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Contents

Credits

Case Study Shipper Manufacturing Company

In April 2007, James Wallace, general manager of the Advanced Products Division at Shipper, was considering a change in manufacturing strategy. Recently, Wallace and his staff had revised the business strategy of the division. As a result, it became apparent that the marketing, engineering, and manufacturing strategies should also be revised.

The Shipper Company started in the aerospace business in the 1960s. In the early years, the company developed and produced the Echo weather satellites, which were launched into space. More recently, the Shipper Company had diversified into three divisions located in Faribault, Minnesota: the Electrical Products Division (EPD), the Materials Division (MD), and the Advanced Products Division (APD). The EPD produced a variety of circuit boards and other electrical products for mass markets. The MD produced laminated plastic materials that were sold to EPD, APD, and outside customers. The APD manufactured specialty products to customer order. The sales growth and profitability of the company have been good for the past five years, as shown in Exhibit 1. Sales and profits of the APD, however, have been somewhat erratic.

The main product of the APD is the aerostat, which is a large lighter-than-air blimp resembling the famous Goodyear blimp. These aerostats are sold to communications companies, the U.S. government, and foreign countries for communications uses. At the present time, the APD produces about 12 aerostats per year, and the aerostat accounts for about 50 percent of the APD's sales.

The APD also produces a variety of other specialty products made to customer order. These products include mine stoppers used to seal mining passages for ventilation control (see Exhibit 2) and blade liners used as inserts in helicopter blades to detect cracks. One unifying feature of these specialty products is that they are made from the laminated plastic materials supplied by the Materials Division of Shipper.

In formulating his business strategy, Wallace envisioned a gradual shift toward products that are sold to multiple customers and manufactured on a volume basis. The business strategy developed by Wallace and his staff is summarized as follows:

> APD will continue to do what it has historically done best—respond to *individual customer* design requirements and tailor new products to unique customer applications. This business is characterized by low volume but sole-source products, by customer funding for product development, and by large year-to-year variations in sales and profits.

Concurrently and increasingly, the APD will become more *market-focused* in its business and will apply resources toward market and product-development programs. Its objective shall be to reduce but not eliminate APD dependence on short-run customer-specified products or projects and to bring on stream new products with higher-volume continuous production. The APD will restrict its market development resources to certain market segments or niches of growth and to mature industries where there is a realistic opportunity and expectation of occupying a dominant or strong competitive position.

This heavy emphasis on marketing strategies will require enlargement of market research, market development, and sales distribution systems. Technologically, materials and systems engineering capabilities will have to be strengthened, as will the production engineering and production control disciplines. The company will need to concentrate heavily on planning, and it must have the patience to focus on and stick to its strategies to see them through to fruition.

EXHIBIT 1 Financial data.

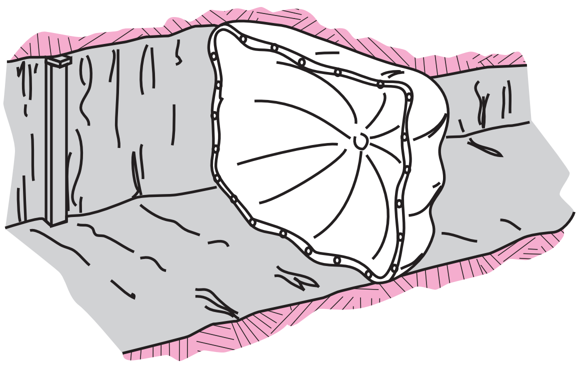
	$ Thousands				
	2002	2003	2004	2005	2006
Shipper Corp.					
Sales	34,884	41,029	46,824	41,914	47,857
Profits (after tax)	1,256	1,324	1,363	1,035	1,579
APD					
Sales	5,977	6,508	4,080	7,600	5,179
Profits (after tax)	703	597	223	1,139	150

This case was prepared as a basis for class discussion, not to illustrate either effective or ineffective handling of an administrative situation.

EXHIBIT 2 Product description.

Shipper
Advanced Products Division
Faribault, Minnesota 55021

Reusable Ventilation Control Stopping for Underground Mines
Part No. 10687



DESCRIPTION

- A DIFFERENT BRATTICE FOR EMERGENCY AND PRODUCTION VENTILATION CONTROL
- INSTALL IN MINUTES
- SELF SEALING
- REUSABLE
- RESISTANT TO BLAST FORCES
- FLAME RESISTANT (To NFPA 701-75 Spec. and ASTM E162 with Flame Spread Index of less than 25.)
- AN ACCESSORY HARNESS IS AVAILABLE TO CONVERT THIS UNIT INTO A "PARACHUTE" SINGLE POINT ATTACHMENT STOPPING

SIZING

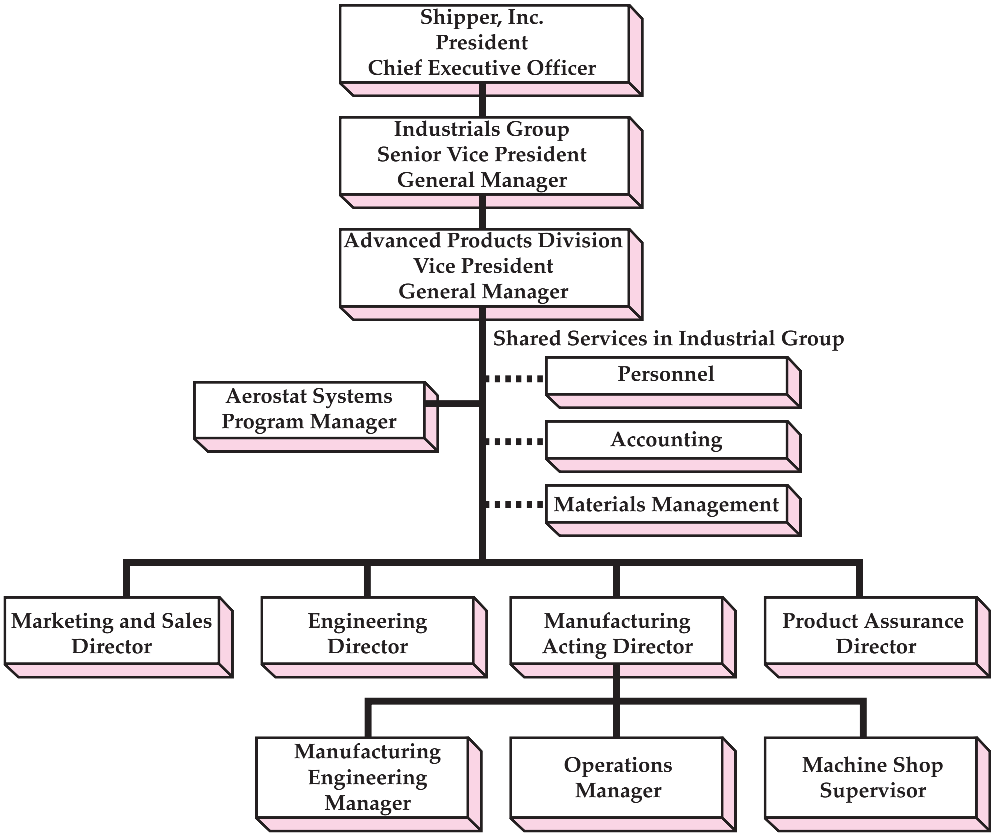
For Airways smaller than 7' × 8' order the 10687-012 Stopping.
For Airways between 7' × 8' and 11' × 12' order the 10687-016 Stopping.

The business unit is growth-oriented with substantial resources directed to new-product/new-market strategies, making it a medium- to high-risk operation. Although investment in product development and capital equipment will be required, the business should retain its low-capital, high-labor-intensive character. Over the five-year planning period, sales, profits, and asset levels should produce a return on net assets (RONA) in the 30 to 40 percent range. Additionally, the business will be a net cash user.

According to Wallace, the shift in business strategy will require a corresponding change in manufacturing strategy. Manufacturing will need to develop facilities, people, and production control systems to support the gradual change from low-volume, one-of-a-kind production to higher-volume, standardized product lines. Among the results of this change in strategy could be changes in organization. The present organizational structure of the APD is shown in Exhibit 3.

Wallace also felt that the shift in business strategy might affect the production and inventory control area. At the present time, production and inventory control is handled by two individuals who were

EXHIBIT 3 Organization chart (detail only shown in manufacturing area).



transferred from the storeroom and the production floor. They have been trained on the job, and they have evolved a manual system of record keeping and production planning. The system appears to work quite well for the present situation, but constant expediting and stock chasing are necessary to keep production moving.

Inventory stock status is computerized by the data processing department. Receipts and disbursements are sent to data processing and then entered into the computer. Because of time lags and problems of record accuracy, the production and inventory control people also keep manual records on the most important parts.

The Shipper Company recently signed a contract with Hewlett-Packard for a new computer, which will arrive in the fall and replace the current IBM equipment. As part of the new computer conversion, the company has investigated software packages available from Hewlett-Packard. The production and inventory control (MRP) software package appears quite good, but conversion of existing computer software will have priority over new systems. The first priority, after the new computer is installed, will be the conversion of existing accounting and financial systems.

In viewing the situation, Wallace wondered what the manufacturing strategy over the next five years should be and how the strategy should be implemented. He knew that manufacturing should support the new divisional business strategy but was unsure about exactly what direction manufacturing should take.

Discussion Questions

1. What objectives should be adopted in manufacturing with respect to cost, delivery, quality, and flexibility?
2. How should the objectives in manufacturing be achieved through process, organization, equipment, workforce, capacity, scheduling, quality management, and production and inventory control systems?

Case Study Southwest Airlines: Singin' the (Jet) Blues

Southwest Airlines, which began as a small Texas airline in 1971, had grown to become one of the largest airlines in the United States.[1] As of 2004, Southwest flew more than 65 million passengers a year to 59 cities in 30 states, more than 2,800 times a day.[2] While the airline industry reported greater than $5 billion in losses during 2003, that year marked Southwest Airlines' 31st consecutive year of profitability.[3]

For more than three decades, Southwest's competitive advantage stemmed from its unique business model, together with its unorthodox management style, especially that of former CEO Herb Kelleher. For example, in March 1992, Kelleher settled a dispute with Stevens Aviation over the right to use the ad slogan "Just Plane Smart," which Stevens maintained it had developed first. Kelleher and Kurt Herwald, the chairman of Stevens Aviation, had decided they would settle things the "old-fashioned way" in a best-of-three arm-wrestling match in the Dallas Sportatorium.

This unusual method of negotiation was entirely in keeping with Herb Kelleher's "disarming" style, which, for some observers, was the principal reason for Southwest's record of 31 consecutive profitable years. Many in the industry, however, pointed to a variety of other factors that ensured the Dallas-based airline would continue to maintain its top record of achievement. Others wondered how Southwest could continue its record of profitability and growth in light of the changing competitive environment in the airline industry.

HISTORY

Rollin King, a former investment counselor who had been operating a small air-taxi service in Texas, founded Southwest Airlines in 1967. The impetus behind King's organization of Southwest Airlines was his perception of a growing unmet need for improved intercity air service within Texas.

In the late 1960s, Houston, Dallas, San Antonio, and Fort Worth were among the fastest-growing cities in the United States. Although each had its own airport, a huge new airport, the Dallas–Fort Worth Regional Airport—which would serve both Dallas and Fort Worth—was then under construction. Two Texas-based carriers, Braniff International Airways and Texas International Airlines (TI), primarily served these four cities. For the most part, service to these cities by Braniff and TI consisted of "legs" of interstate flights; in other words, a Braniff flight might stop at Dallas on its way from New York to San Antonio.

In his talks with consumers before embarking on the Southwest venture, King was struck by the amount of dissatisfaction with the current service and discovered that the market was bigger than many realized. Together with his lawyer, Herb Kelleher, King was able to raise enough capital to incorporate the airline and hire Lamar Muse as president and chief executive officer. On February 20, 1968, Kelleher obtained the Certificate of Public Convenience and Necessity from the Texas Aeronautics Commission, which granted Southwest Airlines the right to provide intrastate air service between Dallas–Fort Worth, Houston, and San Antonio. Southwest's competitors reacted immediately by asking the Texas courts to enjoin issuance of the certificate, maintaining that service was already provided on the proposed routes and that the market was not large enough to support another carrier. The ensuing litigation kept the company's lawyers occupied for several years. In its first 11 months of operation, Southwest lost $3.7 million.

On June 18, 1971, amid a heavy advertising campaign to promote the new airline—as well as restraining orders issued after complaints by its competitors—Southwest launched 6 round-trip flights between Dallas's Love Field and San Antonio and 12 round-trip flights between Dallas and Houston. The takeoff proved to be less than auspicious. Some days saw the airline carrying a total of only 150 passengers on its 18 round-trip flights. Nevertheless, Muse persevered with his ideas by offering unbelievable prices, gimmicks, and creative advertising.

In Texas, 1972 became the year of the fare war. To compete with Southwest, rivals slashed fares and began offering more in terms of service (e.g., free beer, hot and cold towels, one-dollar drinks on Southwest's routes, and more-frequent service). When

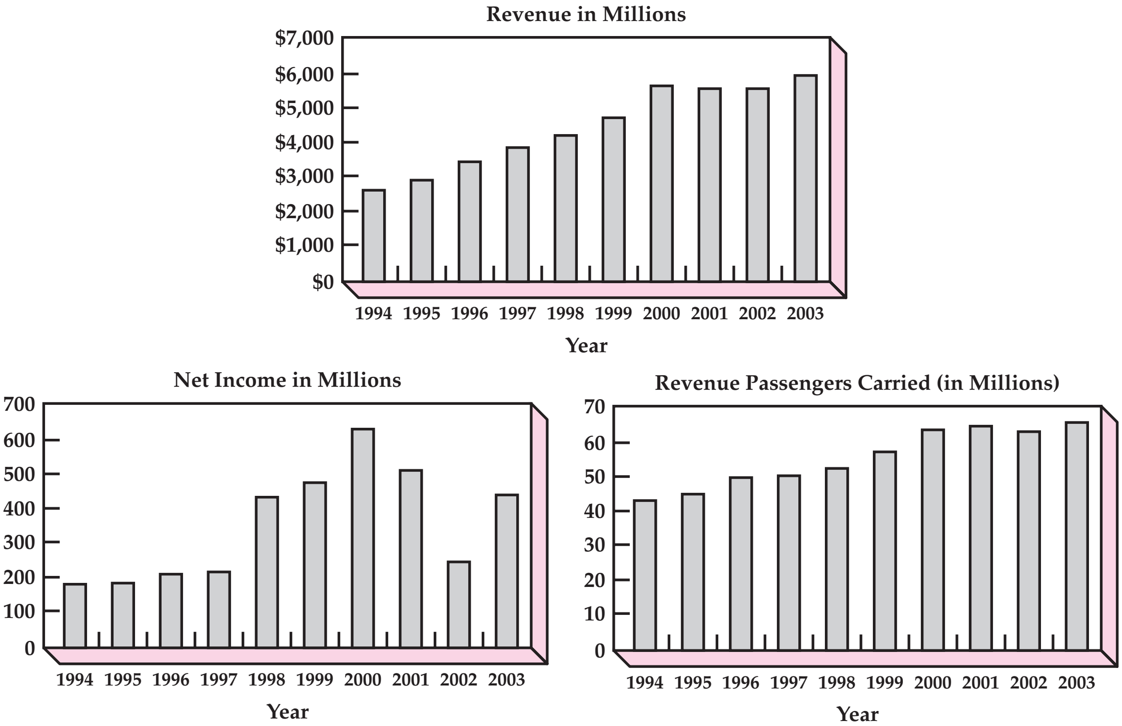
[1] Southwest Airlines, *Annual Report* (2003), 9.

[2] Southwest Airlines, http://www.southwest.com (accessed on 9 June 2004).

[3] Southwest Airlines, *Annual Report* (2003), 5.

This case was prepared by Marlene Friesen, under the supervision of Professor Elliott N. Weiss. Portions of it were taken from the Darden case "Southwest Airlines" (UVA-OM-0743), prepared by Charlotte Thompson, under the supervision of Professor Elliott N. Weiss, and from the Darden case "Southwest Airlines: Keeping That Lovin' Feeling after Herb Kelleher" (UVA-OM-1015), prepared by Anwar Harahsheh, under the supervision of Professor Elliott N. Weiss. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation.

EXHIBIT 1 Revenues, net income, and revenue passengers carried.



Source: Southwest Airlines, *Annual Report* (2003), 14–15.

Braniff decided to offer a half-price fare, Muse countered with a giveaway: free bottles of premium liquor to passengers who paid the full fare; passengers who did not want the liquor would pay half fare. Because corporations were accustomed to paying full fare, business travelers became the happy recipients of premium liquor. During the promotion, Southwest became not only the largest distributor in Texas of Chivas Regal, Crown Royal, and Smirnoff, but also the winner in the fare war. After 1972, Southwest consistently made a profit (see Exhibit 1 for the figures for 1994 through 2003).

HERB KELLEHER

In March 1979, Lamar Muse resigned as president and CEO of Southwest Airlines, and Herb Kelleher was named as his replacement. Kelleher, who had been a student of philosophy and literature in college and later graduated at the top of his law-school class at New York University, was wedded to the Southwest cause from the very beginning.

Early on, Kelleher established a reputation for doing the unusual. At company functions, he would appear as Elvis Presley or Roy Orbison and perform "Jailhouse Rock" or "Pretty Woman." One Halloween night, he showed up at Southwest's hangar in drag, as Corporal Klinger from the *M*A*S*H* television show, to thank the mechanics for working overtime. Although Kelleher's behavior was somewhat unconventional for a chief executive officer, his efforts paid off. His colleagues credited much of Southwest's "magic" to him.

Known for his extreme tenacity and limitless energy, Kelleher slept only four hours a night, read two or three books a week, and chain-smoked. Gary Barren, Southwest's chief operations officer, called Kelleher "the smartest, quickest lawyer—not to mention the best judge of people"—he had ever seen.[4] Kelleher was widely credited with much of the airline's success by promoting and maintaining both a culture that favored people and a coherent business strategy that was consistently successful yet deceptively simple. "People always want high-quality service at a lower price, provided by people who enjoy what they do," he maintained.[5] The results of Kelleher's efforts: Southwest's overall costs were the lowest of any major carrier.

OPERATIONS

Start-up

The first key decision for the airline concerned the number and type of aircraft to be used. After weeks of negotiations with representatives of several air-

[4] Charlotte Thompson and Elliott N. Weiss, "Southwest Airlines" (case study, UVA-OM-0743), University of Virginia Darden Graduate School of Business Administration, Charlottesville, 1993.

