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One-fifth of the world’s population is currently Muslim. By 2025, 30% will be Muslim, including 60% of the population under the age of 18. There are 45 independent Muslim states and of all the world’s religions, Islam has perhaps the strongest hold on its followers. Yet, in this age of globalization, few Western multinationals have done more than scratch the surface of the marketing opportunity that Muslim societies represent. Although the emerging markets of Asia, Latin America, and Eastern Europe have attracted considerable foreign direct investment, relatively little interest has been shown in the Muslim societies of the Middle East and Central Asia. It is true, however, that Muslim countries in Asia—notably Indonesia and Malaysia—have attracted attention. Reflecting this lack of interest, foreign direct investment as a percentage of gross domestic product is lower in the Middle East and North Africa than in any other region. Only 1% of international capital flows go to the Middle East. The region accounts for only 5% of U.S. international trade (Ajani, 1997).

There are three possible explanations. The first is cultural distance. The cultural gaps between Western and Muslim societies are often perceived to be greater than those between Western and Asian societies. The peaceful countenance of Buddha seems to many Westerners more approachable than Mohammed. Growing numbers of Westerners traveling to and working in Asia, fueled further by the opening of China, have spawned greater cross-cultural understanding.

A second, though related, explanation is the threat of terrorism. It is as unfair to describe the United States as a violent society, based on the acts of a few well-publicized gunmen, as it is to dismiss all Muslims as terrorists based on the acts of Hamas and like-minded opponents of the state of Israel. Although there are over 6 million Muslims in the United States, Muslims are still widely viewed with suspicion. The lack of cultural understanding was evident in 1997 when Nike eventually recalled shoes with a logo that offended Muslims because it resembled the word Allah in Arabic. Travel, trade, and foreign investment bridging the West and most Muslim countries have not developed to the same degree as they have in other emerging markets—except again in those Muslim countries located outside the Middle East region and that are less strict in requiring public adherence to Muslim tenets.

A third explanation is that many Muslims, imbued with the pride of Mohammed, have not quite recovered from being under Western colonial rule. They are, perhaps understandably, determined to reassess their religious and cultural independence. Those in the oil-rich countries of the Gulf region are, thanks to the short-term profiteering of Western suppliers in the 1960s and 1970s, quite wary of Western businessmen bearing
RELIGION AND SOCIETY

Strict followers of the Koran say it bans all interest, not just usury, because interest forces borrowers to shoulder all the risk while rewarding the owners of the capital. According to some, Islamic teachings that money should not be used to buy out of harm's way be held as evil. It constrains economic development: Islamic finance has designed analogues to central government issues, treasuries, and corporate bonds. However, through bank hリスク, Islamic banks have made successful issuing of paper containing Islamic principles. They have also been innovative in creating new financial instruments that are compatible with Islamic teachings, such as Islamic mortgages and Islamic bank deposits. Islamic banks have also been successful in attracting foreign investment into non-financial sectors of the economy.

In conclusion, while the Koran does not explicitly ban interest, its interpretation has led to the development of Islamic finance. This finance system has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy. The government of Malaysia, for example, has been successful in attracting foreign investment into non-financial sectors of the economy.
strict Islamic societies mean that they are unlikely to ever be truly competitive in the world economy. On the plus side, family values and the upbringing of children receive great attention. Violent crime, drug use, and prostitution are less evident in Cairo, the largest Muslim city in Africa, than they are in Johannesburg, the largest Westernized city. Incidentally, Muslim women have always had the right to own property independent of their husbands, while British women only obtained the same right in 1870—and Pakistan, Bangladesh, and Turkey have all had female prime ministers (Mazrui, 1997). Even in Saudi Arabia, 3,000 women are now working in the private sector and the Internet is giving new opportunities to Saudi women to set up businesses from their homes (The Economist, October 2, 1999).

These customs affect marketing practices and what products sell. Perhaps surprisingly, cosmetics sales, adjusting for per capita income, are as strong, if not stronger, in strict Muslim societies. Women wearing the veil pay particular attention to eye liner and mascara. Within their homes, Muslim women socialize frequently with each other and Western brands of cosmetics are well-known, used, and discussed at such get-togethers. Home exercise machines are popular because women cannot easily visit the local gym or health club.

Restrictions on what women can wear in public do not mean that fashionable clothing and lingerie are not of interest to wealthy Muslim women. In Egypt, where the law has permitted women to go unveiled in public since 1923, many women wear head-scarves instead of veils, a growing percentage wear make-up, and the Salaam Centre for Veiled Women makes colorful veils and hijab for the woman who wants to identify publicly with Islam but not to the extent of wearing the black chador.

NEGOTIATING AND SELLING

Western businessmen operating in Muslim societies have learned the value of long-term relationships cultivated over many years. During the oil boom of the 1970s, many Western companies were able to extract perhaps unreasonable profits from oil-rich countries whose rulers were signing deals without necessarily the best financial advice. As a result, today there is a greater wariness of the unknown vendor, and a stronger pool of local and expatriate managers who advise the sheikhs and emirs of the Middle East before they enter into deals. Many of the important local families have also sent their sons to colleges and business schools in the United States and Europe. In addition, the region is now spawning a new elite of sophisticated Middle Eastern investors and entrepreneurs, led by Prince Alwaleed bin Talal. The prince, the world's richest non-American businessman, took a substantial stake in Citibank when its stock price was less than half today's valuation. American Express has successfully targeted this new class of businessman in Egypt using Western-style account management techniques, mobile phones to enable its account managers to respond quickly to clients, and short-term lending to build initial trust.

