-mounted furnace blowers that move heated air around the upper half of the warehouse, but are not very effective at circulating air from the ceiling to the floor. HAT units stand two stories tall on the warehouse floor and pull cold air from the floor, heat it and then blow it at ceiling elevation, creating a circulation pattern that repeatedly turns the air and significantly eliminates temperature stratification.

Each of the HAT units was capable of heating 50,000 square feet of space. The installation of HAT units is an example of a low-technology solution for achieving sustainability goals. There is nothing high-tech about HAT units; they are just engineered to move air more effectively to achieve energy cost savings.

FUTURE PLANS FOR SUSTAINABILITY

Richard Murphy planned to move forward to make sustainability an important part of keeping MWC competitive and profitable. From his heavy involvement in the business community and his conversations with clients, he knew that sustainability was increasingly becoming a major criterion in winning new business. More customers were looking for partnerships with logistics providers who could complement their own green initiatives, and sustainability was becoming inextricably linked to economic performance criteria.

LEED CERTIFICATION

Murphy was currently working with a consultant to prepare and submit MWC's application for LEED Gold certification. According to Wikipedia, "The Leadership in Energy and Environmental Design (LEED) Green Building Rating System, developed by the U.S. Green Building Council (USGBC), provides a suite of standards for environmentally sustainable construction. The hallmark of LEED is that it is an open and transparent process where the technical criteria proposed by the LEED committees are publicly reviewed for approval by the more than 10,000 membership organizations that currently constitute the USGBC."

There are four levels of LEED certification: Certified, Silver, Gold, and Platinum. While many companies seek LEED certification, as few as 13 percent of these ever complete the process. "Gold" is the second highest level of LEED certification and a distinct accomplishment that MWC could use to solicit new customers.

ENERGY STAR CERTIFICATION

As part of the LEED certification process, it was discovered that MWC's facilities also met the EPA's Energy Star Certification, with scores in the 99th percentile for being "Most Efficient." According to Wikipedia, "The U.S. (Environmental Protection Agency's) Energy Star program has developed energy performance rating systems for several commercial and institutional building types and manufacturing facilities. These ratings, on a scale of 1 to 100, provide a means for benchmarking the energy efficiency of specific buildings and industrial plants against the energy performance of similar facilities. The ratings are used by building and energy managers to evaluate the energy performance of existing buildings and industrial plants. The rating systems are also used by EPA to determine if a building or plant can qualify to earn Energy Star recognition."

ISO 14000 CERTIFICATION

Another MWC green initiative was the preparation and submission for ISO 14001 certification as a green practitioner. According to the International Organization for Standardization (ISO), the major objective of the ISO 14000 series of norms is "to promote more effective and efficient environmental management in organizations and to provide useful and usable tools--ones that are cost effective, system-based, flexible and reflect the best organizations and the best organizational practices available for gathering, interpreting and communicating environmentally relevant information." The goal of being ISO 14000-certified is the improvement of environmental performance.

NEW GREEN INITIATIVES

Richard Murphy was confident that the sustainable measures his company had taken so far were sufficient to achieve LEED and ISO 14001 certification. But he also knew that there were other emerging green initiatives he might consider adopting.

In the current economic and political environment, there were several tax incentives being passed by Congress as part of stimulus spending packages to promote new energy technologies in solar-generated power, wind energy, and geothermal heating and cooling. Murphy was currently in discussions with the local utilities to determine if he could benefit from any rebates or incentive programs to adopt one or more of these new technologies.

As he pondered the future of his company, Murphy knew that as leader of a family-owned company, he was part of a tradition of taking the longer-term perspective. He wasn't so quick to reject investment projects that had payback periods beyond the typical 3-4 years that public companies needed before approving an investment. He knew that sustainable projects were part of building long-term competitiveness, and it was okay if it took a while for a project to generate a positive return if it was part of MWC's strategic plan.

THE STORMWATER PROJECT: APPROVE OR DECLINE?