[5] Ibid.

plane manufacturers, Southwest decided to purchase three Boeing 737-200 aircraft. This decision proved to be a crucial one, as Southwest wanted to use the same type of aircraft in all its operations and also allow for future expansion. The Boeing 737-200 required fewer crew members than the aircraft used by Southwest's competitors. Maintenance costs were also lower because the airline had to maintain only one type of plane.

Scheduling

Initial decisions about scheduling were constrained by the fact that Southwest had only three airplanes. After studying flight times and on-the-ground (turnaround) times, Muse and King concluded that they could offer flights at 75-minute intervals using two planes between Dallas and Houston (the most important route) and at 150-minute intervals (2½ hours) between Dallas and San Antonio using one plane. This schedule amounted to 12 round trips a day between Dallas and Houston and 6 round trips a day between Dallas and San Antonio. Because of low weekend demand, Muse and King decided Southwest would fly less frequently on Saturdays and Sundays.

In spite of all their well-laid plans, however, scheduling soon proved to be a problem. In the first two weeks, the airline reported an average of 13.1 passengers per flight on the Dallas–Houston route and 12.9 passengers on the Dallas–San Antonio route. Owing to the lack of planes, management concluded that Southwest was unable to compete effectively, and set about to improve its schedule frequencies. Delivery of the fourth plane in late September helped immensely, but perhaps more important than the arrival of the fourth plane was the company's skill at producing a turnaround time of 10 minutes. Proving its ability to turn a constraint into a competitive advantage, Southwest was able to initiate hourly service between Dallas and Houston and to begin flights every two hours between Dallas and San Antonio. The company did this by orchestrating maintenance and servicing to the point that no plane stayed on the ground more than 10 minutes. This development proved to be a real innovation in the industry; Southwest became known for its "quick turns."

Strategy and Service

From the beginning, Southwest's business model was to offer no-frills, low-cost flights to and from secondary airports. Management's focus was the "short-haul, point-to-point" strategy, which advocated short flights to uncrowded airports for quick turnarounds. This adherence to a short-haul strategy enabled Southwest to distinguish itself from its competitors, many of whom failed: several airlines started out in the short-haul business only to become tempted by the more glamorous routes.

Most of Southwest's competitors used a "hub-and-spoke" system in which big planes flew to major airports (hubs) and then linked up with smaller airports (spokes). Southwest developed no recognizable hub, preferring instead to maintain a "spider-web" system in which one strand at a time was spun. Kelleher's reason for implementing this strategy was that a hub-and-spoke network tied up too many valuable assets at too few pressure points, whereas a spider-web system allowed maximum flexibility to disperse assets and reduce stress in the system.

Southwest's no-frills policy included no baggage transfers, no meals, no assigned seats, and reusable boarding cards. When a passenger decided to fly Southwest, he or she would show up at the airport at the designated time, get a ticket at the counter printed out by a machine (at the time, the competition was issuing handwritten tickets), take a reusable boarding card, and board the plane to sit wherever he or she preferred. On board, the passenger could enjoy a drink or two and some peanuts, but nothing more. The reason behind the no-frills policy was that there were other things to offer customers that gave better value: frequent, reliable, on-time flights and very low prices. For Southwest, quality was not a dinner of filet mignon and a fine wine; it was on-time flights and no lost baggage.

One way the airline was able to keep its costs down was through contracting for such things as major maintenance, data processing, and legal services. Southwest also contracted for about two-thirds of its monthly jet-fuel supply and purchased the rest on the spot market.

Southwest's policy with regard to costs and services paid off: Its average number of flights per plane per day was twice the industry average; its planes were in the air 12 hours a day[6] (the industry average was 8 hours a day), which was an especially significant statistic because its flights were the shortest of any airline. Southwest's flights were also more profitable, even though short flights meant higher fuel costs and a greater number of landing fees. Southwest's secret was that it made extremely good use of its most expensive asset, planes (see Exhibit 2).

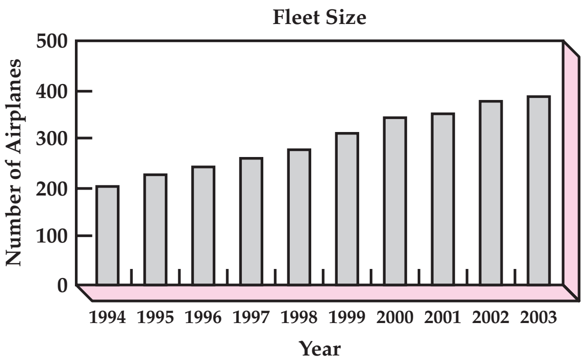
MARKETING

Positioning

Southwest decided from the beginning that it would differentiate itself from its competitors by creating a fun image. In contrast to Texas International, which was perceived as dull, and Braniff, which was seen as conservative, Southwest's personality and theme were focused on the concept of "LUV": flight attendants wore brightly colored hot pants, and in-flight

[6] Southwest Airlines, http://www.southwest.com/about swa/press/factsheet.html (accessed on 9 March 2001).

EXHIBIT 2 Number of employees and airplanes.



drinks and peanuts were known as LUV Potions and LUV Bites.

Herb Kelleher's fun-loving personality served to reinforce Southwest's lively image among its employees and encouraged them to pass it on to passengers. Employees took to donning holiday costumes (such as rabbit garb for Easter), and every holiday became an excuse for in-flight parties with balloons and cake. Words like "young and vital," "exciting," and "dynamic" were sprinkled throughout the personality-model statement.

In 1988, under an agreement with Sea World of Texas, Southwest launched "Shamu One," its flying killer whale in the form of a 737-300 airplane. The painted plane became so popular throughout Texas that Southwest painted two others to resemble Sea World's most popular attraction.

Pricing

Pricing decisions were a particularly important part of Southwest's overall strategy. Southwest looked carefully at preoperating expenditures, operating costs, and market potential before deciding on an initial fare for routes. For its first route, the break-even capacity was 39 passengers per trip, which seemed reasonable given that the airline would have an initial price advantage over its competition. Before the break-even figure of 39 passengers per flight could be reached, however, the airline expected an initial period of deficit operations, a development it was willing to accept to get off the ground. Clearly, the marketing campaign would be crucial to the company's future decisions on pricing.

Southwest was only five months old when Muse decided to try something revolutionary for the airline industry. Because the crew had been flying an empty plane from Houston to Dallas at the end of each week for weekend servicing, Muse came up with the idea of offering a fare of $10 for this last flight of the week. Within two weeks, the plane was flying from Houston to Dallas with a full passenger load.

The success of the two-tier pricing system did not escape Muse, who soon decided to cut fares on the last flight of each day in all directions, which meant that any passenger flying Southwest after 7:00 P.M. on any day of the week would need a mere $10 to climb aboard. A few months later, Muse was able to raise both fares (regular and "night"), but he continued the two-tier pricing system because of its ability to attract passengers. Pricing was a key part of Southwest's strategy, and the company was leery of fare increases. From 1972 to 1978, Southwest did not have a single fare increase. "We base our pricing on profit rather than market share," contended Southwest's Gary C. Kelly, vice president of Finance.[7] In 2001, Southwest's average one-way airfare was about $85, and the average passenger-trip length was 652 miles.[8]

Southwest's rock-bottom prices won both admiration and scorn from competitors, many of whom immediately dropped their prices when Southwest entered their markets. A number of them were also resentful: one American Airlines executive commented, "Value isn't quality; it's getting what you pay for."[9] Some competitors accused Southwest of "airline seat dumping," although the airline made money on its routes from day one.

Promotion

Southwest defined its target market not as the passengers flying other airlines, but as the people who were using other methods of transportation. As Southwest's director of Sales and Marketing stated, "We're not competing with other carriers. We want to pull people out of backyards and automobiles and get them off the bus."[10]

Southwest's promotions were aimed primarily at regular business commuters, who constituted the majority of Southwest's traffic. Accordingly, the airline

[7] *AW* (March 5, l990), 36.

[8] Southwest Airlines, http://www.southwest.com> (accessed on 14 July 2001).

[9] *Time* (March 2, 1992), 15.

[10] Thompson and Weiss, "Southwest Airlines."

used a heavy advertising campaign and a small sales force targeted specifically at the business traveler. Initially, the company strove for name recognition, but its marketing efforts quickly expanded to create an image via mass communications. Southwest also used teaser ads announcing incredibly low fares and a follow-up phone number, as well as the Sweetheart Club, in which secretaries received one "sweetheart stamp" for each Southwest reservation they made for their bosses. For every 15 stamps, the secretary earned one free ride on Southwest.

Southwest's Expansion into New Markets

Part of Southwest's strategy was to investigate potential markets carefully. As flamboyant as Kelleher often was, he admitted to being a very cautious businessman. Cities across the United States requested that Southwest operate from their airports, but Southwest chose only the ones that fit its business model. As Gary Barron put it, "We search out markets that are overpriced and underserved."[11] Small cities and small airports meant that Southwest could get its planes in and out quickly.

Once Southwest decided to enter a market, however, it did so with full force. The airline offered so many flights that customers merely had to show up at the airport and take the next cheap flight out. This part of the strategy not only enabled the airline to spread its fixed costs over many seats, but also served a marketing function in that Southwest could really "make a statement" in a new airport. After years of patient watchfulness and careful consideration, Southwest decided to enter the California market. In 1983, it began offering flights on the San Diego–San Francisco route, but did not expand service until 1989. The California intrastate market was ideal for Southwest: it combined short-haul, high-frequency routes with good weather and a populace appreciative of Southwest's "unconventional behavior." The airline employed a relatively simple strategy of offering service in the mainly suburban areas outside Los Angeles and San Francisco at prices as low as $19 for a one-way flight. Not surprisingly, Southwest's expansion into California led to a series of fare wars as the major airlines tried to keep Southwest from stealing customers. The intensely competitive market in California saw some losers: USAir and American were forced out of the California intrastate market almost entirely. As airline analyst Harold Shenton noted, "Most of the big airlines are trying to protect long-haul revenue, so they're not dependent on local traffic, and they're weakening in the markets outside Los Angeles and San Francisco."[12]

[11] *Inc.* (January 1992), 68.

[12] UPI (2 June 1991), 70.

Southwest undercut its California competitors and emerged victorious in the fare battles. The airline continued to use such tactics as offering free tickets in a "Fly One Way, Get One Way Free" campaign and a $59 unrestricted one-way fare for all intrastate California flights as part of the airline's "California State Fare" promotion. Southwest's California campaign was so successful that Southwest saved its California fliers more than $40 million in 1991.

After years of downplaying any interest in the congested airways of the East Coast, Southwest began serving Baltimore–Washington International Airport (BWI) on September 1, 1993. BWI remained Southwest's lone eastern outpost until early 1996, when Southwest added service to Tampa, Fort Lauderdale, and Orlando. In June 1996, Southwest announced its long-awaited entry into the Northeast market, with service to Providence, Rhode Island, beginning October 27, 1996.[13]

In April 1997, Southwest's strategy took an even larger turn with the introduction of four-hour, nonstop flights from Nashville to Los Angeles and Oakland. This move was a dramatic departure from Southwest's traditional emphasis on short-haul, point-to-point routes. In September 2002, Southwest began its first coast-to-coast route, from BWI to Los Angeles.[14]

In 2003, Southwest continued to add new city-pair routings and increase existing services in many markets, particularly in Baltimore-Washington and Chicago Midway.[15] In May 2004, Southwest announced that it would begin service to Philadelphia.[16] See Exhibit 3 for a list of the cities served by Southwest Airlines in 2004.

PERSONNEL

The company's philosophy toward recruitment remained consistent from the beginning: Southwest invested in its personnel by "spending more money to recruit and train than any of the other airlines"; its policy was to "find the right people to hire, at all levels within the organization, and spend time training them."[17]

Although Southwest's workforce was more than 82 percent unionized, the airline had not seen as much

[13] Stephen Sullivan, Richard R. Johnson, Paul W. Farris, and Marjorie Adams, "Southwest Airlines Coast-to-Coast (Condensed)" (case study, UVA-M-0464), University of Virginia Darden Graduate School of Business Administration, Charlottesville, 1995.

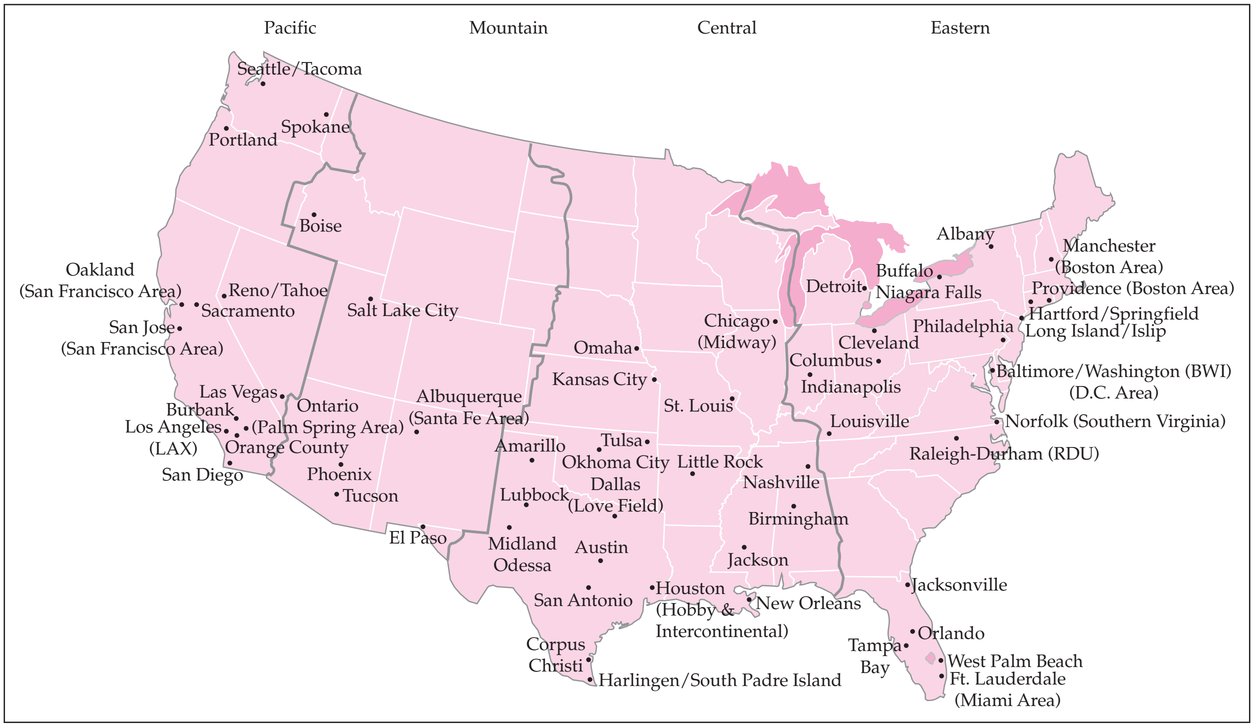
[14] Ibid.

[15] Southwest Airlines, *Annual Report* (2003), 9.

[16] Ibid., 8.

[17] Jody Gittell, R. John Hansman, and Anne Dunning, "Investing in Relationships—An Interview with the Southwest Airlines Management Team," *Harvard Business Review* (June 2001).

EXHIBIT 3 Cities served by Southwest. Southwest now flies more than 65 million passengers a year to 59 cities in 30 states, more than 2,800 times a day.



Source: Southwest Airlines, <http//:www.southwest.com. (accessed on 9 August 2004).

turbulence as the other carriers. The airline industry was notorious for contentious labor–management relations, but Southwest's employees enjoyed sunny relations with management. One reason for the smooth sailing was that employees had a stake in the company's success.[18] Another reason was that Southwest managed to make employees feel as if they were part of an extended family, even if it was a $5.6 billion family.

Southwest's management did not try to hide the fact that the main reason for the airline's success was the commitment of its employees. The quick turnaround time was a perfect example. As Gary Barron stated:

> Our employees bust their butts out there. Ground crews of 6 (12 is the industry average) perform 40 or 50 tasks during the 15 minutes that the plane is on the ground. Because of employee commitment, Southwest has consistently kept to its 15-minute "turn" (planes of major airlines spend usually an hour at the gate) and is always on time.

[18] Ibid.

Another example of employee loyalty was the automatic ticket machines at Southwest counters, which took credit cards and dispensed tickets in just 20 seconds. Southwest employees built these efficient machines in their off-hours. According to Andy Donelson, station manager at Dallas's Love Field, "The machine was thought up by a bunch of guys in a bar one night in Denver."[19]

In 2003, 202,357 people applied for jobs at Southwest. Only 908 were hired.[20]

BUILDING A REPUTATION

At first, many observers believed that Southwest's fun image and no-frills flights would be the last choice for business travelers and cause the airline to take an immediate nosedive into bankruptcy, but the skeptics soon stopped laughing. Initially unprofitable, Southwest ended 1973 in the black, and celebrated its millionth passenger early in 1974. (See Exhibit 4 for a comparison of 2003 revenues, profits, and passengers for the major U.S. airlines.)

[19] Thompson and Weiss, "Southwest Airlines."

[20] Southwest Airlines, http://www.southwest.com (accessed on 9 June 2004).

EXHIBIT 4 Airline revenues, profits, and passengers for 2003.

