

Applications in Basic Marketing

2004-2005
Edition

Clippings from the Popular
Business Press



William D. Perreault, Jr.

E. Jerome McCarthy

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APPLICATIONS IN BASIC MARKETING:

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This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 QPD/QPD 0 9 8 7 6 5 4 3 2

ISBN 0-07-286470-2

ISSN 1099-5579

Publisher: *John E. Biernat*

Executive editor: *Linda Schreiber*

Coordinating editor: *Lin Davis*

Managing developmental editor: *Nancy Barbour*

Marketing manager: *Danial Silverburg*

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Senior digital content specialist: *Brian Nacik*

Compositor: *Electronic Publishing Services, Inc., TN*

Printer: *Quebecor World Dubuque, Inc.*

www.mhhe.com

Preface

This is the fifteenth annual edition of *Applications in Basic Marketing*. We developed this set of marketing “clippings” from popular business publications to accompany our texts—*Basic Marketing* and *Essentials of Marketing*. All of these clippings report interesting case studies and current issues that relate to topics covered in our texts and in the first marketing course. We will continue to publish a new edition of this book *every year*. That means that we can include the most current and interesting clippings. Each new copy of our texts will come shrink-wrapped with a free copy of the newest (annual) edition of this book. However, it can also be ordered from the publisher separately for use in other courses or with other texts.

Our objective is for this book to provide a flexible and helpful set of teaching and learning materials. We have included clippings (articles) on a wide variety of topics. The clippings deal with consumer products and business products, goods and services, new developments in marketing as well as traditional issues, and large well-known companies as well as new, small ones. They cover important issues related to marketing strategy planning for both domestic and global markets. The readings can be used for independent study, as a basis for class assignments, or as a focus of in-class discussions. Some instructors might want to assign all of the clippings, but we have provided an ample selection so that it is easy to focus on a subset which is especially relevant to specific learning/teaching objectives. A separate set of teaching notes discusses points related to each article. We have put special emphasis on selecting short, highly readable articles—ones which can be read and understood in 10 or 15 minutes—so that they can be used in combination with other readings and assignments for the course. For example, they might be used in combination with assignments from *Basic Marketing*, exercises from the *Learning Aid for Use with Basic Marketing*, or *The Marketing Game!* micro-computer strategy simulation.

All of the articles are reproduced here in basically the same style and format as they originally appeared. This gives the reader a better sense of the popular business publications from which they are drawn, and stimulates an interest in ongoing learning beyond the time frame for a specific course.

We have added this component to our complete set of **Professional Learning Units Systems** (our **P.L.U.S.**) to provide even more alternatives for effective teaching and learning in the first marketing course. It has been an interesting job to research and select the readings for this new book, and we hope that our readers find it of value in developing a better understanding of the opportunities and challenges of marketing in our contemporary society.

William D. Perreault, Jr. and E. Jerome McCarthy

Acknowledgments

We would like to thank all of the publications that have granted us permission to reprint the articles in this book. Similarly, we value and appreciate the work and skill of the many writers who prepared the original materials.

Lin Davis played an important role in this project. She helped us research thousands of different publications to sort down to the final set, and she also contributed many fine ideas on how best to organize the selections that appear here.

The ideas for this book evolved from and built on previous editions of *Readings and Cases in Basic Marketing*. John F. Grashof and Andrew A. Brogowicz were coauthors of that book. We gratefully recognize the expertise and creativity that they shared over the years on that project. Their fine ideas carry forward here and have had a profound effect on our thinking in selecting articles that will meet the needs of marketing instructors and students alike.

We would also like to thank the many marketing professors and students whose input have helped shape the concept of this book. Their ideas—shared in personal conversations, in focus group interviews, and in responses to marketing research surveys—helped us to clearly define the needs that this book should meet.

Finally, we would like to thank the people at McGraw-Hill/Irwin, our publisher, who have helped turn this idea into a reality. We are grateful for their commitment to making these materials widely available.

W.D.P. and E.J.M.

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Marketing's Value to Consumers, Firms, and Society

Making High-Tech Play Less Work

To Broaden Appeal, Toy Designers Try a New Formula:
Digital but Not Daunting

BY MICHEL MARRIOTT

In the late 1990's, as personal computers were becoming as common in many American households as televisions and cordless phones, the toy industry quickly embraced technologies like microprocessors, optical sensors and audio synthesizers. But some parents complained that child's play was becoming anything but. Toys and games, they said, were becoming too difficult to set up, charge up and play.

This year, toymakers are increasingly seizing on a strategy embraced already by their consumer electronics counterparts: use smarter technology to make products as simple and easy to enjoy as marbles and jump ropes. This shift in the \$31.9 billion toy industry (including the \$11.2 billion videogame sector) will be evident at the 101st Annual American International Toy Fair, which opens on Sunday in New York.

"In a mature industry, manufacturers are looking for that specific edge that will get their products chosen over someone else's," said Michael Redmond, a senior industry analyst for the NPD Group. Incorporating sophisticated but easy-to-use technology into toys and children's games is more and more important in gaining an edge, he said—particularly given a 3 percent decline in toy sales (excluding games) last year in the United States.

