Applications in Basic Marketing

Clippings from the Popular Business Press

2005-2006 Edition



William D. Perreault, Jr. E. Jerome McCarthy

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2005-2006 Edition

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Preface

This is the sixteenth 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 shrinkwrapped 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 **P**rofessional **L**earning **U**nits **S**ystems (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

Probing Shoppers' Psyche

In Designing New Products, Companies Try to Determine Consumers' 'Unmet Needs'

DEBORAH BALL, SARAH ELLISON AND JANET ADAMY. *WALL STREET JOURNAL.*

THREE YEARS AGO, **Procter & Gamble** Co. set out to build a better air freshener.

P&G researchers learned some useful things when they asked people in focus groups to describe their "desired scent experience." Many people, after about half an hour, seem to adjust to a scent and can't smell it anymore. Most air-freshener scents don't spread evenly across a room. People complained that many scents smell artificial.

P&G took it all in and came back with a solution: a scent "player," that looks like a CD player and plays one of five alternating scents every 30 minutes. The gadget, named Febreze Scentstories and priced at $34.99, has a tiny fan inside that circulates the scent throughout the room. With it, P&G sells five different discs, each $5.99 and holding a variety of scents with trademarked names such as "Relaxing in the Hammock" and "Wandering Barefoot on the Shore."

"Nobody could have articulated Scentstories," says Steve McGowan, a product-development manager for Febreze, "but if you really watch the consumer, they'll tell you what they wish."

Ingenuity has taken an extreme turn in the high-stakes world of product development. Desperate to increase sales and market share, companies are digging deeper into shoppers' homes and habits to discover "unmet needs" and then design new products to meet them. Last year, marketers launched a dizzying 34,000 new foods, drinks and beauty products—representing more unmet needs than most people ever guessed they had.

The strategy is turning out to be expensive, with the costs of marketing and promoting a new product often topping $50 million. In September, a sharp rise in marketing spending led **Colgate-Palmolive** Co. and **Unilever** to slash their 2004 earnings forecasts—but also to resolve to continue spending heavily on marketing to help spur sales. In July, **Kraft Foods** Inc. reported a sharp decline in its quarterly earnings and lowered its full-year forecast amid increased marketing spending.

Even Procter & Gamble, which has led the charge into new products, is feeling the weight of additional costs. Yesterday P&G reported that its operating margins were being squeezed by increased spending on marketing.

Marketers of everything from pet food to soft drinks feel pressure to innovate, for a variety of reasons. Powerful retailers such as **Wal-Mart Stores** Inc. are quicker than ever to pull a lagging product off their shelves, sometimes substituting their own private-label version. Stores also are apt to cut prices of branded items unless shoppers find something new or exciting in them. Marketers must work harder than ever to stand out in superstores that in many cases stock as many as 100,000 different items.

General Mills Inc. rolled out 92 new products this past summer—including Betty Crocker pourable cake-frosting and square-bottomed Old El Paso taco shells—for an increase of more than 30% from the 70 new products launched the previous summer. "Limited-edition" products match shoppers' short attention spans: **PepsiCo** Inc. launched a grape-flavored Mountain Dew, called Mountain Dew Pitch Black, last month just for Halloween and plans to follow with a spicy version of Pepsi for Christmas.

When P&G last month launched a version of Tide laundry detergent with Downy fabric softener, the company said it had "identified an unmet need among a subset of women who want clean and soft laundry, but for various reasons are either unwilling to add liquid fabric softener or are inconsistently adding it because they simply forget."

New products face tough odds. The average American family turns to the same 150 items for as much as 85% of its household needs, says Jack Trout, president of marketing firm Trout & Partners Ltd. Only about 2% of new brands and brand extensions hit $100 million in first-year sales, considered the threshold for success, according to Information Resources Inc.

Sales of C2, **Coca-Cola Co.**'s reduced-calorie, reduced-carbohydrate cola and the company's biggest product introduction since Diet Coke, already have started to fall, just months after the product's introduction. About 25% of so-called line extensions produce no incremental sales, says Valerie Skala Walker, an analyst at Information Resources.

"Consumers are more elusive and harder to reach," says Jim Stengel, head of marketing for P&G. "We are trying to bring true category-building innovations . . . not just another flavor of ice cream." Such an effort requires what salesmen call a "missionary sale," in which the seller first must teach customers what their unmet need is before offering to fill it.

