THE BUSINESS STRATEGY GAME

A Global Industry Simulation

Player's Manual

Arthur A. Thompson, Jr.
Gregory J. Stappenbeck

Fourth Edition

for Windows!

Irwin McGraw-Hill

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THE BUSINESS STRATEGY GAME: A GLOBAL INDUSTRY SIMULATION

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Section 1

THE INDUSTRY AND THE COMPANY

Welcome to *The Business Strategy Game*! You are joining the senior management team at an $83 million company making athletic footwear. Not only is the company's product line gaining in popularity with consumers, but the athletic footwear industry is also on the verge of rapid growth worldwide. You and your co-managers have the challenge of developing and executing a strategy that will propel the company into a leading position in the North American, European, and Asian markets over the next 5 to 10 years. Your company will be in head-on competition with a number of other companies seeking to capture this same market potential.

In playing *The Business Strategy Game*, you and your co-managers will need to address a number of strategic and operating issues. Immediate problems include making the company's recent entry into the Asian market a profitable success, dealing with high production costs at the company's Ohio plant, and meeting growing demand for the company's footwear products in the world's three major geographic markets – North America, Europe, and Asia. Longer range, the challenge will be to build a sustainable competitive advantage and maneuver the company into an industry-leading position. As competition in the marketplace unfolds, you will be pressed to devise actions to defend your company's market position against the competitive offensives of rival firms, and you will have to consider what counteroffensives to launch on your own.

You and your co-managers will have full authority over the company's selling prices, product quality, customer service effort, advertising, product line breadth, retail outlet network, and promotional rebate offers, thus giving you an array of competitive strategy options in each market segment in which you decide to compete. It will be entirely up to you and your co-managers to decide how to try to outcompete rival companies – whether to strive to become the industry's low-cost producer and use your low-cost advantage to undersell competitors, whether to differentiate your company's footwear lineup on the basis of quality or service or other attributes, and whether to compete worldwide or to focus on just one or two market segments. You can elect to position the company in the low end of the market, the high end, or stick close to the middle on price, quality, and service. You can put the marketing emphasis on brand-name footwear or you can stress sales to private-label retailers. You can stick to a North American production base or you can build new plants in Europe and/or Asia. And, you can finance the company's growth with whatever mix of cash, short-term loans, long-term bonds, or new issues of common stock that you deem appropriate.

Whichever long-term direction and business strategy is chosen, you and your co-managers will be held accountable for achieving acceptable financial performance, increasing shareholder value, and making the company a recognized industry leader. The success your executive team has in managing the company will be based on how well your company compares against other companies on six performance measures: market share, after-tax profits, return on equity investment, bond rating, stock value, and strategy rating.

Each decision period in *The Business Strategy Game* represents a year. Very likely, you and your co-managers will be asked to make anywhere from 6 to 12 complete sets of decisions, meaning that you will be in charge of the company for 6-12 years – long enough to test your strategy-making, strategy-implementing skills. Expect the action to be fast-paced and exciting as industry conditions change and as companies jockey for market position and competitive advantage.

What You Can Expect to Learn

The Business Strategy Game is a hands-on learning exercise that will give you valuable decision-making practice and develop your powers of business judgment. In making the strategic and operating decisions that arise in the simulation, you and your co-managers will encounter an array of fairly typical business issues. You'll encounter a need to assess changing industry and competitive conditions, diagnose the strategies of competitors and anticipate their next moves, pursue ways to secure a competitive advantage, evaluate different courses of action, chart a strategic course for your company to take, and adjust strategic plans in response to changing conditions. There will be ample opportunities to gain proficiency in using the concepts and tools of strategic analysis. You will learn what it means to "think strategically" about a company's competitive market position and the kinds of actions it will take to improve it. As your skills in "market-watching" and "competitor-watching" get sharper, your sense of business judgment about how to strengthen a company's competitive position and financial performance will improve. You will get to test your ideas about how to run a company, and there will be prompt feedback on the caliber of your decisions.

