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Table of Contents

Editors and Reviewers ii

Notes To Authors iii

Letter From The Editor iv

Going for Growth at Gecko Press 1

ABC Communications, Inc. 25

Adult Day Care, Inc. 36

Rebuilt To Last: An Organizational Change Initiative 51

Setting a Course for Tissue Repair: Mesynthes 62

Hewlett Packard: Rethinking the Rethinking of HP 78

Editors and Reviewers

The Journal appreciates the time and commitment of all those who generously give their time in reviewing and editing manuscripts. The following are those who have assisted in this volume.

Reviewer names are forthcoming.

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Letter From The Editor

Letter is forthcoming.

Teaching Case

Journal of Applied Case Research

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Going for Growth at Gecko Press

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Going for Growth at Gecko Press*+

INTRODUCTION

The warm interior of the bookstore was a welcomed reprieve from the wild and windy winter weather bombarding the central city business and shopping area of Lambton Key. The Borders bookstore was a relatively new edition to the retail options in Wellington - New Zealand's capital city. As Julia Marshall, the founder and managing director of Gecko Press, surveyed the vast expanse of the multinational bookseller's publications and merchandise, she thought again about how easy it was for the products of a small local children's book publisher to get lost in it all. Even though New Zealand's market was small, it was dominated by imports with a wide array of differentiation and pricing. However, global book distributors such as Borders also represented an exciting opportunity to significantly expand the reach of Gecko Press, a children's book publishing company she founded three years ago.

During Gecko Press' three years of operation Marshall created a distinctive high-quality brand with clearly defined and communicated values. Gecko Press' sales and number of new publications had increased each year, and each product reaffirmed Marshall's focus on 'curiously good books' for children based on translated versions of outstanding non-English children's titles.

The issue now was how to achieve transformational business growth in a slow growth industry. As she walked past Border's large table of 'half-price' books she reflected: "*What was the best way to leverage the niche, values and brand we've created to turn Gecko Press into a high- growth business?*"

THE GLOBAL BOOK PUBLISHING INDUSTRY

The invention of the printing press by German goldsmith Johann Gutenberg in 1439 at the dawn of the Renaissance was a breakthrough technology that arguably had a greater impact than the Internet in terms of social, political and economic change. Today, book publishing is a slow growth industry within the ever widening and increasingly fragmented media industry. In a saturated market full

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* This case was prepared as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

+ Acknowledgements: We would like to thank the editor and reviewers for their excellent guidance and encouragement, as well as the generous support of the Creative HQ business incubator. All views and errors are ours.

of media options, book publishers have increasingly had to seek innovative approaches to create operating leverage. Such options have traditionally included movies, television adaptations, and merchandising. The Internet and digital technology has also added a wide array of options to leverage content through offerings such as gaming, on-line communities, and electronic books (Appendix A). Examples in the children's segment include the powerhouse brands of *Harry Potter* (www.harrypotter.warnerbros.com) and *Narnia* (www.narniafans.com).

As a result, the traditional book publishing value chain (Figure 1) is being reconfigured by social and technological changes. As the head of picture books at HarperCollins stated: "The cream of traditional picture books will survive, but the rest of what we do has to offer something extra."[1]

Orgination	Publishing	Manufacture	Distribution	Retail
Origination of content	Commission and acquisition of content	Printing and reproduction	Warehousing, stock control, and delivery to point of sale	Purchasing
	Coordination of design, production and promotion			Stock management
	Control of rights			Point of sale display and marketing

Figure 1: Print Publishing Value Chain

The global publishing industry was valued in 2007 at US$ 444.1 billion, with an average growth rate of 2.4 percent for the last five years (Figure 2). Book publishing, as a segment alongside advertising, newspapers and magazines, made up 28.1 percent of this global publishing industry[2] (Figure 3).

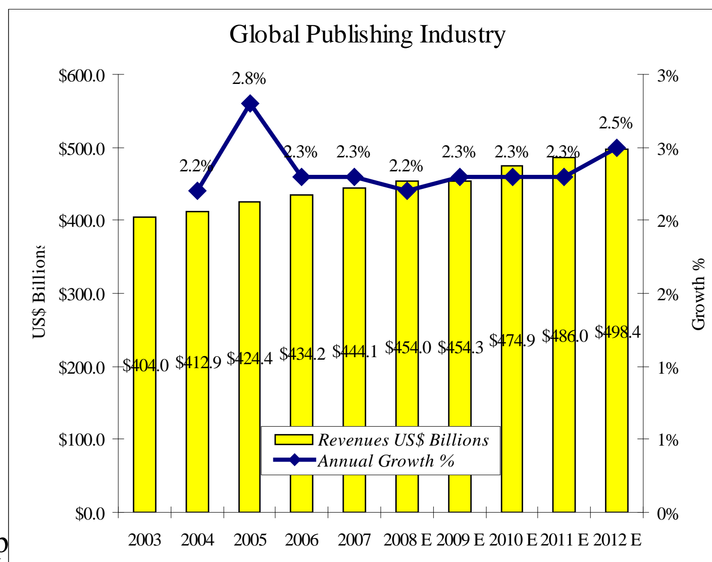

Figure 2: Global Publishing Industry: Global Market Value and Growth Forecast (Adapted from Datamonitor, 2007). [3]

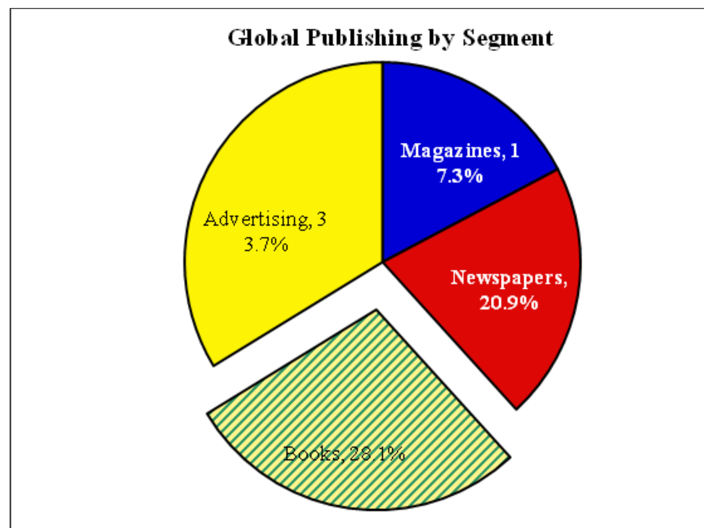

Figure 3: Market Segmentation: % Share, by Value, 2007 (Adapted from Datamonitor, 2007). [3]

The global book publishing industry is valued at US$ 87.4 billion.[3] China is now the largest publishing market by volume, selling about 6 billion units a year. By value the biggest markets are the US, Germany, and Japan, followed by the UK and China. The largest three publishers of new titles and editions are the UK, US and China, with around 200,000 new titles each.[3]

Within the industry there are two primary market segments: adult and juvenile (Figures 4). Compound annual growth rates are similar, with children's books experiencing a slightly higher growth rate of 4.4 percent compared to 3.4 percent for the total market. In unit terms the market it declining, with a compound average growth rate of -0.02 percent for juvenile books and -0.7 percent for adult books. Further, 7 out of every 10 newly launched books fail to reach profitability. In sum, while global book publishing revenues are experiencing low growth, unit sales are declining.[4]

The combination of digital media, increasing power of retail distributors, and writer demands have exerted significant pressure on profit margins.[4,5] Moreover, market power for children's book publishers is limited because the industry is fragmented with the largest 10 publishers holding about 25 percent of all juvenile titles published during the past five years. These top industry players include: Scholastic Inc and Scholastic Library, Penguin Group USA, Simon & Schuster, Heinermann Library, Random House, Gareth Stevens Inc., HarperCollins, Rosen Group and Capstone Press.[6] As an illustration Scholastic Corporation has a market capitalization of US$ 1.9 billion and revenues of US$ 410.1 million.

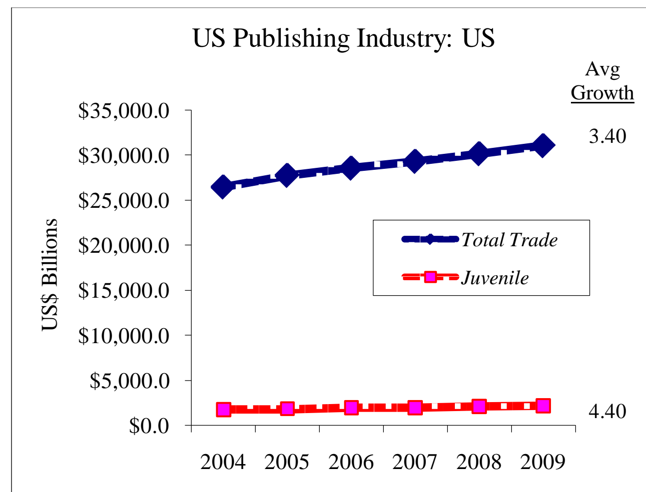

Figure 4: US Publishing Industry – Net Revenue, 2005 estimates (Adapted from: Book Industry Study Group, 2005)[5]

Notwithstanding, the *Harry Potter* phenomenon shows the global potential for a great children's book and illustrates emerging sources of leverage. For example, Harry Potter's sixth book, the *Half-Blood Prince* generated US$ 67 million in 2005.[7] The 'Harry Potter phenomenon' illustrates a broader trend for publishers in the children's sector to be especially innovative in how they reach readers raised in a digital world, using many more direct and indirect streams than do their adult counterparts.[8]

Impact of changes in technology

As noted above, breakthrough digital technologies have significantly disrupted the traditional book publishing value chain (Figure 2) in terms of both vertical and horizontal integration. Historically, companies have tended to focus on one step in the value chain such as publication or retail. However, cost pressures, mixed media offerings, and evolving distribution platforms have lead to vertical

integration between publishers, distributors and retailers. Further, these same pressures have significantly expanded horizontal integration as book publishing became a smaller sub-segment within the larger media content delivery industry, particularly as digital content became dominant in consumer usage trends (Figure 5). As an industry analyst commented: "Convergence within the mass communications industry and the search for content, production operations, distribution channels, and delivery systems changed the media landscape in this nation [U.S.] in the 1990s."[9]

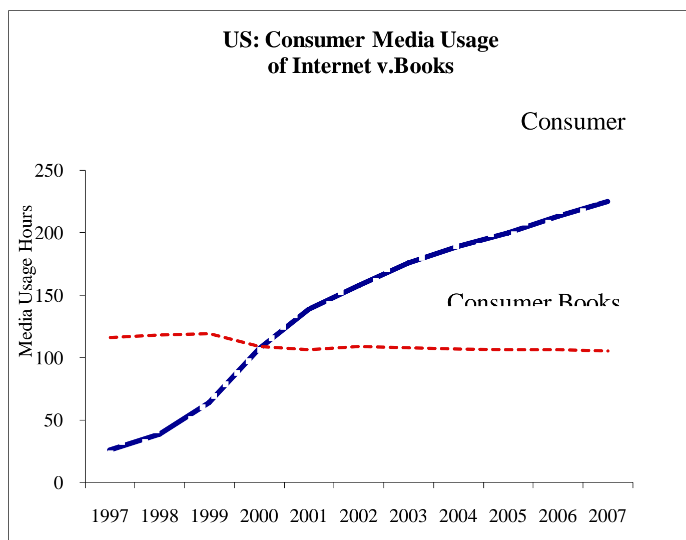

Figure 5: Media Usage Hours (US)[5]

Competitive industry dynamics and integration trends are driven by competition for content and the commercial desirability of leveraging content into different product offerings and multiple distribution channels. The strategic aim for media businesses is to build brands and durable relationships with customers. Once established, such a customer base allows for the progressive development of new services and products and consequently the ability to increase average revenue per user.[10] As an example, the Harry Potter franchise of seven books will become eight movies, numerous video games, a theme park, and musical, as well as a wide range of merchandise from clothing to knitting books to collectables. This has driven the Harry Potter total brand value to an estimated US$15 billion and amassed a US$1 billion fortune for its author.[11,12]

Another attempt to leverage digital technology with publishing has been the E-Book category. Despite high expectations, E-books have not been the 'killer application' that was imagined at the turn of the century, with sharply declining

growth and small sale figures. For instance, in 2007 E-books had net unit sales of 56,396 while audio books, the second smallest category, had net unit sales of 182,162 (Figure 6). Factors such as poor readability, format incompatibility problems, and high price points, as well as cultural values and norms have proven to be largely insurmountable to date.[13]

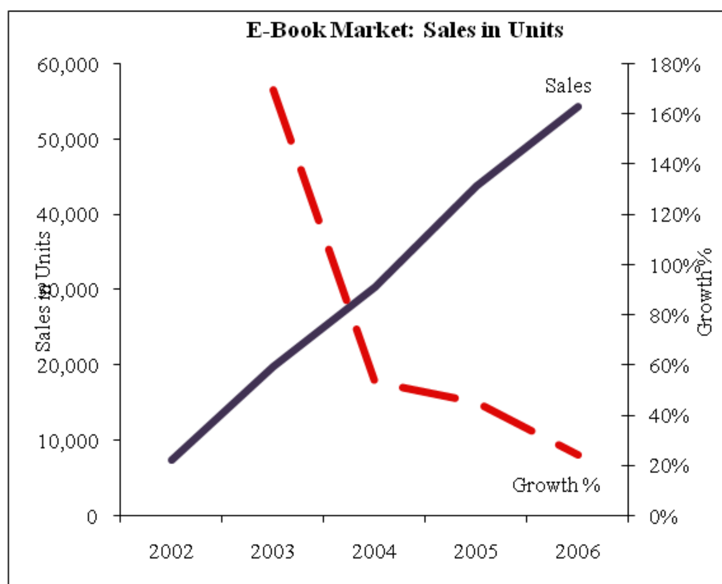

Figure 6 - E-Books[14]

These shifts and pressures in the book publishing industry structure have resulted in consolidation through increased merger and acquisition activity (Figure 7). An illustrative example of how these forces are influencing strategy was the merger between AOL, the leading Internet provider in the US at the time, and Time Warner, a major multinational media company with interests in TV and cable networks, magazines, book publishing, music, and movies. Approved in 2000, this merger combined the digital distribution strength of AOL with the broad content of Time Warner.[10]

Figure 7: Number of mergers and acquisitions in the US book publishing industry (1981-2001)[9]

In addition to agglomeration among industry leaders, digital technology (e.g., print-on-demand) has also reduced the barriers to entry at the other end of the market through enabling the growth of self-publishing and micro publishers such as Xenos Books, Chocolate Tree Books, and Gecko Press. As a result, larger book publishers and distributors are getting further squeezed in the competition for content by nimble smaller publishers who can create smaller, profitable niche brands.

Despite these trends, however, language remains an important segmentation in the publishing industry. While it is comparatively easy to produce and distribute many consumer and business-to-business products on a global basis, this does not hold true in the publishing industry: people can only understand products in their own languages. Language is particularly important in the fiction and children's book markets. While people are willing to read a 'universal language' for their job or education, they principally demand entertainment in their native language.[2] Consequently, book publishing has remained demarcated along language lines in a way many other sectors have not. And as Julia Marshall at Gecko Press has found out, the divide between English speaking children and non-English books was a viable niche waiting to be exploited.

THE NEW ZEALAND BOOK PUBLISHING INDUSTRY

New Zealand is said to be a nation of storytellers and readers. Descriptions of New Zealand's diverse and lively book publishing industry nostalgically evoke Katherine Mansfield's immortalization of New Zealand in the 1920s and global success in children's literacy.[15,16] The book segment makes up 12 percent of the wider New Zealand publishing industry (Figure 8). Imported books comprise 73 percent of the market or NZ$148.5 million; and books published in New Zealand are 37 percent of the market or NZ$87 million.[17]

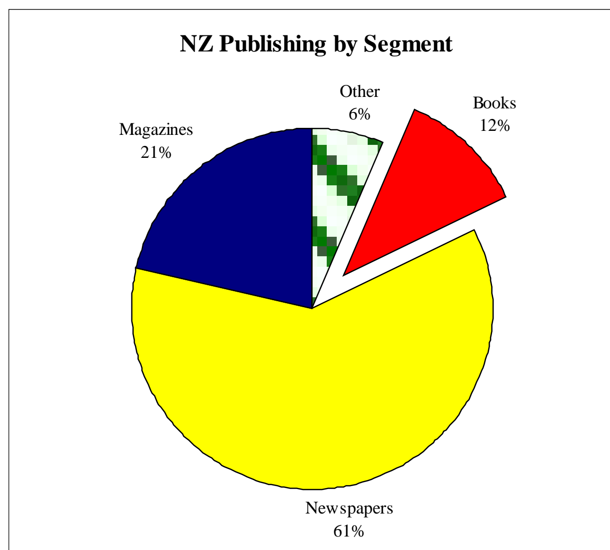

Figure 8 - NZ Publishing Industry, 2002 [17-18]

Total turnover by book publishers operating in New Zealand was estimated at NZ$264 million, with 57 percent of sales being exported.[16,17] Within the book market segment, children's fiction makes up 6 percent of the New Zealand industry total, and 5 percent of total exports (Figure 9).

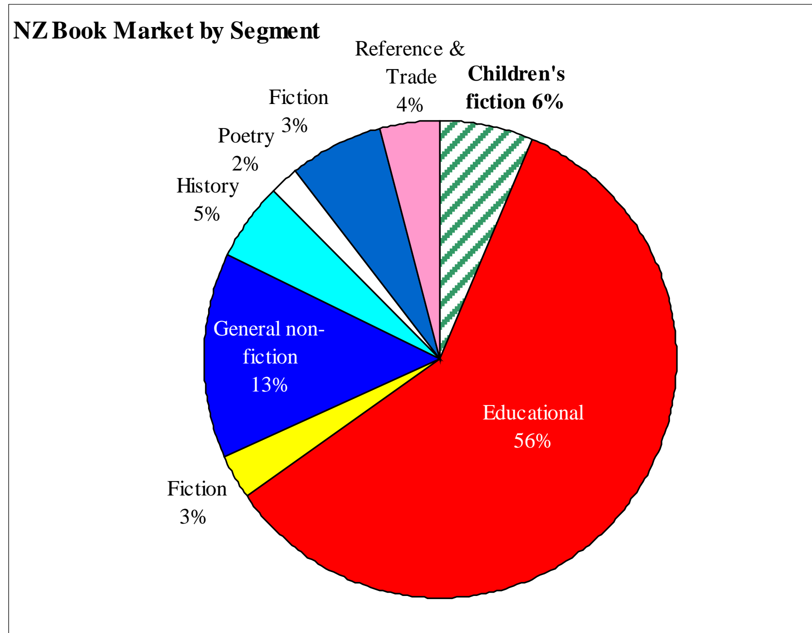

Figure 9: NZ Book Publishing Industry, 2002[17]

With relatively low barriers to entry, the New Zealand book publishing industry mirrors the global market in being highly fragmented with many small players, 34 percent of whom are less than five years old. In 2002, 64 percent of publishers had 0-1 employees, 29 percent had between 2-10 employees, and only 7 percent had more than 10 employees. Further, only 5 percent of New Zealand publishers reached turnover exceeding NZ$1 million, with 74 percent not reaching NZ$100,000 (Table 1).[17-18] In relative terms, small publishers in the US market are defined as firms with less than US$50 million in sales.[19] The small scale of the New Zealand industry has resulted in less market power in negotiating global distribution agreements.[18]

	Number of Publishers	% of Publishers	% of Turnover
Under $100,000	300	74%	2%
$100,000-$999,999	52	13%	10%
$1 million or more	22	5%	88%
Unknown	34	8%	--
Total	408	100%	100%

Table 1: NZ Book Publishers – Revenues[17]

Exporting figures are important for New Zealand as one analyst concluded: "Research shows that New Zealand is a great nation of readers but our small population base means that developing new international markets is vital if this country's writers are to enjoy sustainable careers as full-time writers."[15] Australia and the United States, followed by the Pacific Islands, were the most important export regions for New Zealand publishers.[18]

Strong local and global price competition in publishing, as well as disruptive technological changes cited above, has led to high competitive intensity in the New Zealand book industry. The result of low growth and fragmenting market power has been increasing margin pressure with industry operating margins at approximately 12 percent (Figure 10).[16,18]

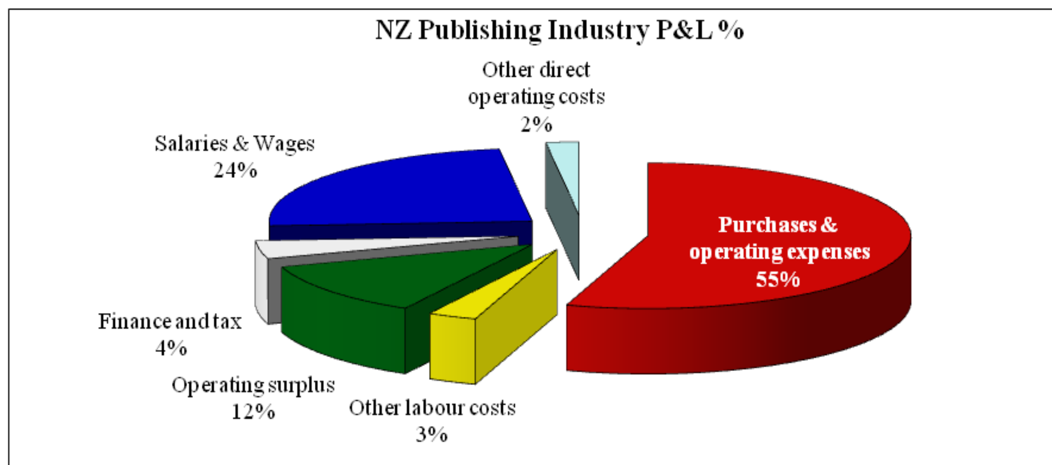

Figure 10: Cost breakdown of book publishing industry[17]

GECKO PRESS

Children in New Zealand have access to hundreds of good books, both those written and published in New Zealand, as well as many imports from the United Kingdom and United States. The key realization made by Gecko Press founder Julia Marshall was that books from another potentially important source – Europe – were unavailable in English.[20] Consequently, Marshall "…buys the rights to books that have been published in other languages, publishes them in New Zealand and Australia and then sells those rights back to the other English-speaking markets."[21] While a common reaction to this premise is "why didn't I think of that," Marshall's background was instrumental to enabling her to see the potential niche and act on it.

A native of the small rural New Zealand township of Marton, Marshall studied at the University of Otago and worked for NZ Geographic before living in Sweden for twelve years where she worked as an editor and translator for a publisher of multi-language magazines. There she learned to work with material in many different languages, with some magazines being published in up to 22 different languages. Marshall stated that this experience "taught me the skills you need to get a great translation, rather than an average one."[22] While there her connection to children's books grew, Marshall elaborated that she had "always loved children's books, but to help me learn Swedish I read quite a lot more." As she improved her language skills through reading the likes of Margaret Mahy (a famous New Zealand children's author) in Swedish she realized that while Mahy and other internationally acclaimed English children's writers were being translated into many languages it was uncommon for European children's books (even bestsellers and award winners) to be translated into English. In Marshall's words: "The Margaret Mahy's of Spain and Holland and France and Germany are being translated into lots of languages - but not English. I thought this was very odd."[21-23] Figures confirm this observation. In the UK, three percent of books published come from outside the country compared to nearly 40 percent in non-English speaking Europe.[23]

Figure 11: Founder Julia Marshall with Customers

Marshall delights in retelling the reaction of the Swedish publisher of Margret Mahy to her idea. “She said to me: ‘you’re either an idiot or it’s a brilliant niche.’ I was convinced it was the latter. However, while I knew I wanted to start Gecko Press I didn’t know where to start.” [20,24] Namely, Marshall had no direct experience in book publishing or distribution. She therefore returned to New Zealand to gain her ‘apprenticeship’ in book publishing by working for Bridget Williams Books for two years. [20-22]

Marshall’s training continued when she headed back to Europe to work and visited major international books fairs in Bologna and Frankfurt. While at first lost amongst the “acres and acres of books” she soon discovered that “…it was quite normal for publishers to start buying rights to other people's books. I went back the next year and made appointments with ones I liked the look of.” The process of getting permission for the English rights was surprisingly easy as the publishers had “been trying to crack the international market.” Marshall also learnt that people “started publishing companies by buying the rights to a few books and then off they go.”[20- 21]

Consequently, Marshall returned home and Gecko Press was registered in June 2004 before becoming one of the start-up ventures housed in Wellington’s Creative HQ business incubator in July 2005. In starting Gecko, Marshall put $100,000 of her own money into the company, supplemented with a small amount from family.[21, 25] Marshall’s first book was the Austrian tale *Donkey’s*, written by Adelheid Dahimene and illustrated by Heide Stollinger. During 2002-2003 the book had won, in its original Austrian guise, the important White Raven award at the Bologna International Children’s Book Fair, the Most Beautiful Book Award of Austria and honors in the Austrian Children’s Book Prize. Gecko’s first print

run (2,000 copies) of its English translation was repeated within six months and it is now in its third reprint.[20-21,25]

Gecko's catalogue is small but growing. Four books were published in 2005, five in 2006, while twelve are planned for 2008 (see Table 2). With increasing sales and operating leverage, Gecko Press reached breakeven in 2007, with net profit reaching 4 percent of sales. This growth has meant that her one-woman band has recently increased, with Marshall employing a part-time administrator and a freelance publicity person in Auckland. However, Marshall remains the 'lynch-pin' to the process. For every book she instructs a translator to do a straight translation (or if it is Swedish she does it herself). She and another writer then work with the material until it "feels right for its audience while still keeping the spirit of the original." [24]

	2005/6	**2006/7**	**2007/8**	**2008/9**	**2009/10**
No. of books	4	5	9	12	15
Average print run	1800	2500	3000	4000	5000
Total sales ($K)	48	106	268	511	894
Net P&L ($K)	-43	-25	10	39	170
Net Profit (% of sales)	-90%	-23%	4%	8%	20%

Table 2 - Gecko Press: Financial Performance & Projections

Gecko Press now distributes to Australia and has the rights to sub-license some titles in the US, Canada, and United Kingdom. She has expanded the scope of Gecko's operations such that when she goes to book fairs she is buying rights for English translations from places as far as Taiwan. Gecko Press remains one of only a handful of publishers arbitraging language rights in this way. Marshall has also sold the US rights for one of the books she published, *Snake and Lizard,* by New Zealand authors Joy Cowley and Gavin Bishop. This original title won the prestigious "NZ Post Children's Book of the Year" in May 2008. This has moved Marshall towards her goal of taking New Zealand stories "back in the other direction." [20, 24, 28]

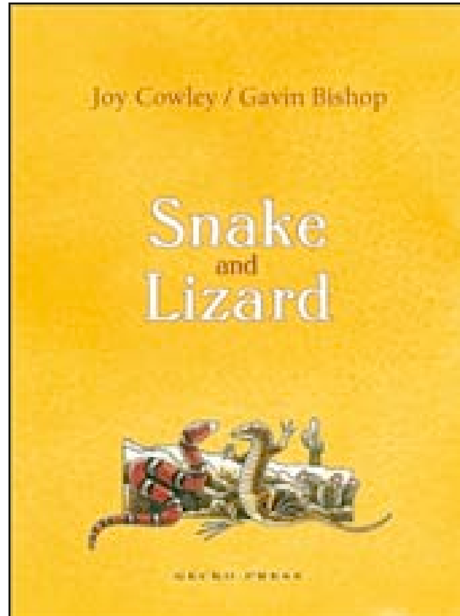

Figure 12 Snake and Lizard by Joy Cowley and Gavin Bishop. Published by Gecko Press.

