Volume 20, Number 5

Print ISSN: 1078-4950
Online ISSN: 1532-5822

# JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES



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# LETTER FROM THE EDITORS

Welcome to the *Journal of the International Academy for Case Studies*, the official journal of the International Academy for Case Studies. The IACS is affiliated with the Allied Academies. Both are non profit associations of scholars whose purpose is to encourage and support the advancement and exchange of knowledge, understanding and teaching throughout the world. The purpose of the *JIACS* is to encourage the development and use of cases and the case method of teaching throughout higher education. Its editorial mission is to publish cases in a wide variety of disciplines which are of educational, pedagogic, and practical value to educators.

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

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Herbert Sherman
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University of Texas of the Permian Basin

# SPEEDY DSL CORPORATION

**Leah Marcal, California State University, Northridge**
**Richard Tontz, California State University, Northridge**

## CASE DESCRIPTION

*The primary subject matter of this case concerns the pricing decision of a service firm, and the use of the appropriate economic model to analyze that decision. A comparison of price-elasticity and cross-elasticity of demand highlights the market structure in which the firm operates and thereby an understanding of how a price change will impact the firm's total profit. Secondary issues involve classifying the cost of the firm's business activities and allocating those costs by sales revenue.*

*The case has a difficulty level of three and is intended for use in junior-level courses. It can be covered in three hours, including a class presentation by a student team. The case requires a minimum of nine hours of outside preparation by students.*

*This case is designed for use in an upper-division, inter-disciplinary business course. The purpose of the course is to enable students to apply the knowledge they have gained in their lower-division, business core courses that include microeconomics, financial accounting, and managerial accounting. Specifically, the case incorporates the understanding of profit-maximizing pricing under monopoly and duopoly models of competition, how price and cross-elasticity of demand are interpreted, and how cost data can be organized for management decisions.*

## CASE SYNOPSIS

*Students view the case through Susan, a recent business graduate, who has struggled to find employment and lives with her parents. Susan is anxious to turn her paid internship into a job. She interns for a local, Internet service provider, Speedy DSL. Speedy has a profit margin that is below the industry average and faces strong competition from Timely Cable in the local broadband market. Currently, the two firms (Speedy and Timely) charge the same price for basic Internet connectivity that is similar in speed and reliability. Another Speedy intern, Matt, uses an estimated monopoly demand schedule and Speedy's own cost data to argue that Speedy should raise its price. Speedy's Marketing Director asks Susan for an evaluation of Matt's proposal. Susan has read industry reports with an estimate of the cross-elasticity of demand between DSL price and Cable subscriptions. Understanding that Timely's gain of customers would be Speedy's loss; students (placed into Susan's position) evaluate the impact of a price increase on Speedy's profit in a* *duopoly setting. Students must also categorize the cost of Speedy's business activities and show the breakdown of those costs against sales revenue.*

## CASE BODY

As she rides the bus to her internship with Speedy DSL, Susan Katz thinks back over the last two years. When she walked at graduation with a B.S. in Marketing, she imagined the walk was from college to a position with a marketing firm. Susan's GPA was good and she had excellent recommendation letters. Susan had served as an officer in the college's marketing association and felt her future was bright.

As the months passed by, with many applications and few interviews, she realized that finding a job was a real challenge. The local unemployment rate was 11% and many of her friends were still searching for work. Susan lived with her parents while looking for work. Her Dad had turned their basement into a studio apartment. Susan worried about the financial burden this placed on her folks.

But things were looking brighter. During the summer, Susan designed and implemented the marketing plan for a charity golf tournament. Robert Baker, the Marketing Director of Speedy DSL, was so impressed that he offered Susan a six-month, paid internship. Speedy DSL is a local, Internet service provider.

Susan had loaded her office cubical with marketing, economics, and accounting textbooks. After four months and a few committee projects, Susan felt she was doing well and getting to know several people in the organization. After sitting at her desk, Susan opens her laptop to review a report on the broadband market and Speedy DSL.

> U.S. consumers purchase broadband or high-speed Internet access from a communications company (e.g., cable, telephone, Internet service provider (ISP), or satellite company) that provides a physical connection from a computer at the consumer's home to the company's network. Broadband speeds vary with the type of technology used (e.g., cable, digital subscriber line (DSL), satellite, wireless, or fiber optic). Consumers are charged higher monthly fees for faster speeds. Typically, the fastest speeds are delivered by fiber optic cable (e.g., Verizon FiOS).
>
> In October 2010, nearly 85 million U.S. households had access to the Internet at home. Of those, 48% have cable access; 35% have DSL; 9% have mobile; 5% fiber optic; and 3% satellite (U.S. Census, 2010). Broadband infrastructure has been deployed to more than 98% of all households. Yet, only 72% of households have purchased broadband (NTIA, 2013). However, the number of broadband connectivity purchases is expected to increase tremendously with the growth of on-

line activities, such as, e-commerce, online gaming, telecommuting, distance learning, and telemedicine.

Cable and DSL are the main sources of household Internet access and they are the biggest rivals in the broadband market. Both offer an "always on" connection between the residential computer and the Internet. Cable and DSL work by providing "last mile access" (i.e., the final leg of a telecommunications network) from the ISP to the residence. Cable companies use their cable television network and coaxial cables to connect users to the Internet. Cable bandwidth is shared across users so connection speeds can slow down during peak usage (i.e., when lots of people try to access the Internet at the same time). Theoretically, residential Cable download (upload) speeds can reach 100 (20) Megabits per second (mps).

DSL uses existing telephone networks and copper wires to connect residential users to the Internet. Unlike Cable, DSL speed depends on the distance between the user and the local telephone company's central office. Download speeds on residential DSL are typically limited to 40 mps. Thus, Cable is considered faster than DSL. However, DSL speeds are more constant throughout the day as a user's broadband is not shared with his/her neighbors (Goldstein, 2010).

Speedy DSL Corporation is an independent DSL provider that rents the local telephone company's lines in order to provide Internet access to customers' homes. Getting an Internet connection requires the installation of equipment at both ends of the phone line to support broadband transmissions. At the customer's home, a splitter must be installed to separate the voice and data signals over a regular phone line. The other pieces of equipment required to complete the connection are a DSL modem and network interface card. The modem converts audio signals into digital signals and the network card completes the connection to the customer's computer.

The other end of the connection requires connecting the existing phone line from a customer's home to Speedy's network equipment co-located at the local telephone company's central office. Speedy rents this local phone line and connects it to their Internet equipment that consists of an elaborate network of servers, routers, and communications software to connect and route traffic to the Internet (Franklin, 2004).

Speedy DSL operates in a large county in the Northeast. It faces strong competition from a local Cable company called Timely Cable. Both companies enjoy good reputations for customer service and offer basic Internet connectivity (for $39.95

per month, including installation) that is similar in speed (i.e., 10 to 25 mps download) and reliability. Last year, each company had 50% of the local broadband market. The cross-elasticity of demand between Speedy DSL price and Timely Cable subscriptions is estimated at 3.49.

During the previous year, Speedy DSL served 408,100 equivalent DSL connections at a price of $39.95 per month per connection. Of those 408,100 subscribers, 12,243 were new connections that required installation. The associated cost data is provided in Exhibit 1.

Most broadband providers in the Northeast enjoyed a healthy return on sales of approximately 25%. Speedy DSL, however, is below the industry average.

Speedy's Marketing Department has been under pressure to find ways to increase profitability. Matt "Bing" Peterson is another intern who was hired with Susan. He is a friendly, salesman-type person with a degree in communications. Susan had a feeling that only one of them would be offered a job when the internships ended.

At this week's meeting, Matt presented an economic analysis of Speedy's demand and cost conditions. He used an estimated demand schedule and Speedy's own cost data (in Exhibit 2) to argue that Speedy should raise its price by roughly 5.76% (from $39.95 to $42.25). Matt also calculated the arc price-elasticity between these two prices and showed that Speedy would only lose 11.40% of its subscribers, while dramatically lowering its total costs. Robert Baker seemed extremely impressed and asked everyone to evaluate Matt's proposal.

When examining Matt's work, Susan noticed that his estimated demand schedule was derived using historical data from a similar DSL company, Terra Loop, in another Northeastern county. However, unlike Speedy, Terra Loop is the sole provider of broadband connectivity. Thus, the demand schedule in Matt's analysis (shown in Exhibit 2) ignores any possible interdependence between Speedy and its local competitor, Timely Cable.

Susan views this assignment as a chance to showcase her knowledge of economics and accounting. Perhaps she could also present a breakdown of Speedy's total revenue by cost categories and profit. Her managerial accounting textbook stated that estimating the cost of major activities performed by a company helps managers identify where costs can be cut. Susan's internship ends in two months. This could be her best and last opportunity to demonstrate her skills and knowledge to Robert Baker!

Put yourself into Susan's position to help Speedy DSL understand its business environment and to assess how a price increase will impact its profitability.

Prepare a memo to Robert Baker outlining your analysis and conclusions to help management understand the company's major costs and the impact of a 5.76% price increase on total profit.

## ACKNOWLEDGEMENT

Our thanks to Dr. Shahid Ansari for his assistance with the accounting aspects of the case.

# NEW PRODUCT INNOVATION AT CHET'S FAN MANUFACTURING, INC. (CFM)

**Jan Bell, Babson College**
**Tony Wain, Babson College**
**Shahid Ansari, Babson College**

## CASE DESCRIPTION

*The primary subject matter of this case concerns the application of target costing, an accounting approach applied during product or process design. Secondary issues examined include using activity based costing data during product and process design, applying entrepreneurial thought and action principles, and pursuing entrepreneurial opportunities within an established organization. The case has a difficulty level of three. The case is designed either to be taught in one and a half class hours and is expected to require about 3 hours of outside preparation by students or in two 75 minute classes with less than 2 hours of outside class preparation.*

## CASE SYNOPSIS

*CFM, established to manufacture and distribute ventilation equipment, was known for superior products, dependable service, competitive pricing, and custom fans. Initially CFM's sales were to original equipment manufacturers of industrial and commercial fans. Seeking growth, CFM entered the residential market with standard fans and blowers to exhaust bathrooms, laundries and kitchens. These products were sold to builders through major wholesalers in Canada and the US. The quality of CFM's products caused Home Depot to offer the company a two year contract for 40,000 basement ceiling fans, sold under Home Depot's brand, and exclusively in their stores.*

*With adequate capacity, CFM's managers must determine how to design and produce this new product to satisfy both Home Depot and CFM's requirements. Home Depot's customer specifications must be met at a retail selling price of $150, with a 30% gross margin to Home Depot. CFM must earn its required profit margin, which would be impossible without considering cost during design.*

*This case about a fictitious company and transaction provides students an opportunity to use target costing as an analytical tool for entrepreneurial creation and prediction. Students experience the entrepreneurial concepts of affordable loss, enrolling stakeholders, and working with the means at hand as they suggest ways that profit and cost targets can be met. Through the case, students experience some of the organizational complexity of shaping an entrepreneurial opportunity within an established organization. Students apply target costing's principles from the initial product concept through the design of product and its manufacturing process. They develop an estimate of the product's* *cost using activity based costing information and a value index. The case also allows students to consider cash flow consequences of growing sales. Earlier versions of this case have been used successfully in undergraduate planning and control courses at the junior level.*

## NEW PRODUCT INNOVATION AT CFM

### BACKGROUND

Chet's Fan Manufacturing Inc. (CFM) was established in 1992 as a US based minority owned business that would design, manufacture and distribute quality ventilation equipment. CFM was known for its superior products, dependable service, competitive pricing, and an engineering department that designed custom fans. Competitive pricing was accomplished by manufacturing in Thailand, and superior design and dependable service was accomplished by domiciling other operations in the US, close to the customer base.

Since its inception, CFM's sales were to original equipment manufacturers for industrial and commercial fans. After two decades of slow growth, CFM entered the residential ventilation market with standard fans and blowers for bathroom exhaust, kitchen range hoods and laundry ventilation. Instead of selling these to original equipment manufacturers, these fans and blowers were sold to major wholesalers of home building supplies in Canada and the US. By entering this new market, CFM pursued sales revenue growth and finally achieved $100 million of sales.

### THE OPPORTUNITY

As a result of their expansion and CFM's reputation for quality ventilation solutions, a buyer from a major US "big box" retailer in the home improvement and building market, Home Depot, approached CFM at a trade show to design and manufacture a heavy duty yet attractive ceiling fan for use in basement renovations where air circulation is poor. The fan would be sold by Home Depot in North America exclusively under its brand for two years; CFM would be free to market this product in other markets under CFM's own brand.

CFM had not sold directly to the big box market before because companies in this market had the reputation of "squeezing" all the profit out of the deal for suppliers. Realizing that this two year trial with Home Depot could potentially open a new, large market, management decided to pursue it. Having a contract would provide a less risky way to learn if this market was one they would like to enter permanently.

Unfortunately, none of the existing managers felt they had the right characteristics to develop this new business. They felt they needed a new position, Product Manager, Big Box Retailers. The position would be responsible for sales, customer service, and product profitability. The ideal candidate would be someone who was not reckless but also not afraid to act and innovative. The manager would need to be financially savvy; able to influence others; and willing to take on an entrepreneurial challenge, understanding that their success at CFM would rest on profitably developing the big box market. The new product manager would be evaluated not only on sales growth but also on profit margin.

The Development Director for Residential Ventilation Solutions, Arjun Patel, a mechanical engineer, had recently completed an executive MBA program at a college that emphasized not only traditional business skills but also entrepreneurial thought and action. He recommended a colleague from his MBA program, Sam Washington, who had prior experience marketing to large retailers, a fierce entrepreneurial spirit, and outstanding financial management skills, to the upper management team as the ideal candidate for the new product manager position.

## ASSESSING THE RISK AND OPPORTUNITY

After interviews and discussions with CFM's management, Sam understood the risks of the job and was excited by the challenges it posed. It gave him an opportunity to develop a new market with a new product and develop a reputation as being entrepreneurial.

In a discussion with Arjun about the job, Sam postulated, "I imagine that none of your existing managers wanted this position because they've been working in markets that are far less risky. It seems like most of the people I met were fairly conservative and don't want to take on something that might not work out. I know that even if I grow sales in this market, unless I can return the 7% profit margin upper management requires, I'm toast. CFM won't pursue the market and at best I'll have my reputation tarnished; at worst I could be looking for a job! Maybe the lessons I'd learn would be worth it—and you know that entrepreneurial adage," fail often, fail fast"? My dream is to be invited by a prestigious incubator like Cambridge Innovation Center to join them. I'd love to build the reputational capital to just be on their radar, and innovation centers would evaluate this experience in a positive light even if it doesn't work out. "

"You're probably right about your future with CFM if you don't deliver," countered Arjun, "But you were looking for an opportunity to start a new venture and be an entrepreneur without having to put in capital. This gives you that opportunity, and even if it doesn't work out, you have a three year contract. In that time, you have a good salary and can gain that experience you want with a startup project. And if it does work, you get profit sharing and stock—think about the money! I don't see how you could lose!"

"Well, Arjun", Sam began," I've got an approach that I'd like to use if I take this on. Do you remember working with target costing in our program? I think we should pilot that process on the Home Depot deal, but it means that your development team really has to work with me. We have to design a fan to satisfy Home Depot's functional and aesthetic requirements at a price they are willing to pay—it can't be full of bells and whistles unless they are willing to pay for it."

Arjun was thoughtful for a few minutes and then replied, "Yes, Sam, I vaguely remember target costing, and it required information from the engineering design team that I thought was difficult to get—not very precise. And it really constrained people to work to tight cost targets and required lots of communication with people outside the engineering group. You may be great at that, but it isn't the way my team is used to working. I'm willing to try on this contract if you think it'll get the results we need. I'll work with my people and we'll cooperate, but after the pilot, we'll have to review what we've learned and whether or not my team will be willing to continue. As engineers, we take pride in what we do. We always get a good understanding of customer's requirements, but customers don't always know what's available and what they need. If target costing restricts our ability to develop innovative products or introduce new technology, I won't be able to support it beyond the pilot."

"I understand," countered Sam, "but I think it holds lots of promise, and everyone wants to be associated with innovative products!" Sam starting reviewing what he remembered, "What I learned is that target costing is a product innovation and a profit management process. It's based on the notion that both the selling price for a product and the required return on sales are determined by others and are not under our control. That's just like this new product proposed by Home Depot. They know what their customer group is willing to pay and CFM knows how much profit margin they have to earn. Target costing provides a way to manage what we can control, namely, the final cost of the product. And it has tools that help design products at costs that maintain margins, satisfy customers, and can be manufactured. If we can't do that, ultimately we'll be out of business. But if we apply target costing principles, hopefully we'll be able to profitably satisfy Home Depot and open a whole new product line. But I understand what you're saying about leading your team. Just keep notes on what works and what doesn't for your team, and then after the pilot, we'll capture impressions and learning from all involved parties. Of course if something really isn't working, I trust that you'll come to me to work it out. I don't want anybody on your team to complain to friends in the organization. I need to know that you'll have my back on this and are as committed to having it work as I am."

After insuring that Arjun was supportive, Sam accepted the job and started reviewing his notes on target costing, contained in Appendix A. He wanted to be ready; he really needed for this project to be successful! It would be a real challenge, and he knew that Home Depot had a power advantage over his company—there are lots of suppliers that would like to sell to them. But he was excited by the challenge and convinced that if anybody could make this work, he would!

## DETERMINING THE MARKET REQUIREMENTS

His first action after settling in was to meet with the Home Depot buyer for the product, Carlos Batista. From his meeting, Sam learned that the retail price for the fan would be about US$150 and the fans would probably be installed by "do it yourself" homeowners and not professionals. Further, customers would expect the product to carry a one year warranty. This was a new challenge for CFM; previous products had been installed by professionals. Sam expressed concern about warranty claims by "do it yourselfers."

Carlos explained Home Depot's approach to warranty claims to Sam, "We don't argue with the customer; we simply replace all products returned in the warranty period with new products without any question. This is a company-wide policy and we won't change it for your fan. Products may be returned because the homeowner simply doesn't know how to assemble and install it, but we still give them their money back or replace the product. We dispose of the returned products, recycling as much as we can. If you'd like to have them back to determine the reason for the return, we'll ship them to you, but you pick up the tab for that. Based on past experience with this line, you should expect about a 3% return rate on sales."

Batista also shared information on customer's requirements for the fan's features and functionality that the marketing group had provided based on a focus group conducted with a group of customers from their target market. That information is provided in Exhibit 1. Batista told Sam, "Home Depot requires a 30% gross profit margin on this line. We expect you to pay for all transportation, customs and handling costs to get the fans to our new state of the art distribution center in McDonough, Georgia. We handle our own internal distribution, so that's not a worry to you in this contract. We've estimated demand and are willing to offer a contract for 40,000 of these units over the next 2 years. We may need up to 15% more per year depending on how the economy improves. At the end of the two year contract, we'll both re-evaluate the contract, but it's likely that redesign will be required because we'll attract competition. I think that we'll acquire the units in lots of 10,000, which should reduce your transportation, handling and customs costs. We'd like to receive delivery at the end of quarters one and three. Given that we're ordering half a year's requirements and have to carry the inventory, we'll pay you for our purchases 90 days after delivery. That way we're both sharing some of the carrying costs."

Sam thanked Carlos for the marketing data and inquired whether or not prototypes could be presented to customers. "It's doubtful that our marketing team would give you access to our customers," Carlos said, "but I'll be happy to evaluate prototypes and so would someone from marketing. We certainly want to approve the product before you start producing it!"

Sam expressed interest in the opportunity to share prototypes and promised to get back to Carlos quickly.

## CFM'S INTERNAL REQUIREMENTS

After returning from the meeting with Batista, Sam shared Home Depot's requirements with Arjun, stressing that the company had to meet Home Depot's customers' requirements. Sam told Arjun, "Boy, Carlos was tough—he basically dictated terms to me and told me they were non-negotiable. I have to worry about everyone's margins in this deal-- Home Depot has a 30% gross profit margin requirement and I'm held responsible for an 7% return on sales for the residential line. I've learned that the 7% requirement is after all the products share marketing and administration costs. I expect the overhead charge for marketing and administration cost to be about 20% of our selling price to Home Depot. Do you think we can do this? "

"Sure we can! We have to—our careers are riding on it! Remember that I recommended you for this job!" replied Arjun, as he absorbed Sam's information and requested a day or two to think about it and gather a little information.

After a few days of investigation, Arjun and Sam met again to share what they had learned. Arjun told Sam, "After brainstorming with my team, we decided that this basement fan could use the same technology and production process that we use on our laundry and bath ventilation fans. The manufacturing process is new, quality defects are few, and so far, competitors haven't gotten anything out there that is as good as our products are. We feel that we've got at least another two years before that happens. But basement fans pose special problems and move lots more air than bath and laundry fans. Plus we have to design something that's foolproof so at-home assembly and installation is easy for the "do it yourself" market. So my group will need a US$200,000 budget for designing and testing how it's going to function in basement conditions."

Sam acknowledged Arjun's budget and replied, "I've done a little digging into the cost of transportation, handling and customs from our Thailand manufacturing facility; those costs should total US$50,000 per shipment. I've tested out the payment terms with Finance and found out that we're generating enough cash flow to manage the 90 days without difficulty, but my product group will be charged 1% of the product's sales revenue for carrying charges, so that increases my return on sales from 7 to 8% to cover it. My real question is how we design to customer specifications and give everyone the margin they need."

## THE TARGET COSTING TEAM

Within a week, Sam and Arjun had expanded their development team by including representatives from Finance (a US based member) and Manufacturing (a Thailand based member) and had a conference call to discuss customer requirements, existing technology, production capacity and target costing concepts. At the end of the meeting, they agreed that they should try to develop an estimate of the product cost based on existing technology and production capacity. Sam would lead the team since he had primary product responsibility; he would interface with Carlos Batista from Home Depot to make sure that the voice of the customer was in the process at every critical juncture. Alina Baskov, the representative from Finance, agreed to supply product and process costing details so the team would know where they were relative to their target. Depending on whether or not it looked like the product could be successfully designed, the team would later consider adding important suppliers.

## PRELIMINARY PRODUCT DESIGN

Learning that the fan was to be produced on the same production lines as the laundry and bath ventilation fans, Par Supitayaporn, the representative from manufacturing, requested a preliminary product design from Arjun's team and information about demand and the timing of shipments from Sam.

Arjun supplied the preliminary fan design to Par. “The fan isn’t that complex,” Arjun told her, “but it does have some nice design features that our engineering team included because they are technologically advanced; I’ve attached a bill of materials (see Exhibit 2). Although we debated using three 52 inch blades, we’ve settled on four, 44 inch blades, each attached to a specially designed hub using a heavy duty blade mount. This is a more technologically sound solution than the three blades. We’ve checked with quality suppliers and found that a set consisting of one blade, one attachment and necessary screws should cost us around $3. That’s about 5% less than we’d pay for the 3 blade design, so my team is already saving us money! The electric motor is important, and we’ve developed specifications for a model we think is appropriate and heavy enough for four blades. With our specifications, it should cost us about $16, and we also have to have a sleek housing and a sturdy hub that should total about $2. Then we’ve designed specs for a ceiling mount/ shaft subassembly plus a shaft extender which should cost about $6.50 at the volume we’re discussing. What’s important is that our suppliers produce these to our exact specifications, because that’s what gives you quality parts to assemble. Then of course our assembly process has to be flawless, so I’m counting on you to create the quality that we’re known for.”

## PRELIMINARY PROCESS DESIGN

Par thanked Arjun for the preliminary design and took Sam’s requirement to deliver 10,000 units in two shipments, one in the first quarter and one in the third quarter, and promised to check for capacity. Early the following week Par reported, “We have excess capacity on two of our lines plus a standby line, so we have enough capacity to produce 20,000 units per year without investing in a new line, but we have to work this product into our normal production schedule. We might have to increase headcount for inspection and assembly, but the work can be done in our one shift operations. These jobs aren’t that highly skilled, and there are lots of full and part time workers out there, so our existing cost structure should hold.”

Working with the preliminary design, the production budget for other products at their normal batch sizes of 60-100 units and the resulting excess capacity, Par reported that the fans could be assembled in batches of 40 over a three month period and shipped to arrive at the end of quarters 1 and 3. After studying the design, the requirement that the unit be easy to assemble at home, and the layout of the production line, Par decided that mount and shaft subassembly would be attached to the motor during the assembly process so the customer wouldn’t have to perform that step. Each fan would undergo one electrical test just prior to placing the assembled unit in the package with blades, blade attachments, screws, and the hub.

## PRODUCT/PROCESS COST DATA

The team set up a conference call to discuss costs. Alina had anticipated what they needed and shared results from a recently completed activity based costing analysis for the manufacturing facility that Par planned to use to produce the new product. (See Exhibit 3). As Alina told the group, "We kept our analysis fairly simple. We decided to cost five major activities: scheduling and setup for the production lines; assembling products; testing and inspecting products; managing materials, which includes purchasing, warehousing and moving materials; and managing plant operations. Sam, you can use the driver rates from this analysis along with the cost of materials that Arjun provided to estimate the cost of your design. I have to express a concern though, and it's about your production plan, Par," Alina said. "That smaller than normal batch size is going to drive up costs. Why do you have to use small batch sizes for this product?"

Par countered, "Well, we already have our production plan for existing products, and we set it for our normal lot sizes. Those figures are already included in everybody's budgets. I thought that we wanted to produce on our existing lines without adding any capacity. I simply can't produce this fan in large batch sizes and keep the plan we currently have. You're telling me that you want larger batch sizes, and I'm telling you what capacity I have available! If I change batch sizes for our other products to increase batch sizes on this one, other product managers will be angry with me because their products will cost more."

Sam, obviously upset, complained, "So you've decided to burden the new product and the new kid? My job is on the line here, and I'm not sure that's fair!! And I bet that a large portion of your production costs are fixed and won't be affected! How is my product going to bear all these costs? I'm sure you don't mean to punish me, but I think we need to come up with another solution here!"

Arjun intervened and soothingly said, "let's use Alina's cost data and see how much difference it's going to make. Maybe Alina could figure out which of the costs in her activity analysis are fixed. When we know if cost is a real problem, we can brainstorm how to address it. I'm sure we could figure out something that will work if we need to."

## FACING THE CHALLENGE

The team decided that Sam and Arjun would study the situation and see how much the suggested design of product and production process would cost compared to what the company needed to earn its required profit margin. When they had more data on the size of the problem they had, then they could discuss alternatives. Sam and Arjun promised that they'd have the analysis done within a few days and would schedule another meeting to discuss how to proceed.

Before they signed off the conference call, Sam asked Arjun to stay on the line for a few minutes. "Boy," Sam said to Arjun, "I don't like the sound of what I just heard. We've got to get cooperation from Par on production scheduling and from your team if redesign is necessary. I know that being entrepreneurial requires perseverance, but dealing with internal issues is more difficult than I thought; you're well known around here and can influence others. Remember that I'm counting on you to support me! What do you think we should do?"

"Don't worry, Sam," replied Arjun, "we're creative—and together we can make this work! I'm sure that we can manufacture a product that will win Home Depot as a long term customer and give us the right profit margin. Why don't you go back to Carlos and see if they have any room in their price? At least try to get them to absorb the warranty cost since it's their liberal policy that causes that 3% of sales to be lost. That's about six times our normal warranty cost!"

Sam scheduled a follow up call with Carlos to discuss the issues. During the call he found no flexibility and came to the realization that the team would simply have to work with Home Depot's terms. There were just too many suppliers that would be eager to be in their position, and having an important customer such as Home Depot help them enter new market was an enviable position.

So to prepare for the next meeting of the target costing team, Sam and Arjun decided to test whether or not the proposed spending on the components for the new fan were in line with the data that Home Depot supplied about customer's preferences. They wanted to construct a value index to test alignment, a practice that other companies using target costing highly recommended.

Immediately Sam and Arjun realized that they would have to do two things. First they'd have to get Home Depot's customer information in a form to use by converting the data to percentages of importance; the data provided was in a scale. That was easy enough. Just by totaling the scores and taking each as a percent of the total they could generate percentage scores. The second was a little more difficult and would involve collecting some information from Arjun's engineering team about how the components contributed to the features that customers desired. Arjun was apprehensive about this requirement. This would test his ability to lead his team to do something they were reluctant to do.

After a few days, Arjun came back to Sam and reported, "I discussed the concept of a value index and what we needed with my team and got a little pushback. Their first response was that this was like "nailing jello to the wall," and they complained that I was asking them to engage in non-value added work at the same time I'm worried about them being productive. I asked them not to be afraid of change and challenged them to try something new. After all, we're a product innovation group. If we aren't willing to try new things, who will be? We need to set an example for others in the organization, and I promised them we'd get recognition for innovative practices in our newsletter. By the way, I need for you to deliver that for me! Then I asked them to think about how components contribute to customer's desires and just write down what they thought. When I asked them to share their individual answers, we found less variability than they had expected. We had a nice debate, and finally the group decided that silent operation was provided 60% by the motor and 40% by blades; variable speed was completely related to the motor; installation ease and low maintenance were 80% related to the motor and about 20% to the shaft; while appearance was about 70% related to blades and about 30% to the shaft. They are interested to see how this data is used and how much the fan is expected to cost given the elements they've designed and the cost of the manufacturing process."

"Thanks, Arjun, for encouraging your team to experiment with this, and yes, I'm planning a series of communications about how we're innovating. I'll be sure to highlight your team and make them proud," Sam said. "Now I've got to figure out both parts of the cost equation! I know how to develop a value index for the component's cost, but that is only a portion of the product cost. The rest is for the production process and its costs, but most of those costs are not really related to any specific component. I found out in a follow up call with Alina that the cost of assembly is mostly variable, about half of inspection is variable, and the rest of the activity cost is mostly fixed. According to her, the company's position is that all the costs must be covered—they don't go for incremental analysis. Their position has to do with the strategic decision to establish this as a new line. While the costs are fixed now, in the long run if we're successful, those costs will go up because we'll have to acquire new production capacity. I guess I understand that logic, but I don't want them to throw out the product without giving it a chance! I don't know for sure, but it seems like the reasonable thing to do is to develop the value index using the cost of components your team provided and then use Alina's information to develop the expected process cost and just see where we are."

"That's good, Sam, and I'll help." replied Arjun, "After we get our costs together and compare them to the target, let's have a group meeting and brainstorm ways to earn the right profit while meeting all of Home Depot's requirements. I've got faith. We can figure out how to make this new product profitable!"

**Exhibit 1**
**Summary of Customer Survey Results**

| Feature | Survey Score (10 point scale with 10 high and 1 low importance) |
|---|---|
| Silent operation | 9 |
| Variable speed | 7 |
| Installation ease & low maintenance | 6 |
| Appearance | 5 |

**Exhibit 2**
**Bill of Materials**

| Item | Part Count | Unique parts |
|---|---|---|
| Blades | 4 | 1 |
| Blade Attachments | 4 | 1 |
| Screw/washer set ( 3 sets to attach Blade to Blade Attachment) | 12 | 1 |
| Screw/washer set (2 sets to attach each blade attachment to hub) | 8 | 1 |
| Mount/shaft/wire assembly | 1 | 1 |
| Shaft extension | 1 | 1 |
| Screws/washer set (2 sets to attach mount to ceiling electrical connection) | 2 | 1 |
| Motor & housing | 1 | 1 |
| Hub | 1 | 1 |
| Packing materials | 1 | 1 |
| | 35 | 10 |

| Exhibit 3<br>Activities & Driver Rates | | |
|---|---|---|
| Activity | Cost Driver | Rate |
| Scheduling/ setup of production lines | # batches produced | $300 per batch |
| Assembly | # parts | $.40 per part |
| Test/inspect subcomponents & product | # of inspections/tests | $5.00 per inspection/test |
| Manage materials (purchase, warehouse & move) | # unique parts times number of batches | $21.00 per driver |
| Manage plant operations | # unique parts | $.14 per unique part |

## APPENDIX A
## NOTE: AN OVERVIEW OF TARGET COSTING

This note is adapted from Target Costing by S. Ansari, J. Bell, and T. Klammer. The complete version can be obtained from Lulu.com.

Target costing is a strategic profit and cost management process that is based on the premise that, for most organizations, both the selling price for products/services and the required return of capital providers are exogenous factors, determined by market conditions. The target costing process manages factors under an organization's control: the design of the product (service), the design of its value chain, the design of internal production processes, and the resulting cost of the product or service.

Many managers underestimate the power of target costing as a serious competitive tool. When general managers read the word "costing", they naturally assume it is a topic for their finance or accounting staff. They miss the fact that target costing is really a systematic profit and cost management process, informed by accounting, but owned by product managers.

What Is a Target Cost?

The Consortium of Advanced Manufacturing International (CAM-I) defines a target cost as the maximum amount of cost that can be incurred on a product and still earn the required profit margin from that product. This is captured by the equation

Target Cost = Selling Price – Profit

At first sight the equation appears to reverse the familiar cost plus price equal profit that many firms use. However, behind the inversion of the equation are two very powerful ideas;

(1) market prices and profit margins are external variables beyond the control of an organization's management; instead they are set by the market and depend on the level of competition.
(2) organizations must provide their product/service to meet the price, feature and functionality requirements of their customers and the financial returns required by their capital providers. They can do this by managing what is under their control: their cost structure.

Target costing, therefore, is a market driven system in which the needs of the customer and the likely reaction of competitors drive planning and design.

The Target Costing Process

To maximize cost control and enhance profit improvement, most companies set aggressive cost targets for their products. The process begins when top management establishes a target cost for a new product (e.g., a hybrid Honda CRV or a Caterpillar Excavator). A cost estimating group then decomposes that target cost for the product as a whole into cost targets for subassemblies and individual component parts (e.g., engine, transmission, seats, etc.).

Normally a "gap" exists between the new product's target cost and cost projections for the new product based on current designs and manufacturing capabilities. Closing the gap through cost reduction is central to the target costing process. It is an iterative process, with many product and process design ideas tested by comparing their cost against the target until either a design is settled on or the project is abandoned because its business model doesn't work.

Designing costs out of the product is accomplished by cross-functional target costing teams, which analyze the product's design, raw material requirements, value chain arrangement and manufacturing processes to search for cost savings opportunities. The cross-functional teams employ a variety of management tools and initiatives to help them achieve their objectives. The following section describes some of these tools and initiatives, and other characteristics of successful target costing companies.

Setting Target Costs

Market price. Target costing focuses on the customer and competitive market conditions. Product strategy defines the customer group that a firm wants to target, and hands-on research with members of the targeted customer group identifies the features that these customers want in the product and the prices they are willing to pay. An evaluation of competitor's products, including their features and prices, and an analysis of the overall market size help management establish a desired market share for the product. Together these factors help management determine a market price for the product.

Setting prices for new models of existing products, such as this year's model of a blue ray disc player starts with the current prices. These prices are adjusted for the features added or dropped. For example, assume we add the ability to view inputs in different formats (NTSC, PAL and SECAM). Also assume that we delete an IPOD dock which was on the previous model since it is not popular. The revised price may be set by taking the current price, adding the price that customers are willing to pay for the multiple format feature and deleting from this price the value customers place on the IPOD dock.

Setting prices for new products is not easy since there is no existing base to start from. Applied market research becomes crucial for this type of product; data must be collected from the representatives of the target market group. Fanack, a Japanese company, uses a simple formula that sets the price at a level that gives them a five-year lead over their competitors. Another technique is to use the price of a substitute product to develop an initial price. For example, fiber optic cable prices may form the basis for pricing satellite-based communication links.

Required return. The profit target, the second variable in the target costing equation, is set relative to the financial rate of return that a firm needs to stay viable in its industry. Since return on sales is part of the return on investment formula, firms often use this to set profit targets. If asset turnover, the second half of the return on investment formula, is relatively stable, it can be ignored and only the return on sales is used for setting target profit margins. A common Japanese practice is to use the return on sales ratio for the industry and the firm's past and future return on sales in a weighted average formula.

All of this requires multiple iterations. The selling price and profit margins are refined and revised as new data is available. An important reminder to the reader, the price and margin setting activity is at the product concept and design development phases. Revisions are not costly at this stage since there is no actual product that is being produced.

## Achieving Target Costs

Target costs are typically aggressive and there is usually a sizable gap between the initial cost and the target cost. The main reason for the large gap is that initial target costs are set at the product concept stage. At this stage there is an effort to provide all of the features that customers desire from a product; work with customers may reveal that they are unwilling to pay for certain features.

For example, an early art rendering of Chrysler's NEON, a small car aimed at the low price segment, showed a car with the front of a Maserati and the back of a Volvo. This humorous depiction captured the fact that Chrysler's early market research data showed that their target customers wanted a car that was "fun to drive" and "safe". Clearly, this ambitious combination of features was later scaled down to match the strategic positioning of the car. However, even after the repositioning, a significant gap usually remains.

Value engineering. A cost gap is closed by using value engineering (VE), a technical often taught in engineering programs. Value engineering is a technique that came out of General Electric in the 1940's. Parts shortages created by World War II led to a movement by GE engineers to provide more for less.

Today value engineering means providing the same functionality, safety, reliability and usability in a product at less cost. Value engineering on a new product is typically conducted in three stages. These stages coincide with the product concept to pre-production stages in a product's life cycle.

The first stage of value engineering (VE) is called "zero-look" VE. At this stage the effort is on what problem is being solved and which technology to use. For example, a manufacturer of TV sets may define their task as getting an image from a sender to receiver. Therefore, existing technology may not be taken as a given solution to this problem.

After a base technology is selected, "first look" VE is undertaken. Here the focus is on the cost of possible designs within the confines of the selected technology. Again major changes to design are considered at this stage.

The last stage is called "second look" VE. Here a particular design has been selected for development and the effort is on more modest gains. For instance, the TV manufacturer may consider outsourcing components, altering manufacturing processes, or tweaking design features.

At each stage, value engineering consists of generating ideas for cost reduction without compromising the features customers want or extending the development period of the product.

Brainstorming is a tool used to identify design ideas. Many companies use "thought starters" to generate VE ideas. A thought starter is a question that begins with "What can we ..." and ends with a verb such as "do without, reduce, enhance, substitute, rearrange, invert, restore, . . . The idea is to generate many possible solution to the design problem. All ideas are evaluated for feasibility and those that are feasible are selected for further development. These should be prototyped and presented to customer groups for feedback.

Value engineering focuses on those areas where current spending is not in line with the perception of customer value using input from customers, component breakdown information from engineers, and cost data from product costing systems.

The Value Index. Value engineering uses a tool called the "value index" to identify areas for cost reduction or additional spending to inform the design process.

For example, assume that marketing survey data reveals that 50% of a customers' value for a TV sound system is derived from "clarity of sound," 30% from "appearance" and 20% from ease of installation. Company engineers subjectively determine what product components contribute to those features. For example, assume that engineers determine that speakers create 80% of sound clarity while the exterior cabinet provides the remaining 20%. By multiplying the feature importance to customers by the engineer's assessment of a component's contribution to that feature, a company can deduce that a customer places 40% of his/her value on speakers.

The customer's value for speakers can then be compared to the percent the company spends on them as a portion of the total cost of the sound system, information contained in the product costing system. Assume that speakers represent 30% of the total cost of a sound system. Dividing the customer's value of 40% by the amount spent, 30%, yields a value index of 1.33 indicating that design teams may wish to spend more on speakers.

See Exhibit A2 for the breakdown provided by company engineers for this simple example.

| Exhibit A2<br>Value analysis for TV sound system | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Feature | Customer Importance | Mapping of components to features | Component contribution to feature | Componen t Value | Customer's value of components | Componen t Cost as % of Total Product Cost | Value Index | Design Action |
| Clarity | 50% | 0 | 80% | 40% | **40%** | 30% | 133% | Enhance |
| | | **cabinet** | 20% | 10% | | | | |
| Appearance | 30% | **cabinet** | 100% | 30% | **40%** | 40% | 100% | No action |
| Installation | 20% | **connectors** | 50% | 10% | **10%** | 25% | 40% | Reduce |
| | | **instructions** | 50% | 10% | **10%** | 5% | 200% | Enhance |
| | 100% | | | 100% | 100% | 100% | | |

An index of 1 means that spending on a component exactly matches customers' perception of the value they derive from the component; less than 1 indicates that the manufacturer is spending more on that component than its value to customers. This is an area in which costs should be reduced. An index of more than 1 indicates the opposite and is an area that may be enhanced.

Besides being driven by value engineering, cost reduction in target costing also has three additional characteristics.

> <u>Value chain involvement</u>. First, target costing involves important members of the value chain in design. This is an obvious strategy for assembly industries, a majority of whose costs (60-80%) come from suppliers and dealers. Management identifies and prequalifies critical suppliers and invites them to participate on product teams. This requires a partnering strategy in which suppliers are trusted to provide input about design and customer requirements. The idea is that a car seat supplier better understands customer requirements with respect to seats better than the car company itself.
>
> <u>Concurrent design.</u> Second, target costing depends on concurrently designing products and processes. It considers manufacturability during the design process. If an activity based costing system is used, information about cost drivers consumed during manufacturing can be utilized to design cost out of the product. Often by changing the number of unique parts or other aspects of the product's design, use of drivers will reduce and so will the manufacturing cost of the product. This approach differs from linear design where subcomponents and products are designed first and then assessed for manufacturability on available equipment. A linear design process is time consuming and costly because the design has to be changed several times to integrate subcomponents, reduce cost drivers and accommodate manufacturing on existing production lines.
>
> <u>Voice of the customer</u>. Finally, all cost reduction efforts are guided by the voice of the customer. Quite often, customer representatives are on the product design team.

If not, marketing staff continually present prototypes and query and collect data from them to ensure that cost reduction does not harm customer value.

## Conclusion

The goal of target costing is to strategically manage product innovation so the company introduces new products that yield value to customers and provide investors the return they require. Target costing is more than a cost reduction process; it is a strategic product and profitability management system.

# CIRQUE DU SOLEIL: AN INNOVATIVE CULTURE OF ENTERTAINMENT

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## CASE DESCRIPTION

*Cirque du Soleil (French for Circus of the Sun) has remained one of the most successful theatrical producers in the history of the entertainment industry. It is a hybrid of circus, acrobatics, and dance performance. Today, the organization has blossomed to 5,000 employees, 1,300 are artists, on five continents. The case is how Cirque du Soleil manages organizational culture and teamwork in a challenging entertainment industry.*

*It is intended for class study and the application of concepts learned in the classroom and designed to complement knowledge derived from concepts in organizational culture and teamwork.*

## CASE SYNOPSIS

*Despite early financial hardships, Cirque du Soleil (French for Circus of the Sun) has remained one of the most successful theatrical producers in the history of the entertainment industry. What started as a troupe of street performers in Baie-Saint-Paul, Quebec, Canada named Les Échassiers de Baie-Saint-Paul (French for the Wading Birds of Baie-Saint-Paul) has grown into a global entertainment business whose performances have been seen by over 100 million spectators in nearly 300 cities worldwide (Cirque du Soleil, 2013; Hoovers, 2013).*

*Cirque du Soleil is a hybrid of circus, acrobatics, and dance performance (Berry, Shankar, Parish, Cadwallader, & Dotzel, 2006). It is a multi-level production without the menagerie of exotic animals, yet is one that captures the magnificence of the human form, agility, and creativity. The performers toured the Canadian province of Quebec in the 1980s as a performing theatre troupe. Les Échassiers encountered financial setbacks that were relieved in 1983 when the government of Quebec extended a grant to the troupe as part of its 450th anniversary celebrations of Jacques Cartier's discovery of Canada (Biography.com, 2013). In less than 30 years, the company had over 5,000 employees worldwide, including more than 1,000 artists, and redefined the circus industry (Hoovers, 2013). The company integrated street entertainment, eccentric costumes, and cabaret with its worldly performers and artistic shows, winning the hearts of millions of spectators worldwide.*

*While Daniel Gautier was the financial and production manager, Laliberté was responsible for all creative elements of productions and performances. Initially, Cirque employed only 73 people, yet by 2001, that number had grown to 2,100 employees worldwide, 500 of whom were performers (Hoovers, 2013). Between 1984 and 1989, Cirque performed only one show at a time. Today, the organization has blossomed to 5,000 employees, 1,300 are artists, on five continents (Cirque du Soleil, 2013). The productions are divided into groups designated as Resident and Touring. Resident indicates occupancy of one location, whereas Touring indicates visiting different cities. Cirque had eight Resident locations in Las Vegas and one in Orlando, Florida. The ten Touring productions can be found across five continents. Of these, five are under the Big Top and five are in arenas (Cirque du Soleil, 2013). The International Headquarters in Montreal is home to 2,000 employees, administration offices, creative laboratories, artisans, and expert performers.*

*As the company traveled across the U.S. and Europe, the success of the organization grew, but not without managerial and organizational disputes, including "artistic rebellions" and partnership clashes (DeLong & Vijayaraghavan, 2002). Furthermore, given that no global entertainment competitor is on par with Cirque du Soleil, the company has to make strategic decisions as it embarks on its third decade in business.*

*Cirque management was aware of the fact that whiles their high-end market disruption strategy, which shifted their competitive focus from head-to-head competition to the creation of a brand new entertainment industry. Cirque was also aware that this new market creation strategy might generate new players who may possibly compete for same scarce resources in the future and present new challenges.*

*Given that no global entertainment competitor has ever been on par with Cirque du Soleil, the company must make strategic decisions as it embarks on its third decade in business. Pivotal questions were:*

> *"How can Cirque maintain its high creative standards and expand its appeal to a larger audience?" And "How does Cirque stay loyal to its original values while continuing to move forward?"*

*Since everyone will be shooting at Cirque, leadership needed to pro-actively respond to possible future threats from competitors in order to preserve its success.*

**Keywords:** Cirque du Soleil, Cirque, Les Échassiers de Baie-Saint-Paul, Organizational culture, Teamwork, Norms, Values, and Entertainment Organization.

## ENTERTAINMENT INDUSTRY AT A GLANCE

As a major player in the performing arts industry, there really was no "clowning around" when circus entertainment was discussed in terms of Cirque du Soleil. While the arts, entertainment, and recreation sector as an industry had several subcategories, performing arts companies were specific to *live* productions that comprised a diverse set of performers including creative artists, actors, singers, dancers, and musical groups. In terms of demands tied to consumer spending, this industry differed from associated industries such as motion pictures, theater and dance companies, orchestra and music production and distribution. The industries that were competing for the consumer's discretionary spending included stage companies (operas and symphonies), movie theaters, museums (art galleries and institutes), zoos (botanical gardens), and parks (amusement and recreation) (Hoovers, 2013).

The consumers' money and time were spread across a number of entertainment choices. Yet for live entertainment and specifically for circus venues, the primary competitors were movies, television, sports (spectator and active) and, to some degree, hobbies and personal interests. Further, because consumers varied by demographic capacity (age, income, and education), cash flow became a matter of uneven and seasonal primacy, highly patterned by attendance fluctuations. Thus, given the competitive landscape, other than admission fees, the performing arts industry was motivated to obtain auxiliary revenues from indirect sources such as contract and residual fees, licensing agreements, royalty fees, and in some cases private contributions (by the Society of Stage Directors and Choreographers) or government grants (National Endowment for the Arts) (Hoovers, 2013). As a circus organization, Cirque du Soleil found its niche in the performing arts industry. Since the economic recession in the late 2000s, this niche experienced a four to five percent growth pattern per year (Hoovers, 2013). Thus, forecasts indicated annual growth even though the industry defines its operating season generally between September and May.

As an entertainment vehicle, Cirque's nearest competitors included the Shubert Organization, Feld Entertainment, and Live Nation Entertainment (ticket seller and promoter of live entertainment). In comparison, Live Nation Entertainment's annual sales far exceeded that of Cirque, Shubert, and Feld combined (see Figure 1).

While Cirque's 2013 annual sales equated to a sturdy \$239.02 million, this extent is marginal to that of Live Nation with \$5.38 billion in 2013 sales (Hoovers, 2013). Nevertheless, from resident shows to touring shows, the products and operations Cirque created developed into a rich and engaging history, whereby resources, talents, teamwork, culture, and innovative actions were optimized.

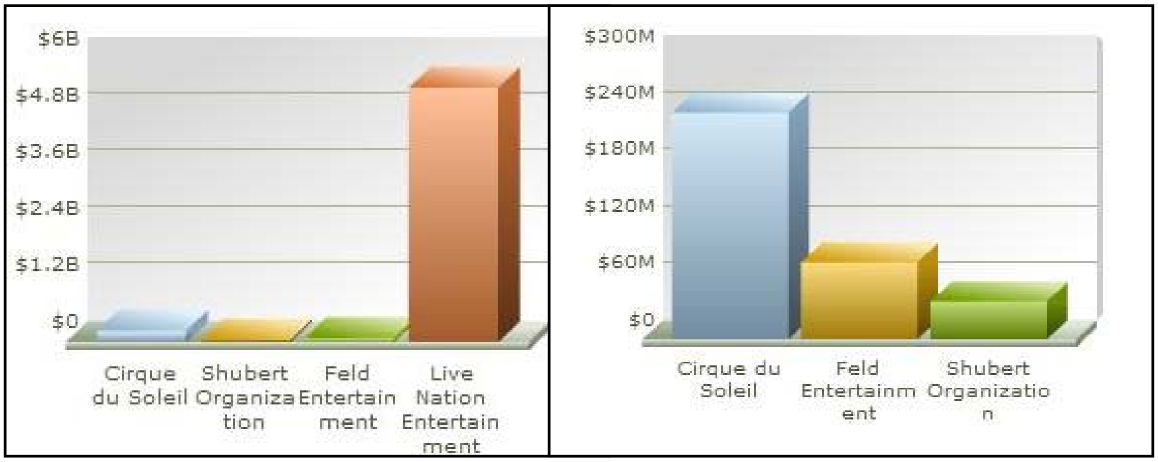


***Figure 1:*** **2013 Annual Sales by nearest competitors (Hoovers, 2013).**

| | Cirque du Soleil | Shubert Organization | Feld Entertainment | Live Nation Entertainment |
|---|---|---|---|---|
| **Annual Sales** | $239.02M | $39.90M | $81.20M | $5.38B |

**Source: Hoover's Inc. (2013) Cirque du Soleil**

## CIRQUE DU SOLEIL: AN UNPRETENTIOUS BEGINNING

Steam calliopes, horse drawn wagons, exotic animals, elephants, troupes, and clowns paraded into town. Each of these built excitement and anticipation leading to the Big Top where the ringmaster skillfully bellowed "Ladies and Gentlemen, Children of all Ages. Welcome to the Greatest Show on Earth! The circus is about to begin!" Indeed, the circus has been a delight for many generations. Lifelong circus lover Ernest Hemingway claimed, "The circus is the only ageless delight that you can buy for money. Everything else is supposed to be bad for you. But the circus is good for you. It's the only spectacle I know that, while you watch it, gives the quality of a truly happy dream" (History Magazine, 2001, para. 2).

For more than 200 years, Europe and the Americas have had a passion for the circus. As a spectacle, the circus was much more than vaudeville, medicine, minstrel, or variety shows; it was a menagerie of entertainment including elements of theater, ballet, music, opera, and art. The forum was associated with specific skills and talents, including acrobatics, juggling, trapezes, trampolines, tightropes, stilt-walking, silk aerials, diavolo dance, and singing. To become stage ready, performers were dedicated, committed, manually dexterous, practiced, and acrobatic—with a pinch of daring.

For Cirque du Soleil, however, gone were the whimsical days of popcorn, peanuts, sawdust, spangles, and calliopes. Instead, Cirque (simply titled) was a hybrid of circus, acrobatics, and dance performance (Berry, et al, 2006). This "Circus of the Sun" was a multi-level production without the menagerie of exotic animals, yet was one that captured the magnificence of the human form, agility, and creativity. Filed under the Art, Entertainment, and Recreation Sector, Cirque was a unique and innovative business with a humble beginning (Hoovers, 2013). Resembling many who wished to run away with the circus, young and creative Canadian street performer Guy Laliberté had a dream to reinvent the circus as an art form with artistic disciplines. This dream was encapsulated in the company's mission statement: "to invoke the imagination, provoke the senses, and evoke the emotions of people around the world" (Personal Interview Tony Ricotta – Company Manager for Zarkana May 30, 2013).

As a musician (accordionist), agile stilt-walker, and daring fire-breather, Laliberté belonged to *Le Club des Talons Hauts* (The High-Heels Club), a group of street performers in the picturesque village of Fête foraine de Baie-Saint-Paul near the St. Lawrence River just outside Quebec City (DeLong & Vijayaraghavan, 2002). Joined by co-performer Daniel Gautier, 25-year-old Laliberté founded Cirque du Soleil in 1984. As an imaginative innovator, Laliberté envisioned combining the entertainment culture of the circus with the artistry of acrobatic performance. This made such a combination the hallmark of all Cirque du Soleil's performances.

Inspired by the national fervor at the 450th anniversary celebration of the founding of Canada by French navigator and explorer Jacques Cartier, Laliberté used his charismatic appeal to persuade festivities organizers that what the region needed to raise national pride and awareness was a provincial tour by his newly formed Cirque du Soleil. With a $1.3 million Canadian government grant, the company toured the province, bringing recognition to Cirque's front door (Hoovers, 2013). The tour performers and production were such a success that the company began to create demand outside of Canada. The demand for more tours was so high that by 1992 Cirque no longer needed grants neither from the public nor from private sectors (Cirque du Soleil, 2013).

While Daniel Gautier was the financial and production manager, Laliberté was responsible for all creative elements of productions and performances. Initially, Cirque employed only 73 people, yet by 2001, that number had risen to 2,100 employees worldwide, 500 of whom were performers (Cirque du Soleil, 2013). Between 1984 and 1989, Cirque performed only one show at a time. The organization then blossomed to 5,000 employees on five continents, of which 1,000 were artists (Cirque du Soleil, 2013). The productions were divided into groups designated as resident and touring. Resident indicated occupancy of one location, whereas touring indicated visiting different cities. Cirque had eight resident locations in Las Vegas and one in Orlando, Florida. The ten touring productions could be found across five continents. Of these, five were under the Big Top and five were in arenas. The International Headquarters in Montreal was home to 2,000 employees, administration offices, creative laboratories, artisans, and expert performers (Cirque du Soleil, 2013).

With the company traveling across the U.S. and Europe, the success of the organization grew, but not without managerial and organizational disputes including "artistic rebellions" and partnership clashes (DeLong & Vijayaraghavan, 2002). In 1998, with Cirque valued at $800 million, Laliberté bought out Gautier percentage and retained full control of the organization until March 1, 2006, when at the age of 47 he resigned and was succeeded by Daniel Lamarre. Although in charge of operations at all levels, Lamarre, who joined the Cirque executive team in 2001, reported to Laliberté, who is titled as Founder and Guide (Hoovers, 2013).

