Issue 1 Volume 1

IVEY BUSINESS REVIEW

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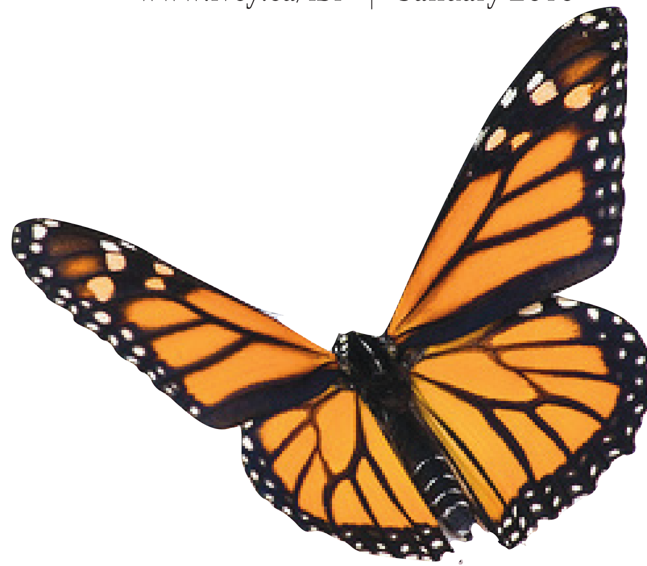

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Changing The Way You Do Business

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IVEY BUSINESS REVIEW

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The *Ivey Business Review* is an undergraduate business strategy publication conceived, written and managed by students at the Richard Ivey School of Business in London, Ontario. Each article represents several months of collaboration between the writers, members of the Editorial Board and select faculty members. The Review's goal is to push the boundaries of student thought and stimulate conversation and education in the Ivey community, with the final goal of fostering the development of world-class business insights into current issues facing business across the globe.

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Richard Ivey School of Business
The University of Western Ontario

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Editorial Note

The first issue of the *Ivey Business Review* focuses on the ultimate challenge that a business can face: how to change their business model. Whether this change is motivated by technological innovation, consumer behavior or regulatory pressures, change is difficult, disorderly and defiant. A decision maker's ability to carve out competitive business models in the midst of a continually changing business environment is the root of success in today's global economy. Our first issue takes on this task head on.

The *Ivey Business Review* challenges the traditional models of student journalism. Unlike other faculty-based magazines and journals, our content is not a collection of papers from a student's coursework or thesis. Instead, each of the articles you will read comes from several months of collaboration between the writer, members of the Editorial Board and select faculty members. The goal of the *Ivey Business Review* is not to provide students with a report or primer on business practices. It's designed to afford its contributors the opportunity to perform rigorous analysis of contemporary business strategies, push the boundaries of student thought and stimulate conversation and education in the Ivey community.

We hope you enjoy it.

The Editorial Board

Apple: **The Forbidden Fruit**

How the apple tablet can make or break the print industry

Will Meneray & Joseph Ghobrial

IF THERE WAS A FIRE AT THE printing press, would anybody care? Certainly the publishers and potentially the workers, but more importantly, would consumers? With the rise of the internet and free access to news and opinion, the answer is almost certainly no; a new reality that newspaper and magazine publishers are struggling to adapt to. From the outset, the industry did not recognize the impact of this low cost substitute and as a result failed to develop a sustainable strategy to adjust to it. In the past two years alone, more than seven major newspapers have failed, along with over 12 major magazines, many of whom had outlasted recessionary conditions before.

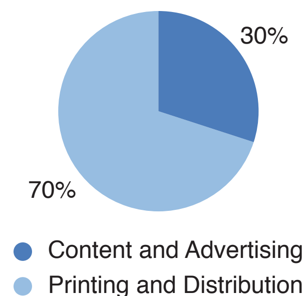
Publisher's struggles stem from a strict adherence to a revenue and cost structure that does not address the changing reality of print media.

For every newspaper or magazine sold, 70% of costs result from printing and distribution expenses. The revenues directly associated with these costs, those from subscription and print sales, make up only 21% of total revenues. This is a startling disparity, especially when considering that the useful life of print media rarely exceeds a few separate viewings.

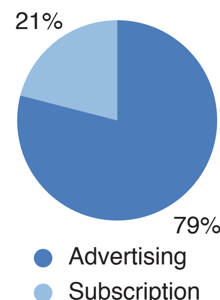
Conversely, advertising makes up a steadily increasing 79% of total revenues. The costs directly associated with these revenues, those to produce content and sell advertising space, represent only 16% and 14% of total cost of goods sold respectively. Again, a startling disparity. Nevertheless, advertising revenues remain fundamentally tied to the print form, with only 10% of publisher's advertising revenues resulting from online ad sales.

So what does all this mean for publishers? If there was some way to break the bond between lucrative advertising revenues and costly print distribution, publishers would be able to drastically improve their economics, and consequently revitalize their industry.

COST SUMMARY



REVENUE SUMMARY



BREAKING THE BOND

While Google CEO Eric Schmidt had some slight bias when suggesting in a recent Wall Street Journal op-ed that publishers have everything to gain from being cooperative with Google by allowing increased access to content, he was entirely right. The key to the survival of the print industry is not a defense of their traditional closed distribution model, but instead an adoption of a revolutionary new method of distribution and associated business model. There are two crucial elements to this strategy.

The first is a recognition of advertising as the industry's primary source of revenue and an accompanying elimination of subscriptions in their current form. Meant initially as a method of extracting the most value from consumers most willing to pay, subscriptions have more recently strangled publishers by limiting consumers to only those willing to pay. When the primary performance driver is reach, given its necessity in generating advertising revenue, the damage this limiting approach creates is self-evident.

The second is to deliver content in a way that will satisfy consumer needs in the same way that online distribution currently does. Besides the drastic differences in pricing, online newspapers and magazines offer readers the ability to instantly access related content and receive news in real time, both of which are practical impossibilities in the world of print media. The print industry must ensure that these compelling parts of the online value proposition are incorporated in any new business model.

THE APPLE TABLET

After years of rumours, most technology observers expect Apple to finally announce its long-awaited tablet device on January 27th 2010 in San Francisco, California. For publishers, this device represents an opportunity to revolutionize their business by moving to a tablet-based distribution model.

Under such a model, for any major newspaper or magazine, consumers would pay the full cost of a yearly subscription and receive access to both the content and the tablet device itself. The key is that the subscription price would not change. Instead, the entire cost of the device would be covered by the publishers. Apple receives substantial margins on the device and the consumer receives substantially more value for their subscription which is now viewed primarily as a product purchase. This presents an attractive profit proposition for Apple and an attractive value proposition for the consumer.

So where does this radical change in distribution leave publishers? We can use the New York Times as an example. Under the current model, the New York Times collects $400 in subscription fees and $1500 in advertising revenue per subscriber. Profit margins, however, are a mere 8%, with print and distribution costs of $1,200 and content creation and advertising-sales costs of $525 per subscriber. Profits in this simple example are $175 per customer. Under the proposed tablet-based distribution model, publishers would replace the $1,200 in annual printing costs, with a one-time $700 tablet purchase. Profits per customer immediately jump to $675, on 36%

2009 IN PRINT

Notable Newspaper Closures

Ann Arbor News
Tuscon Citizen
Rocky Mountain News
The Baltimore Examiner

Notable Magazine Closures

Country Home
Nick & Nick Jr.
Hallmark Magazine
Travel & Leisure Golf
Style & Design
Southern Accents
Best Life
Gourmet
Cookie
Modern Bride
Elegant Bride
Men's Vogue

Recent Pay Walls

The Economist
The Wall Street Journal
The Times of London
The Sun
The Financial Times
The Standard Times

Considering Pay Walls

New York Times
Bloomberg

	Costs				Revenue		
	Supply	Print/Build	Distribution	Marketing	Subscription	Ads	Margin
Print	$280	$1200		$245	$400	$1500	9.2%
Digital	$280	$700*	$100**	$245	$400	$1500	30.3%

*Hardware Manufacturing **Apple Royalty

margins.

It's easy to see that this new distribution model has the potential to substantially change publisher's cost structures by turning the burdensome printing and distribution costs into a one-time device purchase that is significantly less expensive. It is also clear that the new consumer value proposition will easily sustain or even increase subscription sales figures. The question that remains, then, is whether publishers can command similar rates from advertisers despite the products' new electronic method of delivery.

Since publishers typically command lower prices for advertisements online than they do in print, an argument can be made that a tablet-based distribution model might also command low rates. This is where Apple's innovation and best-in-class user interface design come in: the Apple tablet will differ from current online sources in that it will actually read like a newspaper or magazine. The experience is intended to mimic that of paper as closely as possible, with full-size advertisements and column-based content layouts.

The tablet is also expected to include several attributes that will allow for more effective and more profitable advertising. In particular, the tablet's built-in GPS capabilities, along with the data it can collect on a users' browsing and subscription history, will allow advertisers to target ads based on geography and preferences. It is well documented that as ads become more specifically targeted, advertisers are increasingly willing to pay; an Apple tablet presents a significantly better platform for such advertising than print ever could. Additionally, a tablet device will allow for interactive and multimedia advertisements, again, increasing willingness to pay and content publishers' revenues.

While it is difficult to accurately quantify the effects of a tablet-based distribution model on advertising revenue, this model leaves content publishers with a significant margin of safety if ad revenues were to fall. Assuming each tablet purchased is accompanied by a two year subscription, publishers need only maintain 43% of their current ad revenues to remain better-off under a tablet-based distribution model. A feat we expect them to have little trouble achieving given the expected tablet experience and features.

Future considerations are endless. In our example, the cost of the tablet is incurred entirely by a single publisher; in reality, people often subscribe to a combination of several newspapers and magazines, frequently starting and ending various subscriptions at different times. An opportunity exists for publishers to further increase profits by sharing the cost of a single tablet device provided to a consumer, among several content providers. To do so requires that publishers join together to decide on a single, uniform standard for digital distribution – a standard tablet device, and develop a comprehensive method for equitably sharing the tablet's cost. With publishers having joined forces in December 2009 to form an alliance for digital distribution, one can see that the means to do so are already in place.

THE FORBIDDEN FRUIT

We are not so naive as to believe that a tablet-based distribution model is ultimately the way publishers will go. Regardless of the distribution method, unity may be the best weapon of all. Just like the internet, the tablet has the ability to tear industries apart and leave content producers little. Publishers must be exceedingly wary in making deals with Apple; all it takes is one to break ranks and seek short term profits at the expense of the industry's long term viability, to suffer the same fate as the music industry.

Apple, once again, is the most tempting fruit.