ATA Member Airline Statistics—2003

	Operating Aircraft (Year-End)	**Employees** (Full-Time Equivalents)	**Aircraft Departures**	**Revenue Passengers Enplaned** [1] (Thousands)	**Revenue Passenger Miles**[1] (Millions)	**Available Seat Miles**[1] (Millions)	**Cargo Revenue Ton Miles** (Millions)	**Revenues** ($Millions) **Passenger**[1]	**Cargo**	**Operating**	**Profit (Loss)** ($Millions) **Operating**	**Net**
Alaska	110	10,087	180,469	15,046	14,557	20,808	73	1,788	86	2,019	(18)	(2)
Aloha	25	2,477	58,482	4,119	1,968	2,690	10	340	40	393	(8)	1
America West	140	11,107	197,484	20,031	21,266	27,843	70	2,108	35	2,223	24	45
American	743	85,555	887,114	88,151	120,004	164,780	2,012	14,236	621	17,403	(1,444)	(1,318)
ATA	66	7,328	78,402	9,386	11,840	16,373	40	1,006	21	1,398	14	13
Continental	358	34,927	371,100	38,474	56,886	74,969	865	6,556	283	7,333	30	38
Delta	523	59,525	704,759	84,076	89,154	119,912	1,349	10,272	508	14,203	(1,157)	(896)
Hawaiian	26	2,966	50,416	5,597	5,560	6,924	79	627	28	706	60	(48)
JetBlue	53	4,515	66,920	8,949	10,442	13,689	5	965	4	998	169	104
Midwest	29	2,055	37,883	2,098	1,969	2,968	7	260	4	319	(19)	(8)
Northwest	431	39,407	553,245	51,865	68,459	88,573	2,184	7,617	780	9,184	(277)	478
Southwest	387	32,972	950,572	74,719	47,940	71,789	141	5,612	97	5,937	482	442
United	528	63,612	601,361	66,018	103,857	135,867	1,888	10,619	668	13,398	(1,554)	(3,086)
US Airways	277	26,809	438,625	41,250	37,727	51,474	361	4,925	144	6,762	(421)	(465)
Subtotal	**3,696**	**383,345**	**5,176,832**	**509,779**	**591,628**	**798,659**	**9,083**	**66,931**	**3,318**	**82,277**	**(4,118)**	**(4,703)**
ABX	115	5,799	70,401	-	-	-	700	-	1,115	1,161	42	19
ASTAR[2]	41	933	20,568	-	-	-	348	-	148	153	32	18
Atlas	27	1,006	14,651	-	-	-	3,006	-	n/a	n/a	n/a	n/a
Evergreen Int'l	14	447	8,140	-	-	-	677	-	256	266	44	19
FedEx	324	114,306	359,840	-	-	-	9,487	-	8,377	16,807	474	250
Polar	15	682	5,884	-	-	-	1,115	-	n/a	n/a	n/a	n/a
UPS	246	6,098	139.958	-	-	-	4,624	-	1,215	3,046	228	40
Subtotal	**782**	**129,271**	**619,442**	**-**	**-**	**-**	**19,958**	**-**	**11,111**	**21,433**	**820**	**347**
GRAND TOTAL	**4,478**	**512,616**	**5,796,274**	**509,779**	**591,628**	**798,659**	**29,041**	**$66,931**	**$14,429**	**$103,710**	**($3,298)**	**($4,356)**

[1]Scheduled service only.
[2]Financial results reflect the period from July 14 through December 31, 2003.
n/a—Not available at time of printing.

Source: Air Transport Association, *Annual Report* (2004).

EXHIBIT 5 Performance of major U.S. air carriers: average airline quality rating (AQR) score

	2003*		2002**		2001***		2000	
Airline	**AQR Score**	**Rank**	**AQR Score**	**Rank**	**AQR Score**	**Rank**	**AQR Score**	**Rank**
Air Tran	−1.05	8	N/A	—	N/A	—	N/A	—
Alaska	−0.74	2	−0.95	2	−1.19	1	−1.54	2
America West	−0.89	4	−1.08	4	−1.75	7	−3.43	10
American	−1.24	11	−1.21	6	−1.58	6	−2.08	6
American Eagle	−2.10	13	−2.42	10	−2.14	10	N/A	—
ATA	−1.17	10	N/A	—	N/A	—	N/A	—
Atlantic Southeast	−5.76	14	N/A	—	N/A	—	N/A	—
Continental	−1.04	7	−1.10	5	−1.77	8	−2.11	7
Delta	−1.24	12	−1.26	7	−1.48	5	−1.47	1
JetBlue	−0.64	1	N/A	—	N/A	—	N/A	—
Northwest	−1.02	6	−1.39	9	−1.38	3	−1.83	5
Southwest	−0.89	3	−1.00	3	−1.42	4	−1.64	3
United	−1.11	9	−1.27	8	−1.97	9	−3.01	9
US Airways	−0.96	5	−0.85	1	−1.24	2	−1.74	4
Industry	−1.14		−1.19		−1.60		−2.05	

Scores and rankings for 2003 reflect the addition of Air Tran, ATA, Atlantic Southeast, and JetBlue to the group of airlines tracked.
*****Rankings for 2002, 2001, and 2000 reflect the removal of TWA from the group of airlines tracked.***
******Scores and rankings for 2001 reflect the addition of American Eagle to the group of airlines tracked.***

Note: The AQR score is a weighted average of the following: on-time, denied-boarding, mishandled baggage, and customer complaints. Average AQR scores are based on monthly AQR score calculations using AQR weighted-average method. The calendar year is used, and monthly AQR scores are totaled and divided by 12 to arrive at the AQR for the year.

Source: *Average Airline Quality Rating Report* (2004).

Southwest was the first U.S. domestic airline to win all three categories of the U.S. Department of Transportation's ranking report in 1992. It ranked first in on-time performance and had the smallest number of lost-baggage complaints and the lowest number of customer complaints. Southwest then proceeded to win the "Triple Crown" for the next four years, and it placed first in the Airline Quality Ratings in 1993, 1995, 1996, 1997, and 1999.

Although 2003 marked Southwest's 13th consecutive year for leading the industry with the fewest customer complaints, it had not won the Triple Crown since 1996.[21] (See Exhibit 5 for the Airline Quality Ratings for 2000 through 2003.)

CORPORATE CULTURE

Southwest was a "family-friendly place. [Management] is very flexible with scheduling, for example. There is a lot of leeway for employees to trade shifts and so on. People care about one another's families."[22]

Each year, the company hosted a banquet at which outstanding employees were recognized, much in the manner of the Emmy Awards. Kelleher could be seen at these functions mingling with employees from all levels of the company, calling them by name, laughing uproariously with them, hugging and kissing them. Even customers were brought into the family circle. Each month, Southwest invited its frequent fliers to company headquarters to interview prospective employees, the logic being that the company wanted to hire people who matched its customers in personality. Kelleher's role in the formation of Southwest's familial culture was crucial. Jim Wimberly stated that Kelleher had "a knack of really being with you, even if you're one person in a crowd of 1,000."[23] Kelleher firmly believed that employees who were committed to a mission would be more productive than uncommitted employees, and he spent a lot of his time fostering this attitude: "Southwest has its customers, the passengers; and I have my customers, the airline's employees. If the passengers aren't satisfied, they won't fly with us. If the employees aren't satisfied, they won't provide the product we need."

Once a quarter, Kelleher would join his employees to load baggage, serve drinks at 30,000 feet, or

[21] Southwest Airlines, *Annual Report* (2003), 5.
[22] Thompson and Weiss, "Southwest Airlines."
[23] *Inc.* (January 1992), 67.

hand out boarding passes. Every Friday, he wore brightly colored shirts and shorts, regardless of the business to be conducted that day. Kelleher seemed to have found a formula that worked. In 1990, rising fuel costs made Southwest suffer a fourth-quarter loss of $4.6 million. Employees voluntarily created a "Fuel from the Heart" program in which they incurred payroll deductions to purchase fuel for the airplanes. Kelleher was so moved that he dedicated his opening letter in the company's 1990 *Annual Report* to them. "That stop-at-nothing, all-for-one, one-for-all spirit still pervades the company's corporate culture, especially among older employees."[24]

CHALLENGES FACING SOUTHWEST

Although many observers were quick to praise Southwest's unmatched record of success, some were not as enthusiastic about its future. The airline industry itself had always been a risky one. With the Iraq war, SARS concerns, a weak economy, high energy costs, and terrorism threats, the early years of the 21st century were especially difficult for the airline industry.[25] Since September 11, 2001, the major airlines continued to report billions in losses. US Airways and United Airlines filed for bankruptcy. Other major carriers reduced capacity, eliminated jobs, and slashed costs in an effort to survive.[26]

Although Southwest managed to maintain its profitability throughout the turbulent post–September 11 period, the first few years of the 21st century posed many new challenges for Southwest. Turnover in senior management and a series of intense labor negotiations led to tension between management and union employees. Adverse labor relations were highly unusual for Southwest, an airline that had always been known for its collegial culture and approachable management. Post–September 11 security changes challenged the simplicity of Southwest's fine-tuned business model, and an influx of new, low-cost carriers that copied and improved upon Southwest's model forced the airline to rethink its no-frills offerings.

The New Generation of Low-Fare, Low-Cost Carriers

By 2004, the low-fare market that Southwest once dominated had become increasingly crowded with many low-fare, low-cost carriers that tried to emulate and, in some cases, improve upon Southwest's model. While the airlines were selling more tickets than they had the previous year, they were finding it difficult to make a profit because of a flood of cheap fares, many of them from low-cost carriers.[27] In 2004, low-fare, low-cost carriers made up 18 percent of the market; by 2010, they were expected to make up 50 percent of the market.[28]

In the 1990s, the major carriers US Airways, Continental, United, and Delta experimented with their own versions of Southwest-style no-frills, low-fare service.[29] None of them were able to emulate Southwest's model successfully. The new generation of low-cost carriers, however, did prove to be successful. JetBlue became Southwest's most formidable competitor. JetBlue was launched by David Neeleman, 39, an airline-industry veteran who served briefly as an executive vice president at Southwest in 1993. Neeleman believed that most airlines treated their customers inhumanely, and believed he could improve on Southwest's model.

Like Southwest, JetBlue provided point-to-point service to large metropolitan areas with high average fares or to highly traveled markets that were underserved. It also offered low fares, reliable performance, and high-quality customer service. Unlike Southwest, JetBlue offered luxurious leather seating on brand-new planes and free, live TV at every seat. Further, JetBlue used leading-edge technology to streamline operations, offered preassigned seating (to reduce the cattle-herding ambience), and never overbooked its flights. JetBlue's model proved to be hugely successful. Since the start of JetBlue's operations, on February 11, 2000, out of New York's Kennedy Airport (JFK), the airline had put together 12 consecutive profitable quarters. JetBlue went on to boast the industry's best operating margins, top rates for on-time arrivals, and lowest costs per seat-mile. JetBlue operated 222 flights with a fleet of 53 single-class Airbus A320s serving 21 cities throughout the United States and Puerto Rico.[30]

In February 2004, United also launched a new, low-cost, low-fare carrier called Ted. Ted offered preassigned seats, music videos, and episodes of NBC sitcoms in-flight; it also offered trendy margaritas and Atkins bars for the carb-conscious.[31] In April 2003,

[24] Pat Harris, "SJ-Southwest," http://www.simercury.com (accessed on 7 March 2001).

[25] Southwest Airlines, *Annual Report* (2003), 5.

[26] Ibid.

[27] Associated Press, "Southwest Airlines' CEO Parker Steps Down," July 16, 2004.

[28] Dan Reed, "Southwest's Challenges Grow," *USA Today*, October 16, 2002.

[29] Sullivan, Johnson, Farris, and Adams, "Southwest Airlines Coast-to-Coast (Condensed)."

[30] Marlene Friesen and Elliott N. Weiss, "The JetBlue Story" (case study, UVA-OM-1151), University of Virginia Darden Graduate School of Business Administration, Charlottesville, 2005.

[31] "Low-Cost Airlines-O-Matic; View from the Cheap Seats: D.C.'s Discount Airlines," *Washington Post*, 2004.

Delta launched its own discount spin-off called Song. Song targeted affluent urban women, and featured flight attendants decked out in designer Kate Spade uniforms. Song offered apple martinis, cappuccinos with biscotti, and an in-flight exercise band, exercise ball, and how-to manual (for an $8 fee).[32] Song planned to go head-to-head with JetBlue on its lucrative New York–Fort Lauderdale route.[33] Other successful start-ups that emulated the Southwest model included AirTran Airways, Midwest Express, Frontier Airlines, American Trans Air (ATA), and, in Europe, EasyJet.[34] Virgin Atlantic's founder, Richard Branson, had also considered the launch of an airline in the United States.[35] "It's an amenity war," said Stan Hula, ATA's vice president for planning. "Airlines used to fight with food. Turns out that wore out over time. In the end, you have to provide what the consumer wants."[36]

The New York Times reported:

> All that is forcing Southwest to rethink. It is considering moves that might have been blasphemous at the company just a few years ago: adding frills like in-flight entertainment systems and expanding its fleet beyond its trusty Boeing 737 jets. Southwest executives say no firm decisions have been made, and they give every impression that life will fundamentally be the same at the airline known for its old mustard-and-ketchup-colored planes.[37]

THE SOUTHWEST RESPONSE

Intense competition from other low-fare airlines forced Southwest to rethink its model. Kelleher had recently stated, "I recognize that we have to change our tactics frequently as competitors emerge, and as facts and circumstances change."[38] Consequently, the no-frills airline implemented aesthetic and technological improvements—initiatives that might have been considered blasphemous at the company just a few years earlier.[39]

In 2001, Southwest began renewing the interiors and exteriors of its fleet. It updated the exteriors' traditional gold, red, and orange by adding canyon blue. The airline also refurbished the interiors of new and existing planes with all-leather seats in canyon blue and saddle tan, and indicated that it would add newly designed seats for increased comfort. Southwest also worked to make its gate areas more comfortable and traveler friendly. In 2004, Southwest renovated its airport facilities at BWI, Chicago Midway, and Houston Hobby. Major expansion projects were also under way at Fort Lauderdale, Las Vegas, Long Island-Islip, Oakland, Orange County, Orlando, Phoenix, and Tampa Bay.

In June 2003, Southwest announced that its current and future fleet of Boeing 737-700s would be outfitted with blended winglets. The blended winglets would give the fleet a distinctive, technologically advanced look and feel, and would improve aircraft performance by extending range, saving fuel, and reducing both takeoff noise and engine-maintenance costs.

Finally, Southwest implemented several technological initiatives to streamline its operations through automation. For example, the airline began using computer-generated luggage tags at all its facilities. These tags could electronically capture luggage checked by customers. In 2004, Southwest planned to use technology that would allow customers to check their bags and obtain their transfer boarding passes by using rapid-check-in kiosks. The company also planned to offer customers the ability to check in and obtain boarding passes on southwest.com.[40]

LABOR ISSUES

Southwest maintained that its secret weapon remained its affable employees. "There hasn't been a carrier that has been able to match our people in spirit and energy and enthusiasm over the long haul," said Colleen C. Barrett, Southwest's president and chief operating officer.[41] Southwest's employees, however, were becoming tired of being in the bottom half of the industry with regard to pay, especially as they worked for one of the nation's most profitable airlines. Moreover, as Southwest's workforce grew to more than 35,000 employees, the quality of communication between management and labor

[32] Associated Press, "Airlines Hope In-Flight Exercise Will Stretch Market Share," *USA Today*, July 9, 2004.

[33] Arlyn Tobias Gajilan, "The Amazing JetBlue," *Fortune,* http://www.fortune.com/fortune/smallbusiness/articles (accessed on 3 June 2004).

[34] Sullivan, Johnson, Farris, and Adams, "Southwest Airlines Coast-to-Coast (Condensed)."

[35] Gajilan, "The Amazing JetBlue." For additional information on Virgin Atlantic's planned launch of a U.S. airline in late 2005, see http://www.virginamerica.com/Main.aspx.

[36] Ed Sperling, "Cut Costs, Not Services," *Electronic News,* http://www.reedelectronics. com/electronicnews/article/CA415986 (accessed on 7 May 2004).

[37] Micheline Maynard, "Are Peanuts No Longer Enough?" *The New York Times,* March 7, 2004.

[38] David Koenig, "Executive Sparred with Flight Attendants Union," *San Diego Union-Tribune,* August 6, 2004.

[39] Maynard, "Are Peanuts No Longer Enough?"

[40] Southwest Airlines, *Annual Report* (2003), 2–11.

[41] Maynard, "Are Peanuts No Longer Enough?"

deteriorated.[42] Tension between management and Southwest's unions led industry observers to question whether Southwest, the most heavily unionized U.S. carrier, could continue to maintain harmonious relations with its employees. The terms of a recent deal with flight attendants—and earlier settlements with pilots and mechanics—had raised questions about Southwest's ability to keep its costs below those of most of its competitors.[43] Southwest's total labor costs had been on the rise for several years, from just one-third of total operating costs in the mid-1990s to 41 percent of total operating costs in 2003.[44] In addition, through the first six months of 2004, Southwest's labor costs rose 6 percent over early 2003, which helped push its costs per passenger to new highs.[45]

The increased labor costs were the result of contract negotiations with Southwest's unions over the past few years, which Southwest indicated had resulted in higher compensation and enriched benefits for nine of its union groups.[46] On July 30, 2004, flight attendants at Southwest ratified a new contract, retroactive to June 2002, that gave them an average 31 percent pay raise over six years.[47] This agreement settled a two-year labor dispute with Southwest's flight attendants, and would make them the highest-paid attendants in the industry by 2007.[48] In addition, Southwest's pilots agreed to a two-year contract extension that moved them closer to what their counterparts at major airlines earned, and Southwest's mechanics also ratified a new contract—but only after rejecting a prior deal.[49] Gary Kelly, Southwest's new CEO, indicated that expensive new labor contracts were necessary to keep the airline moving forward, but warned, "We're pushing the boundary of what we can afford with our wages."[50]

MANAGEMENT TURNOVER

On July 16, 2004, James Parker, Southwest Airlines' CEO, announced that he would be stepping down, citing personal reasons for his retirement.[51] Parker, who had been appointed to his position by Kelleher three years earlier, was credited with guiding Southwest through the turbulent period after September 11, 2001. In fact, Southwest was the only major airline to post a profit in every quarter following the September 11 terrorist attacks.[52] Parker, a labor lawyer, had been Kelleher's right-hand man since 1994. He led the airline's negotiating team until April 2004, when negotiations came to a halt.[53] When the union attacked Parker personally, Kelleher stepped in to finish the negotiations. Parker announced his retirement three months later.

Southwest stated that Gary Kelly, its 49-year-old chief financial officer, would immediately replace Parker.[54] Kelly had joined Southwest as its controller in 1986, and had served as Southwest's executive vice president and chief financial officer since 2001.[55]

For years, industry observers worried whether Southwest would continue to thrive once Herb Kelleher retired. Kelleher set the culture at Southwest, which had proved to be a source of competitive advantage. Since Kelleher's departure, in 2001, Parker had ensured that Southwest remained profitable. In 2004, however, it appeared that Southwest's collegial culture was showing signs of strain. Would Kelly be able to maintain the profitability of the airline while ensuring the continuation of Southwest's unique culture?

Discussion Questions

1. To what do you attribute the success of Southwest Airlines?
2. How significant is the 10 to 15 minutes turnaround time of Southwest's aircraft in terms of savings in investment and utilization of its aircraft compared to the competitors?
3. What challenges is Southwest facing in the future and how should they meet those challenges?
4. What should their business and operations strategy be for the future?
5. Will Gary Kelly, the new CEO, be able to maintain the profitability of Southwest Airlines while insuring the continuation of their unique culture?

[42] Reed, "Southwest's Challenges Grow."
[43] David Koenig, "Southwest Flight Attendants OK Contract," Associated Press, 30 July 2004.
[44] Southwest Airlines, *Annual Report* (2003).
[45] Koenig, "Southwest Flight Attendants OK Contract."
[46] "SWA Takeoff," http://www.southwest.com/swatakeoff/labor_relations.html (accessed on June 9, 2004).
[47] Koenig, "Southwest Flight Attendants OK Contract."
[48] Ibid.
[49] Reed, "Southwest's Challenges Grow."
[50] Koenig, "Southwest Flight Attendants OK Contract."
[51] Southwest Airlines, "Southwest Airlines Announces Executive Changes," news release, July 15, 2004.
[52] Southwest Airlines, *Annual Report* (2003).
[53] Reuters, "Southwest Airlines CEO Resigns," *Airwise News,* July, 15, 2004.
[54] Southwest Airlines, "Southwest Airlines Announces Executive Changes."
[55] Ibid.