The results of that strategy will soon be apparent on retail shelves. Expect to see plush animals and toy action figures that sing or respond directly to television programs without any need for special transceivers and tangles of wire; a video game whose main character seamlessly responds to thousands of words and phrases spoken by players; and a hybrid game system from Japan that lets players wield real tennis rackets and baseball bats against virtual opponents on their TV sets.

This crop of toys and games, which should begin appearing as early as this spring, uses technology to lower barriers that may have made some playthings almost too complicated, too geeky, for average consumers. Toy and game makers say that consumers want the learning curve to be little more than a speed bump.

"Right out of the package the technology adds to the play value," said Thomas P. Conley, president of the Toy Industry Association, which represents 85 percent of the toymakers in the United States. "What we've got to remember is that all of this is trying to enhance the play value for the child, so the child can enjoy the toy longer."

Mr. Conley said that at least 70 percent of the toys being shown at this year's Toy Fair use microchips. "That number grows every single year," he added. "The chip technology keeps getting better and better, so the toys are able to do more and have more features and still come in at those magic price points that retailers like."

For example, Thinkway is expanding the wildly popular cyberworld of Neopets with a line of interactive Neopet toys that are not only voice-activated but are also engineered to detect a player's mood and respond like a real pet. Bandai America has its own interactive doll, Berry Talkin' Apple Dumplin', that says more than 60 words and phrases but "learns" to recombine them in new ways the more a child talks to the doll. And LeapFrog is introducing technology-enhanced learning toys that incorporate functions like handwriting recognition and software that enables children to enter their homework problems into a hand-held device and get help by way of improved microprocessing.

Advanced microchip technology is also permitting some familiar devices to act more toylike as their makers reach for younger consumers.

YOUR BIDDING In the action-adventure game *Lifeline*, players will direct the character Rio, left, by speaking aloud rather than using a controller or buttons. Rio can understand 5,000 words and about 100,000 phrases.

The latest product from Wildseed, a software company based in Kirkland, Wash., that makes interactive accessories for cellphones, is a line of shells that snap on and off special wireless phones from Wildseed that are expected to cost less than \$100. The shells, called SmartSkins, contain a microchip that personalizes a phone, instantly loading it with digital music, video clips, pictures, wallpaper, games, special ring tones and more without the need for lengthy downloads or tedious typing on tiny wireless handset keypads. The shells are expected to cost \$25 to \$50.

"Technology for technology's sake? The typical parent sees through that," said Kevin Curran, general manager of Fisher-Price Friends, which produces toys based on characters like Elmo on "Sesame Street" and Blue on "Blue's Clues." "You really have to tap into children's play patterns. If the technology doesn't reinforce the play pattern, then it becomes superfluous."

At Toy Fair—an event open only to the industry, with more than 1,500 toy and children's entertainment companies unveiling their latest products—Fisher-Price is showing, among other products, InteracTV. Mr. Curran describes it as a \$40 "learning platform" that lets children play and learn with television characters through special DVDs and a simple remote-control panel.

The brightly colored plastic panel uses infrared sensors and touch-screen technology that wirelessly "speaks" to any standard DVD player with the touch of a child's finger—even if the child does not point the panel at the DVD player.

Children as young as 3 can use InteracTV to play along, answering questions and solving problems, with familiar television characters like Dora the Explorer and SpongeBob SquarePants, Mr. Curran said.

A child watching Dora on everyday television could shout answers to questions posed on the air. But with a DVD made for InteracTV, the child can enter answers and get immediate feedback in the characters' voices.

The lightweight control panel can store multiple remote-control codes that let children use it with a number of different DVD players, including one at home, and perhaps another in the car or at a grandparent's house, Mr. Curran added.

In another effort to capitalize on children's viewing habits, Mattel Entertainment is releasing a new Barbie DVD and videotape, the fourth in a series for the fashion-doll-turned-thespian, with a computer-animated Barbie starring in "The Princess and the Pauper."

The production's innovation will take place not on the screen, however, but in the living room. One of the characters, a sweet-natured cat named Serafina, will be sold as a

(Cont.)

\$40 plush toy stuffed with digital technology that will let it move (wag its tail and purr, for instance) and sing along with parts of the story when prompted by the video.

Julia Jensen, a spokeswoman for Mattel, said that a watermark technology sends signals from the film to the toy cat through a wireless transmitter that looks like a small jewelry box.

"Consumers are not interested in the complex side of any of this," Ms. Jensen said. "We've talked to mothers and know that as they see everything around them getting easier to use, they want their children's toys as easy and seamless, too."

In the same vein, Mattel and Warner Brothers Animation have teamed up to produce a series of Batman toys—a hand-held communicator, action figure and Batmobile—that will use a wireless technology called video-encoded invisible light to respond to minute pixel changes embedded in a new animated television series.

The series, "The Batman," which is to begin in the fall on Kids' WB and the Cartoon Network, is based on the comic-book legend who morphed into a TV and a movie hero but will feature a younger version of the character, with sleeker, more high-tech gizmos than those seen even in the movies, Warner executives said.

Jim Wagner, senior vice president for marketing at Mattel, said the wireless signals would be undetectable to viewers, but not to the Mattel toys made to sense and respond to them.

Mr. Wagner said that the Batmobile, for instance, the most expensive of the interactive toys at \$52, can be prompted to turn on its lights, deploy its fins and make sounds as if its motor is running, all by receiving signals from the television screen.