Second, you will gain a stronger understanding of how the different functional pieces of a business (production, marketing, finance, and so on) fit together, thus integrating the knowledge from other business courses you have taken. *The Business Strategy Game* draws upon many of the standard topics you have studied in your production, marketing, finance, accounting, human resources, and economics courses. The company you will be managing has plants to operate, work forces to hire and pay, inventories to control, marketing and sales campaigns to wage, prices to set, accounting and cost data to examine, capital expenditure and investment decisions to make, shareholders to worry about, sales forecasts to decide upon, tariffs and exchange rate fluctuations to consider, and ups and downs in interest rates and the stock and bond markets to take into account. So there is a bit of everything in *The Business Strategy Game* – it is a "big picture" experience that requires looking at decisions from a ***total-company perspective*** and unifying decisions in a variety of functional areas to create a cohesive strategic action plan. You'll learn why and how decisions made in one area affect outcomes in other areas of the company. All the while, you and your co-managers will be held accountable for keeping the company profitable, earning an adequate return on equity investment, protecting the company's bond rating, endeavoring to maximize shareholder wealth via increased dividend payments and stock price appreciation, and developing an effective business strategy. You will have to live with your decisions – for better or for worse.

Third, *The Business Strategy Game* will give you more insight into the ins and outs of global competition, the different strategies companies can pursue in world markets, and the challenges of competing in a global market environment. We have designed *The Business Strategy Game* to be as realistic and as faithful to the functioning of a worldwide competitive market as a computerized simulation exercise can be. The game brings into play many of the business issues and competitive conditions characteristic of today's global markets. Your company will have to contend with exchange rate fluctuations, tariff barriers, and production cost differences. You will have to decide whether to locate plants where wage rates are low or whether to avoid import tariffs by having a production base in each primary geographic market. You will learn what it means to compete against low-cost, foreign-made goods.

Fourth, playing *The Business Strategy Game* will boost your understanding of basic revenue-cost-profit relationships. The what-iffing and numerical analysis that you'll find essential in operating your company in a businesslike manner will give you far greater command of the numbers commonly found in business reports. You'll get valuable practice in reviewing operating statistics, identifying costs that are out-of-line, comparing the profitability of different market segments, assessing your company's financial condition, and deciding on what remedial and proactive approaches to take. Since the simulation is played on personal computers, the nitty-gritty number-crunching is done in a split second with only a few keystrokes. This makes it simple and quick to do all kinds of "what-iffing" and explore which of several decision options seems to offer the most profit potential. You will be able to construct one-year and five-year strategic plans with relative ease, obtain immediate estimates of the financial performance you can expect, and evaluate the tradeoffs between short-run and long-run performance. You'll grow to appreciate the importance of basing decisions on solid number-crunching analysis instead of the quicksand of "I think. . .", "I believe. . .", and "Maybe, it will work out O.K."

In sum, playing *The Business Strategy Game* will build your confidence in analyzing the revenue-cost-profit economics of a business, help you understand how the functional pieces of a business fit together, and develop your powers of managerial judgment. You will gain needed experience and practice in assessing business risk, analyzing industry and competitive conditions, making decisions from a companywide perspective, thinking strategically about a company's situation and future prospects, developing strategies and revising them in light of changing conditions, and applying what you have learned in business school. The bottom line is that playing *The Business Strategy Game* will make you better prepared for playing the game of business in real life. We predict that in the process your competitive spirit will be stimulated and that you will have a lot of fun.

THE COMPANY AND ITS PRODUCT LINE

You and your co-managers have been chosen by the Board of Directors to take charge of the company's rapidly expanding athletic footwear business. Over the past few years, the company has strengthened its market position; it is well-situated to capitalize on growth opportunities in North America, Europe, and Asia (Australia, New Zealand, China, Japan, South Korea, and other Pacific Rim countries). The Board of Directors expects you to manage the company in a manner which will:

- make the company a leader in the athletic footwear industry and
- build shareholder value via both higher dividends and a rising stock price.

The Board has given you wide-ranging authority to institute whatever strategic actions and operating changes you decide are appropriate.

COMPANY BACKGROUND

The company was founded 10 years ago by John Delgaudio, Richard Tebo, and Walter Ruggles as a small Ohio manufacturer of running and jogging shoes. John and Richard had tried various brands of track shoes while members of the track team at a well-known midwestern university. Both had experienced shoe-related difficulties of one sort or another and felt that no company made shoes that provided good foot protection and that performed well under the conditions encountered in cross country running and in long-distance marathons run on hard pavement. Long discussions about what they were going to do after graduation led them to think about forming a small company of their own to develop and market a new-style shoe line with features that would be welcomed by runners and serious joggers.

