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# **JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES**

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# **BUG BUSTERS CORPORATE TATTOO INITIATIVE: KICKING THE HORNET'S NEST WITHOUT GETTING STUNG**

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

## **CASE DESCRIPTION**

*This case helps students develop skills in planning, composing and delivering a business-related bad news message and offers options for written and oral deliverables. In addition, this case helps students develop skills in synthesizing and contextualizing secondary research and employing APA citation skills. The case is appropriate for junior- or senior-level university courses in business communication. The case is designed to be taught in approximately three class hours; the written and oral assignments are each expected to require two hours of outside preparation by students.*

## **CASE SYNOPSIS**

*John Carson is the founder and owner of Bug Busters, a prosperous extermination and bee-removal company headquartered in Aksarben, Nebraska, with retail locations in five Midwestern and six Western states. The company was founded in 1976 and employs about 900 people throughout its many locations.*

*Carson has always wanted Bug Busters to be a sought-after place to work. To achieve this goal, he has implemented employee-friendly policies and practices, including flexible work hours, bonuses for charity work, permission to use company vehicles for commutes, nap rooms at selected locations, and vouchers for child and elder care. As a result, Bug Busters employees, on the whole, enjoy their work and feel pride in their company—and, most importantly, they tend to stay for the long term.*

*Last month, Carson saw concrete evidence of that employee pride and satisfaction. Scott Lang, who has worked at Bug Busters for six months, showed Carson his newest tattoo: the Bug Busters logo, prominently placed on his bicep. Carson was thrilled that an employee valued his job so much that he would actually make his fidelity permanent on his arm.*

*Scott's tattoo gave Carson an idea—what if he could persuade other employees to get tattoos of the company logo? The tattoos would be a chance for employees to feel part of the Bug Busters “family”; they would also have potential for the company as marketing and publicity tools. Energized by this “great new idea,” Carson emails his Human Resources Director, Courtney Whitmore, to get the ball rolling on the Bug Busters Corporate Tattoo Initiative.*

## INTRODUCTION

Courtney Whitmore, Director of HR for Bug Busters, was ready for the weekend. It had been a tough day—and a tough week, really. In addition to coordinating annual HR training for the Arksaben employees on site, Courtney had also spent a good bit of time that week recording the training sessions and preparing electronic documents so that Bug Buster's other locations would also be able to participate virtually. The virtual training was going well until this morning when the servers had gone down in Kansas and Oklahoma. Her IT team had been dispatched about two hours ago to these locations to fix the problem, and Courtney was on edge, waiting to hear from them.

It was 3:00 p.m. With only a few hours to go before she could call it a week, Courtney decided to spend the rest of the day catching up on email, but after such a trying day, she needed a boost to help her focus. She knew just what would do the trick: a steaming cup of French Roast coffee. Grabbing her largest mug, Courtney headed to the break room and its Keurig machine.

She had just returned to her desk, coffee in hand, when a new message popped up at the top of her inbox. It was from her boss, John Carson, the CEO of Bug Busters, and the subject line read: A GREAT NEW IDEA!!

Courtney sighed. Although she liked and respected her boss, she had learned to be wary of his self-proclaimed “great ideas,” especially when they arrived in all caps and were followed by multiple exclamation points. While some of his inspirations were truly innovative and had brought about positive changes within the company, others were unworkable, and a handful were just plain wacky. She took a fortifying gulp of her coffee, opened the message, and started reading.

Hi Courtney,

I just read a news story on the Internet about a realty company in New York that had offered employees an increase in their commissions if they got tattoos of the corporate logo somewhere on their bodies. Several employees had taken the offer, and a couple of others were quoted in the article saying how it made them really feel like a member of a family, rather than just an employee of the business.

Coincidentally, Scott Lang came into my office earlier today and showed me the Bug Busters tattoo on his bicep. As you know, he's one of our marketing managers and one of our most dedicated employees, and he was really proud of his tattoo. That got me thinking about that New York company and their tattoo program and how Bug Busters might do something similar. If someone like Scott would get a Bug Busters tattoo, maybe our other employees would, too.

So, what I'd like to propose is this: a corporate tattoo initiative for Bug Busters in which we offer incentives—such as a 15% bonus—for our employees to get tattoos of the Bug Busters logo. I think this idea would really appeal to our Millennial employees and may promote engagement among employees of all generations.

I realize that idea is a little outside the box, but what do you think? How would we make this work from an HR perspective?

Best,

John

A tattoo initiative? Yes, that was truly “outside the box.” Carson was nothing but creative, Courtney reflected. But would such an outlandish idea work? True, most of Bug Busters’ employees were Millennials who were open-minded about tattoos and other body art; but how would they feel about sporting their employer’s logo? Permanently.

As Courtney pondered the idea, more questions came to her. What legal issues might Bug Busters run into? What about potential health risks? How would customers or vendors view the initiative? How would such an initiative be likely to play out in the local press? Would there be any religious or cultural considerations Bug Busters would need to be aware of? Finally, who would pay for the tattoo? And what if an employee changed his or her mind and wanted the tattoo removed? Would the company pay for removal?

Courtney knew she needed to proceed carefully. The last thing she wanted to do was to anger Carson with an automatic “no.” The best way to answer her boss, Courtney knew, was to objectively and thoroughly research the issue and present her findings in an impartial and succinct way. Although she had some misgivings, she had worked with Carson enough to know that some of his craziest ideas turned out to not be so crazy after all. Who knows? She might even consider getting a tattoo one day.

# ICHITAN GROUP AND THE PRICE WAR IN THAILAND'S READY-TO-DRINK TEA MARKET

**Thunyarat (Bam) Amornpetchkul, National Institute of Development Administration**

## CASE DESCRIPTION

*The primary subject matter of this case concerns pricing strategies. Secondary issues examined include price competition, competitive advantages, sales and marketing strategies, customer price responsiveness, and business ethics. The case has a difficulty level of five, appropriate for first year graduate level. The case is designed to be taught in 1.5 class hours and is expected to require 3 hours of outside preparation by students.*

## CASE SYNOPSIS

*In November 2015, Tan Passakornnatee, the founder and CEO of Ichitan Group, most well-known for its ready-to-drink (RTD) green tea branded "Ichitan," had an extremely critical business decision to make regarding the firm's strategy in view of the long-lasting price war in the RTD tea industry that he had been part of for more than ten years. As the year 2015 was coming to an end, there were a couple of signs that triggered Tan's worries about his recent business performance.*

*First, based on the third quarter data, Ichitan lost the largest market share to its main competitor, Oishi. Second, the RTD tea market was projected to suffer a declining trend in 2015, following its first negative growth in ten years that took place last year. In addition, although the total consumption of RTD tea in Thailand increased slightly from the previous year, its value had actually dropped due to various forms of increasingly aggressive, and expensive, price promotions that Ichitan's entry into the market had triggered.*

*Tan was not quite sure whether he was doing the right thing for this company and his customers. While low-income customers praised him for offering them opportunities to win big prizes that could completely turn their lives around, others heavily criticized his marketing campaigns for causing excessive consumption of caffeine and sugar, and for luring Thai people into the habit of gambling. He himself had also started to realize that the sales-boosting effectiveness of these campaigns might be decreasing as the market approached its saturation point. Before his board meeting next week, Tan had to decide on both a short-term strategy to secure the largest market share and improve the firm's bottom line this year, and a long-term strategy to develop more sustainable competitive advantages for Ichitan Group.*

Sitting alone in his office while still donning his signature captain's hat, Tan Passakornnatee, the founder and CEO of Ichitan Group, the largest market share holder of the Thai ready-to-drink (RTD) tea market, was pondering what his next moves should be in this highly competitive market that appeared to be closer every minute to its saturation point. He had a very successful track record in the RTD tea business, and was best known for initiating the lucky draw campaigns that gave away prizes worth hundreds of millions of Thai baht. However, as it had recently been revealed, Ichitan's 2015 third-quarter performance did not meet expectation. It was conceivable that his company's largest market share could be lost to his former partner, but now major competitor, Oishi Group. Last year, the RTD tea market itself also had just experienced a negative growth for the first time in ten years. If Ichitan's strategies did not play out well, the market could suffer another year of negative growth. As the 2015 year-end was approaching in less than two months, Tan had to craft out some solution plans and be ready to present them at the Ichitan's board meeting that would take place a week from now.



## **The Journey of Ichitan**

Ichitan Group Public Company Limited was initially established under the name of “Mai Tan Company Limited” on September 3, 2010, with the registered capital of 500 million Thai baht (approximately 14 million USD). In November 2011, the company’s name was changed to “Ichitan Group Company Limited,” consistent with the major brand, “Ichitan,” of its RTD beverages. The company’s original business portfolio consisted of Japanese-styled restaurants, chocolate shops, and beverages. However, in January 2013, the company decided to divest its restaurant businesses to focus solely on its most profitable, largest volume beverage business. The company was publicly listed and traded on the Stock Exchange of Thailand beginning from April 21, 2014 – its stock was named the most heavily-traded stock of the day. As of December 2014, Ichitan’s registered capital was worth 1,300 million Thai baht, and 99.5% of its 2014 net revenue from sales of 6,179.1 million Thai baht came from its RTD tea beverages (see Exhibit 1). Ichitan’s current product lines for RTD tea beverages included green tea, black tea, herbal drink, and low-sugar green tea, under the brands of Ichitan Green Tea, Ichitan Dragon Black Tea, Yen Yen by Ichitan, and Ichitan Selected, respectively.

Although the company was relatively young, at a little over 4 years old, Ichitan had consistently been under a spotlight in the Thai and Asian business world for its unique, and somewhat controversial, business path as well as its corporate strategies.

## **The Founder, Leader, and Brand Ambassador**

Despite its current status as a publicly listed company, Ichitan’s image had always been very tightly tied to its founder, CEO, and largest shareholder (34.66%), Tan Passakornnatee. At the age of 56, Tan had been named the 38<sup>th</sup> richest person in Thailand for the year of 2015, with net worth of 640 million USD. But it was not only his assets that made him an iconic business tycoon. Tan was also recognized as a great entertainer. At certain events, including Ichitan’s initial public offering debut, Tan showed up as “Tan Man,” wearing his distinctive black-and-yellow superhero costumes with a captain’s hat. For other more casual occasions, he could be seen wearing yellow, green, or red pants and a patterned shirt, or a T-shirt with an image of a pig (the zodiac animal for his birth year), but almost never without his captain’s hat. To help stimulate Ichitan’s brand recognition, Tan appeared frequently on the media to promote Ichitan products himself.

Before landing at the current position in his career, Tan actually had quite a rough roller-coaster ride. Growing up in a lower-income family with six siblings in Chonburi province, Tan had to quit school after finishing his 9<sup>th</sup> grade in order to find a job to assist his family financially. He started off as a coolie making only 700 Thai baht per month. However, with his business mind and hard work, he later gathered some savings, with the help from his father and sister, and opened a book kiosk at the Chonburi bus station. He was subsequently able to expand into many other businesses including a gift shop, a bakery shop, a hot pot restaurant, and real estates. His businesses were going well until they were severely hit by the 1997 economic crisis (also known as the Tom Yum Goong crisis for its origin in Thailand). At that time, Tan was under the biggest debt in his life, worth over 100 million Thai baht, causing him to sell almost all of his assets. But with his perseverance and support from people around, he eventually overcame the situation and began his new business – a wedding studio in Bangkok – in 1999.

A major turning point in his career took place when later in 1999 he started the first Japanese buffet restaurant in Thailand, under the brand “Oishi,” which turned out to be a huge success. Following the Japanese buffet restaurant, Tan expanded the business line to include other types of Japanese food and bakery. In 2003, another boom set off when Oishi, under the lead of Tan, launched its first ready-to-drink green tea product “Oishi Green Tea,” which successfully acquired the second largest share of the Thai RTD green tea market in less than a year. Shortly after, in 2004 the company went public under the name of “Oishi Group Public Company Limited,” with “Tan Passakornnatee” – very well recognized by Thai nationals as the founder, CEO, and largest shareholder. Just a few years later, however, Tan publicly announced his intention to step away from Oishi and start another business. In September 2008, Tan sold the majority (43.9%) of Oishi’s shares, worth 3,352 million Thai baht, to Thailand’s largest beverage company, Thai Beverage Public Company Limited (commonly referred to as “ThaiBev” and most known for its alcoholic beverages). [6] Finally, in July 2010, Tan officially resigned from Oishi Group and opened his new company in September of the same year under the name “Mai Tan” – the beginning of “Ichitan.”

The story of how Tan became a successful business tycoon despite his rather underprivileged background served as a great inspiration for younger generations of spirited entrepreneurs. Nevertheless, there was also another side of the public who viewed his act of founding a new company which eventually entered into direct competition with his once-owned company as a clear violation of business ethics.

### **Key Products**

From its start in September 2010, “Mai Tan” received great attention, especially concerning what type of businesses it would be operating. Many people took Tan’s announcement to quit Oishi Group on good terms as a promise that he would never return to the same RTD green tea business. When asked by the media, however, Tan insisted that he had never made such a statement.

In fact, the first product launched by Mai Tan in early 2011 was not a green tea, but a functional drink under the brand “Double Drink.” The drink was a mixture of herbal juices, marketed as a natural and healthy drink for balancing and supporting the body system. The sales of Double Drink were expected to reach 500 million Thai baht at the end of its first year. However, the overall size of the functional drink market was only about 3,000 to 4,000 million Thai baht, less than half the size of the RTD green tea market at the time.

To the public’s surprise, four months later in May 2011, less than a year after Tan’s resignation from Oishi Group, Mai Tan introduced “Ichitan Green Tea” to the market. The RTD green tea was marketed as made from the best breed of tea, carefully grown and picked by educated farmers to deliver health benefits to consumers, chemical free.

After the company was renamed in November 2011, Ichitan continuously expanded its production lines to produce additional sizes (ranging from 240 – 840 ml) and packaging types (can, box, bottle) of its beverages. It also introduced new products of RTD tea, including herbal tea branded “Yen Yen” in February 2013, low-sugar tea branded “Ichitan Selected” in March 2014, and flavored black tea branded “Ichitan Dragon” in September 2014. Its first product, Double Drink, was discontinued in June 2014. The company’s current portfolio of RTD beverages offered 19 flavors and 8 package sizes (see Exhibit 2).

### **Competitive profile**

Ichitan admittedly believed that the RTD beverages currently available in the market did not present clear differentiation in terms of product appearance and taste. Hence, it focused on building a strong brand image and attractive product design that would convey the high quality of its drinks. Ichitan described its production as being strictly controlled for

quality at every step, from research and development, raw materials selection, production process, to packaging. The R&D team, comprised of experts in the beverage field, worked hard to develop new products that truly matched the tastes and needs of Thai consumers. A proof of R&D success was the introduction of the Shiliang tea, under the brand of Yen Yen, which had taken the largest share of the RTD Shiliang tea market. The production processes employed advanced technology to preserve the freshness and high quality of carefully selected ingredients. Package design was ensured to be modern and appealing while not compromising on safety and convenience.

One of the areas in which Ichitan took the most pride of was its factory, situated on 120,000 square meters of land and valued at 3.5 billion Thai baht. The factory, claimed to be the first in Thailand to adopt the latest technology of the “Auto Warehouse System,” which could process automatically from the very first stage of production to the final stage of stowage. The machines were capable of running for up to 120 hours straight, significantly reducing production costs and human errors while enhancing production capacity. With this technology, Ichitan boasted its capacity to produce 600 million bottles and 200 million boxes of RTD beverages per year, using fewer than 100 workers. The factory also employed an advanced technology known as “Cold Aseptic Filling,” which required less usage of energy, raw materials, and labor hours while maintaining the product quality at a higher level. An automated storage and retrieval system implemented in the factory also helped increase the efficiency and reduce costs of Ichitan’s inventory management activities.

From the factory, Ichitan products were distributed through both the modern trade and traditional trade channels, altogether accounting for more than 300,000 channels [10]. Sales performance and inventory turnover were consistently analyzed for each channel to support effective stock management and customize sales and marketing strategies for different regions.

In planning its sales and marketing strategies, Ichitan conducted demand forecasts based on historical and statistical data, and took into account seasonal factors such as weather conditions, special events, competitive environment, and economic situations. The company’s goal was to achieve the demand forecast accuracy within 10% deviation from the true demand. During the summer months, when demand for RTD beverages typically reached its peak, Ichitan would intensively employ both above-the-line and below-the-line marketing activities to capture a big chunk of market share. For the off-peak months, the company would offer discounts through various channels to help stimulate demand. Overall, Ichitan adopted four different types of sales promotions: sales promotions for retailers, sales promotions for distributors, nationwide campaigns, and online campaigns. The budget allocation among these marketing activities was regularly reviewed to ensure its alignment with the sales forecasts and shifts in demand. However, Ichitan did recognize that it had less flexibility in adjusting the selling price of the products due to the intense competition of the RTD tea market.

## **Thailand’s Ready-To-Drink Tea Industry**

### **The Early Days**

The beginning of the ready-to-drink tea industry in Thailand came with the 2001 introduction of the first RTD green tea product, “Unif Green Tea,” by Uni-President (Thailand) Company Limited, a subsidiary of Uni-President Enterprises Corporation, the biggest food company in Taiwan. Marketed as a healthy and trendy drink from a traditional Japanese recipe, Unif Green Tea quickly gained popularity among the Thai consumers, especially the young crowd. The rapid growth of the RTD green tea market invited competition from many new entrants, leading to a phenomenon that the media called “Green Tea Fever.” The market value of RTD green tea started from merely 26 million Thai baht in

2001, grew to 408 million Thai baht in 2002, jumped to 1,428 million Thai baht in 2003, and then surged to over 3,200 million Thai baht in 2004. For the first four years, Unif green tea enjoyed the first-mover advantage, taking the largest market share of about 40-50%. The second largest share of 35% went to Oishi Green Tea in 2004, only about a year after its entrance to the market.

Mainstream marketing campaigns during the early era of RTD green tea focused on communicating the superior health benefits of green tea over the other routine drinks like soda or coffee. A number of commercials also portrayed the RTD green tea as a fashionable drink, to stimulate demand among teenagers and young adults, the main target group for non-alcoholic drinks. Purposefully, the green tea players tried to create strong associations between their brands and Japan, a country well-regarded by Thai people as the origin of premium quality green tea and the trendsetter of Asia. Many companies made their green tea brands sound “Japanese” (e.g., Oishi, Sencha, Fuji-cha), and included some Japanese characters on the package labels. Oishi green tea, in particular, had a natural advantage of its brand association with Japanese vibes as the company had already been well known for its Japanese food and bakery businesses for some time.

### **Green Tea Price War Launch**

The year 2005 marked the historical spark of a new level of competition in the RTD green tea industry. As the market was becoming less responsive to the usual Japanese-, health-, and fashion-focused marketing campaigns from all the brands, other types of promotions were employed – the most notable, price promotions.

First, in its attempt to become number one in the market, Oishi cut the price of its 500ml RTD green tea from 20 to only 15 Thai baht per bottle in its most important channel, 7-11 stores. In response, Uni-President offered its Unif green tea at a promotional price of 17 instead of 20 Thai baht per bottle. Unif’s marketing manager, Kongkiat Wattiranggul, declared, however, that the company had asked all the distributors and retailers of its products to never lower the price below 17 Thai baht as Unif strongly believed that a price war could never do any good to anyone in a long run.

In addition to these price cuts, the green tea players started pouring their marketing budgets into running lucky draw campaigns. During the summer months of 2005, Uni-President launched a “One Million Caps, One Million Prizes” campaign for its Unif green tea, whereby a million prizes worth a total of 50 million Thai baht – ranging from smaller ones like free bottles of Unif green tea or T-shirts, to larger ones like cars, laptops, digital cameras, and a five million Thai baht cash – were awarded to the customers who possessed the prize-winning Unif green tea caps. Not to be outdone, Oishi ran a similar lucky draw campaign during the same months called “Lightning Rich: 30 Caps, 30 Million.” The campaign highlight, however, was the fact that within 24 hours from the moment each of the prize-winning Oishi green tea caps had been discovered, Tan Passakornnatee, the company’s CEO at the time, would go meet the winner and personally present him or her the one-million cash prize. What also drew enormous attention from the public was the stories about how the prizes had changed the winners’ lives. For example, one winner was a lower-ranked staff in a government unit who found the lucky cap from a trashcan and became a millionaire overnight. As this news spread, many people bought dozens of containers of Oishi green tea and even resorted to searching trashcans in the hope that more winning caps might be found.

In consequence of this aggressive new marketing ploy, Oishi moved into first place as market leader in 2005, taking 61% of market share, far surpassing Unif, who at less than 20% share got pushed to the second rank. For the next several years, Oishi continued its marketing campaigns, both price promotions and lucky draws. From time to time, there were new entrants to the RTD tea market, but no competitor was able to dislodge Oishi from its perch

as market leader. As the RTD tea market continued to expand, more variations of the tea products – white tea and black tea – were added to the market. Nevertheless, by 2010, green tea still accounted for about 60% of the total RTD tea market (see Exhibit 3), and was still the key product for most players.

### **The Never-Ending War**

Another critical point for the RTD tea industry was when Tan Passakornnatee left Oishi (in February 2011), but then shortly returned to the market in which he had long been champion with a new brand and supposedly new product, Ichitan green tea. His first challenge upon reentry was to transform his own image from what people had long recognized as “Tan Oishi” to his new identity of “Tan Ichitan.” To accomplish this, Tan proceeded to dedicate a huge number of marketing campaigns to advocate Ichitan as his brand, and even had his own photo, posing as a green tea farmer carrying a basket of tea leaves on his back, printed onto Ichitan’s RTD green tea labels. “For half of my life,” he wrote on his personal Facebook page, “I was born and grew up with green tea. Today, the most important journey of my life has started.” Further on his Facebook page, he posted a promotional video of Ichitan green tea in which he himself starred as a green tea farmer showing the delicacy of green tea harvesting [9]. Another thing that Ichitan did slightly different from the other existing brands in the market was to introduce a new package size. Tan chose to market Ichitan green tea in 420 ml bottles, a mid-point position between the 500 ml and 350 ml bottles of Oishi and Puriku, the largest and second largest players in the RTD tea market, respectively. Tan believed a 500 ml bottle was too big, whereas a 350 ml was too small for one person’s consumption.

Thus, the stage was set for an acceleration of jockeying for competitive position and advantage. Upon the official launch of Ichitan green tea at 16 Thai baht per bottle in May 2011, the existing players “coincidentally” offered price promotions on their RTD tea products sold through almost every channel. For example, Oishi green tea went on sale for 16, down from its regular price of 20 Thai baht. Tea Break, a brand jointly owned by Kirin, a major Japanese beverage company, reduced the price of its 440 ml bottled green tea sold in FamilyMart stores from 18 to 16 Thai baht. Puriku, whose main product line was RTD white tea and whose price was already the cheapest in the market due to the smallest size, also ran a promotion with 7-11 stores where customers could purchase 2 bottles for 21 Thai baht, down from the regular price of 13 Thai baht each. Even Fuji-cha, who positioned itself as a premium green tea brand, put its 500 ml bottled tea on sale for 23, compared to its regular price of 25 Thai baht.

Later in 2011, another strong player, Mirai, backed by one of the largest Japanese beverage companies, Suntory, entered the RTD tea market. This precipitated another wave of the RTD tea price war. Mirai itself spent 300 million Thai baht to promote its official launch, and offered an introductory price of 16, from the original price of 20 Thai baht, for its 500 ml bottled tea. Tea Break promptly responded with a “buy 2 for 22” promotion on its 350 ml tea sold at 7-11, from the regular price of 15 Thai baht each. Joining in, Ichitan cut the price of its tea from 16 to 14 Thai baht. Oishi, as the strongest player with the largest budget, also did a promotion with 7-11 that put its 500 ml bottled tea on the record lowest price of 12.5 Thai baht (“buy 2 for 25”). Concerning this tactical move, Matthew Kichodhan, Managing Director of Oishi group, commented, “They want to fight? We can fight too. Let’s see whether they could still survive.”

As the price war got more intense, the RTD tea market exhibited the fastest growth in the non-alcohol market (see Exhibit 4), and at the same time, became highly concentrated. More than 70% of the RTD tea market in 2011 was held by the three largest players: Oishi – the winner in green tea; Puriku – the leader in white tea; and, Lipton – the pacesetter in black tea, respectively. The other players either slowly left the market or switched to different product lines. Even an old champion like Unif could not keep up with the tea market, and hence decided to focus more on its vegetable and fruit juice products. Hence, as the war continued through 2014, the market became increasingly concentrated, with different players taking the top three positions, as shown in Exhibit 5.

On top of frequent price reductions, lucky draw campaigns were still an important part of the RTD tea marketing activities – indeed, increasingly so as, with Oishi group continuing the lucky draw tradition initiated under Tan's ownership, and now with Tan returning with a new brand, "Ichitan," and revamped marketing tactics. Partly in response to Tan's reentry into the RTD tea market, in mid 2011, Oishi decided to up the ante in promotion tactics. It began offering all-inclusive tours to Japan and gold prizes, worth over 12 million Thai baht in total, to the winners of its bottle-cap lucky draw. By contrast, Ichitan having only recently launched its green tea product and being still relatively small, could offer a bottle-cap lucky draw that gave away two cars, one motorbike, one bicycle, and one hundred gold necklaces, worth only 1.4 million Thai baht. But, determined not to be indefinitely over-shadowed by Oishi's contest prizes, in the summer of 2012, Ichitan massively scaled up its spending to over 70 million Thai baht on a lucky draw campaign for luxurious tours to Japan, similar to what Oishi did. The highlight of Ichitan's tours, though, was that Tan Passakornnatee himself and Udom Taepanich, the most popular stand-up comedian in Thailand and a good friend of Tan's, also accompanied the winners on the trips.

In response, Oishi came forth with a similar lucky draw where the winners got to go to Japan with five Thai superstars. Determined to not yield the spotlight to Oishi for having the most fabulous prizes, Ichitan soon thereafter launched a campaign "Sudden Rich 60 Days 60 Million," where once again Tan traveled to give prizes to every winner himself. Oishi responded with a campaign "Rich Everyday Millions and Cars," giving away gold and car prizes worth over 100 million Thai baht. Although Oishi's prizes were worth more in total, Ichitan was more successful at creating campaign awareness with the image of Tan as a hero who helped the poor with his prizes. As a result, during the campaign period from October 2012 to January 2013, Ichitan took the largest market share of 40%, surpassing Oishi's share of 38%. However, for the whole year of 2012, Oishi still took the largest market share of 44% while Ichitan obtained only 27%.

In 2013, the lucky draw war got heated up even more as both Oishi and Ichitan continued to launch a series of lucky draws with increasingly more valuable prizes given away more frequently (see Exhibit 6). For example, Oishi spent 250-300 million Thai baht on its "Rich Every Hour" summer campaign, and another 200 million Thai baht on its year-end campaign "Gold 100,000 THB Every Hour." Ichitan relaunched its customers' favorite "Sudden Rich 60 Days 60 Million Return" – this time the first winner was a mother of a son, suffering from bone cancer, and a disabled daughter. Many other prizes, such as iPhone 5's and gift vouchers, were also given away, altogether worth more than 100 million Thai baht, the largest in Ichitan's lucky draw history. With touching stories from its prize winners together with a consistent stream of social media on Tan's heroic and philanthropist image, Ichitan took the largest share of the RTD tea market (42%) for the first time in 2013, pushing Oishi to the second rank with a share of 39%.

Ichitan and Oishi continued their lucky draw campaigns in 2014, but overall, on a smaller scale in terms of the total value of the prizes and the frequency. It was believed that too much spending on lucky draw campaigns was the main reason that Oishi's beverage business unit experienced as much as a 30% negative growth of profit in 2013. Oishi declared its intention to not do as many lucky draw campaigns, but would focus its resources on expanding the product line and increasing its brand awareness together with the other business units under ThaiBev. Similarly, Ichitan announced that it would keep only one main campaign each summer, but would launch new products more often. Tan stated,

In business competition, I would not fight until I die. I would not choose to be number 1 in terms of sales. I prefer to be just number 2, if I could still reach the profit target. This is because profit is more important than revenue or market share.

Despite what he said, Ichitan still maintained the largest market share for the year of 2014 (see Exhibit 7). However, the overall market size of the RTD tea in 2014 declined by 4.6% from 2013. This was the first time in ten years that the market experienced a negative growth, suspected to be due to the unusually cold weather and the economic crisis from which the country had not fully recovered (see Exhibit 8).

### **The Industry Outlook**

In 2014, RTD tea accounted for 6.3%, the fourth largest segment, of the total non-alcoholic drink market worth 200 billion Thai baht (see Exhibit 9). It had recently been reported that for the first ten months of 2015, the RTD tea market had a consumption volume of 400.3 million liter, which was a 1.2% increase from last year. However, in terms of the market value, it was estimated at 13,231 million Thai baht, which was a decrease of 2.6% from a year earlier. The long-lasting price war and large-scaled lucky draw campaigns were believed to be the major causes of the lower market value.

For the third quarter of 2015, Ichitan's revenue dropped by 11% and profit plummeted by 55%, compared to the third quarter of last year [17] (see Exhibit 10). Tan believed this was partially a consequence of releasing a new smaller size of Ichitan drinks, sold only for 10 Thai baht per bottle, to target the lower-income customer segment in distant areas. Oishi, on the other hand, realized a revenue increase of 23% and a profit increase of 166% from the third quarter of last year. Correspondingly, Oishi took the largest market share of 43.9% and Ichitan took only 40% during the 2015 third quarter. For the month of October, however, Ichitan actually held the largest market share of 44.2%, though it was a slight decrease from its previous year's share of 44.7%. Oishi obtained 36.7%, but this was an increase from its last year's share of 35.8%.

For future plans, Oishi and Ichitan insisted on their competitive positions of moderating price promotions and pushing the resources more towards product innovations. Oishi aimed to increase its presence in Southeast Asian countries; it had established connections in Myanmar, Cambodia, Lao PDR, Malaysia, and Singapore. Ichitan revealed its plan to diversify product sizing, launch new products, and also expand its market to Indonesia, as well as other Southeast Asian countries in the near future.

### **What's Really in it for Consumers?**

A typical price war enabled consumers to buy products at lower prices. However, in the case of the RTD tea price war, several concerns were raised regarding consumer welfare beyond reduced product prices.

"I do not really like drinking green tea," confessed a housewife, who had just come out of a convenience store carrying a bag filled with RTD tea bottles. Responding quite honestly when asked why she had bought so many bottles of tea, she continued, "But I buy

five bottles every day only because I want to be rich. I want to win the gold.” It was a known fact in Thai society that certain groups of people – especially the lower income, less educated, living outside of major cities – strongly believed in luck as a shortcut to a better life. They comprised the majority of the government lottery tickets buyers. Not surprisingly, they were also the main participants of Ichitan’s and Oishi’s lucky draw campaigns, which in a sense took very similar forms as the government lottery. What was even more exciting about the RTD tea lucky draws than the government lottery was that the lucky draws gave away prizes much more frequently and immediately. Some of Ichitan’s campaigns gave prizes every day; some of Oishi’s campaigns gave prizes every hour; whereas, the government lottery only gave prizes twice a month.

When considering only prices of the “lottery tickets,” the RTD tea lottery was also much cheaper, at about 15 Thai baht per bottle; while, one government lottery ticket was sold at 80 Thai baht. Hence, many of the lower-income people actually preferred buying more of the tea than the government lottery tickets. When taking into account the winning probabilities, however, many analysts did not think the RTD tea lottery was really a better bet overall. In fact, they heavily criticized the tea companies for abusing the campaigns to encourage gambling habits in the society, and to lure customers into purchasing and consuming too much of the RTD tea products, which could be a health danger.

The RTD tea products, which were originally promoted as healthy drinks by their manufacturers, were warned against by health experts due to their inclusion of excessive amounts of caffeine and sugar. From 43 RTD tea samples, a 500 ml bottle contained between 23.76-76.02 mg of caffeine. A human body could generally take up to 200 mg of caffeine per day. Hence, too much consumption of RTD tea could easily lead to a caffeine overdose.

According to the World Health Organization, the daily intake of sugar for adults and children should not exceed 10% of their total energy intake. For additional health benefits, it was recommended to keep the sugar consumption at no more than 6 teaspoons, or about 30 gram, per day. Studies done to determine the amount of sugar in a RTD tea bottle found that a 500 ml bottle of RTD tea typically contained about 9-10 teaspoons of sugar. For those with honey flavors, the amount of sugar could be as high as 13-14 teaspoons per bottle. Hence, a consumption of just one bottle of RTD tea per day already exceeded the recommended level of daily sugar consumption. It was therefore worrisome to imagine what could happen in a long run to the body of a person who drank a few bottles of the tea each day, hoping to win big prizes.

## **The Challenge of Sustaining Growth and Profitability**

Putting his captain’s hat on the desk and leaning back in his chair to relax, Tan closed his eyes for a moment, as he experienced a flashback of his life path. The RTD tea business had become an essential part of who he was today. He had been in it for more than ten years, and he would never want to do anything else until the day he eventually decided to retire for good. But given the current market situation, he was not as confident as before about how he could bolster his beloved business. On one hand, he knew very well that at some point he should fade out the persistent lucky draw campaigns and price promotions, and spend his company’s resources on something else that would better help with future growth, while avoiding the societally troubling aspects of lucky draws and price promotions. But on the other hand, he also knew that the withdrawal of these promotions could dramatically disappoint customers’ expectations, and result in a huge market loss. With next week’s board meeting imminent, Tan had to come up with both a short-term strategy to maintain the largest market share and improve the firm’s bottom line this year, and a long-term strategy to develop more sustainable competitive advantages for Ichitan. Several possible alternatives included, for instance, developing a customer loyalty program or enhancing advertising



activities with popular celebrities to help promote brand awareness in place of running lucky draw campaigns and price promotions. Ichitan might also consider adding new product lines or packaging sizes to its existing product portfolio in response to changing trends in RTD tea consumption. Continuing similar lucky draw campaigns and price promotions was still a possible option as they had worked well in the past. However, if going with this option, Ichitan might want to redesign the rewards and pricing structure somehow to make the campaigns and promotions more effective but less costly.

**Exhibit 1**  
**ICHITAN'S REVENUE STRUCTURE AND FINANCIAL STATEMENTS FROM 2012 – 2014**

**Revenue structure**

Revenue Structure	2012		2013		2014	
	MB	%	MB	%	MB	%
Net revenue from sales	3,906.8	87.1%	6,484.4	99.3%	6,179.1	99.5%
Net revenue from flood insurance claims	518.8	11.6%	-	-	-	-
Other revenue	57.3	1.3%	47.5	0.7%	29.8	0.5%
Total revenue	4,482.9	100.0%	6,531.8	100.0%	6,208.9	100.0%
Sales Growth	269.7%		66.0%		[4.7%]	
Market Share*	27.1%		42.1%		43.8%	
Number of Flavors	16		17		19	

\*from Retail Index of Nielsen, January 2015

Source: Ichitan Group Public Company Limited. (2015). *Annual Report 2014*. Retrieved February 8, 2016, from <http://investor.ichitangroup.com/ar.html>

## FINANCIAL STATEMENTS

### Financial statement for the year ended December 31, 2013

	For the year ended 31 December	
	2013	2012
		(Restated)
	<i>(in Baht)</i>	
<b>Continuing operations</b>		
<i>Income</i>		
Revenue from sale of goods	6,484,375,339	3,906,783,966
Net gain from severe flooding	-	518,816,176
Other income	47,465,928	57,301,987
<b>Total income</b>	<b>6,531,841,267</b>	<b>4,482,902,129</b>
<i>Expenses</i>		
Cost of sale of goods	4,425,029,742	2,866,103,524
Selling expenses	931,190,500	531,472,288
Administrative expenses	130,348,130	134,879,158
Finance costs	161,618,262	125,267,168
<b>Total expenses</b>	<b>5,648,186,634</b>	<b>3,657,722,138</b>
<b>Profit before income tax expense</b>		
<b>from continuing operations</b>	<b>883,654,633</b>	<b>825,179,991</b>
Income tax expense	-	(132,298,555)
<b>Profit from continuing operations</b>	<b>883,654,633</b>	<b>692,881,436</b>
<b>Discontinued operation</b>		
Profit from discontinued operation	-	4,837,588
<b>Profit for the year</b>	<b>883,654,633</b>	<b>697,719,024</b>

Source: Ichitan Group Public Company Limited. (2014). Financial statements for the year ended 31 December 2013 and Independent Auditor's Report. Retrieved February 28, 2016, from <http://ichi.listedcompany.com/misc/FS/20140418-ichi-fs-fy2013-en.pdf>

**Financial statement for the year ended December 31, 2014**

	<b>Financial statements in which the equity method is applied</b>	<b>Separate financial statements</b>	
	Year ended 31 December 2014	Year ended 31 December 2014	2013
		<i>(in Baht)</i>	
<b><i>Income</i></b>			
Revenue from sale of goods	6,179,080,161	6,179,080,161	6,484,375,339
Interest income	9,364,836	9,364,836	1,352,337
Other income	20,420,163	20,420,163	46,113,591
<b>Total income</b>	<b>6,208,865,160</b>	<b>6,208,865,160</b>	<b>6,531,841,267</b>
<b><i>Expenses</i></b>			
Cost of sale of goods	4,065,204,432	4,065,204,432	4,425,029,742
Selling expenses	774,179,994	774,179,994	931,190,500
Administrative expenses	250,418,023	250,418,023	130,348,130
Finance costs	99,415,486	99,415,486	161,618,262
<b>Total expenses</b>	<b>5,189,217,935</b>	<b>5,189,217,935</b>	<b>5,648,186,634</b>
Share of profit of jointly-controlled entity	26,653	-	-
<b>Profit before income tax expense</b>	<b>1,019,673,878</b>	<b>1,019,647,225</b>	<b>883,654,633</b>
Tax income	59,086,769	59,086,769	-
<b>Profit for the year</b>	<b>1,078,760,647</b>	<b>1,078,733,994</b>	<b>883,654,633</b>

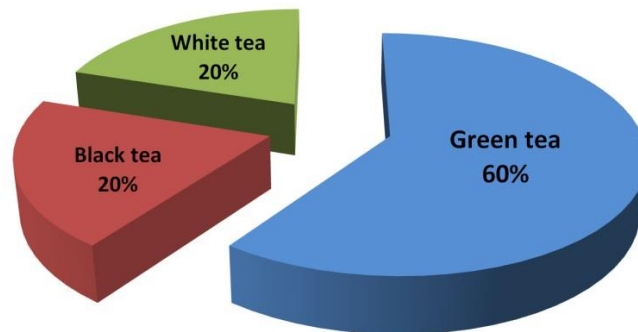
Source: Ichitan Group Public Company Limited. (2015). Financial statements for the year ended 31 December 2014 and Independent Auditor's Report. Retrieved February 28, 2016, from <http://ichi.listedcompany.com/misc/FS/20150225-ichi-fs-fy2014-en.pdf>

**Exhibit 2**  
**ICHITAN'S PRODUCTS AND PACKAGE SIZES IN 2014**

Package	Can 240 ml	UHT 250 ml	PET 290 ml	PET 400 ml	PET 420 ml	PET 450 ml	PET 800 ml	PET 840ml
Price	THB 12	THB 10	THB 10	THB 15	THB 15-20	THB 20	THB 25	THB 25
<b>Green Tea</b>								
1. Original	-	-	-	-	✓	-	-	-
2. Honey Lemon	-	✓	✓	-	✓	-	-	✓
3. Kikucha (Chrysanthemum)	-	✓	-	-	✓	-	-	✓
4. Genmai	-	✓	-	-	✓	-	-	✓
5. Sugar Free	-	-	-	-	✓	-	-	-
6. Midori Punch	-	✓	-	-	✓	-	-	-
7. Corn	-	-	-	-	✓	-	-	-
8. Super Berry	-	✓	-	-	-	-	-	-
9. Apple Kiwi	-	✓	-	-	-	-	-	-
10. Japanese Plum	-	-	-	-	✓	-	-	-
11. Oolong Sugar Free	-	-	-	-	✓	-	-	-
12. TLychee	-	-	-	-	✓	-	-	-
<b>Black Tea</b>								
13. Lemon	-	-	-	-	✓	-	-	-
14. Strawberry	-	-	-	-	✓	-	-	-
15. Mulberry	-	-	✓	-	✓	-	-	-
<b>Herb Tea</b>								
16. YenYen Cool Herb Tea	✓	✓	-	✓	-	-	✓	-
17. YenYen Chrysanthemum Honey	-	✓	-	✓	-	-	✓	-
<b>Low Sugar</b>								
18. Matcha Low Sugar	-	-	-	-	-	✓	-	-
19. Oolong Low Sugar	-	-	-	-	-	✓	-	-

Source: Ichitan Group Public Company Limited. (2015). *Annual Report 2014*. Retrieved February 8, 2016, from <http://investor.ichitangroup.com/ar.html>

**Exhibit 3**  
**COMPOSITION OF THE RTD TEA MARKET IN THAILAND, 2010**



Source: Manager Online. (2010, December 24). "กระทิงแดง" คำนวณแบบ "บ๊วย" โคลง". Retrieved February 11, 2016, from <http://www2.manager.co.th/Travel/ViewNews.aspx?NewsID=9530000181046>

**Exhibit 4**  
**MARKET GROWTH OF NON-ALCOHOLIC DRINKS IN 2010-2011**

Category	2010 Growth (%)	2011 Growth (%)	Market value (million THB)
RTD milk	8	6	40,000
Sodas	8	-4	36,000
Energy drinks	8	6	16,000
Water	23	3	9,000
Juice	14	1	8,500
Canned coffee	6	5	8,500
RTD tea	25	17	8,000
Functional drinks	79	-6	4,200
Electrolyte drinks	23	-7	3,000
Cereal drinks	4	17	2,000

Source: TCIJ. (2012, December 13).

แหล่งข้อมูล: รายงานประจำปี 2555 ของ 'ฟู้ด & เบverage' ภาคตลาดเครื่องดื่มแอลกอฮอล์ในประเทศไทย

Retrieved February 22, 2016, from <http://tcijthai.com/tcijthainews/view.php?id=1695>

'ฟู้ด & เบverage' ชะลอตัวไป  
ใน หยก & เบverage ไม่ค่อยดี.

**Exhibit 5**  
**TOP THREE LARGEST MARKET SHARE HOLDS IN THE RTD TEA INDUSTRY, 2011-2014**

Rank	2011	2012	2013	2014
1	Oishi 44%	Oishi 44%	Ichitan 42%	Ichitan 44%
2	Puriku 17%	Ichitan 27%	Oishi 39%	Oishi 38%
3	Lipton 8%	Puriku 10%	Puriku 9%	Puriku 8%
	Others 24%	Others 19%	Others 10%	Others 10%

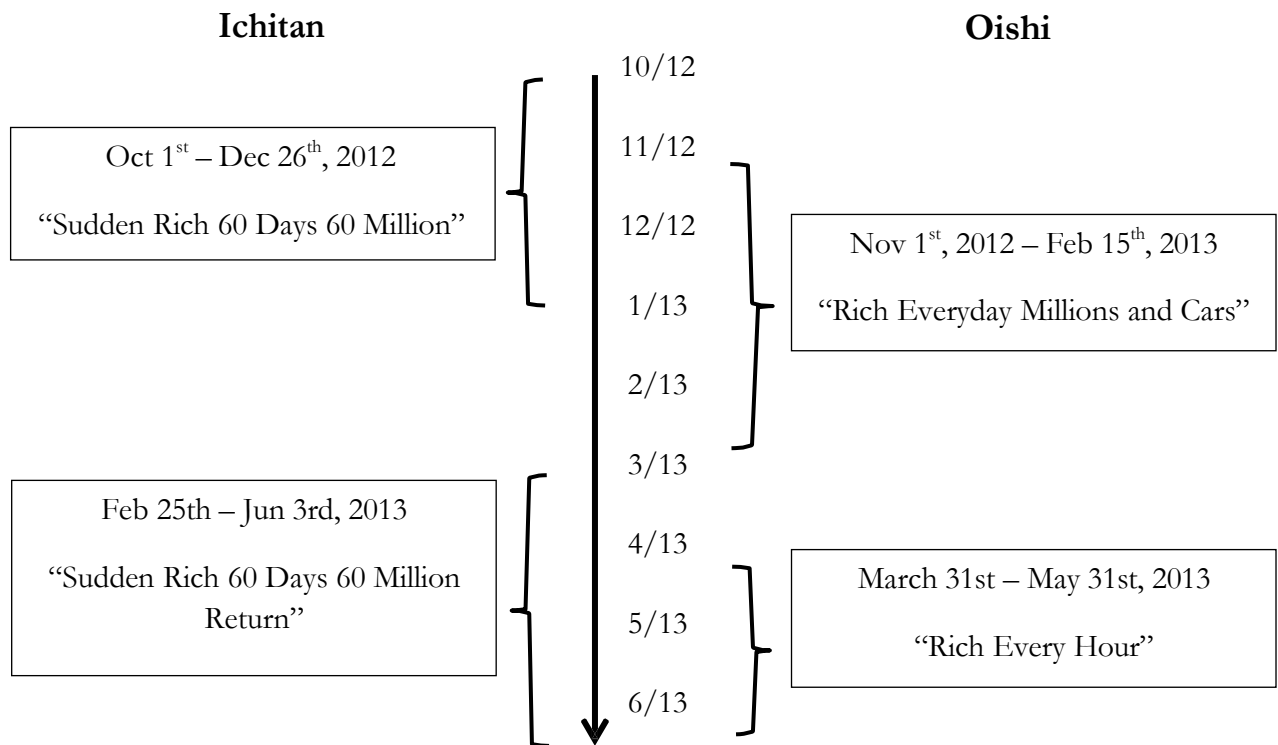
Sources: Prachachat Online. (2012, February 9). ชาพรีเมียมคือนี่ เร่งดันยอดขาย  
จัดบ๊วยแคมเปญ-พลจ

"พรีเมียมคือนี่". Retrieved

February 22, 2016, from [http://www.prachachat.net/news\\_detail.php?newsid=1328764034](http://www.prachachat.net/news_detail.php?newsid=1328764034); Positioning Magazine. (2013, March 29). สืบค้นจากแคมเปญ- "หอยขาเซวี่ ว"-แจกของไม่รู้ว่า-ใครครมว่ากว่ากัน ; Positioning Magazine. (2014,

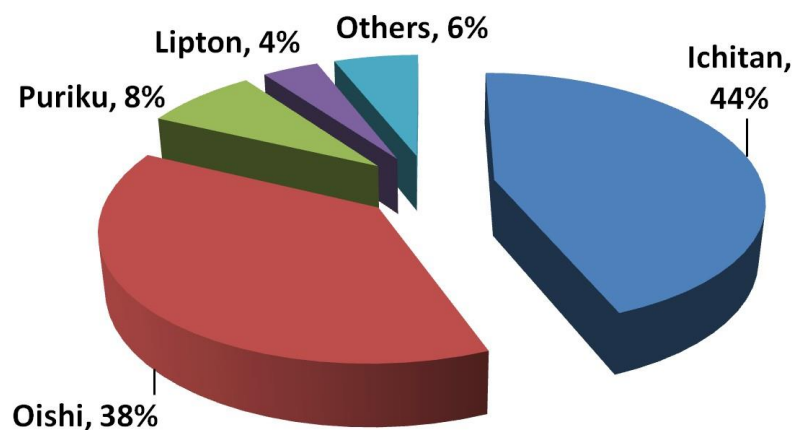
March 5). ถอดรหัส สืบค้นจากแคมเปญ- วปี 57 ใครจะเป็นแชมป์ ?; Positioning Magazine. (2015, February 16). ตลาดชาเซวี่ ปี 2557  
ชาพรีเมียมคือนี่

**Exhibit 6**  
**Timeline for Ichitan's and Oishi's major lucky draw campaigns, 2012-2013**



Source: Positioning Magazine. (2013, May 11). ศักยภาพชาเขียว วใจ VS ชใครวยกวณ

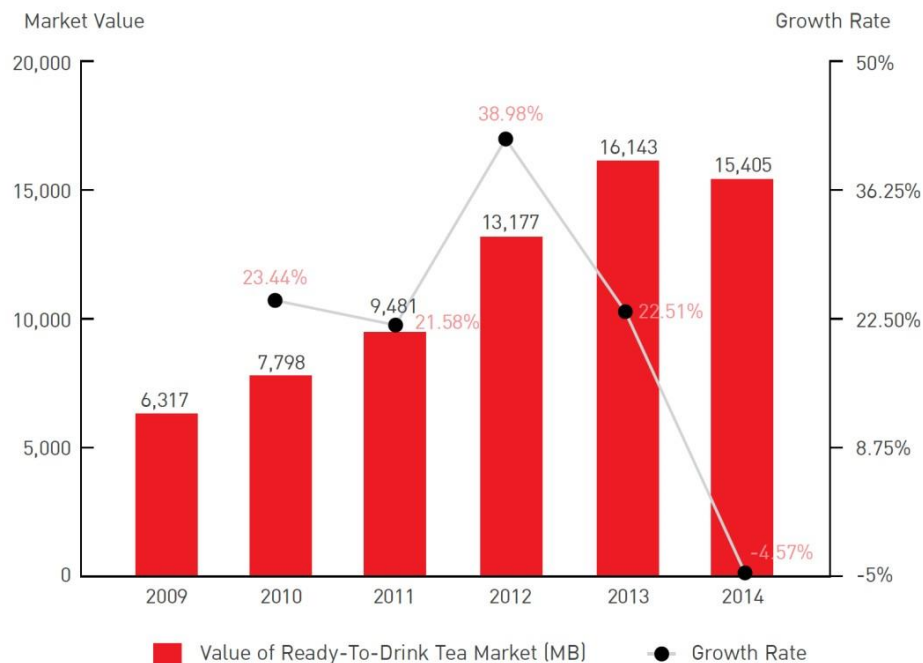
**Exhibit 7**  
**RTD TEA MARKET SHARE IN 2014**



Source: Positioning Magazine. (2015, February 16). ตลาดชาเขียว  
 วใจ VS ชใครวยกวณ  
 from <http://www.positioningmag.com/content/59479>

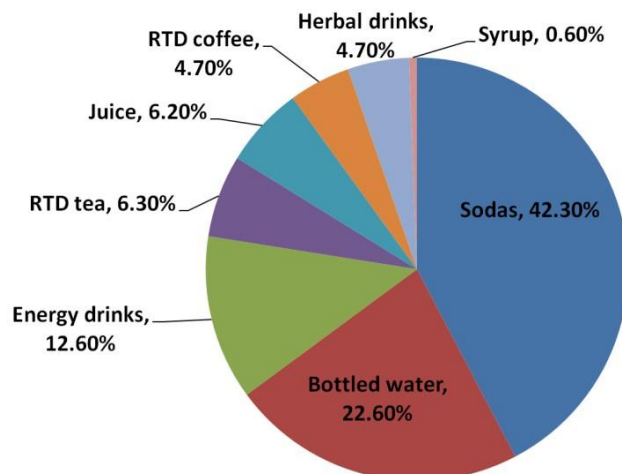
1/ 2557. Retrieved February 22, 2016,

**Exhibit 8**  
**MARKET VALUE AND GROWTH RATE OF THE THAI RTD TEA MARKET FROM 2009-2014**



Source: Ichitan Group Public Company Limited. (2015). *Annual Report 2014*. Retrieved February 8, 2016, from <http://investor.ichitangroup.com/ar.html>

**Exhibit 9**  
**NON-ALCOHOLIC DRINKS MARKET SHARE BY BEVERAGE TYPES IN 2014**



Source: Marketeer. (2015, February 18). สภาวะตลาดเครื่องดื่มไม่แอลกอฮอล์. Retrieved February 22, 2016, from <http://marketeer.co.th/2015/02/no-al/>

**Exhibit 10**  
**ICHITAN'S FINANCIAL STATEMENTS FOR Q3 OF 2015 AND Q3 OF 2014**

	Financial statements in which the equity method is applied Three month period ended 30 September 2015	Separate financial statements Three month period ended 30 September 2015	2014
	<i>(in thousand Baht)</i>		
<b>Income</b>			
Revenue from sale of goods	1,222,659	1,222,659	1,359,516
Interest income	4	4	-
Other income	231	231	16,921
<b>Total income</b>	<b>1,222,894</b>	<b>1,222,894</b>	<b>1,376,437</b>
<b>Expenses</b>			
Cost of sales of goods	866,892	866,892	927,651
Selling expenses	172,665	172,665	148,952
Administrative expenses	36,030	36,030	15,683
Finance costs	21,786	21,786	17,953
<b>Total expenses</b>	<b>1,097,373</b>	<b>1,097,373</b>	<b>1,110,239</b>
Share of profit of investment in joint venture	(2,190)	-	-
<b>Profit before income tax expense</b>	<b>123,331</b>	<b>125,521</b>	<b>266,198</b>
Income tax expense	(6,129)	(6,129)	-
<b>Profit for the period</b>	<b>117,202</b>	<b>119,392</b>	<b>266,198</b>
<b>Other comprehensive income</b>			
<i>Items that are or may be reclassified to profit or loss</i>			
Foreign currency translation differences for foreign operations	(2,110)	-	-
<b>Total comprehensive income for the period</b>	<b>115,092</b>	<b>119,392</b>	<b>266,198</b>
<b>Earnings per share (in Baht)</b>			
Basic earnings per share	0.09	0.09	0.20

Source: Ichitan Group Public Company Limited. (2015, November 11). *Interim financial statements for the three-month and nine-month periods ended 30 September 2015.*

**END NOTES**

The exchange rate for 1 USD was approximately 35.5 Thai baht as of June 2016



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## **PANACEA SPECIALTY CHEMICALS: WHY THE NEW CORROSION INHIBITOR IS CORRODING US?**

**Sushil S. Chaurasia, Symbiosis International University**

Having worked ceaselessly for last 14 hours, Sandarbh Sharma looked up from his laptop and gave a weary sigh. As the recently appointed Head for Small Operations and Retail Clients, he was responsible for marketing the new corrosion inhibitor (Coroguard-101) for use in MSMEs and Institutional Clients in defined niche sectors. Panacea Specialty Chemicals launched Corrosion Inhibitor for the market in 2014 with great expectations and believed it as superior product with unmatched advantages with other competitors having the same product in the market, but the results so far was discouraging. Sandarbh knew that he would be very busy trying to improve the disappointing performance and also proving his worthiness for the first assignment as his first job recently graduating from premier business school. The importance of this concern was highlighted by the constant stream of calls, meetings and email that he had been attending since he joined the company two months back. The urgency and critical nature of problem was summarized by a recent email from his boss, Pradeep Pathak, Country head for water treatment division of Panacea Specialty Chemicals.