Even video games, long since harnessed to the family television set, are getting a make-it-easier makeover.

Next month, Konami Digital Entertainment America plans to release Lifeline, developed by Sony Computer Entertainment

Japan for the Sony PlayStation 2 console. Konami spokesmen say the game is the first fully voice-activated action-adventure video game.

Most of the action is controlled by a player speaking through a headset to a virtual woman named Rio, a survivor of a mysterious explosion aboard a space station hotel orbiting the earth. Rio can understand 5,000 words and about 100,000 phrases, said Robert Goff, a Konami product manager.

The game, already a major hit in Japan, appeals to hard-core gamers, said Mr. Goff, but also to those intimidated by a video game

YES, ROBIN? A hand-held communicator from Mattel and Warner Brothers Animation, part of a new series of Batman toys, will use wireless technology to respond to onscreen cues in a new animated TV series that starts this fall. The cues are relayed by minute pixel changes.

pad's array of buttons. "It's a pretty hard thing to learn," he said of a game controller, although "many of us have grown up with it."

Lifeline's voice recognition virtually eliminates the need for a game controller as players direct Rio through the ruined space station, solving problems and fighting menacing creatures.

In a typical sequence, a player directs Rio to enter a guest room to search for clues to explain the fates of its missing inhabitants. After a player tells Rio to retrieve and open a book there, the character soon comes under attack by a swarm of creepy aliens.

When the player shouts, "Shoot, head!" Rio fires her weapon at the creature's head. "Dodge to the right!" and she complies. "Shoot stomach!" and Rio does.

"It's a more intuitive way to interact with someone," Mr. Goff said of controlling action by telling a character what to do with a voice command rather than using a joystick, buttons and triggers. "Imagine voice activation coming in to football video games. You could call audibles, call man-to-man, zone defenses. Every game could benefit."

Game designers at the SSD Company in Kusatsu, Japan, had a similar thought but took a different route in eliminating the game controller from its video games, its engineers said recently. Their solution is XaviX (pronounced ZAH-vicks), a game system that marries conventional video game technology with toy baseballs, bats, tennis rackets and bowling balls embedded with wireless sensors.

Someone playing a XaviX game—tennis, for instance—inserts the game cartridge into an \$80 XaviX set-top box connected to a television set. Rather than a game controller, the player picks up a special toy racket, squares off in front of the television and swings, smacking a virtual ball that reacts almost like a real one on the screen. The virtual spectators cheer, depending on the level of play; the score is kept; and the real human players often work up a real sweat, said Andre Job, vice president for marketing at the TSC Group, which helped develop XaviX for the American market.

"I think the key thing for kids and adults, no matter the form of entertainment, is that they want simplicity," Mr. Job said. "They want to spend their time playing and enjoying the experience instead of spending enormous amounts of time with complexities, wondering how a thing works."

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Southwest Airlines: The Hottest Thing in the Sky

Through change at the top, through 9/11, in a lousy industry, it keeps winning Most Admired kudos. How? ■ *Andy Serwer*

It's a little strange how some folks still think about the airline business. There are the big players, they'll tell you, like Delta, United, and American. And then you have the smaller fish. The low-cost carriers, led by that wacky Southwest Airlines, which they mention almost as an afterthought.

Now, hang on a minute. Let's look at those "industry leaders" and ask: Big like how? Well, United parent UAL filed the largest bankruptcy in aviation history (\$25 billion in assets) in December 2002. That's big. American is weighted down with nearly \$18 billion of debt on its books. That's pretty big. And finally, the three large airlines lost a total of some \$5.8 billion last year. That's big too.

Now let's look at Southwest Airlines. Last year the company earned \$442 million—more than all the other U.S. airlines combined. Its market capitalization of \$11.7 billion is bigger than that of all its competitors combined, too. And last May, for the first time, Southwest boarded more domestic customers than any other airline, according to the Department of Transportation. Sure, the majors still have more revenue—Southwest, with about \$6 billion in sales in 2003, ranks only No. 7 in that department—and they have more planes and carry more passengers when you include their overseas routes. And yes, some analysts question whether Southwest's amazing growth trajectory can continue. But, bottom line: Is there any question which company is the leader of this industry?

No wonder Southwest has landed in the top ten of FORTUNE's Most Admired Companies in each of the past six years—a distinction shared only by Berkshire Hathaway, General Electric, and Microsoft. Its accomplishments would be estimable in any industry. (Southwest was the nation's best-performing stock from 1972 through 2002, according to *Money* magazine, up a gravity-defying 26% per year.) But that Southwest has achieved this measure of success

in the snakebit airline biz is nothing short of astonishing. What's more, Southwest has sustained that success—and its grip on the top ten list—even nearly three years after its eccentric founder, Herb Kelleher, stepped down as CEO (he's still chairman) and after a swarm of upstart airlines, from JetBlue to Ted, have tried to horn in on its formula.

To figure out how, you could do worse than go back to the airline's conception. Southwest famously began 33 years ago when Kelleher (a lawyer by training) and a partner drew up a business plan on a cocktail napkin. Through decades of battling the big airlines, Southwest hasn't really changed its original formula. It enters markets in which traditional airlines hold sway and then blasts them with much lower fares. Southwest flies "point to point" (city to city), ignoring the hub-and-spoke model of most other airlines. It flies only 737s. It serves no meals, only snacks (peanuts, mostly). It charges no fees to change same-fare tickets. It has no assigned seats. It has no electronic entertainment on its planes, relying instead on relentlessly fun flight attendants to amuse passengers.