Despite his long-term orientation toward his company's strategic investments, Murphy knew he had to make wise decisions in the short-term to protect the finances of his company. Spending $580,000 on the stormwater project was a major commitment of company resources, especially for a property that was over 100 years old. Murphy knew that this cost figure was only an estimate. What if the project, once underway, encountered unforeseen challenges such as soil issues, complications with utilities, etc. that involved additional cost?

Based on information from his Chief Financial Officer, Murphy knew that though the project cost was $580,000, an available 21% first-year tax credit would result in a net project cost of $458,200. Other financial information is provided as follows:

- *The $458,200 net capital requirement would be financed with the company's cash reserves.*
- *A 5% risk-free discount rate is assumed.*
- *The $580,000 project is depreciated at a rate of 13.333% per year over 15 years.*
- *Annual cash savings is assumed to be $68,000 in the first year, with annual increases of 5%.*
- *The corporate tax rate on taxable income is 42%.*
- *Aside from the initial project cost, no additional fixed or variable costs are assumed.*

Richard Murphy also knew that during the two-month construction period, MWC's operations efficiency would be negatively impacted by disruptions in normal warehouse activities. Additional costs might have to be absorbed to minimize these disruptions. For example, construction holes might have to be covered and uncovered to enable truck traffic at night and weekends when construction wasn't taking place. Also, overtime might be required to maintain customer service levels in the midst of the work disruptions. As Murphy thought about his dilemma, he looked out the window and saw a dark thunderhead cloud looming on the horizon, promising another deluge.

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FIGHTIN' MAD IN THE SOUTH: WHAT'S HAPPENING AT WORK?

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CASE DESCRIPTION

The primary subject matter of this case is workplace homicides in the South. Other issues include variations of work-related homicides by region, examples of workplace homicides, reasons why the Southern states have the most homicides, a profile of the Southern workplace killer, and how employers can prevent or mitigate workplace violence. The case has a difficulty level of being appropriate for senior level or first year graduate classes. The case is prepared for two hours of instruction and discussion. The students should receive the case earlier and be prepared to discuss the ramifications of the case together with the instructor.

CASE SYNOPSIS

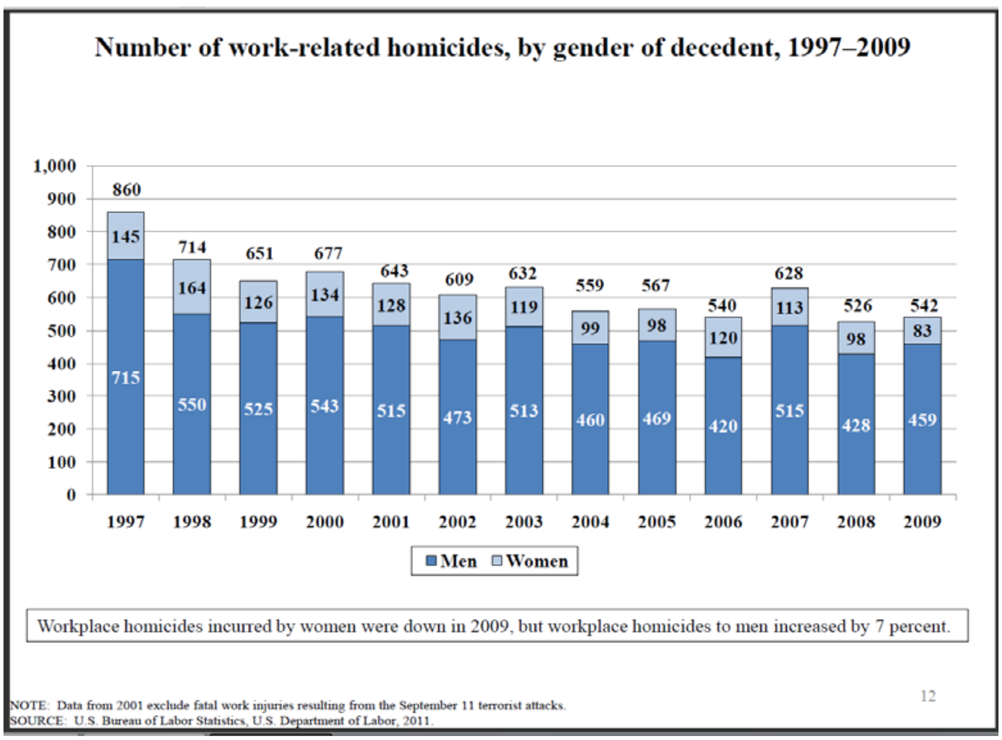
Workplace violence resulting in homicides continues to be a major concern for companies. While most companies have their Violence Prevention and Management Plan policies in place, it is still one of the most feared management nightmares. Of particular interest is a comparison of workplace homicides in the different regions in the United States. When comparing these regions for a thirteen (13) year period from 1997-2009, (representing the most recent available data), the South easily leads the country in both workplace homicides and violent acts of employees. Of the total 8127 workplace homicides during this period, the South had 3784, representing 46.6% of the total, followed by the West with 1639 or 20.2%, the Midwest with 1491 or 18.3%, and the Northeast with 1212 or 14.9% of the total. There are a number of potential reasons as to why the South has such a profound lead for violence in the workplace. In particular, Southern culture, employee behaviors, the work environment, and the current high unemployment rate are discussed. Actual examples of workplace homicides are provided.