John's father had been a manufacturer's representative for one of the traditional athletic equipment companies ever since John was in the second grade. When John and Richard began to talk in earnest about starting their own athletic shoe company, John's father arranged for John and Richard to spend a day touring one of the New England shoe plants operated by the manufacturer he represented. It was during this trip that John and Richard met Walter Ruggles, who at age 32 had risen quickly through the ranks to become plant manager. Walter had a degree in mechanical engineering and was fascinated with machinery and the technical manufacturing aspects of the footwear-making process. The three young men hit it off well together, and John and Richard immediately decided to invite Walter to join them in exploring the possibility of setting up their own company.

Two months after John and Richard graduated, plans for the new company were in high gear. Hours of brainstorming and intensive study of shoes then on the market produced three shoe designs with features no other manufacturer had. One feature involved a special air cushion sole, another involved the use of a waterproof fabric that breathed and wicked away foot perspiration, and a third involved a new type of heel support. Walter's technical know-how proved invaluable in drawing up designs and figuring out how to manufacture the shoes. Meanwhile, John located some used manufacturing equipment in reasonably good condition which could be leased for $5,000 per month with an option to buy.

Attention then centered on two things: a site for a small plant and raising the $35,000 which the partners needed to get started on a small scale. Richard came from a well-to-do family which owned a number of business enterprises in southern Ohio. One of the Tebo companies happened to have a 15,000 square-foot warehouse on the edge of the downtown Cincinnati area that was temporarily vacant. Richard's parents agreed to rent-free use of the warehouse for a six-month period. The matter of the $35,000 was surmounted in the form of $20,000 in savings which Walter had accumulated and $15,000 which John borrowed from his father. Tebo's parents agreed to loan the company up to $50,000 for working capital, if needed, until the company's financial statements were strong enough to negotiate bank loans on its own.

THE FIRST FIVE YEARS. The company was formally incorporated in August, with each founder having a one-third ownership. The group agreed that John Delgaudio would function in the role of president and handle the financial and administrative chores; Richard Tebo took charge of the distribution and sales functions; and Walter Ruggles assumed responsibility for product design, purchasing, and manufacturing operations. The first pair of shoes rolled off the production line in mid-October and the first shipment to a retail dealer was personally delivered by Richard Tebo the week before Thanksgiving, just in time for the Christmas shopping season.

The first two years were a struggle – long hours were spent testing various features and types of materials, perfecting shoe designs for different activities (jogging, walking, tennis, and track), working the bugs out of the makeshift equipment and plant setup, demonstrating the shoes to dealers, and convincing dealers to handle the company's shoe line. Hundreds of pairs were given away free to high school athletes to try; Tebo spent many hours listening to user reactions and monitoring how well the shoes held up under wear and tear. The company lost money in its first year and had to use nearly $32,000 of the $50,000 loan extended by Richard Tebo's parents. But the shoes coming off the assembly line were looking better, manufacturing efficiency was improving, and reaction to the company's shoes was positive. In the second year of operation, the company sold a total of 28,000 pairs and revenues topped $500,000. Most of the sales were to independent retail dealers in the southern Ohio and northern Kentucky areas. Richard Tebo's persistence in calling on these dealers frequently, explaining the features of the shoe models to them, and even assisting the store clerks in selling customers on the shoes were a big factor in giving the company a market toehold.

In the company's third year of operation, cash flows improved and the company's financial status grew less precarious. Pairs sold topped 150,000 and revenues surpassed the $3 million mark. The founders plowed all their profits back into the business, concentrating on designing more models, obtaining additional manufacturing equipment, and broadening geographic distribution. The Cincinnati warehouse which housed the company's operations was purchased from the Tebo family. The company concentrated on selling its line of athletic footwear to sporting goods stores. Then as teenagers and young adults began the trend to wear tennis shoes and jogging shoes instead of leather shoes for everyday, walking-around purposes, the company started marketing to retail shoe stores as well as athletic stores. A line of walking shoes for men and women was introduced.