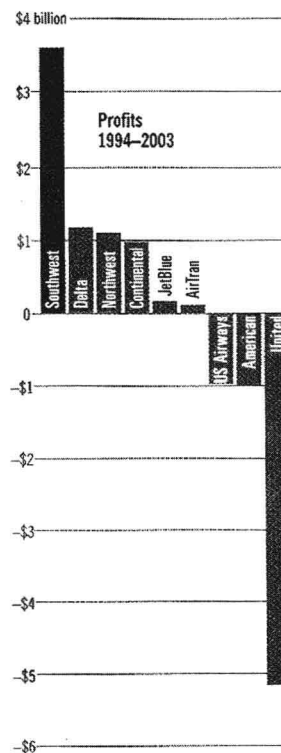
That formula has so far proved unbeatable. Consider Southwest's success against just one old-line competitor: US Airways. According to analysis by Michael Roach, an industry consultant with Unisys R2A, a division of the technology company, when Southwest entered the San Francisco—Southern California markets in the late '80s, US Air had a 58% market share in those routes. By the mid-'90s, Southwest had driven US Air completely out of them. In the early '90s, Southwest entered Baltimore Washington International Airport (BWI), where US Air had a significant hub; now US Air is down to 4.9% of the traffic at BWI, while Southwest ranks No. 1 with a 47% share.

While it's hard for Southwest to play the underdog these days—and it certainly isn't sneaking up on anybody anymore—it's still the industry maverick. No matter what its

competitors say or do, no company walks the talk quite like Southwest. It's iconoclastic, quirky, and sometimes just plain bizarre. Southwest has so much insouciance, in fact, that it has allowed itself to become the sub-

It's the money, honey

Southwest's profits beat the rest of the industry's combined.



(Cont.)

ject of a reality TV show on cable channel A&E called *Airline*. ("We all have our baggage" is the tagline.) The cameras follow Southwest employees—who don't always come across as sugar and spice—as they deal with all manner of crisis: Nasty, staggering drunks. Passengers who stink like Limburger cheese. Chicago thunderstorms. (And yes, the show has been successful enough that A&E wants to renew for next season.) Hard to imagine most admired company Wal-Mart subjecting itself to that kind of scrutiny!

If competitors are trying so hard to copy Southwest, why in the names of Orville and Wilbur Wright haven't they been able to duplicate its success? "Because they don't get it," says Southwest's idiosyncratic president and COO Colleen Barrett. "What we do is very simple, but it's not simplistic. We really do everything with passion. We scream at each other and we hug each other." There's no question that the other airlines practice the screaming part. They haven't been so good at the hugging.

Barrett, a 59-year-old Vermont-born grandmother with a long, gray ponytail, has been with the company since the beginning. In fact, she started as Herb Kelleher's legal secretary. Kelleher, 72, is one of the most unusual businessmen in our country's history. He has some of the best people skills on earth. He is also a walking paradox. As brilliant as he is batty, Kelleher is half P.T. Barnum, half Will Rogers, half Clarence Darrow, and half Jack Welch. (Yes, that adds up to two men—but if you drank as much Wild Turkey and smoked as many cigarettes as Kelleher does, you'd be seeing double too.) Despite battling prostate cancer five years ago and turning over the CEO reins to his longtime protégé Jim Parker in August 2001, Kelleher

is still intimately involved in the company, handling critical government affairs, scheduling, aircraft purchasing, and strategic planning. The public face of Southwest Airlines, however, now belongs to Parker and Barrett.

To truly understand why this company continues to be such a hit with customers, you have to go behind the wall and take a look. Pay a visit to Southwest's headquarters just off Love Field in Dallas, and you'll probably think you've wandered onto the set of *Pee-wee's Playhouse*. The walls are festooned with more than ten thousand picture frames—no exaggeration—containing photos of employees' pets, of Herb dressed like Elvis or in drag, of stewardesses in miniskirts, of Southwest planes gnawing on competitors' aircraft. Then there are the teddy bears, and jars of pickled hot peppers, and pink flamingos. There is cigarette smoking, and lots of chuckling, and nary a necktie to be seen.

"To me, it's comfortable," says Barrett, who as the ultimate keeper of the culture sits at a desk with a burning scented candle surrounded by the densest zone of bric-a-brac. "This is an open scrapbook. We aren't uptight. We celebrate everything. It's like a fraternity, a sorority, a reunion. We are having a party!" she says, throwing up her hands. I ask Barrett how much her annual picture-frame budget is. "Oh, I couldn't tell you that," she says. "Let's just say that I first gave out the framing work to this hippie fella, and now he has a business with 13 employees."

Okay, but come on. This is a serious business, right? So how does Southwest reconcile this insanity—studied though much of it is—with the fact that it flies 5.5 million people through the air each month? (Southwest—knock on Kelleher's head—has never had a fatal crash.) "Yes, our culture is almost

like a religion," says company CFO Gary Kelly, "but it's a dichotomy. In many ways we are conservative. Financially, for instance." Indeed, Southwest is the only airline that maintains an investment-grade rating on its debt—a remarkable accomplishment in that business. And keeping a hawk's eye on costs is just as much a part of the company's culture as its silliness.