There is no need too small for new products to address. Among the new products P&G has successfully sent out to market are Swiffer Sweep+Vac, the latest iteration in its successful Swiffer line of dust mops and disposable cloths. P&G introduced the Sweep+Vac, a small, battery-operated vacuum-cleaner with a Swiffer mop head attached, during the summer, after focus-group participants said they get on their hands and knees to wipe up the small pile of dirt left on the floor after mopping with a dry Swiffer cloth. "We knew that was a compensating behavior that consumers wouldn't want to do," says Joe Miramonte, a product-development manager for the Swiffer line.

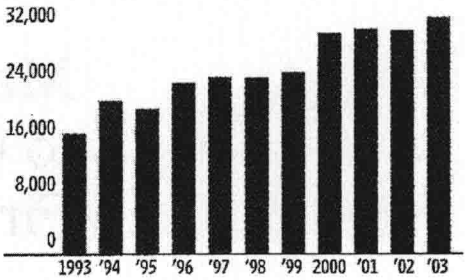
P&G appears to have hit the jackpot with an unmet need it discovered among those consumers who wash their own cars. They told P&G that half of the time they devoted to washing the car was actually spent drying the car, so that water spots won't form. For these consumers, P&G designed Mr. Clean AutoDry Carwash, a sponge along with a nozzle and a liquid-soap cartridge that attaches to a garden hose. A filter in the nozzle removes the minerals in water that cause the spots.

Retailers liked the kit's $24.99 price tag. And the price of refills—$6.99—beats the pennies that consumers might spend on soap to give their car an old-fashioned wash. The AutoDry product is on track to generate more than $100 million in first-year sales, P&G says.

Imitators nip at the heels of successful new products. **Pfizer** Inc. blazed a new trail in packaged products in 2001 with Listerine PocketPaks. The thin, edible, plastic-like mouthwash strips quickly caught on with

Freshening Up

New food, tobacco, beverage, health and beauty products launched in North America:



Source: Productscan Online

(Cont.)

teens and raked in $175 million in first-year sales. Today, supermarket checkout aisles are brimming with all kinds of strips, from Novartis's Theraflu Thin Strips, to Momentus Solutions' Healthy Moments Arthur watermelon-flavored vitamin strips for kids—and even Hartz mint-flavored breath strips for dogs. In the first nine months of this year, 128 different strip products were launched, up fivefold from 2002, according to Productscan Online.

Such innovations rarely stay hot for long, though, Last week, **Wm Wrigley Jr.** Co. said it would close the Phoenix plant where its strips are made because of waning U.S. demand.

"You might be able to hold on to an innovation for six months now, maybe 12 if you're really strong," says Bart Becht, chief executive of Reckitt Benckiser PLC, the maker of Woolite and Lysol. The company says it derived about 40% of its 2003 revenue of $6.81 billion from products introduced within the past three years. Among its recent innovations is Finish Glass Protector, a dishwasher detergent that protects glassware from mineral corrosion.

"We aren't big believers in coming out with just the lemon variant," Mr. Becht says. "We tend to work more towards breakthrough innovations."

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Minding the Store

Analyzing Customers, Best Buy Decides Not All Are Welcome

Retailer Aims to Outsmart Dogged Bargain-Hunters, And Coddle Big Spenders

Looking for 'Barrys' and 'Jills'

GARY MCWILLIAMS. *WALL STREET JOURNAL.*

Brad Anderson, chief executive officer of Best Buy Co., is embracing a heretical notion for a retailer. He wants to separate the "angels" among his 1.5 million daily customers from the "devils."

Best Buy's angels are customers who boost profits at the consumer-electronics giant by snapping up high-definition televisions, portable electronics, and newly released DVDs without waiting for markdowns or rebates.

The devils are its worst customers. They buy products, apply for rebates, return the purchases, then buy them back at returned-merchandise discounts. They load up on "loss leaders," severely discounted merchandise designed to boost store traffic, then flip the goods at a profit on eBay. They slap down rock-bottom price quotes from Web sites and demand that Best Buy make good on its lowest-price pledge. "They can wreak enormous economic havoc," says Mr. Anderson.

Best Buy estimates that as many as 100 million of its 500 million customer visits each year are undesirable. And the 54-year-old chief executive wants to be rid of these customers.

Mr. Anderson's new approach upends what has long been standard practice for mass merchants. Most chains use their marketing budgets chiefly to maximize customer traffic, in the belief that more visitors will lift revenue and profit. Shunning customers—unprofitable or not—is rare and risky.

Mr. Anderson says the new tack is based on a business-school theory that advocates rating customers according to profitability, then dumping the up to 20% that are unprofitable. The financial-services industry has used a variation of that approach for years, lavishing attention on its best customers and penalizing its unprofitable customers with fees for using ATMs or tellers or for obtaining bank records.

