

Case 9 AirAsia: The World's Lowest-cost Airline

By 2009, AirAsia had established itself as Asia's most successful low-cost airline. Between January 2002 and March 2009, AirAsia had expanded from two aircraft and 200,000 passenger journeys to 79 aircraft and 11.8 million passenger journeys. Its route network had grown beyond Malaysia to cover ten Southeast Asian countries. In addition to its hub in Kuala Lumpur (KL), Malaysia, it had replicated its system by establishing associated airlines in Thailand and Indonesia.

By 2007, UBS research showed that AirAsia was the world's lowest-cost airline with costs per available seat kilometer (ASK) significantly below those of Southwest, Jet Blue, Ryanair, or Virgin Blue (Figure 1). It was also one of the world's most profitable airlines. In 2008, when very few of the world's airlines made any profit at all, AirAsia earned a return on assets of 4%.¹ In 2009, it won the Skytrax Award as "The World's Best Low Cost Airline."

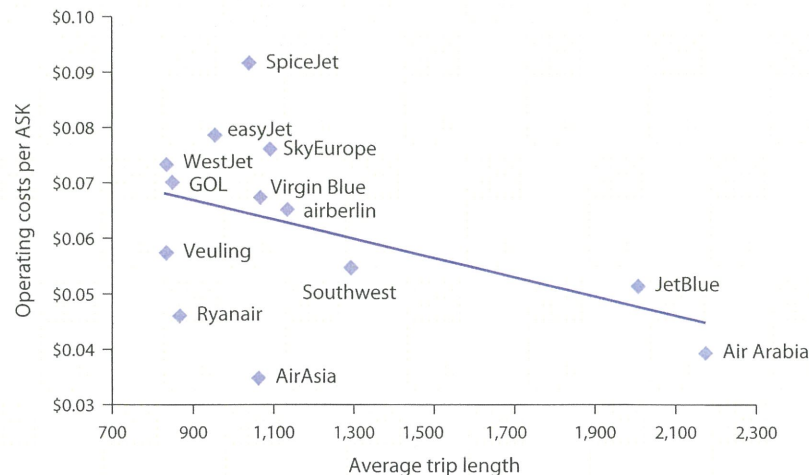
AirAsia had built its business on the low-cost carrier (LCC) model created by Southwest Airlines in the US and replicated throughout the world by a host of imitators. AirAsia had adapted the basic LCC model to the market, geographical, and institutional features of Southeast Asia while preserving the principal operational features of the strategy. However, in 2007, AirAsia embarked upon a major departure from the LCC model: expansion into long-haul flights by inaugurating routes to Australia and China and then, in 2009, to India and the UK. The conventional wisdom was that the efficiency of the LCC model was dependent upon short and medium-distance flights with a single type of aircraft and minimal customer amenities—intercontinental flights required contravening these basic conditions. Very few LCCs had ventured into long-haul; even fewer had made a success of it.

To evaluate AirAsia's potential to expand from being a regional carrier to an international airline would require a careful analysis of the basis of its existing cost advantage and an evaluation of the transferability of these cost advantages to the long-haul market.

The History of AirAsia

The growth of AirAsia is closely associated with the entrepreneurial effort of Tony Fernandes. Son of a Malaysian doctor, Fernandes was sent to boarding school in

Written by Robert M. Grant. The case draws upon a report written by Sara Buchholz, Nadia Fabio, Andrés Ileyassoff, Laurent Mang, and Daniele Visentin: *AirAsia: Tales from a Long-haul Low Cost Carrier*, Bocconi University (2009), and from an earlier case by Thomas Lawton and Jonathan Doh: *The Ascendancy of AirAsia: Building a Successful Budget Airline in Asia* (Ivey School of Business, Case No. 9B08M054 2008). Used by permission of the authors. © 2012, Robert M. Grant.

FIGURE 1 Costs in US cents per available seat kilometer for different low-cost airlines

Source: AirAsia Presentation, CLSA Forum, Hong Kong, September 2007.

Britain with a view to following his father's footsteps into the medical profession. Tony had other ideas and, after an accounting degree at the London School of Economics, he went into music publishing, first with Virgin, then Time Warner. He describes his decision to start an airline as follows:

I was watching the telly in a pub and I saw Stelios [Haji-Ioannou] on air talking about easyJet and running down the national carrier, British Airways. (Sound familiar? Hahaha.) I was intrigued as I didn't know what a low cost carrier was but I always wanted to start an airline that flew long haul with low fares.

So I went to Luton and spent a whole day there. I was amazed how people were flying to Barcelona and Paris for less than ten pounds. Everything was organized and everyone had a positive attitude. It was then at that point in Luton airport that I decided to start a low cost airline.²

He subsequently met with Conor McCarthy, former operations director of Ryanair. The two developed a plan to form a budget airline serving the Southeast Asia market.

Seeking the support of the Malaysian government, Fernandes was encouraged by Prime Minister Mahathir Mohammad to acquire a struggling government-owned airline, AirAsia. With their own capital and support from a group of investors, they acquired AirAsia for one Malaysian ringgit (RM)—and assumed debts of RM40 million (about \$11 million). In January 2002, AirAsia was relaunched with just three planes and a business model that McCarthy described as: "a Ryanair operational strategy, a Southwest people strategy, and an easyJet branding strategy."³

Fueled by rising prosperity in Malaysia and its large potential market for leisure and business travelers seeking inexpensive domestic transportation, AirAsia's domestic business expanded rapidly. In January 2004, AirAsia began its first international service from KL to Phuket in Thailand; in February 2004, it sought to tap the Singapore market by offering flights from Johor Bahru, just across the border from Singapore, and in 2005 it began flights to Indonesia.

International expansion was financed by its initial public offering (IPO) in October 2004, which raised RM717 million. Airline deregulation across Southeast Asia greatly facilitated international expansion. To exploit the market for budget travel in Thailand and Indonesia, AirAsia adopted the novel strategy of establishing joint-venture companies in Thailand (Thai AirAsia) and Indonesia (Indonesia AirAsia) to create new hubs in Bangkok and Jakarta. In both cases, the operations of these companies were contracted out to AirAsia, which received a monthly fee from these associate companies.

From the beginning, Fernandes had set his sights on long-haul travel, guided by the example of his hero, Freddie Laker, the pioneer of low-cost transatlantic air travel. However, this risked his good relations with the Malaysian government because it put AirAsia into direct competition with the national airline, Malaysia Airlines. Hence, Fernandes established a separate company, AirAsia X to develop its long-haul business. AirAsia X is owned 16% by AirAsia (with an option to increase to 30%), 48% by Aero Ventures (co-founded by Tony Fernandes), 16% by Richard Branson's Virgin Group, with the remaining 20% owned by Bahrain-based Manara Consortium and Japan-based Orix Corporation. Operationally, AirAsia and AirAsia X are closely linked.

In 2007, flights began to Australia, followed by China. By July 2009, AirAsia X had flights from KL to the Gold Coast, Melbourne, and Perth in Australia; Tianjin and Hangzhou in China; and Taipei and London using five Airbus A340s, with three more to be delivered by year-end. Planned future routes included Abu Dhabi (October 2009), India (2010), and later Sydney, Seoul, and New York. At Abu Dhabi, AirAsia X planned to have a hub that would serve Frankfurt, Cairo, and possibly East Africa too: "You just can't get to East Africa from Asia," observed Fernandes.⁴ To support its expansion, AirAsia X ordered ten Airbus A350s for delivery in 2016.

AirAsia's Strategy and Culture

Strategy

AirAsia described its strategy as follows:

- Safety first: partnering with the world's most renowned maintenance providers and complying with world airline regulations.
- High aircraft utilization: implementing the region's fastest turnaround time at only 25 minutes, assuring lower costs and higher productivity.
- Low fare, no frills: providing guests with the choice of customizing services without compromising on quality and services.
- Streamline operations: making sure that processes are as simple as possible.
- Lean distribution system: offering a wide and innovative range of distribution channels to make booking and traveling easier.
- Point-to-point network: applying the point-to-point network keeps operations simple and costs low.⁵

Prior to its expansion into long-haul, AirAsia identified its geographical coverage as encompassing three-and-a-half hours' flying time from its hubs. Fernandes' confidence in his growth strategy rested on the fact that "This area encompasses

a population of about 500 million people. Only a small proportion of this market regularly travels by air. AirAsia believes that certain segments of this market have been under-served historically and that the Group's low fares stimulate travel within these market segments.⁶ Its slogan "Now Everyone Can Fly!" encapsulated AirAsia's goal of expanding the market for air travel in Southeast Asia.

To penetrate its target market, AirAsia placed a big emphasis on marketing and brand development. "The brand is positioned to project an image of a safe, reliable low-cost airline that places a high emphasis on customer service while providing an enjoyable flying experience." For an LCC, AirAsia had comparatively large expenditures on TV, print, and internet advertising. AirAsia used its advertising expenditures counter-cyclically: during the SARS outbreak and after the Bali bombings, AirAsia boosted its spending on advertising and marketing. In addition, it sought to maximize the amount of press coverage that it received. AirAsia also built its image through co-branding and sponsorship relationships. A sponsorship deal with the AT&T Williams Formula 1 race car team resulted in AirAsia painting one of its A320s in the livery of a Williams race car. Its sponsorship of Manchester United encouraged it to paint its planes with the portraits of Manchester United players. It also sponsored referees in the English Premier League. A cooperative advertising deal with *Time* magazine resulted in an AirAsia plane being painted with the *Time* logo.

Its internet advertising included banner ads on the Yahoo mobile homepage and a Facebook application for the Citibank–AirAsia credit card. The overall goals were increasing visibility, encouraging interaction, and allowing users to immerse themselves in the AirAsia brand.

This heavy emphasis on brand building provided AirAsia with a platform for offering services that met a range of traveler needs. AirAsia offered an AA express shuttle bus connecting airports to city centers with seats being bookable simultaneously with the online booking of plane tickets. Fernandes also founded Tune Hotels, a chain of no-frills hotels co-branded with AirAsia. Tune Money offered online financial services—again co-branded with AirAsia.

Culture and Management Style

AirAsia's corporate culture and management style reflected Tony Fernandes' own personality: informal, friendly, and cheerful. In the same way that culture and brand identity of Southwest Airlines and the Virgin airlines (Virgin Atlantic, Virgin Blue, and Virgin America) reflect the personalities of founders Herb Kelleher and Richard Branson, respectively, Fernandes has used his personality and personal style to create a distinct identity for AirAsia. His usual dress of jeans, open-neck shirt, and baseball cap provide a clear communication of AirAsia's unstuffy, open culture. Its team spirit, commitment to job flexibility, and lack of hierarchy were reinforced from the top: Fernandes worked one day a month as a baggage handler, one day every two months as cabin crew, and one day every three months as a check-in clerk.

The share offer prospectus described AirAsia's culture as follows:

The Group prides itself on building a strong, team-orientated corporate culture. The Group's employees understand and subscribe to the Group's core strategy and actively focus on maintaining low costs and high productivity. AirAsia motivates its employees by awarding bonuses based upon each employee's contribution to AirAsia's productivity, and expects to increase loyalty through its ESOS [employee

share ownership scheme] which will be available to all employees. The Group's management encourages open communication which creates a dynamic working environment, and meets all its employees on a quarterly basis to review AirAsia's results and generate new ways to lower costs and increase productivity. Employees . . . frequently communicate directly with AirAsia's senior management and offer suggestions on how AirAsia can increase its efficiency or productivity. . .