Case Study Pharmacy Service Improvement at CVS (A)

On a Thursday afternoon in July of 2002 Jon Roberts, Josh Flum, Tom Grossi, and Mitch Betses walked into a cluttered conference room at CVS headquarters in Woonsocket, Rhode Island. For several months, the room had served as the data repository, meeting space, and nerve center for the company's Pharmacy Service Initiative (PSI). Most horizontal surfaces were stacked high with folders, binders, and books, and most vertical ones were covered with whiteboards, sticky notes, sheets of paper, and hand-drawn flow charts. The four men cleared off enough space to sit down around a table.

Their eyes were drawn to two recently added pieces of paper on the nearest wall. One was a list of the problems the PSI team had uncovered during a recent series of observations at CVS pharmacies around the country (Exhibit 1); the other was a description of the problems encountered over the course of a single shift by the person staffing the prescription pickup counter in one pharmacy (Exhibit 2).

Flum looked at Betses. "You told us it was bad, but *this* bad?"

"I told you there were service issues in our pharmacies. But I have to admit, even I didn't know the whole story."

"So what do we do about it?"

"Well, we can't have 67 solutions for the 67 problems we identified," Roberts said.

"Definitely not," Grossi agreed. "But do you have an idea what we *should* do? If you erased that whiteboard and grabbed a pen, could you draw the 'right' flow chart for pharmacy operations?"

"Actually, I think I could come pretty close. And I think my flow chart would look a lot like both of yours. I'm just not sure which parts of it would be easy to implement and which would be tricky. Mitch, you know these places better than anyone—what kinds of changes would make them *really* unhappy?"

"Anything affecting safety. Everyone—not just the pharmacists—is a fanatic about making sure we fill prescriptions accurately and watch out for the health of our customers. So for example if we said, 'In the interests of efficiency we want to have the system spit out fewer alerts about drug-drug interactions,' we would get *killed.* The pharmacists would march us right out the front door of their stores and tell us never to come back. And I wouldn't blame them."

"Got it. What else?"

"Anything that increased customer waiting times. People in the pharmacy feel like customers already wait way too long when they come to pick up prescriptions, especially at peak times. They're not in a good mood when they get to the front of the line, and it can get *really* ugly if after they've waited all that time they're told their medicine isn't ready."

Roberts nodded. "OK. Hand me that whiteboard eraser and pen. Here's the new process. It doesn't degrade safety at all, it *decreases* waiting time, and it improves customer satisfaction. Of course, convincing the pharmacies that's true might not be easy."

PHARMACY OPERATIONS AT CVS

The first "Consumer Value Store" opened in Lowell, Massachusetts in 1963. The company grew quickly after that, both organically and by acquisition, and by 2002 CVS was one of America's largest retail drugstores, with over 4,000 stores and revenue of $24.2 billion, over two-thirds of which was generated by the pharmacies (see Exhibit 3 for selected corporate financial information).[1]

The Pharmacy Service Initiative

As the company grew, managers started to worry that pharmacy operations were not performing well. Anecdotes from both customers and employees indicated that many locations had serious problems with customer service. The company's pharmacy business, however, grew as quickly as the industry average. Some interpreted this to mean that CVS did *not* in fact have serious service problems.

To understand the true state of pharmacy customer service and to make any required fixes, CVS launched the PSI and staffed it with operations executives and managers, including Roberts, the senior vice president of store operations; Flum, the director of store technology; and Betses, the director of pharmacy operations. Also on the team were a top pharmacy supervisor, a top pharmacist, and consultants from the Boston Consulting Group, including Grossi.

[1] Pharmacies were responsible for a roughly equivalent share of CVS profits.

Professor Andrew F. McAfee prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

EXHIBIT 1 CVS pharmacy fulfillment problems noticed by PSI team.

Drop-Off → **Data Entry** → **Production** → **QA** → **Waiting Bins** → **Pickup**

Drop-Off

- Nobody watching in-store drop-off window
- Extended wait before initial greeting in store
- Nobody responds to drive-thru
- Tech must choose between serving customer in store or serving drive-thru
- Drive-thru closed
- Long wait behind someone at drive-thru
- Customer calling in refill left on hold
- Provider left on hold
- Provider voicemail not regularly checked
- Fax machine not regularly checked
- Customer cannot locate drop-off
- Initial interview fails to obtain critical data
- Failure to properly prioritize scripts
- Wait times made up/over-promised
- OOS not checked
- Customer cannot verify demographics
- Script misfiled in lime slot organizer
- Customer with no refills not informed process may take up to three days
- Incomplete information taken from provider
  –Customer later cannot be found in system
- Provider calls/faxes not prioritized as P2

Data Entry

- DURs arise frequently and RPh must intervene
- No clear protocol for resolving third-party problems
- Resolvable third-party issues filled for cash
- Steps taken to resolve third-party issues not recorded with script
- 90-minute lead time on IVR does not provide adequate time to resolve third-party issues
- Customer not notified of third-party issues
- In-store process for handling refill authorizations not optimized
- No standard form for faxing providers
- Faxes/calls to providers not done in timely manner
  –Left in doctor call box
- "MD will call back" box not reviewed regularly
- Patient not notified of need for refill authorization
- IVR holds scripts that need refill authorization in "D" queue
- IVR "D" queue not routinely checked
- IVR informs patient that script without refill authorization can be ready after five hours
- Person at DE cannot read provider handwriting
- Person at DE cannot read tech handwriting
- Prescribed medication no longer manufactured/incorrect dosage

Production

- Group of scripts arrives separately
- Tech cannot determine whether IVR scripts are part of group
- Failure to properly prioritize label print
- OOS issue first determined
- Customer not called about OOS/partial
- OOS not ordered from OV
- Baskets delivered to QA out of priority

QA

- Rx filled incorrectly
- Pill image not in system
- Hard copy image not in system/illegible
- RPh busy at other stations, falls behind at QA
- RPh fails to announce P4 and P3 scripts

Waiting Bins

- Completed order misfiled
- Script groups not maintained
- Green zones not cleaned regularly

Pickup

- Tech/PSA cannot find script
- Tech/PSA finds part of group of scripts
- Tech/PSA does not follow any process to find script
- Tech cannot adequately explain insurance issue
- Tech not sure if doctor called about refill
- Rude staff
- RPh makes no effort to help resolve problems
- Long lines at pickup
- No additional registers opened to ease traffic
- Nobody responds to drive-thru
- No cash register at drive-thru
- Tech/PSA forced to choose between line at pickup and drive-thru
- Drive-thru closed
- Long wait behind someone at drive-thru

OOS:	Out of stock
DUR:	Drug utilization review
RPh:	Pharmacist
IVR:	Integrated voice response (automated system allowing customers to phone in refills)
MD:	Physician
DE:	Data entry
Rx:	Prescription
PSA:	Pharmacy service associate

Source: CVS.

EXHIBIT 2 Issues faced by technician staffing CVS prescription pickup window, as noticed by PSI team members.

Some things techs hear in a typical day

"Why the hell is this four hundred dollars? I always pay fifteen for any drugs!"

"I'm not moving from this spot until we get this cleared up. I am NOT paying that much! This must be a joke!"

"You lost my prescription! I'm tired of this all the time! Why can't you ever do anything right?"

"Where are my other scripts?"

"I'm not sure how many scripts I have."

"What do you mean you can't find my order, I called it in yesterday."

"I talked to someone four days ago to make sure my order would be ready, and you're telling me it's not done?!"

In one eight-hour shift at the register

80—Total number of customers dealt with

32—Total customers with problems

- 21—Customers who waited longer than they thought they should have
- 16—Customers with orders not ready/complete[a]
- 9—Customers paying more than expected[b]
- 4—Customers complaining about front store-related issues (i.e., coupons, sales, stock)

10—Number of times tech was asked a question they were not qualified to answer

4—Number of times tech was verbally abused by the customer

0—Number of problems tech feels they were responsible for

Source: CVS.

[a]Included out-of-stock, partial fills where customer is not previously contacted, refill authorization required, third party.
[b]Includes third-party rejects filled for cash and customer misunderstandings over policy coverage.

EXHIBIT 3 CVS historical financials (millions of dollars).

Year	2002	2001	2000	1999	1998
Net operating revenues	24181.5	22241.4	20087.5	18098.3	15273.6
Cost of goods sold	18112.7	16544.7	14725.8	13236.9	11134.4
Gross margin	6068.8	5696.7	5361.7	4861.4	4139.2
Operating expenses & D. D. & A	4862.6	4577.1	4058.2	3725.9	3198.7
Operating profits	1206.2	1119.6	1303.5	1135.5	940.5
Non-operating expenses	50.4	−288.0	98.5	59.1	−127.7
Pre-tax income	1155.8	1407.6	1205.0	1076.4	1068.2
Income tax	439.2	296.4	497.4	441.3	306.5
Minority interest	0.0	0.0	0.0	0.0	0.0
Net income	716.6	413.2	746.0	635.1	384.5
Net margin	**2.96%**	**1.86%**	**3.71%**	**3.51%**	**2.52%**
Inventories	4013.9	3918.6	3557.6	3445.5	3190.2
Accounts receivable	1019.3	966.2	824.5	699.3	650.3
Cash and cash equivalents	700.4	236.3	337.3	230	180.8
Other current assets	248.5	333	217.2	233.2	327.9
Total current assets	5982.1	5454.1	4936.6	4608.0	4349.2
Property, plan and equipment	2215.8	1847.3	1742.1	1601	1351.2
Other non-current assets	1447.4	1326.8	1270.8	1066.4	985.8
Total assets	9645.3	8628.2	7949.5	7275.4	6686.2
Asset turnover	**2.51**	**2.58**	**2.53**	**2.49**	**2.28**
ROA	**7.43%**	**4.79%**	**9.38%**	**8.73%**	**5.75%**
Accounts payable	1707.9	1535.8	1351.5	1454.2	1286.3
Other current liabilities	1398.0	1530.1	1612.6	1435.7	1847.0
Total current liabilities	3105.9	3065.9	2964.1	2889.9	3133.3
Non-current liabilities	1342.4	995.4	680.8	705.8	442.3
Total liabilities	4448.3	4061.3	3644.9	3595.7	3575.6
Equity	5197.0	4566.9	4304.6	3679.7	3110.6
Total liabilities & equities	9645.3	8628.2	7949.5	7275.4	6686.2
Levarage (Equity/Total assets)	**0.54**	**0.53**	**0.54**	**0.51**	**0.47**
ROE	**13.79%**	**9.05%**	**17.33%**	**17.26%**	**12.36%**

Source: Standard & Poor's Research Insight.

Note: Fiscal Year ends December 31.

Interviews and Analysis
The PSI team began gathering information by analyzing historical data and interviewing current and former customers, as well as customers of other pharmacies. This work quickly confirmed that problems existed at CVS. As Flum explained:

> It was true that we were growing at market rates, but that was only because customers believed that no one provided great service. If they came to us or stuck with us, it was because they didn't think anyone else would take better care of them, not because we were so fantastic. One of our interviewees said, "I've had problems at CVS, but why would I leave? All pharmacies probably have some problems."
>
> Luckily for us, they also thought that it was really difficult to switch from one pharmacy to another. Another interviewee said, "I don't even know what's involved in transferring a prescription. Do I have to call my doctor to get a new prescription? It just seems like it would be such a hassle."
>
> Actually, it's not a hassle for the customer at all. We're required by law to immediately transfer customer records to another pharmacy whenever asked. It's a good thing for us that we weren't asked more often.

Even though customers believed that switching was difficult, deeper analyses showed that many of them took their business elsewhere each year. CVS had 29.5 million pharmacy members at the start of 2000, a year in which total revenue for the corporation year was $20 billion. PSI team analyses indicated that approximately 7.2 million regular pharmacy customers left CVS during the year.[2] The total volume of filled prescriptions *grew* during 2000 because the company also attracted 8.5 million new regular members over the course of the year, but the PSI team's work clearly highlighted that customer defections were hampering growth. The regular customers who left in 2000 took with them an estimated 55 million annual prescriptions that, had they been filled by CVS, would have contributed $2.5 billion to revenue.

Early interviews and analysis also revealed that different kinds of customers left for different reasons. The PSI team divided regular CVS pharmacy members into two categories. Light users, who filled an average of five scripts per year, were most likely to defect because of the pharmacy's location (see Figure A). Heavy users filled an average of 40 scripts a year and were most likely to leave because of poor service. According to Grossi, "We thought that a better fulfillment process in the pharmacies could prevent 60%–90% of the customer defections that were due to service. The PSI team had a pretty big opportunity."

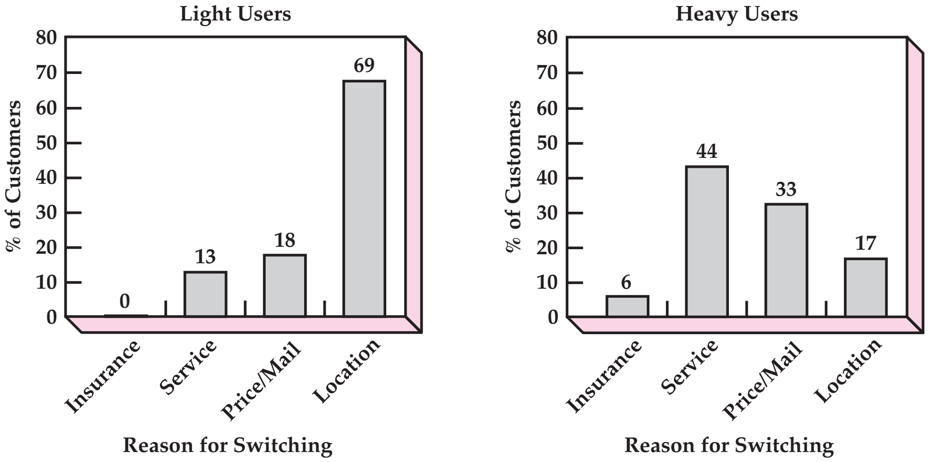
[2] In addition to these regular customers, an estimated 10.9 million infrequent customers left in 2000. Because infrequent customers contributed so little to total volume of prescriptions filled by CVS, the PSI team did not focus on them or include them in analyses.

Field Work
PSI team members spent time in many CVS pharmacies, systematically observing how prescriptions were filled or not filled. In addition to the comprehensive list of problems (Exhibit 1), they gathered other evidence that things were not working well. Approximately one in four scripts experienced a problem at some point in the fulfillment process, and 16% of all scripts had problems that were still unresolved at customer pickup. This not only slowed down pickup for other customers but also made working at the pickup station a stressful and unpleasant job. During a single eight-hour shift observed by a PSI team member, 40% of customers voiced a complaint. The tech was asked 10 questions that he was not qualified to answer and was verbally abused four times. When asked, he said that he felt he was responsible for none of the problems encountered by customers and could have done nothing to prevent them (Exhibit 2). As Betses explained:

> The people working at pickup are our lowest paid, least trained people, but we were asking them to do something that's both no fun and super difficult—dealing with angry customers all day. No wonder lots of them left after less than a year on the job! All of us on the PSI gained a real appreciation for how hard it was to work effectively in our pharmacies. We saw that in the few that *were* working well, people had either developed elaborate workarounds or were making heroic efforts or both.

THE PHARMACY FULFILLMENT PROCESS
The PSI team found that virtually all CVS pharmacies followed the same multistep process to fill prescriptions and experienced the same exceptions to it. The process consisted of five basic steps, diagrammed below in Figure B.

FIGURE A Reasons given by former CVS pharmacy customers for switching to another pharmacy.



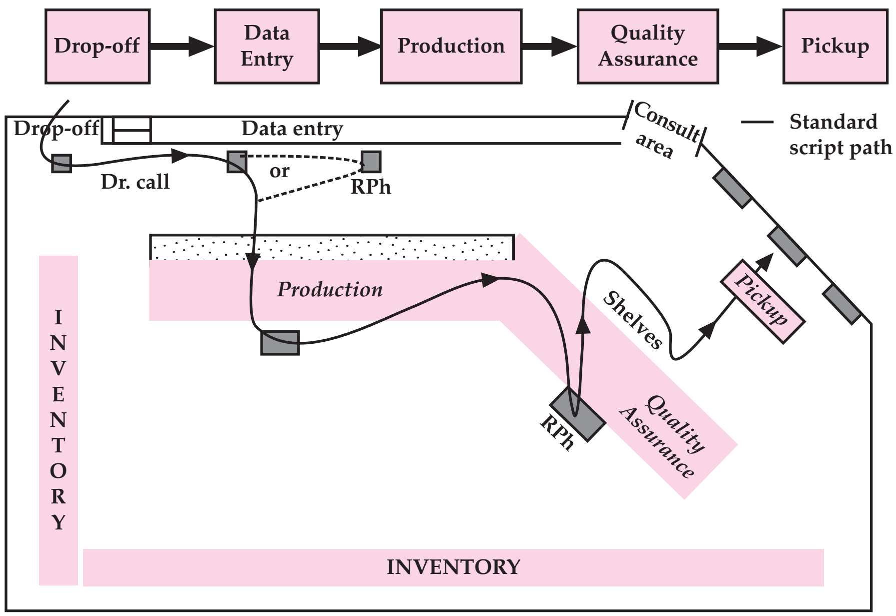
Source: CVS.

Drop-off

When a customer dropped off a script, a tech asked when they would return to pick it up. The tech wrote the requested pickup time on the script itself, then put it in a box that was divided into a number of slots. Each slot was assigned to a specific time period—2 p.m., 3 p.m., 4 p.m., and so on. The tech put the script into the slot corresponding to the hour *before* the desired pickup time. If the customer wanted the prescription filled immediately, the tech put the script in the slot corresponding to the current time.

Although customers dropped off their prescriptions throughout the day, the busiest times at the

FIGURE B Basic flow for CVS prescription fulfillment process.



Source: CVS.

drop-off window were before work, lunchtime, and after work. Regardless of when they dropped them off, more customers wanted to pick up their filled prescriptions after work than at any other time.

Data Entry

Each hour, a tech took that hour's scripts from the box and entered all required data about them into the pharmacy information system, an application used by all locations and connected to CVS's central databases of drug, prescription, customer, payment, and insurance information. Required for each prescription were patient and doctor contact information, data about any third-party payors such as insurance companies or employers, and the specifics of the prescription itself: medication, dosage, number of doses, and so on.