Best Buy seems an unlikely candidate for a radical makeover. With $24.5 billion in sales last year, the Richfield, Minn., company is the nation's top seller of consumer electronics. Its big, airy stores and wide inventory have helped it increase market share, even as rivals such as Circuit City Stores Inc. and Sears, Roebuck & Co., have struggled. In the 2004 fiscal year that ended in February, Best Buy reported net income of $570 million, up from $99 million during the year-earlier period marred by an unsuccessful acquisition, but still below the $705 million it earned in fiscal 2002.

But Mr. Anderson spies a hurricane on the horizon. Wal-Mart Stores Inc., the world's largest retailer, and Dell Inc., the largest personal-computer maker, have moved rapidly into high-definition televisions and portable electronics, two of Best Buy's most profitable areas. Today, they rank respectively as the nation's second- and fourth-largest consumer-electronics sellers.

Mr. Anderson worries that his two rivals "are larger than us, have a lower [overhead], and are more profitable." In five years, he fears, Best Buy could wind up like Toys 'R' Us Inc., trapped in what consultants call the "unprofitable middle," unable to match Wal-Mart's sheer buying power, while low-cost online sellers like Dell pick off its most affluent customers. Toys 'R' Us recently announced it was considering exiting the toy business.

This year, Best Buy has rolled out its new angel-devil strategy in about 100 of its 670 stores. It is examining sales records and demographic data and sleuthing through computer databases to identify good and bad customers. To lure the high-spenders, it is stocking more merchandise and providing more appealing service. To deter the undesirables, it is cutting back on promotions and sales tactics that tend to draw them, and culling them from marketing lists.

As he prepares to roll out the unconventional strategy throughout the chain, Mr. Anderson faces significant risks. The pilot stores have proven more costly to operate. Because different pilot stores target different types of customers, they threaten to scramble the chain's historic economies of scale. The trickiest challenge may be to deter bad customers without turning off good ones.

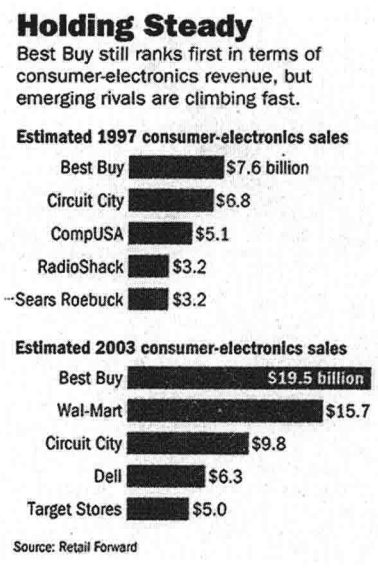
"Culturally I want to be very careful," says Mr. Anderson. "The most dangerous image I can think of is a retailer that wants to fire customers."

Mr. Anderson's campaign against devil customers pits Best Buy against an underground of bargain-hungry shoppers intent on wringing every nickel of savings out of big retailers. At dozens of Web sites like FatWallet.com, SlickDeals.net and TechBargains.com, they trade electronic coupons and tips from former clerks and insiders, hoping to gain extra advantages against the stores.

At SlickDeals.net, whose subscribers boast about techniques for gaining hefty discounts, a visitor recently bragged about his practice of shopping at Best Buy only when he thinks he can buy at below the retailer's cost. He claimed to purchase only steeply discounted loss leaders, except when forcing Best Buy to match rock-bottom prices advertised elsewhere. "I started only shopping there if I can [price match] to where they take a loss," he wrote, claiming he was motivated by an unspecified bad experience with the chain. In an e-mail exchange, he declined to identify himself or discuss his tactics, lest his targets be forewarned.

Mr. Anderson's makeover plan began taking shape two years ago when the company retained as a consultant Larry Selden, a professor at Columbia University's Graduate School of Business. Mr. Selden has produced research tying a company's stock-market value to its ability to identify and cater to profitable customers better than its rivals do. At many companies, Mr. Selden argues, losses produced by devil customers wipe out profits generated by angels.

Best Buy's troubled acquisitions of Music-Land Stores Corp. and two other retailers had caused its share price and price-to-earnings ratio to tumble. Mr. Selden recalls advising



(Cont.)

Mr. Anderson: "The best time to fix something is when you're still making great money but your [price-to-earnings ratio] is going down."

Mr. Selden had never applied his angel-devil theories to a retailer as large as Best Buy, whose executives were skeptical that 20% of customers could be unprofitable. In mid-2002, Mr. Selden outlined his theories during several weekend meetings in Mr. Anderson's Trump Tower apartment. Mr. Anderson was intrigued by Mr. Selden's insistence that a company should view itself as a portfolio of customers, not product lines.

