Issue 2 Volume 1

# Ivey Business Review

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## GOING INTERNATIONAL

| Airline/Flt. | No. | Destination | Gate | Time | Remarks |
|---|---|---|---|---|---|
| MEXICANA | 939 | LOS CABOS | 122 | 11:49A | DEPARTED |
| CONTINENTAL | 6318 | SEOUL | 104 | 12:30P | BOARDING |
| ANA | 005 | NORWAY | 103 | 12:55P | ON TIME |
| AMERICAN | 329 | NEW YORK CITY | 120 | 1:30P | ON TIME |
| CHINA EAST | 005 | SHANGHAI-BEIJING | 105 | 2:00P | NEW TIME |
| UNITED | 661 | FINLAND | 126 | 2:45P | ON TIME |
| AIR INDIA | 921 | DELHI | 107 | 3:10P | ON TIME |
| SINGAPORE | 011 | MARITA SINGAPORE | 120 | 3:30P | ON TIME |
| BRITISH AIR | 278 | LONDON | 103 | 4:10P | NEW TIME |
| AMERICAN | 7709 | NEW YORK CITY | 105 | 4:25P | ON TIME |
| UNITED | 565 | IRELAND | 109 | 4:30P | ON TIME |
| AIR CANADA | 012 | TORONTO | 104 | 5:00P | ON TIME |

The Ivey Undergraduate Journal

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The Ivey Business Review is an undergraduate business strategy publication conceived, written and managed exclusively by students at the Richard Ivey School of Business. The magazine aims to push the boundaries of student thought; foster the development of world-class business insights and give the leaders of tomorrow a chance to voice their opinion on today's major business issues and strategies. Each article has been created specifically for the magazine and comes from several months of intense collaboration between writers and members of the Editorial Board.

The Richard Ivey School of Business at The University of Western Ontario (www.ivey.ca) offers undergraduate (HBA) and graduate degree programs (MSc, MBA, Executive MBA and PhD) in addition to non-degree Executive Development programs. Ivey has campuses in London (Ontario), Toronto, and Hong Kong. Ivey recently redesigned its curriculum to focus on Cross-Enterprise Leadership - a holistic issues-based approach to management education that meets the demands of today's complex global business world.

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# Editorial Note

For the past eighteen months you would have been hard pressed to turn on the television, pick up a newspaper or walk down the street without hearing about the recession. Is it over? Are things getting better? Or are we still waiting to hit the bottom? The 'Great Recession' has swarmed our 24-hour news cycle and breeds fear, hesitation, and wariness. Companies get caught up in circumspection and escape seems hopeless.

Nevertheless, smart companies understand that their success isn't about whether the economy is in crisis or out of crisis. It's not that simple. No matter what's going on around you, there are always opportunities, ways to rethink your business model and to do something new and different. Whether this means going abroad because your future looks nothing like your past; learning how to work with troublesome partners; or rethinking what it means to have a brand in a world that's both off and online - the best and brightest companies realize that these changes are going to be the gateways to long term success.

Crises are not healed by economists saying that things are getting better or by weathering the storm with what you've got. They're healed by businesses making things happen. By looking at a departures board and figuring out where you're going to go next. It's not just about going international. It's about going somewhere new - the place you need to be.

We hope you enjoy it.

The Editorial Board

# Über-Specialization

## A model for industry in developed economies

Felix Cornehl

Throughout the second half of the 20th century, developed countries have witnessed the continued decline of their industrial sectors in the face of lower cost production from the developing countries. Today, the remaining manufacturing companies continue to struggle to find their place in the global economy. In Germany, however, many companies have resisted these trends and the country's unusual strength in industrial exports has become the engine of its economic growth.

While the apparent weakness of domestic demand for industrial products in Germany is an interesting matter, two other issues are more relevant for businesses to consider. The first is to determine how this strong industrial base survived and whether it is sustainable. The second is to figure out whether the factors that contribute to these companies' success are clearly identifiable, and under what conditions they are replicable.

In answering these questions, a sustainable business model for manufacturing companies in developed countries becomes apparent. This model could help decelerate the violently rapid process of deindustrialization, which manufacturing companies and domestic governments have been fighting.

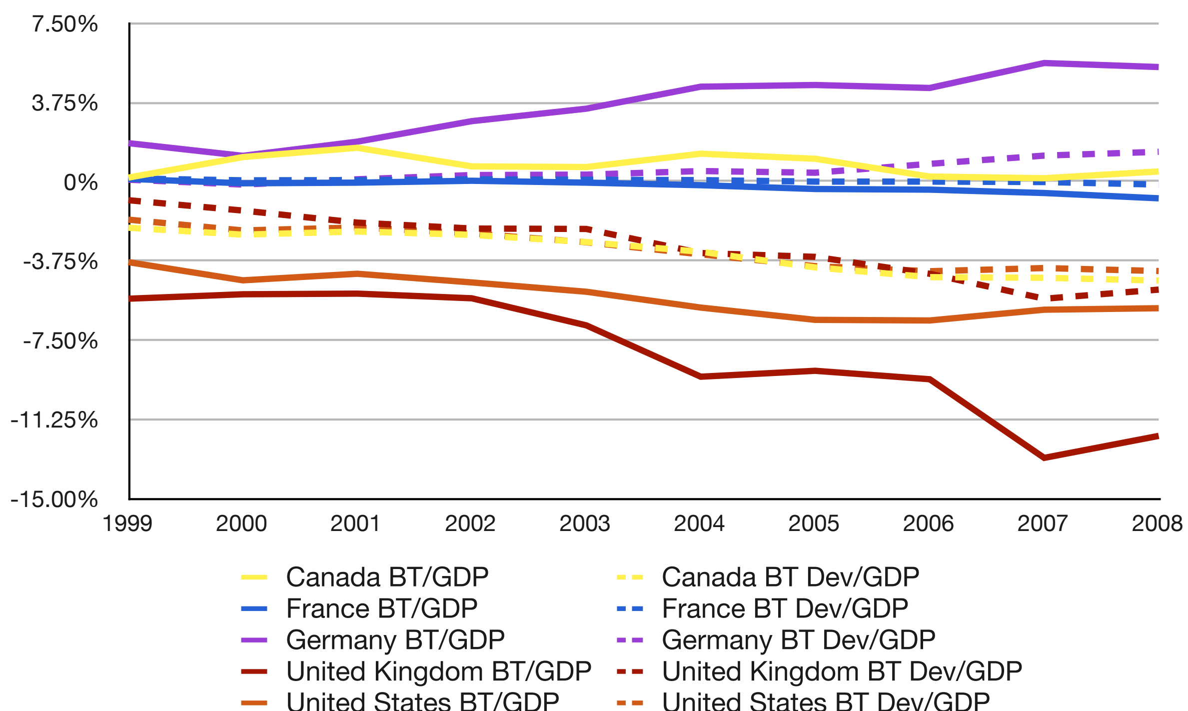
### Applying Macroeconomic Common Sense in an Uncommon Setting

Fundamental macroeconomic theory argues that trade is mutually beneficial, if each party specializes in activities in which it has a comparative advantage. While this is a widely accepted concept, it has important implications at the firm level that are all too often ignored. In a world where borders and distances do not pose prohibitively expensive obstacles to competition, specialization can provide a hedge against competitive forces.

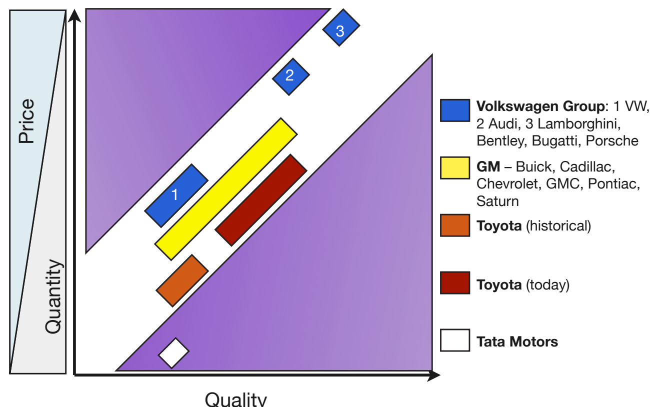
To investigate this, consider the case of the auto industry (chart on next page). The underlying concept of this illustration is that cars can be positioned at various price levels (low price, high volume to high price, low volume), but they need to be justified through some aspect of quality (e.g.: durability, image appeal).

GM (and to varying extent Ford and Chrysler) has run into considerable problems through its obsession with volume. The firm's primary concern appears to have been selling the maximum number of cars, rather than maximizing profit per car. To exacerbate the situation, GM strove to compete in nearly every major segment with every one of its brands, none of which were clearly differentiated or uniquely desired by their customers. This left them especially vulnerable to volume declines and the credit crunch.

Balance of Trade & Balance of Trade with Developing Nations as a Percentage of Gross Domestic Product



Comparative Positioning of Automakers in Terms of Quality and Price/Quantity




In contrast, Toyota has historically placed quality first, and revolutionized the industry from the ground up. Over the years, the company has moved up the value chain, always providing outstanding quality at a lower cost. In recent years the company has shifted its focus from quality towards the tempting goal of "beating" GM. While the company surpassed GM as the largest automaker last year, it is becoming increasingly clear that its shift in focus might have dire long-term consequences for the firm's quality. Despite these recent struggles, Toyota is a prime example of the threat that an entrant with a lower cost structure can pose to incumbents, especially if they can maintain their high quaity.

In relation to these firms, Volkswagen Group has a highly differentiated brand portfolio. While each brand targets largely separate segments, they all tend to cater to the higher price portion of their segments. This specialization is especially clear in the high price, low volume luxury segment. While VW did suffer dearly through the financial crisis and its aftermath, it is in a strong position to rebound after acquiring the world's most profitable carmaker Porsche in a dramatic takeover. In the luxury market, VW has effectively positioned itself in a market where pricing is a secondary concern at best, thereby insulating itself from low cost pressures.

On the opposite end of the Price/Volume spectrum, Tata Motors, the Indian creator of the "$1,000 car", undercuts every incumbent's price structure. This low price, high volume specialization has allowed Tata to position itself in an area that none of its competitors can compete in. However, the real threat for incumbents going forward would be if Tata were able to maintain its cost advantage while moving to higher quality segments in the market.

> In a world where borders and distances do not pose prohibitively expensive obstacles to competition, specialization can provide an effective hedge against competitive forces.

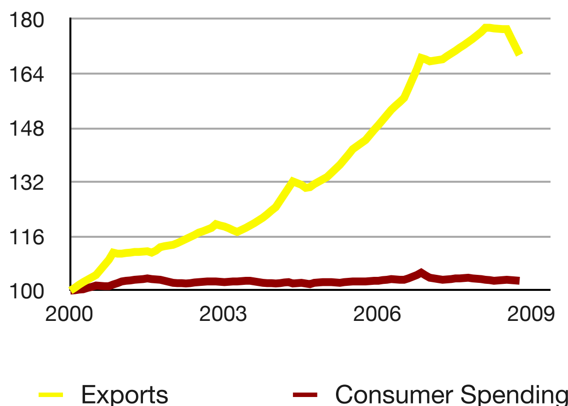
Volkswagen and Tata are both perfect illustrations of how strategic specialization can create endogenous barriers to entry.

## Taken to the Extreme

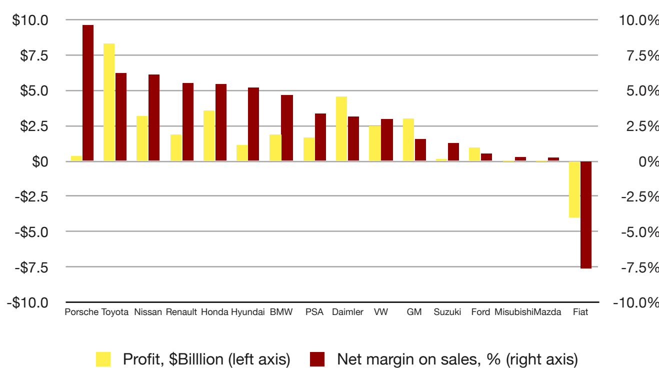
In order to maximize the effects outlined above, companies can take the principle of specialization to the next level. Doing so gives rise to two major factors: It amplifies the reduction of direct competition, reducing pricing pressure. Moreover, it forces companies to embrace globalization, as extreme niche positioning reduces the size of domestic markets to a point where they are insufficient to sustain a company. Therefore, companies need to sell globally to aggregate an adequate demand base.

To illustrate, consider the case of Rational AG. This German firm produces industrial cooking machines ("Self Cooking Centers") that can automatically bake, broil, grill, steam, stew, blanch, or poach any meal "to perfection". Its machines (up to €30,000/CAD$42,000 a piece) replace whole kitchen staffs in places ranging from the Kremlin to Peruvian gold mines, or even the Burj al Arab luxury hotel in Dubai. Others who get to taste the creations of these versatile machines are NATO troops in Afghanistan and the customers of world-class chefs Paul Bocuse and Alfons Schuhbeck. As if the ability to bake flawless soufflés without supervision wasn't enough, the machines automatically clean themselves, receive software updates refining their settings according to the latest findings in culinary science and need only a fraction of the space traditional ovens require. Despite having only 900 employees and revenues of merely €280 million the company controls 53% of the world market for self cooking centers. Each machine is assembled in up to eight hours by a single employee who is also responsible for the majority of administrative tasks associated with each order. While this is counter to traditional manufacturing theory, it allows for the extraordinary quality and customization that the firm's customers demand.

German Exports & Consumer Spending




Top Carmakers Ranked by Net Margin on Sales



There are a multitude of other examples of German manufacturing firms that dominate a small global niche. Herrenknecht AG is the world leader in manufacturing enormous mechanized tunneling machinery. The leader in the production of complex door systems is the small family owned Dorma Gruppe, for whom exports account for over 75% of sales. Whether producing about 6,000 door systems for the world's new largest building, the Burj Dubai, or a single one for Vladimir Putin's shower, their products offer unmatched quality and customization.

## In Pursuit of Über-Specialization

If your company is facing increasing competition from companies with a lower cost structure, who might also threaten to match, or even exceed your product quality, it may be time for you to think about a strategic shift. There appear to be four key factors that contribute to the success of über-specialization. In order to attain dominance of a profitable niche, the first step is to identify a niche for which your company can attain a leading role through differentiation in product specification/quality, distribution networks, or service networks. Contributing to success is a combination of private ownership with professional management. More than 85% of Germany's world leading firms are privately owned enterprises. The vast majority of these companies also have professional management. Combining these two factors allows for the sustained management commitment that such a fringe strategy requires, while also assuring qualified leadership. Another key factor for a successful über-specialization strategy is operational excellence. While niche positioning eases competitive pressures, companies cannot afford to count on such protection. In order to remain competitive in terms of their cost structures and processes, firms need to continually invest in distribution and service networks, restructuring their operations to remain state-of-the-art, while ensuring that labour agreements provide for low costs and flexible time. Finally, clusters, tightly knit networks of firms and resources, enhance innovation. The triple helix of business, research facilities, universities and government plays an important role in spurring innovation. Clusters provide infrastructure and centralized know how that help companies succeed on the global stage.

It is important to note that über-specialization also has some limitations. While the strategy is uniquely suited for customization, it is not very apt at creating products for the end consumer market, due to the rapidly changing nature of tastes/trends. Similarly, industries requiring breakthrough innovation through extremely high investments, like the pharmaceutical industry, are not suitable for a niche focused strategy. Finally, while über-specialization can create successful innovation in the software/IT industry, such companies tend to be purchased relatively quickly. While this is not necessarily negative, it does not allow for a long-term business model. More importantly, the strategy also has two major drawbacks once successfully established. As a company dominating a small niche market, generating growth is extremely challenging. Once every major market has been entered, and every competitor has been acquired, options are limited to exploring alternative products. In fact, growth outside of the core product line creates a risk of losing the focus that is so integral to the underlying strategy. This challenge is one of the reasons why companies that adopt this strategy are largely privately owned, and hence not subject to shareholder pressures. Furthermore, über-specialization renders companies vulnerable to extreme changes in their industry (such as when the product becomes obsolete). It is therefore imperative to mitigate such risk by always staying ahead of industry trends.

Keys To Successful Über-Specialization

1. Dominance of profitable niche
2. Combination of private ownership with professional management
3. Operational excellence
4. Clusters

If your company is facing increasing competition from companies with a lower cost structure, who might also threaten to match or exceed your product quality, it may be time to think about a strategic shift.

In addition, there are some external factors that are enhancing the ability of German firms to succeed with this strategy. For one thing, many family firms have a long-standing tradition in adjacent markets (often over 100 years). Finally, German engineering firms have a strong reputation for outstanding quality. Together, these factors may provide for a significant image/price premium.

Regardless of these limitations, the strategy matches the world's new macroeconomic dynamics. For example, emerging markets require infrastructure and capital goods for industrialization, as well as high quality goods for their growing upper class. In contrast, industrialized countries require cheap mass-produced goods (e.g. textiles, entertainment electronics) from India and China, as well as natural resources (e.g. gas and oil from Russia or Brazil). This balance is important for the long-term sustainability of any trade relationship.

## Manufacturing in the 21st Century

When Germany was one of the first Western economies to emerge out of the recession in the fall of 2009, it was undoubtedly on the coattails of emerging economies. Going forward, manufacturing firms in Western countries will need to continually assess the threat of new entrants from these emerging markets. Instead of hoping for protectionist intervention, it might be time for companies to reassess their competitive positioning and embrace a strategy of über-specialization. While such a radical switch in business model will never be easy, it provides better chances for long-term success than fighting the monumental forces of globalization.

# Kraft Enters India

[AGAIN]

## JUSTIFYING CADBURY'S HIGH PRICE

SAMANTHA CHUNG

In 2002, Kraft Foods optimistically ventured into India with the introduction of its premium-priced Tang powdered drink. A year later, Kraft exited the country after making a series of crucial mistakes that crippled sales. Now, the food giant is attempting to re-enter the market through its controversial acquisition of Cadbury, a British icon that has operated in India for over 60 years.

The question is, however, did Kraft overpay for access to India? The acquisition cost Kraft USD $19.5 billion, 60% in cash and 40% in stock. Its cash component was increased to appease Warren Buffett, whose company, Berkshire Hathaway, is Kraft's largest shareholder at 9.4%. Buffett insisted on minimizing the issuance of equity, believing that Kraft's shares were undervalued. Using Kraft equity would be like using an undervalued and cheap currency in the acquisition, effectively resulting in a higher price. Kraft raised cash by selling its fast-growing North American frozen pizza divisions to Nestle for $3.7 billion in order to focus the company's resources on its priority global brands and categories.