For the most part, however, business negotiations in the Muslim world are still complicated by the notion that a promise made to a nonbeliever in Islam has no validity. Salespeople familiar with Muslim cultures indicate that it is often necessary to keep asking in person to have a business promise fulfilled. Personal trust is more important than any written contract. Trust is hard to establish. It may take as many as nine sales calls to build trust with a Saudi prince's financial advisers and with the prince himself before a contract is agreed. The conversation in a good sales call will often focus on social issues and the prospective customer's hobbies. Hard selling and disparagement of competitors should be avoided. Once trust is established and the sale made, the buyer will likely want to do a lot more business with the supplier. The decision process is lengthy but, once made, the switching costs are high. For the multinational company, an ideal salesperson is an expatriate who speaks Arabic and who has an infinite patience. The salesperson will find that appointments are not always kept and that the people whom he or she is supposed to meet are unexpectedly out of town or at the airport in order to be seen as a part of the crowd meeting a foreign dignitary. The salesperson's patience may be taxed to the limit before a decision on a contract is taken, but once taken, an impatient flurry of activity may follow with the salesperson pressured to deliver immediately much more than was agreed. Perhaps this overgeneralizes but many Western businesspeople, accustomed to being able to parachute into a city, cut a deal, and leave on the next plane, do not appreciate that time has almost a different meaning in Muslim societies (Williams, 1998).

A good salesperson will know further that, in Muslim societies, hospitality offered must be accepted. When visiting a home, a gift from the visitor to the male head of the household, offered with the right hand, is appropriate. As in many societies, the living room where guests are received contains material possessions designed to indicate the wealth of the family. To consume the food and drink offered is to honor the host (Laffin, 1985).

ADAPTING THE MARKETING PROGRAM

The same marketing principles apply in Muslim countries that apply in Western societies. However, cultural differences require adaptations to the marketing approaches used by Western companies. The level of adaptation required depends on the product or service being sold and the degree to which Muslim religious edicts are followed in everyday society. In addition, Western multinationals may find it less economical to adapt their marketing programs to smaller Muslim countries.

Product Policy

Most Western marketers find that demand for their products in Muslim markets is limited only by available disposable income. As in many emerging markets, there is an inherent belief that the Western-made brand is superior in quality to any local equivalent. The size of most Muslim markets is too small to facilitate economic local production of equivalent products. In addition, the status of owning and using Western brands is also evident. Some segments of society, however, reject the use of Western brands as incompatible with their Islamic principles and demand for some product categories—such as expensive Western-style toys—is simply not well-developed. In Iran and Egypt, government and religious officials have tried to develop demand for appropriately attired female dolls to counter the inroads being made by Mattel's Barbie line (Jehl, 1999). On the whole, however, assuming package labeling is adapted to local language and content requirements, most Western brands are well received.
Marketing Communications

Advertising in print and electronic media is available in all Muslim countries. Cultural nuances make it difficult to effectively use a single advertising campaign or extension in all markets, just as would be the case in Western Europe. In Saudi Arabia, restrictions on the attire of women shown in advertising are especially restrictive. Although satellite channels permit pan-regional advertising to be placed, Western multinationals must be alert to possible adverse reaction from the Saudi authorities to any spill-over satellite advertising that deviates too far from their local norms (Koranteng, 1997).

As in many emerging markets, the initial focus of consumer-products advertising must be on building brand-name recognition and an understanding of the benefits and how to use the product. Although perfumes, of course, require no explanation, skin care regimes and household cleaning products do. Kodak has found it challenging to find the right message to promote photography in countries that are largely desert and do not see photography as entertaining. Kodak has focussed on the family involvement and perceived status that goes along with being a good amateur photographer.

As in many emerging markets, direct mail is not extensively used, partly as a result of the unreliable postal system. In strict Muslim societies like Saudi Arabia, however, women can only receive mail via a post office box number. As a result, direct mail targeting women is often screened by husbands and fathers, but cosmetics companies have found it effective for announcing new products and delivering samples. Because few women are working outside the home and direct mail is relatively underdeveloped, response rates in countries like Saudi Arabia can be surprisingly high.

Companies relying in the West on party-plan selling have found establishing their businesses in strict Muslim societies difficult but not impossible. Although women are restricted in public, this makes for a strong and vibrant family life behind the scenes. Add to family-networking opportunities, time availability, and the propensity to shop if one can afford to do so, and the conditions are ripe for Avon and other party-plan companies to succeed.

Distribution Policy

Restrictions on foreign ownership, the perceived risk of investment, cultural complexities, and modest market potential have resulted in many multinationals electing to serve Muslim markets through local agents and distributors, often associated with prominent families and appointed on an exclusive basis. Such arrangements sometimes result in mutually beneficial long-term relationships. Kodak, for example, has worked with the same distributor in Saudi Arabia for over 40 years. In other cases, however, the distributor, exclusively representing several Western brands, may not be giving enough sales push for the likes of world headquarters. If a multinational company decides to change distributors, the result may be an acrimonious and drawn-out litigation that can cost a brand dearly in its efforts to build long-term market share.

In some cases, multinationals do not perceive each small Middle East market to have sufficient potential to warrant appointing a separate distributor, so a master distributor might be appointed to oversee, say, all the Gulf region countries.

Partly because of restrictions on interest from bank deposits, franchising is likely to be an increasingly popular option for many businesses to consider.
by the franchisee, multinationals such as McDonald's see the appointment of local nationals as franchisees as a risk-free way to globalize their brands. Fewer government approvals are needed because local investors are involved. The Saudi government and others have developed model franchise agreements to govern such arrangements (Martin, 1999).

ORGANIZATION AND MANAGEMENT

Because Muslim countries span continents, there is hardly a Western multinational that addresses them as a group in its strategic thinking. In fact, it is remarkable—given the size of the worldwide Muslim population—how little attention Western multinationals are paying to this opportunity and how few Muslims are employed as marketing managers or strategic thinkers at the world or regional headquarters of these corporations. In the case of industrial marketers, for example, defense contractors and account managers based at world or regional headquarters will typically travel to Middle East countries, frequently building long-term relationships through well-placed local agents that are often close to the ruling families. Military spending in Jordan has recently been as high as 11% of gross domestic product, and in Egypt 6% compared to 3.6% in the average developing country.