Gecko Press: Values, Culture and Strategy

> *"Once upon a time, there was a gigantic machine that churned out books for children. Parents everywhere bought the books, and the more they bought, the more the machine churned out. Books started coming out of the machine so fast that some turned out badly. Nevertheless, lots of people kept spending lots of money on even the bad ones."*[26]

If the above fairytale parody was indeed true, then Marshall and Gecko Press could easily be cast as the Fairy godmother. As two commentators stated regarding Gecko: "There hasn't been a dud amongst them" and of a particular Gecko publication "It's beautifully designed and it's beautifully packaged, it has a beautiful harmony of text and illustration."[27] This reflects Marshall's approach, established from the start, of asking overseas publishers for their best. As Marshall explained, "they have to be among the best books in the world. Both because they've got to travel and they've got to be relevant…My criterion is that the author or illustrator should have an established body of work and preferably the book will have won an international award." [22,24] A recognition of the success of this strategy was Gecko Press being named an equal winner (alongside industry

giant Random House) of the Thorpe-Bowker Award for New Zealand Publishing in July 2008. [28]

Their focus on quality is exemplified by how Gecko describes itself: “Gecko Press specializes in English versions of curiously good books from around the world. We choose books by the world’s best authors, which have won awards and have a strong 'heart factor.'”[28] As Marshall elaborated: “Gecko books are all very warm books, I choose the books that for me show the oddness of humanity and don’t take themselves too seriously…It needs to have a unique spirit – a heart and a warmth. I like the book to cause something to have happened emotionally in the reader’s mind by the time they have finished - that they are moved or made to laugh or taken by surprise in some way.”[22,24] Such an approach is summarized in the “value-mix” Marshall identified as distinctively ‘Gecko’: “Integrity + excellence + relationships + bravery = magic.”

Such values are encapsulated in Gecko’s first publication *Donkey’s* – a book that has remained close to Marshall’s heart. It is the story of an old donkey couple who decide after a lifetime of being together that they can no longer live together. They go looking for new partners and in doing so find each other again. As Marshall stated: “They discover that it’s hard to find another donkey out there…The book has been a hit for anniversary and wedding gifts: getting “right to the heart of things without all that extraneous hoo-har.”[21, 24] Marshall’s focus on ‘curiously good books’ is connected to her higher aims “for children not only to learn to read but to learn to love to read” and her belief that “it makes the world a wider and richer place, being able to read the best writers from other countries. Imagine no Anne Frank’s Diary.”[22]

This approach has enabled Marshall to build her brand credibility to the point where she can secure world rights.[21] Marshall outlined that in under “18 months people…[came]… to think that if it is a Gecko book, it must be a good book, and I think that’s a pretty good reputation to have earned in a relatively short time.”[25] The ‘brand name’ itself is pure ‘Marshall’ as she explained, “I went through the vegetable kingdom but nothing seemed to work. Suddenly the idea of Gecko seemed just right. Geckos are little, they’re curious and they’re quick…They’re cute but they’re not too cute and they’re strongly New Zealand and I love the way they’ve got suction feet.” [14,22] The Gecko image does indeed fit. Gecko Press itself is tucked away in a ‘cubby-hole’ within Creative HQ in Wellington. Books spill out of numerous boxes – seemingly wanting to spread out the door. Inside

Marshall with her combination of number eight wire farmer practicality[*] and "artsy dottiness" works amongst her books.[24]

Gecko has tended to publish both hardcopies and paperback at the same time – seemingly able to capitalize on small print runs to give people what they want.[27] Currently, Gecko distributes directly to the New Zealand (via Random House) and Australian (via Tower House) markets. In the longer term, Marshall would like to distribute directly into the UK. In pursuing such growth opportunities, cash flow remains Marshall's biggest hurdle as it is an industry with large inventory carrying costs for publishers.[21]

To supplement the core business, Gecko's focus on overseas books does not mean that "…we can't do really good New Zealand books. The idea is to get the books moving in both directions."[21] There are also opportunities to sell audio rights and enter into other media, as well as to create school packages linked to curriculum to distribute via education channels in Australia and New Zealand.

The high fixed costs of translation, risk of introducing new authors to unknown English-speaking audiences, and substantial inventory carrying costs means Gecko needs to find sources of operating leverage to increase growth and sustainability. Marshall admits that when she started: "Everyone said to me…'you will meet a lot of nice people but you won't make any money.'"[21]

Creative HQ Business Incubator: Aims and Values

Business incubator Creative HQ is a "deliberate development initiative to counteract the high rate of failure that is so common among young businesses." As an incubator, Creative HQ (www.creativehq.co.nz) supports up to 20 creative enterprises who "demonstrate the potential for high growth and development." These enterprises are housed in an interactive two floors space in inner city Wellington and are generally expected to 'graduate' after two years and enter the local business community. Conceived and supported by the regional economic development authority known as Grow Wellington, Creative HQ's aim is "to be the best generator of high growth new businesses in New Zealand." They support member firms by providing business advice, infrastructure, networking, mentoring, and investment/government funding assistance, as well as marketing and promotion.

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[*] Number eight wire is very popular for use as a fencing wire around New Zealand's many farms. It is an emblem of ingenuity and self-sufficiency which is imbedded in the New Zealand idea that anything can be fixed and created with perseverance and creativity.

The incubator is described as "not for the faint hearted" and is about "accelerating growth, building a solid foundation for businesses that are capable of scaling to be globally competitive organizations, and getting improved early results out of early stage business through active challenge and intervention in a caring, work hard/play hard culture." It was, as one of the Creative HQ advisors board members outlined, up to Marshall to now show that her company was congruent with the aims and environment of the incubator it was housed in. Namely, her next move needed to be focused on achieving high growth.[29]

STRATEGIC OPTIONS FOR GROWTH

Discussions with Creative HQ's board led Marshall to formally review Gecko's operating environment and develop strategic options. She met with her advisory board to review her planning options for growth.

"Our ***first option*** is expansion of our current business model – do what we're already doing, but on a larger scale across more geographies. The first aspect of this strategy would be to publish more titles. The second would be to increase the sales of each of those titles by selling it in more places through more channels. We already have a small presence in the Australian market; however we have not yet made inroads into the largest English-speaking markets such as the UK, US or India. In the longer term, we could move beyond sub-licensing to direct distribution." Additionally, she added: "Aiming to publish Kiwi books from scratch and selling the rights into these territories as I have already done with *Snake and Lizard* could only add to this strategy."

One board member offered: "This option provides good fit and focus—it would be about staying with what you know and are good at, but with more titles in more places. The obvious constraint is capital as such an approach would demand a huge sales staff and inventory carrying costs, but increasing sales would also increase operating leverage."

Marshall continued, "Our ***second option*** would be to get greater mileage out of individual products via e-books. The benefits of such a strategy would be that it would not incur dramatic incremental costs to transfer existing digital content into e-book format. It would also be a way of decreasing the impact of physical distance. Teaming up with Amazon and using their Kindle reading device[†] is

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[†] Launched late 2007, Amazon Kindle is an e-book reader, an embedded system for reading electronic books (e-books). It uses an electronic paper display and downloads content over Amazon Whispernet. It can be used without a computer and Whispernet is accessible without any fee. The first offering sold out in five and a half hours and retailed for $399 and is currently only

another way we could get the most out of an e-book strategy. Further, due to lower distribution costs, we could afford to sell these products at a reduced rate to schools. Another benefit would be using the format to drive readers to hard copies. E-books are a potentially interesting option as they have not yet been exploited to their full potential by the industry to date."

"A ***third option*** revolves around selling the Gecko brand concept rather than our individual books as 'the product.' Namely, we've created a brand that parents recognize as 'safe' and values driven. There is, therefore, the potential to use our brand to form an online community which builds on these themes to leverage aspects increasingly associated with children book publishing such as advertising, social networks, gaming, merchandising and film to name a few. In short, several publishing analysts concluded that a successful 21st century book has to be more than a book to achieve profitable growth. A key aspect of this would be the ability to choose books that can build character platforms."

Handing out some examples, Marshall stated: "There are in fact some hugely successful business models that I can present to you to illustrate such an approach further. These are *PBS Kids* (www.pbskids.org), *Webkinz* (www.webkinz.com), and *Club Penguin* (www.clubpenguin.com)" (Appendix B).

"The first example is PBS Kids – the website of PBS, the private non-profit US media organization. It drew 3.29 million unique visitors in July 2006 alone. Their site augments their television shows via associated music, games, coloring, pictures, information and parent/teacher learning resources. PBS receives most of its funding from viewer contributions, corporate sponsorship, foundational grants and cable fees. However, a revenue stream is created through selling a small amount of online advertisement space. A recent addition to the PBS online community is PBS Kids Play (www.pbskidsplay.org). The revenue stream for this facility is slightly different as it charges a subscription for online gaming services."

"A second example is Webkinz which was founded in 2005 by a Canadian family business. In 2007, it was rated by Goggle as the second-hottest search term and has reached 3.8 million registered users. The basic premise of Webkinz is that you buy a Webkinz pet, and using the associated merchandising number you then enter your pet into the Webkinz world which interacts with other registered users

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available in the United States due to Whispernet only working there. The Kindle store started with 88,000 digital titles and this number has steadily increased. Competing devices to Kindle include Sony Blue Digital Book Reader and ECTACO jetBook e-book reader.

online. The emphasis is on creating a family of toys whom you look after online while you play games."

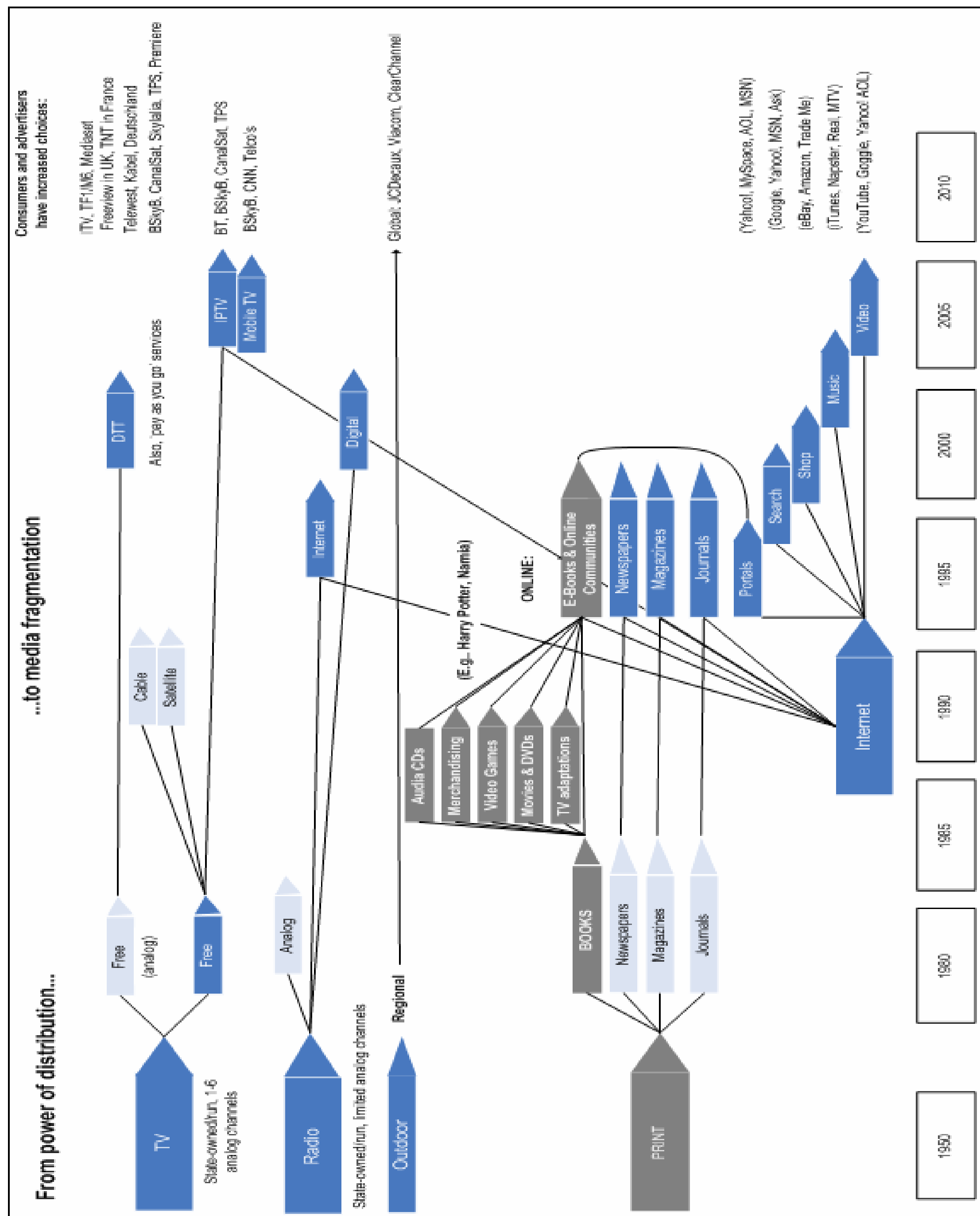
"The third example is Club Penguin which Disney acquired for US$350 million in 2007. The Canadian founders are set to get another US$350 million if performance targets are reached through 2009. It is a safe virtual world for kids to play and interact with friends as their 'penguin' character. They also earn virtual money to clothe and accessorize their penguin or igloo. While anyone can join Club Penguin for free (currently around 12 million people have) a monthly subscription provides access to the best features. Further, Club Penguin related merchandise is also sold online."

Marshall concluded with, "A ***fourth option*** is educational software. Namely, we could utilize our stories to create associated learning software for parents, teachers, kindergartens, home schoolers, and schools. In pursuing this we could potentially leverage the ability to translate non-English materials as well as our respected brand name as competitive advantage. Such a strategy would be strengthened by my current idea of publishing curriculum related titles. This would potentially be an opportunity to bring New Zealand children something new via translation, as we have done with books. Further, our current titles can be used as a foundation for the software."

Marshall handed out a document with initial insights into the educational software industry. With the number of titles running into the thousand, Marshall's overview contained a sample of some key examples. These included those aimed at home education (such as Disney Interactive learning titles based on their famous characters, G Compris, Knowledge Adventure's Math Blaster series and the Learning Company's Reader Rabbit and Zoombinis) and those aimed at the classroom and tied in with national curriculums (for example in New Zealand Software Educational Resources Limited and Success Maker New Zealand).

After a lively afternoon debate with the advisory board, Marshall left for a walk down the busy Cuba Street shopping area which was quickly filling up with after school children huddling around a bookshop window to check out the latest offerings. Her head was already buzzing with the merits and challenges associated with each option and she wondered: "*Had she identified all of the options? What strategy or mix of strategies was right to ignite Gecko into a sustainable, high growth business without compromising my values?"*

Appendix A: Media Industry Roadmap (adapted from: The Goldman Sachs Group, 2007)[30]



Appendix B: Online Communities for Children

Source: www.webkinz.com; www.clubpenguin.com.

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Teaching Case

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ABC COMMUNICATIONS, INC.

Vaughn Jeffs, Vice President of Marketing for ABC Communications, Inc. (ABC) was faced with several concerns as he began preparing plans for the new year. ABC was ending a tremendous year in terms of new distributors, new customers, and revenues, (see Exhibit 1) and Vaughn felt it was extremely important to continue this momentum to insure continued growth. His main concern was how to keep the momentum going in recruiting independent distributors, who were the company's "sales force" while avoiding what seemed to be the inevitable fallout of distributors over time.

BACKGROUND

The predecessor corporations of ABC Communications, Inc. had been in business since late 1982. This isn't a very long history, but in the long distance telephone industry it's about as old as a company can be. This is because it was in the year 1982 that the government "broke up" AT&T creating the opportunity for competing long distance companies to begin operations. ABC Communications, Inc. started business as a regional company acquiring and servicing customers in the Phoenix, Arizona area.

Exhibit 1
ABC Communications Financial and Marketing Performance

	4 yrs ago	3 yrs ago	2 yrs ago	1 yr ago	Past year
Sales	2,000,000	2,750,000	5,125,000	8,265,000	13,426,000
Less pmts to Carriers	1,200,000	1,650,000	3,075,000	4,959,000	8,056,000
Net sales	800,000	1,100,000	2,050,000	3,306,000	5,370,000
Less commissions	500,000	688,000	1,281,000	2,066,000	3,357,000
Contribution	300,000	413,000	769,000	1,240,000	2,014,000
Administration	50,000	60,000	75,000	110,000	160,000
Marketing	100,000	120,000	170,000	235,000	450,000
Net before Interest and Taxes	150,000	233,000	524,000	895,000	1,404,000
Number of customers	500,000	688,000	1,281,000	2,066,000	3,357,000
Number of distributors	100,000	98,000	142,000	172,000	224,000

Five years ago, senior managers decided to operate on a national basis using a multilevel marketing (MLM) or network marketing system of acquiring customers similar to the methods used by Amway, Mary Kay, and Avon. This marketing approach has attracted nationally known leaders in the network marketing industry generating thousands of independent distributors and tens of thousands of customers. The sales organization and customer base expanded rapidly and now represents a powerful force in the long distance telephone industry. Exhibit 1 cites performance data for ABC over the past five-year period.

THE APPEAL OF MLM

The attractiveness of network marketing can be illustrated in the following example. Assume you recruited 3 distributors who, in turn, recruited 3 distributors and this pattern was continued down through all 7 levels of your organization. Also assume each of the distributors had 10 customers. The number of distributors would look like this:

Level	Number of Distributors
1	3
2	9
3	27
4	81
5	243
6	729
7	2187

This would mean you would have 3279 distributors in your downline and if each had 10 customers you would be collecting overrides on the LDU of 32,790 customers. The monthly earnings potential would be significant. Using the national average LDU of $25 a month and 8.5% overrides on 7 levels, your monthly earnings would be about $70 thousand per month.

Of course, the fallacy of this example is that not all distributors will recruit 3 more distributors and distributors may not sign up any customers. Also with the heavy fall out of distributors, you may have to recruit 10 distributors to find one who aggressively signs up distributors and customers. In addition, many customers will change services whenever a more attractive offer is presented.

The first MLM or network marketing system was developed in 1941 by Carl Rehnborg, a chemist, who used the system to market his nutritional product. Multi-level marketing is a type of direct selling which is defined as “face-to-face selling away from a fixed retail location” (Peterson and Wortruba, 1996, p. 2). MLM is the type of compensation structure some direct selling organizations employ. In this type of

compensation structure, salespeople (known as distributors) earn income from product they purchase for themselves, sales to other customers, and a portion of the commissions generated by salespeople they have recruited into the organization. These recruited salespeople are known as the distributor's "network" and covers a certain number of "levels" as specified by the company.

This marketing system has been used by many companies spanning a wide variety of industries. For example, household products (Amway), cosmetics (Mary Kay and Avon), long distance (Excel), prepaid legal services (Pre-Paid Legal Services, Inc.), and weight loss and nutritional products (Herbalife) just to name a few. For the system to work, an individual, usually called an independent distributor, must sign up customers and other distributors who in turn sign up other customers and distributors. Thus a "network" is built by a distributor that covers a certain number of "levels" as specified by the company. A distributor receives commissions or overrides on the products purchased by customers and distributors in these levels or "downline."

These independent distributors are not employees of the company but are in business for themselves and most do this part-time. They receive no fringe benefits directly from the company and the company does not withhold any taxes from their commissions. Each independent distributor is responsible for paying their business expenses and any taxes that may be due on their income.

CRITICISMS OF MULTI-LEVEL MARKETING

Over the years, many criticisms have been cited against multi-level marketing. Some of the standard criticisms are given below.

1. The marketing approach imposes on or takes advantage of family and friends. This criticism is frequently heard because many people involved in multi-level marketing programs approach family and friends as their first source of potential distributors or customers. Sometimes questionable approaches are used such as "I really need to meet with you about an important matter." without revealing what the meeting is really about. This alienates both family and friends because they may later feel deceived about the purpose of the meeting.

2. Some programs require distributors to purchase a substantial amount of products or services to get the "big" discounts or overrides. If the individual is unsuccessful in the program, the products may never be sold and he or she will be stuck with the inventory, or a whole range of services may wind up being paid for on a monthly basis. While some of these products and services may be desired and consumed by the distributor and family members, others may not. Such products could end up in the attic or a rummage sale.

3. Some multi-level programs require a rather large fee to become a distributor and may also require an annual renewal fee to remain a distributor.

4. The excitement or persuasion skills of some recruiters may cause some individuals to be so overwhelmed by the presentation that they postpone or sacrifice other needed expenditures to "get in on the ground level" of the program.

5. In the minds of many, MLM has a negative image.

ABC'S BUSINESS MODEL

It is important to understand that ABC is not an affiliate, nor an agent, nor a marketing arm of the major national carriers who provide the actual long distance transmission services for ABC customers. ABC distributors do not represent the national carriers -- they represent ABC. The customers are customers of ABC, not of national carriers. ABC is a customer of the national carriers and pays the national carriers for the long distance services to ABC customers.

The best way to understand the ABC-national carrier relationship is to understand it in terms of the functions performed by each. ABC acquires customers, provides services, and bills and collects from its customers for long distance services. The major national carriers provide the actual long distance carriage, routing the call to its destination. The carriers also provide ABC with the details of each call including the phone number from which the call originated, destination of the call, time of day the call was placed, and duration of the call. This information is given to ABC on a "billing tape" that ABC simply enters into its computers. Computer software then translates the call detail information into ABC rates, producing a detailed bill that ABC sends to the customer.

The entire thrust of ABC's business model is to acquire independent distributors who then acquire customers and other distributors who buy and use the products of ABC. These products include long distance service for both customers and distributors and a Data Processing Service and Training Package (DPS-Training) that is an optional purchase made by those ABC distributors who are seriously interested in building a business. The use of products by distributors in a network marketing organization is sometimes referred to as internal consumption and may be a significant source of income for an organization having a large number of distributors.

ABC's strategy for attracting customers is to offer lower base long distance rates than competitors and give customers a prompt payment discount of 10-17½ percent if the customer pays within 15 days of the billing date. The prompt payment discount depends on the size of the customer's bill. If the long distance usage (LDU) is $25 or less, a 10%

discount is given, $25.01 to $99.99 bills earn a 12.5% discount, $100.00 to $199.99 earns a 15% discount, and bills of $200 or more earn a 17.5% discount. Since ABC's carriers allow 60 days to pay the carrier, the interest earned on the LDU payments (45 days for prompt payers) generates additional revenues for the company and permits ABC to charge lower LDU rates.

THE INDEPENDENT DISTRIBUTOR

The common denominator of the ABC organization is that everyone is an Independent Distributor (ID). These independent distributors do not work for ABC but are in business for themselves and most do this only part-time. They receive no fringe benefits from the company and the company does not withhold any taxes from their commissions. Each independent distributor is responsible for paying business expenses and any taxes that may be due on their income.

The first function of an Independent Distributor is to acquire customers. If a distributor is interested mainly in signing up personal customers, very little training and virtually no initial investment is required. Simply by completing a distributor agreement, accompanied by a check for $25, ABC enters the individual’s data in the computer, and the new distributor receives a commission on the long distance usage of customers they, personally signed up. Should the distributor later decide not to continue in the business, the company (upon the distributor’s written request) would refund the $25 and assign any customers acquired to the distributor’s "upline sponsor," (that distributor who signed them up in the business).

If a distributor desires to build an organization of distributors and earn overrides (commissions) on long distance usage of customers signed up by other distributors in their "downline," (those independent distributors signed up by the distributor) the distributor must purchase a DPS-Training package for an additional $230. Purchase of this package also entitles the distributor to an intensive training session with an area director. This training is only available to Independent Distributors who purchase the DPS-Training package and the distributor may attend additional training sessions, if desired, at no charge.

THE INDEPENDENT DISTRIBUTOR COMPENSATION PLAN

The Basis of Compensation

ABC has designed its compensation plan to create both immediate and long-term residual income. It’s based on the concept of “something for something.” Commissions are paid on long distance usage of any customers personally enlisted and on that of sub-distributor's customers down through possibly seven levels of the distributor’s organization.

Distributors also earn a $40 commission on sale of the training package purchased by those recruited by them to become independent distributors. This is a one-time commission and is only collected if the distributor pays $230 for the training package rather than the $25 fee. The $25 fee does not include any material or training. An independent distributor who has built a downline of at least 12 distributors and signed up 10 or more customers may become a Regional Training Director by paying an additional fee of $125. This fee covers training provided by another company trainer known as a National Training Director. Becoming a trainer produces another source of income since the trainer is paid $40 by the company for training each new distributor.

Long-Distance Usage

Commissions and bonus payments for the sale of ABC's long distance service are calculated upon the net collected long distance usage revenue of the monthly Dial 1 long distance telephone calls and ABC Card calls made by and billed to the customer. Net collected long distance usage revenue is defined as total per minute usage charges, less discounts, and taxes actually paid by customers to ABC on both domestic and international calls, provided that such payments are postmarked within 60 days from the billing date printed on ABC's bill. The national average LDU is about $25 per month.

Active Customer Defined

Distributors receive commissions in accordance with the commission schedule set forth in the LDU Commission/Override Structure Chart (Exhibit 2) on active customers who pay their telephone bill. An "active" customer is a Dial 1 customer who has signed up for ABC's long distance service and has been accepted by the company. A "personal active" customer is a Dial 1 customer personally signed up by a distributor, or a Dial 1 customer who is also a second level distributor personally signed up by the distributor. A customer who becomes inactive, is disconnected, or cancelled generates no further commissions or bonuses. If a customer is reinstated and ABC receives payment for long distance usage, then the distributor would once again receive commissions for that customer. A customer may become "inactive" if there is no usage on ABC's service for a period of ninety days.

LDU Commission/Override Structure

Customers personally signed up by an ID are considered first-level customers. Distributors that an ID personally sponsors are first-level distributors and the customers that these distributors personally sign up are second-level customers. An ID may personally sign up an unlimited number of customers on their first level, sponsor an unlimited number of IDs on their second level, and sell DPS-Training packages to an unlimited number of personally sponsored distributors. Downline commissions, overrides, and bonuses are paid through certain levels depending on the ID's production performance. IDs receive a 4% commission on all first-level customers. When IDs personally sign up and maintain five active customers and sell two DPS-Training packages, they receive long distance usage (LDU) commissions and overrides through

five levels of customers. When an ID personally signs up and maintains 10 active customers and sells three DPS-Training packages LDU commissions and overrides are earned through six levels. When an ID signs up 15 active customers and sells four DPS-Training packages, LDU commissions and overrides are paid through seven levels.

