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# When Business Plans Go Bust

From Burgers to High Tech, Companies Confront Shaky Strategies

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For the airlines, it's the "hub and spoke" system.

For auto dealers and fast-food joints, it's interest-free financing and dollar menus.

For drug companies, it's charging monopoly prices on a few blockbuster drugs to pay for all the research failures.

All across the economy, companies are concluding that the strategies around which they have long organized their business -- and which generated a gusher of profits during the 1990s -- are no longer working.

"The 1990s are so over they never happened," quips business consultant Michael Hammer.

The fact that so many companies are in the midst of rethinking what they produce, what they charge for it and how they organize their business is one reason the economy remains stuck in low gear. Consultants such as Hammer say that only when companies hit upon viable business models are they likely to begin aggressively hiring and investing again -- a hit-or-miss process that can take a year or more to complete.

Changes in business plans, of course, go on all the time, but during the long boom of the 1990s, the process was largely put on hold. With the economic momentum generating strong increases in sales and profits, executives saw little need to rethink their fundamental strategies. And that was true even after there were indications in many companies that profit margins and market shares were beginning to erode.

"The truth is that companies always take a good thing and push it so far that it becomes a bad thing," said Roger L. Martin, dean of the University of Toronto's Rotman School of Management. "And the longer the boom, the farther they pushed."

It was only after the stock market bubble burst, the economy dipped into recession and expectations for a robust recovery were dashed that companies began to confront the unpleasant fact that as much as half of their operations had been unprofitable, or "value destroying," over the long run, Martin said.

"A lot of industries are questioning their fundamental business models," said David A. Nadler, chairman

of Mercer Management Consulting Inc., a management consulting company. During the boom, Nadler said, "they didn't really know what products or which operations were really contributing to their success."

"As it turns out, in many cases these were not viable business propositions," he said.

Each industry has its own problems and dynamic. But according to Adrian J. Slywotsky, a Mercer vice president, those needing new models generally fall into one or more of these three categories:

- Sectors characterized by extreme overcapacity that cannot be absorbed by a couple of years of economic growth.
- Industries that typically overcharge for a few products to subsidize those that do not pay for themselves.
- Makers of commodity products that have not found a way to bundle goods with related services.

"You can name any number of industries right now in which there needs to be a new business model, but there's no clue what that is," said Slywotsky, author of the recent book "The Profit Zone."

## Airlines

The airline industry, with two major companies already in bankruptcy and the industry on track to lose \$9.5 billion in 2002, is perhaps the most obvious example of an industry desperately searching for a new business model.

For years, the major carriers had built their operations around a "hub and spoke" system in which passengers were ferried from Point A to Point B through one of a handful of hubs around the country where that airline usually held a dominant position: Delta Air Lines in Atlanta, for example, US Airways in Pittsburgh or United Airlines at Dulles. By gathering at one hub all the people who wanted to fly to Point B from all the Point A's nationwide, the system gave the airlines the critical mass of passengers they needed to provide the frequent service customers craved while lowering the cost to serve each passenger. The hub airlines used that advantage to boost profits, pay their workers more, or lower fares and drive non-hub competitors from the route.

In time, however, the hubs that were once the source of strength for the major carriers became a competitive burden. Carriers such as Southwest and JetBlue found they could shuttle planes between major metropolitan areas at a lower cost, in part because of lower labor expenses but also by avoiding some of the operational inefficiencies imposed by the hub-and-spoke structure.

As these upstart "point-to-point" carriers drew away more customers, the major carriers were left to support their large, extended networks with fewer passengers -- a condition made even more acute when

traffic began to fall in 2001. To fill seats, the airlines were forced to offer more and deeper discounts until most of their profits disappeared.

Now, most of the hub-and-spoke carriers have begun to pare flights and reconfigure their networks to include more point-to-point service that does not pass through a hub. How it all may settle is still unclear, but nobody in the industry expects the major hub-and-spoke carriers to turn a profit anytime soon.

## Electronics, Computers

The consumer electronics business is another in search of a sustainable business model.

A decade ago, manufacturers could make substantial profits on an innovative new product for the two or three years it took competitors to get around patents and come up with similar offerings. And because the retail market was fragmented, no one chain had enough clout to force Sony Corp. or Hitachi Ltd. to offer deep discounts in exchange for carrying their products.

Now, according to Mercer's Slywotsky, the innovation cycle is so fast that it takes only a matter of months for competitors to come up with me-too products. At the same time, retail has consolidated into a handful of powerful chains, such as Best Buy and Wal-Mart, that have been able to squeeze whatever profit remained out of the manufacturers.

Even on the retail end, the price competition has become so fierce that the only significant profit in the electronics business comes from installation fees and warranties.