By the company's fourth year of operation, market demand for athletic-style footwear started to take off in the United States and Europe. The rising price of leather shoes made fabric shoes an attractive money-saving option. At the same time, dress styles were becoming more casual among adults, and more people of all ages were taking up jogging, walking, aerobics, recreational activities, and regular exercise. Athletic-style footwear became a standard item in people's personal wardrobes. Meanwhile, the Ohio plant was expanded to a capacity of 1,000,000 pairs annually and a comfortable casual-wear line of shoes for men, women, and children was introduced. In Year 5, demand for the company's brand jumped to 775,000 pairs and revenues rose to $17 million.

THE SECOND FIVE YEARS. Over the last five years footwear sales have expanded threefold to almost 2.5 million pairs; revenues for Year 10 totaled $82.8 million. To achieve this growth, the company took some aggressive steps. In Year 6, the co-founders initiated construction of an ultra-modern 1,000,000-pair plant with state-of-the-art manufacturing equipment. The new plant, which cost $20 million, was located on the outskirts of San Antonio, Texas, to take advantage of ample supplies of low-cost labor in the area. At the end of Year 8 the Texas plant was expanded to a capacity of 2,000,000 pairs annually. A central distribution center was leased in Memphis, Tennessee, to handle all shipments to retail dealers in North America.

The company leased a warehouse in Brussels, Belgium, to handle distribution of the company's brands throughout the European Community; sales to European dealers began in Year 7 when the Texas plant came on line. Also in Year 7 the company began to supply private-label athletic footwear to such chains as Sears, J. C. Penney, Wal-Mart, and K mart on a competitive bid basis; the company uses the Memphis warehouse to handle all shipments of private label shoes. Most recently, the company has opened a distribution center in Singapore to handle sales to dealers in Japan, South Korea, China, Taiwan, Hong Kong, Indochina, Malaysia, Australia, New Zealand, and other countries in Southeast Asia; sales to dealers in the Asian Pacific began on a small scale this past year. So far, all shipments to Europe and Asia have been made from the company's Texas plant.

To finance the company's rapid expansion program, the company went public in Year 7; 2,000,000 shares were sold to outside investors at a net of $5.00 each. The co-founders own a combined 3,000,000 shares, giving the company a total of 5,000,000 shares of stock outstanding. The stock sale proceeds, along with an $18 million bond issue in Year 7 and another $15 million bond issue in Year 9 were used to finance construction and expansion of the Texas plant and provide working capital.

Table 1-1 summarizes the company's performance for Years 6 through 10 – ***all figures are in thousands*** except for earnings per share and dividends per share. As you can see, the company's growth has been profitable. Earnings per share have risen at a brisk clip, from $0.41 in Year 7 to $1.50 in Year 10. Return on equity investment (ROE) has climbed steadily since Year 6 to 20.0 percent. The company is in good financial shape and has a strong BBB bond rating.

The three co-founders – John Delgaudio, Richard Tebo, and Walter Ruggles – have now decided to withdraw from active management of the company. They will remain on the Board of Directors and help set broad policy guidelines, but they are relinquishing decision-making control to you and your co-managers. While they have done a very creditable job of creating an innovative line of running, jogging, walking, and casual wear shoes (a total of 100 models/styles), getting the Texas plant operational, and launching international sales, they are uncertain what sort of long-term strategy the company should follow to become a major player in the world footwear industry. They have discussed at length whether the company can continue to be successful in international markets with a U.S.-only production base. They are unsure whether to expand the company's 100-model product line to include shoes for other types of activities such as basketball, tennis, golf, softball, soccer, and aerobics.

At present, the company doesn't have a well-defined strategy for competing in the world's three major geographic markets; the founders were unable to reach a consensus on whether to follow the same strategy worldwide or whether to pursue separate strategies in North America, Europe, and Asia. Moreover, they didn't agree on whether to position the company as a top-quality, premium-priced producer or as a low-cost producer competing mainly at the low-priced end of the market or as a medium priced seller of an average quality shoe. They were unsure whether it made good economic sense to construct plants in Europe or Asia. They have wavered back and forth on the issue of whether to expand the product line and to contract with sports celebrities to endorse the company's brand. Their indecision on these and other key strategic issues has prompted them to bring you and your co-managers in to run the company and decide what strategic course to pursue.