An ID who personally signs up and maintains 20 active customers and sells five DPS-Training packages receives additional compensation in the form of a bonus on the LDU of all the customers on the seventh level. This means that the override plus the bonus will equal 4% of the distributor LDU on their seventh level. IDs who sign up and maintain 40 active customers and sell 10 DPS-Training packages, receive another bonus on the LDU of all customers on their seventh level. In this case, the override plus the two bonuses will equal 5% on the distributor LDU on their seventh level and 2.5% on the customer LDU on their seventh level.

The LDU Commission/Override Structure, shown in Exhibit 2, illustrates how these commissions, overrides, and bonuses are paid.

Exhibit 2
The LDU Commission/Override Structure

If you have this number of personal active customers	PLUS this number of personal DPS-training package sales	Then you are paid through Level	Distributor LDU Commission override % of	And customer LDU Commission override % of
1	0	1	---	4%
5	2	2	1%	2%
5	2	3	1%	1%
5	2	4	1%	.5%
5	2	5	1%	.5%
10	3	6	2%	.5%
15	4	7	2%	.5%
20	5		+2% bonus	+1% bonus
40 or more	10 or more		+1% bonus	+1% bonus

DPS-Training Package Commissions/Overrides

An ID is entitled to receive a $40 one-time DPS-Training package commission each time they personally sell the DPS-Training package. An ID is expected to help train and manage personally-sponsored IDs, as well as downline IDs, and assist them in obtaining customers and building their organization. In addition to the $40 DPS-Training package, an ID can also earn downline DPS-Training package overrides. When an ID personally sells 5 DPS-Training packages they qualify to receive a $5 DPS-Training package override on their seventh level. This means that the DPS-Training package override plus the bonus will equal $10 paid on DPS-Training packages sold on their seventh level.

The DPS-Training Package Commission/Override Structure (Exhibit 3) explains the number of DPS-Training packages an ID must sell to receive downline DPS-Training package commissions and overrides, and also explains the amount an ID can earn when they meet these requirements.

Exhibit 3
The DPS-Training Package Commission/Override Structure

If you have personally sold this total number of DPS-Training packages	Then you are paid through Level	This Commission or Override per package sold
1	2	$40
2	3	5
2	4	5
2	5	5
3	6	5
4	7	5
5	7	$5 bonus

Independent Distributors who have not purchased the DPS-Training package should have made this choice because their interest in ABC is primarily in the acquisition of personal customers. The decision to not purchase the package does not affect the amount of LDU and DPS downline commissions.

If a distributor does not purchase the DPS-Training package, that distributor will not receive a $40 DPS-Training package commission from the first five (5) personal DPS-Training package sales. However, the Distributor would receive credit for the first five DPS-Training package sales. These credits entitle the Distributor to earn LDU and DPS overrides down through seven levels, the same as a Distributor who has purchased the DPS-Training package.

After training, ABC expects a distributor to recruit customers and other distributors in order to build their network. ABC also expects distributors to work with newly recruited distributors to help them build their own network of customers and distributors. While ABC encourages distributors to work their immediate area, they are also permitted to sign up distributors in other parts of the U.S. This creates the potential for a large network covering many states.

Promotion to Master Distributor

Through performance, an ID can advance within the ABC network and earn additional benefits and recognition. An ID is promoted to Master Distributor status upon

selling 5 DPS-Training packages and maintaining a personal customer base of 20 or more active customers. As a qualified Master Distributor, an ID is eligible to receive a 1% bonus on the LDU of customers and a 2% bonus on the LDU of distributors on the seventh level.

The company also provides opportunities for additional promotions for distributors who achieve high levels of productivity such as Area Director, Master Area Director and Executive Area Director. These positions require the additional responsibilities of training distributors as well as continuing to recruit personal customers and distributors. They are also asked to keep close contact with distributors to help them be successful in recruiting customers and distributors. Additional compensation may be earned from training fees paid by ABC and training bonuses from other area directors in the downline.

Current Issues

The past year had been hectic but successful. Thousands of distributors have been recruited and thousands of customers signed up. ABC is making waves in the telecommunications industry with its rapid growth and nontraditional marketing program. While many multilevel marketing plans had proven to be flawed and either failed or were legally barred from operations, ABC's carefully developed plan has overcome these flaws. While ABC is nowhere near the size of Amway, with its vast product line and more than 3 million distributors worldwide, they have achieved rapid growth in a very competitive industry still dominated by AT&T.

Vaughn's main concern is the continued need to motivate distributors to recruit new distributors and customers. Since the company does practically no advertising, the personal sales efforts of distributors are the means of acquiring customers. Ultimately, a large customer base could provide the funds for growth and stability in the organization but that can only come by adding distributors and customers. As with all multilevel programs, a lot of distributors drop out (an estimated 80-90%) because they don't like being turned down by potential distributors or customers. Those that do stay must be continually motivated to recruit distributors and customers for the network to grow and achieve financial success. Vaughn feels a need to develop a program to create excitement about the opportunity and help sustain distributor recruitment effort. The company uses weekly emails about meeting opportunities and conference calls as one means of motivation. Also, the company's website frequently posts testimonials of successful distributors and also provides distributors with updates on the company, lists of meetings by state, and how to participate in the conference calls which are done weekly.

While earning potential is high, it takes several months for LDU commissions to generate reasonable amounts. A customer must sign up, switch to a new carrier, and then make long distance calls before revenue accrues to the distributor. This takes two to three months to accomplish and another two months before a distributor sees the commissions. At present, no one knows how to shorten this timeframe and, therefore, a five- to six-month period elapses before a distributor receives LDU commissions. LDU

commissions are the residual income that can build over time to create large distributor earnings. Thus, distributors have to continue to recruit customers and other distributors for a relatively long time before receiving LDU income. Distributors receive commissions ($40) for recruiting a distributor who purchases the $230 DPS-Training package within three to four weeks, but this one-time payment is not sufficient to create high income for most distributors. Vaughn believes he needs a motivational program to bridge the gap between signing up customers and generation of LDU commissions, but still is unsure of what type of program to develop.

Questions

1. What are some of the options available to Jeffs to increase the recruiting efforts of current distributors?
2. How important is training of new distributors to the success of the company?
3. What changes, if any, should be made in the current compensation plan to retain current distributors and attract new ones?
4. What recommendations would you make to Jeffs regarding strategies to keep existing distributors motivated?

Teaching Case

Journal of Applied Case Research

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ADULT DAY CARE, INC.

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CASE SYNOPSIS

Mark Babb and his wife, Jennifer, are considering opening an adult day care center where caregivers can drop off adults so they can take care of their own needs. Mark has a university degree in business administration and has been involved in his family's medical supply business for years. Jennifer is a registered nurse who has been working in the adult day care field for years. The Babbs feel that an excellent opportunity exists where they live to start such a business. There are, however, many marketing, management, and financial factors to consider. The Babbs will need to: (1) examine the factors that influence the adult day care market and how their potential day care center fits into that market; (2) understand consumers' needs in specific market segments; (3) analyze the current and potential competition; and (4) assess the potential opportunities for the adult day care center. They sought help from a local university's Small Business Development Center and were assigned a team of students to help complete the preliminary analysis needed before launching the business.

CONCEPTUAL FOUNDATIONS

Prior to launching a new business, a market opportunity analysis should be conducted to determine the feasibility of the business generating enough revenues to cover costs for not-for-profit businesses and to generate an acceptable rate of return for a for-profit business. This case creates the opportunity for students to prepare a market opportunity analysis for a potential new business, an adult day care center. This involves an analysis of the industry/market, competition, potential sales and costs, and expected return on investment for the owners. If students conclude that the business is feasible, then decisions about location, services, promotion, and pricing can be developed as part of the marketing plan needed to launch the business. Students can also prepare a SWOT analysis of the business as well as the training/skills of the owners to successfully execute the business plan. The data provided in the case gives students the information needed to prepare pro forma income statements and use this information to assess the potential ROI for the business.

ADULT DAY CARE, INC.

Mark and Jennifer Babb are a hard-working married couple with everyday financial and family concerns. Like many of their friends and other baby boomers, they have elderly parents with limited resources. Healthcare costs have increased dramatically. The average cost for a semi-private room in a nursing home is $67,000 per year and is much higher in some parts of the country [Block, S., 2008]. A survey conducted by MetLife found that the average home healthcare cost is $19 an hour, which can easily amount to over $40,000 a year [MetLife, 2007]. A nursing home and home healthcare are the only two options available where the Babbs live. Either of these alternatives can be a troubling financial burden. Surely, the Babbs thought, the market is ripe for a more viable alternative: an adult day care center where caregivers can drop off adults so they can take care of their own needs. However, they were not really sure if they could make a living from this type of business and were also concerned with how much money they would need to secure to start the business.

Background

The Babbs live in Monroe, Louisiana, located in Ouachita (pronounced wah-shih-TAH) Parish, which has a population of about 50,000. West Monroe, located just across the Ouachita River from Monroe, has over 13,000 residents. These two cities are often referred to as the Twin Cities. The Standard Metropolitan Area (SMA) has a population of nearly 150,000. In spite of the population size in the Monroe area, the Babbs were not aware of any viable alternatives to the nursing home and home health care options for the elderly.

Mark has a business degree and has been involved in his family's medical supply business for years. Jennifer is a registered nurse and has worked for many years in the health care field. Therefore, they both have experience in the medical field and feel qualified to start a day care center which targets the elderly. The Babbs sense the time may be right to start an adult day care center in Ouachita Parish. There are a number of companies and not-for-profit organizations offering services to the elderly, but no adult care center currently exists. Before beginning an adult day care business, however, the Babbs wisely sought to find out more about the industry. They contacted the Small Business Development Center at the local university for help with this project and were assigned a consulting team of senior business students to help with this task. Excerpts from the students' report are shown below. Their report included an analysis of the industry and market, prospective consumers, potential competition, potential opportunities as well as some financial analysis for the prospective business.

Industry/Market Analysis

The adult day care center market is not as mature as the nursing home and homecare providers' markets. Due to its size and relatively recent emergence, not as much data exists for the adult day care industry. Adult day care is one of many services that falls under the category of "Elderly and Disabled Services" under the North American Industry Classification System (NAICS). Exhibit 1 below shows the projected markets in the United States for the next five years for these three industries. The Home Care Providers segment is growing at nearly twice the rate as full-time care. Services to the elderly and disabled, however, are expected to grow at even a greater pace. Adult day care service is only one of twelve services of the "Elderly and Disabled Services" classification. Other types of services in this category are disability support groups, social activities, and senior citizens centers. Therefore, it is difficult to draw a strong conclusion from the data. Nonetheless, the outlook for such an industry appears to be favorable.

Exhibit 1
Expected Growth for Nursing Home Facilities and Home Care Providers

	Nursing Home Facilities		Home Care Providers		Elderly & Disabled Services	
	Revenue $ Millions	Growth Rate	Revenue $ Millions	Growth Rate	Revenue $ Millions	Growth Rate
Next year	97,593.8	2.8%	60,658.2	5.2%	26,805.0	6.1%
Two years from now	100,424.1	2.9%	63.751.8	5.1%	28,976.3	8.1%
Three years from now	103,235.9	2.8%	66,875.6	4.9%	30,338.2	4.7%
Four years from now	106,126.5	2.8%	70,018.7	4.7%	32,734.9	7.9%
Five years from now	108,992.0	2.7%	73,449.7	4.9%	35,713.8	9.1%

Adapted from: IBISWorld (2008b, 2008c, and 2008d).

Looking back over the last five years, the trend is towards some type of part-time, rather than full-time, care for the elderly. Exhibit 2 below shows the growth in each of three industries for the last few years. One would expect a growth in these industries as the median age of our population continues to increase. According to census information, the median age of the population of the United States was 30.4 years in 1980, 35.4 years in 2000, and 36.4 years in 2006. By the year 2015, the expected median age is 39.1 years. As Exhibit 2 illustrates, there appears to be a trend away from full-time residential healthcare; as the growth rate for home care and other types of services to the elderly has been significantly greater than that of the nursing homes.

Exhibit 2
Real Growth in Nursing Care Facilities and Home Care Providers

	Nursing Home Facilities		Home Care Providers		Elderly & Disabled Services	
	Industry Revenue	Number of Establishments	Industry Revenue	Number of Establishments	Industry Revenue	Number of Establishments
Past year	2.6%	0.1%	5.4%	4.6%	5.8%	3.1%
One year ago	2.5%	0.1%	5.9%	4.8%	4.8%	4.6%
Two years ago	-1.1%	0.1%	4.9%	5.1%	9.4%	2.5%
Three years ago	1.2%	3.2%	9.6%	9.9%	3.8%	4.5%
Four years ago	0.4%	-0.5%	9.6%	10.4%	5.9%	11.3%

Adapted from: IBISWorld (2008b, 2008c, and 2008d).

There are many types of programs in Monroe and West Monroe that provide services to the mature "graying" community. In addition, there are a variety of services to fit the various individual adult care needs. Hence, competition for adult day care in the area is high.

Nonetheless, there is no establishment in the area that provides an adult day care center structured like the one that the Babbs are considering.

The MetLife Mature Market Institute performed a nationwide survey on adult day care services and home care costs. They found that the national average hourly rate for home health aides is $19 an hour and that the national average daily rate for adult day centers is $61. No data was obtained for the Monroe, Louisiana, area. However, Baton Rouge showed an average hourly rate for a home health aide of $14, and an average daily adult day care cost of $54. Thus, it appears that the Louisiana market cost is below the national average [MetLife, 2007]. Exhibit 3 below shows the results of a recent survey conducted by MetLife of nursing home, assisted living, home care, and adult day care costs. Adult day care cost is the least expensive alternative.

Exhibit 3
Daily Average Cost for Nursing Homes, Assisted Living, Home Care, and Adult Care
In Selected Areas of the Southeast

Area/Region	Nursing Home Semi-Private	Assisted Living	Home Care (8-Hour Day)	Adult Day Care
National	$189	$100	$152	$61
Baton Rouge, LA	117	83	112	54
Jackson, MS	164	91	144	65*
Little Rock, AR	131	72	120	58
New Orleans, LA	NA	NA	NA	50
Shreveport, LA	115	71	104	NA

Adapted from: MetLife (2007a and 2007b).
*Figure is for the Central Mississippi area.

The main target group for the adult day care center that the Babbs envision is the elderly. Utilizing information from the most recent census, Ouachita Parish has more than 18,000 individuals age 65 and over. The data also shows more than 28,000 residents, who are five years or older, have some type of disability. The information did not delineate how many of these disabled individuals are also 65 or older.

Nationally, the elderly population continues to grow rapidly. When all of the baby boomers (everyone born from 1948-1964) reach 65, one in five Americans will be 65 or older. According to U.S. Census Bureau, this age group will more than double by 2050, when there will be 88.5 million Americans who will be 65 or older. Accordingly, the increasing age of the population leads to an increase in demand for direct care and medical supervision of the elderly. As the population grows older, there may also be more who face chronic, limiting illnesses or conditions, such as arthritis, diabetes, osteoporosis, and senile dementia. These conditions result in people becoming dependent on others for help in daily living activities. In view of this state of affairs, an adult day care can be a major benefit to the community. Exhibit 4 below gives some sense of the aging U.S. population base over the next 20 years. The growth is noteworthy, particularly in the Southeast where Monroe is located.

Exhibit 4
Share of Persons Aged 65+ from Total Population: 2000 – 2030

Region	Percentage 2000	Percentage 2005	Percentage 2010	Percentage 2020	Percentage 2030
Far West	10.9	11.0	11.8	15.1	18.0
Great Lakes	12.6	12.5	13.0	16.0	19.3
Mid East	13.5	13.4	13.9	16.9	20.4
New England	13.6	13.4	14.0	17.6	21.8
Plains	13.4	13.2	13.6	16.8	20.4
Rocky Mountains	10.1	10.3	11.0	14.6	17.1
South East	12.5	12.5	13.1	16.5	20.1
South West	12.6	12.7	13.4	17.0	20.4
TOTAL	12.4	12.4	13.0	16.3	19.7

Source: United States Census Bureau. (2008). *The 2008 Statistical Abstract*.

The ability of family members to provide long-term care services informally to their parents or other adult loved ones has declined with the increasing rate of women entering the workforce. Working parents cannot provide hands-on care for their elders during the hours when they are at work, but the income they receive from working may increase their ability to finance paid care. Many working caregivers experience conflict between the demands of employment, care for their children, and responsibilities for their elders. The parent-support ratio gives an idea of things to come. This ratio equals the number of persons aged 85 and over per 100 persons aged 50 to 64. Between 1950 and 1980, this ratio nearly tripled from 2.7 to 6.7. Based on the latest census, this ratio is now 10.2 and could again triple over the next six decades.

Consumer Analysis

The prospective clients for the adult day care center in the Monroe/West Monroe market are adults, and perhaps even older teens, who should not be left alone, including those who are physically or mentally disabled. These segments, however, contain great variance, if not in need, in ages. Many may think of an adult day care center to be used only by the elderly, but the largest segment of those with disabilities is not the 65 and older group. Exhibit 5 shows the demographic of those with disabilities. The 16 to 64 group accounts for 57.8 percent of those with disabilities. The exhibit does not indicate the severity of the disabilities. One would expect a greater limitation for those who are older. As expected, a much greater percentage of those 65 and older have disabilities. While a large potential target market exists in the younger age group (i.e., those under 65), the Babbs wanted to focus on the elderly as the primary client of the proposed day care center. They also felt it would be very difficult to mix all the different age groups in one facility.

Exhibit 5
Disability Status

Age Group	Estimated Number with Disabilities	Percentage of Persons with Disabilities
Population 5 to 15 years	2,816,000	6.8%
Population 16 to 64 years	23,809,000	57.8%
Population 65 years and over	14,584,000	35.4%
Total population 5 years and over	41,209,000	100.0%

Adapted from: U.S. Census Bureau.

Based on the most recent census of Monroe (population of over 53,000) and the data presented from the two previous tables, there should be more than 2,500 individuals in Monroe who are 65 and older who have some significant limitation in their daily lives. Not all of these will be current potential customers because the data does not indicate the severity of these disabilities. Exhibit 6 below shows the types of disabilities of this elderly group. Census data indicates that about 41 percent of the 65 and older group has a disability. The percentages in the exhibit total more than 41 percent due to the fact that many have more than one disability. The adult center could possibly attract some who are capable of being by themselves, but who would rather be with others. An adult day care facility might give the caregiver (e.g., the adult children) a greater peace of mind assuring them that their loved one is being aided. Therefore, it appears that there is a need for this kind of care center for the elderly in this market.

Exhibit 6
Persons 65 Years Old and Over – Disability Status

Type of Disability	Percentage of 65 Years Old and Over
With a sensory disability	16.4%
With a physical disability	30.8%
With a mental disability	11.5%
With a self-care disability	9.7%
With a go-outside home disability	16.6%

Adapted from: U.S. Census Bureau.

The "graying of America" is evident. As the population ages, the need for adult care will continue to increase. Exhibit 7 below shows the aging of the U. S. population. The fastest growing age group is 65 to 69. Perhaps surprisingly, the 80-and-over group not only exhibits the second highest growth rate, but is also the largest group, which is more likely to require the greatest amount of care and supervision.

Exhibit 7
Growth in 65 and Over Population by Subgroup

Age	Persons 2007	Persons 2008	Growth	Proportion of Total 65+ Group (2008)
65-69	10,784,352	11,321,863	5.0%	29.3%
70-74	8,584,066	8,732,349	1.7%	22.6%
75-79	7,292,194	7,226,693	-0.9%	18.7%
80+	11,189,060	11,409,264	2.0%	29.5%

Source: IBISWorld (2008a).

The clients and their caregivers would benefit from the services rendered by the adult day care center because they could have an alternative to 24-hour nursing home care. The clients would benefit from the socialization, rehabilitation, nursing care, and supervision. The caregivers would benefit from peace of mind and the freedom to work and run errands, knowing that their loved ones are being taken care of by health care professionals. Importantly, the cost of adult day care is significantly less expensive than nursing homes and home care.

Competitive Analysis

There are currently no adult day care centers serving the Monroe area market. In this sense, there is no direct competition. Competition, however, is present in other forms. Home health care, nursing homes, and community service activities are all potential competitors. It appears unlikely, however, that someone outside the community might establish a day care center in Monroe for there are no major players in the industry. In addition, the lack of an adult day care facility in the local market bodes favorably for possible governmental funding or grants.

The Bell South Yellow Pages for the Monroe area lists 26 nursing home facilities. These establishments offer full-time care for elderly patients with a wide range of health care needs. Some of these patients are potential clients for an adult day care center because they are not completely debilitated. These people are simply in need of someone to cook, clean, and oversee their daily activities.

There are 27 home health care and nursing agencies in the area that offer medical attention to patients with more serious conditions. These organizations would also be potential competition because families may hire them to stay with the patients during the day. Nevertheless, with a nurse on staff, an adult day care center may offer a similar service for a fraction of the cost.

Although indirect, the Ouachita Council on Aging would be another significant competitor in care for the elderly. This institution offers transportation, dance classes, art lessons, and numerous other social activities. The Council's focus, however, is more on entertainment than on health care.

Area churches are also indirect competitors. Many larger churches offer afternoon programs and activities for the elderly, such as "Thursdays Together" at McClendon Baptist. Here, the 65 and older age group meets for lunch, choir rehearsal, and fellowship with transportation provided. These nonprofit organizations may prove to be an alternative to day care for some potential clients, but their availability is limited and their focus is on entertainment

and fellowship, and they do not have qualified staff members to provide care but depend upon volunteers.

Opportunity Analysis

The Babbs appear to possess good managerial strengths. Jennifer is a registered nurse and has had extensive experience in the adult day care field. Mark has a bachelor's degree in business administration and is a seasoned veteran in the medical supply business. Through their many years of work with the medical community, they have established many contacts which should prove to be beneficial.

A variety of funding sources are available for an adult day care center for the Monroe area. In addition to participant fees, Medicare, Medicaid, private insurance, and federal and state grants may be available. There is also the possibility of acquiring financing from individual investors.

Marketing Strategy Development

Based on the current potential within the adult day care industry, the Babbs developedthe following strategic objectives as reasonable:

(1) To achieve at least $100,000 in revenues by the end of the first fiscal year of operation;

(2) To achieve at least $400,000 in revenues by the end of the third fiscal year;

(3) To break even by the end of the third fiscal year; and

(4) To achieve at least 80 percent awareness of the existence and nature of the center by potential clients within the first year of operation.

In view of the forgoing situation analysis and the above objectives, a marketing strategy should be developed that will help build a successful adult day care business. Overall, the basic strategy of the adult day care center is to offer direct care for a portion of the 24-hour weekday to individuals who are physically or functionally impaired. The center should offer a variety of services to maintain its clients' state of emotional, physical, and social health so that they do not deteriorate to a point where admission to an institution is necessary. Additionally, in order to accomplish the above objectives, the following product, place, price, and promotional strategies will be used.

Products/Services

In order for the adult day care center to be successful, essential services need to be offered to distinguish the center from all other types of adult day care programs in Monroe. The services should give people a good reason for choosing the center over competitors. When determining the services which the center should offer, several successful out-of-state adult day care centers were analyzed. Based upon these other centers' success, the following services are highly recommended for the potential adult day care center. These services are discussed below.

Hours of operation should be Monday through Friday, 7:00 a.m. to 6:00 p.m. Attendance may range from two to five days a week. Extended hours should be available from 6:00 p.m. to

8:00 p.m., Monday through Friday, if requested with reasonable notice and if the center is able to comply with the request. An additional fee should be charged for extended care.

Transportation is a high-cost expense relative to the benefits received and is replete with liability issues. Therefore, transportation for offsite trips should be contracted out with commercial companies. Clients should arrange for their own transportation to and from the center.

Staffing should eventually consist of a director, a full-time registered nurse, a certified nursing assistant, a program director, a social worker, a dietician, and someone to handle all the paperwork and any insurance claims that might be filed. At the start of Adult Day Care, Inc., however, an individual might handle more than one role. Based on the owners' professional experience, each of them will be able to fulfill multiple functions. Volunteers should be welcomed. The maximum client-to-staff ratio should equal 6 to 1, to insure individual attention. All staff members should be certified by the American Red Cross in First Aid and cardiopulmonary resuscitation (CPR) annually.

Health care services should include the monitoring of blood pressure and medications, blood sugar testing, health screenings, medical follow-ups, and wound care. Rehabilitative care should also be performed, which includes daily exercise groups, walking, mobility training, and physical and range of motion therapy. A nutritional breakfast and lunch should be served daily, in addition to an afternoon snack. Activities of daily living should be performed, such as hair care, personal hygiene and grooming, oral care, feeding, and bathroom assistance.

Group activities at the center should include dancing, sing-a-longs, discussion groups (e.g., current events), cooking, sewing, arts and crafts, gardening, music, TV, Bingo, card and board games, and sports activities. Community and recreational activities should include frequent outings to places like restaurants/places for lunch, plays, children's day care centers, museums, parks, swimming pools, bowling centers, libraries, book stores, and shopping centers. Additionally, it can also be arranged for community groups to visit the center, such as children's day care groups, and members of the Fire Department, Police Department, and Department of Social Services, among others.

Educational programs should be provided for family members and the community. Potential topics could include "Alzheimer's Disease: How to Handle Difficult Situations," "Advance Directives," and "How to Choose the Right Type of Adult Day Care," among others. Educational programs should be provided to the clients with topics such as, "How to Stop Smoking," "Crime Safety," "Medicaid and Medicare," "Home Fire Prevention," and "Current Events." These educational programs may also result in being an important promotional tool for the center.

Patients with Alzheimer's and other related disorders should be accepted as clients. Accordingly, the center should provide a structured environment and caring atmosphere that keeps these patients socially active, alert, and mobile. Activities should be similar to those of the regular clients, but modified to meet their special needs.

Optional services offered may include occasional visits from speech therapists, manicurists, massage therapists, and a podiatrist. These services may be billed directly to the clients' insurance carrier or to the clients' families.

Place Decision

The adult day care center may not require a location with prime exposure. A centralized area, however, would be especially beneficial. A location near family members' places of work

would add to the convenience of adult day care. The "Garden District" of North Monroe has been suggested as good localized areas. The Garden District is centrally located in an historic area of Monroe. The neighboring areas are well maintained.

An examination of local real estate listings in the Garden District and in North Monroe indicates that the least expensive house is about $80,000. This price does not include such required renovations as handicapped accessible bathrooms, non-slip flooring, and handicap entrance ramps. Although varied, the median cost appears to be about $70 per square foot.