Yet lately, even though the airline still has some of the lowest expenses in the industry, costs have been climbing at Southwest. A key metric used in the business is cost per available seat mile (CASM), and in 1995 Southwest's CASM was 7.07 cents. Today it is up to 7.60 cents. One reason: Fuel prices have risen significantly since then. Another reason: higher compensation. "Southwest's pilots have been getting greedy," says industry consultant Roach. "They seem to think that because they work at the best airline in the business, they should get paid the most."

But let's put the cost creep in context. The big carriers all have CASMs of between 9 cents and 13 cents, and they haven't been closing the gap on Southwest. In other words, their costs are increasing at the same rate. (True, JetBlue has been able to achieve costs below Southwest's, but its have also been climbing recently—which in part explains why JetBlue's once highflying stock is off some 50% from its peak.) And Southwest management is working hard to keep a lid on costs. For instance, late last year the company announced it was closing down three call centers to save money—more than \$20 million annually—as more of its customers make reservations online. "We are not satisfied with these inflationary trends," says Southwest CEO Jim Parker dryly and determinedly.

Follow the leader

The low-cost copycats aren't copying Southwest as closely as you might think.

	Founded	Fleet	Hubs	Unions	Assigned seats	Ticket-change fees	Food	In-flight entertainment
Southwest	1971	Boeing 737s	No	Yes	No	No	Snacks only	Wisecracking flight attendants
AirTran	1993	Varied	Yes	Yes	Yes	\$50	Snacks only	Nothing right now
JetBlue	2000	Airbus A320s ¹	No	No	Yes	\$25	Snacks only	DirectTV at each seat
Song	2003	Boeing 757s	No	Pilots only	Yes	\$25	Meals for sale	Satellite TV at each seat; pay-per-view movies; videogames
Ted	2004	Airbus A320s	Yes	Yes	Yes	\$100	Meals for sale	Nothing special

¹Will add 100 Embraer 190s in 2005.

(Cont.)

Keeping costs under control and keeping its culture alive: These are huge challenges for Southwest as it moves from upstart to prime-time player. The company now has 34,000 employees and flies to 58 cities (59 when it opens up in Philadelphia in May). Las Vegas, with 185 daily departures, has become Southwest's most-served airport. It has a fleet of almost 400 jets, with hundreds more on order (which will be painted deep "canyon blue," replacing the carrier's familiar brown and red). That's big.

So what about it, Herb Kelleher? Is the company losing its soul, as some critics have said? "No," says Kelleher, puffing on an early-morning Merit Ultra Light. (I opt for a PayDay candy bar, which he keeps in a jar on his desk—"because I drink," he says.) "It'd better not be, because I'm not going to be around forever," he laughs. "Listen, we have an incredible esprit de corps here. It's like the Marine Corps. The intangibles have always been more important than the tangibles. Plus we run this company to prepare ourselves for the bad times, which always come in the business."

Of course, the airline industry is just now emerging from the absolute worst of bad times—9/11 and its aftermath. While the rest of the industry laid off thousands of people and lost more than \$22 billion over the past three years, Southwest didn't furlough a single employee and remained in the black every quarter. In fact, it has kept its string of profitable years alive at 31 straight. That's because, unlike its competitors, Southwest has wide enough margins to take a hit.

Even though Southwest has mostly flown above the storm clouds during the past few years, the world has changed dramatically for this business and this company. In JetBlue and AirTran, Southwest faces a couple

of strong, innovative, low-cost competitors (see table). Orlando-based AirTran has been growing fast, operating primarily out of its Atlanta hub—yes, a hub. JetBlue and its high-profile CEO, David Neeleman (who once worked at Southwest), have managed to generate a huge amount of buzz with their cool new Airbus A320s outfitted with DirecTV at every seat (great for kids!). Though JetBlue is still much smaller than Southwest—it has some 50 aircraft and a hundred more on order—and doesn't yet directly compete with any of Southwest's routes, this newbie has definitely caught Jim Parker's attention. For instance: "We have looked and are looking at in-flight entertainment," Parker says. "Right now it just costs too much."

Delta's Song and United's Ted—the low-cost airline-within-an-airline concepts—provide Southwest with another set of challenges. Or do they? Already Song has delayed a planned expansion of its cross-continental routes. As for Ted, it's too early to tell—but its parent, UAL, which is still in Chapter 11, obviously has huge issues. (Read: very high costs.) While some see Song and Ted as parental saviors, Susan Donofrio of Deutsche Bank Securities is less sanguine. "Song and Ted aren't real, viable competitors to Southwest," she says. "They are Band-Aid fixes. The mainline carriers have to address their fundamental cost issues."

As for Kelleher, he's content merely to say, "I've seen this movie before." Perhaps left unsaid is, "And it doesn't end well." Indeed, a recent report of Donofrio's contains a list of 13 low-cost carriers that have filed for bankruptcy since 1991—and that's not counting Kiwi twice and Midway three times!