A first cousin to consumer electronics is the computer business, which is also mired in a no-profit zone. The model on which the industry had traditionally been based involved such manufacturers as Apple Computer Inc. or Hewlett-Packard Co. coming up with products based on their own technology and selling them through independent retailers. But by the mid-1990s, that model proved much less robust than that of Dell Computer Corp., which purchased other companies' technologies, assembled them into a computer and sold them through its own highly efficient distribution system that relied on 800 numbers, the Internet and package-delivery services.

The advantage of the Dell model was that it required the company to maintain limited inventory, invest little in research and development, and share none of its profit with retailers. And by passing some of those savings along to customers in the form of lower prices and better customer service, Dell was able to grab the dominant position in the industry selling computers at prices that were below what it cost competitors to make and distribute computers.

Now International Business Machines Corp., once the leading producer of personal computers, has exited the business of manufacturing personal computers, focusing instead on the much more profitable business of running computer operations for large corporations.

And unless PC makers including Hewlett-Packard, which merged last year with Compaq Computer Corp., come up with breakthrough technologies that can be protected from easy imitation, many analysts believe these competitors will be forced to embrace a version of the Dell model to survive.

## Telecom, Internet

When America Online Inc. announced last month that it was beefing up the services offered to its subscribers, the Internet provider took the first step toward a business plan based on the once-heretical premise in the online world that consumers must pay for "content" -- the information and entertainment offered on the Web.

Reasons for the change in strategy included the precipitous decline in online ad revenue and subscriber resistance to annoying pop-up ads, which AOL promised to discontinue.

But the old model was also under attack from bare-bones providers offering Internet access for \$9.95 a month -- less than half of AOL's standard \$23.90 -- and from high-speed Internet providers, using cable and digital subscriber line connections, which enabled people to bypass AOL. Executives at AOL decided to try to protect their high-margin business by beefing up content and giving customers more reason to pay a premium price for its bundled service.

If AOL is successful and paying for content takes hold, the model holds enormous strategic implications not only for Web portals and service providers such as Yahoo Inc. and EarthLink Inc., but also for cable companies, newspapers, Hollywood and other industries that, in one way or another, need and want to sell content over the Internet.

Business-plan makeovers are also in progress in the older neighborhoods of the telecom sector.

Verizon Communications Inc., BellSouth Corp. and the other regional telephone companies had planned to use the generous profits from their near monopoly on local service to finance their transformation into single-source providers for all telecom services: local, long-distance, cell phone and high-speed Internet. But then the effects of massive overbuilding and ruthless price cutting in the cell phone business began to spill over to other telecom segments.

As consumers started using underpriced cell phones to make calls they used to make on land lines, revenue and profits in those segments began to wane as well. For the first time since Alexander Graham Bell, the number of local phone lines in many areas declined, while the long-distance business that the regional phone companies had long coveted turned into a no-profit zone.

The result: Regional Bells that were expected to emerge as the victorious survivors of the telecom wars find themselves badly wounded and under siege. "All of telecom is searching for a workable model," said

Scott C. Cleland, a partner at the Precursor Group. "The industry is now so segmented that no one segment can make any money."

The music business is another that faces a challenge to what was a highly profitable business model. The arrival of digitized music that can be pirated off the Internet has contributed, along with a dearth of mega-hits, to the first sustained decline in sales of recorded music since RCA popularized the gramophone. The industry is now scrambling to find the encryption technology and legal regime that will allow it to embrace the Internet, rather than fight it.

## Wall Street

Business models are also under repair on Wall Street, where firms are still dealing with the aftermath of the stock market bubble. The bubble fueled the growth of discount brokerage services such as Charles Schwab Corp. and E-Trade Group Inc. in an industry where the major firms had never engaged in fierce price competition for retail customers. To stem the loss of market share to the discounters, traditional firms lowered commissions or instituted different pricing arrangements that made them more reliant on investment banking and underwriting fees for their profits.

The arrangement appeared to work well enough during the boom years, although we now know it put intense pressure on stock analysts working in the brokerage divisions to give favorable ratings to stocks to help the firm win investment-banking clients. With the bursting of the bubble, however, the flow of merger deals and new stock issues slowed to a trickle, generating barely enough profits from investment-banking units to sustain their own operations, let alone subsidize brokerage units and their armies of analysts.

Wall Street is struggling to come up with a new model in which trading, research and investment-banking services are organized, sold and priced independently. For the moment, that has given a competitive advantage to firms that specialize in one function or the other -- stock brokerage Edward Jones, for example, the investment bankers at Lazard Freres and independent research houses such as Sanford C. Bernstein & Co.