For GM and Ford

The Answer Lies Within

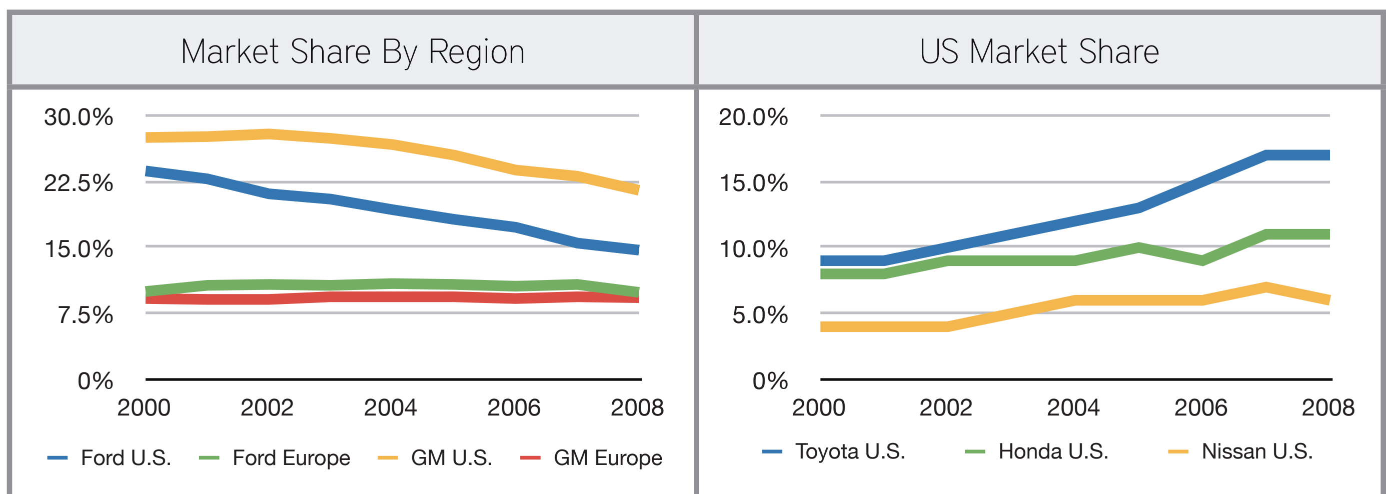
Kelvin Lin

THE NORTH AMERICAN AUTO MARKET WAS ONCE dominated by gas guzzlers, with five of the top 10 best-selling vehicles in the U.S. being either a truck or an SUV. Eight years later, in 2008, that number had fallen to three, as fuel-efficient foreign midsize and compact cars have gained popularity. Furthermore, the perennial best-selling Ford F-150 and Chevrolet Silverado have seen their sales cut in half over the last decade, a clear sign that Ford and GM must sell cars to sustain profitability – cars that are currently missing from their North American lineup.

Developing a successful car to compete against the top five best-selling cars in the U.S. of 2009 (all of which are Japanese) takes time and money, luxuries which neither Ford nor GM have. What they do have are European divisions already producing top selling cars that also have the potential to quickly become popular in North America. In addition to existing models that can facilitate rapid recovery in North America, GM and Ford's divisions have the knowledge and resources to ensure long term global profitability.

Regional Focus

Ford and GM each pursued different strategies in the U.S. versus Europe. The strategy in Europe was one centered on building highly innovative small to medium sized cars. The strategy in the US was centered on building high margin SUVs and Trucks. Two different regions, two different strategies, two markedly different sets of competencies.
Because of these differences, Ford and GM separated their operations regionally, including North America, South America, Europe, Africa and Asia Pacific. These regional organizations have allowed Ford and GM to adjust their product offerings in differentiated markets according to specific needs, though their limited resources also meant they emphasized product and process development for high margin categories at the expense of low margin categories.



The result of multiple product offerings for the same customer in different markets at varying levels of quality is exemplified by Ford's strategy for the Focus. The attempt to develop a product to capture maximum value in each specific market resulted in the cutting edge Mark 2 Focus being developed and sold Europe, a cheaper revised but inferior Mark 1 developed and sold in North America, and the original Mark 1 being sold alongside the advanced Mark 2 in Latin America.

Though desirable for highly differentiated markets, there are unavoidable downsides to regional compartmentalization: automakers incur product and process development costs for the same category multiple times, they sacrifice revenue potential by selling inferior cars and leave the door open for substitutes with superior products to steal market share. With regional markets being defined by increasingly similar trends, the specificity and redundancies provided by the organization of Ford and GM into regional subsidiaries are no longer justifiable.

Global Consolidation

Consolidating all regional product offerings into one set of global product offerings has the potential to make both Ford and GM much leaner organizations. Reducing product and process development to a single model per category simultaneously eliminates the redundant fixed costs required to develop multiple models for each category while making more effective use of physical and human capital by reallocating them to further enhance already bestselling models. They can also replace the subpar products with the best available to greatly enhance potential revenues and reduce the threat of substitutes. Furthermore, competing with the same outstanding products in every region should increase volume per model, increasing revenue potential and economies of scale.

It's important to note that a consolidated global portfolio does not reduce their ability to compete effectively in regional markets. A global portfolio will still include models for all of the profit generating categories required in each region. The biggest difference is that when a product mix is established for a region, all of the required models will be drawn from a single global portfolio, rather than being uniquely developed for that region.

To a small extent, Ford and GM are beginning to adopt this approach by introducing more European based cars, like the 2011 Buick Regal, to North America. While a step in the right direction, introducing European cars to North America captures just a fraction of the benefits that a global consolidation can provide. Ford CEO Alan Mulally demonstrated some awareness of these benefits when he was appointed in 2006, having begun to consolidate the Ford brand through a series of divestitures, but he failed to exploit the benefits of rapidly consolidating car models. Compared to Ford, GM's much more fragmented portfolio of brands presents significantly more challenges to accomplishing an effective consolidation – but also significantly more opportunities to improve.

The public at large seems to believe that Ford and GM are failing companies. In fact, Ford and GM are global companies with robust capabilities not just in Europe, but Asia Pacific, Latin America, and in certain aspects, North America. Leveraging these capabilities across a global market is a difficult task, but the reward of long term global profitability far outweighs the challenges that Ford and GM can expect to be faced with.

The 2011 Buick Regal is based on the European 2008 Opel Insignia

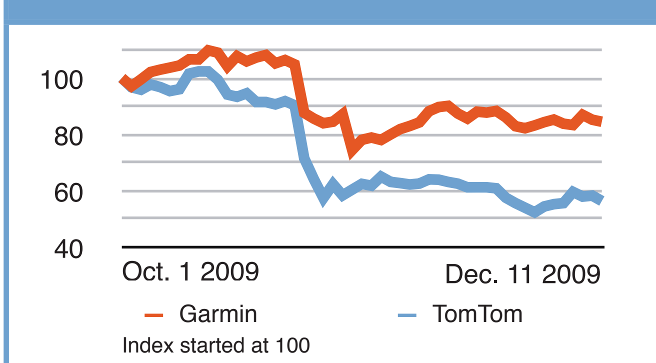
GOOGLE & THE DESTR

HOW GOOGLE'S QUEST FOR GROWTH IS SHUT

ON OCTOBER 28TH 2009, GOOGLE ANNOUNCED that it would be releasing a free turn-by-turn GPS navigation application for smartphones. By October 30th, the stock prices of Garmin and TomTom, the world's leading providers of GPS navigational systems and software had plummeted 22% and 37% respectively. Two months later, their stock prices remained largely unchanged.

Google's critics have typically focused on two aspects of the company's operations: its wealth of sensitive user data and overwhelming share of the search engine and web advertising markets. However, the "Google Threat" has begun to take on a different form – one that jeopardizes innovation and destroys business models.

Many were surprised to hear that Google's application – which is on par with those sold by TomTom for over $100 a year – would be free. How would the company make any money off the application if it gave it away for free? This is even more bizarre given that Google will continue to spend time and money improving the application and releasing new versions of the software. However, Google isn't interested in making money from its GPS application – at least not directly. The company's goal is to use the service to bring, and keep users under the Google brand of products and services.



Google holds a truly unique position in the internet marketplace, where almost every company struggles to find a price or strategy that will allow it to monetize its products and services. The company's overwhelming share of the search engine and web advertising markets allows it to monetize almost all of its products and services without charging users a cent. The company is also more than satisfied to run losses and treats almost all of its products and services (many of which don't even contain the company's own advertisements) as cost centers. Unlike its individual competitors, Google's goal is not to make money from its individual products and services. Instead, they exist in order to concentrate a user's internet usage within the Google product sphere. In doing so, the company can grow its share of internet advertising exposures and improve its search algorithms by scanning every email, YouTube Video and Google Document that its users create or view.

Consumers have benefited from this capability in two ways. Not only have they been given free substitutes for the programs they already use, they've also been able to use products like Google Street View, which would have been nearly impossible to monetize on either a subscription or pay-per-use basis. However, this capability can also have a number of unfortunate long term consequences for the consumer. Just as it did to the webmail industry when it released Gmail, Google's announcement may spur on a period of innovation and increased competition in the navigation market. However, neither Garmin nor TomTom have the advertising power or product portfolio that would allow them to compete on price. Garmin is in a particularly tough spot, as it doesn't actually own its maps and instead pays a licensing fee for each unit sold. Moreover, Google has the resources and dedication necessary to replicate almost any product feature or innovation that Garmin or TomTom might come up with. At the very least, the two companies could try selling a low-priced or free application that was

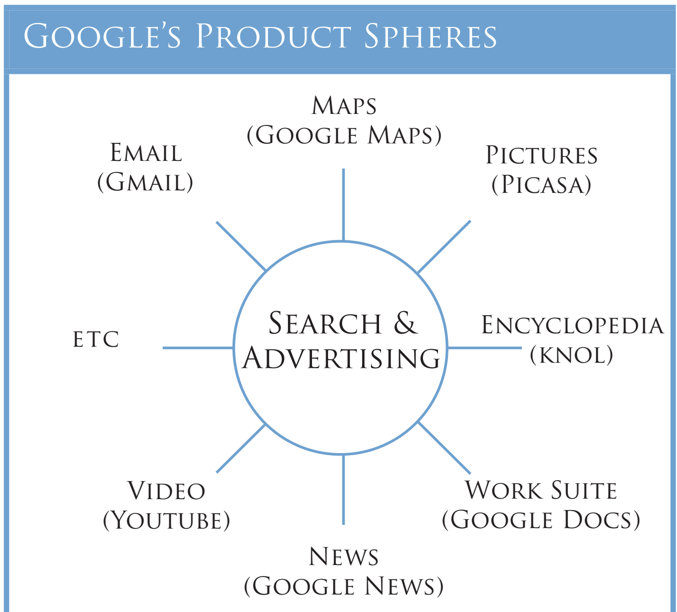
UCTION OF INNOVATION

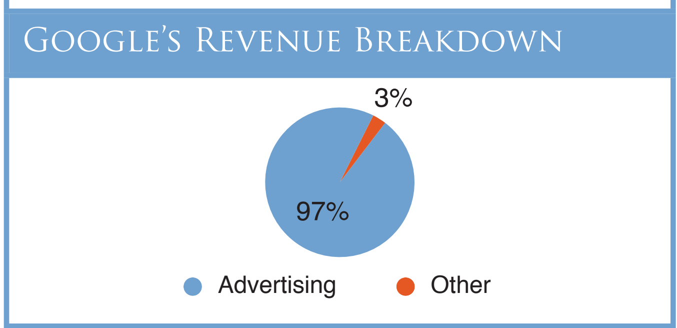
TING DOWN MARKETS AND HURTING THE CONSUMER

Matthew L. Ball

supported by (likely obtrusive) advertisements. However, even Google's application is free of ads.