Meanwhile, Kelleher and Parker continue to do what they do best: take aim at the big guys. On May 9, Southwest will enter Phila-

delphia, a stronghold of beleaguered US Air, which emerged from bankruptcy last year. To Kelleher, the City of Brotherly Love holds special significance. "I grew up in New Jersey," he says, eyes ablaze. "Philadelphia was my city. I bought my first suit there. Went to my first dance there." More to the point, the Philadelphia market is overpriced and underserved, Kelleher says, a problem that Southwest is going to "cure." With a metropolitan-area population of more than seven million, "it is the nation's eighth-largest city, but its airport is only the 18th busiest," Parker points out. Overall, industry consultant Roach expects that Southwest's fares—one-way to Providence for as low as \$29, to Orlando for \$79—will be 25% to 75% lower than US Air's. Some say US Air's very survival is at stake. "We're not going to run away and hide," says a US Air spokesman. "We will be a vigorous competitor to Southwest in Philadelphia on every route they fly."

High-stakes jousting with the majors. Squeezing every nickel. All the while keeping the fun level cranked up to the max. That's how Southwest does business. No question, it's a tricky and singular model. And no question it all begins with Herb Kelleher. So what happens when Kelleher finally does depart from the company? Roach of Unisys puts it thus: "I never thought of Southwest as just the Herb Kelleher show. I look at it like Christianity or Islam. It was started by one guy, but it sure keeps on going." Much to the chagrin of its competitors. And much to the delight of its employees, customers, and shareholders.

"Southwest Airlines: The Hottest Thing in the Sky," *Fortune*, March 8, 2004, p. 86-103. © 2004 Time Inc. All rights reserved.

What's Wrong With This Printer?

Believe it or not, it's too solid. So Hewlett-Packard spent \$1 billion to replace it with new machines that won't hold a person's weight. But they sell for less—and can squash rivals.

■ *by Noshua Watson*

The bet-the-company project that came to be known within Hewlett-Packard as the Big Bang started out with a whimper. And with grumbles and complaints that it shouldn't and couldn't be done. That was how the printer engineers who gathered for a kickoff meeting in Vancouver, Wash., three years ago reacted to the mandate laid down by their boss, Vyomesh Joshi. The mandate was to build a \$49 printer—one \$30 cheaper than HP's least expensive model at the time. Making a cheap printer was not itself an earthshaking proposition, but how Joshi intended to go about it certainly was. He didn't want just one low-end model; he wanted the engineers to conjure an entire new line of more than 50 consumer products—ink-jet printers, digital cameras, “all in one” printer/fax/copier/scanners, and more. He wanted the engineers to ignore the models then being sold and start from scratch.

He wanted HP to be able to introduce the entire product line in one fell swoop. And he wanted to take it from concept to store shelves in less than three years—18 months faster than HP had ever accomplished a product launch.

The designers in the conference room that day, however, weren't in a history-making frame of mind. They were justifiably proud of the high-quality printers they'd been building, and if high quality meant higher prices, so what? Quality was what HP was known for.

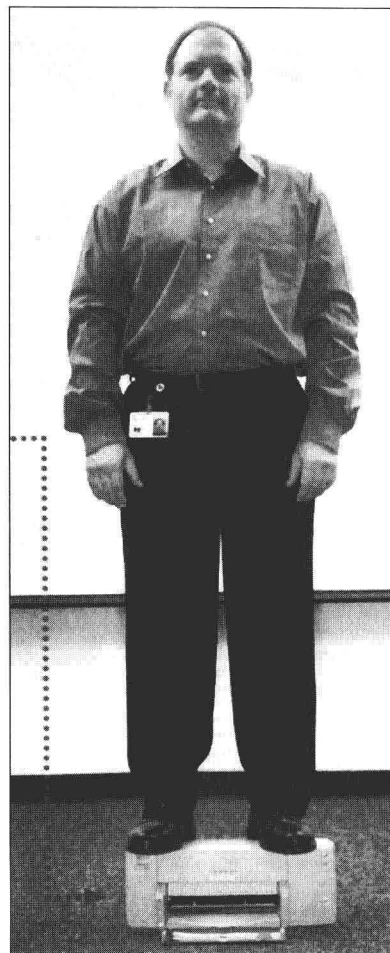
To explode their complacency and focus their attention on the real need to build a frugal machine, manager Tom Alexander finally grabbed an HP printer and set it on the conference room floor. Then he stood on it, all 200 pounds of him. The point behind his grandstanding? Customers aren't going to use printers as step stools, so don't add costs by building them strong enough to withstand the

weight of a grown man. Instead, design them to fit in the kitchen and print nice pictures.

Alexander's Stand helped open the way to a project that was audacity itself. Manufacturers often dream about reengineering an entire key product line, but few actually dare try. The risk is enormous not only because of the direct capital expense, but also because the market moves on. While the manufacturer is tied up getting the new line out the door, customers stray and competitors pounce.

With Joshi's Big Bang, the \$47-billion-a-year company (before its merger with Compaq) was betting more than \$1 billion: \$125 million for R&D, \$900 million for manufacturing, and \$200 million for marketing. More important, HP was gambling its crown jewel. Printers, ink, and related products accounted for 43% of HP's sales and 65% of HP's profits. If the new product line stalled or flopped when it debuted, it would sap HP's strength and very likely hammer the stock.