When comparing the deal to similar acquisitions during the decade, 13x EBITDA is in line with comparable acquisitions of Pillsbury, Nabisco and Ralston Purina. It is also significantly smaller than the 17x EBITDA multiple used by Cadbury's competitor, Mars, when it acquired Wrigley in 2008 (a deal that Buffett's Berkshire Hathaway financed). Kraft also gained more and paid less than Mars in its acquisition of Cadbury as it paid $1.9 billion for each percentage point of global confectionary value share gained (10.4%), while Mars paid $3.9 billion per percentage point (5.9%).

A central reason for this transaction is to establish a stronger foothold in emerging markets as sales in domestic markets slump. Cadbury is entrenched in developing markets with 38% of revenues coming from international markets compared to Kraft's 20%. The hidden jewel of this acquisition, however, is India – the only fast-growing market that Kraft does not have a significant presence in. One can estimate that Kraft paid approximately USD $720 million for Cadbury India, representing a 23% premium using an industry EV to revenue multiple. Although none of its international competitors in India paid as much to get in, this transaction provides Kraft with the solid platform it will need to successfully re-enter this market.

**Premium Calculation**

| | |
|---|---|
| Average EV/Revenue | 1.94 |
| Cadbury India Revenues | USD $300M (3.7% of total revenues) |
| Cadbury Total Revenues | USD $8170M |
| Value ($300M * 1.94) | **USD $580M** |
| Acquisition Price | USD $19.5B |
| Kraft paid (3.7% * $19.5 billion) | **USD $720M** |
| Premium | 23% |

Note: This calculation uses an average EV/Revenue Multiple of other international competitors in India. This is a rough estimate of what Kraft paid for Cadbury India, however, it is impossible to know the exact amount.

## Cadbury India

Cadbury India has seen its annual sales and profits grow by 20% and 30% respectively for the past three years. It has also secured a 70% market share in the country's chocolate market and a 30% share in the Indian confectionary market. This compares to only 7.5% in the global chocolate market share and 10.4% in the global confectionary market. Cadbury's leadership position in the Indian market makes it an attractive entrance opportunity for Kraft.

In addition, Cadbury India provides a distribution network of 1.2 million retail outlets that Kraft can use to introduce its products. Prem Watsa of Fairfax Financial Holdings Inc., a notable Canadian value investor, sees this as a reason to increase his holdings in Kraft. In addition, Cadbury's relationships with its retailers are an added benefit to Kraft as it can leverage them to get shelf space, which would be nearly impossible if the company entered alone. Addi-

**Comparing International Competitors in India**

| Company | Unilever | Nestle | PepsiCo | The Hershey Company |
|---|---|---|---|---|
| **Method of Entrance** | **1888**: Began selling using an import model. **1956**: Its three subsidiaries (created in the 1930s) merged to create Hindustan Lever Limited. | **1912**: Began selling using an import model. **1961**: In partnership with the Punjab government, created a company to help develop the milk economy. | **1988**: Created a JV with the Punjab government-owned Punjab Agro Industrial Corporation (PAIC) and Voltas India Limited. In 1994, PepsiCo bought out its partners and ended the JV. | **2007**: Created a JV with Godrej Beverages and Foods Ltd (GBFL) in India. Hershey has acquired a 51% stake in the new company, Godrej Hershey Foods & Beverages (GHFB). |
| **Cost** | $0 | $0 | $0 | USD $60 million |
| **Market Share as a % of Indian Packaged Food industry** | Market Share: 1.4% (16th) | Market Share: 5.3% (2nd) | Market Share: 1.8% (11th) | Market share: <1% (27th) |
| **Current Position** | Food business grows by 9%, led by introduction of more product flavours, focus on convenience foods and rural penetration | Net sales increasing, beats forecasts, after introduction of premium food products and capitalizing on health trend | Significant growth in all metrics, 32% volume growth in 2009, led by food product innovations and rural penetration | Planning to introduce several of Hershey's international brands in India, new brand has not been formally introduced yet |
| **EV/Revenue** | 1.75 | 1.79 | 2.45 | 1.77 |

tionally, the organized food retail sector is growing at 20% a year with grocery giants such as Carrefour, the world's second largest retailer, looking to enter the market. This is beneficial for Kraft as it can take advantage of shifting consumer trends while remaining in familiar retail formats that are most suitable for its products.

Cadbury's intimate knowledge of the Indian market also helps ensure that Kraft does not make the same marketing mistakes it did in the past. Cadbury has been extremely successful in commanding strong, positive brand awareness. For example, most consumers link its Dairy Milk brand, which holds a 30% share of the chocolate market, with success and therefore purchase it as gifts.

## The Indian Market

The Indian economy is the second fastest growing major economy in the world, with GDP growth between 6% and 9% per year. By 2025, India will surpass China as the most populated country in the world with 1.4 billion people. Currently, India has a growing middle-class looking for value at low price points. Its middle-class segment is approximately 5% of the population but by 2025 it is projected to represent more than 40%. As living standards increase, Indian consumers will spend more of their income on discretionary purchases.

In addition, approximately 60% of India's population is under 30. These customers are curious to try new products but are still cost-conscious. These middle-income young people represent Kraft's ideal target market. The rapid growth in this target market offers Kraft long-term revenue potential that will help offset the cost to acquire Cadbury.

The Indian processed packaged food industry is worth approximately $10 billion and is expected to double by 2014. However, Kraft's desire to launch its high-margin biscuit brands will not be as sweet a deal as people think. The industry is extremely crowded by local and international players due to attractive revenue growth and low barriers to entry. The global industry is also extremely fragmented. Late market entrants see local partnerships as the only way to quickly enter India without making prohibitively large capital outlays and investments. Kraft must be aware of possible acquisitions or joint ventures by competitors that may challenge its market share.

Multinationals like Pepsi, Hershey and Unilever were able to enter the Indian market at a lower cost and with larger distribution networks at their disposal than Kraft. However, this success was partly due to good timing - a critical factor as companies race to establish market share and local partnerships. Entering India alone at this point in time would have been infeasible for Kraft. Through the acquisition Kraft has reduced their time to market from four years to two. Cadbury also offers market leadership opportunities in other emerging markets such as Latin America, where its high-margin product lines (like gum) are growing quickly. It is now 70% ahead of rival Mars in terms of confectionary sales in emerging markets. Cadbury not only offers a door into India, but also a wealth of growing revenues across the globe.

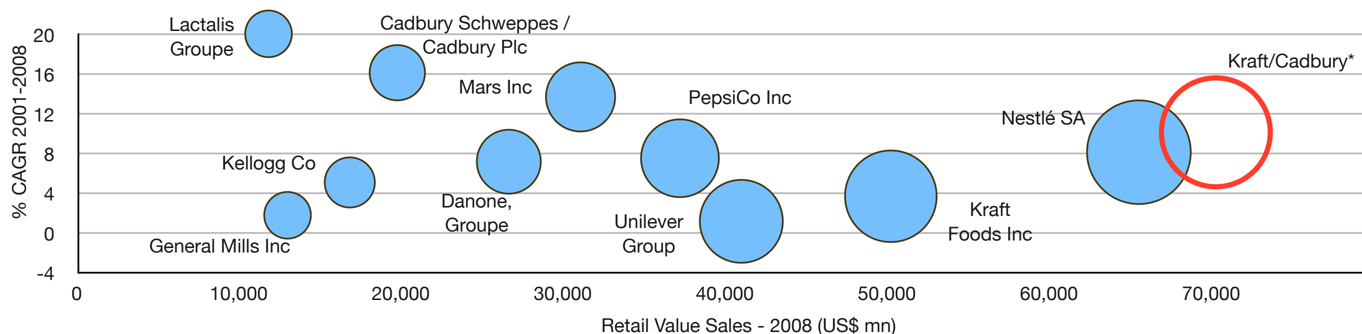
## Going Forward

Looking ahead, it is evident that this acquisition puts Kraft in a prime position to take advantage of India's growth. Cadbury provides market insights from successful ventures that will accelerate Kraft's learning curve in the region substantially. Kraft has also enlisted a management team, including two ex-Unilever employees with Indian experience, to oversee the operations with Cadbury India's management. Success in India depends on these teams having compatible cultures so that they may work together, quickly aligning implementation and corporate goals.

Management wants quick returns to justify the acquisition costs, but the greatest rewards will be seen over the long-term. Indian consumers will be slow to change and much of Kraft's time will be spent building its brand in anticipation of future revenues. However, when consumer spending quadruples to $1.5 trillion in 2025, Kraft will find itself finally situated for success in India. As a result, the company will begin focusing its efforts on reducing its debt levels and will be focusing on increasing its organic growth rate.

Within the next two to three years, however, one should expect Kraft to be looking for smaller, local acquisitions to increase its national presence in various emerging markets. In China, Kraft will need to increase its presence through smaller acquisitions and local partnerships as the country's confectionary industry is extremely fragmented. Kraft is trying to decrease its reliance on stagnant Western nations and to protect itself against downturns in different regions of the world. The acquisition of Cadbury has positioned Kraft to be the leader in the global packaged food industry, but further growth in emerging markets is needed to maintain this position in the long term.

Top 10 Global Packaged Food Players Performance Globally 2001-2008




Solid bubbles show company global packaged food market value share, range displayed: 0.6-3.5%
*Note: Red outline shows back-trended performance of a joint Kraft/Cadbury entity
Source: Euromonitor

# Airlines Aren't Flying So High

## Could a New Revenue Model Bring the Air Travel Industry Back To Profitability?

Andy Krystal

Richard Branson was once asked how he became a millionaire, to which he quickly replied, "I had a billion dollars and I purchased an airline company." While Branson may have been joking, this subject is hardly a laughing matter, as the airline industry is notorious for losing money. According to the International Air Transport Association (IATA), the industry lost in excess of $10 billion in 2009 alone. Furthermore, this is not an anomaly – in fact these losses were minimized due to the relatively low cost of fuel that prevailed during 2009. While some airlines have demonstrated consistent profitability, the majority lose hundreds of millions of dollars each year.

In order to understand why these mountainous losses occur so regularly, one must first understand the business realities of passenger air travel. Since the majority of an airline's costs are fixed, flying an airplane with two passengers will cost an airline almost the same as flying an airplane with two hundred passengers aboard. Furthermore, the product that airlines provide is highly perishable in nature – as soon as an airplane departs, any unfilled seats go to waste, resulting in a lost opportunity to capture revenue. These heavy fixed costs, combined with the time-sensitive nature of the product puts pressure on airlines to capture revenue wherever possible. As such, many airlines look to provide customers with services above and beyond simple transportation in an effort to create new revenue streams.

The last three decades have seen the airline industry focus strongly on product differentiation in an attempt to stimulate increased demand for their various new revenue streams. Fare classes now separate tickets by seat, exchange flexibility, meals, and a variety of other different rules. Consumer prices are set by complex computer programs based on historical and current demand. These changes have added significant complexity to the buying process and customers now have little hope when it comes to predicting future prices. While adding incremental revenue for airlines, fare classes have alienated many consumers, and can often act as a barrier for travelers who would otherwise fly. Additionally, airlines restrict flexibility by selling tickets to unique users and prohibitively pricing returns and exchanges. Most industries do not have significant price volatility or restrictions on the use of their products, since consumers shift away from these goods. For perspective, consider how concert sale prices would be impacted if customers could not re-sell their tickets, and box-office prices varied by as much as 100% a week. By shifting to a more traditional model, airlines could increase revenues and cover their significant fixed costs by selling more tickets, hopefully allowing them to escape their seemingly unending bankruptcies.

### Current Model

Major players in the airline industry currently price using multiple fare classes whose availability changes depending on consumer demand. As an example, Air Canada offers five different fare classes – "Tango", "Tango Plus", "Latitude", "Executive Class Lowest", and "Executive Class Flexible". The most noticeable, (and arguably the only) differentiating factor between the five classes is that the two latter classes are business class, while the three former are economy. The rest of the difference is derived from how easy it is to obtain returns and refunds for fares.

**Air Canada Pricing Model**

| | Tango | Tango Plus | Latitude | Executive Lowest | Executive Flexible |
|---|---|---|---|---|---|
| **Above-Average Demand** | - | - | $289.00 | - | $859.00 |
| **Average Demand** | - | $149.00 | $289.00 | $659.00 | $859.00 |
| **Below Average Demand** | $99.00 | $149.00 | $289.00 | $659.00 | $859.00 |
| **Probable Seat Assignment** | 12B | 12B | 12B | 2A | 2A |

Air Canada uses different fare classes as a means of controlling the supply of their product. Based on historical analytics, Air Canada expects their planes to fill up at a certain rate per day at given pricing levels. If the company sees that a flight is filling quicker than historical rates, they stop selling "Tango" fares, leaving only the more expensive "Latitude" seats available. If the flight is filling slower than historical averages, Air Canada will either issue a seat sale, or increase the number of fares designated towards the "Tango" subclass. As frequent flyers know, this subclass is actually an arbitrary distinction built with the intention of leveraging additional revenue for the same product. Although these practices can lead to full airplanes, and provide increased levels of revenue and more control over their product, most airlines still lose significant amounts of money.

> While adding incremental revenue for airlines, fare classes have alienated many consumers, and can often act as a barrier for travelers who would otherwise fly.

The current model leaves customers feeling exploited by their carriers. More flexible carriers such as WestJet charge less for customers to switch flights after booking. There appears to be correlation between perceived fare flexibility and airline profitability. While profitability is based on many separate factors, it is worth noting that the most profitable airlines have some of the most flexible policies industry wide.

## Is Greater Ticket Flexibility The Answer?

The analysis conducted shows that customers currently ascribe value to fare flexibility and simplicity. By eliminating restrictions on transferring tickets and change fees, airlines could add a secondary-market to their tickets, creating a liquidity premium. As an example, a liquidity premium justifies higher valuations for hotly traded vintage cars than their similar, but less popular comparables. Having a market in which your purchases or investments can be quickly and easily resold adds security and drives up value. Like any other asset, airline tickets also have a liquidity premium built into their price – the more flexible the return rules, the more expensive the ticket. There are significant benefits to both consumers and airlines from increasing the flexibility of airline tickets. By increasing consumer demand for flights through an after-sale exchange, airlines could potentially maximize capacity utilization and become profitable.

## Consumer Effects

Airline customers stand to benefit significantly from increased ticket liquidity. First, the information displayed by an effective exchange would allow consumers to make more informed decisions about their potential trips. Instead of having to trust airlines' unpredictable computer models, customers could view past bidding history before buying tickets. Although over-the-counter prices would be slightly higher, these would be offset by the opportunity to sell tickets in the exchange. It would also reduce their hesitance to purchase expensive airline flights. There is currently considerable consumer reluctance to buy flights due to their high prices and airlines' cost-prohibitive refund policies. By making the market more accessible, easier and safer, an exchange could increase the willingness of consumers to use air travel.

## Airline Effects

Although counterintuitive, there are also ways in which airlines could benefit from increased ticket liquidity. By installing an after-market solution, airlines could eliminate the risk of not selling out flights. If airlines sold at slightly lower price levels, financial speculators and arbitrage seekers would purchase all of the tickets available. Since major airlines currently operate at approximately 80% occupancy, there is the potential for significant upside to guaranteeing sales, even at a slightly lower price. It is even possible that the additional liquidity provided by after-market solutions could raise prices while still maximizing utilization. Besides the potential increased revenues from the changes, airlines could also better predict their sales, reducing their operational risk. Airlines would additionally benefit from increased consumer demand for their products. As previously outlined, consumers will be less hesitant to purchase tickets for potential trips, increasing total demand.

Furthermore, an effective exchange with market-based valuations could improve airline decision making by reducing assumptions on revenue allocations. For example, on a flight between Toronto and Fort Lauderdale, with a connection in Atlanta, Delta Airlines would no longer have to guess what portion of the ticket revenue will be allocated to the Toronto – Atlanta portion, and what part to the Atlanta – Fort Lauderdale portion. Instead, the market would determine the fair value for each flight, allowing the airline to make better managerial decisions as to what routes are profitable, and what routes should be eliminated.

It would be naive to assume that airlines will benefit from all the effects of the increased liquidity. In the current market, significant information asymmetries exist in the corporation's favour. By withholding information from passengers, airlines can charge artificially high prices and misrepresent demand, maximizing their profits while gouging consumers. The industry's dynamic pricing

Switching Costs

| Type of Switch | WestJet | Air Canada (Tango) |
|---|---|---|
| **Change Flight** | $50 + Difference | $160 ($75/direction) + Difference |
| **Cancel Flight** | Fare banked, less $50 upon change | Fare Banked, less $150 upon change |
| **Transferable** | $50 Change Fee<br>"One Fee, Per Call, Per Person" | Non-Transferable |

model is effective at generating maximum revenue from each incremental consumer. Any change towards a more flexible pricing system could have benefits for first movers, but would probably reduce industry-wide margins if all airlines participated.

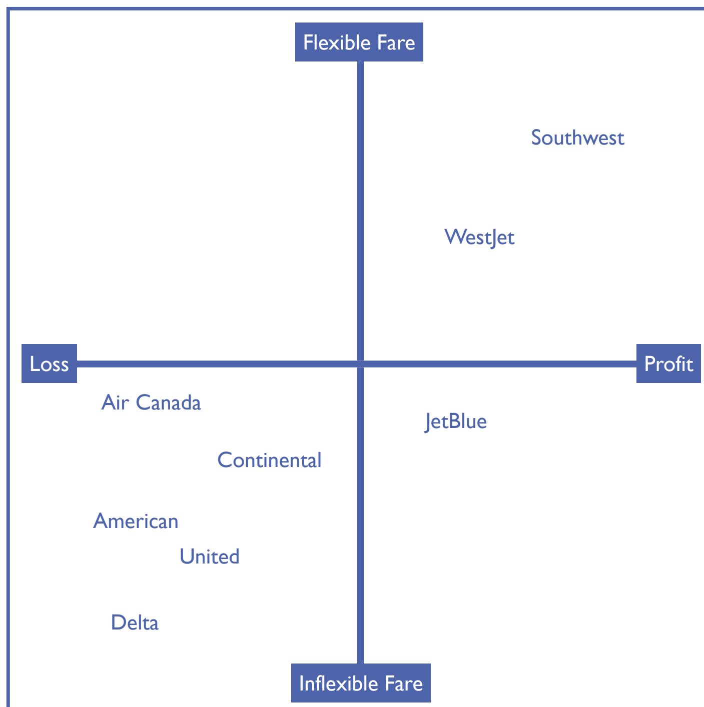
## Potential Implementations

Exchanges regulated by the IATA could develop where airline tickets can be both purchased and sold. Like the futures markets for oil or gold, an exchange for airline tickets can offer many advantages to both airlines and consumers. Besides allowing for the transfer of risk from one party to the other, and providing customers with an increased level of flexibility, the market will ultimately be able to establish an equilibrium price for any given flight.