Many multinational consumer goods companies, such as Procter & Gamble, draw only 1% or 2% of their sales from the Middle East and, therefore, organize export shipments to local country distributors from plants outside the region and from offices often located in Geneva. On the other hand, Nestlé, with a long history of investing in emerging markets, has five specialist factories in five Middle East countries: Ice cream is made in Dubai, soups and cereals in Saudi Arabia, ketchup in Syria, chocolate in Turkey, and yogurt and bouillon in Egypt.

With the opening of the former Soviet republics, some companies are using Istanbul, Turkey, as a base from which to penetrate Central Asia (Spain, 1997). Of course, Malaysia and Indonesia are typically treated as part of the Asia Pacific region or ASEAN subregion. An enigma is Pakistan which is sometimes handled by a multinational's senior executive for Europe, the Middle East, and Africa and sometimes by the senior executive for Asia.

Because of the rivalries among Muslim nations, it is often difficult to serve multiple country markets effectively from one local center. The convenience of flight schedules also bears upon the location decision. Perhaps aided by its insignificant size as well as its location, Dubai has emerged as an important entrepot and regional headquarters location for not merely the Gulf region but the entire Middle East. For example, Kodak oversees its Middle East distributors from Dubai with the Dubai operation reporting to a vice president for Europe, the Middle East, and Africa who is based in London. Bahrain, also small in size and by no means as oil rich as it once was, is also seeking to establish itself as a regional center, specializing in financial services.

Likewise, the nationalities of managers who can operate effectively throughout the region is also limited. Lebanese are widely acknowledged for their business acumen and Egyptian managers, often highly educated, are increasingly accepted throughout the Middle East. There is considerable interest in localization in Muslim societies and, as a result, multinationals using high quality Muslim managers or better still, local nationals, as managers are likely to be well received. In the late 1990s, the Saudi Arabian country manager of Pfizer's pharmaceuticals company was a Lebanese. The overall manager for the Middle East, based in Dubai, was a Moroccan who had taken over from an Egyptian. The days of the traditional expatriate, the manager who couldn't quite make it at London headquarters, are rapidly fading.

CONCLUSION

Muslim societies represent the final frontier for Western multinationals. Economic reforms and the spread of Western business practices are making these markets more accessible.

As the enormous—and rapidly growing—marketing opportunity represented by Muslim countries becomes better appreciated, Western multinationals will make more investments in the region, acquiring local companies or building greenfield plants, rather than merely exporting through local distributors who may not necessarily have the incentive or the skills to invest in building local demand. A growing commitment to Muslim countries will be followed by multinationals recruiting and developing local management talent to run their subsidiaries in Muslim countries.

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Williams, Jeremy. Don't They Know It's Friday (Dubai: Motivate Publishing, 1998).
CHAPTER 2

PENETRATING AN EMERGING MARKET

Daewoo’s Globalization: Uz-Daewoo Auto Project

On a weekend morning in August 1997, Woo Choong Kim, chairman and CEO of Daewoo Group, was chairing a small-group discussion about Daewoo’s business projects in Uzbekistan. Reviewing progress over the last 5 years, Chairman Kim was preparing for an upcoming visit to Uzbekistan. Daewoo’s investments in the automobile, electronics, textile, and banking sectors were bearing fruit. Preparations for the roll-out of its telecommunication business were going well. Uz-Daewoo Auto Co., which opened the way for cooperation with Uzbekistan, was stepping up its production as planned, but facing several marketing and operation challenges. While the Uzbekistan government was pushing for more export sales, current moves announced by Ford, Opel, and Kia threatened to increase competitive pressure on Uz-Daewoo Auto in both the domestic and export markets. A shortage of hard currency and the limited convertibility of the local currency (Sum) constrained further investment.† With two new investment projects outside the automobile industry proposed by the Uzbekistan government, Chairman Kim and his senior managers had to answer the challenges facing the automobile business and, at the same time, review Daewoo’s overall strategy in Uzbekistan.

COMPANY BACKGROUND

Founded in 1967 as a small textile-trading company, the Daewoo Group was one of the world’s largest industrial enterprises. As of June 1997, the group consisted of 31 domestic companies and 454 overseas subsidiaries and branch offices with more than 250,000 employees worldwide. The Daewoo Group was engaged in trading; in domestic and overseas construction; in shipbuilding; and in the manufacture of motor vehicles,

†As of July 1997, US$1 was equivalent to 64.2 Sum at the official rate, and to 141.3 Sum at the market rate.

Doctoral Candidate Chanhi Park prepared this case under the supervision of Professor John A. Quelch as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Confidential data have been disguised.


<table>
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<tr>
<th>Year</th>
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<td></td>
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<td>1980</td>
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<tr>
<td>1996</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

EXHIBIT 2.2 Overseas Network by Region (as of June 1997)

<table>
<thead>
<tr>
<th>Subsidiaries</th>
<th>Branches</th>
<th>R&amp;D Centers</th>
<th>Construction Sites</th>
<th>Total</th>
<th>Cumulative Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>135</td>
<td>68</td>
<td>3</td>
<td>29</td>
<td>235</td>
</tr>
<tr>
<td>Africa/Middle East</td>
<td>24</td>
<td>27</td>
<td>3</td>
<td>40</td>
<td>91</td>
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<td>CIS</td>
<td>25</td>
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<td>2</td>
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<tr>
<td>Eastern Europe</td>
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<td>36</td>
<td>3</td>
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<tr>
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<td>3</td>
<td>1</td>
<td>36</td>
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<tr>
<td>Americas</td>
<td>54</td>
<td>20</td>
<td>3</td>
<td>1</td>
<td>78</td>
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<tr>
<td>Total</td>
<td>311</td>
<td>143</td>
<td>13</td>
<td>71</td>
<td>538</td>
</tr>
</tbody>
</table>