Adult day care centers are also required to have separate bathrooms for males and females. There must not be less than one toilet and hand washing facility for each twelve clients. The facility must provide at least 40 square feet of indoor space for each day care client. There also must be sufficient parking area available for the safe daily delivery and pickup of clients.

Considering the difficulty of attaining a pre-built structure that would lend itself to affordable renovation, building an adult day care center may be the best option. Finding an affordable lot in North Monroe is slightly more difficult than in other areas. The average lot price in local listings is around $30,000. According to ARCO Builders, a local architectural firm specializing in the construction of nursing homes, building a new structure would cost $65-75 per square foot. To build a structure to house 20 people would cost a minimum of $52,000 not counting the cost of the lot, furnishings, kitchen and office space. This size would allow some growing room.

Promotional Decisions

The promotional strategy should consist of the following elements:

- A message of a fun, safe place for caretakers to leave their loved ones for the day will be the main theme of the advertising campaign.

- A pull strategy based on an intensive advertising campaign will be used in the first year of operations.

- A mix of television, print, and radio advertising will be used: 40% of the advertising budget will be allocated to print (newspapers, billboard, and Yellow Pages), 20% of funds will be dedicated to radio, and the remaining 40% will be allocated toward television ads.

- During the first year of operations, advertising effectiveness will be evaluated biweekly and will be recorded promptly for feedback.

- The advertising blitz will have a budget of $25,000 for the first year of operations. Subsequent yearly advertising budgets will be determined at the beginning of each year. The advertising budget will be allocated as follows:

    - The radio budget of $5,000 will include 30 second spots on local AM and FM stations. Two different radio ads will run in the 3-7 p.m. timeslots Monday-Friday, and the ads will be renewed every 3 weeks by advertising executives.

- The television budget of $10,000 will include 30 second spots on local stations; one ad to be run every month; and ads will be during prime time, 7- 10 p.m.

- The print budget of $10,000 will include billboards. The message should change each month. It is desirable to have two billboards, located on different ends of Monroe/West Monroe. The remainder of the funds will be spent on newspaper with the News-Star and, possibly Yellow Page, advertisements.

Financial Analysis

The center should charge approximately $50.00 a day per client for services rendered, which is approximately $6.00 an hour. This price includes lunch. As shown in Exhibit 3, the national average price for all adult day care centers within the United States is $61 a day. Additionally, this price is considerably less than home health care, which charges about $19 an hour, and nursing facility care, which charges about $189 per day for a semi-private room.

Pro Forma Analysis

Since the Babbs may have to consider building, an analysis of the construction costs is necessary. Exhibit 8 below shows start up cost estimates for Monroe. The Babbs are hopeful that their business will grow rapidly so they plan to build or lease a larger facility than will be needed during the first few years.

Exhibit 8
Estimated Start-Up Costs
Capacity per Square Foot

Number of Clients	10	20	40	50
Required Square Footage per Client	40	40	40	40
Capacity Requirements	400	800	1,600	2,000
Additional Space	500	500	500	500
Sick Room	50	50	50	50
Additional Bedrooms	250	250	500	500
Total Square Footage	1,200	1,600	2,650	3,050
Price Per Square Foot	$70	$70	$70	$70
Total Cost	$84,000	$112,000	$185,500	$213,500
Land	50,000	75,000	100,000	110,000
Furniture	15,000	20,000	30,000	40,000
Appliances	6,000	6,000	6,000	6,000
Supplies	5,000	7,000	11,000	13,000
Total Start Up Costs	$160,000	$220,000	$332,500	$382,500

Note: Additional Space would include kitchen, hallways, storage space, and offices.

A pro forma income statement prepared on the cash basis is given in Exhibit 9. The number of clients shown in the table is the expected full-time equivalent clients. The figures for the number of clients are believed to be conservative. Enrollment for the first year is expected to be between 10 and 20 clients, and enrollment in the second year is expected to increase to between 20 and 40. Sales are expected to increase rapidly during the first three years, and then level off to about a 10 percent rate of growth. The sales figures in the pro forma income statement are based upon clients spending an average of 40 hours a week at the center, at $6.00 per hour. Wages make up the largest expense category. Adult Day Care will try to provide the best service for its client. Typically, payments to individuals, such as rehabilitation and counseling, and wages account for about 90 percent of the operating costs for an organization providing services for the elderly and disabled [IBISWorld, *Elderly & Disabled Services*]. Operating expenses include utilities, supplies, and food. The debt service cost for interest and principal is based on a $400,000, 10-year, and a 7 percent loan. The Babbs believe that they will also need to invest at least $100,000 of their personal savings in Adult Day Care, Inc.

Exhibit 9
Adult Day Care, Inc.
Pro Forma Income Statement (Cash Basis)
For Years Ended

	Year 1	***Year 2***	***Year 3***	***Year 4***	***Year 5***
Number of Clients:	12	24	36	40	44
Sales	$144,000	$288,000	$432,000	$480,000	$528,000
Expenses:					
Salaries & Wages	171,600	193,200	214,800	222,000	229,200
Operating Expenses	31,600	53,200	74,800	82,000	89,200
Advertising Expense	25,000	25,000	25,000	25,000	25,000
Debt Service Cost	55,000	55,000	55,000	55,000	55,000
Income (Loss) before Taxes	($139,200)	($38,400)	$62,400	$96,000	$129,600

Other Financial Considerations

Much of the competition to Adult Day Care, Inc., will be from not-for-profit organizations. Eighty-six percent of companies offering elderly and disability services are not-for-profit organizations, which gives these organizations a significant advantage over for-profit organizations. Government grants may be available to aid in starting up the center. It must be shown, however, that there is a need for the service in their area, and that service is not currently being offered by other organizations [IBISWorld, 2008, *Elderly*].

Conclusion

The consulting team of senior business students from the university summarized their report by noting that services to the elderly and disabled are currently in a growth cycle, which is

expected to continue into the foreseeable future. As the median age increases, demand will increase for some type of assistance with daily living activities. In addition, the barriers to the industry are low and there are no major players in the adult day care industry. Health care costs continue to rise, which has caused many to look to alternative, less expensive means of caring for their loved ones who need help. Although an adult day care center may not be profitable the first two or three years of operation, if it follows a sound strategic marketing plan, it can become the new trend in adult day care in Ouachita Parish, and soon generate a profit.

The Babbs thoroughly reviewed the consultants' assessments and recommendations and became optimistic about the prospects. Considering that there is no existing adult day care center within the Monroe/West Monroe area, the Babbs are wondering whether this is an opportune time to launch Adult Day Care, Inc.

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Teaching Case

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Rebuilt to Last: An Organizational Change Initiative

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REBUILT TO LAST:
AN ORGANIZATIONAL CHANGE INITIATIVE

This case details the efforts of a Midwestern small-cap manufacturing company, Arvin Industries, to create an organizational philosophy that would serve as the focus for a major organizational development change effort. However, the philosophy and subsequent change effort were not enough to prevent the company's ultimate demise.

HISTORICAL BACKGROUND

The Company's Founding and Growth

Arvin Industries, an original equipment components manufacturer and supplier in the light-vehicle automobile industry, was founded early in the twentieth century in the small Midwestern town of Columbus, Indiana. It grew from a partnership of three individuals with a single product, who financed the enterprise with their own funds, to a global concern with $3-plus billion in annual sales revenue with manufacturing, sales, and research centers in more than 60 locations on four continents and in more than 20 countries. Including the founding partner who served as its first Chairman and CEO, the company has had seven CEOs, all of whom have come from within the company. During its first 60 years of existence, the majority of the company's growth came from internal product development and growth with existing customers, and this growth was incremental in nature. The following period of growth occurred during the 1980s and 1990s, when the company nearly doubled in size both domestically and internationally, primarily through acquisitions. By the end of 1999, it employed more than 17,000 associates worldwide.

Measures of Success

During its history, Arvin was deemed successful when measured by its longevity and 74-year record of consecutive dividend payments to its shareholders. Arvin's reputation with its customers was equally solid, exemplified by its record of serving the major players in its industry, its dominant market share, and the longevity of its relationships; in 1999, its first customer remained and was the second-largest account. Over its history, the company enjoyed positive labor relations, with the exception of one protracted strike resulting from concessionary bargaining in the late 1980s. It also had very low historical employee turnover until a period of low unemployment in the 1990s. Company records reflected a pattern of long-term employment and significant numbers of employees who had worked only for the company for their entire careers.

Rebuilding the Company

In 1993 under the leadership of new CEO Byron Pond, the company undertook a massive effort to rebuild itself into a world-class competitor by focusing on the implementation of

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The case reports the organizational change effort from an insider's view and by using primary and secondary sources. Quotes and data in this case are authentic and are derived from personal participation and observation from the executive management level during the change process as well as company documents and previously reported public sources before, during, and following the events.

an enterprise-wide Total Quality Management system initiative. All employees worldwide were trained in a systems process approach to quality, and efforts in formal employee involvement and continuous improvement programs were implemented. The company mandated that every employee participate in a minimum of 40 hours of training each year to provide the tools necessary to eliminate waste and to work "Faster Better," which became the company creed during this rebuilding process. Arvin emerged from this intense, internally focused period in 1997 a new company that had improved its operating performance significantly. Following Pond's ascension to CEO, results from continuous improvement and quality programs were reflected in the following statistics, reported by the company in 1997:

- Labor cost had declined 22 percent
- Total Cost of Quality had dropped 40 percent
- Worker productivity had increased 8 percent
- Selling, General & Administrative expense had been reduced 40 percent

The net results led to a reduction of almost 8 percent in Total Cost of Quality. During approximately this same period, specifically from 1992 through 1996, the company attained five-year averages of 10 percent revenue growth, 9.2 percent operating profit, and 21.4 percent net earnings.

A Change of Leaders – A Change of Focus

In the spring of 1997, a planned succession began. President-COO V. William (Bill) Hunt was appointed CEO, setting the stage for him to become Chairman-CEO in May of 1998. The incoming CEO had been with the organization for 20 years and had progressed from Labor Counsel to Vice President-Personnel, then Vice President-Administration and General Counsel, Executive Vice President, and finally President-COO before being named CEO. As a part of outlining his agenda for the company under his watch, he read an article by John Smock in the September 1997 issue of *Director's Monthly,* titled, "'The Vision Thing' - More Than a Buzzword." The article quoted several studies that showed that companies who have a clearly articulated vision statement perform better than those that do not. One of the studies, a four-year examination by Harvard Business School professors John Kotter and James Heskett, reported that companies with strong corporate culture and a shared vision outperformed those without. These companies' revenues grew more than four times faster, job creation was seven times higher, stock grew 12 times faster, and profit performance was 750 percent higher. A 1994 study by *BusinessWeek 1000* also reported that companies with strong statements of corporate philosophy or mission were found to have an average return on stockholder equity of 16.1 percent, while those without reported a 7.9 percent average return (Smock, 1997). Hunt underlined the following elements of the article that he felt had particular importance:

> Vision is a critical element of strategic planning, strategic management, and strategic implementation....A company's vision plays a role in strategic planning similar to what yeast does in the baking of bread….A vision without a specific plan to achieve it is an empty combination of

> uplifting words….The vision process takes not only information development, but sufficient intellectual stimulation of an entire team…such as scenario development and focus groups….The vision statement should be uplifting. A company should not be afraid to "reach" with its vision (Smock, 1997).

The final element of Smock's article was a reference to the book *Built to Last* by James Collins and Jerry Porras (1994). The book, drawing on a six-year research project at the Stanford University Graduate School of Business, compared the cumulative stock returns of "visionary companies" contrasted to "good" companies in the same industries. The book reported that a $1 investment in the general market in 1926 would have returned $415 by 1990. The same $1 investment in the study's "good" companies would have returned $995. The same investment in the "visionary companies" would have returned $6,356! Hunt got a copy of the book and read it over the Labor Day weekend of 1997.

THE PROCESS

The First Steps Toward a Vision

Hunt's first steps towards pursuing a process of developing an organizational philosophy involved distributing a copy of the book *Built to Last* to each of the members of his executive staff. The group consisted of the presidents of the major operating companies and their functional vice presidents for such areas as legal, human resources, finance, public affairs, and research and development. Among them were 13 white men, 1 Latino man, and 1 white woman. Their time of company service ranged from less than six months to over 30 years. By memo, each was instructed to read the book, assigned a chapter to teach to the group, and asked to set aside three full days for an offsite meeting to explore how this book, and its application to the company, could be useful in providing a framework for developing an organizational philosophy. In addition to teaching an assigned chapter from the book, each executive was asked to lead an open discussion related to the chapter's relevance or potential application to the company. The book included many thought-provoking chapter titles, such as "Clock Building, Not Time Telling," "Cult-Like Cultures," "Try a Lot of Stuff and Keep What Works," and "Home-Grown Management" (Collins & Porras, 1994).

Setting the Stage

The CEO opened the offsite retreat with a personal and introspective presentation that recounted the many leadership opportunities he had been blessed to have in his life, from school-boy athletics to fraternities, community service, and professional roles. Hunt confessed that as he assessed his performance in each of them he found that he had always done the "safe thing;" that which was normal or expected. As he looked at the challenge of becoming CEO of a major industrial concern, it was apparent to him that if he was to lead the company to achieve its fullest potential, he and the team he assembled would need to do things differently. They would need to be willing to take risks and be prepared to work outside of what was comfortable and safe. He characterized the task of attempting to build a truly visionary company – one built to last – as a dramatic departure from the corporation's recent past focus. He credited his predecessor with positioning the

company to compete at world-class levels and preparing it to pursue excellence. He told the group that the next three days would be the start of this new journey for him, and he asked the group to join him.

The first activity of the meeting was for each participant to list the three attributes they liked least about the company. This icebreaker was planned to signal to all participants that the session was to be completely open and freewheeling. It was designed to encourage frank and critical dialogue. Hunt himself opened with items such as, “not in charge of our own destiny,” and “not enough pride taken in what we are doing.” Items volunteered by participants satisfied the desired openness, including things such as “lack of diversity,” “willingness to take risks,” “lack of image,” “treatment of employees” and “a lot of bureaucracy with more emphasis on form than content.”

After an hour of this activity, the next item on the agenda was chapter presentations by the participants. For the next day and a half, the executive staff of the company performed the role of teacher, taking the group through the major issues and concepts of their assigned chapters, utilizing overheads slides and citing company-specific examples and issues. The discussions were lively and, at times, heated. Given the professional level of the participants and the significant educational and professional experience in attendance, the no-holds-barred ground rules thoroughly tested and analyzed both the book and the company. The presentations were predominately used to set the stage for the primary agenda item, which was to be an interactive exploration of the company’s core purpose and the values that could then be articulated into a company mission or vision statement.

Hunt initiated a discussion from the book that focused on the importance of articulating a core ideology as a part of building a visionary organization. In Chapter 3, “More than Profits,” Collins and Porras define a company’s core ideology as the combination of its core values and its purpose. They define core values as “the organization’s essential and enduring tenets – a small set of general guiding principles; not to be confused with specific cultural or operating practices; not to be compromised for financial gain or short term expediency.” They define purpose as “the organization’s fundamental reason for existence beyond just making money – a perpetual guiding star on the horizon; not to be confused with specific goals or business strategies” (p. 73).

Core Values

Before attempting to list core values of the company, the group discussed the conceptual issue of where to look for core values. Are they to be found in the company history only, or are they from many sources and simply rearticulated now as the company’s core values? If from history, what is the starting point: the company founding, the “new” company resulting from the 1993 rebuilding process, or today? Utilizing a flip chart, the group first proceeded to list 24 words and phrases that collectively could be considered core company values. The list included items such as “honesty,” “integrity,” “credibility,” “quality,” “respect for the individual,” “technology,” and “customer oriented.” Each item was debated, argued, and tested against company practices and potential business scenarios to determine if the company had lived by or could live by the

value. The list was narrowed to less than 20, and set aside for further thought and refinement.

Core Purpose

The same process was used to explore the company's core purpose. The primary task was to explain why the company exists; or, as restated by the CEO, what would be the impact on the company's stakeholders (investors, employees, customers, suppliers, and communities) if the company ceased to exist? The first list consisted of the following five statements:

- Being the <u>best</u> at all we do
- <u>Continuous Improvement</u>
- Bettering our customers, shareholders, employees, suppliers, and communities through their relationship with the company
- Providing a <u>better quality of life</u> for all those associated with the company
- Being the best at solving customers' problems, drawing on the excellence of the company's people

The statements were again reality-tested and rewritten into the modified "golden rule" format as follows:

- Do unto our stakeholders as we would have them do unto us
- Treat our stakeholders as we would have them treat us
- Do the right things and do things right for our stakeholders
- Be the best for our customers, shareholders, employees, suppliers, and communities

As with the core values, these statements were set aside for further reflection.

"Big Hairy Audacious Goals"

A central tenant of *Built to Last* is the concept that to build an enduring organization, management must simultaneously pursue a strategy of preserving the core while stimulating progress (Collins & Porras, 1994). The authors used the Chinese yin-yang symbol throughout the book to illustrate the point that it is possible to pursue the "Genius of the 'And'" instead of the "Tyranny of the 'Or.'" In this context, the organization can maintain its core values and purpose while stimulating change by establishing "Big Hairy Audacious Goals," referred to as BHAGs. Per the authors, a BHAG must fall well outside the comfort zone, must be so bold in and of itself that it would continue even if the leader disappeared, must have follow-up BHAGs to avoid stall, and must be consistent with the company's core ideology (p. 91). Utilizing this concept, the final major activity of the three-day retreat was to formulate a list of potential BHAGs that the company could use to drive organizational change.

The process resulted in a list of approximately 40 items that were then categorized into financial, competitive, human resources, operational, growth, technology and reputation BHAGs. They ranged from doubling the size of the company and tripling net earnings by

2002 to zero lost-time accidents and voluntary turnover; from becoming the most admired company in every community in which the company operated to zero hires above entry level; from recognition of the company as the leader in its industry to receiving an unsolicited offer by a substantial company to sell itself to the organization.

The retreat ended with an understanding that the CEO would work to shape the results of the collective efforts into a draft for a vision statement that he would share with the participants for further input. The goal was to road test the vision at the Worldwide Management Meeting scheduled for May 1998.

The Road Test

The company convened a meeting of its key mangers from around the world twice a year for training, planning, team building, and camaraderie. The meetings alternated between U.S. and European locations. In May 1998, the group met at a Midwestern university with approximately 75 managers in attendance. In addition to the United States, managers came from Canada, Italy, Spain, Germany, Brazil, Mexico, England, France, Thailand, the Netherlands, South Africa, and Japan. The five-day agenda included leadership training, production best-practices reports, a business group break-out session, and corporate staff reports. On the third morning of the session, the CEO delivered an hour-long presentation of the Company Vision and Company Values.

In what Hunt characterized as his first opportunity to stand before the company's management group, it is significant to note that he chose to set "vision and values" as the tone of his tenure as CEO; statements of the company vision and values had not previously been emphasized, and in recent past, not expressly articulated. He began his address by reviewing company accomplishments, crediting the major efforts exerted to improve operational performance, customer satisfaction, new business growth, and technology improvements. He rated the company as good, but indicated the challenge was not, "How do we remain good?" Rather, it was "How do we become great?" He indicated that the first step was establishing a vision and supporting objectives; i.e., "…to become a company which is great in the eyes of its customers, communities, employees and shareholders." Hunt then continued with his remarks, explaining to the management team why building a company that would last was important to him. He indicated that it proved there could be meaning to our business life beyond profits and salaries; that we can be builders, not users or destroyers; that we can add value to our lives beyond value to our shareholders, and that this value – this meaning – is essential to self-esteem, self-fulfillment, and life itself. He indicated his belief that there is nothing more meaningful in the human experience than building something, building it well, and building it to *last*.

He then went on to teach from *Built to Last*, giving examples of how concepts and chapters were applicable to the company, and then reviewed the work of the Executive Staff Retreat. He indicated that the development of the company's values took years and many months would be necessary to crystallize them into a statement of core values and core purposes easily and effectively communicated to employees and other stakeholders. He listed many of the core values developed at the retreat, and indicated that not surprisingly, they were not unique or unusual for any company to express. The trick, of

course, was to live by and hold true to these values no matter how difficult the operating environment became.

Taking from the book's "Interlude," he indicated that the greatest "tyranny of the 'or'" he could imagine was that a company could not maximize shareholder value and achieve the highest core values at the same time. He concluded his remarks, indicating that the process would be one of making an affirmative statement of "what we stand for, what we aspire to become, what it will take from each of us and, finally, our commitment to achieving this shared goal."

Initial Results

The success of Arvin's efforts to drive organizational change through the use of an organizational philosophy approach rested on its ability to develop, communicate, and live by the core values and purposes it established for itself. The ultimate test would be if it was indeed successful at building a company that lasted. The first page of the company's five-year strategic plan document for the next planning horizon was dedicated to a statement of its vision and core ideology, and drafts of an organizational wide implementation strategy were under review. Hunt had been CEO for just over a year, and all company focus was on becoming a company "built to last."

MORE CHANGE IN STORE

A Chance Meeting

In the fall of 1999, informal conversations took place at a trade association meeting between Hunt and Larry Yost, CEO of Meritor, a somewhat larger original equipment components manufacturing supplier to the heavy-vehicle industry. The topic of the day was the global consolidation trend in their industry, which was putting pressure on the supply base to do the same. The original equipment manufacturers were reducing their number of suppliers as they moved from the purchase of parts to the purchase of systems. Tier one and tier two suppliers were being forced to grow through partnering arrangements and acquisitions or mergers, or risk elimination as a supplier to the industry. Both CEOs had been actively looking for opportunities to scale their firms, but they were frustrated with their inability to find suitable partners with whom they might make an arrangement.

As fortune would have it, the topic of the Smock article concerning *Built to Last* entered the conversation. To their mutual surprise, both were in the process of using the same organizational culture change methodology to ensure that the companies they led would be enduring and successful. While Arvin had used the process discussed in this case, Meritor had actually retained Collins and Porras to serve as consultants to provide training and workshops for senior management. As the two CEOs discussed their readings and understandings of the materials, the seeds were sown for a merger.

A Merger of Equals

Soon, more formal discussions took place regarding the possibility of merging the two organizations that, on the surface, seemed culturally in sync. Early on as the process

became more substantive, they arrived at two critical understandings: First, the consolidation would be considered a merger of equals with no partner having a dominant position; Second, *Built to Last* would be the bible that would be used to guide the merger. All communication externally and internally was keyed on this concept of a merger of equals. Although there had been previous attempts by large-scale corporations to affect this type of arrangement, and although these were subsequently acknowledged as failures in terms of this concept of equals (e.g. Daimler-Chrysler, Alcatel-Lucent, Chase-Citibank), the CEOs were consistent in their message that this merger would be successful in preserving the essence of both partners' core values and purposes. They proclaimed that the organizational culture change approach from *Built to Last* would ensure that this merger would truly be one of equals. The result, they assured, would be a company that would last. By 2000, the merger was complete and the two companies became one.

AFTERWORD

Over the following eight years, the Midwestern city where Arvin's world headquarters once stood watched on. As part of the merger, all of the executive staff members of the company were compensated to accept early retirement, with the exception of Hunt, who would become the President-COO of newly formed larger company. Within 18 months, Hunt had left. After three years, the merged company closed one nearby plant and sold another. Over the following two years, two more plants were sold. In 2005, emotions in the community ran high as the building that served as the company's headquarters was sold. Two more sections of the company were subsequently sold in 2007 and by 2008 only one piece of the original company remained in this "merger of equals." Then the final axe fell, and on May 15, 2008, a story by Boris Ladwig ran in *The Republic*, the Columbus, Indiana newspaper, declaring that the merger was being dissolved:

> "Auto parts supplier to become 2 entities within year's time"
> DETROIT — ArvinMeritor is unmerging.
>
> The Troy, Mich.-based auto parts supplier, formed in 2000 by the combining Columbus-based Arvin Inc. and Troy-based Meritor Automotive Inc., will split.
>
> ArvinMeritor will retain its commercial vehicle systems business, but will spin off its Light Vehicle Systems to shareholders as a new company called Arvin Innovations. The company expects to complete the division within a year, depending on regulatory approvals.
>
> ArvinMeritor Chief Executive Officer Chip McClure said the changes in global markets and within the company prompted the divorce.
>
> In 2000, the companies were merged partially to apply Arvin's emissions expertise to Meritor's heavy-duty truck parts and to sell products to each other's customers.

Some industry analysts had their doubts about the merger's wisdom, saying the merger would create challenges and that a light- and a heavy-vehicle supplier would struggle to sell to each other's customers.

In 2000, Arvin Inc. Chairman, President and CEO Bill Hunt said Arvin could not survive without the merger.

He said as late as 2006, after he had left the company, that without the merger, Arvin might have faced bankruptcy.

Since the merger, however, the company has undergone significant restructuring. Many plants, including five sites in Columbus and one in Franklin, were sold or closed.

Local officials early last year said the merger worked neither for the companies, nor for the Columbus community.

The division is "a sad chapter in a book that never should have been written," said Brooke E. Tuttle, who was president of Columbus Economic Development Board at the time of the merger.

What looked like a win-win proposition at the time resulted in a loss for Arvin, a loss for the employees and a loss for the community, he said.

Although most local plants still are operating, albeit under different owners, the city lost company leaders and a world headquarters.

"That is a large impact," Tuttle said.

The company announced last year it would close 13 plants in North America and Europe and cut 2,800 jobs globally as part of a restructuring plan expected to cost $325 million. So far, McClure said, the company has identified seven of the plants.

Different situation

McClure told investors in a May 6 conference call that the merger made sense in 2000 — but not anymore.

In 2000, Meritor depended heavily on the North American heavy-duty truck market, and Arvin's fortunes were aligned closely with the Big 3, so both companies were looking for a partner that would protect them from their business' cyclicality.

"That made a lot of sense at the time," McClure said.

Today, however, both businesses have expanded their customer base and removed their dependence on their traditional markets.

"At the end of the day … if I fast forward to today, I think the big difference is the market conditions have changed, but more importantly ArvinMeritor has changed," McClure said.

ArvinMeritor shares rose 5 percent on the day the company announced the split.

Analysts Lehman Brothers wrote, "Although its timing came as a surprise, we believe the proposed transaction makes sound strategic sense, as we have long argued that there were few synergies between the light vehicle and heavy vehicle business."

And analyst Bear Stearns wrote that "the businesses appear to be divisible.

"There's little overlap in the end-markets, distribution and R&D … Perhaps the only synergies lost might be the combined entity's steel buy (less of an advantage today in a global market,)" Bear Stearns wrote.

ArvinMeritor shareholders will own all of the common stock of Arvin Innovation, the company said.

When the companies merged, ArvinMeritor's shares sold for $14. Since then, they've fluctuated between about $8 and $28, staying below $20 for most of the eight years. Wednesday, shares closed at $16.42, down 2.52 percent.