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From: Pradeep Pathak  
To: Sandarbh Sharma  
Subject: 2015 Performance  
Send: Tue, Apr 28, 2015 at 1:19 PM

I have looked at the sales report for 2015 and I was very concerned. We have been pioneer in water treatment chemical markets for more than last two decades. Our Corochem-101 corrosion inhibitor has been a successful product among big water treatment plants for Oil and Gas, Power etc. and generated INR 37 Crores revenue for the company in 2015 with almost reaching the expectation of 7% growth in year 2014. As very small amount of Corochem-101 was required for treatment; it becomes unsuitable for smaller scale application in small water treatment plants conditions of for Small Operations and Retail Clients. Thus, In order to gain momentum in this segment across small and niche market we re-engineered our existing product (Corochem-101) to suit with the need of Small Operations & Retail Clients and Coroguard-101 was an outcome of this vision.

Volume target for Coroguard-101 was 1.2 lakh liters (60,000 units) for the first year of sales. However through the first year of selling for water treatment chemicals, our company managed to sell just 8400 liters (4200 Units). Against the expected revenue of INR 900 lakh the new product was just able to reap INR 66.6 lakh.

I realize that you inherited a bit of mess, but it is critical that you get your arms around this situation and fix this with some sustainable solution. We appear to be digging our self deeper into bad situation with every passing quarter. Please have a proposal till next week on recommendations on how we could turn the situation around.

NOTE: 1 Lakh INR = 1491.54 USD (Assuming 1 INR = 0.015 USD)

When Sandarbh was in business school, he had solved hundreds of problem cases, as part of curriculum. Now Sandarbh knows that he has to apply the concepts and techniques he has learned to real business challenge in hand.

### Company Background

Panacea Specialty Chemicals having been established in the year 1983, has been one of the prominent organizations engaged in formulating and supplying a wide assortment of Water Treatment, Surface Treatment and Oil Field Chemicals. Panacea Specialty Chemicals brand was very well known to the very small niche of specialty chemical Industry. Company has small but growing number of Global clients. In year 2015, the Panacea Chemicals product line included over 200 products and company revenues were INR 270 crores (Exhibit 01).

**Exhibit 01**  
**PANACEA SPECIALTY CHEMICALS FINANCIAL DATA (INR Crores)**

	<b>2013</b>	<b>2014</b>	<b>2015</b>
Revenue	263.40	266.40	270.00
Cost of Goods Sold	201.00	203.40	207.00
<b>Gross Profit</b>	<b>62.40</b>	<b>63.00</b>	<b>63.00</b>
Selling, General, & Administrative Expense	17.40	18.00	18.60
Research & Development	4.80	4.80	5.40
Depreciation	9.00	9.60	9.00
<b>Operating Expense</b>	<b>31.20</b>	<b>32.40</b>	<b>33.00</b>
<b>Operating Income</b>	<b>31.20</b>	<b>30.60</b>	<b>30.00</b>
Provision for Tax	7.20	6.60	7.20
<b>Net Income</b>	<b>24.00</b>	<b>24.00</b>	<b>22.80</b>
<b>Water Treatment Group</b>			
Revenue	72.60	78.00	80.40
Gross Profit	21.60	23.40	24.00
Operating Income	9.00	10.20	10.20

NOTE: 1 Crore INR = 149,000 USD (Assuming 1 INR = 0.015 USD)

Extensive marketing function was historically unappreciated at company, as most of the big orders were based on personal relationship or tender process. The company concentrated on B2B sales and placed little awareness on creating consumer segment awareness for the product. More than 80 % of business occurred from 5 big clients and remaining 20% from small clients, this was an excitement and concern for management as a sustainable business strategy. On a research for devising Strategic plan for second phase of extension and growth for Panacea Specialty Chemicals, company's internal analyst analyzed the global corrosion Inhibitor market a significant percent (21%) resulted from application of Corrosion inhibitors in niche sector and areas like Construction, Hospitals, Hotel and Commercial complexes, Food Processing, Beverages and distillery, Textiles etc. That segment was growing and Panacea Chemicals got no active presence. 60 % contribution of chemical application was for Power Sector (for stationary power generation plants and

cooling systems); Oil and Gas Sector (rust protection of liquid transport pipelines and processing vessels in refineries) and Pulp and Paper Industry (protecting plant equipment); in which the company already got its presence. Metal Processing Industry (preventing the rusting of the equipment) and Chemical Processing Industry (prevent the rusting of the equipment) constitutes of 19% of the market.

Based on the recommendation, the R&D division worked for six months in understanding the environment factor contributing to corrosion in these areas and come up with a new corrosion inhibitor, Coroguard-101. After the introduction of new product the company started to invest selectively in developing brand for product for this niche market

### Product and Market Background

Water is an essential part of a domestic and industrial activity. Moreover, escalating industrial activities across different developed and developing economies together with technological progression has led to an upward demand for water for industrial activities. Furthermore, rising demand for clean drinking water and sustaining regulations are expected to enhance the expansion of the water treatment market. Water treatment chemicals are used in decontamination of water by removing any solid particles, salts and other heavy metals. Corrosion inhibitors were the largest product segment within the water treatment chemicals market and accounted for over 20% of the market in 2011. Corrosion inhibitors are chemicals added in small quantities to liquids or gases to reduce their corrosive effect on metallic equipment, carbon steel pipes, and vessels. Corrosion Inhibitors are specialty chemicals that react with the surface of a material/ metal and help to decrease corrosion rate. Sometimes, it also works with the environment to reduce the corrosion causing elements. Inhibitors are introduced in the form of dispersion or solution which forms protective film that inhibits corrosion on the metal surface. Inhibitors are also used as additives in surface treatment and coatings.

**Exhibit 02**  
**CORROSION INHIBITOR PRODUCT & MARKET ANALYSIS**

MARKET	PRODUCT SEGMENT	PRODUCT APPLICATION	END USE	COMPETITIVE FRAME (OTHER EQUIVALENT PRODUCTS)
North America	Organic	Water Based	Power generation	Material selection
China			Oil & gas	
Western Europe			Pulp & paper	Coatings
Central & Eastern Europe			Metals processing	
Russia			Chemicals processing	Cathodic protection
Middle East & Africa	Inorganic	Oil/Solvent Based	Manufacturing	
South America			Petroleum refining	Design
Japan			Water treatment	
Asia			Product additive industries	Inhibitors
Others			Others	

Dissecting the product segment (Exhibit 02), Organic inhibitors was the largest product segment present within the corrosion inhibitors market and accounted for over 70% of the market in 2012. Absence of metals in organic corrosion inhibitors resulted in prevention of unwanted chemical reactions. The increasing use of organic inhibitors in oil & gas and construction sector is expected to drive the demand for this product segment. Inorganic inhibitors such as molybdates are widely used in water treatment with approximately 30% market in 2012. Analyzing the Corrosion Inhibitor from product application perspective, Water-based corrosion inhibitors dominated the market for corrosion inhibitors accounting for over 75% in 2012. Rising awareness regarding the harmful effects of volatile organic compound (VOC) emissions on human life coupled with low or negligible VOC emissions from water-based corrosion inhibitors is expected to drive the demand for this application segment.

The power generation sector dominated the demand for corrosion inhibitors and accounted for over 25% of the demand in 2012, followed by the oil & gas sector. Paper & Pulp and Oil & gas are also expected to be the fastest growing end-use industry for this market, cumulatively all three sectors contributing 60% of the market. Corrosion inhibitor demand from metal processing is expected to reach 683.7 kilo tons by 2019.

The Global Corrosion Inhibitors market is projected to grow up at a CAGR of 4.84 percent during the period 2013-2018. Growing water treatment activities across various regions and application areas is expected to further drive the demand for corrosion inhibitors. Geographic Share on percent volume basis for the use of corrosion inhibitors in Asia Pacific was 38.4%. Demand for corrosion inhibitors was highest from power generation sector in 2012 accounting for over 25% of the market in 2012. Oil & gas was the second largest end-use segment of corrosion inhibitors accounting for 19.4% of the market in 2012. Asia Pacific led the demand for corrosion inhibitors and accounted for over 35% of the total share and Europe and North America together accounted for over 50% in 2012.

According to NACE International (a professional technical society dedicated to protecting the environment and reducing the economic impact of corrosion through engineering and science), countries such as Japan and the US, corrosion losses are estimated to be about 3% of their respective GDPs. Indian manufacturers and consumers incur cost over 4% of the Gross Domestic Product (GDP) due to corrosion. Sector-wise losses incurred by Indian industry annually owing to corrosion are infrastructure Rs 22,600 crore; utility services Rs 47,000 crore; production & manufacturing Rs 17,650 crore; and defense & nuclear waste Rs 20,000 crore.

Panacea chemicals estimated 180 corers market for Corochem-101 in India for large water treatment plants. Pradeep was convinced that market of Coroguard-101 for niche sector and areas like Construction, Hospitals, Hotel and Commercial complexes, Food Processing, Beverages and distillery, Textiles with comparatively small water treatment plants, will have more potential because this segment is ignored by formal big players.

The Global Corrosion Inhibitors market and pricing is driven by several factors. Three of the market growth drivers for corrosion Inhibitors which was discussed in a formal meeting on May 2011 for devising strategy for water treatment chemicals, are mentioned below. This led to the introduction of Coroguard-101 in year 2014.

### **Increased Demand from Developing Economies**

Since corrosion inhibitors are explicitly aimed to end metal corrosion, the significance of this chemical is appreciated and they are being progressively accepted across several industries across sectors. Further, the demand for corrosion inhibitors from the Water

Treatment industry from all the sectors is increasing, especially for the protection of cooling water equipment and boilers. Also, the fast progression of the Construction industry and the Manufacturing sector in the India is further boosting the demand for corrosion inhibitors.

### **Increase in R&D Initiatives**

The surge in R&D initiatives is additional key driver impelling the development of the Corrosion Inhibitor market. Research is being conducted to develop additives that can meet the ever-changing regulations and requirements of end-users. There are enormous growth prospects in the market and therefore several corrosion inhibitor manufacturers are gradually concentrating on the R&D of innovative and high-performance chemical additives to increase the quality of corrosion inhibitors.

### **Increasing Product Innovation**

As the Corrosion Inhibitors market is highly competitive, companies are presenting new and innovative products as well as exploring new application areas for their existing range of products. Moreover, growing environmental and health apprehensions as well as strict regulations are leading companies to focus on the development of eco-friendly and low-toxicity products. The market for corrosion inhibitors is witnessing the introduction of new products and services by major vendors across nation. More research is being done to optimize the performance of several corrosion inhibitors used in applications across various sectors such as Oil and Gas, Chemical Processing, Heavy Manufacturing, and Water Treatment.

Despite the presence of several drivers, the growth of the Global Corrosion Inhibitors market is curtailed by some serious challenges. Although costs vary in relative significance from industry to industry, several generalized elements combine to make up the total cost of corrosion. Factors which increase or decrease the costs of corrosion are applied current Technology; Deferred maintenance; Environmental regulations; Research and development; Extensions of useful life; Technology Transfer; Increased performance requirements and more hostile environment. One of the major challenges faced by this market is the high cost of the raw materials, which affects product prices. Another challenge posing a threat to the growth of the market is the increased vendor competition, which directly affects the pricing policies in the market.

As Corchem 101 of corrosion inhibitors were specifically designed and targeted towards large water treatment plant, Panacea chemicals did not intend to use the same chemical due to its dosage and safety concerns. Concentration of active ingredients in Corchem-101 is very high due to its capacity to treat big water treatment plants dealing with big volume of water. However in case of small water treatment plants this dosage may lead to safety risk so need active technical mediation for dosage and safety. So Panacea chemicals strategy was to concentrate on clients and sectors with big water treatment plants. However in early 2010 they found that a number of specialty retailers had began marketing diluted version of Corchem-101 as a private label corrosion inhibitor for small water treatment plants. Pradeep recognized that there is a big untapped market, if the product can be redesigned and adapted as per the small water treatment plant owner's requirement. Based on the recommendation the R&D division worked for six months in understanding the environment factor contributing to corrosion in these area and come up with a new corrosion inhibitor, Coroguard-101.

## Marketing Channel Selection & Design

Corrosion inhibitors are made available in the market through various distribution channels such as direct marketing, supply agreements (distributors) and third party distribution (retailers). Panacea chemicals have their own distribution and supply channels and directly supply the finished goods to application sectors such as power generation, Paper and oil & gas refining industries.

Panacea Chemicals sold Corochem-101 to its major clients through its direct sales force. All the big water treatment plants are generally of big companies which follow tender process of procurement. Coroguard-101 volume is been sold through its distributors network. The company currently has a network of around 50 distributors covering all major cities and Industrial area of the country. Only for few of the big companies which do have formal tender process of procurement but the volume are very small are also catered through these distributors in the respective regions through authorizing the distributor to bid on Panacea's behalf. In each area there are some Mass retailer and /or Specialty retailer operating under each distributor. Mass retailers are those retailers who source a full range of water treatment chemicals of Panacea including algaecides, biocides, corrosion Inhibitor, Scale controller, and flocculants. Along with Panacea product range, such mass retailers also source other chemical portfolio of other companies (including maintenance chemicals, liquid soap, general surface treatment chemicals and protective coating etc.). Having a portfolio of products gives mass retailer an added advantage of building relationship and business with its clients. However the Specialty retailer not only source a full range of water treatment chemicals of Panacea along with some other water treatment chemicals that Panacea are not in business with but also the unique offering of specialty retailers are, they only deal with its core area of water treatment and they develop customized treatment programs for their client working with water consultants, filter and pump manufacturers etc. It's a bundled service offering that compliments specialty retailer's product offering. Both the mass retailer and specialty retailer are assisted with a sales team of Panacea on demand basis. Alternatively the distributor, mass retailers and the specialty retailers got a dedicated web login on Panacea website where they can track their existing orders, place new orders and also take technical assistance on phone and web chat.

## Pricing and Channel Margin for Coroguard-101

The potential customer market for Coroguard 101 was more scattered and diverse as compared to the existing market of Corochem-101. After doing a small industry survey for the client base Panacea chemicals had found that there are approximately 90 lakh small water treatment plants in India. Even this small water treatment plant size 90 lakh can be further subdivided into "professional" and "frugal innovators". Hardly 25% of the total market is professional. Professionals are those customers that use water treatment chemical for the regular maintenance of their water treatment plants. 75% of the clients generally schedule a small preventive maintenance breakdown whenever they feel the algae and the iron content in the water is rising. In that breakdown period they change the water and use diluted acids for descaling and preventive maintenance.

Sandarbh identified two major competitors for this small water treatment plant corrosion inhibitor business. Chemkleen Chemicals and Ferro Specialty Chemicals. Each of the three competitors got approximately 15% to 20 % of the share. Based on a focused group discussion with selected distributors and retailers (mass and specialty), Sandarbh assembled together a product and price comparison information. As per the summary of the research,

Sandarbh found that most of the retailers considered Ferro-501 to be the most effective corrosion inhibitor. Ferro-501 also reduced the usage of dispersants and other chemical by 15%. Although Ferro Specialty Chemicals never claimed the benefit of reduced use of other chemical as its value proposition, the advantage goes with the contractor and specialty retailer who take annual maintenance contract. The only disadvantage with Ferro Specialty's Ferro-501 is the high dosage required during treatment. Continuous monitoring of dosage replenishment and inventory is required because of this high dosage. This is making inconvenient for the small water treatment plant maintenance manager to carefully look at the inventory all the time or buy at bulk every month.

**Exhibit 03**  
**CORROSION INHIBITOR COMPARISON OF ALL MAJOR PLAYERS**

	<b>Panacea Chemical</b>	<b>Chemkleen Chemicals</b>	<b>Ferro Speciality</b>
	<b>Coroguard- 101</b>	<b>Chemkleen- 51</b>	<b>Ferro 501</b>
<b>Cost per container, retail price</b>	INR 1500.00	INR 900.00	INR 900.00
Form	Liquid	Liquid	Liquid
Liter per container	2.00	1.00	4.00
Cost per liter, retail price	INR 750.00	INR 900.00	INR 225.00
Cost per ml	INR 0.75	INR 0.90	INR 0.225
<b>Cost per treatment, retail price</b>	INR 234.60	INR 140.40	INR 225.00
Replacement cycle (no of monthly treatments)	1.0	2.0	2.0
Monthly cost, retail price	INR 234.60	INR 280.80	INR 450.00
Months of plant usage	12	12	12
<b>Annual cost, retail price</b>	INR 2815.20	INR 3369.6	INR 5400.00

NOTE: 1 INR = 0.015 USD

Manufacturer price for two quart bottle of Coroguard-101 is INR 892.80. For most of the other water treatment products ( like descaling , biocides etc.) distributor has a typical gross margin of 20%. However distributors wished to maintain 30% margin on Coroguard-101, as it was specifically differentiated and branded specialty chemical. Mass and specialty retailers generally take 15% of gross margin. All lead to retail pricing of INR 1500 to the consumers (Exhibit-04).

**Exhibit 04**  
**MARKETING CHANNEL MARGIN STRUCTURE**

	<b>Cost per Container</b>	<b>Cost per Treatment</b>
Mass and Specialty Retailer Price	INR 1500.00	INR 234.60
Retailer / Service Professional gross margin%	15%	15%
Retailer / Service Professional gross profit	INR 225.00	INR 35.19
Distributor price	INR 1275.00	INR 199.20
Distributor gross margin %	30%	30%
Distributor gross profit	INR 382.50	INR 59.76



Panacea Chemical price	INR 892.80	INR 139.20
Gross margin %	35%	35%
Gross profit	INR 312.48	INR 48.72

NOTE: 1 INR = 0.015 USD

### Product and Promotion Strategy for Coroguard-101

After the results of the focus group interview and technical benchmarking the claim shared by the distributors and the retailers (Exhibit 03), Panacea found that the claims were true but the encouraging fact was Coroguard-101 was also surpassing the expectation on the same parameters. The active ingredients used in Coroguard-101 is also able to reduce the usage of dispersants and other chemical by 25%. In a typical water treatment process, three to five chemicals (including corrosion inhibitor) is been used. A cut of around 25% across other portfolio of chemicals for a water treatment process will be a significant cost benefit for small water treatment plants overall maintenance cost. So Panacea chemicals decided to take this cost advantage as unique value proposition for promoting Coroguard 101.

The product launch with this unique value proposition of Coroguard-101 was supplemented by a dedicated website, press release, publication in trade association journals along with product launch in all major chemical trade show to reach all mass retailers and specialty retailers. The chemical received over 3500 inquiries from distributors, mass and specialty retailers in the first 3 months of the launch of Coroguard 101.

The company however had not discouraged retailers for the use of Corochem-101 as private label as company had never claimed anywhere that Corochem-101 is a corrosion Inhibitor for this segment. Moreover the company expects that this private label sales volume might help in generating some additional revenue from the existing market which Coroguard 101 will take time to establish into. Once Coroguard-101 is established in market in long run, Panacea will plan strategy for discouraging retailers using Corochem-101 as private label. However the company is clear that for Coroguard-101, Panacea will not encourage any private label branding and will be solely sold through Coroguard-101 brand. Pradeep had its rational as firstly Coroguard-101 will be strategically the first product with brand development orientation. So far the company has company branding orientation but Pradeep believe that this product branding will give new direction and synergy to the company. Secondly, as the water treatment process include a number of other chemicals, Pradeep envisioned to develop those products in long run and give synergy to its existing product Coroguard-101. He believed that in long run, Panacea Chemicals can have a well established platform for other portfolio of products. It will become like a consumer packaged goods that every mass and specialty retailer, contractor and customer will request.

Despite all the strategy and plans, sales were disappointing INR 66.6 Lakh.

### The Challenge

Frustrated with underperformance of the new chemical introduced for a new market, for a full day, Sandarbh had taken meeting with his sales representatives across territories and collected their viewpoint on this concern. Now it's almost 10.30 pm and the last meeting is over. Sandarbh still wants to stay back in office for an hour to summarize the important concerns raised by his fellow colleagues. This will help Sandarbh to think and reflect on for the whole Sunday and put together to have a proposal till next week on recommendations on how we can turn this situation around. Some of the important suggestions given by his colleagues during discussion were as "Panacea Chemicals is inexperienced in building product

oriented brands. So the company had to wait for few more quarter to conclude that the new product is not working. May be the product need some time to build itself as a brand and monetize.”

“As the market is new for Panacea Chemicals, the company is not able to understand its customers well? Also may be we are not able to communicate how Coroguard 101 is a value product for them. As the unit price of Coroguard 101 is higher than the competitors, the company need to find right way to communicate the right value offering or change the pricing.”

“Retailers and distributors are derived through incentives. The company needs to realign their incentives. If we have space to raise the prices as we are already putting efforts on branding, we can create enough margins for them to make Coroguard 101 more attractive for them to push.”

“Company just need to redesign the channel of distribution. Company had to choose short term (three years) and long term time horizon for the new product channel study and redesign the channel of distribution. As in the short term time frame the product could establish itself in the market and in long run the product get established so may require a different channel of distribution.”

Along with summarizing the points from the meeting Sandarbh got a summary of two survey report on his table. These were reports from Survey, Sandarbh had ordered to be done from all the mass and specialty retailers who had send enquiries (approx 3500 No.) in the first 3 months of the launch of Coroguard 101. The first survey (Exhibit-05) was to get an view of what went wrong in the initial phase especially when the response was good. The summary of reveled that only 25% retailers recalled Panacea Chemicals sending sample pack of launched product to them in response to their inquiries. Sandarbh got to know that all the 3500 inquires were segmented region wise and were been forwarded to the respective distributor of the region but approximately 75% of the retailer communicated that they were not been contacted from the distributor. Now again to boost the sales, Sandarbh can start with these 3500 leads and revamp and reenergize the entire marketing program but he again need a fresh budget (INR 200 Lakh) for entire campaign. The second survey was to learn from the specialty and mass retailers to know consumers use and understanding of corrosion inhibitors. The survey revealed that most of the consumers are simply not aware of the value Coroguard Offers relative to other corrosion Inhibitors offered by the competitors. Panacea chemicals had priced Coroguard at INR 1500 suggested retail price and the estimated an annual cost of INR 3600 for a medium corrosion free water treatment comes out to be lower with most of the competitor’s product. Even still the customers are not able to understand its value offering.

**Exhibit 05**  
**RETAILER SURVEY DATA**

Annual chemical costs at retail prices, excluding corrosion Inhibitor(recommended regime)	INR 21600.00
% of consumers who understand and use corrosion inhibitor regularly	25%
Annual average cost of corrosion inhibitor at retail prices (recommended regime)	INR 3600.00

NOTE: 1 INR = 0.015 USD

Now Sandarbh is with a stock of all the concerns and viewpoints of his teammates and summary report of survey done. He had its arms around this situation and ready to fix this mess with some sustainable solution. With all this current facts and plethora of data in hand he is all set to analyze and have a proposal till Tuesday on recommendations on how he

can rescue Panacea Chemicals with this situation around. Also as a recent B-School graduate, Sandarbh knows that it's his first challenging assignment to solve and prove himself.

### **END NOTES**

Transparency Market Research (2012), Corrosion Inhibitors :Growth, Trends and Forecast, 2013 – 2019.

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# THE EVOLVING ROLE OF PEER-TO-PEER LENDING: A NEW FINANCING ALTERNATIVE

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## CASE DESCRIPTION

*The case follows the Online Peer-to-Peer (P2P) Lending from its inception and examines how the online social lending approach affected the success of the finance industry. Online Peer-to-Peer (P2P) lending is used to describe online marketplaces where lenders (also referred to as investors on notes) can lend to individuals or small businesses. In 2005, the first Peer-to-Peer (P2P) lending platform, Zopa, was established in the United Kingdom (U.K.), followed shortly by Prosper, LendingClub, and others in the United States (U.S.). Today, among a dozen P2P U.S. lending companies, LendingClub and Prosper comprise 98% of the market as of 2014. The primary objective of this case is to expose students to the recent developments and information systems implication in the financial industry and to encourage students to conduct research beyond a textbook to stimulate critical thinking. This teaching case can be used in accounting, finance, management information systems or business law graduate courses.*

## CASE SYNOPSIS

*Online Peer-to-Peer (P2P) lending, a new form of connecting supply and demand for funds has experienced considerable growth since 2005. Founded in 2007, LendingClub Corporation is one of these P2P lending platforms that attracts numerous lenders seeking high returns, and borrowers in need of capital but who are challenged to be financed via traditional channels. In December 2014, LendingClub (Ticker: LC, LendingClub thereafter) launched its Initial Public Offering (IPO) at the New York Stock Exchange (NYSE). As a result, there are two categories of investors in LendingClub: the lenders (investors on notes) who participate in the lending activities via lending platforms, and the shareholders (investors on outstanding stocks) who primarily buy and/or sell stocks on stock exchanges. All public companies are subject to the scrutiny of the Securities Exchange Commission (SEC). Thus the corporate filings of LendingClub have become an important source for lenders (shareholders) to make informed lending (investment) decisions. In the context of Lending Club Corporation, this case examines the development and role of Online Peer-to-Peer (P2P) Lending in the financial industry. Further, this case examines the decision making process of online lenders and shareholders of the P2P platforms.*

## INTRODUCTION

P2P lending is the money transaction between unrelated individuals, or “peers”. Also known as “crowd lending”, P2P lending has been around in some countries (e.g., China) for centuries, in which the “underground” market raises money between family and friends to supplement the insufficient financing from other channels. Contrary to traditional practice, P2P

lending does not go through such financial intermediaries as banks. In the past two decades, the economy and financial markets of the United States have been highly volatile. Evidently the development in information technology (IT) and e-business brought overwhelming changes to the structure and operations in the world of business. Emerging IT developments promise improvements in productivity in a wide range of activities in many dimensions of the economy. Online P2P Lending is one of the innovative new financing models engineered by IT developments, and has gained increasing attention in the past few years. Specifically, online P2P lending refers to the process in which an unsecured loan is originated between private lenders and borrowers on online platforms. Relatively higher returns are associated with higher risks for the lenders, while the borrowers are also expected to pay higher interest rates in exchange for a quick and relatively easy loan application.

The Online P2P model, powered by online platforms, is different from the stereotype “offline” model which was restricted to certain groups of individuals. Early this century, widely used personal computers and the Internet made it possible for lenders (investors) to independently utilize information technology. Infused by the rapid development of information technology and the associated increase in the popularity of social networks, online P2P lending has grown significantly. Characterized by “disintermediation”, this innovative financing model greatly reduced the importance of intermediaries and the related transaction costs.

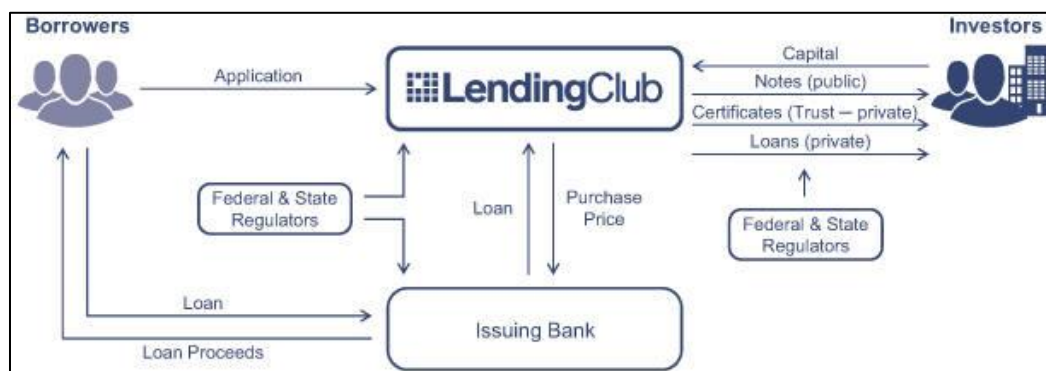
While the Internet extends the crowd sourcing to unlimited possibilities in matching lenders and borrowers, online P2P lending has its own share of problems and issues. For instance, online P2P lending does not normally require collaterals and attracts borrowers who are not qualified for traditional bank loans. Consequently, the lack of sufficient credit status of the borrower is associated with high credit risk and normally leads to high interest rates to lenders (investors). But the higher interest rates are also indicative of the exposure to higher default rates. On the other hand, online P2P lending is considered to be an investment and subject to the regulation by the Securities and Exchange Commission (SEC). In 2008, the SEC mandated that the companies offering platforms for online P2P lending need to register their offerings under the Securities Act of 1933. An investment, unlike deposit or savings in banks, is not protected by the Federal Deposit Insurance Corporation (FDIC).

Evidently, the new financing channel introduced competition to the traditional financing institutions (e.g., banks). This teaching case intends to explore the new development in the finance industry from the perspectives of corporate disclosure, information system, and finance regulation.

## **LENDINGCLUB**

LendingClub is a U.S. based online P2P lending company, with its headquarters located in San Francisco, California. Founded in 2006, LendingClub originated over \$15.9 billion loans as of December 31, 2015. This new financing innovation employs a technology-powered online marketplace. Compared to the system used in a traditional banking system, the online system is believed to be a more efficient mechanism to allocate capital between borrowers and investors. From the borrowers’ perspective, individuals and small business owners borrow through LendingClub enjoy relatively lower costs and a better experience. On the other hand, individual lenders can earn higher returns that are normally only available to institutional investors. As demonstrated in Figure 1, borrowers submit online loan applications to the platform, and LendingClub has two primary channels to fund the loans: through the issuing bank or through investors (lenders in our paper).

**Figure 1**  
**LENDINGCLUB LOAN ISSUANCE MECHANISM**



Note: The Figure is extracted from Lending Club's Form 10-K for Fiscal Year ended December 31, 2014.

LendingClub offers two programs, namely, standard or custom program loans. Standard Program Loans are part of the Standard Loan Program and offer three- or five-year unsecured personal loans to borrowers who have a good credit record (e.g., FICO score of 660 or better). These loans are then invested in notes that are issued in compliance with the Note Registration Statement and are only made available for purchase through its website. On the other hand, Custom Program Loans include small business loans, super prime consumer loans, education and patient finance loans and personal loans that do not meet the requirements of Standard Program Loans. Custom Program Loans are only invested in through private transactions with qualified investors and cannot be invested in through notes. They are also not visible through its public website.

Lenders can find a variety of loan products on Lending Club's platform. This platform utilizes LendingClub's proprietary technology, which supports key aspects to facilitate daily operations, fraud detection, and regulatory compliance. Lenders are able to use data and analytical tools on the platform for decision making and portfolio assessment. In addition, the platform fueled by high technology enables LendingClub to expand beyond P2P lending between individuals and to extend loans to interested small businesses. By doing so, Lending Club expanded its clientele bases from individuals to institutions.

### **BORROWING THROUGH LENDINGCLUB**

To obtain a loan through LendingClub, a borrower needs to open an account on the LendingClub website first and then initiate a request for the rate of a potential loan. The amount requested can be as low as \$1000 and as high as \$40000. The borrower also needs to provide an estimated range of their credit score and select the purpose of the loan from a list that includes: credit card refinancing, debt consolidation, home improvement, major purchase, home buying, car financing, green loan, business, vacation, moving and relocation, medical expenses, and others. Figure 2 illustrates a sample first screen for a borrower to request a LendingClub loan.

**Figure 2**  
**FIRST SCREEN FOR REQUESTING A LOAN**

The screenshot shows the LendingClub website interface. At the top, there is a navigation bar with the LendingClub logo and links for Personal Loans, Business Loans, Patient Solutions, Investing, How It Works, and About Us. A 'Sign in' button and a 'Help' link are also present. On the left side, there is a sidebar menu with links for Personal Loans, Customer Reviews, Borrower Stories, Rates & Fees, Repayment Process, Personal Loan Types, Consolidate Debt, Pay Off Credit Cards, Home Improvement, Pool Loans, and Car Loans. The main content area features a green banner with the text 'Personal loans for up to \$40,000'. Below this text, there are three bullet points: 'Apply online in minutes', 'Get funded in a few days', and 'Make fixed monthly payments'. To the right of the text is a form titled 'How Much Do You Need?' with fields for 'Enter amount from \$1,000 to \$40,000', 'What is it for?', and 'How is your credit?'. A blue button labeled 'Check Your Rate' is positioned below the form, with a note 'Won't impact your credit score' underneath. On the left side of the banner, there is a testimonial from Adrian, a man from Houston, TX, who states: 'Lending Club has made it possible for me to achieve my financial goal of consolidating all my credit card debt into a single, low monthly payment.'

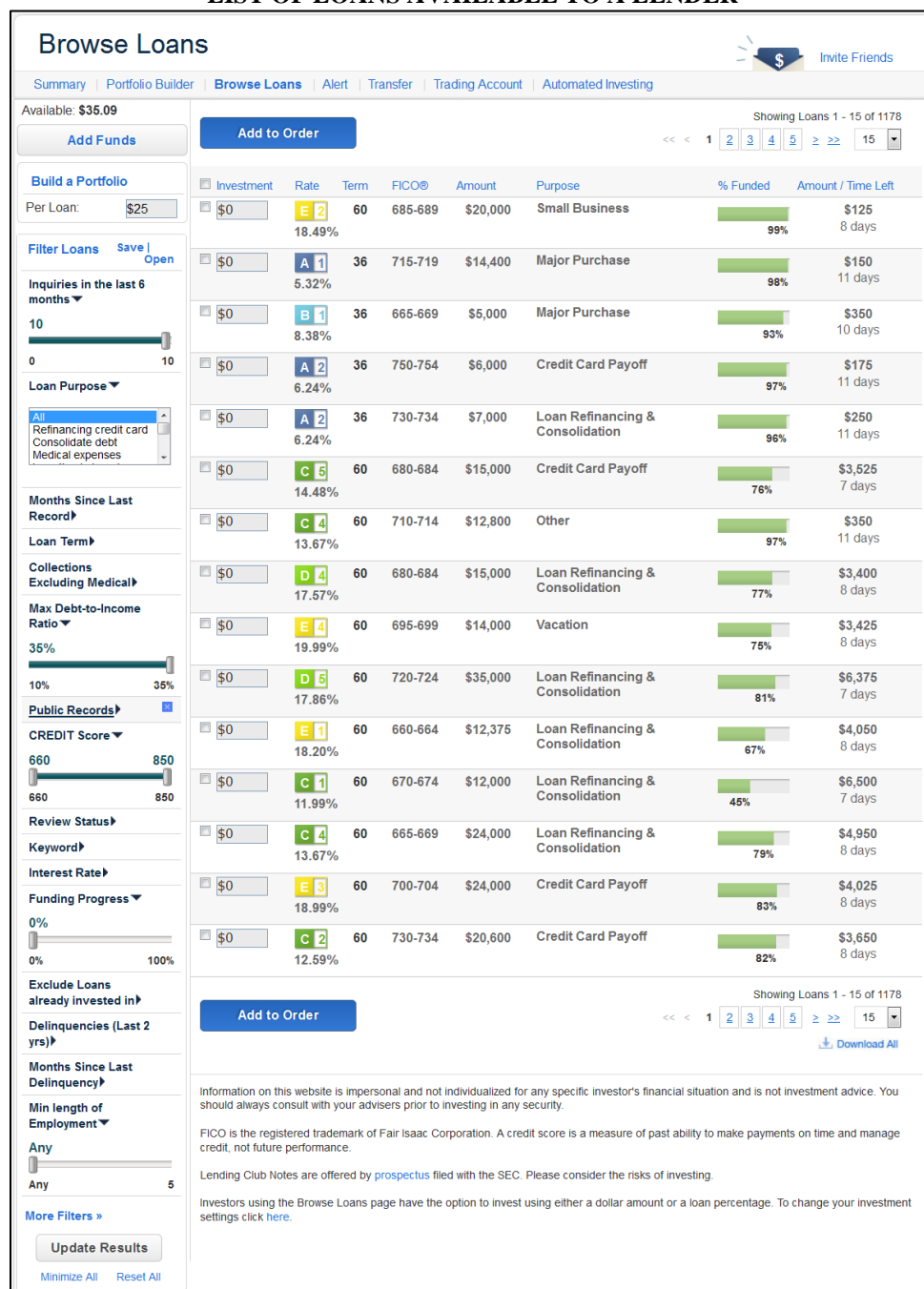
From the initial request, the borrower may be presented with multiple loan offers that they are qualified for, and they can choose the most suitable offer to complete the online application form. At this step, the borrower is required to provide personal and financial information so LendingClub can verify their identity and assess credit worthiness. LendingClub reviews the loan application and may request additional documentations such as pay stubs or bank statements. Many borrowers are deemed too risky and have their applications rejected at this point. Once a loan application is approved, the request is made available to the lenders on the LendingClub platform during a two week window. After the loan is funded by the lenders, the fund is deposited into the borrower's bank account, and the loan is closed. The borrower will then need to make a monthly payment for the next 36 or 60 months depending on the term of the loan. The borrower could also choose to pay off the loan early. In fact, LendingClub may encourage some borrowers whose credit score has improved significantly to pay off their existing loan early with a new loan, presumably at a lower interest rate than the original loan.

## LENDING THROUGH LENDINGCLUB

To invest on LendingClub notes, a lender needs to open an account and deposit funds first. Then they can browse for available loans and purchase notes. Figure 3 demonstrates a sample screen listing loans available for a lender to invest in. For each loan, a collection of information about the loan and the borrower is provided, including the rate (determined by LendingClub's proprietary algorithm), term, amount, purpose of the loan, the borrower's credit score, home ownership, length of employment, revolving credit balance, past delinquencies, etc. Lenders can apply a filter to narrow down the selection of loans based on an extensive set of criteria (e.g., loans with 60 month term requested by borrowers with a credit score higher than

720 and a verified monthly income of more than \$2500). Once a filter is set, it can be saved for later use. A lender can purchase one or more notes from each loan. However, to minimize risk, it is usually advised that lenders diversify their investment to as many loans as possible and limit their exposure to a specific loan.

**Figure 3**  
**LIST OF LOANS AVAILABLE TO A LENDER**



Note: Lender can click on each loan to view additional information about the loan and its borrower

The process of purchasing notes manually can be cumbersome and time consuming. Therefore, LendingClub also provides an automated investing feature. To use automated



investing, lenders first specify a portfolio allocation by choosing one of the three pre-determined allocations, or customize their own mix of loan rates (e.g., 20% in each of B, C, D, E, F rated loans). Lenders can also apply a saved filter to the allocations. Once the criteria is set, LendingClub will automatically invest available funds into new notes meeting the filter, while maintaining the target allocation of the overall portfolio. The funds to be invested can be either part of the lender's initial investment or from the payments received from notes invested.

In addition, lenders can also buy and sell existing notes through FOLIOfn, a 3rd party trading platform of peer-to-peer loan notes. Figure 4 demonstrates a sample screen listing notes available for a lender to purchase on FOLIOfn. For investors residing in states where direct lending is not available, purchasing notes through FOLIOfn provides an alternative mechanism for them to invest. For each note sold on FOLIOfn, in addition to the information on the original loan, lenders can also view the payment history of the loan. Instead of investing in new notes directly on LendingClub, some investors may prefer to purchase notes with an excellent payment history from the trading platform. By allowing lenders to sell their notes, the trading platform also increases the liquidity of their investment.

**FIGURE 4**  
**LIST OF NOTES AVAILABLE TO PURCHASE ON THE FOLIOFN TRADING PLATFORM**

Below are the Notes listed for sale. The Notes belong to other trading members and are held in their Lending Club accounts.

208,256 of 272,005 notes [Add to Order](#)

Showing Notes 1 - 15 of 208256

LENDING CLUB LOAN ID	ORIGINAL NOTE AMOUNT	INTEREST RATE	TERM	STATUS	CREDIT SCORE CHANGE	RECENT CREDIT SCORE	DAYS SINCE PAYMENT	REMAINING PAYMENTS	OUTSTANDING PRINCIPAL	ACCRUED INTEREST	PRINCIPAL + INTEREST	ASKING PRICE	MARKUP / DISCOUNT	YIELD TO MATURITY
5640334	\$25	18.75%	36	Current	▲	680-684	11	6	\$5.21	\$0.04	\$5.25	\$5.40	2.86%	2.11%
889802	\$25	10.65%	60	Current	▼	730-734	20	11	\$5.80	\$0.04	\$5.84	\$6.01	2.91%	0.01%
6625410	\$25	6.62%	36	Current	▲	795-799	1	8	\$6.03	\$0.01	\$6.04	\$6.07	0.5%	1.33%
7094596	\$25	9.71%	36	Current	▼	590-594	5	9	\$6.55	\$0.01	\$6.56	\$6.59	0.46%	5.12%
1030809	\$25	14.27%	60	Current	▼	650-654	14	12	\$6.59	\$0.05	\$6.64	\$6.77	1.96%	6.34%
7087817	\$25	6.03%	36	Current	▼	750-754	7	9	\$6.68	\$0.01	\$6.69	\$6.76	1.05%	0.01%
7056357	\$25	6.03%	36	Current	▼	770-774	7	9	\$6.68	\$0.01	\$6.69	\$6.72	0.45%	1.52%
7056357	\$25	6.03%	36	Current	▼	770-774	7	9	\$6.68	\$0.01	\$6.69	\$6.76	1.05%	0.01%
7056056	\$25	6.03%	36	Current	▲	815-819	7	9	\$6.68	\$0.01	\$6.69	\$6.76	1.05%	0.01%
6617129	\$25	16.78%	36	Current	▼	550-554	7	8	\$6.71	\$0.04	\$6.75	\$6.98	3.41%	3.22%
6976082	\$25	6.62%	36	Current	▼	760-764	7	9	\$6.75	\$0.01	\$6.76	\$6.83	1.04%	0.74%
6994882	\$25	6.62%	36	Current	▼	725-729	7	9	\$6.75	\$0.01	\$6.76	\$6.84	1.18%	0.37%
7096251	\$25	6.62%	36	Current	▲	770-774	7	9	\$6.75	\$0.01	\$6.76	\$6.83	1.04%	0.74%
7044894	\$25	6.62%	36	Current	▼	695-699	4	9	\$6.75	\$0.01	\$6.76	\$6.83	1.04%	0.72%
7096317	\$25	6.62%	36	Current	▲	790-794	5	9	\$6.75	\$0.01	\$6.76	\$6.83	1.04%	0.72%

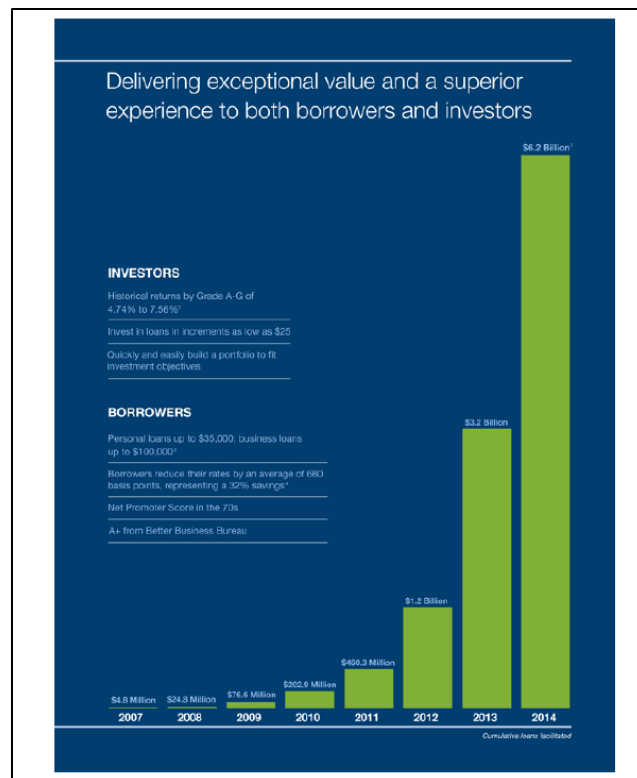
Showing Notes 1 - 15 of 208256

Note: Lenders can click on the status of each note to view additional information about the loan and its borrower

## INVESTING ON LENDINGCLUB

LendingClub registered with the SEC to be traded in the stock market in August 2014 and successfully launched its Initial Public Offering (IPO) on December 10, 2014. On the first day of trading, LendingClub raised \$900 million and was valued at \$8.5 billion. Its stock price fluctuated afterwards, and its recent market value is around \$7 billion. This opened up another investment channel to interested individuals and institutions. This case refers to these investors who hold common stocks of LendingClub to be “shareholders”, to be differentiated from the investors via lending on online platforms. Figure 5 illustrates a picture included in the prospectus of Lending Club, entitled “Delivering exceptional value and a superior experience to both borrowers and investors”. Historically, the opportunities to invest in personal and small business credit are rather limited to individual investors. The IPO brought proceeds to LendingClub's future development and strongly supported its leading position in this industry.

**Figure 5**  
**LENDING CLUB COMPANY PROSPECTUS**



Personal lending, LendingClub's specialization, is a growing and lucrative industry that attracts competition. While LendingClub's position as a leader in this sector seemed solid for the time being, the shareholders (investors in stock) should exercise caution and pay attention to the company's operations, the stock market trends, and any possible regulatory changes.

### DISCUSSION QUESTIONS

1. From the standpoint of an individual lender, discuss how online P2P lending is regulated and identify any regulatory risks that are not typically associated with investment in traditional financial institutions.
2. What are the LendingClub's investment channels offered to lenders (investors on notes) through its online marketplace?
3. What are LendingClub's competitive advantages in the online P2P lending marketplace?
4. Prosper is one of the primary competitors of LendingClub. Prosper, based in San Francisco, is the first online P2P lending marketplace in the United States. Prosper has funded over \$5 billion loans. In April 2015, Prosper raised \$165 million in its IPO and was valued at around \$1.7 billion. Please compare the profitability and solvency of LendingClub and Prosper and discuss which company would be a better investment choice for shareholders (investors on stocks), and why.
5. What are the key technology elements utilized on LendingClub's platform?

# WAS COOPER TIRE & RUBBER RIPE FOR SALE?

**Javad Kargar, North Carolina Central University**  
**Houtan Kargar, North Carolina Central University**

## CASE DESCRIPTION

*The primary subject matter of this case concerns the competitive strategy of a very successful small tire manufacturer – Cooper Tire & Rubber Company (Cooper). It can be used to teach a number of strategic management lessons, particularly implementation and choice of strategic direction. The time frame of the case is from the firm's inception to the middle of year 2013. The case has a difficulty level of four-five, appropriate for senior level undergraduate or second year MBA students. The case is designed to be taught in two seventy-five minute classes and will require approximately three to four hours of outside preparation by the students.*

## CASE SYNOPSIS

*Cooper is a U.S. based independent tire manufacturer with a history of consistent high growth and strong returns for more than a decade. What is interesting about this case is that Cooper has been able to find a niche in a mature industry. Although Cooper is the fourth-largest U.S. tire maker, it does not cater to car manufacturers, a market with strong competition and lean margins. Cooper does not invest much in research and development, preferring to wait two or three years to gauge acceptance of the latest tire designs, then copying the winners and competing on price in the marketplace. Cooper realizes that in a competitive environment like the global tire industry, differentiation is an important component; hence it emphasizes quality in their products to get a differentiation advantage. There is also a focus on a low-cost approach so the customers can get a low-price high-quality product. Moreover, Cooper maintains good relations with its distribution channels in order to achieve competitive advantage. Cooper also realizes that the key factors for survival and growth in the tire industry lie in managing production costs and global expansion. But the future of the company was expected to be periods of continuing and new challenges, with increased threats of competition in the replacement tire market. The company also believed that significant numbers of Chinese tires will be imported immediately following the expiration of the special U.S. tariff on such tires.*

*On June 12, 2013, Apollo Tyres Ltd. (Apollo), the second largest Indian tire maker offered to acquire Cooper. It was obvious for some analysts that Apollo would jump into the North American market someday, but it had to absorb some of its expansions into other regions of the world first, such as Africa and Europe. So was Cooper ripe that Apollo couldn't wait?*

## COMPANY BACKGROUND

Cooper began its journey from obscurity to a tire industry nearly a century ago in 1914, when John F. Schaefer and Claude E. Hart purchased M and M Manufacturing Company in Akron, producing tire patches, tire cement and tire repair kits. A year later, they purchased The Giant Tire & Rubber Company of Akron, a tire rebuilding business, and two years later moved the business to Findlay, Ohio. By 1920, they had broadened the scope of the firm, repositioning it as a tire manufacturer. At that time, the firm had more than 130 domestic competitors, 40 in the state of Ohio alone. In 1930, the company merged with Cooper

Corporation and The Falls Rubber Company to form the Master Tire & Rubber Company. Within a year, the combined production of the three plants totaled 2,850 tires per day. Ira Cooper formed a company to manufacture new tires in 1919.

The firm changed its name to Cooper Tire & Rubber Company in 1946, in recognition of Ira J. Cooper's contribution. In 1960, the company became a publicly held corporation and was listed on the New York Stock Exchange, and its distribution of shares facilitated another decade of growth. Throughout the next five decades, the company expanded its products, manufacturing plants, distribution system and marketplace.

The 1980s were years of significant change for Cooper and the tire industry overall. Many American tire manufacturers scrambled to lower production capacity as the domestic market became saturated. From 1979 to 1987, a total of 23 U.S. tire plants were closed in the rush to downsize. Cooper executives calmly delineated strategies for continued growth and even expansion of production. As its competitors deserted plants, Cooper bought them and upgraded them. By overhauling older facilities, Cooper added capacity for one-third the cost of building new ones. Cooper joined the ranks of Fortune 500 companies in 1983 as one of the largest industrial companies in the United States. In the following year, its net sales exceeded \$500 million, and its net income was more than \$24 million. In 1985, Cooper made its first foreign acquisition—a manufacturer of inner tubes in Mexico. That same year, Cooper was named one of the 101 Best Performing Companies in America.

Capital investments continued to grow in the 1990s: the company purchased a tire manufacturing plant in Albany, Georgia, in 1990, and expanded its Findlay and Bowling Green locations in 1993. Despite a lingering U.S. recession, Cooper's net sales topped the \$1 billion mark in 1991 and the company added almost a quarter of a billion dollars more the following year. Construction of a new plant at Mt. Sterling, Kentucky, got under way in 1995, and a \$10.5 million upgrade of the Clarksdale, Mississippi facility began in 1994. Cooper acquired British-based Avon Tyres in early 1997, which manufactured products for the replacement tire industry in the United Kingdom and Western Europe. The company also had a strategic alliance with Pirelli Tyres of Milan, Italy, which involved contractual arrangements. This arrangement provided revenue to Cooper primarily through commissions on sales of Pirelli tires by Cooper dealers. By 1999, Cooper had 50 manufacturing facilities in nine countries. Much of the company's growth came through the acquisition of The Standard Products Company, a move that added 10,000 employees to its payroll.

Cooper's capital investments, ongoing cost-cutting efforts and focus on the replacement market almost doubled its operating margin from the late 1980s to the early 1990s. In fact, the company's efficient means of production propelled it to the highest gross profit margins in the industry at 33 percent. When larger competitors turned to the replacement market and tried to undercut Cooper's prices, those high margins gave the company leeway to join in the price wars.

With the purchase of the highly regarded Avon Tyres in 1997, and the acquisition of Mickey Thompson Performance Tires & Wheels in 2003, Cooper positioned itself as a preeminent producer of high-performance and ultra-high performance tires. In 2003, Cooper also entered a joint venture with Kenda Rubber Industrial Company Ltd. in China, to produce radial passenger and light truck tires. Then, a huge change for Cooper occurred in 2004, when the company sold its automotive business, Cooper-Standard Automotive, for approximately \$1.165 billion. The sale included the 47 manufacturing facilities and operations of Cooper-Standard Automotive, which was a global manufacturer of fluid handling systems, body-sealing systems, and active and passive vibration control systems, primarily for automotive original equipment manufacturers.

The sale of the automotive business in turn provided new opportunities for funding growth in Cooper's core tire business. In January 2005, the company announced it was

forming a new commercial division encompassing both Oliver Rubber Company and commercial tires. In October 2005, the company announced an agreement to obtain 51% ownership in China's third largest tire manufacturer, Cooper Chengshan (Shandong) Passenger Tire Company Ltd. and Cooper Chengshan (Shandong) Truck Tire Company Ltd.

### **Highlights of Strategic Plan**

Starting in 2008, Cooper embarked on a growth strategic plan used to drive the company in creating shareholder value. The vision of Cooper was, "together, around the world. One company ... one team ... one goal: creating superior value, for our customers, employees, partners and shareholders." The key imperatives of that plan involved developing a competitive cost structure and improving profitability, driving top-line profitable growth, and building organizational capabilities.

While implementing elements of the strategic plan in 2008, the company's existing operations were able to lower production costs. To address the top-line in the past, Cooper launched new premium products that positioned the company very well for growth in that segment of the market. Over 30 percent of the company's sales in 2008 were from products launched in the last two years. The Cooper brand continued with a strong performance. This effort delivered results in the year with the successful implementation of channel strategies at the national, regional, wholesale and independent retail levels. Cooper also continued investing in facilities in lower cost countries. In 2008, Cooper acquired approximately 38% ownership share of a tire manufacturing plant in Mexico, which was the 2<sup>nd</sup> largest plant in Mexico. This positioned Cooper for improved operating costs, greater geographic flexibility, and the ability to penetrate markets outside of the United States. To enhance its capabilities, the company has continued to shift the culture at Cooper to a continuous improvement mindset. To that extent, the company had trained black and green belts, as part of its LEAN Six Sigma efforts, as well as made internal changes in the organization's structure to support quick and sustainable improvements to its operations. The company was also very aggressively pursuing business that was positioning its products in channels of the market where it was under represented. Cooper had cash and untapped credit lines available for capital spending. The company also continued to tightly monitor spending and capital expenditures during 2008 and suspended the repurchase of shares and debt.

In 2009, Cooper had a strong focus on the first of its strategic imperatives. In North America, Cooper closed its Albany, GA plant and successfully moved product from the plant to its remaining two plants, making the transition virtually invisible to its customers while at the same time improving efficiency and reducing waste. The international operations were aggressively attacking costs, while continuously improving quality. From a supply standpoint, Cooper was faced with continually adjusting its production to weakening levels of demand across the industry. Raw materials costs declined in the first half of 2009 from a peak in 2008, but rapidly escalated again in the second half. Across the organization, Cooper did an excellent job of managing its costs against difficult headwinds. These challenges did not detract from its unwavering focus on safety and quality. The company developed and introduced successful new products, including an entry level tire and greater fuel efficiency tire to meet market demands for both product segments, driven by the economic downturn. In Asia and Europe, Cooper also launched products that have been extremely popular in those respective markets.

Among the highlights of 2010, Cooper completed the move to a 24/7 operation in Texarkana, Arkansas and increased production at six of the seven tire manufacturing locations. The company also boosted its ownership stake in Cooper Chengshan Tire (CCT) to 65 percent from 51 percent and increased ownership in Corporation de Occidente SA de

CV, to 58 percent from 38 percent and of Cooper Tire & Rubber Company de Mexico SA de CV, to approximately 100 percent from 50 percent. The company's Cooper Tire Lean Six Sigma (CTLSS) program, in its second year, continued to bring forward successful results as employees around the globe embraced and used Six Sigma methodology to improve the company's overall business.