In addition to the above, AirAsia:

- inculcates enthusiasm and commitment among staff by sponsoring numerous social events and providing a vibrant and friendly working environment
- strives to be honest and transparent in its relations with third parties. . .
- fosters a non-discriminatory, meritocratic environment where employees are offered opportunities for advancement, regardless of their education, race, gender, religion, nationality or age, and
- emphasizes maintaining a constant quality of service throughout all of AirAsia's operation through bringing together to work on a regular basis employees based in different locations.⁷

AirAsia's Operations

AirAsia's operations strategy comprised the following elements:

- *Aircraft*: In common with other LCCs, AirAsia operated a single type of aircraft, the Airbus A320. (It switched from Boeing 737s in 2005.) A single aircraft type offered economies in purchasing, maintenance, pilot training, and aircraft utilization.
- *No-frills flights*: AirAsia offered a single class, which allowed more seats per plane. For example, when it was operating its Boeing 737s, these were equipped with 148 seats, compared to 132 for a typical two-class configuration. Customer services were minimal: complimentary meals and drinks were not served on board—but snacks and beverages could be purchased, passengers paid for baggage beyond a low threshold, and there was no baggage transfer between flights. AirAsia did not use aerobridges for boarding and disembarking passengers, which was another cost-saving measure. Flights were ticketless and there was no assigned seating. Such simplicity allowed quick turnaround of planes, which permitted better utilization of planes and crews.
- *Sales and marketing*: AirAsia engaged in direct sales through its website and call center. As a result, it avoided paying commission to travel agents.
- *Outsourcing*: AirAsia achieved simplicity and cost economies by outsourcing those activities that could be undertaken more effectively and efficiently by third parties. Thus, most aircraft maintenance was outsourced to third parties, contracts being awarded on the basis of competitive bidding. Most of AirAsia's information technology requirements were also outsourced.

- *Information technology:* AirAsia used Navitair's Open Skies computer reservations system (CRS), which linked Web-based sales and inventory system, which also linked with AirAsia's call center. The CRS was integrated with AirAsia's yield management system (YMS) that priced seats on every flight according to demand. The CRS also allowed passengers to print their own boarding passes. In 2006, AirAsia implemented a wireless delivery system which enabled customers to book seats, check flight schedules, and obtain real-time updates on AirAsia's promotions via their mobile phones—an important facility in the Asia-Pacific region because of the extensive use of mobile phones. The YMS helped AirAsia to maximize revenue by providing trend analysis and optimize pricing; it also gave information on future passenger numbers that was used by AirAsia's Advanced Planning and Scheduling (APS) system to minimize operational costs by optimizing supply chain and facilities management. These two IT systems allowed AirAsia to reduce costs in logistics and inbound activities. During 2005, AirAsia adopted an ERP (enterprise resource planning) system to support its processes, facilitate month-end financial closing, and speed up reporting and data retrieval.⁸ This was superseded by an advanced planning and scheduling system, which optimized AirAsia's supply chain management and forecasted future resource requirements.
- *Human resource management:* Human resource management had been a priority for AirAsia since its relaunch under Tony Fernandes. A heavy emphasis was given to selecting applicants on the basis of their aptitudes, then creating an environment and a system which developed employees and retained them. AirAsia's retention rates were exceptionally high, which it regarded, first, as an indicator of motivation and job satisfaction and as a cost-saving measure—because employees were multi-skilled, AirAsia's training costs per employee tended to be high. Job flexibility at all levels of the company, including administration, was a major source of productivity for AirAsia.

AirAsia: Cost Information

To offer a comparative view of AirAsia's operational efficiency and cost position, Table 1 provides operating and financial information on Malaysia's two leading airlines: Malaysia Airlines and AirAsia. Although Malaysia Airlines' route network was very different from that of AirAsia's (Malaysia Airlines had a larger proportion of long-haul routes), it was subject to similar cost conditions as AirAsia.

For the first time since its relaunch in 2002, AirAsia made a loss in 2008. This was the result of Fernandes' decision to unwind AirAsia's futures contracts for jet fuel purchased. When crude oil prices started to tumble during the latter half of 2008, Fernandes believed that AirAsia would be better off taking a loss on its existing contracts in order to benefit from lower fuel prices.

Going Long-haul

Fernandes was aware that expanding from short-haul flights in Southeast Asia to flights of more than four hours to China, Australia, Europe, and the Middle

TABLE 1 Comparing operational and financial performance between AirAsia and Malaysia Airlines, 2008

	AirAsia	Malaysia Airlines
Operating data		
Passengers carried (millions)	11.81	13.76
Available seat kilometers (billions)	18.72	53.38
Revenue passenger kilometers (billions)	13.49	36.18
Seat load factor (%)	75.0	67.8
Cost per available seat kilometers (sen ^a)	11.66	22.80
Revenue per available seat kilometers (sen)	14.11	20.60
Number of aircraft in fleet December 31, 2008	78.0	109.0
Number of employees	3,799	19,094
Aircraft utilization (hours per day)	11.8	11.1
Financial data (RM, millions)^a		
Revenue	2,635	15,035
Other operating income	301.8	466.0
Total operating expense	2,966.0	15,198.3
of which:		
—Staff costs	236.8	2,179.9
—Depreciation	347.0	327.9
—Fuel costs	1,389.8	6,531.6
—Maintenance and overall	345.1	1,146.4
—Loss on unwinding derivatives	830.2	—
—Other operating expenses ^b	139.2	5,020.0
Operating profit	(351.7)	305.5
Finance cost (net)	517.5	60.8
Pre-tax profit	(869.2)	264.7
After-tax profit	(496.6)	245.6
Total assets	9,520.0	10,071.6
of which:		
—Aircraft, property, plant and equipment	6,594.3	2,464.8
—Inventories	20.7	379.7
—Cash	153.8	3,571.7
—Receivables	694.4	2,020.1
Debt	6,690.8	433.4
Shareholders' equity	1,605.5	4,197.0

Notes:

^aRM: Malaysian ringgit; 1 ringgit: 100 sen (cents). During 2008/9 the average exchange rate was US\$1 • RM3.43.

^bFor AirAsia the main components were aircraft lease expenses and loss on foreign exchange. For Malaysia Airlines the main components were hire of aircraft, sales commissions, landing fees, and rent of buildings.

Sources: Company annual reports.

East required major changes in operating practices and major new investments, primarily in bigger planes. The creation of AirAsia X was intended to facilitate a measure of operational independence for the long-haul flights while also spreading the risks of this venture among several investors. The investors in AirAsia X also contributed valuable expertise: Virgin Group had experience in establishing and operating four airlines (Virgin Atlantic, Virgin Express, Virgin Blue, and Virgin USA), and the chairman of Air Ventures was Robert Milton, the former CEO of Air Canada.

TABLE 2 Comparing AirAsia and AirAsia X

	AirAsia	AirAsia X
Concept	Low cost short-haul, no-frills	Low cost long-haul, no frills
Flying range	Within four hours' flying time from departing city	More than four hours' flying time from departing city
Aircraft	Airbus A320 with 180 seats	Airbus A330 with more than 330 seats
Cabin configuration	Single class	Economy and Premium (previously known as XL)
Seat option	Unassigned seating, plus Xpress Boarding option	Assigned seating with seat request option
In-flight dining	Range of light meals and snacks available for purchase onboard	Pre-ordered full meals available including Asian, Western, vegetarian, and kids' meal; light snacks also available for purchase onboard

Source: AirAsia websites www.airasia.com and www.airasiavax.com.

Table 2 shows the principal differences in AirAsia and AirAsia X's operations and services.

Kuala Lumpur to London: Price and Cost Comparisons

A comparison of prices and costs allows a clearer picture of AirAsia's ability to compete in the long-haul market—a market in which AirAsia had to establish itself against some of the world's major airlines. Between KL and London, AirAsia was in competition with at least six international airlines, the closest of which were Malaysia Airlines, Emirates, and British Airways.

A comparison of economy, round-trip airfares between the two cities is shown in Table 3. As Table 4 shows, these fare differentials reflected differences in cost between AirAsia and its long-haul competitors. These cost differences do not take account of differences in load factors, which can have a major effect on the average cost per passenger. AirAsia reported that its KL–London flights had a load factor in excess of 90%. For the airlines as a whole, Table 5 shows load factors.

TABLE 3 Fare comparisons: AirAsia and its competitors between Kuala Lumpur and London

	AirAsia X ^a (US\$)	Cheapest other airline ^b (US\$)	AirAsia price advantage (%)	Cheapest other airlines
KL–London round trip	433.96 ^c	683.68	36.5	1. Gulf Air 2. Qatar Air 3. Emirates
London–KL round trip	433.96 ^c	530.35	18.2	1. Emirates 2. Etihad 3. Gulf Air

Notes:

^aAverage fare between September 1 and October 1, 2009.

^bAverage of lowest airline fare on each day between September 1 and October 1, 2009.

^cAverage outbound fare: \$187.87; average inbound fare: \$209.48; meals and baggage charges: \$36.61.

TABLE 4

Aircraft type
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Notes:

^aKUL = Kuala

^bExcluding m

Source: S. Bur
2009). Data b

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TABLE 4 Flight operating cost comparison: Kuala Lumpur to London (in US\$)

	AirAsia	British Airways	Malaysia Airlines	Emirates	
Aircraft type	Airbus 340-300	Boeing 747-400	Boeing 747-400	Boeing 777-300	
Route ^a	KUL-STN	KUL-LHR	KUL-LHR	KUL-DXB-LHR	
Maximum passenger capacity	286	337	359	360	
				KUL-DXB	DXB-LHR
Flight fuel cost	79,299	159,522	159,522	77,525	80,822
Leasing costs	5,952	0	0	0	0
En route navigation charges	7,949	12,294	12,294	1,435	6,613
Terminal navigation arrival charges	419	645	645	0	645
Landing/parking	1,100	2,200	2,200	2,200	2,200
Departure handling	6,000	12,000	12,000	12,000	12,000
Arrival handling	6,000	12,000	12,000	12,000	12,000
Segment totals				105,160	114,280
Total cost per flight ^b	106,719	198,661	198,661	219,440	
Average cost per passenger ^b	373.14	589.50	553.37	609.56	

Notes:

^aKUL = Kuala Lumpur, STN = London Stansted, LHR = London Heathrow, DXB = Dubai.

^bExcluding maintenance, depreciation, meal services, and crew salaries.

Source: S. Buchholz, N. Fabio, A. Ileyassoff, L. Mang, and D. Visentin, *AirAsia: Tales from a Long-haul Low Cost Carrier* (Bocconi University, 2009). Data based on NewPacs Aviation Tool Software. Used by permission of the authors.

The Outlook for Long-haul

There can be little doubt that AirAsia had been remarkably successful in building a budget airline in Southeast Asia. Its cost efficiency, growth rate, brand awareness, and awards for customer service, airline management, and entrepreneurship all pointed to outstanding achievement, not simply in replicating the LCC business model pioneered by Southwest Airlines but in adapting that model and augmenting it with innovation, dynamism, and marketing flair that derived from Tony Fernandes' personality and leadership style.

However, its AirAsia X venture presented a whole set of new challenges. AirAsia had successfully transferred several of its competitive advantages from AirAsia to AirAsia X. The low costs associated with fuel-efficient new planes, secondary airports, and human resources practices had allowed AirAsia X to become the low-cost

TABLE 5 Difference between airlines in load factors (%)

	2004	2005	2006	2007	2008
AirAsia	77.0	75.0	78.0	80.0	75.5
Emirates	73.4	74.6	75.9	76.2	79.8
British Airways	67.6	69.7	70.0	70.4	71.2
Malaysia Airlines	69.0	71.5	69.8	71.4	67.8

Source: S. Buchholz, N. Fabio, A. Ileyassoff, L. Mang, and D. Visentin, "AirAsia: Tales from a Long-haul Low Cost Carrier," (case report, Bocconi University, 2009). Used by permission of the authors.

operator on most of its routes. The AirAsia brand and corporate reputation provided AirAsia X with credibility on each new route it inaugurated. By sharing web-based and telephone flight booking systems along with administrative and operational services between the two airlines, AirAsia X was able to secure cost efficiencies that would not be possible for an independent start-up.

Nevertheless, doubts remained over AirAsia X's ability to compete with established international airlines. Unlike AirAsia, which was attracting a whole new market for domestic and regional air travel, AirAsia X would have to take business away from the established international airlines whose business models offered some key competitive advantages over that of long-haul LCCs. In particular, the dense domestic and regional route networks of the established carriers offered feeds for their intercontinental flights. These complementarities were supported by through-ticketing, baggage transfer, and frequent-flyer schemes. Their sources of profit were very different from the LCCs: most of their profit was earned from first- and business-class travelers, which permitted subsidization of economy-class fares.