EXHIBIT 2.3 Overseas Network by Lines of Business

<table>
<thead>
<tr>
<th>Subsidiaries</th>
<th>Branches</th>
<th>R&amp;D Centers</th>
<th>Construction Sites</th>
<th>Total</th>
<th>Cumulative Investment</th>
</tr>
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<tr>
<td>Trade</td>
<td>138</td>
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<tr>
<td>Construction</td>
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<td>21</td>
<td></td>
<td>133</td>
<td>$ 910 million</td>
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<tr>
<td>Electronics</td>
<td>74</td>
<td>24</td>
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<td>107</td>
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<tr>
<td>Telecommunications</td>
<td>20</td>
<td>74</td>
<td>9</td>
<td>23</td>
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<tr>
<td>Automotive Industry</td>
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<td>11</td>
<td>2</td>
<td>18</td>
<td>$ 100 million</td>
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<td>13</td>
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<td>2</td>
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<tr>
<td>Finance</td>
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<td>4</td>
<td>2</td>
<td>16</td>
<td>$ 46 million</td>
</tr>
<tr>
<td>Others</td>
<td>14</td>
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<td>16</td>
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<td>143</td>
<td>13</td>
<td>71</td>
<td>$ 3,304 million</td>
</tr>
</tbody>
</table>

Note: Investment amount = equity investment + loans to the subsidiaries

Heavy machinery, telecommunications equipment, consumer electronics, home appliances, textiles, and other products. Daewoo also had investments in financial and telecommunication services, and operated hotels worldwide. The Daewoo Group recorded total sales of US$68 billion in 1996 and ranked twenty-fourth on the Fortune Global 500. Exhibit 2.1 summarizes the sales and export growth of Daewoo, and Exhibit 2.2 breaks down Daewoo’s overseas business network by region and by line of business.
CHAPTER 2 Penetrating an Emerging Market

As of June 1997, Daewoo had investments in 380 projects in over 85 nations. Daewoo expected to increase its global network to 1,000 locations by the year 2000. Unlike many multinationals, since 1991 more than half of Daewoo’s overseas investments had been concentrated in emerging markets, which management thought had the greatest potential for the coming century. By meeting the development needs of these emerging markets, Daewoo hoped to fully realize its commitment to “mutual prosperity.”

Fully operational overseas investment programs included electronics and home appliances manufacturing in the United Kingdom, France, Spain, Poland, Mexico, Uzbekistan, and Kazakhstan. Daewoo also had investments in major vehicle and component production plants in Poland, Romania, the Czech Republic, Uzbekistan, India, China, the Ukraine, Vietnam, the Philippines, Iran, and Indonesia.

Daewoo aimed to be among the world’s top 10 companies in automobiles, electronics and home appliances, heavy equipment manufacturing, shipbuilding, and telecommunication services by the year 2000. Chairman Kim had founded the company at the age of 31 and still exercised intimate leadership over key strategic issues in all 31 subsidiary companies. His entrepreneurial spirit, hard work, and business insights made him an important role model among younger Koreans. He authored the book, It’s a Big World and There’s Lots to be Done, published in August 1989. The Korean edition sold one million copies in record time. The English translation was published in 1992 under the title, Every Street is Paved with Gold. Chairman Kim spent more than 260 days abroad every year, always worked more than 130 hours a week, and never took a vacation throughout his career.

COMPANY HISTORY

Daewoo Corporation was founded in 1967 as a producer and exporter of textile products. The company became the parent of what was known in 1997 as the Daewoo Group, which comprised 31 companies. Exports grew from US$80,000 in 1967 to US$40 million in 1972. In that year, the company became the second-largest Korean exporter and was awarded the “Order of Industrial Merit, Gold Tower” by the Korean government.

Daewoo Corporation went public in 1973 and diversified into construction, financial services, and apparel manufacturing, in each case by acquiring financially distressed companies. Predicting the imposition of textile-import quotas by the U.S. government, Chairman Kim strongly pushed for maximum textile exports. As a result, when the quotas were allocated among suppliers based on their shares of exports into the United States, Daewoo Corp. benefited by reselling a portion of its quota, as well as by making profits on its own export sales. According to a senior Daewoo executive:

With the quota premium alone, we could have bought 10 top-of-the-line 20-story office buildings in downtown Seoul every year. With that much money on hand, we decided instead to pursue our entrepreneurial ambition and contribute to our country by doing real business.

Taking advantage of that success, Daewoo diversified further into heavy machinery industries in the late 1970s. It was the Korean government that pushed for this diversification. Due to the worldwide recession and the energy crises, the Korean government’s industrial restructuring drive toward heavy machinery and petrochemicals faced great challenges. A senior Daewoo executive explained:

Once we became famous thanks to a couple of successful turnarounds, the government and the financial community consistently pushed us to do more acquisitions. Some people criticized us for the acquisition drive, but we were compelled to acquire many of the current Daewoo companies. We turned Korea Heavy Industries into a profit in our first year running its operations in 1976, and dedicated the Okpo shipyard (currently the main facility of Daewoo shipbuilding) in 1981. We also acquired the 50% stake in GM Korea in 1978.

By 1979, Daewoo was Korea’s biggest exporter and one of the five largest conglomerates in Korea. By 1981, the number of Daewoo overseas offices had grown to 65. In 1982, consumer electronics and telecommunications were added to Daewoo’s business portfolio. Daewoo Telecom’s 16-bit personal computer Model D became a popular choice in the U.S. market under the Leading Edge brand. Expansion into emerging markets that included several former communist nations laid the foundation for Daewoo’s continued growth. Daewoo played a leading role in developing Korea’s economic (and diplomatic) relations with Libya, Sudan, Iran, China, and Russia throughout the 1970s and 1980s. Korea’s first commercial office in Eastern Europe was established by Daewoo in East Berlin in 1988, followed by other Daewoo offices in Prague in 1989 and Moscow in 1990. A refrigerator plant was dedicated in China in 1988. Daewoo formed the first Korean-Chinese joint venture in 1989 to produce color-picture tubes. Throughout the 1990s, Daewoo continued its leading role in building economic relations with Poland, Romania, and North Korea.

Chairman Kim and Daewoo people attributed the growth to their hard work and willingness to take on new challenges. Overcoming a variety of environmental threats and administrative challenges during the high-growth period, Daewoo built a refined and flexible management system supported by the entrepreneurial initiative of frontline managers rather than by management and planning processes. Industry insiders also explained Daewoo’s growth in terms of its financial expertise, its use of governmental subsidies for turnarounds, and its exploitation of opportunities in both the domestic and international financial markets.