In 2011, Cooper made visible long term investments, including ownership levels at Cooper Kunshan Tire Corporation de Occidente, and Cooper Tire & Rubber Company de Mexico, as well as agreeing to purchase assets in Serbia. These investments complemented ongoing investments at the company's legacy facilities, targeted to enhance competitiveness. Meanwhile, the company successfully rolled out a re-branding initiative of the Cooper brand that better connected consumers to the great qualities and values they offered.

Cooper continued to reinvest in its business throughout 2012, with capital investments that were higher than historical norms, but necessary to maintain growth momentum. These investments included initiatives such as its ERP deployment, which would ultimately provide a seamless flow of information on a global basis in real time, greatly enhancing the efficiency of its operations. In North America, the company maintained vigilance in driving cost reductions and invested in automation, equipment and other enhancements while achieving a 4% sales increase. By the end of 2012, Cooper had over 65 facilities, which were located within 11 countries. These facilities included manufacturing, sales, distribution, technical and design. In 2012, Cooper was the North America's fourth largest replacement tire producer and ranked as the ninth largest tire producer worldwide (Exhibit 1). Cooper was always regarded as a value tire producer and with a mix equally divided between proprietary house brand and private customers, it marketed its tires in more than 100 countries around the globe.

With the exception of 2005, 2006 and 2008, Cooper had earned a profit in every year since its inception—a truly remarkable accomplishment in a mature business where it was common for industry members to post losses when demand for tire sagged. Cooper had paid dividends to stockholders every year since 1980. Exhibit 4 provides highlights of Cooper's growth since 1983.

## **INTERNAL ENVIRONMENT**

### **Executive Leadership**

#### **Ivan W. Gorr, 1982 – 1994**

The early 1970's had been very troubled times at Cooper—as its very survival was in question. In 1972, certified public account Ivan W. Gorr was an employee of Arthur Young & Co. assigned to the Cooper account, and Cooper was looking for a corporate controller. Gorr was offered the job. For Gorr, the decision to join Cooper in the face of adversity was a challenge. He became president and chief operating officer of the company in 1982 and chairman and chief executive officer in 1989. According to Gorr, "The company turned itself around by embracing one of the fundamental tenets of modern quality management: Listen to your employees (Holzinger, 1993). Cooper had a lot of highly capable people at that time, and top management gave them a chance to stand up and say what the company should be doing and what they could do to help it get there.

Cooper emphasized a strong commitment to customer service and to quality, both of which demanded a high degree of loyalty and an integrated effort among all employees. To

foster this integration, Cooper maintained very short lines in the organization of its staffing. Information needed for decision making was accessed quickly, without unnecessary bureaucratic protocols, and communications were direct. The company's stated goals and objectives were well communicated all the way down the line.

There was also deep investment in employees at the management level. The company had developed a Talent Management program which aimed to produce successful managers. The two main parts of the Talent Management program were Performance Management and Succession Management. The Performance Management part aimed at teaching its managers to focus on strategically important initiatives, thus reducing wasted time on areas that were not directly aligned with the company's strategy. The second main part of the program, Succession Management, used Talent Summits across the company. The Talent Summits were utilized in order to identify strong individuals within the company who were leaders or had the potential, important positions, and also the successors for the positions. This in turn gave recognition to individuals who were capable and were able to successfully move up due to their talents. In order to further support this program, Cooper continuously invested in its employees by providing both internal and external training.

Under Gorr, Cooper was known for its aggressive pursuit of technical challenges, rigorous quality systems, strong emphasis on employee relations and workforce productivity, cost conscious corporate culture, and its ability to achieve low costs per tire produced. The company had a very streamlined organizational structure, incentive based compensation systems, and tire plants that were among the most efficient producer in the tire industry in the United States. Gorr proved himself a master in crafting and executing a low cost, high quality strategy. Cooper's annual revenues increased from \$1.2 billion in 1992 to \$1.4 billion in 1994, while net income climbed to \$128.5 million. Gorr retired in 1994, at age 65, in accordance with company policy, leaving behind a sterling record: sales had increased threefold and profits almost sextupled during his last decade at the helm.

#### **Pat Rooney, 1994 – 1999**

Gorr was succeeded as chairman and CEO by Pat Rooney, who had joined the company right out of college in 1956, and had worked in various roles under Gorr. In 1985, Rooney was given responsibility for all tire sales and was appointed vice president of marketing for Cooper's operations in 1987. Rooney was elected president of tire operations and a director of the company in 1990. Sales continued to grow under Rooney's leadership, totaling \$1.6 billion by 1996. But high raw material costs that, because of competitive pressures, could not be passed on to customers in the form of price increases, cut into Cooper's net profit in the intervening years. Profits declined to \$112.8 million in 1995 and slid to 107.9 million in 1996. Cooper's usually high-flying stock suffered as well, dropping from a high of more than \$39.50 per share in 1993 to less than \$18 in 1996. Rooney retired in June 2000, when he became 65 years old. The firm's net sales in 1956, when Rooney joined Cooper were \$23.4 million. Net sales for 1999, his last year at the helm, reached \$2.2 billion.

#### **Tom Dattilo, 1999 – August 2006**

In 1999, Rooney transferred his duties as Cooper president to Tom Dattilo, who succeeded him as chairman and CEO. Dattilo joined Cooper in January 1999 as chief operating officer. Prior to joining Cooper, Dattilo spent more than 21 years in the automotive parts business with his latest position being president of Dana's sealing products group, one of the world's largest manufacturers of vehicular and

engine components. Cooper has been struggling for the past two years. Though it posted net sales of \$625 million for the second quarter, up 22% versus the same period in 2005, it posted deeper losses for the second quarter. Cooper's loss fell to \$21 million from a loss of \$7 million in the same period of the previous year. It was the firm's sixth consecutive quarterly loss. Besides the earnings shortfall, Cooper had been removed from the S&P 500 index and its credit ratings was downgraded into "junk" territory. Dattilo resigned unexpectedly on August 3, 2006, the same day as the 2<sup>nd</sup> quarter results were announced. The stock fell from the August 2 close of \$10 to \$8.23 on August 9. Raw material prices continued to get higher while industry demand remained weak in North America and Europe.

### **Byron Pond, August 2006 – December 2006**

At the time Dattilo resigned, Byron Pond, a member of Cooper's board of directors stepped in to serve as interim CEO during a search for permanent replacement. Pond also joined two other directors to form an "office of the chairman" to oversee governance of the company during the search process. He took a very proactive role in running the company. As Jonathan Steinmetz, Morgan Stanley analyst stated, "The departure of the company's CEO may lead to a positive management change, but the problems here run deeper than just management, and it may not be easy to attract star talent to a \$564 million market-cap tire company based in Findlay, Ohio. The company's problems include high cost structure, low brand value, rising raw material costs, weak end markets, production problems, lack of captive distribution, increasing production complexity and personnel turnover. The company still does not appear to have a fully developed plan to offset these challenges." (Hockensmith, 2006). Some tire dealers believed that a main problem was that the company had built its business as a value-tire producer and at the time it was harder to produce tires in that segment profitably in North America. According to Mr. Lesieur, a dealer, "I don't know how the company sticks to what it knows best but still makes money." He continued by saying, "I'm unsure what the company's vision is for the next five to 10 years." (Hockensmith, 2006).

### **Roy Armes, CEO and President from December 2006 Onward**

Roy Armes joined the company in December 2006 as its CEO and President. A year later, he was also appointed Chairman. When Armes was hired, some analysts thought it was a sign that Pond was preparing Cooper for sale. Armes came to Cooper following a 31-year career at Whirlpool Corporation, where he rose to senior vice president of the Project Management Office. He also brought with him experience in Mexico and China. Throughout his tenure at Cooper, Armes has spearheaded the positive transformation of the company's business model, creating a stronger, more resilient and more sustainable Cooper that was better positioned to drive long-term value. Like his predecessors, Armes continued to pursue a rapid growth strategy, expanding the company production capabilities via both acquisition and plant improvements. The company has performed well under his direction. In 2008, the company unveiled an ambitious five-year strategic plan, and by the close of 2012, nearly all of the financial and performance goals set within the plan were achieved. In fact, 2012 was a record-setting year for the company as Cooper generated record full-year net sales of \$4.2 billion and record operating profit of \$379 million. Cooper's business was still in the recovery stages in 2011-2012 (see Exhibit 3).



## **Product Line**

Originally, Cooper organized its operations into two business divisions: Automotive products, and Tire products. With more than 1,800 specific parts, Cooper's automotive business produced primary product categories including body sealing systems, hose and hose assemblies, active and passive vibration control systems, and fluid handling systems. The division served primarily the global automotive manufacturers for installation on new vehicles. In 1999, Cooper acquired The Standard Products Company (Standard) for approximately \$864 million. Standard produced vibration control components at a facility in Michell, Canada, and had body sealing plants in Canada, Mexico, Brazil, the United Kingdom, France and Poland. In year 2000, the company also acquired Siebe Automotive. Siebe manufactured automotive fluid handling systems, as well as components to the world's automotive original equipment manufacturers and large Tier-1 automotive suppliers. Each product line in Cooper's automotive division operated in a highly competitive environment. Auto makers, in their own efforts to reduce costs, had been pushing suppliers to lower prices. This was creating opportunities for those companies that had the economies of scale needed to manufacture products cheaply and still remain profitable. On December 23, 2004, Cooper sold its automotive division to Cypress Group and Goldman Sachs Capital Partners. With the sale of the division, the company wanted to focus more on the replacement tires market.

In 2012, based on sales, Cooper was the fourth largest tire manufacturer in North America and the eleventh largest tire company in the world. Cooper mainly focused on the manufacture and sale of passenger and light and medium truck replacement tires. As of December 2012, Cooper operated 9 manufacturing facilities and 38 distribution centers in 11 countries and employed 13,550 people worldwide. The company was organized into two separate, reportable business segments: North American Tire Operations and International Tire Operations. Each segment was managed separately.

### **North American Tire Operations Segment**

The North American Tire Operations segment manufactured and marketed passenger car and light truck tire, primarily for sale in the United States replacement tire market. As of December 2012, Cooper operated three manufacturing facilities in the United States and one in Mexico. The segment operated in a highly competitive market, which included Bridgestone, Goodyear and Michelin. These competitors were substantially larger than Cooper and served Original Equipment Manufacturing (OEMs) as well as the replacement tire market. The segment also faced competition from low-cost producers in Asia, Mexico, South America and Central Europe. Some of these producers were foreign affiliates of the segment's competitors in North America. In 2011, the segment had a market share of about 11 percent of all passenger and light vehicle replacement tire sales in the U.S. (Exhibit 2). The segment also participated in the U.S. medium truck replacement market. In addition to manufacturing tires in the U.S., the segment had a joint venture manufacturing operation in Mexico. Only a small portion of the products manufactured by the segment were exported throughout the world.

Success in competing for the sale of replacement tire was dependent upon many factors, the most important of which were price, quality, performance, line coverage, availability through appropriate distribution channels and relationship with dealers. Other factors included warranty, credit terms and other value-added programs. The segment has built close working relationships with independent dealers. As a steadily increasing percentage of replacement tires were sold by large regional and national tire retailers, the segment has increased its penetration of those distribution channels, while maintaining a

focus on its traditionally strong network of independent dealers. Cooper management believed these relationships have enabled the company to obtain a competitive advantage within this segment and channel of market.

### **International Tire Operations Segment**

The international Tire Operations segment had two manufacturing operations in the United Kingdom, one in the Republic of Serbia and two in China. The United Kingdom entity manufactured and marketed passenger car, light truck, motorcycle and racing tires and tire retread material for the global market. The Republic of Serbia entity manufactured light vehicle tires for the European markets. The Segment's entity in China manufactured only light vehicle tires. Under an agreement with the government of China, all of the tires produced at the facility have been exported. The segment also had a joint venture in China, Cooper Chengshan Tire, which manufactured and marketed radial bias medium truck tires as well as passenger and light truck tires for the global market. As in North America, the segment operated in a highly competitive industry, which included Bridgestone, Goodyear and Michelin. The segment also faced competition from low-cost producers in certain markets.

### **Distribution and Marketing**

One factor in Cooper's success was its confining itself to the replacement tire market. Although Cooper was a midget among the world's tire makers, it was the only major U.S. tire producer that refused to compete for low-profit margin OEM sales to automakers. Instead it concentrated on the replacement tire market, which was about four times larger than the OEM market, and was growing faster because the owners of highly durable cars were keeping them longer. Although the major competitors controlled 57 percent of the replacement market, Cooper doubled its share of the balance between 1986 and 1993 to 23 percent. In fact, Cooper made 11 percent of the 226 million replacement tires sold in North America in 2011 (Exhibit 2).

Cooper had a broad customer base in North America, which included private label tires which were manufactured by the company but marketed and distributed by the company's customers, and purchasers of house brand tires that were marketed and distributed by the company.

Private brands included Sears, TBC, Hercules, Pep Boys, American Car Care Centers, ProComp Tires, and Tires Less Schwab. Over the past recent years, price pressure on private label tires had increased, where the price differential between major brands and private labels had been squeezed. But Cooper management believed that private label tires played a very important role in the replacement tire market. Private label tires were an excellent value and provided the distributors and dealers with the ability to call their marketing shots and maintain product control in their local markets. It was believed that the strong private brands with distributors and dealers who provided good service would continue to prosper.

The other half was primarily sold under its house brand Cooper, Mastercraft, Starfire, Dick Cepek, Chengshan, Dean, Avon and Roadmaster house brands through independent tire dealers and wholesale distributors. Independent dealers and distributors remained crucial to the company's success. They accounted for an estimated 67 percent of replacement tire sales since they were the main suppliers to car dealer franchises, muffler shops, and service stations. According to the retail tire customer survey, "the independent dealers helped customers choose a brand of tires to buy 79 percent of the time. The customers were more

likely to stay with the recommended replacement tire brand suggested by the dealer for the first set of tires than for subsequent sets.” (Modern Tire Dealer, 2011).

Cooper focused relatively modest marketing budget on supporting its independent dealers, mainly by providing superior service and delivery and by offering a value-priced product. Cooper advertising programs assisted dealers and distributors with promotional materials in their local markets. Co-op advertising allowances were based on annual dealer purchases and were applicable to all types of media. The Cooper’s house brands were growing a little faster than its private label business. Dealers loved Cooper because unlike Goodyear, it did not have company retail stores to compete against them and provided them with the highest gross profit margins in the industry—33% vs. an average of 28% for competing brands.

Product shipments to customers were directed through a strategic, nationwide network of distribution centers, which ensured timely deliveries to customers. A new management information system was introduced to further streamline inventory and order-processing operations and to provide even better service to customers.

### **Research and Development (R&D)**

The company also saved on R&D. Cooper generally directed its research activities toward product development, improvements in quality, and operating efficiency. While other tire makers incurred high R&D expenses to capture a share of the OEM tire market segment, Cooper has been able to produce tires with a proven track record and sell them to value-oriented customers. Instead of pioneering its own designs, the company waited to see what sold well as original equipment, and then produced the winners. According to Gorr, “All we have to do is produce the winners.” (Taylor, 1992). Original tires on new cars normally lasted up to four years; therefore, the company had been able to reduce speculative research and development expenditures and had ample time to produce its own versions. The major tire companies were spending freely, 2.5 percent to 3 percent of revenues on R&D. In 2011, Cooper spent 1.1 percent of its revenue on R&D.

### **Choosing Plant Locations**

Moving into low-cost regions has been one of Cooper’s winning strategies, and the company intended to continue utilizing this strategy in the future for further growth of the company. This has been another factor in Cooper’s superior performance having its plants in small-town locations. Cooper wasted no money on frills, not even on utilization of its headquarters in the small town of Findlay, Ohio. Getting attention wasn’t Cooper’s style. When Cooper wanted to add capacity, it did so cheaply by buying old plants and retrofitting them. This had been made possible by the fact that more than 35 tire plants in U.S.A had been shut down since the 1970s. Cooper had a good engineering department, which designed and built the company’s own production equipment as well as adapting and modifying other equipment to meet its own needs and specifications. This engineering team also continually monitored advances in new technology for possible incorporation into Cooper’s manufacturing processes.

Cooper’s tire plants were in places like Tupelo, Mississippi, and Texarkana, Arkansas, where the company was a master employer. In these small towns, Cooper employees at all levels and their families constantly interacted in community churches and organizations. This seemed to develop a feeling that everyone had a stake in the future of the company. Some analysts believed that Cooper’s small-town locations permitted it to pay lower salaries and to reap other savings over companies in urban sites. Most Cooper

employees grew up in and around the rural areas where the company's tire plants were located. Employees drawn from these smaller communities tended to make a more long-term commitment to the firm and to exhibit a stronger work ethic than employees from larger and more mobile communities.

With ever increasing competition within the tire manufacturing industry, there was a trend of establishing its own manufacturing plants in regions where costs were low. Cooper was also investing more in Asian and South American regions. The investment ranged from establishing its own plant to entering a joint venture with an already established manufacturer. There have also been acquisitions of already established plants in such countries. Cooper ran its plants at 100% capacity while others operated at about 80%. In a capital-intensive industry, that creates lots of leverage. Its Tupelo Mississippi factory ran 24 hours a day, seven days a week.

## **Raw Materials**

Over 200 raw materials were used in manufacturing tires. The primary raw materials used for tire production were synthetic rubber, carbon black, natural rubber, rubber chemicals, steel wire, steel cord, polyester and adhesives. Petroleum and natural gas were important for some production of these materials such as rubber and carbon black. Crude oil was the largest raw material cost; about 10 gallons of crude oil was consumed when manufacturing an average-size passenger car radial tire. Raw material costs for a typical passenger car radial were about \$16 (Thompson, 1993). Large economies of scale were very helpful in the industry, as the tire buyers were price sensitive. Cooper's cost of goods sold breakdown are shown in Exhibit 5.

Several Tire manufacturers had integrated backward into rubber manufacturing, and tire fabrics supply. However, there was no evidence that these manufacturers had gained a meaningful cost advantage or had better ability to differentiate their products on the basis of quality. However, in 1993, Cooper opened a purchasing office in Singapore to acquire natural rubber and various materials directly from producers in the Far East. According to management, this purchasing operation enabled the company to work directly with producers to improve the consistency of quality and to reduce the costs of materials, delivery and transactions. Cooper's inventory control policies and procedures were believed to be very efficient—buying ahead on occasion to get the best deals, but no hedging on raw materials.

The industry has not experienced any significant raw material shortages over the past years. In fact, all of the raw materials were commodities, available in bulk from a variety of sources on world markets. Raw materials prices in 2012 demonstrated volatility as prices started the year at an elevated level and declined steadily through the end of the year with the full-year average index down 7% compared to 2011.

In 2012, there was a worldwide crunch for natural rubber (NR), and the rapidly rising NR prices were a major concern for all tire manufacturers. The worldwide shortage of NR was arising mainly due to production cuts in Malaysia and shifting plantations more towards palm oil, the growing usage of NR in radial tires and an increasing demand in China. In the future, usage of more synthetic rubber and the partial replacement of NR by synthetic polyisoprene were expected to rise. Even though natural rubber was traded above \$2 per kg, it was still the first choice for radial truck tire manufacturers because of its excellent physical and mechanical properties, and better adhesion to steel cord.

Volatility in raw material pricing was a factor in Cooper's pursuit of alternative material sources that required innovative technology. In 2012, Cooper along with partner organizations, received a \$6.9 million grant from the U.S. Department of Agriculture to evaluate the U.S. grown guayule plant as an alternative source of natural rubber.

## Operations policy

The company made great strides in developing a participative, cooperative, and less hierarchical work climate. Cooper's management had long recognized that the performance of dedicated employees could make a difference where one or more competitors sell products with very little difference among them. Therefore, Cooper was always seeking motivated employees who were team players and good communicators, and who had the right attitude toward their jobs. Employees became involved at all levels of the organization, especially in the areas of productivity, quality assurance, and customer service. Monthly meetings were held in each department to update workers on new developments and to solicit their suggestions and information about problems.

Cooper's employee recruiting process was operated by examining applicants through a series of screening procedures. Those applicants who passed the initial screening were motivated people—team players and good communicators—with the right attitude and personality to fit the job for which they had applied. Then they took two pencil-and-paper tests, one of which was keyed to a video tape, followed by a one-on-one behavioral-type interview with a supervisor. Those who made it through the preliminary screening were placed in groups, working on problem-solving in situations involving some stress.

All new Cooper employees received a basic, two-week training and orientation course. Each new employee's spouse was also asked to come in to learn what it meant to work for Cooper and why the company considered an employee's spouse to be part of the team. Training courses were designed to meet the specific needs of each employee. After spending two weeks in the basic course, an employee's training could continue for anywhere from three days to over a year. Cooper's management scheduled working hours and shifts so as to allow employees ample days off for participating in community activities so as to develop a family atmosphere at the plants.

An innovative system of incentive was a driving force for Cooper's employees. Cooper's compensation system, in which the earnings of everyone from the CEO to line workers rise and fall with the individual performance and contribution to productivity, instilled loyalty. Executive compensation was tied to performance benchmarks and provided for cuts, as well as raises of up to 30 percent. Profit-sharing opportunities and paid incentives also augmented paychecks of Cooper's blue-collar and clerical workers. Hourly workers got paid extra for producing more, and salaried employees could earn bonuses of up to 7.5 percent based on the return on assets they worked with. In fact, although incentive programs were offered to every Cooper employee, none of them was based on market share.

Employee turnover was discouraged by Cooper's stock option plan. Cooper had a very low (3.1 percent) turnover rate, and absenteeism was at one-tenth of 1 percent. For staff and management alike, a long tenure with the company was the norm. According to Gorr, "We grow our talent and we motivate them with ownership, identity, and pride. The non-performed leaves us very quick." Some pointed to Cooper's tight fiscal controls, its high productivity, and its low-cost manufacturing efficiencies as the key ingredients of its strategy. But Mr. Gorr insisted that the heart of Cooper's success wasn't anything more complicated than a lot of hard work, an obsession with quality, and a devotion to the dealers.

All of Cooper's managers were substantial stockholders, as were many workers. Cooper's stock purchase program has been very rewarding for many employees. The stock rose an astonishing 6,800% during the 1980s, richly rewarding many longtime employees who have invested in the company. According to management, "take a worker who made \$6,811 in 1965 and was earning \$36,774 at the end of 1985. Had he faithfully invested 6% of his salary in Cooper stock, matched by the company, he would own 43,807 shares worth \$2.2 million" (Byrne, 1994). About fifteen percent of Cooper's employees were unionized, a

figure considerably lower than of its rivals. The company had a new contract at one of its two unionized plants in 1994, and the other plant's contracts were reviewed in 1995.

Cooper's quality control policies and procedures were managed by specific staff, but a great deal of the responsibility for quality rested with the individual worker, who was trained to do his own quality-assurance checks. Quality had become such a big part of Cooper's culture that they usually didn't think to talk about it anymore. Employees received as many as 900 hours of training, and signs bearing such slogans as "Quantity is Important, but Quality is MORE Important" hung from factory walls. To symbolize a personal commitment to quality, each tire carried not only a brand name, but also a sticker identifying the worker who built it. It was believed that this helped foster pride in workmanship among Cooper's workers and created a bond with the consumers buying the tires. As a leader of the 215,000 member U.S. Chamber of Commerce, Gorr travelled frequently, carrying the message that there is no substitute for producing quality products and being sensitive to customer needs in today's competitive global marketplace.

### COMPETITIVE ENVIRONMENT

A decade ago, a dozen major tire manufacturers, half of them American, vied for world leadership. In 2011, just four giant global tire companies were dominant, accounting for 49% of worldwide tire sales and included only one U.S.-headquartered company: Goodyear Tire and Rubber Company. Goodyear, the leader for decades, was contending for fourth place (Exhibit 6). In 2012, tire capacity, not production, in North America totaled 322 million tires at 51 plants. U.S. capacity was 262.3 million tires, 81.5% of total North America capacity. There were 37 tire manufacturing facilities in the U.S. down from 48 plants 11 years ago (see Exhibit 1).

The global automobile tire market was highly consolidated and consists of passenger car tire, heavy truck tires, and other segments. Within 1985 and 1990, foreign companies have bought out most of the best-known American labels, including Firestone and Armstrong (Hicks, 1990). In 1989, Michelin Group had agreed to acquire Uniroyal Goodrich Tire Company in a deal valued at \$1.5 billion. This acquisition would sharply boost the size of Michelin to one of the world's largest tire company (Hicks, 1989). In the United States, aside from Goodyear, only the smaller Cooper has remained independent. Exhibit 6 shows the world's 15 largest Tire Manufacturers in 2011. Consolidation has intensified competition to cut production costs and increase quality. North America dominated this market with approximately 30% of the global total in 2011. Europe emerged as the highest potential market followed by Asian Pacific (APAC) and North America. A combination of factors such as vehicle sales, government regulations, and environmental factors impacted market dynamics significantly.

In response to a petition filed by the United Steel Workers with the U.S. International Trade Commission, the Obama Administration imposed punitive tariffs on Chinese tires for three years, starting in September 2009 (Weisman, 2009). A World Trade Organization (WTO) panel determined in December 2010 that the U.S. tariff measures were in compliance with its WTO obligations. The higher tariffs also have caused an increase in imports of low-cost tires from countries other than China, notably Thailand and Mexico, but have not led manufacturers to shift production back to the United States. In 2012, a three-year tariff on the import of Chinese tire was set to expire.

Year 2012 was a record year for global production and shipment of light vehicle tires with worldwide production reaching 1,460 million tires in 2012 (see Exhibit 7). Over the years, tire supply/demand was tight globally and particularly in North America. Tire manufacturers have increasingly moved production of replacement tires from the United

States to Asia, especially China, as imports undercut sales of domestically produced tires. Chinese production capacity far exceeded Chinese domestic demand for tires, and China had pursued an aggressive export agenda. The Asia/Pacific region was by far the largest production region for light vehicle tires, accounting for over one-half of global light vehicle tire production in 2012. Sales of motor vehicle tires in China were the second highest in the world, behind only the USA.

Although tire manufacturing was relatively capital-intensive, there was significant labor content. Labor costs ran from about fifteen to forty percent of total costs, depending on wage rates and labor productivity. Industry observers were predicting increased worldwide sourcing of tires from countries having the lowest labor costs, with Korea, Mexico, and Brazil becoming increasingly attractive production locations. Several major tire manufacturers were considering plant locations in low-wage countries. Shipping costs for tires made in foreign countries and then marketed in the United States were approximately \$1 per tire in 1992.

According to Lucintel, a leading market research firm, Asian Pacific (APAC) was expected to attain the highest growth in rubber demand during the five years (2012-2017) forecast period, reflecting strength in China, India, Thailand and Vietnam. The global automobile tire industry market was forecast to reach an estimated US \$187 billion in 2017 with a CAGR of 4% over the forecasted five years. The passenger car segment was forecast to see the strongest growth during the forecast period. Lucintel's research also indicated that although volatile raw material prices and higher dependency of the suppliers on the OEMs were market challenges, the increasing per capita income in developing nations, population growth, new infrastructural projects, urbanization, increase in middle class population, and green movement all were expected to drive growth in the industry (Lucintel, 2012).

Tire industry comprised of two distinct markets: (1) the original equipment (OEM) market, and (2) the replacement market. Both markets included passenger car tires, light, medium, and heavy truck tires, and farm vehicle tires.

### **The Original Equipment Market**

Auto manufacturers bought all of their tires directly from tire manufacturers. No auto producers have integrated backward into tire manufacturing as they have into other component vehicle parts. Competition among the tire manufacturers to supply tires to the auto manufacturers has been fierce. Since tires were such a small cost item in the overall price of new vehicles, changes in OEM tire prices have virtually zero effect on total OEM tire demand (Thompson, 1994). The demand for OEM tires was directly related to the number of vehicles produced and it was highly elastic to the ease with which motor vehicle manufacturers could switch to other tire manufacturers' brands. However, the vast majority of OEM tires used on American made vehicles were made in the United States in order to reduce carmakers' supply-chain risks and to protect the tire manufacturers' proprietary production processes (Thompson, 1993). All the major tire manufacturers were eager to have new vehicles equipped with their own brands in order to enhance replacement tire sales. Sale of OEM tires was thus seen as strategically important, not only as a way to strengthen sales in the more profitable replacement segment but to achieve economies of scale in manufacturing.

Vehicle manufacturers set detailed tire specifications for each of their vehicle models, and tire producers must meet those specifications if their tires were to be considered original equipment. The automobile companies bought tires in large quantities and, since the number of buyers was low, they could usually negotiate low prices. Using this leverage over the years, the automakers have managed to negotiate an average price for an OEM tire that was several dollars below what wholesale distributors paid tire manufacturers for a replacement

tire of similar quality. In effect, the auto companies bought OEM tires for roughly half the retail price commanded by replacement tires. As a result, the original equipment market has become a low-margin one relative to the replacement tire market.

### **Replacement Tire Market**

The larger portion of the consumer tire market involved replacement tires that were sold to consumers through various retail channels. The postwar era was one of expansion for the tire industry as a result of several converging growth factors. More disposable income enabled more Americans to own cars. Americans experienced the expansion of the interstate highway system and the postwar trend toward suburbanization. This meant more wear and tear on tires and increasing demand for replacement tires. Furthermore, the rail system was being replaced rapidly by buses, taxis, and trucks for local and long-distance transportation.

Demand for replacement tires depended on factors such as per capita disposable income, the average age of a car, the durability of tire tread, the number of cars in circulation, the average number of miles driven, and gasoline prices. Any reduction in new car sales was considered good news in the replacement market because it meant that drivers were hanging on to their cars longer. Even in a strong economy, used car sales rose along with those of new cars, and motorists also spent more time on the road, further increasing the demand for replacement tires. The per capita income was low during the recession, thus the tire sales suffered especially in 2008 and 2009. The consumers were cutting back on spending by holding back on tire replacement, and the OEMs had halted production lines. Since 2006, unit shipments of replacement tires have been flat every year (see Exhibit 8 for volume trends in the United States by segment).

The total vehicle miles were also a useful indicator in determining the replacement tire demand, because a high usage of tires would have resulted in the increase of replacement tire sales. Due to the recession in 2008 and 2009, the budget-conscious consumers had increased, and these consumers wanted tires that could increase gasoline efficiency of their vehicles. This demand had caused tire manufacturers to invest in technologies to produce tires such as low-roll resistance. Total vehicles miles increased by 10 billion miles in 2012. In fact, in 2012, U.S. drivers almost reached the 3 trillion mark. That has happened only twice, according to the U.S. Department of Transportation. In 2006, miles driven totaled 3 trillion; in 2007, they hit a record 3,030 trillion (see Exhibit 9).

Independent tire dealers usually carried the brands of several different major manufacturers as well as a discount-priced private-label brand, providing replacement buyers with a full assortment of brands with varying tread design, widths, durability, quality, and price attributes. Over the years, independent tire dealers handled about 61 percent of replacement tire market, and controlled 77 percent of the market share (Exhibits 10 & 11).

Surveys showed dealers were able to influence a car owner's choice of replacement tires. Studies also showed that most replacement tire buyers did not have strong tire brand preferences, making it easy for tire salespeople to switch customers to tire brands and grades with the highest dealer margins. Dealers normally pushed their private-label tires because profit margins were higher compared to name-brand tires of major manufacturers. Independent tire dealers ran frequently price promotion ads in the local newspapers, making it easy for price-sensitivity buyers to watch for sales and buy at off-list prices.



## Retreaded Tire

The retread tire was made by using the tire's casing and removing its old (worn) treads professionally by machine buffing and replacing it with a new tread. The new tread was put on the casing using a process of pressure and heat and was mold-cured. This added better grip, improved reliability and top-grade tire performance at a reasonable price. New tires were built in layers. The tread layer was the portion of the tire that came in the most contact with the road. Retread tires were not used tires, but rather refurbished tires with newly added grip and improved performance in all road conditions. In the past, retread tires had been widely used by some vehicle users. Retread tire buyers were very price conscious. In 2010, the retreaded tire segment was very small and was declining partly because buyers could purchase a new, more reliable set of tires for about \$100 more than the cost of retreads. The size of the U.S. passenger car retread market dropped from 6.6 million units in 1993 to about 3.1 million units in 1996.

Engineering advancements have made it easier to transfer the technologies from new tires to retreads, according to some experts. "In compounding, designing and manufacturing, Marangoni Tread North America is working continuously to improve and innovate its retread technology," said Giampaolo Brioschi, product marketing manager. "The goal is for fleets to benefit from better reliability, performance, ride, tread fitment and less distortion, resulting in cooler running temperatures, longer wear and lower rolling resistance" (FleetOwner, 2013).

Compliance with the U.S. Environmental Protection Agency's SmartWay program was an important part of all retread manufacturers' long-term commercial tire strategies. In June 2012, EPA announced its SmartWay low rolling resistance requirements for retreaded truck tires. To obtain SmartWay compliance, EPA has determined that certain retread technologies could reduce emissions and fuel use by 3% or more when verified retreads were used on both drive and trailer axles along with verified low rolling resistance steer tires, and when all tires were properly inflated according to manufacturer specifications. "SmartWay is a goal when we are developing new retread products for long haul and regional applications," said Marangoni's Brioschi. "Our R&D department, which is fully committed to achieving SmartWay objectives, keeps improving design technology" (Fleet Owner, 2013).

## FUTURE OF THE COMPANY

On October 11, 2012, The Economic Times reported that Apollo Tyres, one of India's leading tire makers was in the process of acquiring Cooper (Poddar, 2012). It also stated that a controlling stake in Cooper could be in the range of \$600 - \$800 million. This acquisition would give Apollo an access to the huge replacement tire market in the passenger, light and medium trucks segment in which Cooper operates. Of course, like nearly all buyout rumors, this information was based on "sources with direct knowledge" of the deal. But this didn't stop shares of Cooper from moving on the news.

Apollo which has acquired Vredestein in East Europe and Dunlop South Africa in the past was carrying a highly leveraged balance sheet. Its debt was about 2.549 crore, according to a research report by IFCI Financial Services dated September 7, 2012 (Poddar, 2012). Apollo posted net sales of 12,153 crore and a net profit of 409 crore for financial year 2011-12. According to *The Economic Times*, sources suggested that Apollo could be raising close to \$600 million of debt for which the advisor to the deal, Standard Chartered Bank, has already initiated the process (Poddar, 2012).

In September 2012, Cooper insiders owned less than one percent of total shares outstanding and more than 90% of the company's common shares were floated. Cooper's shares were trading at the year-to-date high of \$23.40, which the stock reached in September

2012. Net sales for third quarter, 2012 were a record for any quarter of \$1.1 billion, an increase of \$47 million compared with the same period a year ago. Operating profit was a record for any quarter of \$130 million, \$82 million higher than third quarter 2011. Net income attributable to Cooper was a third quarter record of \$74 million, or \$1.17 per share on a diluted basis, and compared with \$17 million or \$0.27 per share for the same period in 2011.

In October 2012, Taesik Yoon, an analyst in *Forbes* responded to the report of the Economic times, by saying that “it would be difficult for me to believe that Cooper would be willing to sell the firm at these low multiples, especially at a time when the company’s operations are performing at their strongest levels in two years.” (Yoon, 2012).

Year 2012 was a year of distinction for Cooper that demonstrated they could meet or beat the competition across a wide range of industry and global conditions. Delivering innovative, high quality products was key to Cooper’s success and central to its value proposition. During 2012, Cooper continued to see strong consumer demand for its new tires, which continued to take hold in the marketplace and earned significant third-party endorsements. In fact, the RS3-A model was the tire selected by Ford Motor Company as original equipment on its 2013 Ford Focus Titanium and SE models. This represented Cooper’s first ever U.S. passenger car OEM tire fitment.

Cooper posted net income of \$92 million on net sales of \$1,746 million for the six months ended June 30, 2013. That compared to net income of \$74 million on net sales of \$2,043 million for the same period in 2012. Its operating profit rose 16% from \$143 million to a six months record of \$166 million. For the remainder of 2013, Cooper expected uncertainty to persist in the global economic environment. It was expected that demand for tires would vary by region and likely remain sluggish compared to historical growth rates. Through its actions to launch new products and deliver exceptional value, the company believed that it could perform at or above the industry growth rates. According to CEO Armes, “The Company’s focus in the near future would continue to be guided by the Strategic Plan, which calls for achieving profitable top line growth, improving its global cost structure and improving organizational capabilities” (Barron’s, 2013).

<b>Exhibit 1</b>						
<b>NORTH AMERICAN TIRE PLANT CAPACITIES 2012 (in thousands of units)</b>						
Company/Plant Location	# of Plants	Passenger Per day	Light Truck per day	Truck Per day	Others per day	Total per day
Goodyear (Dunlop, Kelly)	9	189.8	38.9	18.4	6.15	253.3
Michelin (Uniroyal Goodrich)	13	162.5	26.5	7.0	4.59	200.59
Bridgestone/Firestone	9	84.8	21.6	14.2	4.76	125.36
Cooper (US & Mexico)	3	73.0	24.0	2.8	0	97
Carlisle Rubber	2	0	0	0	41	41
Continental Tire North America	1	28.0	8.0	4.5	0	40.5
Yokohama/Mohawk	1	23.0	1.0	0	0	24
Grupo/Euzkadi (Continental AG)	1	15.0	5.0	0	0	20
Coporacion de Occidente SA	1	10.0	7.2	2.8	0	20
Titan Tire Corp	3	0	0	0	19.68	19.68
JK Tyre & Industries	3	10.0	5.0	2.0	1.04	18.04
GTY – General/Toyo/Yokohama	1	0	0	7.3	0	7.3
Toyo Tire North America	1	6.0	1.0	0	0	7
Specialty Tires America	2	0	0.4	0	6.2	6.6
Pirelli Tire	1	1.2	0.5	0	0	1.7
U.S. Totals	37	483	106.3	51.42	77.88	718.63
Canadian Totals	7	61.3	11.2	0	4.5	77.0
Mexican Total	7	59	21.6	4.8	1.04	86.40
TOTAL	51	603.3	139.1	56.25	83.42	882.07

Source: Modern Tire Dealer

<b>Exhibit 2</b>			
<b>2011 U.S. REPLACEMENT CONSUMER TIRE BRANDS</b>			
<b>Passenger Tires</b> <b>(Based on 198.0 million units)</b>		<b>Light Truck Tires</b> <b>(Based on 28.0 million units)</b>	
Goodyear	14.0%	Goodyear	11.5%
Michelin	8.5%	BF Goodrich	9.0%
Bridgestone	8.0%	Bridgestone	8.0%
Firestone	7.0%	Michelin	7.0%
BF Goodrich	5.0%	Firestone	6.5%
Cooper	5.0%	Cooper	6.0%

Source: Modern Tire Dealer

<b>Exhibit 3</b>					
<b>FIVE-YEAR FINANCIAL AND OPERATING SUMMARY, COOPER TIRE &amp; RUBBER, 2008-2012</b>					
<b>(in millions, except per share data)</b>					
<b>FOR THE YEAR</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
Net Sales	4,200.8	3,907.8	3,342.7	2,778.9	2,881.8
Cost of products sold	3,546.6	3,562.8	2,940.3	2,359.9	2,805.6
Gross profit	654.2	345.0	402.4	419.0	76.2
Selling, General & Administrative	257.3	181.7	193.4	207.0	185.1
Impairment of Good will	---	---	---	---	31.3
Restructuring	---	---	20.6	48.7	76.4
Operating profit before taxes	396.9	163.3	188.4	163.3	(216.6)
Interest expense	(29.5)	(36.2)	(36.6)	(47.2)	(50.5)
Interest income	2.6	3.2	5.2	5.2	12.8
Other income – Expense	(1.5)	3.8	2.8	1.3	(3.5)
Income (loss) before income taxes	368.4	134.1	159.8	115.5	(257.8)
Provision (benefit) for income taxes	(116.0)	135.5	(20.1)	(0.2)	30.3
Income (loss)- from continued operations	252.5 (32.1)	269.6 (16.1)	139.7 (23.4)	115.3 (31.9)	(227.5) 8.1
Noncontrolling shareholders' interests	220.4	253.5	116.3	83.4	(219.4)
Income (loss) from operations attributable to Cooper stockholders	=====	=====	=====	=====	=====
Net earnings (loss) per share:	3.52	4.08	1.90	1.57	(3.88)
Basic	3.49	4.02	1.86	1.54	(3.88)
Diluted	0.42	0.42	0.42	0.42	0.42
Dividends declared per share	5.3%	6.5%	4.2%	1.9%	-7.6%
Percentage of net earnings to net sales	24.3%	36.3%	26.8%	11.2%	-57.6%
Return on average stockholders' equity	187.3	155.4	119.7	79.3	128.8
Capital expenditures	128.9	122.9	123.7	123.5	142.8
Depreciation & Amortization					
<b>AT THE END</b>	351.8	233.7	413.4	427.0	247.7
Cash, cash equivalents	1,449.7	1,264.0	1,340.2	1,131.8	1,004.2
Current assets	655.1	651.0	694.2	636.3	707.5
Current liabilities	794.6	613.0	646.0	495.5	296.7
Working capital	2.21	1.94	1.93	1.78	1.42
Current ratio	929.3	899.0	824.7	839.4	886.0
Net property, plant, and equipment	2,801.2	2,510.0	2,305.5	2,100.3	2,042.9
Total assets	336.1	329.5	320.7	331.0	325.7
Long-term liabilities	1,892.7	1,812.0	1,782.4	1,636.2	1,661.9
Total liabilities	908.4	697.9	523.1	464.1	381.0
Stockholders' equity	62,561	62,150	61,299	59,439	59,048
Average Common Shares (000s)	13,550	12,890	12,898	12,568	13,311
Employees					

Source: Cooper Tire's Home Page

<b>Exhibit 4</b> <b>COOPER'S GROWING PRESENCE IN THE MARKET FOR TIRE</b> <b>1983 – 2012 (in thousands, except per share and dividend data)</b>					
<b>Year</b>	<b>Net Sales</b>	<b>Operating Profit Before Taxes</b>	<b>Net Income</b>	<b>Net Income Per Share</b>	<b>Dividend per Share</b>
1983	457,780	39,796	21,406	0.27	0.04
1984	555,388	41,978	23,578	0.31	0.05
1985	522,639	31,157	18,471	0.23	0.05
1990	859,896	104,874	66,464	0.81	0.11
1991	1,100,071	124,465	79,435	0.96	0.13
1995	1,493,622	180,070	71,250	1.35	0.27
1999	2,196,343	215,497	79,600	1.79	0.42
2002	1,742,218	113,716	55,032	0.74	0.42
2003	1,850,853	65,019	27,344	0.37	0.42
2004	2,081,609	63,224	27,446	0.37	0.42
2005	2,155,185	26,435	(15,033)	(0.24)	0.42
2006	2,676,242	(9,749)	(85,890)	(1.40)	0.42
2007	2,932,515	134,392	91,435	1.46	0.42
2008	2,881,811	(216,633)	(219,383)	(3.88)	0.43
2009	2,778,990	156,269	83,359	1.54	0.42
2010	3,342,784	188,374	116,331	1.86	0.42
2011	3,907,838	163,301	253,503	4.02	0.42
2012	4,200,836	396,962	220,371	3.49	0.42

Source: Cooper Tire's Home Page

<b>Exhibit 5</b> <b>COST OF GOODS SOLD BREAKDOWN</b>	
<b>Input</b>	<b>% of CoGS</b>
• Labor	20-30%
• Other	15-30%
• Raw Materials	50-55%
<b>Raw Material Breakdown</b>	<b>% of RM</b>
- Natural Rubber	20-25%
- Synthetic Rubbers	25-30%
- Carbon Black	10-15%
- Reinforcing Fabrics	10-15%
- Steel	10-15%
- Other Raw Materials	10-15%

Source: [www.docstoc.com/docs/79573233/CooperTire-\\_amp-Rubber-Company-Strategic-Plan-and-Vision](http://www.docstoc.com/docs/79573233/CooperTire-_amp-Rubber-Company-Strategic-Plan-and-Vision)

<b>Exhibit 6</b> <b>THE WORLD'S 20 LARGEST TIRE MANUFACTURERS IN 2011</b>			
<b>Company</b>	<b>Country</b>	<b>2010 Sales</b>	<b>2011 Sales</b>
Continental AG	Germany	\$34,500	\$40,600
Bridgestone Corp.	Japan	34,900	38,903
Group Michelin	France	23,500	26,829
Goodyear Tire & Rubber Co.	U.S.	18,800	22,800
Sumitomo Rubber	Japan	7,400	8,732
Pirelli & C ApA	Italy	6,400	7,323
Yokohama Rubber Corp.	Japan	6,200	6,000
Hankook Tire Co.	South Korea	5,100	5,841
Cooper Tire & Rubber Co.	U.S.	3,300	3,900
Toyo Tire & Rubber Co.	Japan	3,500	3,794
Hengzhou Zhongce Rubber Co.	China	2,500	3,520
Cheng Shin Rubber/Mixxis	Taiwan	2,900	3,479
Giti Tire	China	546	2,890

Triangle Group Co.	China	3,300	2,520
Kumho Tire Co.	South Korea	2,400	2,450
Apollo Tyres Ltd.	India	1,900	2,224
MRF Ltd.	India	1,800	1,947
Nokian Tyres Plc	Finland	990	1,886
Shandong Linglong Rubber Co.	China	2,200	1,700
Aeolus Tyres Plc	China	1,199	1,580

Source: [http://www.tirereview.com/Content/Site309/ContentBlocks/919902012TireMa\\_00000056257.pdf](http://www.tirereview.com/Content/Site309/ContentBlocks/919902012TireMa_00000056257.pdf)

<b>Exhibit 7</b> <b>GLOBAL LIGHT VEHICLE TIRE PRODUCTION (in millions, 2007 – 2012)</b>						
<b>Year</b>	<b>North America</b>	<b>South America</b>	<b>Europe</b>	<b>Asia</b>	<b>Other</b>	<b>Global</b>
2007	215	63	380	580	57	1,295
2008	200	66	335	624	65	1,290
2009	180	58	320	580	47	1,185
2010	200	64	340	735	48	1,387
2011	200	65	345	770	49	1,429
2012	200	65	345	800	50	1,460

<b>Exhibit 8</b> <b>U.S. TIRE SHIPMENTS (in millions)</b>							
<b>Year</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
<b>Passenger:</b>							
Replacement	196.2	204.0	193.8	189.5	200.6	195.0	197.0
Imports	104.1	116.4	118.9	100.6	120.4	120.6	N/A
OE	48.2	46.3	37.6	24.6	33.2	35.7	40.0
<b>Light Truck:</b>							
Replacement	33.6	34.2	29.4	27.5	28.5	28.5	29.0
Imports	24.0	24.0	20.3	17.3	20.6	20.7	N/A
OE	5.0	4.4	2.9	2.8	3.7	4.2	3.9
<b>Medium Truck/Bus:</b>							
Replacement	16.9	16.6	14.8	12.9	15.8	16.5	17.8
Imports	12.8	11.0	9.4	6.7	8.8	10.3	N/A
OE	6.8	4.7	3.8	2.4	3.3	4.9	5.5

Source: Modern Tire Dealer

<b>Exhibit 9</b> <b>MILES DRIVEN ON U.S. ROADS (All Vehicles)</b>	
2012 = 2,972 trillion	2009 = 2,978 trillion
2011 = 2,962 trillion	2008 = 2,974 trillion
2010 = 2,999 trillion	2007 = 3,030 trillion

Sources: U.S. Department of Transportation, Modern Tire Dealer

<b>Exhibit 10</b> <b>U.S. CONSUMER TIRE RETAIL MARKET SHARE</b> <b>(Based on Retail Sales)</b>		
<b>Distribution Channel</b>	<b>2011</b>	<b>2010</b>
Independent tire dealers	61.0%	60.0%
Mass merchandisers	14.0%	14.5%
Warehouse clubs	8.50%	9.50%
Tire company-owned stores	7.50%	7.00%
Auto dealerships	2.50%	3.00%
Miscellaneous outlets	2.50%	3.00%

<b>Exhibit 11</b>				
<b>U.S. CONSUMER TIRE DISTRIBUTION CHANNEL MARKET SHARE</b>				
<b>Initial channel</b>	<b>2011</b>	<b>2009</b>	<b>2007</b>	<b>2005</b>
Independent tire dealers	77.0%	75.0%	74.0%	74.0%
Tire company stores	8.0%	8.5%	8.5%	8.0%
Miscellaneous*	15.0%	16.5%	17.5%	18.0%

\*Indicates mass merchandisers, warehouse clubs, car dealers, auto part chains, oil companies/service stations

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# **ELECTRICAL AND ELECTRONIC EQUIPMENT CLUSTER IN THAILAND: CAN COMPETITIVENESS BE REGAINED?**

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## **CASE DESCRIPTION**

*The primary subject matter of this case concerns Competitiveness Strategy. Secondary issues examined include Industry Analysis, Economic Clusters, Economic Policies, Regional Positioning, and Emerging Economies. The case has a difficulty level of five, appropriate for first year graduate level. The case is designed to be taught in three class hours and is expected to require five hours of outside preparation by students.*

## **CASE SYNOPSIS**

*In April 2015, General Prayut Chan-o-cha, the 29<sup>th</sup> Prime Minister of Thailand who took over the government to end the political crisis in May 2014, announced upon assuming control of the country that Thailand needed a dramatic reformation before the next democratic election. Now that the country was going through an economic recession, he was pressured to urgently address how to reform the country's economy. In particular, the National Reform Council raised a key issue that the Electrical and Electronic Equipment (EEE) cluster, which had long been the most valuable exported product category providing large employment opportunities, was experiencing a diminishing growth rate. The council demanded directions from the country's leader as to how to resolve the challenges in the EEE cluster and regain the country's competitiveness in the world economy.*

*There had been a few warning signs revealing that the Thai EEE industry was experiencing major challenges. A number of foreign firms had relocated their production to neighboring countries with lower labor costs in response to Thailand's recent announcement of the new higher minimum daily wage. The amount of FDI in the EEE sector had been decreasing during the past few years. Furthermore, the share of export revenues of EEE products, although still large, had shown a downward trend over recent years.*

*A formal meeting with the National Reform Council had been scheduled exactly one week from now and Prime Minister Chan-o-cha needed not only to investigate the problems related to Thailand's EEE cluster but to examine the current development status of the EEE cluster in Vietnam and China, the prime competitors of Thailand in this cluster. Prime Minister Chan-o-cha pondered how he should respond to these challenges facing the key cluster of the country, and in which direction should Thailand be geared towards in order to regain and sustain its competitiveness.*

On a hot summer day in April 2015, General Prayut Chan-o-cha, the 29<sup>th</sup> Prime Minister of Thailand, sat alone in his air-conditioned office, but felt as if he was sitting outside in the blazing sunlight – he could not stop worrying about the fallen status and diminishing prospects of the nation's Electrical and Electronic Equipment (EEE) industry, long a key driver of the Kingdom's overall competitiveness. Not only had the industry been for many years the single most valuable export product category, generating more than \$45 billion in 2014, but it was also a major provider of employment opportunities offering, around 400,000 jobs which contributed to approximately 7% of total employment in the manufacturing sector in 2012.

Furthermore, given the innovative nature of the EEE products, the industry was a significant conduit for the acquisition and development of new technologies. The health of the EEE industry also had important implications for other major export product categories, such as automotive and machinery & equipment, which required electrical and electronics parts in their production. The significance of the industry could hardly be over-stated in terms of the economic well-being of the nation.

For nearly three decades, Thailand had occupied the perch as one of Southeast Asia's top destinations for foreign direct investment (FDI) in the EEE industry by a variety of world-class companies, such as Seagate, Western Digital, Hitachi, and Sony, among dozens of others. In recent years, however, there had emerged unmistakable signs that the industry was losing its luster and its vitality, including its once nearly magnetic appeal to EEE investors. First, recent sizable increases in the national minimum wage in the absence of a corresponding increase in labor skills had prompted some international firms to relocate their production bases to nearby countries such as Laos PDR, Myanmar, Cambodia, and Vietnam – all nations with lower labor costs. Second, the magnitude of FDI had been rapidly diminishing from \$1,819 million in 2012 to \$1,340 million in 2013 and a mere \$988 million in 2014 (See Appendix 1). Third, the export value of the EEE products as percentage of total exports had been consistently declining over the last ten years, from 29% in 2005 to just 20% in 2011, and had ever since remained at about the same level through 2014. Not surprisingly, the recent Thai Electrical and Electronics Industry Sentiment Index, calculated based on the survey of EEE companies in Thailand in September 2014, received a score below 50, indicating that the overall confidence about the industry had worsened.

In the halls of both government and industry, concern had been mounting that unless steps were taken to arrest the trend, the Thai EEE industry seemed destined to play a diminished role in the economic life of the nation – with all the ensuing negative consequences on employment, trade earnings, and ultimately the competitiveness of Thailand. With the vital EEE industry thus under threat, Prime Minister Chan-o-cha, whose military government had been in control for nearly a year, could sense the expectation and feel the pressure to identify the causes of the trend and devise strategies to arrest and then reverse them – while there was yet time.

## **Overview of Thailand**

Located in the strategic center of the Southeast Asian peninsula and bordered by the Gulf of Thailand, Myanmar, Laos, Cambodia, and Malaysia, the Kingdom of Thailand was the world's 50<sup>th</sup> largest nation in land mass (513,115 square kilometers, or 198,120 square miles) and the 20<sup>th</sup> largest country in population (estimated in 2010 as slightly more than 67 million people). The country was divided into six regions (North, Northeast, East, South, West, and Central) plus the administrative region comprising the capital, Bangkok ("Krung Thep"), which was by far the most significant urban area in the country.



Demographically, the country was comprised of a majority of ethnic Thais, but also had a substantial population of persons of Chinese descent (14%), as well as a scattering of other distinct ethnic groups (e.g., the peoples of the several so-called “Hill Tribes”). Approximately 71% of the population fell into the 15-64 age groups; a significant portion (nearly 20%) was in the 0-14 age group; and slightly more than 9% were in the 65 years and older group. A 50:50 ratio of males to females pertained in each age group. The population growth was 0.566% as of 2011, which represented a decline from the previous year. While the culture of Thailand had been shaped by many influences, including the ancient civilizations of India, China, and Cambodia, Buddhism – the state religion, as well as the religious preference of nearly 95% of the population – had exerted the most profound influence on the ethos and mores of Thai society. The country was also alone among its Southeast Asian neighbors in the distinction of never having been a colony at any point in its long history.

Thailand enjoyed a high level of literacy, with nearly 93% of the population who were 15 years old and over able to read and write. Education was provided mainly by the Thai government through the Ministry of Education and was free through the first twelve years of school, but was compulsory only through the first nine years.

### **Thai Economy**

Thailand was an emerging economy and was considered a “newly-industrialized country,” with the main industries being electronics, automobile manufacturing, and agro-industry. As much as 27.4% of the land was arable, which enabled Thailand to be a major exporter of many agricultural products. In fact, it was one of the world's largest exporters of rice [6]. The country was also endowed with rich deposits of natural resources such as tin, rubber, natural gas, tungsten, gypsum and lignite. Although most of the country's labor force (43.3%) worked in the agriculture sector, manufacturing accounted for 40% of GDP, as compared to agriculture's 8.3%, as shown in Appendix 2.