These challenges pointed to the advantages of closer integration of AirAsia X with AirAsia. AirAsia X's CEO, Azran Osman-Rani, had argued for the operational and financial rationale of merging AirAsia X into AirAsia: "It would be difficult for AirAsia in the future if it did not have trunk routes as [this] is where the traffic volumes come from, so AirAsia needs growth from AirAsia X and the merger allows it to tap growth opportunities in the long-haul markets." Responding to allegations that the real rationale for the merger was to allow AirAsia to finance AirAsia X's losses, Azran said: "Rubbish, we can clearly dispute that. For the first quarter ended March 31, 2009 our net profit was RM 18 million and we are net cash flow positive. We even had a little cash at RM 3 million. We are in a very good position and on a much firmer footing and now is an interesting time to talk about a merger."⁹

Notes

1. Operating profit before depreciation, amortization, and interest as a percentage of average total assets.
2. See www.tonyfermandesblog.com, accessed June 3, 2009. Website no longer available.
3. Quoted by T. Lawton and J. Doh, *The Ascendance of AirAsia: Building a Successful Budget Airline in Asia* (Ivey School of Business, Case No. 9B08M054, 2008).
4. "AirAsia X to Hub in Abu Dhabi: AirAsia CEO," *Khaleej Times* (August 5, 2009).
5. "Corporate Profile," <http://www.airasia.com/ot/en/about-us/corporate-profile.page>, accessed July 20, 2015.
6. "AirAsia Berhad," *Offering Circular* (October 29): 3.
7. *Ibid.*: 5.
8. C. Cho, S. Hoffman Arian, C. Tjitrahardja, and R. Narayanaswamy, *AirAsia: Strategic IT Initiative* (student report, Faculty of Economics and Commerce, University of Melbourne, 2005).
9. "AirAsia X CEO backs Merger with AirAsia Bhd," *The Star Online* (July 23, 2009), <http://www.thestar.com.my/Story/?file=%2F2009%2F7%2F23%2Fbusiness%2F4369512>, accessed July 20, 2015.

Case 2 Starbucks Corporation, May 2015

Howard Schultz, chairman and CEO of Starbucks Corporation, opened the company's annual shareholders meeting in Seattle on March 18, 2015 with the following words:

2014 was a remarkable year: record revenue, record profit, record stock price. But, I must say, when I think about the year and what we've accomplished, what I'm most proud of is our consistent ability to balance profitability and social impact.¹

Schultz went on to elaborate some of Starbucks' accomplishments in relation to both financial and social performance and, in doing so, noted that a \$10,000 investment in Starbucks' stock at the time of its 1992 IPO would currently be worth almost \$2 million.

Starbucks' rise from a single Seattle coffee store to a global chain of over 22,000 coffee shops employing almost 200,000 people and generating revenues that would top \$18 billion in 2015 was one of the wonders of American entrepreneurial capitalism. Its founder, Howard Schultz, was a legend among US business leaders, his heroic status enhanced by the fact that, having built a hugely successful corporation and relinquishing the CEO position in 2000, he returned in 2008 to restore Starbucks' flagging performance. Within two years, profits and share price had set new records (Table 1 and Figure 1).

For many observers, including the owners of the Milanese cafés that had provided the inspiration for Schultz, the Starbucks story was little short of miraculous. America's first coffeehouse had opened in Boston in 1676. How could brewing a better cup of coffee in the 1980s produce a company with a market value of \$78 billion? Given the ubiquity of good coffee, could Starbucks possibly sustain its success?

The Starbucks Story

Starbucks Coffee, Tea and Spice had been founded by college buddies Gerald Baldwin and Gordon Bowker. In 1981, Howard Schultz, a coffee filter salesman, visited their store. The coffee he sampled was a revelation: "I realized the coffee I had been drinking was swill." Captivated by the business potential that Starbucks offered, Schultz encouraged the founders to hire him as head of marketing. Shortly afterwards, Schultz experienced a second revelation. On a

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TABLE

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TABLE 1 Starbucks Corporation: Financial data for 2007–2014 (\$million)

12 months to end-September	2014	2013	2012	2011	2010	2009	2008	2007
Income Statement Items								
Total net revenues of which	16,448	14,892	13,300	11,700	10,707	9,775	10,383	9,412
—company-operated stores	12,978	11,793	10,534	9,632	8,964	8,180	8,772	7,998
—licensed stores	1,589	1,360	1,210	1,007	1,744	1,595	1,611	1,413
—CPG, ^a food service, other	1,881	1,739	1,555	1,061				
Cost of sales	6,859	6,382	5,813	4,916	4,459	4,325	4,645	3,999
Store operating expenses	4,638	4,286	3,918	3,595	3,551	3,425	3,745	3,216
Other operating expenses	450	457	430	393	293	264	330	294
Depreciation and amortization	710	621	550	523	510	535	549	467
General and administrative expenses	991	938	801	636	570	453	456	489
Special charges ^b	—	2,784	—	—	53	3,324	266.9	—
Total operating expenses	13,635	15,469	11,513	10,176	9,436	9,335	9,993	8,466
Operating income	3,081	(325.4)	1,997	1,729	1,419	562	504	1,054
Net earnings	2,068	8	1,384	1,246	946	391	315	673
Net cash from operations	608 ^c	2,908	1,750	1,612	1,705	1,389	1,259	1,331
Capital expenditures (net)	1,161	1,411	974	1,019	441	446	985	1,080
Balance Sheet Items								
Working capital (deficit)	690	94	1,990	1,719	977	455	(442)	(459)
Total assets	10,752	11,516	8,219	7,360	6,386	5,577	5,673	5,344
Short-term borrowings	—	—	—	—	—	—	713	713
Long-term debt	2,048	1,299	550	549	549	549	550	551
Shareholders' equity	5,272	4,482	5,115	4,385	3,675	3,046	2,491	2,284

Notes:^aConsumer Products Group.^bThe special charge in 2013 comprised a payment to Kraft Foods arising from litigation. Special charges in other years were restructuring costs.^cOperating cash flow was reduced by the \$2.8 billion payment made to Kraft.

trip to Italy, he discovered the joys of the Milanese coffee houses which offered a combination of good coffee, ambiance, social interaction, and the artistry of the barista. His ideas for recreating Starbucks to be a place where people would come to share the experience of drinking great coffee rather than to buy coffee beans failed to persuade the founders. Schultz left to open his own Italian-styled coffee bar, Il Giornale. In 1987, he acquired the Starbucks chain of six stores, merged it with his three Il Giornale bars, and adopted the Starbucks name for the enlarged company.²

FIGURE 1 Starbucks' share price (\$), May 2005 to May 2015 (adjusted for splits)

Schultz's original idea of replicating Italian coffee bars (where customers mostly stand to drink coffee) was adapted to "the American equivalent of the English pub, the German beer garden and the French café."³ With the addition of wi-fi, Starbucks' stores became a place to work as well as to socialize. By 1992, Starbucks, with 165 outlets, went public. With \$27 million from the stock offering, Schultz accelerated growth. Expansion followed a cluster pattern: opening multiple stores in a single metro area in order to increase local brand awareness and to help customers make a Starbucks' visit part of their daily routine. International expansion began with Japan in 1996 and the UK in 1998. Starbucks relied mainly on organic growth, but with occasional acquisitions: the UK-based Seattle Coffee Company in 1998, Seattle's Best Coffee and Torrefazione Italia in 2003, and Diedrich Coffee in 2006.

The Starbucks Experience

Starbucks' mission "to inspire and nurture the human spirit" required not just serving excellent coffee but also engaging customers at an emotional level. As Schultz explained: "We're not in the coffee business serving people, we are in the people business serving coffee."

Central to Starbucks' strategy was Schultz's concept of the "Starbucks Experience," which centered on the creation of a "third place"—somewhere other than home and work where people could engage socially while enjoying the shared experience of drinking good coffee. The Starbucks Experience combined several elements:

- Coffee beans of a high, consistent quality and the careful management of a chain of activities that resulted in their transformation into the best possible espresso coffee: “We’re passionate about ethically sourcing the finest coffee beans, roasting them with great care, and improving the lives of the people who grow them.”
- Employee involvement. Starbucks’ counter staff—the baristas—played a central role in delivering the Starbucks Experience. Their role was not only to brew and serve coffee but also to engage customers in the ambiance of the Starbucks coffee shop. This was supported by human resource practices based upon a distinctive view about the company’s relationship with its employees. Employees needed to be committed and enthusiastic communicators of the principles and values of Starbucks, which implied treating employees as business partners. Starbucks’ human resource practices were tailored, first, to attracting and recruiting people whose attitudes and personalities were consistent with the company’s values and, second, to foster trust and loyalty that facilitated their engagement with the Starbucks experience. Starbucks’ employee selection emphasized adaptability, dependability, capacity for teamwork, and willingness to further Starbucks’ principles and mission. Its training program extended beyond basic operational and customer-service skills and placed particular emphasis on educating employees about coffee. Unique among catering chains, Starbucks provided health insurance for almost all regular employees, including part-timers. In 2014, Starbucks introduced its College Achievement Plan, providing tuition reimbursement for employees taking online degree programs from Arizona State University.
- Community relations and social purpose. Schultz viewed Starbucks as redefining the role of business in society: “I wanted to build the kind of company my father never had the chance to work for, where you would be valued and respected wherever you came from, whatever the color of your skin, whatever your level of education ... We wanted to build a company that linked shareholder value to the cultural values that we want to create with our people.”⁴ Schultz’s vision was of a company that would earn good profits but would also do good in the world. This began at the local level: “Every store is part of a community, and we take our responsibility to be good neighbors seriously. We want to be invited in wherever we do business. We can be a force for positive action—bringing together our partners, customers, and the community to contribute every day.”⁵ It extended to Starbucks’ global role: “we have the opportunity to be a different type of global company. One that makes a profit but at the same time demonstrates a social conscience.” Starbucks’ sponsoring of social causes was not without controversy: its March 2015 “Race Together” campaign, which encouraged employees to discuss racism with customers, was hit by a “cascade of negativity” on Twitter and was soon abandoned.⁶
- The layout and design of Starbucks’ stores were critical elements of the experience. Like everything else at Starbucks, store design was subject to meticulous planning, following Schultz’s dictum that “retail is detail.” While every Starbucks store is adapted to its unique neighborhood, all stores reflect some

common themes. "The design of a Starbucks store is intended to provide both unhurried sociability and efficiency on-the-run, an appreciation for the natural goodness of coffee and the artistry that grabs you even before the aroma. This approach is reflected in the designers' generous employment of natural woods and richly layered, earthy colors along with judicious high-tech accessorizing ... No matter how individual the store, overall store design seems to correspond closely to the company's first and evolving influences: the clean, unadulterated crispness of the Pacific Northwest combined with the urban suavity of an espresso bar in Milan."⁷

- Starbucks' location strategy—its clustering of 20 or more stores in each urban hub—was viewed as enhancing the experience both in creating a local "Starbucks buzz" and in facilitating loyalty by Starbucks' customers. Starbucks' analysis of sales by individual store found little evidence that closely located Starbucks stores cannibalized one another's sales. To expand sales of coffee-to-go, Starbucks began adding drive-through windows to some of its stores and building new stores adjacent to major highways.

Broadening the Experience

Delivering the Starbucks Experience encouraged Starbucks to broaden its product range. "The overall strategy is to build Starbucks into a destination," explained Kenneth Lombard, then head of Starbucks Entertainment. This involved adding food, music, books, and videos. In music publishing, Starbucks' "Artists Choice" CDs, for which well-known musicians chose their favorite tracks, were particularly successful. "I had to get talked into that one," says Schultz. "But then I began to understand that our customers looked to Starbucks as a kind of editor. It was like, 'We trust you. Help us choose.'"