Mr. Anderson put his chief operating officer in charge of a task force to analyze the purchasing histories of several groups of customers, with an eye toward identifying bad customers who purchase loss-leading merchandise and return purchases. The group discovered it could distinguish the angels from the devils, and that 20% of Best Buy's customers accounted for the bulk of profits.

In October 2002, Mr. Anderson instructed the president of Best Buy's U.S. stores, Michael P. Keskey, to develop a plan to realign stores to target distinct groups of customers rather than to push a uniform mix of merchandise. Already deep into a cost-cutting program involving hundreds of employees, Mr. Keskey balked, thinking his boss had fallen for a business-school fad. He recalls telling Mr. Anderson, "You've lost touch with what's happening in your business."

Mr. Anderson was furious, and Mr. Keskey says he wondered whether it was time to leave the company. But after meeting with the chief operating officer and with Mr. Selden, Mr. Keskey realized there was no turning back, he says.

Best Buy concluded that its most desirable customers fell into five distinct groups: upper-income men, suburban mothers, small-business owners, young family men, and technology enthusiasts. Mr. Anderson decided that each store should analyze the demographics of its local market, then focus on two of these groups and stock merchandise accordingly.

Best Buy began working on ways to deter the customers who drove profits down. It couldn't bar them from its stores. But this summer it began taking steps to put a stop to their most damaging practices. It began enforcing a restocking fee of 15% of the purchase price on returned merchandise. To discourage customers who return items with the intention of repurchasing them at an "open-box" discount, it is experimenting with reselling them over the Internet, so the goods don't reappear in the store where they were originally purchased.

"In some cases, we can solve the problem by tightening up procedures so people can't take advantage of the system," explains Mr. Anderson.

In July, Best Buy cut ties to FatWallet.com, an online "affiliate" that had collected referral fees for delivering customers to Best Buy's Web site. At FatWallet.com, shoppers swap details of loss-leading merchandise and rebate strategies. Last October, the site posted Best Buy's secret list of planned Thanksgiving weekend loss leaders, incurring the retailer's ire.

Timothy C. Storm, president of Roscoe, Ill.-based FatWallet, said the information may have leaked from someone who had an early look at advertisements scheduled to run the day after Thanksgiving.

In a letter to Mr. Storm, Best Buy explained it was cutting the online link between FatWallet and BestBuy.com because the referrals were unprofitable. The letter said it was terminating all sites that "consistently and historically have put us in a negative business position."

Mr. Storm defends FatWallet.com's posters as savvy shoppers. "Consumers don't set the prices. The merchants have complete control over what their prices and policies are," he says.

Shunning customers can be a delicate business. Two years ago, retailer Filene's Basement was vilified on television and in newspaper columns for asking two Massachusetts customers not to shop at its stores because of what it said were frequent returns and complaints. Earlier this year, Mr. Anderson apologized in writing to students at a Washington, D.C., school after employees at one store barred a group of black students while admitting a group of white students.

Mr. Anderson says the incident in Washington was inappropriate and not a part of any customer culling. He maintains that Best Buy will first try to turn its bad customers into profitable ones by inducing them to buy warranties or more profitable services. "In most cases, customers wouldn't recognize the options we've tried so far," he says.

Store clerks receive hours of training in identifying desirable customers according to their shopping preferences and behavior. High-income men, referred to internally as Barrys, tend to be enthusiasts of action movies and cameras. Suburban moms, called Jills, are busy but usually willing to talk about helping their families. Male technology enthusiasts, nicknamed Buzzes, are early adopters, interested in buying and showing off the latest gadgets.

Staffers use quick interviews to pigeonhole shoppers. A customer who says his family has a regular "movie night," for example, is pegged a prime candidate for home-theater equipment. Shoppers with large families are steered toward larger appliances and time-saving products.

The company hopes to lure the Barrys and Jills by helping them save time with services like a "personal shopper" to help them hunt for unusual items, alert them to sales on preferred items, and coordinate service calls.

Best Buy's decade-old Westminster, Calif., store is one of 100 now using the new approach. It targets upper-income men with an array of pricey home-theater systems, and small-business owners with network servers, which connect office PCs, and technical help unavailable to other customers.

On Tuesdays, when new movie releases hit the shelves, blue-shirted sales clerks prowl the DVD aisles looking for promising candidates. The goal is to steer them into a back room that showcases $12,000 high-definition home-theater systems. Unlike the television sections at most Best Buy stores, the room has easy chairs, a leather couch, and a basket of popcorn to mimic the media rooms popular with home-theater fans.