While Laliberté began a new, bold, and visionary foundation to fight world poverty, he retained creative scope and influence over activities. Cirque saw itself as a global citizen and believed that it made the world a better place through its entertainment (Personal Interview Tony Ricotta – Company Manager for Zarkana May 30, 2013). In addition to entertainment, Laliberté also had a goal for the foundation ONE DROP: to provide safe and sustainable water to poverty-stricken areas. With conviction, Laliberté believed "life gives back what you have given and even the smallest gesture will make a difference" (Hoovers, 2013, para. 1). Such an ethos has perhaps been the substance for the many awards and recognitions Laliberté has received. From 1997 to 2007, Laliberté was honored with the following accolades:

- 2007 —Ernst & Young Entrepreneur of the Year award at the Quebec, Canada, and international levels.
- 2004 — The Order of Canada (the highest distinction from the Governor General of Canada).
- 2004 — Time Magazine as one of the 100 most influential people in the world.
- 2003 —The Condé Nast group as part of the Never Follow Program, a tribute to creators and innovators.
- 2001 — Great Montrealer by the Académie des Grands Montréalais.
- 1997 — The Ordre National du Québec (the highest distinction from the Government of Quebec) (Hoovers, 2013)

Evoking imagination that rendered the senses spellbound was a trademark of the Laliberté innovative spirit. The high quality of the performance and the fact that more than 100 categories of occupations made up the company's employees and artists reflected the audacity, conviction, and creative pillars of the organization's success. Coming a long way from its humble beginnings in 1984, Cirque claimed that more than 100 million people worldwide had experienced a Cirque show (Cirque du Soleil, 2013).

## PRODUCTS (SHOWS)

As of July 15, 2013, Cirque du Soleil has offered 20 shows worldwide and focused on nine resident shows and ten touring shows.

## RESIDENT SHOWS

The company's nine resident shows were:

**CRISS ANGEL Believe (Luxor Hotel & Casino, Las Vegas, Nevada)**

This show was a partnership between Criss Angel (regarded as the top magician in the world) and *Cirque du Soleil.* Criss Angel was the most sought after illusionist and most watched magician in television history. He was awarded the "Magician of the Century" (Cirque du Soleil, 2013). At CRISS ANGEL Believe, Angel brought his arsenal of 40 spectacular, dangerous, exciting, and unbelievable illusions to the stage. Additionally, the show was filled with comedy.

CRISS ANGEL Believe and Cirque du Soleil took audiences on a haunting and mystifying journey inside the mind of Criss Angel that defied reality (Vegas.com, 2013a).

**KÀ (MGM Grand, Las Vegas: Nevada)**

KÀ was an unusual, heroic journey of love and conflict brought to the stage in a dynamic, theatrical landscape by 80 some artists from around the world. KÀ transcended time, place, and featured an array of diverse cultures and customs to depict the tale of imperial twins on an adventurous journey to fulfill their destinies. Along their way, the twins confronted characters and were faced with events representing the opposing forces of good and evil. While danger followed them at every turn of their journey, they received a magical talisman for protection just before their world came under attack and collapsed.

The KÀ production and performance proved to be a brilliant masterpiece with a powerful soundtrack that complimented the unusual yet innovative blend of acrobatic feats, Capoeira dance, puppetry, projections, and martial arts (Cirque du Soleil, 2013). The show has been seen by more than six million spectators since its opening in February 2005 (Fastlist.com, 2010).

**La Nouba (Walt Disney World Resort-Downtown Disney, Orlando, Florida)**

*La Nouba* described the meeting of two separated worlds: the fantastic world of the circus artists "the Cirques" (French for circus people), sporting bright, fluorescent colors, and the Urbains (French for urbanites), who wore dark, monochromatic outfits (Cirque du Soleil, 2013). At this show, the dreams and nightmares were brilliantly integrated when these worlds made contact. 'La Nouba' challenged its audience to uncover passions they thought they had lost. The show was intended for the entire family visiting Walt Disney World Resort. The show was to be considered a festive journey of imagination featuring amazing aerial acrobatics and gymnastic feats (Cirque du Soleil, 2013).

La Nouba had numerous acts, one of which featured balls, hoops, and clubs flying in unprecedented numbers at a very high speed that made it difficult for the eyes to process. The tight ropewalker (English for funambule in French) act highlighted remarkable balance and precision on a 90-foot (27-meters), half-inch-wide steel wire: a high-wire walker ascended to a height of 34 feet (10 meters) above the stage while his partner descended from the top of the theater (Cirque du Soleil, 2013). The Skipping Ropes act began with the Urbains (urbanites) performing rigid rhythms in monochromatic tones that paved the way to vibrant dance and acrobatics in a steady stream of solo. The show also featured a four-pendulum-like swing on two different levels that carried a team of perfectly synchronized aerialists 53 feet above the stage.

**Michael Jackson ONE (Mandalay Bay, Las Vegas, Nevada)**

Following on the successful heels of Michael Jackson's IMMORTAL WORLD TOUR touring show, the resident version was introduced in July 2, 2013 and titled Michael Jackson: ONE (Rolling Stone Music, 2013). Master Teacher and Cirque consultant Stefan Haves said, "Technology nearly surpassed the artistry with seamless hologram projections and lasers that it becomes so immersive for the public that it has become a new generation [of entertainment]. The technology is . . . exponentially more incredible, an indication that via technology the future of the circus will be to the point of intoxication" (Personal Interview Stefan Haves 4 July 2013 Artistic Cirque du Soleil consultant and contractor).

ONE offered a fusion of musical montages and sonic experiences in the spirit, glitz, and glamor associated with a Michael Jackson production. The dramaturgical environment utilized Meyer Sound's cutting-edge Constellation System along with specially designed speakers located in the headrest of each seat. ONE rendered a genuine musical miscellany of medleys, tableaus, and mosaics channeled into vibrant and vividly choreographed entertainment (Rolling Stone Music, 2013).

**The Beatles LOVE (The Mirage, Las Vegas, Nevada)**

LOVE intended to celebrate the musical legacy of *The Beatles*. It explored the content of the songs in theatrical scenes that portrayed real and imaginary people and provided the audience with an unusual Beatles panoramic and musical experience.

The show was performed by 60 energetic international artists including aerial performances, extreme sports, and urban free-style dance (Cirque du Soleil, 2013). According to Dominic Champagne, who wrote the original concept and directed the show:

> I wanted to create a Beatles experience rather than a Beatles story, taking the audience on an emotional journey rather than a chronological one, exploring the landscapes and experiences that have marked the group's history. (Cirque du Soleil, 2013, n. p.)

**Mystère (Treasure Island, Las Vegas, Nevada)**

Mystère *(French for mystery) was Cirque du Soleil's high-energy classical show that combined* the powerful athleticism, high-energy acrobatics, and the unimaginable that made it Cirque du Soleil's thriller flagship. The show provided the ultimate discovery of the mysterious life (Cirque du Soleil, 2013). See Figure 2 for selected acts from the "Mystère" show.

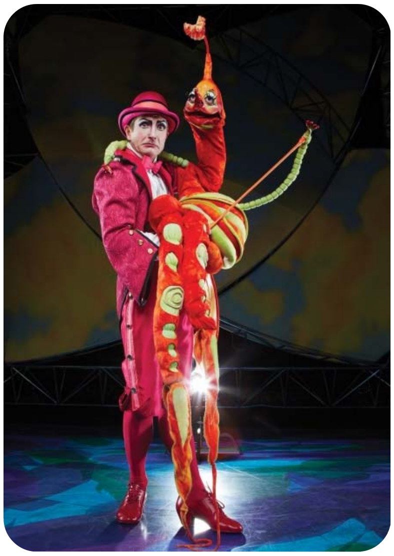

*Figure 2*: **Selected Acts from Mystère in Las Vegas**

**Title:** Moha-Samedi
**Picture credit:** Matt Beard
**Costume credit:** Dominique Lemieux

**Title:** Lizards
**Picture credit:** Richard Termine
**Costume credit:** Dominique Lemieux

**Source: Cirque du Soleil (The above images were used with permission.)**

**"O" (Bellagio, Las Vegas, Nevada)**

Labeled as "an aquatic masterpiece of surrealism and theatrical romance," the "O" production was "inspired by the concept of infinity and by the pure form of the letter "O" (Cirque du Soleil, 2013). The title of this production is also a phonetic representation of the French word for water, the element embodied by this show (Play Bill Online, 2013). The show was an aquatic spectacular where performers rose mysteriously from below the surface of a 1.5 million foot tank, or dove out of sight, never to be seen again. The show was filled with synchronized swimming, acrobats, fire dancers, and elaborate stage effects coupled with live music (Play Bill Online, 2013). See Figure 3 for selected acts from the "O" show.

**FIGURE 3: Selected Acts from "O" in Las Vegas**

**Title:** Clowns
**Picture credit:** Julie Aucoin
**Costume credit:** Dominique Lemieux

**Title:** The Zebra
**Picture credit:** Veronique Vial
**Costume credit:** Dominique Lemieux

**Source: Cirque du Soleil. (The above images were used with permission.)**

**Zarkana (ARIA Resort & Casino at City Center, Las Vegas, Nevada)**

Before arriving in Las Vegas, Zarkana had a very successful track record at Radio City Music Hall in New York City, the Madrid Arena in Spain, and at the Kremlin State Palace Theatre in Moscow, Russia. Opening on November 22, 2013 at the ARIA Resort and Casino in Las Vegas, the show was a stunning acrobatic extravaganza that told a story of a magician named Zark who goes on a mission to find his love and regain his magical power. The journey took Zark to an abandoned theater where 70 international artists performed an unusual collection of acrobatic fantasy scenes (Cirque du Soleil, 2013).

**Zumanity (New York-New York Hotel & Casino, Las Vegas, Nevada)**

Zumanity represented a sensual adult-themed side of Cirque du Soleil. It was a seductive cabaret-style production combined with a Cirque du Soleil twist. While it explored different perspectives of love, it contained explicit and provocative contents through dance and gymnastics (Vegas.com, 2013b). The show was intended for mature audiences of 18 years or older.

**TOURING SHOWS**

Cirque du Soleil's eleven touring shows in alphabetical order were:

**Alegria**

Alegria was a touring show in Italy, France, the Netherlands, Switzerland, Spain, Denmark, Norway, Sweden, Finland, Estonia, Latvia, Lithuania, and Slovakia. The themes of the show, whose name meant "jubilation" in Spanish, included power and power handling over times, the evolution from ancient monarchies to modern democracies, old age, and youth. In the show, kings' fools, minstrels, beggars, old aristocrats, and children made up the Alegria universe. However, only clowns were able to resist the passing of time and its social transformations Cirque du Soleil, 2013).

**Amaluna**

Performed in Canada and the U.S., Amaluna was a show about a mysterious island governed by goddesses and guided by the cycles of the moon.

> Their queen, Prospera, directs her daughter's coming-of-age ceremony in a rite that honors femininity, renewal, rebirth and balance, which marks the passing of these insights and values from one generation to the next. (Cirque du Soleil, 2013)

As a result of a storm caused by Prospera, a group of young men landed on the island, triggering a love story between Prospera's daughter and a brave young suitor that was put to the test. The couple experienced a variety of trials and had to overcome daunting setbacks before they achieved mutual trust, faith, and harmony (Cirque du Soleil, 2013).

**Corteo**

Performed in Germany, *Corteo*, which means "cortege" in Italian, was a joyous procession, a festive parade imagined by a clown. The show brought together the passion of the actor with the grace and power of the acrobat to plunge the audience into a theatrical world of fun, comedy, and spontaneity situated in a mysterious space between heaven and earth.

The clown pictured his own funeral taking-place in a carnival atmosphere, watched over by quietly caring angels. Juxtaposing the large with the small, the ridiculous with the tragic and the magic of perfection with the charm of imperfection, the show highlighted the strength and fragility of the clown, as well as his wisdom and kindness, to illustrate the humanity that is within each of us. The music, by turns lyrical and playful, carried *Corteo* through a timeless celebration in which illusion teased reality (Cirque du Soleil, 2013).

**Dralion**

Dralion was a US touring show and derived its name from two emblematic creatures: the dragon, symbolizing the East, and the lion, symbolizing the West. It integrated the 3000-year-old tradition of Chinese acrobatic arts with *Cirque du Soleil style*. *Dralion* was built on the teachings and inspiration of the Eastern philosophy and its long-standing quest for harmony between humans and nature (Cirque du Soleil, 2013).

In *Dralion,* the four embodied elements that shape the human form were represented by their own evocative color, where air was blue, water was green, fire was red, and earth was ochre. In the *Dralion's world,* cultures blended man and nature, made it one, and achieved balance (Cirque du Soleil, 2013).

**Koozå**

Koozå toured in the USA, United Kingdom, Spain, Belgium, and France. Koozå, whose name was inspired by the Sanskrit word "koza," meaning "box," "chest" or "treasure," told the story of a melancholy loner (the innocent) taking on a journey filled with strength, fragility, turmoil, laughter, and harmony in search of his place in the world (Cirque du Soleil, 2013). The show was also about human connection and the worlds of the good and bad. According to Kooza's writer and director David Shiner:

> The tone is fun and funny, light and open. The show doesn't take itself too seriously, but it's very much about ideas, too. As it evolves, we are exploring concepts such as fear, identity, recognition, and power. (Cirque du Soleil, 2013).

Kooza combined acrobatic performance with the art of clowning. The show highlighted exotic and colorful acts and electrifying themes such as identity, recognition, fear, and power(Cirque du Soleil, 2013).

**Michael Jackson Immortal World Tour**

This World Tour traveled to the United Kingdom, Denmark, Sweden, Finland, Russia, Germany, Austria, Spain, Hungary, Czech Republic, Switzerland, Belgium, and Portugal. Intended for lifelong fans and those who were experiencing Michael's creativity and signature moves for the first time, the show highlighted the King of Pop's artistry and celebrated a legacy that continued to transcend generations (Cirque du Soleil, 2013).

The Michael Jackson Immortal Tour unlocked the secrets of the pop king's inner world including his love of music and dance. Through the art of magic and the beauty of nature, Michael's fantastic, inspirational music and lyrics sent messages of peace, love, and unity to the world (Cirque du Soleil, 2013).

**Ovo**

Performed in Austria, this show was "a headlong rush into a colorful ecosystem teeming with life, where insects work, eat, crawl, flutter, play, fight, and look for love in a non-stop riot of energy and movement" (Cirque du Soleil, 2013, n. p.). A world of biodiversity and beauty, the insects' home was filled with action and quiet emotion. When a mysterious egg appeared in their bustling community, it was love at first sight. The insects were astonished and intensely curious about the unusual object that represented the puzzling, inexplicable nature of their lives (Cirque du Soleil, 2013). The show overflowed with contrasts of the hidden yet spectacular bug's world.

**Quidam**

Performed in the USA, the show told the story of a young girl, Zoé, whose parents were distant and apathetic; they totally ignored her and became bored with her. Seeking to fill the void in her life, she pursued the world of *Quidam, an imaginary world* where she met characters who encouraged her to free her soul (Cirque du Soleil, 2013).

*Quidam meant "*a nameless passer-by, a solitary figure lingering on a street corner, a person rushing past and swallowed by the crowd." It could have been anyone in the crowd, someone in the silent audience. The show, as explained by the show director, was for all the "quidams" whom this show allowed to speak and finally emerge from anonymity (Cirque du Soleil, 2013).

**Saltimbanco**

This show toured in the USA, Puerto Rico, Dominican Republic, and Canada. Saltimbanco, an Italian word which literally meant "to jump on a bench," explored "the urban experience in all its myriad forms: the people who live there, their idiosyncrasies and likenesses, families and groups, the hustle and bustle of the street and the towering heights of skyscrapers" (Cirque du Soleil, 2013, n. p.).

*The Saltimbanco* show was inspired by the urban lifestyle and the city's colorful inhabitants. Diversity was a cause for hope in a setting filled with a spectacular, eclectic cast of characters who brought a fantasy world to an imaginary city (Cirque du Soleil, 2013).

**Totem**

Totem toured in the USA. Totem (which meant a natural object, phenomenon, or animated being) traced "the fascinating journey of the human species from its original amphibian state to its ultimate desire to fly" (Cirque du Soleil, 2013, n. p.). This journey was illustrated through acrobatic and visual scenes where cast members produced a vivid impression of a giant turtle through artistry and imagination. Juggling between science and legend, Totem explored the ties that connect man with his dreams and the infinite potential of other species (Cirque du Soleil, 2013).

**Varekai**

Varekai, a word that meant "wherever" in the Romany language of the gypsies, toured Argentina, Chile, and Peru. The show was an acrobatic tribute to the nomadic soul. Varekai was an unusual world that existed deep in a forest at the summit of a volcano where otherworldly things were possible (Cirque du Soleil, 2013).

The story was about a solitary young man who fell from the sky into the shadows of a magical forest populated by fantastic creatures. Through an unusual adventure, an inspired life was discovered (Cirque du Soleil, 2013).

## THE COMPETITIVE LANDSCAPE OF THE GLOBAL ENTERTAINMENT INDUSTRY

When evaluating Cirque du Soleil's competition in the worldwide entertainment industry, the critic was hard-pressed to find a semblance of genuine competition. Due to Cirque's unique creations that appealed to an audience above and beyond that of traditional circuses (such as Ringling Brothers and Barnum & Bailey), a tangible, competitive landscape was as surreal as the production itself.

Since its inception in 1984, Cirque experienced insurmountable, profitable growth and revenue in less than 30 years, a feat previously unknown in the circus arena. This success was attributed to the fact that Cirque did not compete with entertainers such as the Ringling Brothers circus business, but instead created its own market space (Kim & Mauborgne, 2005). Cirque had clearly transformed beyond the typical and traditional straw and canvas circus.

Rather than focus on how it could outdo competition in the traditional circus tent, Cirque's strategy revolved around a production that included the excitement of a circus performance and the creative richness of the theater. "This strategy enticed a completely new audience of adult and sophisticated theatergoers, who were willing to pay a much higher price than that of a ticket to the traditional circus" (Kim & Mauborgne, 200, p.10). From its humble beginning as an act that included street performing hippies who did not need more than their circus-like talents, Cirque grew into an expensive extravaganza. Although the cost of admission was considered costly to some, the productions were very expensive to run. Despite the high cost of admission to its performances and its perception as an ultra-brand to the affluent, Cirque's corporate position has been to make it accessible to everybody. Further, Tony Ricotta, Zarkana's company manager stated, "I really wish there was a way to communicate that to the world. This is not just a circus for the rich; this is a circus for everybody" (Personal Interview Tony Ricotta – Company Manager for Zarkana May 30, 2013).

Cirque built a $600 million a year entertainment domain that combined acrobatics, music, dance, comedy, and a storyline, all under a glamorized circus tent. Dedicated Cirque goers paid anywhere from $45 - $195 per ticket to see the distinctive and innovative shows (Palmeri, 2004). However, as in any industry, there was purported competition from the traditional circus, theater, dance, and music business sectors, as well as a smidgen of competitors that offered unique entertainment genres over the last few years. The inkling of competition may have caused the innovators at Cirque du Soleil to spend lavishly to stay ahead, with productions such as KÀ, an action-packed story about twins who are separated when their Far Eastern palace is attacked. The grandiose performance was staged at the MGM Hotel, Las Vegas, and the story was told in a unique manner. The plot was communicated without words and through the actions of very talented performers on a $200 million stage. As in any successful business venture, imitators attempted to duplicate the company's success. The creative genius behind Cirque's competition included individuals who were associated with Cirque du Soleil in the past and ventured out to develop their own innovative enterprises (Palmeri, 2004).

**Franco Dragone Entertainment Group**

Competition from Cirque's own talented individuals surfaced over the last ten years with the launch of Dragone Entertainment Group. During the 1980s and 1990s, Franco Dragone became famous while he served as director at Cirque du Soleil. His creative energy led to Cirque's innovative shows such as Mystère, Quidam, Saltimbanco, Alegria, "O," and La Nouba. Eager to develop his own Entertainment Company and globally recognized as a creative genius, Franco founded the Franco Dragone Entertainment Group in 2000. Dragone served as President and Artistic Director, and similar to Cirque du Soleil, he created and produced shows that incorporated dance, special effects, music, and circus art (Franco Dragone Entertainment Group, 2013).

Dragone produced the $110 million show La Reve at the Wynn Las Vegas Resort and was the mastermind behind the continued success of the Celine Dion show at Caesars Palace (Nelson, 2010). Le Reve portrayed an aquatic theme in a circular theater that seated 1,608 people around a pool that was 68.5 feet in diameter, placing the audience at a vantage point that made them feel as though they were a part of the show. The performers included gymnasts, synchronized swimmers, and aerialists who ascended from the water or descended from the ceiling, in addition to running through the aisles in the theater, giving the audience a thrill of a lifetime (Weatherford, 2013). Celine's Colosseum at Caesars Palace was portrayed as a high-end corporate superstar production with lavishness only seen in a Las Vegas production and was worth the price (Weatherford, 2013).

Dragone's vision for the company was to develop the most remarkable live entertainment shows in the world and he planned to accomplish this by opening one long-running spectacular show per year. Examples included The House of Dancing Water, which opened in September 2010 as a permanent show in the City of Dreams, Macau, China with a water theme and an oriental culture basis. A second example was Kung Fu Panda Live, an arena touring show based on Dream Works' Kung Fu Panda movie, which despite production delays, remained scheduled to open in 2013 (Franco Dragone Entertainment Group, 2013).

**Cavalia, Inc.**

Normand Latourelle, President and Artistic Director of Cavalia, was a Cirque du Soleil executive from 1985-1990. Latourelle left Cirque and founded Cavalia, Inc., a privately held company based in Montreal, Canada. In 2003, Latourelle created the unique production Cavalia; an extravaganza based on a mix of acrobatics with an equestrian theme, and toured the United States and Europe with the production. The success of the show, described as Latourelle's passion, reflected his dedication and imagination.

Latourelle was known for linking various styles of creativity, leading audiences to new and exciting entertainment heights. Since its 2003 inception, 3.5 million people have marveled at the production's relationship between horses and humans (Curry, 2012). Similar to the international flair of Cirque du Soleil, Cavalia's artists included acrobats, dancers, and riders from all over the world, as well as musicians and singers. The production cast 11 different breeds of over 50 majestic horses from France, Spain, Portugal, Spain, the Netherlands, and the United States. Latourelle created a new show, Cavalia Odysseo in 2013, which held 105 very successful performances in Toronto. Additionally, the Latourelle production announced in September of 2013 that it was moving its 10-story big top to Monterey, Mexico (Perez, 2013).

**Las Vegas Style Competition**

Besides the competition generated from Cirque's own creative geniuses who ventured out on their own, Cirque's continued success in Las Vegas attracted competition from a new and evolving type of entertainment spurred by the Cirque brand. A review of a variety of productions in Las Vegas from stereotypical dance shows and illusionists to Broadway productions and top concert entertainment was a convincing tribute to the effect Cirque du Soleil had on the Las Vegas show setting (Nelson, 2010).

The classic dance show Jubilee has been showing at Bally's on the Las Vegas Strip for over 25 years and continues to be one of Las Vegas' most popular shows. The sophisticated topless revue with elaborate costumes featured over 100 dancing showgirls with acts ranging from singing and dancing to Cirque style contortion acts. While this traditional Las Vegas dance show provided a flavor of old showgirl performances, it adopted the Cirque brand with a splash of contortionists in the production. To compete with other shows on the Las Vegas strip, Jubilee provided a very tasteful and family friendly performance that did not include topless dancers (Leach, 2014).

The Broadway show Jersey Boys entertained audiences in New York for years and later opened at Paris Hotel and Casino in Las Vegas. The musical featured singing and excellent acting by seasoned professional cast members and kept the sold-out audiences entertained for the duration of the show. The story is based on the Four Seasons singing group and its lead singer, Frankie Valli. Reviews of the show reflected it as one of Broadway's best entertainment productions (Roberston, 2006). Although it did not have the Cirque flair of acrobatics and contortionists, Jersey Boys was sophisticated entertainment, and drew audiences on par with those who patronized Cirque performances, thus giving Cirque legitimate competition.

In the area of magic, David Copperfield, the master of illusion, performed incredible magic tricks at the MGM Grand in Las Vegas. Copperfield's magic drew a very high level of awe from the audience. The typical box trick of slicing a woman in half is replaced with Copperfield locking himself in a shrinking box. Copperfield, a charismatic performer, smiled at the audience while moving his hands and feet as the box got so small the entire length of his body was reduced to a few inches. The box then slowly got bigger and Copperfield jumped onto the stage, incorporating his comical personality. As with Cirque, Copperfield's show included a high level of audience participation as he integrated random people from the audience into his illusions. Copperfield would do magic tricks right in front of audience members when he performed illusions while standing in the audience. For one illusion, he asked a woman to join him in the aisle on the side of the theater. He asked the woman to examine a piece of tissue paper before he rolled it into a ball and made it levitate and dance along his arm with the tap of a finger (Lamare, 2013).

The performance caused competition for Cirque because many theatregoers only attended one performance while in Las Vegas.

Richard Abowitz, a Las Vegas based entertainment reviewer, believed Cirque had competition throughout the strip because "Now even the non-Cirque shows have aerialists. Las Vegas is a spectacle. We are a bandwagon mentality. Cirque has become a brand-name of a generic you can get elsewhere in the city" (Nelson, 2010, para. 30).

**Traditional Circus Entertainment: Feld Entertainment, Inc.,**

Cirque du Soleil's largest competitor in the traditional circus and entertainment industry was Feld Entertainment, Inc., based in Vienna, VA. Feld's leading productions, Ringling Brothers and Barnum & Bailey, visited 90 U.S. cities annually and had the unique distinction of being the only shows in the entertainment industry to run for three consecutive centuries. Feld was a composite of circus, ice, stage, and motorsports that performed shows in over 70 countries, on six continents, and was viewed by more than 30 million people per year.

Chair and CEO Kenneth Feld owned the company and managed the majority of its productions. His father, Irvin, began managing the circus in 1956, many years after Ringling Brothers and Barnum & Bailey Circus had its first performance in 1871. Feld maintained offices and production facilities throughout the world and employed over 3,000 people who worked on creative ideas to thrill and entertain international audiences. In addition to the mammoth Ringling Brothers Circus, Feld's other popular shows included *Disney on Ice* and *Monster Jam*, both of which are Feld Motor Sports productions (Feld Entertainment, 2013).

**Other Traditional Entertainment Competition:**

**Live Nation, Inc.,** a Beverly Hills, California promotion company that controlled concert promotions and ticketing services as well as the management of performers, was considered Cirque's second largest competitor in the traditional entertainment arena. Different from Cirque du Soleil's focus as an entertainer, Live Nation's strategy revolved around promoting a number of genres in the music industry. Its investments included the acquisition of Hard Events, a Los Angeles company that held concerts and dance music celebrations throughout North America. Live Nation expanded in 2011 through a joint venture with Groupon, an online discount company that offered discounts to help Live Nation with its ticket sales to concerts and other entertainment events (Hoovers, 2013).

**The Shubert Organization,** a New York City, New York organization that achieved renowned success on the Great White Way. As Broadway's largest theater operator, Shubert owned and/or managed close to 20 locations in New York City. These establishments included the famous Lyceum and Winter Garden theaters. In 2008, Shubert's Longacre Theater underwent a multimillion-dollar renovation, which restored original plasterwork and architectural detail, expanded theatergoers' amenities, and repaired and upgraded the neo-French classical exterior façade. Expanding beyond New

York City, the Shubert Organization also owned the Shubert Theater in Boston and the Forrest Theater in Philadelphia, and managed the National Theater in Washington, DC. The Shubert Organization orchestrated and presented renowned productions such as *Cats, A Chorus Line, Miss Saigon, The Phantom of the Opera,* and *Spamalot.* In addition to the productions themselves, its Telecharge.com served as the primary ticketing agency for New York Theater events (Hoovers, 2013).

The organization had one Off-Broadway location known as The Little Shubert and all other New York sites were Broadway theaters. As America's oldest professional theater company, The Shubert Organization was founded in 1900 by three brothers- Sam, Lee, and Jacob J. Shubert, who moved from Syracuse, New York to New York City and obtained a lease on the Herald Square Theater. Thus began the road to success on the Great White Way (Hoovers, 2014).

## ORGANIZATIONAL CULTURE, NORMS, AND VALUES

Having entertained thousands on nearly every continent, Cirque maintained its touring and resident venues, each of which was tied to the organization's intrinsic and sustainable culture. Fantastic myths and mind-altering states of imagination came to life in graceful, yet seemingly boneless body movements. The magnificence of colored delights, sights, and orchestrated stories was one of grandeur and opulence. Subtle yet deliberate emotions pervaded the imaginative scenes in a circus show where no animal other than human was engaged. In truth, there was no show like it. As previously discussed, imitators tried to copy this form of live entertainment, but there was no imitating the Cirque experience.

The Cirque culture relied upon strong communications and ethics to bridge any possible cultural differences, building trust between performers living and functioning in close quarters (DeLong & Vijayaraghavan, 2002). Indeed, Ricotta said that as an organization Cirque was "always sensitive" to such relationships. Further, the culture at Cirque was very open and accepting of people and to doing things in different ways. "No is not a word . . . and impossible is not a word at Cirque du Soleil" (Brigitte Belanger-Warner publicist for "O," 2008, n. p.).

With that being said, Ricotta asserted, "you can invite problems or you can offer solutions" (Personal Interview Tony Ricotta – Company Manager for Zarkana May 30, 2013). Behavioral norms and values resulted in the fulfillment and affirmation of the Cirque family, or at the very least, the creation of a community.

In fact, Ricotta recounted from Cirque's beginnings "those values [that] were created when we first began this company were such strong emotional values that they're almost impossible to erase and we wouldn't want to change them necessarily, but there is no dipping in the values when you become part of the company. You just know that they are there and people make you fully aware. Further, they are not posted on the wall but somehow they get to you. At the heart of it all, Cirque sees itself as a global citizen. And it is doing its job for a purpose. I know it's going to sound trite, but it's to make the world a better place, and we do that through entertainment" (Personal Interview Tony Ricotta, May 30, 2013).

Of the 30 shows produced throughout its history, Cirque had as many as 19 extravaganza shows running concurrently in major cities worldwide. While permanent stages were rooted in the United States (Las Vegas, Nevada, and Orlando, Florida), Montreal, Canada remained the location for corporate offices, living, training, and performing facilities. From this location and from its founder, Laliberté, the organizational structure and leadership were promulgated to all venues. Laliberté's ingenuity and management philosophy were based on his knowledge and experience with the performer's eccentric and capricious characteristics (physiognomies). In his leadership capacity, Laliberté was both paternalistic and protective of his performers' creative outlets and comfort levels. This management philosophy served to establish Cirque's organizational norms and values. Thus, protection of a disparate and diverse band of performers resulted in the motivation of said performers to excel in a one-of-a-kind form of entertainment (DeLong & Vijayaraghavan, 2002).

Notwithstanding, as the benevolent caretaker, Laliberté tended to and anticipated the needs of the Cirque troupes. For Laliberté, above all, each performer must be "happy" for the benefit of the production as a whole. Such organizational norms and values served to create the culture of family and teamwork. For instance, the organization understood human companionship when talent was obtained from remote locations such as small villages in Africa, China, and South America. Cirque's practice was to request at least two friends or family members to accompany the performer to help ease the challenging cultural transition due to changes in language and environment. When necessary, family units were kept intact, especially those rescued from dire circumstances. Language courses and educational opportunities were provided for both performers and their children. Troupe parties were also commonplace in the Cirque culture and celebrated diversity. Medical care, transportation assistance, and living facilities were standard benefits for Cirque performers. This was provided to the diverse and exotic breadth of ethnicities working interdependently in an otherwise international communal environment (DeLong & Vijayaraghavan, 2002).

Speaking more than 25 different languages and dialects, artists and performers originated from more than 40 countries. As an organization, Cirque was home to 4,000 employees, 500 of whom were performers (DeLong & Vijayaraghavan, 2002). Thus, given the diversity of merging cultures, communications among recruits and personnel was indeed challenging but certainly not impossible. Add to the mix the complexities of living arrangements and the constant adaptation required on a daily basis, one could easily imagine the critical trust requirements needed when performing highflying stunts with precarious drops and turns.

Cirque du Soleil established a philanthropic organization within the company to positively affect the lives of at risk youth through circus arts. The organization was not only for discovering talented youth and for putting them on stage; it was meant to provide them with a creative outlet and a form of shelter from life's challenges. Cirque, a company with a cause, wanted to make an impression on at risk youth. Its cause was to "try to make the world aware that too many people on this planet don't have access to clean drinking water, for example. And as *citizens of the world* - it's our responsibility to do something about that. In our work, we practice that by showing joy, showing love, showing hardship, showing pain…and somehow getting people involved" (Personal Interview Tony Ricotta, May 30, 2013).

## TEAMWORK: A KEY SUCCESS FACTOR

Each Cirque production required a team of specialized individuals with particular talents, skills, and aptitudes. Productions began on a storyboard with narrative development and design as collaboration between gymnastic choreographers, music writers, composers, engineers, set developers, structural erectors and many more design specialists. Once developed operations became functional, auxiliary services such as catering, communications, medical services, business operations, marketing and human relations were secured.

The enormous number of talented individuals working in a team format required interdependence and group performance so that everyone could "play together." This required a concept known as *task interdependence*, a model developed by James D. Thompson to identify task characteristics and effective distribution of outcomes or rewards among group members. Thus, the extent to which individuals performed was directly affected by what each group member did (Thompson, 1967). The degree and intensity of actions and tasks increased among group members when interdependence across group boundaries increased. Such actions required risks to be taken both in terms of talent and in terms of circumstance. To capitalize on the ingenuity of Cirque's innovative ideas, each designer, artist, performer, and choreographer had to take certain risks.

However, regardless of risk, each employee took great pride in and had affection for the company. This was mainly because employees were contributing in some way, shape, or form to making people happy and affecting the world in a positive way as outlined by Cirque's mission statement. Ricotta speculated that if a poll were taken of Cirque's employees, they could readily give you the three key words in the mission statement: *evoke, invoke, and provoke*. Ricotta attested that he had worked for other companies and yet, "I couldn't tell you what the mission statement was let alone be able to recite it" (Personal Interview Tony Ricotta, May 30, 2013). This indicated the strength of Cirque's values and its mission statement and the belief in it by each employee.

Teams were important to Cirque, simply because theater jobs in most companies were all collaborative. No one person can keep all those balls in the air and do it well, and so it had to be done by teams. However, the greatest competitive advantage that the company had was the diversity of its teams. Tony Ricotta validated that:

> If everybody is from the same side of the river, you are only going to look at it one way and you can't appeal to everybody if you are only looking at it from a very narrow field of vision. So when everything is made up of teams, whether it's the production team, the operations team, or the artistic team, they all come from all

> over the place. So, there is a varied perspective and that is what gives us a competitive advantage. When we started, it was very French Canadian, people said "Oh great we haven't seen anything like that before." But now we have the ability to reach beyond our headquarters and bring in new creators around the globe and give them an opportunity to create in a way that they never had been able to before and do some amazing things. (Personal Interview Tony Ricotta, May 30, 2013)

Change as a product of daily performance outcomes was usually seamless when one accounted for the nearly 30 million spectators who to date have attended Cirque performances (Hoovers, 2013). While the individual show may have differed from venue to venue, change was something Cirque cared to avoid for the sake of consistency. The product being produced had to be sustained for the sake of the audience. As Casting Partner Stefan Haves indicated, Cirque did not say "no" to things and this was necessary for the culture. "Basically, they ask themselves how much more wonderful can we make this?"(Personal Interview with Stefan Haves 4 July 2013). Cirque's philosophy was if it could sustain the performers' "happiness" then the audience/spectator would no doubt experience an emotionally driven, memorable, and glitzy performance.

## FORESEEABLE CHALLENGES

While Cirque consistently invested in education and training, its prime challenge was finding ways to work with people from diverse global cultures. In fact, some operational issues were not necessarily related to cultural behaviors, but rather were merely people issues. For example, if an employee did not wish to comply with organizational infrastructure rules and practices such as timeliness, then immediate management intervention were required as a precautionary measure.

In addition, as *a global citizen*, Cirque performed throughout the world in countries that may not have protected basic human rights, but Cirque relied on the fact that its sole purpose was to make the world a better place through the incorporation of art and entertainment. Therefore, although not politically motivated or associated, the Cirque culture was endearing to the minds of their patrons because entertainment permitted individuals to think differently and thus helped cross a huge cultural gap.

From its infancy, it seemed that Cirque had a string of luck in success nearly and solely based on its leadership and ingenuity of artistic creation. While some shows and venues were neither profitable nor successful, the bulk of the organizational business model had been favorable even during economic downturns and the turbulent global financial crisis. Cirque's leadership challenges were to develop entertainment for the next generation and to find a successor to Guy Laliberté given his age and foreseeable retirement.

Cirque du Soleil significantly disrupted the circus industry through its uncommon strategy of integrating many of the shows or the numbers familiar in Broadway like theatres rather than in traditional circuses to stay in a blue ocean away from competitors. Doing so, Cirque generated new market growth that resulted in higher profits than any other traditional circus (Carpenter & Sanders, 2009).

Cirque management was aware of the fact that while their high-end market disruption strategy, which shifted their competitive focus from head-to-head competition to the creation of a brand new entertainment industry; they were also aware that this new market creation strategy might generate new players who may possibly compete for same scarce resources in the future and present new challenges.

Cirque affirmed its desire to sustain its artistic and entertainment work, yet realized that internal behaviors needed to change. Tony Ricotta admitted that Cirque was "rethinking that [challenge] and how we are going to turn the corner on this century" (Personal Interview Tony Ricotta – Company Manager for Zarkana May 30, 2013).

In terms of entertainment and that which attracted people to the Cirque model, it was clear that this company did not want to be a footnote of global entertainment, but rather a leader where human talent and flair could be showcased. Demonstrating what makes people tick was one key element of leadership, yet not giving up on its mission to make the world a better place was even more of a priority, making Cirque a creative diamond in the rough.

## SUSTAINING THE ROLE

Cirque du Soleil can easily be described in terms of well-developed cultivation: it demonstrates the preparation of a performance group to promote their own growth, develop training, culture, sophistication, and collective acculturation. Laliberté's leadership style was unique and included patterns of behavior that nurtured the building of norms and values of a cognitive performance culture. Laliberté's innovative style and creativity made him a talent harvester and cultivator of people, committed to building individual talent levels while maintaining a stewardship for the individual's physical and emotional welfare. The strategy he developed will surely be applied to future productions.

Given that no global entertainment competitor has ever been on par with Cirque du Soleil, the company must make strategic decisions as it embarks on its third decade in business. Pivotal questions were:

> "How can Cirque maintain its high creative standards and expand its appeal to a larger audience?" And "How does Cirque stay loyal to its original values while continuing to move forward?"

Since critics will be shooting at Cirque, leadership needed to pro-actively respond to possible future threats from competitors in order to preserve its success.

## ENDNOTE

*The authors developed the case for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The case is based on secondary (i.e. published) data. All rights are reserved to the authors. The authors extend their appreciation to Tony Ricotta, Company Manager for Zarkana; Ann Paladie, Senior Publicist; Pauline Fretté, of Cirque du Soleil's department of Global Citizenship; and Cirque's artistic consultant Stefan Haves for their assistance, advice, input, and feedback to the contents of this case. Contact person: Issam Ghazzawi, University of La Verne, 190 Third Avenue, La Verne, CA 91750.*

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# FAMILY FEUD AT JOHN BLAINE TRUCKING COMPANY, INC.

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## CASE DESCRIPTION

*The primary subject matter of this case concerns family business estate and succession planning for a small oilfield trucking company. Secondary issues examined include sibling rivalry, conflict management, and the integration of family counseling theory into family business counseling. This case is appropriate for senior and first year graduate students. It is designed to be taught in three class hours and is expected to require three hours of outside preparation by students.*

## CASE SYNOPSIS

*Carolyn Blaine is the recently widowed owner of John Blaine Trucking Company, LLC. She and her deceased husband, Trevor, have five children and two grandchildren between the two of them. The company was founded in 1961 by Trevor's parents and is currently being managed by the third generation son-in-law. Sibling rivalry has been a significant issue since the two married (a second marriage for both of them). The case opens with Carolyn expressing both anger and heartbreak caused by Trevor's death. In a dream sequence Carolyn shows how Trevor's failure to adequately address estate and succession planning, even though he knew he had cancer and was not going to recover, has left her a nightmare situation to deal with. Trevor's mother, one of the original founders of the company, is suing his widow (Carolyn) for an undocumented debt. Carolyn's daughter, Diana, is trying to take control of her and the company and block the other siblings from sharing in any of the financial aspects of the company. More attorneys and accountants have been hired to help straighten out the mess. As the case ends, one of the grandchildren has been seeing a professional counselor and other family members are also seeking these services. Diana has separated from her husband Brad, who is managing the company, and is trying to get Carolyn to remove him from the company. The two grandchildren are also experiencing problems and Diana is relying heavily on Carolyn for help with Nora. Carolyn is overwhelmed with the business and personal issues she is facing and is contemplating taking the family dog and running away.*

## ANGER AND HEARTBREAK

Carolyn Blaine sat looking at her recently deceased husband's picture and sighed. Since his memorial service a week ago, the conflict between family members had escalated. Carolyn was exhausted from her husband's ten year battle with cancer and felt overwhelmed by the new challenge of family conflict regarding the family business, John Blaine Trucking, Inc.

"Oh Trevor, I am really mad at you right now! I miss you but you have really left a mess for me to handle. It is bad enough you are gone, but I am not equipped to handle all of the money grubbing power plays going on at the business," she said to his picture. Carolyn had attended four meetings with her attorney and accountant in the week since Trevor's death. Although Trevor had consulted with both when writing his will, Carolyn refused to believe that he understood what a mess he had left his personal and business affairs. Her step-children were already planning to file a lawsuit to make her move out of her house since it had become part of the estate associated with the business. And, to make matters worse, his mom had consulted an attorney and was planning on suing the company for a loan she had made to the business twenty years ago.

As Carolyn lay down to take a nap, numbness crept over her as she replayed Trevor's memorial service in her head. The way that Trevor's children had acted at the service was heartbreaking to her. Trevor's children by his first wife (Tiffany, Mary, and Steve) had totally ignored her daughter (Diana). Trevor's mother, Shelia, had refused to sit with the family during the service. When Diana showed the power point presentation that she had prepared in memory of her dad, Carolyn was horrified to see that it only contained memories and pictures of Diana and her immediate family members. She had completely left out any mention of Trevor's children from his first marriage. Carolyn had quickly jumped up after Diana's presentation and asked the other three children if they had anything they would like to say about their dad. As his children stood up to make comments about their dad, Diana stomped out of the service.

As Carolyn started to cry herself to sleep her heart ached for the loss of Trevor and the fear of what the future held. "I don't know if I have the strength to handle this," she thought as she drifted off to sleep.

## COMPANY HISTORY

John and Shelia Blaine founded John Blaine Trucking Company, Inc. in August 1961 in Kilgore, Texas. Both had grown up in east Texas and had decided early in their marriage that they wanted to stay in the area. John was working for an oilfield trucking company during a "boom" period in the oil industry. He was driving the trucks that delivered pipe to drilling sites most of the time and worked in the shop servicing the trucks as the other part of his job. John was respected by the customers he serviced and worked hard to keep up with their needs. There was a shortage of trucks and drivers, and his boss did not want to expand the business. Due to the boom/bust nature of the oilfield industry, his boss did not want to take on debt to expand the business and then have financial problems when the bust part of the cycle started—an aspect of the oil business that is typically inevitable.

A couple of the customers that John had developed a close relationship with talked with him about starting his own trucking company. John and Shelia came from modest income families and did not have access to the type of funding necessary to purchase oil field service trucks and equipment. Yet, they both were entrepreneurial minded and wanted to take advantage of the need for additional equipment. The two customers offered to provide the financing necessary to launch the business and John Blaine Trucking Company, Inc. was born. The two customers moved their business to the Blaine's newly formed company and encouraged three other major exploration companies to become customers also.

John and Sheila turned out to possess good business sense and managed the company well. It grew rapidly and the Blaine's lived very frugally so that they could reinvest most of the earnings to grow the company. As the company grew, it developed a strong reputation for excellent customer service. Also, John was known for his knowledge of this industry and many sought him out for advice. Shelia was a great asset to the new company. Her budgeting, record keeping, and general business skills allowed her to manage the business side. This allowed John to focus on the operations side of the business and develop solid customer relationships.

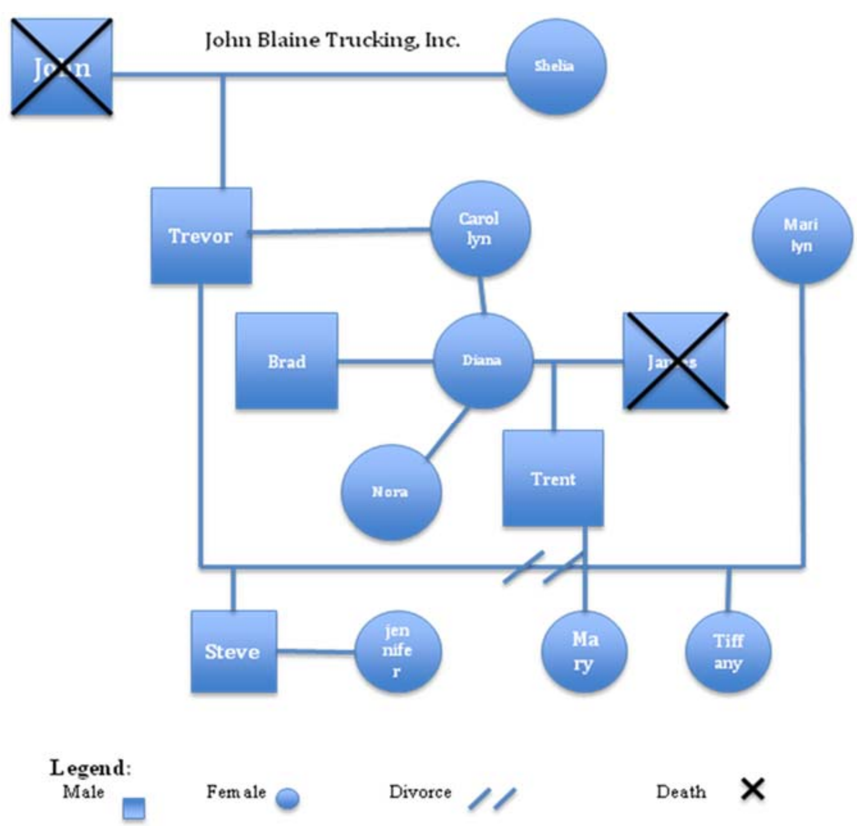
The Blaine's frugality and focus on building wealth served them well in the boom and bust periods associated with the oil and gas industry. They had one son, Trevor, who worked in the business on the operations side with his dad. Trevor told Carolyn that he basically was raised in the shop and couldn't really say when he formally started working there. Trevor loved the business and worked hard to learn all he could. He planned to work full-time at the company after he graduated from high school; however, his parents told him that he had to earn a college degree before he could work full-time for them. Neither John nor Shelia had been able to attend college, and they wanted to provide that opportunity for Trevor. Trevor couldn't see how college was necessary for him to be successful working at the company. After all, Trevor had started driving the trucks around the company lot at the age of 14! Finally, Shelia persuaded him to attend college at Louisiana State University where he chose to pursue a degree in economics and business since he already had the operational/technical skills. He graduated with honors. After graduation he returned to Kilgore and joined his parents in the business. Figure One shows the Genogram at the time of the case.

## TREVOR FALLS IN LOVE

While Trevor was in college, he met Marilyn Boudreaux and they married four months after they started dating. John and Sheila were not pleased with his choice and soon found out the reason for the quick marriage when Tiffany was born five months later. Tiffany was followed by Mary who was born eleven months later. By the time Trevor returned to Kilgore to work with his dad, Marilyn was pregnant with their third child, Steve.

Marilyn was from New Orleans and did not adjust well to life in Kilgore. She told him, "I am tired of sitting in this small town with three kids and nothing to do. In New Orleans I could have a nanny to help raise the children and attend social events with my friends." Trevor tried to help her adjust but he was working long hours at the trucking company. Marilyn complained to Trevor and Shelia that she was lonely and that Trevor needed to spend more time at home helping her with the children. Shelia told Marilyn that the children were her responsibility and that Trevor was fulfilling his responsibility by working twelve or more hours per day. After one year of living in Kilgore, Marilyn left Trevor and took the children to New Orleans to live with her family.

Figure One – Genogram



## TREVOR IS MARRIED TO THE BUSINESS

Trevor buried himself in his work and tried hard to make his parents proud. In 1989, John died suddenly of a heart attack. Shelia owned the entire business and asked Trevor to take over all of the daily operations activities. She remained in charge of the internal business operations. This arrangement worked well for three years although there were times when Trevor and Shelia had conflict regarding changes that Trevor wanted to make in the business. In 1992, Trevor bought his mother's share of the business, and she stopped actively participating in the business. However, she did retain an office and would often come to the business and ask around about how things were going.

## TREVOR FALLS IN LOVE AGAIN

In 1991, Trevor's high school sweetheart, Carolyn, moved back to Kilgore with her young daughter Diana. They started dating and found themselves in love again. Trevor had a lot of guilt regarding the type of relationship he had with his three children from his first marriage. Trevor once told Diana, "I regret that I am not able to spend much time with my children by Marilyn so I always send them money to let them know I am thinking of them". The children lived in New Orleans, and he was working 90 or more hours per week so there was no time to visit. His mother discouraged him from having them visit Kilgore because she didn't want to have to take care of them while Trevor worked. Although he didn't have much of a relationship with his children, he spent time with Carolyn's daughter and found himself enjoying being with both Carolyn and Diana. Carolyn's ex-husband had basically abandoned the two of them, so she was happy that Trevor had established a strong relationship with Diana.

## RECIPE FOR DISASTER

Trevor proposed to Carolyn in 1992, and they were married in January of 1993. Trevor also adopted Diana that same month. Carolyn wanted to help Trevor develop a stronger relationship with his three children so she started arranging for them to visit in Kilgore during breaks from school and during the summer months. No matter how hard she tried, the visits always ended in disaster. The three kids were very jealous of Diana and the relationship she had with their dad. Also, Diana grew increasingly jealous of them as they repeatedly told her "he is not your real dad and he loves us more than you." Marilyn also was jealous of Diana and Carolyn. She poisoned her children against them and encouraged them to make their visits as unpleasant as possible. Carolyn kept trying to build the relationship, but it was a losing battle. Trevor tried to make everyone happy by buying them things they wanted and giving them special spending money from his bedroom safe.

Unfortunately, the visits became further apart in time and the resentment between the children grew. The interesting thing that Carolyn noticed was that their grandmother, Shelia, had started contacting the three children more and was working on developing a closer relationship with them. To Carolyn's dismay, Shelia was not happy to be around Diana. In fact, Shelia always harshly judged Diana to the point that Diana did not want to spend any time with Shelia.

## HIS AND HERS JOIN THE FAMILY BUSINESS

Carolyn was really happy to have reunited with Trevor, and she spent her time trying to make sure that she made his time at home as happy as possible. She cooked his favorite meals, planned fun day trips to provide quick breaks from work, and worked hard to develop a relationship with his mom and his children. When it became apparent that the visits to their house weren't going to work out, she planned trips to New Orleans where she and Trevor would go and spend time with the kids there. As the three grew up, his two daughters did not show any interest in the family business. They were content to receive the financial perks provided by the company. However, Steve asked Trevor if he could work in the business and Trevor was elated. Steve and his wife, Jennifer, moved to Kilgore immediately after their high school graduation so that they could learn the business. Jennifer was given a job in the office, and Steve started rotating through the various jobs that Trevor had learned early in his employment at the trucking company. Trevor hoped that Steve would eventually be groomed to take over the family business when Trevor retired.

Diana decided that if Steve and Jennifer could work in the business that she wanted a job there also. Trevor and Carolyn both tried to discourage Diana from working at the company. Trevor did not want her anywhere near the shop because of the foul language that the male employees used. Carolyn didn't want her to work in the office with Jennifer due to the conflict between the children. Diana was headstrong and prevailed. She was hired to work in the office, but often got bored and would leave work to go shopping. Jennifer fumed every two weeks when she prepared the payroll and had to cut a healthy check for Diana even though she never put in a forty-hour week. Carolyn actually overheard Jennifer telling Steve one afternoon at the shop "Diana is a total waste of a person – it is too bad that your dad lets her think she is a princess the way she comes and goes from work as she pleases."

## EVERYONE WANTS SOMETHING FROM TREVOR

Trevor had established the practice of trying to keep everyone happy at the business and within the family by throwing money at them. For example, he knew that Steve was stealing from the business but did not report this to the police and press charges because Steve was his son. He also realized that Diana was not earning her pay, but he liked it best when she was not at work. Eventually he helped Diana start her own interior decorating business by cosigning on a loan for her. Steve knew that Diana's English degree from college probably didn't provide her with the skills necessary to be successful, but he really didn't care about the money. It didn't surprise him when Diana told him a year and a half after she opened the business that she was shutting it down by declaring bankruptcy. He expected that she had spent the loan on renting an office space and decorating it.

Trevor's other two daughters, Tiffany and Mary, viewed Trevor as their personal banker. For example, he provided substantial loans to both of them for down payments on their homes. In addition, he instructed Carolyn to always purchase extravagant gifts for them on special occasions. When Trevor and Carolyn visited them after they had reached adulthood in New Orleans, Trevor would always leave envelopes with at least $500 cash for each when he was returning to Kilgore.

Non-family employees of John Blaine Trucking, Inc. also benefitted from Trevor's generosity. He loaned or gave money to several of his employees for personal needs. Clearly Trevor was a giving person; however, Trevor often found himself wondering "how much more will I have to give to bring this family together?"

## THANK GOODNESS FOR BRAD WILLIAMS

Diana married the love of her life (James) in 1996, and they had a son, Trent, before they divorced. James and Diana had used recreational drugs during their college years and James continued to use them after their marriage. Diana tried to get James help and begged him to go into a facility for treatment, but he was not successful in kicking the habit. Unable to recover from the death of his father, James died tragically when he hung himself.

