THE STOKELY LETTER

BUSINESS GROWTH SPECIALISTS

Strategy, Marketing, Mergers & Acquisitions

Why *"Success Formulas"* Fail

Most businesses concentrate on refining their business model to improve results.

Over time these business models can become the "Holy Grail" for firms. We often hear phrases such as "*Success breeds success*" and "*Don't fix it if it isn't broken.*"

You may well have such a "success formula" in your firm.

We see examples around us everyday of market leaders who have built their reputations on sound, predictable and consistent models.

United and American Airlines, McDonalds and Blockbuster are a few. Each has developed and aggressively implemented their own particular success formula.

And today each is in serious trouble because of it.

United and American Airlines

The two largest airlines in the world have previously weathered the storms within a turbulent industry.

Their "hub and spoke" system formula has collected air travelers from "feeder" markets, brought them to "hub" destinations like Chicago or Dallas/Fort Worth, and then consolidated them with other passengers on aircraft flying to their desired ultimate destination. They fly a variety of different aircraft to accomplish this.

These airlines developed this formula and their operating practices while the industry was regulated. This better assured predictable revenue based on restricted competition and the ability to pass along cost increases, particularly to the last minute business traveler.

But things have changed.

The "hub and spoke" system contains operating inefficiencies in both human and capital resource utilization. The variety of aircraft flown requires more costly parts inventories and training of maintenance personnel. Due to deregulation, competition sprouted up on many routes driving prices down. Business travelers are changing their behavior by resisting traditionally high last minute fares and teleconferencing more. Through strikes and collective bargaining agreements, personnel costs and work rules have escalated operating costs so that in 2002 United spent 49.7% of revenues on labor, while American spent 48.5%. Southwest Airlines spent 36.1%, while maintaining its high level of customer satisfaction.

United pilots flew an average of 36 hours a month in 2001, while the average at Southwest was 62 hours.

"Our labor costs are the highest in the industry. Unsustainable." says Glenn Tilton, Chairman United Airlines.

Don Carty, former Chairman of American Airlines, believes American can successfully charge a 30% premium for their service for the long term. But even to get there will require enormous wage and work rule concessions.

United is in bankruptcy, and American is close behind.

*Things have changed.........Their old **"Success Formula"** doesn't work anymore.*

McDonalds

When McDonalds began in the 1950's the public enthusiastically welcomed its offering. I remember the initial appeal of their convenient locations, fast service, consistent product quality, and clean facilities. There was nothing like it. And the best part was that it was almost impossible to spend more than $1 for an entire meal, even for a hungry teenager!

Since then McDonalds has grown into a remarkable worldwide success. With 30,000 restaurants in 118 countries they are the largest restaurant company in the world with annual revenues of $40 billion.

They developed the Happy Meal in 1976 to strengthen their appeal to children. With each combination of burger, fries and a small drink the child also receives a free toy. This special offering now accounts for more than 20% of all U.S. McDonalds transactions.

The addition of playgrounds in many McDonalds and powerful advertising featuring Ronald McDonald created strong brand loyalty as a family dining destination.

But things have changed.

Customers can now choose from a broad array of competitive offerings such as Burger King, Wendy's, Taco Bell, and KFC with many of the same appeals, and added variety.

Many other new "fast food" options such as Subway have appeared, offering fresh and lower calorie ingredients. Subway now operates more U.S. locations than McDonalds.

A recent survey in *Restaurants and Institutions* magazine ranked McDonalds food quality for hamburger chains 15th behind Steak n Shake, Burger King and even White Castle.

Aggressive competitive "Dollar Menu" item promotions are relentlessly squeezing margins.

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Happy Meal sales are reportedly declining significantly. A 10-year exclusive licensing agreement with Disney for the free toys has restricted McDonalds from capitalizing on other trendy characters, and sometimes burdens them with disappointing new Disney movie offerings. Some argue this strategy has shifted sometimes fickle kid loyalty to the toy rather than the McDonalds franchise.

The last big new product hit at McDonalds was Chicken McNuggets in 1983. The company has attempted to diversify somewhat with investments in Boston Market and Chipotle Mexican Grill, but this may be a distraction from focusing on correcting the trends at the core McDonalds restaurants.

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Blockbuster

Since Blockbuster started in the 1980's, critics have predicted that video-on-demand would render it obsolete. It hasn't happened.

Blockbuster has grown to 8,500 stores worldwide by offering movies for rent, a simple concept well executed. They have focused on refining a rental business model, rather unique in today's retail sales environment. Blockbuster dominates the $10 billion video rental market.

Their convenient and highly visible locations are open when the customer wants them to be open.

They have developed a straightforward store presentation by movie theme to make it easy to shop, and prominently feature newer releases along the perimeter walls. Large inventories of the most popular current releases enable them to guarantee availability to their customers. No out of stocks or wasted trips.

They boosted profit margins by using their 40% rental market share leverage in negotiations with movie studios, dramatically reducing their product acquisition costs.

But things have changed.

DVD is dramatically growing in popularity. It offers terrific video and sound quality, is very compact, holds large amounts of information and doesn't require any rewinding like traditional videos.

Movie studios decided to drastically cut their prices on new and old movies on DVD to well below $20 to stimulate demand. Retail sales have exploded.

In 2002 retail sales for movies grew 19% to over $12 billion, exceeding rental revenue of $10 billion, which declined 3%.

Blockbuster is now aggressively attempting to sell product as well. However their margin on rentals is 65%, while the margin on sale product is 15%.

Competing in retail sales now brings in a new set of competitors such as Target, Costco and especially Wal-Mart, who already commands a 20%+ share of the sale market for DVDs.

Blockbuster says it isn't going to compete on price, as they attempt to shift with the market while operating their relatively high cost business model.

Recent rental volume is sharply lower at the company.

*Things have changed............the old **"Success Formula"** doesn't work anymore.*

SUMMARY

Change makes ***"Success Formulas"*** obsolete.

Understanding and accepting this can be difficult. Being proactive in doing what is necessary to anticipate and respond to Change is even more difficult.

But the alternative is obsolescence.

Think about what ***"Success Formulas"*** you may consciously or unconsciously be following in your own business, how Change may be affecting you, and what you are doing about it.

We have developed The New Marketing™ as a roadmap to successfully deal with constant Change.

Articles presenting The New Marketing™ are available in the Resource Center on our web site at www.eStokely.com. You are welcome to visit and give us a call anytime.

"You have to give customers what they want - not what you think they want or only what you have on hand." Randy Mott, Sr VP/CIO Dell Computer

"Do what you can, with what you have, where you are."
Theodore Roosevelt