In the long run this threatens eliminating all competition from the consumer navigation industry, leaving consumers largely dependent on Google's pace of progress and innovations to propel the industry forward. On the surface, this might seem drastic. However, with smartphone market share expected to exceed 50% by 2014, it's hard to see why consumers would continue to pay $200 for Garmin's Portable GPS Navigator or TomTom's $100 smartphone software - especially when many smartphones come preloaded with Google products. Google would also have little difficulty creating a physical and significantly cheaper GPS unit, as the company has recently begun working closely with a number of world class manufactures, such as Dell, Motorola and HTC, for its Android and Chrome OS product lines. The company could even retail the unit directly online, as it has done with its Nexus One smartphone. Either way, a number of industry analysts seem to believe that the companies' consumer business models have been irreparably damaged - if not destroyed. Fundamentally, how can they compete with free and pervasive? How can they even exist in a market where their most dangerous competitor is not only disinterested in making money in that market, but is satisfied with selling its products at a perpetual loss?

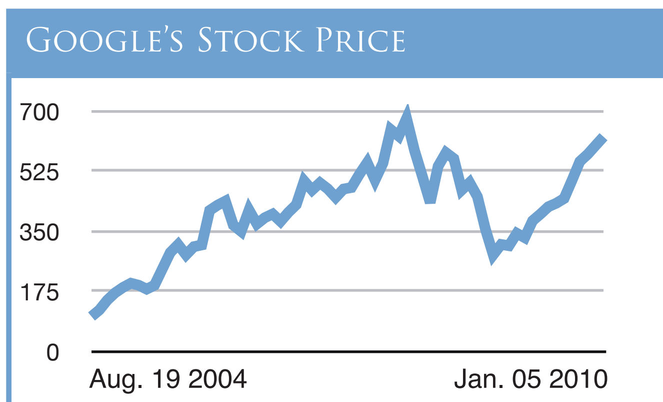




Shutting down emerging markets

One of the most unsettling impacts of Google's strength is how it affects its potential competitors. In 2007, Business Week wrote that Google could "close down a nascent market niche with the merest rumor that it might jump in." Though Google generates 97% of its revenue (approximately $22 billion in 2008) from its advertising programs, it relentlessly pursues online market opportunities - releasing over 50 new products and services in 2009 alone. The risk this poses to start-ups is best embodied in Google's famous "20 percent time", which encourages all of Google's employees to spend one day a week working on anything they want. In fact, the company claims that close to 50% its products have come from "20 percent time", including Gmail, Google News and AdSense. With over 20,000 employees as of January 2010, it

isn't difficult to understand how this policy could scare even the best funded start-ups or those who thought they had a truly unique idea.



Google's Stock Price

However, this fear extends beyond the company's nebulous research and development projects. Google has one of the strongest, most diverse and frequent consumer relationships in the world. This access allows Google to very quickly build up market share and awareness in almost any online market. In December, Google began placing an advertisement for its Chrome web browser on their iconic search page. This page had been clear of advertising and clutter since Google's inception in 1998 and its simple design is often attributed to the company's initial success. By placing an ad on the page, Google is able to expose its product to hundreds of millions of people a day – many of whom will trust the Google brand name and install it. In December, Google entered the URL-shortening market with Goo.gl. Though both TinyURL and Bit.ly control substantial market share and are well backed by Silicon Valley insiders, few believe that Google will have any difficulty usurping either player – particularly due to the fact that Goo.gl is now embedded in the company's web browser.

Google's brand also commands substantial loyalty. Should a competitor release a superior product or service, a quick migration of users is extremely unlikely. Not only does this provide the company plenty of time to react, but the company's $20 billion in cash and cash equivalents ensures that it can dwarf any start-up's budget. The company has been known to spend close to a billion dollars in a single quarter on various projects and power as an acquirer allows it to be kingmaker in almost any emerging technology market.

Unless a company is able to quickly build a strong and unusually loyal user base, it's almost impossible to erect enough barriers to prevent or hinder Google's entry into the market place. Even then, Google is capable of doing considerable damage at will or even whispers. This threat has undoubtedly hurt independent innovation by driving up start-up capital costs and scaring away would-be entrants.

Taking on the real world

Though Google's role in scaring off technology start-ups is nothing new, it's only recently that its business practices have begun to attack some of the world's biggest industries and players. Google has traditionally focused its operations on two priorities: improving the quality of its search engine and advertising programs and creating new and innovative products and services. However, the company has been so phenomenally successful that its strategy has changed. Internet users now spend an overwhelming amount of their time online using Google's products (Google sites make up 30% of the top 10 and 50 websites worldwide). Additionally, the company's dominance in the search engine and web advertisement market has enabled them to play a significant role in shaping internet traffic and commerce. As a result of these two circumstances, Google stands to gain quite a bit from each additional internet user or hour online. So much in fact, that Google's strategy has changed from just building products and services on the internet, to getting people to get on it.

In July of 2009, Google announced that it would be releasing its own PC operating system, entitled Chrome OS. Despite the fact that Microsoft's Windows product line retails for between $100 and $400, Google also announced that Chrome OS would be free. The unique feature of the operating system is that it is designed to work exclusively with web applications. The only application that will actually reside on the PC itself will be Google's Chrome OS web browser. Each of the user's activities, whether email, document editing or photo viewing, will take place online. Google's goal with Chrome OS is to increase overall internet use and then ensure that this use is concentrated in Google's products. As such, Chrome OS is optimized and set-up for Google's suite of products and services, such as Gmail, Google Docs and Picasa. The cost to develop, distribute and market Chrome OS will be undoubtedly expensive. The company's decision to give the product for free is therefore a clear indication of how much the company gains from increased internet activity.

Though the impact of Chrome OS is expected to be small at first, it represents a clear threat to Microsoft's core business. This is particularly true in the netbook market, as these miniature laptops appeals primarily to price sensitive users, and typically retail for under $450. In 2009, Microsoft began discounting Windows by up to 75% for netbooks, in order to prevent Linux (which is also free) from gaining a toe- hold in the market. Though this strategy has been successful, it leaves Microsoft with little leeway when it comes to competing with Google. Moreover, Chrome OS's use of Google's free online office suite, Google Docs, allows users to save an additional $150 to $400 when compared to purchasing Microsoft Office.

In 2006, Google began offering free wireless internet in Mountain View, California, where the company is headquartered. The company has since been working with the San Francisco municipal government in setting up a larger network that will provide free WiFi to the entire city. If the project is a success, many expect a slow growing of the

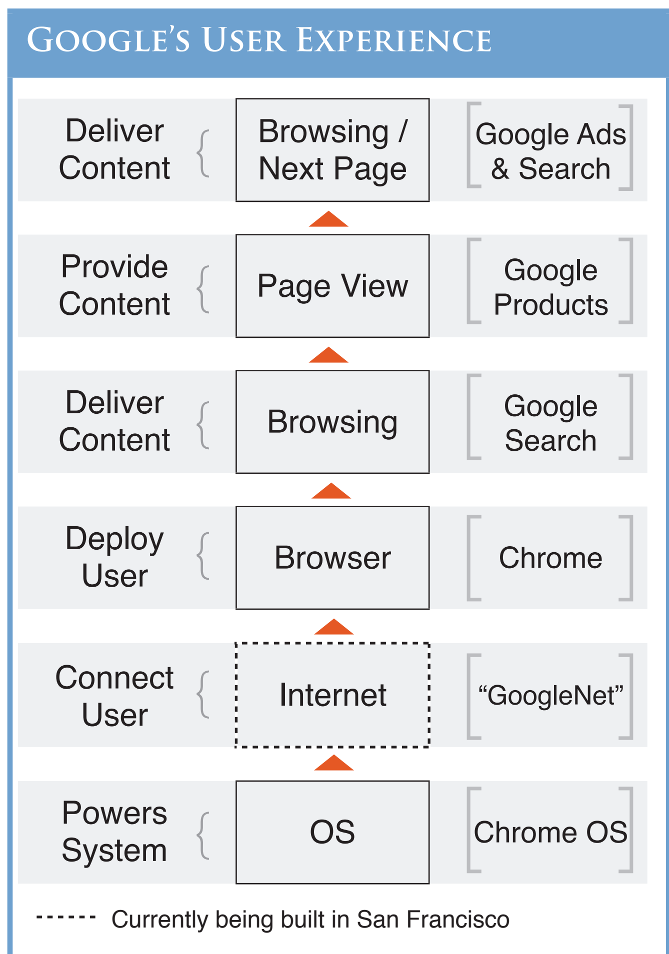
"GoogleNet" nationally. In 2009, the company paid for two months of free internet access across over 50 airports in the United States for holiday travelers. To many, this was a sign that Google had begun testing the financial feasibility of its free wireless municipal networks. As with Chrome OS, the company's goal with this project is to encourage and facilitate increased internet use. However, what would "GoogleNet" mean for the country's big telecommunications companies? How can they compete with free wireless internet? Moreover, it would only take a small step for the company, which is already actively engaged in the smartphone market, to begin offering mobile telephony services.

Google's strategy will give the company control over a user's entire online experience. If a user wants to send an email, read the newspaper or search for information, Google wants its products and services to power their computer, render the Internet, find their webpage and provide the content. Moreover, he company hopes that its search engine or web advertising would then direct the user to all of their subsequent web pages. In doing so, Google is able to capture an overwhelming share of the value generated from a user's Internet activity and essentially locks its competitors out of each of the company's product markets.