ENDNOTES

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Teaching Case

Journal of Applied Case Research
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Setting a Course for Tissue Repair: Mesynthes

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This case was prepared as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The authors would like to gratefully acknowledge Editor Steven Maranville and the anonymous reviewers for their excellent guidance and encouragement. All views and errors are ours.

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Setting a Course for Tissue Repair: Mesynthes

ABSTRACT

Mesynthes is a New Zealand-based tissue regeneration company that uses a novel technology platform for developing a wide range of medical devices, but is initially focused on applications in wound healing and soft tissue reinforcement. The market for bioengineering scaffolds was in an early stage of development, but already the worldwide market for skin substitutes and regenerative matrices was forecasted to grow at over 30% annually to $180 million by 2009. This case considers decisions faced by a medical device start-up as the company builds its product pipeline, considers commercialization channels from a small country context, and obtains venture capital to accelerate growth. The specific decision facing the CEO of Mesynthes is whether to initially develop products locally then expand across borders into larger markets or immediately establish operations in larger international markets in the first instance.

INTRODUCTION

It was mid-2008, and as he sat on the Dominion Post ferry traveling from Eastbourne across Wellington Harbour to a Board meeting, Dr. Brian Ward, founder and CEO of Mesynthes' thoughts wandered: "We've progressed a long way. We've developed our product proof of principle, secured our IP [intellectual property] position, completed a seed round of financing, and built the nucleus of a terrific team." The ferryboat bounced off the choppy waters and Ward smiled to himself—the windswept sea reminded him of the ups and downs of high-tech entrepreneurship. As he approached his destination, Ward's thoughts centered on the key decision facing Mesynthes—should they build the company locally first, then cross the border into larger markets or bypass the local market and immediately launch in the US? Specifically, should Mesynthes file for IP (intellectual property) protection in New Zealand first, or should they file first in their largest potential market (namely, the United States); similarly, should Mesynthes go for product approval locally or launch into the United States with a US FDA approval? Each path offered widely varying degrees of opportunities, costs, and risk.

WOUND HEALING: A MARKET IN TRANSITION

Many of the "best practices" in wound healing date back to ancient times. More than 4,000 years ago, physicians in Ancient Egypt and Greece developed numerous procedures that remain the mainstay of wound healing. Referred to as the theory of "three healing gestures," the approach relied on cleansing the wound, applying a dressing to prevent infection, and bandaging the wound or removing pressure to prevent re-injury.[*] The Papyrus of Ebers circa 1,500 B.C. detailed the use of lint, animal grease and honey

[*] The primary goal of wound healing is to achieve rapid healing with optimal functional and aesthetic results. Ideally, wound healing should be achieved through preventing infection and further trauma, as well as maintaining a moist environment to prevent cellular dehydration and stimulate collagen synthesis (i.e., covering the wound with a topical antimicrobial). The choice of dressing depends on wound cause, size, depth, location, degree of exudation, and level of contamination (see figure 1).

as topical treatments for wounds. In this case, lint provided a fibrous base to promote wound site closure, animal grease provided a barrier to environmental pathogens, and honey served as an antibiotic agent.[1,2]

In the 19th Century, infection control, war, and industrialization brought several breakthroughs in wound healing. Examples include: Hungarian obstetrician Ignas Philipp Semmelweis developed sterile surgical procedures; Louis Pasteur' developed the germ theory of disease; Joseph Lister began treating surgical gauze with carbolic acid (phenol) and consequently decreased the observed surgical mortality rate by 45%; Alexander Fleming used penicillin to treat infections; and Robert Wood Johnson began the production of gauze and wound dressings treated with iodine.

Despite these improvements and a large of number of clinical trials, until the late 20th century, there were relatively few significant advances in terms of patient outcomes versus traditional products.[3] However, the emergence of combination medical device therapies and biologic growth factors significantly changed the industry landscape. Specifically, three new technologies became prominent during the 1980s and 1990—new generation antimicrobials to fight infection, extracellular matrices (ECM) to promote tissue regeneration, and negative pressure wound therapy (NPWT) to enhance healing time.[4,5,6]

Modern demands from demographics changes, epidemiology, and technology advancements increased the importance and value of these new wound healing approaches. In addition to an aging population, which is associated with chronic wounds in developed countries, a growing epidemic of obesity linked to diabetes has been associated with foot ulcers, amputations and chronic wounds. In addition, in 2005 there were over 100 million surgical incisions and 1.4 million trauma wounds requiring advanced care annually in the US alone.[7] Further, of the more than 1.0 million burn injuries recorded each year, approximately 50,000 need hospitalization, 25,000 experience severe burns, and 4,500 burn patients do not survive. Once infected, treatment costs for one surgical infection can quickly reach more than $15,000, while MRSA (methicillin-resistant Staphylococcus aureus) infections can cost over $30,000 to treat effectively.[8]

Traditionally, large wounds such as third degree burns are treated with autografts (using the person's own skin from other unaffected parts of the body). However, autografting causes donor site wounds (e.g., the average patient requires four donor site wounds to treat a severe burn) and can result in wound contraction, scar formation, limit joint mobility, and poor aesthetic quality. Thus, a need was identified for efficacious products that cause less dysfunction and scar formation.[9] Extracellular matrix (ECM) products, such as the one provided by Mesynthes, began to be explored and employed as alternatives.[†]

[†] ECM (extracellular matrices) are sheets made from naturally derived biomaterials obtained from either human cadaver or animals such as ovine, porcine, and bovine. The role of ECMs is to function as "substitute skin" and promote tissue repair that is characterized by increased cell proliferation, capillary budding, and synthesis—all of which promotes the rate of wound healing and restores function.

In addition to burns, other large markets in 2008 were diabetic ulcer wounds, venous stasis ulcer wounds, and pressure sore wounds. Firstly, approximately three percent of the 16 million diabetics in the US develop foot ulcers. Diabetic foot ulceration is a common cause of amputation and can become fatal. However, traditional wound treatment methods are not satisfactory, with 30 percent of wounds failing to heal and 15 percent recurring even after healing. Secondly, venous ulcers are a direct cause of varicose veins and chronic venous insufficiency that can develop into venous ulcers of the leg. Approximately 500,000 venous ulcer patients are typically treated with compression therapy (gradual application of pressure using special bandages from heel to knee). Thirdly, pressure ulcers result from direct pressure on the skin or from shearing forces and friction (although other factors may predispose an individual's risk). As at 2008, there are an estimated 2.3 million pressure ulcer patients in the US, with the risk of occurrence increasing with age. Mesynthes' initial products are aimed at these "chronic" wounds and severe burns.

Phases of Wound Healing

The severity of the wound and rate of healing indicates increasing levels of treatment to include traditional wound care for minor wounds; to advanced wound care for more severe cuts and burns which require prolonged care with moisture and antimicrobials[‡] to ensure healing and infection control; to active care for serious injuries and chronic wounds such as diabetic foot ulcers which may require advanced techniques such as negative pressure wound therapy (NPWT) (Figure 1). ECM products such as Mesynthes' would typically be used in active wound care or phase 3.

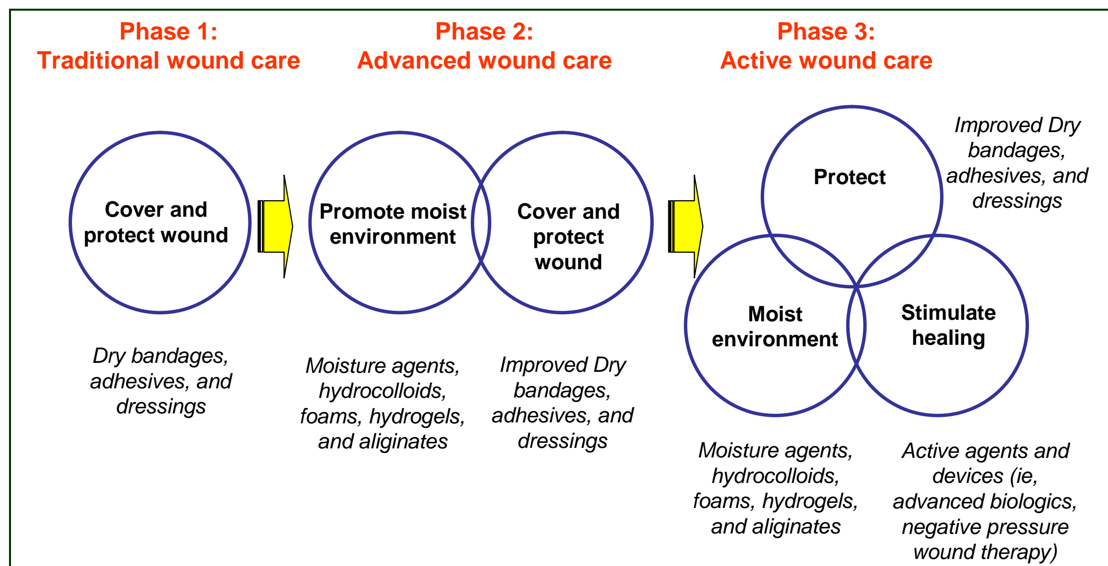

Figure 1: Phases of Wound Care[10]

[‡] Antimicrobials are drugs such as antibiotics and antivirals that either kill or slow the growth of microbes that cause infections. New generations of antimicrobials have emerged dominated by silver-based dressings, which may be used as an alternative to antibiotics and the challenge of resistance from repeated drug exposure.

With the use of recombinant biotechnology to manipulate the actions of growth factors and cytokines,[§] it may be possible to accelerate or modify wound healing. Animal experiments and clinical experience have demonstrated that the topical administration of various cytokines, either alone or in combination, considerably accelerates wound healing by stimulating tissue formation and skin re-growth. Some of these factors have even allowed a complete healing of wounds that were previously refractory to conventional treatment. One example is Regranex® (becaplermin) gel, a prescription drug for the treatment of diabetic foot ulcers. It contains a healing growth factor normally found in the body and part of the body's natural healing process. When used as an adjunct to good ulcer care practices, Regranex increases the incidence of complete healing of diabetic foot ulcers.[11] Johnson & Johnson conducted four separate randomized clinical trials with over 900 patients to demonstrate the safety and efficacy of Regenerex, which achieved sales of approximately US$80 million in 2007.[12]

Wound Healing Market

The worldwide wound care market was $4.7 billion in 2007, with the largest market in the US at $2.5 billion with a growth rate of 10%. Due to low barriers to entry in traditional products, the wound care market has been highly fractionated since the 1940s. Consequently, the majority of wound healing companies have traditionally had low-to-moderate pricing power since most products have not conducted randomized clinical trials demonstrating clear efficacy advantages. [13,14,15]

However, premium products have began to emerge to meet the demands required by the US FDA (Food and Drug Administration) to show efficacy in treating difficult indications such as diabetic ulcers and severe burns. Due to the ability of clinical advances to meet unmet medical needs in the wound healing market, advanced technology segments grew faster (>10-15%) compared to traditional market segments (-2%) (Figure 2). With regards to advanced techniques, the breakthrough convergence was achieved by Kinetic Concepts, Inc. (KCI), which integrated all three of the second stage technologies—NPWT, ECMs, antimicrobials—resulting in a single combined product with over $1 billion in annual revenues with over 80% market share. KCI remained in 2008 the only firm to have been able to combine these three separate, preexisting key innovations into a breakthrough product system in terms of patient value and a dominant market leadership position.[16,17,**]

[§] All phases of wound healing are either directly or indirectly controlled by cytokines (small proteins released by cells that have a specific effect on the interactions between cells, on communications between cells or on the behavior of cells).

[**] Kinetic Concepts, Inc. (KCI) was established in 1976 in San Antonio, Texas, KCI has four areas of focus: (1) Advanced wound healing and tissue repair; (2) Pulmonary complications in ICU (intensive care unit); (3) Bariatric care; and (4) Wound treatment and prevention. KCI's most successful product is a negative pressure wound therapy (NPWT) device system called VAC which produced revenues of $1.3 billion, representing 79% of total sales. KCI is the leader in the NPWT sector, but there are several emerging competitors including Smith & Nephew (which purchased Bluesky Medical Group in 2006); Medela, Talley Group, Boehringer and Engenex. From initial approval in 1995 of the device plus three disposables, VAC has now grown into a multi-product technology platform. Currently, VAC has over 175

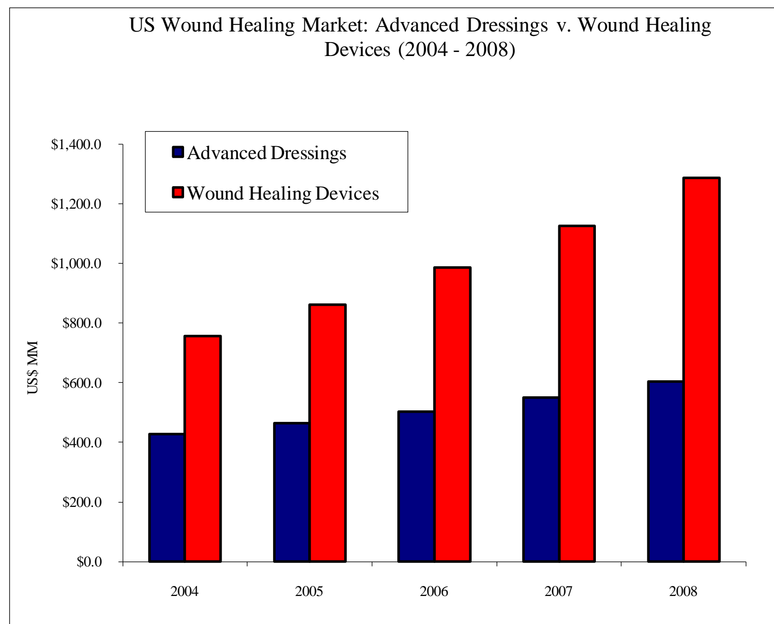

Figure 2: US Wound Healing Market:
Advanced Dressings v. Wound Healing Devices[18]

Tissue repair and reconstruction markets

By 2007, the soft tissue reconstruction segments where ECMs are used represented attractive targets for tissue repair scaffolds, with premium pricing ($500-1,500 per application) compared to devices ($25-50 per application) (Figure 3). For example, Lifecell's (a biotechnology company recently brought by KCI in 2008 as noted above) AlloDerm product was increasingly employed as a viable alternative to synthetic skin for abdominal wall repair cases in which recurrence, infection, dehiscence and adhesion formation make the surgeon's job especially difficult. AlloDerm was also being used successfully in infected mesh removal and traumatic fascia loss, contaminated surgical fields, patients with compromised healing, and reinforcement for hernia repair.

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issued (90 pending) patents; and over 450 scientific publications. This technology is marketed by a worldwide sales force of 2,000 (out of 6,400 total KCI employees). VAC customer channels include over 9,000 acute care hospitals; over 9,200 extended care facilities; and over 10,500 home healthcare agencies. In the US, KCI manages over 375 managed care contracts through its largest distributor Novation (representing $195 million in sales).

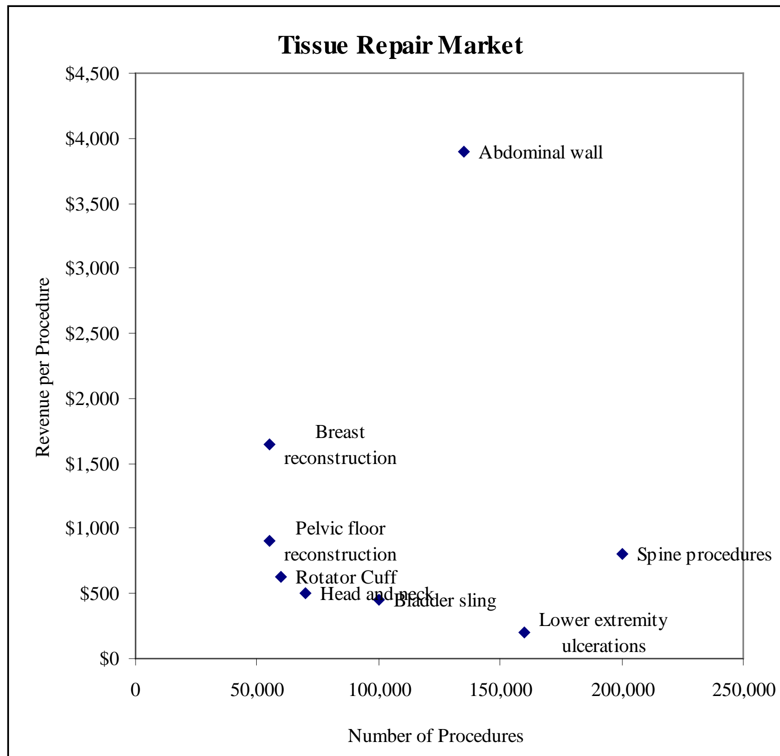

Figure 3: Estimated Market Size and Potential Revenue.
Sources: Corner (2007)[19]; Frost & Sullivan (2007)[20]

MESYNTHES ENTERS THE DYNAMIC TISSUE REPAIR MARKET

Mesynthes, a New Zealand-based tissue regeneration company, used a novel extracellular matrix (ECM) scaffold to develop medical devices for soft tissue repair and reconstruction. This technology provided a platform for developing a wide range of medical devices (Figure 3), but the company's initial focus was on applications in wound healing and soft tissue reinforcement. As of 2008, the markets for bioengineering scaffolds were in an early stage of development, but the worldwide market for skin substitutes and regenerative matrices was forecasted to grow at over 30% annually to $180 million by 2009.

Mesynthes was founded in 2007 by Dr. Brian Ward who serves as the Chief Executive Officer and Director. Brian is a trained veterinarian who has held clinical and senior corporate roles in life sciences and health care companies over the last 20 years. He is a graduate from Massey University with a Bachelors degree in Veterinary Science, a Member of the Royal College of Veterinary Surgeons (UK), and holds a Masters degree in Business Administration. His experience spans across clinical, technical, sales, marketing, business development, corporate development and strategic roles having worked for a number of multinationals including Baxter, Beecham and SmithKline Beecham throughout the world. He has also managed investments into New Zealand technology companies when he oversaw the economic investments team for the

Foundation for Research, Science and Technology (FRST), and was the founding CEO of industry trade group, NZBio.

Mesynthes's pipeline is being developed from a proprietary scaffold derived from a unique form of extracellular matrix that has been shown to elicit a strong regenerative response to aid prompt and complete healing of wounds. Mesynthes has undertaken the majority of its research and development activity within the Wellington region. Collaborations were established with Otago University's Wellington School of Medicine's Biological Investigation Group, Industrial Research Limited (IRL), and National Institute of Water & Atmospheric Research (NIWA) to develop and license a complementary marine-based biomaterial.[††,21]

Mesynthes was founded with seed capital from three sources of New Zealand venture capital: Movac, Sparkbox and the New Zealand Venture Capital Fund. A venture capital fund partner from Movac became chairman and a director of its board.

Technology and Products

The competitive advantage of Mesynthes' technology platform lies in its inherent bioactive composition, strength and format, as well as the opportunity to develop a range of specialty medical devices. Mesynthes' products will require regulatory approval as a device which is comparatively faster and far less costly versus drug development cycle times.

Mesynthes identified two advantages associated with its technology that define its business opportunity. First, their proprietary technology was one of only a few scaffolds available that has the necessary architecture and biological composition to promote constructive tissue regeneration rather than scarring or encapsulation. Second, the Mesynthes scaffold was superior because of its unique bimodal architecture, strength, large surface area, handling characteristics, and favorable biochemical composition. These features make the material ideal for a number of fast growing categories within the tissue regeneration market for which surgeons and distributors are demanding new products (Figure 3).

[††] Two-thirds of scientific publications and patents in NZ originate from publicly funded research form universities and Crown Research Institutes. The New Zealand government has mobilized across national and regional agencies, as well as academia and research institutes, to accelerate Intellectual Property (IP) driven growth. The seminal report entitled *Growing an Innovative New Zealand* (Clark, 1999) articulated the government's aim of 'building an economy that was both inclusive and innovative' and provided a framework for achieving economic goals known as the Growth and Innovation Framework (GIF). GIF provided a framework that directed investment priorities including: (1) Developing, attracting and retaining people with exceptional skills and talent; (2) Increasing global connectedness to overcome the tyranny of distance; and (3) Focusing innovation initiatives in areas which can have maximum impact, particularly biotechnology, information and communication technologies (ICT), and the creative industries such as design and film production.

As of 2008, Mesynthes is developing two products: a wound dressing (a sterile sheet of ECM) and a surgical mesh (a sterile device formed from laminated and fenestrated sheets of ECM). Potential product features and patient benefits are outlined in Appendix B.

Mesynthes is targeting markets segments for "active wound dressings" and tissue reinforcement products. Their initial focus is wound care where there is a shift from traditional wound management to advanced products which improve efficacy, reduce the total costs of management, and result in a better cosmetic outcome. The advanced wound care market is segmented into moist wound dressings, antimicrobial dressings, and active wound dressings. Mesynthes is part of the active wound dressing segment, a market that exists because pressure ulcers, diabetic foot ulcers, venous stasis ulcers, severe burns and severe traumatic wounds can be very difficult conditions to treat. For example, 72 percent of diabetic ulcers and amputations in the US were treated with advanced wound care, while only 10 percent of trauma and surgery wounds are similarly treated.[4]

However, in their path to profit, Mesynthes needs to carefully plan a strategy to differentiate its ECM platform relative to the more than a dozen competitors offering different approaches and biomaterials in the same "space" as Mesynthes (Table 1), and the multi-billion dollar multinational corporations who dominate the wound healing sector more broadly.

Company	Revenues	Market Share	Growth %
LifeCell (KCI)	$140.6	13%	51%
OsteoTech	$98.6	9%	7%
Regeneration Technologies	$70.2	6%	-3%
Wright Medical Group	$65.5	6%	5%
Kensey Nash	$44.2	4%	24%
Tutagen	$42.3	4%	33%
IsoTis	$40.7	4%	14%
Cryolife	$40.1	4%	32%
Exactech	$13.3	1%	17%
Other	$567.2	51%	-2%
Total	$1,122.7	100%	8%

Table 1: Leading ECM (Extracellular Matrix) Tissue Repair Companies[22]

In addition, Mesynthes was considering bypassing its own local markets in NZ and Australia, and instead focus its limited resources in terms of patent filings, regulatory approvals, and commercialization in the US—which represented the world's largest market for ECMs. The immediate focus on the US would expand the commercial potential for Mesynthes, but also significantly increase costs and risks for the New Zealand-based firm.

SETTING A COURSE FOR MESYNTHES

Brian put the medical devices analyst report on ECM competitor activity he was reviewing away in his brief case. As he entered into the offices of one of Mesynthes' venture capital investors in Wellington, he met his Chief Scientific Officer, Barney May at the elevator. "While we have a few minutes, let's review the agenda for our upcoming meeting with the Board," suggested Brian.

"The key issues I think we should discuss with the Board are around our regulatory and patenting timeline and approach. Some in the board are advocating for a US FDA application and IP (intellectual property) protection in the first instance, rather than using local avenues in NZ and Australia."[‡‡]

"This question is linked to the issue of what kind of company we want to be, how much risk do we want to bear, and how much money can we raise? In short, we need to sort out our strategy for scaling our products into larger markets. What's our end goal – to be the next LifeCell and get purchased by a large multinational?[§§] If we want to enter the US market, the New Zealand venture capital market can only get us so far before we really need to access larger pools of international capital" (see Appendix C).

"And this is all about increasing out international visibility with potential alliance partners – can we do that from New Zealand? Going through local avenues does not provide critical relationship links with investors, clinical investigators, and multinational pharmaceutical companies in larger international markets. I was just reading a Harvard Business Review article outlining how companies today are born global and was intrigued by the ability of small companies like ours to effectively coordinate supply chains and distribution channels across borders."[23]

Brian remarked, "When you're in the lab, sometimes you think that all the hard parts are done, but the complexity and trade-offs for building and capturing value globally for Mesynthes is anything but clear. Everybody on the Board wants to build a valuable company, but we all seem to have a slightly different view on how to get there: do we build and strengthen the company through local avenues first or "launch" globally from the start, even at this early stage?"

[‡‡] The US FDA approves ECMs as a medical device under a 510(k) application which requires that the proposed device is "substantially equivalent" in intended use and technological characteristics to a legally marketed Class I or Class II medical device or to a Class III device on the market since May 28, 1976, for which PMA approval has not been required. Selection of predicate device must be used for the same clinical applications and high degree of similarity in operation. Target application review is 90 days—typically takes 4-12 months (US FDA, 2009).

[§§] In 2008, KCI acquired tissue engineering company LifeCell for $51 per share, or about $1.7 billion (or eight times sales suggesting continued high growth expectations). LifeCell's lead product is AlloDerm, an acellular human tissue matrix used for third-degree burns, periodontal surgery, and plastic and reconstructive surgery. The attraction of the acquisition for KCI is integrating Alloderm into the VAC device and anti-microbial silver pad to offer customers a full wound care solution.

APPENDIX A: LEADING WOUND HEALING COMPANIES

Below is a list of the key wound healing competitors for Mesynthes. This shows the large multinational size budgets that can be utilized in either competing with Mesynthes' technology or supporting it through alliances (e.g., the KCI/LifeCell case).