Drug Utilization Review As soon as data entry was complete, the system performed an automated "drug utilization review" (DUR). The DUR checked the script against all other prescriptions in the database for that patient (in other words, all prescription drugs that had ever been dispensed by CVS to the patient) to see if there existed any possibility for harmful drug-drug interactions. The DUR also checked to make sure the drug was appropriate for the patient, given the patient's age, gender, and other demographic data stored in the system.[3]

If the DUR revealed any potential problems, the systems came to a "hard stop" and fulfillment could not proceed until the DUR was reviewed by a pharmacist. In the great majority of cases the pharmacist did not need to involve the customer when reviewing the DUR. In fact, many within the industry considered it better for the customer *not* to be involved, reasoning that if the DUR gave the impression that a prescribed drug could be harmful, the customer might be less likely to take it.

Everyone at CVS felt that the DUR was an essential part of good pharmacy operations and customer service and that the automated review should be a very careful and conservative one.

Insurance Check After the DUR was complete and any hard stops were reviewed, the system performed an insurance check. Most CVS pharmacy customers had their prescriptions paid for by a third party such as an employer, an insurance company, or a government agency. These customers paid only a small amount of their own money, called a "copayment," when they picked up their medicine.[4] Payors had complicated rules about the drugs they would cover and the conditions under which they would pay for them. The insurance check verified that a script followed all of these rules. As Flum explained:

> One of the biggest changes in our industry is the fact that in recent years more and more pharmacy customers have third parties that help pay for prescriptions—over 90% of our customers now. Payors have been putting in place more and more complicated formularies[5] to try to control their costs. This complicates our work a lot.
>
> Say a doctor prescribes a drug that's not on a patient's formulary, which happens all the time because doctors and patients don't usually have formularies at their fingertips. Our insurance check is the first time anyone learns that there's a problem. We would then need to work with the doctor, the patient, and the payor to switch the prescription. Payors have also tightened rules about when they'll allow a prescription to be refilled, so patients basically have to wait longer before coming in for a refill. If they don't wait long enough the payor will refuse to cover the fill. This type of insurance rejection is called "refill too soon," and we've been seeing more and more of them.

In most cases the fulfillment process would continue even if one of these rules was violated; CVS pharmacy employees would attempt to identify and correct the problem while the process continued or when the customer came to pick up their prescription.

Production

The drugs to fill the script were counted and verified by certified pharmacy technicians in the production area, which was near the shelves where medicine was stored.

Quality Assurance

After production, a pharmacist reviewed each script to make sure that it contained exactly the right drugs in the right quantities and that all other details

[3] CVS maintained a separate application that allowed customers to request refills via telephone. This system stored refill requests until 1.5 hours before the requested pickup time, then transferred them to the pharmacy system for fulfillment, beginning with the DUR.

[4] Copayments were typically between $5 and $20, which was a small fraction of the cost of most nongeneric pharmaceuticals.

[5] A formulary is a set of rules governing the medicines a third party will pay for and the circumstances under which they will pay. A formulary might state, for example, that a third party will only pay for a generic version of a certain antibiotic and will only pay for 30 doses a month. Formularies were so complicated that many payors worked with separate companies called pharmacy benefit managers (PBMs) to define, update, and enforce them.

were correct. Quality assurance (QA) was one of a pharmacist's most important tasks and was never delegated to a technician or other employee in the pharmacy.

The steps from data entry to QA could be completed in approximately five minutes if there were no problems.

Pickup

After QA, each completed script was sealed in a bag. Bags were stored in the pickup area in alphabetical order. When customers arrived to pick up their prescriptions, the technician staffing the pickup window searched for the right prescription among the bags, verified customers' identities, and took any required payments from them.

PROBLEMS DURING THE PROCESS

Pickup window technicians also dealt with customers who did not get what they were expecting. Based on their analyses and observations, the PSI team estimated that 16% of customers fell into this category. The team was even more disturbed to find that 27% of scripts encountered a substantial problem at some point in the fulfillment process.

Drop-Off

The only substantial problem that arose at this step, the PSI team found, was an unmanned drop-off window. As Grossi explained, issues were not common at this stage because "nothing happened at drop-off. The customer just handed over a script and walked away while the tech filed it in the box according to pickup time."

Data Entry

When the tech took scripts from the box and entered their details into the system, a number of problems could occur.

No Refill Allowed Many scripts allowed the customer to refill the prescription at least once. Customers could lose track of how many refills were allowed, however, and drop off an ineligible script. When this occurred the system printed a label for the ineligible script, which was put in a "Dr. call bin." A tech would periodically take the contents of this bin and make phone calls or send faxes to doctors' offices asking for their approval to refill the prescription. If the tech reached the doctor immediately and the doctor approved the refill, the script proceeded to the next step in the process. If the doctor rejected the refill, the label was put in a "Dr. denied" box near the pickup area; customers learned about refill denials when they returned to pick up their prescriptions.

If the tech could *not* reach the doctor immediately, the label was put in a "Dr. call-back box." Problems stemming from "no refill allowed" scripts required from 20 minutes to three days to resolve, with an average resolution time of one day. "No refill allowed" scripts were 6% of total scripts.

DUR Hard Stop The DUR generated a hard stop for 20% of all scripts. Over 90% of hard stops were resolved by pharmacists without involving the prescribing doctor. As Betses explained:

> The system checks each script against all others for that patient dispensed over the last 12 months. So the DUR for script A could generate a hard stop because of the possibility of a drug-drug interaction with script B, which was a 10-day course of antibiotics prescribed eight months ago. Pharmacists would clear that kind of hard stop after a careful review. They would clear others after calling up the patient to determine, say, that their weight was appropriate for the dosage prescribed. In both of these cases the system is working as planned; we want hard stops every time there's even a small chance of harm, and we want the pharmacist to take action on them quickly. In a few cases, though, there is a serious potential problem with the script as written. The DUR generates a hard stop, and the pharmacist needs to call the doctor to resolve the potential problem.

Insurance Check Seventeen percent of all scripts encountered a problem during the automated insurance check. The majority of these problems were easy to resolve; they were due to date-of-birth errors on the script or to a customer's having changed jobs or insurers. Some errors of this type could be resolved by the data-entry technician alone; others required a phone call to the customer. Other insurance problems were harder to resolve and required a phone call to the insurer and /or the prescribing doctor. Scripts were filled even if insurance problems were not resolved. When this was the case, the customer was asked to pay the full amount of the prescription at pickup.

Production and Quality Assurance

The only problem identified at the production step was insufficient inventory to completely fill the script. Seven percent of scripts encountered partial or complete stock shortages of the required medicine.

The PSI team did not find any issues with quality assurance as practiced at CVS. Pharmacists diligently and completely reviewed each filled script and made sure that the drugs dispensed were actually the ones prescribed.

Pickup

Team members documented a variety of issues at the pickup window. The most common were unpleasant customer surprises: unauthorized refills, scripts that had not been paid for by insurance, or scripts that were simply not ready yet. Some of these issues prevented fulfillment, causing customers to walk away from the pickup window without medicine and with a bad impression of CVS customer service. Even when problems could be fixed, the resolution process took a long time and increased wait time for other customers in line. The situation at the pickup window was worst between 5 p.m. and 7 p.m., when customers came after work to pick up the prescriptions they had dropped off or called in earlier. Most CVS locations found it difficult to staff this time period simply because pharmacy employees did not want to work then. As one tech said to the PSI team, "I hate the late afternoon shift. You spend all your time dealing with angry people, and you can't do anything to make things better for them."

Flum commented: "Pickup is where customers wait in line, get bad news, get mad, and yell at the poor tech, but that doesn't mean that we need to fix pickup. It means that we need to fix whatever's causing pickup *not* to have the completed script with the right copayment amount ready when the customer walks up to the counter."

CONCLUSION

The PSI team felt that they had a great deal of freedom to change pharmacy fulfillment operations. 'Their work was sponsored and supported by senior management, and CEO Tom Ryan had stated that pharmacy service improvement was the most important corporate initiative for the coming year. Team members therefore knew that their recommended changes to tasks, responsibilities, and processes would carry much weight. They also knew that they could get information systems changed, if necessary; pharmacy IT at CVS was part of the operations function, which had sponsored the PSI.

Team members also realized, however, that any changes they made could not compromise customer safety. Even changes that *appeared* to do so would be difficult to sell to the organization.

As Roberts started to sketch a new fulfillment process on the whiteboad, Flum, Betses, and Grossi wondered exactly what it would look like and how it would be accepted by CVS and its pharmacies.

Discussion Questions

1. What changes do you recommend to CVS's existing pharmacy fulfillment process? What IT changes, if any, are required to implement those changes?
2. How can you be sure that the new process you propose will be an improvement over the existing one? How can you be sure that it won't make things *worse?*
3. What groups, if any, are likely to have problems with your proposed solution? How will you deal with their objections?
4. How will you ensure that there's no backsliding—that there won't still be wooden boxes in use six months from now? How can technology be used to prevent or inhibit backsliding?
5. Does Pharmacy Service Iniative represent a significant opportunity for CVS? Would improving customer service be of significant financial benefit to the company?

Case Study Customer-Driven Learning at Radisson Hotels Worldwide

Under the leadership of its former president, Radisson Hotels Worldwide had added hotels at the rate of about one hotel every seven days. Radisson growth strategy had focused on the hotel owners and on information technology to bring guests to the hotels.

By 1997, Radisson's "growth at any cost" strategy had left Radisson with a tremendous diversity of hotel quality and an "unfocused" brand image. Alignment with hotel owners (more than hotel guests) also seemed to cause Radisson's customer service and hotel management expertise to atrophy.

In 1997 and 1998, Brian Stage, Radisson's president, and Maureen O'Hanlon, Radisson's executive vice president, took several initiatives to drive the organization towards becoming a more customer-focused brand. In their words, they "re-discovered that their primary customers should be the guests—not the owners."

Some of these initiatives included a service guarantee, a guest satisfaction measurement program, an employee satisfaction measurement program, and an information technology initiative. Stage and O'Hanlon were committed to creating the systems and programs that would bring Radisson into the 21st century as a truly "customer-driven learning organization." Their goal was to make Radisson the "most trusted and respected brand worldwide." They were hopeful that these initiatives would make a significant contribution to helping Radisson achieve these goals.

COMPANY BACKGROUND

Corporate Background

Founded in 1938 by Curtis L. Carlson, Carlson Companies, Inc., was one of America's largest privately owned corporations with total system sales of $13.4 billion in 1996 and $20 billion in 1997. Carlson Companies employed about 130,000 people world wide, including those who worked in franchised and managed operations. Headquartered in a suburb of Minneapolis, Minnesota (USA), the company was organized into four operating groups—Carlson Hospitality Worldwide, Carlson Wagonlit Travel, Carlson Marketing Group, and Carlson Leisure Group.

In 1998, Carlson Hospitality Worldwide included Radisson Hotels Worldwide, Country Inns & Suites by Carlson, TGI Friday's, Regent Hotels, Italianni's, Friday's Front Row Sports Grill, Friday's American Bar, and Radisson Seven Seas Cruises. Radisson Hotels Worldwide operated, managed, and franchised deluxe plaza hotels, all-suite hotels, inns and resorts around the world.

Radisson Hotels Worldwide

In 1962, Curt Carlson purchased the nationally known Radisson Hotel in downtown Minneapolis. The hotel was named after the French explorer, Pierre Esprit Radisson, who explored Midwestern North America in the 17th century.

By 1975, Radisson had only 10 hotels, mostly in the midwestern part of the United States. With a commitment to growth, Radisson had grown to 360 locations with over 100,000 rooms in 47 countries by 1998. As Radisson grew to become a global leader in the hospitality industry, it embraced the concept of partnering with existing hotel companies in specific geographic regions. One example of this partnership strategy was the creation of Radisson SAS Worldwide, which resulted from the partnership of Radisson with the SAS Hotel group in Europe and Radisson Moriah Hotel Group in Israel. In 1997, Radisson was pursuing similar expansion/partnership arrangements in Latin America and the Asia/pacific region. In 1997, Carlson Hospitality Worldwide announced plans to grow the number of locations from 1,100 in 1997 to over 2,000 by the year 2000.[1]

In 1997, Curt Carlson continued to retain the titles of chairman of the board and CEO, while his daughter, Marilyn Carlson Nelson, was the chief operating officer and vice chair of the Carlson Companies. Carlson's grandson, Curtis Nelson, was president/CEO of Carlson

[1] Source: *Carlsonian* 8, no. 2, March/April 1997, page 4.

This case was prepared by Professor Arthur V. Hill (Curtis L. Carlson School of Management, University of Minnesota) as the basis for class discussion rather than to illustrate either effective or ineffective handling of a business situation.

The author wishes to thank Brian Stage, President, Maureen O'Hanlon, Executive VP of Marketing and Sales, Sue Geurs, Director, 100% Guest Satisfaction Program, and Scott Heintzeman, VP of Knowledge Technologies, for their invaluable assistance in writing this case.

Further information can be found at the website http://www.Radisson.com.

This case was supported by the Customer-Driven Learning Organization research project sponsored by the Quality Leadership Center at the University of Minnesota.

Hospitality Worldwide. In 1998 Marilyn Carlson Nelson took over as CEO of the Carlson Companies. She is highly regarded as one of the most capable and powerful women executives in the world.

THE SERVICE CHALLENGE

Stage and O'Hanlon were very candid about the challenges facing Radisson. They felt a strong need to change from the owner-centered "growth at any cost" model, to a "champion of the guest" model. As one senior Radisson manager stated, "a brand is a promise and we broke our promise . . . the promise of delivering consistency and uniformity and quality." They felt that there was ". . . no clear-cut definition of the brand . . . no clear definition of what the Radisson brand meant." Another Radisson manager stated that:

> It was very easy to be deluded into serving the franchisee. They are the ones (customers) that we see . . . but at the end of the day only one customer is the source of cash and revenue and that is the person who stays in the room.

By early 1998, they had already "invited" 35–40 hotels to leave. However, they still needed to grow, particularly in some areas where Radisson was underrepresented, but now they wanted to grow in quality as well as in number of locations.

A brochure given at the national meeting in March 1998 stated the following five strategies. (Appendix 1 is a press release that gives more details on some of these strategies.)

> ***Strategy l. Focus on the customer***—The concept was summarized by the quote, "Quality and consistency promise guests an exceptional Radisson experience every time. Delivering at our higher service standard builds long-term guest loyalty and greater brand equity."
>
> ***Strategy 2. Provide individualized marketing and services***—The key idea here was that Radisson needed to use its advanced information technologies to anticipate guests' needs, recognize their preferences, and treat them individually.
>
> ***Strategy 3. Develop hotels in key locations***—This was a plan to establish the Radisson brand in several more key markets so that loyal Radisson guests would be able to find Radisson hotels where they needed them. The plan here was not to grow at any cost, but to find hotels and develop partnerships that met the higher Radisson standards for quality.
>
> ***Strategy 4. Leverage the Carlson Companies Advantage***—The idea here was to pursue synergies with the other three operating groups.
>
> ***Strategy 5. Strengthen global brand presence***—Stage wanted to create a cohesive message for all Radisson properties over the entire world.

Stage and O'Hanlon had initiated many programs during 1997 and 1998 to support these grand strategies. Some of the programs included:

- 100% guest satisfaction program.
- Fully integrated guest information system.
- Guest satisfaction measurement program and employee satisfaction measurement program.
- Guest recognition and rewards program.
- Genuine hospitality program.

The remainder of the case will briefly discuss some of these programs.

THE 100% GUEST SATISFACTION GUARANTEE PROGRAM

Background

Sue Geurs was appointed Director of the 100% Guest Satisfaction Guarantee Program in 1997. Geurs had been the hotel general manager in Indianapolis and knew from experience that Radisson already had an outstanding "Yes, I Can" training program that focused on service quality and service recovery. The company also had a "Second Effort Program," which attempted to recover customers who called a local number and/or an 800 number to register complaints.

Geurs began her efforts by reading everything that she could find on the subject. She conducted extensive research on other hotels including Hampton Inns and Embassy Suites. She was particularly impressed early on by a report from Hampton Inn that showed that the guests with the highest incidence of "invocations"[2] of their service guarantee also were the most loyal customers.

Financial Justification

A financial analysis of the advantages and disadvantages of the guarantee was quite a challenge. The industry-standard "allowances" (adjustments) for customer complaints was about 1 percent of sales. It was not clear if allowances would increase or decrease with the service guarantee. Professor Hill from the University of Minnesota developed a "customer defection" spreadsheet model that suggested that the cost of customer defections was quite high and that a service guarantee could be quite advantageous under a wide variety of reasonable assumptions. Exhibit 1 shows this spreadsheet analysis with

[2] An "invocation" was when a guest complained, "invoked" the guarantee, and received a free room night, or whatever payout the guarantee offered.

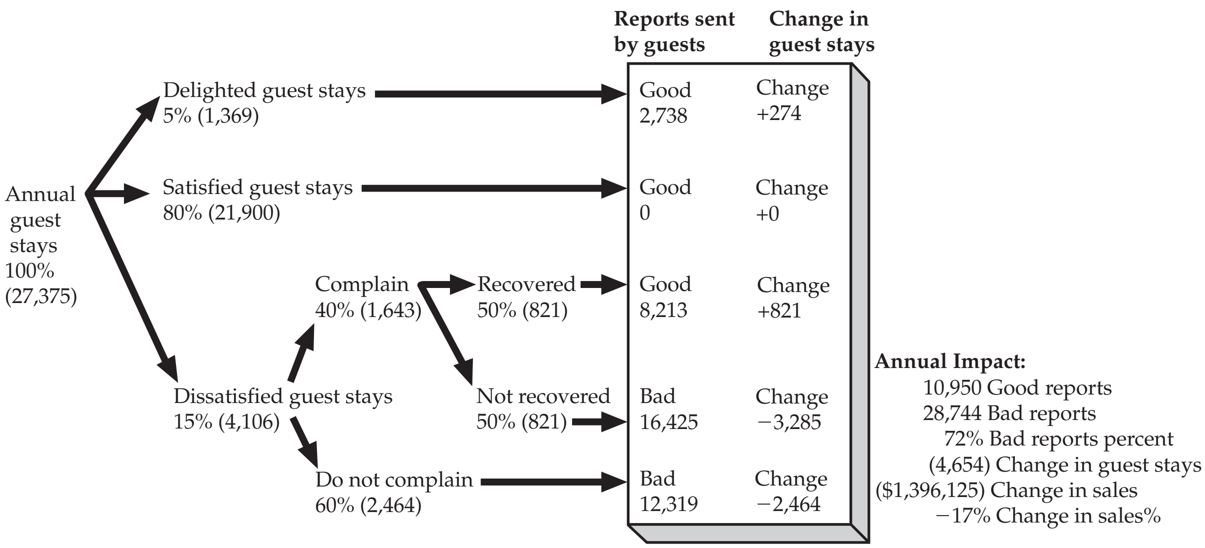
EXHIBIT 1 Hotel guest loyalty economics (with hypothetical data).