A variety of possible methods exist in setting up such a market. The first, and most pragmatic method would be to develop an open exchange for buying and selling tickets. Like an option chain for an equity, each flight on each airline would be listed. One would be able to view both the bid and the ask price for each flight. Although at the onset liquidity would be low, over time liquidity on such an exchange would increase, bringing a complete overhaul to the travel industry as it is known today.

Any change towards a more flexible pricing system could have benefits for first movers, but would probably reduce industry-wide margins if all airlines participated.

There is also a way to provide benefits to consumers if airlines decide not to change their revenue models. In a derivative market, the product would be a derivative instrument based on either individual flights or flight index price. While this type of market does not allow individuals to directly sell their unusable tickets, it would allow airlines to hedge their revenue, while giving individuals exposure to their desired flights at lower costs. By purchasing a derivative, or a synthetic airline ticket, whose value is based off actual flight prices, travellers could effectively book travel without having to commit to the non-exchangeable, non-refundable airline ticket.




## Next Steps

*"We are a resilient industry. We will survive the crisis one way or another. But we must ask some serious questions. In what shape will the industry emerge? Will the shakeout be orderly? And the most important question of all: What can we do to make the industry healthier and stronger?"* - Giovanni Bisignani, Director General & CEO of the IATA

Although consumers would significantly benefit from the increased liquidity and flexibility that would be offered by the alternatives described, it would be extremely difficult to convince airlines that the new models would maximize their incomes. Carriers currently benefit from information asymmetries and product differentiation, both of which they would hate to relinquish. Combined with the potential security risks associated with unmonitored ticket sales, it seems unlikely that any current market participants would institute the recommended changes. In order for customers to see changes to airline pricing, they will have to force the changes upon airlines.

# The Big Pharma BUST

## The collapse of western pharmaceutical companies is inevitable

Natasha Neal & Juthika Thakur

Ranbaxy, Dr. Reddy's Laboratories, Nicholas Piramal, Cipla, and Biocon – are these Indian pharmaceutical companies familiar to you? They may not be today, but in the coming decades these are the brands that will likely be lining the shelves of pharmacies across the western world. Between 2010 and 2013, Eli Lilly will see four of its five patents on top-selling drugs expire. Other leading members of "Big Pharma", such as Pfizer, Novartis, Merck and Sanofi-Aventis will each be facing a similar predicament by 2016. These inevitable patent expirations will provide generic drug producers with a tremendous opportunity to capture a large part of the pharmaceutical industry worldwide.

### The Death of the Blockbuster Drug

Big Pharma has long known that its blockbuster drug business model would come to an end. For years the major industry players have struggled to develop new drugs that would be able to replace giants such as Lipitor, which generated close to $13 billion during 2008 alone. Furthermore, Big Pharma has very few opportunities to accelerate new drug development due to the laborious and time consuming processes involved in developing a drug, undergoing trials, and obtaining regulatory approval.

### Industry Value Chain

Explosive growth in the sales of pharmaceutical industry giants in the 1990s and 2000s was a direct, but not shocking result of the heavy investments Big Pharma made throughout the 1980s. During this time, the major industry players also began to make a series of vertical acquisitions designed to bring more operations in-house in order to protect their intellectual property and bring their promising drugs to market faster. The success (and expense) of Big Pharma's activities during this period prompted the industry's biggest companies to shift their financial resources from R&D to marketing in an attempt to fully capitalize on their high-potential portfolio and swelling asset base. However, the result of this strategy was a weakening of these companies' most essential capability: drug development.

Due to the long-lead times associated with bringing a new drug to market and the favourable patent terms available to Western pharmaceutical companies, the effects of this industry shift are only being felt today. Since recognizing their lack of prospective drugs in the late stages of R&D and exhausting their efforts at acquiring patent extensions, Big Pharma has commenced a series of acquisitions to build their patent portfolio, such as Pfizer's US$60 billion acquisition of Wyeth in early 2009, or have teamed up with generic drug makers to take advantage of their low-cost manufacturing and widespread distribution capabilities. The problem, however, is that there are only so many competitors that can be acquired, and eventually these companies will not be able to sustain themselves without developing their own new products.

In contrast, the lesser-known Indian pharmaceutical companies have spent the past 20 years building strong capabilities in the early stages of the value chain: R&D, production, and distribution. Improvements were facilitated by India's ability to conduct clinical trials faster and an abundance of inexpensive local talent. These advantages, matched with the Indian companies' focus on R&D, rather than marketing, allowed them to reap the benefits of their patent protection.

Western pharmaceutical companies, under the traditional blockbuster drug strategy, simply cannot compete on cost and do not have the R&D pipeline to be sustainable on their own. In fact, the only real advantages that these companies have over their Indian counterparts is their brand equity and existing relationships with consumers. Though this is a crucial selling point, it is one that cannot be sustained without having new, unique and life-altering drugs for an extended period of time. To mitigate this, Big Pharma has begun to aggressively pursue both joint ventures and acquisitions with a number of different Indian pharmaceutical companies. GlaxoSmithKline recently purchased a stake in Aspen (a South African generics manufacturer) and entered into an agreement with India-based Dr. Reddy's laboratory to sell generic products in Asian emerging markets under the GlaxoSmithKline brand. Similarly, Pfizer created Greenstone, a spin-off company selling generics, and has entered an agreement with multiple Indian companies to sell their products in the US and other markets. Though these strategies will help the Western pharmaceutical giants to sustain their profits in the short term, how much longer will it be until their Indian competitors no longer need them to succeed and grow?

### The Black Clouds

Joint ventures between Western and Indian pharmaceutical companies allow Indian generic drug makers to leverage the brand equity of their Western counterparts to sell "branded generics". The two-tiered selling scheme allows Big Pharma to continue selling its higher-priced branded drugs in Western markets while accessing developing markets by selling branded generics at substantially discounted prices.

However, the long term implications of this strategy have yet to be seen. Will consumers from developed countries sit back quietly as the exact same drugs they purchase, made by the same companies, are sold for a fifth of the price abroad? Or will consumers speak up and demand lower prices or seek alternatives, as we have

seen in other industries? The "medical tourism" industry, which is quickly growing internationally, is a prime example of the lengths consumers may be willing to go to reduce their healthcare costs. North Americans are now frequently traveling to developing countries such as Argentina, Cuba, Columbia, India, Malaysia and Thailand in order to obtain faster and cheaper medical treatment.

In addition, there is reason for consumers to be concerned that this strategy ignores the real problem: Western pharmaceutical companies are not rebuilding their capabilities at the early stages of the value chain. A recent study conducted by two professors at York University indicates that drug companies in North America continue to spend three times more on advertising and promotions than on R&D. In an industry that places so much emphasis on the size of its R&D investments, consumers should question the extent to which they trust the big branded companies over their smaller counterparts and other generics producers.

One further aspect to be considered is the actual sustainability of this plan when it comes to emerging markets. Economic growth will eventually bring these countries the levels of government and insurance provided healthcare that we've come to expect in the developed world. However, who is to say that the drug policies of these emerging market countries will cover the purchase of identical, higher-priced drugs instead of cheaper generic drugs that are produced domestically. Instead, it is more likely that consumers will be encouraged, if not forced, to purchase the cheapest generic drugs (that still meet the necessary quality standards), in order to obtain coverage by insurance companies. This trend will further diminish the market power of today's big pharmaceutical companies, and help give rise to India's budding giants.

## Winds of Change To The West

Many pharmaceutical companies, such as GlaxoSmithKline, Pfizer, and Novartis, have realized their long term survival depends on their success in emerging markets. Western pharmaceutical companies employing a vertically integrated strategy simply cannot sell their products at a lower price in emerging markets. To be successful in emerging markets, the Western pharma companies need to outsource non-core processes.

For example, Western pharmaceutical companies could decide to outsource distribution and on developing their R&D pipelines. Another strategy that Big Pharma could employ would be to target a population in a lower economic strata and develop a new market rather than focus on more mature markets. Novartis has taken the initiative to develop a pilot program targeting the bottom of the social pyramid in rural areas of India that plans to reach 50 million consumers that, before now, were not able to afford or access almost all major drugs. Hence, the company's strategy lies in distribution not marketing. An alternative sustainable strategy for Big Pharma lies in innovation. Instead of drug discovery, pharmaceutical companies can focus on new technologies like gene therapy, or "personalized medicine".

The key to being a sustainable global pharma company is to disaggregate the value chain and focus on core competencies based on available resources. A company with a great R&D pipeline, and weak distribution should partner with a company that has strong marketing capabilities and a widespread distribution infrastructure. It is these weaknesses in the value chain of the Big Pharma companes that will force them to outsource non-core processes.

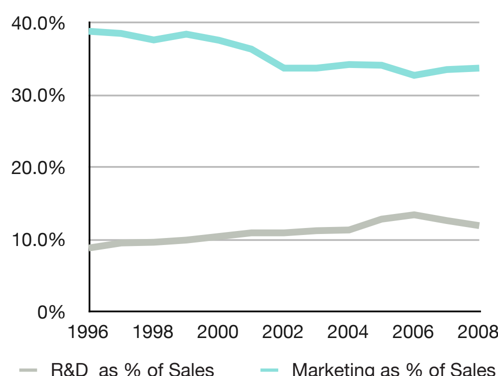
On the other hand, the Indian pharmaceutical companies have engaged in numerous joint ventures with their Western counterparts, and with any joint venture comes the transfer of knowledge. Joint ventures and the establishment of reputable brands by the Indian companies will allow them to be able to gain the support of insurance companies in both developed and developing markets. With high regard from insurance companies, Indian pharmaceuticals will finally be able to secure brand trust and ensure consumer confidence.

Finally, these Indian companies are ideally located in areas of large populations. Many of these companies have distribution already set-up in India, and are very close to other large Asian countries such as China. This will provide them with a huge, and increasingly important population to target before moving to North America and the rest of the developed world.

Indian pharma companies are already ahead of the race. Further acquisitions in this industry have allowed the Indian drug giants to build their R&D pipeline. With strong capabilities in manufacturing at a low cost and widespread distribution infrastructure, the Indian pharma companies are outsourcing their only weak component of their value chain: marketing.

While the Western pharmaceutical companies build their strategy on a disaggregated model, the Indian pharmaceutical companies will gain marketing knowledge, build their brand equity and eventually become vertically integrated. At this point, these companies will have strong capabilities in every component of their value chain. Though it is impossible to know who will come out on top, these changing industry dynamics suggest that "Indian Pharma" is poised to lead the industry in the coming decades.

Marketing as a Percent of Sales




Selection of Most Valuable Drugs in the World

| Company | Drug | Probable Expiray | Annual US revenue at risk |
|---|---|---|---|
| **Pfizer** | Lipitor | 1-Jun-11 | $5.8 billion |
| **AstraZeneca** | Nexium | 1-Nov-14 | $4.8 billion |
| **Bristol-Myers Squibb** | Plavix | 1-Nov-11 | $3.8 billion |
| **AstraZeneca** | Seroquel | 1-Nov-12 | $2.9 billion |
| **Merck** | Singulair | 1-Aug-10 | $2.9 billion |
| **Purdue Pharma** | Oxycontin | 1-Apr-13 | $2.5 billion |
| **Zydus CND** | Actos | 1-Jan-11 | $2.4 billion |
| **Forest Laboratories** | Lexapro | 1-Mar-12 | $2.4 billion |
| **Bristol-Myers Squibb** | Abilify | 1-Apr-15 | $2.4 billion |
| **Eli Lilly** | Cymbalta | 1-Jun-13 | $2.2 billion |

# NGOX

## A New Model For Building Processes In Developing Economies

Jordan Mayes

Many of the emerging markets' most serious problems, such as war, disease and famine can be attributed to their lack of development. Despite this, the developing world remains largely unchanged from its pre-1980s levels. Globalization, it seems, has left almost all of these countries behind. Over the past 50 years, the West has put more than $1 trillion of development aid into African nations alone – with little sign of progress. To address this problem, the concept of "development", and what it means to develop, must be refined and critically evaluated.

There are three key areas of development: Emergency 'Band-Aid' Solutions, Process Development and Infrastructure Building. Band-aids are simply that – temporary, unsustainable solutions that reach an immediate need. This might include handing out bottled water or rations of food to people in need. Process development is the creation of value chains within an economy. These systems, whether it be financial, food or service systems, are crucial to the sustainable growth of an economy. Finally, infrastructure development is the creation of structures – such as hospitals, schools and businesses – in conjunction with the processes. These are all necessary elements of changing a developing country into a self-sustaining member of the global community.

## The State of The NGOs

Of the largest 25 internationally focused NGOs based in the US, 19 have operations that focus on Band-aid solutions, 16 focus on infrastructure solutions and only three look to develop processes. This means that process development becomes the responsibility of local governments, many of which are in conflict and rapidly changing. The lack of NGO involvement in process development is a result of three characteristics:

1. **Processes are intangible:** Donors naturally want to see immediate returns on their donations, such as a new building or a child fed. Processes aren't that immediate, easy to grasp but they require large pools of resources to be used over time.
2. **Processes are iterative:** Processes are difficult to develop over a planned roadmap. They must be constantly tested, refined and changed. Along the road to success this patter requires a significant amount of 'wasteful' spending – not a popular business case in NGOs that have targets to reach and goals to attain.
3. **Talent is limited:** Finding the right human resources to develop processes is a challenge. Ideal candidates for this type of work are young, highly motivated experienced problem solvers. These candidates are in high demand in the private sector and are typically interested in relatively short-term contracts with dynamic exit opportunities.

**Ideal NGOX Employee**

| | |
|---|---|
| **Age** | 24-28 |
| Mobility and flexibility combined with some work experience is important, making employees aged 24-28 ideal | |
| **Education** | MBA from World Class Institution |
| It is important to develop a strong business fundamentals education | |
| **Work Experience** | Consulting / Finance |
| It is important to develop strong experience in solving complex financial, strategy and operations problems before doing so in the developing world | |
| **Country of Origin** | Developing World |
| The iterative nature of developing processes requires that employees be intentional about staying there for the long term | |

## A New Perspective

Profit players in the development market – particularly microfinance institutions and social entrepreneurs – are not typically equipped to develop processes for two reasons. First, process development requires significant collaboration and organization across a wide variety of players. Second, the naturally inefficient and unpredictable nature of process development means that a significant and reliable return is very risky. Other traditional process development players, such as public policy consulting firms, typically do not implement their long-term recommendations, leaving holes in the system that developing governments do not have the resources to fill. In countries with weak governments, this leaves process development to NGOs.

The financing, organizational and employee structures of existing NGOs are not sufficient to build processes. NGOs are typically stunted in their ability to offer competitive salaries, to develop their talent for post-NGO employment and to provide dense, business based hierarchy within their operations. Rather, a new type of NGO, NGOX, needs to be developed that is structured to build processes. This NGO would be a global professional organization that focuses on developing processes alongside governments and other NGOs. NGOX would focus on the coordination and management of these different players and developing the underlying processes of the economy.

## NGOX Employee Structure

For NGOX to be successful, they must tap into a pool of young, highly educated and experienced employees that can work dynamically and creatively in developing world economies. The

problem is that the supply of these employees from leading business schools – particularly with experience in the third world is low while the demand for their skills in private enterprise is high. NGOs have historically had significant problems competing with private enterprises on salary and instead have looked to compete on intangibles – a strategy that is very limiting.

To solve hte problem of talent, NGOX must increase supply and collude for demand. NGOX need to actively develop their unique talent pipeline and look to work with companies to recruit employees in a mutually beneficial way. This can be done by working with business schools, consultancies and financial institutions in a chain of development. Similar to how private businesses partner closely with business schools, NGOX need to ingrain their brand in these schools and firms to become competitive in the global talent market. Firms are increasingly seeking unique exit opportunities to offer their staff - a trend NGOX can latch onto.

**Step 1: Get the Candidates**
NGOX need to actively fill the beginning of their pipeline with bright, young entrepreneurial people from the developing world. Using a combination of interviews and tests, NGOX can effectively fill their pipeline with eligible pre-MBA business people.

**Step 2: Educate the Candidates**
A crucial element of NGOX's pipeline development is education. By effectively leveraging business school partners to train the unique candidates from step 1 and by educating the broader group of future business leaders on the developing world, NGOX can not only refine their pipeline but also grow it.

**Step 3: Mature the Candidates**
Newly minted MBAs typically require a maturation period before they have the requisite experience for solving complex development problems. NGOX should look to partner with a select group of consultancies and financial institutions to offer a unique 2+2 model where candidates gain experience working for a partner firm before they transfer to NGOX after two years. Firms benefit from this partnership by providing their employees with a unique exit opportunity.

**Step 4: Launch the Candidates**
After two years at a partner firm, NGOX hire the employees full time. The key driver for employees to leave their existing positions and join NGOX is to change their home countries while being competitively compensated. This private market competitive compensation is an important part of the strategy to reduce attrition an is one that is afforded by NGOX's unique financial structure.

## NGOX Financing

NGOX have two financing opportunities: grants and service fees. NGOX's unique business model and compensation scheme dictate a strategy focused on support from governments and other NGOs rather than individuals, who have a shorter time horizon when looking for results. As service providers that builds capabilities to achieve goals of NGOs, developed governments and developing governments, NGOX are a logical target for funding.

Service fees from multi-national corporations (MNCs) are a unique NGOX revenue stream that has the potential to dramatically change the scalability and growth of NGOX. As organizations that build value chains and business processes, NGOX require partners from across the business spectrum – entrepreneurs, small and medium sized businesses, MNCs and social entrepreneurs – to put their work into action.