Table 1-1
Company Performance Summary, Years 6 - 10

	Year 6	Year 7	Year 8	Year 9	Year 10
Income Statement Summary:					
Sales Revenues – Branded	$21,675	$31,958	$41,662	$55,194	$68,640
Private-Label	0	4,990	9,012	9,485	14,170
Total	21,675	36,948	50,675	64,679	82,810
Operating Costs - Manufacturing	15,340	25,987	34,094	43,706	50,433
Warehouse	2,030	4,034	5,079	6,318	10,407
Marketing	919	2,063	2,913	3,624	6,081
Administrative	1,453	1,556	2,169	2,328	2,500
Total	19,741	33,641	44,256	55,976	69,420
Operating Profit (Loss)	1,934	3,307	6,419	8,703	13,390
Extraordinary Gain (Loss)	0	0	0	0	0
Interest Income (Expense)	(0)	(347)	(1,774)	(1,584)	(2,702)
Income (Loss) Before Taxes	1,934	2,960	4,645	7,119	10,687
Income Taxes	580	888	1,394	2,136	3,206
Net Income (Loss)	$1,354	$2,072	$3,252	$4,983	$7,481
Financial Performance Summary:					
Ending Cash Balance	$493	$1,954	$2,874	$1,397	$311
Total Assets	$21,264	$44,785	$46,960	$65,208	$69,242
Short-Term Debt	$3,500	$0	$0	$0	$500
Long-Term Debt	$0	$18,000	$16,200	$29,400	$26,100
Total Liabilities	$4,910	$20,359	$19,283	$33,297	$31,850
Total Stockholders' Equity	$16,354	$24,426	$27,677	$31,911	$37,392
Shares of Stock Outstanding	3,000	5,000	5,000	5,000	5,000
Earnings Per Share	$0.45	$0.41	$0.65	$1.00	$1.50
Dividends Per Share	$0.00	$0.00	$0.00	$0.15	$0.40
Return On Equity	8.3%	8.5%	11.7%	15.6%	20.0%
Operating Profit Margin	8.9%	8.9%	12.7%	13.5%	16.2%
After-Tax Profit Margin	6.2%	5.6%	6.4%	7.7%	9.0%
Debt-To-Asset Ratio	0.16	0.40	0.34	0.45	0.38
Times-Interest-Earned		9.54	3.62	5.49	4.96
Bond Rating		A	BBB	BB	BBB

The Industry and Competitive Environment

The prospects for long-term industrywide growth in footwear sales are excellent. Athletic-style shoes have become the footwear of choice for children and teenagers, except for dressy occasions. Increased adult concerns regarding physical fitness are boosting adult purchases for use in exercise and recreational activities. At the same time, greater numbers of adults are purchasing athletic footwear for leisure and casual use, attracted by the lower prices in comparison to leather shoes, the greater comfort, and the easy-care features. The comfort aspects have proved very attractive to people who spend a lot of time on their feet and to older people with foot problems. The combined effect of these factors is projected to generate strong market growth in all three major geographic markets over the next five years (Years 11 - 15):

Geographic Market	Projected Annual Growth in Pairs Sold
North America	5 - 25%
Europe	10 - 25%
Asia	15 - 25%

The lower projected growth for the North American market is due to the fact that a sizable fraction of North American consumers have already purchased one or more pairs of athletic shoes, thus making sales more a function of replacement demand than first-time purchases. A more definite five-year demand forecast for the industry is being prepared and will be published in the Footwear Industry Report, a copy of which you will receive at the end of each year (beginning in Year 11).

INDUSTRY SALES PROJECTIONS FOR YEARS 11 AND 12

Worldwide footwear demand is reliably forecasted to grow 20% in Year 11 and 25% in Year 12, with per company demand averaging 3,000,000 pairs in Year 11 and 3,750,000 pairs in Year 12. The forecasts for the four market segments are

	Private-Label Demand (in pairs)	Branded Demand (in pairs)			Worldwide Demand (in pairs)
		North America	Europe	Asia	
Year 11	600,000	1,450,000	600,000	350,000	3,000,000
Year 12	700,000	1,820,000	780,000	450,000	3,750,000

To determine the overall size of the market your company will be competing for in Years 11 and 12, multiply the forecasted quantities per company by the number of companies in your industry. It is quite unlikely, however, that your company's actual sales in Years 11 and 12 will turn out to be exactly equal to the above company averages. ***How many pairs your company will actually sell in a given year always depends on how your company's overall competitive effort stacks up against the competitive efforts of rival companies.*** Any company can sell substantially ***more*** than the per-company average by outcompeting rival companies. Companies with an attractively-priced, aggressively marketed product will outsell companies having a comparatively over-priced, under-marketed product.