Starbucks also diversified its business model to include other ownership and management formats, additional products, and different channels of distribution. These included:

- Licensed coffee shops and kiosks. The desire to reach customers in a variety of locations eventually caused Starbucks to abandon its policy of only selling through company-owned outlets. Its first licensing deal was with Host Marriot, which owned food and beverage concessions in several US airports. This was followed by licensing arrangements with Safeway and Barnes & Noble for opening Starbucks coffee shops in their stores. Overseas, Starbucks increasingly relied upon licensing arrangements with local companies.
- Distribution of Starbucks retail packs of Starbucks coffee through super-markets and other retail food stores.
- Licensing of Starbucks brands to PepsiCo and Unilever for the supply of Starbucks bottled drinks (such as Frappuccino and Tazo Tea).
- Starbucks' involvement in financial services began with its Starbucks prepaid store card, which was later combined with a Visa credit card (the Starbucks/Bank One Duetto card). The Starbucks card allowed entry to the Starbucks reward program, which offered free drinks and other benefits to regular customers.

Adjusting the Strategy

Crisis and Retrenchment, 2007–2009

Starbucks' downturn of 2007–2009 was triggered by slowing growth of same-store sales and operating profits and exacerbated by the financial crisis. Amidst concerns over Starbucks' strategy and future prospects, chairman and founder Howard Schultz returned as CEO at the beginning of 2008.

Schultz's turnaround strategy comprised two initiatives. First, retrenchment: Schultz cancelled new store openings and revised operational practices to improve cost efficiency. In the summer of 2008, he announced the closure of 600 US stores and most Australian stores; 6,000 jobs were lost in the stores and 700 positions in corporate and support activities. Savings in operating costs of \$500 million in 2009 included Schultz cutting his own salary from \$1.2 million to \$10,000 and selling two of Starbucks' three corporate jets.⁸

The second thrust was the reaffirmation of Starbucks' values and business principles, including revitalizing the "Starbucks Experience" and reconnecting with its customers. Reinvigorating Starbucks' social commitment played a central role in the rediscovery process. During 2008, a company-wide reconsideration of Starbucks' purpose and principles resulted in a revised mission statement and a stronger commitment to corporate social responsibility. Initiatives included participation in the New Orleans clean-up after Hurricane Katrina and launching Starbucks' Shared Planet: an environmental sustainability and community service program.

Schultz's review of operating practices to assess their consistency with the Starbucks Experience and Starbucks' image resulted in reducing the automation of coffee making. To speed up coffee making, Starbucks had replaced its La Marzocco espresso machines, which required grinding coffee for each cup, with automatic machines that required baristas to press a button. During 2008, Starbucks began replacing these automated machines with new coffee machines that made individual servings from freshly ground beans. Revisions to Starbucks' food menu included withdrawing toasted breakfast sandwiches whose aromas masked that of the coffee: "The breakfast sandwiches drive revenue and profit but they are in conflict with everything we stand for in terms of the coffee and the romance of the coffee," noted Schultz.⁹

Reconnecting with customers involved the extensive use of new digital media. Starbucks was a leader in the use of Facebook and Twitter for promotional and loyalty-building purposes. Starbucks also pioneered new payment methods to facilitate transactions and build customer loyalty. The original Starbucks Card, an in-store debit card, was launched in 2002 and was subsequently linked to a loyalty program offering rewards based upon cumulative purchases. The loyalty program was relaunched in 2011 as "My Starbucks Rewards" and was linked to an innovative cell phone payment system. Customers displayed a two-dimensional barcode on their cell phones which was scanned at the point-of-sale. By 2015, ten million customers had downloaded the Starbucks app and mobile transactions accounted for 14% of its US sales.

Most of all, Schultz traveled extensively meeting with employees ("partners") to reignite their drive and enthusiasm and reinforce Starbucks' values. At a series of meetings held in concert halls and other venues, Schultz recounted inspiring tales

that exemplified the “humanity of Starbucks” and challenged his store managers to return to the values and practices that had made Starbucks a special place.¹⁰

Diversification within the US, 2009–2015

With operational efficiency, customer connections, and core values and principles restored, Starbucks returned to growth. In the US market the primary emphasis was on exploiting new revenue opportunities. Overseas, it was building Starbucks’ presence in emerging markets,

Major US initiatives included:

- The introduction of Via, a new type of instant coffee, launched in February 2009 at \$2.95 for a pack of three individual servings and \$9.95 for 12 servings. Via used a patented process which allowed the company to “absolutely replicate the taste of Starbucks coffee.” In less than two years, sales of Via reached \$200 million.
- Entry into single-serve pod coffee systems. In 2011, Starbucks began producing Starbucks’ K-cup pods for Keurig machines. In 2012, Starbucks introduced its own pod-based home espresso system.
- In November 2011, Starbucks acquired premium juice maker Evolution Fresh Inc. with a view to expanding the retail distribution of fruit juices both within its own stores and to the grocery trade.
- In June 2012, Starbucks acquired San Francisco bakery La Boulange, with a view to distributing pastries and baked goods to 2,500 Starbucks stores by the end of 2013.
- In November 2012, Starbucks acquired Teavana Holdings, Inc. for \$620 million with a commitment “to grow and extend Teavana’s already-successful 300 mall-based stores as well as add a high-profile neighborhood store concept that will accelerate Teavana’s domestic and global footprint.” Schultz anticipated over 1,000 Teavana stores and argued that “the tea category is ripe for reinvention and rapid growth. The Teavana acquisition now positions us to disrupt and lead, just as we did with espresso starting three decades ago.”¹¹
- In June 2014, Starbucks introduced its Fizzio Handcrafted Sodas: individually prepared soda drinks in three flavors made from all-natural ingredients.

Several of these initiatives involved growing Starbucks’ sales to the grocery sector. Under Schultz’s leadership Starbucks’ Channel Development (previously the Consumer Products Group) became the fastest-growing part of the company. The strategy was based upon exploiting complementarities between Starbucks’ coffee-houses and the grocery trade:

Starbucks can seed and introduce new products and new brands inside our stores. We introduced Via instant coffee in our stores. Instant coffee is a \$24 billion global category that has not had any innovation in over 50 years. And no growth. If we took Via and we put it into grocery stores and it sat on a shelf, it would have died. But we can integrate Via into the emotional connection we have with our customers in our stores. We did that for six to eight months and succeeded well beyond expectations. And as a result of that, we had a very easy time convincing the trade, because they wanted it so badly.¹²

FIGURE

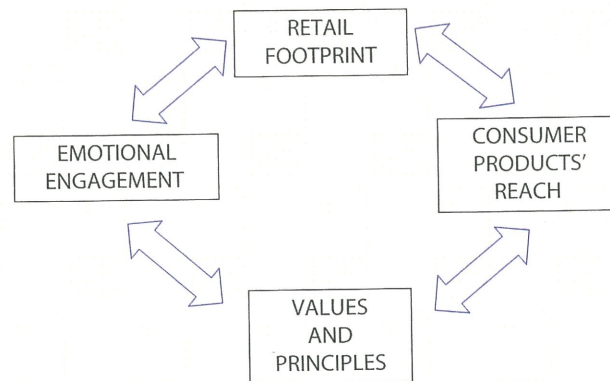
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FIGURE 2 Starbucks' "Blueprint for Profitable Growth"

This use of Starbucks' stores to lead sales through traditional grocery channels became Starbucks' "Blueprint for Profitable Growth" (Figure 2). At the base of the model were Starbucks' values and business principles. As Schultz explained: "We have built the Starbucks brand with a goal of staying true to our values and our guiding principles with a deep sense of humanity. Going forward, we will continue to focus on what made us a different kind of company, one that balances profitability and social conscience while providing exceptional shareholder value."¹³ These values were the basis for Starbucks' emotional engagement with its customers. Increasingly, Starbucks augmented face-to-face customer contact within its stores with its use of social media to extend and deepen its relationships with customers. Starbucks' social media team connects with consumers through over 30 accounts on 12 different social platforms—the most important being Facebook, Twitter, Instagram, Google+, and Pinterest. This online engagement has greatly facilitated Starbucks' expansion into new overseas markets and the introduction of Starbucks-branded products in the grocery trade.

International Expansion, 2009–2015

Schultz saw emerging markets, China in particular, as a huge opportunity for Starbucks:

The big opportunity, in terms of total stores, is what's happening in China; we've got 800 stores in greater China, 400 in the mainland. When all is said and done, we'll have thousands. We're highly profitable there. We've been there 12 years, and I would say that the hard work—in terms of building the foundation to get access to real estate, design stores, and operate them—is well in place.¹⁴

India was next. In January 2012, Starbucks announced a 50/50 joint venture with Tata Global Beverages to establish a chain of Starbucks coffeehouses. By July 2014, Tata Starbucks Ltd. had 50 outlets in India, mainly in airports, malls, and commercial complexes.

Other new market entries during 2012–2014 included Morocco, Colombia, Vietnam, Monaco, Brunei, Costa Rica, Finland, and Norway. In 2014, Starbucks took full ownership of Starbucks Japan, buying out its Japanese partner for \$915 million. Table 2 shows store information by region.

TABLE 2 Starbucks Corporation: Store information, 2007–2014

	2014	2013	2012	2011	2010	2009	2008	2007
Percentage change in same store sales								
Americas	6	7	8	8	7	(6)	(5)	42
EMEA ^a	5	0	0	3	5	(3)		
China/Asia-Pacific	7	9	15	22	11	2	21	71
Consolidated	6	7	7	8	7	(6)	(3)	5
Stores opened during the year (net of closures)								
Americas								
Company-operated stores	317	276	228	32	32	(419)	4,452	10,652
Licensed stores	381	404	280	215	101	110	4,382	7,232
EMEA								
Company-operated stores	(9)	(29)	10	25	(64)	20	2,361	2,861
Licensed stores	180	129	101	79	100	98	5,501	497
China/Asia-Pacific								
Company-operated stores	250	240	154	73	30	24	n.a.	n.a.
Licensed stores	492	348	294	193	79	129	n.a.	n.a.
All other segments								
Company-operated stores	12	343	0	6	(1)	(2)	n.a.	n.a.
Licensed stores	(24)	(10)	(4)	(478)	10	(5)	n.a.	n.a.
Total	1,599	1,701	1,063	145	223	(45)	1,669	2,571
Total number of stores at year-end								
Americas								
Company-operated stores	8,395	8,078	7,802	7,574	7,542	7,574	72,382	67,932
Licensed stores	5,796	5,415	5,011	4,731	4,516	4,415	43,292	38,912
EMEA								
Company-operated stores	817	853	882	872	847	911	2,093	1,831
Licensed stores	1,323	1,116	987	886	807	707	3,020	2,496
China/Asia-Pacific								
Company-operated stores	1,132	906	666	512	439	409	n.a.	n.a.
Licensed stores	3,492	2,976	2,628	2,334	2,141	2,062	n.a.	n.a.
All other segments								
Company-operated stores	369	357	14	14	8	9	n.a.	n.a.
Licensed stores	42	66	76	80	558	548	n.a.	n.a.
Total	21,366	19,767	18,066	17,003	16,858	16,635	16,680	15,011

Note:^aEurope, Middle East, and Africa.

n.a. = not available.