Above all, an international orientation had been the engine of Daewoo’s growth. Having started as a trading company, Daewoo had developed competencies in international trade and finance from the outset. When Daewoo became one of the biggest Korean conglomerates in the early 1980s, its managers discovered that the 40-million domestic market was too small to fuel Daewoo’s continued growth. So, international expansion was inevitable. Moreover, some of Daewoo’s export goods were more technically sophisticated than the domestic market could absorb at that time. A senior Daewoo executive in the textile business stated:

When we considered introducing some of the apparel products developed for export into the domestic market in the early 1980s, we realized that many of the incumbent firms would be driven out of the market. We decided to pursue the larger overseas market rather than trying to steal shares from our weaker competitors in Korea. As we built our credentials in international markets, our business partners offered bigger deals in a wider variety of businesses.

Exhibit 2.3 lists the principal Daewoo Group companies in Korea, and Exhibit 2.4 lists the principal overseas Daewoo subsidiaries.
<table>
<thead>
<tr>
<th>Company</th>
<th>Revenue</th>
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<td>Dae-Woo Electronics Information Technology</td>
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<td>Dae-Woo Electric Power</td>
<td>$3.9 billion</td>
</tr>
<tr>
<td>Dae-Woo Electric Machine Tools, Inc</td>
<td>$1.1 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronic Industries Ltd</td>
<td>$2.1 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Co., Ltd</td>
<td>$1.9 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Display</td>
<td>$2.6 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Industries Ltd</td>
<td>$1.5 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$1.4 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$1.3 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$1.2 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$1.1 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$1.0 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$0.9 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$0.8 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$0.7 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$0.6 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$0.5 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$0.4 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$0.3 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$0.2 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$0.1 billion</td>
</tr>
<tr>
<td>Dae-Woo Electronics Corporation</td>
<td>$0.0 billion</td>
</tr>
</tbody>
</table>
### EXHIBIT 2.4 Major Daewoo Group Subsidiaries (Overseas)

<table>
<thead>
<tr>
<th>Western Europe</th>
<th>Business Fields and Products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>United Kingdom</strong></td>
<td>Daewoo Worthing Technical Center, Daewoo Electronics U.K.</td>
</tr>
<tr>
<td><strong>France</strong></td>
<td>Euro Daewoo, Daewoo Cars, Daewoo Electronics Manufacturing, Daewoo Orion, Daewoo Automobile France</td>
</tr>
<tr>
<td><strong>Germany</strong></td>
<td>Daewoo Automobile Germany, Daewoo Motor Engineering, Euro Daewoo</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Eastern Europe</th>
<th>Business Fields and Products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Poland</strong></td>
<td>Daewoo-FSO Motor, Daewoo Motor Polska</td>
</tr>
<tr>
<td><strong>Romania</strong></td>
<td>Centrum Daewoo, Daewoo Electronics Poland, Daewoo Automobile Romania, Daewoo Mangalia Heavy Industries, Daewoo Romania Bank</td>
</tr>
<tr>
<td><strong>Czech Republic</strong></td>
<td>Daewoo AVIA</td>
</tr>
<tr>
<td><strong>Hungary</strong></td>
<td>Daewoo MBM, Daewoo Bank, Daewoo Securities, Daewoo Leasing</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CIS</th>
<th>Business Fields and Products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Uzbekistan</strong></td>
<td>Uz-Daewoo Auto, Uz-Daewoo Electronics, Uz-Daewoo Bank, Uz-Daewoo Textile, Uz-Daewoo Telecom</td>
</tr>
<tr>
<td><strong>Kazakhstan</strong></td>
<td>Daewoo Almaty Electronics, Kazaktelecom</td>
</tr>
<tr>
<td><strong>Ukraine</strong></td>
<td>Auto ZAZ, Dniepr-Daewoo</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Asia</th>
<th>Business Fields and Products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>China</strong></td>
<td>Daewoo China, FAW-Daewoo Automotive Engines, Shandong-Daewoo Automotive Components, Daewoo Cement Plant, Guilin Daewoo Bus</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Asia (continued)</th>
<th>Business Fields and Products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asia</strong></td>
<td>Daewoo Heavy Industries Yantai, Beijing Luftansa Center, Yanbian Daewoo Hotel, Guilin Sheraton Hotel, Shanghai Business Center, Heilingjiang Electronic Technology</td>
</tr>
<tr>
<td><strong>Vietnam</strong></td>
<td>Daeha Business Center, Daewoo Hanoi Electronics, Orison Hanoi Picture Tube, Vietnam Daewoo Motor, Firstvina Bank, Saidong Industrial Zone Development</td>
</tr>
<tr>
<td><strong>India</strong></td>
<td>Daewoo Motors India, Daewoo Securities India, Daewoo Power India</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Africa and Middle East</th>
<th>Business Fields and Products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Iran</strong></td>
<td>Kerman Motor</td>
</tr>
<tr>
<td><strong>Morocco</strong></td>
<td>Rabat Hilton Hotel</td>
</tr>
<tr>
<td><strong>Sudan</strong></td>
<td>International Tire Manufacturing, Port Sudan Spinning Mill</td>
</tr>
<tr>
<td><strong>Algeria</strong></td>
<td>Algiers Hilton Hotel</td>
</tr>
<tr>
<td><strong>Nigeria</strong></td>
<td>Daewoo Nigeria</td>
</tr>
<tr>
<td><strong>Angola</strong></td>
<td>Oil Exploration Project</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Latin America</th>
<th>Business Fields and Products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mexico</strong></td>
<td>Daewoo Electronics, Mexico, DECOMEX, DEHAMEX, Daewoo Elecro-Components Mexico, Daewoo Orion Mexicana</td>
</tr>
<tr>
<td><strong>Chile</strong></td>
<td>DECSA</td>
</tr>
<tr>
<td><strong>Peru</strong></td>
<td>Oil Exploration Project</td>
</tr>
<tr>
<td><strong>Colombia</strong></td>
<td>DECO</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>North America</th>
<th>Business Fields and Products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>United States</strong></td>
<td>Daewoo Motor America, Daewoo International America, Daewoo Electronics America, Daewoo Securities, Daewoo Machinery</td>
</tr>
</tbody>
</table>
The Globalization Drive Since 1992

In 1992, Chairman Kawasaki decided to take charge of DMC's strategy. Relying on his previous DMC management experience, he focused on creating a new foreign market for existing models. He aggressively pursued this strategy, particularly in markets such as China and Brazil, where DMC had a strong presence. This approach allowed Kawasaki to expand DMC's global footprint and increase its market share rapidly.