While the industry sales forecasts for Years 11 and 12 (and the updated five-year forecasts you will receive in each issue of The Footwear Industry Report) should be considered very reliable information, actual industrywide sales in any market segment can deviate from forecasted levels for either of two reasons: (1) unforeseen changes in economic conditions and consumer spending levels and (2) unusually strong or weak competitive efforts on the part of rival companies to capture the available sales volume.

THE ROLE OF THE S&P 500 INDEX. Past experience shows that sales of athletic footwear vary up or down from the market forecast according to changes in the worldwide level of economic activity, consumer confidence, and employment levels. An important new study shows that the sizes of the deviations from forecasted demand correlate very closely with changes in the S&P 500 Index – a much-watched measure of the prices of the common stocks of 500 companies selected by Standard & Poor's.[1] When the S&P 500 has risen above the prior year's value, actual footwear sales industrywide ***in the following year*** have consistently been *above* the forecasted amount. When the S&P 500 has dropped, next year's footwear sales have consistently been *below* the projected volume. The bigger the up or down move in the S&P 500, the bigger the deviations from forecast have been, although the next year's forecast has never been off by more than 10%.

During the upcoming years you should expect ups and downs in the S&P 500 Index to signal that actual industry sales of footwear will deviate above or below the forecast. Just how big a change in the S&P 500 it takes to induce each 1% deviation from the forecasted footwear volume is still unclear, but astute company managers should be able to arrive at good estimates within a short time. ***The maximum effect that changes in the S&P 500 can have on next year's footwear demand is 10%.*** The size of the deviation from the forecasted amount depends on how much the S&P 500 Index moves above or below the value announced by the instructor/game administrator for the previous year. If the upcoming year's S&P 500 value exceeds the prior-year value, actual market demand will be larger than forecasted market demand; the bigger the gap between the current year's S&P 500 and the previous year's S&P 500 value, the larger the amount the actual volume demanded will exceed the forecasted volume demanded (subject to the 10% limit). Conversely, actual market demand will fall below the forecasted demand when the current year's S&P 500 value falls below the previous year's value.

THE ROLE OF COMPETITIVE AGGRESSIVENESS. Actual industry sales of athletic shoes are also a function of how aggressively all companies as a group try to capture the projected sales volumes. A ***significant*** drop in footwear prices can stimulate buying and cause actual sales to rise above the forecasted amounts. Likewise, if companies as a group ***significantly*** boost product quality or improve customer service, then sales for the year can exceed the projected amounts. ***Unusually aggressive price-cutting and marketing industrywide can boost actual market volume by as much as 4% over the projected amount.***

On the other hand, if average prices for footwear rise sharply or footwear quality drops or marketing efforts are cut to minimal levels, then buyers may not be attracted to purchase as many pairs as forecasted. The weaker the industry's overall competitive effort, the greater the amount by which actual sales can fall below forecasted volumes. All sales volume projections are based on the assumption that companies will present consumers with an "attractive" price-quality-model mix and exert "ample" promotional efforts to win the forecasted sales amounts.

CUSTOMERS AND DISTRIBUTION CHANNELS

The ultimate customers for athletic footwear, of course, are the people who wear the shoes. But athletic footwear manufacturers have all refrained from integrating forward into retailing and making direct sales to the final user. The preferred channel for accessing consumers is through retailers who carry athletic footwear – department stores, retail shoe stores, sporting goods stores, and pro shops at golf and tennis clubs. Each manufacturer in the industry has created a brand name for its shoe line and built a network

[1] *The daily changes in the S & P 500 Index can be found on the first page of the third section of The Wall Street Journal; it is also reported in the business section of many newspapers.*

of retailers to handle its brand in all three geographic markets. Retailers are recruited and serviced by independent sales representatives (sometimes called manufacturer's representatives) who are paid on a straight 10% commission basis. Each company has sales reps to handle its product line exclusively in each geographic market. The role of sales reps is to call on retailers, convince them of the merits to carrying the company's brand of footwear, assist them with merchandising and in-store displays, and solicit orders. Manufacturers gain consumer awareness of their brands via in-store displays of retailers, media advertising, and word-of-mouth.