Thailand was a heavily export-dependent economy, with exports accounting for more than two thirds of the gross domestic product. In descending order of export value, computers and parts, vehicles and parts, and electrical appliances were the country's major export items; crude oil and electrical machinery and parts were the main import items (see Appendix 3). Electronics was one of the largest industries in Thailand, amid a swelling global demand for high-technology consumer electronics such as mobile, computers, and telecommunication devices. Thailand had become a major destination for electronics industry investment. Nevertheless, this highly profitable industry faced competition from low-cost neighboring countries such as Vietnam, Laos, Cambodia, and Myanmar (see Appendix 6).

Another important source of revenues for Thailand was tourism, which accounted for a significant and growing share of the country's GDP (see Appendix 4). Bangkok, the capital city, attracted a large number of visitors each year. In 2011, Bangkok was named by the leading US travel magazine *Travel + Leisure* as “the world's best city.” The country attracted approximately 10 million visitors a year and collected close to \$20 billion. In 2013, there were 24.5 million tourists, up from 22.3 million the previous year. The target number of tourists in 2015 was 30 million.

## **The Great Flood in 2011**

During the 2011 monsoon season, Thailand experienced the worst flooding in its history, in terms of the amount of water, the number of people affected, and the damages caused to its economy. The flooding, lasting from July 2011 to January 2012, spread through the north, the northeastern, and the central parts of the country along Mekong and Chao Phraya river basins, resulting in 815 deaths and costing around \$72 billion in total damages. Sixty five out of seventy seven provinces were declared flood disaster zones, covering over twenty thousand square kilometers.

More than 800 factories in seven industrial zones in Thailand were damaged by the floods. The most heavily affected major industrial sectors included computer hard disk drives, electronic parts, and automotive. Following the floods, the country's economic growth had been reduced from 4.1% to 2.6 %. Shying away from the possibility of future floods, many investors moved their production bases from Thailand to other countries, resulting in the loss of approximately 660,000 jobs due to the factory closures.

Many social planners and academicians believed that flooding in Thailand could have been prevented. Some experts identified major causes of flooding as poorly designed drainage system as well as flawed urban planning. It was also pointed out that a number of factories were built on low-lying zones, or even floodplains, exposing them to higher risks from being flooded during a rainy season. Many reports indicated that Thailand's responses to floods could also have been much faster and more effective if there had been better coordination among government agencies and less redundancy in their roles. For example, in Bangkok areas, the flooding countermeasures were not implemented in a timely manner because the previous Prime Minister Yingluck Shinawatra's government, who was in charge during the 2011 flooding, had conflicts with the Bangkok Metropolitan Administration (BMA) led by the opposing political party. Such polarized political conflicts had long been observed in Thai politics.

## **Thai Politics**

Since the reformation of the absolute monarchy in 1932, Thai politics and government had been conducted within the framework of a constitutional monarchy, with a prime minister as the head of government and a hereditary monarch as the head of state. In concert with the traditional structure of parliamentary systems of governance, the Thai executive branch was also an active participant in the legislative branch of government. An independent judiciary with a supreme court of final authority comprised the third branch. Since the reformation, Thailand had undergone 18 military coups d'état and 18 constitutions and charters, reflecting a high degree of political instability. Moreover, throughout the reform period, Thailand had experienced a series of occasional political crises, such as Black May in 1992, and the recent Yellow Shirt and Red Shirt protests, which had again demonstrated the pronounced fragility and instability of Thai politics. The nation's polarized political situation since 2006 had endangered economic growth, with some major industries such as tourism having declined amidst recurrent protests in the country. Consequently, Thailand faced a scarcity of foreign direct investment as consumer and investor confidence dropped because of ongoing political conflicts.

The current government was formed after the most recent coup d'état, which took place on May 22, 2014. Since then, Thailand had been ruled under the military government, known as the National Council for Peace and Order (NCPO), led by General Prayut Chan-o-cha, later elected as Prime Minister, who assumed full control of the legislative branch. Thailand had then been under the martial law, with the military courts assigned responsibility for some cases that had formerly been under the civilian courts. Nevertheless, even without the constitution, the court system including the Constitutional Court still remained in existence.

As the NCPO took control of the country amid political instability and economic downturns, Prime Minister Chan-o-cha announced that Thailand needed a dramatic reformation before the next democratic election. At the top of his government's agenda lay the objective of regaining the country's competitiveness, especially through sustainable economic performance.

### **Thailand's Competitiveness**

Based on the Global Competitiveness Report 2014-2015 by World Economic Forum (WEF), Thailand was ranked 31<sup>st</sup>, making it the 4<sup>th</sup> most competitive country in the ASEAN, after Singapore, Malaysia, and Brunei Darussalam. Although the country's overall competitiveness had been improving during the last few years, its ranking on several dimensions – namely Institutions, Infrastructure, Labor Market Efficiency, and Innovation – had nevertheless been dropping. For the pillar of Institutions, Labor Market Efficiency, and Innovation, Thailand's score was just about the same as the average of its emerging and developing Asia counterparts; whereas, in the other pillars, it received a higher score than its regional neighbors (see Appendix 7).

Recently, the cost of doing business in Thailand had increased due to the government-mandated increase in wages across many industries and positions. This was a consequence of the increased cost of living, to which the government had responded with a policy decision to increase minimum wage (see Appendix 5). The 300 baht (approximately \$10) minimum daily wage policy was implemented in 2012, bringing the monthly minimum wage in Thailand above that of many of its regional neighbor countries (see Appendix 6). A number of companies, both local and foreign, filed petitions with the Administrative Court to halt the government's implementation of its 300 baht daily minimum wage policy – to no avail. Thereafter, a number of international investors moved their production bases to less expensive countries.

The competitiveness of Thailand has traditionally been based in labor intensive and commodity agriculture products, as well as tourism. However, driven in part by the increased cost of doing business imposed by the 2012 hike in the minimum wage, Prime Minister's Chan-o-cha's new government had come forth with a new economic vision. Not only had his government faced the challenge of strategizing how to restore of the vitality of the EEE sector, but also that of accelerating the shift in focus from traditional agriculture and labor intensive activities to more technological- and innovation-based competition.

## **The EEE Cluster in Thailand**

The social and economic policies in many countries around the globe these days were influenced by the framework and key concepts of “clusters,” first introduced in the 1990s by Michael E. Porter, the world-renowned figure in the field of competitiveness and economic development. Porter defined a cluster as “a geographic concentration of related companies, organizations, and institutions in a particular field that can be present in a region, state, or nation”. The benefits of cluster development, as described by Porter, included increased productivity, better access to employees, suppliers, public goods, specialized information, and innovation promotion, among many others. Ultimately, the existence of clusters was used to explain how a location, whether nation-state or particular region within a nation, achieved a high level of competitiveness.

In Thailand, the conceptual framework about clusters and competitiveness was not very well known to the general public; nevertheless, the term “cluster” was not completely unfamiliar to some groups of people, especially policy planners, government executives, and managers of companies in certain industries. To them, “cluster” was often associated with industrial or exporting zones; hence, “innovative cluster,” of which the EEE cluster was considered an instance, was usually associated with high-tech industrial zones and science parks.

## **Historical Development**

Industrialization, a basic requirement of the EEE cluster development, did not materialize in Thailand until the late 1980s. Before that, in the 1960s and 1970s, Thailand’s economic growth was primarily sustained by expansion of the agricultural sector, and the majority of manufacturing activities were simple processing industries of agricultural and aquatic products like wood, sugar, and fish. In the 1970s, manufacturing accounted for only 17% of the country’s GDP, whereas agriculture accounted for 27%. In the 1980s, however, there were initiatives to transform the country’s economy to be more like those of developing countries in Asia, which were based on export-driven industrialization. Such an initiative was incorporated into the 6<sup>th</sup> national economic and social development plan (drafted by the Office of the National Economic and Social Development Board, and implemented during 1987-1991), promulgating several development guidelines to improve and better utilize science and technology to advance industrialization. Another initiative was the establishment of the National Electronics and Computer Technology Center (NECTEC) in 1986 as a project under the Ministry of Science, Technology and Energy (later named the Ministry of Science and Technology). The primary goal of NECTEC was to encourage research and development activities as well as collaboration between the public and private sectors in the field of electronics and computer technologies.

Concurrently, there were several external factors taking place during the 1980s which helped accelerate Thailand’s economic transformation into an export economy based on industrial production. In 1985, Japan, South Korea, and Taiwan – three major industrialized countries in Asia – experienced currency appreciation, pushing firms to relocate their production to other countries with lower costs. Thailand was considered a very attractive destination as a new production base due to its cheap low-skilled but trainable labor,

abundant natural resources, and location at the heart of Southeast Asia – as well as its favorable government policies for foreign investment and export enterprises, including tax incentives and infrastructure provision. Consequently, an influx of foreign investments started flowing into Thailand, predominantly in the manufacturing sector where more than 80% of the production output was exported. The FDI grew rapidly from about \$421 million in 1986 to over \$2 billion in 1989. Soon after, Thailand was recognized as a newly industrialized country (NIC) and a major exporter.

Among many product categories exported, Thailand found most success in electrical appliances and electronics, as the products were highly value-added and the demand had been skyrocketing. Several aspects of the country were particularly pivotal to the development of the Thai EEE cluster.

### **Supporting Factors**

Thailand was endowed with an advantageous location in the Southeast Asia, and hence, became a hub of transportation in the region. Compared to its peers in the region, Thailand was also equipped with relatively well-established infrastructure, including a number of international airports, seaports, and motorways. Raw materials and finished goods could easily be distributed between Thailand and its neighboring countries in proximity, including those accessible by land -- e.g., Cambodia, Laos, Malaysia, Myanmar, Singapore, Vietnam, and the south of China. Others accessible by short-haul air or sea freight included Brunei, the Philippines, and Indonesia. The export value of electrical appliances and electronics in the Southeast Asian market was estimated at over \$277 billion in 2013.

In brief, then, strategic location, together with convenient infrastructure, made Thailand an attractive destination for foreign investments in the EEE industry. Mr. Hirotaka Murakami, CEO of the Panasonic Group of Companies in Thailand, once stated, “Thailand is a good operating base for us due to being the center of the Indochinese peninsula. Here we have quick access to export markets in surrounding countries. Additionally, Thailand’s infrastructure is well established. A lot of suppliers have already shifted their production here”.

Another pull factor for foreign investments in Thailand was the low-cost and capable labor force. The country had over 60 public and private engineering institutes accredited by the Council of Engineers. As of early-2015, there were already 152,000 certified engineers, and each year, around 20,000 new engineering graduates were produced. The Thai government also implemented a Human Resources Development Plan, through collaboration between the Board of Investment (BOI) and the Ministry of Education, to establish several technical training programs catered to the EEE industry. These included, for instance, the Thai Microelectronics Center (TMEC), established by the Ministry of Science and Technology in 1998, and the Western Digital HDD Technology Training Institute (HTTI), established through the collaboration between the NECTEC and Western Digital. Moreover, as Thailand was rapidly gaining its high position in the global market for the hard disk drives (HDD), the NECTEC also established industry and university cooperative research centers in three prime areas to further develop Thai human resources for the HDD sector. These were 1) HDD Advanced Manufacturing (Institute of Field Robotics (FIBO), King Mongkut’s University of Technology, Thonburi), 2) HDD Components (Engineering Faculty, Khon Kaen University), and 3) Data Storage Technology and Application (King Mongkut Institute of Technology, Ladkrabang).

Recognizing the importance of the EEE cluster to the country's competitiveness, the Thai government also established several other supporting organizations. A new government agency founded as a result of the enactment of the Science and Technology Development Act of 1991 was the National Science and Technology Development Agency (NSTDA) under the Ministry of Science and Technology. Subsequently, the NECTEC was transformed into a specialized national center under the NSTDA in 1991, with the NSTDA assigned the role to promote the advancement of knowledge, human resources, and infrastructure for the field of science and technology (NSTDA, 2014). Both the NSTDA and NECTEC were located inside the Thailand Science Park (TSP), a fully-integrated R&D hub for science and technology, built in 2002. Equipped with advanced facilities and business space, the TSP provided a full range of value-added services to support technology businesses and strengthen Thailand's capabilities in research and innovation.

In addition to the NSTDA and the NECTEC, the TSP also housed three other research centers, namely the National Center for Genetic Engineering and Biotechnology (BIOTEC), the National Metal and Material Technology Center (MTEC), and the National Nanotechnology Center (NANOTEC). Another organization working closely with the EEE industry was the Electrical and Electronics Institute (EEI), established in 1998 under the Ministry of Industry. The EEI served as the center of information for the industry, provided quality and standard test services, promoted and supported the technology upgrades and export of electrical and electronic products. Industrial standards in Thailand were governed by the Thai Industrial Standards Institute (TISI). Also founded to support and represent the firms in the EEE industries were the Federation of Thai Industries (FTI) and the Electronics and Computer Employers' Association (ECEA). The FTI acted as a representative of industrial operators in the private sector and helped promote collaboration with the public sector. The ECEA protected interests relating to the conditions of employment, and helped promote good relations between employers and employees, as well as among the employers themselves in the electronics and computer industry.

In terms of pro-FDI policies, the Board of Investment of Thailand (BOI) offered both tax and non-tax incentives. Tax incentives included exemption or reduction of corporate income tax as well as import duties on machinery and raw materials. For non-tax incentives, firms were allowed to bring in foreign workers, take or remit foreign currency abroad, and even own land. Thailand also had free trade agreements with ASEAN and other major markets such as Australia, India, and Japan. In fact, since the ASEAN Free Trade Agreements (AFTA) was established in 2010, most parts and finished electronics exports among ASEAN countries were free of tariff.

The electronics and electrical appliances industry was among those receiving special incentives from the BOI, especially if invested in the promoted locations. The BOI divided the country into three zones based on economic factors such as population earnings and primary facilities. Bangkok and nearby provinces were categorized into Zone 1. Other 12 provinces around the central of Thailand were grouped as Zone 2. The remaining 59 provinces were in Zone 3, representing the regions with relatively lower income and less-developed infrastructure. (see Appendix 8) Maximum incentives were offered for investments in Zone 3, less incentives for Zone 2, and least incentives for Zone 1. If located in certain industrial zone or industrial estate, firms would also receive special incentives, more than investing in Zone 2, but less than investing in Zone 3. Most of the industrial zones in Thailand were privately owned, developed, and managed, and were located around central and eastern of Bangkok. Many companies in industrial zones used Thailand as a production or assembly base to manufacture parts or finished goods and export to other countries. Some

companies found local suppliers while others imported parts from nearby countries, e.g., China for standard parts, and Japan or Singapore for high-tech parts.

### **Current Status**

In recent years, the Thai economy had been heavily export-dependent, with exports accounting for about three quarters of the country's GDP. For the last decade, the biggest chunk of export revenues came from the electronics and electrical appliances product groups combined, contributing almost \$46 billion or 20% of the country's exports in 2014 (see Appendix 9). Major export destinations in 2011 were ASEAN (17%), the EU (14%), China (14%), the US (13%), Hong Kong (12%), and Japan (11%). (BOI, 2013) The other product groups in the top five export revenue generators were Automotive, Agro-manufacturing, Machinery and Equipment, and Petro-chemical, contributing \$32, \$27, \$19, and \$13 billion, respectively.

Key electronics and electrical products included hard disk drives (HDD), automotive electronics, air conditioning, refrigerators, integrated circuit (IC), and radio-frequency identification (RFID). Local suppliers were generally available for low- to medium-tech parts. However, many of the high-tech parts were imported from outside of the country (e.g., companies' headquarters, the EU, and Singapore), then assembled by Thai labor, and finally exported for sale in other countries. Most foreign firms established facilities in Thailand for production and assembly. A few also established their own R&D labs, which worked independently from other companies and government institutes, and often did not result in technology transfers. The Thai government did offer extra incentives and privileges to foreign companies in the field of skill, technology, and innovation, who spent at least 1% of revenue from investment on R&D activities in Thailand, hoping to induce spillovers of more advanced technology. However, the government did not impose technology transfer as a condition for companies investing in Thailand. Despite a number of human resources development and research collaboration programs established by government organizations, many companies believed they could address their needs more efficiently and effectively using their own resources. In fact, while Thai education produced a large number of engineers and a large percentage of workforces with college or higher degrees, compared to other ASEAN countries, the number of scientists, researchers, and workers with the professional or technical degrees needed for high-tech EEE activities was nevertheless rather small (see Appendix 10).

As the largest production base for electrical appliances in ASEAN, with more than 800 factories, Thailand was the world's second largest producer of air conditioning units and fourth largest producer of refrigerators. The country had attracted investments from many leading companies in the sector. About half of the foreign companies were Japanese, including Canon, JVC, Hitachi, Mitsubishi, Nikon, Panasonic, and Toshiba, to name just a few. Other nationals represented in Thailand included Taiwan (e.g., Acer), South Korea (e.g., LG and Samsung), the US (e.g., Honeywell, Hutchinson, Seagate, and Western Digital), and the European Union (e.g., Electrolux and Philips). The top three electrical appliance products, based on the export revenues in 2011, were air conditioners, digital cameras and video camera recorders, and refrigerators, accounting for 15%, 12%, and 10% of the electrical appliance industry, respectively.

For the electronics industry, Thailand was the world's largest producer of HDD and components, accounting for more than 40% of the worldwide HDD production in 2011. The HDD also took the largest share, i.e., approximately 34%, of Thailand's total electronics

exports. The second largest share of electronics exports, estimated at 26%, belonged to IC. Foreign electronics companies – such as Fujitsu from Japan, LG from South Korea, Seagate from the US, and Philips from the Netherlands – established various types of facilities in Thailand, ranging from production and assembly to testing and R&D. Hence, in the view of some industry participants, the electronics industry possessed very promising prospects of high demand growth: “Data creation is expected to grow by 44 times in the next decade,” noted John Coyne, the President and CEO of Western Digital Corporation, “but storage capacity for that will increase by about 30 times. Thus, this gap adds up to a very significant demand for digital storage”.

Notwithstanding such sanguine views on the prospects of particular EEE products, Prime Minister Chan-o-cha had reason to be concerned about the future prospects of the EEE industry in Thailand. In recent years, some economic indicators for the Thai EEE industry had not looked as promising as the government had hoped to see. Of particular note, the FDI made by manufacturers of EEE products had been especially low during 2009 to 2011, and had diminished from 2012 through 2014. More concerning still was the Ministry of Commerce’s report that the sector’s exports grew by only 0.8% in 2011 versus 25.7% in 2010. Further, although the shipments of electrical appliances increased at 8.5%, electronics exports fell 4%. This was believed to be a consequence of major floods that the country experienced in 2011, which caused serious damage to many EEE companies in and nearby Bangkok. After the floods, some companies relocated their plants and shifted investment to other emerging countries like Vietnam and China in order to diversify their production bases and lower their supply chain risks.

In any event, the EEE sector’s declining fortunes were brought into bold belief by an approximately 50% reduction in sector employment, i.e., from about 400,000 jobs several years earlier to only about 200,000 jobs in 2012. With this negative trend, it was expected that the sector’s employment could be cut in half again in a few years if the Prime Minister and his government could not find a way to make significant improvement in the sector’s prospects going forward. A rising concern worrying stakeholders of the EEE sector was regarding the quality of the Thai workforce. Out of the total population of 67 million, 38 million people were employed, but most were unskilled and worked in the agricultural sector. In fact, according to the data collected by the Encyclopedia of the Nations in 2006, Thailand was reported as having the highest percentage (83.5%) of unskilled workers in manufacturing among the 37 countries surveyed. Expressing his presentiment of the Thai labor in electronics sector to the press, Sampan Silapanad, the President of the Electronics and Computer Employers’ Association, bluntly stated, “Thailand can no longer rely on cheap labor . . . [W]e must upgrade to high value-added production. However, a major obstacle is many of our workforce cannot speak English”. With its recent increase in the minimum wage without a proportionate increase in labor skills, Thailand was losing its advantage in the EEE sector to neighboring countries, especially those emerging economies in the Greater Mekong Subregion (GMS) like China and Vietnam (see Appendix 11 for GMS map).

### **The EEE Cluster in Competitor Countries**

At the 5<sup>th</sup> Greater Mekong Subregion Summit held in Bangkok, Thailand in December 2014, Prime Minister Prayut Chan-o-cha had a great chance to discuss with other countries’ leaders regarding the challenges and future directions of the GMS economy. The GMS countries’ leaders from Cambodia, People’s Republic of China, Lao People’s



Democratic Republic, Myanmar, Thailand, and Vietnam had extensive exchanges of views about ways to promote subregional cooperation and encourage subregional economic integration. At the status quo, only the relatively more developed countries – i.e., Thailand, Vietnam, and China (specifically, only Yunnan Province and Guangxi Zhuang Autonomous Region) – were parts of the GMS, and generally involved in higher value-added trades, including exports of EEE products; whereas, the less developed countries – i.e., Lao PDR, Cambodia, and Myanmar – served as suppliers of raw materials, which were of lower value when traded.

In addition to discussing the collaborative projects among the GMS countries, Prime Minister Chan-o-cha took the opportunity to learn more about the status of the EEE production and exports in Vietnam and China, Thailand's major competitors. The two countries had recently transformed from centrally-planned to market-driven economies. In fact, the Vietnamese and Chinese economies had not only grown rapidly during the last decades, but also changed dramatically in terms of product lines, from simple, labor-intensive products to a wide range of sophisticated products. The average GDP growth for the Yunnan province of China and Vietnam between 1992 and 2009 was estimated at 10.5% and 7.5%, respectively. The economic activities in both Vietnam and Yunnan contributed significantly to the global value chain, especially for the EEE products and services traded in the global economy. A sizable and growing number of EEE manufacturers and production plants were located in the two countries' high-tech industrial zones, engaged in high value-added trade activities.

Prime Minister Chan-o-cha learned that the development and growth of EEE clusters in Vietnam and Yunnan largely resulted from government policies and establishment of supporting institutions in the 1980s, which paved the way for the rise of high-tech and innovative industries. Hence, he was particularly interested in finding out more about how these two principal competitors had achieved their impressive presence in EEE production and marketing, hoping to gain potential insights into what Thailand had to do in order to revitalize its own EEE sector, and thereby forestall additional loss of FDI to Yunnan and Vietnam.

### **Historical Development of the EEE Cluster in Vietnam**

At the GMS investment forum, Prime Minister Nguyen Tan Dung of Vietnam briefly discussed his country's EEE cluster development and investment policies. In Vietnam, until the 1980s, the government policies had been focusing on constructing heavy industries. However, at the 7th Party Congress in 1991, new guidelines for industrialization were introduced to include new and advanced science and technology as a basis for growth and enhanced economic achievement. In the same year, the first, and to date the most successful, export processing zone in Vietnam, Tan Thuan Export Processing Zone (TTZ) was established in Ho Chi Minh City to promote economic development through high value-added manufacturing, trading, and services.

The development of Industrial Zones (IZs) in Vietnam evolved rapidly to offer standard factory accommodation for both foreign and domestic manufacturing sector. A total of 267 approved IZs in 2010 were established in key economic areas (KEAs) to extend the network of manufacturing agglomerations. The major manufacturing hubs were located in Hanoi (Northern KEA) and Ho Chi Minh City (Southern KEA), including the adjacent provinces. Both KEAs together covered 176 industrial zones (approximately 66% of the total IZs) and 68.8% of the national total gross value of industrial output. The degree to which

these industrial zones were the economic engine of Vietnam could be deduced from GDP growth. From 2006 to 2010, the annual GDP growth was estimated at 10.8% and the zones had an annual average per capital income of \$1,662. With nearly 12,500 foreign investment projects in 2015, the zones were expected to achieve an annual average per capital income of \$3,000 and a 14-14.5% increase per year for the zones' export import turnover. Over the past two decades, the Vietnamese economy had grown outstandingly and continued to attract high quality foreign investment. According to Vietnam's 2013 export portfolio, the EEE sector alone accounted for 28% of the total trade value of about \$38.4 million, which ranked 12<sup>th</sup> in the world's EEE exports.

Vietnam was considered a bright future for global investment. The Vietnamese government released a set of policies to attract foreign direct investment, such as tax incentives for foreign investors. Vietnam offered four years tax exemption for any foreign company investing within the industrial or exporting zones. With such an attractive policy, IBM, for instance, had entered Vietnam and built a semiconductor chip assembly and testing manufacturing facility, generating thousands of jobs for residents of Hanoi, Ho Chi Minh City, and Da Nang. Samsung Electronics also considered investing \$1 billion in building a third factory for the manufacturing of displays to be used in smartphones and tablets.

By the conclusion of the Vietnamese leader's presentation, Prime Minister Chan-o-cha had begun to realize a significant loss of FDI from Thailand to Vietnam was actually taking place. Indeed, he had recently received a report that Samsung Electronics had recently halted its TV production in Thailand. This action was taken after the company had decided to build a consumer appliances complex in Vietnam, as part of efforts to increase production in a lower-cost country. To make it worse, LG electronics, the world's second largest television maker after Samsung Electronics, had also recently revealed its plan to move the TV production from Thailand to Vietnam. The company's marketing director said the main reason for doing this was because Vietnam offered much better logistics due to its closer proximity to China, from where most materials were brought.

### **Historical Development of the EEE Cluster in Yunnan**

Endowed with massive population and land, China was another key competitor in the EEE arena to which Prime Minister Chan-o-cha paid close attention. At the GMS Summit, Chinese Premier Li Keqiang gave a quick overview of the EEE cluster development and supporting policies in China.

The Chinese government began proposing and implementing national programs for science and technology in the 1980s. The Key Technologies R&D Program was launched as the largest science and technology program in the country, with the most funds invested, the most personnel employed, and the greatest impact on the national economy. In the mid-1980s, the government launched more than 100,000 science and technology projects, as parts of the "Spark Program," to expand the development of science and technology to rural areas throughout the country. In the late-1980s, another initiative, known as the "Torch Program," was established with a tripartite objective: to promote the development of high-tech products with economic value for both domestic and foreign markets; to establish high-tech industrial development zones around the country; and, to explore managerial and operational mechanisms to support high-tech industrial development. Then, beginning in 1998, the "973 Program" was launched to encourage scientists to conduct research on issues with the potential for significant impact on economic and social development in the 21st century. The resulting strong development in science and technology in China equipped the country

with the basis for the manufacturing of high-tech products, including a broad range of EEE parts and devices.

In Yunnan province, Kunming was one of the flagship cities for foreign investment. With a population of over 6.53 million, Kunming was the center of Yunnan's economy, with a GDP of RMB 301.11 billion that was increasing at approximately 14% annually. There were two major high-tech industrial zones in Kunming: 1) Kunming Economic and Technological Development Zone (KETDZ), and 2) Kunming High-tech Industrial Development Zone (KHIDZ). These two high-tech industrial zones not only boosted the development of the EEE cluster at the national level, but also were considered the hub of advanced technology and R&D activities in Yunnan province. The GDPs of KETDZ and KHIDZ were estimated at RMB 17.85 and 15.46 billion respectively, which accounted for about 10% of the city's total in 2012.

### **Supporting Factors and Current Status of EEE Clusters in Vietnam and Yunnan**

Both Vietnam and Yunnan were located in the geographic center of Asia. Kunming was a gateway to Southeast Asia; while, Vietnam, with several major ports facilitating import and export processes, was considered the bridgehead to both Southeast Asia and the great Chinese markets.

To draw inward FDI in the EEE and other high-tech sectors, Vietnam and Yunnan equipped their industrial zones with high-quality infrastructure such as sufficient utilities, reliable communication networks, and proximity to research centers and transportation. In China, the government established a number of science parks to facilitate localized knowledge flow through collaboration among firms, research institutes, and universities. As a result, 80 percent of high-tech industry output in China was produced by firms located in science park. By 2009, there were 56 science parks nationwide in China. This initiative had transformed the Chinese economy into a knowledge-based economy and, in addition, also led to the development of innovative clusters in many regions, such as Chenggong New Zone, Jincheng Xinjie New Zone, and Kun-yang. In Vietnam, although to date only three science parks – Hoa Lac Hi-tech Park in Hanoi, Saigon Hi-tech Park in Ho Chi Minh City, and Da Nang Hi-tech Park in Da Nang – had been established by the government: there were an increasing number of privately-owned hi-tech facilities, often located in or nearby industrial zones. Currently, little collaboration among firms, research institutes, and universities was evident in Vietnam. However, as the influx of FDI from hi-tech companies flowing into the country continued, it was expected that more hi-tech zones would be established and more collaborative activities between firm and academia would be formed in the near future.

While firms could enjoy privileged infrastructure and advanced facilities inside high-tech industrial zones and science parks in Yunnan and Vietnam, they would not be able to get anything similar outside of the zones. There were still sharp inequalities in economic development and standards of living within both countries due to the lack of linkages between global companies inside the zones and local companies outside of the zones.

Aside from high-quality infrastructure, research and development activities were necessary elements to help sustain the development of an innovative cluster like the EEE cluster. However, both Vietnam and Yunnan were still lacking on this dimension. In 2011, the expenditure on R&D in Vietnam was 0.21% of its GDP; that in Yunnan was only 0.01% of its GDP. In Vietnam, special tax incentives were actually offered to companies located inside an industrial zone to invest in specific technology and R&D. However, a low

level of R&D activities was still observed, implying either that the incentives offered by the zones were not sufficient to motivate R&D activities, or that there were other more important obstacles, not addressable by the zones, which made it difficult to conduct more R&D activities. In Yunnan, although many companies in the high-tech zones often had their own R&D centers, there was no strong linkage between these research centers and universities or public institutes, and hence, R&D outputs were not realized at a high level, unlike in certain other parts of China where science parks achieved their goals. This was because most R&D activities in Yunnan were privately funded and focused on products for the domestic market. Overall, little connection on R&D could be deduced between local companies and foreign companies in Vietnam and Yunnan or those in the rest of the world.

Despite the relatively low level of R&D and collaborative activities, the EEE clusters in both Yunnan and Vietnam had been rapidly growing mainly due to the large size and the expansion of the local markets. Kunming, the capital of Yunnan province, in particular, served as an enormous market for innovative products in Asia. In fact, the primary market for Yunnan province was domestic-oriented, in that the percentage of products exported to other countries was very small. Out of \$6 billion in the total trade in Yunnan, approximately \$2 billion came from KETDZ and KHIDZ in Kunming [34, 35]. Vietnam, on the other hand, did not have as large a domestic market for EEE products. However, given its close proximity to the Chinese market, Vietnam too benefited from serving the massive Chinese market through simple logistics.

Perhaps nothing better illustrated the importance of the internal Chinese market than the case of local high-tech companies. SUNPA Telemedicine, a Kunming-based company, provided an effective telemedicine system with more than 700 technicians and managers with an estimated investment of \$550 million. The company also had the largest telemedicine information system network, which included four centers in Kunming, Beijing, Shanghai, and Guangzhou that were integrated with about 6,500 experts and 76,000 physicians worldwide. With more than 626,000 cases annually, 70% of its customers were domestic, and only 30% came from abroad. Similarly, the key source of income was from selling equipment and solutions to the PRC (70%) and foreign (30%) hospitals.

SUNPA Telemedicine was by no means unique in its focus on the Chinese internal market. Kunming Dongxun Technology, a multi-lingual international e-business trading portal funded by the Chinese government's National Development and Reform Committee and Ministry of Commerce, included as its main services Software Development, Internet Services, Internet system for e-commerce, tax-application, and e-invoice printing systems. Yet, 100% of its approximately 1 million customers were in Yunnan province only.

To serve the sizable demand of EEE products in China and the rest of the world, millions of workers were employed in Yunnan and Vietnam. At the current stage of their industrial development, the basis of both economies was still that of labor-intensive businesses. With the minimum daily wage estimated at between \$3.2 and \$3.76 in Vietnam and between \$13.04 and \$15.64 in Yunnan (see Appendix 6), the labor costs still remained relatively cheap, compared to those in the US, the EU, and other developed countries. Consequently, low labor cost remained one of the key factors that attracted FDI, especially from those companies with labor-intensive, low-to-medium-tech operations, to the recently established industrial zones in both countries.

A major concern to employers in both Vietnam and Yunnan province, however, was the low level of education and technical skills of labors. Since the majority of the Vietnamese

and Chinese workforce were still of the low- to mid-skill levels, high-tech and innovative companies sometimes found it difficult to set up operations or completely move their facilities to the countries. Additionally, issues of language and culture acted as barriers to foreign business expansion. The problem of English deficiency was quite common among the Chinese and Vietnamese workforce.

After the 5<sup>th</sup> GMS Summit concluded, Prime Minister Chan-o-cha had seen challenges and threats from Vietnam and Yunnan, especially with respect to their outstanding growth of the EEE production and exports. Although at the moment Thailand still maintained a larger share in the global market of certain electrical appliances and electronics, compared to Vietnam and Yunnan, there were several issues relating to politics, economics, and education, which could directly and indirectly drive many investors to move their production facilities to another country. Considering the fact that the local demand in China was constantly expanding and the FDI policies and infrastructure in Vietnam were improving, Prime Minister Chan-o-cha believed the EEE cluster in Thailand had reached a pivotal stage, where fresh strategic impetus was needed to reinvigorate the cluster's competitiveness. Without any further actions, in his view, Vietnam and Yunnan would soon take Thailand's position and become the next regional bases of EEE production.

### **Where to from Here and How to Get There?**

Based on what he had learned so far, it was clear to Prime Minister Chan-o-cha that the EEE cluster in Thailand was facing both internal and external challenges, resulting in negative impacts on the country's economy. But what remained puzzling to him was the issue of whether the EEE cluster had all it required to become a successful cluster at the outset, and whether it would be the right decision to continue promoting the EEE sector as the key industry in Thailand. Further, and most importantly, assuming affirmative answers to these two questions, what reformation plan should be crafted to help Thailand regain its competitiveness?

These issues regarding the performance of the EEE sector and the country's competitiveness were to be formally discussed at the next meeting of the National Reform Council, scheduled to take place a week from now. At that time, all eyes and ears would be focused on him, anxious to hear what he hoped would be viewed as realistic and practical solutions to a matter of great national importance.

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**Appendix 1**  
**FOREIGN DIRECT INVESTMENT CLASSIFIED BY BUSINESS SECTOR OF THAI ENTERPRISES**  
**(MILLIONS USD), as of February 25, 2015**

<b>FDI by Business Sector (millions of USD)</b>	<b>2014 n</b>	<b>2013 n</b>	<b>2012 n</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
<b>Agriculture, forestry and fishing</b>	4.63	16.97	3.19	-2.38	5.71	7.30	9.33	2.74	-2.67	12.61
<b>Mining and quarrying</b>	-95.68	-118.65	39.87	220.08	419.23	640.80	-2.11	1,307.24	256.69	-111.00
<b>Manufacturing:</b>	3,797.45	5,006.47	4,599.41	4,007.97	4,622.72	2,412.02	4,891.26	4,495.41	5,160.94	3,500.55
- food products	230.37	101.22	-137.21	355.69	106.49	139.80	136.76	190.79	103.95	75.97
- beverages	113.50	70.34	49.50	-8.94	36.53	54.25	33.72	40.85	48.00	-101.12
- paper and paper products	105.71	78.58	-5.85	266.38	34.92	24.10	389.40	14.08	-42.89	-9.35
- coke and refined petroleum products	76.16	314.48	137.23	200.16	-20.63	181.85	-437.79	1,237.53	364.85	-72.61
- chemicals and chemical products	241.55	272.58	551.73	363.28	872.85	506.66	616.04	-121.58	198.45	499.75
- basic pharmaceutical products and pharmaceutical preparations	89.40	34.60	-14.96	35.24	0.00	0.00	0.00	0.00	0.00	0.00
- rubber and plastics products	268.70	280.19	413.31	414.76	331.91	305.08	389.76	312.80	494.33	467.71
- computer, electronic, optical products, and electrical equipment	987.91	1,340.24	1,818.90	905.46	906.06	325.86	1,643.11	860.94	1,731.41	1,010.69
- machinery and equipment n.e.c.	306.26	336.39	112.46	581.04	65.03	191.44	118.63	145.39	138.19	87.45
- motor vehicles, trailers and semi-trailers	783.49	1,680.86	1,310.03	512.04	1,398.20	384.35	914.44	1,080.26	1,536.98	1,161.54
- furniture	-0.20	4.51	-4.36	29.68	7.15	-2.86	-0.77	0.06	-4.54	3.53
<b>Electricity, gas, steam and air conditioning supply</b>	-261.93	41.39	-26.59	44.79	-56.08	221.92	200.43	33.20	353.83	-87.71
<b>Construction</b>	73.38	21.37	-170.24	-34.76	27.21	1.43	-34.04	29.96	-93.79	29.56
<b>Wholesale and retail trade; repair of motor vehicles and motorcycles</b>	1,087.89	2,617.30	453.34	610.59	58.96	344.86	131.58	262.52	845.21	260.27
<b>Transportation and storage</b>	49.11	87.05	39.83	222.48	-131.52	118.42	450.25	-43.31	80.53	155.05
<b>Accommodation and food service activities</b>	-23.99	98.53	27.26	-2.81	113.70	46.00	-51.34	166.77	124.97	-29.94
<b>Financial and insurance activities</b>	2,563.37	4,715.84	1,236.24	2,121.48	2,279.85	274.15	1,765.99	2,815.04	691.65	3,269.45
<b>Real estate activities</b>	1,267.01	1,663.95	1,014.63	1,078.04	984.24	767.96	1,202.53	1,103.16	1,419.06	73.28
<b>Others</b>	3,376.23	3,891.29	3,482.23	-161.45	905.45	18.59	-16.77	1,683.59	623.23	975.96
<b>Total</b>	11,837.47	12,806.90	10,699.17	3,861.08	9,111.55	4,853.45	8,547.09	11,331.29	9,459.64	8,048.08

Source: Bank of Thailand. Retrieved from

<http://www2.bot.or.th/statistics/ReportPage.aspx?reportID=656&language=eng> on March 25, 2015.



### Appendix 2 THE STRUCTURE OF THE THAI ECONOMY

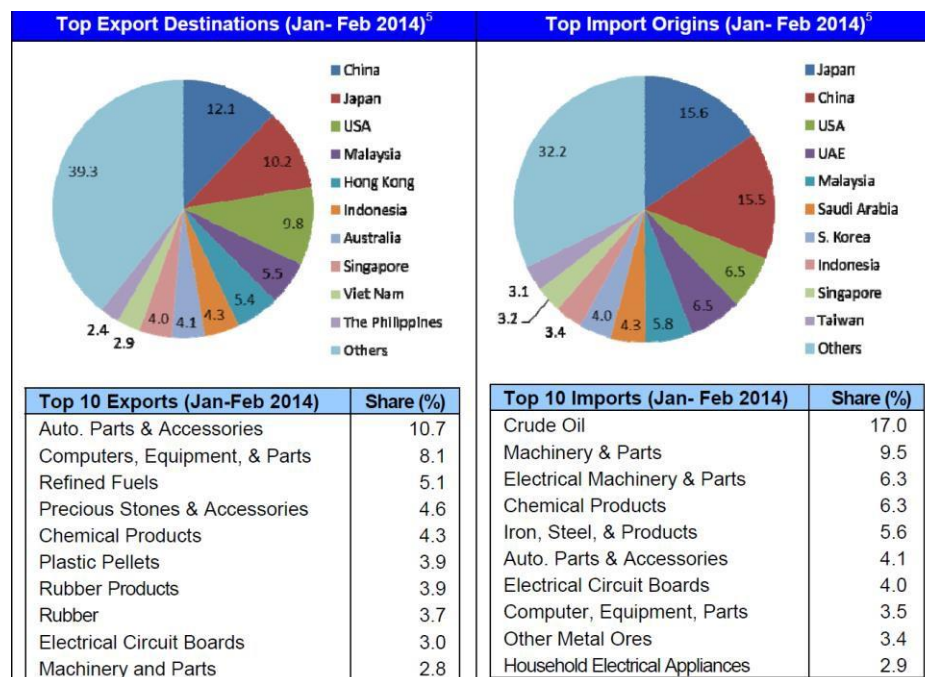
Sector	% of GDP by Sector	% of Labor Force by
Agriculture	8.3	43.3
Manufacturing	40	13
Wholesale and Retail Trades	13.3	15.1
Construction and Mining	4.4	4.8
Other Services (financial, educational, hotels & restaurants, etc.)	33.2	23.9

Source: Bank of Thailand, Thailand at a Glance, 2010.

### Appendix 3 MAJOR EXPORT AND IMPORT ITEMS AND DESTINATIONS MAJOR EXPORT AND IMPORT ITEMS

Major Export Items		Major Import Items	
Computers and parts	8.5%	Crude oil	12.5%
Vehicles and parts	9.6%	Electrical machinery & parts	8.9%
Electrical appliances	7.1%	Industrial machinery & part	7.5%
Base metal products	4.1%	Iron and Steel	6.1%
Plastic products	4.8%	Integrated circuits	3.6%
Petroleum products	4.5%	Computer parts	2.2%

Source: Bank of Thailand, Thailand at a Glance, 2010.



Source: Economic Watch, Thailand Economic Structure, 2010. Retrieved from [http://www.economywatch.com/world\\_economy/thailand/structure-of-economy.html](http://www.economywatch.com/world_economy/thailand/structure-of-economy.html) on December 15, 2011.



**Appendix 4**  
**TOURISM ARRIVALS IN THAILAND**



Source: World Bank and Thailand's Tourism Department

**Appendix 5**  
**LABOR COSTS IN THAILAND**  
**MEDIAN MONTHLY SALARIES FOR SELECTED POSITIONS (SURVEY DATE – Q2 2013)**

Position	Q2 2012	Q2 2013	
	Baht	Baht	USD
MD/GM	100,000	100,000	3,351.20
Financial Controller/ CFO	70,000	65,000	2,178.28
Personnel Manager/ HR Director	50,000	50,000	1,675.60
Office Manager	50,000	50,000	1,675.60
Plant Manager	61,500	60,000	2,010.72
Purchasing Manager	50,000	50,000	1,675.60
Marketing Manager	50,000	50,000	1,675.60
Executive Secretary (Bilingual)	32,000	28,250	946.71
Typist	9,463	11,500	385.38
Office Clerk	11,000	13,500	452.41
Receptionist	10,000	12,000	402.14
Programmer	20,000	20,000	670.24
Webmaster	20,000	22,500	754.02
Accountant	16,000	17,500	586.46
Researcher	22,500	20,000	670.24
Translator	25,000	21,400	717.15
Sales/ Marketing Staff	16,500	17,250	578.08

Public Relation Staff	13,000	15,000	502.68
Engineer	20,000	20,000	670.24
Technician	12,000	13,000	435.65
Skilled Labor	10,000	12,000	402.14
Semi-Skilled Labor	9,000	9,500	318.36
Unskilled Labor	8,225	9,000	301.60
Driver	9,600	10,000	335.12
Housekeeper	8,200	9,000	301.60
Other			
- Engineering Manager	72,000	100,000	3,351.20
- Production Staff	-	9,000	301.60
- Import & Export Staff	10,500	28,000	938.33
- Sale/Marketing Manager	57,000	53,000	1,776.13
- Purchasing Officer	-	17,400	583.10
- General Manager	-	50,000	1,675.60
- Production Staff	-	10,000	335.12
- Business Analysis	-	65,000	2,178.28
- Assistant Production Manager	-	80,000	2,680.96

Notes: Bonus conditions vary from business to business, although one to two months extra salary a year is closest to the average. These figures are based on the results of a survey of BOI-promoted companies, conducted in June 2013.

Source: Thailand Board of Investment. Retrieved from [http://www.boi.go.th/index.php?page=labor\\_costs](http://www.boi.go.th/index.php?page=labor_costs) on March 25, 2015.

#### Appendix 6

#### MINIMUM DAILY WAGE IN THE GREATER MEKONG SUBREGION (GMS) COUNTRIES IN 2012

Country/Province	Minimum Daily Wage (USD)
Yunnan, PRC	13.04-15.64
Thailand	9.45-10.00
Vietnam	3.20-3.76
Lao PDR	3.33-4.08
Cambodia	2.03-2.05
Myanmar	0.58

Source: Retrieved from <http://www.business-in-asia.com>; <http://www.wageindicator.org> on March 25, 2015.

**Appendix 7**  
**PROFILES OF ASEAN COUNTRIES' COMPETITIVENESS**

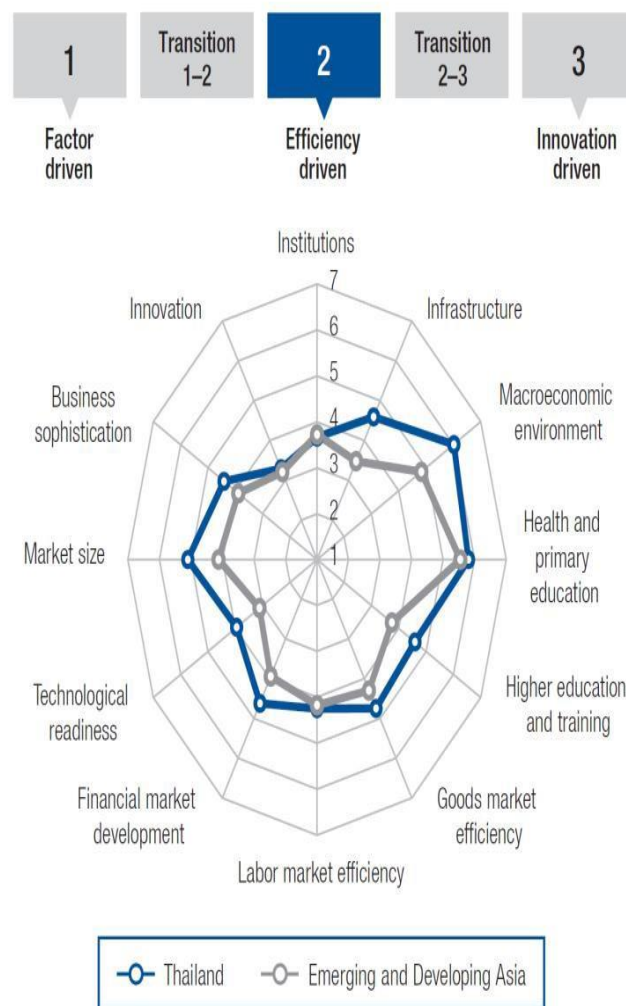
**GLOBAL COMPETITIVENESS INDEX OF ASEAN COUNTRIES, 2014-2015**

Countries	Global Competitiveness Index	Institutions	Infrastructure	Macroeconomic environment	Health and primary education	Higher education and training	Goods market efficiency	Labor market efficiency	Financial market development	Technological readiness	Market size	Business sophistication	Innovation
Singapore	2	3	2	15	3	2	1	2	2	7	31	19	9
Malaysia	20	20	25	44	33	46	7	19	4	60	26	15	21
Brunei Darussalam	26	25	58	1	23	55	42	10	56	71	131	56	59
Thailand	31	84	48	19	66	59	30	66	34	65	22	41	67
Indonesia	34	53	36	34	74	61	48	110	42	77	15	34	31
Philippines	52	67	91	26	92	64	70	91	49	69	35	46	52
Vietnam	68	92	81	75	61	96	78	49	90	99	34	106	87
Lao PDR	93	63	94	124	90	110	59	34	101	115	121	79	84
Cambodia	95	119	107	80	91	123	90	29	84	102	87	111	116
Myanmar	134	136	137	116	117	135	130	72	139	144	70	140	138

\*Brunei Darussalam's data collection was not completed for the 2014-2015 report; hence, the country was excluded from the 2014-2015 ranking. In the table, the ranking from the 2013-2014 report was used for Brunei Darussalam instead.

**GLOBAL COMPETITIVENESS INDEX OF THAILAND, 2009-2015**

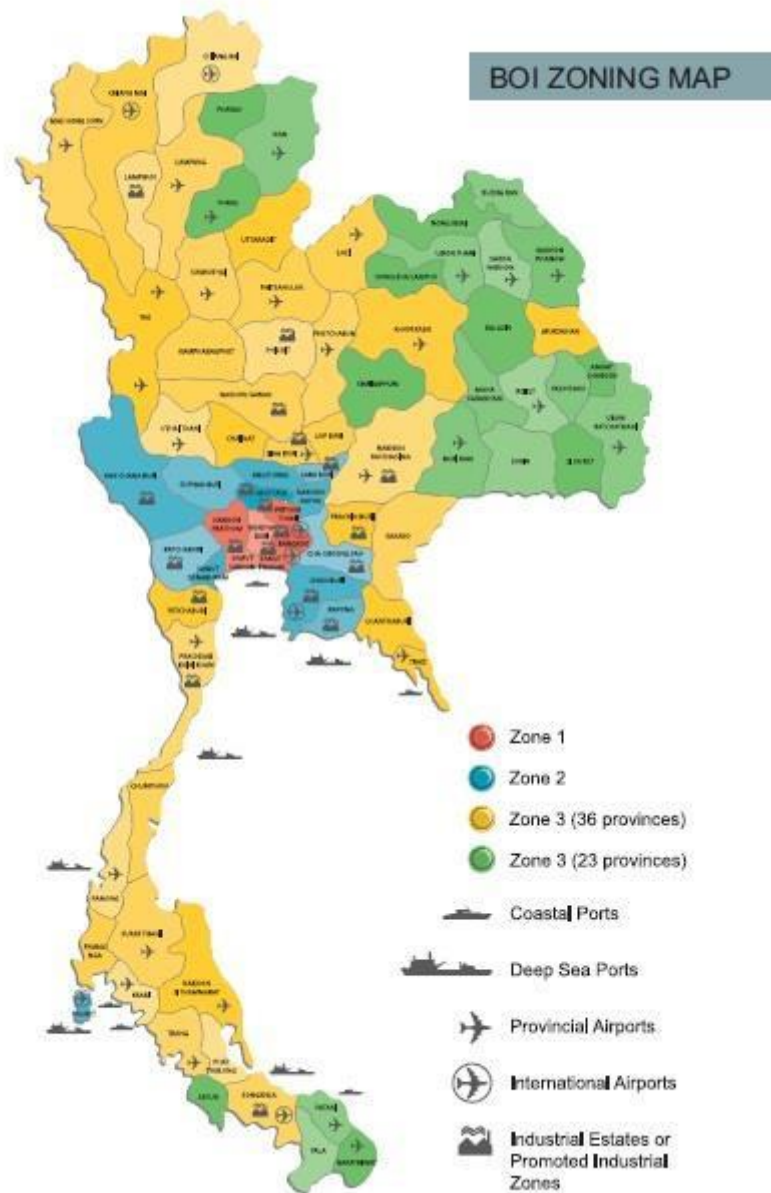
Year	Global Competitiveness Index	Institutions	Infrastructure	Macroeconomic environment	Health and primary education	Higher education and training	Goods market efficiency	Labor market efficiency	Financial market development	Technological readiness	Market size	Business sophistication	Innovation
2009-2010	36	60	40	22	61	54	44	25	49	63	21	43	57
2010-2011	38	64	35	46	80	59	41	24	51	68	23	48	52
2011-2012	39	67	42	28	83	62	42	30	50	84	22	47	54
2013-2014	37	78	47	31	81	66	34	62	32	78	22	40	66
2014-2015	31	84	48	19	66	59	30	66	34	65	22	41	67

**PERFORMANCE OVERVIEW OF THAILAND'S COMPETITIVENESS SCORE, 2014-2015****Stage of development**

Source: World Economic Forum, The Global Competitiveness Report 2009 – 2015.

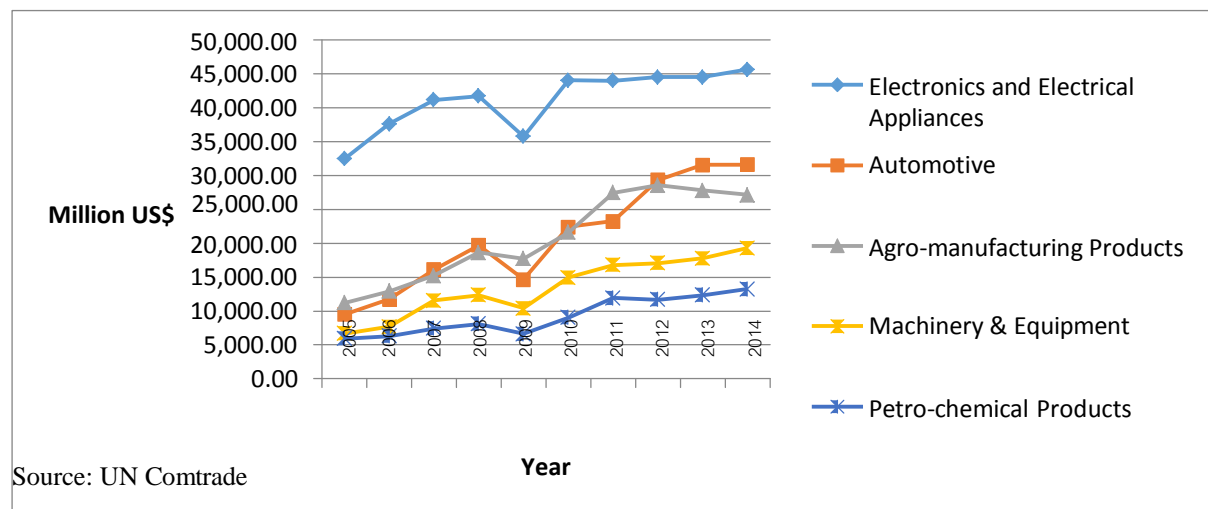
### Appendix 8

#### THAILAND BOARD OF INVESTMENT ZONING MAP



Source: Thailand Board of Investment

**Appendix 9**  
**THAILAND'S MAJOR EXPORT PRODUCT GROUPS**



**Appendix 10**  
**PUBLIC SPENDING ON EDUCATION, R&D EXPENDITURE, AND RESEARCHERS IN R&D PER MILLION PEOPLE IN SELECTED ASIAN COUNTRIES**

Country	Public Spending on Education (% of GDP)	Research development expenditure (% of GDP)	and Researchers in R&D (per million people)
Singapore	3 (in 2013)	2 (in 2012)	6,438 (in 2012)
Malaysia	6 (in 2011)	1 (in 2011)	1,643 (in 2011)
People's Republic of China	4.3 (in 2012)	2 (in 2012)	1,020 (in 2012)
Thailand	8 (in 2012)	0.37 (in 2011)	332 (in 2009)
India	3 (in 2012)	1 (in 2011)	160 (in 2011)

Source: World Bank, Ministry of Education of the People's Republic of China, National Bureau of Statistics of China, National Science Technology and Innovation Policy Office (Thailand)

**Appendix 11**  
**GREATER MEKONG SUBREGION (GMS) MAP**



Source: Pacific Rim Innovation & Management Exponents, Inc. Retrieved from <http://www.primexinc.org/wordpress/wp-content/uploads/2012/08/GMS-map.jpg> on June 26, 2016.