At stores popular with young Buzzes, Best Buy is setting up videogame areas with leather chairs and game players hooked to mammoth, plasma-screen televisions. The games are conveniently stacked outside the playing area, the glitzy new TVs a short stroll away.

Mr. Anderson says early results indicate that the pilot stores "are clobbering" the conventional stores. Through the quarter ended Aug. 28, sales gains posted by pilot stores were double those of traditional stores. In October, the company began converting another 70 stores.

Best Buy intends to customize the remainder of its stores over the next three years. As it does, it will lose the economies and efficiencies of look-alike stores. With each variation, it could become more difficult to keep the right items in stock, a critical issue in a business where a shortage of a hot-selling big-screen TV can wreak havoc on sales and customer goodwill.

Overhead costs at the pilot stores have run one to two percentage points higher than traditional stores. Sales specialists cost more, as do periodic design changes. Mr. Anderson says the average cost per store should fall as stores share winning ideas for targeting customers.

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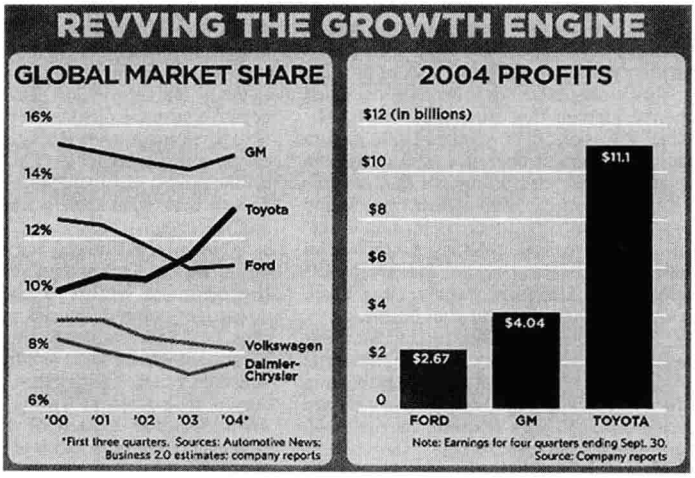
THE SMARTEST COMPANY OF THE YEAR AND THE WINNER IS . . . TOYOTA

Hot cars. Hot brands. Hot technology. Here's how Japan's largest automaker keeps firing on all cylinders.

By: Andrew Tilin

WHAT YOU CAN LEARN FROM TOYOTA

Nothing says smart like great results, and during the past year *Business 2.0's* smartest company certainly delivered. After leapfrogging Ford to become the No. 2 automaker worldwide, Toyota saw profits soar to a record $11.1 billion. Behind the numbers were intelligent moves in every corner of the operation, from product design and marketing to manufacturing and leadership. On the following pages, we spotlight some of the winning practices that put Toyota at the top of our list. Take a look—you might find an idea or two to make your own business smarter.



MARKETING

1. KNOW THE LIMITS OF YOUR BRAND.

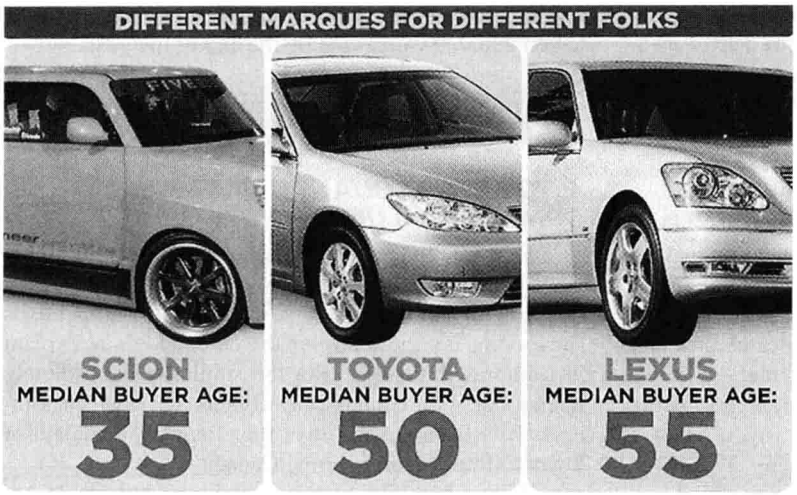
It was a strange place to hype a new car: Last June, just outside iMi Jimi, a hipster clothing shop in Denver, stood four new coupes from Toyota, a brand better known for Camrys than cool. The hope was that young fashionistas would take time away from trying on Vans sneakers to go for a spin.