Company	Symbol	Exchange	Market Capitalization (US$ billions)	Share Price Sep 2007	Share Price Sep 2008	Share Price change %	2007 Revenues (US$ billions)	Income (US$ billions)
J&J/Ethicon	JNJ	NYSE	$196.82	$61.79	$70.43	14%	$61.10	$10.58
3M/3M Wound Care	MMM	NYSE	$50.05	$90.99	$71.60	-21%	$24.46	$4.10
Baxter International Inc	BAX	NYSE	$42.53	$54.76	$67.76	24%	$11.26	$1.71
Bristol-Myers Squibb/ConvaTec	BMY	NYSE	$42.25	$29.15	$21.34	-27%	$19.35	$2.17
Genzyme	GENZ	Nasdaq	$21.45	$63.07	$79.85	27%	$3,813.52	$480.19
Kendall Healthcare/Tyco Int	TYC	NYSE	$20.63	$44.16	$42.88	-3%	$18.78	-$1.74
Tyco/Kendall	TYC	NYSE	$19.41	$43.69	$40.88	-6%	$18.78	-$1.74
Nucryst Pharmaceuticals Corp	NCST	Nasdaq	$15.44	$2.98	$0.84	-72%	$30.09	-$4.02
Smith & Nephew/ BlueSky Medical	SNN	NYSE	$10.63	$58.89	$60.08	2%	$3.37	$103.00
Smith & Nephew	SNN	NYSE	$10.63	$58.89	$60.08	2%	$3.37	$103.00
CR Bard	BCR	NYSE	$9.45	$84.11	$95.11	13%	$2.20	$0.41
Protein Polymer Technologies Inc	PPTI	OTC	$5.90	$0.15	$0.06	-62%	$0.29	-$3.25
Mylan Inc/UDL Laboratories	MYL	NYSE	$3.56	$15.29	$11.55	-24%	$2.18	-$1.14
Kinetic Concepts/Lifecell Corp	KCI	NYSE	$2.55	$60.11	$35.16	-42%	$1.61	$0.24
Integra LifeSciences Corp	IART	Nasdaq	$1.33	$48.57	$48.49	0%	$0.55	$0.03
Wright Medical Group Inc	WMGI	Nasdaq	$1.22	$27.40	$32.38	18%	$0.39	$0.00
CryoLife Inc	CRY	NYSE	$0.45	$8.93	$15.78	77%	$97.46	$7.20
Advanced Medical Solutions	AMS	LON	$0.42	$23.00	$29.50	28%	$0.31	$0.034
Synovis Life Technologies Inc	SYNO	Nasdaq	$0.25	$20.55	$19.75	-4%	$0.07	$0.00
Iflow/AcryMed	IFLOW	Nasdaq	$0.25	$17.65	$9.96	-44%	$0.12	$0.04
Nutraceutical Int Co./Monarch Labs	NUTR	Nasdaq	$0.13	$15.16	$12.14	-20%	$0.16	$0.01
Biospecifics Technologies Corp.	BSTC	OTC	$0.12	$13.00	$20.50	58%	$1.51	-$4.54
Osteotech Inc	OSTE	Nasdaq	$0.09	$7.40	$5.11	-31%	$0.10	$0.00
Uluru Inc	ULU	AMEX	$0.08	$4.60	$1.24	-73%	$0.00	$0.00
Comvita Ltd	CVT	NZSX	$0.07	$4.13	$2.38	-42%	$0.07	$0.00
Derma Sciences Inc	DSCI	OTC	$0.03	$0.78	$0.65	-17%	$0.034	-$0.003
Cytomedix, Inc	GTF	AMEX	$0.02	$1.10	$0.75	-32%	$0.002	-$0.050
Ivivi Technologies	IVVI	Nasdaq	$0.01	$5.00	$0.71	-86%	$0.00	-$0.01
Average	-----	-----	$16.28	-----	-----	-12%	$146.83	$24.86
Median	-----	-----	$1.94	-----	-----	-12%	$1.56	$0.01
Maximum	-----	-----	$196.82	-----	-----	77%	$3,813.52	$480.19
Minimum	-----	-----	$0.01	-----	-----	-86%	$0.00	-$4.54
Std Dev	-----	-----	$38.15	-----	-----	38%	$718.93	$93.24
Nasdaq Biotech Index				$80.48	$85.90	7%		
Nasdaq Index				$2,630.00	$2,367.00	-10%		

APPENDIX B: MESYNTHES' PRODUCT DETAILS
(Source: Company reports)

1. Wound Dressing Product is a sterile sheet of ECM.

Features	Benefits
Natural architecture	Provides a scaffold-like three-dimensional structure to attract host cells and supports constructive tissue remodelling.
High growth factor, GAG and collagen III content	Encourages early cell migration, differentiation and constructive remodelling with minimal scarring
Presence of the Lamina propria surface	Promotes epithelialisation
Thicker matrix	Easier handling and greater persistence
Larger surface area	Can easily produce dressings for large skin deficits

2. Surgical Mesh Product is a sterile device formed from laminated and fenestrated sheets of ECM.

Features	Benefits
Thickness & Density	Tensile strength, suture holding and persistence
Larger surface area	Ideal for large format surgical devices
Natural architecture	Provides a scaffold-like three-dimensional structure to attract host cells and supports constructive tissue remodelling.
Papilla	Keys under pressure for improved lamination

APPENDIX C: RAISING PRIVATE EQUITY—ANGEL INVESTORS & VENTURE CAPITAL

Angel investors are typically wealthy individuals, often with an industry-specific background, which puts them in a position to judge high-risk investments. Angels usually make small investments (<$ 1 million) in very early-stage companies with a few employees (<5) through to proof-of-principle or demonstration which will enable a syndicated venture capital financing.

Venture capital is a form of private equity fund (typically a limited partnership) of pooled wealthy individual and institutional investors. Managed by a venture capitalist (VC), the funds provide cash to high risk, early stage companies in exchange for equity shares seeking commensurate returns. VCs often add managerial experience, technical expertise, and governance to firms. The venture capital market is increasingly globally, both in terms of sources and targets of investment.

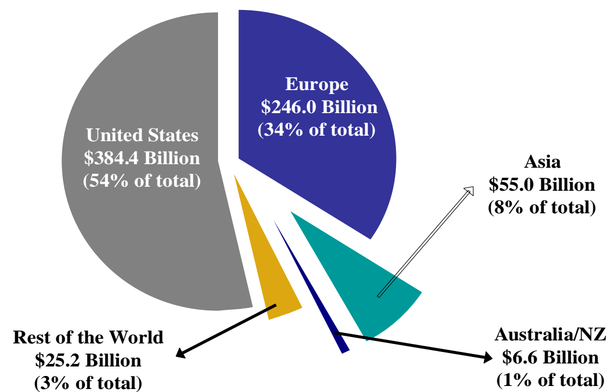

Figure 4: Global Venture Capital. Source: AVCJ[24]

Following the global market, the New Zealand venture capital and private equity market continues rapid growth as it attracts an increasingly broad investor base.

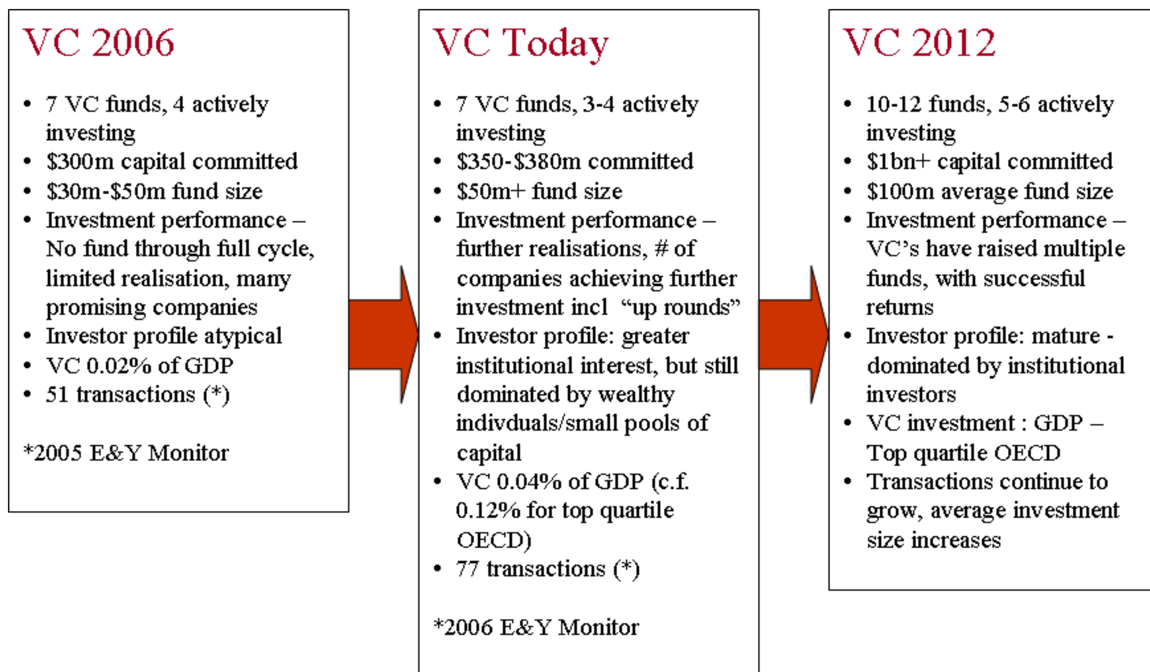

Figure 5: Venture capital funds. Source: NZVCA

The New Zealand VC market grew from NZ$88 million in 2003 to NZ$1,210 million in 2006 or a growth rate of 1,275%.[25]

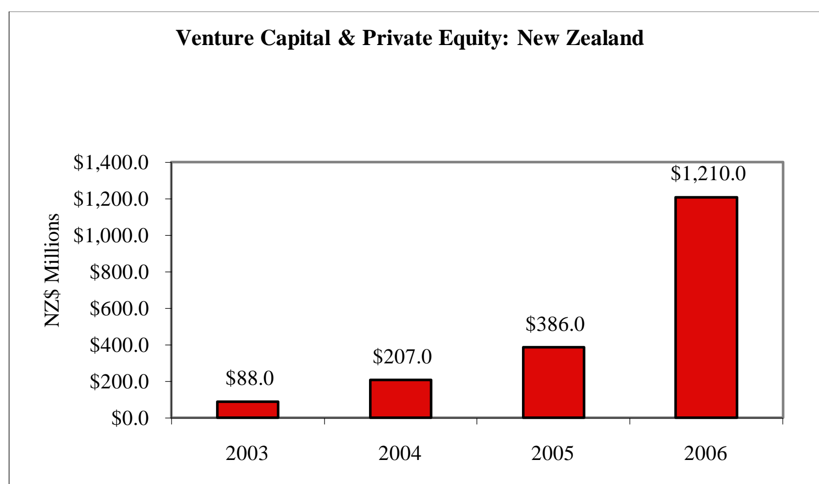

Figure 6: Venture Capital & Private Equity in NZ. Source: NZVCA

By the mid-2000s, the early-stage financing environment has entered a period of dramatic realignment due to the entry of private equity hedge funds into earlier rounds of funding for private and small publicly traded companies. Further, there is a marked trend towards exit via trade sale or mergers and acquisition versus IPOs (Initial Public Offering).

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Teaching Case

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Hewlett Packard: Rethinking the Rethinking of HP

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Hewlett Packard: Rethinking the Rethinking of HP

On a rainy evening in early February 2005, Hewlett-Packard's (HP) board of directors held an emergency meeting at the Hyatt Regency O'Hare hotel in metropolitan Chicago to consider the fate of HP's President, CEO and Chairman of the Board, Carly Fiorina. In the months preceding the meeting, HP's board had become increasingly concerned that Fiorina was failing to effectively execute her strategy following HP's merger with Compaq Computer Corporation.[1] An HP insider assessed the mood of the board: "Things needed to make us more competitive in certain segments weren't being done."[2]

HP had failed to meet Wall Street expectations in two of the preceding five quarters. The board was dissatisfied, and Fiorina's relationship with the board had grown contentious. Three weeks before the board meeting, Fiorina met with three members of the board of directors at HP's headquarters in Palo Alto, California. At the meeting, the directors demanded that Fiorina delegate some of her control to others.[3] Fiorina described the elements of the board members' demands and her reaction:

> …they gave me a precise prescription for how to reorganize the company into two units, with a president heading each. They even gave me the names of the presidents…And they said the Board needed more ongoing communications with the CEO…
>
> I assumed that this meeting was a discussion. I did not believe this group could, or should, give me orders on how to execute and produce results. They became obviously offended when I did not immediately embrace these ideas. [4]

The board was concerned that Fiorina's growing celebrity (some members of the media called Fiorina a "rock star") was a liability. They felt that Fiorina was spending too much time traveling and not enough time managing. Perhaps most damning was the decline of Fiorina's popularity with the media. Only a few days before the meeting, an article appeared in *Fortune* magazine that vilified Fiorina for HP's poor performance.[5]

On the second day of the Chicago meeting, Fiorina met with the board. She was immediately surprised to learn that the board had met with an expert on corporate governance the night before without her. Patricia Dunn asked Fiorina to make a statement defending her position. After listening to her statement, the board asked Fiorina to leave the room. Three hours later, Fiorina was asked to return. When she entered, she discovered that all but two board members had left. Bob Knowling who had voted against her dismissal said, "The board has decided to make a change. I'm very sorry Carly." While Fiorina was not completely surprised by this outcome, her "hands shook from the shock" when she returned to her hotel room.[6] In a later interview with *Time* magazine, HP director Patricia Dunn summed up the feelings of the majority of the board: "Looking forward, we think the job is very reliant on hands-on execution, and we thought a new set of capabilities was called for."[7]

Two days after Fiorina's dismissal, HP issued the following press release:

HP Chairman and CEO Carly Fiorina Steps Down

> PALO ALTO, Calif., Feb. 9, 2005 — The board of directors of Hewlett-Packard Company today announced that Carleton S. Fiorina has stepped down as chairman and chief executive officer, effective immediately. Robert P. Wayman, HP's chief financial officer, has been named chief executive officer on an interim basis and appointed to the board of directors…"Carly Fiorina came to HP to revitalize and reinvigorate the company. She had a strategic vision and put in place a plan that has given HP the capabilities to compete and win. We thank Carly for her significant leadership over the past six years as we look forward to accelerating execution of the company's strategy," said Dunn, on behalf of the board.[8]

HP had become an icon of American business. Its name was synonymous with organizational and technological innovation that emanated from its corporate culture known as "the HP way." In the 1982 best selling classic, *In Search of Excellence*, HP was among the short list of "excellent" companies. The computer industry, though, experienced dynamic change during the 1980s and 1990s to which HP—as well as all other competitors—were compelled to adapt. Consequently, Fiorina's tenure was one of "rethinking the HP way." The acquisition of Compaq Computer Corporation reflected this rethinking.

The board now sought an individual with the ability to lead through strong execution who could return HP to sustained success. Inheriting HP's history for better or for worse, the new CEO would need to "rethink the rethinking of the HP way."[9]

Evolution of the Personal Computer Industry

In 1965, Gordon Moore predicted that the number of transistors placed on a microprocessor would double every two years, and the output of the microprocessor would double every 18 months.[10] This principle, which is known as Moore's law, implied that computer processing capacity would grow rapidly. The computer industry timeline in Figure 1 illustrates this fact. In 1981, an IBM PC's microprocessor had a clock speed of approximately 5 MHz. Twenty years later, Intel microprocessors were running at 2.8 GHz.

The ability to rapidly improve technology, as described by Moore's law, had a profound effect on the personal computer industry during its infancy. In 1981, International Business Machines (IBM) released the first personal computer (PC) based on the Microsoft operating system. In the 20 years following the introduction of the IBM PC, there was tremendous market growth as the PC went from being a business computer to a common household appliance.

But, unlike appliances, PCs were typically not replaced when they wore out. Instead, they were replaced when they became obsolete. Hardware obsolescence was driven by advances in software. In particular, Microsoft's frequent releases of new operating software with greater system requirements led users to discard their computers after only two or three years of use so they could purchase the latest offerings from Microsoft. Intel and Microsoft developed a very lucrative market synergy. Microsoft's new software would drive demand for new Intel processors while new Intel processors provided Microsoft with expanded capability, which allowed them to produce more processing-intensive software. This dynamic, which industry observers frequently referred to as Wintel, provided the computer hardware and software industries with tremendous market lift, which gave rise to the emergence of a multitude of hardware and software manufacturers.[11, 12]

Figure 1. Computer Industry Timeline[13]

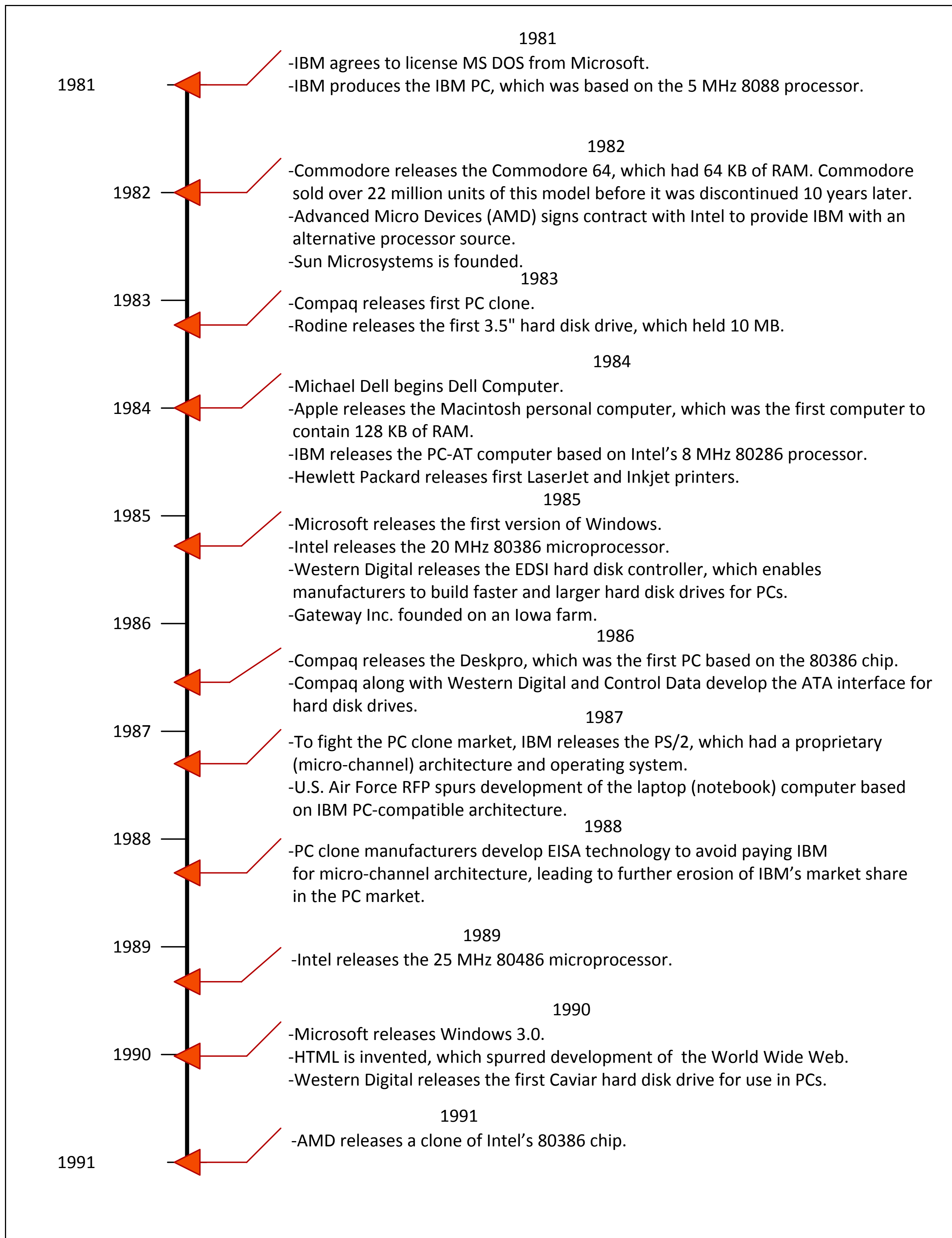
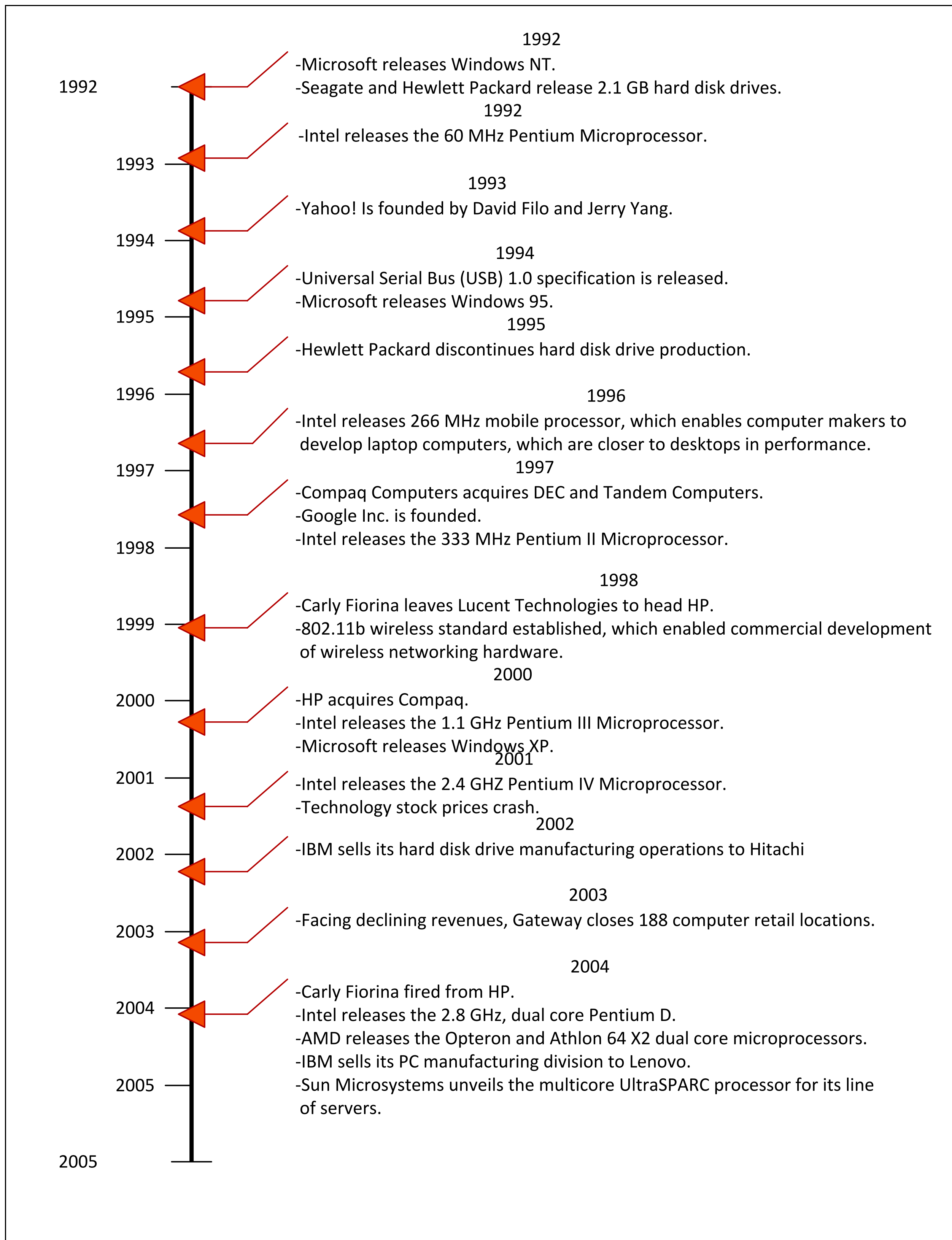


Figure 1. Computer Industry Timeline (continued)



Compaq Computer Inc. was one of the new hardware manufacturers that directly benefited from Wintel and their ability to replicate essential portions of the PC architecture. In 1983, Compaq released its first IBM PC clone. During the first year of sales of this product, Compaq earned $111 million.[14] Compaq had demonstrated that IBM's architecture could be replicated, and thus no longer proprietary, which allowed many electronics manufacturers to follow Compaq's lead. The replication of IBM's architecture led to rapid growth of the PC market, but also led to an erosion of IBM's market share. Further eroding IBM's market share was the introduction of a substitute to the PC. In 1984, Apple Computer released the first Macintosh, which was very popular in a portion of the personal computer market. Unlike the IBM PC, the Macintosh used a proprietary architecture and operating system, and, more importantly, it had the first graphical user interface.[15] Perhaps the fatal blow to IBM's supremacy in the PC market was delivered by Compaq in 1986, when Compaq released the Deskpro, which was the first PC to use Intel's fastest chip, the 80386.[16] IBM sought to recapture market share lost to PC clone manufacturers with their release of the PS/2. But, this system failed to generate sufficient enthusiasm in the market.[17] Following the release of the PS/2, Compaq and others developed the EISA architecture, which allowed PC clone manufacturers to compete with the PS/2.[18]

One of the characteristics of this era was the inability of firms to protect hardware technology and thereby retain market share. IBM was a good example. While firms continued to patent technology, other firms would quickly imitate the patented technology with one-off products or they would develop more efficient technology. Furthermore, given the high cost of computer equipment during this era, consumers tended to choose computers based on open technology—like the PC clone—rather than proprietary technology because it was less expensive. This was one of the reasons why the arguably superior Macintosh did not gain mass market appeal, and why firms like Dell and Compaq were forced to produce computers that were very similar in construction and capability.

While desktop PC technology had matured by the end of the 1990s, the notebook computer and server markets still provided manufacturers opportunities for differentiation and high margins.[19, 20] HP, Compaq, Dell, and IBM battled for supremacy in both markets while Sun Microsystems targeted Internet businesses with high end servers and Toshiba focused on the notebook market. While the server market continued to grow by the end of 2005, the maturation of notebook technology, declining market growth, and downward price pressure had eroded the profitability of the notebook segment[21].

The commodity nature of the desktop and notebook PCs, the emergence of the Internet, and the fact that computer processing and storage power had outpaced software development at Microsoft led to an increasingly competitive environment in the PC hardware business. Competition from Asian firms producing an increasingly mature product further eroded margins of U.S. manufacturers. This pressure led many computer hardware manufacturing firms to consolidate. In 2001, HP and Compaq merged. Gateway computer closed 188 retail outlets in 2004 as a cost cutting move, which followed their purchase of eMachines, a low cost producer of desktop PCs.[22] While PC manufacturers like Gateway and HP sought ways to cut costs, IBM opted to leave the PC manufacturing industry entirely; on May 1, 2005 IBM sold its personal computer business to Lenovo for $1.25 billion.[23]

The HP Compaq Merger

Like all computer hardware manufacturing firms, the dot-com collapse that began in early 2000 had an immediate impact on HP. It was impossible to escape the effects of the failure of 762 Internet-based companies representing roughly 10% of the total number.[24] During a conference call with investors, Carly Fiorina, chairman and CEO of HP since 1999, described the rapid revenue decline: "it feels like someone just turned the lights out." Fiorina recognized that the change was not simply an "economic downturn."