Having no idea how to function without James, Diana returned to Kilgore so that her parents could help her sort things out and provide support in raising Trent. She worked part-time and had financial assistance from her parents. Trent was able to spend a lot of time with his grandparents and developed a very close relationship with them. Diana worked on the development of her social life and became pregnant with her second child, Nora. Nora was a surprise, and Diana chose not to marry Nora's father. Trevor and Carolyn were upset with Diana's behavior but did not want to turn their backs on her, especially because of their love for Trent. Nora also won their hearts and they served as the stable presence in both of the grandchildren's lives while Diana sorted out her personal life. She returned to school and pursued her master's degree in psychology.

Brad Williams met Diana through some mutual friends, and he fell in love with her and both of her children very fast. Brad had moved to east Texas to help coach one of the Texas Louisiana League baseball teams. He started taking Trent to peewee baseball games and then served as the coach of Trent's team. He and Diana married and Brad eventually went to work for the trucking company also. Diana's parents and her children were very happy to have Brad in their lives. He provided the stability that the children needed and he became the dad that neither of them had. Both Trent and Nora were excited and proud when Brad legally adopted them.

Trevor was very proud of Brad's eagerness to learn the trucking business and the hard work and long hours that he was willing to invest. Trevor began spending a lot of time with Brad teaching and mentoring him. This fact was not lost on Trevor's son, Steve. Steve was very upset about this new relationship, and he used this as an excuse to steal more from the business. After all, he was Trevor's real son and should be entitled to whatever he wanted from the business. Trevor chose to "look the other way" each time this happened because he felt guilty. He knew that he could not trust Steve to run the company and keep it going. If fact he had discovered that Steve had been coming to work often stoned and actually caught him smoking marijuana on the company lot. Trevor was relieved to have Brad at the company and began to often think that "Brad represented the company's future".

## UNTIMELY ILLNESS FOR TREVOR

By the year 2000, Trevor and Carolyn really believed that they had been able to develop tolerable relationships between all of the members of the family. Trevor's mom had developed a cordial position and the grandkids were the fun part of their lives. Their relationship with Trent and Nora deepened. Trevor traveled periodically to see his two daughters and they seemed to be satisfied with this arrangement.

During this time, Trevor purchased a million dollar touring bus. He felt confident in the ability of Brad to run the company while he and Carolyn traveled. They really enjoyed driving to Colorado and New Mexico and exploring these areas. It was also fun to take the grandkids with them on shorter trips. Trent was turning into a good golf partner and Nora was a beautiful young girl who liked to entertain them with her great sense of humor. Since Brad and Diana still faced financial challenges because Diana like to shop a lot and spend money, Trevor and Carolyn often bought the grandkids items they needed or wanted. Also, they kept a local country club membership so that the grandkids could swim, golf, and play tennis with their friends during the summer. As the grandkids got older, the grandparents would send them to expensive summer camps so they could get out of the small town of Kilgore and learn more about the world in which they lived. Diana enjoyed having her parents help with the children and often asked them for more money to buy things that the kids needed.

Unfortunately in 2002, Trevor was diagnosed with cancer. He and Carolyn faced this with grace and fought the cancer as hard as they could. Trevor was able to live for ten years after the initial diagnosis. He had periods of good health during this time, but the cancer always returned at some point in time. Both Trevor and Carolyn would seek out new treatments and when offered the opportunity, would travel to participate in medical trial tests. Diana and her children were a welcome relief from the cancer focus that invaded Trevor's and Carolyn's lives. During the last five years of her father's life, Diana had finished her master's degree and was working at a local junior college to earn money to supplement her husband's salary from the company. There never seemed to be enough income to cover her spending habits, even when Trevor would get money from the "magic" bedroom safe periodically and give it to her to buy things for the grandchildren.

During the last couple of years of Trevor's life, Diana and Brad started experiencing difficulty in their marriage. Carolyn started getting frequent telephone calls from Diana who complained a lot about Brad spending too much time on the golf course and drinking too much with the guys. Diana also complained that Brad did not spend enough time with the children. Carolyn would patiently listen to Diana and try to explain to her the pressure that Brad was under at work. Diana finally started telling Carolyn that "one of these days I am going to divorce Brad and kick him to the curb with nothing. I will have all of the money from the business to myself!" Carolyn was very disturbed by Diana's behavior and comments but there was nothing she could do. When she tried to talk to Diana rationally, Diana would start screaming and arguing with Carolyn, so it became easier for Carolyn to keep quiet.

Diana quit working the final year of Trevor's life to help Carolyn take him to doctor appointments and with other things as needed. At this point, Diana was put back on the payroll at the family business. She became very focused on controlling both Brad and her mother. Diana assumed that her mom would need her after Trevor's death, and she began planning her mother's future before Trevor passed. Diana also felt it was a good thing for her to have more time at home with Brad and the children. She wanted to take better care of Brad by preparing nutritious meals for him and supporting him as he took on increasing responsibility at the business. She also felt the need to have more quality time with her children as they were of high school age. Carolyn was encouraged by the seeming change of heart towards Brad, but she knew from past experience that it might not last long. Diana seemed to be developing quite a range of emotions and Carolyn learned that they varied on a day by day basis. She grew worried about Diana. Brad was also worried about Diana and they were having a lot of arguments. Brad once told Carolyn "I just don't know what to do anymore. She acts like she cares for me one day, and the next she is screaming at me that she wants a divorce. I would go to counseling with her if she thinks that will help us survive because I really love that woman!"

Throughout the ten years of his illness, Trevor continued to work daily at the business. It wasn't until his last year that others began to question his ability to make solid business decisions. Brad and others tried to talk with Trevor to make sure that he had everything in order and that Carolyn would be well taken care of. Trevor assured everyone that he had engaged the services of the family attorney to prepare the transition of the company ownership and to help with estate planning. However, he refused to talk about the specific details with any of the family members. This resulted in a lot of speculation and power plays within the family. As the levels of uncertainty increased, old rivalries emerged and Trevor's mother (Shelia) began to question Trevor and Carolyn about the company's finances and performance. The conflict intensified after Trevor's death as all of the family members worked to make sure they got their "fair share" of what they believed they were owed.

Diana became very vocal about what she considered to be hers. Although Carolyn was in good health when Trevor died, Diana began to treat her as if she was incapable of taking care of herself or making decisions regarding her future. Carolyn found this to be humorous at first because during the time that Trevor was ill, Carolyn was taking care of both Trevor and her own mom. Her sense of humor soon wore thin when Diana announced that she would be going to all of the meetings with Carolyn. Diana also began to plan expensive trips for her and her mother because she believed her mother needed to travel and get away from the stress of everything. Carolyn looked forward to paying for the trips and spending time with Diana at first. She hoped that spending this time with Diana would bring them closer together so she considered the money well spent.

After the second trip to Colorado, Carolyn soon learned through Diana's comments that Diana considered the estate and money to be hers since she was Carolyn's daughter. As a matter of fact, Carolyn was appalled by Diana's attitude and the hateful manner in which she discussed Trevor's other children. Diana also let Carolyn know that she would not approve of Carolyn even dating anyone else for several years because it would take her that long to get over the loss of her dad. Carolyn found herself thinking "my goodness, if I have to wait to date someone for three to five years, I will be at least 75 years old".

## UNRAVELING THE WEB OF CONFUSION REGARDING THE ESTATE

When the family attorney read Trevor's will to all of the family members at a meeting in his office, anger immediately erupted and the old conflicts were intensified. Carolyn sat in shock as she listened to the legally binding plans Trevor had made for the company and for her personally. She was overcome with anger at him not only for dying, but also for how he had left things and how poorly they were thought through. She felt sure that he had not meant for their personal house to be included in the business estate. It horrified her to think that his children and mother could band together and force her out of her house.

After the initial meeting, the extended family divided into camps. Trevor's mom and his children from his first marriage started meeting and planning a strategy to make sure that Diana and her children would not benefit more than they did. Trevor's mom, Shelia, started visiting the office more and demanding that she be allowed to review company records, etc. Shelia was a millionaire but wanted more. Carolyn was not surprised when she received notice that she was being sued personally and, as the owner of the company, for debt that she did not know existed. Sheila and John had loaned Trevor $500,000 to expand the company before John died. There was no formal note or repayment arrangement between them, and they had told Trevor that he really didn't need to pay them back. Now Carolyn had to fight this debt in court. Steve became more brazen at work and took tools and gas from the business as he pleased. The two daughters were not happy with the arrangements in the will because they believed that Diana benefitted more than they did. Also, Trevor had left two signed notes in his paperwork which the daughters had signed on the loans for the down payments on their houses. Although they had signed them, they believed that Trevor had never meant to collect the money. Now they were faced with having to repay $50,000 each, which neither of them had.

Carolyn met with Trevor's attorney several times and began to mentally question if he knew what he was doing. There were inconsistencies in what he told her from one meeting to the next, and her accountant also pointed out issues that he was concerned with. Diana insisted on attending all of these meetings so that she could "take care of her mother". Carolyn was often blocked from asking questions and stating opinions in these meetings by Diana. Also, Diana insisted that other attorneys be brought into the situation, so Carolyn hired another set of attorneys and a CPA who specialized in family business. This was done to help her sort things out and develop a strategy to deal with the legal issues surrounding the business. The original attorney was a longtime family friend that Trevor trusted but these actions cost the friendship of the longtime family attorney.

Diana grew increasingly hostile about the family business situation and kept pressing Carolyn to take actions to eliminate the other children's interest in the business. At the same time, Brad was calling Carolyn more frequently about business issues, including the increasing marital pressures he was receiving from Diana. Diana kept telling him, "I am going to divorce you and have my mom fire you as the head of the company. You will then be nothing and have nothing".

Their children Nora and Trent were also increasingly feeling the stress from Diana's constant fighting with Brad. Nora's performance in school started to decline and Diana started taking Nora to counseling. Diana insisted that the decline in school performance was due to Nora's ADHD. Nora privately confided to her grandmother that

Diana and Brad were screaming all of the time at home and that she couldn't concentrate on her school work. Trent had graduated from high school and did not have a clear path for the future. He tried several options but each time the going got tough, either Brad or Diana rescued him. He missed the application deadline for college and was supposed to work in the pipe yard at the business. The company rented an apartment for him. Unfortunately Trent was not very motivated to show up for work on time. He spent his time drinking with his friends and having his girlfriend spend the night. Some days Trent decided he didn't have to go to work at all. His grandmother finally had a talk with him about his lack of performance and he decided to enroll in the military. Trent was excited to be accepted for sharp shooter school and started working out and training. Unfortunately he did not pass the physical requirements when it was time for him to depart so he did not get accepted into the elite program.

Nora was not having much success improving her grades as the summer break approached. Diana decided to separate from Brad and to take Nora with her. To address the school problems, Diana researched home school as an option and enrolled Nora in an online home school program. The timing was not too good for this move as Diana was starting a new career and would not be home much during the day to help and guide Nora. Trent had decided to open a pool cleaning business and was seeking a loan to get the equipment he needed to get started. His parents agreed to co-sign on the loan with him at the company bank. At the last minute, he decided that he did not want to go into debt and opted out of the offer of the loan. Diana decided that he should become the main marketing representative for the company and be put on the payroll in this capacity. Fortunately an opening in the pipe yard developed and Brad placed Trent there so that he could learn the business from the bottom up.

Carolyn was trying to be a support role for the two kids and was very concerned about Diana's behavior. There was no way she was going to terminate Brad. Brad was doing a great job for the company and she loved him like a son. At times Carolyn found herself wondering "did Trevor leave things the way he did due to the tremendous amount of guilt he carried about the way he treated his first three children throughout their lives?" She also knew that the company was earning high profits during this new boom period in the East Texas oil fields, but that a bust would eventually come back around and the value of the company would go back down.

## WAKE UP CAROLYN

The demanding ringing of her cell phone woke Carolyn up from her nap. She was even more tired than when she laid down because her dreams were about the mess that Trevor had left the business and her in. As she looked at the phone she saw that Diana was calling her. Instead of leaving a voice mail message, Diana had redialed Carolyn three times. Carolyn resigned herself to the fact that Diana wasn't going to quit calling so she answered the phone. As Diana began speaking, Carolyn heard Diana say "I need a raise to help me with my business and personal problems…you have the money and it is mine too."

Carolyn began thinking that selling the business and buying out all of the interests in the trust might be the best solution. Or she could just pack a bag for her and the family dog, and run away!

# TINY'S TINY PIES: PIE IN THE SKY

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## CASE DESCRIPTION

*Tiny's Tiny Pies has been in Austin, Texas since 1976 but only emerged as a Limited Liability Company in November 2010. Tiny Pies are made with all natural ingredients and without preservatives. They come in a several different sizes including the original 3" Tiny Pies, the traditional 9" Not So Tiny Pies, Teeny Tiny bite size pies, Pie Pops that come in different shapes and on a stick and the 1/2 pint Mason jar pies. These products can be found in Austin, Dallas, San Antonio and Houston, mostly in Central Market stores and they also ship within the contiguous United States. Tiny's Tiny Pies also caters weddings, corporate and other special events and offers cooking and baking classes locally.*

*Jack Horner is a fictitious millionaire that wants to return to his Texas roots after a 30-year hiatus, but he has no desire to retire. He is actively looking for a business interest that would provide both an opportunity to return to Texas and a daily challenge to grow and prosper in the community. A chance encounter puts him in touch with the owners of Tiny's Tiny Pies and he is now weighing the opportunity to partner with these entrepreneurs.*

*The case is examined from Jack's viewpoint that he has an opportunity to partner with the current owners, or possibly buy them out altogether. Jack is on a four hour flight from Austin to San Francisco as he reviews basic information about Tiny Pies, the pie industry, and other factors relevant to the investment decision.*

## CASE SYNOPSIS

*This case offers a multitude of teaching opportunities but is centered on Jack's evaluation of Tiny Pies as an investment/partnering opportunity. Jack's analysis of Tiny Pies looks at the products, the buyers, the markets, competitors, and growth potential for the company. This case could easily be turned inside out and challenge the student to evaluate from Tiny Pies' perspective whether or not a partner is desirable.*

*Students can evaluate Jack's analysis of Tiny Pies and determine whether enough information has been identified to allow for an informed decision. They may decide that additional information is needed.*

*The case can easily be turned upside down so that the student is challenged to view the case from the owners' point of view. Questions then can address the needs of the business, including, but certainly not limited to, whether or not taking on a partner or selling are viable alternatives.*

*An undercurrent to the entire case is Jack's familiarity with Amanda. They were good friends in high school but drifted apart over the years. Had fate brought them together again? He felt as if he was home again.*

*He wants to return to his roots, return to Texas. The fact that he would be working with an old friend is appealing. This will give him an opportunity to actually run the day-to-day operations of a business. He has yet to actually run a company, become a part of the operations.*

## TINY'S TINY PIES: PIE IN THE SKY

### All about Jack Horner

Jack Horner powered down his I-pad and sat back in his seat as United Flight 6805 destined for San Francisco taxied toward the runway. He stared out the window as the plane barreled down the runway and lifted off, leaving Austin, Texas fading into the dusk. His mind was racing as he processed the past few days.

Jack Horner had grown up in the Hill Country of Texas, just outside of Dripping Springs. He went to Tarleton State in Stephenville, Texas to run cross country and track. He managed to graduate with a business degree in 1984 and thanks to a connection one of his track buddies had with a brokerage firm in San Francisco, he applied for and was accepted into a financial management apprenticeship program. He packed his bag and headed west for what he figured to be a year or two at most. Now thirty years later, he was still out west, but with more wealth than he could have ever imagined and a strong yearning to get back to his Texas roots.

He knew that just going back to Texas would never be enough. He needed to be busy so he started looking for something to do. He needed something to build. He wanted to become part of something that would give him purpose. He wanted to work with people and make something that everyone would enjoy. He'd spent too many years just studying numbers. It was time that he did something for himself. Heck, he even thought about opening or buying a bar on 6th Street in Austin. As fate sometimes has it, Jack had come back to Texas to attend his nephew's wedding. The wedding reception had been catered by an outfit out of Austin.

One of the things that captured his attention was the half pint Mason jar pies. One thing led to another and Jack soon had the telephone number of Amanda, co-founder and co-owner of Tiny's Tiny Pies and the creator of these half pint delicacies. While throwing rice on the bride and groom, Jack dialed Amanda's number and was flabbergasted when, after he introduced himself, the voice on the other end turned out to be a long lost friend. The next day Jack eagerly drove to the meeting with Amanda. Wow. She looked amazing, even better than he remembered. For a long while they gazed at each other and rapidly filled in the lost years. Jack was fascinated listening to Amanda tell of the history of Tiny Pies, how it all began when her young boys wanted to take pie in their school lunches, and how recently they'd really gone all in and stepped up the production and distribution. Jack could sense that the business side of baking pies was a bit over-whelming.

As Amanda led Jack on a tour of the baking room, she talked about all the things she had to do, and she sighed when telling Jack that her mother would be retiring next month. When Amanda admitted that help was needed to grow and run the business side of baking, Jack told her of his desire to come back to Texas and expressed an interest in exploring partnership opportunities. They laughed at the idea of working together, both enjoying memories of their high school days.

Now, with so much more to think about, Jack excitedly powered up his I-pad and opened up some research he'd downloaded as he lingered in the United Club prior to boarding. Years of experience taught him to research every inch of a company before making an investment, and this time, he was considering investing more than money; he would be investing himself.

For the first time, he was going to become part of his investment's operations. He was going to be there, hands on, helping to make the day-to-day operating decisions. Can he do this? It is one thing to identify investment opportunities, yet quite another to actually manage the business itself.

**All about Tiny's Tiny Pies**

The first file Jack opened contained the web information on Tiny's Tiny Pies (Tiny Pies, 2013). He read the story about Amanda Wadsworth and her mom Kit Seay making their pies from old family recipes. He noted that high quality all-natural ingredients were sourced from local farmers markets. He studied each product: the nine inch Not So Tiny Pies, three inch Original Tiny Pies, bite size Teeny Tiny Pies, pie on a stick called Pie Pops, the half-pint Mason Jar pies, Cinnamon Pie Poppers, and Cheddar Cheese Straws.

He learned that their products are sold at farmer's markets, catering events, on-line sales, and traditional wholesalers to retailers. It didn't surprise him to learn that catering weddings, corporate events, meetings, and any other special event was a big part of the Tiny Tiny Pies' business.

The customer service philosophies of Tiny's Tiny Pies were demonstrated by free tasting events where they allowed potential customers to select and try four different pie flavors. For out of town customers they would ship the samples and all the information the customer needs. They ship most of their products anywhere in the contingent United States. The company also offers Tiny's Tiny Pies or ½ Pint Mason Jar Tiny Pies packaging with a brand, logo, or other customer specified design. The last thing he read about Tiny's Tiny Pies described baking classes offered as a girls' night out event or any other specialty parties.

As he closed the file on Tiny's Tiny Pies he thought that for a mother/daughter company with six employees, they sure do seem to have a lot going on.

**All about Pie**

The flight attend poured Jack a cola as he closed one file and opened another one on the pie industry. He'd invested in food companies many times but he had learned to revisit the industry before making a critical decision. He took a sip and began to read.

> Most U.S. consumers do not think about pie until the winter holidays. Pies, for the most part, are a seasonal treat. Seasonal trends aside, pies from the fresh in-store bakery have significant year-round sales potential, totaling $600 million in 2012 (Nielsen, 2013). Pies were predicted by food media and industry experts to be the "it" dessert of 2010, but it often takes time for pop culture food trends to develop and flourish in grocery stores. With that being said, pies have been gaining ground in the in-store bakery department in 2012 as it was fueled by an insurgence of mini pies and indulgent flavor innovations.
>
> The majority of pie sales occurred during the last two months of the year leaving another ten months of opportunity for retailers to fill. During this ten month time frame, $234 Million in revenue is available for gain if Pies can diverge away from a seasonal trend towards a more year round product (Nielsen, 2013).
>
> Pies have a strong nostalgic essence about them, and consumers are responding with a resurging interest. In 2012, pie sales growth outpaced most other in-store dessert categories, including cookies, cakes and specialty desserts. The products behind this growth are not your traditional eight-slice apple and pumpkin pies. Rather, retailers are cashing in on innovations involving smaller portion sizes and unique flavors.
>
> Mini pies are the fastest growing pie on retail shelves. Though they make up less than 10 percent of the category, they racked up sales growth of 22 percent last year, outpacing the nearest sub-category by 12 percentage points (reference). The mini pie sub-category grew sales by 22 percent last year as more stores brought them into their assortment in an effort to appeal to smaller households. Individually sold pie slices are following the same upward trend as minis, as sales grew 18 percent in 2012, proving consumers are looking for a personal-sized pie experience (Nielsen, 2013). Consumer preference for mini pies and smaller pie slices opens the door to a key opportunity to make pies an everyday dessert for any household rather than just a holiday dessert for large gatherings.

> Pies will always have a place at holiday celebrations, but not just those occurring during the fourth quarter. In 2012, pie sales increased on each of the major spring and summer holidays compared with the prior year. Tying pie purchases with other commonly purchased categories for Easter, Memorial Day, Independence Day, and Labor Day celebrations provides another leverage point to gain that one additional pie purchase and close the opportunity gap for the category (Figure 1).
>
> While no one can deny consumers' love for traditional pie flavors like apple and cherry, a good portion of recent growth has come from new flavors. Key lime, peanut butter and banana cream accounted for double-digit growth last year, highlighting consumers' desire for alternatives to the traditional favorites. But it's important for retailers to not abandon those long-standing iconic flavors such as apple, pumpkin and cherry as they still account for 47 percent of all pie sales (Nielsen, 2013).

Jack closed the file and finished his drink. He digested the information and thought about how Tiny's Tiny Pies could prosper in this industry. The low battery light flashed on his I-pad so he got up to retrieve his briefcase from the overhead storage. Plugged in again, Jack opened another file.

**All about Catering**

Tiny's Tiny Pies catering service captured Jack's attention at the wedding reception. Until that time, Jack had never thought of catering as an industry. He opened the file that he'd hastily saved back at the airport and began to read.

> Companies in the catering industry provide single-event food services at customer-owned and company-owned facilities. Within this industry, there is not a single leader in regards to service, market share or annual sales. The US catering industry includes about 10,000 companies with combined annual revenue of about $7 billion. Additionally, moderate growth is forecasted during the next two years. Key growth drivers include locally sourced foods, mobile technology, and social media (First Research, 2013).
>
> Catering demand is driven by corporate profits and consumer income. The profitability of individual companies depends on cost controls and effective marketing. Large companies have advantages in offering expanded services such as facilities management, room rental, and entertainment. Small companies can compete effectively by serving small groups and offering personalized service. The industry itself is highly fragmented allowing for the top 50 companies to account for less than 15 percent of industry revenue (First Research, 2013).

> The Catering industry is in the mature stage of its industry life cycle. The industry's value added (IVA), a measure of an industry's contribution to GDP, is expected to rise at an average annual rate of 1.8% during the 10 years to 2018 which compares with GDP growth of 2.1% during the same period. Generally, industries that grow at a similar rate as the US gross domestic product are considered to be mature. In addition, the basis of the industry's business is widely accepted in its current form and has not experienced any major technological change (IBISWorld, 2013).

Jack closed the file on catering and reflected on the highly fractured and highly competitive nature of the industry. While it wasn't the primary source of income for Tiny's Tiny Pies, it was income producing and also an excellent venue to market the product. He wondered how many opportunities existed for catering in the Austin area and how many caterers were vying for these jobs.

**All about Competition**

With competition on his mind, Jack opened a file and looked at several miscellaneous things he'd found that he felt were related to Tiny's. From direct competition with major brands to health conscious eating, there is always one more thing to think about. Jack continued to read.

> While most pastries are not thought of as being healthful, pies may be some of the least unhealthy pastries. As Americans are constantly reminded of how much larger they are getting, they may seek the warmth, comfort and love in each form of Tiny's Tiny Pies to help get them through dessert with some form of fresh fruit and potentially fewer calories than cakes, cupcakes and candy.
>
> With their 9" frozen pie crust, Tiny's Tiny Pies competes with all the major brands in the pie industry. In 2010, the top supplier for frozen pies was Schwann with over $155 million in sales, the second supplier was American Pie with over $91 million and the third was Sara Lee with over $74 million (AIB International, 2010). Even though Tiny's Tiny Pies is not that big, they are going to have to compete with all the companies no matter their size.
>
> In the world of weddings, as far as the dessert, most people think of cakes and cupcakes. Humans are creatures of habit. When a girl thinks of her wedding day, she thinks of cake as the traditional dessert. As wedding cakes become more expensive than ever, trending in the wedding dessert category are cupcakes. They are less expensive than wedding cakes, and they are easier to serve and eat than cake. They eliminate the need for expensive serving utensils and plates.

> Bridal shows throughout Texas present many potential customers for Tiny's Tiny Pies to enable customers to sample the product and include it in the wedding plans. Pinterest, Facebook, and YouTube can keep the interest in Tiny's Tiny Pies alive as people pin their favorite flavors and recipes, take photos at the bridal shows and weddings and post them on their own Facebook pages and Twitters. The electronic "word-of-mouth" will give Tiny's Tiny Pies the reach they need to grow the business.

Jack remembered Amanda talking about these bridal shows. The wedding market may represent growth opportunity for Tiny's Tiny pies. Television programs such as "Four Weddings," "Bridezilla," and "Say 'Yes' to the Dress," enable coast-to-coast viewing audiences to see the latest trends in wedding couture and menus. These programs can enable Tiny's Tiny pies to enter the wedding market via product placement as "the" absolute best dessert to offer wedding guests.

Amanda had mentioned making a bid to have Tiny Pies placed in a movie being produced in Austin. She was excited for the opportunity but was unsure what the impact would be on production. If they get that movie spot they would most likely need more equipment, possibly a larger building, and definitely more employees. She was concerned whether they could provide enough product if they were awarded the bid. But, it is exciting to make such a bid and it represents a huge opportunity. She did not know if she could take care of orders for her current customers and fill the product requirements for the movie placement.

Jack looked down at his watch and calculated that he had about an hour before landing in San Francisco. He had one more file to review.

**All about Demographics**

Although Jack had grown up in Texas and had gone home for visits once or twice each year, he really hadn't paid much attention to anything other than enjoying time with family and friends. Now he turned his undivided attention to relearning his native state. He opened the file and began to read.

> The Third Coast, which stretches along the Gulf of Mexico from south Texas to western Florida, is projected to grow another 18% the coming decade.
>
> The energy industry and burgeoning trade with Latin America are powering the Third Coast, combined with a relatively low cost, business-friendly climate. By 2023 its capital--Houston--will be widely acknowledged as America's next great global city. Many other cities across the Gulf, including New Orleans and Corpus Christi, are also major energy hubs. The Third Coast has a concentration of energy jobs five times the national rate, and those jobs have an average annual salary of

$100,000, according to EMSI. As the area gets wealthier, The Third Coast's economy will continue to diversify. Houston, which is now the country's most racially and ethnically diverse metro area, according to a recent Rice study, is home to the world's largest medical center and has dethroned New York City as the nation's leading exporter. Mobile, Ala., seems poised to become an industrial center and locus for trade with Latin America, and New Orleans has made a dramatic comeback as a cultural and business destination since Katrina.

At the time of the Civil War the southeastern United States was both out-peopled and out-manufactured. Today the Southeast is the largest region in terms of population (60 million) and is establishing itself as the country's second industrial hub, after the Great Lakes.

It is attracting large-scale investment from manufacturers from Germany, Japan, and South Korea. Although most of the region still lags in educational attainment, the education gap with the Northeast and Great Lakes is slowly shrinking. The population holding college degrees has been expanding strongly in Nashville, Raleigh, Birmingham, Richmond and Charlotte.

More babies and the migration of families, including immigrants, to this low-cost region suggest an even larger political footprint for the Southeast in the decades ahead. Population growth has been more than twice as fast since 2001 as in the Northeast, a trend that is projected to continue in the next decade. The region looks set to become smarter, more urban and cosmopolitan and perhaps a bit less conservative.

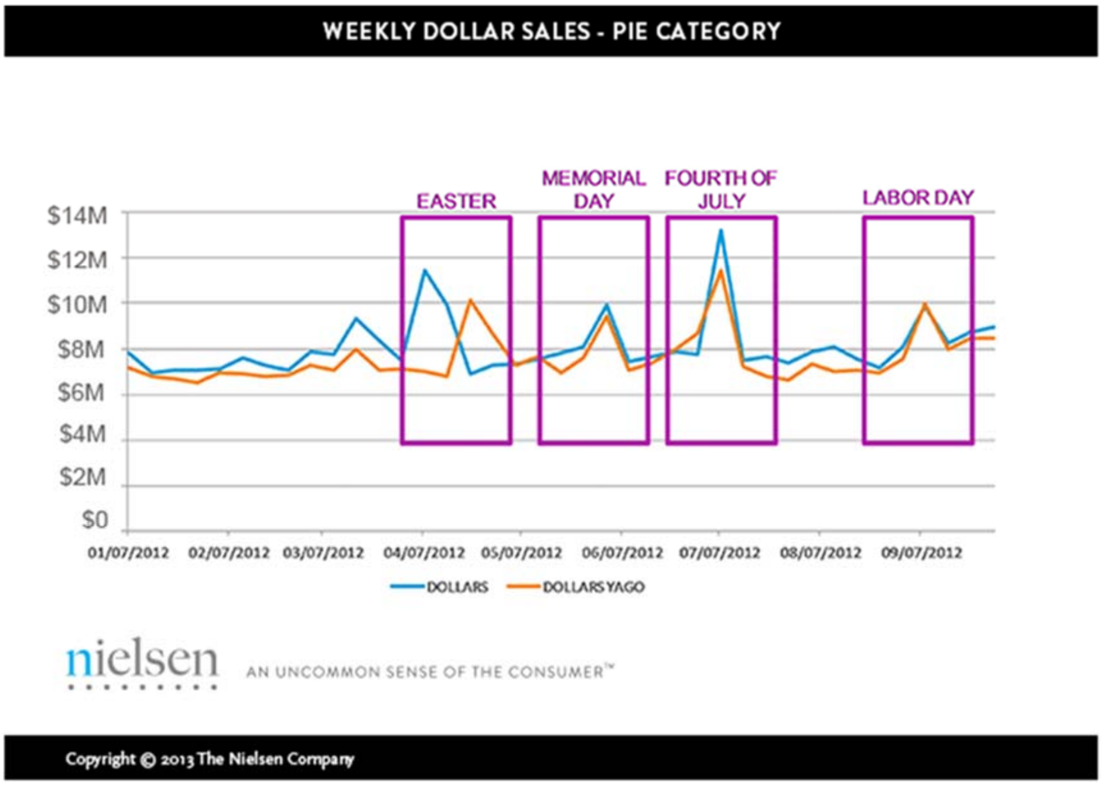
The Dallas-Fort Worth area and the Houston area are growing faster than anywhere else in the country and the Austin metro area is also growing rapidly (Stiles 2013).

The flight attendant announced that they were on final approach and asked for all electronics to be powered down. Jack obediently closed his files and powered off his Ipad.

## CONCLUSION

Jack stared out the window into the darkness. As the lights below grew closer and brighter, Jack thought about all that he'd seen and read these past few days. He enjoyed thoughts of reconnecting with an old friend and the possibility of going home to work with her. He felt confident that Tiny's Tiny Pies is a great company with an abundance of opportunities. He also knew that competing in a market that has been dominated by other desserts is going to be a challenge. As the wheels squealed on the tarmac Jack breathed a sigh of relief and knew that he had plenty to think about.

**FIGURE 1.**

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# THE GROWTH AND DECLINE OF THE NEW REVIVAL PENTECOSTAL CHURCH

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**Beverley J Alleyne, Belmont University**

## CASE DESCRIPTION

*The primary subject matter of this case is organization and taxation issue affecting a nonprofit organization. The case is appropriate for a senior or graduate level government and nonprofit accounting course. It could be used in the nonprofit portion of the advanced accounting class. The case is designed to be taught in one class hour and is expected to require approximately three hours of outside preparation by students. The events described in this case are based on real world experiences, but all names have been disguised.*

## CASE SYNOPSIS

*The case concerns the humble beginnings followed by the rapid expansion and subsequent decline of the New Revival organization. New Revival Church ("the church") started as a small congregation in Brooklyn, New York. The church grew based on the charisma of its young minister, Pastor Thomas. The minister created an oversight board, the Board of Elders, to provide structure and to make decisions on behalf of the organization. However, decisions such as the building of a new church building, the expansion of New Revival through the creation of daughter churches, and the acquisition of bank loans, were made by the minister without prior board approval. The case demonstrates the challenges faced by some nonprofit organizations especially religious organizations, when management control is centralized and the corporate governance structure is either ineffective or nonexistence.*

## INTRODUCTION

The Reverend John Thomas smiled at his wife Rebecca as they rose from prayer. He knew in his heart that everything would work out but he couldn't see how at that moment. They had been praying off and on all weekend in preparation for a meeting with his church, New Revival Pentecostal Church's Board of Elders on Monday. He was going to have to tell his Board that the financial structure of the ministry and thus the mission itself was collapsing. After years of grace and favor, it appeared to Rev. Thomas that his ministry was unraveling and he needed a plan and –it went without saying- divine intervention would be welcome.

## THE CALL

Reverend John Thomas was 'called' to the ministry in February 1995. With no formal training, and only a high school education, Reverend Thomas (the minister) answered the call and started his ministry. He signed a store front lease in Brooklyn, New York, and established the New Revival Pentecostal Church (the church). The church had a very humble beginning with only 30 members - the pastor, his wife Rebecca Thomas, other family members, and close friends. Annual income was approximately $7,000. A banking relationship was established with a local bank and the minister was the only authorized signer on the account. Ms. Thomas assisted in the ministry by performing all administrative and financial duties. The minister was introduced to an accountant by a fellow minister, and used this person as an unpaid consultant on accounting and taxation issues.

Word started spreading in the neighborhood of the new church with the young dynamic minister and his fiery gospel message, and this attracted some interest from the neighbors. Within a year, membership had expanded to 70 members and the ministry expanded into the adjoining vacant storefront to accommodate the growing congregation. With this expanded membership, the minister felt emboldened to employ a part-time secretary to assume the administrative tasks performed by Ms. Thomas. Tracey Morgan was hired as the new administrative secretary, and the minister classified her as an independent contractor. As such, she was responsible for paying all taxes and the church did not assist in this process.

## YEARS OF GROWTH

The church expanded rapidly over the next five years, and the minister moved to a bigger rental space within the same Brooklyn neighborhood so that by the year 2000, the church had grown to 2,000 members with annual revenue of approximately $1,000,000. The new growth created the need for additional structure and the minister created a governing body, The Board of Elders (the board), to provide oversight of the church.

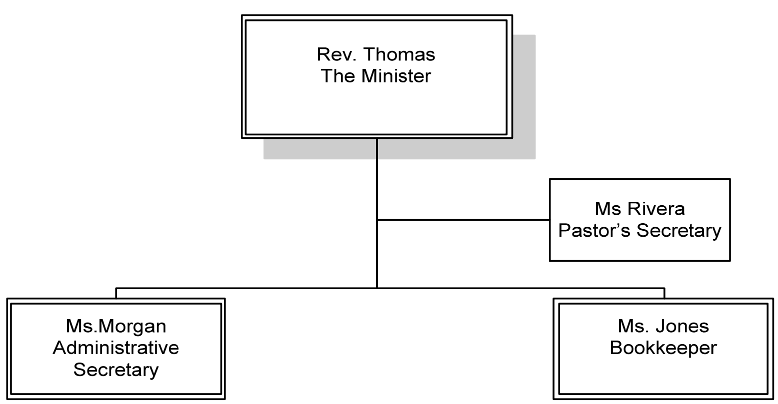
The Board of Elders consisted of five founding members of the church including Ms. Thomas, the minister's wife. As such, the board was very loyal to the minister who made all decisions regarding the church's operations. With the revenue growth, the church also hired two new personnel, Ms. Jones, as bookkeeper, and Ms. Rivera, as the pastor's personal secretary. Ms. Thomas continued in her role as the church's administrative assistant or secretary. The new employees along with Ms. Morgan were now classified as employees since the church had the income to absorb the payroll related expenses.

Ms. Jones was a member of the church but had no college degree or formal accounting training. However, she worked as an accounts receivable clerk in a previous job. The minister was comfortable that she was competent to manage and process the church's financial transactions and maintain the privacy and confidentiality of all information. Ms. Jones consulted with the accountant on an ad-hoc basis on accounting and tax related issues. The payroll function was initially performed in-house by Ms. Jones, but it was later outsourced to a payroll service provider.

The minister continued to be the sole authorized signer on the church's bank account. Members were provided with an annual statement showing contributions made to the church. The board was informed periodically of the church's financial position and financial information was shared at the annual members' meeting. However, the information provided was verbal and no questions were asked by the membership. The trust and faith in the minster was an informal understanding of the membership.

New Revival's personnel structure appears below:

New Revival Tabernacle
Personnel Structure




**NEW BUILDING**

With the increase in membership, the minister believed it was time for the church to have a permanent home. With the board's approval, the church purchased its current rental location along with the three adjoining storefronts in order to construct a new church building. To propel the project forward, the church obtained a $500,000 construction loan from a local bank based on its financial strength and its long term banking relationship. The minister was also asked to provide the bank with a personal guarantee since the bank manager believed that the minister was the driving force behind the congregation.

The building cost was projected at $1.5m to be financed by the construction loan and the church's building fund. The minister assumed the role of project manager and worked on all phases of the project including the building's design, and the selection of the contractor. The minister informed the board of decisions made on an ad-hoc basis. The church had begun a capital campaign through its building fund and received pledges of approximately $1 million from its members.

The construction loan required interest only payments during the construction period and the loan was expected to convert to a conventional loan upon completion of the building. New Revival was required to provide the bank with quarterly unaudited financial statements as part of the loan agreement. Preparation of the financial statements was the responsibility of Ms. Jones who was been increasing challenged by the growth of the church.

## THE CHURCH EXPANDS

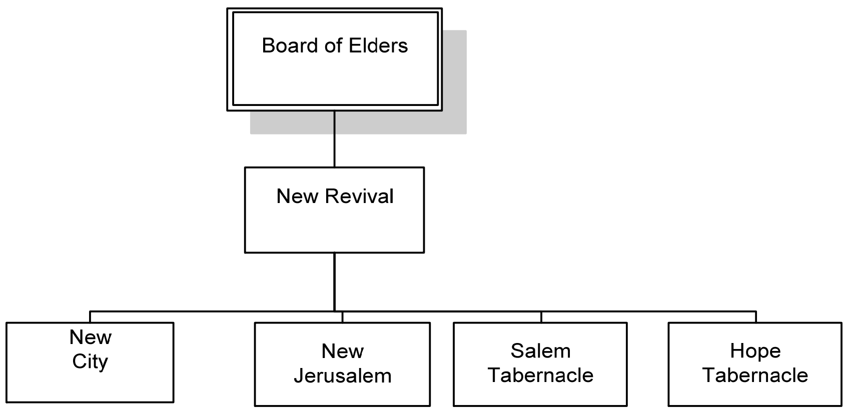
While the new building was being constructed, Rev. Thomas felt it was also time for the church to expand its brand or mission. He consulted with the board and easily received its approval to develop a new church now referred to as 'daughter'. The first daughter church was established in 2005 in a non-competing neighborhood in Brooklyn, New York. The goal was to expand without diluting the membership base. The church provided a non-interesting bearing loan to the daughter church as seed money so it could get started. The daughter church rented its worship space so the seed money was intended to fund six months rental and utility expenses.

The loan agreement was informal i.e., there was no loan agreement, so payment terms and a maturity date were never established. The minister appointed a dynamic young deacon to serve as pastor of the new church now called New City Revival Church (New City), and directed a few members to attend this church. These members were from the same neighborhood as the New City, so this directive was intended to shorten their commute to church. This new pastor agreed to work without compensation until New City was financially stable. This was expected to occur by the end of the first year of operations.

Three daughter churches followed, two in 2006 and one in 2007. New Jerusalem Revival and Salem Tabernacle were organized in 2006 and Hope Tabernacle in 2007. The daughter churches were established using the same approach as New City. As such, the pastors and the new churches all reported to New Revival on spiritual and financial reporting matters. In fact, New Revival maintained the operating accounts for all the churches, and paid the related expenses. The daughter churches were all located in different areas of Brooklyn, New York, to prevent dilution of the New Revival brand.

The new organizational structure for New Revival appears below:

New Revival Tabernacle
Organization Chart




## NEW CHALLENGES

The new organization structure remained intact for approximately one year before the daughter churches demanded more autonomy from New Revival. Among the churches' concerns were the use of their funds to help cover New Revival's construction and daily operating costs, and the lack of compensation. The ministers at the four daughter churches believed that they should have control over their funds and demanded to be separated from the parent, New Revival.

Meantime, change orders initiated by the minister increased the new building's cost by approximately $500,000. Fortunately, the minister was able to secure additional short term loans from a few affluent members to ensure the continuation of the project. These loans were expected to be paid from additional bank financing. The economic downturn impacted some of the members' income and they were not able to satisfy their financial commitments (pledges) made to the church. With declining revenue from the parent church and expanding building costs, the church was forced to reduce expenses, primarily payroll, by laying off all employees except the bookkeeper. As the only remaining employee, Ms. Jones assumed all administrative and financial duties for the New Revival organization.

As noted earlier, the church was able to continue the new building construction by using short term loans from members. The loans were non-interest bearing and were expected to be repaid in six months. With the need for permanent financing, the minister met with the church's bank to request additional loans to replace the members' loans and complete the building construction. An existing loan covenant required the church to provide the bank with quarterly unaudited financial statements. However, the bookkeeper was now performing multiple functions and was not able to maintain the financial information for the five entities on a current basis. The church had not provided the bank with any financial information for the last three quarters. Facing her own organizational pressures, the branch manager gave the church one week to comply with the terms of the original loan before the bank would consider the new request.

A week later, the branch manager contacted the minister to inquire about the financial statements. The bookkeeper worked as diligently as she could to ensure that the financial information was current, but she was overwhelmed by the number and complexity of the transactions, and was still a few months behind schedule. Since the church was unable to provide the requested information, the branch manager had no other option but to 'call the loan'. With no additional funding source available, work on the new church building was halted.

## A DAY OF RECKONING

Reverend Thomas did not take the default news lightly. He felt that his dream of answering the call to ministry and hence creating a legacy was unraveling. Under the circumstances, he needed time to absorb the news and develop an action plan before discussing it with the board. Since this was a Friday, Reverend Thomas decided to spend the weekend in prayer with his wife, before meeting with the board. After Sunday services, he met briefly with the board to arrange a formal meeting for the next day. At the Monday meeting, Reverend Thomas shared the default news with the board along with the halt in construction, and the challenges with the daughter churches.

The members of the Board were by turns astonished and infuriated at the news Rev. Thomas gave them. The Board was not aware that the financial statements were not current and provided to the bank as required. They asked that Rev. Thomas excuse himself from the meeting and in private session voted to place the minister on paid leave pending an independent evaluation of the organization. The evaluation soon expanded from the financial situation to the overall management of the church. The Board asked for a plan to avoid the loan default in the short term but also to put the church on more sound management footing to ensure its continuity. They asked Rev. Thomas to continue praying.

# EB03 BANK OF NIGERIA

**Basil Okoli, Baze University**
**D.K. (Skip) Smith, Baze University**

## CASE OVERVIEW

*This case invites students to play the role of Mr. Edi Agbam, a Nigerian who worked for many years at EB03 Bank of Nigeria (EB03 Bank is the disguised name of a real bank in Nigeria). At one time, EB03 Bank of Nigeria was the market leader in the banking industry in Nigeria; over the years, however, EB03 Bank has fallen from #1 to "emerging big bank." Currently, Mr. Agbam serves as a lecturer for the Faculty of Business Administration at Baze University, a new private University located in Abuja, Nigeria; yesterday, however, Mr. Agbam received an offer to take up a consultancy appointment with EB03 Bank, so as to assist the bank in developing a strategy to regain (in retail banking) the market leadership position it once held in Nigeria in many areas including retail banking. The case is appropriate for senior level undergraduates as well as students in MBA and/or executive development programs. It is designed to be taught in a one-hour and a half class session and is likely to require at least a couple hours of preparation by students.*

## CASE SYNOPSIS

*Mr. Edi Agbam, a former EB03 Bank of Nigeria employee currently employed as a lecturer at Baze University in Abuja, has been offered a consultancy at EB03 Bank of Nigeria, so as to assist the bank in developing a strategy to regain (in retail banking) the market leadership position it once held in the banking sector in Nigeria in many areas including retail banking.*

*Additional data and information in the case include:*

1) *For Nigeria, the Nigerian environment, and the Nigerian economy: Historical background plus selected statistics.*
2) *For the banking sector in Nigeria: Historical background plus selected statistics.*
3) *For EB03 Bank of Nigeria: Historical background plus selected statistics.*

## THE SITUATION

Sensing that his meeting with the Non-Executive Director of EB03 Bank was ending, Mr. Edi Agbam (a former EB03 Bank of Nigeria employee currently serving as a lecturer at Baze University in Abuja, Nigeria) gathered up his notes. Although he might, later on, need specific information from those notes, Agbam knew he would have no trouble remembering the challenge the Non-Executive Director had given him, that is, to identify (within the next 30 days) a set of alternatives for reviving and rebuilding (over the next 12 months) EB03 Bank's retail banking business in Nigeria. Because his teaching schedule was already quite intense, Agbam knew that taking on this assignment meant that for the next 30 days, he would be very busy.

## ADDITIONAL INFORMATION (1): BAZE UNIVERSITY

Baze University is a two-year-old private, for-profit university which aspires to provide a British style and quality undergraduate education to young men and women in Nigeria and neighboring West African countries. Because the quality of university education available at public universities in Nigeria is perceived by many people as being quite low, the idea that Baze offers a truly British style and quality of undergraduate education in Nigeria is very attractive to students, parents, employers, and other individuals interested in the quality of university education available in Nigeria. Baze University started (in April 2011) its first academic term with approximately 30 students and a very few faculty members; subsequently, however, the university grew very rapidly. At the time of this case (the academic term running January-April 2013), approximately 550 students were enrolled in a wide variety of classes taught by more than 30 faculty members. Baze University offers programs through three faculties: The Faculty of Law, The Faculty of Computing and IT, and the Faculty of Management and Social Sciences. Lecturers at Baze University are encouraged to spend up to one day per week on consultancy assignments; the Vice Chancellor of Baze (Prof. Michael Hodd) believes that doing consultancies (that is, doing applied work in one's field) impacts powerfully and positively on the quality of education lecturers are able to deliver to their students.

## ADDITIONAL INFORMATION (2): THE COUNTRY

The Federal Republic of Nigeria is a large (one tenth the landmass of the United States) country in West Africa. Administratively, Nigeria is composed of 36 states plus the Federal Capital Territory (FCT). These states differ in many ways, one of which is that the terrain ranges from beaches and swamps in the south to desert conditions in the north. Levels of education and income tend to be higher in the south than in the north. The dominant religion in the north is Islam while the south is predominantly Christian. Hausa is the dominant ethnic group in the north; in the east, the dominant group is the Igbo, while the west is predominantly Yoruba. A small set of statistics on Nigeria, together with comparative data for the United States, are as indicated below:

| | NIGERIA | USA |
|---|---|---|
| Size (square kilometers): | 923,768 | 9,826,675 |
| Population: | 170 million | 314 million |
| Major Ethnic Groups: | Hausa/Fulani 29% | White 80% |
| | Yoruba 21% | Black 13% |
| | Igbo 18% | Hispanic 15% |
| | includes white+black | |
| Religions: | Muslim 50% | Christian 78% |
| | Christians 40% | Jewish 2% |
| | All Others 10% | All Others 20% |
| Median Age: | 19.2 | 36.9 |
| Life Expectancy at Birth: | 52 years | 78.5 years |
| Fertility Rate (births per woman): | 5.38 | 2.06 |
| Infant Mortality Rate: | 74/1000 | 6/1000 |
| School Life Expectancy: | nine years | 16 year |
| % Of Population Who Are Literate: | 68% | 99% |
| GDP (purchasing power parity, or PPP): | $414 billion | $15.04 trillion |
| GDP per capita (PPP): | $2600 | $48,100 |
| % of Population Below Poverty Line: | 70% | 15% |
| Unemployment Rate: | 21% | 9% |
| Electricity Consumption: | 18 billion KWH | 3.741 trillion KWH |
| % Of Population In Urban Areas: | 50% | 82% |
| % of Population Internet users | 26% | 78% |
| Kilometers of Roads | 193,000 | 6,506,204 |
| % Of Roads Paved: | 15% | 67% |

Source: CIA World Factbook 2013

## ADDITIONAL INFORMATION (3): HISTORICAL OVERVIEW OF THE ECONOMY

Historically, Nigeria produced large amounts of agricultural products including (in the North) groundnuts) and (in the south) palm oil. In the early 1950s, however, oil was discovered in Nigeria and slowly but steadily, Nigeria became an oil monoculture. By the late 1970s, oil selling at $40 per barrel was generating large amounts of money for Nigeria. At this time, the Federal Government of Nigeria (FGN) made huge investments in roads, bridges, and buildings for the public sector (administrative buildings, housing estates, apartments, etc.). The FGN also invested huge amounts of money in a large number of "showcase projects," including steel mills, paper plants, expensive hotels, and a new federal capital city called Abuja. Many people moved to the oil areas, the project areas, and/or the large cities, hEB03ing to find jobs in the oil sector, work on the private/public projects financed by petrodollars, and so on.

As a consequence of the large inflows of cash and the changing opportunities available in Nigeria, agriculture and agricultural production were badly neglected. By the early 1980s, agricultural exports had nearly disappeared, and Nigeria no longer produced enough food to feed itself. The shortfall in food production was made up by importing large amounts of food, including both traditional staples and alternative foodstuffs such as wheat.

In the early 1980s, the price of oil collapsed; over the next 10 years, the price was in the range of $10-$20 per barrel. The annual impact of this price collapse depended on the level of production; however, it is probably correct to say that during this period, each decrease of one dollar in the price of a barrel of oil reduced Nigeria's export earnings by at least $700 million per year. Over the decade of the 1980s, the total revenue loss for Nigeria from oil price decreases undoubtedly exceeded $70 billion.

It took years for the impact on the Nigerian economy of the drying up of the oil revenues to fully manifest itself. The first economic consequences, caused by the shortage of foreign exchange, were the scaling back of the importation of big-ticket consumer items (for example, new cars). Subsequently, manufacturing activity relying exclusively on imported equipment, raw materials, and/or supplies began to suffer. For companies in these industries, the cost of imported equipment, spares, raw materials, and supplies increased sharply, as large amounts of local currency chased an ever shrinking pool of hard currencies including dollars. The increased cost of overseas materials led many industries to substitute local materials for imported ones (for example, brewers of beer substituted locally-grown sorghum for imported malt). Companies not able to find local substitutes increased prices, downsized their operations, or dropped out of business entirely.

The drying up of oil revenues had additional negative effects on the quality of life and economic activity in Nigeria. Over time, basic services like roads, electricity, water supply, and telecommunications began to deteriorate. By the late 1980s, neither industrial nor residential customers relied exclusively on public service providers for electricity or water. Instead, both groups had invested vast amounts of money in back-up generators (electricity) and private boreholes (water). In addition, because Nigeria's hardwire phone equipment barely functioned due to severe overloads and lack of maintenance, numerous business persons invested large amounts of money first in dedicated radio/microwave links and later, cellular telephone equipment. The need to make such investments increased the cost of doing business in Nigeria, and dramatically reduced the international competitiveness of Nigerian products and industry.

Another effect of the tremendous decrease in oil revenues was a very substantial increase in corruption. Due to the revenue decreases, federal, state, and local governments in Nigeria were unable to pay public sector employees. As prices of goods and services containing imported materials increased (most products sold in Nigeria are either manufactured overseas or include overseas components and/or materials), and as public-sector salaries fell or went unpaid, civil service and public sector employees searched for alternative sources of funds to maintain their standards of living. Ultimately, many public-sector employees started demanding bribes before they would act on requests for service by individual and/or corporate customers. By the late 1980s, Nigeria (and especially its international Airport in Lagos, Murtala Muhammed Airport) had acquired the reputation of being both lawless and corrupt.

For most of the decade of the 1980s and much of the decade of the 1990s as well, Nigeria was a military dictatorship. While military dictatorships tend to be harsh, it must be said that from 1993 until the middle of 1998 the military dictatorship led by General Sani Abacha was particularly harsh and oppressive. During these years, the country of Nigeria became quite isolated internationally, as more and more countries backed away from Abacha and his regime.

In June 1998, General Abacha died of a heart attack. In an extraordinary chain of events, Nigeria moved quite rapidly from being an outcast country under a military dictatorship to a democracy. In the first presidential elections, held in 1999, former general (and, under Abacha, prisoner) Olusegun Obasanjo, running on a platform which promised to tackle corruption and other major problems faced by Nigeria, was elected president. While Obasanjo's efforts to address the country's problems and move Nigeria forward met with limited success, Obasanjo was reelected to a second term in 2003. In 2007, however, when Obasanjo attempted to change Nigeria's constitution so as to be allowed to contest for a third term, the Nigerian Senate refused to support that change. Subsequently, Obasanjo stepped down and was replaced, as president of Nigeria, by Yar' Adua, a former governor of the northern Nigerian state of Katsina.

As indicated above, since the last days of the decade of the 1990s, military dictatorship has been replaced by democratic governance. Along with the move to democracy, there was a move in Nigeria toward privatization and a more market-oriented approach to managing the economy. During the decade starting in 2000, there were some huge private sector success stories in Nigeria; one of these was the telecoms industry and especially the rise of MTN, a provider of cell phone services in much of sub-Saharan Africa including Nigeria. In January 2001, MTN purchased its first GSM license in Nigeria; at that time the company had a subscriber base of zero. By the end of 2008, however, MTN had a customer base in Nigeria of more than 20,000,000 subscribers; that base has now expanded to more than 100 million customers. Nigerians have been very eager to purchase cell phones and use cell phone service; companies such as Cadbury Nigeria, Nestlé Nigeria, and Unilever Nigeria (that is, companies which sell foods, beverages, and personal care items including soap and laundry detergent) have discovered that individuals with very low levels of disposable income (millions of Nigerians are in this category) are very likely to reduce their purchases of foods, beverages, and personal care items, so as to be able to afford to purchase air time for their cell phones.