Source: Starbucks Corporation, 10-K reports.**TABLE**1 Bet
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TABLE 3 Seven strategies for growth

3	2007	Theme	Action	Notes
	42	1 Be the Employer of Choice	Invest in partners capable of delivering a superior customer experience	First and foremost, Starbucks is a people business: customers' relationship with Starbucks employees is a key determinant of customer loyalty
	71	2 Coffee Leadership	Build our leadership position around coffee	Central to Starbucks' commitment to quality coffee is close control of its supply chain right back to the grower
	5			During 2015, 99% of Starbucks' coffee would be ethically sourced and sustainably produced
2	10,652	3 Grow the Store Portfolio	Increase the scale of the Starbucks store footprint with disciplined expansion	Number of stores in China Asia-Pacific to double during 2015–2019, including growth from 1,600 to 3,400 stores in China
2	7,232			India would become one of Starbucks' top-five markets
1	2,861			In N. America new retail formats include small stores, Starbucks' mobile trucks for college campuses, and "Reserve" roasteries
1	497	4 Create New Occasions	Grow store usage throughout the day with new product offers	New food offerings to include hot breakfast items, lunchtime meals, and evening snack and alcoholic drinks
	n.a.	5 Consumer Product Brand Growth	Focus on the Starbucks brand to unlock industry-leading profitable growth	Starbucks to grow sales of packaged coffee and ready-to-drink coffee beverages by 60% by 2019
	n.a.			Growth will come primarily for Asia-Pacific—especially China where Starbucks partnering with Tingy
	n.a.	6 Build Teavana	Create a second major business in tea	Teavana to spearhead Starbucks' growth within the \$125 billion global market for tea
9	2,571			Starbucks' tea revenues to double by 2019
		7 Extend Digital Engagement	Drive convenience and brand engagement through mobile commerce platforms	Starbucks' growth to be underpinned by its Rewards program and its mobile payments platform
32	67,932			New features to the Starbucks mobile app include advance ordering and payment prior to pick-up at a Starbucks store
32	38,912			
3	1,831			
0	2,496			

Source: Starbucks 2015 Annual Meeting of Shareholders, Growth Strategy Panel Discussion.

Starbucks' Strategy, 2015

By 2015, these themes had been developed into a seven-part strategy that was outlined by Beto Guajardo, senior vice president for global strategy. The "Seven Strategies for Growth" are summarized in Table 3.

The Market for Coffee

Coffee was the most popular beverage of North America and Europe, with Northern Europeans the heaviest consumers (Table 4).

The US was the world's biggest market for coffee with expenditure (for consumption at home, at work, and at catering establishments) of \$52.5 billion in 2013. In terms of expenditure, the market was split roughly equally between sales for

TABLE 4 Coffee consumption per head of population, 2014

Rank	Country	Kilograms	Rank	Country	Kilograms
1	Finland	9.6	11	Bosnia-Herzegovina	4.3
2	Norway	7.2	12	Estonia	4.2
3	Netherlands	6.7	13	Switzerland	3.9
4	Slovenia	6.1	14	Croatia	3.8
5	Austria	5.5	15	Dominican Republic	3.7
6	Serbia	5.4	16	Costa Rica	3.7
7	Denmark	5.3	17	Macedonia	3.6
8	Germany	5.2	18	Italy	3.4
9	Belgium	4.9	19	Canada	3.4
10	Brazil	4.8	20	Lithuania	3.3

Source: Euromonitor (www.caffeineinformer.com/caffeine-what-the-world-drinks).

the home-brewed coffee and sales of ready-brewed coffee. However, in terms of consumption, 80% of the coffee consumed in the US was at home. Sales of home-brewed coffee had recently reversed their long-term decline due to the popularity of single-serve coffee makers.

The US market could also be segmented between “ordinary” coffee and “specialty” coffee (also known as “premium” or “gourmet” coffee). Although specialty coffeehouses had existed for many decades, especially on the east and west coasts of the US, Starbucks’ achievement had been to bring quality coffee to the mass market. Sales of premium brewed coffee were estimated to have grown from about \$3.5 billion in 2000 to about \$13 billion in 2013, with the number of coffee shops roughly doubling over the same period to reach 29,000.

Although Starbucks had been the primary driver of this growth, its success had spawned many imitators. These included both independent coffeehouses and chains, most of which were local or regional, although some aspired to grow into national chains (Table 5).

In addition to specialty coffeehouses, most catering establishments in the US, whether restaurants or fast-food chains, served coffee as part of a broader menu of food and beverages. Increasingly, these outlets were seeking to compete more directly with Starbucks by adding premium coffee drinks to their menus. McDonald’s had introduced a premium coffee to its menu but had reconfigured its outlets to include McCafés which highlighted its premium coffee drinks. Burger King and Dunkin’ Donuts had also moved upmarket in their coffee offerings. Both McDonald’s and Dunkin’ Donuts had targeted Starbucks in their advertising, characterizing Starbucks as overpriced and snobbish.

Outside of the US, Starbucks’ competitive situation varied by country. In many, competition was even more intense than in the US. For example, Starbucks’ withdrawal from Australia was a consequence of a highly sophisticated coffee market developed by southern European and Middle Eastern immigrants. Throughout continental Europe, Starbucks had to deal with well-developed markets with high standards of coffee preparation and strong local preferences. In the UK, where Starbucks was second to Costa in terms of outlets, it was barely profitable.

TABLE 5 Leading chains of coffee shops in the US, 2014

Company	No. of outlets	Headquarters
Starbucks	10,780	Seattle, WA
Tim Hortons	714	Oakville, Ontario
Caribou Coffee	415	Brooklyn Center, MN
Coffee Bean and Tea Leaf	296	Los Angeles, CA
Peet's Coffee & Tea	193	Emeryville, CA
Tully's Coffee Shops	180	Seattle, WA
Coffee Beanery	131	Flushing, MI
It's A Grind Coffee House	105	Long Beach, CA
Gloria Jean's	90	Chicago, IL
Dunn Bros Coffee	85	St Paul, MN
PJ's Coffee	50	New Orleans, LA
Port City Java	32	Wilmington, NC

Source: Multiple web sources.

As well as competition from the bottom (McDonald's, Dunkin' Donuts), Starbucks faced competition from the top. The upmarket Italian coffee roaster Illycaffè SpA was expanding in the US through franchise arrangements with independent coffee-houses. Some observers believed that once Starbucks had educated North Americans about the joy of good coffee consumers of gourmet coffee would go on to seek superior alternatives to Starbucks.

The home-brewed coffee market was also being revolutionized. Sales of Italian-style espresso coffee makers, which used highly pressurized hot water to make coffee, had grown rapidly since 2000. The key stimulus had been the popularity of single-serve coffee pod systems pioneered by Nestlé's Nespresso subsidiary. In the US, Keurig Green Mountain with its K-Cup system was the market leader. Other major entrants were the Senseo system launched by Philips and Sara Lee, Kraft's Tassimo system, Lavazza's Espresso Point system, and Illy's Iperespresso system. In March 2012, Starbucks joined the fray by launching its own single-serve, home coffee makers under its Verismo brand. Starbucks also supplied K-Cups for Keurig coffee makers. By 2014, Starbucks was US brand leader in retail sales of both premium packaged coffee and single-cup capsules (Table 6).

TABLE 6 Brand market shares of packaged coffee shops in the US, 2014

Premium roast ground coffee		Single cup servings	
Brand	Market share (%)	Brand	Market share (%)
Starbucks	26.1	Starbucks	16.3
Dunkin' Donuts	14.8	Green Mountain	15.9
Private label	8.5	Private label	11.2
Peet's Coffee & Tea	7.7	Folgers Select	9.5
Eight O'clock	7.6	Coffee People	6.5

Source: Multiple web sources.

Looking Ahead

The credibility of the growth projections revealed by Beto Guajardo, head of global strategy, at Starbucks' 2015 shareholders meeting was reinforced by the release of the company's quarterly financial results on April 26, 2015. For the quarter ended March 26, 2015, revenues were 18% higher than the corresponding quarter in 2014 and operating profit was 21% higher. Among 30 investment analysts polled by the *Financial Times* on April 24, 2015, 23 assessed Starbucks as a "buy" or "outperform."

Yet amidst the acclaim for Starbucks' resumption of its growth path since 2009 and confidence in its expansion strategy for the future, doubts existed over the company's ability to sustain its outstanding performance record. Several of these risks were identified in Starbucks' 10-K report for 2014, including:

- Risks to Starbucks' brand reputation resulting from "business incidents, whether isolated or recurring and whether originating from us or our business partners, that erode consumer trust, such as actual or perceived breaches of privacy, contaminated food, recalls or other potential incidents..."¹⁵
- Growing competition in all of Starbucks' markets: "In the US, the ongoing focus by large competitors in the quick-service restaurant sector on selling high-quality specialty coffee beverages could lead to decreases in customer traffic to Starbucks ... Similarly, continued competition from well-established competitors in our international markets could hinder growth ... Increased competition in the US packaged coffee and tea and single-serve and ready-to-drink coffee beverage markets, including from new and large entrants to this market, could adversely affect the profitability of the Channel Development segment. Additionally, declines in general consumer demand for specialty coffee products for any reason, including due to consumer preference for other products, could have a negative effect on our business."¹⁶
- Saturation of the US market: "because the Americas segment is relatively mature and produces the large majority of our operating cash flows, such a slowdown or decline could result in reduced cash flows..."¹⁷
- In international markets, Starbucks' future growth was heavily dependent upon China and Asia Pacific. Here risk factors included political and regulatory uncertainties, difficulties of protecting intellectual property and enforcing contracts, reliance upon foreign partners, and the challenge of adapting to differences in consumer tastes and business and employment practices.

Some observers expressed concern over Starbucks' growing diversification—both its widening range of food and beverage products and its entry supplying the grocery trade, about which Barclays Capital analyst Jeff Bernstein observed: "They're starting a new chapter from scratch ... the question has to be: Do you realize the magnitude of the task you're taking on?"¹⁸ Other commentators expressed concern over the possible erosion of the Starbucks Experience and Starbucks' identity as it extended into tea, soda drinks, hot food, instant coffee, and drive-through stores.

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Appendix: Starbucks' Country and Segment Data

Starbucks' Stores by Country

TABLE A1 Starbucks' company operated stores

	2014	2012
US	7,303	6,856
Canada	983	874
Brazil	89	53
Puerto Rico	20	19
UK	506	593
Germany	152	157
France	78	67
Switzerland	55	50
Austria	17	12
Netherlands	7	3
China	823	408
Thailand	203	155
Singapore	106	80
All other ^a	369	14
Total	10,711	9,327

Note:

^aIncludes Seattle's Best Coffee, Teavana, and Evolution Fresh.

Source: Starbucks Corporation 10-K reports.

TABLE A2 Starbucks' licensed stores

	2014	2012
US	4,659	4,189
Mexico	434	356
Canada	462	300
Other Americas	241	166
UK	285	168
Turkey	220	171
United Arab Emirates	115	99
Spain	86	78
Kuwait	72	65
Saudi Arabia	67	64
Russia	87	60
Other EMEA ^a	391	282
Japan	1,060	965
China	544	292
South Korea	700	467
Taiwan	323	271
Philippines	240	201
Other CAP	625	432
Other licensed	42	76
Total licensed	10,653	8,702

Note:

^aEMEA: Europe, Middle East, and Africa.

Source: Starbucks Corporation 10-K reports.

Starbucks' Segment Results, 2013 and 2014

TABLE A3 Starbucks' Americas segment (\$million)

	2014	2013
Net revenues:		
Company-operated stores	10,866.5	10,038.3
Licensed stores	1,074	915.4
CPG, food service and other	39.1	47.1
Total net revenues	11,979.6	11,000.8
Cost of sales including occupancy costs	4,487.0	4,214.9
Store operating expenses	3,946.8	3,710.2
Other operating expenses	100.4	96.9
Depreciation and amortization expenses	469.5	429.3
General and administrative expenses	167.8	186.7
Total operating expenses	9,171.5	8,638.0
Income from equity investees	—	2.4
Operating income	2,808.1	2,365.2

Source: Starbucks Corporation, 10-K report for 2014.

TABLE A4 Starbucks' EMEA^a segment (\$million)

	2014	2013
Net revenues:		
Company-operated stores	1,013.8	932.8
Licensed stores	238.4	190.3
CPG, food service and other	42.6	36.9
Total net revenues	1,294.8	1,160.0
Cost of sales including occupancy costs	646.8	590.9
Store operating expenses	365.8	339.4
Other operating expenses	48.2	38.5
Depreciation and amortization expenses	59.4	55.5
General and administrative expenses	59.1	71.9
Total operating expenses	1,179.3	1,096.2
Income from equity investees	3.7	0.4
Operating income	119.2	64.2

Note:

^aEMEA is Europe, Middle East, and Africa.

Source: Starbucks Corporation, 10-K report for 2014.