INTRODUCTION

The most dangerous place in America is how the U.S. Justice Department describes the workplace. Virtually unheard of a half century ago, workplace homicide is now the second leading cause of fatal occupational injury in the United States. Workplace homicides can and does happen anywhere, at anytime, in large cities, in small towns, in large businesses or industries, in "mom and pop" operations, in hospitals, and yes, even on college campuses. The impact of each incident is overwhelming. It is often compared to an airplane crash because when something happens, it receives several days' worth of national coverage and creates a fear mentality that disrupts feeling of safety for some time to come.

According to the U.S. Bureau of Labor Statistics, U.S. Department of Labor, 2011, there were 860 workplace homicides in 1997 as compared to 542 in 2009. During the 13 year period of 1997-2009, an average of 626 work-related homicides occurred each year in the United States. A current comparison, as reported by the National Census of Fatal Occupational Injuries in 2009, indicates that workplace homicides fell by 1 percent in 2009, in contrast to the 17% decrease in fatal work injuries overall. However, when compared by gender of the decedent, workplace homicides to men increased by 7.2% between 2008 and 2009 (428 to 459). Workplace homicides incurred by women were down for the same period (98 to 83) (Bureau of Labor Statistics, US Department of Labor).

Figure 1: Number of Work-Related Homicides, by Gender of decedent, 1997-2009



Workplace homicides are most commonly reported in media coverage of workplace shootings. Our study of workplace homicides from January 1, 1997 to December 31, 2009, reflects a total of 8127 occupational homicides, with shootings accounting for 6431, or 79% of them. The South had a significantly higher average workplace homicide rate than the other regions with 46.6% of the total, followed by the West with 20.2%, the Midwest with 18.3%, and the Northeast with 14.9%.

Recent incidents involving the office shootings in Orlando, FL., in November 2009, the shootings at the University of Alabama in Huntsville in February 2010, the shootings at a manufacturing plant in Albuquerque, N.M., in July 2010, and the January, 2012 triple homicide at McBride's Lumber Company in Star, North Carolina, along with other examples, will be discussed in detail later in this paper. It is interesting to note that three of the above four recent examples occurred in the South. This brings us to one of the focus points of this research regarding the reasons for the Southern states leading the way in incidents of workplace homicides and violence in general.

VARIATIONS BY REGION

Table 2 below clearly supports the conclusion that the South is significantly more prone to workplace violence resulting in homicides when compared to the other regions of the United States. The Southern states averaged 221 homicides, or 46.6%, of all workplace homicides during the studied period from 1997 through 2009.