NGOX and MNCs need to form important partnerships. To achieve their goals, NGOX require a broad mix of partners to create sustainable value chains. Likewise, MNCs require a stable business environment – one they cannot build alone when injecting their business capability, capital and resources into developing nations. The combination of developing world markets and developed world business practices provide MNCs with a strong opportunity to enter unsaturated markets by working with NGOX. While working with multinationals, it is crucial that NGOX maintain their independent non-profit focus, and work to develop processes that benefit nations, not simply their MNC sponsors. This should be accomplished by having infrequent funding periods, so that NGOX are not dependent on MNC, to operate day-to-day or even year-to-year.

## The Future of Development

NGOX look to radically change the often-parasitic relationship NGOs have with large public enterprises. The NGOX model of developing process and value chains not only makes it feasible to develop countries on a broad scale but it also provides a unique mechanism to develop talent and generate profits for MNC partners. These benefits - and potential revenue streams - need to be carefully balanced against NGOX's goal of developing processes. The not-for-profit structure of NGOX is meant to ensure value cocreation is a priority.

NGOX offers a viable, sustainable mechanism to bridge the gap between band-aid solutions and infrastructure development with processes that benefit all stakeholders. Structuring these win-win scenarios for the developing world is the only way sustainable, long-term results can be achieved.

Top 25 US Based International NGOs – Activities by Revenue

| | Band Aid | Process | Infrastructure |
|---|---|---|---|
| Catholic Charities USA | ■ | | |
| American National Red Cross | ■ | | |
| Food for the Poor | ■ | | |
| World Vision | ■ | | ■ |
| Brother's Brother Foundation | ■ | | |
| CARE USA | ■ | ■ | ■ |
| Catholic Relief Services | ■ | | ■ |
| United States Fund for UNICEF | ■ | | ■ |
| Save the Children Federation | | | ■ |
| Population Services Int. | | | ■ |
| Operation Blessing Int. Relief | ■ | | ■ |
| Compassion Int. | | | ■ |
| MAP Int. | | | ■ |
| Coop. Housing Foundation Int. | ■ | ■ | ■ |
| Family Health Int. | ■ | | ■ |
| American Jewish Joint Dist. Cmte | ■ | | |
| International Rescue Committee | ■ | | |
| Operation Compassion | ■ | | |
| ChildFund Int. | | | ■ |
| Mercy Corps | ■ | ■ | ■ |
| Catholic Medical Mission Board | | | ■ |
| PATH | ■ | | ■ |
| Christian Aid Ministries | ■ | | |
| Project HOPE | ■ | | ■ |
| Direct Relief Int. | ■ | | |

## ACLU v. Myriad Genetics

In May 2009, the American Civil Liberties Union (ACLU) filed a lawsuit against biopharmaceutical and genomics company Myriad Genetics on behalf of a broad coalition including medical and scientific organizations, individual researchers and physicians, and cancer patients. The suit is challenging the validity and constitutionality of seven of the company's patents on two genes, known as BRCA 1 and BRCA 2; however, the true substance of the case lies in the challenge against gene patents in general. Because the public generally feels uneasy about a company having exclusive rights over a part of the human body, the case has garnered a significant amount of media attention within the last year and has been dubbed "one of the most important legal battles in the history of biotechnology." The case effectively highlights the practical conflicts raised by patents, but also raises questions as to whether gene patents require special consideration.

The term "gene patent" is used to describe patents relating to methods of testing for genetic conditions, various markers or probes using particular genes, or even the genes themselves. Approximately 20% of all human genes are currently patented – including genes associated with Alzheimer's disease, muscular dystrophy and asthma. Prior to 1980, the U.S. Patent and Trademark Office did not permit the patenting of a biological organism; however, in a landmark decision, the US Supreme Court held that a genetically-modified bacteria for cleaning up oil spills was patentable subject matter. The majority judgment, which remains the key decision in the US and in many countries (including Canada), stated that, "everything under the sun that is made by man" may be patented, including living organisms and genetic material. Shortly after the decision, the US Patent and Trademark Office was flooded with applications relating to genes and genetic testing methods and the number continues to grow. As of 2003, approximately three million genome-related applications have been filed.

Current international trade and patent harmonization agreements, such as the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), affirm this position. The signatories consider genes (including those of human origin) to be patentable material, provided they meet general patent criteria and are demonstrated to be new creations (ie. artificial genes) or are isolated from nature and identified (i.e., cloned and sequenced), and shown to have a particular function and use. Myriad's gene patents are on BRCA 1 and BRCA 2, which are the genes associated with hereditary forms of breast and ovarian cancer. Although the patents do not claim the genes themselves, their claims cover isolated DNA molecules and all methods of diagnosing cancer using these molecules. Brian Poissant, a lawyer for Myriad states, "…this is not nature's handiwork. This is the ingenuity of man." The claim does not specify any specific steps to compare the genes, nor does it recite any structural limitations or otherwise link the method to any particular instrumentation or equipment. With these patents, Myriad holds the only currently available diagnostic test for these genes (which they sell for a little over US$3,000) and they control the right to allow testing and experimentation on these genes.

## Hindering or Stimulating Innovation?

The Biotechnology Industry Organization warns that undermining a firm's ability to sue patent infringers will deter investment in developing new tests and therapies, while the ACLU holds that the patents are deterring innovation by creating significant obstacles for research. Patents have long been viewed as an essential part of the innovation process - particularly in biotechnology, as noted by Robert Cook-Deegan and Stephen McCormack, "no other sector of the economy depends as much on strong patent protection" as the pharmaceutical and biotechnology industries. A potential monopoly is arguably a necessary incentive when big profits are often not achieved until decades after the initial discovery. Investment will only occur if there are significant rewards for years of research and substantial risk incurred. Furthermore, one of the rationales for the existence of patents is to facilitate the disclosure of useful information to the public, which will, in theory, lead to further innovations and technological developments. In order to receive monopoly protection, the inventor must provide a detailed description of his/her invention.

> Some ethicists argue that gene patents involve the "commodification of life" because they place a commercial value on human life and reduce it to a marketable product.

Despite the support for patents within the biotechnology industry and much of the research community, there is a growing concern that, in the context of human genetics, patents may actually deter

innovation. The human genome is essentially a finite resource, which has led some to believe the proliferation of gene patents will slow or stop researchers from working on particular regions of the genome for fear of infringing on an existing patent. With the current system, upstream patents on "inventions," such as expressed sequence tags, can slow or impede the development of practical, downstream inventions, including gene tests and therapeutics. A study by the Secretary's Advisory Committee on Genetics, Health and Society found that conditions such as Huntington's disease, cystic fibrosis and colorectal cancer, which do not have patented genes, have more widely available tests than for diseases such as breast cancer.

Given the recent advancements in our knowledge of genetics, it seems unlikely that the judges from the Chakrabarty decision could have possibly contemplated the significance and consequences of their decision back in 1980. In a symposium on the subject in the Chicago-Kent Law Review, John M Conley comments, "Every year, we seem to hear more about the multiplicity of tasks that our relatively few genes perform. With each year's hindsight, last year's understanding of how genes work looks incomplete and primitive." As such, patent offices should be cautious when granting upstream and early patents since they can create rights of unknown scope and significance.

## Patentable Material?

Many critics argue that the genes are products of nature that occur without human manipulation and that the useful properties of the "invention" are natural properties of the gene. In its submission, the ACLU claims that Myriad did not "invent, create or in any way construct or engineer" the genes, but merely "located them in nature and described their informational content as it exists and functions in nature." An "isolated and purified" gene, which is what Myriad has patented, is essentially a gene that was identified and reproduced outside of the body – a cloned gene. Myriad's clone, or cDNA version of the naturally-occurring gene, differs from the naturally-occurring variant only in that the introns, or non-coding regions, are absent. This "isolated and purified gene" is used to compare with a patient's gene to search for mutations in the genetic sequence known to cause cancer. Thus, while an isolated gene is different in terms of chemical structure, the entire utility of the claimed isolate lies in the fact that it is functionally indistinguishable from the natural version.

## Morally Wrong?

The case has received significant media attention largely due to the personal and human aspects of the material. As Mark Perry, Professor of Biotechnology Law at Western, describes, people are drawn in by the connotations associated with owning genes because "we don't like the idea of people owning human life." Some ethicists argue that gene patents involve the "commodification of life" because they place a commercial value on human life and reduce it to a marketable product. In more extreme situations, gene patenting may support an increasingly market-driven view of disease, disability and normality, as companies would clearly benefit from a broad definition of "disease" and a narrow definition of "normalcy". Through active advertising and marketing, companies like Myriad may facilitate "inflated perceptions of the value of specific genetic tests [and] could drive a wave of inappropriate testing".

## What does the Decision Mean for the Public and the Biotechnology Industry?

Patent holders are granted a twenty-year monopoly over the invention, allowing them to charge a premium to help recoup their costs from research and reward their innovation and risk. However, this premium may also prevent the patients who could benefit from accessing their technology. Myriad has actively enforced their patent rights in the past, as seen in 2001 when they were upheld in Canada against a challenge from provincial health care ministries. As a result, a number of Canadian provinces have stated that the public system cannot afford the Myriad test. Several provinces have taken the position that they will either ignore or fight the patent. Women with one of these gene mutations in the BRCA 1 and BRCA 2 gene have an approximately 40-85% lifetime risk of developing breast cancer. This test would be especially beneficial for women predisposed to a higher risk of cancer, such as those a family history. If they had access to this test, this knowledge would lead to earlier and more vigilant screening for the cancers and improve their medical decisions.

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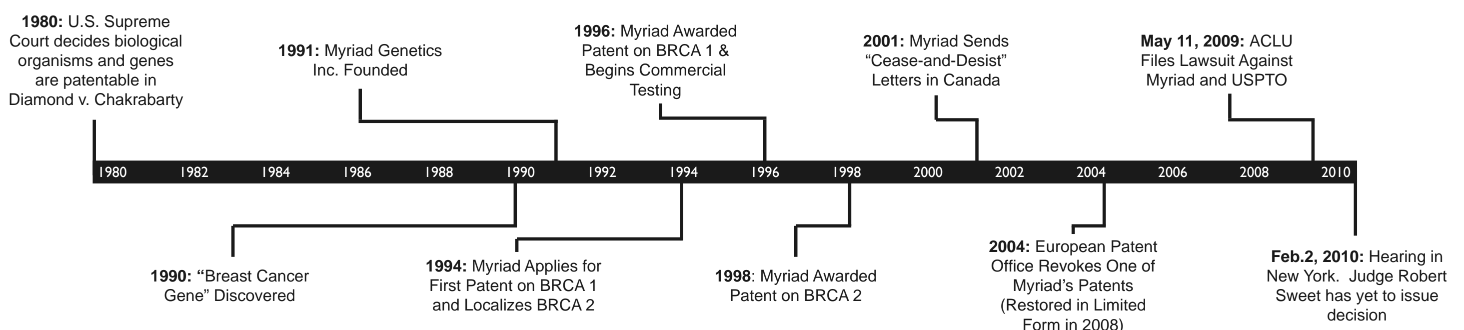
Gene patents also raise concerns regarding the quality of genetic tests. In the rush to patent the findings from research, others in the field cannot verify the results of these findings. For example, the accuracy of newly patented genetic tests, for example, cannot be confirmed. With more open access to the genes, more tests could be developed to provide an opportunity for a second opinion.



As of this date, Judge Robert Sweet has still not issued a decision from the February 2nd hearing at the New York Southern District Court. Myriad does not appear worried about the outcome, despite the company's share price dropping from $32.55 on the day before the suit was announced to a low of $20.62 in mid-February. Myriad's CEO has attempted to calm investors, assuring them that the ACLU is only challenging 15 method and composition claims on seven BRCA patents of Myriad's 23 patents and 179 claims on BRCA Analysis. However, Myriad should not be too comfortable, as it is a company built upon a narrow intellectual portfolio. The ACLU has a much larger goal in mind, and it was only a matter of "pick[ing] one case as our case." Despite focusing on a narrow set of claims, the ACLU intends to not only invalidate Myriad's patents, but the concept of genetic patenting in general. Such a result would lead to a massive overhaul in the biotechnology industry and open up research completely.

As previously mentioned, the potential for a monopoly is a driving force behind a company's research. The invalidation of gene patents would create a tradeoff: researchers would have greater access to information and further innovation, yet the funding and investment would almost certainly decrease. Who will fill this funding gap? While public funding is available, it will never compare to that of the private sector. One must ask what is more important, improving access to new discoveries and technology or fostering innovation and promoting the economy? These are policy questions that would need to be addressed prior to a decision abolishing patents on genes.

## What Can We Expect?

Despite the arguments presented above, it would certainly be premature to sell one's shares in Myriad Genetics at this point. It is possible that the courts will reinterpret or reverse the precedent but it is far more likely to continue the status quo of limiting gene patents at the margin. The most probable of the outcome of the case will be a narrowing of the scope on some of Myriad's patents, some of which are very broad. In fact, Myriad's European patents have similarly been challenged, with parts of them being overturned. Ultimately, it will be a long, uphill fight for the ACLU.

The invalidation of gene patents would create a tradeoff: researchers would have greater access to information and further innovation, yet the funding and investment would almost certainly decrease. Who will fill in this funding gap?

Given the billions of dollars invested in gene patents, it safe to assume that even if the court ruled against gene patents, the biotechnology industry would appeal this decision as far as possible - a process which could take years. However, some commentators have suggested that the outcome of the case will become unpredictable once it reaches the Supreme Court, where policy plays a greater role. It has been almost 30 years since the Diamond v. Chakrabarty decision and a lot has changed in the area of biotechnology, which may warrant revisiting the issue. As Conley for the Genomics Law Report explains, "there is some concern on the Supreme Court that biotech patents have gone too far. In a couple of years we may finally find out just how deeply that concern runs."

Tang Tang & Kenny Choi

What has happened to Microsoft? The company that pioneered the PC and struck fear into an entire industry has become a manufacturer of knock off goods and also-rans. For close to a decade, Microsoft has failed to release a single innovative or market changing product. Only three of the company's five divisions, Windows, Office and Server Tools, are profitable – and each of them is based on products the company established long ago. The two divisions that represent the future of the technology landscape, Entertainment & Devices and Online Services, have remained unprofitable for years, despite billion dollar investments. Microsoft's inability to move outside of its core businesses shows in its stock price; since 2000, the company's share prices have declined by 40%. During this same time, Apple and Google's shares have risen by 600% and 450% respectively as these companies revolutionized more than a dozen markets or industries.

These differing returns are indicative of the different approaches to innovation that each company has taken. Apple is undoubtedly a revolutionary company. It looks at existing value chains and markets to see where there are opportunities, insufficiencies or competitive tunnel vision. The company then works relentlessly to provide consumers with a single product that changes the way they think about the entire category. Apple's most fundamental passion is innovation. Google, on the other hand, develops dozens of new products and services each year, which can be anything from an incremental to a paradigm changing improvement over competing products and services. This philosophy is deeply embedded within Google's culture; as Marissa Mayer, Google's Vice-President of Search Products and User Experience, puts it, "We believe that we should be launching more products than what will ultimately become phenomenally popular." To fuel their rapid pace of innovation, Google allows its employees to spend 20% of their week developing their own ideas. This approach has generated a number of resounding successes, such as Gmail, AdSense and Google Earth. Google views innovation as the key to staying relevant, regardless of their present-day dominance and success.

Microsoft was once an innovative company. The company pioneered the era of the personal computer by developing many of the foundational products and partnerships that drove the widespread adoption of the PC that defines life today. This success, however, is also at the core of Microsoft's recent innovation troubles. The company's three golden eggs, Windows, Office and Server Tools, have provided Microsoft with a war chest of cash and near-monopolistic control over their customers. As a result, the company now prefers to act as a market follower, rather than a market maker. At its core, Microsoft believes that its cash reserves will allow it to overcome any market obstacles and that high switching costs will prevent its users from adopting any competing products.

Given this mindset, it is no surprise that the company has failed to release an innovative product for close to ten years, or that its newest products, such as the Zune, struggle to provide its target customers with a compelling reason to switch. Even the company's fabled Windows division is showing signs of weakness. Though Windows continues to enjoy above 90% market share, Mac OS has close to 20% market share among computer users under 25 years old and has stolen share from Windows every year since 2002.

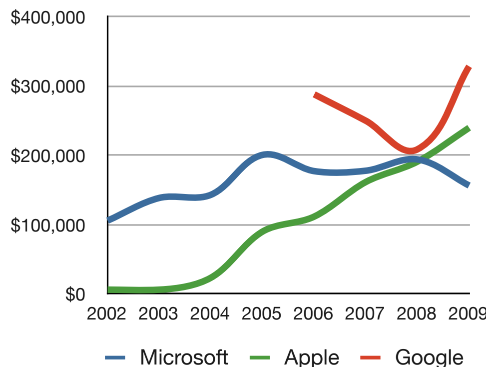
Across the board, one prevailing fact becomes evident: Microsoft's fundamental approach to competing in the technology industry is flawed. In the last decade, Microsoft has made a point of never developing new markets. Instead, the company has operated under a policy of only entering markets that are deemed "stable" and can support at least yearly sales of 50 million total units. This strategy has impacted the company in two ways. Firstly, it allows Microsoft's competitors to secure a first mover advantage and define the marketplace and points of competition. Secondly, it drastically alters the company's culture and perception of innovation. A company that no longer feels the need to push itself and simply relies on its cash reserves to solve its competitive problems is not one that innovates.

For close to a decade, Microsoft has failed to release a single innovative or market changing product. Only three of the company's five divisions, Windows, Office and Server Tools, are profitable – and each of them is based on products the company established long ago

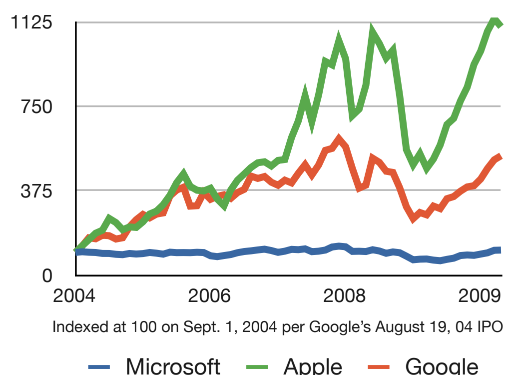
So how is it possible that a company that employs some of the brightest minds in the world can't seem to introduce a truly innovative product? Even by just sheer luck, something should have come out from the 90,000 people who work at Microsoft. In fact, Microsoft files more patents a year than any other company in the United States other than IBM. At 20 patents a day, Microsoft files more than ten times as many patents as Apple and more than six times as many per employee. Even when Microsoft has a truly unique idea, like the Microsoft Courier, it is often weighed down by the company's cumbersome and chaotic development process. The Courier is a "booklet PC" which contains two multi-touch screens hinged like a day planner and uses both a pen and an on-screen keyboard for text inputs. The product first leaked in September 2009 – five months before the iPad was announced – and is widely believed to be a wholly superior product to Apple's tablet computer. Nine months later, the product appears no closer to launch and Microsoft will again end up being overshadowed by Apple's first-to-market competing product.