## Pharmaceuticals

Perhaps no sector of the economy faces a bigger business-model crisis than the pharmaceutical industry. Until now, drug companies operated by charging monopoly prices for a handful of popular drugs in the U.S. market and used the proceeds to finance research laboratories charged with trying everything to find the next billion-dollar blockbuster molecule.

"Seventy percent of the cost of drugs goes to pay for the research failures and dead-ends," said Michael J. Silverstein, a senior vice president of the health care practice of the Boston Consulting Group.

By collecting high prices in the U.S. market, the drug companies were also able to charge lower prices in less affluent countries with nationalized health plans that could negotiate favorable bulk rates.

Now, however, public outcry over drug prices threatens to unwind what has been the most consistently profitable model in all of American business. Federal and state governments are threatening to use their clout as the largest customers to win bulk discounts for Medicare and Medicaid patients. And giant new pharmacy managers such as AdvancePCS Inc. and Medco now routinely play one drug company off another for the right to have their cholesterol or anti-depression drug given preference on new formularies that attempt to steer patients to the lowest-cost drugs.

At the same time, with more Americans finding ways to import drugs from Canada, Mexico and other countries, pharmaceutical companies are finding it increasingly difficult to "overcharge" Americans to sell drugs at discounted prices to everyone else.

According to Silverstein, drug companies have tried to compensate for this squeeze on profits by boosting sales through direct advertising to consumers. They also are searching for ways to become disciplined in their research spending, pulling the plug earlier on research programs with questionable payoffs and relying more on research partnerships with smaller biotech firms, rather than developing everything in-house. While this model evolves, however, Silverstein predicts that drug companies will have to content themselves with lower profit margins and smaller, less-risky portfolios of drugs under development.

## **Autos, Big Macs**

The game may also be up for U.S. automakers, despite another year of near-record sales in 2002.

As foreign manufacturers have come to dominate the low and high ends of the market, the Big Three's share of passenger cars sold in the United States has fallen below 50 percent. To maintain their declining share, Ford Motor Co., Chrysler Corp. and General Motors Corp. have had to provide such deep discounts and interest-free financing that they effectively are selling the vehicles for less than it costs to make them. In fact, other than pride, the only reason the Big Three have continued to produce money-losing passenger cars is to balance out the lousy fuel efficiency of their highly profitable trucks, vans and SUVs, which flew out of dealer showrooms for much of the 1990s.

Now, however, increased competition from foreign manufacturers has begun to cut into sales of the gas guzzlers, forcing the Big Three to lower prices and profits on those as well. That dynamic has already squeezed all the profits out of Ford's U.S. operations, and if volume declines next year, as many analysts predict, it threatens to do the same for Chrysler and GM.

"This typical Big Three business model is not a winning one," Dieter Zetsche, chief executive of the

Chrysler Group, said recently.

George Stalk, a director with the Boston Consulting Group who has studied the auto industry, calculates that U.S. automakers now spend more on marketing their vehicles than they do on final assembly or design.

Stalk said that for the U.S. industry to remain viable, it will have to radically revamp how it does business. Plants will have to be closed, and large parts of the remaining manufacturing and assembly work will have to be outsourced to low-cost countries such as China. To match industry-leading Toyota, the process of taking a car from initial design to full-scale production will have to shrink from four years to two or less, according to Stalk. And instead of cars being sold through dealerships that make little if any money on new-car sales, cars will have to be manufactured to order in a week or two and delivered to customers' homes.

Getting to this model, however, will not be quick and easy: It faces stiff opposition not only from unionized U.S. autoworkers but from a politically powerful network of dealers who already make most of their profits from service rather than sales.

The need for a new business model has become so widespread that even McDonald's Corp. has been forced into it. According to Martin, the dean at the Rotman School, McDonald's grew into the world's largest restaurant chain largely by selling franchises to independent business owners in the United States and abroad on the promise that their sales and profits would grow every year. And for nearly two generations, they did.

Now, however, the market is saturated with fast-food outlets, and consumers are showing signs of hamburger fatigue. McDonald's has been forced to close stores and offer deep discounts in a desperate effort to maintain its sales and market share. While its dollar menu may be popular with consumers, it is widely unpopular with franchisees, who fear they are trapped in a never-ending price war that is gradually eroding their profit margins.

Nobody is suggesting that McDonald's is in jeopardy. But experts like Martin say the only way the corporation can return to its former growth path is not by selling more franchises that must compete on price to sell more burgers, but by bringing out new concepts like Chipotle, the chain's Mexican food branch.

"The constant discounting, supported by more and more advertising, is not a sustainable model in any industry," said Rajendra S. Sisodia, a marketing professor at Bentley College in Massachusetts.