## **ETHICAL ISSUES RELATED TO EARNINGS MANAGEMENT: AN INSTRUCTIONAL CASE**

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Gary Taylor, Culverhouse School of Accountancy University of Alabama**

### **CASE DESCRIPTION**

*This instructional case explores the comparative ethical implications of accrual versus real earnings management. Primary issues include management's concern about how to meet analysts' annual earnings forecasts and its effects on future performance. Secondary issues include use of the COVER ethical decision-making model to help students address the difference between the two types of earnings management. In addition to gaining experience in ethical decision-making, students are introduced to implications of various stakeholders' concerns about short run versus long run performance. The case has a difficulty level of four and five to include senior level business courses as well as first year graduate students. The case is designed to be taught in three class hours and is expected to require six hours of outside preparation by students.*

### **CASE SYNOPSIS**

*Apostolou et al (2015) identify a profile for instructional cases where "an actual or hypothetical set of information followed by a set of questions or activities" encourage students to understand complexities of a topic or topics (p. 70). We introduce students to an ethics toolkit providing them with a strategy they may apply when faced with an ethical dilemma. We begin by asking the students to research the similarities, differences, and ramifications of/between real and accrual earnings management. Then the students are asked to utilize the ethics toolkit to analyze an ethical dilemma involving real and accrual earnings management. It is important to note that while the toolkit is introduced and explained with respect to the earnings management dilemma, the skills reflected in the toolkit may be used in any number of ethical dilemmas.*

### **CASE OVER VIEW**

Bernie Madoff, in describing how a client's secretary became involved in an embezzlement scheme, said "Well, you know what happens is, it starts out with taking a little bit, maybe a few hundred, a few thousand. You get comfortable with that, and before you know it, it snowballs into something big." (Gino, Ordenez, and Welsh 2014). C. S. Lewis may have said it best with "Indeed the safest road to Hell is the gradual one – the gentle slope, soft underfoot, without sudden turning, without milestones, without signposts" (Thinkexist.com). Welsh, Ordenez, Snyder, and Christian (2015) find that unethical behavior tends to grow over time in conjunction with the increase in magnitude of the unethical act. For accountants, earnings management may represent the slipperiest slope of accounting ethics.

There are numerous instances where accountants are forced to make reporting decisions where there is no bright line right or wrong decision. Both Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) require accountants and auditors to use their judgment in making the appropriate financial reporting decision. Many



accounting professionals would contend that a significant amount of earnings management, while not fraud, is unethical. While the reported financial results may fall into the category of acceptable principles and standards under both GAAP and IFRS, they result in a misleading picture of the firm's financial status. These actions may be taken to increase management compensation or mislead the firm's stakeholders. Consider the idea that accountants and auditors should hold themselves to a higher standard than "it is acceptable within GAAP (IFRS)" and ask whether the reported financial disclosures fairly portray the financial activities and status of the firm.

This is a fictional case that focuses on management's concerns about meeting analysts' annual earnings forecasts. Rich Dailey is the President and Chief Executive Officer (CEO), and Joe Jones is the Chief Financial Officer (CFO) of Devon, Inc. This case begins by asking you to investigate and understand the differences between accrual and real earnings management. Throughout the discussion, you are asked to consider the ethical issues involved in accrual and real earnings management using tools designed to help you recognize and prevent ethical lapses in organizational decision-making.

At the end of the case, you are asked to answer nine questions about the case from both an accounting and business ethics perspective. Note that several articles are recommended in the accompanying reference list, and reading and including them in your answers is part of the assignment. Note, while we provide the COVER (Mitchell and Yordy, 2010) ethical decision making model, this model is only one of many similar frameworks for this purpose. While we provide guidance to work through this specific decision, other approaches are available that help guide you through a variety of ethical dilemmas.

### **The Case Scenario**

"Joe, I need to talk to you right now about our earnings projections for this quarter," said Rich Dailey, President and CEO of Devon, Inc., a publicly-held pharmaceutical company whose shares are traded on the New York Stock Exchange at \$50.30 per share at the current time. Analysts' forecasts of earnings per share are \$3.00, \$3.35, \$3.75, and \$4.20 for each of the next four years. Analysts note that a significant portion of the growth is attributable to Devon, Inc.'s reinvestment of its earnings into the firm's advertising, and research and development departments. Devon, Inc. has a proud history of turning research and development projects into marketable and profitable products.

Rich was speaking to Joe Jones, the CFO of the firm. "What do you have in mind, Rich?" asked Joe.

"I have just reviewed our internal projections for next year's earnings per share. Based on our analysis, it appears that we will fall a penny short in next year's earnings per share. Our current projections are that next year's earnings per share will be \$2.99. I am very concerned that this year's earnings will fall short of the analysts' forecast, and you know what happens to our stock price when we miss the forecast even by just a penny—it takes a nose dive. As a result, I am proposing an approach to assuring we meet the forecast without our independent auditors calling us to task."

"Rich, you know that you are asking me to engage in earnings manipulation, and you know that it goes against my moral fiber to be associated with such inappropriate behavior!"

“Joe, listen, I am not asking you to engage in earnings manipulation. All those firms that got in trouble with the SEC were manipulating their accruals, and I agree that such behavior is wrong. However, there is a substantive difference between earnings manipulation and earnings management. What I am proposing is that we cut back on discretionary expenditures like R&D and advertising for the rest of the year since those items are a direct reduction of the bottom line. I am not taking this action lightly. In order to determine whether or not this would be considered fraud, I spent the weekend reviewing the International Standards for the Professional Practice of Internal Auditing (ISPPA). The ISPPA specifically defines fraud as, and I quote, as “Any illegal act characterized by deceit, concealment, or violation of trust.” Here is the website for you to check yourself here: <https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx>. Based on the ISPPA, I think fraud relates to theft of assets, performing illegal acts such as paying bribes or engaging in insider trading, or intentionally misrepresenting the financial data. I do not believe that this falls into any of those categories. In fact, we are being very honest and transparent with what we are doing. We will factually report the reduction of R&D and advertising expense on the income statement.”

“But Rich,” exclaimed Joe, “cutting back on R&D and advertising will hurt the bottom line in future years—don’t you realize that?”

“Joe, my concern is this quarter, not future years. I don’t want a precipitous decline in our stock price, and remember that my annual bonus is tied directly to the annual earnings number, and I have hungry mouths at home to feed! Determine how much R&D and advertising must be reduced in order for us to meet analysts’ forecasts of \$3.00 a share.”

“But Rich, what you are proposing will reduce the firm’s future cash flows. Our investors are trusting us to do what is in the long term best interests of the company. I cannot in good conscience do something that will affect the long term prospects of this company.”

“Joe, I beg to differ. I think our investors only care about the immediate effect on the stock price. We both know that the stock will get hammered if we do not at least meet the earnings forecasts. I believe our shareholders would prefer that we avoid the immediate negative stock price reaction from missing analysts’ forecasts even though we may be reducing future investment opportunities and growth prospects. Joe, in other words we are exchanging a short term negative market reaction with a reduction in long term market performance.”

“But Rich, what are the ethical ramifications for maximizing the short term market price by reducing the future growth prospects of the company!”

## THE CASE ASSIGNMENT

### Part 1: Using an Ethical Decision Making Toolkit

Accounting professionals are especially challenged with ethical dilemmas since money decisions are thought to offer the greatest temptation for which to sacrifice ethics (Kerr and Smith 1995, p. 989). Also, many ways exist that accounting professionals can influence the reported results of companies, including reporting of earnings or earnings management. Ethical ambiguities are associated with the practice of earnings management since certain types of earnings management activities are widely accepted, and others are considered ethically objectionable. As with other areas of business management, the line between ethical and unethical is unclear. However, for accounting professionals, when earnings are managed so that financial statements do not fairly reflect the economic health of the company, then stakeholder trust is violated (Fischer and Rosenzweig 1995, p.433).

Mitchell and Yordy (2010) provide a framework called **FIAS -- COVER** to guide you through ethical dilemmas such as the one we pose here. This acronym stands for *First I Ask Some* questions about *Facts, Issues, Alternatives, and Stakeholders* to **COVER** my bases. The **COVER** part of the acronym stands for addressing questions about *Codes, Outcomes, Values, Editorial and Rules*.

With this case, the facts, issues, alternatives and stakeholders have been provided for you.

So for the case analysis you will want to consider:

**C:** the legal and regulatory codes that apply for how accounting professionals report earnings.

**O:** the outcomes of the decision considering the pros and cons of different earnings reporting scenarios.

**V:** the duties or obligations of accounting professionals based on their individual values with respect to earnings reporting.

**E:** the editorial aspects of the decision or what will hit the news, social media, etc. with respect to adjustments to earnings reporting.

**R:** this decision as the rule for all other similar earnings management decisions that follow for these stakeholders.

## **Part 2: Review the Reference List**

Please read and use the articles below as references for your answers to the questions concerning the Ethical Issues Related to Earnings Management case.

**Lager, J. M. (2010). Governments demand compliance, ethics demands leadership. Journal of Public Affairs, 10(3), 216-224. doi:10.1002/pa.361.**

This article suggests that a leader wishing to avoid fines or business failure should prevent abusive or improper business conduct not by adoption of government rules, codes of conduct and periodic rules-based ethics training, but by establishing and maintaining a values-based organizational culture supportive of ethical behavior, largely through the principles of ethical leadership.

**Mitchell, J. M., Yordy, E.D. (2010). COVER It: A comprehensive framework for guiding students through ethical dilemmas. Journal of Legal Studies Education, 27(1), 35-60. doi:10.1111/j.1744-1722.2010.01067.x.**

The article provides an overview of the recommended ethical decision-making model for this case, COVER, since it addresses ethical dilemmas. It discusses several other models used for addressing ethical dilemmas including the Triple Font Theory (TFT) and the WPH Process of Ethical Decision Making and demonstrates that the COVER model incorporates a combination of theories that are relevant to accounting issues in particular.

**Xu, R., Taylor, G. K., & Dugan, M. T. (2007). Review of real earnings management literature. Journal of Accounting Literature, 26, 195-228.**

The article provides an overview of the literature about extant real earnings management. According to the article, one of the features of real earnings management is that it involves manipulation of real business activities, such as research and development expenditures, capital

investments and the production, sale and disposal of long-term assets. Instances of real earnings management in terms of operating, investing and financing activities are explored. Research is surveyed on the consequences and potential costs of real earnings management on firms' subsequent performance. Investors' reactions to real earnings management as well as studies on the interaction between accruals and real earnings management are discussed.

**Sun, J., Lan, G & Liu, G. (2014). Independent audit committee characteristics and real earnings management. *Managerial Auditing Journal*, 29.2, 153-172.**

This study investigates factors that may affect the ability of audit committees to constrain real and accrual earnings management. This article is important to this case in that it provides a detailed discussion comparing accrual and real earnings management. In addition, the article provides an in depth discussion relating to the effects of real earnings management on firm operations.

### **Websites of interest**

<http://cookingthebooks.blogspot.com/2011/04/earnings-management-what-and-why.html>

[http://www.swlearning.com/pdfs/chapter/0324223250\\_1.PDF](http://www.swlearning.com/pdfs/chapter/0324223250_1.PDF)

These two websites discuss earnings management, accruals earnings management, accruals management, and real earnings management. Both websites contain a discussion about the ethical considerations related to these topics.

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# DETOURS TOURING: FIGHTING CITY HALL

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## CASE DESCRIPTION

*The primary subject matter of the DeTours Touring case concerns entrepreneurial decision-making and negotiation. Secondary issues examined include governmental regulation, resource constraints, the competitive environment, and the business startup process and challenges. The case has a difficulty level of three and above, as it has been taught in junior/senior level and MBA classes. This negotiation works with classes ranging from 12 to 60. As a fishbowl exercise, a class size of under 20 is best. As a one-on-one exercise, larger class sizes also work well. The case is designed to be taught in one to one and one-half class hours. It works best in a class of at least 75 minutes. Allow 15 minutes for the precis, initial discussion and introduction. There should be 15 to 30 minutes for negotiation and an additional 30 to 45 minutes for post-exercise discussion and debriefing. The case is expected to require approximately one hour of outside preparation by students.*

## CASE SYNOPSIS

*The founder of DeTours Touring LLC, Rasa Vella, was on the verge of launching her new venture when the process was brought to a sudden stop. She was a young entrepreneur with a graduate degree in sport and tourism management from Temple University and related past experiences from around the world, including working in eco-tourism in the Amazon rainforest. From the inception of her business idea in September 2009 to the end of the case in June 2010, she succeeded in assembling all but one of the resources needed to launch a guided touring company in the Old City district of Philadelphia. Her concept was based on active outdoor pursuits, such as gliding on Segways, biking, and running. The missing piece was a permit from the Fairmount Park Commission (FPC), which controlled activities in and around 63 neighborhood and regional parks in Philadelphia. Under a week before the scheduled launch date, the previously unresponsive FPC demanded \$5,600 for a permit to operate in the Park Commission's jurisdiction. Vella was faced with the choice of paying from her operating reserves, seeking additional funds, negotiating with the FPC, or delaying the launch of her business to change her routes.*

## INTRODUCTION

Rasa Vella stared in shock and disbelief at a notice from the City of Philadelphia's Fairmount Park Commission. It demanded \$5,600 for a permit to use the trails and sidewalks abutting the city parks for her Segway tours. Vella was concerned and frustrated as she sat at her new desk at DeTours Touring in the Old City section of Philadelphia. It was less than a week before her scheduled July 1 opening and Vella had not expected such a large fee. The Philadelphia Streets Department charged her an annual permit fee of \$40 to use the streets and pavements in Center City Philadelphia and she could hardly believe that the Parks Commission charged so much just to ride Segways by a parkland that comprised less than 20 percent of her six-mile route. She had repeatedly requested information about the fees and received no response. This close to opening, the fee was a major setback for her fledgling enterprise.

## **BACKGROUND**

Vella was born in Michigan, where several members of her family business owners, and later moved to Reading, Pennsylvania. She completed a degree in entrepreneurship and marketing at Syracuse University and worked briefly for the Detroit Pistons and Amazon.com, sailed with Semester at Sea, and served with the Peace Corps in Africa. Vella relocated to Philadelphia in 2007 to pursue a master's degree in sport and tourism management at Temple University. She completed an eco-tourism placement with Kapawi Lodge in the Amazon Rainforest and another placement with Comcast Sports. While completing her studies and placements, Vella actively searched for a career opportunity that encompassed her interests in recreation, tourism, and entrepreneurship. Upon graduation from the program at Temple, Vella worked part time jobs so that she had time to find the right opportunity.

## **OPPORTUNITY IDENTIFICATION**

During a family vacation in Paris, Vella took a 3-hour Segway tour of the city. The Segway proved a perfect way to explore more of Paris than the average tourist could while enjoying the benefits of a guide's local knowledge. The proverbial light bulb went off in Vella's head. Segway tours were an opportunity to combine her love of outdoor recreation with tourism in her adopted hometown of Philadelphia. To the best of her knowledge, no one in Philadelphia was providing Segway tours in the historic Old City district.

Upon her return to Philadelphia in September 2009, Vella immediately began working on feasibility analysis via a business plan for a company focused on Segway, running and bicycle tours of Old City. She circulated the first draft to her uncles, both of whom were self-employed and potential investors, in December 2009. In February 2010, after some discussions and plan revisions, Vella's family members tentatively agreed to inject up to \$50,000 of equity. DeTours Touring began to work toward an official launch date of July 1, soundly in the middle of peak tourism season, which permitted time for acquisition of resources and startup efforts.

### **Tourism in Philadelphia**

Philadelphia was the fifth largest metropolitan area in the United States, and home to around six million people. Founded in 1682 by William Penn, its name literally meant "City of Brotherly Love". Philadelphia was probably best known for being the birthplace of the American Revolution in 1776. The Declaration of Independence was written by Thomas Jefferson and signed by the founding fathers in the Pennsylvania State House (now known as Independence Hall). In 1787, the Constitution was signed in the same location. Philadelphia served as the capital of the United State from 1790 to 1800. Many of the major landmarks from revolutionary times were preserved as part of the Independence National Historical Park (INHP), often referred to as 'America's most historic square mile'.

According to the Greater Philadelphia Tourism Marketing Corporation (GPTMC), the Philadelphia region received over 37 million domestic visitors in 2010. Approximately 12.5 million were overnight leisure visitors, a number that grew by 71 percent between 1997 and 2010. The GPTMC also reported that one-quarter of the U.S. population lived within a five-hour drive of Philadelphia. Most visitors came from the Philadelphia region (19 percent), followed by the New York (17 percent) and Washington (6 percent) metropolitan areas. Overnight travelers tended to be older, more educated, and more affluent than the U.S. average, stayed an average of 3.2 nights, and tended to travel in pairs.

The GPTMC also reported that center city hotels sold about 2.75 million room nights in 2010, which accounted for 35 percent of the total room nights in the five county area of greater Philadelphia, with leisure travelers accounting for 30 percent of the demand and convention/groups accounting for another 35 percent of the demand.

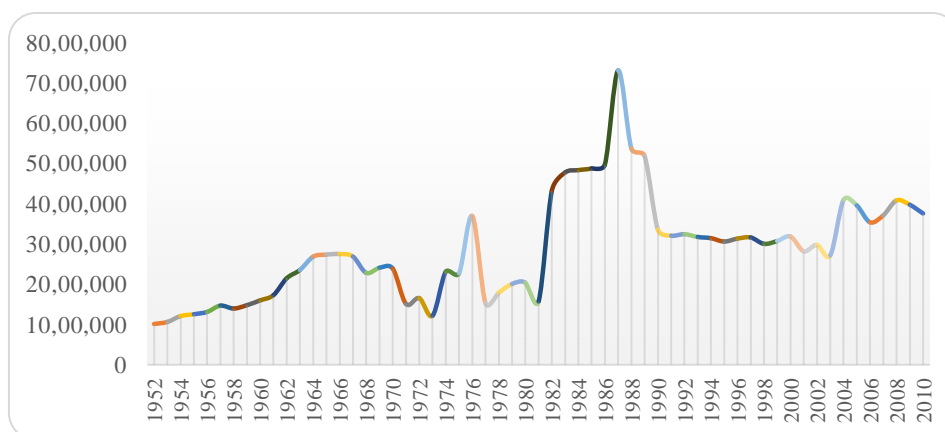
The National Park Service also maintained statistics on the number of visitors to the Independence National Historical Park in the Old City region of center city. Over the sixty years from 1950 to 2010, the number of visitors increased steadily to around 4 million visitors per year (see Figure 1). Around 40 percent of the visitors arrived in the summer months of June, July and August, while fall and spring each attracted around 25 percent of the visitor volume. Winter was the slowest season with around 10 percent of the visitors to the park. In June 2010, the National Park Service reported over 300,000 visitors at its visitor center, with about 100,000 people taking the paid tour at the National Constitution Center.

### Segways and Segway Tours

The Segway was a self-balancing personal transport device invented in 2001. The name ‘Segway’ was a homonym for ‘segue’ meaning “to transition smoothly from one state to another”. In 2006, Segway introduced the second-generation i2 model, which operated at up to 12.5 miles per hour with a range of 16 to-24 miles on a single electric charge and retailed for approximately \$6,000. With dimensions no larger than the average adult body and the ability to emulate human balance, the Segway used the same space as a pedestrian and could go wherever a person could walk. Since Segway’s launch, 31 states, including Pennsylvania, passed laws to allow Segways to operate on sidewalks and roads.

Segways became increasingly popular with tourists over time. One report found that Segway tours operated in at least 490 locations worldwide. Touring on a Segway allowed riders to travel on roads and pavements, mount and dismount, and cover relatively large distances in a short amount of time. People usually mastered the use of the machine with minimal training. Although a fun way to see a city or attraction, Segways also had disadvantages. Segway tours were more expensive than low-tech forms of guided tours, such as walking tours and bicycles, and riders had to be over 90 pounds, limiting families with young children. The lack of shelter from the elements made them less attractive in inclement weather than a bus or trolley tour. It was also not advisable to explore an area away from the machines (such as inside a building) as Segways were subject to theft. Finally, people could get injured if they operated the machine unsafely or incorrectly.

**Figure 1**  
**NUMBER OF VISITORS TO INDEPENDENCE NATIONAL HISTORIC PARK**



Source: <https://irma.nps.gov/Stats>



One other Segway tour company was operated in Philadelphia prior to DeTours' launch. iGlide, owner of 10 Segways, operated tours around the Art Museum and Fairmount Park area (approximately two miles from Old City) and was not licensed to operate in the Old City district. They also offered Segway rentals for corporate events and trade shows. iGlide charged \$73 for a 150-minute tour (day) and \$53 for a 90-minute tour (evening).

### Other Philadelphia Tour Competitors

Philadelphia Trolley Works, the largest tour company in town, offered bus, trolley, and horse-drawn carriage tours of the city. A 90-minute narrated tour with 21 stops on a trolley or bus sold for \$27 with the ability to hop on or off at any stop. A horse-drawn carriage ride around Old City was priced at \$80 per hour for one to four people. The company also offered a guided 75-minute walking tour of Old City for \$16.

Philadelphia Trolley Works sold other tours and attractions, including a city pass to six attractions around Philadelphia including the zoo, art gallery, and several museums. In addition, they cross-listed a number of 'specialty' tours such as a ghost tour, an Amish experience, a mural arts tour, and iGlide's Segway tours. None of the listed attractions or tours competed directly with Trolley Works' core bus/trolley/carriage business.

Philadelphia Ride the Duck Tours, which offered a land and water tour of the city on a six-wheel amphibious truck called a DUKW (hence 'duck') were also popular. Duck Tours were established in other cities such as Boston and San Francisco. In Philadelphia, a 70-minute tour was priced at \$27 for an adult, which compared favorably to an average price of \$33 in other cities.

A list of durations and prices for various competitor tours appears in Exhibit 1. This was a representative sample of tours available in the city. At least two other tour bus companies operated in Old City and another group offered free walking tours with costumed guides (compensated only with tips). Food tours were also an emerging niche market.

<b>Exhibit 1</b>						
<b>COMPARATIVE DURATIONS AND PRICES OF SELECTED GUIDED TOURS</b>						
	<b>DeTours</b>	<b>iGlide</b>	<b>Bus/Trolley</b>	<b>Walk</b>	<b>Carriage</b>	<b>Duck</b>
<b>Duration</b>	180	150	90	75	60	70
<b>Price</b>	\$79	\$73	\$27	\$16	\$80	\$27
<b>\$/Minute</b>	\$0.44	\$0.49	\$0.30	\$0.21	\$1.33	\$0.38

Sources: [www.iglidetours.com](http://www.iglidetours.com), [www.phillytour.com](http://www.phillytour.com), [phildelphia.ridetheducks.com](http://phildelphia.ridetheducks.com)

In addition, the Delaware and Schuylkill rivers were hosts to various boating tours, including sailing and a dinner cruise. Static attractions such as the National Constitution Center (\$12, free for children under 12), the Liberty Bell (free), and Independence Hall (free) also competed for tourist time and dollars.

### COMPETITIVE STRATEGY

The overall positioning of DeTours was "Recreation Tourism" to take advantage of an emerging trend for active, healthy experiences in tourism rather than more the passive tourist activities served by buses, boats, and trams. The name DeTours Touring was selected to allow room to grow the concept to other markets.

### Product & Price

Vella designed a 3-hour, 6 ½ mile tour of the Center City area that covered all of the important sites in Old City as well as the Art Museum (with its famous "Rocky" steps) for

\$79 (Segway), \$69 (bicycle), and \$55 (running). This tour was represented by the “Long/Orange” route in Figure 2 and included 15 stops. At \$0.44 per minute, the Segway tour was priced below iGlide and covered all of the famous attractions of Old City that iGlide did not. DeTours, therefore, differentiated itself from iGlide by offering a historical tour that also had the option of including the park areas on a longer tour.

## Place

Vella based her business in an Old City retail location reasoning that yielded greater access to passing tourists, increased the visibility of the DeTours brand, provided a convenient and comfortable space for her clients, and made it easier to form relationships with other vendors and stakeholders in the Old City district. By contrast, iGlide, transported the Segways on a trailer to a parking lot on the edge of Center City and had no retail storefront for customers.

## Promotion

DeTours planned to use a grassroots marketing campaign to promote Vella’s new business. Starting with a professionally developed website that accepted online bookings, she planned to ride around on a Segway in a bright orange t-shirt handing out flyers to tourists in the Old City area to generate awareness. At a networking function in April, Vella met the Philadelphia representative of a new website called “Groupon”. The concept seemed to be a great way to promote DeTours. She had to discount her tour by 50 percent and give half of the reduced revenue to Groupon. However, Groupon’s 110,000 subscribers in Philadelphia were exposed to the daily offer rapidly and greatly increasing DeTours’ brand awareness.

**Figure 2**  
**DETOURS TOURING ROUTES**



## TIMELINE

By the end of March, Vella completed much of the research for launching the business. She spoke with the Business Services Center (BSC) at City Hall about the requisite

permits and licenses. The BSC was a group designed to assist entrepreneurs with starting businesses and interfacing with the various departments that regulate business activity in Philadelphia. They told her DeTours needed a business privilege license (a onetime fee of \$300), as well as five annual permits. Three of these permits came from the city's Department of Licensing and Inspection: a use and occupancy permit for retail space, a signage permit to put a sign on the store window, a handbill permit to distribute flyers to tourists. DeTours needed a permit from the Philadelphia Streets Department to operate on city streets and pavements and another permit from the Fairmount Park Commission (a subsidiary of the City's Department of Parks and Recreation) to operate on the pavement surrounding city parks and through the Schuylkill River Trail on the west side of the city (the green areas on the route map – Figure 2).

In addition to city regulations, Vella researched business structures, federal and state regulatory requirements, accountants and attorneys, retail locations, Segway dealer prices, website designers, and business loans. On the basis of the information, her family agreed to provide up to \$50,000 of equity for DeTours subject to Vella receiving approval for a business loan to fund any remaining startup costs.

### **Realizing the Dream**

In April, Vella formally registered the business as a limited liability company (LLC), received a federal Employer Identification Number (EIN), opened a company bank account, and hired a website developer (see Exhibit 2 for timeline). Vella applied for a business loan from Wells Fargo Bank and reached out to the city government departments as suggested by the BSC for information on permitting. By the end of the month, she was working on a route proposal for the Streets Department, had not received a price from FPC, and her loan application had been denied.

In the beginning of May, Vella applied for a microloan from the Cooperative Business Assistance Corporation (CBAC) and she received an equity injection of \$10,000 from two family members. By using this money, Vella worked with a realtor to secure a two-year lease on a property at 3<sup>rd</sup> and Market Streets for \$2,500 per month starting on June 1. The realtor assisted with an application to the Department of Licenses and Inspection for a use and occupancy permit, a process which was complicated because the department had never licensed a Segway tour office. The signage and handbill permits quickly followed. The month ended with the CBAC approval of a \$25,000 microloan subject to two family members acting as guarantors. On the basis of this news, Vella sent a deposit to her Segway dealer, interviewed staff, and bought signage and office equipment.

At the start of June, Vella bought seven bicycles and started training staff. She met with representatives from the city departments to discuss permitting requirements in person. By mid-month, the website was completed and DeTours was able to start taking online orders. She also submitted her route proposal to the Streets Department and Fairmount Park Commission, carefully addressing the congestion and safety issues that were raised in the earlier meeting.

Toward the end of the month, Vella signed her loan documents (\$25,000 at prime plus 2.5 percent over 5 years) and received the final equity investment from her family (for a total of \$45,000). Vella purchased six Segways to be delivered on June 30. The Streets Department permit and a letter from the Fairmount Park Commission arrived on the same day as Vella ordered the six new Segways.

## The Fairmount Park Commission

The Fairmount Park Commission (FPC) was established by an Act of Assembly of 26 March 1867. The Act authorized the City to purchase land for Fairmount Park in order to preserve the purity of the City's water supply and provide a place of public enjoyment for the people of Philadelphia. The mission of the Fairmount Park Commission was to preserve and protect its open space; provide opportunities for recreation; and maintain the landscapes and structures, streams and woodlands that existed within its 8,700 acres. The 63 neighborhood and regional parks managed by the FPC comprised the largest municipally operated landscaped park system in the United States. Since 1951, the commission was a subunit of Philadelphia's Department of Parks and Recreation.

<b>Exhibit 2</b>	
<b>Timetable of DeTours Events</b>	
<b>Month</b>	<b>Activity</b>
Jan-Mar	Researched regulatory requirements, locations, equipment prices, service providers, and funding
April	Formed DeTours Touring as an LLC Applied and was rejected for a loan (Wells Fargo Bank) Contacted Streets Department and Fairmont Park Commission
May	Applied for and received a microloan (CBAC) Received equity investments Signed lease with May 17 move-in date Received business license and occupancy permit Recruited staff Bought office equipment and signage Placed a deposit on six Segways
June	Purchased eight bicycles Trained staff Met with Streets Department and Fairmont Park Commission Created route proposals for the Streets Department and Fairmont Park Commission Website went live Signed loan documents and received funds Received final equity investments from family Acquired Segways Issued a permit by the Streets Department

In addition to managing open spaces, the FPC operated numerous and diverse recreation facilities and activities within the city parks. These included 7 recreation centers; 9 day camps; 22 playgrounds; 127 tennis courts at 15 locations; 160 baseball, football, soccer, and softball fields; 35 basketball courts; 4 outdoor pools; and numerous hiking trails. Many special events also took place in Fairmount Park, including several running events, bicycle and antique car races, walk-a-thons, regattas, and small and large picnics, including the Greek Picnic with over 100,000 participants annually from around the country. The FPC was required to compensate other city departments for any additional costs generated during the events it ran (e.g. additional police for security during an event or sanitation workers for cleanup after an event). The FPC recovered these costs from permit fees levied on event organizers.

The Fairmount Park Commission had 16 members of whom 10 were citizens appointed for five-year terms by the Board of Judges of the Court of Common Pleas of Philadelphia. The remaining six were ex-officio members and included the Mayor, the President of City Council, the Commissioner of Public Property, the Recreation Commissioner, the Water Commissioner and the Chief Engineer and Surveyor of the Department of Streets.

## THE CHALLENGE

The FPC letter hit Vella like a bombshell. In their letter, the FPC explained that they would issue a permit to DeTours at the same rate as its main competitor. iGlide was charged \$5,600 to operate on park property during a six-month touring season that stretched from May to October. FPC required payment in full from DeTours to issue the permit.

Vella had been working seven days a week for the last three months to launch DeTours Touring on July 1. Adding to her frustration was the knowledge that she had been trying to get information on the cost of the FPC permit since April but nobody made a decision (or even returned her calls most of the time) during the almost three months. City officials themselves were unsure about whether the pavements next to the parks were regulated by the Streets Department or the FPC, so this decision was even more baffling. The FPC fee was unreasonable to Vella on a number of grounds:

- The Segways planned to be on park trails for 30 minutes a day (with another 30 minutes on the pavements alongside various parks).
- The DeTours tour planned to spend 2 hours a day on the streets and pavements of the city with a permit that cost \$40.
- iGlide spent all of their 2 ½ hour tours in and around the parks.
- Segway tours did not consume any extra city resources such as security or sanitation.

As she reviewed her finances (see Exhibits 3 and 4 for sources and uses of funds and operating projections respectively), Vella wondered whether her business could afford the seemingly arbitrary costs. Her options appeared pretty limited to her – somehow pay the \$5,600 for the permit, delay the launch of the business to get new routes approved without the FPC areas, or negotiate for a better solution. With under a week to her launch date, the pressure was on Vella to find a solution.

<b>Exhibit 3</b>	
<b>DETOURS SOURCES AND USES OF FUNDS</b>	
<b>STARTING CASH</b>	
Equity	\$45,000
Loan	<u>\$25,000</u>
<b>TOTAL CASH AVAILABLE</b>	<b>\$70,000</b>
<b>STARTUP COSTS</b>	
Segways (6)	\$33,000
Lease (first and last months)	\$5,000
Bicycles/Helmets	\$3,000
Insurance	\$3,000
Office Equipment	\$1,500
Promotion/Marketing	\$1,500
Website	\$1,500
Licensing Department	\$600
Streets Department	\$40
Fairmont Park Commission	<u>?</u>
<b>TOTAL STARTUP COSTS (No FPC)</b>	<b>\$49,140</b>
<b>OPERATING CASH RESERVE</b>	<b>\$20,860</b>

<b>Exhibit 4</b>	
<b>PRO-FORMA MONTHLY OPERATING STATEMENT</b>	
<b>REVENUE</b>	
Maximum Tours per Month	60
Maximum Paid Segways per Tour	5
Estimated Occupancy	33%
Estimated Segways Tours Sold	100
Net Price per Segway Tour Sold	\$75
Projected Monthly Revenue	\$7,500
Tour Guides @ \$50 per tour	<u>\$3,000</u>
Gross Contribution	\$4,500
<b>FIXED MONTHLY EXPENSES</b>	
Rent	\$2,500
Insurance	\$1,000
Loan	\$500
Utilities	<u>\$500</u>
<b>TOTAL</b>	<b>\$4,500</b>

# WALMART IN INDIA

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## CASE DESCRIPTION

*The primary subject matter of this case concerns international business strategy. This case is appropriate for senior level and first year graduate level courses. The case is designed to be taught in 3 class hours and is expected to require 2 hours of outside preparation by students.*

## CASE SYNOPSIS

*In 1962, Sam Walton, opened the first Walmart in Arkansas. Unlike other retailers that had frequent sales, Walmart used an Every Day Low Price strategy. This required a strong emphasis on searching for lower costs, through economies of scale in purchasing, delivery, and information systems. As Walmart's growth in the US eventually began to slow, global expansion became imperative. Walmart had several clear successes, as well as outright failures, in applying its expertise abroad. However, one country that seemed on the verge of either was India. Upper management needed to carefully consider past lessons learned overseas, as well as weigh the unique benefits and challenges of doing business in India, to decide if and how Walmart should continue its presence there.*

## INTRODUCTION

In early 2013, Doug McMillon, the CEO of Walmart's International division, worked on an urgent presentation to the company's Board of Directors that was coming up in the next two weeks. McMillon realized that Walmart's commitment to India, the world's second largest country by population (Central Intelligence Agency, 2014), had to be addressed now.

India had turned out to be very different from Walmart's many other expansions in the West. A large population and growing middle class presented a potentially lucrative opportunity. However, India's business and political climates had posed challenges lately. The Indian economy's growth rate slowed from 6.2% in 2011 to 5.3% in 2012 (Times of India, 2013). India's currency, the rupee, was already very weak. In mid-2011, the exchange rate was 61.36 Indian rupees for 1 US dollar. The rupee fell another 25% in 2012 (Sahoo, 2012). This further eroded the purchasing power of India's consumers.

There was always an undercurrent of hostility towards international corporations, left over from India's colonial days (Bajaj, 2012). However, there were signs of potential change. India was poised to elect a new Prime Minister. A candidate widely perceived as particularly strong was Narendra Modi. As Chief Minister of Gujarat, Modi had implemented pro-business reforms (Hume & Udas, 2014). The more welcoming climate successfully attracted more investment, such as a Tata car factory, which significantly increased Gujarat's economic growth. Modi's rule could therefore result in new opportunities for Walmart to expand. However, Modi's Bharatiya Janata Party believed in the Hindu nationalist policy of *swadeshi*, self-reliance, and did not welcome foreign retailers (Punj, 2014). How Modi would balance these competing demands was uncertain.

McMillon reviewed Walmart's progress in India to date. Walmart had already made a significant investment in India, going back to 2007. Unfavorable economic and political environments had led Walmart to sever ties with its Indian partner, Bharti Airtel, and consider giving up. However, important changes seemed imminent. The political landscape had shifted. E-commerce in India was growing. Rival foreign retailers continued to assess the Indian market. McMillon wondered what he should recommend to the Board.

### WALMART'S HISTORY

In 1962, Sam Walton, opened the first Walmart in Rogers, Arkansas (Walmart, 2013e). Competitors relied on periodic sales and promotions, which encouraged customers to wait for a sale before buying. Instead, Walmart used an Every Day Low Price strategy, which relied on lowering costs through economies of scale, heavy use of computer technology, and a hub-and-spoke distribution network. Walmart quickly grew to 24 stores by 1967, with a nationwide expansion and Initial Public Offering in 1970. Headquarters moved to Bentonville, Arkansas in 1971. The 1980s saw the debut of the Walmart Supercenter concept, which included supermarket operations, and the Sam's Club warehouse chain. Table 1 shows Walmart's store types in the US.

<b>Table 1</b>		
<b>WALMART US STORE TYPES</b>		
Store Type	Size (Square Feet)	Year Introduced
Discount Store	106,000	1962
Supercenter	182,000	1988
Neighborhood Market	38,000	1998
Express	15,000	2011

(Walmart, 2013a)

As the US economy worsened in the mid-2000s, the retail sector increasingly faced the question of how best to cope with long-term stagnation. By 2014, Walmart's annual revenues were \$476.2 billion, up 1.6% from 2013 (Walmart, 2014a). US operations made up 59% of net sales, 38% of Walmart's approximately 11,000 stores, and 59% of Walmart's 2.2 million employees (Walmart, 2014b). However, US same store sales were down 0.6% (Walmart, 2014a). Walmart was also facing increasing pressure from its US competitors. Annual US revenue growth over approximately the same time period was 5% at Costco (Trefis, 2014) and 4% at Target (Target, 2013). Walmart's growth in US demand was forecasted to remain low for the foreseeable future, with steep price cuts needed to spur spending in a weak economy (Wahba & Baertlein, 2013).

### INTERNATIONAL EXPANSION

The financial outlook was much better for Walmart's international division. Net sales, excluding currency exchange rate fluctuations, increased 4.6%, to \$140.9 billion (Walmart, 2014a). A faster pace of international expansion was critical to Walmart's long-term success. Table 2 shows highlights of this growth as of fiscal 2013. The US store count includes all Walmart and Sam's Club formats. International store counts include all retail and wholesale Walmart brands. Estimated revenues are for fiscal 2013 unless otherwise noted.



<b>Table 2</b> <b>HIGHLIGHTS OF WALMART'S INTERNATIONAL LANDSCAPE</b>		
Country	Total Retail Units (As of July 31, 2014)	Estimated Revenue
US	4,921	\$275 billion
Brazil	556	\$11.5 billion (2011)
Canada	391	\$11 billion
China	400	\$10 billion
India	20	\$500 million
Mexico	2,204	\$3.94 billion
United Kingdom	583	\$36.5 billion

Total Retail Units from Walmart, 2014c

US Estimated Revenue from Walmart, 2013a

Brazil Estimated Revenue from Dalbo, 2012

Canada Estimated Revenue from Martell & Wohl, 2012

China Estimated Revenue from Loeb, 2013

India Estimated Revenue from Bailay & Chakravarty, 2013

Mexico Estimated Revenue from Guthrie, 2013

United Kingdom Estimated Revenue from Walmart, 2014a

## Strategies

Walmart already had considerable experience operating globally. In 1991, Walmart opened a Sam's Club in Mexico City. As Walmart considered the potential for more growth, an international division was created in 1993, under the direction of Bob Martin (Walmart China, 2013). Walmart thus chose a geographic structure, with separate CEOs for the US and International divisions. Most of Walmart's international expansion strategies involved applying its expertise in pricing, logistics, and store location selection to new contexts, with the help of local partners. Stores were often scaled down to better meet local needs, such as the Neighborhood Market format in Mexico, and the Urban 90 small supercenter concept for densely populated areas in Canada (Russell, 2012). Walmart made these changes to maintain a viable position, especially when local competitors began to adapt some of its successful strategies.

## Successes

Walmart rapidly expanded abroad throughout the 1990s, with new acquisitions and partnerships every year. By 2014, success stories included Mexico (Walmart, 2013i), Canada (Walmart Canada, 2013), China (Walmart China, 2013), Brazil (Walmart, 2013g), the UK (Walmart, 2013j), and Sub-Saharan Africa (Maylie, 2013).

## Failures

The nature of global retail was quickly changing, and Walmart needed to more effectively evolve with it. As Doug McMillon explained, "Walmart is progressing from being a domestic company with an international division to being a global company" (Boyle, 2009).

Walmart dropped out of Germany in 2006 (Landler & Barbaro, 2006). There were many reasons for this decision. Walmart had appointed an expatriate American to lead German operations, who did not speak the language (Schultz, 2006). This made it more difficult for Walmart to navigate the German retail landscape, which already contained a large number of competing discount brands. Germany's dense population and zoning laws

made it hard for Walmart to build more stores (Schultz, 2006). Walmart opened new locations on the fringes of metropolitan areas, and offered items in large boxes (Landler & Barbaro, 2006). Many German consumers lived in cities, did not have cars, and preferred to make daily purchases of small batches of fresh food from local specialty markets. German consumers disliked smiling cashiers and greeters at the front door, which they viewed as flirting (Landler & Barbaro, 2006). Meanwhile, German employees disliked morning warm-up chants, and a ban on flirting with colleagues (Schultz, 2006). Walmart bought large quantities of inappropriate products, such as pillow cases in American, rather than German, preferred sizes (Schaefer, 2006). German environmental sensibilities were offended by flimsy plastic products in large plastic packages wrapped in free plastic bags (Macaray, 2011). Laws intended to protect small businesses limited Walmart's evening operating hours and discounting (Schultz, 2006). Labor laws were incompatible with Walmart's expectations of a high turnover, low wage workforce (Schultz, 2006), as was the common German practice of close collaboration between management and labor unions (Landler & Barbaro, 2006). Walmart's German workforce was also not as interested in labor mobility as its counterpart in the US. When Walmart closed a regional headquarters, many German managers preferred to quit rather than relocate (Landler & Barbaro, 2006).

Also in 2006, Walmart dropped out of South Korea (Landler & Barbaro, 2006). Many South Koreans liked to enjoy luxurious items in their very limited spare time, and were not receptive to marketing approaches that emphasized the lowest price (Marshall, 2010). South Korean consumers were primarily urban, but Walmart only had 1 store in Seoul (Kim, 2008). There were just 16 stores in the whole country, which limited Walmart's ability to achieve economies of scale needed for deep discounts. These issues were compounded by an inappropriate product mix and customer experience, a recurring theme from Walmart's failure in Germany. Consumers wanted fresh food and beverages from big-box stores, not electronics (Berfield, 2013). They preferred shelves low in height (Landler & Barbaro, 2006), attractive point of purchase displays (Sang-Hun, 2006), clerks actively drawing attention to the goods, and store roof decorations to mask beams and pipes (Landler & Barbaro, 2006). Consumers also wanted free product samples and frequent sales, which clashed with Walmart's Every Day Low Price strategy (Kim, 2008).

## **THE INDIAN RETAILING MARKET**

### **Demographics**

India offered Walmart a huge opportunity. India's population grew quickly from approximately 400 million in 1950 (World Population Review, 2014) to 1.2 billion in 2013 (Mustafi, 2013). Recent population growth averaged approximately 1.3% nationwide and 2.5% in cities (UNdata, 2013). It was estimated that by 2030, 570 million Indians would live in cities, double the current US population (Chakraborty, 2014).

India's economy was also rapidly growing, but unevenly. The proportion of Indians living in poverty dropped from 45% in 1994 to 22% in 2012, although as many as 56% of the population was estimated as unable to meet their basic needs (Mahr, 2014). The middle class was estimated at 25% of the population, and was expected to grow to 583 million by 2025 (Mustafi, 2013). Most of India's economic growth was predicted to occur in high-performing metropolitan clusters in southern provinces (McKinsey & Company, 2014). These provinces were forecasted to reach the same purchasing power parity as some entire countries by 2025.

Despite these promising demographics, Walmart had to proceed cautiously in India. Successfully overseeing operations halfway around the world from Arkansas headquarters posed several challenges. As Walmart had seen in Germany and South Korea, the social,

economic, and political environments in Walmart's home market sometimes proved unsuitable for export. Walmart had evolved in the context of a relatively transparent government, a generally safe supply chain, and a comprehensive distribution infrastructure. Americans had decades of experience purchasing items from impersonal big-box retailers. They grew accustomed to, and increasingly preferred, shopping over the Internet. Many American consumers also had positive experiences with foreign brands. Therefore, the American context provided a more liberal approach to trade than India.

### **Economic Liberalization**

India gained independence from Britain in 1947 (Kaul, 2011). Since that time, its markets were zealously guarded with layers of inefficient government bureaucracy, under the guise of self-sufficiency (Weinraub, 1991). However, over several decades, this led to large government deficits and inflation. It became clear that the long-standing system was unsustainable.

India's foreign debt had rapidly grown from \$20.5 billion in 1980 to \$72 billion in 1991 (Weinraub, 1991). India had \$1.1 billion in foreign currency reserves to pay for imported goods, which would have lasted for 2 weeks. The Soviet Union had frequently provided financial assistance, but as it sat precariously on the verge of disintegration, was no longer able to do so.

India's central government scrambled to avoid default (Weinraub, 1991). It sold 20 tons of gold to pay its immediate bills, and requested a large emergency loan from the International Monetary Fund. However, such a loan came with strict demands for structural economic reforms. India had to reduce budget deficits, open its protected markets to foreign direct investment, and streamline its government bureaucracy.

There was a widespread popular outcry that India, which preferred self-reliance since its independence from Britain, was forced to allow foreign interference (Weinraub, 1991). The central government realized liberalization was needed to save India's economy from imminent collapse, and agreed to the International Monetary Fund's demands. However, in deference to political pressure, economic liberalization came gradually to different sectors of the economy.

### **Retail Industry**

The retail sector was especially resistant to change. By 2013, India's retail sector was worth approximately \$520 billion, and predicted to grow at 13% annually, to \$950 billion in 2018 (Ernst & Young, 2014). However, organized retail was just 7.5% of this huge market. Most retail in India was unorganized, and consisted of small, family-run local stores called *kiranas* (Deloitte, 2013). 40% of Indian retail activity occurred in rural areas with poor infrastructure (Equity Master, 2013). However, organized retail in India was expected to grow at 20% annually (India Brand Equity Foundation, 2012), to 10% of the market in 2018 (Ernst & Young, 2014). In 2012, the largest retail category was food and grocery, with 60% of total retail revenues. The largest organized retail category was Apparel, with 33% of organized revenues. The second largest organized retail category was mobile and telecom, with 11% of organized revenues. Luxury retail segments were forecast to grow 25% each year (Equity Master, 2013).

Several Indian retail chains dominated the organized sector. Their brands and 2013 store counts are shown in Table 3.

<b>Table 3</b>		
<b>INDIAN SUPERMARKET STORE COUNTS AS OF 2013</b>		
<b>Parent Company</b>	<b>Brand</b>	<b>Total Store Count</b>
Reliance Industries	Reliance Fresh	550
Future Group	Big Bazaar	530
	Food Bazaar	
	Foodhall	
	KB's Fairprice	
Aditya Birla Group	More	504
REI Agro Ltd	6Ten	344
Bharti Group	Easyday	210
RP-Sanjiv Goenka Group	Spencer's	135
Avenue Supermarkets	D-Mart	79
Godrej Group	Nature's Basket	32
Tata Sons	Star Bazaar	11

(The Economist, 2014)

Poor infrastructure was a major hindrance to the growth of India's retail sector. Produce in India was supplied by a large number of very small farms, separated from retailers by several government wholesale markets, a long string of middlemen, improper storage, and poorly maintained roads (Sharma & Mukherji, 2013). Air pollution destroyed approximately 6.7 million tons of India's crops annually, worth approximately \$1.3 billion (Mosbergen, 2014). Adequate municipal waste disposal and recycling facilities were sorely lacking (Acharya, 2012). These supply chain challenges often resulted in long delivery times, a need to tie up capital in large inventories, and a lack of product freshness (Ernst & Young, 2014). Local corruption continually stymied the Indian central government's attempts at improving social welfare and infrastructure (Rachman, 2012).

### Competition

Unorganized retail in India was highly entrenched for a long time, which gave it several advantages over foreign multinational newcomers (Price Waterhouse Coopers, 2012). *Kiranas* benefitted from low labor, real estate, and tax costs. Their close geographical proximity to customers, local preferences for frequent small purchases, willingness to grant credit, and free delivery, enabled personal relationships to flourish (The Economist, 2014). In some cases, these relationships spanned multiple generations (Price Waterhouse Coopers, 2012). Although supermarkets emphasized one-stop shopping, with a lot of product variety, *kirana* clusters were able to meet many of the same needs (The Economist, 2014). Over 60% of wealthy city residents preferred *kiranas* to supermarkets. These strong preferences remained relatively consistent across many product categories. To remain competitive with larger, foreign stores, some *kiranas* adopted Western inventory and demand forecasting technologies (Price Waterhouse Coopers, 2012).

By 2013, this intense competition led an increasing number of retailers to expand to smaller Indian cities. These included Jaipur, Nagpur, Ludhiana, Vadodara, Aurangabad, and Kochi (Ernst & Young, 2014). Retailers also increasingly sought to balance growth and new store formats with strategies to increase the profitability of existing outlets. New productivity initiatives involved increasing store energy efficiency, improving customer service, increasing product freshness, greater use of contract employees, and talent retention.

Multinationals thus had to contend with strong consumer loyalty to increasingly agile local brands, in addition to competition with each other, in an increasing number of geographic areas. Yet, there were signs of change.

## Consumer Trends

India frequently found itself caught between opposing forces regarding liberalization of foreign trade. This was in large part due to a demographic divide. 50% of the population in India was under 25 (Bajaj, 2012). They were born around the time India began opening its economy in the early 1990s, and saw many foreign corporations create jobs in the era of outsourcing. These young adults were inclined to view foreign brands as premium and aspirational status symbols (Corstjens & Lal, 2012). However, they had not yet accumulated as much disposable income as their parents (Bajaj, 2012). This made the younger generation more receptive to the value proposition that stores like Walmart provided.

In contrast, the older generations tended to prefer locally owned stores over Western-style shopping malls (Bajaj, 2012). They remembered India's socialist policies that favored self-sufficiency, a reaction to Britain's colonial rule. They believed that foreign multinationals would drive local companies out of business, and repatriate the profits to their home countries. Many Indian politicians were in this age range, and since young people in India were less likely to vote, these politicians had little incentive not to advocate for protectionist views. Such differences in attitude between the half of the population that was favorable to foreign retailers, and the half that was not, frequently led to swings in economic policy.

## A BARRIER TO ENTRY: POLITICS

Shopkeepers, intermediaries, market workers, and farmers feared that India's economic liberalization threatened their jobs (Franz, 2010). Shopkeepers were afraid of losing market share to large supermarkets. Intermediaries and market workers expected that Western-style supply chains would obliterate their roles. Farmers anticipated that large retailers would demand large price concessions.

Nongovernmental organizations (NGOs) took up the cause. The NGOs argued that displaced workers were uneducated and unskilled, which would make it very difficult for them to seek other employment (Franz, 2010). A consortium of NGOs, led by India FDI Watch, consulted with the Association of Community Organizations for Reform Now (ACORN), a veteran of anti-Walmart campaigns in the US. Warring stakeholder factions were united against a larger common enemy. Battle plans were drawn up targeting Western retailers that were poised to enter the Indian market, as well as against large Indian retailers on the brink of rapid expansion.

In 2006, the Indian central government proposed liberalized foreign direct investment rules (Franz, 2010). In response, NGOs organized a one-day Delhi bazaar strike, and rallies in front of Parliament House. Other protests were more violent. In 2007, large numbers of protestors attacked supermarkets and distribution centers that belonged to India's Reliance chain. In 2008, protestors claimed that Germany's Metro wholesale outlets did not verify that its buyers were really *kirana* owners, as promised. These demonstrations severely hindered Metro's expansion plans in India.

## WALMART'S STRATEGY IN INDIA

In 2005, Walmart announced its intent to invest in India (Franz, 2010). However, this could not be accomplished until the retail sector was further liberalized.

In 2007, despite popular resistance in many areas, the Indian central government sought to attract more such foreign direct investment. Multinational retailers were allowed to fully own wholesale outlets, but they were limited to a 51% ownership stake in single-brand

retail stores, and were not allowed to have any stake in multi-brand retail stores (Aggarwal, 2007). Walmart thus decided to use a back door strategy involving only wholesale.

Walmart created a joint venture with well-known cell phone retailer Bharti Airtel, dubbed Bharti Walmart Private Limited (Walmart, 2013h). The joint venture initially managed the supply chain for Bharti's retail chain, EasyDay (Sharma, 2011). Walmart increasingly left its mark on EasyDay, with frequent site inspections, the introduction of Every Day Low Pricing, and sales of Walmart private labels in EasyDay stores (Mookerji, 2013). However, since Walmart historically placed its own name on stores under its direct control, EasyDay retained a separate layout and brand name (Sharma, 2011). In 2009, the Bharti Walmart partnership was expanded to operate cash and carry stores, dubbed BestPrice Modern Wholesale.

In September 2012, the Indian government relaxed trade restrictions again. Foreign corporations were allowed to have up to a 51% ownership stake in multi-brand retail supermarkets, but only in cities with at least 1 million people, and only in willing states (Deloitte, 2013). Conditions were added to help placate the ensuing protectionist uproar. 30% of products had to be sourced from local small businesses. A minimum \$100 million investment was required, with half designated to improve back-end infrastructure. Foreign multi-brand e-commerce was prohibited, even though Internet usage in India was expected to increase 175% from 2013 to 2015 (McKinsey & Company, 2013).

### SIGNS OF TROUBLE

Problems soon surfaced. In 2012, the *New York Times* reported that since 2005, senior Walmart executives in Mexico bribed local government officials, to accelerate the approval of new store permits, and actively attempted to hide their activities from US headquarters (Barstow, 2012). Walmart's lead investigator recommended the investigation be expanded, but until the article's publication, this was actively thwarted. Instead, Walmart chastised the internal investigators for being too aggressive. Walmart then arranged for the investigators' files to be transferred to the same lawyers in Mexico City that had approved the bribes. Not surprisingly, the lawyers found that no wrongdoing had been committed. Headquarters later expanded the bribery investigation to Brazil, China, and India (Kazmin, 2013). Walmart's troubles did not end there.

The Indian central government claimed that Walmart used underhanded tactics to skirt the foreign ownership rules. In December 2009, Bharti had changed its business registration from retail to consulting services, and in January 2010, changed its name to Cedar (Bose, 2012). Foreign ownership of consulting firms was allowed. Walmart then gave Bharti a \$100 million interest-free loan, which would be required to be converted to an equity stake, if India later allowed foreign retail store ownership (Harris, 2013; Kazmin, 2013).

As elections approached, the Indian central government caved to political pressure, especially from small shop owners in poor northern provinces (Rapoza, 2013). Several international retailers had planned on opening big box stores in partnerships with local firms.

Meanwhile, the Indian economy's growth rate slowed from 6.2% in 2011 to 5.3% in 2012 (Times of India, 2013). The already-weak rupee fell 25% in 2012 (Sahoo, 2012), which further eroded the purchasing power of India's consumers.