Digging deeper, it becomes apparent that the problem does not solely stem from Microsoft's inability to generate ideas, but also, from the company's inability to execute them. The vast majority of Microsoft's plethora of patents simply never leave the Microsoft machine. Apple and Google both have simple, well-defined processes for bringing innovative ideas to market. At Apple, great ideas are carried up to the top. If Steve Jobs or another member of the executive likes it, they will take control of the project, coordinate departmental cooperation and do everything they can to deliver it to market. At Google, employees are allotted 20% of their time to pursue anything that interests them and are given the resources and people they need to bring these ideas to market. Microsoft's approach to innovation recognition and development is markedly different. At Microsoft, an innovative idea must be approved and championed by layer after layer of middle management before being passed on to the head of a product division. At this point, the idea is pitched to other product managers and divisions who have to sign off on the product and allocate their own resources before the project can go ahead. Dick Brass, a former Vice President at Microsoft explains that even when projects do move forward, many of them become crippled or abandoned as a result of "internecine warfare" between Microsoft's many product groups. Innovative ideas are continually sidelined due to layers of bureaucracy, politics or smply because managers of Microsoft's existing product areas are threatened by them. This lack of ownership and drive to push any new ideas forward results in countless products and innovations becoming lost within Microsoft every year. The consequence of these lost opportunities is clear. Over the past decade, Microsoft's Net Income per Employee has dropped by 24% - leaving it at less than half that of Google.

Income Per Employee




Stock Price Over Time (Index = 100)



Moving forward, Microsoft needs to understand and accept three realities. First, the company is a market maker not a market follower. The Microsoft's success came from building and locking down industries – not fighting for leftovers. Secondly, Microsoft must understand that long-term success in the technology industry comes from constant innovation. Yesterday's leading products won't lead forever, and cash band-aids and high switching costs will never eliminate the need to innovate. Microsoft already has the tools necessary to create and realize new markets and products. However, it needs to put the trust back in its employees and create a culture that facilitates the creation, development and release of innovative products.

To spur innovation and ensure its products make it to market, Microsoft must understand one final point: it is time to drastically alter its current organizational structure and behavior. Microsoft's management may argue that change is unnecessary, particularly given the fact the company is generating close to $60 billion a year in revenue and $15 billion in profit. However, two of its five divisions continue to be unprofitable, its shareholder returns languish; and soon, band-aid solutions will be unable to save its three golden eggs. But what exactly should the company do? Should Microsoft follow the Apple model of top-down product control? Or should the company follow the Google model, where employees are given the freedom to develop their own products and operate in a largely flat organization? Microsoft doesn't actually have to do either. Instead, the company should create a new organizational structure to take advantage of the company's strong market position while pushing their 90,000 employees to execute innovative ideas and deliver them to market as soon as possible.

> Over the past decade, Microsoft's Net Income per Employee has dropped by 24% - leaving it at less than half that of Google.

To do this, Microsoft must dismantle the Microsoft Machine and change the way its product groups operate and are compensated. Firstly, each of Microsoft's existing divisions should be made more independent and profit focused. The company cannot afford to allow products such as the Xbox to go ten years without showing signs of a cumulative profit, or rely on integration with successful products from other divisions to bring them to profitability.

Microsoft Courier Concept

When new, viable ideas emerge from within the organization, Microsoft should create separate entities focused solely on developing these ideas and bringing them to market. Such entities should be separated from the rest of the corporation and be governed by their own President, Executives and Vice Presidents. They should be set up to closely mimic silicon-valley technology startups, with small, focused teams, entrepreneurial employees, and the leeway to take risks. Additionally, employee compensation should be tied directly to the commercial success of their specific product, rather than Microsoft as a whole. In this way, the success of the unit and its employees will be dependent primarily on the success of their products. As a result, employees will be motivated to turn their innovative ideas into commercially viable products and ensure that they go to market as soon as possible.

These "intrapreneurial" units will be able to leverage Microsoft's resources as a financier, marketer and distributer, while remaining independent of the company's bureaucracy and providing the entrepreneurial culture needed to quickly bring innovative ideas to market. Such entities would attract the best and the brightest employees, and provide them with the freedom, excitement and reward of working at a technology start-up - one with a virtually unlimited war chest. If such an entity was formed for the Courier in 2009, it's possible that Microsoft, not Apple, would be leading the tablet PC revolution.

> Microsoft should create separate entities focused solely on developing these innovative ideas and bringing them to market.

This type of change will be difficult for Microsoft. However, the company's long-term success depends on creating innovative products and building markets, not insulating its users with high switching costs or using its cash reserves to play catch-up. Microsoft needs to change the way it operates, the way it thinks and the way it develops its ideas. In doing so, the company will be able to unleash the creative talents of its leading workforce and return to leading the industry it helped create.

# IS CHINA'S GROWTH A HOUSE OF CARDS?

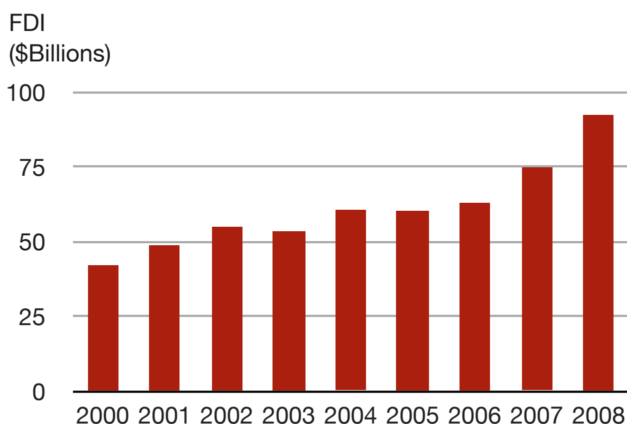
## AVOIDING THE PITFALLS OF OPERATING IN THE WORLD'S FASTEST GROWING MAJOR ECONOMY

LORNE CREIGHTON & CALVIN WHITE

With growth in Gross Domestic Product soaring to 10.7% in the fourth quarter of 2009, China has seemingly defied the global recession of the past two years, remaining the world's fastest growing major economy. Not surprisingly, the incredible track record of steady growth in China has prompted many Western executives to centre their aggressive growth strategies in this area of the world. According to the Ministry of Commerce of the People's Republic of China, foreign direct investment (FDI) inflows in China reached a record level of US$92.4 billion in 2008, largely driven by a push by Western multinationals to build a dominant position in a market that is becoming increasingly important in a global context.

Despite the clear strategic motivation for numerous Western multinationals to invest in China, there are many pitfalls that executives need to be mindful of. The notion that economic growth will insulate foreign entrants from the negative consequences of poor strategic decisions and execution is unfounded. In fact, many companies will find that the true growth potential for their operations in China is far lower than the reported quarterly GDP figures would lead them to believe.

FDI Inflows




## Roads and Bridges to Nowhere

China appears to have a Field of Dreams approach to their continued economic growth, perhaps hearing the same whisper Kevin Costner's character hears in his cornfield, "if you build it, they will come". The New South China Mall, the world's largest mall based on gross leasable area, has remained approximately 99% vacant since its opening in 2005. The new "Ghost City" of Ordos, lavishly built in only five years as a home for one million residents, remains empty while construction on new projects in the city continue. Infrastructure projects such as these are common in China, partly to encourage people to relocate to urban areas, but more likely to boost the country's GDP through government spending.

What's interesting about this situation is how economic activity is driven by GDP forecasts in China, and not the other way around. Patrick Chovanec, a professor at Tsinghua University in Beijing, recently said in an interview "Who wants to be the mayor who reports that he didn't get eight percent GDP growth this year? Nobody wants to come forward with that. So the incentives in the system are to build. And if that's the easiest way to achieve that growth, then you build."

This type of economic growth, based on the expansion of inputs rather than growth in output per unit of input, is exactly what Paul Krugman spoke about when referring to Singapore in his 1994 paper titled The Myth of Asia's Miracle. What makes this type of growth particularly concerning in the case of China is the fact that so many of the factors driving China's growth are not repeatable. For instance, investing to increase the level of education can only happen once before the country reaches an education level similar to Western economies. In addition, there are a finite number of infrastructure projects that China can invest in before zero economic value is added and roads and bridges are quite literally built to nowhere. This alone should lead companies to be skeptical of China's ability to continue growing at its current rate. Companies must also contend with the fact that reported economic performance is unreliable, since the data is often time-lagged and manipulated prior to public reporting. The implication for Western multinationals looking to invest in China is clear: economic growth is currently overstated and is very likely to decline in the future. There is certainly growth available for new entrants to capitalize on, but if they are expecting the wondrous reported numbers of China's unfailing growth, they are in for a rude awakening.

## China Plays by China's Rules

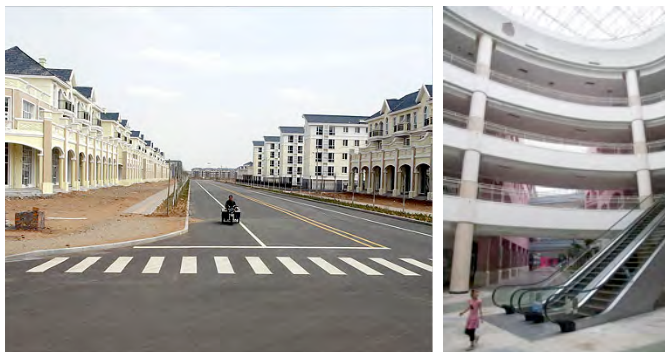
China's rapid expansion of inputs isn't just causing an unclear growth outlook for multinationals. One of the most frightening aspects of China's growth has to do with its various state-owned enterprises (SOEs) which can manipulate markets and create overcapacity. Unfortunately, China plays by China's rules and government-controlled entities such as SOEs rarely exist purely to generate profits. Instead, SOEs often operate solely to fulfill certain policy objectives such as increasing the supply of available housing or affordable office space. What makes this situation so dangerous for a foreign private enterprise operating in China is the fact that its competitors, often SOEs, are not bound by similar economic constraints. This leaves companies exposed to the risk that an SOE may offer their product or service at a lower price to increase affordability for citizens at the expense of profit. China's input-fueled growth is likely to cause serious problems for foreign private enterprises operating in industries where SOEs can easily offer lower prices to consumers or build excess capacity in the industry.

## Avoiding the Pitfalls

Although the Chinese growth story causes many potential problems for companies looking to enter the market, this shouldn't prevent Western companies from building a meaningful presence in the country. After all, operating in a country with an uncertain growth outlook and the presence of SOEs may be preferred to slow growth in domestic markets with intense competitive pressures. Instead of ignoring the Chinese market due to uncertainty, Western multinationals should enter China with sound business objectives and the expectation that growth in their product market will not be as robust as advertised. For many companies, this means looking to achieve depth in the Chinese market as opposed to attempting to ride the coattails of growth.

The success and sustainability of a company's entry into China can be measured based on growth in market share instead of absolute growth in customers. In the coming decade it will become apparent that many of the failed market entry strategies were the result of failing to grow market share on a percentage basis. To illustrate this point, consider a company achieving growth of eight to ten percent in China, far exceeding their growth in Western markets. At China's reported current growth rate, this means that the company is failing to achieve any real growth attributable to the company's management. As the growth rate of China's economy inevitably declines, so too will the growth of the company, leaving it in no better competitive position than at the point of market entry. Compare this to a company which achieves its sales growth in China through a focused strategy of gaining market share in a few key product lines. In this instance, the company's success is far more dependant on factors within the control of management. Long after economic growth slows in China, a company that has positioned itself with a distinct competitive advantage can continue to achieve impressive growth over time.

Ghost City of Ordos & New South China Mall



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It is important to note that choosing to develop a sustainable competitive position in China involves tradeoffs, and attempting to replicate a successful existing strategy in China is not the way to ensure success. When Coca-Cola entered China in 1981, the company discovered that Cola was not a well-known or popular beverage in the country. Realizing that it would be very difficult to gain traction with its flagship product, Coca-Cola invested heavily in two products, Sprite and Fanta, which were much more popular in China at the time. Although this narrow focus differed significantly from what Coca-Cola was doing in Western economies at the time, the company recognized the need to establish itself as a market share leader at an early stage. In contrast, Pepsi failed to gain traction because of its decision to pursue early-stage growth in all of its beverages, including Cola. Over time, Coke became a successful product in China due to the well-established presence of Coca-Cola's other, more popular products. To this day, Coke sales in China are nearly three times more than Pepsi sales. Almost all of this difference in sales can be attributed to Coca-Cola's initial decision to pursue an aggressive market share expansion strategy with a narrow product focus.

## Managing Risk

Even if Western multinationals can insulate themselves from the effects of a growth slowdown, the risks associated with overcapacity and competing with SOEs must be addressed prior to market entry. To date, many companies have taken the approach of partnering with SOEs through joint venture agreements. These can be especially valuable in China, as they not only mitigate the risk of capacity being over-built, but also offer local connections and ties with the government. Teaming up with other private enterprises is also a viable option, offering a partner that can successfully operate independently (as opposed to the government support SOEs receive), and with goals in line with foreign entrants, including the long-term success of their organization operating within China. The difficulties for foreign entrants exist in situations where SOEs or private enterprises are unwilling to pursue partnerships or the industry is highly fragmented. In this scenario, foreign entrants face the risk that their fixed investments in China will become highly underutilized due to factors outside of their control. Although there is no way to completely eliminate this risk, two strategies can be put in place to reduce the effect of adverse competitive forces. Firstly, companies can attempt to achieve flexibility in their Chinese operations from both a cost and mobility perspective. For example, if overcapacity is a serious risk for the company, investment dollars should be directed towards operations with low fixed costs

relative to variable costs, such that the company is insulated from volume declines. From a mobility perspective, companies should attempt to achieve flexibility by producing products that can be easily sold in neighboring markets, if necessary. Secondly, companies should pursue opportunities in industries that the Chinese government does not view as being imperative to the economic development of the country. This reduces the risk that the industry will become the focus of SOE investments, driving capacity utilization and industry profits lower. Companies may need to adapt their current global or western strategies to successfully pursue the Chinese market and therefore must be cognizant of their organization's ability to stretch and adapt their core capabilities. Furthermore, they must then be willing to change accordingly if needed.

## Recognizing Where the Real Growth Is

Roughly a year ago, Coca-Cola's $2.3 billion planned acquisition of the Chinese company Huiyuan Juice fell through due to apparent government anti-monopoly sentiments. While this deal made sense for Coke on a number of levels, one of the greatest benefits would have been Coke's new market penetration in third and fourth-tier cities in China. When looking at the Chinese market, most companies focus on Shanghai and Beijing and ignore the less-developed areas. Coke, however, recognized that these areas, home to roughly 800 million Chinese consumers, are where the real growth is. These consumers have been relatively shielded from the financial panic, and though they spend less than their mega-city counterparts, they still represent an important component of domestic consumption. Companies with inexpensive products, like Coke, should look now to these areas as they develop, and companies with more expensive products may need to scale their products down, for the emerging customers who can't afford to buy large but still want the best. It's important for foreign companies in China, and those considering entering, to not only execute their strategy but develop their strategy around the markets where they can find the largest customer growth.

## Enter China for the Right Reasons

China represents an incredible opportunity for Western multinationals to profitably expand their businesses; however, the road to success is lined with numerous pitfalls that are rarely understood and often foolishly sought after. Recognizing the growing importance of China, Western multinationals that can adjust their strategies to gain depth in the Chinese market will ultimately be rewarded. Companies investing in China solely for growth will find that they have underestimated what it takes to be successful in the world's fastest growing major economy.

# Why Goliath needs David

## How major film studios are threatening their long-term survival by closing their speciality divisions

Evan Dell'Aquila

The business behind the film industry is far removed from the glamorous world its products display on the silver screen. For every blockbuster or sleeper hit, studios release dozens of other films that either under perform or lose millions. For decades, success has depended on a studio's ability to create the perfect synthesis between a film's source material, writers, cast, production team, director and so on. However, the film industry has begun to shift towards a new model, one that focuses almost exclusively on building franchises and leveraging existing markets. This shift has drastically impacted every aspect of the industry.

The movies being produced today are predominantly based on established content from comics, to board games, books, old movies and even bubble gum characters. The success major studios have found with this new strategy has compelled more than half of them to shutdown or divest their independent film divisions over the past few years. The increased importance of content ownership also prompted companies like Marvel Entertainment to form their own studios rather than license their material to companies like Universal or 20th Century Fox. Only 14 months after Marvel released its first self-financed and self-produced film, Disney purchased the entire company for $4 billion in an effort to secure franchises such as Iron Man and X-Men. The acquisition of this type of content further aligns with the strategic industry shift towards 3D, IMAX and computer generated imagery films; all of which are difficult to incorporate into independent films.

From the major studio's perspective, this strategy makes sense. Shutting down their middle-market and specialty subsidiaries allows them to concentrate their resources on films with lower risk and higher profit potential. However, the strategy itself holds inherent risk, limiting studios to a draw from a finite amount of creative content – the driving force in the industry.

## Film Industry

The film industry's traditional value chain has only a few points in which much value is created or captured. The majority of the value is created during production and distribution and captured by the studio during the film's theatrical release, and to a lesser extent DVDs. This process requires a tremendous amount of financial resources and expertise, and has typically insulated the major studios from new competition. The studio's focus on downstream revenues (video games, merchandise, television show licensing broadcast rights etc.) has traditionally been minimal, as its total value was relatively small compared to the film's theatrical revenues and primarily captured by the original license owner. In recent years, however, downstream revenues have been generating up to five times more than film's theatrical release for certain film franchises. This trend empowered content owners and prompted companies like Marvel to realize that they were leaving money on the table by licensing their content to the major studios for only a fraction of theatrical revenues. As a result, many began to establish their own studio subsidiaries in order to capture value across the entire value chain.