FIGURE 2: WORKPLACE HOMICIDES BY REGION AND STATE, 1997-2009

Northeast		South		Midwest		West	
Connecticut	82	Alabama	170	Illinois	357	Alaska	26
Maine	10	Arkansas	92	Indiana	196	Arizona	160
Massachusetts	72	Delaware	22	Iowa	22	California	954
New Hampshire	15	DC	53	Kansas	58	Colorado	116
New Jersey	188	Florida	603	Michigan	230	Hawaii	39
New York	515	Georgia	347	Minnesota	48	Idaho	15
Pennsylvania	311	Kentucky	117	Missouri	202	Montana	19
Rhode Island	10	Louisiana	149	Nebraska	42	Nevada	76
Vermont	9	Maryland	201	North Dakota	4	New Mexico	55
		Mississippi	154	Ohio	237	Oregon	47
		North Carolina	295	South Dakota	5	Utah	32
		Oklahoma	92	Wisconsin	90	Washington	91
		South Carolina	219			Wyoming	9
		Tennessee	231				
		Texas	762				
		Virginia	237				
		West Virginia	41				
Totals	1212		3785		1491		1639
All States	8127						

This is quite remarkable when compared to the remaining three major regions consisting of the Northeast which averaged 135 homicides per state, or 14.9% of the total; the Midwest which averaged 124 homicides per state, or 18.3% of the total; and the West which averaged 126 homicides per state, or 20.2% of the total homicides during these 13 years.

If two of the northern most states (Delaware and West Virginia) and the District of Columbia are excluded from the Southern states count, the South's average per state total increases another 19% to a total average of 262 homicides per state for this period. When you compare this average for the South (262 per state) with the average for the remaining three regions of the United States (128 per state), it is surprising to note the South has 204% of the workplace homicides per state in the US. Accordingly, this data must lead to a closer scrutiny of examples and reasons for such a significant difference in workplace violence resulting in homicides in the Southern states.

EXAMPLES OF SOUTHERN WORKPLACE HOMICIDES

My first experience with workplace violence occurred very early in my Human Resources career in 1978. I was working for a large manufacturing plant in Northeast Alabama which employed some 4000 hourly and 550 salaried employees. My first incident involved a husband, who was in the process of being divorced by our employee. He entered the plant one afternoon as the 1st shift employees were exiting and the 2nd shift employees were entering the gatehouse entrance. This was before the time of badge readers and turnstile entry lanes, so employees ingressed and egressed in groups by the main entrance gate to the plant for each shift. The victim employee entered the plant and reported to her work station as normal that day. Her estranged husband followed shortly after with a pistol hidden in his clothing. Approximately 30 minutes after the start of the 2nd shift, the husband forced the employee outside and shot her in the head, killing her instantly. The killer was arrested later that night and was convicted of first degree murder. Our employees and the community was literally in disbelief that a murder of this nature could happen so quickly and easily within the major industry of this small southern city.

Workplace homicide examples in the South, or in the United States as a whole, cannot be studied without a review of the U.S. postal incident in Edmond, OK some eight years later in 1986. The actions of a postal employee named Patrick Henry Sherrill brought the issue of violence in the workplace into the spotlight of the media more than any other individual. Sherrill, age 44, was an angry and surly employee, as described by co-workers. He had been reprimanded by his supervisor and told to expect a poor performance review. The supervisor had considered the meeting with Sherrill as a routine counseling session but Sherrill was convinced his 18 months with the postal service were about to come to an end. He was a former U.S. Marine claiming falsely to have served in Vietnam. Enraged with perceived injustices in his mind, Sherrill went to the Oklahoma Air National Guard, where he was a weapons instructor, an expert marksman, and a member of the Guard's marksmanship team. He checked out 300 rounds of ammunition, to go along with 200 rounds he had from a previous competition, and two Colt .45-caliber pistols.

The night prior to the post office shootings, Sherrill made two telephone calls to a postal union steward in Oklahoma City trying to arrange a transfer to the main post office. These calls were made after he had complained to another union officer that his supervisors were picking on him and concluded the conversation with, "I gotta do something now, right now" (Baron, 1993).