The 30% local sourcing law ultimately became the most bothersome of all. Walmart argued that the law was unfair, since it did not apply to Indian retailers (Harris, 2013). Walmart also explained that the small local businesses were unable to fulfill the large orders needed to achieve economies of scale. Given this constraint, the best it could do was purchase 20% of products locally (Agence France-Presse, 2013).

## STRATEGIC DIRECTION

As a large, populous country, India presented many potentially lucrative opportunities. Yet, Walmart's efforts there increasingly faced an uncertain political and economic future. What should upper management do?

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# **BUILDING A SYMBIOTIC SUSTAINABLE MODEL: A COMMUNITY BASED ENTERPRISE**

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## **CASE DESCRIPTION**

The primary subject matter of this case concerns the community based enterprise, social and sustainable development, and strategic partnering. Secondary issues examined include the corporate social responsibility and strategic positioning of the community based enterprise. The case is at a difficulty level of three and would be better suited for third year junior level students or higher. It can also be used for more advanced levels as well with guidance from faculty. The case is structured to be taught in a 60-minute class with the case assigned to individuals or teams for prior reading before class discussion. Outside preparation by students is expected to be approximately three hours.

## **CASE SYNOPSIS**

This case explores the nature of symbiotic relationship between an Indigenous community (Maasai) and an international non-governmental organization (ADCAM). The case details the evolution and development of the relationship between the community and the non-governmental organization as they focus on creating sustainable solutions that are community owned and operated. The Maasai are the keepers of the land, culture and they provide the talent needed to develop products for foreign markets. ADCAM's role is to link community-based entrepreneurs to the fashion industry in Western Europe, North America, Japan etc. The partnership has thus far been successful over the last seven years.

## **INTRODUCTION**

### **The Role of ADCAM: Linking the Indigenous Entrepreneurs to the Corporate World**

ADCAM International was founded in Spain in 2005. ADCAM International, headquartered in Alicante, Spain, stands for *Asociación de Desarrollo, Comercio Alternativo y Microcrédito* in Spanish which can be loosely translated into 'Development, Alternative Trade and Microcredit Association'. It established a chapter in Kenya in 2007 and another in the United States of America (USA) in 2013. The founding President of ADCAM International, Ms. Rosa Escandell had more than twenty years' experience in the corporate and microcredit field before she founded ADCAM International. She had previously worked with Muhammad Yunus, recipient of 2006 Nobel Peace Prize and developed projects in a number of developing nations such as Bangladesh, Brazil, India, Colombia, Mexico, and Argentina among a host of others. ADCAM International has always strongly advocated for the rights of marginalized people to self-determination, meaning that the people themselves must be free to determine the terms of their own development. Sustainable development and self-determination are two sides of the same coin for this organization. There must be a genuine commitment to dealing with both sides simultaneously if sustainable progress is to

be achieved. ADCAM International seeks to promote culturally sensitive business opportunities for both developing and developed nations. Symbiotic sustainable models are built on mutually beneficial relationships where the involved parties create shared values. The partners seek to meet their present needs without compromising the ability of future generations to meet their needs. It aims at preserving both cultural and natural heritage while providing a livelihood for the present generation.

For the Maasai and other marginalized communities, ADCAM International was able to understand and relate to their cultural and spiritual issues, and also to act as a bridge between the communities and western markets, thus spanning the divide. ADCAM International attempted to connect the supply (goods and services rendered by the marginalized communities) and the demand (mostly markets in the developed nations) in a fair trade and socially responsible manner. ADCAM International understood cost structures, deadlines and tight market timelines, quality control and value of brand equity required by multinationals as well as the need for a fair return on investment. At the same time it respected the communities' right to determine the terms and pace of their development. After working with several development projects in Bangladesh, Brazil, Colombia, Mexico, and India among a host of other nations, Ms. Escandell decided that maybe it was time to venture into Africa.

### **A SAFARI TO KENYA: MEETING THE MAASAI MORAN (WARRIOR)**

Ms. Escandell's first trip to Kenya was in 2005. As part of her itinerary, the Spanish embassy in Kenya had prepared an impressive lineup of community-based social enterprises to pitch their proposals to her in Nairobi. At this juncture, Ms. Escandell was considering the possibility of working with a local partner, preferably a community-based organization. After three days of non-stop presentations, she was impressed, but none of the proposals really touched her heart. With just a day left before her departure to Spain, an employee at the embassy mentioned in passing a certain Maasai man who had frequented the embassy for the past eight years asking for assistance to build a school in the Mara and a market for the Maasai women to sell their crafts. Ms. Escandell was intrigued by the story of a Maasai man who had the audacity and perseverance to single-mindedly pursue a goal for more than eight years without any tangible results. She told her program coordinator, Ms. Cristina Pérez Fortes, "I want to meet this Maasai man; I have never met a Maasai, moreover I am curious to see this man who has not given up after eight years of asking for help to no avail." So arrangements were made to fly the Maasai warrior, William Ole Pere Kikanae, to Nairobi the next day.

William Kikanae did not disappoint. He spoke passionately about his dream for a school in the Mara. However, what won over the ADCAM International team was his dream for the Maasai women which resonated with ADCAM's vision and also gave the relatively new organization a purpose in that region of the world. William also elaborated on the challenges his tribe faced because of prolonged drought seasons, since the Maasai were historically a nomadic community. Furthermore, the ever-diminishing share of land due to fragmentation of communal land and loss of land to national parks and game reserves meant that the community no longer was able to keep large herds of cattle which was its economic mainstay. He spoke of the changing lifestyle imposed by external factors and how the community was ill-equipped to deal with its new realities.

In the past, the older generation never saw value in education. Our lifestyle was self-sustaining without the intrusion of the outside world. Our diet consisted of meat, blood, milk, honey and herbs from the bush. You know, one cannot farm in the savannah because of the wild animals and the type of soil. When we got ill, we used herbs. We consumed herbs as part of our diet, but there are also medicinal herbs that we use to this day. All that has now changed. Our diet has changed as well. The illnesses people have today sometimes require modern medicine. We have moved from the blended life with the wild animals, and we now live on the peripheral areas of the Mara. We have to buy our vegetables from the open market. We need money for medical care. We need money for clothing. We no longer have free access to critical resources within the reserves. - William Ole Pere Kikanae, Maasai Leader and Director of ADCAM (Kenya).

### **THE MAASAI COMMUNITY**

The majority of the Maasai live in Southern Kenya and Northern Tanzania, mainly in the Maasai Mara region, where they have pursued traditional nomadic culture for centuries. The Maasai population is estimated at about one million. Maasai Mara derived its name from the ancestral inhabitants of the region, the Maasai tribe and Mara River, the path of the great annual migration of wildlife. It is estimated that around 1.3 million wildebeest, 0.6 million zebra, and Grant's gazelle trekked from Tanzania's Serengeti Plains to Kenya's Maasai Mara National Reserve every year (see Exhibits 1a and 1b). The Maasai people are among the most well-known indigenous communities in the world, and they are desperately trying to preserve their traditional culture and practices. Over the years, the Maasai preserved their cultural heritage by excluding themselves from mainstream communities. However, severe droughts and fragmentation of communal land, forced them to increasingly embrace private ownership of land, livestock and other resources. In 1911, the Maasai community lost about 60% of its best pasture land when it was evicted from the northern region of the Great Rift Valley to create room for European colonists forcing them to settle in the southern region of the Rift Valley consisting of Narok and Kajiado counties. In 1945, the Maasai suffered a second wave of land alienation when parks and game reserves were created where they co-existed with the wild animals and the land. Unfortunately for the Maasai this changed again with the Land Adjudication Act of 1968 which initiated the designation of these lands as group ranches. The land was thereafter fragmented further into individual title deeds due to insecurity of land tenure. As a result, the Maasai were forbidden from accessing pastureland or water within the reserves. The Maasai were driven by necessity to find ways to preserve their heritage while at the same time earning a livelihood.

The Maasai tribe, like most indigenous peoples across the globe, have been marginalized. They have had very limited access to basic amenities such as drinking water, elementary education and basic healthcare. As a result, they tend to suffer poorer health, experience reduced quality of life and lower life expectancy than their other African

counterparts. According to the 2007 United Nations Declaration on the Rights of Indigenous Peoples, the Maasai tribe was severely threatened and endangered, meaning their lives and livelihood, were quickly changing and likely to be extinct in the near future. For instance, the Maasai, like many other indigenous peoples, were fast losing their language and culture. Maa, the Maasai dialect, is an oral language that has not been documented and therefore vulnerable to extinction.

Today, the Maasai would like to create economic opportunities for themselves while preserving the integrity of their heritage. Currently, the Maasai's entrepreneurial activities range from individual activities (selling crafts such as carvings, embroideries, footwear, baskets, accessories as well as hair braiding, etc.) to communal activities (for instance, traditional dance known as '*Adumu*'). Tribal narratives and a tribal worldview largely guide their entrepreneurial activities.

**Exhibit 1a**  
**MAP OF KENYA DEPICTING THE MAJOR NATIONAL PARKS AND GAME RESERVES**



Retrieved from: <http://www.africa-travel-guide.com/wp-content/uploads/2012/04/Kenya-national-Parks-map.jpg>

**Exhibit 1b**  
**MAP OF MARA DEPICTING PREDOMINATELY OCCUPIED BY THE MAASAI TRIBE**



Retrieved from <http://masaimara1.blogspot.com/>

### WOMEN IN PATRIARCHAL CULTURES IN EASTERN AFRICA

Officially, the Maasai women played no part in any of the tribal decision-making roles. Even when their opinions were requested, the final decision rested with the elders and the warriors who were men. The Maa language classified women in the same word group as children despite the fact that rites of passage existed for women. Most domestic tasks were carried out primarily by women and the girls, and this reduced time for economic opportunity tasks and schooling. While the young boys and the warriors were required to herd the cattle, the Maasai women and young girls were tasked with fetching water, hauling and hewing firewood, building *manyattas* (huts), babysitting and cooking, working on and selling their handicrafts amongst a host of other responsibilities.



Extreme poverty coupled with traditional practices such as arranged marriage and dowry/bride price limited the chances of girls to obtain an education and to determine their own destiny. However, these issues were more than just a conservative pastoral patriarch's running over the individual rights of young girls. The Maasai community over the years had been faced with predicaments like land reform, political and economic marginalization and failures of state systems. Confronted with severe time constraints, and lacking the economic resources to access market substitutes, individuals were forced to make trade-offs. For instance, women and the girls were tasked with household chores for the provision of subsistence that were essential for the family's survival while the men took care of livestock, their primary source of sustenance either as food or as a commercial commodity that can be traded in the marketplace for other commodities.

The few government schools in the community were understaffed and inadequately funded thus being of lower quality than the mainstream government schools. Maasai children often trekked long distances to attend school, and at times had to make their way through the game reserves thus facing wild life perils. These factors tended to reduce years of education for all children and even more so for the young girls since who could be married off in order to educate the boys and feed the family.

"When William mentioned the women's project I was won over. All the groups and individuals I met before him talked of education, which is a core pillar of our model but women's empowerment in patriarchal cultures is imperative to community development." - Rosa Escandell, President and founder of ADCAM, International.

### **THE SYMBIOTIC SUSTAINABLE BUSINESS MODEL**

Ms. Escandell believed in creating linkages and building community capacity using minimally invasive, culturally relevant and appropriate approaches. Ms. Escandell also believed that ADCAM International should create partnerships that were mutually beneficial for all parties. ADCAM International sought to balance the tension between respecting the communities' rights to self-determination and fair trade while concurrently respecting the need for corporate investors or entrepreneurs to earn a return for their investment. To achieve this balance, it was imperative that ADCAM International create symbiotic linkages. This entailed a careful selection of corporate partners who were truly committed to social corporate responsibility, and at the same time, the community had to be committed to adhering to demands agreed upon such as deadlines and quality control.

ADCAM International adopted a two-phase approach to creating sustainable symbiotic relationships. The first phase involved capacity building. The second phase involved phasing out the presence of the international NGO and allowing the local community to manage the projects on its own with minimum input or complete autonomy from the international NGO (see Exhibit 2). From the beginning, ADCAM International created a local chapter and equipped the local people with valuable skills such as logistics management, leadership and basic bookkeeping. ADCAM International's intention was that ultimately, after sufficient capacity building, the linkage between the local community and the domestic and international markets, would be left in the hands of the community and the local ADCAM chapter, which was to be administered by the local community on its own.

**Exhibit 2**  
**SYMBIOTIC SUSTAINABLE BUSINESS MODEL**

Elements of building sustainable enterprises	Readiness metrics, examples
<b>Phase 1</b>	
Find community that fits with international NGO – value,	Maasai community fit with ADCAM International NGO
Understanding of community's culture, challenges, aspirations	Ms. Escandell lived among the Maasai for two years to learn their cultural heritage and language before engaging other entities
Develop successful small projects with community (e.g. micro finance)	Set proximal goals (short-term goals) that are instrumental in achieving a distal goal (long-term goals). Ms. Escandell started a micro finance project as she trained the women on basic personal finance even before bringing in corporate partners.
Develop a presence in the community (project coordinator, director, etc.)	ADCAM International initiated ADCAM Kenya, a local chapter headed and fully operated by the local community.
Make formal proposals to relevant constituents of the community (e.g. women, warriors, elders)	Be culturally sensitive. Indigenous communities are highly stratified, community elders have built up extensive social credits (in terms of obligations and expectations) that they can call at will. Failure to win the elders approval can doom any initiative. Decisions are made based on communal consensus but ultimately the elders' decisions are greatly respected.
Selection of appropriate corporate partner	ADCAM International was particular about the kind of corporation they were looking for. They wanted a company with strong ethics and a track record in creating social value; a company that took its corporate social responsibility seriously.
Creation of local chapter of the NGO	Initiation of ADCAM Kenya
NGO builds capacity of community ✓ Organization structure ✓ Logistics Management ✓ Bookkeeping ✓ Leadership/supervision ✓ Production quality ✓ Time Management ✓ Recruitment ✓ Product Design	✓ Initiation of ADCAM Kenya with a clear structure (with a branch for education, safari camp – income generating tourists camp; Community projects such as drinking water and public library; and microcredit facilities for the women). All branches were headed and operated by the local community. The teachers were mainly from outside the community but were paid using community resources. ✓ Annual training of women artisans in August. ✓ Creating two logistic centers: Maasai Mara (Kenya) & Oloita. (Tanzania) – headed and operated by the local community. ✓ Cross training among artisans from Kenya and those from Tanzania, ✓ Organizing artisans into 11 cooperatives for the purpose of recruitment, training and logistics.
Grow the enterprise	<ul style="list-style-type: none"> <li>• Started with a small group in Mara steadily increased in number and expanded to Tanzania.</li> <li>• Started with a small microcredit facility and personal finance training grew to a collaboration with an Multinational Corporation (MNC)</li> <li>• Started the collaboration with about 20 women and three designs, grew to 12 designs and over 1,600 women by season 5.</li> </ul>



**Exhibit 2**  
**CONT.: SYMBIOTIC SUSTAINABLE BUSINESS MODEL**

Elements of building sustainable enterprises	Readiness metrics, examples
Transition International NGO out of model • Develop strategy • Clarify mission/goals • SWOT analysis on capacity of system established • Analysis of market opportunities • Assessment of potential product options • Analysis of potential additional/new partners • Development of plan	• Currently ADCAM International is involving the community in its strategic planning process. • Complete a SWOT analysis based on the facts given in the case.
<b>Phase 2 – NGO is out of model</b>	
Define ongoing relationship	Are they ready?

**BUILDING THE FIRST PHASE OF THE SYMBIOTIC BUSINESS MODEL**

**During the initial phase of creating a viable and sustainable business model,**

Ms. Escandell felt that it was imperative to learn the cultural predispositions of the community and fully comprehend what it wanted and what it was willing to provide. Ms. Escandell understood that meeting William Kikanae and learning about his dreams and aspirations for his community was one thing, but gaining the acceptance and buy-in from the community was quite another. However, this was a necessary step since she was a strong believer in the right to self-determination - that is, the community's right to determine its own development. To this end, Ms. Escandell decided to pitch a tent among the Maasai *manyattas* (a settlement or a compound established by a Maasai or Samburu family/clan) for interim periods of three months at a time for a period of two years. During that period, she learned about the Maasai culture and its challenges as well as its people's hopes and aspirations. During this period, she started a low-key microcredit scheme to help the Maasai women own cows for the first time in their lives. She slowly won their trust and confidence. She was also able to witness firsthand the challenges the community faced in accessing basic amenities such as healthcare and drinking water. A majority of the adults did not have any formal education and their children faced a similar fate if nothing changed. During this two-year period, as Ms. Escandell worked hard on winning the trust of this indigenous community, she was always studying feasible options that could link the community to developed markets. Winning the trust of the Maasai community was a gradual uphill task.

It took six months to have a meaningful conversation with the Maasai women. It took one full year before they invited me into their homes for a cup of tea. It took about three years before the project took off and seven years to talk about real women's issues such as marriage, ovulation, menopause, etc. Now I am family, but it did not happen overnight. - Rosa Escandell, President and founder of ADCAM, International.

At the same time Ms. Escandell was getting to know the Maasai, she was also hard at work looking for possible business partners for the Maasai in the West. After two years of networking with a number of fashion houses in Europe, and winning the hearts and minds of the Maasai community, she felt ready to make a proposal that was culturally relevant and

economically viable to the community. But first she had to get approval from the Maasai community.

### **Seeking Approval from the Clan**

William Kikanae arranged for a *baraza* (a traditional official meeting) with the entire clan. During the meeting, Ms. Escandell and Cristina Pérez (the Project Coordinator) made the proposal to the community. They first addressed the questions and concerns from the women. Once the women were done, they addressed the warriors next, and finally the elders. The community did not want anything that would change its culture or the roles of any members of the community. The basic proposal was to have the women do beading work for the export market. First and foremost, this was a craft that the women had passed down over several generations; thus it was very much in line with their traditional roles. Second, they were assured that they would work from their own homes and at their own pace (see Exhibit 3). However, they were also made to understand that once they made a commitment to fulfill a certain quality and quantity, it was imperative to meet that commitment. This was a community where contracts were still sealed by word-of-mouth and a handshake, so they understood the significance of honoring their word. It definitely helped that Ms. Escandell had lived among them for two years. The women also appreciated the microcredit project that she had initiated. It was now time to bring in the corporate aspects of the project.

### **A Faulty Start and A Homerun**

ADCAM was particular about the kind of corporation it was seeking to partner with the Maasai. It wanted a company with strong ethics and a track record in creating social value; that is, a company that took its corporate social responsibility seriously. When such a company was identified, Rosa proceeded to let the Maasai community know that the women needed to create samples. After much effort, the samples were completed and submitted to the prospective partner. However, the deal did not go through. The company was a subsidiary of a large multinational business, and whereas the subsidiary was excited about the opportunity, the parent company did not approve. When the deal fell through, Rosa got on the next plane to Kenya and went straight to Mara to let the community know what happened.

The people appreciated her honesty and asked her to continue searching for a suitable partner. Within a matter of weeks, ADCAM International pitched the proposal to Pikolinos Groups Inc. and was invited to submit samples. When asked why Pikolinos took a chance with the Maasai community, the Vice President clearly articulated its corporate culture and strategic vision.

My father comes from a humble background, and he believes in giving back to society. At first, we thought that we would carry a few sandals in our own stores for a couple of seasons. We just wanted to help the community. In 2009, the first year of our collaboration, we had only three designs and worked with about twenty women artisans. We featured our first 2010 Maasai collection in our company-owned stores. When my father met William, the two of them instantly connected. You see, my father was born on a small ranch, so as a boy he was a shepherd. William and my father connected based on their love for animals and similarity in their backgrounds and philosophy. We were also able to see the impact of the project on the community. We have since grown from three designs to twelve designs, and we are currently employing about 1600 women artisans. Our initial thought was this was going to be a small social project, but we later realized that there was a natural fit between the Maasai project and our company philosophy. We

believe in using natural products, we are very colorful and our logo 'naturally good' speaks to the kind of work environment and work ethic that surrounds our company, it is not just about our products. We felt we had these things in common with the Maasai people. It made good business to collaborate with them. Now, we sell the Maasai sandals all around the globe. - Juan Peran Bazan - Vice President, Pikolinos Group.

### Exhibit 3

#### SAMPLE OF THE MAASAI SANDALS, MAASAI WOMEN AT WORK, PROMOTION OF MAASAI COLLECTION



Clockwise: 1) sample of sandals 2) Maasai women at work 3) Juan Peran Bazan - Vice President, Pikolinos Group; Olivia Palermo, renowned model; William Ole Pere Kikanae, Maasai Leader and Director of ADCAM (Kenya) 4) Pop-up store in Soho, New York.

## **CORPORATE CULTURE AT PIKOLINOS INC.**

*Pikolinos*, a family-owned business was founded in 1984 and internationalized in 1989, barely five years after inception. By 2003, it had extended its presence to over 60 countries worldwide, exporting over 80% of its products. From its inception, Pikolinos had a desire to create social value, but it was not until 2007 that it founded the Juan Perán-Pikolinos Foundation, creating the '*Grupo Pikolinos*' (Pikolinos Group). Pikolinos Group was driven by its desire to create social value (through Juan Perán-Pikolinos Foundation), economic value (by generating competitive returns for investors) and environmental consciousness (by using natural and non-toxic components). Pikolinos Group was engaged in a wide variety of activities ranging from tanning leather to manufacturing shoes to operating its own retail outlets. Pikolinos manages and processes the tanning of its leather in-house. It prides itself on crafted production and a diverse body of employees. The firm described its talent pool as "a young, multitalented, international team of over 10 different nationalities." It worked to remain fresh and relevant in the global market; thus having employees from diverse cultural backgrounds facilitated that goal. Pikolinos Group's commitment to creating social value was evident in its collaboration with over 16,000 families in countries such as Peru, Guinea-Bissau, India, Bangladesh, Pakistan and most recently Kenya and Tanzania, among a host of others. The company's philosophy, as articulated by the Vice President, Juan Peran Bazan was a natural fit with what the Maasai community stood for and what ADCAM was looking for in a partner.

### **Making the Connection**

Reaching across a diverse cultural divide required considerable time, and Ms. Escandell spent two years learning the language, culture, and developing sufficient trust to gain a reasonable level acceptance among the Maasai community. She facilitated the connection and partnership with Pikolinos. Even though Pikolinos was sensitive and responsive to social issues, the company did not have the time, resources or patience needed to bridge the cultural divide and overcome the language barriers. ADCAM International's ability to speak the corporate language as well as understand and relate to the cultural and spiritual issues of the disadvantaged communities helped bridge the gap.

Prior to our collaboration, I did not know much about the Maasai. I knew that they are Africans, and they live in Maasai Mara, Kenya, but that is about all. I have friends who had spent their honeymoon in Kenya, but that sounded too exotic to me.

ADCAM International earned the trust of the Maasai community, so it dealt with all of the logistics. We gave ADCAM the leather, and it handled the packaging of all the required raw materials, dealing with customs officials in Kenya at the point of import of the raw materials, exporting the semi-finished products, as well as the training of the artisans and their actual production and payment. Our designers also helped with the training to ensure quality control. Pikolinos mainly deals with manufacturing of the final product in addition to marketing and promotion. - Juan Peran Bazan -Vice President, Pikolinos Group.

## **THE BUSINESS CYCLE OF THE MAASAI/PIKOLINOS PROJECT**

The Maasai/Pikolinos business cycle consisted of three main stages (see Exhibit 4). Stage one focused on the product design and recruitment of the artisans, stage two dealt with the actual production, and the third stage was about commercialization of the finished product.

**Exhibit 4**  
**BUSINESS MODEL OF THE MAASAI PROJECT/PIKOLINOS COLLABORATION**

<b>Stage 1: Product Design and Recruitment of Artisans (March-August)</b>	<b>Stage 2: Production (August to February)</b>	<b>Stage 3: Commercialization (November-August)</b>
<p>Pikolinos' design team prepared the initial design, this is refined through focus groups consisting of Pikolinos' distributors &amp; customers.</p> <p><b>ADCAM</b> International through its network of 11 women artisans' cooperatives recruit artisans from Maasai Mara (Kenya) and Oloita (Tanzania), estimated at a high of 1,600 women.</p>	<p><b>Women's training.</b> ADCAM team trains the most skilled women from each cooperative.</p> <p>Each trained leader will subsequently train all artisans in their cooperative.</p> <p>The dynamics of learning is fully integrated and trainees work directly on the datasheet that is made for each shoe design.</p> <p><b>Production:</b> There are two logistic centers: Maasai Mara (Kenya) &amp; Oloita (Tanzania).</p> <p>The logistics managers of each of these centers receive the leathers sent by Pikolinos, buy beads &amp; sewing kits from Narok Maasai market and prepare individual bags with the leathers and the exact amount of raw materials for making the different designs. Each bag is given a serial number.</p> <p><b>Bags distribution with the raw material and production process:</b> Project Coordinators in Kenya &amp; Tanzania are responsible for distributing the material to different women's cooperatives, creating a register of each woman's work, and the payments made.</p> <p>Each artisan is given a design of his or her choice and the serial number is recorded. The payment for each design is publicized.</p> <p><b>Collecting the final product and triple quality control:</b></p> <p>The coordinators are responsible for collecting the finished product &amp; replenishing raw materials.</p> <p>A triple quality control is done on each finished embroidered leather. Each embroidery has the name of the artisan who worked on it and if there is a mistake he/she is responsible for repairing it.</p> <p>Once the products are approved, they are prepared in boxes in the logistics centers and forwarded to Spain, clearly labeled with serial #s and the names of the artisans who worked on each design.</p>	<p><b>Assembly and distribution.</b> Pikolinos does the final assembling of the shoes in Spain.</p> <p>By February all designs are usually in the stores.</p> <p>The final presentation includes a booklet with the project specification and a label with the name of the artisan who made it.</p> <p><b>Market presentation and diffusion.</b> Every year different media events featuring the Maasai leader, William Kikanae, are organized.</p> <p>The media campaign is carried out in North America, Europe and Japan. E.g. Pikolinos Pop- up store in Soho, New York, opening and a gala dinner at UN attended by important personalities from the fashion, business and media world.</p> <p>Featured renowned model &amp; trendsetter Olivia Palermo.</p> <p><b>Establishing other marketing channels.</b> The fashion world is trendy and fast evolving, hence ADCAM International recognizes that it is important to expand their clients' network &amp; broaden the Maasai product lines. Currently they are working on silver jewelry prototypes with the Maasai motifs with a number of fashion houses in Europe.</p>

In stage one, Pikolinos' team created the initial design. This design was thereafter refined through focus groups consisting of Pikolinos' distributors and customers. According to Juan Peran Bazan, Vice President of Pikolinos Group, by the second year of the collaboration the group relied on the Maasai women to create the color combinations.

There is something about the way the Maasai women combine colors. It is in the animals, the sunset and sunrise on the horizon of the Mara; it is in the way they dress. It is just something so African, so unique, that we quickly realized that we could not master it. They combine white, red, orange and black and it looks astonishing. It is Maasai, it is African, you can pick it out anywhere you go around the world and say...Aha! That is Kenyan." - Juan Peran Bazan - Vice President, Pikolinos Group.

During this first stage ADCAM Kenya recruited artisans from Maasai Mara (Kenya) and Oloita (Tanzania) through its network of 11 women artisans' cooperatives, estimated at 1,600 women in 2014. A few men have since joined these groups of women artisans.

Stage two focused on training and actual production of the embroidered leather. This stage dealt with: (a) training of the artisans, (b) preparing and labeling of the raw materials, (c) preparing pay roll, (d) distribution and production of the embroidered leather, and (e) collection of finished products and quality control.

### **Women's Training**

Every year during the month of August, ADCAM International's team trained the most skilled women from each cooperative. Each trained leader would subsequently train all artisans in their cooperative. The dynamics of learning was fully interactive and trainees worked directly on the datasheets that were made for each shoe design. Besides training women on the Pikolinos' production, the women also received training on basic business skills and personal financial management. The women also got an opportunity to cross-train each other, for instance, the Maasai women of Kenya were better at building the *manyattas* while those of Tanzania were better at crafting ornaments. Business training was particularly important since it was the only way they could diversify their sources of income.

### **Preparation**

ADCAM Kenya created two logistics centers: Maasai Mara (Kenya) and Oloita (Tanzania). The logistics managers of each of these centers received the leathers sent by Pikolinos through ADCAM International, and they bought beads and sewing kits from a Maasai market at Narok. The logistics managers and their support staff carefully packed individual bags with a piece of leather, a datasheet detailing pictorial instructions for a design and the exact amount of raw materials for making each design. Each bag was given a serial number, which was used to track the material from the raw material stage, to the embroidering stage, to assembly in Spain and ultimately to the final product. The serial numbering was essential for quality control purposes and for tagging the final product as authentic handcrafted footwear complete with the name of the artisan.

### **Distribution and Production**

Project coordinators in Kenya and Tanzania were responsible for distributing the raw material, creating a register of work allotment and payments made to each artisan. Each



artisan was given a design of her choice and the serial number was recorded. The pay rate for each design was publicized, the more complex designs fetched a higher rate than the simpler designs. The amount of work was assigned to each artisan based on her track record.

Exceptional workers were given slightly more pieces than beginners. However, each artisan was given only a few pieces at a time. Her stock were replenished upon completion of the initial assignment. However, there was no time restriction or a required schedule. The women were free to plan their schedules in a manner that was least disruptive to their traditional responsibilities. The women worked in the comfort of their homes; they were not required to report to a factory or workshop. When any individual needed help, the head of her cooperative, as well as the project coordinators, were readily available. Everybody understood the significance of completing the assignments in a timely manner. In addition, since the pay was based on piece work, each artisan was paid for each unit of work completed; thus the artisans were motivated to deliver in a timely manner.

As the process continued to develop, an interesting *gender impact* phenomenon of role reversal emerged. Even though the women had not radically broken away from their traditional roles, it was common to find Maasai Warriors assuming some of the tasks that were typically assigned to the women, such as fetching water, childcare or cooking, in order to help the women meet their production targets. The women's newly found earning capacity gave them a voice in their families and earned them respect from their men. The elderly were also engaged, either directly in production or indirectly by providing support for family to facilitate production.

### **Collection of the Final Product and Triple Quality Control**

The coordinators were responsible for collecting the finished product and replenishing raw materials. A triple quality control procedure was implemented for each piece of finished embroidered leather. Each piece of embroidery had the name of the artisan who worked on it, and if a mistake was detected, she was responsible for repairing it. Once the products were approved at the logistics centers, they were packed in boxes and clearly labeled with serial numbers and the names of the artisans who worked on each design and then forwarded to Spain (see Exhibit 3). The third stage involved assembly of the final product as well as its marketing and promoting.

### **Assembly and Distribution**

Pikolinos did the final assembly of the shoes in Spain. By February, all designs were usually in the stores ready for the spring and summer sales. The final presentation included a booklet with the project specification and a label with the name of the artisan who made it.

### **Marketing and Promotion**

Every year, different media events featuring the Maasai leader, William Kikanae, were organized. The media campaigns were carried out in North America, Europe and Japan. For instance, during 2013-14, a major campaign was carried out in a number of states in the USA. The main highlights were at Pikolinos' Soho pop-up store opening in New York followed by a gala dinner at the United Nations (UN) attended by important personalities from fashion, business and the media world. A global campaign featuring renowned model and trendsetter, Olivia Palermo, was also launched (see Exhibit 3).

### **Establishing Other Marketing Channels**

Pikolinos and ADCAM International recognized that the fashion world was trendy and fast evolving, so it was important to expand the clientele and broaden the Maasai product lines. The Maasai 2015 collection included moccasins for men with a small Maasai beading detail. Pikolinos designers and ADCAM International were constantly trying to create fashionable innovative product lines that incorporated the Maasai beading technique. They also included a new line of women's beaded flat shoes as well as new designs of popular Maasai sandals. Furthermore, they expanded into bags and accessories. Juan Peran Bazan - Vice President, Pikolinos Group, made it clear that in about five years, he hoped that the Maasai community would not need his company. He was keen on encouraging the development of the entrepreneurial skills of the community because he knew that in the fashion industry, no product line lasts forever (see Appendix 1).

### **Are We Ready for The Second Phase?**

Rosa was now at a point where she was wondering if the Maasai were ready for the second phase of the symbiotic sustainable business model. If not, what should they do to get there (see Exhibit 2). This concern was particularly urgent given that 2015 marked the sixth consecutive year of great success of the Maasai collection.

## **MARKET LINKAGES, SUCCESSION PLANNING AND OVERALL IMPACT**

In the first phase, ADCAM International focused on capacity building and grooming leaders within the community. It saw its position as spanning multiple markets and knowledge domains. ADCAM International played a dual role in linking communities from developing nations to corporations and markets in the developed nations. On one hand, ADCAM was dedicated to finding viable sustainable business opportunities for the indigenous communities to improve their quality of living. ADCAM International provided the needed training and quality control, and it taught the community how to meet deadlines in order to sustain the partnership. These responsibilities were carried out in a manner that was respectful to the community and that also upheld and preserved its culture. ADCAM International was in the unique position of having the diverse knowledge of indigenous communities in general, which was augmented by Ms. Escandell's stay with the community whereby she gained an intimate knowledge of the Maasai community. Moreover, ADCAM International was headquartered in Europe and had a chapter in New York which provided access to western markets. On the other hand, ADCAM International understood the workings of corporations in developed nations and sought to create opportunities for these organizations by introducing to them unique and competitive products that were complementary to the development of their brand equity.

During the first phase, ADCAM International had emphasized building market linkages, both local and international (see Exhibit 5). ADCAM International led the initiatives in European and North American markets as well as in Japan and China. Ms. Escandell led the team in identifying potential partners, designing prototypes of potential product lines and writing business proposals. The Maasai community had a voice in the strategic direction of the planning but did not have the capacity to participate in the strategy formulation. Its low level of formal education was a major hindrance. The face of the Maasai product lines was the Maasai leader, William Ole Pere Kikanae. William Kikanae was also the Director of ADCAM (Kenya). He appeared in all promotional media coverage, he was the community spokesperson, and he had spoken in prominent forums



such as United Nations conferences. William Kikanae was being groomed as the international face and leader of his people.

In terms of domestic and regional markets, ADCAM International had made tremendous effort in entrepreneurship training. Before the Pikolino-Maasai project, the Maasai women were not active participants in the local market. The income earned from the Pikolinos project, the entrepreneurial training and the microcredit facilities officiated by ADCAM International enabled more Maasai women to start small businesses in the local market. The East Africa market remains relatively untapped in terms of selling opportunities for the Maasai women. Whereas there was an active collaboration between Maasai community of Kenya and Maasai community of Tanzania, it was largely a labor pool rather than a market for the Maasai product lines. William Kikanae, a group of Kenyan Maasai elders, and the Tanzanian Maasai elders were collectively responsible for all local initiatives. ADCAM (International)'s role was limited to facilitating training.

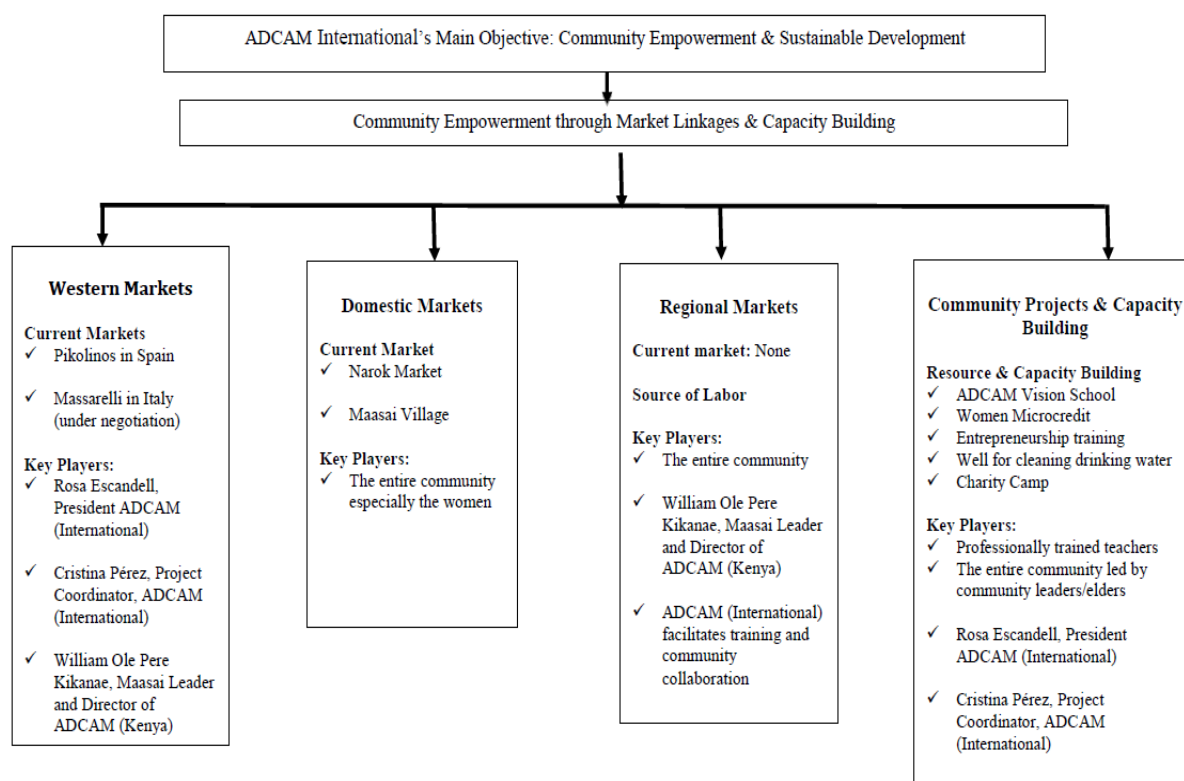
ADCAM International strove to foster community projects that sustained the development initiatives in the community. For instance, educating the next generation of Maasai children would ensure that the community would not only have a voice in the strategic direction of their development, but would actually be involved in the formulation and implementation of those strategies. Entrepreneurial training and microcredit was facilitated by ADCAM International and supported by Pikolinos. In a truly symbiotic relationship, it is required that all parties involved must mutually benefit. The entrepreneurial training created a business mindset among the community. This was important because, in the fashion industry, the business cycle is short and seasonal. For instance, the Pikolinos-Maasai project consisted of a five-month production cycle. Moreover, as Mr. Bazan stated, the fashion industry was highly dynamic. Supporting the entrepreneurial training was Pikolinos' way of preparing the community for the inevitable nature of the industry. Ms. Escandell used her connections in the developed market to generate initiatives that supported the community's wellbeing, such as clean drinking water and a charity camp. These projects were managed and led by the local community.

Both the financial and non-financial impact of Maasai project was substantial (see Exhibit 6). In 2014 alone, the estimated sales revenues generated from the Maasai product line were over US\$ 4 million. The list of non-financial impacts included issues such as gender inclusion, which were imperative for community development and sustainable growth. In 2015, the Maasai-Pikolino project covered over 1,600 artisans in both Kenya and Tanzania.

The realization that the Maasai culture is one of the most unique indigenous heritages and that the Maasai live on peripheral areas of the best wildlife reserves in the world encouraged ADCAM International to help the Maasai set up a tourism business that provides the usual wildlife safari excursions as well as authentic Maasai experiences culminating in a visit to Maasai Manyatta. This tourism venture is growing venture with the hopes that it will also provide some sustainability to the Maasai.

Capacity building and succession planning are continuous processes; not a single event, so in some communities they may take a few years to implement while in others they may require a couple of decades before transition is a viable possibility. How should Ms. Escandell and her team proceed?

**Exhibit 5**  
**MARKET LINKAGE AND SUCCESSION PLANNING**



**Exhibit 6**  
**THE IMPACT OF THE MAASAI PROJECT THE FINANCIAL IMPACT OF THE MAASAI PROJECT**  
**(US \$)**

Year	Number of Units Sold	Average price per Unit <sup>1</sup>	Estimated Revenue Generated per Year	% Increase in annual sales
2011	7,850	\$122.40	\$960,840.00	100%
2012	11,000	\$136.00	\$1,496,000.00	56%
2013	25,000	\$149.60	\$3,740,000.00	150%
2014	14,450	\$163.20	\$4,080,000.00	9%
2015	9,375	\$175.00	\$1,640,625.00	-60%

Note that the unit price differ across designs and markets (based on interview with Cristina Pérez, ADCAM International Project Coordinator).

**The Non-Financial Impact of the Maasai Project**

- ✓ Gender equity and gender inclusion (Maasai Project and Microcredit System)
- ✓ Education (ADCAM Mara Vision School; Adult Literacy Education; Vocational Entrepreneurship training)
- ✓ Health & wellbeing (Drinking Water Project)
- ✓ Eco-tourism (ADCAM Camp)

The decrease in demand, especially of 2015 collection led to reduction in the number of artisans employed by the project since 2013, from 1,600 artisans to just less than 1,000.

## APPENDIX 1

### FASHION INDUSTRY PROFILE

According to the Bureau of Labor Statistics, Americans spend more than \$200 billion on the fashion industry each year. The fashion industry is a multi-billion-dollar global enterprise. The manufacture and sale of accessories, such as footwear and handbags, and undergarments are closely associated with the fashion industry and range from exorbitant luxury goods to inexpensive mass-produced items. Strictly speaking, the fashion industry includes only the business of making and selling clothes, often referred to as apparel industry. For trade and statistical purposes, the apparel industry and the manufacture and sale of accessories are usually integrated. In this appendix, we have used the term fashion industry to broadly refer to both apparel and accessories, which includes footwear.

As depicted in Exhibit 7, the fashion industry can be sub-divided into four or more categories. For this particular case what is important is to understand that different sectors offer different players opportunities contingent on their competencies and comparative advantages. The megatrend of the 21st century has changed markets dynamics. Globalization and digitalization has made it possible for products to be designed in one country, manufactured in another, and sold throughout the globe. For instance, it is common for an American or European Fashion Company to source fabric from China and have the clothes manufactured in Vietnam or Thailand, finished in Italy, and shipped to a warehouse in the United States or Europe for distribution to retail outlets internationally.

**Exhibit 7**  
**LEADING COMPANIES IN REVENUES & SALES VOLUMES**

<b>Companies</b>	<b>Sectors/Product Lines</b>	<b>Geographical Presence</b>
Adidas AG - 3 main brands: Adidas, Reebok & TaylorMade	A range of athletic & sports lifestyle products.	Operates through 170 subsidiaries in Europe, the Americas & Asia – under 3 segments: wholesale, retail & other businesses,
Bata Shoe organization	A range of branded footwear.	Merchandise in over 70 countries and has manufacturing facilities in 26 countries – under 3 segments: Bata Emerging Market, Bata Europe & Bata Protective.
Esprit Holdings Limited	A range of women's, men's & children's apparel, footwear & accessories. Other lines - timewear, eyewear, jewelry & fragrance, bedding & other home products.	Operations spread across Europe, Asia Pacific & North America. Under – 3 distribution segments: retail, wholesale & licensing.
NIKE, Inc.	Design, development & worldwide marketing of footwear, apparel, equipment & accessory products - four product lines: footwear, apparel, equipment & other	Operates in over 170 countries across the Americas, Europe, Middle East, Africa & Asia Pacific. Under – 3 distribution segments: retail stores and various distributors & licensees.

The fashion industry is still labor intensive despite all the advances in innovation and technology, which has led to advent of Computer Aided designs (CAD) and Computer Aided Manufacturing (CAM) systems. Arguably, the fashion industry may have developed first in Europe and America but increasingly labor intensive activities such as production of materials and manufacturing is carried out in low-cost manufacturing nations primarily in Asian countries such as China, Vietnam, India, Turkey, Thailand, Indonesia etc. The textile design, fashion design, fashion shows, media and marketing are sectors that are still dominated by American and European companies.

There are two sectors in the fashion industry that are particularly well suited to indigenous communities or niches players; the world fashion sector and the fashion system sector. World fashion sector consist of two main categories. The first category comprises of simplified and very low-cost version of Western clothing such as a T-shirt with pants or a skirt. Such clothing are mass produced. The second category encompasses several smaller and specialized fashion industries in various parts of the world which tend to serve specific national, regional, ethnic, or religious markets. For instance, saris in India, hijab for Muslim women, Kitenge in East Africa, boubous in Senegal, etc. This sector is a natural fit for niche players such as indigenous communities. Whereas a majority of these industries operate in parallel with the global fashion industry on a minor and localized scale, the number of renowned international models and designers are creating awareness of this niche. For instance, *Adiree*, Bibi Russel projects in Bangladesh and Fashion for development movement (F4D). *Adiree* was founded in 2009 with the aim to host annual international Africa Fashion Weeks in fashion capitals around the globe. The target cities are New York, Miami, Los Angeles, London, Paris, Milan, Berlin and Tokyo. This initiative has created visibility for designers from across the globe that have a passion for Africa fashion. Bibi productions works with indigenous women and infuses indigenous Bengali cultural elements into her lines. F4D was launched in 2011 as a private sector organization that supports United Nations millennium development goals especially those dealing with women issues and marginalized communities. F4D articulates its mission as “to harness the power of the fashion and beauty industries to implement creative strategies for sustainable economic growth, preservation of culture, wellness and independence of communities worldwide.”

The other sector that may work well for indigenous communities is the fashion system.

Fashion system embraces the business of fashion, the art & craft of fashion, the production and consumption. It encompasses the complex and often conflicting aspects of fashion industry trendsetters (the likes of Michelle Obama, Sarah Jessica Parker, Lupita Nyong'o and Angelina Jolie) as well as those who rebel against conformity (Lady Gaga, Madonna, Miley Cyrus, etc.). Fashion system thrives on those who embrace fashion and even more from those who reject it. What makes the industry thrive is its flexibility and diversity. The global megatrends such as sustainability which seeks to address environmental and societal issues beyond just financial returns creates unique opportunities for niche players.

### **A Focus on the Footwear Industry**

The global footwear industry is hugely influenced by consumer trends. In 2013, women's footwear dominated the industry as in the years past. Women's footwear accounted for 53.5% of the total global industry sales while men's and children's footwear accounted for 34.5% and 12% respectively. The women footwear were driven predominately by comfort and fashion, while the men and children footwear were driven primarily by value.

The men's footwear exhibited slower changes in the styles which allowed existing machinery equipment and inputs to be used for longer periods in comparison to the women's footwear. Furthermore, the men's footwear tended to be more generic and were better suited for mass production. Likewise, most children's shoes were value driven given that only a very small percentage of consumers purchased children's shoes for design and/or brand names.

Women's shoes on the other hand, regularly changed in style which created high competition levels within the industry. Most of the footwear sold across the globe were sourced from manufacturers in low-cost manufacturing nations, especially in Asia, where most manufacturers produced moderately priced or budget footwear. There are very few players in innovative high-fashion footwear. The largest world's footwear producers are in the North Asia region at 59.6% (led by China), followed by South East Asia region at 13.2% (dominated by Vietnam) and the third region is India & Western Asia at 9.6% (led by India and Turkey). Over the years, footwear manufacturers in the United States, Europe, Hong Kong and Taiwan increasingly shifted their operations offshore to developing countries such as China, Brazil and Vietnam to take advantage of low production and wage costs. This in turn, increased the level of import competition in the industry. Besides pricing competition and innovative designs, the footwear industry is also driven by several factors such as growing awareness about healthy and active lifestyle, rising population and disposable income levels, as well as emerging retail culture. It is estimated that the footwear market alone will be valued at \$211.5 billion by the end of 2018<sup>13</sup> owing to the increased demand from Asia Pacific amongst other factors. Exhibit 8 and Exhibit 9 depicts the salient features of the footwear industry, which encompasses market growth drivers, factors limiting market growth, current market trends, market structures and market projections for the coming years.

#### Exhibit 8 KEY SECTORS OF THE FASHION INDUSTRY

<b>Level One: Textile Design &amp; Production</b>
<b>Major Features</b> <ul style="list-style-type: none"> <li>• Highly automated and carried out by computer-controlled high-speed machinery.</li> </ul>
<b>Major Trends</b> <ul style="list-style-type: none"> <li>• Natural fibers (such as wool, cotton, silk, &amp; linen) &amp; synthetic fibers (such as nylon, acrylic, &amp; polyester) are used.</li> <li>• Sustainable fashion (or “eco-fashion”) led to greater use of environmentally friendly fibers, such as hemp.</li> <li>• High-tech synthetic fabrics with such properties as moisture wicking (e.g., Coolmax).</li> <li>• Stain resistance (e.g., 303 High Tech Fabric Guard), retention or dissipation of body heat, &amp; protection against fire, weapons (e.g., Kevlar), cold (e.g., Thinsulate).</li> <li>• Ultraviolet radiation (Solarweave), and other hazards</li> </ul>
<b>Level Two: Fashion Design &amp; Manufacturing</b>
<b>Major Features</b> <ul style="list-style-type: none"> <li>• A minute number of designers &amp; manufacturers produce innovative high-fashion apparel.</li> <li>• An even smaller number produce <i>haute couture</i>- most esoteric, exclusive and expensive designer fashion,</li> <li>• A majority produce moderately priced or budget apparel.</li> <li>• Relatively labor-intensive.</li> </ul>

<b>Major Trends</b> <ul style="list-style-type: none"> <li>• Development of computer-guided machinery, resulted in the automation of some stages of garment assembly.</li> <li>• China emerged as the world's largest producer of clothing due to its low labor &amp; production costs.</li> </ul>
<b>Level Three:</b> Fashion Retailing, Marketing, & Merchandising
<b>Major Features</b> <ul style="list-style-type: none"> <li>• Retailers make initial purchases for resale 3-6 months before the customer is able to buy the clothes in stores.</li> <li>• Marketers are responsible for identifying and defining a fashion producer's target customers and for responding to the preferences of those customers.</li> <li>• Merchandising involves selling the right product, at the right price, at the right time &amp; place, to the right customers (use of Internet – online shopping; Inventory-tracking computer program have facilitated this).</li> </ul>
<b>Major Trends</b> <ul style="list-style-type: none"> <li>• The Internet has become an increasingly important retail outlet.</li> </ul>
<b>Level Four:</b> Fashion Shows Media & Marketing
<b>Major Features</b> <ul style="list-style-type: none"> <li>• Media of all kinds are essential – social media/online advertising, print media, broadcasting, specialty, etc.</li> </ul>
<b>Major Trends</b> <ul style="list-style-type: none"> <li>• Cinema newsreels-short motion pictures of current events and the upsurge of television and other electric media makes it possible for people all over the world to see fashion shows and imitate the fashionable clothing worn by celebrities.</li> <li>• The rise of fashion photography and of heavily illustrated fashion magazines e.g. Vogue, InStyle.</li> <li>• Fashion blogs, red-carpet events such as awards ceremonies provide an opportunity for celebrities to be photographed wearing designer fashions - creating publicity to the designers.</li> <li>• Late 20<sup>th</sup> &amp; early 21<sup>st</sup> centuries, fashion shows became more evident with elevated runways for the models, and played an increasingly prominent role in the presentation of new fashions.</li> </ul>
<b>World fashion</b> <ul style="list-style-type: none"> <li>• Specialized fashion industries cater to specific national, regional, ethnic, or religious markets. E. g. design, production, and marketing of saris in India, boubous in Senegal, ethno-religious dress such as hijabs.</li> <li>• Operate in parallel with the global fashion industry on a minor and localized scale.</li> </ul>
<b>The fashion system</b> <ul style="list-style-type: none"> <li>• Embraces the business of fashion, the art and craft of fashion, and the production and consumption of fashion.</li> <li>• Involves all the factors that are involved in the entire process of fashion change.</li> </ul>
<b>Affiliated Industry:</b> Accessories, such as footwear, handbags, and undergarments.

**Source:** fashion industry. 2015. *Encyclopædia Britannica Online*. Retrieved 10 July, 2015, from <http://www.britannica.com/topic/fashion-industry>

**Exhibit 9**  
**TRENDS IN THE GLOBAL FOOTWEAR INDUSTRY**

<b>Market Growth Drivers</b>	<b>Factors Limiting Market Growth</b>	<b>Current Market Trends</b>	<b>Market Structure</b>	<b>Market Projections for the Coming Years</b>
<p>Rise in disposable income across major economies.</p> <p>Rising retail culture.</p> <p>Growing demand for innovative footwear designs.</p> <p>Increased awareness about healthy lifestyle – demand for athletic footwear.</p> <p>Increased demand of teenage fashion.</p> <p>Fashion &amp; social trends lead to changing demand for certain footwear styles.</p> <p>Consumers are influenced by advertising &amp; brand image.</p> <p>Aging population in some developed countries- increased demand for walking shoes.</p> <p>Seasonal factors &amp; weather conditions.</p> <p>Population growth.</p> <p>Country or origin bias – patriotism vs. perceived quality &amp; fashion (favoring shoes made in Italy for instance).</p>	<p>Entry of new players.</p> <p>Rise in pirated products in the developing economies.</p> <p>Keeping pace with teenage fashion is a major challenge.</p> <p>A rise in footwear tariffs on products from particular manufacturing countries can limit output as the demand for exports may reduce.</p> <p>Slower economic growth &amp; aging populations will continue to constrain industry growth in Europe.</p> <p>Tariffs on Chinese &amp; Vietnamese footwear implemented by the European Union (EU) are only expected to have a short-term impact on these countries before they find alternative markets.</p>	<p>Non-athletic footwear segment is estimated to grow at the fastest rate.</p> <p>Athletic footwear segment is expected to grow at a CAGR of 1.8%, \$84.4 billion by 2018.</p> <p>Consumer segments - men's footwear dominates the overall market with 52% share.</p> <p>Increasing demand for comfortable &amp; designer footwear for kid - estimated at a CAGR* of 3.7%.</p> <p>Increasing demand in non-store based distribution (online shopping) - CAGR of 6.9%, US\$18.5 billion by 2018,</p> <p>Growing affluent &amp; middle classes in India &amp; China will see a rise in niche &amp; luxury exports from Europe &amp; the USA.</p>	<p>Four key regions: Europe, North America, Asia Pacific, and Rest of the World.</p> <p>Asia Pacific currently leads and is expected to do so in near future - expected to hold about 30.1% share in the market.</p> <p>Europe is expected to emerge as the second largest market for footwear by 2018.</p> <p>Leading players like Nike, Puma, Reebok, New Balance, &amp; Adidas control the market, collectively accounting for 70% of the total market.</p> <p>Other prominent vendors in the market are Asics, Converse, Sketchers, &amp; K- Swiss.</p> <p>Manufacturers of less expensive footwear &amp; athletic shoes are mainly situated in developing regions of Asia &amp; South America.</p> <p>Designers, large wholesalers &amp; retailers are predominantly located in Europe, the USA &amp; developed Asian regions e.g. Taiwan.</p>	<p>Increase in celebrity endorsements coupled with innovative promotional strategies.</p> <p>Industrywide CAGR of 1.9%, 2012 - 2018.</p> <p>The global footwear market was worth \$185.2 billion in 2011. Expected to reach a value of \$211.5 billion in 2018.</p>

\*CAGR - A Compound Annual Growth Rate

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# TO DISRUPT OR NOT DISRUPT THE INDUSTRIAL FLUID VALVE INDUSTRY

**R. Barth Strempek, Elon University**

After a career of nearly fifteen years in the corporate world followed by twenty in academia, Barth Strempek was sitting in his office at a university in central North Carolina wondering if he should take the plunge into real entrepreneurship at the age of 56. An opportunity of significant proportions had fallen in his lap. It was November of 2008 and he had spoken with Gene Feild only a month earlier after being out of touch for over six years. It was somewhat unexpected to receive the phone call from Susan Ferm informing him that the inventor had passed away from heart and lung failure at the age of 91. Susan was the daughter of Richard Ferm, retired Ph.D. chemist and Gene's longtime friend and colleague. Following almost twenty-five years, three company start-ups, and his most recent attempts to resurrect and commercialize the revolutionary non-turbulent valve technology he had invented, Gene had finally run out of steam in a nursing home in northern California.