In the North American market only, there's a second distribution channel – private-label sales to large chain store accounts. Certain chains prefer to sell athletic footwear under their own label at prices 20% to 30% below manufacturers' name brands. These chains buy their private-label merchandise from manufacturers on a competitive-bid basis in lots of 50,000 pairs. All chain stores specify minimum quality and product variety; the bids of manufacturers who cannot meet quality and style specifications are automatically rejected even if their bid prices are lower. During the past three years chain stores have purchased private-label shoes at prices of $2.50 to $5.35 per pair lower than the average wholesale prices manufacturers have charged retail dealers for name brand footwear. ***The maximum price that chain store buyers will pay for private-label footwear is $2.50 under the average North American wholesale price manufacturers charge for branded footwear – without a price break of at least $2.50 per pair, they believe they're better off selling name brands.***

The typical footwear retailer sells name brand shoes at a price that is double the wholesale price of manufacturers, whereas private-label footwear retails for a markup of only 70% over the price paid to manufacturers. The lower wholesale price which your company and other footwear manufacturers charge for private-label footwear reflects (1) lower costs – manufacturers incur essentially no marketing costs on private-label footwear sales and (2) competition for the business of chain retailers.

Customer demand for athletic footwear is diverse in terms of price, quality, and types of models. There are customers who are satisfied with no frills budget-priced shoes and there are customers who are quite willing to pay premium prices for top-of-the-line quality, multiple features, and fashionable styling. The biggest market segment consists of customers who use their shoes for general wear, but there are sizable buyer segments for specialty shoes designed expressly for tennis, golf, jogging, aerobics, basketball, soccer, bowling, and so on. The diversity of buyer demand gives manufacturers room to pursue a variety of strategies – from competing across-the-board with many models and below-average prices to making a limited number of styles for buyers willing to pay premium prices for top-of-the-line quality.

Raw Materials Supplies

All of the materials used in producing athletic footwear are readily available on the open market. There are some 300 different suppliers worldwide who have the capability to furnish interior lining fabrics, waterproof fabrics and plastics for external use, rubber and plastic materials for soles, shoelaces, and high-strength thread. It is substantially cheaper for footwear manufacturers to purchase these materials from outside suppliers than it is to manufacture them internally in the small volumes needed. Delivery time on all materials is a matter of one or two days, allowing manufacturers to stock less than five days' worth of inventories.

Suppliers offer two basic grades of materials: normal-wear and long-wear. The use of long-wear fabrics and shoe sole materials improves shoe quality and performance, but they currently cost about twice as much as normal-wear components. Materials for a shoe made completely of long-wear components cost $12 per pair versus a cost of $6 per pair for shoes made entirely of normal-wear components. However, ***shoes can be manufactured with any percentage combination of normal-wear and long-wear materials.*** All footwear-making equipment in present and future plants will accommodate a mixture of normal-wear and long-wear components.

All materials suppliers charge the going market price, and the quality of long-wear and normal-wear materials is the same from supplier to supplier. Materials prices fluctuate according to worldwide supply-demand conditions. ***Whenever worldwide shoe production falls below 90% of the footwear industry's worldwide plant capacity (not counting overtime production capability), the market prices for both normal and long-wear materials drop 1% for each 1% below the 90% capacity utilization level.*** Such price reductions reflect weak demand and increased competition among materials suppliers for the available orders. Conversely, ***whenever worldwide shoe production exceeds 100% of worldwide plant capacity utilization (meaning that companies, on average, are producing at overtime), the market prices for normal and long-wear materials rise 1% for each 1% that worldwide capacity utilization exceeds 100%.*** Such price increases reflect strong demand for materials and greater ability on the part of suppliers to get away with charging more for essential raw materials.