The next morning Sherrill put on his postal service uniform and packed his mail bag with two Colt .45 caliber pistols, a .22 caliber handgun and hundreds of rounds of ammunition. With a weapon in each hand and without speaking to anyone, he walked up to two supervisors and shot them dead. According to the account of one surviving witness, "Sherrill didn't have any preference about who he was shooting. Women and men, black and white were shot. He shot anything that moved." He continued looking for other victims shooting some at their work stations, others as they walked down a hall. His last victim was himself. He left 14 dead, excluding himself, and six wounded. It was the third worst mass murder by a single gunman in US history, surpassed only by the massacre at a McDonald's restaurant in San Ysidro, CA, in 1984, in which 21 persons were killed, and the 16 persons killed in 1966 by a sniper from a tower at the University of Texas in Austin (Baron, 1993).

Similar workplace nightmares occurring in the Southern states include the following examples: in Kentucky, a 47 year old former employee, armed with an AK-47 assault rifle, walked into the printing plant at which he had recently worked and began firing. He killed seven persons and wounded 15 others. He then placed the gun against his own head, firing it one more time making himself his eighth victim.

In Maryland, a bank employee carrying a black athletic bag took an elevator to the seventh floor and, as the elevator doors slid open, removed from the bag a .38 caliber revolver. He shot and killed three co-workers. Another was shot in the face but survived. The bank employee then fatally shot himself in the head.

In Florida, on June 18, 1991, eight employees at General Motors Acceptance Corporation were killed and five wounded because the company repossessed a customer's vehicle. Angry at the lack of response he felt he was getting from the company, and his own poor financial position, the customer used a .30 caliber semiautomatic rifle to get even. He then turned the rifle on himself, dying immediately (Baron, 1993).

In November, 2009, a 40 year old man opened fire at an engineering firm in Orlando, FL killing one person and wounding five. When asked why he had attached his former colleagues, the shooter replied, "Because they left me to rot." Witnesses told police they recognized the former employee when he entered the Company's lobby. They said he pulled a handgun from a holster under his shirt and shot an employee standing next to the receptionist's desk, killing him. He then went into the normal work area and fired several shots, wounding five other employees. The shooter had worked on drawings in the firm's transportation group, but much like Sherrill in Oklahoma, his performance was not up to their standards, and when he failed to improve, he was fired. The company did not hear from him again until the day of these shootings 2 ½ years later. The shooter told detectives that the company had fired him without cause and had made him look incompetent (msnbc.com).

At the University of Alabama in Huntsville, AL, three people were killed and three others wounded in February, 2010. During the course of a routine meeting of the biology department with approximately 12 educators in attendance, a professor stood up and began shooting those closest to her with a 9 millimeter handgun. In March, 2009, the professor had been denied tenure at the university and was beginning her last semester there per university policy. As a result of the media attention from these shootings, previous incidents involving her violence are being reevaluated. She previously had the attention of law enforcement officials in 1986 when she shot her brother in an incident ruled to be an accident at the time. In addition, she and her husband were questioned about a 1993 pipe bomb incident directed toward her lab supervisor at the time (Wikipedia.org).

Our most recent example to this study occurred on January 13, 2012, when an employee of a North Carolina lumber company, Ronald Dean Davis, age 50, arrived at the McBride Lumber Company in Star, N.C. around 6:15 a.m. , armed with a 12-guage shotgun and began shooting. Three people were killed and a fourth, who identified the gunman to authorities, was also shot and remains in the UNC Hospital at the time of this writing. The suspect, Davis, died a couple of days later from a self-inflicted gunshot wound to the head. According to reports, there were 16 employees in the business at the time of the shooting. Montgomery County Sheriff Dempsey Owens stated that Davis appeared to have targeted the four men he shot. Davis left a six page handwritten note, of which, the contents are still under investigation and still have not been released. Sheriff Owens has indicated that there is a "possibility" Davis was being harassed at work by the four targeted, however, a motive has not been identified yet.

While much has been written about these workplace homicides in the South, few attempts, if any, have been made at explaining the reasons why the Southern states clearly lead in these incidents. The remainder of this study will focus on these reasons as provided by research data and as observed throughout my 35 year career in Human Resources.