## BACKGROUND

Strempek first met Gene in 1999 when he struck up a conversation while having dinner at adjacent tables at the Mayflower Seafood Restaurant. Learning during their conversation that Strempek had been a civil engineer early in his career, Gene said that he had something to show him. Gene joined him at the table where, on a paper napkin, he drew a sketch of the internal topology of a unique fluid valve that he had invented over a dozen years earlier. Strempek politely listened and watched as the drawing took shape, not expecting anything of importance to come of it. As Gene explained the workings of the device, Strempek became increasingly more interested and could envision how fluid could flow smoothly through the device. His former engineering training led him to believe that this might actually be the "real deal" and not just the pipedream of an old man. He knew that valves were fairly crude mechanical devices and their basic designs had not changed much in nearly a century. All high performance valves are plagued by internal turbulence creating an array of problems including cavitation (imploding gas bubbles which erode valve seats), leakage, vibration, noise, imprecise control, and longevity issues. A truly laminar-flow (non-turbulent) valve would be the *holy grail* of fluid control - if it were true.

After drawing the diagram, for the next two hours Gene told Barth the story of how he arrived at his breakthrough idea to improve car wash valves and how, over the previous dozen years, he had founded three companies to develop and commercialize the product. His most recent enterprise, Feild Technologies LLC (FTL), had taken the original flat-plate technology and added the ability to balance the valve for both input and output pressures allowing actuation (opening and closing) with only a small force. This advancement allowed high-performance (high flows and/or pressures) valves to be controlled entirely by hand or by very small motors. This full-balance technology had not yet been patented but presented the possibility of renewed protection beyond the remaining life of the original patents. A patent application for the full-balance valve had been drafted and was nearly ready to be filed with the US Patent Office.

For three years Barth assisted Gene in identifying potential demo applications and attracting additional entrepreneurial resources. He also invested a modest sum in FTL to maintain the foreign patent annuities on the original flat-plate valve technology which had about five years remaining at the time. In return for this investment Strempek received a small share of FTL. For numerous reasons unrelated to the technology (Gene's age, lack of definitive test data, lack of funds, a non-business-oriented inventor) they were unable to conclude several promising deals. At the last minute, Gene invariably rejected every one. In 2002, Professor Strempek received a large Federal grant (FIPSE) from the US Department of Education to develop an integrated business curriculum and entrepreneurship program. This would occupy all of his time for the following four years or more, necessitating his withdrawal from the valve venture.

For years Barth wondered what had happened to Gene and regretted passing on the possible chance of a lifetime. He suspected that he had just walked away from an opportunity to revolutionize an industry, create a more environmentally compatible technology, and take a nice chunk of a very large (\$30 billion) domestic market. The international opportunity was undoubtedly much larger, perhaps three times larger.

By late 2008, with the Federal grant and his role as director of the entrepreneurship program at the university completed, Strempek began thinking about one last challenge for the final stage of his career. Although very complex, perhaps there was a way to reinvigorate the fluid control venture after all. After all, he knew where all the bodies were buried, so to speak. Was it possible to reassemble all the pieces of the puzzle required to finally commercialize the technology?

Fortunately, a co-inventor had helped Gene develop the advanced technology (Professor Tom Christensen, Professional Engineer and Professor of Fluid Power at the University of Maine) who might provide technical support. However, Professor Christensen was hesitant to undertake the business risks required to regenerate this technology. Gene's will designated Susan Ferm as heir to the valve prototypes (10 different prototypes) and files (over 50 valve designs) which now resided in her garage in Lafayette, California. But it was not clear whether Susan actually owned the advanced version of the technology and its prototype since it was developed by FTL, Gene's last company. It was also unclear whether the prototypes were in working condition having been in storage for nearly a decade.

## **SIGNIFICANCE OF FLUID VALVES**

Unless one faces a leaky faucet or low water pressure, most of us take fluid valves for granted. In reality, valves play a critical role in modern life. Our way of life might not be possible without effective devices to control the amount, direction, and pressure of media (fluid, gas, vapor, slurry) flowing through conduits. On a basic level, how else would we economically deliver water to our homes and waste to the treatment plants? At an industrial level, how would we accomplish the myriad tasks required to do things like pump oil or gas, combine chemicals, produce products, and operate hydraulic systems? Much of industry depends on having the ability to accomplish basic valve functions: start or stop flow, change the rate of flow, divert flow, prevent back flow, change pressure, or relieve pressure ([www.valvias.com](http://www.valvias.com)).

Valves have been, and continue to be, relatively crude devices fraught with many design and technical problems (refer to the Appendix for a more detailed description of current valve technology). These devices can be categorized into two basic types of internal topologies: (1) plug in a hole, or (2) barrier over a hole. Few improvements in these basic designs have been

made over the past hundred years because it has been exceedingly difficult to find a way to eliminate turbulence inside the device. Plugs and barriers cause restriction of fluid movement resulting in areas of chaotically turbulent flow. Lacking newer ideas for improved internal valve topology, designers instead turned most of their attention to improving materials and computerized control. For example, because the amount of flow through a valve can be highly variable and difficult to control, auto manufacturers have spent much effort regulating fuel injectors by computer in order to inject a predictable amount of fuel into a cylinder, thereby significantly improving engine performance and fuel economy. If the mechanical devices themselves (injectors/valves) were more precise, the need for computer control would be reduced.

### THE FEILD VALVE TECHNOLOGY

Gene Feild was a mostly self-taught engineer and inventor. With only a high school education he made significant technical contributions while working at Stanford Research Labs and earlier on the Manhattan Project during World War II where he knew and worked with Albert Einstein. Following his first retirement, Gene bought and operated a four-bay car wash in California. Always a problem solver, Gene became frustrated with the inconsistent control of water, soap, and wax in the fourth bay of the carwash, and set about solving the problem. His revolutionary flat-plate valve design was the result, allowing twelve bays to be accommodated on one water line with significantly improved valve longevity. To commercialize the new technology Gene applied for patents and formed his first company, U.S. Paraplate (still in operation today). However, management determined that the company could not make money selling valves that seemed nearly indestructible. Over the objection of the inventor they redesigned the valves to be only marginally better than competitors' products in order to fit a traditional business model that could generate a recurring revenue stream and support a permanent sales force. Gene Feild disagreed strongly with this approach, suspecting that there were further improvements to be made and bigger problems to solve. Ultimately, the company lost its ability to design and improve the technology when Gene was forced to leave the company.

In the ensuing years the inventor established a second company to develop and market the technology. He raised several million dollars, designed new valves, obtained new patents, and hired a key executive from Bechtel Corporation. The new team built a manufacturing plant and offices in Indiana. They tested various advanced valve designs on hydraulic oil, crude oil, gasoline, various chemicals, and water applications. For two years, prototype choke valves handling sea water and crude oil were successfully tested on oil platforms off the coast of California. Unfortunately, various management issues and strategic disagreements (unrelated to the technology) prevented this company from becoming operational. This was a perfect example of the entrepreneurial adage that even on the cusp of success: *if you run out of cash, you fail*.

Following Gene's second debacle, he formed a third company, Feild Technologies Limited (LTL), to reacquire the previous patents and to develop an advanced version of the flat-plate technology that would be balanced for both upstream and downstream fluid pressures. This would allow the valves to be controlled with minimal effort instead of requiring large muscles or motors. The resulting prototype was rated at 200 gpm @ 6000 psi and could be opened and closed against any pressure with only a few ounces of force. The device was much more compact than existing designs, only 17 inches tall, 5.5 inches in diameter, weighing approximately 80 lbs.

For some space-critical applications the valves would need to be redesigned into in-line configurations. By the time this device was developed, Gene was in his 80's and unable to attract serious capital for another startup attempt.

As stated earlier, most valve designs are some version of a plug in a hole or a barrier across an opening, which inevitably introduces chaotic turbulence (See Appendix). The resulting negative consequences are extremely difficult to ameliorate. The Feild technology uses an entirely different internal topology to generate truly laminar (non-turbulent) flow within the device, thus nearly eliminating most of the unwanted effects. The basic design consists of two parallel flat plates as shown in the Exhibit below. After entering the device through the input orifice, fluid rises around the outside of the cylindrical bottom plate. When it reaches the top of the plate the resistance of the cylinder itself disappears and the fluid shoots across the plate from the entire circumference. The flow collides in the center from all directions. An outlet orifice (hole) is cut in the center of the bottom plate directly below the fluid collision. Fluid exits the device down this orifice. The end result is fluid flow through the device with no turbulence along the operating surfaces, resulting in superior operation and control somewhat akin to superconductivity in electricity. It is difficult to believe that this circuitous route through the valve results in laminar flow – but it does.

Over the years, numerous prototypes were developed and tested demonstrating the following benefits:

1. Precise control of flow and pressure
2. Vast improvement in longevity
3. Near linear control characteristics (simplifying both manual and computer control)
4. Contaminant tolerance (for particles smaller than plate separation)
5. Vibration and noise suppression

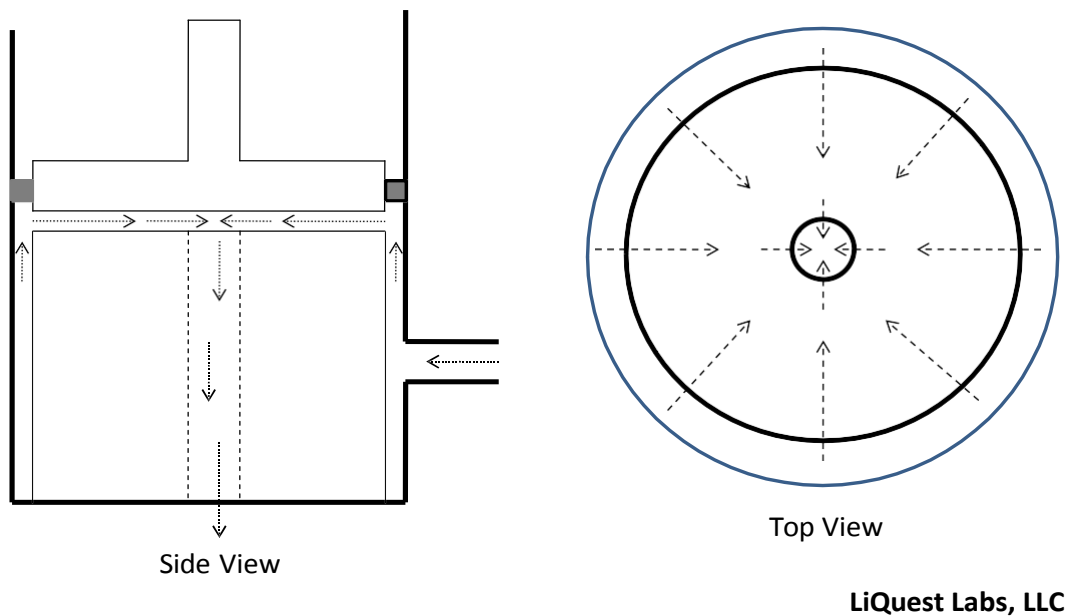
### **THE UNITED STATES VALVE INDUSTRY**

The US Valve Industry includes various types of valves, plumbing fixtures (valves, faucets, etc.), piping, hoses, and fittings. Industry revenue grew steadily for the four years from \$22.1 billion (2004) to \$29.3 billion (2007). Actual domestic demand grew from \$28.6 billion to \$34.9 billion over the same period, the difference being filled by imports. This total represents revenues in four industrial segments:

	<b><u>Share of Industry Sales (2007)</u></b>
Industrial Valves	42.1%
Fluid Power Valves and Hose Fittings	29.1%
Plumbing Fixture Fittings and Trim	17.2%
Other Metal Valves and Pipe Fittings	11.6%

Although the flat-plate technology could be used for low performance applications (ie., residential plumbing operates at less than 50 psi), its most appropriate application is in the high-performance (hundreds or thousands of psi) segments: Industrial Valves, and Fluid Power Valves and Fittings. Potential products designed for the other two segments are well down the priority list and in many cases may not be particularly cost effective for customers in these segments. Industry profitability is modest with net margins of approximately 8%. Individual firms' results are highly variable.

**Exhibit**  
**HOW THE FLAT-PLATE VALVE TECHNOLOGY WORKS**



A wide variety of industries benefit from the use of high performance valves. These vertical markets include:

<u><b>Share of Industry Sales (2007)</b></u>	
Chemical and Petrochemical	22%
Water and Wastewater Systems	20%
Petroleum Production and Pipeline Transmission	20%
Power Generation and Electric Utilities	16%
Construction	12%
Process Industries	10%

The value that valves provide varies widely by industry and application. Some industrial applications are no more critical than turning your kitchen faucet off and on, while other applications are so critical that valve failure could cost a fortune or even lives. Failure of the blowout protectors on the Deep Water Horizon oil well in the Gulf of Mexico was fundamentally the failure of relief valves and the systems surrounding them. Disruption of critical chemical processes, power generation, or hydraulic systems due to valve failure can be catastrophic and expensive.

The valve industry was relatively fragmented with well over a thousand separate valve manufacturing enterprises. The top four firms generated approximately 27% of industry revenue. Modest consolidation occurred in the preceding years as some larger firms engaged in merger and acquisition activity and a few smaller firms exited the industry. This industry consolidation was fueled by several trends including the desire for operational efficiencies, strengthening of

customer relationships, global expansion, and the acquisition of complementary technologies. IBISWorld projected that by 2013 the four firm concentration ratio may approach 40%.

As might be expected, the industry experienced a trend toward the importation of valves from Mexico and China (and away from Germany and Japan) where manufacturing costs were lower. Imports were increasing at a rate of over 30% per year.

Tyco International Ltd. was the largest player in the industry with a market share approaching 14%. The next largest was Emerson Electric with about 10%. After these two firms, market share dropped to 3% for Cameron International Corporation, followed by Curtiss-Wright Corporation, Crane Co., and Flowserve with 1.5% apiece. There were also a number of valve subsidiaries of major industrial companies such as Bosch-Rexroth, Eaton, and Caterpillar. Segment data on these divisions was difficult to obtain. Many small specialty valve manufacturers can be found across the country that frequently specialize in certain types of valves for particular vertical markets. Requirements can be quite different for each application making it difficult to develop universal valve designs. For example, the oil and gas industry sets standards and requires valves to undergo a certification process through the American Petroleum Institute. This process can cost thousands of dollars per valve design.

### **OTHER CONSIDERATIONS**

Facing so many unanswered questions, Strempek first contacted Tom Christensen in Maine to begin sorting out the technology ownership issues. Tom contacted the attorney who set up FTL nearly 15 years earlier to clarify FTL ownership and whether the remaining owners had sole authority to negotiate. Barth learned that per the FTL Operating Agreement, upon the death of one of the owners, the remaining shareholders had full decision-making authority. Therefore, Gene's heirs had no say in FTL decisions. Barth and Tom also discovered that registration fees had not been paid to the State of Maine for several years. If the full-balance technology was still owned by FTL, the company would need to be reconstituted by paying the back fees before any negotiations could commence.

Gene and Tom each owned 37.5% of FTL. The remaining 25% was owned by three other shareholders: a married couple in Carmel, ME who had contributed capital, and a defunct recording company that had acquired ownership of the original patents following the failure of Gene's second company in Indiana. In addition, Strempek had documents signed by Gene that gave him 5.0% ownership of FTL. He had received this for contributing cash to FTL in 2000 for the purpose of maintaining the foreign patent annuities. Strempek also contacted Gene's patent attorney in Portland, Oregon, who had retained copies of the patent application and was willing to resurrect the project - for the right price of course.

### **DECISIONS**

With less than ten years left until retirement age but a desire to take on one more major challenge, Strempek began to think through the issues pertinent to his decision to proceed or not. The following questions were foremost in his mind:

1. Was this a good entrepreneurial opportunity?
2. What major issues would be involved with the adoption of a disruptive technology in a mature industry with entrenched competitors?

3. Who actually owned the technology? Susan Ferm clearly controlled the existing prototypes and files, but did she actually own the advanced technology that had been developed by Gene's last company (FTL)?
4. How much cash would it take to acquire the technology? With limited personal funds, should Strempek attempt to acquire the technology himself or assemble an initial investor group to spread the risk?
5. Would they be able to obtain some amount of patent protection on the advanced full-balance technology going forward?

Longer term, Strempek was also beginning to think about how a modern valve venture might be best structured (legal, operational, strategic)? Was there a feasible business model different from the traditional model employed by competitors in the industry?

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## **APPENDIX**

### **VALVE HISTORY, TECHNOLOGY, AND PROBLEMS**

Nobody knows when the first valve was invented but we do know that they have been used for over 2000 years. Elaborate aqueducts and water distribution systems were built by the Romans to deliver and distribute fresh water to communities throughout the Empire, thus allowing the growth of cities and improved living conditions. Extensive systems of lead pipes and mechanical valves (made of lead and bronze) were used to regulate the flow of water for many uses (homes, businesses, public baths, fountains, etc.). These ancient valves are surprisingly similar to plug valve designs still in use today, thus highlighting the snail-paced evolution of valve designs through history. Engineers are currently studying a first century B.C. water distribution network in the Roman city of Pompeii where they have discovered an extensive system of pipes and valves (Lorenz, 2013).

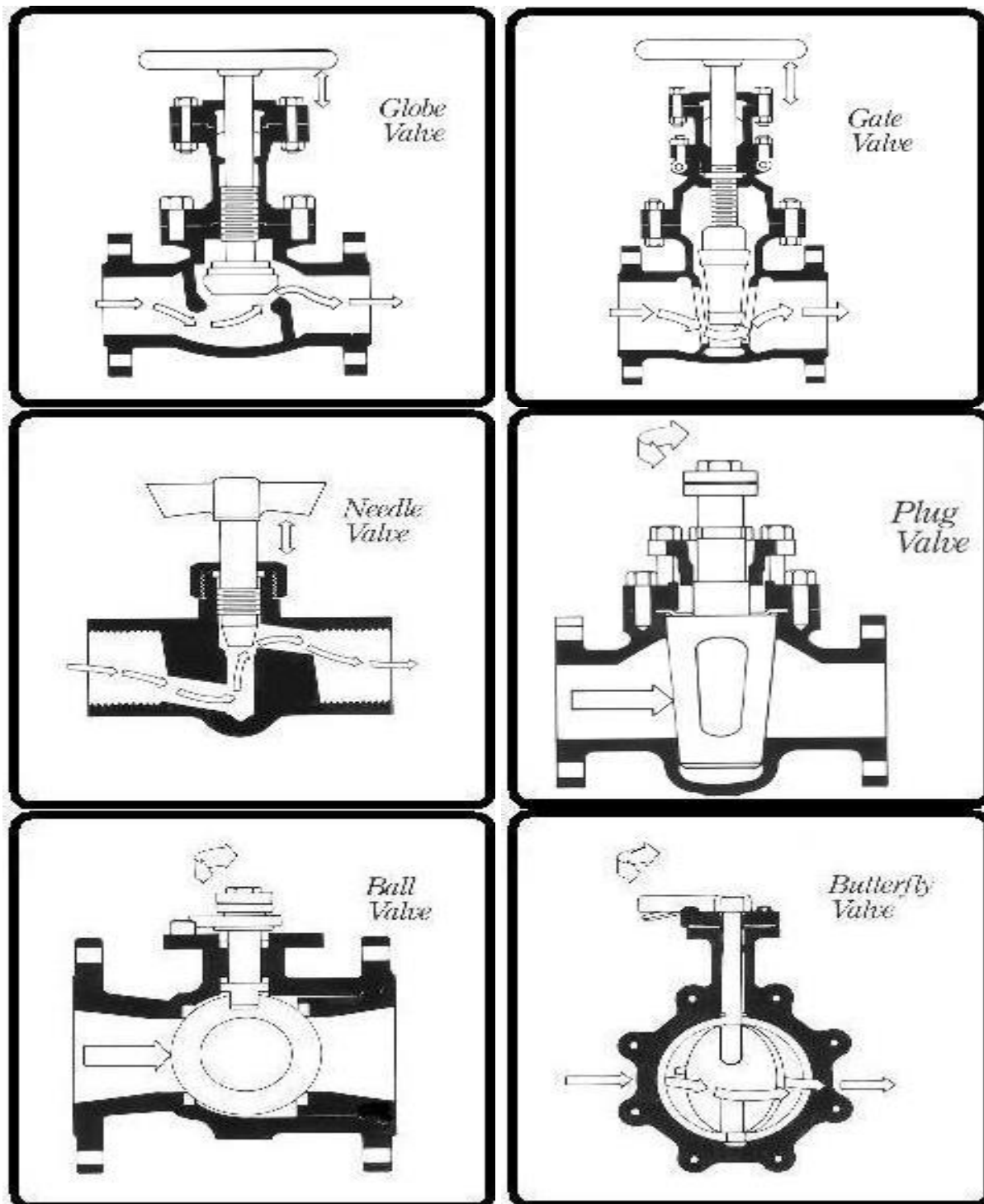
Very few improvements in valve design were made until the Renaissance, some even drawn by Leonardo DaVinci. The industrial revolution brought some progress in fluid control as large machines (i.e., steam engines) required the ability to handle higher flows, pressures, and temperatures ([www.valvias.com](http://www.valvias.com)). The 19<sup>th</sup> and early 20<sup>th</sup> centuries saw modest incremental improvements in valve design. Over time, two basic configurations/topologies that have evolved: (1) plug in a hole (plug, needle, globe), and (2) barrier over a hole (ball, gate, butterfly). The diagram below illustrates these designs. Other specific types not illustrated below include pin (plug), sleeve (barrier), and diaphragm designs (barrier).

Turbulence in a valve causes a variety of negative effects including cavitation, noise, vibration, imprecise control, and excessive wear. Some fluids (especially water) include dissolved gasses which, when accelerated through a constriction, form small bubbles that implode with enough force to cause minute bits of metal to be dislodged from the edge of valve seats and housings. In time, enough metal erodes from the valve surfaces that the device begins to leak and control properties (ability to precisely regulate flow and/or pressure) are diminished. Eventually the valves must be reconditioned or replaced. In high performance applications this may require the expensive shutdown of important processes (hydraulic applications, chemical processes, hydroelectric generation, etc.). Turbulence also causes noise and vibration, which increase over time as valve integrity deteriorates. Precision applications requiring quiet and stability are greatly disrupted by excessive noise and vibration.



**SELECTED TYPES OF VALVES**

(Source: Valve Manufacturers Association of America)



# **MAGICBANDS IN THE MAGIC KINGDOM: CUSTOMER-CENTRIC INFORMATION TECHNOLOGY IMPLEMENTATION AT DISNEY**

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## **CASE DESCRIPTION**

*The primary subject matter of this case concerns customer-centric information technology implementation. Secondary issues examined include customer experience, innovative technology development and adoption, customer relationship management, and big data. The case has a difficulty level appropriate for junior level courses or higher. The case is designed to be taught in three class hours and is expected to require three hours of outside preparation by students.*

## **CASE SYNOPSIS**

*Imagine a child watching Snow White and The Seven Dwarfs on DVD before visiting the Magic Kingdom in Orlando, Florida. Once on vacation, the child rides the Seven Dwarfs Mine Train. While on the ride, the child hears the same music played in the movie, visualizes the same characters, and smells the mine that was featured in the movie. Afterwards, the child attends a meet and greet with the Snow White princess and a couple of the dwarfs. Nowadays, with IT processes that will be discussed in this case study, Snow White can call on the child by their name if they are wearing a special RFID-enabled wristband known as a MagicBand. That personal touch and experience is something the child will likely remember for many years to come.*

*This case examines the Walt Disney Company's use of information technology in the theme parks, especially, the recent introduction of MagicBands at the Orland Disney World. Disney has always prided itself on being one of the best service providers in the world. They have long used the slogan "happiest place on earth" to describe their amusement parks. The introduction of MagicBands exemplifies what Disney does so well in connecting their customers to a memorable personalized experience. Overall, this case illustrates a company's application of information technology to serve a customer-centric business model.*

## **A BRIEF BACKGROUND OF THE WALT DISNEY COMPANY**

The Walt Disney Company, commonly known as Disney, was co-founded on October 16, 1923 by brothers Roy and Walt Disney. Moving forward nearly one hundred years, Disney has grown into one of the most successful and well recognized brands in the world, with several

revenue generators, including broadcasting, consumer products, motion pictures, and of course, theme parks. Disney has become a household name and provides plenty of joy for children and families of all ages. The success of Disney can be attributed to a few critical factors such as their solid customer base, successful branding, and ability to diversify into multiple industries. Their longevity is due to the fact that they continue to create happiness through magical experiences and lifelong memories. This has remained their core promise since the very beginning. In recent years, Disney vowed to be relevant to every single guest that interacts with their brand (Adamson, 2014).

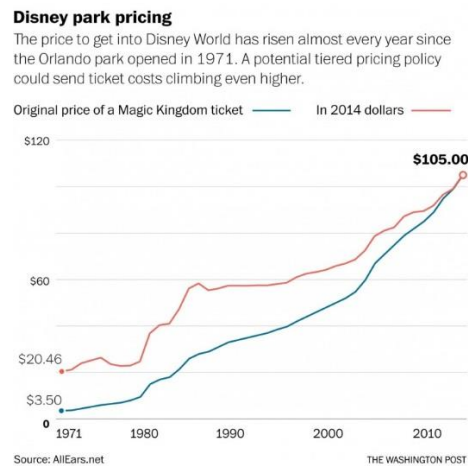
Most of these magical experiences occur in Disney's two major theme parks: Disneyland in California and Disney World in Florida. Walt Disney first inquired about a theme park back in 1953. He dreamt of a location with only one entrance, off the beaten path of nearby streets, that featured custom themed rides which highlighted the storytelling more than the thrill aspect. His dream became a reality on July 1955 when Disneyland opened in Anaheim, California. Following the initial success of his first theme park, Walt Disney was motivated to expand and build a second one. His vision found a home on 30,000 acres of land just south of Orlando, Florida and would eventually be named Walt Disney World's Magic Kingdom (Niles, 2013). Walt Disney's passion and vision has led to much success and Disney is known as one of the world's top hospitality providers.

Today, creating personal touch and experience remains the centerpiece of Disney's customer-centric business model. Disney has long used the slogan "happiest place on earth" to describe their amusement parks. At the Disney theme parks, hundreds of attractions, rides, and characters exist. Disney focuses on more of a show aspect by connecting each attraction on a personal level to the parkgoers with sights, sounds, and smells that are infused into the customer's memory as part of the "Disney Experience." Given the brand recognition and unrelenting focus on customer experience, it is no surprise that Disney enjoys a strong and loyal customer following. Customers become walking advertisements and sub-consciously recommend company products and services to family, friends, and other fellow Disney consumers. Disney thrives on having a loyal customer base that will likely make return visits over and over again. This allows for Disney to have a continuous revenue stream, and very little time throughout the year where park attendance is underperforming. In addition to park attendance, Disney's loyal customers also spend generously on merchandise, dinner reservations, vacation packages, and hotel reservations. With such a loyal following, Disney is able to hold significant market share in the theme park and entertainment industry.

## **INFORMATION TECHNOLOGY AND CUSTOMER EXPERIENCE**

Disney is a great example of a company that invests their capital in order to stay on top of the service industry pyramid. Disney commands the highest prices in the theme park industry (Figure 1 illustrates the pricing history of the Orlando park), yet continues to drive some of the highest attendance rates within the industry. This is why the Disney Experience, including both the tangible and intangible components of that experience, is imperative to the success of Disney. Technology is a driving force in that success, and a major component of Disney's customer-centric business model.

**Figure 1**  
**DISNEY PARK PRICING HISTORY (Source: The Washington Post)**



Given the popularity of Disney theme parks, a constant point of concern for guests is overcrowding and long wait times at all of the attractions. Despite having multiple theme parks in different locations, each one is always extremely busy. Guests are faced with having to make selective decisions on certain rides or attractions that they wish to attend as opposed to indulging in them all. Many guests now utilize the FastPass+, a ride reservation system designed to moderate wait times at popular attractions. Each guest has a maximum of three passes to use within one day, and these guests often show greater satisfaction of their experience. Visitors can make FastPass+ selections up to sixty days in advance. When booking the passes, customers will either be able to choose a certain time for their reservation or Disney will suggest one to them. Similar to a restaurant reservation, it is valid for a limited time only. Thus, visitors can redeem their FastPass+ up to one hour after their assigned time. When making same day reservations at one of the FastPass+ Kiosks, visitors can only book one FastPass+ at a time and must redeem it before making another reservation. With the help of the introduction of fast passes, Disney hopes for a broader distribution of these passes among their guests.

Disney has always placed great emphasis on creating personalized experiences. One of their current goals is to cater to every single person that expresses interest in their attractions. They plan to have an effect on every guest that enters their amusement parks. With many guests spread across multiple locations, it can be quite an overwhelming task to personalize the experience of all guests and add a personal touch dimension to their Disney Experience. Along with the problems associated with the amusement parks, retail stores within the Disney parks have lagged behind in terms of the cycle of entering, buying, and documenting transactions. Customers have often complained of too high of prices and no quick way to get through a line anywhere in the park. Disney, on the other hand, was also looking for a way to meet these needs as well as gather the data necessary to process and analyze customer transactions.

Another focus area for issues within Disney hones in on the problems associated with the hotel booking, check-in, and checkout process. It can be quite the task to book an entire Disney vacation. With the millions of guests that check in and out of Disney resorts each year, it was almost unheard of to never have to wait in line. Somehow the reservation process needed to be simplified. Even better, if Disney could identify opportunities to implement the same technology

at the parks that could be applied at the hotel, that would reduce overall infrastructure cost. In sum, Disney needed to explore possibilities of technology that would benefit the hotels and theme parks simultaneously.

Customers are ultimately the key decision-makers to any service-related companies. With the Disney Experience, customers demand a compelling and unforgettable experience. They do not want to be sidelined by long wait times around the parks, merchandising stores, and resorts. In order to provide that flexibility and meet demand, Disney must decide where to go from an information technology standpoint to address the concerns mentioned. They must determine which issues are at the top of the complaint list, and how information technology can provide the infrastructure to support the magic that Disney is known for and renowned for achieving. These problems are important now more than ever because of the industry landscape that Disney plays. There is pressure on Disney to be innovative in order to maintain a competitive advantage and remain profitable. With the current financial condition of the United States and global economy, consumers are becoming more and more sensitive about how they spend their discretionary dollars. That notion requires that Disney provides the best service to match their high price points. Their reputation for continuously innovating and enhancing their theme parks only provides the visitors with higher standards and much larger expectations.

To address the problems faced by Disney within their theme park and resort operations, Disney decided to focus on several key areas of information technology: Internet of Things, Customer Interaction, and Big Data. Through these major areas, the potential solutions to problem areas can be identified and expanded on more in detail.

## **THE MAGICBANDS**

A major area that Disney chose to focus on in recent years is the Internet of Things (or IoT). Many businesses are trying to differentiate themselves by having objects that are interconnected via technology. This could be a mobile device or any physical items that can communicate efficiently and wirelessly. A customer-facing example of IoT is using a mobile application to access a thermostat at home to control the temperature inside even when nobody is home. Another example is monitoring the number of parking spaces that are available in a given area, such as a large city, through a mobile device. There are many applications that can arise from the Internet of Things, and Disney wanted to be at the frontlines to implementing this type of technology.

In order to match Internet of Things technology to the amusement park and resort setting, Disney decided that wearable technology would be their primary objective. This would prove to be a challenging task as it entails more than simply connecting several parks and resorts elements to a mobile application. It requires designing an object that can be physically attached to a guest throughout the duration of their vacation without being obstructing. Several items were up for consideration, including wristbands, necklaces, and even Mickey Mouse ears. The product Disney went on to develop is called the MagicBand.

The MagicBand, as illustrated in Figure 2, is an exclusive product developed by Disney and released in early 2014. It relies on RFID readers at The Walt Disney World Resort to register a MagicBand (a wearable wristband) with various elements around the theme parks, retail stores, and hotels (Baldwin, 2014). "To make the MagicBand work, Disney had to wire an entire new infrastructure into its parks. Stores and restaurants needed to be outfitted with the new payment systems. Every hotel room needed new lock systems to work with the MagicBand's RFID transmitter" (Grainer, 2015). As of late 2015, this technology was only available in the Orlando,

Florida location at The Walt Disney World Resort. However, Disney is pursuing the expansion of this product in California as well as on their cruise lines.

**Figure 2**  
**MAGICBANDS (Source: The Walt Disney Company)**



Following Walt Disney's famous motto "Plus It", the company continues to be an innovator of the future. In the early years he used the quote, "Nothing of the present exists" in some of the original promotional brochures for the park (Kuang, 2015). The Orlando location in particular remains the testing site for all the new experimental prototypes. Disney wants the customers to familiarize themselves with technology that no one has even imagined yet. Their long term goal is to master the art of customer service. Utilizing the wearable technology, they now possess the great ability of turning a negative experience into a positive one through personalization. For example, if a guest has waited a long time in line the park can send them a coupon for a free ice cream cone or small gift shop souvenir. The transmitters will be able to communicate when a guest may need a little pick me up and upload some type of freebie treat onto their account. This is a major advancement in improving their customer service overall.

The MagicBands that Disney have unveiled is priced at about \$13, but offer convenient and unique technology that enhances the entire Disney Experience. Containing a very simplistic build, the rubber wristbands are offered in multiple colors such as gray, blue, green, pink, yellow, orange, and red. Each has enough battery life to span over two years. Unlike most wearable or even non-wearable technology, this adds an extremely convenient benefit of never having to worry about charging the unit. The interior contains an RFID chip and a radio similar to one in a 2.4 GHz cordless phone. The band connects a guest to a system of numerous sensors all over the park. Despite their astonishing capabilities, the bands do not look very astonishing at all. It is very simplistic, a colorful center panel contained by a grayish looking border. The sizes are adjustable to fit a child's wrist or a large adult (Kuang, 2015). Disney was insistent on the design in order to make two points clear: everyone is equal within the park, and everyone is always welcome. The magic they create is almost invisible, just how Disney likes it to be. Additionally, the MagicBands are typically included at no extra charge with the purchase of a Disney vacation package or an annual pass. These MagicBands offer several positive elements to both Disney theme park employees and customers alike.

## Development of the MagicBands

This section will discuss the process it took to create the MagicBands. Although the team eventually grew to beyond 1,000 people, the original idea began many years ago with just a few individuals. They were kiddingly referred to as the Fab Five - sometimes even referenced as Mickey, Minnie, Donald, Goofy, and Pluto. In 2008, the original crew received direction from Meg Crofton, the then President of Walt Disney World Resort, to remove all friction within the Disney World experience. She said, "We were looking for pain points". Focusing mainly on the consistently long wait times throughout the park, she wanted to answer the question, "What are the barriers to getting into the experience faster?" (Kuang, 2015). The associates working on the project foreshadowed the future when they envisioned Disney's ultimate future by coming back with a drawing of the Magic Kingdom without turnstiles.

The Fab Five originally drew inspiration from the then booming wearables market. They were initially fascinated by the Nike FuelBand whose capabilities included a synced heart rate monitor and a pedometer built into the bottom of your shoe, all connected to a wrist mounted display. They then brainstormed on this question: what if a product like that could be the key to unlock anything and everything that Disney has to offer at their parks. Their initial vision came to life for the first time in the spring of 2010. Many ideas were tossed around to decide what the actual object would be: a band, a lanyard, or even Mickey ears.

This entire development took place in an area of the park that resembled a studio backlot. The front windows were blackened out, and the venue appeared to be closed. Inside the building were roughly thirty or so designers as well as engineers spread out at makeshift desks. The developers wanted the design to be simplistic enough for guests to be able to learn right away. All you have to do is simply touch the circled Mickey icon on the band, when everything works the reader flashes green. If something goes slightly wrong, it glows blue.

Once the engineers had developed a prototype for the MagicBand, it was time to present their idea to the upper level executives, including CEO Bob Iger as well as Pixar board member John Lasseter. The many people working on the project created independent rooms on an 8000 square foot sound stage with fifty foot ceilings. Each one was supposed to represent the newly revamped Disney Experience. Each room was a display to portray a certain stage of the visitor's trip, perhaps where a family might sign up for their ride reservations or book a meet and greet with one of the princesses. The team wanted to show the executives what the futuristic booking system would look like and take a peek into the newly developed Disney World Experience. On a small scale, these rooms illustrated how the new infrastructure would function. Following their tour through the new futuristic experience, the executives were thrilled. The board of directors would eventually sign off on the one billion dollar cost of going ahead with the system (Kuang, 2015).

Despite receiving the go-ahead on the MagicBand project, it would take another two years of work to completely transform the original prototype into a real world model. Once that phase was completed, it took another year and a half to make the necessary adjustments within the park. The old sound stage where the product was initially developed became the new training area for Disney employees (who are always referred to as cast members). Currently, the soundstage no longer exists and hardly any evidence exists of the project ever being worked on (Kuang, 2015).



## **MagicBands and Customer Interaction**

Disney is always looking for ways to improve its interaction with customers, and continue its positive image of creating memorable vacation experiences. The first positive aspect that Disney and customers achieve through wearable wristbands is a personal touch point with customers. Customers can have their names or nicknames directly inscribed on the MagicBand. In addition, throughout various locations in the theme parks, park staff can know the name and location of a guest. For example, a young girl goes up to meet Cinderella at the castle in the Magic Kingdom. As she walks up to Cinderella, Cinderella's guard whispers to her and says, "This is Sarah." Cinderella then calls Sarah by name as she approaches. In addition, a family walks up for their 6:00pm reservation at a restaurant within the Walt Disney World resort. As they walk up, like magic, the hostess says, "Welcome Smith family." This is all possible through the use of MagicBands, and the RFID technology within them. After swiping the band at a kiosk, it would light up with a pleasant chime sound signifying a successful transaction. Disney is now one step ahead in catering to the needs of their consumers simply by knowing their name without having to ask.

The Internet of Things technology utilized by the MagicBands, as well as other RFID and fingerprint technology, allow the guests to have an expedited and easier entry to the parks. As shown in Figure 3, with just a touch of the wearable wristband, a guest can gain access to the theme park. This is a much more simple process than purchasing tickets at the gate, waiting in a long line to enter, and slowly gaining access to Disney attractions. For those guests concerned with the rains or water destroying their wristbands, Disney thought of that as well and made the MagicBands waterproof.

**Figure 3**  
**PARK ENTRANCE WITH THE MAGICBAND (Source: The Walt Disney Company)**





In addition to the effects on the theme park element of the MagicBands, the hotel processes have also been influenced by MagicBands. The locks at every hotel room in the Walt Disney World resort were outfitted to communicate with the MagicBand. By signing up in advance for the “Magical Express”, the band substitutes all of the hassles with paperwork once arriving in Florida. The Express users do not have to be concerned about the luggage (after being tagged it will arrive at your specific hotel room). This allows for wireless entry into one’s hotel room with just the swipe of the wrist. This can additionally help expedite the check-in and check-out process by just activating or deactivating the MagicBands to a particular hotel room.

In addition, the customer interaction piece of information technology revolves around a newly developed rollout called MyMagic+. MyMagic+ encompasses several components that include the following: FastPass+, PhotoPass Memory Maker, My Disney Experience, and MagicBands. FastPass+ is a customer option to select up to three attractions a day, at one park location, to receive a time in which to skip the normal ride queue and get priority access to those attractions. These selections can be made up to thirty days in advance of the visit, and in some cases for sixty days in advanced (Walt Disney World, 2015). PhotoPass Memory Maker provides guests online access within their Disney accounts to digital photos taken by PhotoPass photographers at various attractions, character meet and greets, shows, and restaurants throughout the park. My Disney Experience is both the website and mobile application platform that allows customers to book and manage their Disney vacation. This includes being able to designate FastPass+ selections, make food reservations, see the displayed wait times for attractions, or even find the nearest available bathroom. There are many other features of the online and mobile platform, but it is essentially a tool for customers to view and manage their vacation experience all in one location. In essence, the MagicBand functions as the physical “key” to all of the customer service components of MyMagic+.

### **MagicBands and Big Data**

The last focus area of IT that will be addressed is big data. Big data is essentially any large data set that can be analyzed to reveal trends or patterns about a certain market segment. Applied in particularly to Disney, with the MagicBands being able to collect various types of information about a customer, there are significant opportunities in terms of big data analysis. Disney has the opportunity to access key pieces of information such as purchase history, attraction preferences, location, and visiting preferences (Van Rijmenam, 2015). All of this information can be invaluable to a company like Disney. They are giving themselves the opportunity to discover trends within datasets to ultimately generate more revenue for Disney, all while providing a valuable service to customers.

With the rollout of the MagicBands, Disney can now track customer purchases, and even determine customer preferences. With the data available to Disney through MagicBands, they can better customize marketing messages and promotions directly to the proper customers. For example, a customer bought four dolls from a Disney park’s store from the movie Frozen. Next year, Disney might be able to send a targeted email to that customer about a Frozen show that is new and exclusive to Walt Disney World Resort that coming December. When customer preferences are known, generating revenue from that customer can become a much more simplified process. Although some options on the MagicBands can be enabled or disabled, any insight into customer purchase habits or preferences may lead to increased future revenue for Disney. Additionally, Disney is adding a little bit of personal touch in the customer’s mind by catering a message specifically to them.

## Reception and Impact of the MagicBands

The initial reception of the MagicBands has been extremely positive. As one visitor commented on Facebook: “My family used the bands in October, we loved them. We chose our colors and names. You can even attach a spending limit to each band so you can let younger folks spend their “own” money. It was so easy, we paid for meals, souvenirs, adult beverages, everything.” Another poster praised: “We used our bands last weekend and loved them! Great going to the pools and parks with no need for a wallet or purse! Getting into your room is so much easier now even if your hands are full.” Even the Disney cruise liners are starting to incorporate them into their facilities. Different airlines and professional sports organizations have approached Disney with inquiries about the new technology.

It is too early to assess the exact financial impact the MagicBands have on Disney’s bottom line. The MagicBands may not have a direct immediate effect on the bottom line considering the fact that they are only currently available at the Orlando location. However, through the next few years we could expect Disney’s theme park revenue to increase partly due to the rollout of MagicBands. The major objective of the bands is to have people spend less time waiting in lines. The guest schedules will now be more available to explore beyond the usual top attractions, therefore total usage of the park will improve. In the end, guests will be able to do more throughout their visit which means that they will spend more. As a result, they will have the best experience they have ever had at the Disney theme parks and will be much more eager to come back and experience it all over again.

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# ACCOUNTING FOR LEASES: A CASE EXPLORING THE EFFECT OF THE NEW LEASE ACCOUNTING STANDARD ON THE FINANCIAL STATEMENTS

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## CASE DESCRIPTION

*The primary subject matter of this case deals with the new lease accounting standard recently issued by the Financial Accounting Standards Board (FASB). The primary objective of this case is to help students learn and understand the major changes to accounting for leases, especially with respect to leases currently classified as operating leases. The case focuses on lessees' accounting and reporting since the new standard affects primarily lessees. Secondly, the case explores some of the financial reporting issues that motivated FASB to issue this new standard, as well as some of the potential strategic and economic implications for organizations with significant lease obligations.*

*The case has a difficulty level of three to four and can be taught in about 40 minutes. Approximately two hours of outside preparation are necessary to fully address the suggested case-specific analysis and research questions, which are largely independent providing instructors with considerable flexibility. The case can be utilized in an Intermediate Accounting course, where accounting for leases is typically covered, and serves to reinforce the related concepts and issues discussed in class. It can also be used in an advanced level undergraduate or graduate course focusing primarily on the research components and the strategic implications of the new accounting standard.*

*Using this case can enhance students' technical, analytical, research, and communication skills. Furthermore, the case also provides students with some insights into the economic effect of accounting standards and the potential effect on managements' strategic decisions.*

## CASE SYNOPSIS

*After nearly ten years of collaboration with the International Accounting Standards Board (IASB), two exposure drafts, and extensive due process; in February 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-02, "Leases." Once implemented into the FASB Accounting Standards Codification (ASC), the new standard will supersede all currently existing Generally Accepted Accounting Principles (GAAP) related to leases. ASU 2016-02, which includes several appendices and spans nearly 500 pages, is quite complex and significantly changes lessees' accounting for and reporting of leases.*

*This case explores the effect of the new lease standard on the measurement, recognition, and reporting of leases and the effect on the financial statements of a company with significant lease commitments. Furthermore, the case explores some of the issues surrounding this accounting change and the potential impact on managements' capital budgeting decisions.*

*The main character in this case, with which students are asked to identify, is a highly motivated accounting major who interviews for and accepts an entry-level position at a mid-tier accounting and consulting firm whose clients tend to lease a significant portion of their plant assets. The characteristics ascribed to the character; which include currency in the professional field, excellent technical knowledge, high motivation to excel, and ability to*

*impress interviewers with detailed knowledge of the firm's clients and niche; are those that accounting majors would likely aspire to.*

*The case includes selected company-specific financial statement information, including lease related disclosures. The case also includes an exhibit comparing major provision of the new lease standard applicable to lessees with current GAAP.*

*This case may enhance students' understanding of changes to accounting for leases and the effect on lessees' financial statements, and serves to enhance their research, technical, critical thinking, and communication skill. The context of the case may also enhance students' understanding of characteristics that help future accounting professionals prepare for and succeed in a challenging career.*

## THE CASE

Skylar Karrington, an accounting major, is currently completing the last two courses necessary to meet the requirements for the Certified Public Accountant (CPA) exam. She is also preparing for the CPA exam, which she plans to successfully master within the next nine-month period, while completing a masters' degree in accounting. She has started the interviewing process for an entry-level accounting position. As an active member of an accounting-oriented professional student organization, she has had many opportunities to explore the diverse careers available to successful accounting graduates. After careful consideration, she decides that a mid-tier accounting firm, specializing in accounting and consulting services, rather than a "Big 4" accounting firm, would correspond with her immediate career objectives and her desire for work-life balance. Having networked extensively over the past two years, she has identified several firms, which she feels would complement her career objectives as well as her personal style. She ranks the firms based on her personal carefully developed criteria.

After interviewing with three of the top five firms on her list, Skylar secures an all-day interview with the number one ranked firm, Merburg Accounting and Consulting LLP; her interview is in two weeks. She recognizes the importance of being well-prepared for an interview, and although she is already very knowledgeable about the company, its professionals, and its culture, she conducts additional research that includes information about the firm's clients. She soon realizes that many of Merburg's top clients lease their plant assets. A review of several of their top clients' financial statements reveals that a significant portion of those leases are currently classified as operating leases.

Skylar, who strives to be a proactive and well-informed professional who is aware of and anticipates changes in accounting, closely monitors new developments with respect to both U.S. GAAP and International Financial Reporting Standards (IFRS). She is aware of the trend towards globalization of accounting standards and is especially interested in standards that are the result of the FASB and IASB's joint efforts to converge accounting standards. For example, Skylar watched closely the FASB and IASB's nearly ten-year efforts to issue a converged revenue recognition standard and the recently issued lease accounting standard. Skylar knows that on February 25, 2016, FASB finally issued the long-awaited standard – Accounting Standards Update (ASU) 2016-02, "Leases." Having previously reviewed the two exposure drafts issued by the FASB and the IASB, she is also cognizant of the likely effect of the new standard's provisions on the financial statements of companies that lease assets.

After considering what she learned about Merburg's clients and after reviewing the newly issued lease standard, she realizes that knowledge about the new lease standard's main provisions will provide her with a number of opportunities and advantages. First, she believes that as a future accounting professional it is very important that she be knowledgeable about

the provisions of a new important accounting standard and the resulting changes to GAAP. Second, she believes that knowledge regarding the lease standard's new provisions will provide her with the opportunity to distinguish herself during her upcoming interview with Merburg's professionals. In fact, during the scheduled visit at Merburg, she is planning to reveal to key professionals of the firm her knowledge of the new lease standard. She realizes that in order for this strategy to be effective and to help her project the image of a confident and knowledgeable professional, she will need to prepare for potential question by Merburg's staff about the new standard. Third, she decides to incorporate the knowledge she gains about the new lease standard in her master's degree thesis, which deals with the economic effect of accounting changes.

### **Preparations for the Upcoming Interview**

During the next few days, Skylar studies the main portion of the new standard and also participates in a free podcast hosted by one of the "Big 4" accounting firms. She then summarizes key provisions of the new standard and contrasts them with current GAAP. Her summary is shown in Exhibit A. Next she develops a number of potential questions that she wants to consider prior to her interview and that may also be useful to her thesis related research.

A few days prior to the interview, she reviews what she knows about Merburg Accounting and Consulting LLP. She makes a list of key factors pertinent to her interest in this firm and then composes a brief profile of Merburg.

### **Merburg's Profile**

Merburg is located in the western region of the United States. The firm has twelve offices. The main office is located in California and employs 148 professionals and many support staff members. Merburg specializes in accounting and consulting engagements for primarily midsize private entities. While many of its clients are not required to report to the SEC nor are required by law to publish financial statements, most of them publish annual reports to comply with lender stipulations and stakeholder expectations. Many of Merburg's clients currently lease a large portion of their equipment, with a significant portion of those leases classified as operating leases. Thus, the new lease standard is likely to affect their financial results. Merburg's accounting division helps clients prepare for changes in GAAP, particularly when extensive comparative information must to be derived and reported.

### **Day of Interview**

During the office visit, Skylar is very favorably impressed by what she learns about Merburg's professionals, professional environment, and strategic plan. She gains additional information about the firm's current market position, its economic outlook and future plans, and the typical career path toward becoming a manager and partner. She also has the opportunity to demonstrate her knowledge related to the new lease standard. She asks one of the partners whether he expects that the firm will be assisting many of its clients with the implementation of the new lease standard. The partner confirms that they expect to work closely with most of their small and midsize clients. He also indicates that several clients already have contacted Merburg about this issue.

Walter Kunze, the managing partner of the firm, who extensively speaks with Skylar is very impressed by her knowledge and her qualifications; at the conclusion of the interview he offers her a full-time entry-level position commencing in ten months. In addition, he offers

her a part-time internship with a very flexible schedule and invites her to participate in the upcoming in-house training seminars.

Skylar thanks Walter and indicates that she is very interested in the offered position and looks forward to receiving the formal written offer of employment. She indicates that she has several more interviews scheduled with other firms and requests a one-month period to finalize her decision, which is granted. Immediately after returning home, Skylar sends an e-mail to Merburg's managing partner, expressing her appreciation for the opportunity to meet with the firm's professionals and emphasizing that she is very interested in the offered position.

Two days later, one of the managers she met during her visit with Merburg, phones her to inquire whether she would be willing to briefly share her knowledge of the new lease standard at the training seminar held in three weeks. Participation would provide her with the opportunity to meet professionals who were not present during her office visit. Skylar replies that she will be honored to do so. Afterwards she thinks, 'I am so glad that I have already reviewed the standard and considered a number of related issues.' She retrieves the financial statements of one of Merburg's clients and summarizes selected financial statement information, including information about the company's leases; the summary is shown below. She decides to utilize the information to illustrate/explain some of the effects of the new leasing standard. She hopes that this very practical approach will capture and hold the professionals' interest. She also knows that she can use this information for her master's thesis. Next, she develops concise answers to all the questions that may be of interest to Merburg's professionals.

### **Selected Financial Statement Information for One of Merburg's Clients**

Merburg's client is a medium-size manufacturer of accessories for various electronic devices, such as tablets and smart-phones. The company manufactures exclusively in the U.S. and owns its land and buildings, but leases a significant portion of its manufacturing and office equipment. In order to compete with competitors who moved production to lower-cost countries, the company continually strives to improve its efficiency through automation and high energy efficiency, especially with respect to its manufacturing processes. This is one of the primary reasons why the company leases, rather than buys its equipment. Leasing allows the company to utilize cutting-edge, energy-efficient equipment and to replace its equipment as needed. A significant percentage of the leases currently are classified as operating lease. The following information is extracted from the most current financial statements of Merburg's client.

<b>SELECTED FINANCIAL INFORMATION – 2016 FISCAL PERIOD</b>	<b>NUMBERS ARE IN THOUSANDS</b>
Current assets	\$ 11,595
Long-term assets	24,520
Total assets	36,115
Total liabilities	19,250
Total stockholders' equity	16,865
Total revenue	42,400
Net income	3,600

The note disclosures provide the following information under the heading of "Contractual Obligations."

<b>NOTE DISCLOSURES - LEASES</b>				
Contractual Obligations	Total Payments	Payments due during 2017	Payments due during 2018-2019	Payments due thereafter
Financing leases	\$290	35	35	220
Non-cancellable operating leases	\$2,280	540	490	1,250
Off-balance sheet arrangements relate to operating lease commitments detailed in the footnotes to the consolidated financial statements.				

### ASSIGNMENTS

Pretend that you are in Skylar's place. Answer the questions assigned by your instructor.

### EPILOQUE

The training seminar is highly successful. Three days after the seminar, Skylar accepts Merburg's offer of a full-time position.