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3. J. Wiggins "Whe Times (Decembe
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TABLE A5 Starbucks' China/Asia Pacific segment (\$million)

	2014	2013
Net revenues:		
Company-operated stores	859.4	671.7
Licensed stores	270.2	245.3
Total net revenues	1,129.6	917.0
Cost of sales including occupancy costs	547.4	449.5
Store operating expenses	221.1	170.0
Other operating expenses	48.0	46.1
Depreciation and amortization expenses	46.1	33.8
General and administrative expenses	58.5	48.4
Total operating expenses	921.1	747.8
Income from equity investees	164.0	152.0
Operating income	372.5	321.2

Source: Starbucks Corporation, 10-K report for 2014.

TABLE A6 Starbucks' Channel Development segment

	2014	2013
Net revenues:		
CPG	1,178.8	1,056.0
Food service	367.2	342.9
Total net revenues	1,546.0	1,398.9
Cost of sales	882.4	878.4
Other operating expenses	187.0	179.4
Depreciation and amortization expenses	1.8	1.1
General and administrative expenses	18.2	21.1
Total operating expenses	1,089.4	1,080.0
Income from equity investees	100.6	96.6
Operating income	557.2	415.5

Note:

Channel Development comprises sales of packaged coffee, packaged beverages, and other products to the grocery and food service trades.

Source: Starbucks Corporation, 10-K report for 2014.

Notes

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Case 7 Harley-Davidson, Inc., May 2015

For us and for our loyal customers, the motorcycles we build aren't just motorcycles. They are living pieces of American history, mystique on two wheels. They are the vehicle with which our riders discover the power, the passion, and the people that define the Harley-Davidson Experience.

—HARLEY-DAVIDSON, INC.¹

On May 1, 2015, Matt Levatich took over as CEO of Harley-Davidson, Inc.. Levatich was 48 years old and had joined Harley as a management trainee in 1994. He held an engineering degree from Rensselaer Polytechnic Institute and an MBA from Northwestern. The company he was taking charge of was not among the world's biggest motorcycle companies—it shipped 270,726 bikes in 2014 compared to Honda's 17 million. However, it was the world's most financially successful motorcycle manufacturer: it earned a higher sales margin and a higher return on equity than any of its rivals.

Levatich's predecessor was Keith Wandell, who had stabilized Harley after the financial crisis of 2008–2009 and returned the company to its growth path. During Wandell's six-year tenure, Harley's cumulative total return to shareholders was 280%, compared to 172% for the S&P 500 as a whole.

The road ahead, however, looked distinctly bumpy. On Levatich's first day as CEO, investment advisor James Berman published a newsletter that asked the question: "Is the long, classic American love affair with Harleys a thing of the past?"² Harley's profit growth depended on its ability to keep expanding the sales of its high-priced, heavyweight motorcycles. While no other company could replicate the emotional attachment of riders to the "Harley Experience," there was always the risk that motorcycle riders might seek a different type of experience and become more attracted to the highly engineered models produced by European and Japanese manufacturers. Equally worrying was the fear that motorcycles might lose their appeal both as a leisure activity and as a male status symbol. Such concerns were fueled by demographic trends. Harley's core market was the baby-boomer generation—and this cohort was moving more toward retirement homes than outdoor sports. Would the next cohorts—Generation X and Generation Y—have the same affinity for noisy, heavyweight motorcycles and the cultural values that Harley-Davidson

represented? Moreover, with consumer spending weak in both North America and Europe—Harley's two biggest markets—the demand for luxury leisure products costing between \$7000 and \$38,000 was likely to be subdued.

The History of Harley-Davidson

From Birth to Maturity, 1903–1981

Harley-Davidson, Inc. was founded in 1903 by William Harley and the three Davidson brothers: William, Arthur, and Walter. In 1909, Harley introduced its two-cylinder, V-twin engine with its deep, rumbling sound; this engine type would be the characteristic feature of Harley-Davidson motorcycles for the next hundred years. At that time there were about 150 US motorcycle producers in the US; by 1953, Harley-Davidson was the sole survivor.

The postwar affluence and the rise of youth culture created a growing demand for motorcycles. This was satisfied primarily by imports: first the British (BSA, Triumph, and Norton) and then the Japanese (led by Honda). Harley benefitted from the rebirth of motorcycling as a leisure activity. However, its acquisition by the leisure conglomerate AMF in 1969 was followed by quality problems and financial losses.

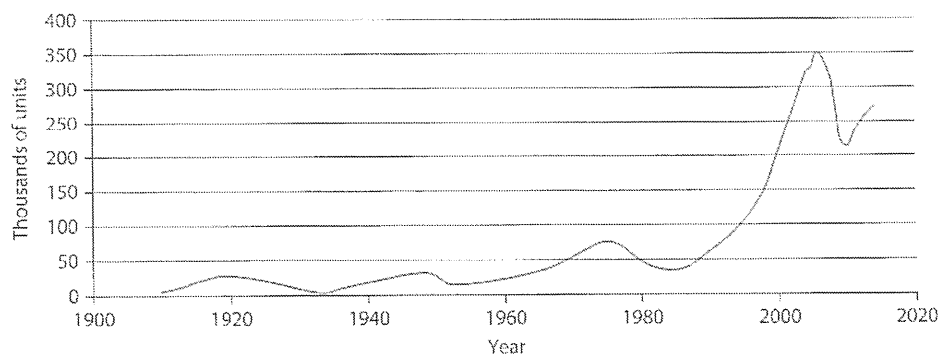
Rebirth, 1981–2008

In 1981, Harley's senior managers led a leveraged buyout of the company. Despite a perilous financial condition, the management team embarked upon rebuilding production methods and working practices. Managers visited Japanese automobile plants and introduced their own version of Toyota's just-in-time (JIT) system called "MAN" (materials-as-needed). Harley's manufacturing plants adopted collaborative processes of quality management.

The 1986 initial public offering of Harley-Davidson's shares fueled investment in new models, plants, and dealerships. Harley's share of the market for heavyweight motorcycles (over 500cc) grew steadily. During the 1990s, Harley's biggest challenge was satisfying the surging demand for its products. In 1996, Harley announced its Plan 2003 to dramatically increase production capacity in the period preceding its 100th anniversary in 2003. In 2004, Harley sold more than 300,000 motorcycles, a tenfold increase on 1983. From 1984 to 2008, Harley's output and revenue had grown in every single year (Figure 1).

Downturn and Readjustment, 2008–2014

The financial crisis of 2008 put an abrupt end to growth. After decades of customer waiting lists and a shortage of production capacity, Harley faced plummeting sales, excess inventory, and problems of bad debts as customers defaulted on their loan repayments. In the shrinking motorcycle markets of North America and Europe, Harley—with the highest average retail price of any major manufacturer—suffered disproportionately. Amidst the credit crunch, Harley-Davidson Financial Services (HDFS), which supplied credit, insurance, and extended warranties to Harley dealers and customers, was unable to securitize its customer loans and was forced to retain them on its own books.

FIGURE 1 Annual shipments of motorcycles by Harley-Davidson

Sources: Harley Davidson annual reports and Harley-Davidson archives.

When Keith Wandell took over as Harley's CEO in May 2009, his priorities were to restore funding for Harley's consumer lending, align production and employment with lower demand, and refocus on the core Harley-Davidson brand—which involved closing Buell Motorcycles³ and selling Italian subsidiary MV Agusta.⁴ In 2009, Harley posted a net loss for the year—its first as a public company. (Appendix Table A1 provides details of Harley-Davidson's financial performance.)

During 2010–2014, Wandell established “a bold, clear strategic direction that would maximize our opportunities going forward and restore the company as a strong business that could consistently grow over the long haul.”⁵ The resulting transformation of Harley included:

- Rethinking and restructuring of manufacturing operations including reducing capacity and increasing flexibility to allow a wider range of models to be produced and to match production to seasonal fluctuations in demand—what Harley called its “surge production system.”
- Expanding international sales. The primary focus for Harley's overseas sales had been Europe—the world's biggest market for heavyweight motorcycles. With Europe mired in recession, emphasis shifted to building distribution and growing sales in the emerging markets of Asia and Latin America. In 2011, Harley opened an Asia-Pacific regional headquarters in Singapore, and an assembly plant in India.⁶
- Expanding the customer base. To reestablish growth in North America, Harley needed to broaden its customer base from its core demographic of white males of 45 years or more. Targeted groups included: women riders, “Harlistas” (Latino riders), “Iron Elite” (African-American riders), “Harley's Heroes” (military and veteran riders), and, most of all, younger riders through new models. The result was a major investment in new product development. During 2013, Harley launched its “Project Rushmore” motorcycles: “The first to come through our new, world-class product development pipeline and introduce major innovation and design improvements. They were developed with

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a level of consumer input that brought the voice of the customer to product design in an unparalleled way for us.”⁷ They were followed by the “Street” models—lighter, sports motorcycles featuring new, liquid-cooled 500cc and 750cc engines.

The Heavyweight Motorcycle Market

Until the financial crisis of 2008–2009, the heavyweight segment had been the most rapidly growing part of the world motorcycle market, with the US accounting for a major portion of this growth. Worldwide sales of heavyweight motorcycles trebled between 1990 and 2008. However, during 2008–2010, sales dropped sharply in North America and Europe and the subsequent recovery has been slow.

In North America, Harley was the leader in heavyweight bikes, with over half the market (Table 1). Overseas, Harley had been unable to replicate this market dominance, despite strong sales in a few markets. Harley achieved the remarkable feat of becoming heavyweight market leader in Japan. It held similar leadership in Australia and Brazil. The European market was more fragmented, with Harley one among a leading group that included Honda, BMW, Suzuki, Yamaha, Kawasaki, and Triumph, each with market shares in heavyweight motorcycles of between 8 and 15%.

The heavyweight motorcycle market comprised three segments:

- *Cruiser motorcycles*: These were “big, noisy, low riding, unapologetically macho cycles,”⁸ typically with V-twin, large displacement engines and an

TABLE 1 Retail sales (registrations) of heavyweight motorcycles (601+ cc), 2005–2014 (thousands of units)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
North America										
Total market	554	579	555	477	304	260	271 ^a	299 ^a	306 ^a	316 ^a
Harley-Davidson	265	282	267	235	174	154	152 ^a	161 ^a	168 ^a	167 ^a
Market share (%)	47.8	48.6	48.7	49.3	53.2	54.9	55.7	53.8	54.9	52.8
Europe										
Total market	351	377	372	384	314	301	293	300	282	320
Harley-Davidson ^b	30	34	42	45	40	41	44	36	36	39
Market share (%)	8.5	9.1	11.3	11.7	12.0	12.7	13.7	12.1	12.8	12.0
Asia-Pacific										
Harley-Davidson	11	13	23	25	23	21	21 ^c	25 ^c	27 ^c	30 ^c
Latin America										
Harley Davidson	n.a.	n.a.	3	8	6	6	7	9	11	12

Notes:

^aUS only.

^bIncludes Middle East and Africa for 2005–2011.

^cIn each year, sales in Japan were between 10,000 and 11,000.

n.a. = not available.

Source: Harley-Davidson 10-K reports.

upright riding position. Their design reflected the dominance of styling over either comfort or speed. For the urban males (and some females) in congested cities such as Los Angeles, New York, Paris, and Tokyo, the cruiser motorcycle, while a practical mode of transportation, was primarily a statement of style. The cruiser segment was practically created by Harley and represented over two-thirds of the heavyweight market in the US. Most of Harley's competitors in this segment had imitated the main features of the traditional Harley design.

- *Touring motorcycles:* These included cruisers especially equipped for longer-distance riding and bikes especially designed for comfort over long distances (including the Honda Goldwing and the bigger BMWs). These tourers featured luxuries such as audio systems, two-way intercoms, and heaters. While Harley led this segment on the basis of style and image, Honda and BMW had engineered their motorcycles for greater smoothness and comfort over long distances through the use of multi-cylinder, shaft-drive engines and advanced suspension systems.
- *Performance motorcycles:* These were based on racing bikes, with high-technology, high-revving engines offering speed, acceleration, race-track styling, and minimal concessions to rider comfort. The segment was the most important in the European and Asia-Pacific markets, representing 62 and 65% of total heavyweight bike sales respectively. The segment was dominated by Japanese motorcycle companies, with a strong representation of European specialists, such as Ducati and Triumph. Harley had competed in this segment during 1993–2010 through Buell Motorcycles.