WORK AND SELF-ESTEEM

More than any other region of the country that I have lived, employees in the South tie their personal self-worth directly to their work. Job lost is a traumatic blow to their pride and self-esteem. Prior to the 1980's, employees had satisfaction in knowing there was job security and they could go perform their work each day without the fear of losing their job. Major layoffs, terminations, early retirements, acquisitions, sales, mergers, takeovers, and corporate restructuring have all been a very real source of fear during the last 30 years and there is no end in sight now. The constant fear of losing jobs, and increased resentment toward corporations, have led to what is known as "excessive anxiety" or the feeling that you have no control over what is happening to you. This type of fear makes employees feel powerless as they face life-shattering changes. Many employees go into a state of denial or resistance to change, worry, and become nervous, jerky with behavior that is often extreme and frequently inconsistent. These people become psychologically battered, looking for potential coercion, malicious in their wishes and are often described in the following ways:

Narcissistic: "I'm watching out for number one."
Paranoid: "I think everyone's out to get me"
Territorial: "I'm grabbing my turf and surrounding it with barbed wire."
Rigid: "I'm hanging on to what I know."
Cynical: "I'll believe it when I see it."
Political: "I'm keeping my eyes open" (Bardwick, 1991).

Many of the above descriptions are consistent with the psychological state of Patrick Henry Sherrill prior to the shootings in Oklahoma. Sherrill could easily be described as narcissistic, paranoid, territorial and rigid when he complained to his union official that his supervisors were picking on him and said "I gotta do something now, right now." The next morning he began killing co-workers, not strangers, and then finally himself.

SOUTHERN CULTURE AND GUNS

In the South, there is an easy access to guns. Guns can be easily purchased not only at regular gun shops and gun exhibits but also at trade shows, craft and collection gatherings, and parking lot swap meets. At the informal gatherings, no identification is necessary nor is a registration made of the gun transfer. In the South, there is a 'macho' image attached to owning guns and weapons. The South has a high acceptance and tolerance of guns. In the rural areas, guns are used for protection and hunting. Women have guns and know how to use them. This is acceptable behavior. Children are taught to use guns as they grew up around them. Children are given guns at an early age, with many boys receiving b-b guns or pellet rifles when they are as young as 7 or 8. There is a tolerance of violence (as protection of the 'old way' of life). In addition, for many people there is a tolerance and/or appreciation of the KKK, Alabama Militia and other organizations such as these. Lastly, people take pride in the ownership of their guns, showing them off to their friends and fellow workers. An example, in our immediate area was a terminated worker who came in with a shot gun and killed his boss. All the witnesses told police that they thought he was showing off his new gun so no one attempted to stop him.

INFATUATION WITH WEAPONS AND VIOLENCE

During my 35 year Human Resource career, I was amazed at the infatuation with guns, and violence in general, at my Southern plant assignments. I can give numerous examples of required discipline at assignments in Alabama, Tennessee, and Texas involving guns, knives, and physical violence in general. From the above described homicide of a spouse at the Alabama plant; to a gun that was brought into the Tennessee plant in an employee's lunch kit who stated he needed protection from the demons in the janitor's closet (no, he didn't test positive to drugs to everyone's surprise); to the employee at a Texas plant who threatened to "stick a (co-employee) with a knife and watch him bleed to death"; guns and violence were simply part of the Southern culture.

The earlier examples of workplace homicides in the South also point to the killers' infatuation with guns: Sherrill in was a member of the Oklahoma Air National Guard's marksmanship team and had two Colt .45 caliber pistols and a .22 caliber handgun in his mail bag as he entered the post office and killed 14 co-workers (including himself); the Kentucky killer used a AK-47 assault rifle to kill eight (including himself) and wound 15 others; the Maryland bank employee used a .38 caliber pistol in a black bag to kill four (including himself); the Florida GMAC customer used a .30 caliber semi-automatic rifle to kill eight and would five other employees (plus himself); the UAH professor used a .9 millimeter handgun to kill three peers and wound three others, and the small town (850 people) lumber yard worker in rural N.C. used his 12-guage shotgun, a traditional hunting weapon in the South, to gun down four co-workers.