A second demand-supply condition causing materials prices to change is widespread substitution of long-wear materials for normal-wear materials. ***Once industrywide usage of long-wear materials passes the 25% level, the prices of long-wear materials rise 0.5% for each 1% that the percentage use of long-wear materials exceeds 25%; simultaneously, the worldwide market price of normal-wear materials will fall 0.5% for each 1% that the industrywide usage of normal-wear materials falls below 75%.*** Thus the price gap between long-wear and normal-wear materials widens as industrywide use of long-wear materials rises above 25%.

Despite price fluctuations, materials suppliers have ample capacity to furnish whatever volume of materials footwear manufacturers need. No shortages have occurred in the past. Just recently, suppliers indicated they would have no difficulty in accommodating increased materials demand in the event footwear-makers build additional plant capacity to meet the growing demand for athletic-style shoes. ***Footwear manufacturers are thus assured of receiving all orders for normal-wear and long-wear materials*** no matter how much new footwear capacity is built down the road.

MANUFACTURING

Footwear manufacturing has evolved into a rather uncomplicated process, and the technology has matured to the point where it is well understood throughout the industry. At present, no company has proprietary know-how that translates into manufacturing advantage. The production process consists of cutting fabrics and materials to conform to size and design patterns, stitching the various pieces of the shoe top together, molding and gluing the shoe soles, binding the shoe top to the sole, and inserting the innersole and laces. Tasks are divided among production workers in such a manner that it is easy to measure individual worker output and thus create incentive compensation tied to piecework. Labor productivity is determined more by worker dexterity and effort than by machine speed; this is why ***piecework incentives can induce greater output per worker.***

On the other hand, there is ample room for worker error; unless workers pay careful attention to detail, the quality of workmanship in the final product suffers. ***Quality control procedures at each step of the process are essential to minimizing the reject rates on pairs produced***.

Studies have shown that assembly lines are most efficient producing only one model at a time, though it is easy to produce different sizes of the same model simultaneously. To switch production over from one model to another takes several hours of set-up time and usually is done between shifts. Machine maintenance is also done between regular work shifts. There is sufficient time after allowing for maintenance and production setup for new models to accommodate overtime production up to 20% of normal production capacity. Thus a plant capable of producing 1 million pairs annually with a normal 40-hour work week can turn out 1.2 million pairs annually with the maximum 20% use of overtime.

Industry observers are predicting that companies will take a hard look at the economics of producing athletic shoes in Asian countries where trainable supplies of low-wage labor are readily available. Wages and benefits for Asian workers start at $2,500 annually compared to $9,000 in Europe and $10,000 or more in North America. The basic shoe-making abilities of workers in Asia, Europe, and North America are roughly equal since only modest labor skills are needed and training periods for workers are short. However, worker productivity levels at different plants can vary substantially due to the use of different incentive compensation plans, different production methods, and different automation options.

WEAPONS OF COMPETITIVE RIVALRY

Competition among footwear producers centers around eight sales-determining variables: wholesale selling price, product quality, service, product line breadth, the number of retail outlets handling each company's brand, advertising, celebrity endorsements and brand image, and use of customer rebates. Each company's market share in a given geographic area (North America, Europe, Asia) depends on how its combined use of the eight competitive weapons stacks up against the competitive effort of other companies competing in the same region. The stronger a company's overall competitive effort is relative to rival companies, the more pairs the company will sell and the larger its market share in that geographic region will be (provided, of course, that it has produced enough pairs to meet demand). It is essential that you understand the role and impact of each of the eight weapons of competitive rivalry.

WHOLESALE SELLING PRICE. This is the most important of the eight competitive factors. The higher your company's wholesale price to retailers, the higher the prices that retailers will charge consumers. Consumers are quite knowledgeable about the prices of different brands, and many do comparison shopping on price before settling upon a brand to purchase. If your company's wholesale price in a geographic area is above the industry average in that area, some shoppers who otherwise are attracted to your brand will switch to lower-priced brands. The more your company's wholesale selling price is above the geographic average, the bigger the percentage of sales your company stands to lose to competitors. However, a higher-than-average selling price can be partially or wholly offset by a combination of higher product quality, better service to retailers, extra advertising, bigger customer rebates, the use of celebrity endorsements, the addition of more models to your company's product line, and a larger network of retail outlets. But the higher your