Unlike its Japanese competitors, Harley was highly market focused: its Harley's models were concentrated on the "super-heavyweight" segment (over 850cc) and within this on cruiser and touring motorcycles.

Harley-Davidson in 2015

The Brand

Harley-Davidson's image and the loyalty the company engendered among its customers were seen as its greatest assets. The famed spread eagle signified not just the brand of one of the world's oldest motorcycle companies but also an entire lifestyle with which it was associated. Harley has been described as "the ultimate biker status symbol ... a quasi religion, an institution, a way of life."⁹ Harley had a unique relationship with American culture. The values that Harley represented—individuality, freedom, and adventure—could be traced back to the cowboy and frontiersman of yesteryear, and before that to the quest that brought people to America in the first place. As the sole surviving indigenous motorcycle company, Harley-Davidson represented a once-great tradition of American engineering and manufacturing.

The Harley brand was central not just to the company's marketing but also to its strategy as a whole. The central thrust of the strategy was reinforcing and extending the relationship between the company and its consumers. Harley-Davidson had long

recognized that it was not selling motorcycles: it was selling the Harley Experience, which formed the central theme in almost all its external communications:

A chill sweeps through your body, created by a spontaneous outburst of pure, unadulterated joy. You are surrounded by people from all walks of life and every corner of the globe. They are complete strangers, but you know them like your own family. They were drawn to this place by the same passion—the same dream. And they came here on the same machine. This is one place you can truly be yourself. Because you don't just fit in. You belong.¹⁰

Customers and Customer Relations

If the appeal of the Harley motorcycle was the image it conveyed and the lifestyle it represented, the company's challenge was to ensure that the experience matched the image. Harley's involvement in its consumers' riding experience was through the Harley Owners' Group (HOG), which organized social and charity events. Employees, from the CEO down, were encouraged to take an active role in attending HOG shows, rallies, and rides. "The feeling of being out there on a Harley-Davidson motorcycle links us like no other experience can. It's made HOG like no other organization in the world ... more family reunion than organized meeting."¹¹ Customer loyalty led to their continuing reinvesting in Harley products: Harley-branded accessories and apparel, customizing their bikes, and eventually trading them in for a new (typically more expensive) model. About half of bike sales were to repeat customers.

Financial success involved Harley's repositioning from blue-collar youngsters to middle-aged and upper-income buyers, many of whom had never ridden a motorcycle before. Harley's core demographic was Caucasian males aged 35 and over. The average age of Harley's customers was believed to be 47.¹² In his final letter to shareholders, retiring CEO Keith Wandell reported success in expanding Harley's customer base:

For the third straight year, Harley-Davidson grew U.S. retail sales to outreach customers, which includes young adults, women, African Americans and Hispanics, at more than twice the rate of the growth in sales to core customers. International retail sales of new Harley-Davidson motorcycles grew more than 5 percent and accounted for more than 36 percent of total retail Harley-Davidson motorcycle sales, with dealers in the Asia Pacific, EMEA and Latin America regions posting their highest new retail motorcycle sales on record for each region.¹³

The Products

Broadening Harley's market appeal had major implications for product policy and design. Ever since its disastrous foray into small bikes during the AMF years, Harley had recognized that its competitive advantage lay with super-heavyweight bikes. Here it stuck resolutely to the classic styling that had characterized Harleys since the company's early years. At the heart of the Harley motorcycle was the air-cooled V-twin engine that had been Harley's distinctive feature since 1909. Harley's frames, handlebars, fuel tanks, and seats also reflected traditional designs.

Harley's commitment to traditional design features may be seen as making a virtue out of necessity. Its smaller corporate size and inability to share R & D across cars

and bikes (unlike Honda and BMW) limited its ability to invest in technology and new products. As a result, Harley lagged far behind its competitors in the application of automotive technologies: not only did its motorcycles look old-style, much of their technology was old-style. Since the Evolution engine launched in 1984, Harley has introduced just four entirely new engines.

Yet, even in its 2015 models, Harley's commitment to tradition was clear. Long after other manufacturers had moved to multiple valves per cylinder, overhead camshafts, liquid cooling, and electronic ignition, most Harley bikes featured air-cooled push-rod engines with two valves per cylinder. In suspension systems, braking systems, and transmissions, Harley was also a laggard.

Nevertheless, Harley was engaged in constant upgrading—principally incremental refinements to its engines, frames, and gearboxes—aimed at improving power delivery and reliability, increasing braking power, and reducing vibration. Harley automotive technology alliance partners included Porsche, Ford, and Gemini Racing.

Although technological innovation was limited, Harley was very active in new product development. By 2015, Harley offered 38 different models. Its Product Development Center and Prototyping Lab were among the most important units within the company. Most of Harley's product development efforts were limited to style changes, new paint designs, and engineering improvements; however, after 2000, Harley accelerated technological development. Milestones included the V-Rod model introduced in October 2001, which featured innovative styling and an all-new liquid-cooled engine; the Twin Cam 96 engine in 2006, which featured electronic ignition and a six-speed gearbox; the Street models in 2015; and Harley's prototype all-electric motorcycle. Among the 218 US patents awarded to Harley during 2000–2014, a large proportion related to the design of peripheral items: saddlebag mounting systems, footpegs, seats, backrests, electrical assemblies, and motorcycle music systems. Over the same period Honda was awarded 10,982 US patents, Kawasaki 2002, and Suzuki 625.

Central to Harley's product strategy was the belief that every Harley rider should own a unique, personalized motorcycle—hence the offer of a wide range of pre-sale and post-sale customization opportunities. New bikes offered multiple options for seats, bars, pegs, controls, and paint jobs, with over 7000 accessories, and special services such as "Chrome Consulting."

TABLE 2 Harley-Davidson shipments of motorcycles, 2003–2014

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
US ^a	237.7	260.6	266.5	273.2	241.5	206.3	144.4	131.6	152.2	160.5	167.0	174.0
International ^a	53.5	56.7	62.5	76.0	89.1	97.2	78.5	78.8	80.9	87.1	93.4	96.7
Product mix^b												
Sportster ^c	19.7	22.0	21.3	18.5	21.8	20.0	21.4	19.5	21.3	20.5	19.3	21.0
Custom	52.0	48.6	45.2	46.2	43.7	46.4	40.9	41.4	39.2	39.1	39.5	33.8
Touring	28.4	29.4	33.5	35.4	34.5	33.6	37.7	39.0	39.5	40.4	41.2	45.2
Buell	10.0	9.9	11.2	12.5	11.5	13.1	9.5	2.6	0.2	—	—	—
Company total^a	301.2	327.2	340.2	361.6	342.1	316.4	232.4	213.0	233.2	247.6	260.5	270.7

Note:

^aThousands of units.

^bPercentage of total shipments.

^cIncludes sales of Street motorcycles for 2014.

Source: Harley-Davidson 10-K reports.

TABLE 3

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Reconciling product differentiation with scale economies was a continuing challenge for Harley. The solution was to offer a wide range of customization options while standardizing key components. Thus, Harley's broad model range involved "permutations of four": four engine types, four basic frames, four styles of gas tank, and so on.

The Harley product line also covered a wide price range. The Street 500 model was priced as an entry-level bike, beginning at \$6799, less than one-fifth of the price of the CVO Limited, at \$39,349. Table 2 shows Harley's motorcycle output by product type.

Distribution

Upgrading Harley's distribution network was central to its resurgence during the 1980s and 1990s. At the time of the buyout, many of Harley's 620 US dealerships were operated by enthusiasts, with erratic opening hours, a poor stock of bikes and spares, and indifferent customer service. If Harley was in the business of selling a lifestyle and an experience, then dealers played a pivotal role in delivering that experience. Moreover, if Harley's target market had shifted toward mature, upper-income individuals, Harley needed to provide a retail experience commensurate with the expectations of this group.

Harley's dealer development program increased support for dealers while imposing higher standards of pre- and after-sales service, and requiring better dealer facilities. Dealers were obliged to carry a full line of Harley replacement parts and accessories and to offer an expanding range of services: in addition to traditional services such as service and repair and financing, dealers offered test ride facilities, rider instruction classes, motorcycle rental, consulting services for customizing bikes through dealer-based design centers and Chrome Consultants, and insurance services. Harley-Davidson Authorized Tours offered vacation packages with bikes supplied by Harley dealers. Over 90% of Harley dealerships in the US were exclusive; most other motorcycle manufacturers sold through multi-brand dealerships.

Dealer relations were a continuing strategic priority for Harley. Its Retail Environments Group established a meticulous set of performance standards and guidelines for dealers that covered every aspect of managing the showroom and interacting with actual and potential customers. Harley-Davidson University was established to "enhance dealer competencies in every area, from customer satisfaction to inventory management, service proficiency, and front-line sales."¹⁴

Expanding international sales required Harley to extend its dealer network into countries where it had little or no distribution presence. As Table 3 shows, emerging

TABLE 3 Harley-Davidson's dealership network, 2008–2014

	US		Canada		EMEA		Asia-Pacific		Latin America	
	2008	2014	2008	2014	2008	2014	2008	2014	2008	2014
Full-service dealerships	686	669	71	69	383	369	201	273	32	55

Note:

In addition, there were 152 non-traditional dealerships in 2014: US 96, Canada 4, EMEA 11, Asia-Pacific 12, and Latin America 29.

Source: Harley Davidson 10-K reports.

TABLE 4 Harley-Davidson's non-motorcycle sales, 2005–2014 (\$million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Parts and accessories	815.7	862.3	868.3	858.7	767.2	749.2	816.5	836.7	873.1	875.0
General merchandise	247.9	277.5	305.4	313.8	282.2	259.1	274.1	282.5	295.9	284.8
Financial services	331.6	384.9	416.2	377.0	494.7	682.7	649.4	650.1	641.6	660.8

Source: Harley Davidson 10-K reports.

markets accounted for the whole of the increase in Harley's dealerships between 2008 and 2014.

Other Products and Services

Sales of parts, accessories, "general merchandise" (clothing and collectibles), and financial services represented 28% of Harley's total revenue in 2014 (Table 4)—much higher than for other motorcycle companies. Clothing sales included not just traditional riding apparel but also a wide range of men's, women's, and children's leisure apparel.

Most of the "general merchandising" business represented licensing of the Harley-Davidson name and trademarks to third-party manufacturers of clothing, giftware, jewelry, toys, and other products. Most of these were sold through channels other than the Harley dealership network. To expand sales of licensed products, Harley opened "non-traditional" dealerships: retail outlets selling clothing, accessories, and giftware but not motorcycles.

Manufacturing

As already noted, Harley-Davidson's development during the 1980s and 1990s focused heavily on upgrading its manufacturing operations: capacity expansion permitted investment in new plants and equipment and the introduction of more advanced process technologies. Particular emphasis was placed on developing manufacturing capabilities through total quality management, JIT scheduling, CAD/CAM, and the devolution of responsibility and decision making to the shop floor.

Despite the constant development of its manufacturing facilities and operational capabilities, Harley's low production volume relative to Honda and the other Japanese manufacturers imposed significant cost disadvantages, especially in the purchase of components. Despite this lack of bargaining muscle, Harley sought close, collaborative relations with key suppliers. Its Supplier Advisory Council (SAC) served "not only to improve purchasing efficiency, but also to provide a forum to share information, ideas, and strategy."¹⁵

Harley's capacity for efficiency was also limited by its dispersed manufacturing operations: engine manufacture in Milwaukee, Wisconsin and assembly in York, Pennsylvania and Kansas City, Missouri. During 2009–2014, Harley reorganized its manufacturing plants and manufacturing systems. A program of plant consolidation involved combining the two Milwaukee-area powertrain plants into a single facility and merging the separate paint and frame operations at York, Pennsylvania.