There is another economic development which must be mentioned. After Nigeria moved to democratic governance in 1999, and continuing until up through 2008, the average price of a barrel of oil increased most years, as indicated below:

| YEAR | AVERAGE PRICE OF A BARREL OF OIL |
|---|---|
| 2000 | $27.39 |
| 2001 | $23.00 |
| 2002 | $22.81 |
| 2003 | $27.69 |
| 2004 | $37.66 |
| 2005 | $50.04 |
| 2006 | $58.30 |
| 2007 | $64.20 |
| 2008 | $91.48 |
| 2009 | $53.48 |
| 2010 | $71.21 |
| 2011 | $87.04 |
| 2012 | $86.46 |

Source: InflationData.com

Because the country had been producing (prior to the worsening of an insurgency in the Niger Delta) somewhere in the range of 2 million barrels of oil per day, an increase in the price of a barrel of oil has a huge positive impact on the revenues of the Federal Government of Nigeria. The good news in the above figures is that for years Nigeria has benefited from a steady increase in the value of each barrel of oil produced. While the lower average oil prices starting in 2009 had massive negative implications not just for the Federal Government of Nigeria and its budgets but for the country and its people as well, the other good news for Nigeria in the data shown above is that the average price of a barrel of oil is now (that is, today) quite close to the all-time high annual average of $91.48 in 2008.

## ADDITIONAL INFORMATION (4) NIGERIA'S BANKING SECTOR

In colonial times (that is, prior to October 1960) banking in Nigeria was dominated by two large banks: Barclays Bank Dominion, Colonial, And Overseas (that is, Barclays Bank DCO) and Bank of British West Africa. After independence, many additional banks were founded; by the late 1990s, in addition to numerous small community-focused banks, there were at least 90 “universal banks” with branches all across Nigeria. Having said this, however, even in the days of approximately 100 “universal banks,” Dongli (2002) indicates that the industry is “highly concentrated and oligopolistic in nature” and that “only 10 banks dominate the banking system in Nigeria.”

In 2004 the Central Bank of Nigeria (CBN) raised the minimum capital requirement for a “universal bank” to 25 billion naira. To satisfy this requirement, many banks merged and/or were acquired by other competitors. In the end, 24 banks met the new 25 billion naira capital requirement set by the CBN.

The global financial crisis of 2008/2009 powerfully (and negatively) impacted the Nigerian financial sector. During 2009, in a special examination of each of the 24 banks in Nigeria, the CBN and the Nigerian Deposit Insurance Corporation (NDIC) concluded that a number of banks exhibited the following characteristics: Low capital adequacy ratios, low liquidity ratios, weak corporate governance structures, and high volumes of nonperforming loans. In response, the CBN not only injected funds but also replaced the entire executive management team at several banks. At this point, a long-standing problem with nonperforming loans (before the global financial crisis, more than a third of the loan portfolio at some banks; after the global financial crisis, higher than that) was also addressed; the Federal Government of Nigeria (FGN) established an entity called the Asset Management Corporation of Nigeria (AMCON) to acquire nonperforming bank loans and (in so doing) strengthen the capital positions of the banks from whom the nonperforming loans were acquired. Regarding AMCON, a recent study by a global consultancy indicates that by April 2011, this entity had:

1) Purchased (at a price of 600 billion naira) 6 trillion naira of nonperforming loans from 22 banks.
2) In the process, significantly improved the nonperforming loan ratio of banks in Nigeria.

Regarding the current structure of the banking industry in Nigeria, a recent study by a global consultancy indicates that banks in Nigeria can be divided up into the following six categories:

| | CATEGORY | BANKS IN THIS CATEGORY |
|---|---|---|
| 1) | Top-Tier Banks | TT01 Bank, TT02 Bank, TT03 Bank, TT04 Bank |
| 2) | Emerging Big Banks | EB01 Bank, EB02 Bank, EB03 Bank |
| 3) | Mid-tier Banks | MT01 Bank, MT02 Bank, MT03 Bank, MT04 Bank, MT05 Bank |
| 4) | Regional/Specialized Banks | RS01 Bank, RS02 Bank, RS03 Bank, RS04 Bank |
| 5) | Subsidiaries of Foreign Banks | SF01 Bank, SFB02 Bank, SFB03 Bank |
| 6) | Rescued Banks | RB01 Bank, RB02 Bank, RB03 Bank |

Regarding the performance of the banking industry in Nigeria, a recent study by a global consultancy indicates that:

1) Over the period 2007-2011, approximately 70% of the gross income of the banking industry has come from interest income. It seems worth noting that interest rates in Nigeria are quite high (20% or more is not uncommon); given those rates, the fact that a very high percentage of banking industry gross income is generated by interest earnings is not surprising.
2) Over the period 2007-2011, net interest margin has fallen from 66% in 2007 to 46% in 2011.

3) Over the period 2007-2011, Return on Assets (that is, ROA) for the banking industry has been either slightly above or slightly below 5%. As for Return on Equity (that is, ROE) it has varied from slightly above 20% in 2007 to -56% in 2009; by 2011 ROE had partially recovered, to a bit more than 5%.

Regarding challenges facing the banking industry in Nigeria, Donli (2002) indicates that these include:

1) The banks rely heavily on public sector funds placement and also on borrowing by the public sector; however, both funds available from the public sector and borrowing by the public sector are heavily dependent on the price Nigeria receives for its oil. Because that price can and does increase or decrease substantially, planning can be very difficult and the monetary authorities (that is, the CBN) impose quite a harsh regulatory regime on the banks.
2) In the past, banks in Nigeria have suffered from low ethical standards, low levels of transparency, and weak levels of corporate governance in a number of areas including:
    a. Risk management has been inadequate
    b. Responsibility and authority have not been clearly assigned
    c. Staff have given assignments which clearly involve conflicts of interest
    d. Information systems have not been secure and/or reliable
    e. Internal audits have not been carried out by operationally independent, well-trained, and competent staff.
    f. Widespread violations of insider lending regulations have occurred.

Regarding additional information:

1) In a recent report, a global consultancy indicates that the market shares of banks in Nigeria (please note: names of each individual bank is disguised) are as indicated below:

| NAME OF THE BANK | MARKET SHARE |
|---|---|
| TT01 Bank of Nigeria | 15% |
| TT03 Bank of Nigeria | 12% |
| TT04 Bank of Nigeria | 10%+ |
| EB01 Bank of Nigeria | 8% |
| TT02 Bank of Nigeria | 8% |
| EB02 Bank of Nigeria | 6% |
| MT01 Bank of Nigeria | 5%+ |
| EB03 Bank of Nigeria | 5% |
| MT05 Bank of Nigeria | 5% |
| MT04 Bank of Nigeria | 4% |
| MT03 Bank of Nigeria | 3%+ |
| SF03 Bank of Nigeria | 3% |

2) In its recent report, a global consultancy also indicated that the level of competition in the banking industry in Nigeria is likely to increase.
3) Historically, Nigeria has been a cash society. A few of the implications of this fact include:
    a. As indicated earlier, the population of Nigeria is approximately 170 million people; Oxford Investments Group (2011) estimates that nearly 90 million of these are adults but that of that number, approximately 70% do not have a bank account. In other words, a very large percentage of the population of Nigeria is "unbanked," that is, they do not have bank accounts.
    b. Of the 30% of the adult population in Nigeria who do have bank accounts, most do not have credit cards. In addition, individuals are often reluctant (because loans are so expensive) to borrow money, even if lenders are willing to lend. Having said this, however, in a recent report, a global consultancy comments that "For the first time, we see consumer lending as one of the major areas for loan growth. . . because the middle-class is expanding in a context of high-growth economic prospects. . . consumer lending could therefore be a strong factor in earnings improvement. . ."

## ADDITIONAL INFORMATION (5A): THE COMPANY

From its inception, EB03 Bank provided financial services not only to major trading companies in Nigeria (including UAC, UTC, SCOA, and John Holt); the bank also provided financial services to indigenous merchants and businessmen, contesting the special favors given by the colonial administration in London to Elder Dempster & Company and to other banks.

Not so many years after its founding, an overseas bank acquired what was to become EB03 Bank of Nigeria. In 1972, as a result of the Nigerian Enterprises Promotion Act, the Federal Government of Nigeria acquired 51.67% of the shares of EB03 Bank of Nigeria. In 1979, the overseas bank sold its remaining shares in EB03 Bank of Nigeria to Nigerians; at this time, the name of the bank was changed to EB03 Bank of Nigeria PLC.

By the early 1980s, while TT01 Bank of Nigeria had more branches in Nigeria (more than 300), EB03 Bank of Nigeria had nearly as many branches but surpassed AB Bank of Nigeria both in terms of total deposits and total assets. These deposit and asset totals were based on EB03 Bank of Nigeria's aggressive involvement in a number of different areas, including expansion of its retail banking branch network, involvement in the oil and gas business in Nigeria, involvement in the agricultural sector, involvement with government related financing of projects, involvement in export and import trade, involvement with manufacturers, and the training not only of its own staff but the staff of other banks as well. Until the mid-1990s, based on the characteristics listed below, EB03

Bank of Nigeria could legitimately claim to be the market leader in the financial services industry (including retail banking) in Nigeria:

1) The link (back to colonial times) with its overseas partner gave EB03 Bank a strong image and widespread acceptance both by businesses and by the general public.
2) Based on the bank's widespread acceptance by both businesses and the general public, EB03 Bank of Nigeria enjoyed a very strong customer base.
3) To maintain the banks widespread acceptance by both businesses and the general public, EB03 Bank of Nigeria management invested significant amounts of money in the training and upgrading of staff. During these years, in fact, EB03 Bank of Nigeria trained not only its own staff but also provided training for the staff of many other banks. While the staff training center was in Lagos, EB03 Bank of Nigeria also developed regional training centers all across Nigeria.
4) As indicated earlier, EB03 Bank of Nigeria had a large number of branches; this meant that the bank was able to provide financial services to business and retail customers in all major cities and towns in Nigeria. In addition, EB03 Bank of Nigeria had a network of correspondent banks in EurEB03e, Asia, and North America; this meant that (unlike many indigenous banks in Nigeria at the time) EB03 Bank of Nigeria was able to provide its customers with assistance on foreign trade-related transactions.

As indicated above, EB03 Bank of Nigeria entered the decade of the 1990s as the financial sector market leader in Nigeria in many sectors, including retail banking. By the mid-1990s, however, as a result of dramatic shifts in the economic life and inadequate responses by the leadership of the bank to those changes, EB03 Bank of Nigeria had lost its leadership position in the financial services sector (including retail banking) in Nigeria. Major changes in the economic environment in Nigeria during the early to mid-1990s included the fact that the degree of competition in the marketplace increased dramatically due to at least the following three factors:

1) Many new financial institutions (commercial banks, merchant banks, finance companies, assurance companies, and so on) entered the marketplace.
2) The needs and wants of customers (both business and retail customers) began to become more sophisticated.
3) Some financial institutions (including some of the new entrants) began to deploy new technologies in the marketplace, so as to better serve the needs and wants of both business and retail customers.

In addition to the heightened competition, there were in the early 1900s a number of other changes in the economic financial services environment in Nigeria, not all of which played to the advantage of EB03 Bank of Nigeria; these changes included:

1) As a result of falling oil prices, the naira (Nigeria's currency) depreciated massively. In the mid-1980s, the official exchange rate was one naira to one

US dollar; by the mid-1990s, however, one US dollar was worth more than 100 naira. This massive depreciation in the value of the naira impacted very negative and on the business of the import-based multinational trading companies like UAC, UTC, and SCOA. As indicated earlier, these companies had for many years been an important part of EB03 Bank of Nigeria's business success.

2) As its business with the multinational trading companies deteriorated, management of EB03 Bank of Nigeria did not do as good a job as it could have in working intensively to grow its business with indigenous enterprises.
3) EB03 Bank of Nigeria continued to build and open new branches; however, the placement of these new branches was often influenced by political factors rather than strategic (that is, customer-oriented) business considerations.
4) By the mid-1990s, EB03 Bank of Nigeria's international partner had sold off all of its ownership interest in EB03 Bank of Nigeria; at this point, the overseas partner withdrew completely from the management of the bank. While staff selection and management and training had been (for many years) a strength of EB03 Bank of Nigeria, the withdrawal by the senior management team of the overseas partner opened the door for a number of unfortunate developments, including staff selection based on connections rather than on merit-based considerations. Furthermore, some top management staff ended up being appointed based on political connections rather than deep knowledge and competence of various expects of the financial services industry.
5) While competitors were taking advantage of new technologies to better understand and meet the needs of both business and retail customers, EB03 Bank of Nigeria seemed to be focusing more and more on the mass selling of low margin banking services.
6) When EB03 Bank of Nigeria finally did attempt to implement system-wide Enterprise Resource Planning (that is, ERP) software, the implementation of the technology system which was chosen was not handled well. The banking software system which was chosen had been developed overseas; for that reason, staff assigned to implement the system were sent overseas for two months of training. As it turned out, two months of training was not enough time; in addition, the process for selecting people to go overseas to receive training did not appear to ensure that the right people were selected. Furthermore, when EB03 Bank of Nigeria employees returned from overseas to Nigeria, many of them were given assignments that had nothing to do with the implementation of the new ERP program. Finally, insufficient amounts of equipment to implement the new ERP system (computers, workstations, and so on) were provided and the updating and ongoing training of EB03 Bank of Nigeria staff on various aspects of the system appeared to be ineffective.

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As a result of the above factors, the profitability of EB03 Bank fell dramatically. In response, top management stopped recruiting new staff. The existing staff, well-versed in the provision of existing services, did not move quickly to embrace new technologies and/or new opportunities presented by these technologies. Competitors began using new technologies to identify the needs and wants of both commercial and individual customers; unsurprisingly, many of EB03 Bank of Nigeria's customers left the bank to take advantage of the new products and services being offered by these technologically savvy new competitors. While EB03 Bank of Nigeria continued to maintain a very large branch system (almost 300 branches), the bank fell far behind TT01 Bank of Nigeria in terms of total deposits and total assets. In other words, EB03 Bank of Nigeria was no longer able to claim that it was the market leader in retail banking or any other sector of the financial services industry in Nigeria.

By the end of fiscal year 2006/2007 EB03 Bank had fallen from industry leader to the number seven position in the industry; reasons for this included:

1) The bank was carrying a very high debt burden. This burden was a result of EB03 Bank of Nigeria's acquisition of failing commercial banks during a recently-concluded (in Nigeria) banking industry consolidation exercise; during that consolidation exercise, the Central Bank of Nigeria (CBN) increased the minimum capital requirement for every bank in Nigeria to 25 billion naira. To meet that minimum, banks in Nigeria partnered up and merged; as a result, the banking industry in Nigeria shrank from 100 banks to 25. Because of the high debt load and the strain it placed on the bank's liquidity position:
    a. Customers of EB03 Bank attempting to withdraw large amounts of funds sometimes experienced delays in getting their money; as one would expect, customers complained bitterly about these delays.
    b. Customers of EB03 Bank attempting to receive financial assistance (including loans) experienced delays and/or complete rejection of their requests.
2) The bank's Information and Communications Technology (that is, ICT) package was experiencing frequent failures; this was very frustrating not only to customers but also to staff.
3) Development of new branches was sluggish, and improvement of existing branches (for example, upgrades on both appearance and service capabilities) were not up to the standard of competitors.
4) Marketing programs to galvanize patronage were not systematically implemented; in addition, corporate and product advertising and the other elements of the marketing strategy were badly planned and badly executed.

Given the above, it is no surprise that in the mind of the general public (that is, potential retail customers), EB03 Bank of Nigeria had totally lost its original position in the banking industry; as a result, customers (both business and retail) continued to desert EB03 Bank for competitors.

## ADDITIIONAL INFORMATION (5B): THE COMPANY (2008-PRESENT)

The global financial crisis of 2008/2009 powerfully (and negatively) impacted the Nigerian financial sector. During 2009, in a special examination of each of the 24 banks in Nigeria, the CBN and the Nigerian Deposit Insurance Corporation (NDIC) concluded that a number of banks including EB03 Bank exhibited the following characteristics: Low capital adequacy ratios, low liquidity ratios, weak corporate governance structures, and high volumes of nonperforming loans. In response, the CBN not only injected funds but also replaced the entire executive management team at several banks including EB03 Bank. At this point, the Federal Government of Nigeria (FGN) also established an entity called the Asset Management Corporation of Nigeria (AMCON) to acquire the nonperforming loans of the affected banks; in December 2010 and April 2011AMCON purchased (for 228 billion naira of zero coupon bonds) billions of naira of nonperforming loans from EB03 Bank. As a result of that purchase and investments by a group of investors, the shareholder equity of EB03 Bank of Nigeria increased from a negative to a positive number. While restoring the bank to a situation where shareholders equity is positive is a huge step forward, the strategies to begin moving EB03 Bank back to its market leader position in the banking industry (and in the retail banking sector as well) in Nigeria are yet to be fully developed and/or implemented.

## ADDITIONAL INFORMATION (5C): THE COMPANY (CURRENT RETAIL BANKING STRATEGY)

Regarding the current retail banking strategy of EB03 Bank of Nigeria:

TARGET MARKET: While certain promotional campaigns (for example, efforts to EB03en large groups of new accounts quickly) target “C” level customers (that is, lower middle class customers including junior level managerial, junior level administrative, and entry-level supervisory personnel), the primary target market for EB03 Bank’s current retail banking strategy is “A” (that is, upper-class customers including senior level managers, highly successful doctors, lawyers, and other professionals, etc.) and “B” level (that is, Nigeria's emerging middle class including mid-level managerial, administrative, and/or professional) customers.

PRODUCTS: the primary products which EB03 Bank’s currently offers its retail banking customers include:

1) A variety of loan products including:
    a. EB03 Household (that is, personal loans for the acquisition of household items including furniture, television, computers, generators, laundry and kitchen appliances, etc.)

   b. EB03 Auto Loan (that is, a personal loan for the acquisition of a vehicle)
   c. EB03 Salary Advance (that is, easy access to funds for customers receiving a regular and steady monthly salary)
   d. EB03 Share Purchase Loan (that is, personal loans to purchase shares of blue-chip companies)
   e. EB03 Mortgage Loan

**2)** Credit Cards

PRICE: In Nigeria, interest rates on loans tend to be high (20% or more); this helps explain why (for banks in Nigeria) interest earnings often account for 70% or more of the income of the bank. In addition to interest, retail customers often must pay various additional costs, including service charges, management fees, legal fees, etc.

PROMOTION: Regarding media, banks in Nigeria (including EB03 Bank) promote themselves and their products using a variety of media including electronic (radio, television, etc.), print (newspapers, etc.), the internet, etc. The mission statement, vision statement, and theme of EB03 Bank's current promotional indicate that EB03 Bank of Nigeria aspires to be perceived as the best and leading financial institution in Nigeria, that it aspires to be perceived as providing high levels of customer satisfaction, and that it aspires to be perceived as being a very large and very strong bank.

PLACE (that is, distribution): So as to promote its products and services to the A&B consumers in its target market, EB03 Bank has:

1) An extensive branch network in Nigeria; that branch network includes:
   a. Lagos: EB03 Bank has divided this city of 17 million people (Lagos is the fourth largest economy in all of sub-Saharan Africa) into zones; within those zones, EB03 Bank has multiple Business Development Centers (BDCs) and multiple branches as well.
   b. Northern Nigeria: EB03 Bank has divided northern Nigeria into zones; within those zones, EB03 Bank has multiple BDCs and multiple branches.
   c. Southern Nigeria: EB03 Bank has divided Southern Nigeria into zones; within those zones, EB03 Bank has established multiple BDCs and multiple branches.
2) A presence in London. In the past, EB03 Bank operated a branch in London. At present, due to pressure from banking authorities in the UK, EB03 Bank in London operates as "EB03 Bank(UK)," a free-standing banking company standing (and operating) on its own.

## ADDITIONAL INFORMATION (6) ATTITUDES AND BEHAVIORS OF MEMBERS OF THE A&B SOCIO-ECONOMIC CATEGORIES IN NIGERIA REGARDING FINANCIAL SERVICES

Over the last 20 years, Mr. Agbam has been (using primarily qualitative research-based approaches) working to learn more about the attitudes and behaviors of members of the A&B socio-economic categories in Nigeria. Regarding financial services-related attitudes and/or behaviors of the members of these groups, the data he has collected lead Mr. Agbam to believe that:

1) . Members of these socio-economic groups are very keen to work up strategies to create businesses opportunities and/or strategies to enhance their quality of life; once they have devised a business and/or a lifestyle-enhancing strategy, they are likely to come to a bank looking for the money to implement that strategy.

2) For many members of the A&B socio-economic group, their earliest memories of banks and banking-related services will relate to the fact that after they (or someone they know) identified an idea and registered a company to pursue that idea, they came to a bank looking to borrow money to finance their company. Mr. Agbam suspects that for many of these individuals (when they arrived at a bank seeking a loan for the first time):
   a. Because they had very little knowledge of the policies and procedures which banks follow when making loans (the need for a primary source of repayment, the need for collateral and a second source of repayment, the importance to the bank of the character and credibility of the borrower, the service charges and/or fees associated with loans, etc.), there was a lot they needed to learn about banks and banking and borrowing.
   b. What they learned about banks and banking and borrowing (the interest rates, the fees and service charges, the need for collateral, and so on) may not have pleased them very much. Borrowing money for the first time to pursue a business opportunity and/or to enhance their quality of life may (at first glance) have looked and sounded painlessly easy and simple; what they would have discovered very quickly is that dealing with banks and banking and borrowing is neither painless, easy, nor simple.

3) The best experience members of the A&B socioeconomic class have noted is that after they have paid off their loan to the bank, all of the net cash flow generated by their business flows into their own pocket. The worst outcome members of the A&B socioeconomic class have experienced is that their business fails and the bank not only seizes their business but also liquidates the collateral they had provided to the bank as well.

4) Regarding pivotal (that is, attitude and/or behavior-changing) experiences with banks: Mr. Agbam believes that a very negative (and potentially behavior-changing) situation experienced by some bank customers is when they go to the bank to withdraw funds from their account but are told (because the bank is short of funds) that the bank is not able (at that moment) to give them cash from their account. A related and very negative experience would be if the bank is unable (due to its liquidity position) to provide the financial assistance (including loans) which the customer has requested.

5) Regarding ideal and/or "worst case" experiences with banks:
   a. An ideal experience might look approximately as indicated below:
      i. When the individual walks into a bank, he or she is greeted in a friendly and courteous manner by a bank employee.
      ii. After greeting the individual, the bank employee asks the individual what he or she wishes to accomplish and then takes the individual to the bank employee who can do what needs to be done.
      iii. The individual explains to the bank employee what he or she is trying to accomplish and what service he or she is requesting from the bank.
      iv. The bank employee requests key bits of information from the individual; having collected that information, the bank employee tells the individual whether it should be possible for the bank to provide the support which the individual is requesting.
      v. If the bank employee says that it is possible that the bank will be able to provide the support the individual is requesting, the bank employee now tells the individual exactly what additional information and/or documentation the individual must provide to the bank.
      vi. Once the individual has provided the additional information and/or documentation requested by the bank, the bank reviews the situation and (in a very timely manner) decides whether or not to provide the requested financial support.
      vii. Assuming the bank has decided to provide the requested financial support, that financial support is provided in a very timely manner and as requested.
   b. A "worst case" experience might look approximately as indicated below:
      i. When the individual walks into a bank, there is no bank employee to greet them in a friendly and courteous manner.
      ii. There is no bank employee to ask the individual what he or she wishes to accomplish and/or to take the individual to the bank employee who can do what needs to be done.

iii. There is no bank employee to whom the individual can communicate what he or she is trying to accomplish and what service he or she is requesting from the bank.
iv. The bank employee does not request all of the information which he or she needs from the individual, so as to be able to make a decision as to whether it should be possible for the bank to provide the support which the individual is requesting.
v. Assuming the bank employee says that it is possible that the bank will be able to provide the support the individual is requesting, the bank employee does not tell the individual all the additional information and/or documentation the individual must provide to the bank.
vi. Once the individual has provided all the additional information and/or documentation requested by the bank, the bank does not review the situation in a timely manner and/or is not able to give a clear answer as to whether or not the bank will provide the requested financial support.
vii. Although the bank has agreed to provide the financial support requested by the individual, that financial support is not provided in a timely manner and/or as requested.

6) Regarding issues which prevent individuals from experiencing an ideal experience with a bank:
   a. Lender-related issues which prevent individuals from having an ideal experience with a bank include:
      a. The bank employee interacting with the individual does not know enough to handle the individual's request but is not willing to admit that he or she is not knowledgeable enough.
      b. Moving through the bank's policies and procedures and requirements can be time-consuming.
      c. Certain characteristics of the loan which a bank offers (the interest rate, the duration of the loan, the deposit account which the borrower could be required to open, the collateral which the bank will require, and so on) may not be acceptable to the borrower.

   b. Borrower-related issues which prevent individuals from having an ideal experience with a bank include:

   a. Certain characteristics of the borrower and/or the borrower's request (interest rate, duration of the loan, collateral to be provided, the character of the borrower, the credibility of the borrower, etc.) may not be acceptable to the bank.

7) Regarding their concerns at this time in their life, not only about the financial services offered by banks but also in general:
    a. Ensuring that the day-to-day needs of themselves and their family are dependably and ongoingly provided for.
    b. Becoming powerful, so as to gain access to additional business and/or financial opportunities.

8) Regarding the issues which they were happiest about: Mr. Agbam believes that the thing which makes members of the A&B socioeconomic classes in Nigeria most happy is when they finish paying off loans they owe/money they have borrowed from banks.

9) Regarding the most important things members of the A&B socioeconomic class in Nigeria are trying to achieve at this time in their lives, Mr. Agbam believes that these include:
    a. Ensuring that the day-to-day needs of themselves and their family are dependably and ongoingly provided for.
    b. Becoming powerful, so as to gain access to additional business and/or financial opportunities.

10) Regarding the one thing members of the A&B socioeconomic classes in Nigeria would change about financial services from banks, if they had a magic wand: Mr. Agbam believes that members of the A&B social class believe that banks need to make available to customers a full range of short-term and long-term loans, so as to be able to provide the total package of financial services which members of the three key segments of the A&B socioeconomic classes believe they need, to be able to achieve their overall objectives, that is:
    i. To ensure that the day-to-day needs of themselves and their family are dependably and ongoingly provided for.
    ii. To become powerful, so as to gain access to additional business and/or financial opportunities.

## THE CHALLENGE

Assume you are Mr. Edi Agbam. What alternatives for reviving and rebuilding EB03 Bank of Nigeria's retail banking business will you recommend to the Non-Executive Director?

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### ATTACHMENT 1
### MAP OF NIGERIA SHOWING EB03 BANKREGIONS AND ZONAL HEADQUARTERS

# EXECUTIVE EXPRESS

**Michael J. Pesch, St. Cloud State University**
**Larry A. Logeman, Executive Express**

## CASE DESCRIPTION

*The primary subject matter of this case concerns how focusing on excellence in customer service can drive success and profits. But success in a service business does not stem from a lot of "feel-good" exhortations about serving customers. It happens because of leadership experience and vision, understanding customer needs, hiring and training the right employees, technology investments that enhance communication and streamline non-value-added activities, and quality metrics that drive continuous improvement. Executive Express is an airport shuttle company that provides passenger ground transportation services to the Minneapolis/St. Paul International Airport (MSP). The case discusses how Larry Logeman became the new owner of Executive Express and turned a poorly managed, inwardly-focused company into the dominant provider of airport transportation in Central Minnesota by building a customer-focused organization. The case has a difficulty level of three or four, appropriate for junior and senior level students, and is designed to be taught in a one-hour class period, with two hours of outside preparation by students.*

## CASE SYNOPSIS

*Imagine you are Larry Logeman, the owner and CEO of Executive Express, an airport shuttle company based in St. Cloud, Minnesota that you've owned for seven years. You have been successful at building a company that is focused on delivering service excellence to customers who need transportation to the Minneapolis/St.Paul International Airport, located 75 miles away. Meeting your customers' needs was at the core in making technology decisions, hiring and training employees, and tracking performance measures for quality improvement. Although Executive Express has been successful with this business strategy, it now faces a new threat from the City of St. Cloud's efforts to recruit an airline to reestablish air service at the St. Cloud airport. You need to decide whether to implement an aggressive competitive response to this threat by increasing the number of roundtrips per day to attract new customers who are currently driving themselves to the airport, and to contend with a potential new airline by maintaining your position as Central Minnesota's most convenient and reliable airport transportation option. What do you do?*

## INTRODUCTION

On a bright morning in January 2012, Larry Logeman poured himself a cup of steaming coffee and sat down at this desk to scan the morning newspaper. The headline leaped off the front page: "City of St. Cloud Pushes to Restore Local Air Service." Larry was the owner and CEO of Executive Express, a St. Cloud-based airport shuttle company that provided ground transportation services to and from the Minneapolis/St. Paul (MSP) International Airport. The MSP airport was located about 75 miles from St. Cloud, Minnesota.

Since 2009 when Delta Airlines pulled its air shuttle service out of the St. Cloud airport, Executive Express was by far Central Minnesota's dominant provider of transportation to the MSP airport. In the two years since Delta's announcement, Larry increased the number of daily airport runs and expanded airport shuttle service to more than 40 communities. Now, according to the newspaper article, the St. Cloud City Council had approved a contract with a consulting group to actively recruit an airline to provide twice-daily air service from the St. Cloud Airport to a large airport hub in Chicago or Denver.

Larry contemplated the impact on his shuttle business if air service from St. Cloud to a major airport were reestablished. In the seven years as owner of Executive Express, Larry strived to offer his customers the best in convenient and reliable airport shuttle transportation services. He invested heavily in vehicles, employees, and technology. Now he wondered if a new air service would trump his hard-earned success at offering top customer service.

Before the push for new air service was announced, Larry had already planned to increase the number of daily roundtrips to MSP from the current 10 trips to 14 trips. The newspaper's announcement prompted Larry to consider pushing up the schedule to implement the 14-trip schedule by March 1, and establish a beachhead before the air service arrived.

## BACKGROUND

### "I LOVE SERVING PEOPLE"

Larry Logeman graduated from Luther College (in Iowa) in 1987 with a degree in sociology and public communications, and began looking for a job that offered personal fulfillment and reasonable compensation. He tried direct sales for about a year, but it left him "feeling empty." Remembering his college internship experience at the Holiday Inn hotel chain, Larry returned to the hospitality industry and worked as the Food and Beverage Director at a Days Inn in Minneapolis, Minnesota. After a year in that position, Larry became the general manager of the newly-opened Radisson Hotel in St. Cloud, Minnesota, a community with a greater metropolitan population of about 100,000.

The Radisson's business culture focused on delivering excellence in customer service and the Radisson was where Larry's passion for serving people caught fire. The owner of the St. Cloud Radisson franchise, James Graves, was a stickler on the details that drive customer service and he was an important mentor to Larry. Larry recounted:

> *"While we always strived to achieve high levels of service, when Jim Graves came to visit, we would scramble to get the hotel absolutely perfect. Inevitably though, Jim would come in and see something like a small accumulation of dirt in a corner by the front desk, and say, 'Larry, how can this be? What impression do you think this makes on a customer who is waiting to check in?' Of course he was right, and Jim's intense focus on the customer's experience is how I try to manage Executive Express today."*

At the Radisson, Larry developed his personal philosophy of customer service. He described it as having a "service heart:"

> *"Having a service heart means being focused solely on making someone happy, and by making someone happy, you make yourself happy. I'm not sure a service heart can be taught—you either have it or you don't. I love serving people. I get an adrenaline high from working with people who are service-oriented."*

One of Radisson's branding strategies for conveying to both customers and employees its spirit of service is the motto "Yes I Can!©" The motto captures the positive, proactive approach of Radisson associates toward customers to find ways to meet every customer need, as long as it is not illegal or will reduce the service that other customers are receiving. Although Larry has not worked for the Radisson for nearly twenty years, the "Yes I Can!©" philosophy is the inspiration for his leadership of Executive Express. Larry commented:

> *"I have more than 60 employees and I want each of them to say "Yes I Can!©" to customers as often as possible. When a customer asks for something out of the ordinary, we should not immediately think that because we don't normally do something, it's impossible for us to do that. I want my employees to be creative and try to solve the customer's problem and meet their needs. We had a customer once who asked our driver if we could drive him 300 miles from the Minneapolis airport to International Falls,*

> *(Minnesota) to meet his buddies for a fishing trip because he missed his flight connection. Thankfully the driver did not immediately say no, but instead checked with our office. We did some calculations, checked the driver schedules, gave the man a price, and he accepted our offer. I use this example in our training to teach the "Yes I Can!©" philosophy. Simply put, every time we can say yes to a customer, it improves our business's opportunities."*

Larry worked for the Radisson for 4 years and helped build the St. Cloud Radisson into a top award-winning hotel in the Radisson chain. But the long hours that are typical in the hospitality industry conflicted with Larry's family priorities. He left the Radisson because he wanted work hours that provided better balance with his personal life.

After leaving the Radisson in 1994, Larry worked for a health maintenance organization (HMO) as the Director of Sales, Marketing, and Member Services, but found himself doing more "back office" duties such as negotiating contracts versus working directly with customers. He moved to a position as the Interim Executive Director of the local YMCA, working with the community to bring the "Y" back from the brink of financial insolvency. In 2002, Larry assumed the position of president at the St. Cloud ServiceMaster franchise, one of the largest and most successful ServiceMaster franchises in the United States.

Larry believed his prior experiences in a wide variety of service industries were critical in preparing him for the rigors of owning a service business:

> *"When I think back, I realize that my past positions gave me invaluable experience in working with diverse groups of people, ranging from highly-educated and high-income professionals in the medical and the business communities, to people who didn't have a high school education and needed coaching on basic skills such as showing up for work on time. At ServiceMaster, for example, my typical work day involved coaching disaster restoration cleaners and thanking them for coming to work that day, teaching groups of insurance agents on the technical aspects of fire and smoke damage, dispatching work crews to disaster sites, managing on-going projects, and bidding on new work".*

In 2005, Larry felt it was time to realize his ultimate dream of becoming a business owner. He worked with a business broker to locate a suitable business, and Larry soon became the new owner of Executive Express.

## EXECUTIVE EXPRESS, MARCH 2005: A SLEEPY COMPANY

Larry purchased Executive Express because he saw opportunity. The business's sales revenues for the past five years had been flat, and the previous owner, Jerry Kerber (not his real name), admitted that in those five years he had not done a single sales call. While at the time there was an air shuttle service from St. Cloud to the Minneapolis/St. Paul airport (MSP), there were no other over-the-road shuttle or train services for getting to the MSP airport from the St. Cloud area. The biggest source of competition for Executive Express was people driving themselves to the airport.

As part of the purchase agreement, Jerry Kerber and his office manager, Cheryl Markman (not her real name), agreed to stay on for 30 days to help with the transition. On the first day after taking over the business, Larry was sitting in the office with Jerry in the late afternoon. The phone rang and Larry reached over to answer it. Jerry quickly intervened, "Don't answer that!" Larry looked up, surprised, and asked, "Why not?" Jerry explained, "We're closed! They can call back tomorrow." Jerry then activated a small Casio answering machine and he played for Larry the message callers heard when the Executive Express offices were closed: "Hello. You've reached Executive Express. We are currently closed. Please call back during regular business hours of 8am to 5pm. Goodbye."

Larry thought to himself that telling customers to call back later was not how he was going to run the business. But he told himself to be patient and moved the conversation along and asked Jerry, "So don't you think a computer would help you keep track of reservations and driver schedules?" Jerry responded, "We don't need computers. We just write the schedules on these weekly forms and hand them out to the drivers. As the reservations are taken, we write them down on the individual airport run sheets so the drivers can check off people's names and collect the money."

The next morning, Larry waited in the office for Jerry to arrive and noticed that the shuttle drivers entered the Executive Express building through the unheated garage, then walked to a small window in the wall that separated the office area from the garage. Cheryl, the office manager, slid the window open, handed the driver a schedule, and slid the window shut. Larry asked Cheryl why the drivers don't just come into the office to get their schedules. Cheryl replied, "Well, if you did that, the drivers will want coffee and just stand around and talk." Larry nodded.

The phone rang and Cheryl picked up the phone. Larry overheard Cheryl say, "I'm sorry sir, I can't understand you. Please repeat that. What? Say that again? When are you arriving? Please speak up!" Then Cheryl abruptly hung up the phone. "These foreigners! You can't understand what they're talking about."

Larry knew he'd heard enough and later that day, he told Jerry that he wouldn't need him to stay on any longer and he would take over from there. (Cheryl left several months later when the company moved away from the paper-based management system.) Larry was sure that he had made the right decision to buy Executive Express. Despite the poor management practices he had observed over the past two days, the company was still making money. Larry felt that with his energy, customer service experience, and service heart philosophy, he could revitalize the company and expand it into a major provider of airport shuttle transportation in the greater Central Minnesota region and beyond.

## "I DON'T NEED DRIVERS; I NEED PEOPLE WHO WANT TO SERVE MY CUSTOMERS"

Larry devoted a lot of time to selecting, training and coaching his employees with a primary focus on customer service. It happened frequently that someone visited the Executive Express office to ask about becoming a driver. The individuals stated that they wanted to be a driver because they "love to drive." Larry questioned them and often discovered that these potential driver applicants were retired over-the-road truckers who were looking for a job that didn't involve overnight assignments. Larry asked them, "So how long were you an over-the-road truck driver?" A typical response was, "Oh about 20 years." Larry asked them, "And how often did you have someone riding with you in the truck?" The person almost always said, "Why, never!" Larry politely responded to the person, "See, that's a problem for me because what I really need are people who have a strong desire to serve our customers."

Every several months, Larry held an information session for people who were interested in becoming shuttle drivers. He emphasized the importance of anticipating customer needs and conveying to customers a friendly and helpful personality. Larry provided his audience with an example: "If you are standing outside your vehicle at the pickup point and you see a car a ways off in the parking lot with its trunk lid open, you should immediately recognize that this is probably one of our customers! You should go to meet that person, greet them, and assist them with their luggage."

In addition to coaching his drivers on how to serve customers, Larry also provided drivers with uniforms to promote a sense of professionalism. He changed office procedures so drivers were welcomed into the office, where pots of high-quality fresh coffee were available. Larry commented, "It took a while for the long-term drivers to get used to entering the office. They would stand at the door and I'd have to call out their name and say 'Come on in!'"

Another big change for drivers was learning to use computers instead of relying on paper forms to do their jobs. Computers were used by drivers to check driving schedules, check in passengers, and run credit card charges. Some drivers could not make the transition and left the company. In interviewing for new drivers, Larry asked several questions to see if an applicant felt comfortable using computers. He asked applicants if they knew how to send an email, could they Google something on the Internet, and did they own a computer.

**NEW TECHNOLOGY**

In shaping Executive Express's business strategy, Larry knew availability and accessibility were critical to success:

> *"We live in a global economy, and Executive Express needs to be available to serve customers 24 hours-a-day/7-days-a-week. In 2005 when I bought the company, we had people who were visiting Central Minnesota from around the world to attend college, conduct business, or for any other professional or personal reason. There was an expectation from customers that we would have the ability to communicate and conduct commerce over the Internet."*

With a sense of urgency, as a temporary measure, Larry purchased a new phone system with a voice mail reservation box that allowed customers to leave messages, but which required calling the customers back to finalize their reservations. Immediately after implementing the phone system, Larry set out to find online technology that could help his company connect with customers at the customer's convenience, not Executive Express's.

Larry searched for a software system that provided real-time reservation and dispatching capabilities. Finding none, Larry partnered with a self-employed software developer to build a custom reservation and dispatching system. Although the developer was talented in translating Executive Expresses needs into software code, he could not keep up with the fast-growing and changing needs of the company. The software also proved to be unreliable, and as the sole software specialist, the developer was not always available to fix the system when it crashed. Since the paper-based system used by the previous owner had been scrapped, there was no backup when the software failed.

In early 2009, knowing how essential having capable and reliable software was to delivering top customer service, Larry hired The Hudson Group, a software engineering firm in Boston, Massachusetts with a specialization in advanced transportation reservation technologies. In four months, Hudson built a software system with the performance features, speed, and near-100% reliability to meet Executive Express's needs. Over the next three years, as Executive Express added more daily airport runs, more vehicles and drivers, and more cities to its network, the Hudson software adapted and continued to serve Executive Express's technology needs at top levels of performance.

In 2012, to serve both Internet customers and customers who prefer to interact with a live person, Executive Express maintained a website-based reservation system and a new phone system with live reservationists that was linked by software to the reservation and dispatching system. Larry employed a half dozen "Home-Based Reservationists" (HBRs) who answered customer calls from home and were paid a fixed payment for each reservation they sold (payment was always collected by credit card at the time the reservation was made). HBR productivity was tracked with phone tracking software that recorded a wide range of measures, including the number of calls, call length, the number of times a call is transferred, where it was transferred, how long the caller is on hold, and the percentage of reservations made out of total calls answered.

Larry used the data tracking tool to monitor the performance of HBRs and to coach them on ways to improve. For example, the data indicated that customers who purchased reservations on the website and have no interaction with a reservation agent, made single trip purchases about 60% of the time and roundtrip purchases about 40% of the time. Larry felt that HBRs should be able to book more than 40% roundtrip purchases just by pointing out to customers the discount available for roundtrip bookings, and the flexibility of being able to use the return ticket on any trip without penalty. Larry worked with HBRs on their customer interaction skills, implemented bonuses for reaching performance thresholds in roundtrip purchases, and awarded gift cards to the top HBR in roundtrip purchases for the month. As a result of using the software-generated data to drive employee coaching, roundtrip purchases increased to 50% for several HBRs.

The Hudson software enabled all drivers, managers, and office staff to monitor on a real-time basis the status of all scheduled runs. The online schedule displayed key information, including the run number, departure time, vehicle number, the driver's cell phone number, the time the driver punched in, the driver's confirmation that they have checked the schedule, the number of passengers, the vehicle's passenger capacity, and a section for special notes. The software provided transparency in information sharing so everyone knew the current status of what needed to be done to serve all customers. Potential problems could be avoided by being able to see that a driver knew they had a special pickup, or observing that a vehicle was getting close to capacity and a second vehicle could be scheduled to carry additional passengers.

Regarding how the Hudson technology aligned with the Executive Express mission of meeting every customer's transportation needs, Larry observed:

> *"Our future is driven by the technology. But while technology provides the ability to manage higher levels of complexity as we get larger, it also limits our ability to 'Say yes' to an individual customer's request if that type of request hasn't been programmed into the software. For example, we offer home pickups in the major cities in our network, but the smaller communities that we serve don't have the home pickup option programmed into the system, so we're trying to deal with that. Size and complexity make*

*it more difficult to cater to individual customer needs, though that doesn't mean we don't keep trying."*

**PURSUING EXCELLENCE IN CUSTOMER SERVICE**

The challenge of achieving excellence in customer service became more challenging as Executive Express expanded its network of cities, served more passengers, and added more drivers and vehicles. Larry knew that in the midst of managing the challenge of a growing business, he could not take his eye off the never-ending pursuit of satisfying every one of Executive Express's customers.

Two examples demonstrated how important it was to relentlessly pursue the goal of achieving a "zero defects" level of service performance. The first was when passenger luggage gets misplaced. Executive Express had special procedures for loading luggage on vehicles according to the airline check-in locations where different passengers will be dropped off. A system of tagging luggage by airline was also used to ensure that the right luggage comes off the shuttle vehicle at the right airport drop-off location. Despite these careful procedures, luggage could easily get misplaced if passengers unloaded someone else's luggage, thinking it was their own, and walked away with it.

Larry was shocked when he looked over a stack of incident reports that showed a high frequency of luggage errors. "When a person takes the wrong bag, it can cost us tremendous amounts of money to deliver bags overnight to get them to the right passengers—both the passenger that took the wrong bag, and the passenger whose bag was taken. Recently, it cost us $350 to resolve a misplaced bag incident."

After studying the problem, Larry and his staff changed the standard driver greeting that all drivers delivered to their passengers at the start of every trip. The revised driver greeting included a friendly request to "not take your own luggage." Along with introducing himself/herself, and going over arrival times, stops, and issues concerning passenger safety and comfort, the driver now included the following appeal:

*"…And when we get to the airport, please remember not to take your own luggage. Let us help you with your luggage. This trip is important to you and when you get to your destination, we wouldn't want you to open your suitcase to see someone else's pink underwear!"*

A second customer service issue that received special attention was passengers not getting picked up at the promised time and location. In a recent incident, a driver tried to call a husband and wife who were scheduled to be waiting for pickup at the MSP charter terminal instead of the main terminal. When the passenger did not answer his cell phone, the driver assumed the two passengers were not at the terminal and the driver skipped the pickup. The passengers were missed and had to take a later shuttle.

Larry shook his head in recounting the story: "Missing passengers is the kiss of death in this business. First, it costs us money both to refund the fare AND issue free vouchers for future trips. Second, it erodes our credibility as a reliable provider of transportation to the airport. When these things happen, it automatically increases the likelihood that our customer will decide to drive themselves next time."

To address the problem of missed passengers, Executive Express developed a "Missed Passenger" form that must be filled out in great detail every time a passenger was missed. The purpose of the form was to completely understand the details of a missed passenger incident. Completed forms were analyzed by a "Missed Passenger" committee that included Larry and members of his staff, and potential root causes of missed passengers were discussed. Solutions for addressing root causes of missed passengers were developed to prevent recurring mistakes.

## 2005-2007: IMPLEMENTING THE BUSINESS STRATEGY

In 2005 after purchasing Executive Express, Larry's business strategy was to offer customers increasing levels of convenience and reliability in transportation to the MSP airport. He knew he was competing with the option of people choosing to drive themselves to the airport for reasons of convenience and reliability, so he adopted a 2-pronged approach. First, by increasing the number of trips per day, more people would be able to match an Executive Express trip to a time close to their outgoing or incoming flights. Second, Larry incorporated into his marketing campaign the slogan, "We Never Cancel!"

The slogan "We Never Cancel!" meant that a customer who had a paid reservation could count on Executive Express delivering them to their destination at the promised time, and it would not cancel a run for lack of a sufficient number of passengers. The only time that Executive Express would cancel an airport run would be if the Minnesota State Patrol completely closed the road due to a severe storm event. It would never cancel a run for profitability reasons.

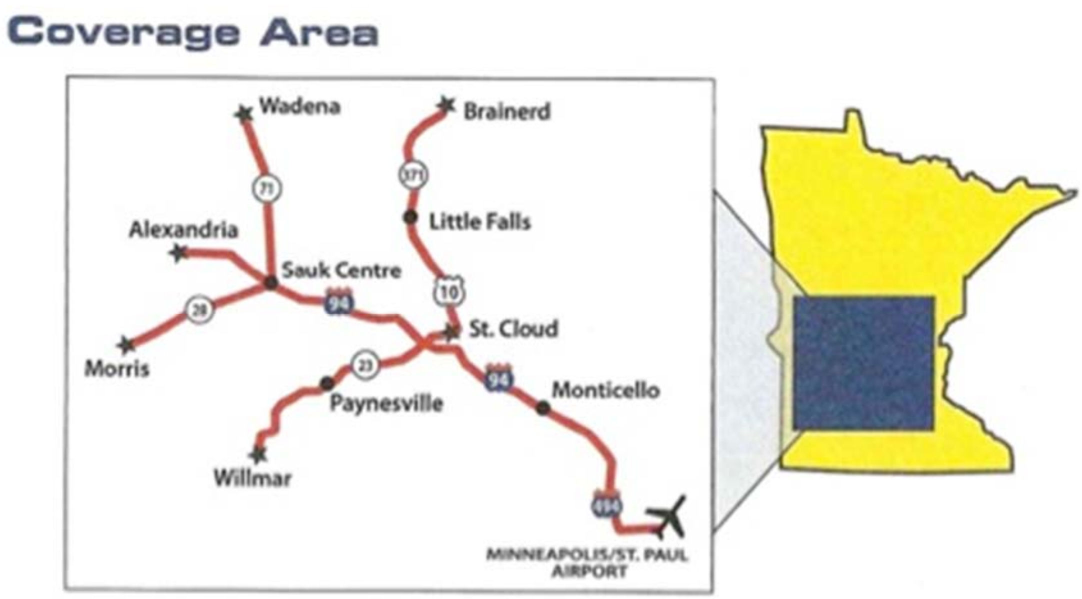
In 2005, Executive Express served mainly the 75-mile route on Interstate Highway 94 from St. Cloud to the MSP airport (Figure 1). The company provided five roundtrips per day, stopping at a few small communities along the way for special pickups or drop-offs. To begin implementing his business strategy of offering greater transportation convenience to more customers, Larry first expanded his service area by adding four-trips daily service between St. Cloud and the community of Brainerd, located 65 miles to the north, and between St. Cloud and Alexandria, located 70 miles to the northwest (Figure 1). Additionally, these new service arteries allowed Executive Express to serve additional customers living in communities in the surrounding areas along these routes.

Soon after launching the new service to Brainerd and Alexandria, in May 2006, Larry increased the number of roundtrips between St. Cloud and MSP to six per day. A year later in 2007, roundtrips were increased again to eight per day.

**2009: EXPANSION TO IOWA**

On a trip to attend a funeral in Iowa in the fall of 2007, Larry discovered that there was no shuttle service between Ames, Iowa and the Des Moines International Airport (DSM). Ames had a population of 60,000, which included 28,000 students who attended Iowa State University. As a vibrant community comprised of students from the U.S. and around the world, faculty and other professionals, and a strong business sector, Ames appeared to have viable demand for roundtrip transportation service to DSM, located about 40 miles to the south on Interstate 35W.

**Figure 1: Executive Express's Minnesota Airport Shuttle Routes, 2012**




Larry decided to conduct more research on the Ames-Des Moines market and in 2008 he made several trips to Ames to interview hotel proprietors, travel agents, and Iowa State administrators. At the time, Iowa State was relying on the city bus service to transport students back and forth from the airport. The city bus service didn't view itself as a shuttle transportation service, and both the bus service and Iowa State welcomed Larry to take over the shuttle operation.

In the midst of the 2008-2009 "Great Recession" that was taking place in the United States, Larry could not get a bank loan to fund the expansion to Iowa. Not wanting to miss a rare opportunity, Larry took out a second mortgage on his home. In August 2009, Executive Express began serving the Ames-DSM market. After losing money in Iowa in 2009, due to numerous start-up costs, Executive Express began making money in the Iowa market in 2010.

**2009: DELTA DROPS AIR SERVICE**

In October 2009, Delta Airlines announced that it was dropping its air shuttle service between St. Cloud and MSP. While Delta's action provided an opportunity for Executive Express to fill the reduction in transportation services to MSP, Larry knew he had to move fast. Although an increase to ten roundtrips per day was already in the works for 2010, Larry moved up the schedule to implement the 10-run expansion by the 2009 Thanksgiving holiday. Larry didn't get much sleep in those last months of 2009. New scheduling and dispatching software was written and implemented, vans were purchased, and new drivers were hired and trained.

After the successful launch of the 10-run per day schedule in 2009, over the next two years Executive Express continued to serve more customers and to build its reputation as the "airport transportation provider of choice" for the Central Minnesota region. A summary of passenger traffic in the seven years of Larry's ownership of Executive Express is shown in Figure 2.

**Figure 2: Passenger Statistics 2006-2011**

When the company was purchased in 2005, there were no statistics or accounting records on past passenger volumes. 2006 was the first full year for which passenger statistics were available. The following statistics relate to traffic flow on the main St. Cloud-MSP route. One passenger is defined as "one passenger traveling one-way on the St. Cloud-MSP route." Iowa passengers are not included in these statistics.

| Year | Passengers | Notes |
|---|---|---|
| 2006 | 19,170 | Increased to 6 runs per day |
| 2007 | 23,844 | Increased to 8 runs per day |
| 2008 | 27,104 | 8 runs per day. A severe nation-wide recession begins. |
| 2009 | 26,989 | Increased to 10 runs in November 2009. |
| 2010 | 39,464 | 10 runs per day. |
| 2011 | 43,440 | 10 runs per day. |

## JANUARY 2012 DECISION: INCREASE TO 14 RUNS?

Larry set the newspaper down on his desk, took a sip from his cooling coffee, picked up a pen and began writing a list of pros and cons on whether to move forward with his plan to boost daily airport runs to 14 roundtrips by March 1, 2012. Though establishing new air transportation service in St. Cloud would be a significant undertaking for the City, Larry knew he needed to consider the impact of new air service competition on his business. The St. Cloud airport featured a 7,000-foot runway that could easily accommodate small, medium, or large passenger jets. The airport also featured a beautiful, newly refurbished terminal, security-ready passenger processing equipment, and free parking. Once a contract with an airline was signed, air service could conceivably begin within a couple of months.

On the positive side for Executive Express, a 14-trip daily schedule would fit almost any customer's travel schedule, both going to MSP and returning to St. Cloud. This would make taking Executive Express more convenient than people driving themselves to the airport because downtime at the airport would be minimal and customers wouldn't have to contend with traffic and parking.

Another positive factor was that the new 14-trip schedule would add only five additional driver hours per day to the total daily driver hours under the present 10-trip schedule. This was because drivers would no longer have extensive downtime of sitting at the desk at the airport, waiting for the return trip to St. Cloud. Although drivers would be working harder because they would be driving more, they would also have more opportunities to earn tips from their passengers.

While new air service in St. Cloud could detract from Executive Express's customer volumes, Larry thought he had two factors in his favor. One was that the City Council's plan asked for an airline to provide low-frequency twice-daily air service, a schedule that would be challenging for many customers to fit with their connecting flight plans. The second factor was that under bad weather conditions, Executive Express's service to MSP was usually more reliable than air service. In the past, the Delta shuttle service out of St. Cloud had problems with cancellations due to fog and other weather-related issues. Air passengers were also at risk of being bumped if the aircraft was deemed to be overweight. Executive Express's "We Never Cancel" slogan was a strong pitch to customers who placed high value on knowing they would make their connecting flights at MSP.

On the negative side, a short-term challenge of launching a 14-trip schedule by March 1 was expediting the Hudson Group's upgrades to the scheduling and dispatching software. Another challenge was calling hundreds of passengers with existing reservations to change their reservation to fit the new schedule.

Other drawbacks to the 14-trip schedule included the added cost of fuel and maintenance and some additional driver hours to provide the additional capacity in the schedule (Figure 3). Employee issues included training drivers on new procedures to reduce turnaround times in both MSP and St. Cloud, and the possibility that some drivers would quit because of the added workload and time pressures.

Above all else, the dominant concern for Larry was whether passenger demand would increase sufficiently to support the 14-trip schedule. He hoped that more trips per day would entice new customers to opt for the convenience of taking Executive Express over driving their private vehicles. This strategy worked over the past seven years as the number of daily trips increased from 5 to 6, from 6 to 8, and from 8 to 10. But if the 14-trip schedule didn't work out and had to be down-sized, there would be negative consequences, including increased customer confusion, changes to software, and adjustments to employees and vehicles.