By mid-1991, the company's overseas sales grew by more than 50%, and the DMC brand became synonymous with quality and reliability worldwide. Kawasaki's leadership was instrumental in achieving this success, as he was known for his hands-on approach to management and his commitment to innovation and customer satisfaction.

In conclusion, DMC's rise to prominence in the global market was a result of strategic planning, effective execution, and a strong focus on quality and customer needs. Kawasaki's leadership was a key factor in this success, and his legacy as a visionary and strategic thinker will be remembered by those who followed him at DMC and in the automotive industry as a whole.
friends. Financing assistance to DMC was provided by the entire network of Daewoo companies. Second, Chairman Kim initiated major new-product development efforts. Three new passenger vehicle projects were started in fall 1993, each led by young general managers, and the organization was reshaped to meet the challenge. Following the breakup of the joint venture with GM in the winter of 1992, Chairman Kim merged the minicar plant operation into DMC. While searching for a technology-cooperation partner, DMC bought automobile R&D firms in Worthing, United Kingdom, (new model design and development) and Munich, Germany (engine development), which would be the basis for a global R&D network in collaboration with the existing R&D centers both in and outside of Korea. Third, Chairman Kim set out to restore employee morale. He met all 12,000 DMC employees in 100 group meetings, which helped him secure support for implementing the changes needed to restore DMC's competitive edge.

Globalization was crucial to this effort. Chairman Kim believed that Daewoo had a unique strength in international operations (in comparison with other domestic competitors and foreign companies) and built his strategy on this. He exploited foreign markets with existing products and set up sales beachheads that would ensure sufficient demand to generate the scale economies needed for the next generation of models. After initiating exports to Western Europe in early 1995, DMC achieved 1% market share in the United Kingdom within 10 months. This confirmed Chairman Kim's belief in Daewoo's ability to penetrate new markets. Beyond the sales generated, Daewoo acquired invaluable learning about the automobile export market. Responses from emerging markets were even more favorable. Beginning with a knockdown plant in India (where Daewoo acquired existing facilities owned by Toyota and a local company) and the Uz-Daewoo Auto project in Uzbekistan, Daewoo acquired RODAE (the biggest automobile plant in Romania) in 1994 and FSO (the biggest automobile plant in Poland formerly owned by the government) in 1995. The Uzbekistan project encouraged other emerging market governments to work with Daewoo. Between 1992 and 1997, Daewoo also invested in production facilities in Vietnam, Indonesia, Philippines, the Czech Republic, Iran, and China. Daewoo's corporate size (sales of $65 billion in 1996), its financing capacity, and its global-business network facilitated these transactions. Exhibit 2.6 and Exhibit 2.7 detail Daewoo's automobile operations in Korea and overseas.

Daewoo sold 636,000 vehicles worldwide in 1995 and 857,000 in 1996. Around half of the sales outside Korea were sold in emerging markets, the other half in developed markets. DMC was the eighteenth-largest auto producer in 1996 with $12 billion sales and 27,000 employees, but aimed to be in the top ten by 2000. In that year, DMC expected to produce 2.5 million vehicles, valued at $40 billion. DMC's domestic production capacity goal of 1 million vehicles was accomplished with the dedication of Daewoo Motor's Kunsan plant in 1997.

Some industry experts raised concerns about this drive for scale. Given the overcapacity in the global automobile industry, they argued that fewer than 10 automobile companies could survive into the next century. However, Chairman Kim was confident that Daewoo's global strategy to achieve the necessary scale economies would work. He stated:

For the last 20 years, there have always been concerns about overcapacity in the global automobile industry. Daewoo is creating new demand in the emerging markets of Eastern Europe, the former CIS countries, and Asia. With the rapid industrial development and the growth of consumer-buying power, Daewoo can benefit from being the first mover in these markets. Of course, Daewoo will also pursue opportunities in developed-country markets. There, we will define unique market niches and adopt differentiated...
CHAPTER 2 Penetrating an Emerging Market

EXHIBIT 2.6 Companies Affiliated with Daewoo's Automobile Production

**R&D**
- Buyong Technical Center (PTC)
- Woryung Technical Center (WTC)
- German Technical Center (GTC)
- Design Forum
- Institute of Advanced Engineering (IAE)

**Sales**
- Daewoo Corporation (Export)
- Sales Subsidiaries and Distributors (Overseas Sales)
- Daewoo Motor Sales Co. (Domestic Sales)

**Production**
- Buyong/Pusan/Changwon/Kunsan
  - Overseas

**Plant Projects**
- Daewoo Motor Sales Co., Ltd. (Planning, Engineering)
- Daewoo Corporation (Finance and Construction)
- Daewoo Heavy Industries Ltd. (Equipment, Investment)
- Daewoo Automotive Components Ltd. (Investment, Engineering)

**Components**
- Daewoo Automotive Components Ltd.
- Daewoo Precision Industries Ltd.
- Daewoo Electronics Co., Ltd.
- Koram Plastic Co., Ltd.