The Internet, by Google

Google has created an incredibly effective and largely impenetrable empire. While this strategy will continue to provide consumers with a number of fantastic products, services and opportunities, it's also shutting down markets and stifling independent innovation. Furthermore, as the company continues to expand into the physical world, it's hard to believe that these trends will stop. Google is no longer satisfied with dominating the online world, it wants to control the entire experience – from powering your computer to delivering and providing the content. By doing so, the company is effectively enveloping its users under the Google brand and insulating itself from any competition along the way. In the long run, this isn't good for consumers.

The issues of Google's privacy policies and share of the online search and advertising markets are undoubtedly important. However, what's potentially more significant is how Google's operations affect each of the industries within which it operates. Unfortunately, there are few solutions to this problem. You can't punish a company for being innovative, or for giving its products away for free. Though its impossible to know what Google will do next, you can guarantee that it will be big. In December, the company formed a new subsidiary, "Google Energy" and applied for a federal license to buy and sell wholesale electricity.



High Fashion in a Recession

The Evolution of the Luxury Handbag

Elizabeth Clark & Natalia Ignatenko

THE LUXURY GOODS MARKET was traditionally believed to be recession proof because the majority of its sales were generated by consumers whose disposable income was only marginally impacted by an economic downturn. While this analysis may have been true in the past, today's market is vastly different. The resilience of the market in economic downturns is weakened when an increasing percentage of luxury goods companies migrate from exclusivity and prestige towards the mass market, thereby vastly expanding their customer bases and cash flow. Now, most luxury companies not only cater to the wants and needs of the middle and upper-middle class, but depend on them. This article will use the luxury handbag market as a case study outlining both the market and effect of the global economic recession.

Luxury Goods Market

In 2008 the size of the luxury market totaled US$230 Bn. Since the 1980s, the luxury consumer base has become broader and more complex, forcing luxury companies to reconsider their market planning strategies. The focus on exclusivity of the 1980s gave way to brand proliferation and increased availability (due in part to a lower average ticket price) in the 1990s, which then transitioned into diversification of product offerings in the 2000s. A customer base with constantly evolving aspirations has gradually pushed luxury goods companies from a designer driven to a customer-focused approach.

The growth in the handbag market over the past five years was fueled in part by the "It Bag" craze among the growing segment of affluent women. This trend was supported by rapid style innovations by companies such as Mulberry, Bottega Veneta, and Burberry, who saw strong growth in their premium handbag and accessories sales. In 2006, 25% of Louis Vuitton's sales came from new styles. However, in 2007 the growth for premium handbags slowed down to 4.8% a year, as consumers became less willing to spend thousands on the latest trend.

Luxury Handbag Segmentation

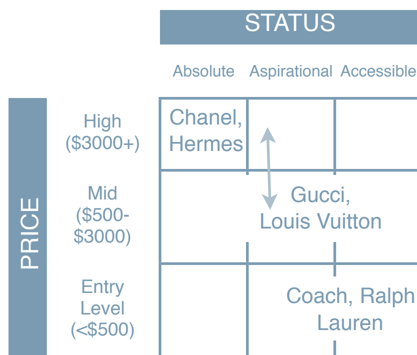
The premium handbag market can be divided into three categories:

1. **Absolute**: This segment's brands appeal to consumers for whom money is not a consideration and who appreciate brand history and reputation.

2. **Aspirational**: Brands competing in this segment are still viewed as prestigious, but appeal to customers with slightly lower income. They often include broader and faster-changing product lines.

3. **Accessible**: Brands in this part of the market appeal to consumers in middle and upper-middle class, who strive for luxury goods as symbols of differentiation and status, but have budget restrictions. They are also the most susceptible to the purchase of counterfeit items.

According to Luca Solca of Bernstein Research, 60% of the luxury market is now based on demand from aspirational customers rather than from the wealthy elite. These customers can shop in the first two price segments, but can rarely afford the $3,000+ price tag. Brands in this segment still portray elitism and exclusivity, but have a slightly more affordable image than those in the absolute segment.



Impact of the Recession

The current financial crisis has significantly impacted luxury revenues and profits. In 2008 the market stagnated, hitting its second lowest growth performance in over 10 years. As stated by Stephan Sadove, CEO of Saks Fifth Avenue, "shoppers are in frozen mode…clearly, our customers don't feel wealthy. They are not in the mood to shop."

As GDP growth slowed worldwide and the level of debt increased, luxury consumers were affected as their cash inflows decreased and balance sheets shrunk. Decreased cash flow was driven by a shortage of disposable income due to rising unemployment, tightening credit and increased debt servicing cost. The reduced value of balance sheet assets was caused by a drop in the value home equity, shares, and retirement plans. Decreased consumer cash flow is a classic short-term recessionary impact, while the decrease in consumer "balance sheet" assets affects confidence and financial capacity in the medium-term. Consumers of aspirational brands were severely impacted by the decrease in personal cash flow and have significantly modified their purchasing behaviors. A healthy economy broadens this segment of the luxury goods market by increasing average disposable income to a level that permits occasional luxury spending. Not only have aspirational segment purchases decreased, but many companies mistakenly overestimated the true size of their absolute market.

Customers in the absolute segment are less impacted by the recession. In recent years, stock options, hedge funds and Wall Street have created many new fortunes that are not dramatically impacted by economic downturns. This is reflected in the relatively strong performance of absolute brands such as Hermes and Chanel. In general, this segment still has the disposable income to purchase luxury goods though some consumers may choose to modify purchase choices and volumes.

The Luxury Handbag Market

In the short-term, consumers scaling back their non-entry level handbag purchases. In the long-term, changing consumer aspirations and buying patterns in the handbag market could have a lasting effect. Consumers are increasingly reluctant to pay for handbags at full price and are waiting for sales. Since mid-September 2008, promotional activity has escalated across the entire sector and consumers are actively looking for good value purchases. Ostentatious items are substantially less popular than more discrete, classical or durable items. Industry experts suggest that "the era of conspicuous consumption, at least for the foreseeable future, has come to close." Handbags are increasingly viewed as an investment due to the high frequency of repeated use. Service and experience are now paramount in consumers' buying behaviours. 80% of luxury consumers surveyed by American Express agreed that an important part of their enjoyment of a luxury experience was how well the service personnel treated them and the extra service they provided.

Strategy in a Redefined Market

Traditionally, all aspects of a luxury handbag were decided by a company's creative talent – its designers. Product development was based solely on their vision and interpretation of the main trends of the season; trends they either set or followed depending on the market position and reputation of their company. Luxury handbag strategy was an art. With changing consumer preferences and tightening consumer budgets, these companies can no longer dictate to their clients what they should want to pay a premium price for. An "art+science" approach to market planning must be adopted to successfully deal with recessionary pressures and the lasting impacts. The science part of this equation means a tighter focus on market planning to ensure that what the company offers is what its particular segment wants. This means a change of approach to product development, customer service, and cash flow management. A more business-focused approach will allow luxury handbag companies to turn this recession into an opportunity for growth.

Product Development

Luxury handbag companies must change their approach to product development to introduce products that better fit the market they are targeting. This can be accomplished by seeking out consumer insights on design, colour, and functionality and incorporating them into new collections. Though customers do not always know what they want when it comes to a designer product, they are often certain about what they do not want. Luxury handbag companies need to develop a more systematic, disciplined and formal approach to capturing consumer behavior, thereby embedding the voice of the consumer into creative and merchandizing processes. During the recession, these companies still need to take risks with their designs, but these risks need to be creative and calculated.

With focus shifting away from ostentatious consumption back to the intrinsic value of a product, handbag companies must manufacture and position their new offerings as "classic". As suggested by F.H. Pinault, CEO of PPR, "people want to return to genuine values like timelessness." Handbags must be seen

as durable and high-quality, as opposed to the latest "It" bag; investments, rather than discretionary purchases. For example, in June 2005 Valerie Hermann, CEO of the then struggling YSL, introduced a new handbag known as the "Muse." By the end of the summer, it had achieved widespread popularity and was deemed a bestseller. This handbag, an oversized leather carryall, was versatile and timeless, thereby appealing to a broad range of customers. It is still popular today and has been instrumental to the newfound profitability of YSL.

YSL MUSE

Bogetta Veneta Ball

Chanel 2.55

The "Muse" bag and other successful recent product offerings share common qualities: they are discrete, practical and classic. They lack product features such as oversized labels and flashy adornments, further illustrating the fact that luxury consumers have an increasing interest in functionality. Extravagance should give way to esthetically pleasing practical, understated design. This will be appreciated by customers in all segments.

Balancing high fashion items with a more commercial offering will help companies generate cash flow by expanding their customer bases, if the previously proposed principals of functionality and timelessness are adhered to. It provides an entry point for younger customers who are likely to transition up market as they accumulate wealth. An entry level product would not constitute a full repositioning in the market, but a small diversification initiative. A good example of such diversification is YSL's "Edition 24," a permanent, season-less and sharply priced collection of essentials. This collection's entry-level handbags were priced at €1000, broadening YSL's customer base and appealing specifically to fashionable business women. As stated by lead designer, Stephano Pilati, "it's not a second line, [but a way to] address fashion in a more accessible way… And it's not necessarily linked to the direction of the season." The collection has since contributed positively to cash flow through increased sales volumes. It is instrumental that lower priced offerings differ in name, design and materials so it is not confused with core product offerings. For example, Marc Jacobs produces his namesake collection and a lower priced collection called "Marc by Marc".

Entry level product offerings in applicable segments aid brand development, unlike promotional discounts. Consumers are less likely to invest in a luxury handbag if there is a chance that its status will be eroded by end-of-season sales. Louis Vuitton, a brand that has performed well despite the recession, understands this risk and manages pricing accordingly. The company "never discounts, never has a sale" because it views both strategies as "image-killing, brand-killing." Louis Vuitton is able to adhere to this policy because of their classic product offering, excellent customer service, and exceptional production planning, which allows it to efficiently manage inventory levels.

Customer Service

Another important aspect of luxury companies' short-term focus should be customer service. Sales staff needs to be trained to be friendlier and more approachable, able to identify consumers' intrinsic desires and pitch them the appropriate product out of the company's line. Luxury handbag companies should also attempt to shorten their supply chains through industrialized logistics in order to reduce the time it takes for a product to get to market. This will lead to better customer satisfaction through shorter delivery times, as well as enhance the business' capability to refresh and reduce inventory.

Conclusion

The recession has increased the power consumers have over luxury goods companies. Given this new reality, corporations must better tailor their product offering and service to the desires of their chosen segment. They need to adopt a more business-focused "art+science" approach to developing their collections and selling them to customers.