The gamble didn't scare Joshi, 48. The greater risk, he felt, was to maintain the status quo. HP had gained preeminence in the printer market by relying on the “waterfall” or “cascade” method of product development. Engineers would design a printer, put it on the market at a high price, and then gradually tweak the design to reduce the manufacturing cost. Meanwhile they'd also work on developing the next-generation machine. When the new generation eventually hit the shelves, HP would lower the prices on the old machines. The waterfall method worked: It put the emphasis where HP was strongest—on its superior engineering and allowed it to dominate the inkjet-printer market during the 1990s. But in late 1997, HP got a shock when competitor Lexmark introduced the first inkjet printer to sell for less than \$100. By mid-1999



(Cont.)

Lexmark had doubled its market share to 14%, according to market researcher ARS. The price pressure was on.

Joshi predicted that HP's low-end printer business would slowly but surely erode unless HP abandoned the waterfall practice and went head-to-head with Lexmark on price. That meant the cost of making printers had to come down—way down.

When Joshi came to that conclusion in 1999, he was not yet in charge of the printing group, and CEO Carly Fiorina was new to the company, having come from Lucent just four months before. The head of the printing group, Carolyn Ticknor, then Joshi's boss, saw the urgency in his proposal and pushed for the massive capital investment. Other division heads objected—it was a risk they felt HP could not afford—but Joshi and Ticknor prevailed. Convinced that the imaging business would be a high-growth area and merited a billion-dollar investment, Fiorina overrode the objections, cut the check, and gave Joshi free rein.

Joshi's cost-cutting concept was this: He wanted his engineers to build 14 inkjet printers and seven all-in-ones using two new, cost-efficient platforms while he squeezed productivity from every link in the supply chain. The printer platforms consist of the main chassis and printer carriage on which the plastic casing and output trays rest. The Malibu mechanism was developed for high-performance, top-of-the-line models like the 7350 and the 5550 that start at \$150. But the key to the Big Bang's low-end strategy was the Crossbow platform, a design that taxed the Vancouver engineers' ingenuity.

In developing the Crossbow line, HP engineers had to count pennies for the first time. To make money on low-end printers, HP would have to make more than a million Crossbows a month. At that volume, each additional cent in unit manufacturing costs adds up quickly. For three months the engineers brought design after design to management only to be told that it wasn't cheap enough. And the heat was on: The old waterfall cycle had taken about four years. "We wanted to do it in less than three years," says Joshi, "because Lexmark was already there."

Finding the solution, the designers finally realized, depended on a kind of printer-engineer Zen. To clear their minds, they began to conceive of the printer not as a complex mechanism but rather as an empty box. It was perfectly light and inexpensive but would get heavier and

The engineers brought design after design to management only to be told that it wasn't cheap enough.

costlier with every new feature. The object of the exercise was to think simply, adding only what the customer would absolutely need. Suddenly bells and whistles like the ability to print on glossy paper or card stock seemed easy to live without.

But frugality had its limits. One of the fiercest debates broke out over the power switch. Technically there is no need for an on-off switch, since a PC can turn on a printer automatically, and installing a manual switch adds about \$1 per machine in cost. The engineers thought they had hit on easy savings until the marketing department got wind of it. The marketers argued that the average customer wouldn't understand how the printer could turn on and off without a power button and would become frustrated looking for it. The power switch stayed.

While the Vancouver engineers were perfecting the Crossbow mechanism and case designs, engineers in Corvallis, Ore., were racing to overhaul the most technologically complex part of the printer: the cartridge. "If a printer is a car, the cartridge is the engine and the gas tank," says Keith Bartlett, a cartridge group vice president. HP's intellectual-property stronghold in cartridges is formidable: Each cartridge is supported by nearly 100 patent applications, and in their

own extension of Moore's law, HP's engineers have succeeded in doubling the number of ink drops per second every 18 months.

The little jewel boxes are also big money. For every printer on a store shelf, HP makes ten to 20 cartridges. Some go in the printers, and the rest go to retail stores as replacements, where they sell for between \$20 and \$35 each. A customer spends more on cartridges over time than on the printer itself. Not surprisingly, cartridges and other supplies account for half of the imaging group's revenues and a higher percentage of its profits.

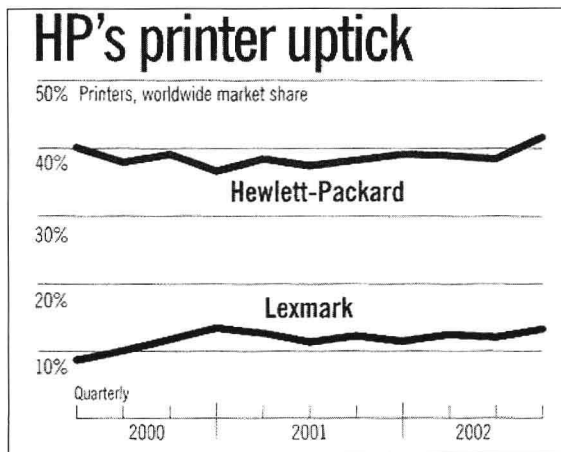
Because of the high volumes, savings on the manufacturing cost of the cartridges would be even more significant than savings on the printer itself. The cartridge engineers shaved off "nickels and dimes," says Bartlett, by using thinner plastic on the cartridge casings and covering the top with a paper label rather than a plastic cap.