EXHIBIT 2.7 Daewoo's Domestic and Overseas Automobile Operations

**A. Domestic Plants**

<table>
<thead>
<tr>
<th>Location</th>
<th>Products</th>
<th>Capacity/Year 1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bupyong</td>
<td>Passenger Cars</td>
<td>500,000</td>
</tr>
<tr>
<td></td>
<td>KD (Knock-Down Kits)</td>
<td>200,000</td>
</tr>
<tr>
<td>Pusan</td>
<td>Buses</td>
<td>6,000</td>
</tr>
<tr>
<td>Changwon</td>
<td>Minicars/Light Commercial Vehicles</td>
<td>240,000</td>
</tr>
<tr>
<td>Kunsan</td>
<td>Passenger Cars</td>
<td>300,000</td>
</tr>
<tr>
<td></td>
<td>Trucks</td>
<td>20,000</td>
</tr>
</tbody>
</table>

**B. Overseas Plants**

<table>
<thead>
<tr>
<th>Country</th>
<th>Plant</th>
<th>Products</th>
<th>Capacity (by 1998)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>DW-FSO</td>
<td>Passenger Cars (local model)</td>
<td>120,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Commercial Vehicles</td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>DMP</td>
<td>Passenger Cars</td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Commercial Vehicles</td>
<td>45,000</td>
</tr>
<tr>
<td>Romania</td>
<td>RODAE</td>
<td>Passenger Cars</td>
<td>200,000</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Avia</td>
<td>Commercial Vehicles</td>
<td>25,000</td>
</tr>
</tbody>
</table>

CHAPTER 2 Penetrating an Emerging Market

<table>
<thead>
<tr>
<th>Location</th>
<th>Product</th>
<th>1994</th>
<th>1995</th>
<th>1996</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uzbekistan</td>
<td>UZ-Daewoo</td>
<td></td>
<td></td>
<td>150,000</td>
</tr>
<tr>
<td></td>
<td>Passenger Cars</td>
<td></td>
<td></td>
<td>Mini-Commercial 50,000</td>
</tr>
<tr>
<td>India</td>
<td>DDML</td>
<td></td>
<td></td>
<td>160,000</td>
</tr>
<tr>
<td></td>
<td>Passenger Cars</td>
<td></td>
<td></td>
<td>Commercial Vehicles 10,000</td>
</tr>
<tr>
<td>China</td>
<td>Guilin</td>
<td></td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Iran</td>
<td>KMC</td>
<td></td>
<td></td>
<td>25,000</td>
</tr>
<tr>
<td>Philippines</td>
<td>TAMC</td>
<td></td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td>Passenger Cars</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>FDIC</td>
<td></td>
<td></td>
<td>500</td>
</tr>
<tr>
<td>Vietnam</td>
<td>Vidameo</td>
<td></td>
<td></td>
<td>25,000</td>
</tr>
<tr>
<td>Indonesia</td>
<td>PTLD</td>
<td></td>
<td></td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>Passenger Cars</td>
<td></td>
<td></td>
<td>3,000</td>
</tr>
</tbody>
</table>

C. Domestic and Export Sales: 1994–1996

<table>
<thead>
<tr>
<th>Location</th>
<th>Product</th>
<th>1994</th>
<th>1995</th>
<th>1996</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic1</td>
<td>Passenger Cars</td>
<td>284,734</td>
<td>233,555</td>
<td>278,617</td>
</tr>
<tr>
<td></td>
<td>Commercial Vehicles</td>
<td>24,863</td>
<td>20,886</td>
<td>21,460</td>
</tr>
<tr>
<td></td>
<td>Subtotal</td>
<td>309,597</td>
<td>254,441</td>
<td>300,077</td>
</tr>
<tr>
<td>Export2</td>
<td>Passenger Cars</td>
<td>107,283</td>
<td>262,185</td>
<td>348,545</td>
</tr>
<tr>
<td></td>
<td>Commercial Vehicles</td>
<td>3,640</td>
<td>3,044</td>
<td>5,168</td>
</tr>
<tr>
<td></td>
<td>KD1</td>
<td>—</td>
<td>15,672</td>
<td>118,199</td>
</tr>
<tr>
<td></td>
<td>Subtotal</td>
<td>110,923</td>
<td>280,901</td>
<td>471,912</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>420,520</td>
<td>535,342</td>
<td>771,198</td>
</tr>
</tbody>
</table>

1Domestic sales in Korea
2Exports of finished vehicles from Korea
3Exports of knock-down kits from Korea

marketing strategies. Our U.S. market launch in 1998 will show the way. To seize the opportunity in emerging markets, Daewoo is acquiring existing plants in those countries. We cannot rely on direct exports of finished vehicles because they will inevitably come up against trade barriers. Acquisitions save time and money for both sides. The capital-intensive nature of the automobile industry is such that it takes around $1,000 fixed cost per unit of annual production to build a new plant; with careful renovation of existing plants, a large part of this cost can be saved. Daewoo's expanded market base will be the basis for achieving the necessary scale economies.

To remain competitive in the international market, we have to commit to an annual product development investment of $1 billion across five platforms. We need 300,000 to 400,000 unit production for each platform (including the variants such as convertibles and wagons), totaling two-million units of annual production. At this level of production, per unit R&D cost can be
Korea's domestic automobile market is too small for three producers (Daewoo, Hyundai, Kia). With the expected market entry of Samsung, which will add capacity to Daewoo and Hyundai, there will be increased competition in the domestic market. 

As of July 1997, more industry insiders were accepting the logic of Daewoo's move toward globalisation. As one put it:

"Korea's domestic automobile market is too small for three producers. Daewoo, Hyundai, Kia. With the expected market entry of Samsung, which will add capacity to Daewoo and Hyundai, there will be increased competition in the domestic market."

As of July 1997, Daewoo's three new models were entering the market, and Daewoo and DMC were regaining market share leadership. The Leganza would be launched in September 1997.