That's just what they did, by the hundreds, at iMi Jimi and other trendy clothing and record stores, cafes, and pubs nationwide. The attraction wasn't mega-rebates or zero-percent financing. It was the tC coupe, a stylish hatchback from Toyota's new youth-focused marque, Scion. Thanks to clever positioning, smart marketing, and a trio of edgy-looking, sub $20,000 vehicles, Scion sold some 100,000 cars last year—about as many as Gen Y-targeted competitors Honda Element and Mini Cooper combined.

Toyota launched Scion because it recognized the limitations of its existing brands. The average Toyota driver is 50, and buyers of the company's big Lexus sedans are even older. But Scion is attracting an entirely new cadre of customers with a median age of only 35, extending Toyota's reach to the 63 million-strong "echo boomer" generation. "You have to be who you are," says marketing consultant John Winsor, author of *Beyond the Brand.* "If you're going to switch directions, you'd better start fresh."

That includes creating a completely new approach to selling cars. Because its target market is notoriously skeptical of advertising, Scion relies more on experiential marketing. Thus the informal test-drives at youth-centric hangouts as well as sponsorships of events like hip-hop concerts and graffiti art shows. Even Scion's showrooms look different: Tucked within larger Toyota dealerships, they're outfitted with flat-screen TVs and industrial-chic brushed metal. As a result, the new line

(Cont.)



isn't cannibalizing its parent: 85 percent of Scion owners have never purchased a Toyota. Of course, the company hopes that Scion drivers will become Toyota customers for life. "It's a good toe in the water," says Brian Bolain, Scion's national sales promotions manager. "Toyota gets a lot of experience with a group of consumers that's going to be around for a long time."

CULTURE

2. MAKING GREAT PRODUCTS MEANS GOING THE EXTRA MILE (OR 53,000).

An old Toyota proverb goes something like this: To make a better product, get off your rear end and experience the marketplace. Charged with revamping the Sienna minivan for 2004, Toyota chief engineer Yuji Yokoya did just that. To improve on the previous Sienna—small and underpowered—Yokoya embarked on a 53,000-mile North American minivan road trip that included five cross-continent treks, visits to every Mexican state and Canadian province, and loops around Puerto Rico, Hawaii, and the Virgin Islands. "When we asked Mr. Yokoya about his vision, he got very prophetic," recalls Mark Amstock, a Toyota marketing manager. "He said, 'The road will tell us.'"

Driving to the beat of the Pet Shop Boys' "Go West," Yokoya had many epiphanies. In Santa Fe, N.M., narrow downtown streets convinced him that the new Sienna should have a tighter turning radius. On the gravel of the Alaska Highway, he understood the need for all-wheel-drive. After squinting in the Mississippi sun along the Gulf Coast, he ordered roll-up sunshades for the second- and third-row side windows. There were small triumphs as well: On Utah's Bonneville Salt Flats, he tried to make the minivan fishtail. He was happy to report that "it's difficult to put the Sienna into a spin."

Soon after its debut, the 2004 Sienna became the car critics' darling. Through the first 11 months of last year, Sienna sales were up 60 percent over the same stretch in 2003, moving it into second place in the U.S. minivan race behind the perennial top seller, the Dodge Caravan. While Yokoya's trek took product testing to new extremes, it's also emblematic of Toyota's unswerving focus on the nitty-gritty of the user experience. "Occasionally he'd stop to take a breather or shoot a picture of something pretty," Amstock says. "But mostly it was to fix a flat or because he was lost."

INNOVATION

3. STUDY THEIR MISTAKES— AND YOUR OWN.

The first hybrid car sold in the United States, the wedge-shaped Honda Insight, certainly stood out. But weird looks plus a teeny cabin that could barely contain two early adopters added up to a tough sell. Between 1999 and 2004, Honda moved fewer than 13,000 of the vehicles. Figuring that consumers wanted something more conventional, Honda did somewhat better in the 2003 model year with a Civic hybrid that's indistinguishable from its gas-only twin. But it took Toyota's 2004 Prius, a car that walks the line between Honda's futuristic and familiar extremes, to make six-month waiting lists for hybrids a reality.

Mining niches pioneered by others is a Toyota specialty. In 1989, Toyota introduced its high-end Lexus line, which within three years outsold BMW and Mercedes-Benz to become the No. 1 luxury import. The company's family-oriented Camry sedan out-Taurused the Taurus in quality and function and is still a perennial chart topper. With hybrids, Toyota stumbled out of the gate: The first Prius, a four-door introduced in the United States in 2000, suffered from a lack of cargo space, poor acceleration, and plain-Jane looks.

(Cont.)