The biggest savings were to be found by altering the cartridge's engine head, the most important part of the inkjet system. The head consists of a silicon plate perforated by ink nozzles and glued to a piece of flexible plastic embedded with metal circuits. The flexible plastic wraps around the bottom of the cartridge, which skims back and forth above the paper's surface. When it's printing at full speed and top quality, the nozzles fire eight to ten million drops of ink a second.

The more ink-shooting nozzles on the engine head, the better the printing speed and quality. But engine heads are cut from pricey silicon wafers. The HP engineers' challenge was to make the heads smaller, thus using less silicon, without sacrificing the number of nozzles. In the end they managed to shrink the engine head to half its original size and still squeeze 30% more nozzles onto it by making each nozzle narrower. (They also refined the ink.)

By early 2001 Joshi, now head of the imaging and printing group, was ready to move the new line into the plants. To guard its cartridge-making secrets, HP designs and manufactures the little boxes almost entirely in-house, at a design and fabrication facility in Corvallis and high-volume manufacturing plants in Ireland, Singapore, and Puerto Rico. Printers, meanwhile, are farmed out to contract manufacturers in Southeast Asia, China, and Mexico.

HP's contract factory owners were in for a big surprise. After test runs were complete, Joshi wanted to increase production from zero to



(Cont.)

one million units a month within three months, ten times faster than any previous ramp-up for an HP product. To support the huge volume, HP's manufacturers would have to build factories, and do it faster than ever. Under the old system, engineers would design the production line in the U.S. to get out the kinks before sending the plant blueprints overseas. That process typically took about 18 months. But under the pressure of the Big Bang, Joshi gave them only one year. To speed up building the plants, engineers passed along tooling specifications to the factories before the printer designs were final. There wasn't a minute to lose, and everyone felt it. Paul Speer, who supervises the Vancouver engineers, recalls debating alternatives in his cubicle with two program managers when the fire alarm went off. Sent out into a rainstorm, Speer and his staffers huddled behind a passenger van in the parking lot to continue their discussion.

Building printers from just two platforms—the Malibu and the Crossbow—made the production line more efficient. Before the Big Bang, HP had built printers using multiple platforms, and the production line had to shut down and retool when switching from one platform to the other. Now several different models could be built from the Crossbow alone. The line could run continuously, splitting into smaller lines to finish off different products. The Crossbow printer's compact dimensions doubled the number that HP could pack on a shipping pallet, saving shipping costs. Even a 20-year veteran like Speer was awed by the millions of machines spilling from the production lines by early 2002. "I walked into a factory in Singapore and looked all the way down the line to the curvature of the earth," he claims. "All I could see were Crossbow printers."

Back home, HP's marketing department was

To support the huge volume, HP's suppliers would have to build new plants, and build them faster than ever.

preparing to sell this sea of Crossbows. The timing couldn't have been worse. HP's merger with Compaq had just been announced. The tech sector was in a slump. Still, the marketers knew they had to go all-out to make sure Big Bang wasn't a bust. After mailing one million direct-mail "magalogs" and outfitting three tractor-trailers with HP products and demos to tour the U.S., the company invited major retailers, including Circuit City, Office Max, and Best Buy, to Cupertino, Calif., for product demos. The retailers were hesitant to commit to buying the Big Bang line. HP was making a lot of demands: It wanted better displays, with all its new printers lined up together in a single aisle. At the same time, HP had disappointed many retailers by failing to keep them stocked with its old products. Without a guarantee that the new machines would be in the stores on time, the retailers wouldn't advertise the Big Bang printers in their Sunday circulars.

HP marketers promised to supply more than 8,000 stores by July 28, 2002. To make that date, the printers would have to be shipped from Asia in May or June at the latest. Most of the factories kept to the schedule, but by June it was apparent that thousands of printers weren't going to make it onto ships because of manufacturing problems in Singapore. Rather than jeopardize its relationships with retailers, HP paid a huge sum to transport tens of thousands of printers from Southeast Asia

by air. By July 28, HP had put more than one million printers on store shelves.

Joshi had been waiting for that moment for three years. Despite the economic slump in general—and the tech slump in particular—he was optimistic. "I was extremely confident," Joshi says. "I felt like a proud parent." In the next few months the market justified his pride. In a year when overall printer sales fell 10%, HP's printer sales increased by 3% between June and December. Shipments of color inkjet printers to stores grew by 18%. Joshi was particularly pleased by the results in the high-margin all-in-one market: After the Big Bang, HP took 20 percentage points of market share—most of it from Lexmark—to grab nearly 70% of the market. In June, Joshi had promised Wall Street that his \$20 billion business would grow 10%, with 12% to 15% margins. In the fourth quarter his results made analysts purr—record revenues of \$5.6 billion, representing 12% year-over-year sales growth. His margins: 16.5%.

Joshi's lieutenants now brag that he wants a Big Bang every year. "We're improving our cost structure all over HP," says Larry Lesley, senior vice president in the imaging and printing group. "This isn't an endgame; it's an ongoing philosophy." Leveraging its new competitive advantage, HP plans to launch new products in June and to continue to make the existing Big Bang line faster and better. As John Solomon, printer category manager, summarizes the success of the new line, "It's much cheaper to make, much better in terms of image quality and speed, and it's half the size." But success does have its price: "Of course, you can no longer stand on it."

"What's Wrong with This Printer?," Fortune, Feb 17, 2003, p. 120C–120H.
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