JUDGMENTAL OF OTHERS

Another lesson learned during my career in Human Resources is that, unfortunately, the people in the "Bible Belt" (South) are simply more judgmental of other individuals. This, along with Biblical teaching heard throughout their lives, often leads to another infatuation – with death. It is most interesting to note that the great majority of workplace homicides end with the shooter turning the gun on himself in the end. Again, look at the above examples. Almost all ended with the killers taking their own lives. Could this be their way of spiritual justice for taking the lives of others in cold blood? I'm certainly of that opinion.

Much has been written about the psychological profile of an emotionally enraged employee with the potential for violence. Almost always, there are psychological and behavior criteria associated with these individuals. One of these criteria is psychosis. Psychosis is simply a loss of contact with reality and can include schizophrenia, major affective disorders and paranoid states. Major affective disorders may also be described by a loss of contact with reality, but mainly they involve a mood disorder which may be accompanied with severe depression (Baron, 1993).

THE DEPRESSION SYNDROME

As expected, depression is the most common symptom treated by counselors. Almost one in seven depressives will commit a violent act on themselves or on others up to and including suicide and/or homicide. Signs of depression include the following:

I just don't care anymore
What difference does it make (or similar expressions of despair)
A slowed work pace
Perpetual blank, sad, or frowning expression
Self-destructive behavior
Distractibility and sluggish decision making
Increased apathy; lack of motivation
Withdrawing socially
Unrealistic expectations
Excessive self-condemnation
Feelings of hopelessness
Sense of helplessness
Inappropriate guilt or shame
Unkempt physical appearance (Baron, 1993).

How many of these signs of depression have you observed in the workplace? These signs lead to issues that a Human Resource Manager should deal with sooner rather than later. Again, it is interesting to compare these signs with the behaviors of the above described individuals which resulted in workplace violence and/or homicides.

SOUTHERN ENTITLEMENT MENTALITY

Another unfortunate observation as a Human Resource Manager is that employees in the South have more of an entitlement mentality than in other regions of the United States. While we strongly feel that all individuals should have a good job and a rewarding career, we must stop short of saying this is an "entitlement". Entitlement is an attitude, a way of looking at life. Employees who have this attitude believe that they do not have to earn what they get. They feel that they should get something because they are owed it, or entitled to it. Entitlement is running rampant in most occupations today. We have people not really contributing but still expecting to get their raise and their scheduled promotion. The entitlement attitude was created when employers stopped requiring performance as a condition for keeping a job or getting a raise. Simply put, entitlement destroys motivation in individuals and in the long run crushes self-esteem. Beginning in the 1980's, corporations that rarely laid off or terminated employees began to do so. Later in the decade the rate of reductions increased, with 1989 and 1990 seeing more cutbacks than ever. This trend has continued at an even more alarming pace in the 21st century with the recession of 2003 and the great recession beginning in 2008 and continuing to the present.

Accordingly, it was not a coincidence that workplace shootings resulting in homicides were brought to our attention in 1986 with the Oklahoma Post Office killings. Did Patrick Henry Sherrill feel an entitlement to his job when disciplined or counseled by his supervisor? Did this entitlement lead to the fear of losing his job causing him to focus on attempting to protect his job rather than doing it? All of the previously described facts leading up to his workplace massacre point to the affirmative. In the 2010 example at UAH in Alabama, Amy Bishop she was described as "smart but abrasive in her interactions with other members and as feeling 'entitled to praise' ". This entitlement mentality most likely played an important role in the shootings of her co-professors as well. As explained by the UAH president, Bishop was denied tenure in March 2009 and expected not to have her teaching contract renewed after March, 2010. She had appealed this decision to the University's administration and without reviewing the content of the tenure application itself, the University officials determined that the process was carried our according to policy and denied the appeal. According to a friend, Bishop had penned three unpublished novels, one of which featured a female scientist working to defeat a potential pandemic virus, and struggling with suicidal thoughts at the threat of not earning tenure (Wikipedia.org).