More than ever, companies need to pay attention to their cash flow management and focus on reducing unnecessary expenses, while looking for additional sources of revenue. Throughout the process, innovative product development and advertising must be maintained. The success of these strategic initiatives is dependent on one key element: companies must attract not only star designers, but star managers. The long-term success of luxury handbag companies follows a cyclical pattern: art creates the need for science, and science enables the future of art.

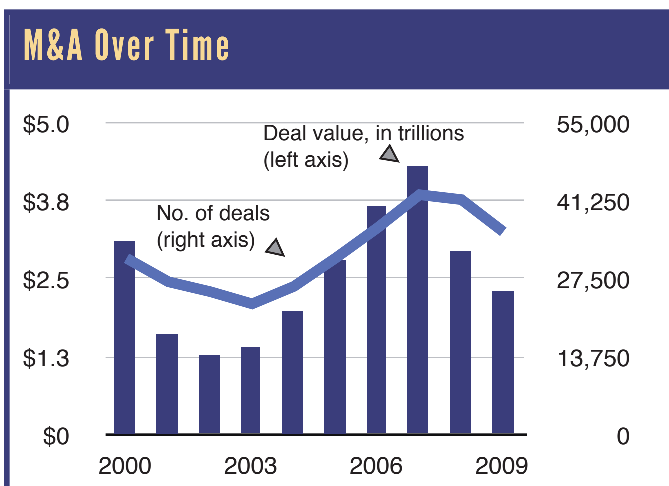
MERGERS & ACQUISITIONS

How Companies Can Ensure Success

Mohamed Punjani

THE QUINTESSENTIAL MERGERS AND ACQUISITION (M&A) transactions of this decade have created long-term shareholder value and realized the future strategic needs of their respective firms. Chevron acquiring Texaco, J.P. Morgan Chase merging with Bank One, and AT&T buying Bellsouth. There are similarities between all of these groundbreaking deals; each had obvious revenue and cost synergies, while also increasing the combined entity's competitive advantage.

The economic recession curbed the volume of acquisition activity significantly, but the companies that did participate were able to take advantage of lower valuations.



Exxon, Pepsi, and Oracle all engaged in core acquisitions. However, have their pursuits been driven by a long-term strategic need, or are they simply capitalizing on the economic climate?

Strategic Acquisition Best Practices

The success of mergers and acquisitions hinges upon choosing a target that is crucial to the long-term strategy of a firm. All firm strategies centre on creating shareholder value through top-line growth, improved margins, and mitigation of risk. It is important to note that although the price of a target greatly affects the success of a deal, it should not be the sole driver.

Revenue growth is often cited as a major reason for companies to engage in strategic acquisitions. If this is the primary reason for an acquisition, success can only be achieved if the deal allows the combined company to achieve more absolute growth rather than the growth from the two stand-alone companies. The costs and risks associated with an acquisition must be outweighed by the newly-created revenue synergies. Deal activity is motivated by the opportunity to cross-sell products, acquire new product technologies or achieve greater distribution capabilities.

Margin improvement can be realized through successful recognition of cost synergies between two companies. Most cost synergies relate to economies of scale, and include reducing headcount and/or shutting down a corporate headquarters. These actions will reduce the expenses of the

combined entity, thus increasing shareholder value. These synergies are relatively quick to realize and more easily measurable than revenue synergies. As such, this is a fundamental part of almost every acquisition.

The final method of creating shareholder value through an acquisition is through reducing business risk as a combined entity. This decrease can be achieved through increasing control over supply, augmenting market share, reducing the number of competitors, improving response to customers' evolving needs, etc. Despite being the most evident reason for a transaction, the reduction of business risk tends to be difficult to quantify and measure.

This decade's best deals follow the framework for successful strategic acquisitions very closely. Do recent M&A transactions fare well when compared to the developed structure?

Analysis of Some Recent M&A Activity

Exxon purchased XTO Energy for growth. The deal signals Exxon's expectations of an increase in natural gas prices. It is important to note that Exxon has indicated that this deal is in the long-term interests of shareholder value creation, and could be initially dilutive. The revenue synergies are apparent as Exxon and XTO can share their respective natural gas expertise to extract more resources. Regardless of whether the price of natural gas does rise, the deal shows that the strongest companies are willing to commit to decisions for long-term value creation.

Pepsi buying Pepsi Bottling Group and PepsiAmericas is a shift of strategy for the company. By reacquiring the bottlers they had previously divested, Pepsi can achieve cost synergies through efficiency, and is able to gain more control over bottle manufacturing and their distribution system. It pulls them closer towards the end-consumer, and allows them to be more nimble to respond to shifting consumer demands. Pepsi is responding to the ever-evolving soft drinks industry, and has made an acquisition that they see as an integral component to their long-term strategy.

Oracle's acquisition of Sun Microsystems, and subsequent consolidation in the technology industry, is another example of companies responding to shifts in industry. Oracle recognized that customers required truly global and integrated software, hardware, and services. This forced Oracle to respond to these trends, mitigating their own business risk, while simultaneously attaining revenue and cost synergies with Sun. Oracle's CEO, Larry Ellison, noted that "We weren't in the hardware business, now we're diving in with both feet."

These recent transactions signal a true appreciation of successful M&A best practices by the various companies. They have each followed the framework outlined above, and ensured that their acquisitions are driven by a long-term strategic need, as well as a response to shifting industry landscapes. Furthermore, they share very distinct similarities with some of the most successful deals of the last decade. The economic recession has lowered valuations for the different acquisitions, thus reducing the downside potential of each deal.

The most striking similarity is that each deal was a response to an evolution in their particular industry. Oracle responded to consumers' desire for a complete platform. Exxon acted in response to the development of unconventional natural gas, and Pepsi to consumers' breadth of soft drink preferences. Moreover, each company is not concentrating solely on economies of scale, but focusing on acquiring different products. Exxon expanded its reach in natural gas, Pepsi moved towards vertical integration, and Oracle extended into the hardware sector. This bodes well for the transactions, as they have become stronger competitors in each of their respective industries.

It is important to note that the recession has indeed improved the risk vs. reward prospects of each deal. Exxon's foray into natural gas will hurt shareholders if the price of natural gas does not rise to the levels indicated in their valuation, but these levels are lower than those that prevailed if Exxon had purchased XTO in the preceding boom period. Pepsi may not reap the expected synergies with its bottlers, and the deal could take the company away from its core competencies. Customers may not be drawn to an integrated technology provider such as the combined Oracle-Sun. In both of these cases, the downside potential has been greatly reduced due to the lower price tags. As a result, the potential payoff of these deals is far more than the relatively low levels of risk the companies are taking. In the words of Larry Ellison, these deals are "opportunistic".

Disasters Waiting to Happen?

In desperate times, companies can often forget the golden rules of successful strategic acquisitions. A company cannot overpay for an acquisition, and the deal must make strategic sense for the company, as per the developed framework.

Kraft's acquisition of Cadbury follows the M&A framework very closely, but is the price justified? The deal has potential revenue synergies from the dramatically increased geographic distribution capabilities for Kraft. Furthermore, cost synergies through administration and operational savings are estimated at $625 million. However,

Expected Synergies	Risk: Low	Risk: High
High	Exxon-XTO Pepsi-Bottlers Oracle-Sun	Kraft-Cadbury
Low	Apple - P.A. Semi	GM-Delphi

Acquirer	Target	Reason	Fit with framework
Exxon	XTO Energy	Value creation for many years, expected higher price for natural gas	Revenue synergies present + increased exposure to future energy sources
Pepsi	PBG and Pepsi-Americas	Change in business conditions, accelerate revenue growth, speed up decision making as consumer demands shift	Cost synergies present + increased competitive advantage responding to shifts in soft drink industry
Oracle	Sun Micro-Systems	Consumer demands shifting to integrated hardware and software	Revenue and cost synergies present + increased competitive advantage
Kraft	Cadbury	Desire to expand confectionary business globally	Revenue and cost synergies present + increased competitive advantage, but overpaying, deal was worth more to Hershey
GM	Delphi	Assure uninterrupted supply of parts, access to increased government funding	Low revenue and cost synergies + no increased competitive advantage compared to peers

because Kraft experienced competition from Hershey, the higher valuations are unable to justify the increased competitive advantage. The fact that Hershey was able to muster the resources to compete in this deal may signal that the upswing in valuations has already begun. Kraft increased their bid price, against Mr. Buffet's advice, and will be overpaying. This has deviated the company from realizing its primary goal: creating long-term shareholder value.

GM spun off Delphi, its largest parts supplier in 1999, but has now acquired a minority stake in the company. Is there an evolution in the industry that places GM at a strategic advantage to its competitors through this deal? The simple answer is no, excess cash should have been directed to solve some of GM's fundamental problems. GM did not face significant problems ensuring parts supply throughout Delphi's extended bankruptcy, and there was no reason to reacquire them now. The deal draws comparisons to Pepsi acquiring its bottlers again, but in Pepsi's case, the deal helped Pepsi better meet customer's changing preferences.

Due to lower valuations in recessionary periods, there are some acquisitions that do not necessarily need to achieve high revenue and cost synergies. Apple made a relatively small purchase of a boutique microprocessor design company called P.A. Semi. The microprocessors produced by the company are not currently featured in any of Apple's products. Apple was interested in the firm's intellectual property and development expertise. The deal does not directly address an immediate long-term need for Apple and may be solely driven by Apple's desire to keep the technology away from competitors.