The possible reinstatement of St. Cloud air service only added to the uncertainty of future passenger demand. Yet, as Larry dumped out his cold coffee and poured another hot cup, he thought that taking an aggressive approach now by building a strong market presence might pay off when new competition arrived, from whatever source.

**Figure 3: Cost and Revenue Assumptions For Expansion To 14 Roundtrips Per Day**

Add 4 runs per day for Monday-Friday schedule to move from 10 to 14 trips
Add 6 runs per day for Saturday and Sunday schedule to move from 8 to 14 trips
A roundtrip is 75 miles each way * 2 = 150 total miles
Fuel efficiency (miles per gallon) = 15
Cost per gallon = $3.60
Cost per mile for maintenance = $0.15
Additional labor per day (Monday through Friday) = 6 hours
Additional labor per day (Saturday and Sunday) = 10 hours
Cost of labor = $10 per hour
Fare per passenger per one-way trip = $40

# BEARKAT GAMES' CORPORATE TATTOO: A CASE FOR PERSUASION

**Traci L. Austin, Sam Houston State University**
**Lucia S. Sigmar, Sam Houston State University**

## CASE DESCRIPTION

*The primary subject matter of this case concerns the strategy for composing and delivering a written persuasive message in a business environment. Secondary issues examined include conducting primary and secondary research and employing APA citation skills. The case has a difficulty level of three to four (suitable for junior- or senior-level courses). The case is designed to be taught in approximately three class hours and is expected to require four hours of outside preparation by students.*

## CASE SYNOPSIS

*Jon Osterman is the CEO of BearKat Games, a large gaming company headquartered in Houston, Texas, with offices in Dallas and San Antonio. Osterman has worked hard to make BearKat Games become a sought-after place to work. To achieve this goal, he has implemented practices that encourage employees to enjoy their work, feel pride in the company, develop strong relationships with co-workers, and—perhaps most importantly—stay with the company for the long term.*

*Two years ago, Osterman saw evidence that his efforts to increase employee loyalty had paid off. Brett Reed, a six-month BearKat employee, showed Jon his newest tattoo: the BearKat Games logo, prominently placed on his bicep. Brett's tattoo gave Jon an idea—what if he could persuade other employees to get tattoos of the company logo? Not only would the tattoos be a chance for employees to demonstrate their commitment to the company; they would also have great potential for marketing and publicity. He decided to offer a 15% bonus to any employee who chose to get a BearKat Games tattoo.*

*Pepper Potts is one of the employees who participated in the tattoo incentive; for the last several months, she has sported the BearKat Games logo on her ankle. Recently, however, the company decided to close its Dallas office, and Pepper's job was eliminated. She is now on the market for another job. Her BearKat Games tattoo—once a sign of professional pride—is now a professional liability. She would like to have the tattoo removed, and she wants BearKat Games to pay for it.*

## INTRODUCTION

Pepper Potts was ready for the weekend; it had been a hectic week at the BearKat Games Dallas office. She and the other employees--Bruce Wayne, Diana Prince, and Lex Luther--had just completed the Parker project after months of work. The four collaborators were giddy with excitement. Despite a series of difficulties along the way, they and the project support staff in Dallas had managed heroically to surmount each challenge, and they were looking forward to company bonuses for project completion. They knew their CEO, Jon Osterman, would also be pleased. BearKat Games stood to increase its yearly revenue 30% with the addition of this latest gaming system. The four were looking forward to announcing their news in less than thirty minutes at the regular office "TGIF Happy Hour." They could already smell the buttery aroma of popcorn emanating from the conference room and were thirsty for the ice cold beer that Osterman always provided for the occasion.

Promptly at 4:00 p.m., Pepper closed her office door and met Bruce, Diana, and Lex in the hallway. It had been a company tradition to wear the corporate colors on Fridays, and they were all resplendent in orange and black. In addition, for the last ten months, Pepper had sported a BearKat Games tattoo on her ankle which was visible below her black pencil skirt. Pepper, leading her team, strode confidently into the conference room and greeted the other employees and her CEO. As other employees slowly gathered, Pepper leaned over and asked Jon if she could have the floor once everyone had arrived. Jon, expecting her announcement, nodded his head.

When everyone had arrived, Pepper tapped her beer bottle with a bottle opener to gain the crowd's attention. Others followed suit until the room grew quiet.

"Everyone, if I could have your attention!" Pepper cried. "Our team has some great news."

The crowd turned expectantly toward Pepper, who smiled broadly and announced, "Thanks to all of your hard work and to the hard work of our principles—Bruce, Diana, Lex, and myself—we have successfully completed and are ready to launch the Parker project."

At first there was silence, then the crowd erupted into exuberant applause and cheers. The project had taken nearly a year of their lives. Beer bottles clinked as employees toasted themselves and each other for a job well done. It was almost an hour later when the celebration finally settled down.

Jon Osterman, who had been uncharacteristically quiet during the revelry, rose slowly to address the group. The somber expression on his face got the attention of every employee immediately.

"I am so proud of the hard work you've all put into the Parker project, and it has been my privilege to work with and to get to know each one of you."

Jon paused and looked around the room at the expectant faces. "I received an email from corporate earlier this afternoon." He paused again and took a deep breath. The room had fallen completely silent. "Because of the recent downturn in our economy, our board of directors has decided that it would be in the best interest of the company to downsize. At this time, they are prepared to keep only the Houston and San Antonio offices open." Jon cleared his throat. "Our offices will be closed effective at 6:00 p.m. today; your computer accounts have already been closed." Jon paused for a moment and surveyed the shocked audience. "We have staff available who will gladly assist you in clearing your personal areas. I'm sorry." He turned quickly and left the room with tears in his eyes.

Numb, Pepper looked down at her tattoo, an orange and black intertwined "BK" the size of an egg, sitting just above her ankle. The mark was visible below shorts, skirts, crops, or workout wear—and now, her only interview outfit, a black skirt suit. What would potential employers think when they saw the gaudy emblem on her leg? She sighed. Her symbol of professional pride had now become a professional liability.

Pepper slowly walked back to her office and boxed her belongings. By the time she had exited the building, the indomitable Pepper Potts had already decided what she would do about that tattoo.

# TECS TIME KEEPING FRAUD

**Robert Slater, University of North Florida**
**Susie Infante, Texas A&M Corpus Christi**

## CASE DESCRIPTION

*This case introduces students to a real fraud that occurred at a company called TECS. Students are introduced to the CEO of the company and his interactions with the employee who uncovers the fraud. Students get a firsthand account of the investigation as the employee investigators try to determine which employees were involved in the fraud. The employees involved in the fraud were time keepers within the company. The fraudsters were altering their time clock data to add extra hours to their paychecks. This case is targeted for students in undergraduate auditing, fraud, or forensic accounting courses. The case may be used as a take home assignment or as the focus of an in-class discussion.*

## CASE SYNOPSIS

*This case is taken directly from the internal audit files of a large construction company. The paper illustrates a case of employee fraud where the manager of a time keeping department and one of his subordinates have been altering the time card data of the time keepers in their office. The fraudsters developed a scheme to be able to close their office for 2-3 hours a week and add the hours back to their time card data. In the case, a time keeping employee comes forward and identifies that at least two of her fellow employees have been altering the time card data for the entire local time keeping staff. The CEO of the company, Jim Edwards, is informed of the fraud by his director of internal auditing. Students are put in the role of Jim Edwards as he tries to think through the issues and tell his employees how the company will respond to the situation.*

## INTRODUCTION

A former college football player, Jim Edwards is a large man who is sitting at an even larger mahogany desk. His office surrounded by dark wood walls adorned with pictures of bridges and platform oil rigs. Jim Edwards is the CEO of TECS, a large construction and engineering firm. The pictures are of former construction projects his company has designed and built. Mr. Edwards takes a sip of coffee while looking at his computer monitor. His eyes glance up at the door as his director of internal audit, Kat White enters his office.

Mr. Edwards looks up and says, “Hey Kat. You wanted to see me?”

“Yes sir,” Kat responds, “We have identified a problem that needs your attention.”

Before Kat can finish her thought, Mr. Edwards interrupts, “A problem?”

Kat continues, “Yes, sir. We have discovered a fraud in the time keeping department.”

Mr. Edwards interrupts Kat again, this time elevating his voice “A fraud?”

“Yes sir” Kat continues, “We believe that Jay Gonzales and Fay Fleming have been manipulating time keeping records. They have been overpaying themselves and the other central time keepers.”

“How much did they get?” Mr. Edwards asks.

“We’re not really sure yet.” responds Kat.

“I guess the amount doesn’t matter.”, Mr. Edwards says sounding frustrated. “My central time keepers are should be the companies most trustworthy employees and you are telling me they are all stealing from me?”

“Not all of them.” Kat responds as she hands Mr. Edwards an incident report. “Joan Degut reported some suspicious activity with her time card data to Tony Lemond about a month ago. Tony, Sandy, and I have investigated the incident and interviewed the employees involved. We would like to have a meeting with you to discuss our findings and get your advice on how you want to proceed.”

“Okay” Mr. Edwards responds. “Let me read your report and let’s set up a meeting tonight after the other employees leave for the night.”

“Yes sir” says Kat.

As Kat White walked out of his office, Mr. Edwards eyes returned to his computer monitor but his mind was elsewhere as he tried to work. Jim Edwards had hand crafted most of his management team about five years ago. The new management team has been trying to improve processes at the company. The new managers have battled change resistance from long time employees. As CEO of a large company, his job title would allow him to completely delegate responsibility for matters such as a fraud to his management team, but Mr. Edwards took great pride in his company at every level. One time two employees driving a company truck cut him off on a local roadway. Mr. Edwards pursued the truck and read both drivers the riot act for carelessly operating the company vehicle. As he spoke with the employees, they were quiet and both looked shocked but shook their head in agreement with everything Mr. Edwards said to them. He gave the two employees one of his business cards so they would know who Mr. Edwards is within the company. A few hours later, Mr. Edwards received a call from the manager of the two employees. The manager asked Mr. Edwards if his employees were in trouble. Mr. Edwards told the manager they were not in trouble and that he felt that both men got his message loud and clear and that was all that needed to be said about the matter. The manager informed Mr. Edwards, that neither man spoke English and neither of them had any idea what Mr. Edwards had said to them!

Knowing his mind would focus on little else, Mr. Edwards grabbed the report Kat handed to him and began to read the details of the incident.

## COMPANY BACKGROUND

Technical Engineering and Construction Services (TECS) is a multifaceted construction and engineering corporation with operations in the U.S., Latin America, Canada, and other international locations. The company is headquartered in Central Florida and has been in business approximately 35 years. TECS provides construction, fabrication, and engineering services to petroleum refineries and exploration companies. TECS is a publically traded company on the NASDAQ exchange. TECS' annual sales have doubled in each of the last five years and are expected to be 1.5 billion dollars this year. TECS employs over 4,000 employees who work at various locations throughout the country. Of the 4,000 employees about one third are permanent employees for the company while the rest of the employees are hired for temporary jobs that may last from 1 to 5 years.

## TIME KEEPING DEPARTMENT

A large percentage of TECS' contracts are "time and materials" contracts. This means that TECS provides services for another company and then bills that company at an agreed upon rate for the type of labor employed. For example, a particular job might use 50 welders who work 8 hours per day. TECS pays these welders $25 per hour for their work. TECS would then bill the client $50 per hour. The billing rates are unique to each client. The billing rates are determined when the TECS initiates a contract with a client. Each contract has a "Rate Package" sheet which contains the authorized billing rates for each craft.

On a job site, groups of employees are broken into crews. Each crew has a foreman who records information about his employees such as how many hours they worked and for which clients/contracts their hours should be billed. The detailed information collected by the foreman is stored in a foreman's report. The foreman's report is given to a field timekeeper. The employees clock in and out of the job site each day. The field timekeepers are responsible for reconciling the clock data with the foreman's report. The matched clock data is sent to the payroll department where the employees are paid for their time. The field timekeepers then create a Job Time Sheet for each client by job code each day. The field timekeeper then sends the Job Time Sheet to the foreman and the client's representative at the job site for both of their signatures. TECS cannot bill a client until the Job Time Sheet is signed by both the foreman and the client's representative. Once the Job Time Sheets are signed and returned to the time keeper, the time keeper forwards the signed Job Time Sheets to the billing department.

The time keepers play an essential role in the time and billing function. They are the gatekeepers of information flows from the field to the payroll and billing departments. There are two classes of time keepers: field time keepers and central time keepers. The field time keepers work at the job site while the central time keeping staff work at an outpost building on the company's headquarters. There are 20 central time keepers working at the headquarters.

Joan Degut is new to central time keeping. Although Joan has worked in the company for over 12 years she was transferred to central time keeping headquarters in January of this year. Jay Gonzales is the Central time keeping supervisor. Jay has been with TECS for 15 years. Fay Fleming is the senior time keeping clerk and is second in command. Fay has worked for TECS for 18 years. Overseeing all of the company operations, including time keeping, is Tony Lemond, Administrator and Risk Manager. Eighteen years earlier, Tony and a former employee built the time keeping program still used by the company today.

## THERE IS AN ERROR IN MY TIME CARD DATA

On March 1$^{nd}$, Joan Degut noticed that her paycheck included pay for two extra hours. She approached her supervisor Jay Gonzales about the difference and Jay told her "I took care of you." Uncomfortable with the situation Joan asked Jay not to "take care" of her again. Less than two weeks later, Joan found another two extra hours on her paycheck and time card. She once again went to Jay's office and asked him not to add any hours to her paycheck. Jay agreed that he would not "take care of her" in the future.

As a long time employee, Joan was friends with the other employees in the department but she was feeling uncomfortable with what was going on. Not only did her paychecks reflect extra time, but her time clock records in the system were being doctored somehow. During a lunch conversation with Fay Fleming, Joan asked Fay how Jay was able to alter the time clock data to add hours to their paychecks. Fay responded "You don't want to know. If you knew you could get fired with the rest of us." Joan, uncomfortable with Fay's response, dropped the topic from their conversation.

Less than one week later, Joan found another discrepancy between the actual hours she worked, the clock data, and her paycheck. Three hours had been added to her paycheck and clock data. While Joan was upset, she was also confused as Jay was out of the office on vacation and Fay Fleming was filling in for Jay.

Joan realized that something was systematically wrong in her department. With reluctance, she approached risk manager Tony Lemond about the situation. Tony understood right away the severity of the situation. At first Tony was unsure how to handle the information Joan had provided to him. Tony wanted to act fast on the information but he also wanted to protect Joan Degut. Tony did not want other employees in the company to know that Joan was the one who came forth with the accusation. Tony also had to think about the ramifications of a fraud like this occurring in the time keeping department. Most likely, some of his most trusted employees and friends were going to be fired and maybe even criminally prosecuted. The companies TECS did business with had to trust the TECS time keepers and employees. A fraud in the time keeping department could have negative consequences with TECS clients.

Tony decided to conduct an audit of the timekeeping system. By conducting an audit, he could find the malfeasance without anyone knowing Joan was the informer. Tony enlisted the help of IT staffer Sandy Morgan and internal audit director Kat White. Sandy Morgan is a computer services specialist; she helps fix the time keeping program when problems arise.

The first agenda item for the group was to determine how the fraud had occurred. Kat White noted that the group should first document how the time keeping system worked. Once the system was documented it would be easier to determine where the weak points in the system may be. Kat and her staff were tasked with creating a narrative of the timekeeping process at TECS.

## TIMEKEEPING DOCUMENTATION

The employees clock in using an electronic time clock. Each employee has an employee ID card that is issued to them. The card has a magnetic stripe which is encoded with the employee ID number. When an employee swipes his/her timecard the clock records the employee ID number and the time of the swipe. The clock gives employees a green light if the swipe was successful. The time keeping system is designed to determine punches in and punches out by sequence. So if you swipe in at 8:00 a.m. and re-swipe your card at 8:01 a.m. (because you thought the first one did not take) the system would clock you in at 8:00am and then back out at 8:01am. These double swipes are called “proximity punches” since two punches are in close proximity to each other.

The information gathered by the clock is stored in the clock’s memory until it is downloaded to a networked computer. The time clocks are not connected to the network. At the end of each day the time clock data is downloaded to a local computer using a special data cord. The data is stored in a temporary file on the local computer until it is manually imported into the time keeping system. Upon being imported into the time keeping system, a backup of the temporary file is stored on the local computer.

The time keeping system has been designed to sort and store the employees’ clock data. To account for proximity punches the time keeping system has been designed to ignore any two punches that are within five minutes of each other. For example, if an employee is heading out of the plant and swipes his/her card out and then realizes they need to come right back and he/she re-swipe his/her card in, the employee would be logged out, then logged back in. By ignoring proximity punches the number of manual adjustments was cut way down.

The timekeeping system was written 18 years ago in a programming language called RPG (Report Programming Generator). The programming language was designed to capture data and create printed reports. The electronic reports are then used as inputs for the payroll system. The timekeeping system collects the clock data for the employees and summarizes the data for input into the payroll system. While RPG was effective at creating reports from data, the programming language lacks basic internal control mechanisms found in today's' software.

The timekeeping system also allows for manual adjustments to be made by timekeepers. This is a necessary and essential requirement of the system as quite often clock data that comes from remote locations may be incomplete or inaccurate. For instance, if an employee failed to clock out, a manual entry might be necessary. Manual entries are recorded into the payroll system and are treated just like clock entries. Manual entries can be identified in the time keeping system because the system puts an "M" directly following any manual clock entry.

## THE AUDIT PLAN

To determine where to begin their audit, the audit group decided to examine the evidence they already had available to them in order to determine how the fraud was being committed. The auditors knew they had three instances where Joan Degut's clock time had been altered. Joan suspected that two of the alterations were done by Jay Gonzales and the third might have been done by Fay Fleming but she was not quite sure. The team would start by examining these three records to determine if there was a traceable pattern. Joan let the team know that all three incidences occurred when the time keeping staff had left early for one day during the week. The entire department shut down at 3:00 p.m. and everyone clocked out as normal. Joan's paycheck and time clock records indicated that she clocked out at 6:00 p.m. and not 3:00 p.m. as she remembered.

The internal audit staff decided to examine the electronic time keeping system records. Tony Lemond knew he had designed the system to allow for manual entries but he could not determine how the time keeping employees were removing valid time clock entries. Upon examining the electronic records for the day in question things started to make sense. Kat White created a report showing the clock data regarding Joan Degut for the day in question. There were six entries in the database for Joan on that day. There should have only been four entries: a clock in for the day and then back out for lunch as well as one clock in from lunch and one clock out for the day. The system showed six entries, two of which were manual entries.

**TECS**
**Time Keeping Audit Report**
**Joan Degut's Time Card**
**March 1, 2013**

| Employee | Date | Time | Manual |
|---|---|---|---|
| 2345 | 3/1/2013 | 9:00 a.m. | 0 |
| 2345 | 3/1/2013 | 11:21 a.m. | 0 |
| 2345 | 3/1/2013 | 12:19 p.m. | 0 |
| 2345 | 3/1/2013 | 2:00 p.m. | 0 |
| 2345 | 3/1/2013 | 2:04 p.m. | M |
| 2345 | 3/1/2013 | 6:00 p.m. | M |

After reviewing Joan's time card report for March 1, 2013 it was apparent that someone had created two manual entries. The first manual entry at 2:04 p.m. triggered the "proximity punch" mechanism in the system since there was one punch at 2:00 p.m. and another within five minutes at 2:04 p.m. By entering the manual punch into the system they essentially deleted the real clock out time for the employee. The perpetrator then entered another manual entry at 6:00 p.m. thus giving the employee four extra hours of pay.

The audit team was excited as they were pretty sure they knew how this fraud was perpetrated. It appeared that the employees had taken advantage of the proximity punch trigger to alter the records. Just to be sure Kat White ran another report looking at Joan's time sheet for the other two days that Joan stated she was overpaid.

**TECS**
**Time Keeping Audit Report**
**Joan Degut's Time Card Data**
**March 15, 2013 & March 22, 2013**

| Employee | Date | Time | Manual |
|---|---|---|---|
| 2345 | 3/15/2013 | 9:01 a.m. | 0 |
| 2345 | 3/15/2013 | 11:15 a.m. | 0 |
| 2345 | 3/15/2013 | 12:18 a.m. | 0 |
| 2345 | 3/15/2013 | 6:03 p.m. | 0 |
| 2345 | 3/22/2013 | 9:05 p.m. | 0 |
| 2345 | 3/22/2013 | 11:12 a.m. | 0 |
| 2345 | 3/22/2013 | 12:14 a.m. | 0 |
| 2345 | 3/22/2013 | 6:02 p.m. | 0 |

Less than enthusiastic Kat realized the teams' work was not complete. Somehow, the time records for March 15th and March 22nd were edited without the system recording any manual entries for her time card. Kat recalled Joan stating that Jay Gonzales was out of town when the third incident occurred and that Fay Fleming was in charge of time keeping when she was given three extra hours. The audit team was pretty sure they had two different perpetrators but could they also have two different methods to conduct the same fraud?

Sandy Morgan reviewed the time keeping database and could see no alterations to the data from the time it was imported into the system. The team decided to trace the data from the original source to the time keeping system. The data originates with the time clocks. As stated above, employees are given an ID card they swipe which generates records on the time clock itself. The time clocks had limited display LED screens and very few functions that can be run on the clock itself. The auditors did not think any of the staff would be able to hack the time clock itself to make changes.

To download the data from the time clock you needed to have a special cable. The clocks are physically taken to a local PC in the timekeeping office. To download the data the time keepers click an icon on the desktop which initiates the timekeeping system download module. The download software came directly from the hardware vendor who sold the time clocks. When the software downloads the time clock data it keeps two sets of files. One file is a working file and the second file is a log file. The working file is made up of the currently downloaded data. The log file contains a history of the prior clock data. As new data is downloaded from the clock two transactions happen simultaneously. First, the new downloaded data is automatically appended to the log file. Second, the new downloaded data is written to a working file. The timekeeping module runs a routine on the working file, reformatting the date field from the clocks so they are consistent with the customized timekeeping software. Once the date field is reformatted the working file is uploaded the mainframe's customized timekeeping software.

It had always been assumed that the working file saved by the local computer was somehow protected by the software. To the audit teams' surprise, they found that by searching through the directory of the computer you could find the working file and edit the data in a text editor before uploading the data to the system. The audit team suspected some of the changes were being made in this temporary file. Now all they had to do was prove it.

## THE STING

The audit group knew the timekeepers perpetrated their fraud on days when the timekeepers closed the shop early. The auditors decided to catch the group in the act. They knew the timekeepers generated a lot of network traffic on the local area network when they were operating at full speed. The group asked the network manager to notify them if the network activity for the timekeepers was low during normal business hours. Within two weeks the IT department called Tony at 3:30 p.m. on a Wednesday and stated that the network traffic for timekeepers was almost at a standstill. Tony walked across the property to where the time keepers shop was located. He found the office was locked, the shades were drawn and it appeared everyone was gone for the day. Tony called Jay around 3:38 p.m. and Fay around 3:39 p.m. and there was no answer from either of their office phones. Around 4:00 p.m. Jay called Tony back from his cell phone. Tony did not let on that he knew they were not in the office instead he asked a routine question and Jay answered without suspicion.

Tony had Sandy Morgan meet him at the time keepers building. The time clock the time keepers used to punch in and out that day was still in the office. Sandy brought a laptop with her. Tony and Sandy downloaded the daily punches for the time keepers to her laptop. The original data was left on the time clock so Jay would not know anyone had been there. Sandy also made a backup of the history file from Jay's desktop computer. The history file stored the previously downloaded time clock data. All that was left to do was to wait for Jay to alter and upload the fraudulent data into the timekeeping software.

As expected, at the end of the week the time clock data from central time keeping was uploaded to the time keeping and payroll systems. Eighteen out of the nineteen employees working on the day of the sting all had time cards that reflected punch outs at 5:00 p.m. The only employee without extra hours added to her time card was Joan Degut.

## THE CONFRONTATION

Tony Lemond knew that TECS had a problem that needed to be addressed. Some of his most trusted employees were stealing from the company. Tony wasn't sure how long they had been stealing from the company or how much money they had already received. Tony knew one thing; he was not going to let them run their scheme again.

On Monday morning, Tony Lemond and Kat White asked the time keeping staff to come to the main office for a meeting to evaluate new time keeping software. The time keeping software evaluation was a guise so they did not tip any of the employees off as to their true intentions. As each employee arrived, they were escorted into a private office and interviewed regarding the theft.

Fay Fleming was the first employee to be interviewed. Tony told Fay that he knew she and the other time keeping staff were being overpaid. Tony stated that he noticed they were closing the office down as early as 3:00 p.m. and paying themselves until 5:00 p.m. and 6:00 p.m. on some days. Fay stated that she was never overpaid. Tony asked Fay if Jay had ever "taken care of her" and Fay stated she never had any hours added to her time cards. She also stated that she had heard Jay use the phrase "I took care of you" to other employees but she did not know what he was referring to.

Tony presented Fay the changes made to the time clock data from the previous week. Fay stated that she was aware that changes could be made in the time keeping system using manual adjustments but she did not know that the data could be altered in the PC before being uploaded. Fay insisted that any changes she ever made to a time card using the manual entries were within company guidelines. Kat asked Fay who in the time keeping staff would have the knowledge to alter the time card data on the PC, Fay stated Jay Gonzales was the only person she knew with those skills.

Kat asked Fay why she thought her colleagues might steal from the company. Fay stated that often times the time keepers would miss a break or do some work at home and that they may have added hours to their time cards to make up for these extra hours. Kat then asked Fay if they could determine that she was overpaid, would she be willing to pay the company back and Fay stated that she would.

Penny Moore was the next time keeping clerk in the office that morning. When asked about the overpayment from the previous week Penny stated that she did not realize she had been overpaid. Penny claimed that she never kept track of her hours and that her checks are direct deposited so she didn't even really look at the amounts. Kat and Tony evaluated Penny's knowledge of the time keeping system and determined that she did not have the access to change the data in the PC or do to a manual entry in the system.

Penny was also asked that if a dollar amount could be determined of what she had been overpaid, would she be willing to pay this amount back. Penny stated she would pay the money back if that was the only way to keep her job. The other time keepers' stories were similar to Penny's story. Each of the time keepers indicated they would be willing to pay back any overpayments as determined by the company's auditors.

Jay Gonzales was the last employee from the time keeping department to show up at the main office. Tony and Kat brought Jay into the main conference room and laid out the evidence they had regarding the overpayments from the prior week. Jay was very defensive and verbally attacked Jay yelling at him "Do you know how long I have worked for this company? Do you realize how many of my nights and weekends have been spent fixing problems for this company? I can't believe you would question me like this!" Tony tried to calm Jay down but it was very difficult to do. "Why did you change the clock data Jay?" Tony asked. Jay denied changing the clock data and stated that he could not figure out who on his team would do such a thing.

After several minutes of silence, and without a confession from Jay, Tony asked Jay "What would you do if you were in my position?" to which Jay responded "I'd probably let all of us go." When asked if he would be willing to pay back any money the company determined he was overpaid, Jay Gonzales agreed he would.

Tony told Jay he was going to be put on leave without pay. Tony then escorted Jay back to his office to clean out his personal belongings. As Jay was packing up his things he stated "Boss, I messed up real bad" to which Tony had no response.

**Meeting of the Investigative Team and Mr. Edwards**

Kat White, Sandy Morgan, and Tony Lemond walk into the main conference room at TECS. The rest of the employees have gone home for the night. Mr. Edwards is already sitting at the end of the conference table. Laid out on the table in front of him is a copy of the report given to him by Kat White as well as a yellow legal pad. Before the three employees even sit down Mr. Edwards looks at Tony Lemond and says:

> "Tony, tell me why I shouldn't just fire you right now?"
>
> Confused and slightly shocked Tony responds, "Me? Why would you fire me? I didn't have any part in this!"
>
> Sternly Mr. Edwards says, "You oversee operations at this company and you never noticed that you have an entire department leaving early every week? Besides you built this system the employees hacked." Before Tony can even respond to the question Mr. Edwards continues, "Maybe I am responsible? After all, the buck stops with me. And how am I supposed to believe the time keepers who state they didn't know they were overpaid? It's not like they are uneducated laborers, they're time keepers and they get paid to deal with this kind of thing!"
>
> Happy the subject seems to have changed for the minute; Tony quickly responds to Mr. Edwards and says, "Do you want me to fire the whole department boss?"
>
> Before anyone else could talk Sandy Morgan responds, "If we fire all of the central time keepers, who will do the job of the time keeping department, and who will train the new time keepers? They are a critical part of our operations."
>
> Kat White joins the conversation and says "We cannot fire Joan. We have to be careful how we treat her. She may be considered a whistleblower."
>
> Tony cuts Kat off saying "I didn't mean I was going to fire Joan. I'm not even sure if all of the other time keepers were in on this scam."
>
> "What about the police," adds Tony, "Should we get them involved?"

Sandy responds to Tony, "We might have ruined some of the forensic evidence during our investigation."

"STOP!" exclaims Mr. Edwards as he stands up, "I don't want the police involved! Well, I am not really sure if I want the police involved. I am not sure what I want to do right now. I have to protect the integrity of our operations while at the same time protect the reputation of our company. Let's wrap this meeting up now and meet again first thing in the morning. I have a lot on my mind right now."

Mr. Edwards grabs his copy of the report and his legal pad and returns to his office. Sitting back in his chair he throws his feet up on his desk and starts thinking about the best way to handle the situation.

# REAL ESTATE INVESTOR'S INC.

**Shelley Morrisette, Shippensburg University**
**Louise Hatfield, Shippensburg University**

## CASE DESCRIPTION

*This case can be used to focus on several different types of analysis – financial, management and investor goals, and strategy. The case traces the evolution of a small real estate investment company created by three individuals who meet in an MBA Program. The case also addresses the synergies and conflicts of meshing personal lives with the creation, management, and growth of a small business. This case would be most appropriate for undergraduate courses in small business management and graduate courses as a class discussion. The case is designed to be discussed in one to one and one-half hours and should take students no more than three hours of outside preparation.*

## CASE SYNOPSIS

*Ryan Mathau is one of three partners in a relatively young and small real estate investment company, which was created in 2004 when capital is easily available. The three partners purchase inexpensive rental buildings in need of significant work, renovate and standardize the buildings, and then manage the rental properties. The partners stopped buying shortly before the 2008 banking crisis and were content to hold their current size until an opportunity presented itself in 2011. At the same time Ryan is experiencing increased time conflicts in his personal life and begins to question the long hours he is putting into this business while also employed full-time as an accountant. The company and Ryan must decide where to go from here.*

## INTRODUCTION

Ryan Matthau woke up after a short night's rest in the fall of 2011. His back hurts, his shoulders are bruised, and he is badly in need of coffee. He rolls over and is ready to start another day in his real estate adventure. Questioning his own sanity, he stumbles to the kitchen for much needed caffeine; another renovation is in progress which will tie up his entire weekend. Ryan Matthau is a partner in a three-man real estate investing corporation. His partners, Chris Belker and James Daniels, will be waiting for him to arrive at their newest remodeling project in about an hour.

## BACKGROUND OF FOUNDERS

Ryan Matthau, Chris Belker, and James Daniels started to invest in real estate together in 2004. As they repaired and remodeled each property, its value increased as did their equity portion in the property. After a new bank appraisal, they then used the new-found equity to fund the acquisition and remodeling cost of the next property to fuel growth. Each had related experience they brought to the table, making the investing, maintaining, and managing of these properties a feasible, and profitable, endeavor.

Chris Belker has an undergraduate degree in Chemical Engineering from Rochester Institute of Technology (RIT). Unlike the typical engineer, Belker realized he was quite the "people person"; so, he earned his real estate license and began working as a Realtor in the Rochester, NY area immediately out of college in 1995. Though he was making a living, with an annual salary of $33,000, his true inspiration was in investments and following Wall Street. To further pursue this love, he began taking prerequisite courses at Babson College in 2001 in pursuit of his Master of Business Administration (MBA). Over time, Chris dabbled in some small real estate investments and other home projects on his own; but, the fear of risk in the real estate market held him back.

James Daniels worked his way through college, eventually earning his Bachelor of Science degree in Business Administration from Boston College in 1997. Having grown up in a construction family, most of his earnings were derived from construction and handyman endeavors. Even though he was a college graduate, he felt most at home on a job site with a hammer on his hip or a circular saw in his hands and spent his entire career in various construction-related positions. He believed that his real-world skills and book knowledge could lead him to great success as a Donald Trump-like developer. He entered into the Babson College MBA program in 2003 to further his business education.

Ryan Matthau earned his undergraduate degree from Boston University in accounting in 1991 and immediately went to work as an accountant for a logistics and warehousing company in Pittsford, NY, a popular suburb of Rochester. He completed his CPA exam in 1996 and received a small increase in pay. He served his company well with long hours and diligent financial analysis for many years. By the beginning of 2003, he began to realize that his upward mobility was limited at his current employer so he applied, and was accepted for, the Babson College MBA program. He began taking night classes beginning in the Fall semester of that year.

Matthau and Belker met in the MBA program in 2003 and were assigned to work as teammates in a number of their MBA courses. They became good friends and Matthau eventually bought a house from Belker. In January 2004, Matthau and Belker met Daniels and decided to join as a three person team to solve the casework assigned in an Entrepreneurship class. After working through a particularly lengthy case involving real estate investing, they started to realize real estate investing was their calling. Moreover, their skills and personal goals complimented each other nicely. What's more, Belker's current job as a Realtor in the Rochester, NY area allowed him to be exposed to a plethora of great deals; each of which seemed ripe for the picking

## HISTORY OF REAL ESTATE INVESTOR'S INC.

Eager to capitalize on the easy money from the banks in 2004, the group first incorporated as Real Estate Investors, Inc. (REI, Inc.), each taking a full third ownership. The corporation structure with subchapter S election, was chosen to reflect the legal structure their lawyers, accountants, and insurance agents could best come to terms with recommending. Because Daniels had a job in the real estate industry, finding an appropriate accountant, lawyer, and insurance representative was simple. By this point, they just needed to purchase properties and find a reasonable way to pay for them.

The group started by pooling some of their hard-earned savings together. Belker had been selling houses at a breakneck pace, so he had commission checks aplenty. Daniels did quite well in construction, and Matthau convinced his wife this would be a great idea. All told, the group initially invested $75,000.

The team bought two properties by mid 2004, within weeks of each other, and learned quite a bit at the onset. Many of their assumptions and financial analysis was flawed. From these experiences, however, they learned quite a bit and adapted fast which fueled their growth for rapid purchase. They began to understand the real estate business more with each property, and were able to make wise decisions. Their properties typically had two or three units per building, which could be rented for between $440 (for an efficiency 1-room unit) and $685 (for a 3-bedroom unit). The goal was to provide tenants with a clean, safe, and well-maintained place to live. The group also emphasized standardization of paint, light fixtures, door locks, window blinds, and all items required for a renovation. They shopped at bargain outlets and used sales at Lowe's and Home Depot to keep expenses down.

The men worked as a team when a property was purchased. Typically, their purchased properties were in need of a significant overhaul; therefore, the properties were usually very inexpensive. The group emphasized tenants paying their own utility bills, and actively worked to convert all utilities to electric for this very reason. This method would yield fewer total utilities, making them easier to split for the multi-unit properties. Using this plan, the team installed electric ranges and ovens, baseboard heat, and electric water heaters while eliminating maintenance-intensive furnaces in need of oil or gas. The group had grown accustomed to using a local electrical outfit, CM Squared, Inc., who provided the investors with reliable work at fair pricing. All in all, each investor had his strength. When combined, they could accomplish nearly any remodeling task in a property.

The money seemed so easy to borrow from the banks that Daniels quit his day-job as a Project Manager at a small construction firm to work full time for their own corporation as Project & Maintenance Manager for an annual salary of $40,000 with no benefits. He was responsible for mowing lawns, changing locks, unclogging drains, purchasing materials, and managing outside contractors. Belker continued to work as a Realtor; but also served as the corporation's Tenant Relations Manager which involved showing perspective tenants available units, dealing with day-to-day tenant correspondence, and rent collection issues. Matthau also kept his full time position as an accountant at the logistics firm; but, agreed to the position of Office Manager for REI, Inc. His duties included: interacting with the accountant & attorney, processing mail, keeping the financial records, and processing all paperwork. Belker and Matthau each received an annual compensation of $10,000 annually with no benefits.

All three cleaned out apartments when tenants left, remodeled properties, and assisted with minor maintenance repairs. When a renovation was in full swing, they put in an exorbitant amount of time.

At the beginning of 2008, the management team agreed that the current company size of 42 properties yielding 94 apartment units was good place to hold for a while. Indeed, it had been a fast-paced adventure; but, the group continued to look to the future. They stopped buying and focused on strengthening their policies, procedures, and profitability issues of the now sizable company.

The market quickly changed with the global banking crisis of October 2008, while the real estate industry virtually collapsed. With the failure of several major financial institutions and many others on the brink of collapse, money was no longer loaned out without discretion. Banks placed limits on borrowers, even in good standing, that had never been seen before.

The group initially shrugged off the economic changes and had an excellent 'gung-ho' approach. They rallied behind the camaraderie of their Babson College experience and applauded how the hand-holding campfire experiences there had led them to foresee the coming collapse. Since they were no longer buying, all they needed to do was maintain. Additionally, they shared with each other, "where will all the people go who were foreclosed upon – they will turn to rental units and our demand will skyrocket along with our profits." Truly, they believed, they were invincible.

As the months wore on, Matthau began to secretly worry more than Daniels or Belker. Matthau received intense pressure from his wife, who feared the pressures of the market would collapse the company. Moreover, Matthau and his wife were expecting their first child. "Time to grow up…." became staple conversations at the dinner table; when Matthau was home to enjoy it. The 70 – 90 hour weeks were wearing thin, and the market news did not help in the least.

By October of 2011, Chris Belker and Ryan Matthau each were putting in around 6-15 hours per week, over-and-above working a full week at their 'normal' jobs, and James Daniels worked 30-60 hours per week as needed, depending on current maintenance issues or remodeling projects underway. Belker and Daniels loved the arrangement. They were making profits and could foresee a time in the next decade when mortgages began to be paid in full and that extra cash-flow could flow to the bottom line instead of the mortgage payments. Though Matthau appreciated the financial achievements and enjoyed working with the other two, the extra weekends and late night remodeling projects were wearing on him. He didn't want to seem snooty; yet, still kept asking himself why he bothered to invest 6 years in an undergraduate and graduate degree, plus a CPA, only to do blue-collar work in his free time. He increasingly didn't like the remodeling projects and wasn't particularly good at it.

## FINANCIALS

Table 1
REI, INC. COMPARATIVE PROFIT & LOSS STATEMENTS

| | Jan - Dec 08 | Jan - Dec 09 | Jan - Dec 10 | Jan - Dec 11 (Projected) |
|---|---|---|---|---|
| Ordinary Income/Expense | | | | |
| Income | | | | |
| 4000 · Fee Income | | | | |
| 4010 · Application | 3,715 | 1,534 | 2,229 | 1,260 |
| Total 4000 · Fee Income | 3,715 | 1,534 | 2,229 | 1,260 |
| 4200 · Rental Income | | | | |
| 4210 · Monthly Rent | 526,501 | 570,988 | 616,208 | 560,148 |
| 4220 · Late & Penalty | 23,303 | 23,436 | 32,454 | 13,699 |
| 4230 · Forfeited Sec Dep | 18,552 | 7,413 | 18,430 | 13,866 |
| 4240 · Damages | 113 | 643 | 326 | 1,172 |
| Total 4200 · Rental Income | 568,469 | 602,480 | 667,418 | 588,885 |
| 4500 · Purchase Discounts | 68 | 55 | 82 | 118 |
| Total Income | 572,252 | 604,069 | 669,729 | 590,263 |
| Expense | | | | |
| 4001 · Reconciliation Discrepancies | 0 | 1,125 | -398 | -0 |
| 5500 · Maintenance & Repairs | | | | |
| 5510 · Property Maintenance | 35,810 | 20,345 | 34,746 | 16,159 |
| 5520 · Grounds Maintenance | 10,873 | 9,887 | 8,313 | 11,766 |
| 5530 · Equipment Maintenance | 40 | 0 | 410 | 0 |
| Total 5500 · Maintenance & Repairs | 46,723 | 30,232 | 43,469 | 27,925 |

| | | | | |
|---|---|---|---|---|
| 5600 · Utilities | | | | |
| 5610 · Electric | 4,179 | 6,230 | 5,078 | 5,399 |
| 5620 · Water & Sewage | 44,618 | 48,183 | 59,175 | 60,369 |
| 5630 · Trash | 18,273 | 17,309 | 18,907 | 16,034 |
| 5640 · Gas & Oil | 10,248 | 0 | 0 | 0 |
| Total 5600 · Utilities | 77,318 | 71,722 | 83,160 | 81,802 |
| 6000 · Advertising Expense | 4,000 | 5,895 | 677 | 2,637 |
| 6100 · Depreciation Expense | 111,119 | 123,951 | 122,456 | 118,993 |
| 6150 · Amortization Expense | 3,424 | 3,840 | 3,840 | 3,840 |
| 6200 · Office Expense | | | | |
| 6205 · Printing & Repro | 182 | 82 | 3 | 0 |
| 6210 · Office Supplies | 2,682 | 1,035 | 121 | 180 |
| 6215 · Postage & Delivery | 901 | 781 | 467 | 665 |
| 6260 · Voice Phones | 63 | 63 | 69 | 127 |
| 6265 · Wireless Phones | 522 | 428 | 497 | 506 |
| Total 6200 · Office Expense | 4,350 | 2,389 | 1,157 | 1,478 |
| 6300 · Insurance | | | | |
| 6310 · Property Insurance | 20,950 | 16,505 | 16,806 | 17,542 |
| 6350 · Life Insurance | 474 | 474 | 474 | 474 |
| Total 6300 · Insurance | 21,424 | 16,979 | 17,280 | 18,016 |
| 6450 · Tenant Discount | 255 | 0 | 0 | 0 |
| 6500 · Professional Fees | | | | |
| 6510 · Accounting | 2,385 | 2,690 | 2,560 | 2,560 |
| 6520 · Legal | 6,252 | 3,270 | 9,034 | 4,445 |
| 6530 · Background Checks | 1,376 | 1,055 | 911 | 945 |
| 6540 · Dues & Subscriptions | 120 | 120 | 60 | 0 |
| Total 6500 · Professional Fees | 10,133 | 7,135 | 12,565 | 7,950 |
| 6600 · Interest Expense | | | | |
| 6610 · Mortgage Interest | 211,068 | 222,623 | 207,554 | 178,170 |
| 6620 · Credit Line Interest | 9,116 | 1,373 | 690 | 0 |
| 6630 · Credit Card Interest | 3,090 | 5,514 | 2,554 | 21 |
| 6640 · Bank Service Charge | 1,283 | 530 | 804 | 785 |
| 6650 · Loan Interest | 5,946 | 12,762 | 14,183 | 11,435 |
| Total 6600 · Interest Expense | 230,503 | 242,802 | 225,785 | 190,411 |
| 6700 · Payroll Expense | | | | |
| 6710 · Salaries | 60,000 | 60,000 | 60,000 | 60,000 |
| 6720 · Medicare | 870 | 870 | 870 | 870 |
| 6730 · Social Security | 3,720 | 3,720 | 3,720 | 3,720 |
| 6740 · Unemployment | 2,111 | 1,907 | 1,822 | 1,886 |
| 6750 · Benefits | 0 | 0 | 0 | 0 |
| Total 6700 ·Payroll Expense | 66,701 | 66,497 | 66,412 | 66,476 |
| 6800 · Taxes | | | | |
| 6820 · State Tax | 96 | 110 | 110 | 110 |
| 6830 · Local Tax | 170 | 146 | 400 | 395 |
| 6840 · County Property Tax | 30,728 | 38,804 | 39,429 | 39,827 |
| 6850 · School Property Tax | 56,342 | 57,660 | 59,551 | 61,806 |
| 6860 · City Property Tax | 10,744 | 7,226 | 7,226 | 7,339 |
| Total 6800 · Taxes | 98,080 | 103,946 | 106,716 | 109,477 |
| 6900 · Bad Debts | 29,540 | 16,706 | 54,243 | 26,848 |
| Total Expense | 703,570 | 693,219 | 737,362 | 655,853 |
| Net Ordinary Income | -131,318 | -89,150 | -67,633 | -65,590 |
| Other Income/Expense | | | | |

| | | | | |
|---|---|---|---|---|
| Other Income | | | | |
| 7010 · Interest Income | 296 | 34 | 19 | 27 |
| 7030 · Other Income | 3,000 | 0 | 0 | 0 |
| Total Other Income | 3,296 | 34 | 19 | 27 |
| Other Expense | | | | |
| 8010 · Other Expenses | 0 | 0 | 7 | 0 |
| Total Other Expense | 0 | 0 | 7 | 0 |
| Net Other Income | 3,296 | 34 | 12 | 27 |
| Net Income (EBT) | -128,022 | -89,116 | -67,621 | -65,563 |
| Net Income (EBTDA) | -13,479 | 38,675 | 58,675 | 57,270 |
| - Excludes Depreciation & Amortization (from above) | | | | |

## MARKET DATA

Census data for household demographics for store neighborhoods are presented in Table 2. Beginning in 2010 the Census Bureau used a clustering program to place households into one of 60 behavioral profiles. These profiles are based on socio-economic, behavioral and demographic similarities. The family profiles indicate media, consumption, and life-style habits and are used by numerous database companies to segment consumers. The clustering program, MOSAIC, was developed by Experian (a credit rating agency).

## 2011 MARKET ANALYSIS

The outlook for the real estate market was similar to national economic forecasts. Overall, consumer confidence was low and tightened lending regulations forced many mortgage loan applicants, who would have been approved for a mortgage before the lending crisis, to rent. The tightening of lending regulations also gave all-cash buyers a lot of leverage. Nationally, 18% of home buyers paid all cash in July 2011 which increased to 22% in August 2011. Up to half of all home purchases were made in cash in hard-hit areas like Las Vegas and Miami. Although the Greater Rochester area real estate market seemed above the national averages in terms of real estate sales, days on the market increased while sales prices, as indexed to the listing price, plummeted.

The National Association of Realtors (NAR) predicted that the rise in rent was forecasted to increase for the next 20 years. Rents would double in 20 years if GDP growth remains at or near 3.5% or would double within 14 years if GDP growth increases to 5%. NAR also indicated that the increase in housing prices will follow a similar path as the rental market with an expected doubling in real estate prices in 14-20 years from what they believe is the now recorded "generational bottom" of the market.

## A NEW OPPORTUNITY

In order to increase his exposure and education of the industry, Chris Belker joined the Rochester Area Property Owners Association (RAPOA) on behalf of REI, Inc. as a founding member in May 2005. Now, serving as its Vice President, Belker is both a source of inspiration to many of its members and a go-to member for advice and expertise. On Oct 21st, 2011, as its regularly scheduled monthly meeting, he was presented with an opportunity for growth and a model neither he, nor the firm, had considered heretofore - purchasing properties directly from the owner without a Realtor listing. A local investor and fellow buy-and-hold landlord, Bobbi Cujones, had enough and wanted out as the ups and downs of the industry were more than she could handle. Cujones was a small-timer with only one 2-unit rental building. She approached Belker with an offer to sell her holding fast and cheap.

The building can be purchased for $50,000 which includes closing costs; such, as notary fees, legal work, commissions, and buyer-side fees. The property will require $12,000 in construction repairs before it passes city inspection criteria and is ready to rent by REI's rigorous self-evaluation standards. If the company finances the property at 6.4%, it will be required to invest 20% of the purchase price, or $10,000, and must absorb $1,000 in financing fees which cannot be incorporated into the loan. They can, however, use the equity in their other holdings to complete the deal with no cash outlay. Total equity investment of $23,000. REI's required rate of return is 10%.

The firm is in the 28% tax bracket which will not change by incorporating this property. Once upgraded, the property will have a fair market value of $75,000 and should be able to sell in a reasonable amount of time for that value, though the firm does not intend to sell.

The property is in a neighboring town that attracts a higher-class of tenant and better rents. It includes a 1-bedroom apartment on the first floor that should rent for $700/month and a 2-bedroom apartment on the second and third floors that should rent for $800/month. Respective tenants pay all utilities, except as noted in what follows.

Experience provides the firm with the projected conservative monthly expenses: 5% of rent toward vacancy allowance, 5% of rent toward ongoing maintenance, water/sewer/trash paid by landlord of $180/month and common electric of $15/month. Annual real estate taxes of $2,200 and liability insurance of $560.

Table 2 reports the financial analysis for this opportunity.

Table 2
NEW OPPORTUNITY

| **Calculations:** | |
|---|---|
| $r_{equity}$ | 10% |
| Initial Cash Investment | $ 23,000.00 |
| Debt Interest Rate | 6.4% |
| Tax Rate | 28% |
| Principal of Loan | $ 40,000.00 |
| Interest-Only Loan Payment | $213.33 |
| Interest Paid/Year | $ 2,560.00 |

| **Annualized Revenue** | |
|---|---|
| Rental Income | $ 18,000.00 |
| **Annualized Costs** | |
| Bills: W/S/T & Electric | $ 2,340.00 |
| RE Property Taxes | $ 2,200.00 |
| Interest Only Payment | $ 2,560.00 |
| Insurance | $ 560.00 |
| Vacancy Allowance | $ 900.00 |
| Maintenance | $ 900.00 |

Using Flow To Equity (FTE) Approach:

| **Revenue** | |
|---|---|
| $ 18,000.00 | rental income |
| **Costs** | |
| $ 2,340.00 | bills |
| $ 2,200.00 | RE property taxes |
| $ 2,560.00 | int. only pmt |
| $ 560.00 | insurance |
| $ 900.00 | vacancy allowance |
| $ 900.00 | maintenance |
| $ 9,460.00 | TOTAL |
| | |
| $ 8,540.00 | EBT |
| $ 2,391.20 | tax @ 28% |
| | |
| $ 6,148.80 | **Cash Flow** |

$$r_e = .10 + \frac{D}{E}(1 - T_c)(r_{all\ equity} - r_d)$$

$$r_e = r_{all\ equity} + \frac{\$23{,}000}{\$6{,}149}(1 - .28)(.10 - .0624) = 19.7\%$$

$$Market\ Value\ of\ Equity = \frac{\$6{,}149}{.197} = \$31{,}219$$

$$\boxed{NPV_{FTE} = \$31{,}219 - \$23{,}000 = \$8{,}219}$$

Using Weighted Average Cost of Capital (WACC) Approach:

$$r_{wacc} = \left(\frac{equity}{equity+debt}\right)(cost\ of\ equity) + \left(\frac{equity}{equity+debt}\right)(cost\ of\ debt)(1 - tax\ rate)$$

$$r_{wacc} = \left(\frac{\$31{,}219}{\$31{,}219+\$23{,}000}\right)(.197) + \left(\frac{\$31{,}219}{\$31{,}219+\$23{,}000}\right)(.064)(1 - .28) = 14.0\%$$

$$\boxed{NPV_{WACC} = \frac{\$6{,}149}{.14} - \$23{,}000 = \$23{,}921}$$

Using Adjusted Present Value (APV) Approach:

| **Revenue** | |
|---|---|
| $ 18,000.00 | rental income |
| **Costs** | |
| $ 2,340.00 | bills |
| $ 2,200.00 | RE property taxes |
| $ 560.00 | insurance |
| $ 900.00 | vacancy allowance |
| $ 900.00 | maintenance |
| $ 6,900.00 | TOTAL |
| | |
| $ 11,100.00 | EBT |
| $ 3,108.00 | tax @ 28% |
| | |
| $ 7,992.00 | **Cash Flow** |

$$NPV_{all\ equity} = \frac{Unlevered\ CF_{per\ year}}{r_{all\ equity}} - initial\ investment$$

$$NPV_{all\ equity} = \frac{\$7{,}992}{.1} - \$63{,}000 = \$16{,}920$$

$$NPV_{tax\ shield} = \frac{tax\ shield_{per\ year}}{r_d} = \frac{(r_d)(D)(T_c)}{r_d} = (D)(T_c)$$

$$NPV_{tax\ shield} = (\$40{,}000)(.28) = \$11{,}200$$

$$APV = NPV_{all\ equity} + NPV_{tax\ shield} + PV_{other\ side\ effects}$$

$$\boxed{APV = \$16{,}920 + \$11{,}200 + (-\$1{,}000) = \$27{,}120}$$

<u>Using Capital Cash Flow (CCF) Approach</u>:

$$r_{ccf} = \left(\frac{equity}{equity+debt}\right)(cost\ of\ equity) + \left(\frac{equity}{equity+debt}\right)(cost\ of\ debt)$$

$$r_{ccf} = \left(\frac{\$31{,}219}{\$31{,}219+\$23{,}000}\right)(.197) + \left(\frac{\$31{,}219}{\$31{,}219+\$23{,}000}\right)(.10) = 15.0\%$$

NOTE: To get Annual Cash Flow, add back interest payment. Thus \$6,149 + \$2,560 = \$8,709

$$\boxed{NPV_{CCF} = \frac{\$8{,}709}{.15} - \$23{,}000 = \$35{,}060}$$

## A NEW WAY OF THINKING AND A PATH FOR GROWTH

Belker and Daniels were intrigued by the idea of purchasing this property and using this as a spring-board for starting a new growth phase to take advantage of current market conditions. Matthau was hesitant based on the previously listed internalized concerns. Belker and Daniels worked together to lay out a well-positioned argument to their partner:

The company's property appraisals ranged from July 2005 to Apr 2008; so, none were considered current (as defined by the industry as within 6 months). That said, the combined appraised value of all properties was \$4,137,630. Their current outstanding loan balances was \$2,917,071; thus, their Loan-To-Value (LTV) was 70.5% meaning they had 29.5% equity.

Since REI, Inc. had used a model of making future purchases by using the equity of current holdings in the past, they believed it was important to understand the market conditions and how conditions apply to any future potential purchases as related to their equity standing moving forward. They brainstormed:

PROPERTY SALES PRICE BELOW APPRAISED / ASSESSED VALUE: Since appraised values have become more scrutinized after the collapse of the housing bubble and now use more conservative approaches, the company could pursue properties to purchase only when the listing price is below the market average. Thus, some percentage of equity would be earned with each purchase.

REMODELING TO INCREASE EQUITY: REI, Inc. would continue to keep their standards high. Properties would be updated to code compliancy, remodeled for better flow and a newer feel, and modernized to attract a stronger tenant. Moreover, they would continue their standardization plan by using colors, materials, and manufacturers to which they had become accustomed. Remodels should gain equity.