But the slow and steady path to success is signature Toyota. For the 2004 Prius, Toyota set out to deliver the power and roominess of a family sedan in a design that screams eco-friendly. To make the $20,000 car perform better, Toyota engineers packed 50 percent more power into the electric motor and modified the engine so it could switch power sources 50 times faster. Meanwhile, the Prius's sloped, aerodynamic contours ensure that drivers look PC while they're getting high MPG. Soaring gas prices make the design seem all the more brilliant. "Honda's hybrid appeals on a rational basis," says Jim Hossack, a vice president at AutoPacific, an automotive market research firm in Tustin, Calif., "while the Prius says, 'Look at me!'"

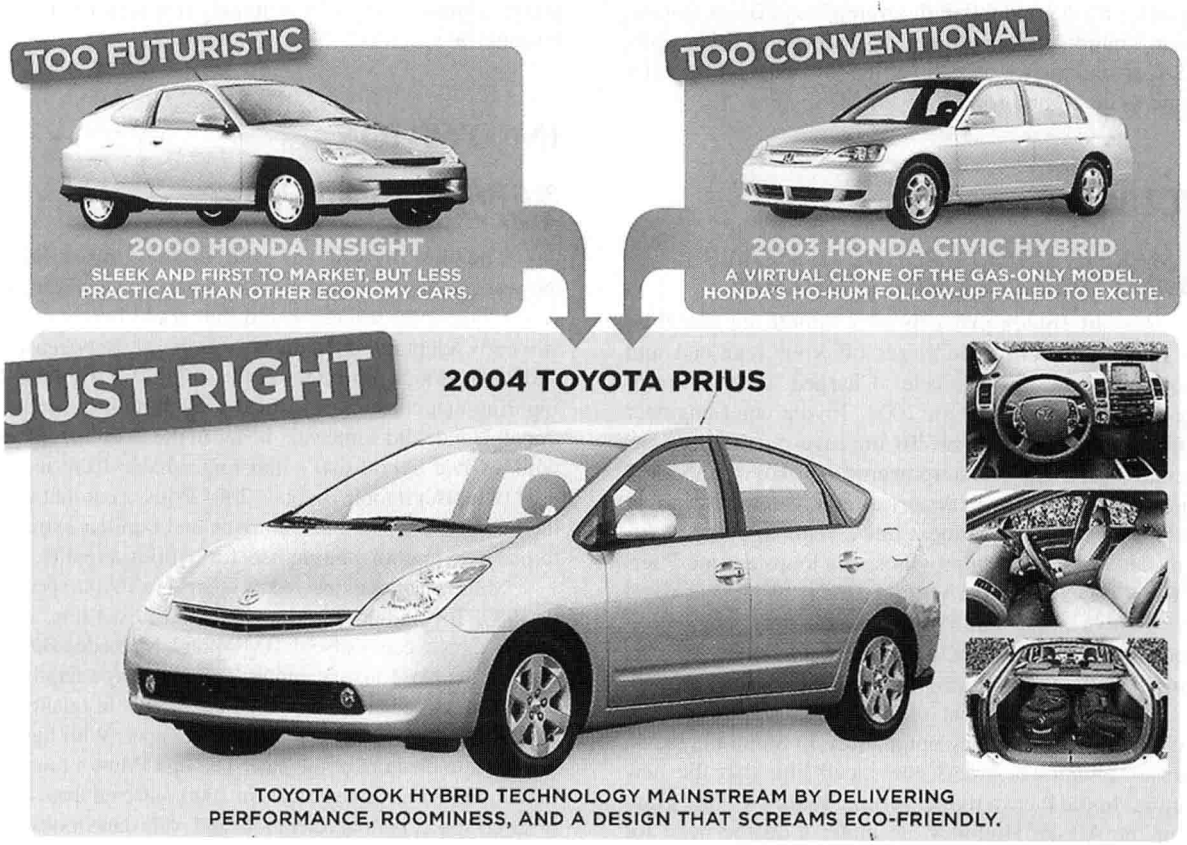
As a result, the Prius outsells the Civic hybrid two to one and has ignited a mania for hybrids. Toyota's new Lexus RX 400h, scheduled to start shipping in April, already has more than 10,000 confirmed orders. Back in 2001, people laughed at Toyota president Fujio Cho when he predicted that Toyota would sell 300,000 hybrids by 2005. Turns out he wasn't far off: The company expects to sell 228,000 worldwide by the end of the year.