Conclusion

Those most apt to benefit from acquisition activity coming out of the downturn, at depressed prices, are the most well-capitalized companies, since they are able to take advantage of financially weaker targets, and generate long-term shareholder value. Furthermore, the most successful companies are those that have not let the financial downturn make them overly cautious. They struck early and ahead of competitors thus reducing their deal price, integrating earlier, and increasing their competitive edge

THE EUROPEAN COMMISSION'S POLEMIC

REGULATING HEDGE FUNDS

Jason Luo & Aris Economopoulos

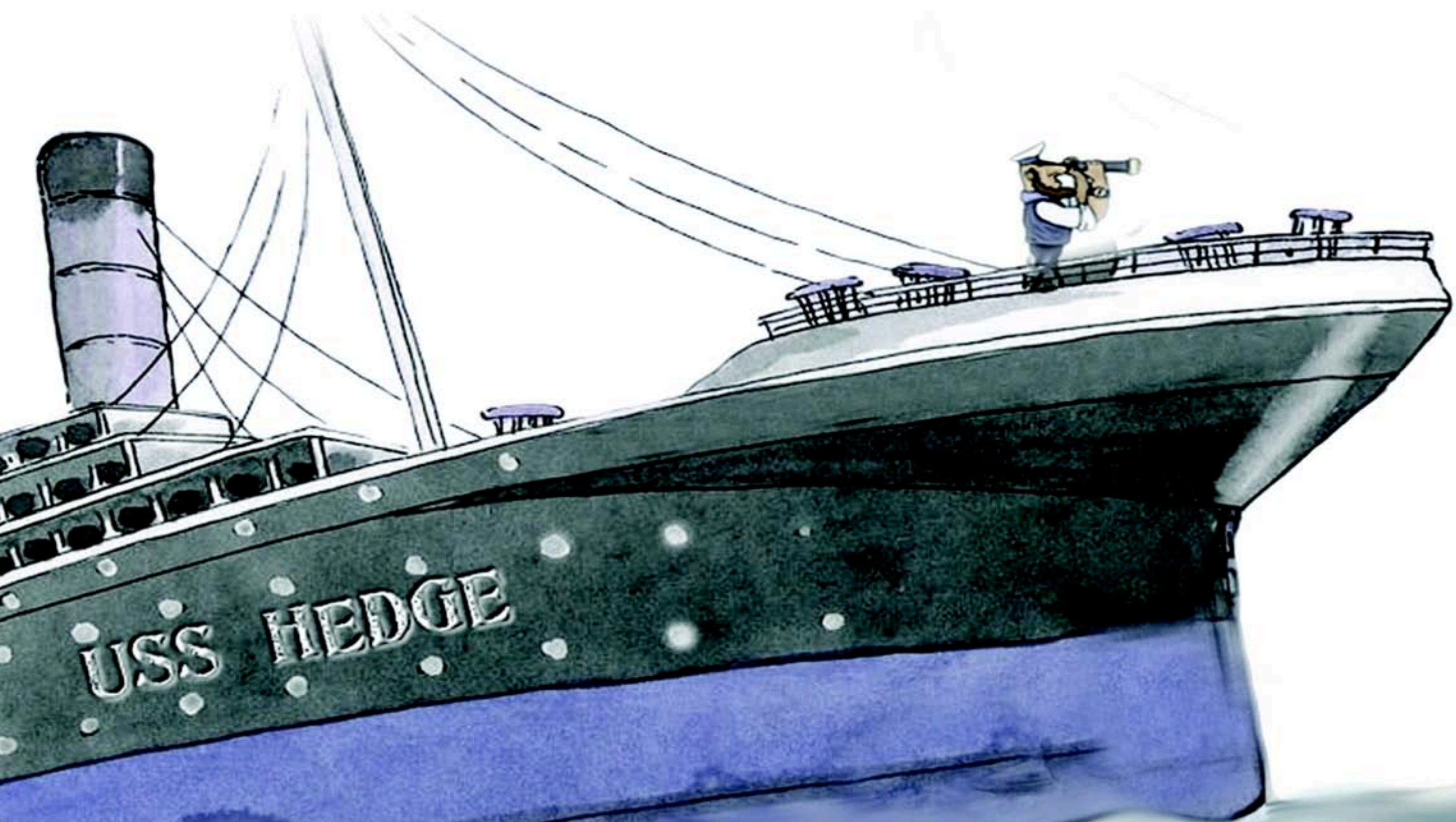
IN 1949, A MAN BY THE NAME OF ARTHUR W. Jones formed a tiny investment partnership to test out a new investing strategy. Instead of investing his partners' capital in a typical long-only equity fund, Jones used leverage to purchase more shares, and sold short to minimize exposure to market risk. This was the world's first official hedge fund.

Unlike traditional mutual funds, which are subject to restrictions on what they can buy and the amount of debt they can use, hedge funds have been able to mostly avoid regulations due to exceptions in the law. Under the Investment Company Act of 1940, which governs all investment companies, funds with 100 or fewer investors or funds with "qualified purchasers," are exempt from regulation.

Since the birth of hedge funds, little has changed regarding their regulation. This lack of regulation, combined with an attractive compensation structure for managers that performed well, fueled the rapid expansion of the hedge fund industry. From the seminal $100,000 USD hedge fund Jones created in 1949, the industry grew to a peak of almost $2 trillion USD in 2008. Although this may seem large, it is relatively insubstantial in comparison to the estimated $26 trillion USD worldwide value of mutual funds.

Despite being relatively small in the context of the global financial eco-system, hedge funds still represent a large and distinct risk to the global financial system. Many major financial institutions are very interdependent, and particularly in the case of hedge funds, the collapse of one firm could quickly lead to the collapse of others. This is called counterparty risk. Counterparty risk and systemic risk are not new ideas to financial regulators. However, the collapse of a major hedge fund such as Long Term Capital Management (LTCM) was deemed near impossible, and few regulators and investors considered the magnitude of the risk to the system. Yet, in 1998, without a bailout, LTCM would have collapsed and sent global financial markets into chaos. More recently, the near collapse of two Bear Stearns hedge funds in 2007 was the catalyst that sent financial markets tumbling and changed the investment banking industry permanently. Coupled with the financial crisis, these events have triggered calls to action from leaders around the world to regulate hedge funds.

Two years later, only Europe has made any headway toward hedge fund regulation. In April 2009, the European Commission proposed a Directive on Alternative Investment Fund Managers (AIFMs), aimed at monitoring and curbing cumulative systemic risk of hedge funds, which had been flying under the regulatory radar. The AIFM Directive is intended to protect macroeconomic balance by



improving the risk management and transparency of all European alternative investment funds (AIFs).

By the end of 2008, the AIF sector in the European Union had reached nearly $4 trillion USD in assets under management. However, the sector has become very complex. AIF regulations will not only apply to hedge funds, but also to funds investing in real estate, private equity, commodities and infrastructure. On the surface, regulating hedge funds based on their geographic location seems rational, but further investigation hints that the AIFM Directive may be more of a temporary call to action than a fundamental systemic improvement.

Although the details surrounding its implementation are hotly contested, the proposed AIFM Directive calls for audit arrangements, detailed reports of planned investments, and minimum capital levels. To ensure that no eligible AIF eludes effective regulation and oversight, the Directive proposes the regulation of all major sources of risk by subjecting key service providers (e.g., depositaries) to stringent regulatory standards.

The Directive also plans on having a nationally sanctioned Competent Authority (CA) authorize and oversee managers who control more than €100 million. If properly enforced, this covenant could satisfy regulators and the global investment community alike as it would result in the regulation of about 30% of hedge funds that control 90% of hedge fund assets in Europe.

If the fight for hedge fund regulation is a snowball on the precipice of a cliff, and the Directive is the push needed to give the ball downhill momentum, can we soon expect the adoption of similar policies around the world?

Historically, hedge fund managers have not been subject to many regulations, nor held accountable for the consequences of their decisions. Lax regulations have allowed hedge fund activities to remain relatively opaque and complicated efforts to increase transparency and accountability. For the AIFM Directives to work, hedge fund managers must be willing to cooperate.

The hope behind the proposed Directive is that this change will become the driving force toward successful global hedge fund regulation. Unfortunately, there are many economic and political incentives for managers to circumvent these protocols.

In the face of the new wave of regulations, many hedge fund managers are considering moving money into countries with less red tape. It is no accident that Switzerland is reclaiming its post as a haven for the world's financial elite. The Swiss regulatory environment is far more accommodating to hedge funds, with minimal transparency requirements and legal barriers preventing foreign policy intervention. Further, there is no provision in the Directive preventing hedge fund managers from creating separate legal entities under the €100 million limit and controlling them separately. Legally, the possibilities to evade the Directive by allocating assets to exploit divergent laws and ownership structures are endless. Until hedge fund managers face similar regulations around the world, the proposed Directive may have limited impact. Although an international financial watchdog would be nearly impossible, it is up to global regulators to create a common framework for hedge fund regulation in order to ensure broader policy effectiveness.

While it would be naïve to expect the Directive to immediately change the world of hedge funds, there is still hope it is a step in the right direction. The Directive ambitiously claims that it will regulate hedge funds through an "all-encompassing approach." While the initial iteration is intended to encompass all of Europe, the path to sustainable success lies in something even bigger: going global. The current crisis has illustrated three reasons why it is better for hedge funds to be centrally regulated. The first is to prevent moral hazard. By placing responsibility with hedge fund managers the Directive will stop hedge fund managers from taking on exceptional risks without fear of regulatory reprisal. Second, standardizing hedge fund risk assessment and reporting requirements will improve regulators' ability to determine hedge funds' individual risk profiles and their contribution to systemic risk. Finally, regulating hedge funds in the EU as a distinct investment class will provide an example for other nations in the hopes that the regulations will become global.

The European Commission's Directive provides the first robust and flexible framework from which to keep pace with innovation and regulate hedge funds while ensuring macroeconomic stability. More importantly, it provides regulators with a better way to track hedge fund activities and monitor their risk profiles, while still maintaining freedom for hedge fund managers to use leverage and unrestricted investment policies.

Careful examination of the proposed Directive reveals the paradigm shift that European regulators hope to achieve: a universal regulatory environment that focuses on transparency, accountability, and systemic stability. Europe has taken a stand, but only with global cooperation will an all-encompassing regulation be effective.

THE GLOBAL WIRELESS REVOLUTION: WHO SHOULD ENTER NEXT?

Safir Jamal

A look at which telcos are best positioned to succeed in the new era of mobile communications

GLOBAL MOBILE TELECOM IS THE FIRST STEP IN international free trade. Among the world's recent telecommunications mergers and acquisitions, Indian telco Bharti-Airtel's $24 billion offer for South Africa's MTN certainly stands out. Not only was it telecom's largest deal proposal of 2009, but this example also reflects just how much the industry is evolving and stresses the need for telcos around the world to take notice. With mega telcos such as Vodafone and Orange already operating in as many as 31 different countries, it is only a matter of time before the telecom industry becomes an open space and allows for the free flow of both carriers and consumers.