Belker and Daniels further came up with a multi-faceted approach to acquire properties most efficiently and to increase equity in a very short time frame:

BUY DIRECT FROM SELLER: While Real Estate Investors are not advertising this means of purchasing, the company can begin informing current tenants of the interest to buy potential rental properties. As an incentive, the company can offer current tenants up to one month of free rent if it closes on a property that the tenant had recommended. This is a win-win-win for all parties involved; the tenant gets a free month rent, the seller sells, and REI acquires. Additionally, Belker can spread the word at RAPOA.

SHERIFF'S SALE: Tax foreclosures are usually in bad shape as compared to properties for sale via a real estate agent. Oft times, such properties were vandalized (electric wiring, $H_2O$ lines torn out for scrap copper, cement poured into the main sewer lines, etc.) by their previous disgruntled owners or other criminals. Generally speaking, it is difficult to acquire this type of property because the bank (mortgagee who is first in line with biggest loss) will potentially outbid any other buyer to minimize their losses. But, the potential for a good deal always exists.

Using the expertise gained by eight years of operations, Belker and Daniels additionally devised the following criteria for future purchase consideration. If perspective units are not already presently equipped as such, the expense to do so must be considered with the purchase price.

PURCHASING CRITERIA / CONDITION OF UNITS: The major capital expenditures on a rental unit are as follows (not in any particular order):

*HVAC System:* All units must be outfitted with electric appliances, including heating and cooling (if available). In some instances REI will opt out of purchasing units with gas or oil-fired heating systems as the cost to convert to electric baseboard is $3,000 per unit.

*Electrical Wiring:* Despite the great relationship with an electrical contractor, properties which are knob and tube (standard used from 1880 to 1930) wired, without any ground-wire can cause serious safety hazards; thus, this type of update can pose a significant cost.

*Roof:* Belker, Daniels, and Mathau have worked many roofs together and are at an expert level of replacing asphalt shingles and installing industrial-grade rubber roofing on flat surfaces. All three of the partners are reluctant tackle any roofing projects where the angle of the roof is high. Therefore, it is not the roof, but the pitch of the roof that is a hindrance to the purchasing decision, since hiring a roofing contractor can add upwards to $15,000 for a 1,500 sq. ft. dwelling.

*Structural Foundation:* The structural integrity of a building is best understood in the basement. Over the years, the company has gained much experience by inspecting footers, rafters, load bearing walls, and leaning or sagging issues mostly due to water or moisture damage over time. Properties with visible structural issues are candidates for a generous bargaining margin; since, they will not qualify for any type of financing from any lender. In the past, REI has purchased a few units with structural issues. When fully informed and prepared, the corrections were not too costly, reflecting mostly labor. The purchase price is normally an average of 75% less than the market price for properties with similar features in a 5-mile radius.

PRICE GAUGING AND MAKING A GOOD OFFER: It is essential to make offers that reflect repairs needed, current tax burden, and potential 'rentability'. After that, buyers rely on gut and experience to get as close to the lowest sales price as possible. Offers that are too low can turn off some sellers; thus, eliminating any chance of negotiating or purchasing in the future. Also, Realtors are well aware of "low-ballers" and are not enthusiastic about working with them. Over the years, the REI team has developed the following guide to aid them in most effectively bidding on properties:

Understand shape / condition of property and funds / time needed to complete remodeling.

Understand the going market price for properties with similar features in a reasonable radius. Zillow.com and Realtor.com can be utilized or any Realtor will be able to supply a Comparative Market Analysis (CMA).

Pay close attention to Days on Market (DOM) info. Many Realtors leave this parameter out of the sales data they supply, especially if over 90 days, as they do not want the buyer to lower the price. If the DOM is over the 108 days (average DOM for Rochester) the seller is likely getting desperate and an offer can reflect that desperation through a lower price.

Check the assessed tax records. Many counties have the tax records online or at the courthouse. The assessed taxes are not necessarily reflective of the market value.

## FINAL THOUGHTS AND DIRECTION OF REI, INC.

Ryan Mathau had best drink his coffee quickly; his co-investors would be waiting for him at their new remodel. Still, as his mind began to awake his thoughts turned to the long and hard challenges the group had faced together. He did not want to continue like this. His fellow investors wanted to buy this new property and begin another growth spurt; but he just wanted to sell, make money, and not deal with tenants. He wondered if all this effort was worthwhile. The market had significantly changed since their investing had begun a few years ago….

***This is an actual company (although the names have been changed to protect all concerned).***

# ALABAMA AIR SHUTTLE: FIGHT OR FLIGHT

**Devon Bagwell, Samford University**
**Noel Dowling, Samford University**
**William Satterfield, Samford University**
**Heather Williams, Samford University**
**Charles Carson, Samford University**

## ABSTRACT

*David Gentry, owner of Alabama Air Shuttle, had to decide whether to continue the operation of his charter service or close its doors. If he chose to remain in business, then a new strategic plan had to be developed to combat declining revenue streams. If he decided to leave the private flight industry, then several exit strategies had to be explored, including selling the business as a whole, liquidating the major assets, leasing aircraft to fractional owners, or simply shutting down.*

## INTRODUCTION

Entrepreneurs are among the most passionate and driven individuals in the business world. But as any business owner knows, this passion must be accompanied by market savvy and solid business strategy. These skills are essential to guide the entrepreneur through the ups and downs of business ownership and the ebb and flow of the economy. Alabama Air Shuttle was an air charter business whose owner, David Gentry, was certainly passionate about his business. However, during the first five years of operations, Alabama Air Shuttle also experienced instability in the economy and other various obstacles. In August 2009, David sat down at his desk with bills piling up around him. His bank account was near empty, and the phone that used to ring with new customers was now silent. David knew that something had to change and he debated many options: Should he continue his focus on air charter for business travelers? Make a change in the aircraft he utilized? Alter the marketing plan? Or should he develop an exit strategy to leave the private flight industry? As David pondered the future of Alabama Air Shuttle, he knew that he couldn't run his business on passion alone.

## COMPANY BACKGROUND

David Gentry, owner and operator of Alabama Air Shuttle, always had a zeal for creating and developing. He worked in product management for the corporate banking industry where he developed and prepared business services. David put it best when he said, “What I like to do is start with a blank sheet of paper and go from there, and turn it into something that people will actually pay money for. I just get a kick out of it.” David realized he would like to do this for himself and pursued his passion for flying and a few years later, developed an air charter business. He began his research in 2001 by reading up on the industry and interviewing those already in the field. At one point he was advised: “Don’t do this. …It’s high capital and thin profit margins…No one in Birmingham has ever been successful in doing it.” In 2002, he hired NFO Worldwide to conduct market research for approximately $15,000 and received a result that indicated a route through Gatlinburg, Birmingham, Destin and Gulf Shores for vacationers may be beneficial (See Exhibit 1, NFO Worldwide Market Research Results). However, David’s research from interviews of those already in the industry, lead him to conclude that a route through Huntsville, Birmingham, Montgomery and Mobile would be profitable if he focused on business travelers. David believed that Alabama was an underserved market that would benefit from an air charter business. His drive to succeed in this business was evident as he said, “I was out simply to prove to myself that my marketing background would make a difference, because typically air charter businesses are started by pilots who don’t know anything about business.”

Following this research, he incorporated Alabama Air Shuttle on March 9, 2004. During the next year, Alabama Air Shuttle worked with the Federal Aviation Administration (FAA) to obtain a certificate as an on-demand air carrier, which allowed the company to become operational on March 9, 2005 (See Exhibit 2, Air Carrier Certificate). The certificate allowed for a single pilot, single plane operation. Based on cost and David’s research, the decision was made to obtain a small business loan to purchase a Beechcraft Baron, a best-in-class, air-conditioned light twin engine piston aircraft with leather seats and a passenger capacity of five. Paul Nation came on board as a full-time employee (Chief Pilot in 2004 and Director of Operations in 2008) before the first plane was purchased and during the FAA certification process. The first flight was March 10, 2005. For the remainder of that year, Alabama Air Shuttle pursued a Basic Certificate (allowing them to increase their fleet to five planes), continued market research, obtained insurance, and wrote the required manuals to comply with FAA regulations. Although business was increasing, it became apparent that Alabama Air Shuttle could not make a profit with one plane. Seventy charter flights were flown in the first year of operation, but the company had to turn away 24 charters because only one plane was used. Operations for this year produced an annual net loss of over $78,000. In hopes of increasing future revenues, the company purchased a second Beechcraft Baron, identical to the first aircraft, in the fall of 2006.

David’s original marketing plan was to offer a regular route connecting Huntsville, Birmingham, Montgomery and Mobile in round-trip services. Prices for each flight ranged from $169 to $589 per person, round trip. The original marketing plan also mapped out further phases in which Alabama Air Shuttle would obtain or lease additional aircraft to expand its fleet and to extend its market reach to Jacksonville, FL. Part of this original marketing plan also included providing flights for cruise passengers to and from the Port of Mobile. According to the written plan, David believed that this would be a soft sell to Carnival Cruise Lines since they operate cruises out of the port. Unfortunately, this plan of providing a regular route was found to have very little demand and was abandoned in 2006 for a revised marketing plan (See Exhibit 3, Business Plan, 2006) that focused more on individual charter flights for small businesses. Additionally, a new component of the revised business plan was to partner with aircraft owners and help defray costs by chartering those aircraft when the owners were not using them. The goal was to help businesses take advantage of a tax loophole by leasing their business aircraft to a charter company such as Alabama Air Shuttle. By then turning around and allowing the business to "charter" their own aircraft they would avoid large tax penalties. These partnerships, according to the business plan, would produce a Cirrus SR22 (three to four passengers) at the beginning of the first year, a King Air C90 (six passengers) by midyear, and a King Air 200 (seven passengers) by the beginning of the second year. Staffing would increase by one additional full-time pilot and other pilots on an on-demand basis. Although Alabama Air Shuttle's business plan needed tweaking along the way, David was still sure that the basic concept was profitable and marketable.

## INDUSTRY BACKGROUND

Key advantages to charter flight operations include efficiency, privacy and flexibility. Air charter can be incredibly valuable to companies when taking into consideration the value of their time. Charters reduce wait times, are less hassle than commercial flights, and allow customers to fly into thousands of smaller airports around the country. Customers have the freedom to customize their transportation based on their needs. However, the air charter industry is known to be a difficult venture for operators. It is an extremely high-capital industry that relies on high volume to keep a profit margin. It is considered by many to be a luxury service, and is therefore susceptible to fluctuate wildly when the economy changes. In addition to these factors, the airline industry is also heavily regulated by the federal government. Operators could consume a great portion of time and money adhering to these regulations.

Some charter operations are simply that—privately owned planes with full time pilots ready to take passengers to any destination at a moment's notice. Other charter operations utilize charter management programs where planes are leased from individuals or businesses and managed by a second party so that both the charter operation and the aircraft owners benefit from the charter revenue. Other options include fractional ownerships (several owners share one plane and split costs), Jet Cards (pre-paid membership cards good for a set number of flight hours on a particular aircraft) and Shared-Ride Private Jet Services (on-demand charter sold by the seat).

According to the FAA, there were more than 2,500 air charter operators nationwide in 2009. These operators were required to hold an Air Carrier Certificate issued by the FAA. This allowed charter operators to conduct on-demand operations under FAR Part 135. Air charter operations that did not hold this FAA Certificate operated illegally. Without an FAA Certificate insurance companies would not pay damages in the event of an accident.

In order to understand the charter industry, one must have a general knowledge of the types of aircraft used (See Exhibit 4, Aircraft Types). Most charter operations utilize turboprops and light jets, since these planes travel farther and faster than piston planes. Some planes in the turboprop and jet categories also provide the option for an on-board lavatory. Single and multi piston aircraft are popular for shorter flights into smaller airports. They also cost less than turboprops and jets and they are even able to land on unpaved airstrips, which makes them the aircraft of choice for places like the Bahamas.

Pricing for charter flights is often charged by the hour. Although most fees are usually included in the base price, various fees and surcharges may also be charged including handling fees (landing and take-off), ramp fees (parking), overnight fees, fuel surcharges, federal and state taxes, and positioning fees (travel to departure location).

The general aviation industry took a hit in 2001 due to the September 11th attacks on the World Trade Center. Americans avoided flying at all costs. Fear gripped the country and paralyzed this industry. In 2002, the general aviation industry started to climb once again. People were still fearful of flying commercial, but many general aviation and charter businesses started to rebound from 2001. With economic growth, the aviation industry flourished from 2002 until 2007. Increase in the cost of fuel caused a temporary increase in general business travel spending in 2007. In 2008, however, the economy continued to weaken and as the country went into a recession, businesses cut travel budgets and the charter industry suffered (See Exhibit 5, Business Travel Spending). The image of the charter industry suffered even more when CEOs of the three big automakers took private luxury jets to Washington to plead for government bailouts in 2008. Fears of public scrutiny lead to further hesitation of businesses to utilize the charter industry.

## ALABAMA AT A GLANCE

Alabama Air Shuttle had approximately fifteen competitors that ran charter operations based in Alabama. One of these was exclusive to air ambulance services and another was solely a cargo carrier. One third (33.3%) of these companies used turboprop planes, 36.7% used light jets, 10% used mid-size jets, 6.7% used multi-engine piston planes, 6.7% used single-engine piston planes and 6.7% utilized helicopters (See Exhibit

6, Charter Aircraft Operated in Alabama). Only one other competitor in Alabama flew a multi-engine piston plane. Alabama Air Shuttle charged $695 per flight hour while this competitor charged $700 per flight hour. This direct competitor also chartered two turbo-props ($1,700 per hour) and three light jets ($1,800 to $2,525 per hour) in addition to the one multi-engine piston plane. Alabama Air Shuttle was the only charter operator in Alabama that operated two multi-engine piston planes and did not have a supplementary fleet.

According to David, a customer base analysis revealed that eight of Alabama Air Shuttle's ten best customers were small business of under $25 million in annual revenues, and most of these eight were actually under $10 million in annual revenue. These small businesses defined Alabama Air Shuttle's target market (See Exhibit 7, Small Businesses in AL).

## MARKETING ALABAMA AIR SHUTTLE

Alabama Air Shuttle quoted on its website, "Our goal is strong, carefully managed, consistent growth in providing first class, economical air travel services—a smart value for increasing numbers of air travelers. …We will never neglect our specialty of providing solid value for the 250–500 mile trip." They focused on providing first class service and targeted a niche market of small businesses (those willing to pay $500–$1000 per person to fly to their destination). David often said that his business was not for the rich, or for the poor, but for the "rest of us."

David approached the advertising campaign for Alabama Air Shuttle using a "shotgun" effect, mainly through print ads, charity events, radio and TV from 2005 to 2007. Print ads were run in the Yellow Pages, Auburn Alumni Magazine, physician's newsletters, and advertising in the Huntsville Symphony Orchestra playbills. A postcard mail-out was conducted based on a Dunn and Bradstreet list that targeted companies having between $1 million and $25 million in annual revenues. In addition to print advertisements and mail-outs, Google Ads were used with moderate initial success, but ultimately resulted in diminishing returns. David recalled his frustration with this type of marketing, "What did it [radio and TV ads] get? Zero. What did the print ads get? Zero." All in all, a total of $100,000 was spent on marketing efforts. In 2007, David discovered that the internet could be a beneficial alternative to print ads. A short commercial was shot and added to the website. David also started a blog to increase web presence. By 2008, David estimated that 75% of new customers were finding Alabama Air Shuttle via the internet. David felt that he had finally landed on an advertising method that worked for his business.

"Be competitive and as clear and simple as possible." That was David's pricing strategy for Alabama Air Shuttle. The price charged per hour was $5 below competitor pricing ($695 per hour). Round trips averaged approximately $2,500 and after considering costs, according to David, "…our profit was in the area of $50–$61 per hour." Additional fees such as positioning fees (a percentage of the hourly rate to bring the plane to the departure site), parking fees (only when applicable at certain airports), overnight fees ($250 or $300 in resort areas), and fuel surcharges (after the increase in fuel prices in 2007, anything over $3.00 per gallon) were also charged. To keep it simple, David would calculate the flight time and fees and provide a firm quote. A firm quote meant that the customer's price would not change even if the actual flight time varied. A customer could show up at the airport 15 minutes before departure, sign one form and provide credit card information before taking off. David's desire to provide first class service was exemplified through a streamlined and uncomplicated process.

Slowly but surely Alabama Air Shuttle began to increase the number of flights taken. Its main customer base was extremely varied, including construction companies and medical supply representatives. During 2008, there was an average of 13 trips a month with a total of 657 revenue hours almost equally divided between the two planes (See Exhibit 8, Revenue Hours). By the end of 2008, ten percent of customers were providing ninety percent of revenue. Sixty-eight percent of customers only took one trip a year (See Exhibit 9, Returning and New Customers). According to David, "We had, unfortunately, too many who took only one trip."

## FINANCIAL PROBLEMS

March 10, 2005 was a great day for David Gentry and Alabama Air Shuttle as the company flew its first billable flight to a Nissan plant in Mississippi. Nissan had called needing a part delivered immediately and Alabama Air Shuttle delivered as promised. The time, energy and cash investment in the company was starting to produce revenue and it all seemed worth it as the business began showing signs of life.

With the upfront purchase of an airplane, fixed salary for Paul Nation and other overhead expenses, David knew that Alabama Air Shuttle needed to produce revenues and it needed to produce them quickly. 2005 was the first year revenues were recognized, and although earnings were low during this initial year, the revenues began to climb as the company became known. By year end 2008, the revenue had quadrupled from its opening year.

2008 seemed like a turnaround year with Alabama Air Shuttle turning a profit for the first time. There were signs of financial stress, though, even during this banner year. Shortfalls during 2004–2007 could not seem to be overcome. Turbulent times occurred when it was discovered that operating cash flow failed to cover the expenses accrued during the start up years. There were several ways to financially analyze what exactly was occurring inside Alabama Air Shuttle. Return on assets ratios and debt service coverage ratios could have been used to diagnose financial problems.

David lamented, “At some point my seed money is going to run out. My question always is, ‘When am I going to reach the point where I simply run out?’” The debt service coverage ratio showed the ratio of cash available for the payment of interest, principal and lease payments. The higher the ratio was, the stronger the company. A 1.0 debt service coverage ratio would indicate a breakeven point where the operating cash flow would be enough to cover the debt payment, but produce no additional cash flow surplus. For the five year period ending on December 31, 2009, Alabama Air Shuttle had one year where it produced enough cash flow to pay for its debt: 2008. The first three years of operations produced losses that resulted in the draining of cash reserve balances. Increases in credit card debt were used to fund this short fall in cash flow. Along with the increase in credit card debt came increased annual debt service amounts in order to pay for the extra debt accrued. Therefore more cash flow was needed to cover this higher amount. David knew that this was draining his seed money and something would have to change if his business was to be sustainable.

The year end 2005 total debt included the debt on the airplane and other start up costs associated with getting the business moving forward. From year end 2005 to year end 2008 (end of the highest revenue year) total debt had increased by 20%. From year end 2005 to year end 2009 total debt had increased by 37%. David knew that almost all of the increase in debt was attributed to increases in credit card debt which was used to fund cash flow shortfalls. He even stated, “I had *high* credit card debt…I hate credit card companies. I had 4, 5, 6 credit cards. The fools kept givin’ them to me.” During the same period, year end 2005 to year end 2008, cash balances for the company plummeted 72% and from year end 2005 to year end 2009 cash balances had dropped 95%. According to David, “It just fell apart.” The company was feeling an enormous amount of stress due to increasing credit card debt, depletion of cash reserves and declining revenues in 2009. Additional cash flows were needed to service the company’s ever-increasing debt.

Another measure of Alabama Air Shuttle’s profitability was the ratio of net income to total assets, commonly referred to as Return on Assets (ROA). ROA gave an idea as to how efficient David was at using his assets to generate earnings. The higher ROA number the better because that meant more money was being earned on less investment. In regards to Alabama Air Shuttle, the company had a negative ROA for four out of five years from 2005–2009. The ROA in 2005 was -39%, 2006 was -17%, 2007 was -5%, 2008 was 10.5%, and 2009 was -8%. The trends for the ROA continued in line with the revenue trends, as well as cash flow trends, which grew to an ROA of 10.5% in 2008. The negative returns in years 2005–2007 indicated a need for additional funds to cover losses which lead to further depletion of cash and increases in credit card debt.

The financial strain for Alabama Air Shuttle was further exacerbated by its timing in the economic cycle in regards to one of the longest economic recessions ever recorded. In July of 2005, shortly after the company started operations, the economy was going strong and the unemployment rate was at a four year low (5% and lowest since 9/11/01). However, from the beginning of 2006 to 2010 the unemployment rate doubled as a result of the deep economic recession. Banks were struggling as subprime loans and mortgage backed securities produced massive losses and the credit market for small business was drying up. Alabama Air Shuttle was unable to obtain loans for additional aircraft and David noticed a sharp decline in revenues as businesses started cutting travel budgets.

## ALABAMA AIR SHUTTLE AT A CROSSROADS

David reflected on the past few years, “This was one of the scariest things I’ve ever done...talk about sleepless nights.” He had experienced the ups and downs of business ownership as well as the ebb and flow of the economy. Several factors played into the fact that 2009 only brought 290 revenue hours and the forecast for 2010 didn’t look any brighter. Credit card debt, bills to be paid and employees that were relying on David for the paychecks to provide for their families—all of these factors weighed heavily on David’s heart as he poured over the figures one more time. There were options to be considered: should he continue the operation of his charter service or close its doors? If he chose to remain in business, then a new strategic plan had to be developed to combat declining revenue streams. If he decided to leave the private flight industry, then several exit strategies had to be explored, including selling the business as a whole, liquidating the major assets (aircraft), leasing aircraft to fractional owners, or simply shutting down. David was faced with the difficult decision: Should he exit the business or should he try and weather the storm?

## *Exhibit 1- NFO Worldwide Market Research Results* [Graphs not included]

**Survey Results**

Destinations of Gulf Shores, Destin, and Gatlinburg are attractive for a new commuter airline because they are among the most-planned-to-visit locations, they do not have regular air service, and they are not too close to Birmingham. If a destination is too close, such as Montgomery, AL, and Philadelphia, MS, the air travel cost/benefit ratio is not favorable. Actually, Atlanta is the most popular destination, but Atlanta is not attractive because the survey reveals that most people who plan to go to Atlanta plan to go there to travel from Hartsfield. A new commuter airline could not go to Hartsfield because the service would not be permitted by the FAA: there already is regular air service provided by major airlines between Birmingham and Hartsfield. The percentage of survey respondents who plan to travel to Atlanta as a final destination is smaller than the corresponding percentages for Gulf Shores, Destin, and Gatlinburg. There are other attractive survey destinations, but Gulf Shores, Destin, and Gatlinburg are the most attractive.

The graphs show the numbers of passengers who intend to buy at the $250+ level. The numbers are:

Birmingham/Gulf Shores, 3,389
Birmingham/Destin, 2,017
Birmingham/Gatlinburg, 1,908

Total, 7,314.

**CONCLUSION**

There are enough likely passengers in the Birmingham area, at least 4,000 to 5,000 in a 12 month period, to make a new commuter airline successful if service is provided to Gulf Shores, Destin, and Gatlinburg or to Gulf Shores and one of the other two.

Source: David Gentry, Alabama Air Shuttle, Birmingham, AL

***Exhibit 2- Air Craft Carrier Certificate***

Schedule 5.14

US Department
of Transportation
Federal Aviation
Administration

# Air Carrier Certificate

This certifies that

**ALABAMA AIR SHUTTLE, INC.**
**MADISON COUNTY EXECUTIVE AIRPORT**
**358 BOLLING ROAD**
**MERIDIANVILLE, ALABAMA 35759**

has met the requirements of the Federal Aviation Act of 1958, as amended, and the rules, regulations, and standards prescribed thereunder for the issuance of this certificate and is hereby authorized to operate as an air carrier and conduct common carriage operations in accordance with said Act and the rules, regulations, and standards prescribed thereunder and the terms, conditions, and limitations contained in the approved operations specifications.

This certificate is not transferable and, unless sooner surrendered, suspended, or revoked, shall continue in effect indefinitely.

By Direction of the Administrator

James H. Fitzgerald

Certificate number: G5FA979K

JAMES H. FITZGERALD
(Signature)

Effective Date: MARCH 8, 2005

MANAGER
(Title)

Issued at: VESTAVIA HILLS, AL

SOUTHERN REGION, FSDO-09
(Region/Office)

FAA Form 8430-18 (6-87)

AFS Electronic Forms System - v2.2

Source: David Gentry, Alabama Air Shuttle, Birmingham, AL

***Exhibit 3- Business Plan, 2006***

# ALABAMA AIR SHUTTLE, INC.
# BUSINESS PLAN SUMMARY
# JUNE 2006

**PREPARED BY DAVID GENTRY,**
**OWNER AND PRESIDENT**

# "ADAPT AND OVERCOME"

**A MOTTO OF THE UNITED STATES MARINES**

## ORIGINAL PLAN

The original plan of September 2004 relied heavily on a regular route from Huntsville to Birmingham to Montgomery to Mobile in the morning and then a reverse of that route in the evening. People would pay by the seat, as opposed to the typical air charter payment for the entire aircraft. Market research and anecdotal evidence showed a significant level of interest. The novelty of the idea seemed to catch people's imagination, but when the litmus test of paying occurred people were not willing to pay a sufficient amount. It is notoriously difficult to determine in advance how much people will actually pay.

The plan was to have two Beechcraft Barons in operation on the regular route and available for traditional air charter. The Federal Aviation Administration (FAA) took a year longer than anticipated to approve Alabama Air Shuttle to use more than one aircraft, so only one has been used until the present time. We received required approval on February 9, 2006, and we are currently in the process of purchasing a second Baron.

We promoted the regular route aspect of the business from before we went into operation. The regular route is the main feature of our widely distributed marketing brochure. After going into operation on March 9, 2005, we had no credible demand for the regular route beyond an occasional casual inquiry. We wanted to wait until we had two aircraft before offering the regular route in the event that one aircraft were in maintenance. Finally, we decided to use a real test of market demand, and we began actively offering and advertising the regular route beginning on October 1, 2005, with one aircraft and with no success. In May of 2006, we discontinued offering the regular route.

The good news about the original plan is that the traditional air charter part of the plan as opposed to the regular route exceeded projected revenue. In fact, revenue from one aircraft exceeded planned revenue from two aircraft. The Year 1 plan was for $94,514 in traditional air charter revenue from two aircraft. The actual revenue from one aircraft in the first twelve months of operation was $122,342 on an accrual basis. Operation began on March 9, 2005, and in the first twelve months we flew sixty-nine revenue flights and 250 hours.

Despite best efforts to estimate costs, they were higher than planned for one aircraft. One half of the planned cost for the first year is $226,072. One half is used because the plan is based on two aircraft. Actual expenses were $232,665 for the first twelve months of operation. Expenses *before* the first year of operation were $83,548, including 2004 and the first two months of 2005. One factor for the higher expenses was that some costs were fixed, and they would have occurred with one or two aircraft. Another factor is that it cost more than expected to promote Alabama Air Shuttle as a *first class* operation. First impressions are important, and everything reasonable was done to portray a quality image and service. This effort was especially important given that our marketplace is the Birmingham and Huntsville areas of Alabama. The history of air charter companies in this area is rife with start-ups that do not go anywhere. The expensive effort to convince people that Alabama Air Shuttle is in business for the long term will pay dividends. A third factor is that it cost more than expected to prepare an aircraft for air charter. The maintenance inspection cost $25,000, and upgrades to the aircraft cost an additional $17,000.

Since the original business plan was based on two aircraft and a regular route, neither of which materialized, it is problematic to compare actual financial results to the plan.

## NEW PLAN

The new plan is partially based on the successful component of the old plan, namely traditional air charter. Upon analyzing our customer base with the help of Dun and Bradstreet, it was found that eight of ten best customers are small businesses of under $25 million in annual revenue and that most of the eight are under $10 million in annual revenue.

The new plan will become operational when a second Beechcraft Baron is purchased, and when revenue is increased through the second aircraft, a direct mail campaign, and a continuation of current marketing efforts. September/October 2006 is the target for the new plan to become active.

For a direct mail campaign, an extract from the Dun and Bradstreet business database has been produced based on geography, annual revenue of under $25 million, and similarity to our current best customers. The Huntsville and Birmingham Metropolitan

Statistical Areas are the geographical areas. Similar businesses were selected based on Standard Industry Classification Codes. Five thousand businesses were selected. The communications medium is an 11-inch by 5.5-inch bulk mail card on 100-pound paper stock. Three different cards were professionally designed, and they are striking. The first mailing occurred on June 5. Dun and Bradstreet predicts that 1% to 3% of the targeted businesses will respond. Of these, 1% to 3% will become customers. Thus far, thirty-five companies have responded to the first mailing. Seven of these show good potential to become customers, and another became a customer. Fewer responded than expected: thirty-five vs. fifty, but we expect to obtain more than expected actual customers. (We are still receiving responses.) We expected less of a response to this mailing than to the next two, because the first mailing was sent at the beginning of the summer vacation period. We expect strong results from the direct mail campaign. A second mailing will occur the third week of August 2006 when families return from vacation and children in North Alabama return to school. A third mailing will occur in the third week of October 2006.

A second Beechcraft Baron will be purchased this summer to be available for the fall. In 2005, the period from August 15 to November 15 produced two to three revenue trips per week, and we had just started operation in March of that year. This fall, we expect five to six revenue trips per week.

Current marketing efforts will continue. They have produced a successful first year of operation with approximately $120,000 revenue from one aircraft. The most successful sources of new customers have been the BellSouth Yellow Pages (both print and online versions); Internet search engines, our efforts to increase our Internet visibility, and our website; Fixed Base Operators (small aviation terminals), especially Madison County Executive and Shelby County; and person-to-person contact efforts of our staff. The Internet source has grown in importance. Advertisements in the BellSouth Yellow Pages' print editions in Birmingham and Huntsville will be discontinued due to the growing importance of the Internet source and the high expense of the BellSouth print advertisements. A listing will appear in bold in the BellSouth Yellow Pages, but not a business card size advertisement. BellSouth online advertisements will be continued.

Another component of the new business plan is partnerships with aircraft owners who wish to get the most return possible from their aircraft. Alabama Air Shuttle will help these owners defray the cost of ownership by chartering the owners' aircraft when the owners are not using them. A second potentially very significant benefit for some of the aircraft owners will be advantageous tax treatment. The federal government is toughening its position on the personal use of business aircraft, and IRS audits in the fall of 2006 will be the first notice to many business aircraft owners of this new stringency. Leasing a business aircraft to an air charter carrier, such as Alabama Air Shuttle, and then chartering from the carrier is a method of avoiding large tax penalties. According to tax experts, this tax strategy is the only valid one available, short of not using a business aircraft for any personal flights. It is expected that Alabama Air Shuttle will not have to search for owner partners once the IRS fall 2006 business audits commence. Owner partners will be anxious to partner with Alabama Air Shuttle. In addition to a message advertising for owner partners on approximately 15,000 bulk mail cards, Alabama Air Shuttle will produce advertising to let aircraft owners know that we are interested in partnerships.

The new business plan modestly projects that through partnerships we will have a Cirrus SR22 available at the beginning of the first year of the plan. In the second half of the first year, a King Air C90 will be available, and, at the beginning of the second year, a King Air 200 will be added to our fleet.

Staffing will be accomplished through two full-time pilots, and other required pilots will be part-time or on-demand part-time. The two full-time pilots will be a Director of Operations and a line pilot.

## CONCLUSIONS

Much has been accomplished and learned since planning for this company began in 2000:

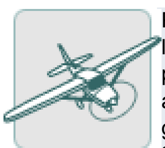
- A regular route connecting the major cities in Alabama is an attractive concept to some people, but it is not viable for a small, start-up air carrier. Possibly, a carrier with a large advertising budget could accomplish it.
- There is a market in the Birmingham and Huntsville areas among small businesses for a first class, economical air carrier. Probably, there is a market among larger companies for more expensive air charter services, and this is a market that Alabama Air Shuttle will explore with aircraft owner partners. Before operation and in the beginning months of operation, marketing efforts were a "shotgun" effort, namely "Try everything." Now, marketing resembles a rifle. We know we appeal best to small businesses. We remain opportunistic to develop other productive market niches, but we do not chase every aviation idea.
- Alabama Air Shuttle acquired a difficult-to-obtain FAA air charter certificate for multiple aircraft and multiple pilots.
- Alabama Air Shuttle has earned a reputation for first class, economical, reliable air charter services. We attract customers from competitors, and we receive accolades for our services. We have shown that Alabama Air Shuttle is a smart value.
- Alabama Air Shuttle has attracted capable employee partners, and these partners are a nucleus for growth.

- Alabama Air Shuttle operated 55 revenue flights in 10 months in 2005, and we have conducted 49 revenue flights in the first six months of 2006. The number of revenue flights per month is increasing. Please see a graph in this section.
- The trend line for net income in the first 16 months of operation is rising. Please see a graph in this section. It is conservatively expected that with two aircraft Alabama Air Shuttle will break even. We will purchase a second aircraft in the summer of 2006. We will purchase a third aircraft in 2007. With three aircraft, we will make money.
- We will supplement income from our solely owned aircraft with income from partnerships with aircraft owner partners and from brokering air charters to other operators. Aircraft owner partners will be able to help defray the costs of aircraft ownership and obtain tax advantages.
- Alabama Air Shuttle has a business plan for steady, sustained growth, and we welcome partners to share in our success, such as employees, aircraft owners, financiers, vendors, advisers, and other air charter operators.

Source: David Gentry, Alabama Air Shuttle, Birmingham, AL

## EXHIBIT 4- AIRCRAFT TYPES

### Single-Piston Aircraft



Pistonprop single-engine aircraft are ideally suited for short-range flights with a few passengers or light load of cargo in good to fair weather conditions. Pistonprop aircraft are propelled by a gas combustion propeller engine. Pistonprops are typically smaller than other aircraft categories and therefore cannot fly as far without stopping for fuel, but they are able to access many airports with shorter runways, thereby getting the charter passenger closer to their ultimate destination. Pistonprop single-engine aircraft are typically flown by a single pilot, but a charter provider should be able to supply your flight with a co-pilot upon request.

**Average Passenger Capacity:** 3-4

**Representative Aircraft:** Beech Bonanza, Cessna 206, Cessna Skylane 210, Piper Cherokee Six, Cirrus SR-22

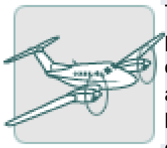
### Multi-Piston Aircraft

Pistonprop multi-engine aircraft are ideally suited for short-range flights for a small group of passengers or light cargo. Pistonprop multis are usually less expensive than turboprops or jets. Pistonprop multi-engine aircraft are considered safer and more reliable than single-engine piston aircraft, especially in inclement weather situations. While pistonprop multis are larger than their single-engine counterparts and can carry more people, weight and cargo, they are still typically smaller than turboprops and jets. Pistonprop multi-engine aircraft are typically flown by a single pilot, but a charter provider should be able to supply your flight with a co-pilot upon request.

**Average Passenger Capacity:** 1-5

**Representative Aircraft:** Beech Baron, Cessna 402, Piper Navajo

## Turboprop Aircraft



Turboprop aircraft combine the low-cost advantages of the piston aircraft while sharing some of the performance and cabin comfort advantages of light jets. Turboprops are powered by turbine propeller engines. With average cruising speeds of over 300 mph and an average nonstop range above 1,000 miles, a turboprop can travel further, faster and offer more comfort than piston aircraft while keeping charter costs below those of jet aircraft. Popular for short to mid-range flights, turboprops can access runways that are often too short for jet aircraft. Amenities often include: pressurized passenger cabins for added comfort, safety and performance and a semi-private lavatory.

**Average Passenger Capacity:** 4-8

**Representative Aircraft:** King Air 90, 100, 200, 300, Cheyenne I, II, III, IV, Merlin, Beech Starship, Pilatus PC-12, Commander

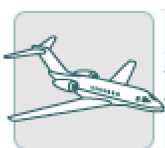
## Light Jets

Light jets are the entry-level jet class in the charter industry. Light jets are the most economical choice for short to mid-range trips. With average cruising speeds of 440 mph and an average nonstop range of about 1,500 miles, a light jet can travel further and faster than non-jet aircraft while operating in and out of airports not accessible by the major airlines. Amenities often include: pressurized passenger cabins for added comfort, safety and performance and a semi-private lavatory. Light jets have limited baggage capacity and often cannot accommodate skis or large golf bags.

**Average Passenger Capacity:** 4-8

**Representative Aircraft:** Citation II, Learjet 35, Falcon 10, Westwind, Beechjet 400

## Mid Jets



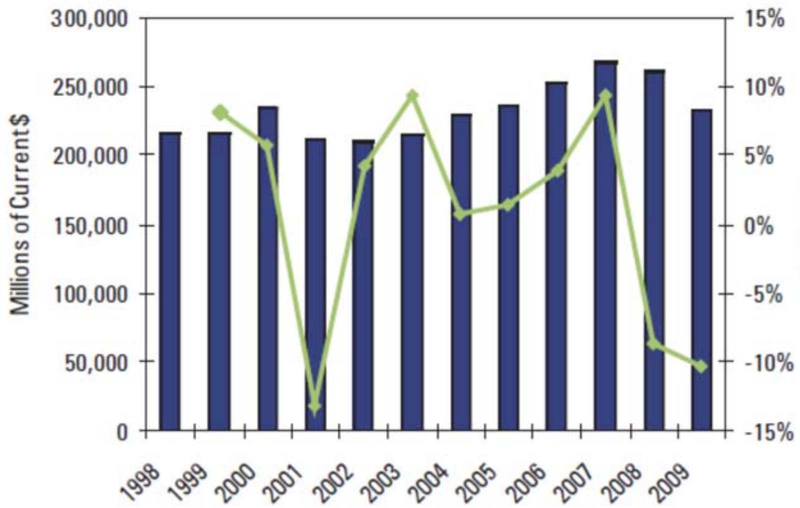
Midsize Jet aircraft optimally blend comfort, performance and economy for medium length flights. With average cruising speeds over 500 mph and a nonstop range of about 2,100 miles, a midsize jet can travel further, faster and with more comfort then light jets while operating in and out of airports not accessible by the major airlines. Most of the midsize jet aircraft have external baggage storage and can accommodate a reasonable amount of baggage. However, some aircraft such as the Hawker line of private jets only have internal baggage storage and can pose problems for skis or other bulky items. Most midsize jets offer a private lavatory.

**Average Passenger Capacity:** 5-9

**Representative Aircraft:** Learjet 55, Falcon 20, Hawker 800, Citation VII

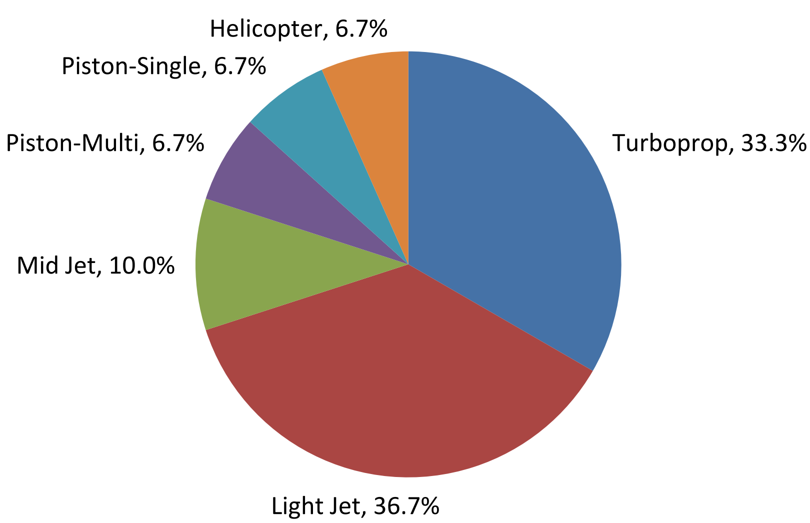
Source: AirCharterGuide.com/Aircraft

***Exhibit 5- US Business Travel Spending***




Source: HIS Global Insight, D.K. Shifflet, OTTI, and NBTA

***Exhibit 6- Type of Aircraft Operated in Alabama for Charter Services***




Source: Data compiled from AirCharterGuide.com/US_Operators/AL/Alabama

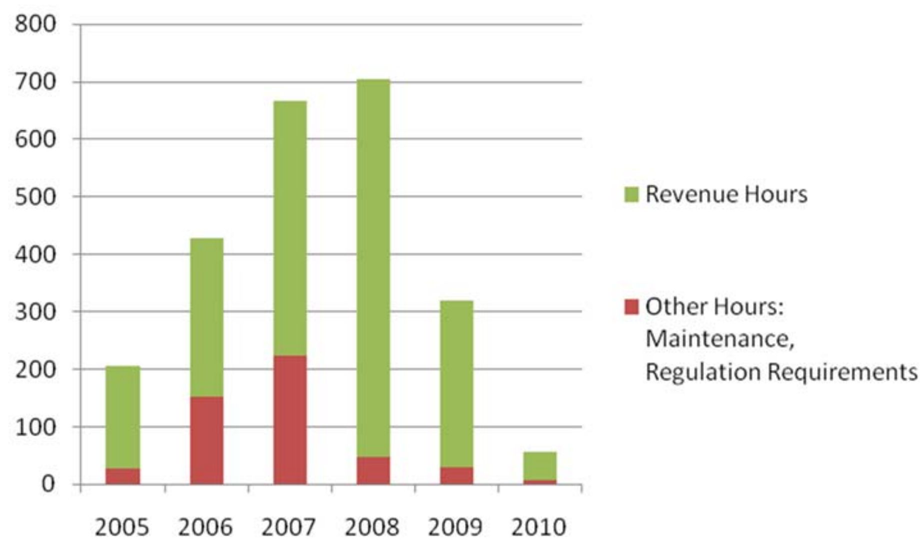
***Exhibit 7- Small Businesses in Alabama***

| Number of Employees | # of AL Businesses | AVG Annual Receipts |
|---|---|---|
| <20 | 69,177 | $ 724,075 |
| 20-99 | 8,102 | $ 6,432,925 |
| 100-499 | 1,985 | $ 23,439,623 |
| 500+ | 2,301 | $ 106,017,030 |

Target Market for AL Air Shuttle

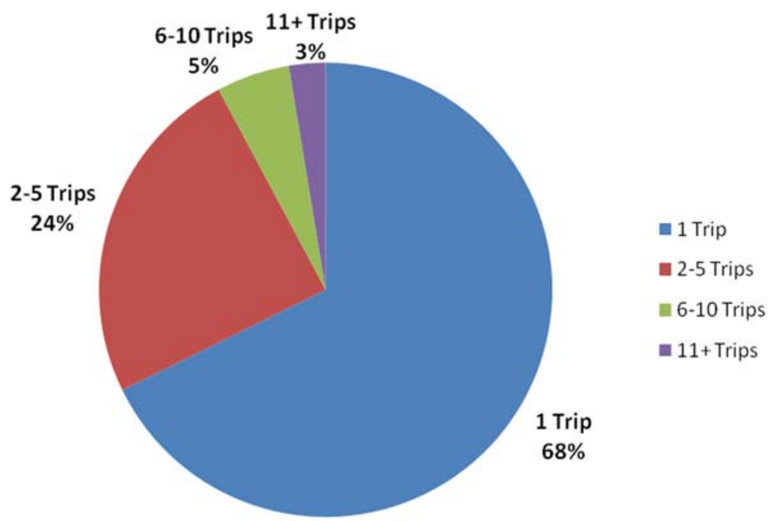
Source: U.S. Small Business Administration, Office of Advocacy, based on data provided by the U.S. Census Bureau.

***Exhibit 8- Revenue Hours for Alabama Air Shuttle***




Source: David Gentry, Alabama Air Shuttle, Birmingham, AL

***Exhibit 9- Returning and New Customers for Alabama Air Shuttle***




Source: David Gentry, Alabama Air Shuttle, Birmingham, AL

***Exhibit 10- Alabama Air Shuttle Time Line***

### 2001

- David beings research by interviewing those already in the industry.
- David was advised, "Don't do this. This is not good. It's high capital and thin profit margins."
- Airline industry takes a major hit due to 9/11/01 terrorist attacks.

### 2002

- David hires NFO Worldwide to conduct market research for approximately $15,000.
- NFO Worldwide begins research in Birmingham and Hunstville markets to determine if there is a market for a new commuter airline (assuming aircraft size of 10-30 seats).

### 2003

- NFO Worldwide concludes that a route for vacationers from Gulf Shores, Destin and Gatlinburg may be profitable.
- David determines that there is a market for business travel from Huntsville to Birmingham to Montgomery and to Mobile, and decides to pursue his dream of an air charter business.

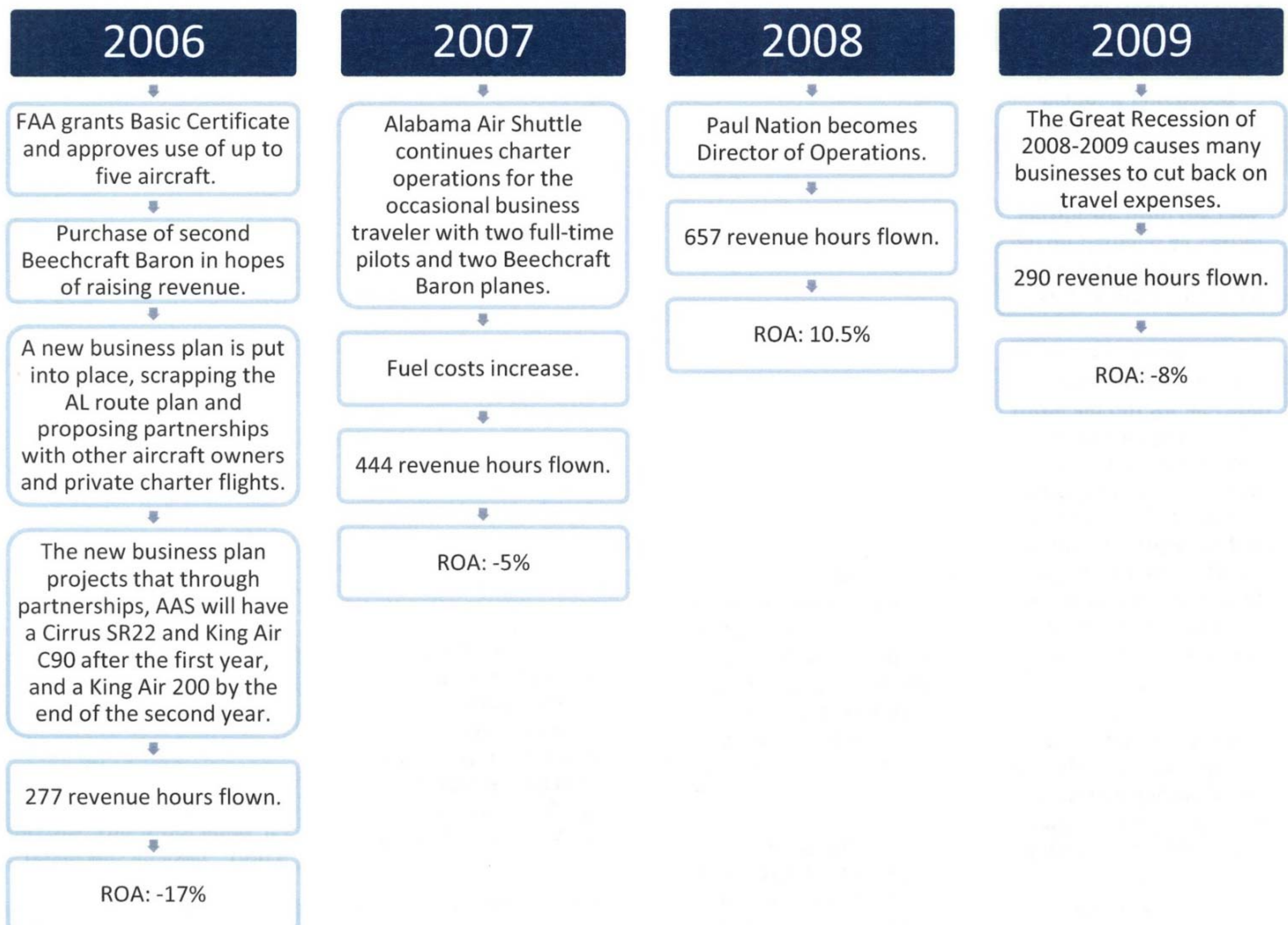
### 2004

- AL Air Shuttle (AAS) is incorporated on March 9, 2004.
- Market plan is developed to offer a regular AL route (Huntsville, Birmingham, Montgomery and Mobile) with a "pay by the seat" policy.
- Market plan (Scenario 1) projects that within 5 years, AAS will fly a fleet of twin-engine, piston aircraft, and will anticipate adding mini-jets in two years. Scenario 2 projects that within 5 years, AAS will fly four King Airs, three aircraft for air cargo services and will invest in a mini-jet.
- David prepares manuals and paperwork to receive an on-demand air carrier certificate from the FAA.
- First Beech Baron Aircraft (5 seat twin engine piston plane) is purchased.
- Pilot, Paul Nation, is hired.

### 2005

- FAA grants an Air Carrier Certificate for one aircraft.
- The first revenue flight is made March 10, 2005.
- AAS pursues Basic Certificate from FAA which would allow up to 5 aircraft in operation.
- 179 revenue hours flown.
- ROA: -39%

### Exhibit 10- Alabama Air Shuttle Time Line Cont.



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# THE SOUTHEASTERN THEATER COMPANY

**Roger Gagnon, North Carolina A&T State University**

## CASE DESCRIPTION

*The case concerns planning job/staffing needs and schedules for employees and management for a medium-size movie theater. The students are required to: (1) analyze the amount of time required to perform work activities; (2) recognize that the amount of work and time required may differ by season, day, or even hour; (3) recognize that particular work activities can only be performed by certain classes of workers or management; (4) calculate how many employees of each type are needed to complete the work required; and (5) create feasible schedules for each type of employee. This case is designed for level three and up and is appropriate for undergraduate juniors and beyond. The case can be taught in two class hours in an operations management, production management, services management, or human resources management course. It is expected to require about three hours of outside preparation and necessitates familiarity with spreadsheet software*

## CASE SYNOPSIS

*One of the more difficult, but necessary, business areas to instruct is : how to design jobs – how to combine work tasks, not on an assembly line, into jobs; how many employees to have for each job category; and how to schedule them on a seasonal, daily, and even hourly basis. Production/operations text offer suggestions (e.g., job enrichment, job enlargement, team assignments), but few specific examples, problems, or cases are available. This case portrays an environment that all students have visited – a movie theater. The case requires the students to recognize the various job skills required; determine the amount of time required to perform various work activities and that this capacity can fluctuate by season, day, or hour; calculate how many employees of each type are needed to complete the work required; and create feasible work schedules for each type of employee.*

## COMPANY HISTORY AND OPERATIONS

Because of the growth in cinema attendance and revenues Wendell Carrington and Bill Meyers, formerly involved in restaurant and hotel management, established The Southeastern Theater Company (SETC) in 1995 in Atlanta, Georgia. Their dream was now to design, build, and operate movie theaters throughout the Southeast; they currently own and manage 15 such theaters with revenues exceeding $50 million. Typically their theaters have 15 or 18 screening rooms and have been located in larger, southern cities (e.g., Atlanta, Georgia; Orlando, Florida; and Memphis, Tennessee). Their newest design, which seems to fit well in medium-sized cities, their new target market; adjusts for the recent, national economic decline; and requires less land at lower costs. It incorporates a 12-screen theater having digital, surround sound and stadium seating in all showing rooms. The problem facing the SETC owners and senior management is how many employees are needed to operate such a theater in their newly constructed, Charlottesville, Virginia location. The employee staffing decisions for this theater will be the template used for other theaters of the same design. Management acknowledges that a general manager is needed, but is uncertain as to how many assistant managers, ticket sales employees, projectionists, ticket collectors, and concession workers are needed. Management also recognizes that the staffing needs are not simply proportional to the number of screening rooms or total number of theater seats, since the new theater design has fewer screening rooms, each with less seating capacity than those of SETC's other theaters, yet the total weekly operating hours will be the same.

## THE MOVIE INDUSTRY

The U.S. cinema industry has experienced steady revenue growth, expanding from $4.9 billion in 1992 to $9.5 billion in 2002 (Motion Picture Association, 2002). Admissions have grown from 1.2 billion to 1.6 billion annually (Motion Picture Association, 2002). During July 2002, 107 million Americans (45%) reported going to the movies (at least once) that month. Perhaps due to the lagging economic recovery, enhanced television channel selections, Red Box discount movie DVDs, digital gaming, and the internet, ticket sales have decreased from 1.55 billion in 2002 to 1.37 billion in 2012. However, due to inelastic demand revenue has continued to increase hitting $10.71 billion in 2012. Ticket sales and revenues are both projected to increase in 2013 to 1.43 billion and $11.35 billion respectively (Nash Information Services, 2013). Thus, while ticket prices increase, the cinema is appealing to younger and more affluent moviegoers. A study revealed that in January 2003, 95 million Americans - 40% of U.S. persons as young as 12 went to the movies in the past month (ZenithOptimedia, 2002). Movies are particularly important to teens and young adults, who go in larger numbers and attend more often.

Theaters are also becoming more than a place to sit a watch a movie; they are becoming entertainment centers including audio programming, video programming and games, and information kiosks. Also, small to medium size rooms can be reserved for special events such as children's birthday parties.

Food and beverage offerings have also expanded to include, not only popcorn, candy, and beverages, but meals (pizza, hot dogs, nachos and cheese, etc.). This “fast theater meal” trend is likely to continue.

Thus, cinema revenues have increased for they have multiple revenue sources. Ticket sales and concession revenues have long been the dominant source of income. However, wall posted and on-screen advertising is increasing as a revenue source (ZenithOptimedia, 2002). ZenithOptimedia estimates that in 2002 over $800 million was spent worldwide on cinema advertising. The U.S. cinema industry, in particular, is poised for growth in this marketing arena as advertisers begin to realize the reach and unique value of cinema advertising (Arbitron, 2002).

## THE NEW 12 SCREENING ROOM THEATER AND ITS OPERATIONS

Wanting to enter the medium-size city cinema market with its potential advertising revenue Wendell Carrington and Bill Meyers have constructed their first, new, downsized, cinema in Charlottesville, Virginia. As shown in Figure 1, the new theater building houses 12 screening rooms, four rest rooms, parallel concession areas, and storage rooms. The upstairs contains management offices, a break room, and 12 projection rooms all connected along a hallway.