Major Studios & Specialty Divisions

| | Specialty Division | Market Share |
|---|---|---|
| **Warner Bros. Pictures** | New Line Cinema | 20.10% |
| **20th Century Fox** | Fox Searchlight | 16.10% |
| **Paramount Pictures** | Paramount Vantage | 14.30% |
| **Columbia Pictures** | Sony Picture Classics | 14.10% |
| **Walt Disney Pictures** | Miramax | 11.90% |
| **Universal Studios** | Focus Features | 10% |

Red Indicates Closure

The first movie Marvel independently financed was Iron Man, which was released in 2008 and grossed over $575 million in worldwide theatrical revenue. By self-producing the film, Marvel also obtained a greater share of the movies downstream revenue, bringing the film's total revenue to over $1 billion. This success demonstrated the extensive power Marvel possessed with its library of over 5,000 established characters and brands, and led to Disney acquiring the company only 14 months later. Disney had realized they had been paying for the marketing of Marvel's downstream material, and that a failure to acquire Marvel or other content owners could be a serious long term liability. This issue is of even greater concern as Marvel and others continued to move up the value chain and become outright competitors of Disney.

The Marvel acquisition is emblematic of what is a much larger strategic shift for major studios, and serves as a precursor to what direction the film industry is heading. Virtually all major studios are producing movies from unoriginal content, franchising the brand and capturing all aspects of revenue related to it. Essentially, film studios are no longer solely film studios, but a holding company. Each of the studio's franchises or brands act as "subsidiaries", which provide the company with continuous revenue streams across the entire value chain. This transformation reduces the importance of a film's theatrical revenues and causes a fundamental shift in the way films are developed - ultimately leading to the question of whether specialty film divisions are worth keeping.

Film Industry Value Chain

## Disney Holdings, Incorporated

One of the major benefits of the franchise holding company model is the way in which it allows the studio to reduce production and marketing costs through scale. Avatar cost 20th Century Fox an estimated $350 million to produce. However, the vast majority of production expenses, such as developing the film's character models or buying content rights, were one-time costs that would not be incurred in developing a sequel. Many other production related costs, such as staffing and casting expenses, would also be lower due to the ability to simply carryover talent. As a result, 20th Century Fox can expect a considerably lower production costs for Avatar 2.

Marketing budgets for films are notorious for drastically reducing the net profit a film will receive. By developing film franchises, studios are able to leverage existing consumer awareness around the brand and use momentum from other brand launches, such as a recently released video game or new television series. These tactics allow the studios to further reduce film budgets and achieve other franchise-related marketing synergies that will drastically improve overall profitability. The proof of this can be evidenced by the fact that studios are continually shortening the gap between a film's theatrical release and its appearance on DVD. Ten years ago, companies like Disney would have never reduced this window, as it was their primary source of revenue and could damage theatre relations. However, shortening this gap allows them to retain strong consumer awareness and interest around the brand as it continues down the industry value chain.

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The upcoming Avengers franchise by Marvel provides an example of this strategy on a mass scale. In 2008, the company released The Incredible Hulk and Iron Man, both shared key characters and organizations. The films' successes have prompted Marvel to begin signing leading actors, such as Samuel L. Jackson, to nine film contracts. In May 2010, Marvel releases Iron Man 2, with Thor and Captain America coming out the following year. Each of these films is expected to build upon each others "mythology" and contain crossovers from the leading characters in the other films. Finally, all of these characters will appear together in The Avengers in 2012. This rapid succession of films, as well as their subsequent downstream revenues, allows Marvel to continue consumer awareness of these franchises for several years and effectively subscribe consumers to repeated purchases.

Non-franchised films have a clear contrast, having one shot at covering marketing expenses and making a solid profit. Conversely, studios are much more inclined to make a smaller profit when introducing a brand like Avatar, which could have substantially greater long term value. Even in the event that one of the films fails, they will simply put it on a layaway and re-launch it in a few years.

This holding company model further exemplifies the importance of content ownership. Once a major studio owns a brand, they own it for its lifetime. This magnitude of potential profits is only made possible through the content ownership. The business model shows why independent features are losing their place. Compared to franchised movies, independent movies are not well equipped to have significant reoccurring revenue, or cost savings.

Movies Being Made on Existing Toys and Games

- Hot Wheels
- Battleship
- Candyland
- Max Steele
- Stretch Armstrong
- Monopoly
- Lego
- Asteroids
- Magic 8-Ball
- Smurfs

## The Dominant Business Model

With the revenue potential Marvel holds, Disney's decision to shut down its famed film house, Miramax, becomes much clearer. Many specialty divisions are unable to adjust to – or compete with – the new business model being adapted by the major studios. Major studios benefit from a significantly simpler and less risky production process. By using existing franchises or brands, major studios can quickly and easily develop film content. Production is more streamlined and requires less effort when it comes to cinematography or location-finding. Additionally, potential blockbusters can also be produced in 3D or IMAX, which are not only increasingly popular with audiences but can also increase ticket prices by 35%. Lastly, using existing brands means that the likelihood of the film's failure is also reduced. Even if the theatrical release does not cover the budget, downstream revenue helps the company improve its financial return.

Speciality divisions have an entirely different process that's also significantly riskier. Strong source material is harder to find, slower to develop and typically based on a completely new idea. The production is often less efficient and the film itself is less likely to be 3D or IMAX. Finally, the release has very high risk of failure, especially since it caters to a much more niche audience. Contrasted to a studio, the failure of one major independent film can bring down the entire independent studio.

Holding Company Model

| Company | 2009 | | 2011 | | 2012 | | 2013 | | 2014 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Exp. | Rev. | Exp. | Rev. | Exp. | Rev. | Exp. | Rev. | Exp. | Rev. |
| Franchise | $300 | $500 | $250 | $500 | $200 | $550 | $200 | $600 | $200 | $700 |
| Independent 1 | $10 | $50 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Independent 2 | 0 | 0 | $20 | $5 | 0 | 0 | 0 | 0 | 0 | 0 |
| Independent 3 | 0 | 0 | 0 | 0 | 0 | 0 | $30 | $200 | 0 | 0 |

It is often independent movies that herald critical acclaim and win many of the most prestigious awards. However, blockbuster movies are major studios' core competency and primary revenue source. Conversely, studios not only make substantially less with its independent films, they also have a tougher time with marketing and distribution to their niche appeal and the amount of nurturing they require throughout the process. As a result, the studios' incremental investment will almost always be put towards building the next potential franchise, rather than towards its speciality division.

## David's Advantage

What studios fail to realize is the long-term implications the closure of specialty divisions will have in creating a sustainable competitive advantage relative to other major studios. Originally, the birth of specialty divisions arose from major studios recognizing the additional revenue streams they could capture by creating films for niche markets. The hyper competitive nature of the business caused each of the six major studios to create or acquire their own branches, and this same competitiveness is now causing studios to divest.

For an industry that relies on content, this decision should be alarming. By closing their specialty divisions, the major studios are essentially turning off any new inflow of ideas and resigning themselves to their existing stock. Prominent film franchises such as The Godfather, Terminator, Twilight, Saw and Star Wars, were all launched from a major studio's speciality division. Save for the odd exception, it's difficult to see how the major studios' current strategy will have any similar franchises see the light of day.

Many major studios would argue their new strategy will still incorporate smaller scale independent films. History paints a clear picture of the limited success they have had in marketing these productions. Simply put, the independent film industry is very different from mainstream movies. Independent divisions are called specialty divisions because of the expertise required in producing and marketing their films. Studios have considerable experience and understanding of the mainstream market. However, what they do not know is how to market a specialty documentary, foreign or art-house film. They all serve niche markets of varied and diverse demographics where individual attention is essential for success.

Paramount has recently announced an interesting new strategy, spending $1 million on 10-20 micro-budget films a year. While this is an admirable effort to continue to develop new talent, without a specialty arm to properly nurse the movies' development it will likely be unsuccessful. The inconsistent performance of these films will influence studios to revert back to their reliable holding company model when determining which films to finance. In an industry where content drives the value chain, when studios release more content to be produced by other firms they are distributing power.

The major studios' shift away from the independent market has already allowed new players to compete and thrive. Independent studios like Summit Entertainment, Overture Films and The Weinstein Company have been on the rise. The performances of these companies indicate that non-mainstream markets still exist, and there is a significant amount of money that can be made serving them – even without the holding company model.

By closing their specialty divisions, the major studios are essentially turning off any new inflow of ideas and resigning themselves to their existing stock.

Major studios are forgetting the importance of mixing creative inputs when it comes to ensuring their long term success. The independent subsidiaries should not be treated as a drag on the studios' blockbuster franchises, but rather an investment needed to develop new ideas and secure the studio's competitive position in the marketplace. Furthermore, the long-term direction of the industry may result in another rise of the independents. In this event, the studios that have shutdown or divested their subsidiaries will find themselves unable to catch up. Meanwhile, newly formed independents will find it's their time to shine. When this happens, the major studios shouldn't count on them to be an easy buy.

# Sidecar Funds: A New Battleground in the GP/LP War

Matthew H. Hall & Courtland Morrice

The private equity (PE) industry has seen a number of innovations since the days of the first leveraged buyout (LBO) boom 25 years ago. Along with the proliferation of innovation in deal-making, structuring, and financial engineering, the private equity fund-raising model has developed a new wrinkle. North American and European PE funds have begun raising committed co-investment pools (CCPs), known colloquially as "sidecar funds", alongside their primary (LBO) fund-raising activities. CCPs have common sponsorship and management with the primary funds, and provide the General Partner (GP) a bypass on restrictions against operating multiple funds concurrently. Many times the fund's initial investors can deploy capital in the CCP on a pro-rata basis (though this is not always the case).

There is reasonable and logical justification for the proliferation of CCPs. They allow sponsors to access capital beyond primary fund commitments for attractive investments on a short-term basis, instead of having to go through a formal fund-raising process. For example, if a sponsor reaches its concentration or committed capital limit in a given fund, they can use a CCP to deploy additional capital in attractive opportunities in which they would otherwise be precluded from participating in. In addition, CCPs also offer deal structuring flexibility. Large syndicated or "club" deals, which involve a number of sponsors and typically arise from situations where the lead sponsor does not have the committed capital or concentration space in their primary fund to take the deal themselves, can be particularly complex and arduous. CCPs are a good way of getting around this complication as they technically do not count against concentration limits. Finally, from a psychological perspective, it also allows sponsors to raise more money from their Limited Partner (LP) base at a given time (it helps reduce the "sticker shock" of large fund raising activities).

However, as the private equity industry battled through the recent economic downturn the purpose of these CCPs began to fundamentally change. They became less about reducing the need for club deals or making new investments after the main fund had run dry, and began to focus on bailing out poorly-performing portfolio companies (previous investments). The buyout euphoria leading up to 2008 had left many recently acquired companies with too much debt. This, combined with the economic downturn, pushed these companies right up against their banking covenants. While the private equity industry as a whole was performing poorly (particularly the 2005 vintage funds), several GPs saw an opportunity: raise a CCP (in some cases 4 years after closing their main fund), use the funds to provide much needed equity to their own troubled portfolio companies (at all-time low valuations), and then earn "carry" on the sure-to-perform CCP (while the primary fund would be lucky to restore its original capital base).

## Key Terms

**Private Equity** An asset class that involves investments in companies that are not publicly traded or buyouts of publicly traded companies in order to make them private companies.

**Leveraged Buyout (LBOs)** LBOs involve a financial sponsor acquiring a controlling interest in a company's equity where a significant percentage of the purchase price is financed through leverage (borrowing) in order to increase returns to equity-holders.

**Club Deal (Syndicated Investment)** Refers to an LBO or other private equity investment that involves several different financial sponsors.

**Carried Interest** A share of the profits of an investment partnership paid to the manager as compensation.

**Covenant** A promise in a formal debt agreement, that certain activities will or will not be carried out.

**Dilution** A reduction in the proportionate equity stake that occurs through the issuance of additional shares or the conversion of convertible securities.

**Financial Sponsors** A term commonly used to refer to private equity investment firms.

**Fairness Opinion** A professional evaluation by an investment bank or other third party as to whether the terms of a financial transaction are fair.

**Limited Partner (LP)** A provider of capital on a limited liability basis to an investment partnership which is subsequently managed by a General Partner (GP).

**General Partner (GP)** An operator of an investment partnership to which one or more Limited Partners have contributed capital. GP's hold agent authority for the entire investment partnership.

The first mega-fund to pitch this idea to its investors was the "grand-daddy" of U.S. private equity, Kohlberg Kravis Roberts & Co. (KKR). During the summer of 2009, KKR asked investors for □730 million to prop up its second European fund (KKR Europe II, currently tracking at a -13% IRR), which held high-profile investments such as UK-based pharmacy chain Alliance Boots. The target fund-raise for this CCP represented 16% of the €4.5 billion main fund. KRR's proposal has prompted a number of other PE shops to adopt a similar strategy, giving rise to several critical and closely related issues.

The first interesting issue deals with who is allowed to participate in these funds, and to what extent. Forgetting for an instant the quandary of throwing good money after bad, and making the assumption that any LP would want to invest in these CCPs, an important problem arises when some LPs can't invest due to their own liquidity problems. This sets the scene for a corresponding misalignment of interests between the committed LPs, the non-committed LPs, and the GPs. The question then becomes two parts: 1. to whom/how do you offer the CCP; and 2. what happens when some or all of the main fund's LPs can't commit.

Both questions are relatively simple to address. A rights offering, a staple of non-dilutive corporate financing, is arguably both simple and fair to all parties involved. The main fund's LPs would be offered the opportunity to deploy capital in the CCP on a pro-rata basis. It is the LPs' capital which the main fund has impaired, and thus they should be given first opportunity to earn compensatory returns. Should one or more LPs not commit to the CCP, the remaining capital should be re-offered to the committed LPs on a pro-rata basis to their existing CCP commitments. This cycle would then be repeated until either the fund-raising was complete or no LP was willing to commit additional funds. It is only after this process has been exhausted that fund-raising should take place outside the main fund's LP base. Although some would identify a "free-ride" problem (why would any LPs pour more equity capital into bailing out their investment when others might?), this should be mitigated by the ultra-low valuations (and commensurately high internal rates of return on the marginal capital deployed) the LP would be offered.

Related to the above in its application to cases where the primary fund LP base is not identical to the resulting CCP LP base (either in absolute identity or ownership %), is the question of what valuation the CCP should make its investments. GPs will say the purpose of their sidecar is to provide some level of recovery for the main fund's investments, however the underlying driver is all about earning returns by any means possible (to please their current LPs, so that they can pay themselves, and for future fund-raising purposes). The best way to earn the largest possible return is to ensure the investment is entered at the lowest possible valuation (i.e. be as dilutive as possible to the main fund). This is fine when the main fund's LPs are identical to the CCP's LPs, but when they differ, and the GP has a contractual obligation to both, how are their competing interests with respect to valuation balanced?

Arguably, the best way to handle this second issue is to start by valuing proposed CCP investments as stand-alone operating companies (using public trading comparables or discounted cash flow analyses). Next, the operators need to determine how much equity capital the company needs to keep it clear of any possible covenant breaches. Knowing the amount of equity needed, and the fair valuation, the CCP will then make its dilutive investment. While there are two critical inputs to the above equation ("fair" valuation and required equity), the biggest issue of these for the LP is the valuation. As noted above, the GP (and in this case the CCP LP base) is incentivized to be as dilutive as possible. To balance this, the main fund LPs should be given the opportunity to obtain an independent fairness opinion on any proposed cross-fund investment (where in this case cross-fund refers to investments originally made by the main fund). From a fairness perspective, should the valuations differ materially the main fund LPs' valuation should be accepted. While any GP will seek to maximize returns on their CCP, those returns won't mean anything in a fund-raising cycle if no LP will give you an audience. From a fiduciary point of view, this issue needs to be clearly discussed in any future CCP agreements.

Sponsor compensation may be the most contentious CCP issue. However, for some GPs who marketed CCPs over the past year, there is only a very slim possibility of earning carry on their main fund. While each agreement will differ, it is not unimaginable that the GPs who raised these funds would try to include language permitting them to earn carry on a separately calculated basis from the main fund. If this were the case (as we assume) then the CCP would represent an extremely lucrative opportunity for the GPs to achieve phenomenal returns (and thus phenomenal compensation) in a period when the GP might otherwise see nothing until their next main fund was raised and harvested. This would provide significant incentive to focus a disproportionate amount of time on the CCP's performance while possibly neglecting the main fund.

An important problem arises when some limited partners can't invest due to their own liquidity problems.

One potential solution to deal with this issue would be to introduce a "high-water mark" incentive structure for the fund managers (an idea borrowed from hedge fund incentive structures). In order to earn carried interest on CCP investments, managers would have to ensure that the total investment value and commensurate IRR exceeds the fund's hurdle rate and high-water mark. For example, assume a PE fund bought out a company for $10 billion at a 10x EBITDA multiple, financed with 70% debt. If the fund was forced to deploy CCP capital into the investment (for example, $1 billion at 5x EBITDA), the carried interest would be calculated on the overall returns including both funds (the CCP would act more like a direct extension of the initial fund) and not awarded until the main fund had been restored to its high-water level. Another way to accomplish this idea, although without the high-water mark requirement, would simply be to judge carry on an overall fund (main fund plus CCP) basis. In this case, proceeds from the harvesting of the CCP would flow directly to main fund LPs until their original capital was restored. At that point, returns would be divided pro-rata between the main fund and the CCP. Only after both LP bases had received their original capital commitments plus their preferred return would the GP be entitled to carry. This structure would no doubt be favourable to main fund LPs and encourage them to deploy additional capital through the CCP.

While the issues raised above are not exhaustive, they do provide a glimpse into the multi-level complexities which GPs will be forced to deal with when considering potential future CCPs. Until the economic downturn has been safely navigated, GPs and LPs will be provided yet another battleground on which they will wage their perpetual war.

# INTERACTING WITH GOVERNMENT

## A framework for how corporations should react to government actions

JACK HANSEN & ANSHUL RUPARELL

Governments and corporations have a symbiotic relationship, with each relying on the other to survive and thrive. The government's success depends on private expenditure, which brings employment opportunities and increases citizens' standard of living. Businesses require adequate risk-adjusted returns on their investments and look for predictable government policies when conducting their operations. This co-dependence generally results in policies that meet both parties' needs. However, government actions do sometimes result in adverse conditions for business investment. When this occurs, corporations are faced with difficult choices about how to react. Based on an analysis of three seemingly unrelated, but timely events, a number of considerations have been found that businesses should address when determining how to respond to unexpected government actions.