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<b>Exhibit A COMPARISON OF CURRENT AND NEW GAAP ON LESSEES' ACCOUNTING FOR LEASES</b>		
Accounting/Reporting Issue	Currently Effective GAAP	New Accounting Standard – Future GAAP
<b>Leases Classified as Financing Lease</b>		
Recognition and reporting of leased asset	Recognize and report as asset classified as property, plant and equipment on the balance sheet (statement of financial position)	Recognize and report as right-of-use asset recognized on balance sheet (statement of financial position)
Recognition and reporting of related future lease payments	Recognize and report the present value of future lease payments as a liability	Recognize and report the present value of future lease payments as a liability
Subsequent measurement – reporting	For depreciable assets, asset-related depreciation and lease liability related interest expense are recognized separately on statement of comprehensive income	Amortization of the right-of-use asset and lease liability related interest are reported separately on statement of comprehensive income
Amortization of lease asset and liability	The related asset is depreciated/amortized using the same method used for purchased assets. Interest expense is based on the present value of the remaining lease payments multiplied by the lessee's implicit	The related asset is depreciated/amortized using the same method used for assets purchased outright. Interest expense is based on the present value of the remaining lease payments multiplied by the lessee's implicit interest rate or incremental borrowing rate. The

	interest rate or incremental borrowing rate. The difference between the lease payment and the interest expense represent a reduction of the lease liability.	difference between the lease payment and the interest expense represent a reduction of the lease liability.
Recognition of lease related cash payments	Payments related to interest are classified as operating cash flows; re-payment of lease liability principal are classified as financing cash flows	Payments related to interest are classified as operating cash flows; re-payment of lease liability principal are classified as financing cash flows
Leases Classified as Operating Lease – Except for Those with Lease Terms Twelve Months or Less for Which Lessee Selects Exception		
Recognition and reporting of leased asset	Leased asset is not recognized on balance sheet	Right-of-use asset is recognized on balance sheet; typically classified as long-term asset
Recognition and reporting of related future lease payments	Not recognized as liability. Future lease payments are disclosed in financial statement notes	Recognize and report the present value of future lease payments as a liability (initial amount will be the same as if it were classified as financing lease)
Recognition on statement of income/comprehensive income	Total periodic lease payments are typically recognized as operating expense	Total periodic lease payments are recognized as single line item on the statement of comprehensive income. For unequal lease payments, total lease payments are expensed straight-line over the lease term. --
Amortization of lease asset and liability	The related asset and liability are <u>not</u> recognized on the balance sheet; thus, no amortization is recognized	The right-of-use asset is adjusted for (1) the difference between the current period lease payment and the lease expense, which consists of the total lease payments divided by the number of payments, and (2) the current period decrease in the present value of the future lease payments, which also reduces the lease liability
Recognition on statement of cash flows	Periodic lease payments are classified as operating cash flows	Periodic lease payments are classified as operating cash flows

\*Author's Note: This case deals with a fictitious company; any similarities with real companies, individuals, or situations are purely coincidental.



# EXPLORING PRICE DISCRIMINATION IN AN E-COMMERCE ENVIRONMENT

**Dmitriy Chulkov, Indiana University Kokomo**  
**Dmitri Nizovtsev, Washburn University**

## CASE DESCRIPTION

*This case study focuses on e-commerce price-setting practices and provides an opportunity to review the underlying principles of price discrimination as well as other pricing strategies. Its instructional value extends beyond its focus on the growing specialty tea market. The case is designed to address a number of learning outcomes in a managerial economics course at the M.B.A. or upper undergraduate level and has been tested in M.B.A. economics courses at two business schools over several semesters. The content of this case may also be relevant to other business disciplines concerned with pricing issues, such as marketing.*

## CASE SYNOPSIS

*The market for specialty teas in the USA is experiencing robust growth. The US is now the second largest importer of tea in the world. A small specialty tea store featured in the case seeks to participate in the growing market, but must adjust to the online environment in which consumers find pricing information easily and many sellers offer similar products. A number of recent studies have demonstrated that charging customers different prices for the same product or service is becoming more common in the online marketplace. This case asks students to evaluate the feasibility of non-trivial pricing, in particular third-degree price discrimination, in an e-commerce setting. It is designed to help students better discern between different pricing strategies and review the conditions for their successful implementation.*

## CASE INTRODUCTION

Jason Lee has been selling specialty teas for fifteen years. It all started when, as a teenager, he was helping his father manage a brick-and mortar shop selling imported teas in a Chicago suburb. His father's knowledge of the tea market helped establish relationships with importers and bring in specialty teas directly from India, Sri Lanka, China, and Japan. Upon graduating college with a business degree, Jason chose to take over the operations, in part because of his father's health issues combined with the strong reluctance to sell the business. Tea is the most widely consumed beverage in the world, but other than the iced tea version it has not been quite as popular in the US Midwest. However, the twenty-first century has brought a revolution to the tea market in the US as the millennials have taken a taste to the beverage, and the search for a healthier lifestyle brought millions of new customers to tea sellers. Jason wanted to position his business to benefit from this market change.

Jason has always been fascinated with technology. Ever since he took his first and only college course in e-commerce, he was thinking of giving his family business a stronger online presence. Finally, two and a half years ago the online store of Lee's Teas went live. Along with exposure to a broader market, that transition came with a handful of new headaches. The sales volume increase resulted in greater expenses required to ensure the availability of the product. Jason considered outsourcing some of the logistics to Amazon's

fulfillment program that is designed to help small businesses sell through the Amazon platform while taking advantage of Amazon's expertise in order fulfillment. He also worried about the promotion of his online store to help it rank highly on the search results lists. This required doing some research on how the content and keywords on the e-commerce site reflect on its search results placement. Making the website mobile-friendly and easy to share on social media also helped its visibility and drove additional customer traffic.

The most important challenge, however, consisted in the changed nature of the competition he was facing. Previously, he had a well-established niche in his geographical region and had a consistent pool of loyal customers who learned to appreciate his father's quality teas as well as fair pricing. The new environment, however, was very different. On the Internet, no one knew him. There were plenty of other online stores selling a similar selection of teas. All this made his profit margins decline.

### **Growing Tea Market in the USA**

Tea is the second most popular beverage in the world after water. People have been drinking tea for nearly 5,000 years. According to Chinese legends, tea was discovered in 2737 BC by Chinese Emperor Shen-Nung when some tea leaves were accidentally blown into the Emperor's pot of boiling water.

The growth in US tea consumption in recent years has been very impressive. USA is currently the fourth country in the world in tea consumption behind only China, Russia, and Japan, and is the second largest importer of tea behind Russia. The total wholesale value of tea sold in the US grew from \$2 billion in 1990 to over \$10 billion in 2014. (Tea Association of the USA, 2015)

The preference for healthier beverages is driving consumers away from sugary drinks and boosting the demand for tea. According to the USA Tea Association, "tea is an all-natural and environmentally sound product from a renewable source. Tea contains flavonoids, naturally occurring compounds that are believed to have antioxidant properties. Tea flavonoids often provide bioactive compounds that help to neutralize free radicals, which scientists believe, over time, damage elements in the body. Every day, new findings from the international scientific community lend credibility to tea's healthy properties." The USA Tea Association lists a number of academic studies that have shown health benefits of tea for prevention of heart and neurological diseases, certain cancers, and osteoporosis.

The majority of the tea consumed in the US is ready-to-drink bottled teas such as Snapple, Lipton, and Gold Peak owned and promoted by food industry giants PepsiCo, Coca-Cola, and Dr.Pepper. However, specialty teas including high-quality loose-leaf teas constitute a healthy 17.5% of the market and saw total sales of \$1.9 billion in 2014 (Tea Association, 2015). Specialty teas include different varieties of white, green, and oolong teas. They are typically of higher quality and have higher prices both on the wholesale and retail markets. Specialty tea is attracting affluent, young, educated and health conscious consumers who like to experiment with unique and organic flavors. The recent acquisition of Teavana chain of tea stores by Starbucks has helped fuel significant growth in this segment. As the number of restaurants serving specialty tea and the number of tea salons have also been increasing, the consumer exposure to this segment of the tea market and the consumer demand have been on the rise.

Traditionally, specialty teas have been popular with customers who were brought up in a tea-drinking culture such as Chinese, British, or Russian. This has been the traditional base of customers Lee's Teas has built upon. More recently, new and distinct segments of demand come from the millennials attracted by the variety and the organic properties of teas,

as well as from the aging baby-boomer population interested in the health benefits of tea consumption.

### **Can Price Discrimination Help?**

Looking for a way to increase the sustainability of his e-commerce profits, Jason started thinking about possible ways to differentiate among his customers instead of charging everyone the same price. As an avid Internet user, he knew that companies such as Google and Netflix have successfully used personalization to provide tailored services to their customers. He was also aware of coupons distributed by retailers and manufacturers alike and has himself used them many times. However, he wanted to explore this idea further and see if there is something that works for him as a small e-commerce business owner.

He recalled the discussion of price discrimination in his college Managerial Economics course. Under this pricing method, sellers are able to boost their profits by identifying their customers' willingness and ability to pay and setting their prices accordingly. Economics textbooks distinguish three types of such pricing strategies (Baye and Prince, 2013). First-degree price discrimination occurs when each individual customer is charged the price equal to their willingness to pay. With second-degree price discrimination, sellers openly offer a variety of fee options linked to the volume of purchase – with such examples as discounts for buying large quantities of a product, or reduced bank fees for keeping large account balances. With third-degree price discrimination, the seller attempts to segment the market into various groups that have different levels of price sensitivity and charges the groups accordingly. Common examples of third-degree price discrimination include senior-citizen and student discounts. Price discrimination may also involve changing prices over time which is common for electronics products such as Apple's iPhone (Chulkov and Nizovtsev, 2014).

Jason couldn't remember much more from that discussion so he used one of his afternoons to research the Internet for additional details. He was able to find several examples of online price discrimination, some of which were in fact quite prominent. That encouraged him to explore the topic further.

### **Variation in Prices on Travel Websites**

The first study Jason came across (Hannak et al., 2014) was authored by a team of computer scientists at Northeastern University who recruited three hundred users and tracked their search experience on different e-commerce sites. The researchers also developed hundreds of fake accounts to see whether browsing and purchase histories as well as clicks through the sites had an impact on the prices seen by the users. They found that six of sixteen popular e-commerce websites charged consumers different prices for a similar product and none of the sites alerted their customers to that fact. For example, online travel agencies Cheaptickets and Orbitz favored the members of these sites and charged users looking for hotels an average of \$12 more per night if they were not logged into the sites. Meanwhile, Travelocity charged users of Apple Inc.'s iOS mobile operating system \$15 less for hotels than other users. Priceline personalized the order of search results based on the user's history of clicks and purchases.

According to the same study, Expedia and Hotels.com online travel agencies appear to break their users into groups and steer users from one group at random to pricier products. Expedia and Hotels.com are both units of Expedia Inc., and the company confirmed that it constantly refines its pricing strategies using a method called A/B testing, the researchers said. Customers are randomly placed in a group that highlights either less or more costly

hotels. In an example, one group of customers was shown an average hotel listing price of \$187 a night. The other group saw prices that were about 10% lower. Expedia spokesman Dave McNamee was quoted saying in an interview to the Wall Street Journal that “presenting different booking paths and options to different customers allows us to determine which features customers appreciate most. Pricing is not manipulated by Expedia.com” (Dworkin, 2014).

Orbitz, an online travel site, popped up in Jason’s search two more times. As it turned out, Orbitz has been accused of price discrimination as far back as year 2002 (Clemons, et al., 2002). Another Wall Street Journal investigation found in 2012 that Orbitz steered Mac users to pricier hotel offers, which effectively resulted in those customers paying as much as 30% more than PC users for a night’s lodging. The company later discontinued the practice, which it characterized as a month-long experiment (Mattioli, 2012).

### **Online Retailers’ Pricing Practices**

The Northeastern University study also found that Home Depot’s website didn’t charge users different prices for identical products but showed more expensive products, as much as \$100 more expensive on average, to people who shopped using a smartphone. “In the real world, there are coupons and loyalty cards, and people are fine with that,” said Professor Wilson from Northeastern University who led the research team. “Here, there is a transparency problem. The algorithms change regularly, so you don’t know if other people are getting the same results.” (Dworkin, 2014)

In an interview with the Wall Street Journal, Home Depot didn’t dispute the accuracy of these findings, but the company claimed that they were not “intentionally steering search results,” said company spokesman Stephen Holmes. Many factors could influence what a customer sees on the company’s website, including prior browsing and purchase history, the location of the store, and whether the customer is on mobile or not, said Mr. Holmes (Dworkin, 2014).

Staples Inc. varied its online prices based on the users’ location (Valentino-Devries et al., 2012). The office supply chain uses not only the customer’s location, but also the customer’s distance from competitor stores such as Office Depot as a factor in setting its.

One fact that Jason found very interesting was that the majority of consumers are unaware of the elaborate pricing practices used by online retailers. A study from the Annenberg Center at the University of Pennsylvania (Turow et al., 2005) found that 64% of American adults who use the internet do not know that online stores “charge different people different prices at the same time of day.” When presented with various scenarios of price discrimination, between 64% and 91% of respondents in this survey voiced their disapproval and 87% believed that online stores should not charge different people different prices for the same products. The study concluded that while consumers may be used to the idea of coupons and sale prices in retail stores, they expect the online environment to be a level playing field with similar prices for different buyers of the same product.

### **Pricing by Car Rental Websites**

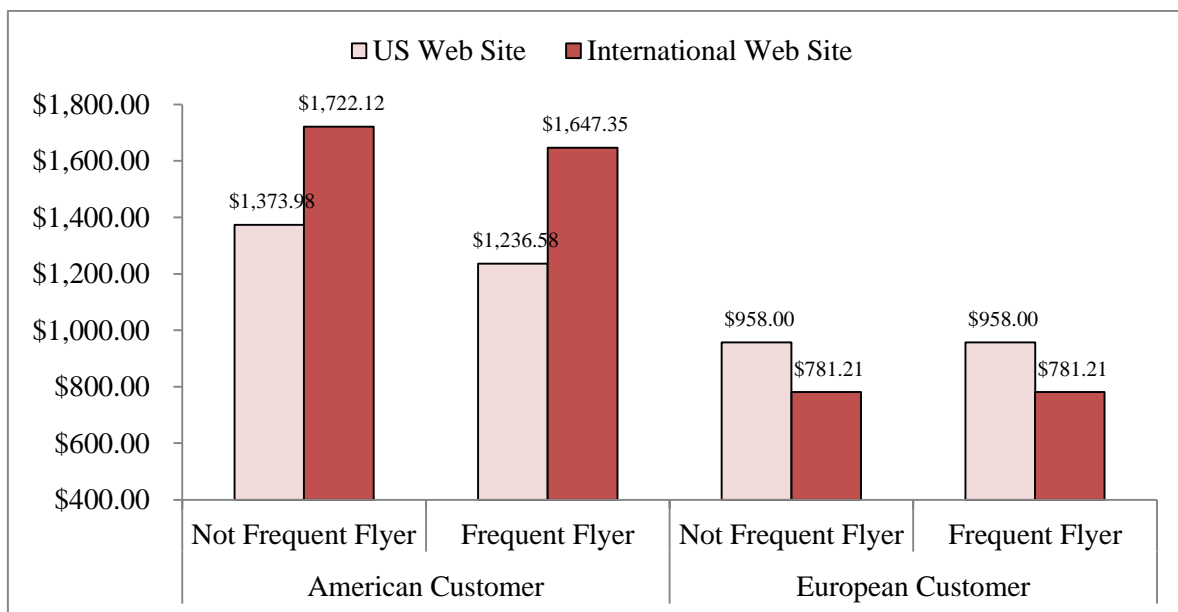
Just as Jason was contemplating his own pricing strategy, life suddenly gave him more food for thought. He was researching the options for a Christmas vacation with his family, choosing between trips to California or Spain. He needed to rent a car for ten days and went to the Budget Rent-a-car websites. The rates quoted by Budget.com and BudgetInternational.com looked somewhat high to him but most interestingly, they were different! This fact baffled him. Being resourceful, he asked his cousin who lived in Spain, to

run a similar search on the same websites. This exercise revealed an interesting pricing pattern in the rental car market. Budget's websites offered different prices for the exact same rental dates and type of vehicle to customers coming from the US and from Europe.

As Figure 1 demonstrates, for a local US customer Budget's US website offered a lower price compared to the price offered on the international version of the website. At the same time, Budget's international website offered a substantially lower price to the European customer compared to the price offered to the same customer on the US site. European customers also were offered lower prices overall. For a ten-day one-way rental of a small sport-utility vehicle (SUV) in California over the Christmas holiday period, the price for a US customer ranged between \$1236 and \$1722. In contrast, the price for the same type of vehicle offered at the same time to a European customer ranged between \$781 and \$958. Frequent flyer customers received a discount on the US website, but not on the international website.

**Figure 1**

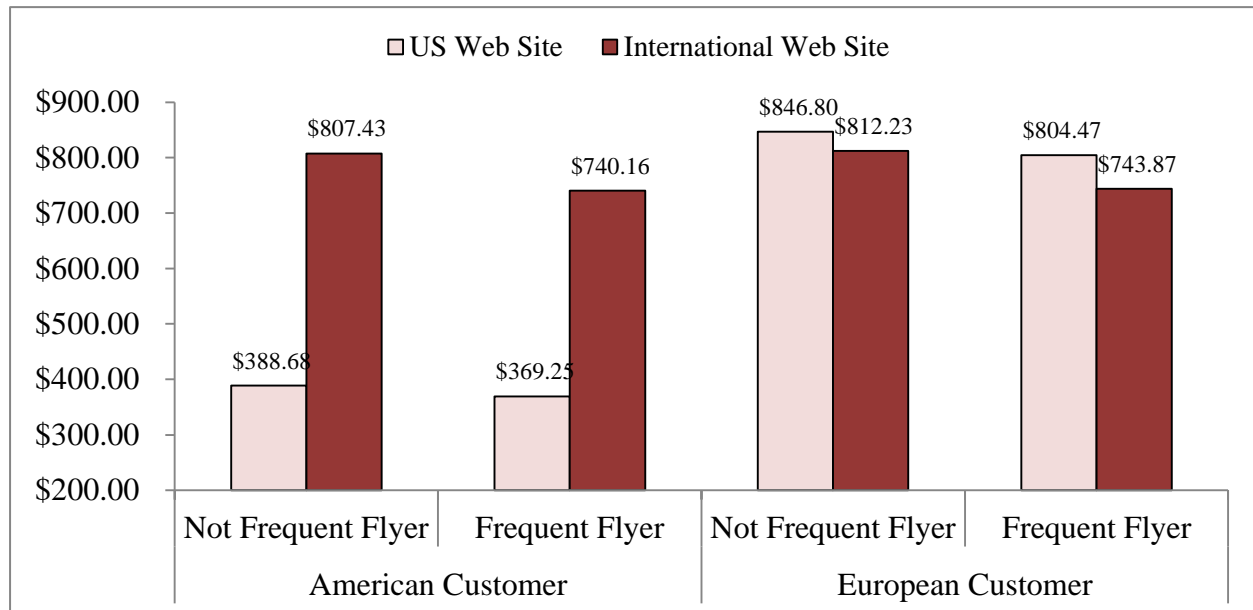
**CAR RENTAL PRICES FOR THE SAME LOCATION AND PERIOD IN CALIFORNIA**



Sources: Authors' research, Budget.com, BudgetInternational.com

Figure 2 reports the prices for similar rental queries for a ten-day one-way vehicle rental in Spain. In a reversal of pattern from the case of the California rental, in this case US-based customers were offered overall lower rates. A US customer renting in Europe saw a price as low as \$369. Meanwhile, a European customer would pay between \$743 and \$846 for the same type of vehicle over the same period in Spain. Budget's US website also offered much lower prices to local US customers than the international website.

**Figure 2**  
**CAR RENTAL PRICES FOR THE SAME LOCATION AND PERIOD IN SPAIN**



Sources: Authors' research, Budget.com, BudgetInternational.com

### Legal Considerations

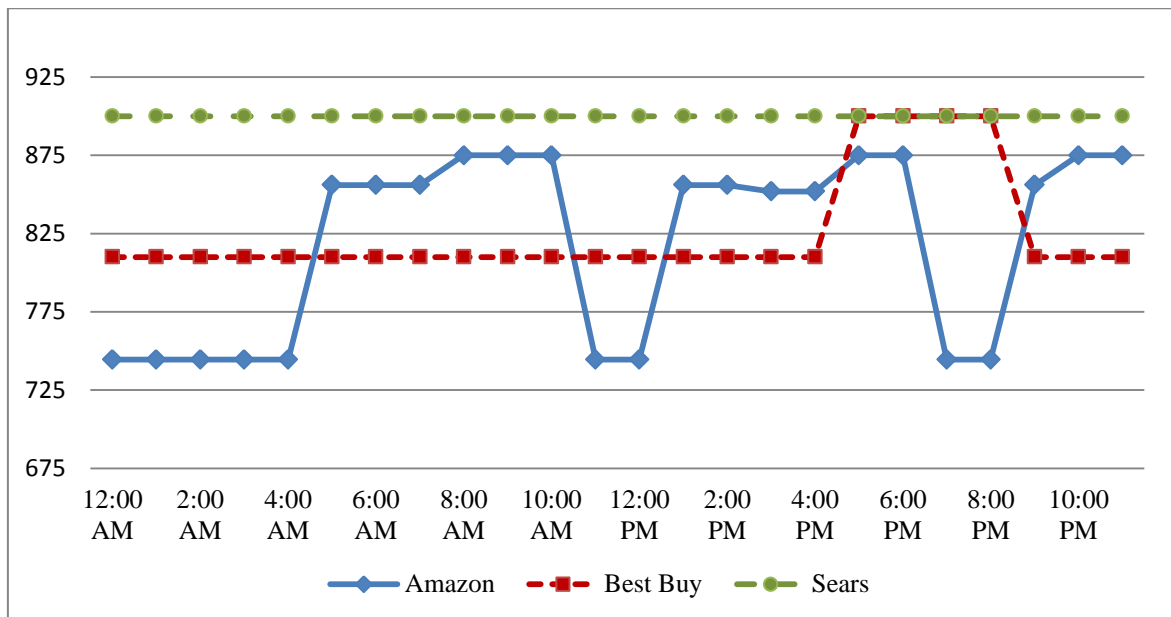
At some point in his search, it became clear to Jason that price discrimination practices benefit the sellers, while some buyers seem to be worse off as a result. A thought crossed his mind, "Is it even legal to do that?" and so he dug deeper into the available sources.

As it turned out, using market power to charge different prices to different customers has been outlawed in the US since the Clayton Act of 1914. Furthermore, the Robinson-Patman Price Discrimination Act of 1936 focused on the elimination of monopolies in wholesale trade and required that: "It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce... Provided that nothing shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery." (United States Code, 1936)

Legislation in the US also prevents charging different prices on the basis of race or religion. However, courts have allowed application of different prices in such cases as men being charged a higher rate for car insurance than women. The justification has been the fact that women have better driving records and therefore lower insurance cost than men.

Not all price differences on e-commerce sites may be attributed to conscious efforts at price discrimination by the firms and therefore have no such legal obstacles. A study by the Wall Street Journal finds that some websites may change prices randomly for the same customer multiple times over the course of a day (Angwin and Mattioli, 2012). Figure 3 presents the pattern of pricing for the same product – a high-end microwave oven – at three popular websites over one day that was discovered in the study. One rationale behind this pricing strategy is that the unpredictability of price changes makes it less advantageous for the customers to delay their purchase as the price may increase at any moment.

**Figure 3**  
**ONLINE STORE PRICES FOR THE SAME PRODUCT OVER ONE DAY**



Sources: Angwin and Mattioli (2012), Decide.com

### Lee's Teas' Dilemma

Jason came to the realization that the variety of pricing practices in the online environment creates both challenges and exciting opportunities for consumers and firms. He saw the ubiquity of online price discrimination examples as an indication that such practices are effective, or at least promising, in boosting sellers' profits. One thing Jason didn't want to do, however, is alienate his present and potential customers. Not surprisingly, consumer advocates have long protested price discrimination by online stores. In one highly publicized case, Amazon.com upset its customers with a policy that used buyer profiles to charge different prices for the same DVDs. The resulting customer outrage prompted Amazon.com CEO Jeff Bezos to apologize and characterize the pricing differences as an internal research program in which consumers were shown different prices for identical products. He called the experiment a "mistake." (Dworkin, 2014)

The growth in the specialty tea market brings increased demand from various groups of customers – millennials attracted by the organic properties of tea, baby-boomers interested in the health benefits, as well as the traditional tea drinkers brought up within the tea culture. With the growth in the industry comes increased competition from larger firms such as Teavana, and from online sellers all over the nation. Should Jason experiment with his pricing strategy and if so, how should he proceed to help sustain the success of his business?

## CASE QUESTIONS

1. What are the conditions for a successful implementation of price discrimination? In your opinion, can price discrimination help increase Jason's profits? Why or why not?
2. Which of the companies mentioned in this case – Orbitz, Expedia, Hotels.com, Home Depot, Budget – actually uses price discrimination? Provide argumentation to support your opinion.
3. Should Jason experiment with first-degree price discrimination? Why or why not? Which type of price discrimination would you recommend Jason consider?
4. Do the Internet and e-commerce make the implementation of price discrimination easier or harder for sellers? Provide your argumentation.
5. When implementing price discrimination for Budget car rentals, for which customer groups would you charge higher prices and for which lower? What could be the rationale for the price differences reported in the case?
6. In your opinion, are price discrimination practices ethical? Is price discrimination good or bad for the society? Should it be illegal to engage in such practices? If Jason decides to go that route, should he alert his customers to the fact that he uses these practices?
7. If Jason uses price discrimination, what criteria do you recommend he uses to estimate his customers' willingness to pay?
8. The case mentions frequent flyer programs. What is the rationale for the firms to offer such programs? Would you recommend Jason to implement a similar scheme?

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# THE CURSE OF KNOWING TOO MUCH

**Mark Linville, Kansas State University**

## CASE DESCRIPTION

*The primary issue of this case is to explore the professional's responsibility for confidential client information. Although the case is designed primarily for accounting students, all professions deal with client information whose security must be assured by the professional. Improper disclosure of client information is unprofessional behavior. This case also discusses conflict of interest. In this case, the conflict of interest is created by a personal relationship and not a professional obligation. This case also introduces students to the three major codes of conducts which govern the accounting profession and also provides an opportunity to discuss the concept of "spirit versus letter" of the rules. Finally, the case also illustrates that compliance with ethical obligations can create personal costs to the professional. The case has a difficulty level of four meaning it is appropriate for senior level courses. Students should have some understanding of the professional environment and exposure to the ethical concepts. The case was initially designed for a senior-level accounting class after exposure to the profession's code of conduct. This case works best in a 75-minute class and should take students 2-4 hours to prepare depending on how the case is administered.*

## CASE SYNOPSIS

*Professionals are frequently entrusted with client information, the disclosure of which could cause damage to the client. Professional ethics impose requirements on the professional to protect this information. Professionals may find themselves tempted to improperly release or use client information.*

*Jean James finds herself in such a dilemma. In her professional duties, Jean learns of confidential information which would prevent a close personal friend from making what would be a catastrophic economic decision. Jean knows that she is precluded from releasing the information by the professional code of conduct but she has a life-long loyalty to this friend and desire to protect him. What is she to do? Is there some way around the code of conduct? Is it ethical to stand by and watch her friend suffer while she sits on the information her friend so desperately needs?*

## CASE BODY

### **Jean James and her history**

Jean James entered college 20 years ago like many incoming freshmen – she had no idea what career path she wanted to pursue. Jean initially declared herself to be an electrical engineering major at the suggestion of her good friend, Fred Tyson, who was an electrical engineering major in his junior year, and in part because she thought that she really needed a declared major. Early in her first semester, Jean quickly decided that the engineering program did not interest her, despite sterling success in her classes.

The only class that Jean enjoyed in her first year at the university was the first accounting class. After discussing the issue with her parents, Jean became an accounting major. Early in her junior year, Jean took a managerial accounting course and realized that she would like to pursue a career in corporate controllership with ultimate goal of becoming the chief financial officer (CFO) for a major publicly-traded corporation. Consistent with her personality, Jean pursued this career goal with laser-like focus.

Jean continued her high academic performance in the accounting curriculum and was heavily involved in extra-curricular activities, particularly Beta Alpha Psi. After becoming a member of Beta Alpha Psi, Jean did not miss a single meeting or activity of the club and served a term in every office, including president.

After working a summer internship in the accounting department of a major corporation and a spring internship with a public accounting firm, Jean had multiple job offers. She finally accepted a position with a Big Four accounting firm. Even in this decision, Jean kept her sights on her career goal. She felt that the training offered by a Big Four firm was unsurpassed and successful employment there would enhance her resume when she decided it was time to switch to industry. Plus, working as an auditor would allow her to identify an industry and possibly a company with which to pursue her desire of becoming a chief financial officer.

Jean excelled in her role as an independent auditor. In particular, Jean was very quick to spot deficiencies in the client's control or operational systems and provided most of the suggestions for improvement in the management letter for those engagements. This skill was recognized by both her employer and its clients. She was quickly given more and more responsible tasks which she completed with distinction and was quickly promoted to senior accountant. Her promotion to audit manager was inevitable and there was talk that Jean could become the youngest person offered a partner position in the history of this office.

At the same time, Jean impressed the right people outside her firm. She was a CPA, a certified management accountant, and a certified internal auditor. Jean served on a couple of committees of the state society of CPAs and of the Institute of Management Accountants (IMA). Because of her efforts on the other committees, Jean was nominated and accepted for a position on the IMA's national ethics board.

When Jean's supervisor at the Big Four firm informed her that he was recommending her for promotion to audit manager a couple of years earlier than was normal and the partners were in agreement, Jean felt it was time to make her move to industry. Jean had already informed her employer of her long-term career goals but no one expected her to move so soon. However, Jean felt that it was the right time and she was concerned that if she accepted the audit manager position, she would be blocking the promotion of someone who is more likely to stay.

Several factors contributed to Jean's conclusion that the time for the move was right. One factor was timing – Jean had just received an attractive offer to become assistant director of the internal audit department of Meditech Industries, a publicly-traded company which manufactured high-tech medical equipment. The director of Meditech's internal audit department was planning to retire in a year's time and the new assistant director would be promoted. Jean had been the senior for the past two years on the Meditech audit and thus, knew and was known by senior management. Each had high respect for the other.

Jean had been introduced to her future husband, Eric, by her friend, Fred, when she was a freshman. The relationship deepened and they were married shortly after Jean graduated (with Fred being the best man). Eric had his own career working with a not-for-profit charity and although he was willing and able to move elsewhere, he really liked his current position. As a

result, Eric would prefer to stay where they were. In addition, their twin sons had just started school, so both Jean and Eric preferred to put roots down. Meditech's headquarters were located only a few miles from Jean's home and both she and Eric had extended family in the immediate area.

Another personal reason for Jean's desire to move to Meditech was that her life-friend, Fred Tyson, was the manager of one of Meditech's divisions. Jean was excited about the possibility of working with Fred.

Because everything seemed so perfect, Jean resigned from her current job and accepted Meditech's offer of employment.

### **Fred Tyson and his history**

Fred Tyson had entered Jean James' life so early that Jean has no recollection of a time when Fred was not there. The James and Tyson families were very close, often taking vacations and spending holidays together. The children of the two families were like siblings to one another. This was most true for Jean and Fred. Although Fred was about three years older than Jean, there was always a special bond between these two. While childhood friends often drift apart, Jean and Fred remained close friends throughout the years. In an odd twist, both Fred and Jean had introduced the other to their future spouses. Jean and Fred's wife, Sally, had grown to be close friends and confidants as had Fred and Jean's husband, Eric.

While Jean excelled at school, Fred was an indifferent student, always doing just enough to get by, in part because Fred allowed himself to be distracted by his personal interests, particularly horses. Because of Fred's mediocre grades, he had only one offer coming out of college. This position was not a job that most engineering graduates would have desired. Although requiring some technical skills, it did not really require someone who had an engineering degree. Fred was offered the position because he had worked with MedAssemble during summer breaks as an assembly line worker. MedAssemble manufactured a critical digital component used in high-tech medical equipment. When the advertised position was not filled, Fred's former boss on the assembly line suggested Fred who had just completed his engineering degree. Shortly, after Fred accepted the position, MedAssemble was purchased by Meditech.

While the digital component which Fred worked with was a highly technical piece of equipment, the difficult engineering issues had been solved before Fred arrived. While Fred had a lot of knowledge about the technical details of the component, he was not involved with any of its technical development nor does he probably have the ability to contribute to its future technological improvement. Fred's current position posed few technical challenges but really just involved keeping production lines working. Although Fred claimed to be an engineer, his job duties were more in line with those of a foreman.

This lack of technical expertise led to problems a couple of years later. Fred was asked to work on a special project with Tom Wales, a consulting engineer. They were part of a team who was charged with designing a new component for existing X-ray machines which would lead to clearer X-ray images in older machines, effectively extending their useful life. Tom Wales was a hard-charging, productivity-driven professional with poor "people" skills. Tom seldom made friends among his co-workers and he did not care one bit. However, none of Tom's previous problems with co-workers compared with the difficulties that resulted with Fred. Early in the project, Tom questioned Fred's technical expertise in front of the other team members. Fred took exception to this and a heated shouting match ensued. Throughout the rest of the project, Tom never missed an opportunity to belittle Fred's abilities. When Fred learned that these criticisms

were being passed to his supervisors, Fred began to respond in kind and the bickering reached such a degree that the team became dysfunctional. The project was a failure, the only failure in Tom's career, which Tom blamed on Fred and informed anyone who would listen. Fortunately for Fred, while his supervisors realized that many of Tom's accusations were true (even if greatly exaggerated), none of them had a desire to replace a long-time employee who has performed adequately in his day-to-day activities.

Unfortunately for Fred, Tom was a very influential man in their profession while Fred was not active at all with professional organizations. Tom never failed to disparage Fred when the opportunity presented itself. Most people in the profession who had heard of Fred had heard of him through Tom's corrupted viewpoint. However, things got worse between Tom and Fred.

Fred and Jean's husband, Eric, had worked together on a project for charity. As a result, Fred was nominated for a civic award. As it turned out, Tom Wales was on the board of directors of the organization who was handing out the award. After fiercely fighting Fred's nomination, Tom resigned from the board at its next meeting in protest of giving the award to Fred. In his resignation, Tom heavily criticized Fred and belittled the accomplishment which had led to Fred winning the civic award.

Fred was informed of Tom's statements shortly after the meeting and of course, was angered. Tom's actions were so unusual that his protests were reported in the local press the next day. Upon hearing of this, about a week later, Fred Tyson filed a defamation of character civil lawsuit against Tom Wales seeking \$250,000 in damages. Fred's attorney had advised against the lawsuit stating that it had essentially no chance of success and would only serve to further publicize the troublesome statements. After further consideration of his attorney's advice, Fred withdrew the lawsuit a month later but not before Tom has incurred a few thousand dollars in legal fees. The entire lawsuit episode only embittered Tom even more against Fred.

### **Fred's Current Situation**

While Fred and Tom are in the same profession in the same city, they successfully avoid one another. The bitterness between the two is still present.

Although Fred's supervisors at MedAssemble are aware of Fred's technical limitations, his skills are adequate for the position he currently holds which does not require the technical training of an engineer. Fred is reasonably satisfied with the position he holds and does not want to look for a new job because Tom's criticisms have shaken his confidence in his skills and because Fred is convinced that Tom has effectively 'blacklisted' him in the professional community.

Besides, Fred is more focused on another interest. Fred has always had a passion for horses and he and his wife have long dreamed of running a stable. In fact, they have been saving since their marriage to fund their dream. Fred's wife, Sally, has minimal marketable job skills, so they are reliant on Fred's salary to pay living expenses. Despite that, Fred's wife has a knack for thrift and has assembled a surprisingly large nest egg.

The Tysons had been aware of a piece of property near their current home on which a stable could be established. The property was mostly on a slope and because of drainage issues and possible mudslide concerns, it would not be suitable for residential or normal commercial development. This explained why the property, although it had been on the market for years at a reasonable price, had not sold. The zoning of this plot would allow its use as stable and the steepness of the property would not prevent its use for pasture land and enough flat ground existed for the necessary buildings of a stable. Certainly, this plot was not ideal for a stable but

probably adequate. More suitable property for a stable is much more expensive, which the Tysons could not afford. In fact, it would really stretch their budget to acquire this land. Fred and Sally had sought loans from every commercial lending institution in the city and were refused each time. The explanation always told the Tysons was that the property's lack of marketability would make it unsuitable collateral for a loan.

Although few people know of Fred and Sally's dream, it is not surprising that Jean and Eric did. All four people recognized that the stable plan required Fred to continue his position for at least a couple of years until the stable became profitable enough to allow Fred to draw a full salary. Jean and Eric were offered an opportunity to invest in the stable but, after some consideration, declined, feeling that their current financial situation would not allow for such a risky investment.

With the fulfillment of dream so close, Fred and Sally decided to buy the land. They put together an offer sheet at the stated market price because the present owner made it clear that was the bottom-line acceptable amount. The offer sheet allowed either party to nullify the deal within the next ten days with the potential buyers forfeiting their \$1,000 earnest money deposit if they nullified the deal. This was signed by both parties on November 1, 2012 to become effective on November 10, 2012 unless nullified by one of the parties.

### **Current Situation at Meditech**

Five years after accepting the position at Meditech, Jean's career had continued to progress. After spending a year as the associate director of internal audit, Jean was promoted to director of internal audit. After spending three years in that position, Jean was promoted to controller. In this position, she served directly under the CFO, Barney Cimes, who happened to be her mentor. Barney was a couple of years from retirement and had convinced the board of directors that his successor should be Jean. By putting her in the controller position, she could work with Barney who would prepare her for the CFO position.

As controller, Jean was asked to attend board of directors' meetings to provide information to the directors and to express her educated opinions when appropriate. Jean enjoyed sitting in on these meetings as it gave her great insight into the major issues facing the company and long-term corporate strategy. It gave her a great sense of being "in-the-know." But sometimes being in the know is not always pleasant.

On the morning of November 8, 2012, Jean settles into her seat at the board meeting, nursing her first cup of coffee. She notes that the first item on the agenda is the special report of the product subcommittee, followed by consideration of a Wales Medical offer. Jean thought that she had not known of the activities of the subcommittee. "Must have been given its assignment before I was invited to the board meetings," she thought "I hope this is not boring – I should have gotten more sleep last night."

The chair of the subcommittee began her report by stating that "this development makes our MedAssembly digital unit functionally obsolete." Suddenly, Jean was no longer sleepy. Jean realized that this is bad news for MedAssembly and anything that is bad news for MedAssembly is bad news for Fred Tyson. Jean knew that MedAssembly is a one-trick pony and if the digital component was not marketable, MedAssembly is ultimately a goner even if it could hang on for a couple of years. MedAssembly had obtained a foothold in this small niche and while the component is still marginally profitable, the market is small enough that no one else has seen it worth the effort to unseat an entrenched manufacturer.

Jean sat in stunned silence as she heard the chairman of the board say “well, with that as background information, let’s move on to agenda item 2 – the Wales Medical offer for MedAssembly.” “Oh, no, not that,” Jean thought. She knew that Wales Medical was owned by Tom Wales and she was very aware of the bitterness of Tom Wales towards Fred Tyson. In addition, Jean knew that Tom Wales supervises all projects himself and would not need someone else to manage the manufacturing division.

The board discussed the possibility of Meditech selling the MedAssembly division to Wales Medical. Although Jean had not been asked ahead of time to determine the economic effect of the subcommittee’s information, she did not need time. If the digital component was obsolete, MedAssembly had little reason to exist and in good conscience, she would have to advise MedAssembly’s sale at whatever price. This was a no-brainer decision for anyone concerned about Meditech’s interests.

The board is informed by the corporate attorney that Wales Medical has its financing for the deal assembled. Wales Medical insisted on complete confidentiality and has actually made this provision grounds for nullification of the deal by Wales Medical. This confidentiality concern is due to some legal issues about warranty obligations. Wales is willing to take on all the obligations but is concerned that if the probable sale becomes known, the affected customers will likely seek and get a restraining order from a court which would delay the transaction until after the critical November 30, 2012 deadline. Since there are tax considerations in play which make this deal attractive to Wales, the deal has to be done by that date in order to be reported in the current fiscal year which ends on that date. Because of possible synergies with its existing product lines, MedAssembly has some limited value to Wales Medical despite the technical obsolescence of its product but it is the tax benefits which drive the deal. Without the tax benefits, Wales would not have a desire to complete the deal. The entire deal must be kept in complete confidentiality until the public announcement on November 30, 2012.

Jean knows what would happen to Fred if Tom Wales obtains MedAssembly and she also knows what would happen to Fred and Sally’s horse stable dream.

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# HEARTLAND PHARMACY: TOBACCO OR NOT TOBACCO

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## CASE DESCRIPTION

*The subject matter of this case concerns the primary objective of the corporation: shareholder wealth maximization. Case examines a situation where profits and “the right thing to do” conflict. The case requires students to have an introductory knowledge of accounting, finance and general business issues thus the case has a difficulty level of three (junior level) or higher. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 2-3 hours of preparation time from the students.*

## CASE SYNOPSIS

*At the most recent board meeting, Dr. Allen Springer, a board member of Heartland Pharmacy, suggested Heartland follow the lead of CVS Caremark and announce the removal of tobacco products from its stores by the end of 2014. Springer, a family practitioner, argued that selling tobacco products was inconsistent with the company’s objective of improving customers’ health care. Springer had not discussed the recommendation with John Wiley, Heartland’s President and Chief Executive Officer (CEO), or Robert Davis, Heartland’s Chief Financial Officer (CFO) prior to the meeting. Both Wiley and Davis were surprised with the unexpected suggestion. Wiley’s initial thought was the proposal had merit, but Davis pointed out sales and profitability would suffer and that the primary objective of Heartland management and board is to increase the wealth of the shareholders. Springer said he expected sales and profits to decrease but that discontinuing tobacco products from their stores was the right thing to do. After a contentious debate, the board of directors of Heartland Pharmacy agreed to table the recommendation until further information and analysis could be obtained.*

*The learning objectives of the case include: 1) A review of the primary objective of a firm’s management: shareholder wealth maximization 2) Identification of the different stakeholder groups of a corporation and how their interests enter into the wealth maximization objective, 3) An examination of the ethical issue regarding the sale of tobacco products, which are a known carcinogen and 4) A review of alternative ethical perspectives.*

## BACKGROUND

At the most recent board of directors meeting of Heartland Pharmacy, Dr. Allen Springer, a vocal board member, suggested Heartland follow the lead of CVS Caremark and announce the removal of tobacco products from its stores by the end of 2014. Springer, a family practitioner, argued that selling tobacco products was inconsistent with the company’s objective of improving customers’ health care. Springer had not discussed his recommendation with John Wiley, Heartland’s President and Chief Executive Officer (CEO), or Bob Davis, Heartland’s Chief Financial Officer (CFO) prior to the meeting. Springer had mentioned his proposal to a few of

the other board members and received very limited support. Both Wiley and Davis were surprised with the unexpected suggestion. Wiley's initial thought was the proposal had merit but was concerned with how lost revenues and profits from the sale of tobacco products would impact the firm. Davis pointed out that tobacco and related products are one of Heartland's higher margin categories and that their removal would most likely result in a reported loss. Davis asked Springer how he thought the company could compensate for the lost sales and profits. Springer said he did not have an answer and he expected sales and profits to decrease but that discontinuing tobacco products from their stores was the right thing to do. After a contentious debate, the board of directors of Heartland Pharmacy agreed to table the recommendation until further information and analysis could be obtained.

Heartland Pharmacy is a closely held corporation headquartered in Poplar Bluff, Missouri. Heartland serves a predominately rural, Midwestern market. It operates forty-three pharmacies in southern Missouri, southern Illinois, northern Arkansas, western Tennessee and western Kentucky. All pharmacies are located in small towns. An additional six stores are scheduled to open over the next two years and expansion into northern Mississippi and eastern Oklahoma is also being studied.

The company was started by John Wiley's grandfather, Sam Wiley, in 1948 with a single pharmacy in Poplar Bluff. Expansion was slow during the fifties and sixties but accelerated over the next three decades under the leadership of John Wiley's father James. John has been CEO since 2001 and has continued growing the business by expanding geographic coverage but maintained the company's strategy of focusing on serving small, rural, communities.

Company growth has been financed with internally generated funds and private equity sales to friends of the Wiley family. The external investors were needed when growth financing requirements exceeded family resources. There are seven major external investors, mostly friends and business associates of James Wiley, and all are members of the board. A number of Heartland's managers are also shareholders, but their holdings are relatively small. The Wiley family owns a controlling interest, but the non-family board members currently control close to forty percent of the outstanding shares.

### **CVS CAREMARK'S DECISION**

In February of 2014, CVS Caremark, the nation's largest drugstore chain in terms of overall sales, announced that it would discontinue the sale of cigarettes, cigars and chewing tobacco at its more than 7,600 drugstores nationwide. According to CEO Larry Merlo, "We have about 26,000 pharmacists and nurse practitioners helping patients manage chronic problems like high cholesterol, high blood pressure and heart disease, all of which are linked to smoking. We came to the decision that cigarettes and providing health care just don't go together in the same setting." (Strom, 2014) It is estimated that this decision will cost the company about \$2 billion in annual sales, less than two percent of overall sales of \$123 billion in 2012.

In discussing the announcement, Dr. Troyen Brennan, a former professor of medicine at Harvard University, and current chief medical officer for CVS, noted that the decision to drop tobacco products will give his company a "competitive advantage" against other pharmacies because of the credibility it will give CVS when talking to physicians. This "credibility" may be related to participation in Accountable Care Organizations, in which health care providers are paid according to patient outcome, not procedures. Over the past few years, major drugstore chains have become more involved in the provision of health care, with walk-in clinics that treat



common ailments and offer flu shots. According to Forbes, “if CVS can help save money or keep patients healthier, it might get a piece of the action.” (Herper, 2014) This is one reason why CSV did not downgrade its earnings forecast for 2014. Some critics note that this attempt to appeal to physicians in order to increase CVS’s business as a health care provider/partner is the real motive behind the decision.

The impact of CVS’s decision upon the market for tobacco products is uncertain. According to Nik Modi, an investment analyst at BBS Capital Markets, CSV’s decision will have little impact upon total tobacco sales, since convenience stores account for over 75 percent of cigarette sales (Strom, 2013). Walgreens and Rite-Aid, competitors of CVS, have made no move to halt the sale of tobacco products, although they did announce that they continue to “assess and review” their product mix. In an interesting turn, in 2013 Dollar General began selling tobacco products in an attempt to lure consumers into their stores. According to Forbes, this decision fueled a 39 percent boost in share value of the Goodlettsville, Tennessee chain for the year, and a 20 percent increase in the last six months of 2013 (Touyalai, 2013).

According to the most recent statistics available, more than 293 billion cigarettes were purchased in the United States in 2011, and \$8.4 billion was spent on cigarette advertising and promotion. In that same year, approximately 124.6 million pounds of smokeless tobacco were purchased (Center for Disease Control and Prevention). Between 2009 and 2012, the estimated annual costs associated with smoking on the U.S. were more than \$289 billion, including \$133 billion for direct medical costs and \$156 billion in lost productivity (Center for Disease Control and Prevention).

## **BUSINESS TYPE, INDUSTRY CHARACTERISTICS AND PROSPECTS**

The following industry information is from Drug Store Business and Industry Profile, published June 18, 2004, by the Illinois Department of Commerce and Community Affairs, in cooperation with U.S. Department of Commerce (Economic Development Administration) and Southern Illinois University at Carbondale (College of Business and Administration).

The publication was authored by Lynn Andersen Lindberg, Business Research Management Services Institute and Donald Vaughn, Professor of Finance, both of Southern Illinois University. The publication was edited by John Moulton, Office of Urban Assistance, Department of Commerce and Community Affairs.

The complete paper can be found at: <http://www.sbaer.uca.edu/Publications/pub00055.txt>

### **Industry**

Drug stores have been assigned the Standard Industrial Classification (SIC) Industry Number 5912. These are establishments engaged in the retail sale of prescription drugs, proprietary drugs, and nonprescription medicines. Also, this SIC includes drug stores which can also operate a soda fountain or lunch counter, and may carry a variety of related lines such as cosmetics, toiletries, tobacco, novelty merchandise, and lottery machines in those states with lotteries.

Corporations dominate in the retail pharmaceutical industry, with 76 percent of total firms being incorporated. Single proprietorships account for 20 percent while partnerships represent 4 percent. From 1976 to 1986, independent stores witnessed sales growth of 75 percent

over the ten year period 1976-1986 (about a 6.4 percent annual rate). The large chains grew much faster in this period than the independents, increasing their share of the market from 45 percent to 60 percent, with sales growth of over 200 percent or nearly three times the rate of sales growth shown by independents.

### **Nature of Business**

A broad line of merchandise may be carried to appeal to a wide range of shoppers. Some of the items generally carried by a drug store include: cosmetics/fragrances, cigarettes and cigars, small art and crafts items, hair care/skin care products, magazines/books, film/film developing, vitamins, greeting cards, batteries, disposable diapers, blank videotapes, oral hygiene products, contact lens solutions, diet aids, pet food, and candy. Some drug stores have added a cooler with beverages and snack foods.

The following products generate more than 5 percent of average total sales per store:

<b>Department</b>	<b>Percent of Revenue (%)</b>	<b>Gross Profit Percent (%)</b>
Prescriptions	27.2	35-40
Drugs/proprietarys	14.5	30-35
Toiletries	10.8	25-30
Tobacco	7.5	15-20
Housewares	6.7	35-45
Cosmetics	5.3	35-40
Other (stationery, candy, toys, general merchandise, grocery, liquor, miscellaneous)		15-45

### **Growth Potential**

Prospects for growth in the future decade are mixed. There is likely to be a growing demand for certain products while other product lines may shrink due to changing demographics. The population in the U.S. is aging; thus, sales of prescriptions and proprietary drugs are likely to increase. However, the older population spends fewer dollars on cosmetics and beauty aids, so there may be some sales shrinkage in this area. Diversification of product lines and general merchandise geared toward customer needs and volume business may hold the brightest future for the independent drug store.

### **Level of Competition**

Beginning with the early 1980's, the retail drug market became more competitive. That is, large supermarkets began to stock a wider range of household items, beauty aids, and proprietary drugs. Some supermarkets even installed their own pharmacy. The combination store (roughly one and one-half times the size of a supermarket) began to appear, offering the combined products usually carried by a supermarket, a drug store, and a dry goods store. Moreover, K-Mart, Wal-Mart, and other expansion-minded discount or department stores began to promote these product lines more vigorously.

Health maintenance organizations sometimes install their own pharmacies at hospitals and clinics. Thus, the squeeze has been felt by the independent drug stores, many of which

liquidated in recent years. The liquidation rate in this industry is about 4.5 percent yearly, somewhat higher than the rate of formations, indicating a growing degree of competition.

Total sales of products generally carried by drug stores should continue to rise by 1 to 2 percent annually above the level of price inflation, but profit margins are likely to be squeezed as more generic drugs flood the market and as more price discounters expand their sales. Large chains that are open virtually around the clock are likely to continue to expand their sales, while sales for many of the independents will stagnate.

## **THE SITUATION**

After the board meeting, John Wiley asked Davis to join him in his office to discuss how they were going to address the tobacco issue raised by Springer. Wiley did not think the board was likely to support a decision to remove tobacco products without adding a new revenue source and even then some members may be reluctant to sacrifice profits. Wiley valued Springer's long service and wanted to provide an objective analysis of his suggestion.

Davis stated that tobacco sales varied from store to store, but company-wide tobacco products contributed about ten percent of Heartland's annual revenue over the last four years. He also stated that the average gross profit margin on tobacco sales during that same period was close to twenty percent. Wiley instructed Davis to prepare a report that would quantify (dollars) the impact of removing tobacco products from their stores. Wiley suggested modifying the projected income statement for 2015 and, to keep the analysis simple, he suggested they reduce revenues (by 10% to reflect the removal of tobacco products) and remove gross profits from tobacco sales (using a tobacco sales gross margin of 20%) but make no adjustments to selling or administrative expenses and examine the results. In addition, Wiley asked Davis to begin thinking about non-quantitative reasons for continuing the sale of tobacco products other than shareholder wealth maximization.

Davis discussed the task with the company controller, August Sawyer. Sawyer did not think preparing the revised 2015 statements would be difficult particularly with key assumptions provided, but he expressed reservations with the non-quantitative analysis. Sawyer stated that a class in his graduate business program examined decision-making from a number of ethical perspectives and suggested this might be a basis for developing non-quantitative reasons to either support or oppose Springer's recommendation. Sawyer explained that teleological and deontological are the most common categories of ethical theories used to analyze the ethics of conduct; he also mentioned libertarian theory. Davis asked Sawyer to prepare a brief description of the various ethical theories and models and to explain where maximizing shareholder wealth fits into the decision-making process.

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### Appendix 1 HEARTLAND PHARMACY

Income Statement (\$000)				Projected
For the Year Ended December 31	2012	2013	2014	2015
	\$	\$	\$	\$
Sales revenue	173,200,000	179,600,000	199,200,000	204,100,000
Cost of goods sold	132,324,800	136,675,600	152,587,200	157,136,590
Gross profits	40,875,200	42,924,400	46,612,800	46,963,410
Operating expenses				
Selling expense	23,728,400	24,784,800	27,290,400	27,859,650
General & administrative expenses	8,140,400	8,800,400	9,661,200	9,796,800
Depreciation expense	3,048,320	2,819,720	3,167,280	3,326,830
Total operating expense	34,917,120	36,404,920	40,118,880	40,983,280
Operating profits	5,958,080	6,519,480	6,493,920	5,980,130
Interest expense	850,163	669,904	850,577	806,187
Net profits before taxes	5,107,917	5,849,576	5,643,343	5,173,943
Taxes (rate = 30%)	1,532,375	1,754,873	1,693,003	1,552,183
Net profits after taxes	3,575,542	4,094,703	3,950,340	3,621,760
Dividends	1,787,771	2,047,352	1,975,170	1,810,880

**Appendix 2**  
**HEARTLAND PHARMACY**

Balance Sheet (\$000)				Projected
As of December 31	2012	2013	2014	2015
	\$	\$	\$	\$
<b>Assets</b>				
Current assets				
Cash	1,039,200	898,000	996,000	1,020,500
Accounts receivable	11,578,301	11,120,438	12,334,027	13,968,268
Inventory	16,336,395	16,348,756	18,517,864	19,162,999
Total current assets	28,953,896	28,367,194	31,847,891	34,151,767
Gross fixed assets	21,026,480	24,281,920	28,525,440	30,472,130
Less: Accumulated depreciation	4,583,000	7,402,720	10,570,000	13,896,830
Net fixed assets	16,443,480	16,879,200	17,955,440	16,575,300
Total assets	45,397,376	45,246,394	49,803,331	50,727,067
<b>Liabilities and Stockholders' Equity</b>				
Current liabilities				
Accounts payable	9,607,143	10,409,812	10,911,030	11,365,496
Notes payable	1,334,895	1,400,632	1,454,228	660,668
Accruals	990,338	804,628	830,552	415,828
Total current liabilities	11,932,376	12,615,072	13,195,809	12,441,992
Long-term debts	10,510,000	7,628,970	9,630,000	9,496,674
Total liabilities	22,442,376	20,244,042	22,825,809	21,938,666
Stockholders' equity				
Common stock (at par)	10,500,000	10,500,000	10,500,000	10,500,000
Retained earnings	12,455,000	14,502,352	16,477,522	18,288,402
Total stockholders' equity	22,955,000	25,002,352	26,977,522	28,788,402
Total liabilities & stockholders' equity	45,397,376	45,246,394	49,803,331	50,727,067