Hotel Parameters:

300	Rooms per hotel
$100	Average daily rate
75%	Occupancy rate this year
3.0	Average nights/guest stay
82,125	Room nights this year
27,375	Guest stays this year
$8,212,500	Total room sales this year

Guest Loyalty Parameters:

2	Good reports per delighted guest stay.
0	Good reports per satisfied guest stay.
10	Good reports per recovered guest stay.
10	Good reports this year needed to gain one guest stay next year.
20	Bad reports per non-recovered guest stay.
5	Bad reports per non-complaining dissatisfied guest stay.
5	Bad reports this year needed to lose one guest stay next year.



values for a hypothetical hotel. The numbers in parentheses are the numbers of customers in each category.

The Design

One tough issue was the wording of the guarantee. The books and consultants often spoke highly of the "unconditional satisfaction guarantee." However, Geurs was considering an unconditional "two-step" service guarantee that would give Radisson a chance to fix the problem before they paid for the guest's room. One proposed guarantee was written as follows:

> If you have a problem, please let us know and we'll make it right or you won't pay.

Pilot Hotel Plan

Under Geurs' leadership, Radisson's management decided to launch a pilot study to evaluate service guarantees in about 30 different pilot Radisson hotels in different market segments and locations. The plan was to evaluate the pilot by comparing the "before" and "after" measurements from Radisson's standard customer satisfaction/loyalty complaint data (from comment cards). This data measured:

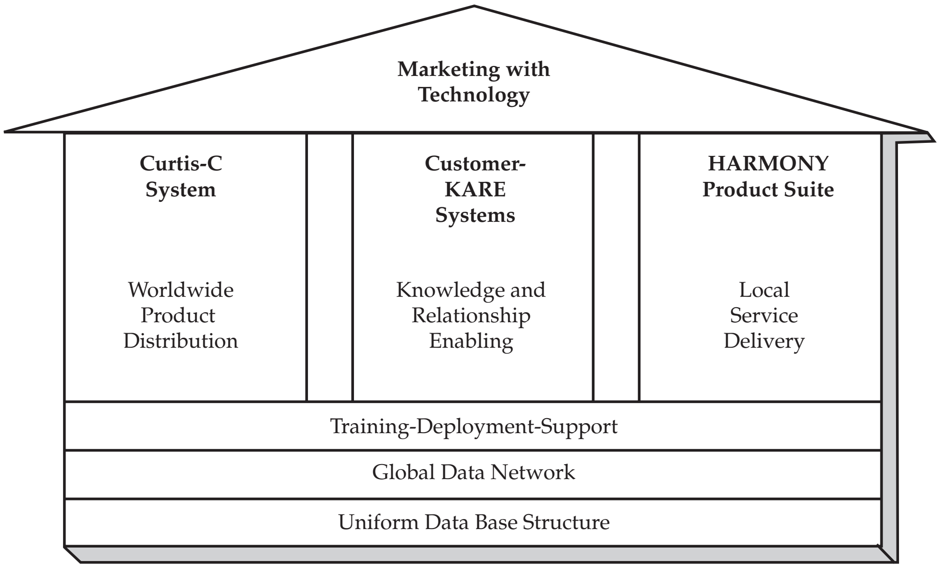
- Willingness to return
- Percent advocates
- Percent defectors
- Percent complaints

Radisson's management also planned to measure the number of times that the guarantee was invoked and how much money was spent on these "invocations." A University of Minnesota research team planned to conduct a "before" and "after" survey on "employee motivation and vision" and "organizational service learning" to discern how the service guarantee affected culture in the pilot hotels.

The service guarantee pilot test program clearly needed a strong training program to support it. The planned training program included the following initiatives:

- Enhance the "Yes, I Can" program in the general orientation to help all new employees understand the importance of the service guarantee.

EXHIBIT 2 Marketing with technology.



- Provide information on the service guarantee for general managers and owners in a one-day format.
- Provide training to the hotel management teams on the philosophy and payback of the service guarantee.
- Teach district directors about service guarantees so that they could provide the necessary leadership to their hotels.

Geurs knew that the pilot could not test the marketing impact of the service guarantee. She also knew that it could become a "hard sell" to the hotel owners if the number of "invocations" was high and if they found that the allowances (payouts) outweighed the benefits.

As Geurs began her job as the director of this exciting (but potentially dangerous) new program, she had many challenges ahead of her. Some of these included:

1. How should Radisson word the guarantee? Should it be a "two-step" process?
2. How should hotel managers and employees be trained for the program?
3. Should the training be conducted by Radisson employees using a "train the trainer" approach or should Radisson employ a professional training firm to do the training?
4. How should they handle hotels that did not readily buy into the program?
5. Should Radisson's corporate office pay for the invocations for the test hotels?
6. What role should the guarantee play in Radisson's marketing communications?

FULLY INTEGRATED GUEST INFORMATION SYSTEM

Scott Heintzeman, VP of Knowledge Technologies for Radisson, took a number of initiatives to enhance Radisson's information technology approach to support Radisson's strategy. As suggested in Exhibit 2, the information technology approach included three "pillars"—the Curtis-C System worldwide distribution (reservation) system, the customer database (Customer-KARE Systems), and the HARMONY property management system.

Product Distribution System

This sophisticated system was the world's leading global reservations system. It helped Radisson capture business from electronic commerce and toll-free telephone services reaching into 125 countries. The worldwide computer reservations system provided instantaneous, convenient service for customers, travel agents and hotel staff. The "Curtis-C" reservation system was also accessible through airline reservations systems worldwide. Radisson's toll-free U.S. number 1-800-333-3333 was the most memorable in the hotel industry.

The CustomerKARE System

The "Customer Knowledge and Relationship Enabling" system that is on top of Radisson's information data warehouse "enables us to know and build relationships with our guests." This database had at least three uses:

- The marketing department could use this database to observe trends and manage direct marketing campaigns.

- Hotels could access customer service profiles so that they could personalize local service delivery programs (with sensitivity to guest privacy).
- Radisson Reservation Services could expedite the booking process and customize the sale to the needs and preferences of the customer.

One of the newer features of this system was the complaint management system, which could provide rich detail on (1) problem hotels, (2) problem customers, and (3) repeat common-cause problems across the organization or regions. The technology allowed the data to be "sliced and diced" any way that users wanted it.

HARMONY Property Management System
HARMONY provided "rich statistical/analytical business information" for the hotel management. This was an "executive information system" to support the general manager in evaluating staff productivity, sales patterns, employee turnover rate, etc. It also supported corporate office and hotel owners and hotel management companies. According to Heintzeman, "our next project is to create an online Information Management System for our managers that will include the very most important key performance indicators (a balanced scorecard) so that managers can look at a number of key performance indicators from their desktops." It will include an online/interactive version of their current "triage report" which provides a key set of statistics, which allow managers to assess the health of a hotel very quickly. According to Radisson's Web page,

> [HARMONY was] also a technology link between Radisson Hotels and Curtis-C, providing instantaneous guest profile information, which could be used to deliver faster, and more customized service to each guest.

The plan was to have the HARMONY property management system in place in all Radisson hotels by the end of 1998. Radisson planned on using this technology to further personalize services for guests. (See Appendix 2 press release for more details.)

PROGRAMS FOR MEASURING GUEST AND EMPLOYEE SATISFACTION

Customer Satisfaction
As mentioned above, Radisson measured customer satisfaction and loyalty primarily through hotel guest complaint cards, which measured four variables over time:

- Willingness to return
- Percent advocates
- Percent defectors
- Percent complaints

Radisson management was concerned that the number of respondents was very small and considered other means of collecting this information. In one extreme example, the Radisson Slavjanskaya hotel in Moscow received only 100 comment cards per month for 9,000 room nights. One alternative was to hire a data collection firm (such as Gallup) to randomly sample guests to collect more "transaction" detail information.

The goal of the measurement program, of course, was to measure and increase loyalty. Loyalty had several different aspects—loyalty to a particular Radisson hotel and loyalty to the brand. Radisson management was considering a program for increasing loyalty, particularly to the brand.

One of the Carlson Companies' strengths since its inception was developing "recognition" programs, such as Gold Bond Stamps that had been given away in grocery stores to promote customer loyalty, and, more recently, frequent flyer programs for many airlines. However, as of 1997, Radisson did not have its own frequent guest program. Its only guest recognition program was tied to airline frequent flyer programs.

Employee Satisfaction
Several research studies have found a strong link between employee satisfaction and customer satisfaction. Radisson management considered how they might measure and improve employee satisfaction as a part of the overall program. Some thought had been given to developing new loyalty programs for Radisson employees.

2007 Update
In 2007 Carlson Hotels Worldwide is one of the world's leading hotel companies with five brands spanning luxury to economy, including Regent International Hotels, Park Plaza Hotels & Resorts, Country Inns & Suites, Park Inn, and Radisson Hotels and Resorts. Carlson Hotels is focused on delivering high value and quality for business and leisure travelers.

In 2007 Radisson has 400 hotel locations in 63 countries. They have implemented several initiatives aimed at acquiring and satisfying customers. These include the following

- Express Yourself℠ pre-arrival online check-in.
- Custom-designed Sleep Number bed by Select Comfort℠, available exclusively at Radisson Hotels.
- The "Curtis-C" reservation system, also accessible through airline reservation systems.

- "Yes I can!" training program, focusing on total guest satisfaction. The program translates the company's service philosophy for hospitality excellence to the frontline service employees worldwide.
- Rewarding guests and travel agents with gold-points plus^{SM}. This program offers members the opportunity to earn reward points more quickly than any other hotel program.
- Providing a service guarantee for 100% guest satisfaction.

Radisson Hotels and Resorts plan to continue to improve their hotel service operations and guest satisfaction well into the future.

CONCLUSIONS

Radisson had initiated a program that required Radisson corporate management to call customers every Monday morning in response to complaint letters. This policy helped Radisson "make it right" for its customers and also helped Radisson management take on more of a "guest champion" role and mentality. However, O'Hanlon wondered what more Radisson could do to change the corporate structure and culture to keep close to the "guests"—and to become more of a "champion of the guests." As Radisson developed the different initiatives, Brian Stage and Maureen O'Hanlon wondered what they could do to improve their strategies and their recent quality initiatives. They also wondered if there might be other projects that they should be pursuing to accelerate their "customer-driven learning" efforts.

Discussion Questions

1. How should Radisson define and implement their service guarantee?
2. What role should information technology play in accelerating the drive to improve service quality?
3. How should Radisson measure and improve customer satisfaction and employee satisfaction?
4. How should Radisson drive commitment to service quality through their franchise organization?
5. How should Radisson align the goals of the hotel management team, hotel workers, owners, corporate management, and corporate staff with their new brand strategy?

APPENDIX 1 Radisson press release, March 23, 1998.

Radisson Hotels Worldwide Advances New Strategic Direction, Guests Are Center Stage

LAS VEGAS, Nev. (Mar. 23, 1998)—Radisson Hotels Worldwide today announced the global hotel company is on track six months after introducing the key initiatives of its new customer-focused strategic vision. This latest progress in its strategic plan aligns the global hotel company's development, marketing, technology and service strategies to higher levels of brand quality, consistency and customer satisfaction.

"Having expanded rapidly during the past decade to become a worldwide brand in the hotel industry, we are poised to take Radisson to the next level of success as a quality-driven, totally customer-focused organization," said Brian Stage, president of Radisson Hotels Worldwide. "As the Radisson brand continues to grow and mature, we are moving toward the goal of 100 percent guest satisfaction—an objective which is the foundation of our strategic agenda for the remainder of this decade and into the 21st century," he added.

There are five key strategic components to the vision for Radisson Hotels Worldwide that Stage has articulated: guest satisfaction and brand consistency; individualized marketing and guest services; strategic development of key hotels in prime locations; global brand presence; and the strengthening of the synergy among Carlson Companies.

Putting Guests First

To be the brand of choice among travelers, Radisson is focused on guest satisfaction to ensure guests receive consistent, reliable fault-free service at every Radisson hotel, every day. Radisson recently completed a pilot test of a 100 percent guest satisfaction program.

This spring, the brand will begin to implement a guest satisfaction guarantee worldwide, at every Radisson hotel. "When guests get what they expect, and more, at Radisson, they come back again and again," said Stage.

"Having a large number of hotels and being widely known are not enough," said Stage. "The Radisson brand is being defined by providing high-quality products and offering services for our guests' benefit and convenience—not ours," he added. "It is a strategy which will enable the next generation of growth and success of the Radisson brand."

Providing Individualized/Personalized Marketing and Services

Focusing on the trend of increasing customer sophistication, Radisson is moving forward to use state-of-the-art technology to custom tailor services for individual guest needs at every point of contact.

"We are developing new systems and processes that will enable Radisson to move from mass marketing to an approach that will create strong relationships with our best customers," Stage said. "Our goal is to anticipate and recognize individual customer needs, and act on those needs. The best way to win customer loyalty in the future will not be by points, premiums or miles. The next currency of customer loyalty will be convenience," explained Stage.

Radisson will soon begin to customize some of its core global marketing programs to further meet individual guests' needs. Advanced capabilities for ongoing customer data collections, enhancement, analysis and systemwide dissemination will allow the brand to deliver personalized service unlike any other hotel company.

Develop Key Hotels in Prime Locations

Over the past 15 years, Radisson's expansion strategies have rapidly grown the company from a regional hotel chain to a global brand with more than 360 hotels in 47 countries. Now that Radisson is approaching a critical mass to compete in a global marketplace, the company is directing its expansion efforts on selective, strategic developments in major markets with significant hotels. Stage said that global development will be guided by the belief that customer quality and consistency are the organization's top priority. Radisson is focused, with its franchisees as partners, to provide exceptional quality of operations and properties, and ensure a consistent, exceptional guest experience at every one of its hotels.

"Radisson is committed to continuous product improvement and has redefined specifications for the Radisson hotel product and services," he added.

Radisson is focusing on developing more hotels and resorts in major cities and leisure destinations with hotels and resorts that define the brand and meet quality standards. "Some of these developments may include equity participation and management by Radisson," Stage said.

Since Stage became president of the hotel brand in July 1997, several new Radisson hotels have been announced in key cities such as Los Angeles and Chicago, as well as new resort properties in Florida. Radisson is finalizing a partnership with the Aruban government to develop its Aruba property into a premiere Caribbean destination. Plans call for the resort to undergo a $35 million renovation before it re-opens in 1999.

APPENDIX 1 (Continued)

Strengthen Global Brand Presence

Radisson's drive to become a global brand has continued under Stage's direction. In 1998, Radisson opened its first hotels in India and Korea, and will be expanding its presence in Eastern Europe with hotels opening in Cottbus, Germany, and Vilnius, Lithuania. In the Middle East, the brand recently opened two new Jordanian Radissons in Amman and Aqaba, while Australia's newest Radisson is in Melbourne. In Canada, Sun Peaks, British Columbia, is home to a new Radisson resort. Radisson's global growth will continue with the help of strong partnerships that draw on local knowledge and resources in the theaters of the world where Radisson operates.

Leveraging Carlson Companies Synergy

Heading into the millennium, Radisson will continue to develop its global presence, while preserving the integrity of the brand. The company will seek opportunities to further capitalize on the synergy derived from Carlson Companies' four operating groups, Carlson Hospitality Worldwide, Carlson Wagonlit Travel, Carlson Leisure Group and Carlson Marketing Group. Carlson's travel agency interests include over 5,300 locations in 140 countries, providing a powerful support network for the company's hotel operations. "Making it easier for Carlson's travel businesses to book Radisson will earn us an increasing share from these giants in the global travel industry."

Carlson Marketing Group's dominance of the multi-billion dollar incentive industry offers opportunities for Radisson to attract these lucrative programs.

"This is an exciting point in Radisson's history," said Stage. "During the next five years the company will solidify its position as a leading global brand with a strong core of high-quality hotels distinguished by personalized, high-quality services to meet the needs of individual customers. We want to be sought by investors who respect the power of our brand. By taking care of guests, we'll be able to take care of our owners."

APPENDIX 2 Radisson press release, January 20, 1999.

Carlson Hospitality Worldwide Introduces New Generation Central Reservation System; "Curtis-C" Sets New Industry Standards in Technology Sophistication

OMAHA, Neb. (Jan. 20, 1999)—Continuing to set new standards and cut new ground with innovative technology, Carlson Hospitality Worldwide today introduced a new generation central reservation system, "Curtis-C" (pronounced "Courtesy"), at its worldwide reservation headquarters in Omaha, Neb. Named in honor of Curtis L. Carlson, founder and chairman of parent company Carlson Companies, Inc., Curtis-C was a three-year journey that re-invented Carlson's system into one of the most sophisticated in the hotel industry and was completed without disruption of reservation services.

Curtis-C is built upon a three-tier client server architecture, relational database and global data network utilizing the most advanced systems methodologies to harvest business and manage operations of Carlson's brands on a real time basis worldwide. The system serves Carlson's hotel and cruise ship operations including Regent International Hotels, Radisson Hotels Worldwide, Country Inns Suites By Carlson and Radisson Seven Seas Cruises.

Joining in the dedication of the new Curtis-C system were Curtis Nelson, president and CEO of Carlson Hospitality Worldwide; Eric Danziger, president of Carlson Hotels Worldwide; and Scott Heintzeman, vice president of Knowledge Technologies for Carlson Hospitality Worldwide. "The new Curtis-C system is truly a breakthrough," said Nelson. "It is a technology showcase which distinguishes us from the competition and sets new global standards for our industry. It is also a vital cornerstone in achieving the customer-focused strategic vision of Carlson Hospitality Worldwide for the next millennium," added Nelson.

"The project was completed in 'chunks' and was designed to integrate all of our worldwide systems, preparing us for massive future growth, and enables us to better focus on the individual preferences of our customers," said Heintzeman. "The capabilities of this system will allow us to not just take reservations, but to better manage our business and build fuller relationships with our customers."

In addition to taking reservations through toll-free telephone, the Global Distribution System (GDS), and the Internet, Curtis-C also interfaces with the company's more than 550 hotels worldwide via HARMONY, the company's property management system and the CustomerKARE system—or Customer Knowledge And Relationship Enabling system.

APPENDIX 2 (Continued)

In addition to HARMONY and CustomerKARE, the company systems that interface with Curtis-C include the HARMONY Database Manager, which provides access to hotel inventory along with the ability to deliver reservations through several distribution systems; the Guest Communication Manager, a system which manages guest satisfaction information; and KnowledgeNet, an Intranet system that will provide hotels easy access to valuable company information. All of these components provide numerous business benefits such as creating and distributing products worldwide in seconds; making information easily accessible to customize the customer experience; allowing for synergies between applications and reducing resource requirements; and adapting to changing markets and technologies. "Curtis-C is the platform upon which we are building our customer-focused future," added Heintzeman.