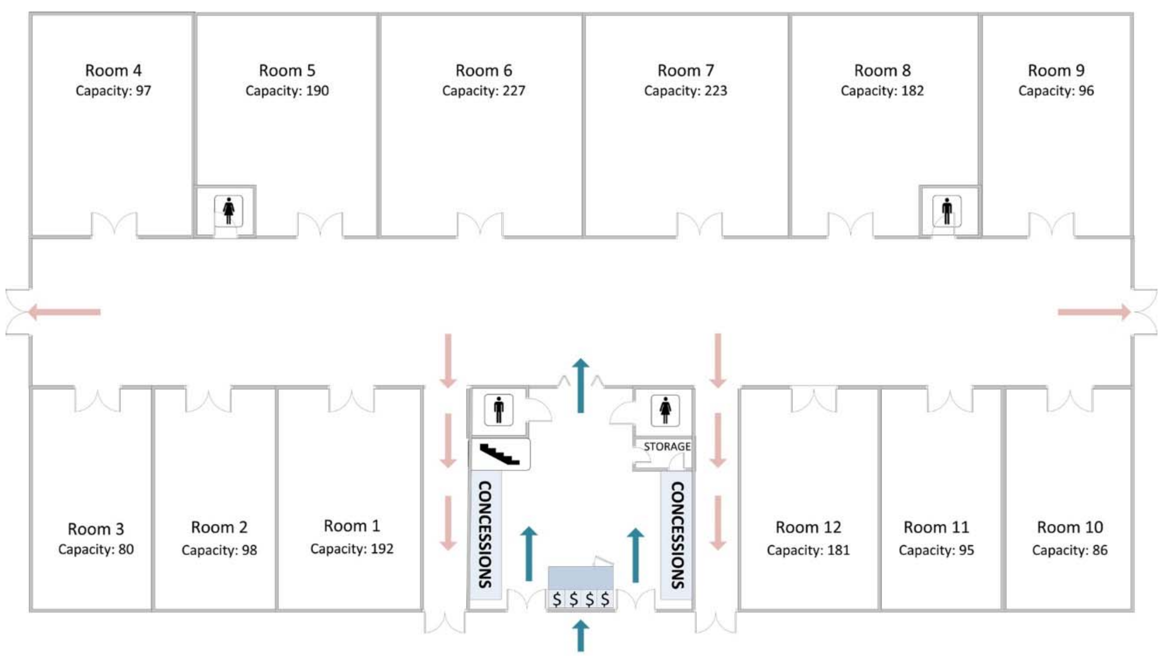



**Figure 1**
**Layout of the 12-Screen Theater**

The theater will be operated 365 days a year and typically from 12:30 PM (doors open 30 minutes before the first show which is usually 1:00 PM) until closing time usually about 12:00 midnight (with exception for a midnight show on New Year's Eve and prescreening movies for employees). Movies are usually shown daily at approximately 1:00 PM, 4:00 PM, 7:00 PM, and 9:45 PM with some exceptions for 3 hour movies; these are generally shown at 1:00 PM, 4:30 PM, and 8:00 PM. For planning purposes these 3 hour shows are rare and can be ignored.

The seating capacities of the 12 screening rooms are as follows:

| Screening Room | Seating Capacity |
|---|---|
| 1 | 192 |
| 2 | 98 |
| 3 | 80 |
| 4 | 97 |
| 5 | 190 |
| 6 | 227 |
| 7 | 223 |
| 8 | 182 |
| 9 | 96 |
| 10 | 86 |
| 11 | 96 |
| 12 | 181 |

The slow seasons are February through April and September through October. The busy seasons are May through August and November through January. In the slow seasons ticket sales are projected to average 7,000 per week; in the busy seasons ticket sales are forecasted to average 15,000 per week.

Irrespective of the season, the average percentages of weekly sales attributed per day are projected by top management to be as follows:

| | |
|---|---|
| Monday | 6% |
| Tuesday | 10% |
| Wednesday | 12% |
| Thursday | 15% |
| Friday | 20% |
| Saturday | 25% |
| Sunday | 12% |
| | 100% |

Regardless of the season, the expected average percentages of daily sales attributed to each movie showing time are shown below:

| Showing Time | Percentages of Daily Sales |
|---|---|
| 1:00 PM | 10% |
| 4:00 PM | 25% |
| 7:00 PM | 40% |
| 9:45 PM | 25% |
| | 100% |

Patrons usually begin arriving 30 minutes before the posted show time and continue until the main feature begins, which is usually 15 minutes after the posted start time (i.e. the 7:00 PM movie does not begin until 7:15 PM preceded by 15 minutes of advertising and previews). On average 50% of customers attending a movie arrive between 10 minutes before and until 5 minutes after the scheduled time (i.e., from 6:50 PM until 7:05 PM for a 7:00 PM scheduled show time). On average 28.6% of the patrons attending a movie arrive between 30 to 10 minutes before the scheduled showing time. Finally, on average 21.4% of customers attending a movie arrive between 5 – 20 minutes after the scheduled show time.

With the exception of the 1:00 PM shows patrons are allowed to enter the showroom 20 minutes before the scheduled start time (i.e., 6:40 PM for the 7:00 PM show) or whenever the cleanup is completed - whichever is later. However, patrons do not enjoy waiting needlessly for entrance to the showing room; after all, they came for entertainment, not for waiting.

Only managers, assistant managers, and ticket sales agents can sell tickets. The ticket sales agents are "bonded" and perform no other activities than prepare cash drawers, sell tickets, count drawer money, and aid in the bookkeeping.

On average a ticket sales transaction takes only 1/5 minute or five ticket sales can be completed per minute per ticket salesperson. However, if patrons arrive at a greater rate than 5 per minute, the ticket sales employees work faster - at a rate of 6 sales transactions per minute per ticket salesperson.

Movie tickets are collected after patrons enter the movie theater and after they pass through the concession area, but before they are allowed to enter the showing room corridor area. On average each ticket collector can gather up to 30 tickets per minute.

There must be a manager or an assistant manager on duty at all times. A manager or assistant manager must open the building one hour before the first patrons are allowed into the theater (e.g. 11:30 AM); this allows ticket sales agents, projectionists, ticket collectors, and concession workers to report to work at 12:00 PM and perform any initial tasks. Managers typically work 45 hours per week and are salaried. Assistant managers work a 40 hour work week and are also salaried. Usually both the manager and an assistant manager are on duty from 6:00 PM to 12:00 AM on Friday, Saturday, and Sunday. The manager and assistant managers work 6 days a week with a weekday off.

Ticket sales employees, projectionists, ticket collectors, and concession workers are considered part time employees – meaning that they are paid on an hourly basis and receive no insurance or retirement benefits. They can work up to 8 hours per day. One benefit for these employees is that they can watch any movie free (on their own time or a company sponsored showing) and their immediate family enjoy the same benefits (along with free drinks and popcorn). Most ticket sales agents are senior adults seeking additional family income (these employees usually work up to 8 hours each day) or college students. The ticket sales agents usually complete their work by 11:30 PM. (No one is allowed to purchase a ticket later than one hour after the last scheduled movie- i.e. 10:45 PM). They never work more than 40 hours per week.

Most ticket collectors and concession workers are high school students (over 16 years of age) or college students. The high school and college students typically work 3 to 4 hour shifts on Monday through Thursday and up to 8 hour shifts on Friday, Saturday and Sunday. On Monday through Friday high school students cannot be scheduled before 3:30 PM. Turnover among the students is quite high - 300% in one year is not unusual.

There must be at least one projectionist on hand from 12:00 PM until closing (12:00 AM). However, on Friday, Saturday, and Sunday evenings two projectionists are needed from 6:00 PM until 12:00 AM. Additionally, one projectionist must accompany the manager or assistant manager nightly to the bank to deposit the day's receipts; this is usually completed by 12:30 AM. Projectionists can each work up to 40 hours per week.

Between shows each showing room must be "quick-cleaned"; this means making certain everyone has left the screening room and all trash is picked up from the floor and trash containers emptied. This process usually takes two concession workers and/or ticket collectors about 10 minutes for each of the six, smaller rooms (under 100 seats) and 15 minutes for each the six, larger ones. This work duty is completed during their idle, "spare time" between shows. Concession workers spend most of their time servicing the concessions - about 30% of customers buy concessions with the average service time requiring 2 minutes. One concession purchase usually serves an average of two patrons.

As indicated in Figure 1 the concession stands or bars are on each side of the entrance foyer. There are four point-of-sale (POS) registers at each bar. From 1 to 8 of these POS registers can be readied and used for patrons. Up to 2 employees can be assigned per register (i.e., two customer orders served simultaneously per register). There is 1 popcorn machine and 1 popcorn warmer (keeps popcorn warm) per bar. Each popcorn machine used must be set-up to operate (filled with popcorn kernels, oil, and started); this is done when the first concession workers arrive for work and is completed before the first patrons enter the theater. All popcorn machines and warmers used that day must be emptied and cleaned at the end of the evening. Cleaning and restocking the concession bar(s) commences with the scheduled start of the last show (e.g., 9:45 PM) – leaving just one or several work stations open. All concession sales cease with the actual start of the last feature movie (e.g., 10:00 PM). Concession workers typically complete their clean-up and restocking duties and leave about 10:30 PM.

Since no tickets are sold after 10:45 PM the ticket collectors typically leave at 11:00 PM. At other similar theaters one or two ticket collectors are usually sufficient, but the new manager is uncertain for this theater location and expected patronage.

The final vacuuming and clean-up of the screening rooms, hallways, and rest rooms is performed by an outside cleaning service. The outside cleaning service also cleans all glass windows – inside and outside.

## COMPANY DILEMMA

The problem facing the SETC management, and in particular Debra Wilson, the manager of the new Charlottesville, Virginia Southeastern Theater, is how many employees are needed to operate such a theater. Management recognizes that a general manager is needed, but is uncertain as to how many assistant managers, ticket sales employees, projectionists, ticket collectors, and concession workers are needed and how should they be scheduled given the various customer arrival rates by season, day of the week, and hour.

## REFERENCES


Bouvard, P., J. Fitzgerald & P. LeFort (2003). *The Arbitron Cinema Advertising Study*. Arbitron, Inc. New York, New York.

Motion Picture Association (2002). *U.S. Entertainment Industry: 2002 MPA Market Statistic*s. Retrieved July 21, 2013, from www.mpaa.org.

Nash Information Services (2013). The numbers: movie market summary 1995 to 2013. Retrieved July 21, 2013, from http://www.the-numbers.com/market/

ZenithOptimedia (2002). Advertising expenditure forecasts December 2002. Retrieved July 21, 2013, from www.zenithoptimedia.com.

# CUSTOM CIRCUITRY INTERNATIONAL

**Eric Kyper, Lynchburg College**
**Leon Schimmoeller, Lynchburg College**

## CASE DESCRIPTION

*The primary subject matter of this case concerns an audit of manufacturing defects for a manufacturer of printed circuit boards. Secondary issues examined include process analysis and statistical quality control. The case has a difficulty level of six, appropriate for first year graduate students. The case is designed to be taught in two class hours and is expected to require six to eight hours of outside preparation by students.*

## CASE SYNOPSIS

*This case presents evidence of manufacturing quality control problems for a maker of printed circuit boards. The objective is for students to identify the primary sources of variation in quality and recommend solutions. The observations provided below (including defect categories, defect costs, production flow charts, control chart data, and range/proportion data) are sufficient to critically analyze the current process and enable one to present a revised production process.*

## INTRODUCTION

Custom Circuitry International (CCI) manufactures custom printed circuit boards. Susan Banning is the current production manager. She has been with CCI for 18 years and has held a variety of positions. Historically high quality products have been CCI's competitive advantage. However, lately Susan has been under increasing pressure from Howard Anderson, the sales manager, regarding sporadic outbursts of customer complaints and returns. Susan has promised Howard she will give these issues her full and immediate attention. As one of Susan's team leaders you are tasked with investigating production rejects and rework, and the poor results of efforts to remain within quality targets. The general manager Tom Weldin knows these issues can lead to loss of revenue, declining profit margins, loss of market share, etc. Your boss Ms. Banning has invited you to attend a meeting with the production shift leaders, and the quality assurance manager (Alejandro Martinez) to discuss the problem. Alejandro assures everyone in the meeting that the problem is under investigation, and that he will have a report within the week.

A week later, Alejandro presents the following summary of the defects found at inspection during the last 5 days. 1,276 defects were found in the boards tested. Alejandro also presents control chart data for the last 5 days (table 2) and informs us the standard error for control data is 0.038. The types of defects were:

| Table 1: Breakdown of defects by category | | |
|---|---|---|
| Defect Category | Occurrences | Percent |
| Wrong component | 217 | 17% |
| Components not adhering | 146 | 12% |
| Excess adhesive | 64 | 5% |
| Misplaced transistors | 600 | 47% |
| Wrong board dimension | 143 | 11% |
| Improperly positioned mounting holes | 14 | 1% |
| Circuitry problems on final test | 92 | 7% |

***Control Chart Data***

| Table 2: Final inspection data for last 5 days | | | | | | |
|---|---|---|---|---|---|---|
| Sample # | Size | Defects | | Sample # | Size | Defects |
| 1 | 50 | 4 | | 26 | 50 | 3 |
| 2 | 50 | 6 | | 27 | 50 | 5 |
| 3 | 50 | 2 | | 28 | 50 | 2 |
| 4 | 50 | 5 | | 29 | 50 | 1 |
| 5 | 50 | 5 | | 30 | 50 | 2 |
| 6 | 50 | 7 | | 31 | 50 | 4 |
| 7 | 50 | 7 | | 32 | 50 | 3 |
| 8 | 50 | 8 | | 33 | 50 | 5 |
| 9 | 50 | 3 | | 34 | 50 | 8 |
| 10 | 50 | 5 | | 35 | 50 | 3 |
| 11 | 50 | 7 | | 36 | 50 | 5 |
| 12 | 50 | 1 | | 37 | 50 | 2 |
| 13 | 50 | 5 | | 38 | 50 | 1 |
| 14 | 50 | 4 | | 39 | 50 | 3 |
| 15 | 50 | 3 | | 40 | 50 | 3 |
| 16 | 50 | 2 | | 41 | 50 | 3 |
| 17 | 50 | 7 | | 42 | 50 | 5 |
| 18 | 50 | 5 | | 43 | 50 | 2 |
| 19 | 50 | 2 | | 44 | 50 | 4 |
| 20 | 50 | 3 | | 45 | 50 | 6 |
| 21 | 50 | 1 | | 46 | 50 | 5 |
| 22 | 50 | 4 | | 47 | 50 | 4 |
| 23 | 50 | 6 | | 48 | 50 | 4 |
| 24 | 50 | 4 | | 49 | 50 | 6 |
| 25 | 50 | 2 | | 50 | 50 | 3 |

Upon request from Susan Banning, Alejandro later analyzed a sample of each defect type, and isolated the following factors:

Wrong component: Stock keeping unit (SKU) code assignment, Uniform product code (UPC) label placement, recording error, delivery error. Manuals not updated (Change Order not recorded).
Components not adhering: Adhesive in poor condition. Board or component contaminated. Adhesive applied at improper temperature, adhesive applied in incorrect amount.
Excess adhesive: Dispensers faulty, operator error (measurement).
Misplaced transistors: Part incorrectly labeled, incorrect transistor supplied. Manuals not updated (Change Order not recorded).
Wrong board dimension: Operator error (incorrect specification, measurement).
Mounting holes improperly positioned: Manuals not updated (Change Order not recorded). Improper templates, faulty templates. Operator error (incorrect specification, measurement).
Circuitry problems on final test: See Wrong component, adherence, transistors above.

A further analysis by Alejandro's team shows breakdowns by category in table 3 below.

**Table 3: Breakdown of specific defects by category**

| Aggregate Defect Category | Specific cause of defect | % of defects |
|---|---|---|
| **Wrong component** 17% of total defects | SKU assignment | 18% |
| | UPC label placement | 44% |
| | Recording error | 12% |
| | Delivery error | 6% |
| | Manual not updated, Change order not recorded | 20% |
| **Components not adhering** 12% of total defects | Poor adhesive | 40% |
| | Component contaminated | 5% |
| | Adhesive applied at improper temperature | 5% |
| | Incorrect amount of adhesive | 50% |
| **Excess adhesive** 5% of total defects | Faulty dispenser | 2% |
| | Operator error | 98% |
| **Misplaced transistors** 47% of total defects | Incorrectly labeled part | 22% |
| | Incorrect transistor supplied | 50% |
| | Manual not updated, Change order not recorded | 28% |
| **Wrong board dimension** 11% of total defects | Incorrect specification | 100% |
| **Improperly positioned mounting holes** 1% of total defects | Manual not updated, Change order not recorded | 20% |
| | Improper/faulty template | 70% |
| | Operator error | 10% |
| **Circuitry problems on final test** 7% of total defects | Wrong component | 30% |
| | Components not adhering | 40% |
| | Misplaced transistors | 30% |

Different defects were associated with different costs. Problems caused by adhesives were cheaper to fix as the part had not been soldered to the board. Wrong or misplaced components had to be carefully removed from the board and replaced. Failures at final test involved expensive trouble shooting of the circuitry, repair, and then re-test using expensive equipment. To further elucidate the problem the Alejandro's team calculated the costs to resolve each category of defects (table 4).

**Table 4: Breakdown of defect costs by category**

| Defect Category | Average Cost |
|---|---:|
| Wrong component | $20 |
| Components not adhering | $10 |
| Excess adhesive | $10 |
| Misplaced transistors | $20 |
| Wrong board dimension | $12 |
| Improperly positioned mounting holes | $12 |
| Circuitry problems on final test | $80 |

Table 5 shows sample ranges of proportion of defective boards (**R**) and number of defects per board (**C**) in samples of size 25; last 25 weeks.

Table 5: Range of proportion defective and number of defects

| Week | R | C | | Week | R | C |
|---|---|---|---|---|---|---|
| **1** | **0.1679** | **2** | | **14** | **0.2088** | **3** |
| **2** | **0.1777** | **2** | | **15** | **0.1867** | **2** |
| **3** | **0.1604** | **1** | | **16** | **0.2049** | **2** |
| **4** | **0.1665** | **2** | | **17** | **0.1758** | **1** |
| **5** | **0.1940** | **1** | | **18** | **0.1829** | **1** |
| **6** | **0.1739** | **1** | | **19** | **0.1728** | **3** |
| **7** | **0.1631** | **0** | | **20** | **0.2065** | **5** |
| **8** | **0.1942** | **1** | | **21** | **0.2050** | **2** |
| **9** | **0.1761** | **2** | | **22** | **0.2150** | **2** |
| **10** | **0.1811** | **0** | | **23** | **0.1965** | **0** |
| **11** | **0.1927** | **1** | | **24** | **0.1917** | **1** |
| **12** | **0.1814** | **0** | | **25** | **0.2104** | **2** |
| **13** | **0.1759** | **2** | | | | |

## SYSTEM DESCRIPTION

As productions manager Susan Banning is responsible for product specification (product definition and constituent components), production schedules, and component supply. However, the system currently used is not of Susan's design and is something she has inherited with the job. Susan has made it clear she is willing to consider changes to the system as long as any proposed improvements are supported by empirical evidence. Susan is also responsible for meeting production schedules and product quality (conformance to specifications: correct components and performance). Susan's counterpart in purchasing (Elka Johansson) is responsible for acquisition, component coding (SKU, and UPC), and labeling. Three major databases are used to support these functions and are separately maintained. The Materials Resource Planning (MRP) database includes the Master Production Schedule, and the Bill of Materials (BOM). The Production Specs file includes the BOM for the current period's orders, and the SKU-UPC file contains cross listed inventory accounts.

**FIGURE 1: CURRENT OVERALL PRODUCTION PROCESS**

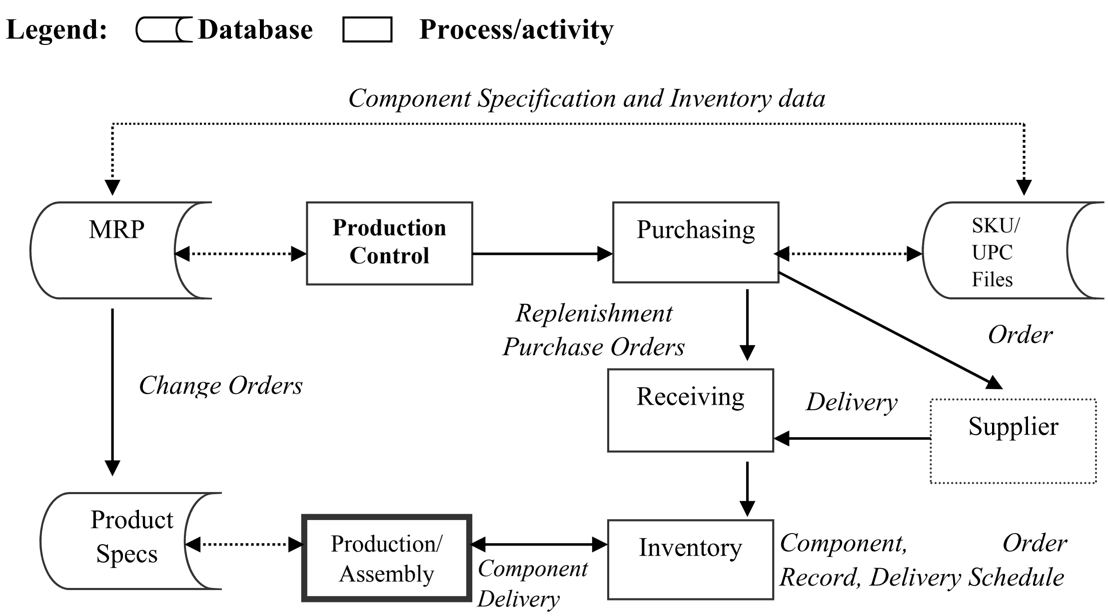
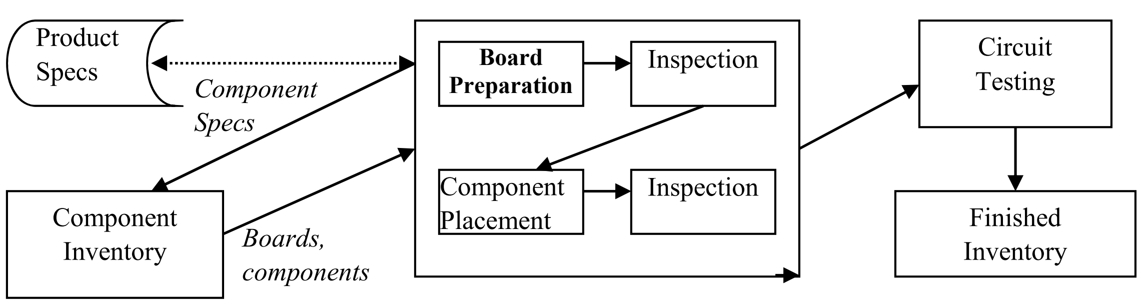



**FIGURE 2: DETAIL OF THE PRODUCTION/ ASSEMBLY PROCESS**



Susan realizes the seriousness of this situation for both her team and the company. Failure to rectify quality problems will cost business and likely jobs within this company. Another meeting is scheduled for next week between Susan and her boss Tom Weldin. Susan needs to know if the main culprit is a production flaw or a quality testing problem. She needs your help making this decision and presenting evidence on how to reduce future returns and customer complaints.

## SUGGESTED STUDENT RESOURCES

McDonough, M. (2010). Creating Pareto Charts with Microsoft Excel. from http://www.brighthub.com/office/project-management/articles/8708.aspx

vertex42. Fishbone Diagram/ Cause and Effect Diagram. from http://www.vertex42.com/ExcelTemplates/fishbone-diagram.html

# MANAGERIAL CARROTS AND STICKS: ENCOURAGING STRATEGY IMPLEMENTATION

**John Leaptrott, Georgia Southern University**
**J. Michael McDonald, Georgia Southern University**
**Jerry W. Wilson, Georgia Southern University**

## CASE DESCRIPTION

*This case addresses many strategic management issues. Selected issues related to the formulation and implementation of both low cost and differentiation strategies are illustrated. The importance of lower level managers embracing their company's strategy and showing initiative to implement that strategy is also highlighted. The case illustrates the importance of having these managers understand and recognize the need to use informational resources available within an organization to objectively assess their area of responsibility in the context of strategy implementation and gives examples of how they can act constructively based on that information. Other topics include a discussion of challenges in transitioning from the role of college student to employee and from employee to manager. The case also provides students with a perspective as to how they might be evaluated by their superiors once they are employed as managers. The case has a difficulty level appropriate for senior level and graduate level students in strategic management courses. The case is designed to be taught in 1-2 class hours and is expected to require 3 hours of outside preparation by students.*

## CASE SYNOPSIS

*The case chronicles the strategic evolution of a fictitious privately held small local company that grew to become a midsize regional sporting goods retailer. The company was founded by three brothers who used their enthusiasm for sports and the knowledge gained from their participation in those sports to formulate and implement a successful differentiation strategy. This strategy resulted in steady growth of the company in multiple locations. A private equity firm bought the company and after a failed attempt at pursuing a strategy primarily designed to lower costs and increase profitability prior to an initial public offering, the firm replaced their CEO hired to pursue that strategy with a new CEO who is orchestrating a return to a differentiation strategy. The company has now regained profitability by returning to that strategy.*

*As part of the company's new evaluation and control procedures associated with the differentiation strategy, the CEO and the Vice President of Managerial Development meet individually with each store manager each year to review the performance of their store for the prior year. The case describes two of those meetings. In one meeting, a store manager receives praise for achieving a high level of performance by successfully formulating and implementing a differentiation strategy tailored to the local market. In the other meeting, a different store manager receives criticism for the substandard store performance at his store due in large measure to his failure to embrace the company's return to a differentiation strategy. This manager continued to implement the unsuccessful companywide cost-based strategy instituted by the prior CEO. The new CEO must decide how to reward the personnel at the high performing store and what changes need to be made at the lower performing store.*

## THE COMPANY

Sport Life Outfitters, Inc. is a regional sporting goods retailer serving Washington, Oregon and Idaho through approximately 30 small and mid-size retail locations. The Seattle based company was founded in 1950 by three brothers, Jim, Bill & Tom Lee. The original business model included selling high quality sporting goods that corresponded to the recreational interests of each brother. Jim was an avid golfer and a member of one of the larger country clubs in the Seattle area. Bill was a camping and hiking enthusiast who enjoyed the recreational opportunities in the nearby Cascade Mountains and Olympic Peninsula. Tom regularly played tennis at one of the area's tennis clubs. The brothers brought their enthusiasm and knowledge of their particular sport to their retailing activities at the store. Jim was in charge of golf related sales. Likewise, Bill was in charge of camping and hiking related sales and Tom was in charge of tennis related sales. The brothers' activity in their particular sports resulted in productive relationships with the public that lead to both increased sales and positive word of mouth advertising. Their in-depth product knowledge allowed them to purchase inventory that was in great demand in their local area and was usually not available at the national retailers' Seattle area stores. Because of their success at their initial location, they soon expanded to five new stores in Washington and three in Oregon. The brothers recognized that their primary distinctive competitive advantage in their marketplace was the level of product knowledge and enthusiasm for recreational activities possessed by their sales staff. That knowledge and enthusiasm was gained through actual participation in recreational activities in their respective market areas. As a result of this success, the company required new employees to be active or past participants in a recreational activity that corresponded to a merchandise category sold in that particular store.

As the brother's approached retirement age in the mid 1990s, they were approached by Auctus Argentarium Partners (AAP), a large private equity firm located in New York. AAP performed due diligence on the company and, based on the outstanding past performance history of Sport Life Outfitters, Inc., made the three brothers a cash offer for their ownership interests which they accepted.

**THE BAKER ERA**

While performing their due diligence preceding the offer to purchase the company, the analysts at AAP noted that the gross profit and operating profits of the company were typically 35% and 11% of sales respectively, which were about 5% higher than the 30% gross profit and 6% operating profit percentages common to the industry. The company's plan was to acquire Sport Life Outfitters, Inc at a price based on operating profit percentages at the industry average and at a multiple that was lower than the price earnings ratio of publically traded companies in that industry. Once the company was acquired, they planned to grow the company as fast as possible by adding additional stores and boost the profit percentages implementing a cost based strategy. Bolstered by anticipated higher sales and net income increases achieved through cost cutting, they would then take the company public and realize a substantial profit on their investment.

Soon after the successful acquisition from the Lee family, AAP hired a management team to oversee the implementation of this plan. The new CEO, Greg Baker, started his career as a staff accountant with a public accounting firm, transitioned to a CFO position at a manufacturing company and was promoted to CEO after initiating a significant cost reduction program at that company. Subsequently, he accepted CEO positions at progressively larger manufacturing companies. He continued his history of successful cost cutting at these companies. Once AAP selected Mr. Baker as CEO for Sport Life Outfitters, Inc., he chose to bring his operational and accounting team with him from his last manufacturing company assignment even though the team had minimal retail and sporting goods industry experience.

Mr. Baker's team rapidly opened 19 additional stores in Washington, Oregon and Idaho. The company sought to reduce costs in many ways as part of the implementation of a cost based strategy. Except for the positions of store manager and assistant store manager, wages were lowered to a range that began at minimum wage and ended at $2.00 per hour above minimum wage. In addition, they no longer provided the high deductible medical insurance to their employees that had been offered to employees by the Lee family. The number of sales staff in each store was also reduced by approximately 20% and, in order to facilitate the staffing of stores during the rapid expansion, the requirement that employees currently or formerly participated in sports activities related to products sold in the stores was discontinued. These new policies substantially reduced labor costs. In addition, in order to lower purchasing, logistics and merchandise costs through volume purchasing, they standardized the product offerings in every store and centralized the purchasing activity in the Seattle home office. Unfortunately, soon after these cost cutting changes were made, same store revenue and profitability began a slow, steady decline. After four years under Mr. Baker's management the company was no longer profitable and, by the sixth year, the company reported a substantial loss. Because of this disappointing performance, AAP had to postpone plans to take the company public and decided to replace Greg Baker with Jack Colwood.

## THE COLWOOD ERA

After receiving his bachelor's degree in marketing, Jack Colwood started his career as an assistant store manager for a national retailer that was pursuing primarily a cost leadership strategy. He soon became frustrated by the amount of inappropriate inventory shipped to his store. The company utilized a centralized purchasing activity that provided similar merchandise to each store. The advertising and marketing functions were also centralized. As a result, promotions and advertising activities were identical from store to store. While most merchandise sold satisfactorily at his store, a substantial amount was out of season for his location or was simply not in demand in the local marketplace. This merchandise tied up display space and had to be highly discounted to be sold. Savvy local and regional retailers were much more sensitive to the particular needs of his local area and were able to tailor their inventory to better meet the demands of the local customer base. He recognized that a national retailer could not easily customize their product offerings to optimally fit each local market. As a result, these larger national companies had to offer lower prices for goods that may not be optimal for some customers, but rather acceptable to most customers, in order to generate a satisfactory level of sales. He also realized how difficult that cost leadership strategy was to implement since a high volume, low margin operation required a high capital investment for the logistics system, IT system, high inventory levels and large retail stores necessary to produce a high volume of sales. However, Jack did successfully utilize whatever little discretionary purchasing and advertising authority he had as assistant manager, and later as store manager, to tailor his store to best meet the needs of his local customer base. His marketing skill in selecting and promoting products over which he did have purchasing authority resulted in higher performance for his store compared with similar stores in his region.

While he felt very positive about his store achieving higher performance due to his limited purchasing and marketing activity, he felt somewhat constrained by the centralized, cost based strategy of the company. He realized that he would prefer a management position in a company that would allow him substantially more decision-making authority. In preparation for that career change, Jack returned to his University and received an MBA with a marketing emphasis. After receiving his degree, Jack was hired by a small regional hardware retailer as their marketing manager. He recognized that his new employer could not be price competitive for merchandise that was essentially the same as that sold by the national discount stores and national hardware retailers because of their greater purchasing power. Therefore, he embarked on a strategy to increasingly differentiate the company based on customer service and product availability. He instituted an employment policy that required new employees possess prior experience in the hardware or building industry and provided in-house training for employees conducted by the major vendors on many of their products that were sold by the company. He had each store manager set up meetings between Jack, the store manager and a few major contractors in each store's area to determine what additional items could be carried by that store to better serve the contractors' needs. In addition, he had the IT department provide each store manager with a summary of sales by product for that store and the average for all stores. This allowed each manager to identify specific product categories that might possibly receive an increased emphasis and categories that may well be over emphasized given their level of sales. He placed store employees on an incentive system based on each store's profitability. He also returned purchasing and employment decision-making authority to the store managers. In a short period of time, the efforts to differentiate the company from its competition resulted in significant increases in performance. Both revenue and net income increased substantially. Jack's success was noted by AAP after they had acquired the hardware retailer and Jack was soon reassigned to be CEO of Sport Life Outfitters, Inc.

In the three years since replacing Greg Baker, Jack instituted many of the policies he used successfully at the hardware company. He delegated a substantial degree of decision-making discretion to the individual store managers. An incentive system was instituted that rewarded store managers and their sales staff if they met profitability goals based on their store's previous performance. Colwood's primary mandate to his store managers was to build competencies in product areas that were likely to be the most successful in each location. This involved seeking personnel that had considerable expertise in those product areas to replace the relatively unskilled sales associates hired in conjunction with the previous cost-based strategy. He also suggested that store managers involve those personnel that possessed high levels of product knowledge in the purchasing and promotional decisions related to their product area. The policies he developed at the hardware company also included a commitment to the development of store managers.

He recognized that there was a major transformation of roles when someone was promoted to store manager and that the company had a responsibility to assist new store managers with making this transformation. Based on his experiences managing the hardware retailing company, Jack observed certain problem areas that their new managers typically encountered. His observations were also confirmed by research he read while seeking his MBA (e.g. Hill, 2004; Knippen & Green, 1999; Pearce, 1982). He found that many new managers had difficulty adjusting to an environment where they did not receive frequent specific guidance from a superior, but rather were expected to use their discretion to manage in ways that achieved the company's objectives. Often, the anxiety new managers had regarding the lack of specific guidance was heightened due to the time required to deal with unanticipated problems that would arise, or by the perceived need to "do it yourself" rather than properly delegate tasks to the other employees. Many new managers also had difficulty in forming proper relationships with their store employees. Frequently these problems arose when other unsuccessful candidates for the store manager position remained at the store and bore some degree of resentment to the successful candidate. Relationship problems also arose when the new store manager was relatively unskilled at giving instructions or disciplining employees. Some managers felt hindered in disciplining employees because of relationships that were formed prior to being selected as the manager, similarities in age, education or experience between themselves and their subordinates or because of a perceived need to be friends with all the employees.

Jack's primary tool in helping new managers prepare for and execute their new responsibilities at Sport Life Outfitters, Inc. was to establish the position of Vice President of Managerial Development and hired Patrick Raines to serve in that capacity. Patrick's developmental program consisted of two primary activities, onsite one-on-one new manager orientation sessions and annual store manager retreats. When a new manager was designated for a store Patrick would spend about two weeks at the store site helping the new manager adjust to his or her new role. During that visit Patrick would emphasize that the new manager's future success was no longer primarily dependent on his or her individual efforts, but dependent upon the collective efforts of all the store employees. He would also stress that the company's differentiation strategy was based on offering unique products tailored to the local market and high levels of customer service. Therefore, the training provided by Jack Colwood and Patrick Raines was directed toward teaching store managers to differentiate their stores by providing excellent customer service and specialized product selection. To help achieve this goal they encouraged store managers to create an organizational culture which fostered entrepreneurial activity that encouraged and rewarded innovative thinking by employees.

Jack also realized that experience plays a significant role in developing the managerial skills of the new store managers. To accelerate the process of experiential learning Jack asked Patrick to moderate annual full day retreats attended by the store managers at corporate headquarters. The goal of these retreats would be to allow the more successful experienced store managers to act as mentors to the newer store managers through their leadership of small group breakout sessions. These sessions consisted of small numbers of store managers that were generally located fairly close to one another. Common topics included the realities of the manager's role, assessing employee strengths and weaknesses, and how managers successfully deal with those strengths and weaknesses, managing stress, and establishing and maintaining the type of entrepreneurial culture that Sport Life wanted to develop. Other topics included various decision making techniques, how to best use the IT resources of the company for store management purposes and significant developments in the industry and within the network of the company's stores. The breakout sessions usually resulted in an ongoing informal mentoring relationship between the newer store managers and the store manager that lead the breakout session and peer to peer relationships between the breakout session attendees.

Jack was also aware that many other factors could affect the success of a differentiation strategy. As leases for stores approached expiration, the facilities manager for the company consulted with each store manager to determine whether the current store location was optimal for their customer base or whether a different location might be preferable. In addition, Jack had the IT department prepare detailed product sales histories for each individual store and for the company as a whole. Store managers could also request any additional performance information reports they felt were helpful in managing their store. The annual store manager's retreats had resulted in most managers' requesting similar IT reports that they collectively felt were genuinely helpful in managing store operations.

The individual store managers reacted to Jack Colwood's leadership in different ways. Almost all store managers adapted to the return to a differentiation strategy quite successfully. They appreciated the increased decision-making discretion, particularly in product selection, marketing and employee hiring decisions and welcomed the opportunity to be financially rewarded along with their staff for high levels of performance. However, a few store managers were more resistant to the changes implemented by Jack Colwood choosing to continue in varying degrees to operate as they did when Greg Baker was CEO.

## THE TACOMA STORE

Nancy Harding, manager of the Tacoma, Washington store, had been hired by the original founders of Sport Life to work in one of the Seattle area stores prior to the purchase of the company by the private equity firm. She played on the golf team for her University and regularly competed in amateur golf tournaments after graduation. One of the brothers, Jim Lee, had met her at a tournament and recruited her for a sales associate position. Because of her success in building the golf related sales at the store she was soon promoted to assistant store manager and then store manager. She personally supervised the golf sales for the store. She was quite successful promoting golf apparel and equipment at amateur golf tournaments and at related social functions held in conjunction with the tournaments. She received periodic incentive bonuses for her promotional activities. After the company was acquired by the private equity firm (AAP) and Greg Baker (then CEO) instituted centralized purchasing, the type of golf merchandise available to sell became very restricted and Nancy's store was no longer able to purchase many of the brands that had proven so successful in the local area. Once these brands were no longer available, the remaining golf merchandise was usually also available at the national sporting goods retailers at prices that were slightly lower than could be offered by Sport Life Outfitters, Inc. As a result, her incentive bonuses began to decrease. Because of the lackluster performance of the store in the final year of Baker's tenure as CEO, she received no incentive bonus and had begun to contact potential employers about employment opportunities.

Jack Colwood's appointment as the new CEO and the company's return to a differentiation strategy came as welcome news to Nancy. She recognized the opportunities that he had provided to store managers and employees through the granting of expanded store level decision-making authority. She looked forward to the ability to earn incentive bonuses once again. In an effort to better understand the demand in her particular area, she requested product sales histories for the period prior to the implementation of Baker's low cost strategy and compared that to her personal recollections of store activity by product type during that period. The sales history data confirmed her recollection that the store had previously performed exceptionally well in the area of higher priced bicycles and women's golf apparel and equipment. The information also indicated that sales in these areas rapidly declined when the centralized purchasing office replaced the more expensive specialty items with lower price point items that were also frequently available at many large national retailers.

Many of her sales staff left when the company cut wages and benefits under Baker's policies and were replaced with associates that had little or no knowledge of the products. After Baker left and the company once again implemented a differentiation based business strategy, Nancy began to change the organizational culture in her store. She returned to the hiring policy of the Lee brothers that required new employees to be active or past participants in a recreational activity that corresponded to a merchandise category sold in her store. She provided her sales staff with training by product vendors to educate them regarding their products. Any sales staff persons that resisted the new requirements for increased product knowledge were replaced. She also provided incentives, such as partial club membership fee reimbursement for her sales staff, which encouraged them to participate in activities involving merchandise sold by the store. For example, Nancy reimbursed Ernest Michaux for his membership fee in the local mountain bike club and provided him with a demo bike to ride in the club's events. Similarly, Nancy reimbursed George Snyder for his entry fees for local fishing tournaments and provided him with the latest in high quality fishing tackle to use in those tournaments. The sales personnel, by virtue of their increased customer contact, were now in a position to offer Nancy valuable advice on which products to order. This approach, coupled with modest financial incentives for the sales personnel based on increased sales, had resulted in a much higher public profile for the store and greatly increased sales and profits for those product lines that were promoted by the sales staff. Many of her managerial ideas had been adopted by other store managers after she presented them at store manager's retreats. She looked forward to the midyear review visit by Jack Colwood as it represented an opportunity to gain new ideas and draw upon his experience in dealing with issues that affecting her store.

## THE EUGENE STORE

Don Canard, manager of the Eugene, Oregon store, was hired as a sales associate in that store and had been promoted to store manager during the period when the company was managed by the previous CEO, Greg Baker. Don originally was a hiking and camping enthusiast when he joined the company, but found participating in outdoor activities less appealing as he reached middle age. He was promoted to store manager after the previous manager, hired by the Lee brothers, quit after the incentive program was reduced. He had received recognition from Baker for reducing the store's labor costs by replacing employees that were lost due to the wage and benefit reductions with part time employees that did not qualify for the modest benefits the company provided to full time employees. These part time employees were generally willing to work for minimum wage rates. This hiring policy reduced overall labor costs for the store. Typically, these employees were either retirement age and were supplementing their social security income with their wages or were second income earners in their family.

Unlike Nancy, Don chose to make only small, incremental changes to his store's operation once Jack Colwood took over the management of the company. He had developed close friendships with most of his store's suppliers over the years and trusted their judgment when selecting what merchandise to carry in the store. Unfortunately, because these suppliers did not offer a great variety of products, the product mix currently offered in the store heavily emphasized hiking and camping equipment and had not changed significantly since the company was acquired by AAP. Many of the products that were offered by the store were very similar or identical to what was offered by the national retailers although Don did take advantage of discounts offered by suppliers on manufacturer overruns and discontinued products. None of the current sales staff participated in activities related to sports merchandise the store offered, and few were eager to attend after hours training sessions the suppliers would occasionally volunteer to present. However, Don felt strongly that all the members of his sales staff were really dedicated, dependable people although he felt that their managerial ability was limited to the point that he needed to personally make all important decisions related to the store. Sales and profits had been stable since Colwood took over, but at a level that was well below that of the company's stores in similar size markets. Although he would have liked to receive additional pay from the incentive bonuses, he felt that it would take too much effort to bring his store's sale performance to that level. Instead, he tried to reduce costs as much as possible through his hiring practices and through the purchase discounts his suppliers offered him, primarily on closeout merchandise. Like all store managers Don had access to whatever accounting information related to his store that he needed. However, he did not have a business degree and did not possess much understanding of the accounting process or financial statements. He did focus on the "bottom line", the monthly net income figure each month, and was content if each month was profitable and not substantially less profitable than in that same month during the previous year. He was uncomfortable being gone from the store for any length of time and often did not attend the store manager's retreats because he felt it was more important to be at his store. When he did attend retreats, he felt much of the discussion was not relevant to his particular store because he perceived his store's market to be somewhat unique. Don did not look forward to Jack Colwood's midyear review visit for many reasons. It took time away from overseeing the many aspects of store operations and often resulted in some measure of conflict as Jack did not seem to fully understand the unique character of his store or its marketplace.

## THE REVIEW PROCESS

Jack Colwood instituted a two part annual managerial review process. The first part was a series of on-site midyear reviews conducted in the late summer or early fall after the six month financial statements were completed. Armed with financial results for individual stores, Jack and Patrick Raines traveled to each store to meet with the store manager. They would also meet privately with employees without the store manager present to hear their concerns. They would end each visit with a meeting with employees and the store manager to discuss the company's differentiation strategy, developments in the industry and management's performance expectations for the coming year with respect to that individual store and the company as a whole.

The second part of the review process was unofficially called "judgment day", the day when each store manager met privately with Jack and Patrick at corporate headquarters to review the performance of his or her store for the previous year. The "judgment day" process consumed much of the months of March and April and began once the accounting for the previous calendar year was completed. This afternoon both Nancy and Don were at company headquarters to meet with Jack and Patrick to receive their official annual review.

## NANCY'S REVIEW

As Nancy entered Jack Colwood's office she felt a bit nervous. Jack and Patrick were seated at the conference table in Jack's office. On the wall adjacent to the conference table was a large flat panel television displaying line graphs containing the past two year's month by month sales and gross profit results for her store by major product area. After she was seated, Jack addressed her:

Jack: Welcome Nancy. It appears your store has had a very good year. I am particularly pleased with how well you have understood the company's efforts to return to a differentiation strategy.

Nancy: I'm really pleased with the company's return to a differentiation strategy. Your new policies have allowed me to feel that I'm empowered as a store manager. They have provided an incentive system that allows my staff and I to receive significant financial rewards if our store's performance results in increased profitability for the company. My staff sincerely appreciates the opportunity to be rewarded for high performance.

Patrick: As you are well aware from our meetings at your store and the various store managers' meetings I've conducted, Jack and I are convinced that a differentiation strategy is the only way the company can compete with large national retailers who enjoy a cost advantage. The large chains have much higher purchasing power and extremely efficient in-house logistics systems. I know that implementing a differentiation strategy in the sporting goods retail marketplace is difficult, but it's not impossible. When you consider how sports related recreational activities can differ among our many store locations, the company has to give store managers the ability to seek out market opportunities in ways our larger competitors simply can't pursue. When this company was founded by the Lee brothers, it initially employed a differentiation strategy with great success. When it was purchased by AAP it got off track strategically. Since we've returned to a differentiation strategy, and once again begun to focus on giving store managers more discretion to be innovative in finding ways to pursue that strategy, we're getting really good results.

Nancy: A good example of how the new strategy has worked to our advantage has been our success in selling mountain bikes. My store sponsored Ernest Michaux, the sales person most knowledgeable about mountain bikes. The store paid his membership fees for the local mountain bike club, paid his expenses to participate in several high profile events, and negotiated with the representative from one of our mountain bike suppliers to provide him with one of their bikes that they thought would be a good fit for the mountain bike enthusiasts in our area. Based on the feedback Ernest received while participating in the events, we stocked bikes that these enthusiasts preferred. The large retailers stock bikes for the general public that generally sell in the under $500 range. We've found that our market is in the $1,000+ price range. We now pretty much own that segment of the market in our area. To solidify our market position, we've dedicated part of our square footage to a bike service facility and have hired Rachel Rusch, a technician that Ernest met from his club activities who's also active in the club. The store also sponsors her and provides her with a demo bike from a different supplier that also fits our market well. We've added to the activities of the service facility as we've seen the demand develop. Even though we're not large enough to compete with the national retailers in obtaining volume discount pricing, the size of our company allows us to realize some discounts single store retailers don't receive. In addition, our multiple store locations and resulting volume allow us to demand exclusive rights to market the bikes we carry in our area.

Jack: As a result of your initiative, you've not only built a core competency related to that product for your store, but that competency is a distinctive one. You're now insulated from national retailer competition in a large segment of the mountain bike market in your area. Plus, you've made it very difficult for a small independent bike shop to compete. In your market segment for bicycles you have a purchase cost advantage, dealership exclusivity and, in addition, you have the intangible value of the relationships Ernest, Rachel and other sales personnel have with the bicycle enthusiasts in the area. The ability to develop these types of competencies is exactly the type of attribute I am looking for in store managers.

Now let's review how the store has performed over the past year. Because of the ease of accessing accounting data, the company can readily assess numerous metrics related to your store's performance. We can get a very detailed picture of how your store performed compared to prior years and also how the store performed in comparison to our other stores in the area. Meeting quantitative expectations is a reality we all have to face. I'm no exception. The board hired me to increase the profitability of this company. If I cannot do that they will quickly find someone that can. The same standard has to apply to store managers as well. However, in your case you need not worry. Your store's quantitative measures have been excellent. As you can see by the year over year sales and gross profit by product line you have produced a dramatic increase in almost every area. You can see the increase in the bike sales which our analysts had already identified in comparing your store's results with our other stores. The next few slides show your store's performance in each product area compared to the other stores in your area and companywide averages. You will note that your store compares favorably with both the stores in your area and the company as a whole. Great job!

Nancy: Thank you very much. However, it has been a team effort and my staff deserves credit as well. I have been very careful about my human resource management policies at the store and I believe these policies have made a significant contribution to our success. In addition to using valid criteria in the hiring process, I feel a manager should be actively involved in developing their subordinates. One area I emphasize is developing new employees that are recent college graduates and helping them transition from being college students to being productive employees. This developmental activity includes explaining the differences between their former role as a college student and their current role as an employee. I also carefully and thoroughly communicate our company's expectations for their behavior and performance as employees, observe them closely during the initial period of employment and assign a very experienced colleague as a mentor for their first year.

Jack: It is certainly true that your store's success has been a team effort and your employees' contribution to your store's success will be recognized. I agree that not all recent college graduates can make the transitions from college student to employee successfully. None of our store managers have the time to give detailed instructions on what each employee should be doing like they receive from a professor in a college class. We have to have employees who are self-motivated, resourceful, and who understand how different our company's expectations are from what is expected of a college student. I am glad to hear you share my perspective on both hiring and employee development.

In reviewing the data for your store our analysts noted that sales and profitability in the areas of children's soccer and ladies' workout wear was exceptional strong. What is the story behind those numbers?

Nancy: That is an interesting story. One of my two assistant store managers, Amber, has two sons, Lucas and Hunter. They both play soccer in the youth soccer league and Amber is an avid runner. She is also a very astute marketing person. Amber suggested that we give the youth soccer teams a 5% discount on shoes and apparel. She felt that would increase traffic as the soccer players' parents would bring their kids into the store to get them outfitted with shoes, shirts and shorts. We then placed the soccer items in the back of the store and placed men and women's running and workout wear between the entrance and the soccer items so the parents would have to pass through those items to get to the soccer section. In addition, she and her husband, Jeff, informally discuss running and workout wear with their friends on an ongoing basis to insure we stocked items that the friends prefer that are not stocked by the national retailers. While it has increased men's running and workout wear sales, the women's sales have really taken off. In addition, Jason, my other assistant manager, has also been a source of sound advice. He avidly surfs in the Pacific Ocean and has steadily increased sales of boards and wetsuits in our store. While it may not have shown to be a significant sales item in the sales reports yet, I expect it to be very significant in the near future. His wife, Christine, and two sons often accompany him on his surfing trips and Christine and Jason have been working together trying to identify unique beach friendly tents, seating, coolers and cooking systems that our store could carry.

Patrick: I wish more of our store managers could be as resourceful and proactive as you are. You treat managing the store like it's your own rather than it simply being a job. A manager in this company needs that kind of attitude to succeed. The Company is very pleased with how you're running the store and encourage you to keep up the good work. You also have made many good suggestions at our store manager's retreats that have been adopted by other store managers. Someday soon we will be asking you to start leading breakout sessions at the retreats. The bottom line is that you and your team have performed exceptionally well and deserve to be rewarded.

Jack: Patrick and I will inform you of how we will reward you and your team after we have an opportunity to discuss it further. I'll call you next week and inform you of our decision.

Nancy: Thank you very much. I will be looking forward to hearing from you. We are eager to continue to find opportunities for the company in our market and appreciate your recognition for our efforts.

As she left Jack's office, Nancy felt highly motivated to continue her efforts to explore ways to tailor the store's sales to better meet the needs of customers. She appreciated the fact that both Jack and Patrick noticed and valued what she and her staff had done. She also believed that the bonus compensation system would fairly reward her and her staff's efforts and provide significant motivation to continue their efforts to achieve a high level of store performance.

## DON'S REVIEW

As Don entered Jack Colwood's office he also felt somewhat nervous. That nervousness increased as he sensed a somewhat hostile tone in Jack's voice as he directed Don to have a seat across from Patrick at the conference table. Jack started the conversation.

Jack: Don, I have been reviewing the financial information for your Eugene store for last year and, quite frankly, I am very disappointed by the results. As you can see from this graph, the current year's month by month sales and gross profit have shown no significant increase over the prior year. In addition, your store posted the lowest increase in sales for your area in all product categories. What's your explanation for these substandard results?

Don: The numbers do not tell the whole story. It was a tough year for the economy and we did the best we could.

Patrick: Sorry Don. We are not buying that explanation. Your store faces the same economic conditions that all our stores face. Eugene's economic conditions are about the same as those in Tacoma and Corvallis. Each of those stores posted significant gains in sales and profitability over last year's levels. Exactly what steps did you take to increase sales and profits and to identify and act upon new opportunities in your market?

Don: Hiking and camping equipment are our big sellers and I was afraid that making any major changes would be too risky. I certainly didn't want to lose sales in those product areas.

Jack: When we met at your store last summer I pointed out that your product offerings had not significantly changed since I became CEO. We also talked about the fact that your store had the lowest performance numbers in the area. That should have been a wakeup call for you to try to change your store's operations. During that meeting I explained to you in great detail why your store had to change its strategic orientation from trying to compete on cost to trying to meaningfully differentiate yourself from the national retailers in order to achieve the levels of performance our other stores enjoy. I also told you to analyze past sales patterns for your store and compare them to the sales patterns at our other stores in markets similar to that in Eugene.

Don: I really haven't had the time to get that information together. You have been to all the stores and talked to the other managers. Why haven't you told me exactly what product changes I needed to make?

Patrick: This isn't college where your professor gives you detailed instructions on how to complete every assignment. You're the store manager. You're in charge and you need to make good things happen. Maximizing sales and profits is your job! You need to figure out what it takes to achieve that goal with your store. Most of our store managers and assistant managers do that very well. In addition, it's clear to me that either you do not understand our differentiation strategy or you're choosing not to implement it. We're trying to provide products that customers want that are not available from the national retailers because we cannot compete with them on price. What those products may be can be completely different from store location to store location. Neither one of us can identify those products unless we are actively communicating with current and prospective customers. You just can't wait for customers to come to your store and buy whatever the store may be offering. You and your staff have to be proactively trying to discover what products your market wants and then promote them along with promoting your store.

Don: I don't feel that the sales staff is paid enough to get them involved in that kind of communication and promotional activity, so I don't feel right about asking them to do that sort of thing.

Jack: You have the authority to use incentives to get your staff involved. Our strategy is to differentiate ourselves from the national retailers by selling merchandise that better suits our customer's needs. Your job is to implement that strategy at your store. There are thousands of students in Eugene attending the University. Where are they buying bikes, hiking and camping gear, fishing equipment, and other recreational and sporting equipment items? Couldn't your staff get involved with clubs and groups that are active in these recreational activities? Couldn't your staff and yourself work together to identify new market opportunities?