The technology industry's downturn forced many companies to seek alliances or outright mergers to survive. Fiorina believed that this provided HP with a tremendous opportunity. She had been considering the benefits of merging with Compaq Computer since early in 2000. Fiorina knew that the recession that had resulted from the dot-com collapse had hurt Compaq more than HP, because HP had a more diversified product line than Compaq.[25] She believed that Compaq's strengths in Windows-based servers, enterprise storage, and Internet sales would provide HP with expertise in areas where they were weak. McKinsey & Company, the consulting firm that performed the strategic analysis for Fiorina, concluded "the two companies fit together like a zipper."[26]

On September 3, 2001, Carly Fiorina and Michael Capellas, President and CEO of Compaq, explained the merits of the merger in the following joint press release:

> **Hewlett-Packard and Compaq Agree to Merge, Creating $87 Billion Global Technology Leader**
>
> PALO ALTO, CA and HOUSTON, TX, September 3, 2001 — Hewlett-Packard Company (NYSE: HWP) and Compaq Computer Corporation (NYSE: CPQ) announced today a definitive merger agreement to create an $87 billion global technology leader. The new HP will offer the industry's most complete set of IT products and services for both businesses and consumers, with a commitment to serving customers with open systems and architectures...
>
> The merger is expected to generate cost synergies reaching approximately $2.5 billion annually and drive a significantly improved cost structure. Based on both companies' last four reported fiscal quarters, the new HP would have approximate pro forma assets of $56.4 billion, annual revenues of $87.4 billion and annual operating earnings of $3.9 billion. It would also have operations in more than 160 countries and over 145,000 employees…
>
> "This is a decisive move that accelerates our strategy and positions us to win by offering even greater value to our customers and partners," said Fiorina. "…At a particularly challenging time for the IT industry, this combination vaults us into a leadership role with customers and partners -- together we will shape the industry for years to come."
>
> Capellas said, "We are creating a new kind of industry leader -- one founded on customer success, world-class engineering, and best of breed products and services. In sharp contrast to our competitors, we are committed to leading the

industry to open, market-unifying architectures and interoperability, which reduce complexity and cost for our customers. With this move, we will change the basis of competition in the industry…" [27]

Investors were not as impressed with the merits of the proposal as were Fiorina and Capellas. In particular, investors were concerned that the depressed competitive environment—both firms had been struggling since the technology industry's decline that began in 2000—and the immense difficulties inherent in combining two huge firms would dominate any gains from the potential synergies. Following the merger announcement, shares at the two companies fell dramatically. In one day, the two companies lost over $13 billion in market capitalization (see Figure 2).[28] As one large institutional investor put it, "It's like taking two stones and tying them together to see if they float."[29]

HP's and Compaq's competitors were equally unimpressed. Sun Microsystems Inc. President Edward J. Zander explained to investors on September 5, "When two sick companies combine, I'm not sure what you get. This is a great opportunity for us, IBM, and others to go after market share."[30] Six days after the merger announcement, Michael Dell, the President and CEO of Dell Computer stated that he saw the merger as an opportunity for his firm. He stated, "Mergers of this size are very hard to do. The opportunity it presents to us, given the elimination of brands and the confusion -- that's pretty compelling."[31]

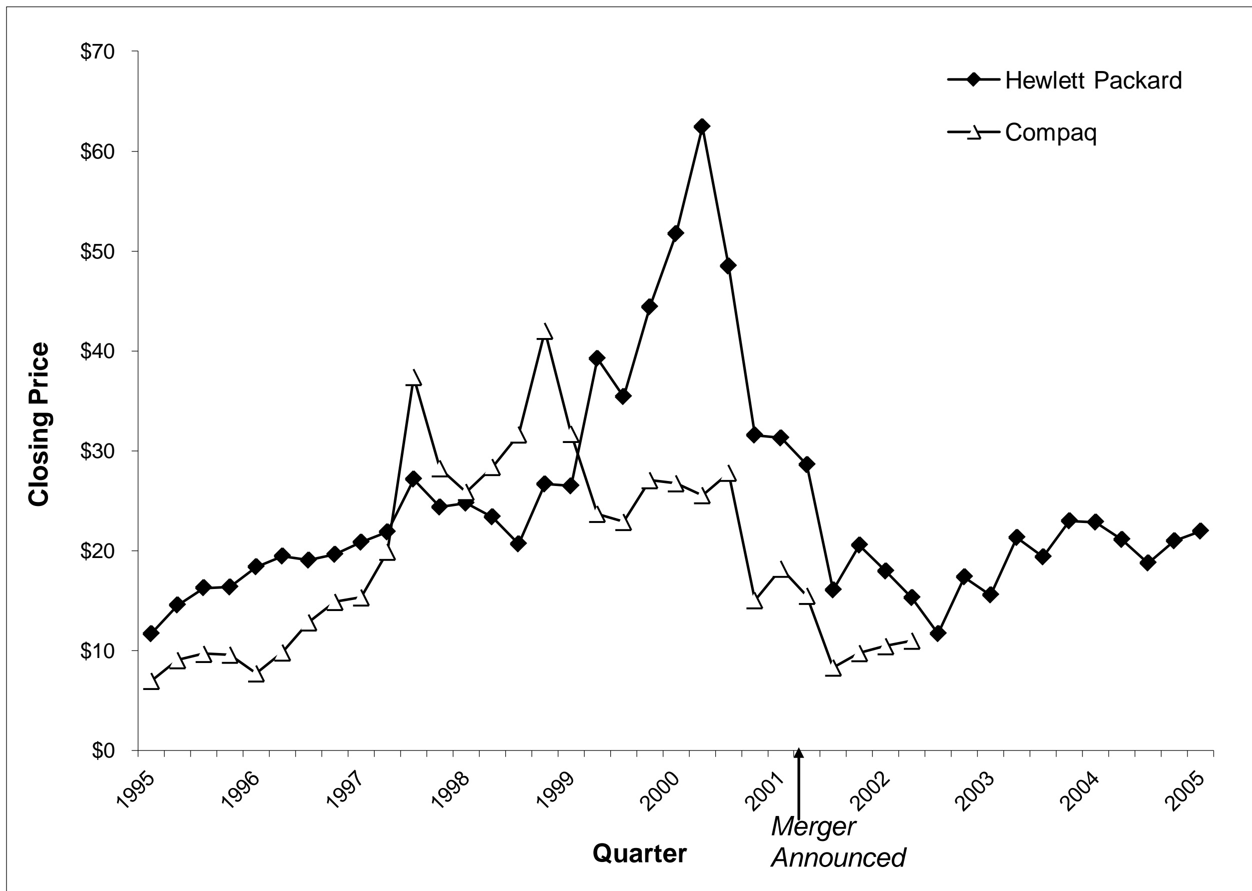
From the very beginning, Fiorina believed that the acquisition of Compaq would deliver economies of scale, which would enable HP to dominate the computer hardware and services markets. Director Walter Hewlett, son of co-founder Bill Hewlett, opposed the merger because he believed that this committed HP to the "profitless mess of the personal-computer business."[32] More importantly, he believed that this merger would take HP further away from the HP way.[33] This difference of opinion led to a seven-month power struggle between Fiorina and Hewlett. In the end, Fiorina prevailed. On April 17, 2002, HP stockholders voted in favor of Fiorina's vision and approved the acquisition of Compaq Computer Corporation. A Delaware court later upheld the vote after Hewlett challenged its legitimacy (see Appendix 1 for a timeline of events following the merger).

Compaq Computer Before the Merger

Before its expansion in the late 1990's, Compaq Computer Corporation had been a leading manufacturer of personal computers and Windows NT servers. Under the leadership of Eckard Pfeiffer, President and CEO of Compaq from 1991 to 1999, Compaq was amazingly successful. It was the fastest growing company in U.S. history, and at the peak of its success in 1997, *Forbes* named Compaq the "Company of the year" in recognition of its exemplary financial performance and rapid growth.[34]

Compaq's purchase of Digital Equipment Corporation (DEC) and Tandem Computers in 1998 signaled a dramatic change in Compaq's strategy. DEC, which had struggled for years with high manufacturing and product development costs, was known for its line of UNIX-based minicomputers and servers and for the Alpha microprocessor, which was superior to Intel's Pentium processor.[35] Tandem Computers was a well-respected manufacturer of very reliable computer systems used by hospitals, banks, and stock exchanges.[36] Compaq management believed that the successful combination of Compaq, Tandem, and DEC would give them an inimitable combination: the mergers would provide them with the necessary products, expertise,

Figure 2. Quarterly Closing Stock Prices



Data Source: http://investor.hp.com/stockLookup.cfm

and sales force to compete with IBM in the enterprise systems market and the application of Compaq's relatively lean cost structure to Tandem's and DEC's operations would allow the combined companies to deliver these systems at lower cost than their competitors.[37] But the mergers failed to fulfill their promise. Pfeiffer's inability to effectively manage the integration of these two companies was one of the primary reasons for his ouster in 1999.

With Pfeiffer's departure, Michael Capellas, President and CEO of Compaq from 1999 to 2001, assumed control of a company that had gone from a Wall Street darling to disarray in less than two years. In addition to the ongoing problems with integrating DEC and Tandem, Capellas had to deal with the fallout from Pfeiffer's acrimonious departure,[38] and the recent loss of five key executives who took early retirement or who were forced out by Pfeiffer.[39] More importantly, the declining margins in the PC business and the ascendancy of Dell Computer were eroding Compaq's core business. While Compaq had relied heavily on independent retailers for its home and business sales, some of its competitors were rapidly grabbing greater market share and reaping large profits through Internet direct sales. Profits at Dell Computer, for example, were growing rapidly. In the first quarter of 1998, Dell reported profits that were 54% greater than the same quarter the year before. During the same period, sales growth fell at Compaq as many potential corporate customers switched to online sales, and per-unit profits fell as Compaq was forced to cut prices to its dealers in order to help them reduce inventories.[40]

Compaq's Business

In its 2001 annual report to investors (Form 10-K), Compaq described itself as

> …a leading global provider of information technology, products, services and solutions, [that] designs, develops, manufactures and markets products and services that help customers build a competitive advantage and succeed in the evolving Internet-based economy.[41]

Compaq divided its products and services into three segments: Enterprise computing, Access, and Global Services. The Enterprise Computing segment consisted of servers, enterprise storage, business critical systems, high performance computers, and enterprise software solutions. The Access segment consisted of desktop, notebook, and workstation PCs, thin client workstations, and networking products. Access also included personal electronics devices including hand held computers and home entertainment products. The Global Services segment provided systems integration services and solutions to corporate customers as well as financial and asset management services.

At the end of 2001, the Access segment was the largest segment in terms of net revenue (45.1%), but the worst performer in terms of profit margin (–3.9%). Enterprise Computing was second in size with 31.8% of total net revenue and second in profit (1.5%). Global Services was the smallest segment with 13.6% of total net revenue, but the most profitable with a profit margin of 23.1% (see table 1).

Table 1. Compaq Computer Corporation Contribution to Total Revenue and Profitability by Segment

	Enterprise Computing*	Access**	Global Services
Profit Margin by Segment			
2001	31.8%	45.1%	23.1%
2000	33.6%	48.7%	17.7%
1999	33.6%	47.1%	19.3%
Ratio of Segment Revenue to Total Revenue			
2001	1.5%	-3.9%	13.6%
2000	11.6%	0.7%	11.8%
1999	5.2%	-2.4%	13.5%

*The Enterprise Solutions and Services segment was divided into the Enterprise Computing and Compaq Global Services segments in Compaq's 2001 Annual Report.

**Commercial and consumer computing segments were combined to form the Access segment in Compaq's 2001 Annual Report.

Source: Compaq Annual Reports

Table 2. Market Positions in the Computing and IT Services Markets on the Eve of the Merger[42]

Personal Computers		Servers	
Rank	Share	Rank	Share
1. Dell	14.1%	1. IBM	26.5%
2. Compaq	**11.3**	2. Sun	16.7
3. IBM	8.1	**3. Compaq**	**13.4**
4. HP	**6.9**	**4. HP**	**12.9**
5. NEC	5.0	5. Dell	6.8

Printers		IT Services	
Rank	Share	Rank	Share
1. HP	**40.4%**	1. IBM	5.0%
2. Epson	14.5	2. EDS	2.9
3. Canon	8.9	3. Fujitsu	2.0
4. Xerox	8.4	4. CSC	1.6
5. Lexmark	7.4	5. Accenture	1.5
		8. HP	**1.1**
		9. Compaq	**1.0**

Source: *The New York Times*

Market Position

In 2001, Compaq was a significant competitor in PC and server markets and a minor player in information technology (IT) services (see table 2). Compaq was second in personal computers with 11.3% market share, which was 2.8 percentage points behind the industry leader, Dell Computer. Compaq ranked third in the server market with a 13.4% share. This share represented about half of the share commanded by the market leader, IBM, and was about half a percentage point higher than HP. Compaq ranked ninth in IT services with a 1.0% share of the market. This represented roughly one fifth of the market share of IBM, the market leader.

Financial Position

From 1997 to 1999, Compaq's total assets grew from $14.6 billion to over $27.2 billion. Much of this growth was fueled by the acquisitions of Tandem Computers and DEC. In 2001, Compaq's total assets had declined by about 13% from its peak in 1999 to $23.6 billion (see table 3). Growth in total revenue reached a peak of $42.2 billion in 2000 before falling sharply to $33.5 billion in 2001 (see table 4). Earnings as a percentage of total revenue did not follow Compaq's growth. Compaq posted a loss in two of the five years preceding the merger. After posting a 7.6% profit in 1997, Compaq posted a loss of 8.8% in 1998. Compaq then struggled through two years of slim profit margins before posting a 2.34% loss in 2001.

Corporate Culture at Compaq

While HP had a relatively long and stable history, Compaq's history was relatively short and unstable. Change was the norm at Compaq. Since its founding in 1982 by Rod Canion, Jim Harris, and Bill Murto, Compaq experienced rapid growth. In 1983, Compaq's gross revenue

Table 3. Compaq Computer Corporation Consolidated Balance Sheets, 1997-2001
($ millions)

	1997	1998	1999	2000	2001
Assets					
Current assets					
Cash and cash equivalents	$6,418	$4,091	$2,666	$2,569	$3,874
Short-term investments	344		636		
Accounts receivable	2,891	6,998	6,685	8,392	6,504
Inventories	1,570	2,005	2,008	2,161	1,402
Deferred income taxes	595	1,602	1,460		
Other assets	199	471	394	1,989	1,498
Total current assets	12,017	15,167	13,849	15,111	13,278
Property, plant and equipment	1,985	2,902	3,249	3,431	3,199
Other assets, net	629	4,982	10,179	6,314	7,212
Total assets	$14,631	$23,051	$27,277	$24,856	$23,689
Liabilities					
Current liabilities:					
Accounts payable	$2,837	$4,237	$4,380	$4,233	$3,881
Borrowings			453	711	1,692
Deferred income		845	972	1,089	1,181
Accrued restructuring costs		1,110	1,002		
Other current liabilities	2,365	4,541	5,031	5,516	4,379
Total current liabilities	5,202	10,733	11,838	11,549	11,133
Long-term debt				575	600
Postretirement/post employment benefits		545	605	652	839
Minority interest	___	422	___	___	___
Total Liabilities	$5,202	$11,700	$12,443	$12,776	$12,572
Equity					
Common Stock	2,096	7270	7627	8,039	8,307
Retained Earnings	7,333	4,501	4,948	5,347	4,393
Accumulated other comprehensive income		(36)	2,919	27	(132)
Treasury Stock	___	(384)	(660)	(1,333)	(1,451)
Total Equity	9,429	11,351	14,834	12,080	11,117
Total Liabilities and Equity	$14,631	$23,051	$27,277	$24,856	$23,689
Fiscal Year Ending Stock Price	$32.00	$31.63	$19.13	$30.41	$8.75

Source: Compaq Computer Corporation Annual Reports

Table 4. Compaq Computer Corporation Consolidated Statement of Income, 1997-2001 ($million excluding net earnings per share)

	1997	1998	1999	2000	2001
Revenue					
Products	$24,122	$27,372	$31,824	$35,506	$26,728
Services	462	3,797	6,623	6,716	6,826
Total revenue	24,584	31,169	38,447	42,222	33,554
Cost of sales					
Products	17,500	21,383	25,263	27,624	21,536
Services	333	2,597	4,535	4,793	4,906
Total cost of sales	17,833	23,980	29,798	32,417	26,442
Expenses					
Selling, general and administrative expense	2,947	4,978	6,341	6,044	5,328
Research and development	817	1,353	1,660	1,469	1,305
Restructuring and related activities		393	868	(86)	742
Merger-related costs	44				44
Purchased in-process technology	208	3,196			
Other (income) expense, net	(23)	(69)	(1,154)	1,503	466
Total Expenses	3,993	9,851	7,715	8,930	7,885
Income (loss) before income taxes	2,758	(2,662)	934	875	(773)
Provision (benefit) for income taxes	903	81	365	280	(210)
Income (loss) before cumulative effect of accounting change	1,855	(2,743)	569	595	(563)
Cumulative effect of accounting change, net of tax				(26)	(222)
Net income (loss)	1,855	(2,743)	569	569	(785)
Basic Net Earnings Per Share					
Before accounting change	$1.23	($1.71)	$0.35	$0.35	($0.34)
Cumulative effect of accounting change				(0.02)	(0.13)
Net Earnings Per Share	$1.23	($1.71)	$0.35	$0.33	($0.47)

Source: Compaq Computer Corporation Annual Reports

was nearly $111 million.[43] By the end of 2001, Compaq's gross revenue had grown to over $33 billion. Fueled by several mergers and acquisitions, Compaq's growth accelerated in the 1990s. From 1993 to 2001, Compaq's assets grew from $4.1 billion to $23.7 billion. With each acquisition, Compaq faced the daunting task of integrating large groups of people into its culture. Tandem Computers, for example, employed over 7000 people and DEC employed over 54,000 people. Geographical separation complicated an already difficult problem: Tandem Computers was located in California and DEC was located in Massachusetts.[44] Compaq began as a deliberative, consensus-building company in which management strived to maintain the benefits

of a small firm while growing into something very different. In an interview published in the *Harvard Business Review*, Rob Canion described the corporate culture at Compaq:

> Our culture is designed to keep the characteristics of a small company alive while the company grows. In 1983, we were growing by leaps and bounds. We saw bureaucracy creeping in and development cycles stretching out. At that point, I realized that the company was getting too big for me to be everywhere or for the management team to mandate and enforce short development cycles through strict planning and reporting. Trying to force short development cycles on people would have failed miserably.
>
> I concluded that what we really needed to do was tell people what was good about what they had been doing. I wanted to make them aware of the fact that they'd worked together as a team, that they'd done things in parallel. I wanted to get them to look at what we'd been doing that had worked and consciously try to keep the small-company advantage. We started doing that in 1984, and we've kept doing it…Everybody takes it as a personal job to keep the culture--to keep the good qualities of a small company as we get big.[45]

After Canion's ouster in 1991, Pfeiffer made changes that would permanently change Compaq's culture. He cut Compaq's workforce by 12%,[46] and he refocused the firm's core strategy from a manufacturer of leading-edge computers to a manufacturer of less-expensive IBM PC clones, built with off-the-shelf components.[47] Downsizing, reorganization, and cost cutting became a way of life at Compaq. With each successive merger, the almost ideal qualities envisioned by Canion were swept away.

Pfeiffer's authoritarian management style, which in the early days of his tenure was responsible for much of Compaq's success, became one of its major problems in the late 1990's. Compaq's culture had become increasingly confrontational. Teamwork had given way to infighting, and power and politics had become more important than problem solving.

Problems internal to Compaq were not the only concern. When Capellas assumed control of Compaq after Pfeiffer's departure, he quickly recognized the clash of Compaq's culture with the cultures of Tandem and DEC. Compaq was a young, energetic, consumer-oriented company, and Tandem and DEC were older more established firms that were, at times, out of step with the rapidly changing technology industry. Rather than seeking a comprehensive solution, Capellas decided to insulate them. He reasoned that integrating acquired firms across the company was "working against the culture instead of with the culture."[48]

Hewlett-Packard Before the Merger

In July of 1999, HP's board hired Carly Fiorina to be the firm's President and CEO. Fiorina was different than her predecessors. While most had an engineering background, her education included a degree in philosophy from Stanford and an MBA from the University of Maryland. Fiorina was also the first "outsider" to hold the top job at HP. She had spent her previous 20 years as an executive for AT&T where she began as a marketing representative and left as President of Lucent's (a subsidiary of AT&T) Global Service Providers Division.

HP's board was not easily satisfied. In the seven years as President of HP, Fiorina's predecessor, Lewis Platt, President and CEO of HP from 1993 to 1999, had nearly tripled sales.

Yet Platt, who had a bachelor's degree in mechanical engineering from Cornell and a MBA from the Wharton School of Business, was considered too conservative. Fiorina was hired to change that.[49]

In her first two years as President and CEO, Fiorina made dramatic internal and external changes at HP. Internally, she combined 87 product-based business units into six divisions, she created new incentives for new technology development, and she changed HP's profit sharing plan to a performance-based bonus plan. Externally, Fiorina developed an "e-services" strategy intended to compete with IBM and Sun Microsystems in the growing e-commerce business. Yet, Fiorina's boldest move was her bid to acquire troubled computer manufacturer Compaq Computer Corporation in 2001.[50]

HP's Businesses

For decades before the merger with Compaq, HP was a leading inventor of electronic devices. In 1938, Dave Packard and Bill Hewlett began selling their first invention, a resistance-capacitance audio oscillator, which was an instrument used for sound testing. In the 1940s, HP developed microwave devices for the U.S. war effort. In the 1950s, HP developed new testing equipment for the radio industry. In the 1960s, HP continued to expand its electronics testing and measurement business with the introduction of medical testing equipment, the atomic clock, and chemical analysis devices.[51]

By the end of the 1960s, HP began to sell consumer electronics. One of the more famous of these inventions was the world's first programmable desktop scientific calculator, which HP introduced in 1968. In the 1970s, HP expanded its development of products that used semiconductors. Products such as the first hand-held scientific calculator and the first computer based on dynamic access memory were introduced during this decade.[52]

In the 1980s, HP began selling personal computers and printers. Many of the components developed for the personal computer industry during the 1980s were invented at HP. Perhaps the most famous of these inventions was the inkjet printer. In 1984, HP began manufacturing the world's first thermal inkjet printer called the ThinkJet.[53]

By the 1990s, HP's development of innovative electronic devices had begun to slow, and problems with production costs and product quality in the PC business had arisen.[54] While HP still introduced new products, the advances in technology were more incremental than revolutionary. The decline of HP innovation accelerated in 1999 when HP decided to spin off its instrument business. During the deliberations leading up to the creation of the new company, board members debated whether to call the new company HP, because the instrument business was the original business created by Bill Hewlett and Dave Packard, and this business more closely reflected the HP way. In the end, board members decided that there was too much risk in rebranding the surviving computer hardware and services company and decided to call the new company Agilent Technologies.[55]

In its 2001 Annual Report, HP described its business as "…a leading global provider of computing, printing and imaging solutions and services for business and home, and are focused on making technology and its benefits accessible to all."[56] HP had three business segments: imaging and printing systems, computing systems, and IT services. The imaging and printing segment included laser and inkjet printing devices, laser and inkjet printer cartridges, all-in-one inkjet devices, scanners, digital photography products, personal color copiers and faxes, and consulting services. The computing systems segment consisted of commercial personal computers (PC), home PCs, PC servers, UNIX servers, and storage and software solutions

including OpenView, which was designed to manage large-scale systems and networks. The IT services segment included customer support, consulting, outsourcing, and technology financing.[57]

In 2001, imaging and printing was by far the largest segment, in terms of net revenue, contributing 42.4% of the total. Computing systems (38.8%) and IT services (16.6%) were second and third respectively (see Table 5). Imaging and printing was the most profitable segment (10.2%) and the IT services segment was the second most profitable (4.5%). The computing systems segment, on the other hand, was a disappointment. After four years of consistent profitability, this segment was losing money (-2.5%).

Market Position

In 2001, HP played a significant role in several IT markets. They were the dominant player in the printer market with over 40% market share, which was greater than the combined market share of their four closest competitors (see Table 2). HP was a major player in the server market where they ranked behind Compaq with a 12.9% share. HP was fourth in sales of personal computers with a 6.9% share. In IT services, HP lagged well behind the leaders in eighth place with a 1.1% share.

Financial Position

At the end of 2001, HP had about $32.6 billion in total assets. HP's growth, which had been dramatic in the early 1990s, had slowed considerably. From 1997 to 2001, HP's total assets grew by about 2.6% (see Table 6). Revenue growth, on the other hand, continued to grow through 2000 and then declined somewhat in 2001. Growth in total costs and expenses outpaced revenue growth, however, as net earnings fell from 9.67% of total revenue in 1997 to 0.9% of total revenue in 2001. Similarly, earnings per share fell from $3.04 in 1997 to $0.21 in 2001 (see Table 7).