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New agreements negotiated with unions allowed for more flexible employment arrangements and working practices, which supported the introduction of a new enterprise resource planning (ERP) system at the York plant. Combined with Harley's "surge production," the new system meant customer demand would drive manufacturing, every production line would have the flexibility to build every model, and inventories could be reduced.

Human Resource Management

Central to Harley-Davidson's remarkable growth between 1981 and 2007 was the creation of a new relationship between management and employees that was forged following the buyout from AMF. The new approach to human resource management was built on participation, self-management, open communication, and team-based organization. Team-based organization extended from eight- to 15-member work groups at plant level right up to senior management where three functional teams—the Create Demand Circle (CDC), the Produce Product Circle, and the Provide Support—were coordinated by the Strategic Leadership Council.¹⁶

Despite Harley's commitment to employee participation and development, the production cutbacks and cost-cutting pressures during 2009–2012 created tensions between the company and its employees. These were resolved by the 2012 labor agreement, which created a new framework for workplace flexibility.¹⁷

Competition

Despite Harley's insistence that it was supplying a unique Harley experience rather than competing with other motorcycle manufacturers, the more it took market share from other manufacturers and expanded its product range and geographical scope, the more it came into direct competition with other producers. The clearest indication of direct competition was imitation: Honda, Suzuki, Yamaha, and Kawasaki had long been offering V-twin cruisers styled closely along the lines of the classic Harleys, but at lower prices and with more advanced technologies (Table 5). In competing against Harley, the Japanese manufacturers' key advantage was the scale economies that derived from vastly greater volume. However, despite their price premium, Harley-Davidson motorcycles benefitted from a lower rate of depreciation than other brands.

Almost all of Harley's competitors were, compared to Harley, highly diversified. Honda, BMW, and Suzuki were important producers of automobiles, and more than one-third of Yamaha's turnover came from boats and snowmobiles. These companies could share technologies, engineering capabilities, distribution, and brand awareness across their different vehicle divisions. Moreover, sheer size conferred purchasing power.

Imitators of Harley's retro-styled, V-twin cruisers were not only the Japanese motorcycle companies but also domestic competitors—including new entrants Excelsior, Polaris (Victory), and a resuscitated Indian. Their heavyweight cruisers typically sold at prices exceeding those of Harley.

Appendix Table A2 compares the financial performance of leading motorcycle companies.

TABLE 5 Recommended retail prices for V-twin, cruiser motorcycles, 2015

Model	Specifications	Price (\$)
Harley-Davidson		
Sportster 883 Low	V-twin, air-cooled, 883cc	8,249
VRSC V-Rod Muscle	V-twin, liquid-cooled, OHC, 1247cc	16,649
Fat Boy	V-twin, air-cooled, 1690cc	17,699
Heritage Softail Classic	V-twin, air-cooled, 1690cc	18,349
Honda		
Shadow 750 Aero	V-twin, liquid-cooled, OHC, 745cc	7,499
Fury	V-twin, liquid-cooled, OHC, 1312cc	9,999
Interstate ABS	V-twin, liquid-cooled, OHC, 1312cc	10,999
Suzuki		
C50	V-twin, liquid-cooled, OHC, 805cc	8,199
C90T	V-twin, liquid-cooled, OHC, 1462cc	12,899
Boulevard C90 B.O.S.S.	V-twin, liquid-cooled, 1462cc	12,389
Kawasaki		
Vulcan 900 Classic	V-twin, liquid-cooled, 8-valve, OHC, 903cc	7,499
Vulcan 900 Custom		8,499
Yamaha		
V-Star Custom	V-twin, OHC, 4-valve, air-cooled, 649cc	6,990
Stryker	V-twin, OHC, 8-valve, liquid-cooled, 1304cc	11,690
Polaris		
Victory Vegas 8-Ball	V-twin, 8-valve, air-cooled, 1731cc	14,999
Victory Hammer 8-Ball		17,899

Note:

OHC = overhead camshaft.

Source: Websites of different motorcycle manufacturers.

Meeting the Challenges of Tomorrow

Harley's first-half results for 2015 reinforced fears over the sustainability of Harley's top-line growth. Profits were 8% lower than in the year-ago period, sales revenue was 6% lower, and unit sales were down by 1.4%. Wandell's strategy had been strongly orientated around expanding sales to "non-core" customer segments. Among these were younger riders in the US and potential customers in overseas markets.

The need to attract younger riders was driven by unfavorable US demographic trends—the aging of the baby boomers and the smaller number of white males entering the 40–55 age band. However, would the Harley Experience have the same appeal for Generation X and Y as it did for the baby-boomers? As the *New York Times* noted, "BMW, Honda and Yamaha are attracting younger customers who seem less interested in cruising on what their old man rides."¹⁸

International markets also presented a major challenge: should Harley adapt to the different requirements of these markets or should it remain faithful to the traditional Harley image? "The US and Harley are tied together," observed Britain's *Bike* magazine, "the guy who's into Harleys here is also the guy who owns cowboy boots. You get a Harley and you're buying into the US mystique."¹⁹

Harley claimed that its new Street 500 and Street 750 models had met with an enthusiastic response both in the US and in India (the two countries where this model was manufactured). However, Harley's previous incursions into smaller motorcycles—including Buell—had not been successful.

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TABLE A1**Income stat**

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A Milwaukee blogger summarized Harley's dilemma:

So what does Harley do? One tack would be to stay focused on what it does best: big bikes. While that strategy may make sense on some fronts (focus on what you know, stay loyal to the brand identity, etc.), that approach will mean greatly reduced growth prospects and could doom it if the current consumer spending environment holds out long term. And meanwhile its core audience just gets older.

Or it could do what people have been saying what it should do for years: Make smaller, more affordable bikes. That's harder than it sounds, as it would force Harley to compete against the Japanese manufacturers on their own turf. But if the market is moving away from Harley, does it have a choice?²⁰

Appendix: Financial Data

TABLE A1 Selected Items from Harley-Davidson financial statements, 2005–2014 (\$million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Income statement items										
Net sales	5,342	5,801	5,727	5,594	4,781	4,859	5,311	5,581	5,900	6,229
R & D	179	178	186	164	143	136	145	137	152	138
Selling, administrative, and engineering expense	762	846	901	985	979	1,020	1,061	1,111	1,127	1,160
Operating income, of which:	1,470	1,603	1,426	1,029	197	559	829	1,000	1,154	1,281
–Financial services	192	211	212	83	(117)	181	268	259	283	278
Interest income/(expense)	23	27	22	9	(22)	(90)	(45)	(46)	(45)	(4)
Income before taxes	1,488	1,624	1,448	1,034	178	390	792	961	1,114	1,283
Income taxes	528	581	514	379	108	130	244	338	380	439
Net income	960	1,043	934	655	(55)	146	599	624	734	845
Balance sheet items										
Cash	141	238	403	594	1,630	1,021	1,526	1,327	1,067	907
Finance receivables	1,943	2,101	1,575	1,378	1,436	1,080	1,168	1,344	1,774	1,917
Accounts receivable, net	122	143	181	296	269	262	219	255	261	248
Inventories	721	288	350	401	323	326	418	428	425	449
Total current assets	3,145	3,551	3,467	5,378	4,341	4,066	4,542	4,216	3,989	3,948
Property, plant, and equipment, net	1,012	1,024	1,061	1,094	906	815	809	819	842	883
Total assets	5,255	5,532	5,657	7,829	9,155	9,430	9,674	9,513	9,405	9,528
Current portion of long-term debt	205	832	398	0	1,332	0	399	682	1,176	1,011
Accounts payable	271	763	300	324	162	225	255	248	240	197
Total current liabilities	873	1,596	1,905	2,604	2,268	2,013	2,698	0	2,510	2,389
Long-term debt	1,000	870	980	2,176	4,144	2,516	2,396	2,936	3,417	3,762
Post-retirement healthcare liability	61	201	193	274	264	254	268	258	216	203
Stockholders' equity	3,084	2,757	2,375	2,116	2,108	2,207	2,420	2,558	3,009	2,909
Cash flow items										
Operating activities	961	762	798	2,685	609	1,163	885	801	977	1,147
Capital expenditures	(2,198)	(2,220)	(2,242)	(2,232)	(116)	(170)	(189)	(189)	(208)	(232)
Total investing activities	(177)	(2,35)	(3,91)	(2,393)	(863)	145	(63)	(261)	(569)	(745)
Financing activities	1,272	2,637	1,038	1,293	1,381	(1,856)	(309)	(990)	(393)	(536)
Net increase in cash	2,134	97	164	191	1,134	(542)	(505)	(459)	(2)	(160)

TABLE A2 Comparative financial data for Honda, Yamaha, and Harley-Davidson

	Honda Motor Co. ^a		Yamaha Motor Co. ^b		Harley-Davidson	
	2013	2014	2013	2014	2013	2014
Revenue (\$bn)	117.8	115.0	14.9	14.1	5.9	6.2
Operating income (\$bn)	7.5	5.9	0.6	0.8	1.2	1.3
Net income after tax (\$bn)	5.7	4.8	0.5	0.6	0.7	0.8
Gross margin (%)	26	25	35	25	39	40
Operating margin (%)	6.3	5.2	3.9	5.7	19.6	20.6
Net margin (%)	4.8	4.2	4.0	4.5	12.4	13.6
Operating income/total assets (%)	4.8	3.9	1.7	3.4	12.3	13.4
Return on equity (%)	9.4	7.9	11.8	14.3	24.4	29.0
Inventory turnover	8.5	8.5	5.2	4.8	13.9	13.9
Debt/equity ratio	0.52	0.53	0.31	0.36	1.14	1.29
Capital expenditure (\$bn)	6.4	6.0	5.1	5.5	0.2	0.2
—of which motorcycles (\$bn)	0.6	0.6	3.0	3.8	0.2	0.2
R & D expenditure (\$bn)	6.5	6.1	0.8	0.8	0.2	0.1
Advertising expenditure (\$bn)	2.7	2.8	1.0	0.9	0.1	0.1
Motorcycles shipped (thousands of units)	10,343	10,742	6,010	5,800	213	233.2

Notes:

^aHonda's data relates to the whole company (motorcycles account for about 14% of Honda's total sales). Financial year 2013 covers 12 months to March 31, 2014; financial year 2014 covers 12 months to March 31, 2015.

^bYamaha's data relates to the whole company (motorcycles account for about 65% of Yamaha's total sales).

Sources: Company annual reports.

Notes

1. "The Company," http://www.harley-davidson.com/content/h-d/en_GB/company/becoming-a-dealer/the-company.html, accessed July 20, 2015.
2. "Harley-Davidson: Running Out of Road?" <http://www.forbes.com/newsletters/the-berman-value-folio/2015/05/01/harley-davidson-running-out-of-road/>, accessed July 20, 2015.
3. Buell Motor Company, founded by Harley engineer Erik Buell, built performance motorcycles using Harley engines and other components, and targeted younger riders. The Buell range included a 490cc single-cylinder bike with a price tag of \$4,595—Harley's cheapest motorcycle. However, Buell's sales both in the US and overseas had been disappointing.
4. Harley acquired MV Agusta, an Italian manufacturer of premium, high-performance motorcycles in July 2008. On August 6, 2010, Harley sold it back to its previous owner for €3 (\$3.90).
5. "Letter to Shareholders," Harley-Davidson, Inc. annual report for 2009.
6. The Indian plant was its second overseas assembly plant, the first was established in Brazil in 1999.
7. K. Wandell, "Chairman's Annual Letter," Harley-Davidson 2013 annual report.
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11. "Welcome Letter," Blackstone Valley HOG Chapter, <http://www.blackstonevalleyhog.com/HTML/Welcome.php>, accessed July 20, 2015.
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19. Reported in Marco della Cava, "Motorcycle Maker Caters to the Continent," *USA Today* (April 22, 1998): 8B.
20. "Screw it, let's ride is not a strategy," *Brew City Brawler*, January 23, 2009, http://brewcitybrawler.typepad.com/brew_city_brawler/2009/01/screw-it-lets-ride-is-not-a-strategy.html, accessed July 20, 2015.

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