GLOBAL MANUFACTURING

4. TO EXPORT QUALITY, FIRST EXPORT COMPANY VALUES.

Don't be fooled by the leather furniture, rich brown walls, and giant chrome Lexus symbol perched proudly on gleaming hardwood floors. This isn't a swanky Lexus showroom; it's the lobby of the automaker's new plant in Cambridge, Ontario. But the similarity is absolutely intentional. "It reminds our workers of what customers expect from Lexus," says Ray Tanguay, president of Toyota Motor Manufacturing Canada.

Toyota has long manufactured cars outside Japan. But to do so for Lexus, the company had to export the brand's culture of perfection—a level of expectation that



surpasses even that of the exacting mother brand. On a Toyota, for instance, a 1-millimeter gap between hood and grille is acceptable; on a Lexus, the separation can't be thicker than an eyelash. Cambridge workers receive special training in Lexus manufacturing processes, and if no one on the floor responds to computer-detected manufacturing flaws within 15 minutes, upper management is paged by BlackBerry. "'Can I prevent it, can I predict it, can I see it?' That's the mentality we're always reinforcing to the staff," Tanguay says.

Before launching the new plant, Tanguay, a 13-year veteran of Toyota Manufacturing, toured every Lexus factory in Japan, looking for ways to improve on what he saw. The upscale entrance is one of his innovations, as are the quality-control systems that *triple*-check every stage of the Lexus-making process. Tanguay also extended the drive for improvement to suppliers, inspiring a Michigan-based maker of wood steering wheels to turn to a piano manufacturer for better lacquering techniques.

The impeccable execution of Cambridge's very first Lexus product—a 2004 RX 330 sport utility vehicle—should be the envy of any company competing in the global marketplace. That's because replicating manufacturing success across borders is easier said than done: When Nissan opened its Canton, Miss., plant in 2003, it experienced manufacturing glitches galore. Still, Tanguay believes that a better measure of his $470 million facility is how well it stacks up against other Lexus plants. An April 2004 J.D. Power & Associates quality survey showed that the differences are indeed minimal. "The only way to distinguish a Japanese RX 330 from a Canadian one?" Tanguay says. "The sticker."

LEADERSHIP

5. ACT, IMPROVE, REPEAT

Since Fujio Cho became its president in 1999, Toyota has been riding an unprecedented wave of prosperity. Sales are up 39 percent, and profits a whopping 141 percent to more than $11 billion. After joining the company in 1960 at age 23, Cho transplanted Toyota's famed manufacturing process to American factories in the 1980s. Known for spotting opportunities the Prius hybrid and the youth-oriented Scion brand debuted under his watch, Cho says smart companies are always striving to do better.

What makes Toyota so smart? I'm not sure the term "smart" really suits Toyota. Rather than dealing with problems neatly in our heads, we execute. If our solutions don't work, we try something else. I like to think of Toyota as a company that's not afraid to get its hands dirty. If you want to call that smart, OK.

Let's use your definition then. How does Toyota stay smart year after year? Toyota grew out of Sakichi Toyoda's invention of automated looms, and the spirit of the inventor is alive and well. It's a focus on results, where action is key. I learned when I was young that you had to get out into the field—you're always surprised by what you find. And I learned not to give up. If I failed at some project, my bosses never talked about blame. Rather, they sent me back to the drawing board. Good managers never say, "Do what you're told," because that tells subordinates that it's OK not to use their heads.

Companies worldwide are studying the Toyota Production System. Can they become as smart as Toyota? Some people think that if they just implement our techniques, they can be as successful as we are. But those that try often fail. That's because no mere process can turn a poor performer into a star. Rather, you have to address employees' fundamental way of thinking. At Toyota we start with two questions: "Where are we wasting resources like time, people, or material?" and "How can we be less wasteful?" Take conveyor belts. Some manufacturers use them to move a product from worker to worker on an assembly line. But belts can actually waste time because workers have to take the product off the belt at each manufacturing step. It's faster to keep the component stationary and have workers approach it as necessary. The Toyota we know today is the result of challenging ourselves to get rid of waste for more than 40 years.

How does Toyota maintain quality as it expands globally? This is a big problem, and something we have to conquer. We have strict standards, but sometimes those standards are not met. So we need a culture that is not afraid to halt production. When I worked in America, people were afraid to stop the line at first because they didn't want to upset their managers. But within a year, they became really skilled at knowing when to do it. Last year we opened our global support centers, where plant managers from around the world go for training. Our 40 or so factories worldwide compete on quality, and some from overseas are starting to give those in Japan a run for their money.

What other companies do you think are smart? You can learn a lot about brand image from Shiseido, the cosmetics company. Canon is a model for global expansion. And I have long admired GM: When it moved into Europe in the 1950s and '60s, its subsidiaries there became truly European. For students of success, every company can be a teacher.

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