Don: What about costs? I'm sure that because I employ only part time employees at minimum wage with no benefits and chose to focus on buying manufacturer closeouts whenever possible that my costs have to be lower than any other similar stores in the company. Sponsoring employee activities costs money. In addition, I would have to pay those type of employees a higher wage.

Patrick: You really don't understand our business strategy do you? Your costs are lower than our comparable stores. However, because of the level of sales by your staff and your purchase decisions to stock merchandise that is similar to the national retailers, your stores sales and profits are much less than any other store in the company. The national retailers pay approximately the same wage rates and, even with the purchase discounts you receive, they can still buy merchandise cheaper than you can. Our Tigard store also emphasizes hiking and camping equipment. Their employees are involved with numerous organizations that are active in hiking and camping in the Cascade Mountains and, as a result, they sell lots of higher priced specialized merchandise for both hunting and camping. That store is three times more profitable than your store with twice the sales per salesperson. Because of their bonuses and higher wage rates the employees are paid more than the employees in your store, but the store achieves much higher profitability for that higher pay.

Don: It is just not fair to make these kinds of comparisons. Our situation in Eugene is different.

Jack: Every one of our stores faces market conditions that are somewhat different. That is one of the reasons we have implemented a differentiation strategy and achieved great success. Each store can tailor their operations to best fit the local market. You have been reluctant to embrace that strategy and your stores performance has been adversely affected. We may wish to make some changes at the store. Patrick and I will discuss both the performance of your store and your leadership activities and inform you of what changes we will make some time next week.

## WHAT TO DO?

Shortly after Don left Jack's office, Jack and Patrick reviewed their notes from the meetings with Nancy and Don and the performance of both stores for the prior year. It was now time to decide what to do about rewarding Nancy's store for their performance and what steps to improve the performance of Don's store.

How should Nancy and her staff be rewarded? Nancy and her store's employees certainly deserved a performance reward, but how big should it be and how should the reward be allocated among the employees? Was money enough? Should there be other types of rewards given? How much should performance awards differ between stores? Several of her newly hired staff were very talented and productive. How could Sport Life Outfitters keep them from leaving the company and going elsewhere? How could the company and Nancy keep them motivated and provide them with further development? For that matter, how could Sport Life keep Nancy motivated? How could they keep her from leaving the company and continue to motivate her to be innovative?

Jack was also concerned about Don and his store. Don had been with the company for a long time. Because of the stage of his career, it would be tough for him to find other employment if he were fired. He was known throughout the company and was respected for his loyalty. In prior years under the previous CEO he'd had a modestly profitable store. However, his store was no longer keeping pace with the rest of the company and changes needed to be made. Should Don continue as manager or should he be fired and replaced? Was it really possible to get Don to change his ways? Could Patrick Raines (V.P. of Managerial Development) get Don to change his managerial philosophy by working with him in a very intensive mentoring approach? Should Don be placed in another position within the company that might be a better fit for him? What actions would be needed to change the Eugene store's organizational culture to be more like that of other stores that were implementing a successful differentiation strategy? What other measures would be required to improve the Eugene store's performance? Could it be done with the current roster of employees? Both Jack and Patrick were very much aware of how important making the right decisions in these circumstances can be.

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# PARK STERLING BANK: THE BEGINNING

**Michael D. Evans, Winthrop University**

## CASE DESCRIPTION

*The purpose of this case is to highlight the risks and potential rewards of starting and/or investing in a community bank. This case, based on the formation of Park Meridian and Park Sterling Banks in Charlotte, NC, is intended for junior level courses in corporate finance, management, money and banking, or investments. The case can be discussed in 1 - 2 class periods and will require 2 – 3 hours of outside preparation by students. Specifically, students will assess the unique challenges faced by community banks and evaluate the attractiveness of investing in a de novo bank. Secondary issues include the importance of qualified management and the role of bank directors.*

## CASE SYNOPSIS

*Larry Carroll, a prominent financial planner practicing in Charlotte, North Carolina, read with interest an article in the Charlotte Observer announcing the formation of a new community bank. Larry contacted the President of the proposed bank to express his interest in joining the organizing group. Through their efforts, Park Meridian Bank commenced operations. After ten years of steady growth, Park Meridian Bank was sold to Regions Bank. Larry experienced an attractive return on his investment. Now, Larry desires to "do it again!" He is now leading an effort to start another community bank and has recruited his friend and business colleague, Mike Evans, to join him in this business endeavor. Mike is extremely excited and flattered that he has been invited to join the organizing group. However, Mike faces some challenges. The reader will be introduced to the issues Mike faces in making the decision whether to participate or not.*

## INTRODUCTION

Larry Carroll, CFP®, CMFC, read with interest an announcement in the Charlotte Observer that Kevin Kennelly, Sr., a former executive with NCNB National Bank was spearheading an effort to start a new community bank in Charlotte, North Carolina. Larry was President of a very successful financial planning firm. Further, he was nationally recognized as one of the country's leading financial planners. He previously served as National Chairman of the Financial Planning Association and was regularly listed among the top financial planners in the country by publications such as Barron's. Larry was well aware of the favorable investment performance of community banks. He had the desire and necessary capital to participate in the formation of a de novo bank. He pondered how he might be introduced to the key principals. Larry felt that his financial planning background, reputation in the Charlotte community and large client base would be assets for any group seeking to start a community bank. He asked himself, "How do I position myself to be invited to join the organizing group?"

The organizers planned to start a niche bank that would cater to small business owners and affluent individuals. They wanted to offer a brand of private banking to their target market. The bank would be lead by Kevin Kennelly, Sr. and Bryan Kennedy. Each brought a wealth of banking experience and strong ties to the local community to the proposed venture.

Larry discussed his interest with Kelly Graves, one of his partners. It turned out that Kelly knew Kevin Kennelly, Sr. Introductions were facilitated and after phone and face-to-face discussions, it was mutually agreed that Larry would join the group of organizers of the proposed bank.

Early on, Larry expressed some concerns regarding the composition of the organizers. He felt that there were too many people with similar backgrounds (i.e., financial services professionals). Further, a few of the individuals worked for large broker/dealer firms or other financial services firms that might restrict their ability to raise capital for the proposed bank. Unfortunately, Larry's views were not widely shared nor appreciated. He was asked to "resign" from the organizing group.

The organizers submitted an application for charter to the North Carolina Banking Commission. Banks can either be Federal or state chartered. Federal chartered banks are regulated by the Office of the Comptroller of Currency (OCC). State chartered banks are regulated by their state banking division and also by the Federal Deposit Insurance Corporation (FDIC) unless they elect to join the Federal Reserve System.

The application for charter was approved by the North Carolina Banking Commission and the organizers were given the challenge of raising a minimum of $8,000,000. The capital raise proved to be more of a challenge than expected. It was not the best time to try to raise capital for a new venture. There was a great deal of nervousness in the market.

Larry received a call from a Charlotte Observer reporter. The Observer is the major daily newspaper in the Charlotte region. The reporter asked Larry if the deal would get done. Larry responded, "The organizers will raise the required capital and the deal will be completed." After the article appeared, Larry received a phone call from one of the organizers. The organizers were pleased that Larry spoke favorably of the deal even though he was no longer a part of the group. Larry was asked to rejoin the group with the caveat that he would commit to invest $100,000 personally and raise another $500,000. Larry readily agreed.

Over the next 8 months, a total of $8,525,000 was raised. Shares were issued at $11 per share. With the capital raise completed, Park Meridian Bank opened for business.

## PARK MERIDIAN BANK

The bank began operations in a new office building in the SouthPark area of Charlotte. This building, purchased by the bank, was surrounded by the wealthiest zip codes in the city and was in close proximity of SouthPark Mall, the premier shopping destination in the state. Bank operations were conducted on the first level of a two-story facility. The second story included office space and a large conference room. There were no “teller cages”. Instead, customers sat down face to face with bankers to effect transactions. The goal was to provide a more personal banking experience for customers.

Park Meridian’s strategy was well-received. The bank experienced growth in assets and deposits each year. Larry served as a member of the Executive Committee of the Board of Directors. This afforded him the opportunity to participate in the development of the bank’s strategic plans as well as gain a thorough understanding of bank operations and regulation.

## THE DECISION TO SELL

Park Meridian’s success did not go unnoticed. Larger banks seeking to gain entry into the Charlotte and/or North Carolina market eyed Park Meridian as a possible acquisition target. Larger banks viewed acquiring smaller banks in a desired market more viable than starting a banking operation in that market from scratch. The acquirer would immediately have the infrastructure in place by acquiring a going concern. Branch locations would already exist and personnel would be in place. Further, there would be an existing deposit base and established customer relationships.

Regions Financial Corporation (Regions), an Alabama-based financial institution and one of the 25 largest financial institutions in the country, agreed to acquire Park Meridian Bank some 11 years after it commenced operations. The agreement called for Regions to exchange .55 shares of its stock for each share of Park Meridian stock. At the time of the agreement, Park Meridian Bank had grown to $284 million in assets and $202 million in deposits. The proposed acquisition, subject to shareholder approval, would provide Regions with entry into North Carolina. It would afford the customers of Park

Meridian with additional products and services given the substantial size and resources that Regions would provide.

The shareholders of Park Meridian Bank overwhelming approved the acquisition. Shortly thereafter, the Park Meridian name disappeared from the Charlotte landscape. Regions Bank appeared in its place.

## KEY PERSONNEL

Initially, Regions retained all of Park Meridian's personnel. Kevin Kennelly, Sr. and Bryan Kennedy assumed executive positions at Regions. Each was required to sign a non-compete clause as part of their employment agreement with Regions. Bryan entered into a 3-year contract with a 1-year non-compete on the back end. Thus, he could not leave Regions to go to work for another bank for a period of 4 years from the agreement date. Kevin and Bryan dove into their new responsibilities and looked forward to a new chapter in their respective banking careers.

## LARRY CARROLL'S INVESTMENT

As noted earlier, Larry initially invested $100,000 in Park Meridian Bank. Over the years, he made additional investments in Park Meridian shares. While Park Meridian did not pay cash dividends, it did issue stock dividends. Accordingly, the number of Park Meridian shares owned by Larry increased over the years. Approximately, six months prior to the sale of Park Meridian to Regions, Larry was offered the opportunity to purchase an additional 10,000 Park Meridian shares at $10 per share. Note that Park Meridian shares had traded in a narrow range (between $8 and $12 per share since its inception). Larry accepted the offer.

The shareholders of Park Meridian Bank received .55 shares of Regions for each of their shares. At the time of the acquisition, Regions' shares had a market value of $29. This was the equivalent of receiving $15.95 for each Park Meridian share.

Larry experienced a phenomenal return on investment. Just six months earlier, he had bought a substantial block of Park Meridian shares at $10 per share. Further, he held the shares of Regions subsequent to the acquisition. Regions shares hit $36 per share. At that point, Larry engaged in profit taking (i.e., selling some of his Regions holdings).

The day the sale of Park Meridian to Regions was completed, Larry said to Bryan Kennedy, "Let's do it again!"

## COMMUNITY BANKS IN THE CHARLOTTE REGION

Charlotte was a fertile environment for the formation, growth and sale of community banks. Investors in these banks realized handsome returns. Larry adopted the practice of investing in all of the Charlotte-based de novo banks. Bank of Mecklenburg opened 3 years prior to Park Meridian Bank. It was subsequently acquired by Triangle Bancorp and is now a part of RBC Bank. First Commerce Bank opened 5 years after Park Meridian. It was subsequently acquired by Bank of Granite. American Community Bank, The Scottish Bank and First Trust Bank began operations in Charlotte prior to the sale of Park Meridian Bank. All were successful in growing their banking operations. Investors in these financial institutions realized significant returns on their investment. Investing in community banks in the Eastern United States and the Charlotte region appeared to be a formula for success. Twenty-five banks were started in the eastern region in 2005, one more than in 2004 (Danielson Associates, 2006). The basic strategy was:

1. Start a community bank
2. Grow the bank
3. Sell the bank to a larger financial institution seeking to gain entry into, or increase market share, in the Charlotte region

Only Crown National Bank failed to reward its shareholders. It opened in 1989 and failed four years after commencing operations. The bank was also located in the prestigious SouthPark area of Charlotte. However, it lacked the management expertise that is desperately needed to run a community bank effectively. Further, the Board of Directors failed to provide sufficient oversight to overcome management's errors. With the exception of Crown National, shareholders of North Carolina de novo banks on average received attractive returns. "If you start with good bankers and they grow conservatively, it's been an attractive investment almost universally" (Mildenberg, 2006). Community banks have several advantages (Independent Community Bankers of America, 2007). These include the ability to:

1. Focus on the needs of the local community
2. Concentrate lending activity within the neighborhoods where their depositors live and work
3. Be more accessible to customers
4. Make faster loan decisions
5. Better understand the challenges faced by small business owners

Larry Carroll continued to invest in community bank shares over the years. An investment in a de novo bank proved to be a "no brainer." He experienced a satisfactory return from each investment. Unfortunately, he missed the satisfaction of starting and growing a bank.

## PARK STERLING BANK

Bryan Kennedy's non-compete agreement had expired at Regions Bank. While he enjoyed his tenure at the larger financial institution, his heart remained in community banking. Thus, he called Larry and said "I'm ready." Bryan and Larry agreed that the time was right to re-create a community bank in the mold of Park Meridian. Bryan recruited Frank Ix to join the proposed venture. Frank had previously helped organize and run Bank of Mecklenburg, a Charlotte-based community bank that had been acquired by a larger institution. Most recently, Frank served as an executive with RBC Bank. The two brought a wealth of banking experience in the Charlotte region. Further, Bryan most recently served as President – North Carolina for Regions. In this capacity, Bryan had developed relationships with bankers from across the state. A number of those bankers expressed interest in joining the proposed bank once it was up and running. Thus, the proposed bank had the prospect of attracting established bankers who could bring a book of business with them.

Larry, Bryan and Frank set about the task of developing a business plan and recruiting individuals to serve on the Board of Directors. The business plan incorporated a number of the elements that made Park Meridian successful. The proposed bank would target professionals, real estate developers and mid-sized businesses. Real estate lending would be an area of focus. Home equity lines of credit would be the primary retail product. Wholesale funding (up to 70% of total deposits) would be used to supplement local deposits. The goal was to "create long-term shareholder value through strong earnings, exceptional loan quality, a diversified book of business, a strong base of core depositors, and a committed and active group of directors" (Park Sterling, 2006). It was expected that the proposed bank would generate a return on assets > 1% and return on equity > 10% by the end of the third full year of operations. Initially, the bank would operate from a midtown location (i.e., a location between uptown Charlotte and SouthPark). It was expected that a SouthPark location would be added at a later date.

Mike Evans, CPA, CFP® read an article that appeared in the Charlotte Observer newspaper. It announced that his friend and business colleague, Larry Carroll, was starting a community bank. Mike had long harbored an interest in serving on a bank board. Previously, he had been recommended to executives at Wachovia, Bank of America and Southern National Banks. While feedback had been favorable, he had not been tapped to serve.

Mike was one of the first African-Americans to obtain the Certified Financial Planning Practitioner™ designation in the Carolinas. Larry had served as a mentor as Mike started his financial planning practice. They shared ideas and best business practices over the years. Larry and Mike had enjoyed a personal and business relationship of over 20 years. Mike hoped that this might be his chance to serve on a bank board.

Larry, Bryan and Frank recruited a strong group of executives, business owners and professionals to serve on the board. As they looked around, they noticed that the proposed board lacked diversity. There was a strong interest in adding a woman and a minority who would be able to make positive contributions to board deliberations and to the overall success of the bank. Anne Leggett, an attorney at that time with one of Charlotte's largest law firms, agreed to serve.

A day or two after the article appeared, Larry called Mike and asked him to come to his office to talk. The subject for the meeting was not disclosed. Mike prayed that Larry would ask him to serve on the bank board. Indeed that was the case. Larry didn't know it, but Mike was already sold. Accordingly, Mike cut off Larry's "presentation" to express his interest in serving. His only question was "What is it going to cost me?"

Larry shared that the North Carolina Banking Commission required that a minimum of $27,000,000 and a maximum of $45,000,000 be raised to capitalize the bank. He didn't see any problem in reaching the minimum requirement. It was hoped that each director would invest a minimum of $100,000. Larry was personally investing $2 million. A listing of the proposed directors and their initial investment appears in the following table.

| Board Member | Profession | Initial Investment |
|---|---|---|
| David M. Bishop | Attorney | $100,000 |
| Larry W. Carroll | Financial Planner | 2,000,000 |
| Mike Evans | Financial Planner | ? |
| E. Hooper Hardison, Jr. | EVP, Manufacturing Co. | 100,000 |
| Averill C. Harkey | Attorney | 200,000 |
| Thomas B. Henson | Attorney and Private Investor | 300,000 |
| Frank W. Ix | EVP, Park Sterling Proposed | 250,000 |
| Bryan Kennedy, III | President, Park Sterling Proposed | 260,000 |
| Anne S. Leggett | Attorney | 100,000 |
| Steven W. Luquire | Marketing and Public Relations Executive | 100,000 |
| Joseph J. C. (Chip) Mark, Jr. | Developer | 100,000 |
| Bailey W. Patrick | Real Estate Executive | 100,000 |
| Shawn P. Quillin, M.D. | Medical Doctor | 200,000 |
| J. Carlton (Carl) Showalter, Jr. | Construction Company Executive | 100,000 |
| William B. Webb, Jr. | Sports Marketing Executive | 100,000 |

One of the early tasks of the board was coming up with a name for the proposed bank. The board unanimously concluded that the name of the bank should clearly draw upon the Park Meridian legacy. Several alternatives were offered during a brainstorming session. Ultimately, the board decided on the name "Park Sterling Bank."

The proposed board set about the task of raising capital. No consultants or investment banking firms were utilized in the capital raise. Talking points were prepared for board members. Presentations were made at country clubs, before civic organizations and at meetings of professionals and business executives. The goal was to exceed the total minimum capital requirement of $27 million. The minimum investment of $25,000 per investor was established by the board. The initial thought was to make this amount $50,000. However, the amount was lowered after much discussion. The board desired to keep the number of shareholders below 500. Companies with 500 or more shareholders are considered a public company by the Securities and Exchange Commission. Such companies bear increased compliance and reporting requirements and costs in order to adhere to the provisions of Sarbanes Oxley.

Approximately one year prior, the organizers of New Dominion Bank (with the help of consultants) raised $40 million to capitalize this de novo bank. At that time, it represented the largest capital raise for an NC community bank. In a matter of 13 weeks, the organizers of Park Sterling Bank received total subscriptions exceeding the maximum $45 million. This was now the largest capital raise for an NC community bank. This was Mike's golden opportunity! However, there was a large hurdle to overcome. A personal investment of $100,000 was required.

Mike reviewed his current financial position. He and his wife had done well financially over the years. However, the timing was not the best to invest $100,000 in a business venture. With three kids in college at the same time, cash flow was at a premium. Further, Mike and his wife were diligent to maximize contributions to retirement accounts each year. Thus, the bulk of their net worth was in IRAs, 401(k) and other tax-deferred accounts. If Mike wanted to participate, he would either have to:

1. borrow some or all of the required investment
2. make the investment inside one of his retirement accounts
3. utilize most of his liquid assets (i.e. use available cash and liquidate investments in personal accounts)

The clock was ticking. This appeared to be a great investment opportunity. While there would be no cash compensation for serving, each board member would receive options to purchase additional shares at the current market price at the time of the option grant. The first tranche of options would have a $10 exercise price. That is, each board member would have the ability to purchase additional shares at $10 per share irrespective of how high the shares climbed in price. The options were exercisable at any time at the discretion of the board member within ten years of their grant date.

Further, there was solid management in place. A group of experienced bankers was ready to join Park Sterling and the proposed bank board appeared strong. There were risks, however.

1. Each organizer would be required to personally guarantee a loan to fund start-up costs in the amount of $100,000. The loan would be paid in full if the capital raise was successful, but there was no guarantee that the organizers could raise the minimum $27 million. However, organizers would be responsible to pay off any monies borrowed to fund start-up activities if the capital raise was unsuccessful.
2. There was substantial competition in the Charlotte region. Bank of America and Wachovia banks were headquartered in Charlotte. Further, numerous regional and community banks operated in Charlotte. Accordingly, competition for deposits and loans was fierce.
3. There was no guarantee that Bryan Kennedy and Frank Ix would be effective in attracting and maintaining a quality staff and managing bank operations.
4. Some of the proposed Directors did not know other each other well. There was the risk that they would not be able to agree on strategy and/or work together effectively as a cohesive board.
5. The proposed niche of focusing on real estate lending could prove to be ill-advised.
6. Several other groups announced plans to start a community bank in the Charlotte region at the same time as the Park Sterling group. This meant that there would be competing groups seeking to raise start-up capital at the same time.
7. There was precedent for a community bank failure in Charlotte. When Crown National Bank failed, its shareholders lost approximately 80% of their initial investment. Mike was one of the investors in Crown National. This was his first and only previous investment in a de novo bank. Would Mike be unlucky again if he decided to invest in Park Sterling?
8. Serving as a bank director would involve a significant time commitment. One would be required to attend board and committee meetings as well as devote time for establishing bank policy, monitoring management for adherence to policy and banking regulations and engaging in business development.
9. Directors may be held personally liable (civil and criminal) for losses arising from violation of specified banking regulations (e.g., insider transactions, exceeding legal lending limits, bank failures).

Mike was analyzing the risks and potential rewards of joining the group of organizers when he received a call from Larry. Larry asked, "Are you in?

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# ECAMPUS.COM: SITTING IN THE CATBIRD SEAT

**Stephen L. Loy, Eastern Kentucky University**
**Steven Brown, Eastern Kentucky University**

## CASE DESCRIPTION

*The primary subject matter of this case concerns the current trends in the college rental textbook market. After studying this case, students should be able to (1) understand the competitive dynamics and emerging trends of the college textbook rental market, evaluate the competitive position of Ecampus and (3) assess the options facing Ecampus and recommend a course of action.*

*This case is suitable for graduate and undergraduate strategy classes and has a difficulty level of four. It is suitable for classes in management information systems and management strategy. Students should spend from six to twelve hours outside of class analyzing the case, depending on the breadth and depth of the analysis the instructor desires.*

## CASE SYNOPSIS

*This case presents an overview of the college textbook rental market in which Ecampus competes. It presents a brief history of Ecampus and descriptions of its competitors. The case portrays the company as being in an enviable position in its industry and the company president thinking about the future of the company.*

*Ecampus.com was created during the "dot com bubble" by investors who hoped to grow it into an IPO. The plan was to "get big, fast" strategy and measure success by brand strength instead of earnings. In its first six months, Ecampus spent $40M for commercials on three cable television networks. These ads created 87% brand name awareness, but only $2M in sales.*

*Two events forced Ecampus into bankruptcy in 2000. First, the "dot com" bubble burst in March 2000 and venture capital and IPO markets dried up. Second, suppliers and potential investors were scared off by the personal bankruptcy of the CEO.*

*A Book Company, LLC purchased Ecampus for $2.5M at a federal district court auction in 2001. The new owners employed a traditional business-driven strategy focused on internal efficiency, strict cost controls, highly targeted marketing, and internal* *financing for expansion. By 2007, Ecampus broke even and profits have steadily increased since.*

*Ecampus began renting textbooks in 2007. Since then, several new companies, financed by Silicon Valley venture capital companies and employing aggressive business models, have entered the rental market and grown rapidly. These rental companies are dependent on Ecampus' large supply of used books for their rental business. The president is now thinking about the future. How should Ecampus prepare itself for expansion into the e-textbook market? Could it use acquisitions and alliances? Should Ecampus continue using only internal financing for expansion?*

## INTRODUCTION

"Textbook rental business is booming. We started doing textbook rentals four years ago. Today, it makes up 30% of our revenue. We rank second in the textbook rentals and second in used textbook buy-back volume. Our rental books come from our stock of used books. We make no distinction between a rental book and a used book in the warehouse," states Matt Montgomery, President of Ecampus.com. "If we rent a book twice, we cover our costs. After that, we make a profit. Some textbooks, such as chemistry books, can be rented for ten to twelve times because editions come out only come out about every five years. However, the books that have a new edition every two years, we can only rent them about four times," he explains.

"Our competitors are very price-aggressive," Matt states. "Amazon, Barnes & Noble, Chegg, CampusBookRentals, and BookRenter are well-capitalized companies that spend much more on advertising than we do. We spend about $2 million annually on advertising while each of our competitors spends more than $20 million. We survive because our core competencies are our customer service, the industry's most efficient order fulfillment center, the largest buy-back operations, the best program of shredding and recycling worn out textbooks, and our highly efficient marketing program. Additionally, we have excellent relationships with the textbook publishing companies because our management and staff have publishing industry experience. That experience gives us a better understanding of the textbook market. We operate as an extended arm of the publishing companies."

"We have self-financed our growth, while our competitors use venture capital firms and by becoming public corporations. The venture capital market has rebounded in the last few years, and is funding Silicon Valley startups, such as Chegg, CampusBookRentals, and BookRenter. We're holding our own right now. We're not feeling much pressure because we supply most of the used books that our competitors rent, and those rental books come back to us at the end of the rental period. The more books our competitors rent, the more revenue we make for fulfilling their orders and shipping textbooks to their customers.

We are sitting in the catbird seat right now, but we do need to think about the future direction of Ecampus, once e-textbooks become more popular."

## BACKGROUND

Ecampus.com went online in July1999, just eight months before the "dot.com bubble" bust. It was created as an independent virtual retail store for Wallace's Book Company (WBC), a wholesale textbook distribution company. The force behind the creation of Ecampus was Wallace Wilkinson, the founder and owner of WBC, and former Governor of Kentucky. Using his personal influence and reputation as a successful executive, he persuaded John Y. Brown (Kentucky Fried Chicken founder), Dave Thomas (Wendy's founder) and several other wealthy friends and business associates to invest \$50M to create Ecampus and to fund its "get big fast" strategy. This strategy rested on gaining first-mover advantage through technological leadership provided by WBC's state-of-the-art warehouse and by a newly constructed e-commerce Web site. The competitive strategy was to position Ecampus as a low price/high-added value vendor in the industry (Bowman and Faulkner, 1997). A high-quality and expensive marketing campaign was designed to give Ecampus a dominant share of college textbook retail market

Success came quickly for the new company due to the highly creative commercials that ran on three cable TV networks in August and September of 1999. By mid-August, the Ecampus Web site quickly became one of the twenty busiest sites on the Internet. More importantly, Ecampus achieved a phenomenal visitor-to-buyer conversion rate of 14%. It looked like Ecampus was going to be a huge success. In October 1999, an additional of \$49 million was contributed by Ecampus investors for the purchase the WBC warehouse and inventory, and for the upcoming December-January marketing campaign.

The initial success was short lived, however. The "dot.com" bubble burst in March 2000 and two months later, it was revealed that Wilkinson was more than \$400M in debt and had used Ecampus investors' money personal uses. Immediately, Ecampus suppliers demanded payment of outstanding balances and advance payment for new orders. Unable to meet the demands of suppliers, Ecampus filed for Chapter 11 bankruptcy in June 2000. The federal district court allowed Ecampus to continue operating until sold by the court at public auction in June 2001. The new owners, A Book Company (ABC), implemented a traditional business strategy based on operating and marketing efficiency. While the process of reviving the company was been a slow and bumpy process, the company stabilized and grown over the last ten years.

Since 2008, price competition has intensified from companies selling low-cost imported textbooks, electronic textbook publishers and textbook rental companies. Moreover, federal and state governments are pressuring higher education institutions and publishing companies to find ways to lower textbook costs for students. Consumer groups have organized to provide low-cost and even free textbooks to students in some states. A company named Flat World Knowledge was created to disintermediate the textbook distribute channels and to streamlining publishing processes. The newest competitors, such as Chegg, focus on renting textbooks. These companies employ innovative uses of technology, flexible pricing and social network platforms, are disrupting the retail textbook industry.

## BUYER AND SUPPLIER POWER

The textbook market is a $7B-10B market that does not operate like most consumer markets in that the end consumers (students) do not select the product, and those who select the product (i.e., professors) do not purchase it. Removing price from the consumers purchasing decision gives disproportionate market power to publishers in setting prices. (Koch, 2008)

The textbook industry is intensely competitive. It is an industry with relatively few publishers and a low threat of new entrants, due to the enormous startup costs required. Consolidation in the recent decades reduced the number of major publishing companies from around 30 to just a handful (Koch, 2008). The high start-up costs combined with rapidly changing technology creates substantial barriers to new entrants. However, with the advent of the Internet, many new companies emerged to sell textbooks and digital media that include textbook chapters and exercises, online tutoring systems, video lectures, etc.

More recently, an increasing number of authors are foregoing commercial publishers and offering their textbooks under a creative commons or other open license. The New York Times recently endorsed the use of free, open, digital textbooks (NY Times, 2008).

The economic downturn is affecting how students buy textbooks. Ten years ago, approximately 80 percent of students purchased their textbooks at the college store; by 2009, only about 60 percent did. According to Follett's research, 40 percent of students who rented textbooks used the money they saved to purchase other items, such as other course materials (40%), school supplies, and clothing (15%) (Sabo, 2010).

The National Association of College Stores (NACS) reports that 1,500 of their 3,000 member stores offered a textbook rental program of some kind in 2010, a 25% increase from the previous year. Of the campus bookstores that responded to a fall 2010 NACS survey, 38% (570) indicated having a book rental program, 16% (240) provide a rentals for a majority of the courses offered by their college, while 84% (1260) only having rental textbooks for a few courses. Two-thirds (67%) of the stores surveyed said they planned to increase the number of rental titles in 2011 (NACS, .2010).

Sixty-nine percent (69%) of the campus bookstores had been in operating less than a year. Of those, ninety-six percent (96%) indicated they would continue the rental program due to the positive response from students (86%), administrators (77%), and faculty (59%).

Campus bookstores use various methods to rent textbooks. Some rent through the on-campus store (77%), a store web site (44%), a partnership with a book wholesaler (44%), a textbook rental company (23%). Nearly 50% of stores offering rentals use social media to promote themselves.

The prices campus bookstores charge for rental books are set: (1) as a percentage of the publishers new book retail price (47%) or (2) by the rental partner (32%). Of those that use the new book retail price, the average rental percentage is 45%. Used textbook rental price is 37% of the used textbook price. About 29% set a minimum price for rentals that average $36.40 for new books and $31.20 for used books (NACS, 2010, p. 3).

About 30% of campus bookstores report that their rental program increased student traffic in their store and web site by an average of 48%. Nearly 21% report an increase in sales of non-book merchandise due to the rental program. Of those stores not offering rentals, 43% indicated that they have definite plans to begin offering a book rental program within the next 12 months (NACS, 2010, p. 3).

With higher education costs rising, the cost of textbooks has attracted attention. The 2005 Government Accountability Office (GAO) report on college textbooks said that since the 1980s, textbook prices increased at twice the rate of inflation. The report cited the increased investment publishers made in new products to enhance instruction and learning, publishers' practice of packaging supplements with a textbook to sell as one unit, which limits using less expensive used books, more frequent revisions of textbooks and the increasing use of customized textbooks as the primary factors contributing to increasing textbook prices (USGAO, 2005).

A June 2007 Advisory Committee on Student Financial Assistance (ACSFA) report stated that, the average U.S. college student spends $700–$1000 per year on textbooks (Turn, 2008). Many groups blame publishers, bookstores, and faculty for the high cost of textbooks. The report calls on all parties within the industry to work together to find ways, including the use of open textbooks and low-cost digital media, to reduce costs.

## DIRECT COMPETITORS

The online rental market is a $200 million market that is growing at a 30% annual rate. The two largest competitors, Chegg and Amazon, are highly capitalized corporations. Amazon had a gross margin of 22.8% in 2011 (NASDAQ). Amazon spent $1.3B, a 63% increase, on marketing expenditure in 2011. Amazon spends 3.3% of its sales revenue on marketing, 5.9% on technology, and 8.7% on order fulfillment (Amazon.com, 2011).

BarnesandNoble.com, eFollett.com, and Ecampus.com were created during the "dot.com bubble" as Web retail storefronts for a wholesale distributor.

**Amazon.com**

Amazon is the Wal-Mart of the Web. It employs a multi-leveled e-commerce strategy by offering a wide assortment across many product categories. Some fear Amazon could move from book sales into publishing. If it did, the publishing companies will need to innovate quickly to survive (Pepitone, 2011). Amazon employs anticompetitive tactics. "…its practice of routinely selling e-books at a loss. Such practices, commonly known as predatory pricing, are a means of using superior capital resources not to innovate nor to provide better service, but to weaken or eliminate competition" (Authors Guild, 2012).

How big is Amazon? In the first quarter of 2011, Amazon reported sales of $5.5B (+44.6%) in North America and $4.4 in international sales. Its North American operating income was $ 290M (+6.2%) with a gross profit margin of 22.8%. Amazon spent $327M on marketing and had $2.64B in cash and cash equivalents on hand. As a percent of net sales, Amazon spent 8.7% on fulfillment, 3.3% on marketing, and 5.9% on technology and content (Amazon 10Q 2011, p. 19).

Amazon controlled about 90% of the e-book sales in 2010 and 75% of the printed book sales (Authors Guild, 2012b). In July 2010, it launched the Kindle textbook rental program that allows customers to set their own rental period and calculating the rental price based on those dates (Merino, 2011a).

Amazon has a database of deep, detailed, real-time market knowledge. This database eliminates the guesswork from marketing, which enables Amazon to run countless pricing experiments and immediately analyze the results. With this information, predatory prices can be precisely set to maximize the sales of the latest Kindle e-books to the most desirable categories of consumers. It can maximize the losses of a targeted competitor as well.

"For book publishers, the relevant market isn't readers (direct sales are few), but booksellers, and Amazon has firm control of bookselling's online future as it works to undermine bookselling's remaining brick-and-mortar infrastructure. Amazon controls every growing segment of the industry: online physical books, downloadable audio books, online used books, and e-books. Amazon commands about 75% of the online market for print books, and 60% of the e-book market (a percentage that decreased from Amazon's reported 90% two years ago, as a result of agency pricing" (Authors Guild, 2012a).

Amazon's North America sales growth rate was 45% in the first quarter of 2011 compared to the first quarter 2010. Growth primarily was driven by increased unit sales due to reduced prices, reduced shipping costs to customers, increased sales of electronics and other general merchandise, increased in-stock inventory availability and increased selection of product offerings (Amazon.com, Inc., p. 16). "We seek to mitigate costs of shipping over time in part through achieving higher sales volumes, negotiating better terms with our suppliers and achieving better operating efficiencies. We believe that offering low prices to our customers is fundamental to our future success, and one way we offer lower prices is through shipping offers" (Amazon.com, Inc., p. 17).

Amazon sees the competition among industry rivals as intense.

> *"Our businesses are rapidly evolving and intensely competitive, and we have many competitors in different industries, including retail, ecommerce services, digital content and digital media devices and web services. Many of our current and potential competitors have greater resources, longer histories, more customers, and greater brand recognition. They may secure better terms from vendors, adopt more aggressive pricing, and devote more resources to technology, infrastructure, fulfillment, and marketing. Competition may intensify as our competitors enter into business combinations or alliances and established companies in other market segments expand into our market segments. In addition, new and enhanced technologies, including search, web services, and digital, may increase our competition. The Internet facilitates competitive entry and comparison shopping, and increased competition may reduce our sales and profits." (Amazon.com, Inc., p. 24)*

Amazon has been described as "... a bully … Anyone who gets that powerful can push people around, and Amazon pushes people around. They do not exercise their power responsibly." (Authors Guild, 2012a)

**Barnes and Noble**

BarnesandNoble (BN) has three operating segments: B&N Retail, B&N College, and B&N.com. It has a vast network of warehouses across the United States and stocks over 1 million titles for immediate delivery, which is larger than any other online bookseller. It is a leading seller of e-books, offering over 1 million titles, and the BN Marketplace offers millions of new and used items from a network of trusted sellers.

For the first quarter of 2011, BN reported sales of $2.3B, up 6.9% over first quarter 2010. Its operating profit was $113M (+ 4.9%) with net income of $60.5M (-24.6%) and cash and equivalents of $26.5M (-34%) (B&N 10Q, 2011, pp. 19-20).

*B & N Retail*

B & N Retail became a nationwide retailer in after purchasing 797 Dalton Bookstores from Dayton Hudson in 1999) This operating segment includes 705 bookstores under the Barnes & Noble Booksellers trade name. These stores generally offer a NOOK (NOOK 3G, NOOK Wi-Fi and NOOK Color eBook Reader devices) Boutique/Counter, a comprehensive title base, a café, a children's section, a Toys & Games department, a music department, a magazine section and a calendar of ongoing events, including author appearances and children's activities. The B&N Retail segment also includes the company's publishing operation, Sterling Publishing (B&N 10Q, 2011, p. 19).

*B&N College*

B&N College purchased B&N College Bookstores from Leonard Riggio in September 2010. B&N College operates 636 college bookstores under contract. The B&N College stores generally sell and rent new, used and digital textbooks, as well as sell course-related materials, emblematic apparel and gifts, trade books, school and dorm supplies, and convenience and café items (B&N 10Q, 2011, pp. 19-20).

*BarnesandNoble.com*

BarnesandNoble.com was created in 1997 as a retail subsidiary, owned by Leonard Riggio, to sell books online. In 1999, Barnes & Noble.com went public in what was "the largest Internet IPO in history at the time. Total proceeds generated by the transaction exceeded $486 million." (BarnesandNoble, 1999, p. 16)

Today, BN.com includes the e-commerce site featuring eBookstore and digital newsstand, as well as, the development and support of NOOK™. NOOK is free software that enables customers to buy and read eBooks on the widest range of platforms, including NOOK™ eBook Readers, devices from partner companies, and hundreds of the most popular mobile and computing devices using.

BN.com offers$25 annual membership program that entitles members to receive: 40% discounts on in store purchases of hardcover Barnes & Noble bestsellers; 20% discounts on all adult hardcover books and 10% discounts on other eligible items; unlimited free express shipping; and periodic special promotions (B&N 10Q, 2011, p. 20).

Competition in the book business is intense in every channel in which Barnes & Noble competes.

> *Barnes & Noble retail stores compete primarily on the quality of the shopping and store experience and the price and availability of products. The importance of price varies depending on the competitor, with some of Barnes &*

*Noble's competitors engaging in significant discounting and other promotional activities. NOOK competes primarily with other eBook readers on functionality, consumer appeal, availability of digital content and price.*

*Barnes & Noble retail stores also compete with specialty retail stores that offer books in particular subject areas, independent store operators, variety discounters, drug stores, warehouse clubs, mail-order clubs and other retailers offering books, music, toys, games, gifts and other products in its market segments.*

*Barnes & Noble faces competition from many online businesses, notably Amazon.com and Apple, mass merchants, discounters, the Internet, and digital distribution including "eBooks" and eBook readers.*

*New and enhanced technologies, including new digital technologies and new web services technologies, may increase Barnes & Noble's competition. Competition may intensify as Barnes & Noble's competitors enter into business combinations or alliances or established companies in other market segments expand into its market segments. Increased competition may reduce Barnes & Noble's sales and profits*

**eFollett.com**

The Follett Corporation is a textbook wholesale distributor. Efollent.com is the name of its retail Web site. Follett operates the largest chain of college and university bookstores in North America with 860 company owned stores and about 800 independent affiliated stores. Follett sells books and audiovisual materials to elementary and high schools and libraries, and provides library automation software and consulting services.

Follett is a privately held company incorporated 1894 with headquarters in a suburb of Chicago. The family-owned company has more than 10,000 employees and estimated sales of $2.7 billion (Follett About).

efollett.com was created in January 1999 as a nationally advertised Web site. In addition to discounted prices, efollett capitalizes on the company's chain of brick-and-mortar stores to provide students the convenience of easy pickup and returns. These brick-and-mortar stores provide a steady stream of used textbooks for reselling or renting.

The majority of Follett stores offer 30 percent or more of their campus's adopted titles for rental. Several staff members are dedicated to tracking textbook adoptions and continually updating national and local rental lists. It is predicted that both the percentage of rentable titles and rental transactions will grow significantly over the next few years before leveling off (Sabo, 2010).

Follett rents physical textbooks through its RentAText program, which is available at more than 900 universities. In the 2010-11 academic year, Follett rented 2.5 million textbooks (Rosen, 2011). RentAText uses CafeScribe.com where students can find about

12,000 eligible e-books and download a free three-day trial of an e-textbook. e-books can be rented for 180 days or purchased outright. The drawback to purchasing is that the buyer is limited to printing a maximum of 30 percent of the text. Some students find that purchasing is "Not worth the head and heartache of having to keep track of what you have and haven't printed." (Bernard, 2011)

**Chegg.com**

Chegg has become Silicon Valley's most successful start-ups. From starting as a purely textbook rental company in 2007, it has evolved into a Web 2.0 company that uses a "social education platform" that features Homework help, Course selection, Note taking, Textbook and e-textbook rentals, and the Chegg For Good (a philanthropic program to support education, the environment and various communities. Chegg has collaborated with American Forests to plant a tree for every textbook that is rented, bought, or sold.

Chegg started as a local textbook rental company, textbookflix.com, located in Ames, Iowa in 2003. In 2007, the company was incorporated as Chegg.com and was relocated to Silicon Valley. Chegg raised $219M from venture capital companies, such as Ace Limited, Foundation Capital, Gabriel Venture Partners, Insight Venture Partners, Kleiner Perkins Caufield & Byers, Pinnacle Ventures, Primera Capital, TriplePoint Capital (Crunchbase, 2011 ).

Chegg now services more than 6,400 universities and community colleges across the United States (Crunchbase, 2012; Chegg Media Center, 2012). Its estimated 2010 revenue was about 130M (Tsotsis, 2011) and company value increased 16% to an estimated $425M in 2011 ("The Next Wave of Tech IPOs," 2012). Chegg is thought to have about 80% of the textbook rental market share. Chegg is expected to file for an IPO in March 2012 (Swisher, 2012).

Chegg, like traditional e-tailers Amazon and Zappos, requires a complex infrastructure to handle warehousing, shipping, and returns for millions of physical items, as well as a customer service desk that is highly seasonal. Because Chegg is innovating in an existing industry, the company faces rampant competitive threats from both the old guard and new entrants alike (Carpenter, 2010b).

*Chegg's competitive strengths are quick testing and fast rollout, viral marketing, operational excellence (i.e., excellent at pick, pack, ship and return), scalability and customer service (Carpenter, 2010a).*

**CampusBookRentals.com**

CampusBookRentals (CBR), located in Ogden, Utah, has become of one of the largest textbook rental companies since its creation in 2007. CBR services students with flexible rental options and low prices on over 4,000 college campuses. CBR offers shorter rental periods and customized rental periods so students can rent books for a semester, a quarter, or a summer term. Rental prices vary based on the rental length. Additionally, students can select their own return date based on when their class end, such as a 4-week or 6-week class. Furthermore, CBR has a 30-day money-back guarantee if a student drops a course after renting a book. Chegg offers a 21-day guarantee and Amazon began flexible rental periods in July 2011 (Chegg, 2011).

CBR is ranked 31st on Forbes list of "America's Most Promising Companies" (Nelson et al., 2011). CBR tripled its staff from 100 employees from in 30 one year ago and upgraded to larger offices five times in four years. The company plans to use the $20M it raised from equity venture capital companies (Level Equity, Five Elms Capital, and Cherokee & Walker) for hiring, textbook acquisitions, and other operational expenses (Kelly, 8-2-2011).

CBR has a feel-good donation-per-rental feature. Like Chegg, CampusBookRentals.com offers a feel-good nonprofit donation promise for every book rented. While Chegg plants a tree for every book rented, CampusBookRentals.com donates a portion of all proceeds to Operation Smile, an organization that provides cleft-palate correction surgeries for the children of families who cannot afford it (Chegg, 8-2-2011).

**BookRenter.com**

BookRenter (BR) is one of the fastest growing startups in Silicon alley, growing at over 600% each year. It offers more than 5.5 million titles and students on over 5,000 campuses, CEO, Mehdi Maghsoodnia, claimed in 2010 that BR accounted for about 30% of the revenue in the online, excluding offline, rental market (Merino, 2010).

BR is a privately owned company, located in San Mateo, California. Some of its owners are prominent Silicon Valley venture capital firms. In February 2011, BR secured $40M from new and existing venture partners Adams Capital Management, Comerica Bank, Focus Ventures, Lighthouse Capital Partners, Norwest Venture Partners, and Storm Ventures. These funds are financing the expansion of BR's Rapid Platform program (Merino, 2011b).

Rapid Platform is a turnkey package that enables college stores to launch their own online textbook rental site and to integrate with BR's network of over 560 college bookstores, including eight of the ten largest independent bookstores. Rapid Platform has gained tremendous traction with schools looking to reduce the cost of education for their students (Merino, 2010). BR competes by allowing students to return their rented textbooks to a participating bookstore. The bookstores benefit from the increased buyback activity and merchandise transactions. This strategy is reversing the trend of students shopping elsewhere on the Web for their textbooks. According to the NACS OnCampus

Research report of January 2011, compared to the previous year, customers of stores that offer BookRenter rentals are 21% more likely to rent a textbook 10% more likely to purchase items from a brick-and-mortar store (NACS, 2010).

**Neebo.com**

Neebo.com is the online sales network of Nebraska Book Company (NBC), which is a privately held book distributor that owns a network of 280 college bookstores. Their Web site provides a list of participating college's courses and required books. Neebo.com sells new, used, and rental textbooks for college students, as well as college gear and other college-branded accessories (Neebo.com, 2012).

On June 27, 2011, NBC, and all of its subsidiaries, filed for reorganization relief under Chapter 11 of the United States Bankruptcy Code. A at the end of 2011, company asset value was $538M and a net consolidated loss of $18.7M (Nebraska Book Company, 2012, p. 17). The Textbook Division posted for first nine months of 2011, textbook sales of $113.1M and an Adjusted EBITDA of $29.3M (Nebraska Book Company, 2012, p. 27). In the fourth quarter of 2011, there was a "$13.2 million increase in textbook rental revenue, which was partially offset by decreased new and used textbook sales revenues." (Nebraska Book Company, 2012, p. 30)

The Chapter 11 petition was filed due to"... the inability to fully refinance our existing debt and vendors' unwillingness to extend can credit to us under normal terms due to refinancing uncertainties." (Nebraska Book Company, 2012, p. 7) NBC is operating as a "debtors-in-possession" while reorganizing.

## SUBSTITUTES AND NEW ENTRANTS

Digital textbooks or e-books are substitutes for hardcopy textbooks. E-textbooks sales are growing at a 20% annual rate (Roizen, 2010). Nearly all online textbook rental companies offer them for sale or rent. Publishers predict the demand for e-textbooks will increase as more content and number of titles increase. Electronic content is appealing to publishers because sales of these products are less affected the used textbook market than print products (USGAO, pp. 14-15).

The price of e-textbooks is about half that of a new hardcopy textbook. Passwords enable access to an online version of e-textbooks. Until the password expires, a student can access the textbook as many times as they wish to review chapters or printing a hard copy. Despite their lower price, e-textbooks have not caught on with most students, but that is predicted to change.

The next generation of e-textbooks will feature animated figures and graphics. Kno is a tablet textbook company started by Chegg co-founder Osman Rashid. The Kno tablet has a variety of features to" bring textbooks to life, including Facebook integration, automated quizzes, and an activity stream of notes." (Schonfeld, 2011)

The 3D feature of Kno can enhance models of molecules in chemistry textbooks by converting standard chemistry notations of how atoms are bonded in a molecule into a spinning 3D model along the margins. These 3D models can be enlarged and rotated. The Kno can take original text, blueprints, engineering diagrams, or other types of illustrations and make them appear 3D (Schonfeld, 2011).

Other features of Kno textbooks include a journal to stream of your highlights, notes, audio notes, and photos. You can add video clips recorded directly from the iPad camera as well. Smart links will bring in more video into each textbook, but in context with what you are reading. Initially, these video clips were Khan Academy videos, but future clips will include other online videos (Schonfeld, 2011). Chegg has already converted more than 40,000 textbooks with the ability to take notes, online chat and highlight passages (Greenberg, 2012).

Certainly, Amazon and Apple could be major threats if they use their enormous financial power and technological knowledge to dominate the e-textbooks market by partner with publishing companies or acquiring existing textbook distributors.

## CONCLUSION

Ecampus faces a highly competitive market with aggressive competitors and potential new entrants with substantial capital backing. Chegg recently formed a partnership with Apple to develop 3D technology for e-textbooks. Ecampus does fairly well in attracting people to its web site (Table 1) and has a good Internet marketing efficiency rating (Table 2). Amazon is not included in the tables because they are a multi-leveled e-commerce company and BarnesandNoble publishes books and operates a chain of brick-and-mortar bookstores. The six listed companies are similar in strategy and product offerings.

Table 1
Comparison of Web Site Visits in August 2011 and Average Visits per Month 2011

| Company | Total Unique People Visits Aug 1-Aug 31 2011 | Avg. People Visits Per Month 2011 | Percentage of Total Visits August 2011 | Avg. Percentage of Total Visits Per Month 2011 |
|---|---|---|---|---|
| Ecampus | 264,188 | 137,684 | 28.5% | 14.9% |
| BookRenter | 205,355 | 128,785 | 22.2 | 13.9 |
| Chegg | 144,753 | 87,580 | 15.6 | 9.4 |
| Efollett | 140,380 | 59,623 | 15.1 | 6.4 |
| CampusBookRentals | 105,061 | 40,766 | 11.3 | 4.4 |
| Neebo | 67,253 | 50,279 | 7.3 | 5.4 |
| Totals | 926,990 | 504,717 | | |

Source: Quantcast.com (Retrieved 2-18-2012)

Table 2
Estimation of the traffic brought through by AdWords vs. Natural Traffic

| Company | Internet Marketing Effectiveness* | Traffic Rank - US | Organic Traffic | Adwords Traffic | Facebook Shares | Facebook Likes | Twitter Backlinks |
|---|---|---|---|---|---|---|---|
| Chegg | 74.7 | 2,525 | 33.9% | 66.1% | 46,291 | 8,296 | 13,480,212 |
| BookRenter | 80.4 | 14,827 | 62.9% | 37.1% | 27,215 | 3,564 | 4,396 |
| CampusBookRentals | 68.1 | 24,883 | 83.2% | 16.8% | 2,704 | 225 | 4,589 |
| Neebo | 78.2 | 20,476 | 89.7% | 10.3% | 1,565 | 232 | 410 |
| Ecampus | 75.1 | 9,340 | 86.6% | 13.4% | 1,184 | 82 | 2,071 |
| efollett | 56.7 | 24,636 | 100.0% | 0.0% | 124 | 21 | 26 |

*Source: WooRank.com (Retrieved 2-18-2012)*

Since A Book Company acquired Ecampus, it has used internal funds to fund expansion. While this approach has produced steady growth and protected its market share, internal funding does limit its growth.

The competitive strengths or core competencies of Ecampus are:

*Strong brand name*

*Most efficient fulfillment center in the industry*

*Excellent relationships with publishing companies*
*Management and staff experienced in publishing industry and warehouse operations*
*Highly efficient target marketing strategy*
*Industries second biggest supply of used textbooks due a strong buy back program*
*History of competent management and stable growth*
*Best customer service reputation in the industry.*
*Wide selection of textbooks allows students to buy all or most of their books at the same time, which enables bundling the shipment to save shipping costs.*
*Strong sales in K-12 textbooks market. Provides textbooks to many public school districts and statewide systems.*

Ecampus sells more textbooks through Amazon than through its own web site, which boosts Ecampus to second in the industry in online textbook sales. Ecampus' fulfillment is the most efficient in the industry and has excess capacity during the off-peak months. Some of that excess capacity is used to fulfill orders for Chegg and Amazon.

Because Ecampus fulfills all of its orders and provides customer service in-house, which gives it tighter control over these functions that is unmatched by the competition.

*The biggest challenges facing Ecampus are:*
*Lack of a physical footprint on campus*
*Protecting its market share against the new, aggressive, deep-pocketed competitors, such as Chegg, CampusBookRentals and BookRenter*
*Impending threat of e-textbooks replacing physical textbooks*
*Fully utilizing operational capacity due to seasonality of sales*
*Finding ways to finance faster growth*

In the last three years, the venture capital market has revitalized. In that time, forty-nine percent of the venture capital went to buy a stake in companies at the early or the even earlier "seed" stage of funding. The average seed deal was $2 million, and the average early stage deal was $5.7 million. Expansion stage companies like Ecampus, raised $10M to $12.5M on average from venture capital companies (Ortutay, 2011). However, Chegg raised $219M from venture capital investors, BookRenter raised $40M, and CampusBookRentals raised $20 M.

It is four o'clock in the afternoon and Matt Montgomery is sitting in his office overlooking the Ecampus warehouse floor. He thinks about the challenges and opportunities confronting Ecampus. This is his baby. He has been with Ecampus since it was born, nursed back to health when it was sick, and nurtured into a healthy company. However, markets and technology change, and companies have to change as well. Matt thinks about Ecampus' competition and the company's next stage of growth.

Amazon is big, aggressive, but poses little threat top Ecampus because textbooks are minor component of the company and over half of Ecampus' rentals and sales are come through Amazon. B&N is a low threat in the textbook rental market and is focused on the e-book market with a large offering of e-book titles and the Nook reader. Chegg, CampusBookRentals, and BookRenter have grown rapidly, but pose a low-level threat to Ecampus. In fact, Ecampus supplies textbooks and order fulfillment service to all three competitors, So, Ecampus profits from the success of its competitors. Finally, Neebo is similar to Ecampus in that it is a textbook wholesale distributor with its own order fulfillment operations, a solid customer base in the K-12 and community college markets and a large inventory of used textbooks. Unlike Ecampus, Neebo operates many brick-and-mortar stores on college campuses. Neebo is not consider a threat to Ecampus.

Ecampus has positioned itself very nicely in its industry as a supplier of rental text books to students and to its direct competitors. Its new and used textbook sales and textbook rentals are the company's current strength, and e-textbooks are its primary future growth area. The big questions are how long will be before the hardcopy textbook rental market starts to decline, and what can Ecampus do to position itself to grow into the e-textbook market? The owners of Ecampus do not want to use venture capital companies to finance a move into the e-textbook market, because they do not want to give up control to outsiders. Matt also has no desire to sell Ecampus. However, if someone made the right offer, the A Book Company owner would give it due consider. Not being president of Ecampus might give Matt time to sharpen his golf game.

Then, he remembers. "Oh! Golf! I promised the guys I'd be there at 4:30 to play 18 today before it gets dark. I better get going."

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