A Tale of Two Races

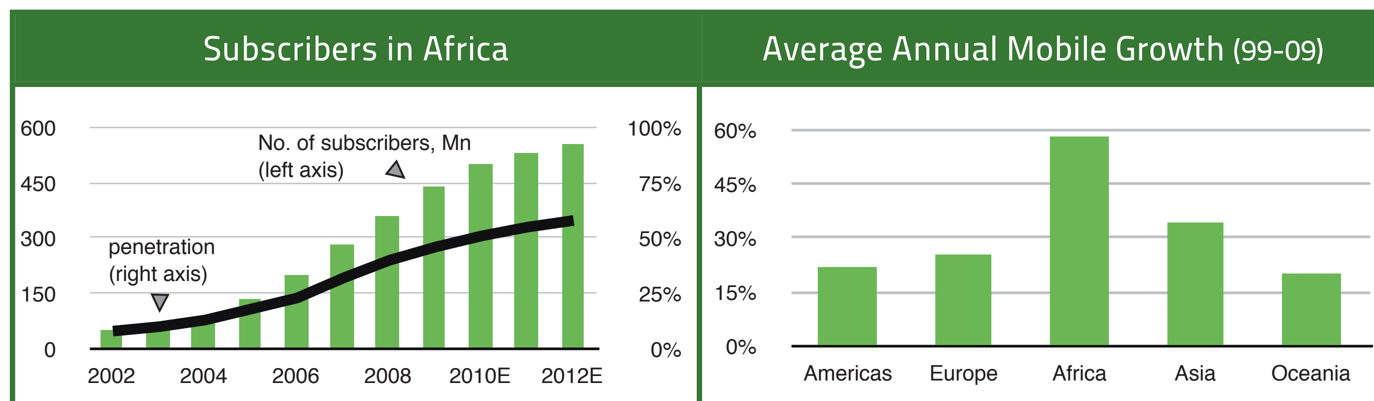
As mobile communications goes global, wireless carriers should expect to face two worldwide races: one to provide the cheapest and most accessible service and another to secure the highest number of new subscribers. Given that dominant global players will need to offer competitively-priced wireless service to as many subscribers as possible, hundreds of telcos will compete for their share of the world's 2.4 billion current mobile users. Nevertheless, this is more than just a numbers game – international expansion is about strategic vision. The question that every major telco's CEO should now be asking is: who will likely be the players in these two global races?

The Race for Cheaper and More Accessible Service

The race for cheaper and more accessible service stems from a strengthening consumer push to open up competition. State governments that once aimed to protect domestic interests by prohibiting foreign-owned telcos from entering their markets are gradually loosening regulations, even in some of the historically guarded telecom hubs, such as Canada and India. As markets increasingly open to allow foreign players, first-mover telcos will win the price and accessibility race by entering the market quickest, reaching out to consumers with competitive pricing offers first, and securing access to essential coverage areas. However, it's the carriers that currently operate in the highest number of geographic markets that will be best positioned to realize this critical first-mover advantage. A telco competing in multiple countries not only has the expertise of entering new markets, but the company can also leverage its existing international operations to offer access in multiple geographies - thereby eliminating current roaming charges.

In looking at the mobile carriers most likely to win this race, Vodafone is extremely well-positioned, seeing that the British telco offers wireless service in 31 countries, while operating partner networks in another 41. French carrier Orange also stands a winning chance, as the company currently has a presence in over 45 countries spanning five continents. With their widespread global operations, these telcos can realize numerous economies of scale, build brand recognition and carry best practices into other markets in order to replicate home-grown success.

These benefits ultimately equip Vodafone and Orange with the necessary competitive weapon to truly threaten existing players in their respective markets. Should either of these two telcos choose to enter the United States one day, they would be able to leverage these benefits, in addition to eliminating roaming charges. In doing so, these telcos could potentially drive America's favourite telcos out of their home market by offering consumers wireless service for half the price charged by AT&T, Verizon Wireless or Sprint-Nextel.



The Subscriber Race

The second race in the mobile communications industry is one for subscribers. More subscribers means more bargaining power. Telcos would be able to dictate cross-border roaming agreements and exert influence over manufacturers in granting them the exclusive right to carry the latest devices. New subscribers can either come from the developed world, where consumers seek high functionality for low prices, or from the developing world, where consumers merely seek increased wireless coverage. Of particular interest to telcos should be high-growth subscriber markets, leading them to Africa, the last frontier.

Home to 34 of the 50 poorest countries on Earth, it might come as a surprise that Africa is by far the fastest-growing wireless market in the world. The continent plays a pivotal role in the imminent global race for subscribers, boasting an astonishing 440 million mobile users and counting. With a consumer base this large consisting of users who have only recently been introduced to mobile usage and have yet to develop any brand loyalty, Africa represents a golden opportunity for telcos to capture the large subscriber numbers needed to be dominant industry players.

As the first continent where mobile subscribers outnumbered landline users, Africa's wireless growth is largely fuelled through the innovative use of mobile phones by the growing low-income segment of the rural population. While farmers can use their phones to get the best price for their produce by checking market prices in advance, fishermen who may not have regular access to a bank can now actively perform mobile transactions. As rural adoption is being driven by both technological proliferation and using cell phones as substitutes for inaccessible activities, there now exists a clear need for mobile use. This status of necessity helps in ultimately justifying why Africa's poor are still willing to spend part of their minimal disposable income on wireless service.

Despite Africa's \$6-\$9 average revenue per user (ARPU) being alarmingly lower than the \$52-\$55 ARPU that foreign telcos enjoy in the developed world, per-capita income in Africa is growing by 31% per year. This means that as income levels and development continue to rise over time, Africa's mobile market will appreciate and will provide telcos with attractive revenue advantages. Telcos must therefore enter these markets early in order to gain a first-mover advantage in capturing untapped subscribers. Yet in order to capture, one must know how to succeed in a low-ARPU rural market – a task that few mobile carriers are poised to achieve.

KSFs: Familiarity and Experience

When Bharti-Airtel initially announced its interest in entering Africa, the company repeatedly referred to its success in penetrating India's low-income rural segment. By leveraging its understanding of consumer behaviour at the bottom of the pyramid, Bharti would be able to provide an appealing product offering to a familiar customer segment in Africa. Familiarity and experience are the two key determinants of a carrier's success in this market. Much like Bharti-Airtel, China Mobile and Telenor are also well-positioned.

In each of their current markets, these three companies have built service around low ARPU instead of viewing the metric as an entry deterrent. This approach consists of increasing ARPU through data services offering users tangible benefits that they are willing to spend money on, despite their financial situation. Bharti-Airtel, for instance, has developed SMS subscription services to update low-income rural users on two central aspects of Indian culture: cricket and Bollywood. China Mobile, however, has more directly engaged its rural consumers through SMS services, providing villagers with news updates in local dialects and fishermen with weather alerts. Likewise, Telenor has increased ARPU among Central Asia's rural users by encouraging consumers to share their phone with friends and family, as the more users sharing the phone, the more revenue generated from a single mobile subscription.

In looking at who will win the African, and thus the global subscriber race, China Mobile, Bharti-Airtel and Telenor are all well-positioned to thrive. With proven success in similar operating environments, ranging from the fields of inland China to the villages of Bangladesh, they are familiar with innovating, generating revenue and creating value in this market. Ultimately, they have the experience to understand the African game well – the game of working on high volumes, low margins, building economies of scale, and developing higher affordability. Using this knowledge, these players have a significant advantage in the race for global wireless domination – leaving companies such as AT&T, currently holding over \$7 billion in cash, to seriously consider this daunting reality.

Key Foreign Telcos In Africa [Global Subscribers]

#2 **Vodafone** (UK) – 428 million subscribers; present in Sub-Saharan Africa

#5 **Orange** (France) – 189 million subscribers; present in Sub-Saharan Africa

#10 **Orascom** (Egypt) – 111 million subscribers; present in Northern Africa and South Africa

#11 **MTN** (South Africa) – 108 million subscribers; present in Sub-Saharan Africa

Telcos Poised to Enter Africa [Global Subscribers]

#1 **China Mobile** (China) – 518 million subscribers; experience in rural China and Pakistan

#6 **Telenor** (Norway) – 172 million subscribers; experience in S.E. Asia, Eurasia

#9 **Bharti-Airtel** (India) – 116 million subscribers; experience in India and Sri Lanka

R.I.P.

REST IN PEACE OR REAP IN PROFIT?

[THE ETHICAL CONUNDRUM OF DEATH BONDS]

KIM EICKEMIER & ZAHRA JAMANI

WHAT IS A DEATH BOND?

TODAY, THERE IS A PRICE TAG ON JUST ABOUT everything - constellations, water, the genetic makeup of plants – even death. Death bonds are a relatively new financial innovation that enable people to cash in early on their life insurance policies. The process is fairly simple: sell your life insurance policies to third party investors in exchange for an amount that is greater than the cash surrender value listed by the insurance company. The investor inherits the premium payments, becomes the policy's beneficiary, and upon the original holder's death, collects the policy's payout.

Investment banks package these pieces of financial engineering, just as they packaged ill-fated sub-prime residential mortgages into RMBS. The investment bank groups policies into pools based on risk (in this instance, mortality expectations) before selling different tranches to third party investors. Unlike RMBS investors, death bond investors enjoy pre-payment: the earlier the death, the better the investor's rate of return.

Since death is a certainty, there is huge market potential – Canada alone has $1.8 trillion in outstanding individual insurance policies. The value of these bonds is relatively independent of the general economy, making them valuable for any diversified portfolio. Intrinsically, there is little associated market risk since movements in asset markets are not strongly correlated with deaths in the general population. The biggest risk for investors is the possibility that policyholders outlive their actuarially assumed lifespan, thereby destroying investor returns.

The life settlement packages are made up of policies ranging from healthy people to those with specific medical issues, thus diversifying the impact of a single-disease cure and its associated effect on payoff timing. In the aftermath of the global market collapse, minimizing risk is paramount and death bonds represent a unique hedging instrument.

The life settlement industry was established in the 1980s during the AIDS crisis. Terminally ill AIDS patients sold their policies to a third party for cash, turning an otherwise illiquid asset into cash needed for medication. Two issues led to a downturn in this new market. First, advances in drug treatment made it difficult to approximate life expectancy. Secondly, fraud was also prevalent – doctors would overstate the severity of patients' illnesses and make their deaths seem more imminent. As these problems emerged, the life settlement industry fell dormant until the late 2000s. Greater accuracy in actuarial predictions coupled with enhanced fraud prevention have resurrected the industry.

DEFINITIONS

Death Bonds: Formally called "life settlement-backed securities", are securitized life settlements – the life insurance response to securitized mortgages.

Residential Mortgage Backed Securities (RMBS): A type of security consisting of pooled residential mortgages. Holders of the residential debt, like subprime mortgages, pay interest and principal payments that then flow to holders of the RMBS.

Life Settlement Industry: The secondary market for life insurance policies

WHAT IS THE CURRENT APPEAL?

As people grow older, their families become more financially stable meaning life insurance policies lose some of their appeal. Consequently, many have chosen to monetize their holdings rather than continuing to pay out premiums for policies they no longer need. Dr. Larry Wynant, a Professor of Finance at the Richard Ivey School of Business, explained that, "people have in their minds a poor old couple with a typical sob story" but in reality, individuals have started moving their money out of life insurance into increasingly liquid assets. As the Canadian population ages, death bonds could act as an effective method of transferring capital and risk between investors and policyholders.