### World Tour

In 2007, the Albertan government instituted a new Royalty Rate Regime in an attempt to maximize government revenues from the province's thriving energy sector. Royalties can essentially be viewed as a tax on gross production. Whenever an oil or gas company sells any of their extracted resources, the government immediately takes a share of the realized sale price. These royalty revenues have historically constituted up to a third of Albertan Provincial government tax revenue. After conducting a royalty review, the government instituted new and significantly higher rates dependent on both production volume and commodity prices. This increased the maximum government take on oil and gas revenues from 35% to 50%. Producers immediately rebelled, with EnCana Corporation publicly shifting CD $1 billion of capital expenditures out of Alberta and into British Columbia and Saskatchewan. Combined with a decrease in commodity prices and the onset of the current recession, corporate oil and gas expenditures, and tax revenue plummeted in Alberta. In the ensuing two years, the government instituted many temporary programs to stimulate increased investment. In March, 2010, the Albertan government gave in to producer demands by instituting a new royalty regime that essentially matched the pre-2007 program. It remains to be seen how producers will react to this new regime, as the private sector will likely harbour feelings of mistrust towards the government for some time and doubt the longevity of any public initiative or promise. It is, however, clear that their demands and reduced investment eventually broke the Stelmach government's willpower.

In July of 2009, the Chinese government arrested four employees of Rio Tinto, an Australian iron-ore producer, on charges of commercial spying, bribery and espionage. Although the espionage charge was later dropped, this abrupt action shows how quickly changes can occur in business-government relations. After these arrests, speculation arose that they were political moves by the government to affect Rio's ongoing price discussions with the state-controlled steel industry group. Other analysts cited Government anger over state-controlled firm Chinalco's failed US $19.5 billion investment in the firm – one that Rio had accepted, and subsequently rejected when other sources of capital became available. Surprisingly, in late-March 2010, the detained employees plead guilty to charges of bribery. The trial of these employees for stealing confidential information is ongoing, but is closed to foreign press on the grounds of "State Secrets". Although the outcome of this trial has yet to be determined, the charges were met with international scorn as the information in question would be considered fair and standard research in almost any other country. Further complicating this relationship is the 9% stake that Chinalco holds in Rio Tinto. Even with these trials proceeding, Rio Tinto and the Chinese Government continue to hold negotiations and undertake business ventures together – including a recently announced US $1.35 billion joint venture in Africa.

It is clear that oil producers' demands and reduced investment eventually broke the Stelmach government's willpower.

Google's recent decision to close its Chinese search engine was a direct consequence of a series of cyber-attacks, allegedly originating from China, on Google source code and the Gmail accounts of Chinese human rights activists. Although Google had entered the Chinese market with reservations about censoring search content, they followed Government censorship rules until these attacks occurred. Although Google's other Chinese operations are currently ongoing, analysts are unsure if the Chinese government will allow this to continue. The government has been harsh in its condemnation of Google, issuing strongly-worded statements and demanding internally that large Chinese corporations sever ties with the search provider. Until January, Google had abided by Chinese censorship laws in an attempt to gain market share in the world's fastest growing Internet market.

### Corporate Considerations

By examining these three events, it becomes clear that corporate and government actions differ vastly depending on their relative power in the relationship. In determining how to respond to an unexpected government decision, there are a set questions that an organization should ask itself to help determine a suitable response.

1. Can the absolute or relative returns being earned be replicated elsewhere?
2. Does this decision jeopardize the firm's operations in other jurisdictions?
3. Is the government able to obtain the same level of investment from other companies?

By using this framework, firms can determine the power relationship between themselves and the government, allowing them to pursue the accordingly correct actions. The relative importance of these considerations varies depending on the situation. It is crucial that corporations correctly judge the relative importance of each question.

## Can The Corporation Earn Comparable Returns Elsewhere?

The primary concern of any corporation is its ability to earn a return on its investments. If the returns available in a district can be exceeded in other jurisdictions, organizations will shift their expenditures to these new districts, thereby reducing government revenues in the original area. Power will then shift from the local governments towards corporations. Any actions taken by governments that reduce returns will be met with immediately decreased investment. The ease of transferring capital expenditures to B.C. and Saskatchewan was the most important threat used by Albertan oil producers in their effort to reduce royalty rates.

Corporations must take both absolute and relative returns into account when evaluating potential returns in varying jurisdictions. Although Rio Tinto could potentially earn better relative returns on expenditures in other districts, the absolute returns in China are so large as to preclude the corporation from stopping Chinese investment. In 2009, Chinese buyers accounted for 24.3% of Rio Tinto's sales. The organization's recognition of their reliance on China is exhibited by the CEO Tom Albanse's recent comments to a Chinese delegation, "I can only say we respectfully await the outcome of the Chinese legal process. We remain committed to strengthening our relationship with China, not just because you are our biggest customer, but because we see long-term business advantages for both of us."

Compared to the other two corporations, Google faces a more complex return analysis. Although only 2.5% of its current revenues are generated in China, the company's decision to leave the country could have a long-term impact on its corporate earnings, as it will be hard to re-enter this fast growing market. In the short run, these revenues are likely replaceable, but the total financial impact will not be measurable for at least a decade.

## How Will These Decisions Affect The Firm's Operations In Other Jurisdictions?

The second question that the organization must ask itself is if the unforeseen government decision will have a negative impact on returns being earned in other jurisdictions. Many corporations operate in different countries, but these operations are run independently and have little to no effect on one another. Although this is the case for the Alberta oil and gas producers and Rio Tinto, in Google's case, the issues in China could be detrimental to its businesses in North America and Europe. While the firm has been operating under Chinese censorship laws since the launch of its Chinese-language search engine in 2006, only after the recent discovery of "China originated" cyber-attacks has it come under-fire from the media that it may not be adhering to its "Don't be evil" mantra. With the threat of additional negative press and lost business in its core operating areas, Google has decided to cease its Chinese operations. In these circumstances a corporation must determine which of its operating areas are the most valuable and make the decision that protects those areas. If this means that the firm must end its relationship in a certain jurisdiction, then the company is obliged to follow Google's footsteps and do so.

## Can The Government Obtain The Same Level of Investment From Other Sources?

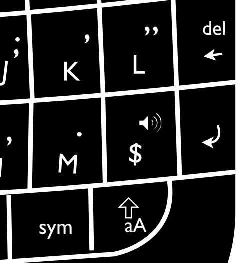
Finally, organizations must ask themselves whether the government in question has the ability to substitute other firms into their place. Governments will seldom make decisions that assuredly set their jurisdictions back financially in the long run, thus if a decision has the effect of driving out investment with no means to replace it, then the power ultimately lies with the corporation. In Alberta, the government eventually realized that oil and gas producers could easily move their investments to other locations, and that they were not being replaced by other industries. As such, they had no choice but to change the royalty programs back to their former, lower levels. In such cases, where the corporations hold signficant power over governments, there are numerous strategies that may be effective in reversing these unexpected decisions. Whether a firm leaves or adamantly protests the decision, ultimately the financial realities will convince the government to remedy the situation.

"I can only say we respectfully await the outcome of the Chinese legal process. We remain committed to strengthening our relationship with China, not just because you are our biggest customer, but because we see long-term business advantages for both of us." - Tom Albanse, CEO, Rio Tinto

In circumstances like the one faced by Rio Tinto, however, the power may rest in the hands of the government. Any steel producer would gladly engage in business with the Chinese government to secure the rights to such a large and growing market. Knowing this, Rio has no choice but to continue its operations in the country – regardless of what decisions the government is making. These are the situations where a corporation may be forced to lower its head and continue to work with the government, because any other decision would be detrimental to the firm.

## Leaving Your Comfort Zone

As evidenced by the three examples studied, corporations can understand the power dynamic between themselves and governments by asking themsleves three simple questions. The realizations reached through this framework can show how businesses must act in response to government actions. It is important to note that this is only a framework, and that judgment must be applied in determining responses to questions and in evaluating the relative importance of each consideration. In certain instances, one question may be so dominant as to trivialize the other two. When applied correctly, this framework can help interested parties predict and understand corporate reactions to government actions.




# Social Media Off The Rack

## Tailoring Social Media Strategy for High-End Fashion

Ian Rosen

Over the past few years, social media hubs, such as Facebook and Twitter, have rapidly emerged as an essential tool for businesses looking to bolster their brand image and build a relationship with their target market. However, the rush to capitalize on this unprecedented opportunity has resulted in many businesses failing to create an effective social media strategy. Furthermore, many of the companies that originally viewed social media as a competitive necessity are now concerned that their online campaigns might inadvertently damage their brand image.

The high-end fashion industry is no stranger to this conundrum. Larry Rosen, CEO of Harry Rosen, acknowledges the need to engage social media, but has yet to discover an appropriate tactical and strategic balance. "We consider ourselves to be in the learning phase of using social media. We hope that over time it can become a very important communication channel for our younger demographic." This hopeful outlook has developed en masse among fashion retailers, highlighted by Facebook pages that range from less than one thousand "fans" to over a million. However, the social media race has left many companies with online strategies that do not match their brick-and-mortar goals and are almost entirely indistinguishable from one another. As a result, high-end fashion retailers and manufacturers are endangering their brands and defeating their in-store strategies.

## Social Media for Luxury Brands

The need for social media in high-end fashion is increasing as Generation Ys begin to form the core of a retailer's client base. Businesses recognize the importance of satisfying the customers of today, as well as laying the foundations for the customers of tomorrow. In the past, this meant updating product lines and adjusting one's brand image. Today, however, building an intimate relationship through social media is essential for companies looking to keep pace with tomorrow's evolving customer base. Failing to recognize social media's importance or appeal will threaten the longevity of a business and leave room for other companies to fill the resulting void. Companies may, however, risk undermining their competitive advantages through frivolously entering social media without a defined strategy in place.

Iconic brands such as Gucci, Lacoste, and Chanel have all established Facebook and Twitter pages for the public to view and follow. However, these pages often conflict with the company's individual marketing and brand image strategies. Firstly, they are almost always undifferentiated due to the formatting standards or functional limitations of sites like Twitter or Facebook. Similarly, many companies only use these sites to inform their users of the latest sale, product introduction or event photos. As a result, the social media experiences these companies provide their users are often indistinguishable from one another. This is surprising, given that the same brands spend hundreds of millions of dollars each year distinguishing themselves from their competitors. Luxury brands need to understand that their social media strategy should focus on reinforcing a distinct brand image and connecting with the consumer. As such, they must focus less on promotions, announcements and alerts, and more on reinforcing the company's unique identity or culture. Tweets should convey the brand's passion and style by commenting on major news, events or trends just as the company's "Follower" or "Fan" might expect to see from their friends online.

Traditionally, upscale brands have been able to carefully restrict their customers through high-prices and targeted distribution. However, the open nature of social media means that anyone can associate themselves with a luxury brand at the click of a button. This type of exposure can jeopardize a brand's "exclusive" or "premier" positioning, as their names appear alongside advertisements for student housing and Muscle Milk. The result can be the loss of control over their tremendously important brand image.

In the early 2000s, British "hooligans" began to wear Burberry's least expensive products in an attempt to avoid being watched by local police. Though the sales of these products temporarily skyrocketed, the brand eventually became closely associated with thugs, rather than typical upper-class patrons. In order to repair their image, Burberry discontinued many of their then best selling products and unveiled a comprehensive and tightly controlled advertising campaign in high-end magazines.

Twitter and Facebook pose a similar risk to companies. Whenever they "Become a Fan" of a brand, consumers have the ability to damage a luxury brand's meticulously crafted image. Seeing that every one of your friends are Facebook fans of Dolce & Gabbana, for example, would undoubtedly remove some of the mystique and exclusivity of owning one of their handbags. As such, brands that covet their "exclusive" position and customers should be wary of allowing such generic access to their brand and products – however attractive social media may seem at first.

Social media also allows the customer to form their initial or primary relationship with the brand online, rather than through a purchase. The connection made with a purchase is both authentic and personal; the product is the ambassador of the brand. In contrast, following the brand on Twitter provides the customer with a user experience that isn't exclusive, memorable or distinct. By permitting extensive and undifferentiated access to the company online, these iconic brands may be actively diluting the experience associated with purchasing and owning their products.

High-end fashion companies should re-evaluate their social media strategy to determine what they're trying to achieve and how sites like Twitter and Facebook may be endangering their image. While it is certainly important to attract the customers of tomorrow, the fashion industry lives and dies based on the strength of their brands. With the advent of mobile applications and other new technologies, opportunities to gain access to promising markets using social media are bound to arise. Until then, iconic brands must fundamentally change their social media strategies or strategically remove themselves from this marketplace and refocus on more traditional and intimate forms of marketing.

## Finding Fit With Fashion Retailers

High-end fashion retailers typically brand themselves with the experience and service they offer to a customer. This decision is a result of the fact that they carry many of the same products as competing retailers and associate with a wide-variety of competing luxury brands. At Harry Rosen, for example, individual members of the sales staff look to build a long-term relationship with specific customers where they can act as their personal wardrobe consultant. The long-term value of a customer explains why retailers strive to create new connections with potential customers, and why they have reacted so strongly to social media trends.

For service-oriented fashion retailers, however, social media can easily conflict with their in-store strategy. On Twitter, for example, users typically form relationships with the corporation as whole, not individual members of a sales staff. As a result, customers can end up circumventing the sales agent experience entirely to take advantage of a sale or product arrival that had been posted by the company's corporate account. These types of purchases are not the type a company can build its foundation upon, and threaten their ability to build long-standing customer relationships and compete with other retailers.

A fashion retailer's social media strategy must reinforce the intimate relationship and high level of service that the company has branded itself behind. Furthermore, it must transcend the corporate image and become an extension of a customer's in-store sales experience. As such, fashion retailers should shy away from communicating by way of a corporate social media account, and instead encourage its sales staff to use their own company accounts to connect with their customers to build up the company's online presence. This creates a unique competitive advantage that would develop stronger customer ties and drive future sales. The sales agent would be able to use social media to send personal messages checking in with recent customers or to learn more about the client's interests and activities.

As an example, imagine that one of their regular customers "tweets" a message that their sister had become engaged. It would be invasive for the sales agent to reply saying that they have the perfect tuxedo in mind. However, if the customer comes into the store, the sales agent would be able to use this information to build their rapport and to check to see if they had everything they needed for the occasion or recommend any new items. Though most of this information will never be used, it will allow the agent to anticipate the needs of the customer to develop a deeper relationship and create an experience that would be extremely difficult for competitors to replicate or overcome.

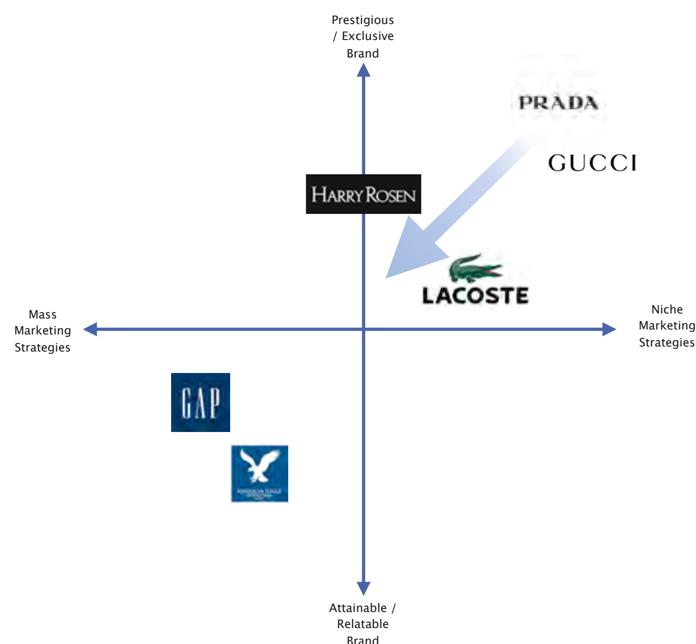
In order to create a social media strategy that replicates their core competencies and is truly unique, retailers must train their employees to actively engage the web pages as part of their job function. Companies like Harry Rosen, Brooks Brothers, and Holt Renfrew already invest considerable amounts of time and money into training their employees. This training included how to reach out to customers periodically throughout the year by phone, email or with seasonal cards. This needs to be extended to the realm of social media – particularly when it comes to attracting the customers of tomorrow.

## Winning with Social Media

Social media is an incredibly appealing marketplace for the luxury fashion industry, as it provides them with low cost access to millions of young consumers eager to affiliate themselves with iconic brands. However, the rush to capitalize on this new market has resulted in a number of social media strategies that risk damaging these companies' most important asset: their brand. Retailers and manufacturers alike must realize that Facebook and Twitter are not solely just marketing outlets to broadcast announcements of upcoming sales, new product arrivals or hot trends. This type of promotion is something that everyone in the industry can and will do and fails to understand the importance of building a genuine relationship in social media.

Industry players must use this medium to build a personalized relationship with a customer that embodies their unique image or service. In doing so, they can create a competitive advantage that is genuinely attractive to the customer and hard for their competitors to replicate. Maintaining such an intricate social media strategy does add costs, however, the benefits of personal online communication will commensurate. The fashion industry is built upon the ideas of differentiation and customer ties. Until companies with high-end brands are able to develop a social media strategy that allows them to maintain the factors that have been instrumental to their brands' success, they should remove themselves entirely from the social media platform. The risk of missing out on the latest media trend is far outweighed by the threat of becoming overly accessible and irrelevant.

Social Media Pressures Top Brands To Go Mass Market



# STEPPING UP TALENT MANAGEMENT

## How Corporations Can Get Their Greatest Assets To Climb The Management Ladder

Jennifer Gautier

It used to be that the top business school graduates looked for a steady career in a corporation where they could work their way up to the top. Companies such as General Electric, General Motors, and Proctor & Gamble regularly had candidates lined up around the block waiting for the opportunity to just apply for their coveted management program positions. Today is a different story. Take a look at any of the highest-ranking business schools and it is clear that the most competitive and in-demand jobs for new graduates are found, year after year, in the professional services industry. Since 1975, the percentage of business students who go into professional services has doubled. As a result, many corporations are unable to find enough talented candidates to meet their entry-level need, which in turns forces them to hire much of their middle management and above from outside the corporation, rather than from within.