Table 5. Hewlett-Packard Corporation Contribution to Total Revenue and Profitability by Segment

	Segment			
Year	**Imaging and Printing Systems**	**Computing Systems**	**IT Services**	**All Other**
	Ratio of Segment Revenue to Total Revenue			
2001	42.4%	38.8%	16.6%	2.2%
2000	41.1%	41.4%	14.3%	3.2%
1999	43.6%	42.5%	13.7%	0.2%
	Profit Margin by Segment			
2001	10.2%	-2.5%	4.5%	-31.8%
2000	13.0%	4.9%	6.6%	-5.9%
1999	12.2%	4.6%	10.8%	-13.8%

Source: Hewlett-Packard Annual Reports

Table 6. Hewlett-Packard Company Consolidated Balance Sheets, 1997-2004 ($ millions)

	1997	1998	1999	2000	2001	2002	2003	2004
Assets								
Current Assets:								
Cash and cash equivalents	$3,072	$4,046	$5,411	$3,415	$4,197	$11,192	$14,188	$12,663
Short-term investments	1,497	21	179	592	139	237	403	311
Accounts receivable, net	6,142	5,104	$5,958	6,394	4,488	$8,456	8,921	10,226
Financing receivables, net	1,123	1,494	$1,889	2,174	2,183	$3,453	3,026	2,945
Inventory	6,763	4,699	4,863	5,699	5,204	5,797	6,065	7,071
Other current assets	2,350	3,143	$3,342	4,970	5,094	$6,940	8,351	9,685
Total current assets	20,947	18,507	21,642	23,244	21,305	36,075	40,954	42,901
Property, plant and equipment, net	6,312	4,877	4,333	4,500	4,397	6,924	6,482	6,649
Goodwill	165	174	189	224	667	15,089	14894	15,828
Other Assets	4,325	8,150	9,133	6,041	6,215	27,711	12,386	10,760
Total Assets	$31,749	$31,708	$35,297	$34,009	$32,584	$70,710	$74,716	$76,138
Liabilities								
Current Liabilities:								
Notes payable and short-term borrowings	$1,226	$1,245	$3,105	$1,555	$1,722	$1,793	$1,080	$2,511
Accounts payable	3,185	2,768	3,517	5,049	3,791	7,012	9,285	9,377
Employee compensation and benefits	1,723	1,195	1,287	1,584	1,477	2,012	1,755	2,208
Taxes on earnings	1,515	2,796	2,152	2,046	1,818	1,529	1,599	1,709
Deferred revenue	1,152	1,248	1,437	1,759	1,867	3,260	2,496	2,958
Other accrued liabilities	2,418	2,622	2,823	3,204	3,289	8,704	9,254	9,825
Total Current Liabilities	11,219	11,874	14,321	15,197	13,964	24,310	25,469	28,588
Long-Term Debt	3,158	2,063	1,764	3,402	3,729	6,035	6,494	4,623
Other Liabilities	1,217	852	917	1,201	938	4103	5,007	5363
Total Liabilities	$15,594	$14,789	$17,002	$19,800	$18,631	$34,448	$36,970	$38,574
Equity								
Common Stock	$1,187	$10	$10	$19	$19	$30	$30	$29
Additional paid-in capital	0	0	0	0	200	24660	24,587	22129
Retained earnings	14,968	16,909	18,285	14,097	13,693	11,973	13,332	15,649
Accumulated other comprehensive income	0			93	41	-401	-203	-243
Total stockholders' equity	16,155	16,919	18,295	14,209	13,953	36,262	37,746	37,564
Total liabilities and stockholders' equity	$31,749	$31,708	$35,297	$34,009	$32,584	$70,710	$74,716	$76,138
Fiscal Year Closing Stock Price	$24.05	$23.52	$28.96	$46.50	$16.83	$15.80	$22.31	$18.66

Source: Hewlett-Packard Annual Reports

Table 7. Hewlett-Packard Consolidated Statement of Earnings, 1997-2004
($million excluding net earnings per share)

	1997	1998	1999	2000	2001	2002	2003	2004
Net revenue								
Products	$30,400	$33,836	$36,113	$41,653	$37,498	$45,878	$58,826	$64,127
Services	5,065	5,583	5,960	6,848	7,325	10,390	13,768	15,389
Financing income			298	369	403	320	467	389
Total net revenue	$35,465	$39,419	$42,371	$48,870	$45,226	$56,588	$73,061	$79,905
Costs and expenses								
Products	21,326	24,295	25,436	30,343	28,370	34,127	43,619	48,359
Services	3,198	3,495	4,284	4,470	4,870	7,477	10,031	11,791
Financing interest	215	235	168	233	234	189	208	190
Research and development	2,191	2,380	2,440	2,634	2,670	3,368	3,651	3,506
Selling, general and administrative	5,345	5,850	6,225	7,063	7,259	8,763	11,012	11,024
Amortization of purchased intangible assets						402	563	603
Restructuring charges				102	384	1,780	800	114
Acquisition-related charges						701	280	54
In-process research and development charges						793	1	37
Total costs and expenses	$32,275	$36,255	$38,553	$44,845	$43,787	$57,600	$70,165	$75,678
Earnings								
Earnings from operations	3,190	3,164	3,818	4,025	1,439	-1,012	2,896	4,227
Interest and other, net	378	530	345	356	171	52	21	35
Net investment gains (losses)			31	41	(455)	(75)	(29)	4
Litigation settlement					(400)	14		(70)
Gains on divestitures (losses)				203	(53)			
Earnings from continuing operations before taxes	3,568	3,694	4,194	4,625	702	(1,021)	2,888	4,196
Provision for taxes	(1,053)	(1,016)	(1,090)	(1,064)	(78)	(118)	349	699
Adjustment for extraordinary items					(216)			
Net earnings from discontinued operations	604	267	387	136				
Net earnings	$3,119	$2,945	$3,491	$3,697	$408	($903)	$2,539	$3,497
Basic net earnings per share								
Continuing operations	$2.45	$2.59	$1.54	$0.18	$0.32	(0.36)	$0.83	$1.16
Discontinued operations	0.59	0.26	0.19	0.7				
Adjustment for extraordinary items					-0.11			
Net earnings per share	$3.04	$2.85	$1.73	$1.87	$0.21	($0.36)	$0.83	$1.16

Source: Hewlett-Packard Annual Reports

Corporate Culture at HP

From their modest beginnings in a garage in Palo Alto, California in 1938, Bill Hewlett and Dave Packard strived to create a different kind of company. In the next 50 years, HP became both a technology leader and a trendsetter in organizational culture and management style. From its inception, HP had an open culture where employees were trusted to do their best. Hewlett and Packard were early adopters of the management-by-objectives style in which employees were given goals to meet and were given considerable latitude in determining how they would meet those goals. HP's culture was particularly open and employee-friendly. In the 1940s, management introduced an "open door policy" in which employees could discuss problems with management without fear of retaliation. In addition, employees enjoyed catastrophic medical insurance, profit sharing, and a relaxation of formalities in the workplace.[58]

In 1957, Hewlett and Packard developed a set of corporate objectives that became the basis for their business philosophy. These objectives, which became a basis for the "HP Way," were revised in 1966 and included the seven points shown below:

1. **Profit.** To recognize that profit is the best single measure of our contribution to society and the ultimate source of our corporate strength.

2. **Customers.** To strive for continual improvement in the quality, usefulness, and value of the products and services we offer our customers.

3. **Fields of Interest.** To concentrate our efforts, continually seeking new opportunities for growth but limiting our involvement to fields in which we have capability and can make a contribution.

4. **Growth.** To emphasize growth as a measure of strength and a requirement for survival.

5. **Employees.** To provide employment opportunities for HP people that include the opportunity to share in the company's success, which they help make possible. To provide for them job security based on performance, and to provide the opportunity for personal satisfaction that comes from a sense of accomplishment in their work.

6. **Organization.** To maintain an organizational environment that fosters individual motivation, initiative and creativity, and wide latitude of freedom in working toward established objectives and goals.

7. **Citizenship.** To meet the obligations of good citizenship by making contribution to the community and to the institutions in our society, which generate the environment in which we operate.[59]

HP's egalitarian culture had a dramatic influence on the way that it grew. While most large firms tend toward vertical specialization as they grow, HP developed a relatively horizontal hierarchy in which each product group had its own management team, sales force, and research and development budget. This led to problems. In particular, the product-based organization

structure was not customer friendly. For example, if a customer wanted to purchase products from different divisions, they were forced to work with more than one sales representative. [60] Carly Fiorina described HP culture when she arrived in 1999:

> It was a company with unique assets, but untapped potential. It was a company that had a great history, but was probably too focused on celebrating that history and not enough on creating the future. It was a collection of tribes, instead of a powerful, focused company…It was a company that had not been projecting its sense of the future clearly enough, so customers really didn't have a sense of where we were going. [It was] a company that had great relationships with customers, but also a company that was increasingly frustrating its customers.[61]
>
> At HP, however, the past and the status quo were also wrapped in the religion of the HP Way and the mythology of the founders. Bill and Dave had once been radicals and pioneers, but now there were too many instances when a new idea was quickly dismissed with the comment, “We don’t do it that way. It’s not the HP Way” [62]

In an effort to centralize management and get closer to customers, Fiorina chose to integrate the 87 businesses into six entities using a “front and back” strategy; three entities would form the front of the company and would perform the marketing function and the other three entities would form the back of the company and would perform the remaining company functions. The divisions were divided according to segment. One front and back pair was created for imaging and printing, one pair was created for computing systems, and one pair was created for IT services.[63]

In 1999, HP unveiled a new corporate logo that included the word, Invent. This change was intended to focus attention on HP’s history of innovation and became the theme for subsequent advertising campaigns. When Fiorina assumed control of HP, she recognized that innovation was a company strength that had been flagging. In response, she offered employees incentives to produce patentable technology. As a result, patents at HP increased dramatically.

By the end of 2001, Fiorina’s efforts had returned mixed results. HP employees were very unhappy with the new organizational structure. They had lost confidence in the direction that the company was heading. Half of the board was unhappy (including Walter Hewlett and the Packard descendants), and, according to Fiorina’s opposition on the board, the threat of 15,000 layoffs loomed following the proposed merger with Compaq Computer. [64]

The New HP

Following the merger of HP and Compaq, HP management was faced with the daunting task of integrating the two firms. The task could not have been more complex. The new HP had over 150,000 employees operating in 160 countries. The firm had duplicate departments, management functions, sales territories, and product lines. Further complicating the problem were the radically different cultures of the two firms.

Given the controversial nature of the merger, integration, reorganization, and rationalization of product lines had to be made quickly. Fiorina and Capellas responded to this challenge by appointing the top three layers of management before the deal was approved. Next, they established an integration team made up of HP and Compaq managers. In the following

months, the team reorganized the two firms, eliminated duplicate products, and identified over 16,000 positions that could be eliminated through layoffs. The integration phase of the merger was widely viewed as a success. In the first nine months following the merger, HP had identified almost $3 billion in savings through layoffs, elimination of offices, and supply chain integration.[65]

While Fiorina's team was effective at integrating the two firms, execution of an effective strategy proved to be far more difficult. Fiorina's strategy was clear. She sought to maintain HP's industry leadership in printing, to take the lead in both the server and PC markets, and to eventually take the lead in IT services. Through economies of scale and the combined knowledge base of the two firms, Fiorina believed that each of these goals could be met profitably. Yet, by the end of 2004, the new HP had failed to meet three of these goals. HP was second to Dell in PC market share, second to IBM in server market share, and a distant fourth in IT services. The only bright spot was the printer market where HP maintained a commanding lead (see Table 8).

The new HP was organized into six segments: Imaging and Printing, Personal Systems, Software, Enterprise Storage and Servers, HP Services (IT integration services), and HP Financial Services. As with the pre-merger HP, the new HP relied heavily on the imaging and printer segment for its profitability. By the end of 2004, this segment accounted for almost 30% of HP's revenue and it generated a profit margin of almost 16%. The personal systems group was the largest segment, but it earned less than 1% profit in 2004. Similarly, enterprise storage and servers, which generated approximately 18.7% of HP's revenue in 2004, had a profit margin of 1.1% (see Table 9).

Post-merger Performance

The timing of the merger was not ideal. Soft demand for computer hardware in 2001 and 2002 put many firms in the red (see Figures 3 and 4). At the same time that HP management was integrating the two firms, many firms in the industry were fighting for survival. To their credit, HP managers were able to manage the integration and remain competitive. In fact, HP briefly

Table 8. Market Positions in the Computing and IT Services Markets at the End of 2004

Personal Computers		Servers	
Rank	Share	Rank	Share
1. Dell	17.0%	1. IBM	38.2%
2. HP	**16.0**	**2. HP**	**25.9**
3. IBM	5.7	3. Sun	9.4
4. Acer	4.3	4. Dell	9.0
5. Fujitsu	4.0	5. Fujitsu	4.7

Printers		IT Services	
Rank	Share	Rank	Share
1. HP	**40.5%**	1. IBM	5.0%
2. Epson	14.0	2. EDS	2.9
3. Canon	14.0	3. Fujitsu	2.8
4. Lexmark	10.2	**4. HP**	**2.3**
5. Dell	5.8	5. Accenture	2.3

Sources: IDC and Gartner

Table 9. Hewlett-Packard Corporation Contribution to Total Revenue and Profitability by Segment

	Enterprise Storage and Servers	HP Services	Software	Personal Systems Group	Imaging and Printing	HP Financial Services	Corporate Investments
Ratio of Segment Revenue to Total Revenue							
2004	18.7%	17.0%	1.1%	30.4%	29.9%	2.3%	0.6%
2003	19.8%	16.8%	1.0%	28.8%	30.6%	2.6%	0.4%
2002	18.2%	15.8%	1.2%	25.7%	35.6%	3.0%	0.5%
Profit Margin by Segment							
2004	1.1%	9.2%	-15.7%	0.9%	15.9%	6.6%	-39.6%
2003	1.0%	11.0%	-24.5%	0.1%	15.9%	4.1%	-46.8%
2002	-3.0%	9.8%	-49.5%	-1.6%	16.5%	-7.9%	-80.6%

Source: HP 2005 Annual Report

took the lead in both PCs and servers in 2002, and they posted a profit in the last quarter of FY 2002 and in the first half of FY 2003.

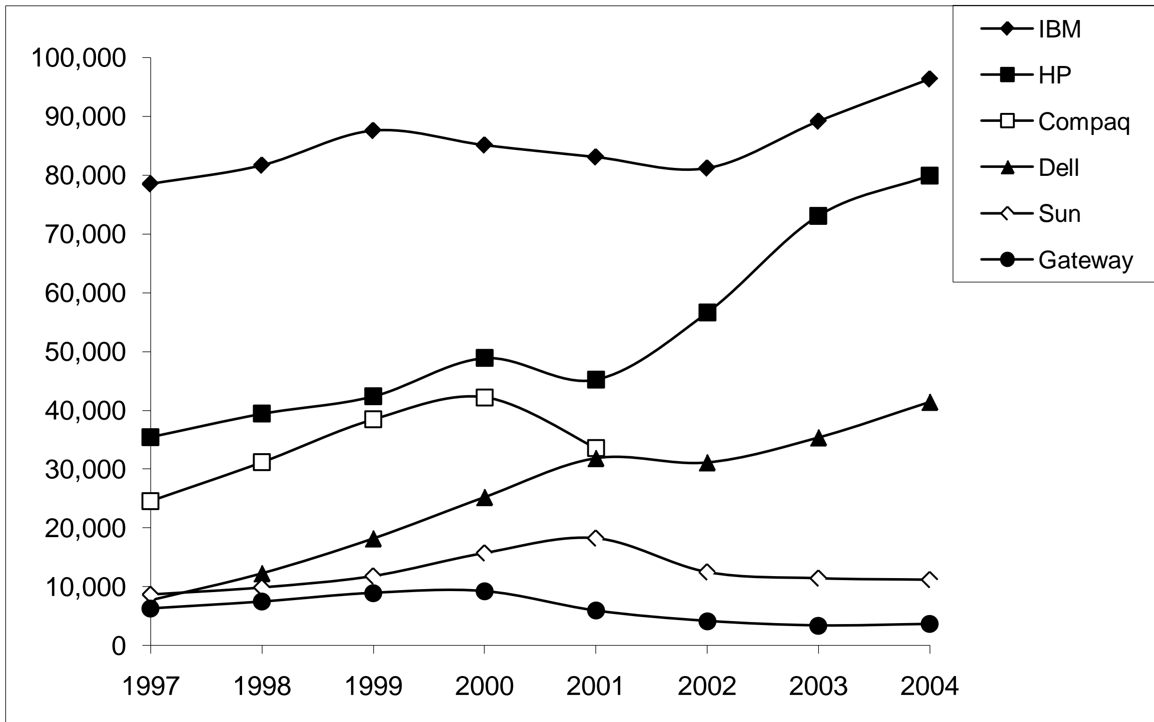
HP's financial and market successes were fleeting. In the third quarter of 2003, HP failed to meet Wall Street expectations for sales and earnings. Stiff competition in the PC market and weak demand in the server market were cited as keys to HP's poor performance. Fiorina stated that the PC group had been over-aggressive with price cuts, which caused the Personal Systems group to lose $56 million in the quarter. Fiorina assured investors that the pricing errors had been corrected. [66]

Fiorina's admission that HP had cut their prices too much highlighted a persistent weakness: HP still marketed their PCs through a network of resellers, which was inherently less flexible and more costly than the direct marketing strategy used by Dell Computer. Her admission also provided Dell with valuable information. A day after HP's announcement, Dell Computer cut prices on PCs and printers by up to 22%. This move further solidified their market lead in PCs, which they had regained eight months earlier.[67]

Integrating HP's server and storage business was more challenging than integrating the PC business. In the early stages of the merger, Fiorina and Capellas chose former Compaq Executive Peter Blackmore to rationalize server and storage product lines while growing market share. While eliminating PC product lines that were either redundant or incompatible was relatively easy, HP was more reluctant to eliminate server lines. In the first year following the merger, HP maintained its leadership in servers with a 29% share. But this segment had little growth and was generally unprofitable. Blackmore believed that HP could maintain share while lowering costs by migrating server lines based on HP microprocessors to microprocessors manufactured by Intel.[68]

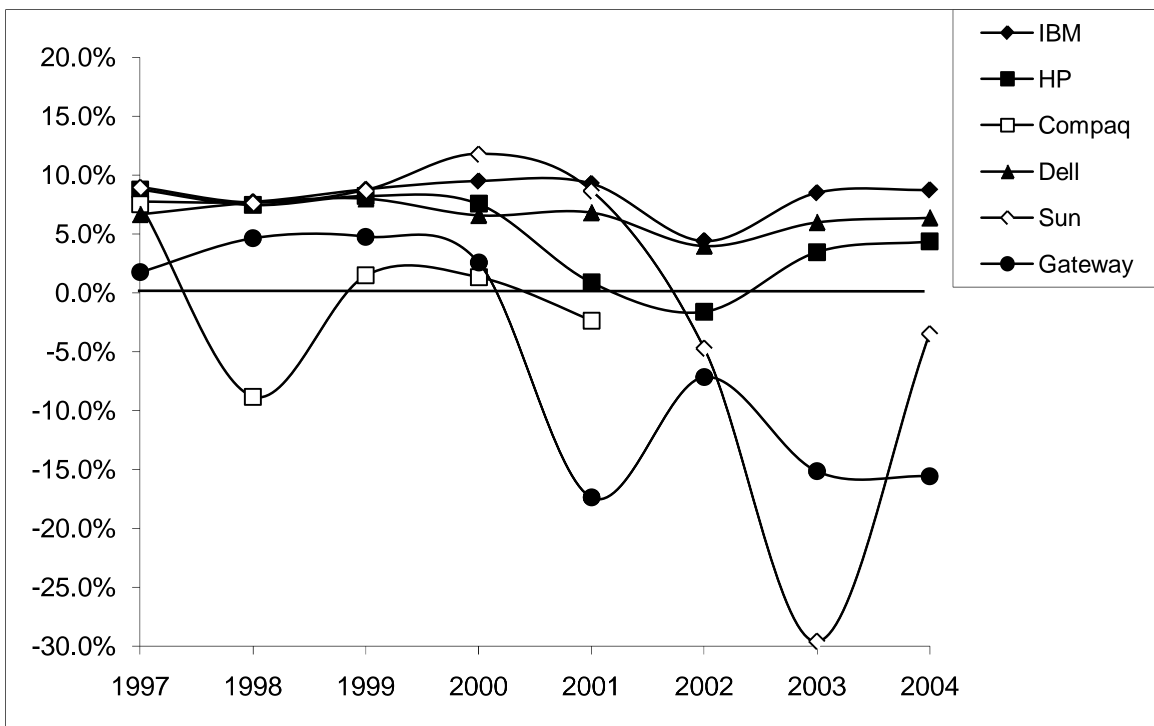
Blackmore's strategy was unsuccessful. On August 12, 2004, HP announced that its quarterly earnings would fall 23% short of expectations. One of the principal drivers of HP's poor performance was the enterprise servers and storage group, which lost $208 million. While ordering software problems and soft demand received some of the blame for the failure of the group, the migration to Intel microprocessors, an increased emphasis on lower-profit products, and increased competition from Dell and IBM all contributed to the shortfall.[69] After HP's announcement, Clint Roswell from IBM offered some perspective. "We see real demand in the

Figure 3. Annual Revenue (in $millions) for HP and its Competitors



Source: Company annual reports.

Figure 4. Net Income as a Percentage of Revenue for HP and its Competitors



Source: Company annual reports.

marketplace. Some of our competitors don't see that demand. But it might be about execution."[70] Apparently, Fiorina agreed. Calling the group's performance "unacceptable," Fiorina fired Blackmore and two of his senior VPs within hours of the earnings announcement.[71]

By the latter half of 2004, it was clear that a major change would be necessary if the new HP were to realize its promise. HP was engaged in battles with Dell in the PC and server market and with IBM in the server and IT services market. It was winning neither of these battles. More importantly, if HP was unable to increase the profitability of the PC and server business, it would be forced to write off much of the goodwill that was allocated to these segments at the time of the merger (see table 6).[72]

Fiorina responded to the combined threats from Dell and IBM in early 2005 by placing the management of the printer and PC divisions under Vyomesh Joshi (see Appendix 2 for more on Joshi and other key executives at HP). Joshi had proven that he was an outstanding manager during his three years as VP of the printer division. During that period, Joshi increased operating profit by 84%. Joshi also had vision. He believed that HP should expand its printer business to copiers. He argued that HP, which was expert at digital printing, had a potential competitive advantage in the copier market where only 4% of copiers were digital.[73]

While Joshi's appointment looked good on paper, it was clear that more changes would be necessary to stop the bleeding. Many drastic measures were being considered to improve HP's long-term profitability including spinning off HP's profitable printer division.[74] But in the end, the board chose to terminate Fiorina.

Mark Hurd Takes the Helm

On March 29, 2005 HP announced that Mark Hurd had been hired as the new President and CEO of HP. Hurd, whose resume included a business degree from Baylor University and 25 years of managerial experience, was the former president and CEO of NCR. HP released the following statement to the press:

> **HP Names Mark Hurd to Serve as CEO and President**
>
> PALO ALTO, Calif., March 29, 2005 — HP today announced that its board of directors has named Mark Hurd to serve as the company's chief executive officer and president.
>
> Hurd, 48, has served since March 2003 as president and chief executive officer of NCR Corp. (NYSE: NCR), where he has spent his 25-year career in a range of general management, operations and sales and marketing positions. Prior to his current responsibilities, he was NCR's president and chief operating officer, responsible for driving the performance of the company's five business units. Previously, Hurd served three years as president and chief operating officer of the company's Teradata division, which he built to be a global leader in enterprise data warehousing, analytic applications and data warehousing services.
>
> Patricia Dunn, HP's non-executive chairman, said… "Our search for a new leader to return HP to sustained success has been focused and thorough. Mark came to our attention because of his strong execution skills, his proven ability to lead top performing teams and his track record in driving shareholder value. He

> demonstrated these skills by turning around NCR, which, while smaller than HP, is a complex organization with multiple business segments…"[75]

The following day, Hurd met with members of the media and financial community to discuss the future of HP. In the meeting, Hurd emphasized that he did not have a firm plan in place, and he noted that he was under no obligation to keep HP intact. While he did not rule out spinning off HP's printer business, he stressed that he would focus on execution first. "'I see a company that is fundamentally strong," Hurd said, "but it's clear the company is not performing to its potential."[76]

Appendix 1. Timeline of Events at HP

4/17/02	HP stockholders approved merger
5/14/02	In its last pre-merger earnings report, HP's posted net income of $252 million and EPS of $0.25.
7/19/02	HP moved into lead in PC market share.
8/28/02	HP posted Q3, 2002 loss of 2.03 billion. Restructuring charges and losses in the Personal and enterprise systems groups were to blame.
10/18/02	Dell Computer regained lead in PC market share.
11/12/02	Michael Capellas, HP's President and former Compaq CEO, resigned.
11/20/02	HP posted a net income of $390 million and EPS of $0.13 in Q4, 2002. 12,500 layoffs and cost cutting were credited for HP's return to profitability.
1/21/03	HP announced a new line of Alpha Server models based on the Alpha microprocessor.
1/24/03	HP moved into the lead in worldwide server market share in the fourth calendar quarter of 2002.
2/25/03	HP posted a net income of $721 million and EPS of $0.24 in Q1, 2003.
2/28/06	HP awarded Fiorina a $2.9 million bonus and a 850,000 share stock option.
5/20/03	HP posted a net income of $659 million and EPS of $0.22 in Q2, 2003.
5/20/03	HP announced that it had laid off 16,600 employees following the Compaq merger.
8/19/03	HP posted a net income of $297 million and EPS of $0.10 in Q3, 2003. The Personal Systems Group lost $56 million in the quarter.
8/20/03	Dell Computer announced sweeping price cuts of up to 22% on PCs and printers.
9/2/03	IBM regained lead in server market share.
9/16/03	HP announced that Howard Elias resigned as senior VP of business operations and management for the Enterprise Systems Group. He was not replaced immediately.
11/19/03	HP posted a net income of $862 million and EPS of $0.28 in Q4, 2003. Both personal systems and enterprise systems groups posted profits.
2/19/04	HP posted a net income of $936 million and EPS of $0.30 in Q1, 2004.
5/18/04	HP posted a net income of $884 million and EPS of $0.29 in Q2, 2004.
6/9/04	Following 26,800 layoffs since the merger, HP announced that it planned to add 5,000 jobs in the next 12 months.
8/11/04	Alex Gruzen, senior VP of HP's mobile-computing global business unit, resigned from HP to take a job at Dell.
8/12/04	HP posted a $586 million net income and EPS of $0.19 in Q3, 2004, which was 23% less than Wall Street expectations.
8/12/04	HP fires Executive VP Peter Blackmore and Senior VPs Jim Milton and Kasper Rorsted.
11/16/04	HP posted a net income of $1.1 billion and EPS of $0.37 in Q4, 2004, which was entirely driven by the $1.1 billion net income earned by the imaging and printing group.
1/12/05	Fiorina met with three HP directors who asked her to delegate operational control.
1/14/05	HP joined printer, PC units under Vyomesh Joshi.
2/9/05	HP announced Fiorina's resignation and selection of Robert Wayman as interim CEO.

Appendix 2. Key Decision Makers at HP on April 1, 2005

Mark V. Hurd President and CEO	Mr. Hurd was named President and CEO on April 1, 2005. Before joining HP, he served as CEO of NCR Corporation from 2003 to 2005 and as President from 2001 to 2005.
Ann O. Baskins Senior VP, General Counsel and Secretary	Ms. Baskins was elected Senior VP in 2002 and VP in 1999. She also served as General Counsel since 2000 and Secretary since 1999.
Gilles Bouchard Executive VP, Global Operations	Mr. Bouchard became Executive VP in 2004. He was CIO from 2004 to 2005. From May 2002 to December 2003, he was Senior VP of Imaging and Printing Group Operations. From 2001 to 2002, he was VP of Business Customer Operations and he was VP of Worldwide Operations for Personal Computing from 1999 to 2001.
Jon E. Flaxman Senior VP, Controller and Principal Accounting Officer	Mr. Flaxman was elected Principal Accounting Officer in 2005. He was elected Senior VP in 2002 after serving as VP and Controller since May 2001. From 1999 to 2001, he was VP and CFO of the Business Customer Organization.
Vyomesh Joshi Executive VP, Imaging and Printing Group	Mr. Joshi became Executive VP in 2002. He became a VP and was named President of the Imaging and Printing Group in 2001. Mr. Joshi was also Chairman of Phogenix Imaging LLC, a joint venture between HP and Kodak, from 2000 until 2003.
Richard H. Lampman Senior VP of Research	Mr. Lampman became Senior VP in 2002 and director of HP Labs since 1999.
Catherine A. Lesjak Senior VP and Treasurer	Ms. Lesjak was elected Senior VP and Treasurer in 2003. From 2002 to 2003, she was VP of Finance for Enterprise Marketing and Solutions and VP of Finance for the Software Global Business Unit.
Ann M. Livermore Executive VP, Technology Solutions Group	Ms. Livermore became Executive VP in 2002 and VP in 1995. Since 2004, she was in charge of the Technology Solutions Group. In 2001, she became President of HP Services. In 1999, she became President of the Business Customer Organization.
Shane V. Robison Executive VP and Chief Strategy and Technology Officer	Mr. Robison was elected Senior VP in 2002 as a result of the HP-Compaq merger. He was Chief Strategy and Technology Officer since 2002. Mr. Robison was Senior Vice President, Technology and Chief Technology Officer at Compaq from 2000 to 2002.
Michael J. Winkler Executive VP, Customer Solutions Group and Chief Marketing Officer	Mr. Winkler became Executive VP in 2002 as a result of the HP-Compaq merger. In 2004, he became Executive Vice President, Customer Solutions Group. In December 2002, he became the Chief Marketing Officer. Mr. Winkler was Executive VP, Global Business Units of Compaq from 2000 to 2002.
Robert P. Wayman Executive VP and CFO	Mr. Wayman served as Executive VP since 1992 and CFO since 1984. Mr. Wayman served as interim CEO from February 2005 through March 2005. He was elected to HP's Board of Directors in February 2005 for a second time after serving from 1993 to 2002.

Source: HP 2004 and 2005 annual reports

End Notes

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