Dr. Wynant added that getting rid of an insurance policy is a natural process. People are able to re-deploy their assets as they see fit while the investors benefit from the discarded policies. Dr. Richard Ascough, a Professor of Business Ethics at the Richard Ivey School of Business, explained that from a utilitarian viewpoint it's a "win-win situation across the board" given that all parties receive something they value.

ARE DEATH BONDS UNETHICAL?

A potential issue arises as people sell stakes in their lives to non-interested third parties. The question remains whether or not it is ethically justifiable to view human life this way. In a sense, society has implicitly decided it is ethical given the existence of life insurance policies; however, death bonds take this economic approach to human life further. Dr. Ascough remarked that, “when powerful people have a vested interest in people dying early so the minority wins, it is a very dangerous thing”.

Those that see death bonds as unethical argue that conflicts of interest could also be a problem. Take for instance an entity that has significant holdings in death bonds as well as pharmaceuticals. If a revolutionary new drug was discovered, would the corporation take it to market if it lengthens life expectancy and correspondingly the maturity of their bonds, thus limiting returns? The power to control people’s health this way could have disastrous consequences. Although the aforementioned scenario sounds alarming, it is unlikely to materialize according to Dr. Matt Davison, a Professor of Statistical and Actuarial Science at the University of Western Ontario. The present value of a drug that would be beneficial for the entire population would in all probability far outweigh the gains achieved from the comparatively small number of policies held, particularly since life settlement packages are not categorized according to illness.

It is the authors’ belief that the very slim possibility that death bonds might be maliciously manipulated, blinds people from seeing the advantages they offer as risk management tools. Following the pharmaceutical example, death bonds offer a way to hedge the risk that the drug in question doesn't come to market. If the drug is profitable, this would likely make up for the decrease in value of the bonds being held (they decrease because people with the disease would now live longer) but if the drug does not pass the development stage, death bonds provide some downside protection as they will theoretically pay off sooner. This scenario is extremely morbid, and not everyone engaged in fund management would employ death bonds but there is certainly economic justification for their existence.

Another potential ethical issue is the limited supply of policies available for sale. One way for investors to increase supply would be to coerce people to take out life insurance policies they did not otherwise want. It is uncertain how far investment banks will go to make money, so governments will have to be proactive in policing these activities. Although all markets have potential for abuse, regulated markets play an important role in providing people with flexibility, liquidity, and an optimal allocation of scarce resources.

DO DEATH BONDS HAVE A FUTURE?

The market for death bonds has financial potential, though it appears to be marred with ethical complications. Since death is uncorrelated with broader markets, and as the Canadian population ages and mortality assumptions become more precise, there will be continued financial incentive on both sides of the securitization process. The Canadian government should examine worst-case scenarios and create limits on the securitization process to minimize ethical complications, but should encourage positive use of death bonds.

People are uncomfortable with the idea of commoditizing death, but to think that this has not previously happened is a naïve assumption. Stakeholders currently exist on both the side of extended life and early death, such as insurance companies and pension funds respectively. As Dr. Davison explained, “because it’s about life and death, it makes people feel queasy” but in reality, death bonds are simply another innovation to help improve a market that already exists.

THE LIGHTHOUSE IN A SEA OF INDICES

The Baltic Dry Index and its Significance

Alexandra Silverberg & Monica Nichita

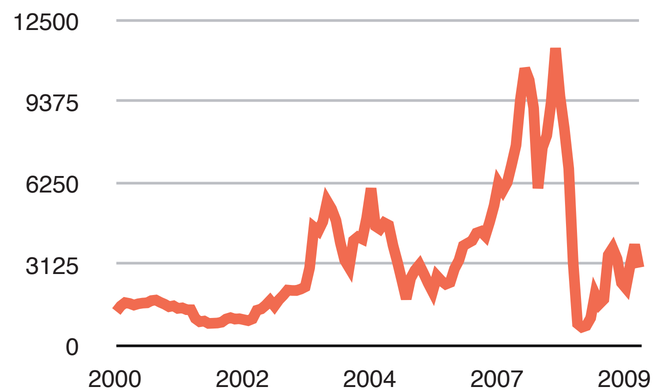
THE BALTIC DRY INDEX (BDI) IS A DAILY composite measure of the cost of bulk international shipping, and is calculated by the London-based Baltic Exchange based on a number of factors such as destination, weight, and product. Despite the Index's logistical focus, it's one of only a handful of accurate and leading economic indicators and many of its insights can be readily used by the business community.

What makes the BDI so valuable is that it focuses solely on the shipping of dry bulk goods, such as coal, iron ore or grain. These products are primarily used as raw materials and inputs for the production of intermediate and finished goods such as concrete, electricity, steal and food. As a result, the BDI gives a real-time look into how major industries are ramping up production, and is therefore seen as a leading economic indicator. Not only is the BDI tied to actual business activity, unlike other tenuous indicators such as consumer confidence, but it also has little speculative content. Freighters are not booked unless there are raw materials to move. Therefore, the prices that compose the BDI have few external influences, giving users a purer sense of overall production and economic performance.

Fluctuations in shipping prices are subject to a wide range of variables that collectively affect the Index. The laws of supply and demand play a principal role in determining the prices that compose the BDI. The supply of freighters available for shipping is inelastic because ships are costly, have long lead-times, and are too expensive to take out of circulation. Conversely, in terms of demand, merchants can easily stop booking ships as demand for their raw materials fall. This allows the BDI to provide real-time information about the demand for the products that drive global production, and thus, the economy. Moreover, because the cost of crude oil makes up a large proportion of the cost of shipping, oil prices have a significant influence on the BDI. Inherent in the volatility of the Index are variables such as the impact of seasonal pressures and the political stability of access to oil.

The Index is also highly responsive to slight changes in economic activity. For example, if only 49 freighters are available and 50 loads are competing to get shipped, rates go up. Similarly, if there are 50 freighters but only 49 loads to be shipped, rates drop. The index is pushed higher quickly by marginal demand increases while similar decreases will cause it to fall promptly. Moreover, the magnitude of these price changes shows how valuable each shipment is. Increases in the BDI also give observers a fair indication of global inflation levels and interest rates and how global activity can affect companies whose operations might be focused in only one country.

The Baltic Dry Index



Although the majority commend the BDI for its predictive ability, the volatility of the Index, especially in 2009, has created some concerns over its reliability. However, changes in the Index across 2009 are an honest reflection of the uncertainty experienced over the past year; climbing as hopes for recovery were high and falling to reflect negative sentiments. The key to this criticism is that instead of considering short term fluctuations to be reliable indicators, longer-term trends offer users more reliable indications of global production.

This leads to a second common criticism of the Index – false positives. Currently, critics fear Chinese producers are buying not to produce goods, but rather to hoard and stockpile. In this case, an increase in the BDI does not automatically imply an increase in production or post recession economic recovery. Others suggest that by simply buying the ore, China is stimulating the economy, regardless of whether or not production occurs immediately.

Looking Back

Between 2003 and 2008, the BDI soared from less 2,000 to nearly 12,000 as rapid globalization strained the world's limited supply of cargo ships. High demand from China for raw materials in conjunction with a shortage of ships caused shipping rates to increase dramatically. This rise was further sustained by a period of easy access to capital and soaring market prices for dry bulk commodities such as grain, coal and copper. However, the financial crisis hit the BDI hard,

with the Index plummeting from a high of 11,793 in June 2008, to less than 663 six months later. There are few better examples of how global trade slowed during the global recession than the BDI; the last time the Index had fallen below 700 was in 1986.

When compared to other indicators, such as the S&P 500 and the U.S. Consumer Confidence Index (CCI), businesses can use the BDI to better understand whether public sentiments reflect actual economic activity and production. As such, the BDI can be used to assess the extent to which the U.S. began emerging from the recession in 2009. Beginning in March, both the S&P 500 and CCI began a significant rally. This was accompanied by a gradual opening up of credit markets, which allowed trade merchants to finally secure financing for their shipments, restarting some industrial activity in both the U.S. and abroad. With close to 10% of the world's freighters at anchor, many business owners began looking to take advantage of low shipping prices. As a result, the BDI doubled to 3,750 by July. Though the equity markets and CCI continued to rise throughout the rest of the year, the BDI fell back to 2,200 by October. Businesses, it seemed, had overestimated their need for raw materials and soon found themselves with excess inventory. This same cycle occurred again between October and January of 2009. These trends suggest that underlying economic activity is not as strong or stable as many hoped, and that we are likely to experience a longer and more gradual recovery.

Going Forward

Over the next three years, the total number of freight ships available for shipping will grow by 60%. For some in the industry, this brings back memories of the 1980's, when oversupply kept thousands of freighters at port. Still, others shrug off the idea of oversupply as shipments of cheap Australian coal and iron ore to China have been constrained for years by a lack of freighters. With a greater supply of ships, shipbrokers will likely lower their prices and stimulate trade growth, leading to price reductions for businesses that use the raw materials transported by ship. That being said, many believe that shipbuilders are unlikely to fulfill all of their orders, given the lengthy and expensive lead-times and the probability of cancellations. In the short run, the BDI is likely to remain below 5,000 as businesses remain cautious and international expansion plans are scaled back. However, the past decade has shown that that the possibility of a quick and monumental increase in international shipping costs can't be dismissed.

The BDI's ability to quickly surge has a number of relevant implications for businesses, particularly for those directly dependent on raw material inputs and international shipping or receiving. With the BDI at approximately 3,500, many companies should be looking to enter into long-term shipping contracts to secure low shipping prices in the future, even if present day operations are strained. Additionally, companies with non-perishable goods should evaluate whether the cost savings of shipping today will outweigh the costs of storing excess inventory or the risk of obsolescence. Companies should also look at the BDI between 2004 and 2007 in order to better understand and study how increases in foreign economic activity can impact their domestic operations.

Despite these imperfections, it is clear that the BDI is a powerful tool, with one simple requirement to useful analysis - context. Gathering information about why the Index is behaving the way it is, is the key to ensuring that its volatility and occasional false positives do not mislead decision makers. Comparing BDI to more speculative figures such as the S&P or consumer confidence can give businesses an idea of how far off real production is from general market performance. Additionally, it's essential for business of all kinds to focus on what the BDI is suggesting; even if its values seem skewed by stockpiling, this information itself tells businesses a considerable amount about how the costs of their inputs might change in the near future. The BDI may not be the perfect economic indicator, but it is an extremely useful tool that businesses can use to better understand price fluctuations in the inputs to production, inflationary changes, and equity market conditions.