## Firm Specific Skills

The trend of people leaving professional services firms to join corporations at advanced entry levels is not new. The very reason many graduates pursue careers in consulting, accounting or investment banking in the first place is to avoid the slow-moving corporate ladder and jump straight into corporate upper management after only a few years in the workforce. Furthermore, graduates are attracted to the prestige, high salaries and superior learning experiences that many professional service firms claim to provide. However, this increasingly popular trend is leaving corporations with employees who never get the opportunity to develop any organization specific skills or insights.

A firm specific skill set is one that allows an employee to truly bring a competitive advantage to their organization. Their intimate knowledge of the company's functional areas, capabilities and assets allow them to become more effective leaders as well as teammates, and are particularly skilled at helping an organization reach its unique potential. This skill set can only be acquired though several years of working in different areas of an organization and not all employees even have the potential to ever develop this far. Glenn Rowe, Director of Ivey's Executive MBA program, estimated that only 5-10% of all employees are capable of becoming a source of competitive advantage, and that even the most talented employees cannot do this in only a few years. Still, these employees will be the company's most valuable sources of insight. Their firsthand experience with the implementation of strategic initiatives makes them much more in tune with what works for the company and what does not. Equally important is that a company which develops enough of these employees is able to create an asset that is both loyal and hard for its competitors to replicate. In some industries, especially where costs of specialization make training costs high or intellectual property is a closely guarded asset, this can be crucial to the long-term viability of the firm.

Developing employees who are a source of competitive advantage for a corporation involves not only recruiting the best talent, but also retaining this talent long enough for the skill set to develop and to be able to utilize it. Many North American corporations, such as General Electric – a company renowned for its ability to create the world's most talented managers and executives – have publicly announced their inability to attract top-tier graduates from top business schools. Furthermore, the candidates they have selected often fail to remain at the company for more than two to three years. As a result, many of these companies are bringing in top talent from outside the organization as they feel that many of their most important positions cannot be filled by their current employees.

If this cycle is permitted to continue, 10-20 years from now corporations will find themselves being led by individuals who are either not talented enough or too new to the organization to become a source of competitive advantage. This will place these companies at a significant disadvantage – particularly against international companies that operate in countries where company loyalty is strong. These organizations, along with a few North American corporations who place emphasis on employee retention, will have developed leaders who can use their natural talent and years of experience in the organization to truly excel.

## Hiring Tomorrow's Leaders Today

The first step to developing employees that can bring an organization a competitive advantage is to recruit the best talent early. Professional services firms have identified that their talent is their biggest asset, and they make this clear through their recruiting tactics. Career management offices at both U.S. and Canadian business schools are quick to mention that professional services firms are always the first to come talk to their students, invest the most time and money in their recruitment programs, and are most aggressive in their pitches and job offer strategies. Traditional industries, on the other hand, are "notoriously late to market", according to Craig Ingram, Ivey's Head of Career Management puts it, and "don't approach recruiting with long term vision". When asked to list the organizations who invest the most time and money into their graduate recruiting programs, Career Management staff at the Rotman School of Management listed a series of different banks, consultancies and accounting firms – but not a single traditional industry corporation.

North American corporations need to realize that the value of their brand is no longer enough to attract the top students. Banking and consulting jobs in particular have become the most

attractive jobs for students who are looking for the prestige of a fast paced, intellectually changing and well-compensated career. The recruiting tactics of the professional services have permeated the cultures of many top business schools. As such, it will take a concentrated effort to spark change. Corporations who want to attract business graduates away from professional services need to make a direct pitch about what their training programs will provide their recruits, why their corporation is the best place to work and advertise those who have moved up from the bottom of the organization. Professional services firms do not shy away from outwardly telling students that their firm is the number one place to work, establish a career, and build leading skills. Industry firms need to focus on their recruiting tactics and convince top-tier students to turn down professional service offers and begin a long-term career at their organization. However, this alone isn't enough. The corporations need to fundamentally reboot the way they treat and organize their entry-level leadership positions.

One of the biggest barriers for many considering entering a traditional industry corporation is the idea of getting stuck in middle management. Careers like consulting and investment banking have very defined career paths. Their employees get constant feedback and evaluations and know that in two to four years they will be in a different position than they are now. Corporations on the other hand, are notorious for their slow-moving management programs and propensity to bring in younger talent from outside the organization for top-level positions. As such, graduates entering professional services firms know they will not only make more money in the short term, but they will also have a better chance of reaching upper management in industry if they ever choose to join a corporation later in their careers. Business students know this – and often actively avoid joining the corporation of their dreams until having proven themselves in professional services. If corporations want to develop employees with an organizationally specific skill set they will need to identify these employees from the outset and then put them in a position in which they can develop and succeed.

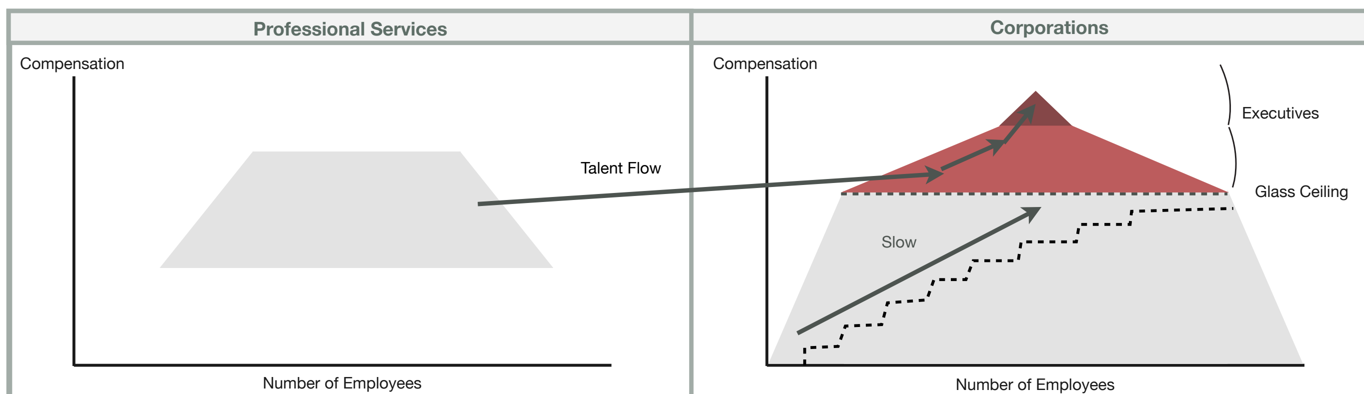
McDonalds is one North American corporation that has almost perfected the employee evaluation and motivation process. This process has been so successful that 60% of McDonalds' senior management and 30% of franchisees began their careers as crew people. Bill Johnson, a former CEO of McDonalds Canada and Mexico, began his career as a crewperson and worked his way through the corporation to become the CEO 30 years later. Johnson credits much of his rise up the corporate ladder to the culture of "ask and get" that McDonalds' has created for its employees. When Johnson decided that he was ready to move up in the company, he would ask for a promotion, "That was always my golden rule – I always let them know what I wanted". The culture at McDonalds' is one where the employees know that they have the opportunity to be successful. "Companies like McDonalds want you to be successful, at the end of the day that was the goal from the beginning with [McDonalds' Founder] Ray Kroc," says Johnson. "We want everyone to be successful – the suppliers, employees and franchisees… when you build that culture, you will be successful,"

McDonalds may seem like an odd example for recent graduates of top business schools. Yet its ability to motivate and promote its employees throughout all levels of the company is a testament to the potential major corporations have to attract top candidates for its entry-level positions. Simple internal programs such as formal evaluations, experience request systems, management fast-track programs, and a promote-from-within policy will give employees the motivation to want to grow within one organization, rather than by hopping between companies. More importantly, these companies also need to be more active when it comes to exposing their candidates to a diverse set of experiences – something consultancies and investment banks all excel at. Corporations need to take the initiative to actively throw their youngest recruits at major problems and challenges, domestically and abroad. This is the only way companies will be able to truly train leaders of tomorrow and provide them with the firm-specific skill set the company needs to thrive.

## Getting People Up the Ladder

While these are all important steps, even the best recruiting tactics and the most streamlined management fast-track programs will not be able to achieve the necessary employee retention rates unless corporations compensate them fairly. One of the biggest factors attracting top talent to the professional services industry is the lucrative compensation. Employees have to work hard, long hours, but they are compensated accordingly. To that end, many professional services firms spend more on their entry-level hires than they get in return for several years. However, these companies look at these first few years as a long-term investment in their most important asset. They hope that in doing so they will build a relationship that will provide them with considerable value in the long run. Though corporations have a similar goal in mind, it's unlikely that they'll have much luck until they can prove it with their cheque book.

Even in an era of exponential technological innovation, the most essential asset for an organization continues to be their people. Corporations may be getting by with CEOs who used to be investment bankers and consultants or with entry-level staff that either isn't up to par or gets stuck on some rung of the corporate ladder. However, corporations cannot compete with their competitors by simply bidding for talent on the open market. Long-term success comes from building a workforce with unique skills, insights and capabilities that allow the company to unlock its hidden potential and cannot be easily replicated by its competitors. To do this, corporations must fundamentally change the ways in which they recruit, compensate and train their entry-level employees. Only then will the best candidates return to knocking on their doors for jobs.



# apple enters the amazon

## Power Dynamics in the eBook Industry & the Future of Amazon

Andrew Rowland

Over the past decade, Apple has revolutionized almost every market it has entered. To that end, it would have been naïve to believe that the company's iPad would not fundamentally alter the dynamics of the eBook market. However, no one predicted just how dramatic this impact would be – especially on Amazon and the digital distribution industry as a whole.

The continuing decline of print media has spurred the explosive growth of the online eBook market. Though it is not necessarily the death knell of the traditional book format, eBooks are fundamentally changing the way the industry operates and how its consumers behave. Amazon was the first company to truly capitalize on this trend when it released the Kindle in late 2007. The company's proprietary eBook reader provided consumers with a single-purpose reading device that was capable of delivering thousands of books, magazines and newspapers straight to their customer's hands all at the click of a button. A year and half after it was released, the Kindle had gone on to capture more than 90% of the rapidly growing and increasingly competitive eBook market – worth close to $35 million in January 2010 alone. This, in addition to Amazon's role as the world's largest print retailer, gave the company overwhelming control over the book industry and its publishers.

Shortly after Apple's iPad announcement, however, everything changed for Amazon. Macmillan Publishers, one of the world's largest and most influential publishing houses, demanded that Amazon raise its prices to match those offered by Apple's iBookstore. Amazon refused, and over the ensuing days the two engaged in a very public war of press announcements. Eventually Macmillan ordered all of its eBooks removed from Amazon's digital store. In response, Amazon removed all of Macmillan's print products from its retail operations, an act that sent shockwaves throughout

the entire industry. Despite this seemingly catastrophic blow, Amazon capitulated to Macmillan's demands only a few days later. This concession prompted several major publishers to follow Macmillan's lead, ultimately forcing Amazon to raise the prices of almost all of its eBooks.

How did this dramatic power shift occur? Why was Amazon, the world's largest print and digital book retailer, forced to concede to the demands of just one of its thousands of suppliers? This remarkable transformation of industry power dynamics can be attributed to several factors, including Amazon's retail strategy, it's mismanaged supplier relations, the maturation of the digital distribution industry, and the superior functionality of the Apple iPad.

## Going for Control

Under Amazon's original digital distribution model, the company purchased wholesale eBooks from various content publishers at prices ranging from $12.00 to $16.00. This price was determined based on the promotional stage of the physical print edition of the eBook (new release hardcover, soft cover paperback, mass market paperback etc.). However, Amazon used its bargaining power to set the retail prices of many of its eBooks at $9.99 - close to a 50% discount from the company's wholesale cost. The purpose of this was to cross-subsidize the "full cost" of owning a Kindle, which retails from US$259 to $489. In doing so, Amazon was able to stimulate sales of its eReader, and drive the growth of the eBook market as a whole. This increased publisher profitability in the short term, as it stimulated sales without any incremental costs. However, this strategy also placed downward pricing pressure on sales of regular print editions by decreasing consumers' perceived value of books in general. This was particularly damaging with new releases, which are often twice as expensive as regular titles and are a significant profit driver for publishers.

Amazon's decision to use its power advantage to exploit the publishers as much as possible, rather than to build strategic partnerships, severely damaged its supplier relations and set the stage for Apple's market entry. The company

went to major publishers and put forward a considerably different business proposition. Apple's iBookstore would operate on the "agency" model, which would allow the publishers to set the retail prices for the majority of their eBooks. Revenues would be split 70/30 in favor of the publisher. This type of agreement meant that each party won and lost together and could keep each others' corporate motivations (such as hardware sales versus the preservation of print prices) in check. There's no better example of the strength of this model than Macmillan's willingness to leave Amazon entirely in order to sell its eBooks at Apple.

## Understanding the Game You're Playing

Why didn't Amazon see this coming? One of the primary reasons seems to be that they incorrectly assumed that they had the same amount of control Apple enjoyed after building the online music market in the early 2000s. Though both companies were the first to establish profitable, sustainable, and dominant models in their respective digital distribution industries, there are a number of key differences which explain why their bargaining positions were different. First, Apple had much longer to develop and secure their market position than Amazon. Conversely, the Kindle and Amazon's eBook stores operate in an industry with numerous competitive substitutes and where the established user base is considerably smaller than Apple's had been with the iPod.

More important, however, is the extent to which the digital distribution industry has matured since the early 2000s. Back then, it would have been almost impossible for the major record companies to leave Apple. There were no other major digital distributors and the entire concept of paid digital distribution was still unproven. As a result, the record companies would have needed to not only find a new distribution platform, but they would also have needed to educate consumers and form never-before-seen partnerships. Today, however, digital distribution has become far more widespread, and content providers now have considerably more options when it comes to picking their distributors and know what it takes to succeed in the digital content distribution industry. Lastly, when Apple established iTunes in

2001, the music industry was in a far worse state of affairs than the book industry is today. This increased bargaining power meant that Macmillan could do to Amazon what record companies were unable to do to Apple close to a decade ago.

## …And the hand you've been dealt

Amazon predicated its customer value proposition on two primary points. First, it would provide its customers a one-stop online destination for almost all of their retail needs. Second, the company's leading distribution and logistics system would allow it to offer highly discounted prices versus its online and brick-and-mortar competitors. The company's success with this business model allowed it to become the world's largest retailer of dozens of items, as well as the biggest customer for most international publishing companies. As a result, Amazon believed that they held almost total control over the value chain. However, the company neglected to understand how their bargaining position differed from Macmillan's during their war of words.

Amazon's failure to carry one of the world's largest publishers caused severe and public damage to its one-stop-shop proposition. As a result, they not only lost the sales of Macmillan's products, but also countless additional sales. Furthermore, Macmillan knew that Amazon would have difficulty building its eBook reputation and dominance without carrying one of the world's largest publishers – especially given the voracious reading habits of most Kindle users.

Conversely, Macmillan's switch to the Apple iBookstore would have a significantly lower impact on the company's bottom line. Unlike Amazon, Macmillan's success in the marketplace did not come from its corporate brand image or stock of titles. Instead, it relied on individual books, which interested consumers could find at dozens of other retailer on or offline. In the long-run Macmillan would have difficulty surviving without Amazon's market power and extensive footprint. They rightly assumed, however, that the magnitude of Amazon's short and long term pressures would cause the company to eventually concede to their demands.

Apple's position was also uniquely different from Amazon's. When it came to attracting the major publishers, Apple was able to offer a fervent user-base and its cutting edge and highly differentiated and multi-purpose iPad. This, in addition to the company's historical success, provided Apple with a strong base with which it could promise quick sales growth to any publisher that was wary of abandoning the current market leader in eBooks. Unlike Amazon, Apple also does not need to offer the full suite of major publishers, as the iPad's value proposition extends far beyond its eReader capabilities. Therefore the company was content to secure partnerships with only some of the world's largest publishers. Lastly, Apple would be far more willing to transfer its eBook margins to the publishers, as it doesn't sell any print books whose sales would be cannibalized.

## Changing the Game

The consequences of this watershed shift are far-reaching. From an industry perspective, market power has shifted back towards content publishers. As a result, digital distributors must look to become strategic partners with their content providers, not tyrants. Though it was once possible for a single distributor to hold all the power, the industry has grown from the days in which content owners had only one digital lifeline and where consumers were unaccustomed to the idea of purchasing digital content. As a result, content providers are now able to leverage their ability to switch between online retailers in order to claw back the power they lost earlier in the decade.

Amazon exploited the industry's biggest players in order to build them an online marketplace and believed that it would be able to continue to do so in perpetuity. Yet, the company neglected to understand how easily the major publishers could switch distributors once the market had been established. One could argue that Apple's success with online music proves that this conclusion is not true. Apple pioneered the digital distribution of music, and despite the fact that the company was notorious for the ways in which it bullied major record companies, its sales and catalogue have grown every year since its inception. In actuality, however, Apple's actions prove that even the most dominant player in the digital distribution industry is liable to the loss of content.

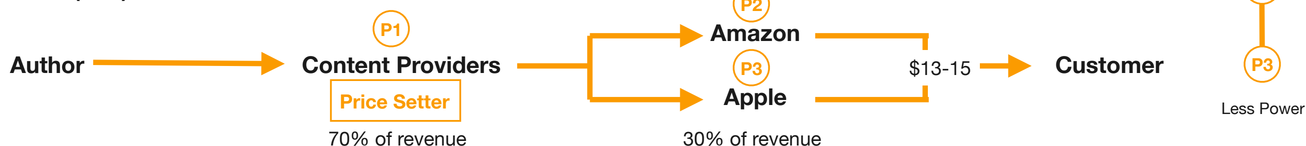
Over time, Apple has continually shifted towards a more thorough partnership model. In 2009, the company finally allowed record companies to set prices other than Apple's mandated $0.99, even though they had repeatedly stated that this flexibility would hurt both iPod and iTunes sales. Apple did this because they knew that the record companies could eventually get up and join another distributor, irrespective of the fact that Apple had saved the industry less than a decade earlier and was now the largest music retailer in North America.

Today, success as a digital distributor depends on building strong relationships with content providers. Gone are the days in which a distributor could build an industry and then relentlessly exploit its biggest players. Amazon misunderstood this, and as a result, it has alienated those that allowed it to gain 90% share in one of the digital world's fastest growing markets. Apple, welcome to the Amazon.

Wholesale Model vs. Agency Model

**Wholesale Model (old)**

**Agency Model (new)**



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