In summary, the entitlement mentality is the result of too much generosity which is particularly noted in the South. People are given what they expect and are not held accountable for meeting required criteria. Accordingly, when people don't have to earn what they get, they soon take for granted what they receive. Instead of being grateful for what they get, they want more. During my HR career I have heard employees make a statement similar to the following on countless occasions: "I've worked here a long time and have done what was expected. I deserve my security." This is the supposition of the majority of people who work in various bodies of government, in all levels of schools, in large and powerful unions, and in Corporate America. Total security is what entitlement is all about (Bardwick, 1991).

UNEMPLOYMENT RATES

Another factor that can be linked to work and self-esteem is regional unemployment rates. While past studies have been inconsistent, social scientists generally agree that persistent, long-term unemployment leads to higher crime rates. In their study of the effect of annual changes in unemployment on changes in the crime rate, David Cantor and Kenneth C. Land find significant effects related to negative opportunity for homicide, robbery, and burglary, and a significant positive motivation for robbery and burglary. Other studies, however, have identified relationships between unemployment and involvement in a crime, suggesting that the decrease in income and potential earnings associated with involuntary unemployment increases the relative returns of illegal activity (Janicak, 2003).

The Pearson Correlation procedure was performed to determine the relationship between the unemployment rates and the occupational homicide rates. Monthly unemployment rates for the regions were correlated with the monthly occupational homicide rates during a period from 1997 to 2000. A significant correlation coefficient of .258 ($P < .000$) indicates that a relationship does exist between unemployment and occupational homicides (Janicak, 2003).

PROFILE OF THE SOUTHERN WORKPLACE KILLER

Based upon our studies in the above seven (7) areas, a profile of the typical workplace killer in the Southern states would possess the following characteristics: a middle-aged Caucasian male is profoundly narcissistic, holds himself out to be superior exhibits an entitlement mentality inclined to feeling powerless when rejected resulting in violence feels he is a victim of injustice while being judgmental of others is controlling and demanding, making co-workers uncomfortable is prone to multiple gun ownership with a fascination for weapons and violence is task-oriented rather than people-oriented, insensitive to co-workers subject to excessive drinking or drug abuse suddenly becomes unemployed due to layoff or employment termination finds self-esteem and identity through his job blames others for his problems sudden changes in behavior (particularly appearance or attitude) has a history of depression or paranoia files numerous grievances and makes “mountains out of molehills”

HOW TO PREVENT OR MITIGATE CONSEQUENCES OF WORKPLACE HOMICIDES

There is no simple solution to protecting employees and preventing acts of workplace homicides. However, an adequate plan can provide security for employers and employees. Companies are responsible for providing their employees with a safe place to work. To aid in the prevention of workplace violence, companies should offer training to all employees. Training teaches supervisors what to look for in potential violent employees. Outplacement services should be offered by companies who are downsizing. Outplacement can consist of contacting an unemployment agency to expedite claims and contacting temporary agencies to help place workers in jobs. Counseling should also be provided for workers who are laid off or terminated for reasons out of their control. Pre-screening potential employees should also be a focus of the human resource management department. While these services may be costly to companies, they will be better off if they are prepared. Charles Prucnal compared today’s companies to fire departments by stating, “just like the fire department has to be prepared at all times for potential fires, companies also have to be prepared for potential acts of workplace violence” (Prucnal, 2008).

CONCLUSIONS

Experts are predicting that workplace violence will increase even more in the next five to 10 years as teenagers not respectful of authority enter the workforce (Slage, 1997). This is evident based upon the bullying epidemic our nation is currently encountering, along with the overall unruly and disrespectful behavior of many of our youth. Because employees need unlimited access to the workplace and to their co-workers, employee violence is difficult to control. Interpersonal relationships are supposed to develop more in a team atmosphere which is frequently found today. The need for the average worker to depend on his or her co-worker puts strain on that relationship and can often lead to violence.

As this study shows workplace violence leading to homicides is not distributed evenly across our nation. As the U.S. economy continues to shift toward the Southern states and service sectors, potential workplace violence and homicides will be an increasingly important issue that must be properly identified and addressed by employers.

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