Following is an overview of the core applications.

HARMONY Database Manager

The HARMONY Database Manager (HDBM) is a powerful software platform. Developed by Carlson Hospitality, the HDBM provides a hotel with PC access to electronically update rates, availability, and stay controls in the following distribution systems: Curtis-C, HARMONY, the GDS, and Internet distribution systems. "Through the HDBM, revenue management controls are literally placed in the properties' hands, thus increasing efficiency and sales effectiveness," explained Heintzeman. "Each hotel now has the ability to react immediately to a rapidly changing market. Within seconds, new rate products can be placed on the shelf, existing products modified, new selling strategies implemented and availability controls adjusted."

Guest Communication Manager

The Guest Communication Manager system supports the company's 100 percent guest satisfaction strategy. With this system, the company is able to monitor the history of service problems that occur for any individual guest and for any specific hotel. The system also allows Carlson to minimize problems by scanning for trends and patterns. "We can see if there is a common problem that continues to present itself or a specific hotel or group of hotels that needs attention. The system helps us identify service problems so issues can be properly addressed," said Heintzeman.

KnowledgeNet

Because Carlson Hospitality is a global company, it is important for all hotels to have access to company information on any day, at any time. KnowledgeNet contains a wealth of information such as corporate policies; forms; reports; hotel procedures; and newsletters. In addition, KnowledgeNet eliminates the monthly printing of hotel reports and distribution to the properties. "For a company that works in a team environment, this system allows us to be more cross-functional, which in turn produces a more successful bottom line," explained Heintzeman. "Managing knowledge and making that information available to the right people at the right time is the goal of every IT department, and KnowledgeNet represents the future of information management systems."

Carlson Hospitality Worldwide is a global leader in hospitality services, encompassing nearly 1,100 hotel, resort, restaurant and cruise ship operations. Specific brands include: Regent International Hotels; Radisson Hotels Worldwide; Country Inns Suites By Carlson; Carlson Lifestyle Living (Carlson Park); Carlson Vacation Ownership; Radisson Seven Seas Cruises; T.G.I. Friday's; Friday's Front Row Sports Grill; Friday's American Bar; Italianni's; AquaKnox; Star Canyon; Timpano Italian Chophouse; Samba Room and Provisions. Carlson Hospitality Worldwide is one of the major operating groups of Carlson Companies, Inc., headquartered in Minneapolis, Minn. Other Carlson Companies groups include Carlson Marketing Group, a worldwide marketing services company operating in 17 countries; Carlson Leisure Group, responsible for leisure travel ventures around the globe; and Carlson Wagonlit Travel, a world leader in business travel management.

Contact: Betsy Day, 402-498-5000, bday@carlson.com, or Kristi Arndt, 612-212-5626, karndt@carlson.com, both of Carlson Hospitality.

Source: http://www.hotel-online.com/Neo/News/PressReleases1999_1st/Jan99_CarlsonCRS.html.

Case Study eBAGS: Managing Growth

In early 2004, Jon Nordmark and his management team (Exhibit 1) sat down to review the most recent sales numbers for the holiday season with much anticipation. Thus far, it had been quite a ride for eBags management. The company had survived the "tech bust" of 2000 to 2002 relatively unscathed and was one of the few Internet retailers to turn a profit. In December they had been named one of *Internet Retailer* magazine's Top 50 Websites. Now, the financial statements before them indicated their company could boast of a seventh consecutive quarter with a positive cash flow and second consecutive quarter of profits.

While Nordmark and his team felt optimistic about the current state of eBags, they realized that e-commerce was evolving quickly and the strategic choices they made over the next few months would determine the future growth of their company. Thus far, the management team had concentrated its efforts on marketing and merchandising but realized that expansion would require a more holistic view of the business.

The team concluded that eBags would have to seek out additional revenue streams to sustain its high level of growth. Two proposals for expansion were under consideration. One involved expanding the current business model to Europe, while the other involved adding shoes to the eBags product portfolio. While both options looked promising, Nordmark knew that there would be challenges from an operations standpoint and wanted to make sure that he thoroughly understood the implications of each option.

eBAGS HISTORY

In the spring of 1998, Jon Nordmark convinced four other people, Peter and Eliot Cobb, Frank Steed, and Andy Youngs, to join forces with him to build an online luggage- and travel-products store. The choice of a business that provided a wide variety of luggage, bags, backpacks, and travel accessories was not surprising since Nordmark, Peter Cobb, Youngs, and Steed were all top executives with Samsonite USA and American Tourister. Together they saw the Internet as an opportunity to take their experience and build a major retail company.

It was a risky move for each of them. To get the company started, each contributed $50,000 and agreed to work for free until the company could establish funding from outside sources. As they struggled to find the initial funding, Nordmark took cash advances on his credit cards, borrowed money from his family, and took a second mortgage on his home to keep the company afloat. At one point in late 1998, both Nordmark and eBags were completely broke.

In January 1999, Benchmark Capital, a leading Silicon Valley venture capital firm, stepped up to the plate with funding. Robert Kagle, a partner with Benchmark, praised Nordmark as both a visionary and pragmatic businessman. Soon after the initial investment, other venture capitalists "smelled blood" and began to contribute capital, with investments totaling $6.8 million.

In March of 1999, eBags.com officially was launched. More venture capital money followed, and by November 1999, eBags had received over $30 million in funding. With plenty of capital, Nordmark and his team focused on driving sales growth and boosting brand offerings. By the end of the first year of operations, eBags had achieved an average monthly sales growth of 98% and had broadened their product offering from six to fifty-six brands. The year 2001 marked the turning point for eBags as it was named website of the Year by *Catalog Age*, and had its first profitable month in December. Numerous marketing and merchandising awards followed in the ensuing years.

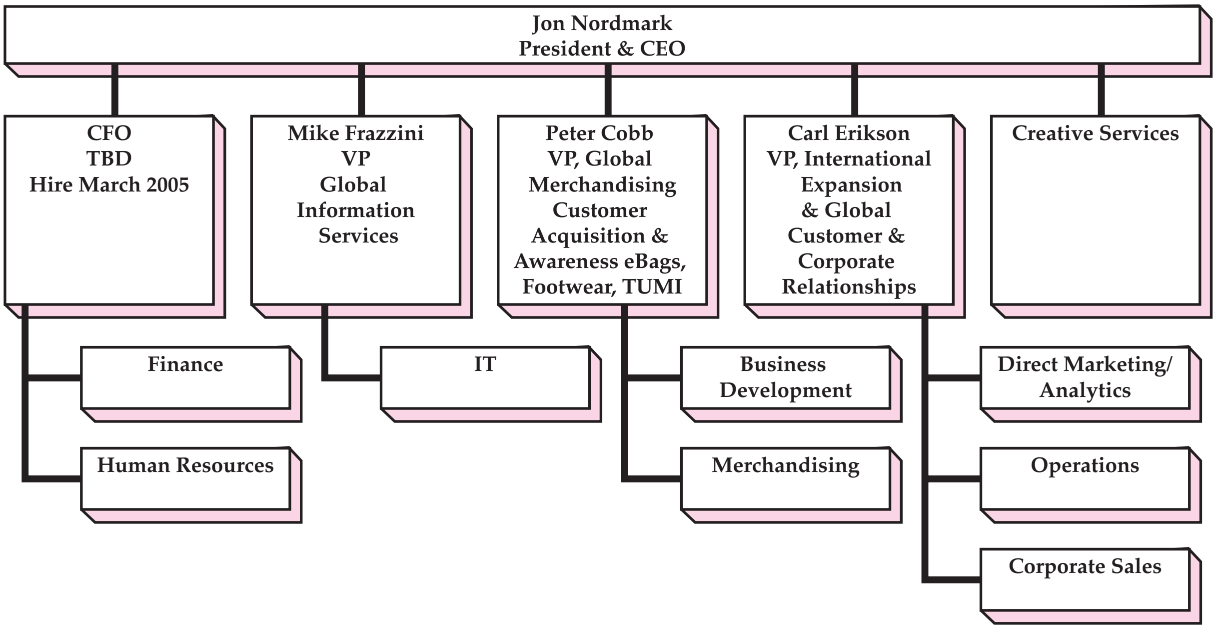
By early 2004, eBags was the largest online provider of bags and accessories, carrying over 200 brands and 8,000 products. eBags had sold over 2.5 million bags and had been a consistently profitable company, one of the few dot-coms to survive, let alone thrive.

THE LUGGAGE INDUSTRY[1]

Like most U.S. industries, the luggage industry experienced significant growth and innovation as a result of the nation's transformation after World War II. Materials such as rip-stop nylon, fiberglass, plastics, aluminum, leather, and simulated fabric that had been developed for wartime were now put to use in

[1] "Luggage," *Encyclopedia of American Industries*, Online Edition. Gale, 2004. Reproduced in Business and Company Resource Center. Farmington Hills, MI.: Gale Group, 2005. http://galenet.galegroup.com/servlet/BCRC.

EXHIBIT 1 Organization chart.



the industry. Manufacturers designed products that were durable yet light enough to meet federal air-travel requirements. During the 1970s, utility yielded to fashion as designer luggage became the vogue. Also, as air travel became more efficient, the emphasis was on speed, and manufacturers began to produce carry-on luggage that allowed travelers to avoid check-in lines and baggage claim areas. In the 1980s, luggage became a status symbol. Consumers demanded that their luggage demonstrate their wealth, status, and fashion taste. In response, manufacturers produced luggage in a wide range of styles, colors, sizes, and fabrics, which led to a surge in the breadth and fragmentation of the industry. While fashion remained a key determinant, the 1990s and early 2000s saw a return to emphasis on utility, as international business travel exploded in the new global economy.

The domestic luggage market, a $1.28 billion market in 2000, was fragmented with a wide range of products that were distinguished primarily by product quality, product usage, and price. The luggage market included traditional travel bags, suitcases, briefcases, backpacks, handbags, computer cases, and other travel accessories. The high end of the market consisted of high-quality, full-featured products with prestigious brand names. These items carried high price tags and were selectively distributed to specialty stores and a few major retailers. The middle portion of the market held a vast number of products that were differentiated by features, brand name, and price. Distribution was wide in this portion of the market, with products reaching specialty stores, large retailers, and discount stores. The low end of the market consisted of private-label and unbranded products. These products had few differentiating features and were sold in significant volume at low prices, which resulted in low margins for retailers and manufacturers.

Due to the fragmentation of the marketplace, there were only a few major competitors with significant national market shares, namely, Samsonite, American Tourister, JanSport, and Eastpak. The rest of the market was divided into smaller national or regional brands that served a specific niche. Brands such as the North Face, kate spade, Totes, Eagle Creek, and Liz Claiborne were just a few of the many recognizable names found in the market.

Manufacturing was managed through global sourcing with a focus on the lowest cost processes that met the quality standards and specifications of the product. For example, Samsonite, the only truly global luggage producer, operated eleven manufacturing facilities worldwide, two in the United States, three in Western Europe, and the remainder in the developing regions of Eastern Europe, Mexico, India, and China. JanSport listed over twenty contract manufacturers on its website including five in the United States, four in China, three in El Salvador, and two in Mexico. Other locations included

Vietnam, Madagascar, Indonesia, Singapore, Malaysia, Honduras, Macau, and Jakarta.

The fragmented base of luggage producers and the wide range of quality/price segments led to a broad and fragmented retail market as well. Luggage and travel accessories could be acquired through retailers ranging from department stores, luggage specialty stores, discount stores, and, in some cases, manufacturer-owned outlets. Marketing programs focused on brand advertising that reinforced the unique qualities of the product. In-store point-of-sale programs and promotional activities supported the marketing strategy as well.

It was the fragmented nature of the luggage market and his experience with Samsonite that led Jon Nordmark to launch eBags as an innovative business solution.

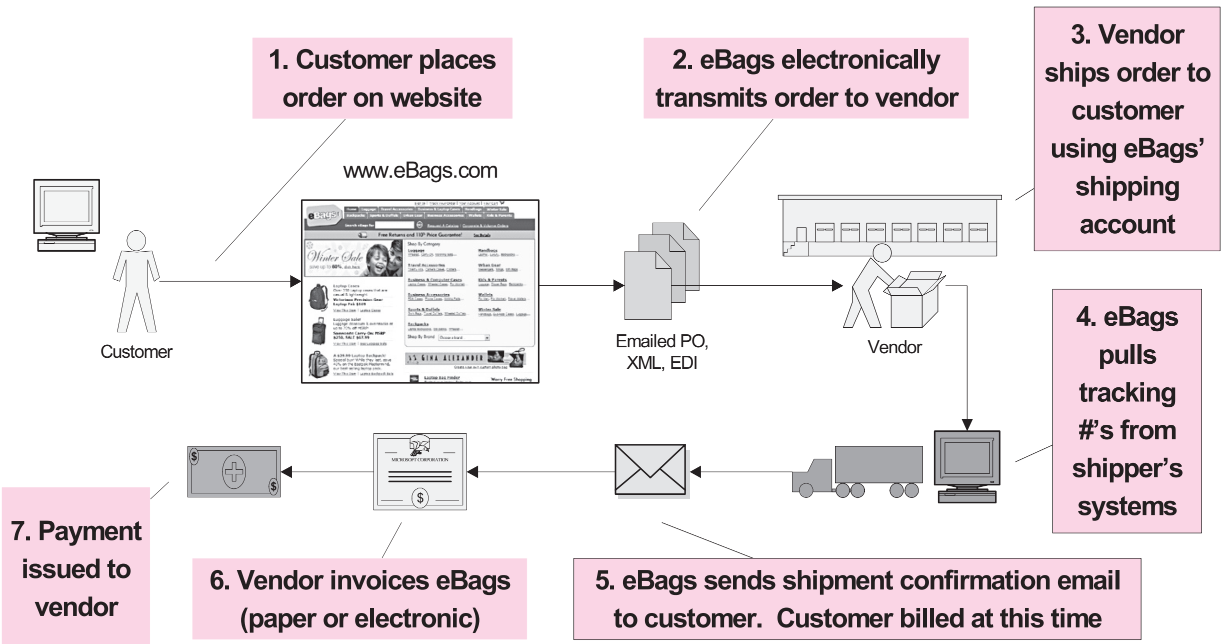
eBAGS BUSINESS MODEL

Nordmark and his team's experience in the luggage industry provided a strong foundation for success, but the eBags business model represented a major departure from the traditional business model. eBags sought to reduce industry fragmentation and bring the customer closer to the manufacturer by bringing a diverse collection of brand-name products into one online store location.

eBags began by developing strong relationships with major manufacturers and by marketing four different product lines: bags, business cases, handbags, and backpacks. The company sought products in these categories that covered the three segments of the market (high end, middle, and low end). eBags sold its concept to manufacturers by stressing the value added by bringing a wide range of customer segments into closer contact. Furthermore, the online storefront shortened the supply chain thereby offering the opportunity for significant inventory cost savings. In exchange for bringing the customers closer to the manufacturer, eBags pushed the drop-ship inventory model (see Exhibit 2) onto the manufacturers. In this model, inventory was managed at the manufacturer or distributor level. In serving as the intermediary for the customer, eBags placed daily orders to the vendor, who then shipped the item directly to the customer. This model eliminated eBags' risk of inventory obsolescence, which was a significant consideration in a market being driven more by style than by functionality.

With most products sold in shippable cartons, the drop-ship model was not a large departure for the major luggage providers, and it gave them more immediate feedback from the customers than the traditional retail model. For eBags, the drop-ship model practically eliminated the need for inventory, thereby reducing holding costs below those of traditional retailers. Furthermore, eBags could offer a much wider "virtual" assortment than a

EXHIBIT 2 **Drop-ship order fulfillment process.**



traditional luggage retailer facing physical space constraints and/or needing costly floor space to expand.

To effectively reach all potential customers, eBags built an engaging Website storefront that marketed products based on demand and availability. The main selling point to the customer was eBags' ability to bring a wide variety of products to one location. Without the storefront, customers had to spend time and money traveling to different specialty shops or department stores in search of the perfect product. With the eBags site, customers could search by type, brand, product line, and price. eBags made a conscious decision not to compete on price. Rather, they chose to compete on product breadth, selection, and convenience. Products on the eBags site, therefore, showed the manufacturer's suggested retail price (MSRP). Since the ability to comparison shop in such a fragmented market was important to the customer, the eBags site was judged successful in reaching the target market.

eBags' challenges stemmed from having to disrupt the traditional value chain that existed between manufacturers and retailers. Department stores and specialty shops presented significant friction to the online system. When eBags initially launched its site in 1999, online retail accounted for only 1% of market sales, but based on the success of Amazon.com and eBay, the handwriting was on the wall. The retailers argued that they provided manufacturers with consistent demand and an inventory cushion, advantages that eBags could not provide. eBags countered with the argument that its business model brought more customers to the manufacturers at a faster pace and that these advantages outweighed the inventory holding costs. In time, the online market data would be available for manufacturers to better estimate demand and handle inventory. Additionally, eBags argued, this business model allowed them to focus extensively on product promotion and marketing activities that would increase sales levels. eBags assumed the responsibility of maintaining the website, photographing products, and marketing and promoting products and brand names.

As the initial products and brands experienced sales success, eBags was able to build up its supplier network from 10 to 300 suppliers, with product lines increasing from 1,000 Stock Keeping Units (SKUs) to over 15,000 SKUs. In order to build awareness, eBags developed an affiliate program that encouraged non-retail websites to promote eBags. In return for setting up a link to eBags on their independent website, the affiliate earned a commission as high as 20% for every eBags sale that resulted from the customer clicking on the eBags link. This served as a low-cost way to market eBags and promote sales in previously untapped market segments.

As the supplier base expanded, eBags saw a need to better serve the low-end, cost-conscious portion of the market. Feedback from the website indicated that customers were looking for generic travel products that were reliable but low in cost. In response, eBags launched its own private label that was sourced through low-cost Asian manufacturers. In this manner, eBags was able to satisfy the low end of the market with decent margins. The drawback came when eBags was forced to maintain an inventory for the private label, as the drop-ship model could not be applied efficiently with its Asian contract manufacturers.

eBAGS OPERATIONS MODEL

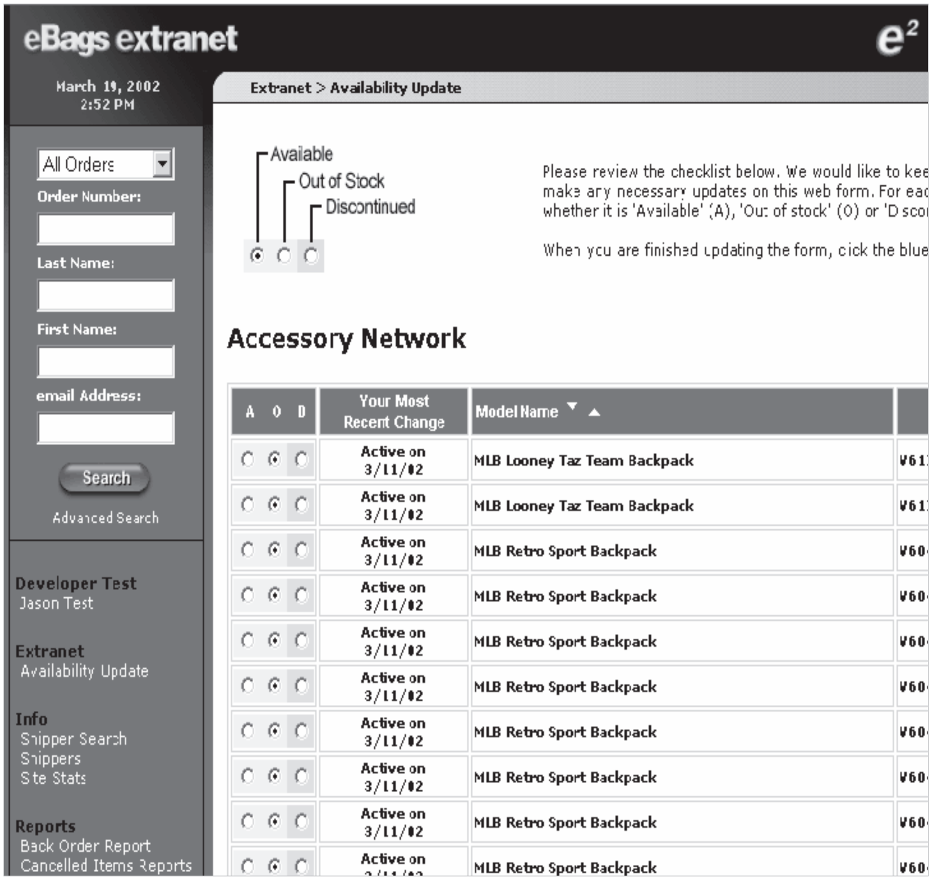
In order to eliminate the high inventory holding costs associated with over 8,000 different luggage items and 15,000 individual SKUs, eBags employed the drop-ship model (Exhibit 2),[2] which accounted for 85% of the shipments for eBags. Trade-offs existed in earning lower profit margins than traditional retailers and the inability to control the shipping schedules of the manufacturers, however.

With the development of the private label, eBags incorporated the traditional speculative inventory model. The private label consisted of 15% of shipments, with roughly 1,000 SKUs maintained in an eBags warehouse in Dallas, Texas. In line with its strategy of limited inventory holding costs, eBags strived to maintain an estimated two-month sales level of private-label inventory and to minimize production runs, while maintaining the same timeliness and accuracy targets that it held for drop-ship products. By global-sourcing the manufacture of the private label through a network of low-cost Asian manufacturers and tight inventory management, eBags could satisfy the cost-conscious customer—while still enjoying a healthy profit margin.

Data management was critical to eBags' operational efficiency, and the company built strong vendor relationships by maintaining a high degree of transparency. eBags exchanged data with vendors on a daily basis through a system called the eBags Partner Network (EPN). This Web-based interface constituted 60% of the data exchange, while traditional file transfer protocol (FTP) and electronic data interchange (EDI) constituted the remaining 40%. The EPN allowed vendors to update inventory status for individual SKUs on a real-time basis, identifying them as in stock, out of stock, or discontinued

[2] "Looking Big: How Can Online Retailers Carry So Many Products?" *Wall Street Journal*, April 28, 2003.

EXHIBIT 3 EPN screen sample—vendor inventory update.



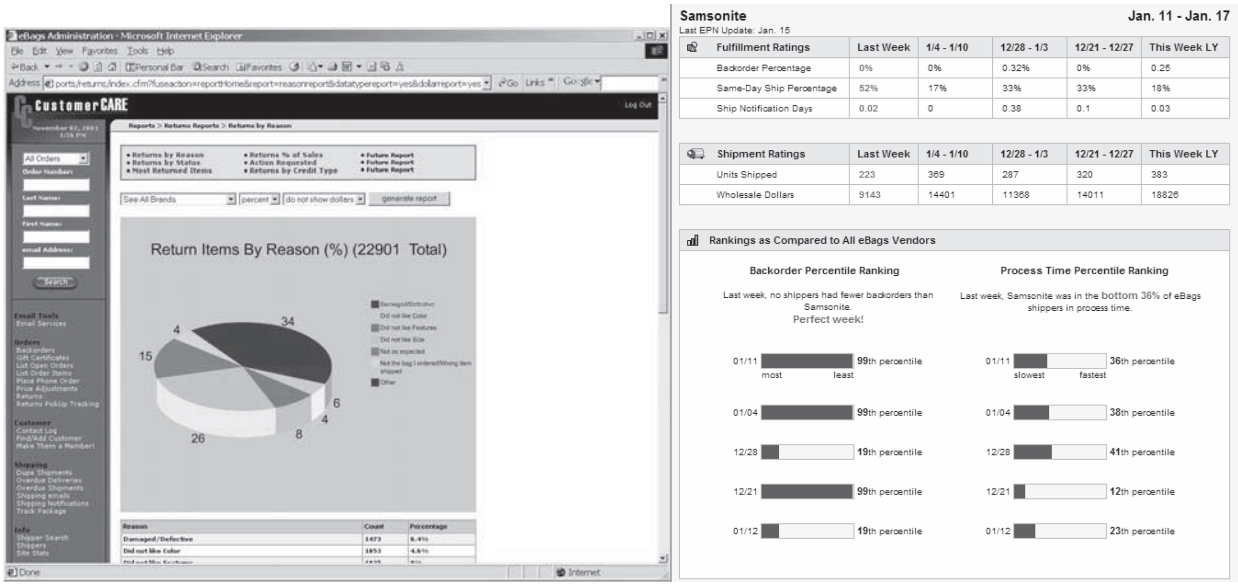
(Exhibit 3). In turn, this enabled eBags to more effectively market the product lines to the customer, ensuring that customers did not request items that the manufacturer could not deliver.

eBags incorporated a vendor scorecard system into the EPN that enabled vendors to track key metrics such as product sales, product returns, customer ratings, and testimonials (Exhibit 4). The information on the vendor scorecard served as a motivational tool for vendors to improve operational performance on such operational elements as back-order rates, delivery time, and processing rates. eBags set stringent goals for its vendors and strived to achieve overall objectives of maintaining an on-time delivery rate of 95%, a shipping accuracy of 99.995%, a back-order rate of less than 1%, and an order-process time of fewer than two days. The vendor scorecard was a valuable tool in enabling eBags to maintain the visibility of vendors and reinforce positive performance that increased customer satisfaction and led to strong sales growth.

Shipping was handled through one primary carrier—United Postal Service (UPS). Products were sent directly from the manufacturer or from eBags' own warehouse to the customer. eBags and the customer could track the product shipment status via UPS's on-line system. eBags was responsible for the cost of shipping to the customer, as well as the cost of return shipping for any product that did not meet the customer's expectation. eBags sent a prepaid UPS shipping label directly to the customer, who simply mailed the package back to the manufacturer or eBags, depending on the agreement with the individual vendor.

The return policy was liberal but consistent with that of other Internet retailers. eBags offered a 30-day grace period for free returns. Return rates for luggage averaged 6% to 7% of the bags sold, a relatively low rate. This was believed to be primarily due to the ability of the customer to evaluate and understand the product prior to purchase. The key determinants of size, fabric/material, color, and purpose were

EXHIBIT 4 EPN screen sample—vendor inventory update.



easy to communicate via a product photo on the website.

THE FOOTWEAR INDUSTRY[3]

In 2003, the domestic footwear industry was a $40.7 billion market, making it nearly three times larger than the luggage and travel accessory market currently served by eBags. As with the luggage industry, the footwear industry was highly competitive and extremely fragmented. The top-five U.S. footwear manufacturers were Nike Inc., Jones Apparel Group, Reebok International Ltd., Timberland Company, and Brown Shoe Company Inc., with none of the competitors holding more than 8% market share. The competitive nature of the industry led to fragmentation, as shoes were distinguished by performance, design, product quality, fashion awareness, styling, and—finally—price. With nearly 30% of domestic consumers demonstrating strong brand loyalty, it was imperative for manufacturers to develop consistent and reliable products that met the target market's demand.

The consumer market was divided into three segments: women's (50.4% of sales), men's (40.3%), and children's (9.3%). Personal consumption of footwear accounted for 15% of overall apparel spending, with women spending on average 80% more than men. As discount retailers entered the market, the average price paid for shoes decreased such that shoes priced under $100 currently accounted for 36% of total shoe sales in the United States. The market was also seasonal, with peaks occurring during the Back-to-School, Christmas, and Easter periods.

Distribution was managed primarily through specialty outlets (47% of the market), department stores (20.6%), and mass merchandisers (16.7%). Specialty outlets focused on a specific type of footwear, such as Foot Locker's athletic shoes. Typically smaller than a mass merchandiser, specialty outlets offered fewer brands and styles than a mass merchandiser. Unlike a discount retailer such as Walmart, mass merchandisers sold only footwear and offered a wide variety of types because offering multiple brand names gave them a broad range of low-priced products to offer customers.

In the early 2000s, consumer price sensitivity increased significantly and mass merchandisers such as Famous Footwear, DSW, and Payless Shoes increased their focus on a low-price strategy, which continued to bring price-conscious customers into their channel. As a result, specialty stores experienced a decrease in importance as a retail channel in the domestic footwear market. eBags hoped to exploit this price sensitivity in the marketplace, coupled with the advantages of e-tailing.

In many ways, the product extension into footwear seemed like a logical one to eBags. By leveraging its strengths in marketing and merchandising, eBags felt confident that it could exploit the similarly fragmented footwear industry by providing

[3] "Footwear in the USA," http://www.euromonitor.com/mrm/scripts (accessed June 2004).

EXHIBIT 5 Comparative data by category.

Product Category	Purchase Frequency	Return Cost %	Model Count	SKU Count	Avg. Selling Price	Avg. Gross Margin	Product Lifecycle	Product Return Rate
Backpacks	1.08	15.1	621	1,486	$53.00	46%	2 yrs	7%
Business Cases	1.05	12.3	330	557	$55.00	49%	5 years	6%
Bus. Accessories	1.06	20.2	383	873	$25.00	48%	4 years	6%
Handbags	1.23	12.9	1,913	4,571	$55.00	52%	3 months	10%
Luggage	1.14	10.8	832	1,818	$90.00	47%	6 years	6%
Shoes (Shoedini)	*1.16*	*9.87*	*3,123*	*92,218*	*$68.00*	*48%*	*3-6 months*	*25%*

one-stop shopping for consumers. The breadth of products and consumer behavior was similar to the luggage industry although shoes did present some unique challenges versus luggage and travel accessories. Shoes needed to be tried on by customers before they were satisfied with the product, and on-line buying behavior suggested that customers often purchased multiple pairs of shoes simultaneously, fully intending to return ones that did not fit correctly or otherwise failed to meet their expectations.

Another challenge for eBags stemmed from having to increase consumer awareness. The name eBags did not suggest to the average consumer that footwear could be purchased on the website. eBags needed an approach to overcome this barrier, either through website acquisitions/mergers, affiliate programs, or advertising and marketing. By 2004, more than 36 online footwear retailers existed in the marketplace. Each one was viewed as a potential acquisition/merger for eBags. Affiliate programs would consist of agreements between eBags and other non-retail websites. In promoting eBags on their own websites, these affiliates would receive a commission for every sale that occurred as a result of the customer navigating through the affiliate's website.

A comparison with a potential acquisition candidate, Shoedini, highlighted many differences between footwear and the current eBags product lines (Exhibit 5). If successful in the footwear market, eBags saw future potential for additional product extension in the clothing and apparel market, which was the largest online retail market.

THE EUROPEAN MARKET

The European luggage market was considered to be just as highly fragmented as the domestic market that eBags currently faced. Most European luggage retailers were small, family-run stores that operated with limited selling hours and offered a less diverse product line. As international travel increased, these retailers did not meet the demands of their customers adequately. Customers were looking for wider selection and variety along with breadth of style and utility, and, even more important, those in one country had different priorities from people in a neighboring country. For example, German customers placed a high value on functionality, while French and Italian customers valued style, color, and seasonality. British customers looked for a balance in their luggage selection; they preferred a mix of function, value, and quality.

A key motivation for developing the European luggage market was the high level of Internet usage that Europe had reached by 2002. An estimated population of 190 million Internet users spread across Europe and surpassed the 165 million Internet users in the United States. Additionally, the Internet penetration rate (percent of population with Internet access) averaged nearly 50% among the top-12 nations in Europe (Exhibit 6). And, finally, the levels of online retail sales in the two largest regions (Germany and the United Kingdom) had risen dramatically from 1997, reaching a total of $1.94 billion in 2002 (Exhibit 7). eBags estimated that the reachable European market could expand up to $17 billion by 2004, an estimate supported by projected annual European electronic commerce market growth of 33%.[4] The recent success of online retailers Amazon.com and eBay in European markets provided encouragement for eBags.

A significant void existed in the European market space that eBags intended to occupy. European vendors had yet to build significant relationships with online retailers, and eBags could capitalize on the opportunity to consolidate the distribution channel and reduce fragmentation. Establishing a one-stop

[4] "Online Retailers Look Overseas," *New York Times*, January 10, 2005.

EXHIBIT 6 **European Internet usage.**

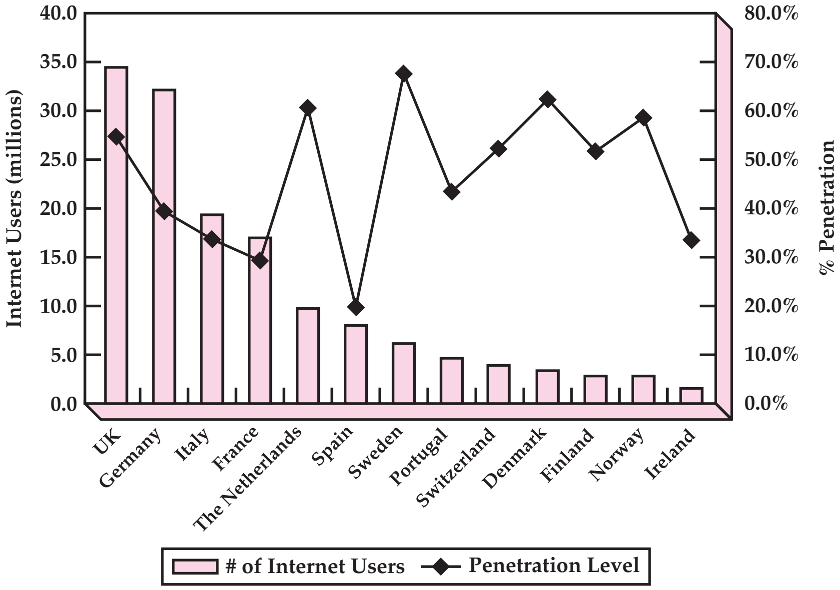
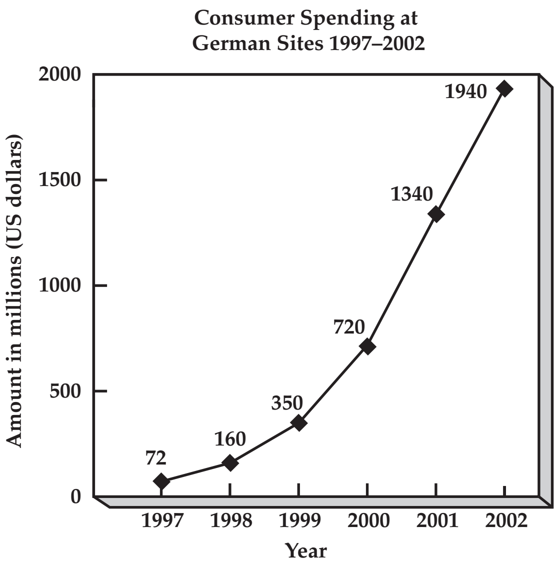
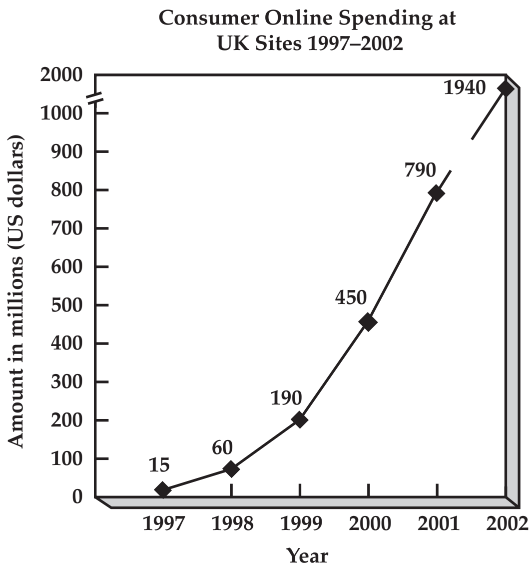


EXHIBIT 7 **European online consumer spending.**





shopping experience for customers in the European marketplace could provide the same level of success that eBags had achieved in the United States.

Nonetheless, challenges existed in bringing the eBags business model overseas: language barriers associated with packaging and labeling, shipping requirements, brand awareness, maintaining the EPN interface, and Web page administration.

WHERE DO WE GO FROM HERE?

Jon Nordmark leaned back in his chair and contemplated the decision in front of him. The success enjoyed by eBags was a result of innovative thinking and aggressive management that had created a unique opportunity to consolidate the fragmented luggage market. Now it was clear that eBags needed a strategy to project this success into the future.

Should eBags consider product extension into footwear, with the hopes of further extension into the online clothing retail market? Should the company consider business expansion into Europe? If so, what European markets should it enter and could the product expansion of footwear also be introduced in the European market? Each option presented its own set of unique advantages and challenges.

Clearly, the future of online retailing was on the rise. Consumers were enjoying convenience, variety, speed, and personal-tailoring that online markets brought to their shopping experience. This phenomenon was spreading beyond luggage into all retail market segments. What was the best way for eBags to leverage its strengths and profit from the continued growth of e-commerce?

Discussion Questions

1. Contrast and compare the supply chains required for the private label eBags and those drop-shipped directly from manufacturers.
2. If eBags were to enter the footwear business, what new supply chain management capabilities would be required compared to the present eBags market?
3. If eBags were to enter the European market for luggage, what challenges does this present for supply chain management?
4. From a business perspective, what decisions should Jon Nordmark make regarding the European expansion and the footwear markets. What is the best way for eBags to leverage its strengths and profit from the continued growth of e-commerce?