Both the Leganza and the DMC broke the first month sales record for a new model in the United States.
### Chapter 2 Penetrating an Emerging Market

#### Exhibit 2.9: Former-Soviet Republics: GDP and GDP per Head (at Purchasing Power Parity)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia—GDP</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>17.6</td>
<td>5,062</td>
<td>4,804</td>
<td>4,469</td>
<td>2,143</td>
<td>1,853</td>
<td>2,051</td>
<td>2,124</td>
</tr>
<tr>
<td>Azerbaijan—GDP</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>21.8</td>
<td>3,076</td>
<td>2,804</td>
<td>2,872</td>
<td>1,866</td>
<td>1,474</td>
<td>1,163</td>
<td>986</td>
</tr>
<tr>
<td>Belarus—GDP</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>49.9</td>
<td>4,879</td>
<td>4,910</td>
<td>5,006</td>
<td>4,631</td>
<td>4,228</td>
<td>3,645</td>
<td>3,365</td>
</tr>
<tr>
<td>Estonia—GDP</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>7.7</td>
<td>4,896</td>
<td>4,670</td>
<td>4,334</td>
<td>3,988</td>
<td>3,803</td>
<td>3,836</td>
<td>4,067</td>
</tr>
<tr>
<td>Georgia</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>24.1</td>
<td>4,420</td>
<td>3,919</td>
<td>3,275</td>
<td>2,005</td>
<td>1,405</td>
<td>1,032</td>
<td>1,005</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>71.9</td>
<td>4,327</td>
<td>4,477</td>
<td>4,304</td>
<td>3,827</td>
<td>3,316</td>
<td>2,523</td>
<td>2,416</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>11.0</td>
<td>2,550</td>
<td>2,706</td>
<td>2,524</td>
<td>2,164</td>
<td>1,842</td>
<td>1,364</td>
<td>1,311</td>
</tr>
<tr>
<td>Latvia</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>14.5</td>
<td>5,437</td>
<td>5,471</td>
<td>5,118</td>
<td>3,462</td>
<td>3,070</td>
<td>3,209</td>
<td>3,288</td>
</tr>
<tr>
<td>Lithuania</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>33.0</td>
<td>8,945</td>
<td>9,121</td>
<td>8,031</td>
<td>5,141</td>
<td>3,681</td>
<td>3,813</td>
<td>4,025</td>
</tr>
<tr>
<td>Moldova</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>15.9</td>
<td>3,666</td>
<td>3,722</td>
<td>3,195</td>
<td>2,336</td>
<td>2,362</td>
<td>1,666</td>
<td>1,661</td>
</tr>
<tr>
<td>Russia</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>856.7</td>
<td>5,815</td>
<td>5,918</td>
<td>5,835</td>
<td>5,124</td>
<td>4,805</td>
<td>4,301</td>
<td>4,227</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>$ bn</td>
<td>per head ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>9.9</td>
<td>1,915</td>
<td>1,920</td>
<td>1,770</td>
<td>1,248</td>
<td>916</td>
<td>781</td>
<td>693</td>
</tr>
</tbody>
</table>

### Source:

Of macroeconomic stability among the former CIS countries in Central Asia. According to V. Golishiev, the presidential economic advisor:

During the first stage of economic reform (from independence to mid-1994), Uzbekistan created a new commercially based legal framework and started market reforms. During the second stage (from mid-1994 to 1996), macroeconomic stabilization was the main objective. While Russia experienced a 50% decline in GDP from 1990 to 1996, Uzbekistan's GDP fell only 18% and the country achieved 1.6% GDP growth in 1996. The national budget deficit has been less than 3.5% each of last two years Inflation in 1996 was 5.6% per month (half of the 1995 level), and is expected to drop further in 1997. The labor market is stable with 4% unemployment despite 1.5% to 2% population growth each year. Now, the government is pursuing a stabilization policy together with privatization and price reform. We are also promoting the formation of small- and medium-size business through a variety of ownership structures. To attract foreign investment, additional tax and customs duties concessions are planned.

Some Western analysts were more cautious, pointing to the large current account deficit, growing external debt burden, continuing restrictions on currency convertibility, regulatory controls on banking transactions, and the legacy of the communist bureaucracy, all of which discouraged importers and investors, particularly small- and medium-size businesses.

A senior Daewoo executive involved in the Uzbekistan automobile project commented:

In emerging markets, we always find that there is an opportunity on the other side of any threat. If everything were fine, these countries wouldn't need us. We jump into difficult markets and take advantage of the opportunities they present while managing the risk. By working hard, we build credentials with our partners (whether they are government officials or entrepreneurs) and find the best solutions for mutual prosperity. By being the first mover, we are in a better position to obtain cooperation. As a country becomes richer, it doesn't have to concede as much to later entrants.
After gaining independence from the Soviet Union, Uzbekistan needed managerial talent, financial capital, and technology to realize its growth potential. Because Uzbekistan had to specialize in the production of cotton and other raw materials when it was part of the Soviet Union, it had relied on Russia for most of capital goods and it was even self-sufficient in durables. President Karimov’s ambition was to turn Uzbekistan into a strong economic power in Central Asia through industrial development and export promotion. This required foreign investment. However, multinationals from the developed countries were concerned about political risks, macroeconomic instability, and various regulatory barriers. Siemens, Lufthansa, and Cargill had business interests in Uzbekistan, but none of them had been willing to commit to substantial investment. Japanese firms that had been active investors in developing countries in the 1960s and 1970s were also reluctant. It was Daewoo that first answered the call.

Daewoo’s unique commitment to Uzbekistan was described by Golišev, the presidential economic advisor:

Daewoo was the first foreign company to commit to a large-scale manufacturing plant in Uzbekistan. My country needs long-term, reliable partners, not casual partners in pursuit of a quick profit. The speedy entrepreneurial decision making of Daewoo management and the leadership of President Karimov helped to overcome the bureaucratic obstacles. For example, it took only 24 months to build the Uz-Daewoo plant while it usually took at least three years to build an automobile plant in Korea. The Uz-Daewoo plant became the leading symbol of Uzbekistan industrial development. The day the plant opened was declared a national holiday (Uzbekistan-Korea Friendship Day). Today, Daewoo’s presence is not limited to automobile production. Daewoo is increasing its role in other key industries such as cotton, electronics, and telecommunications.

The Uz-Daewoo Auto Project

President Karimov visited Korea in June 1992 and expressed interest in Daewoo’s Changwon auto project. Daewoo signed a 50/50 joint venture agreement with Uzauto-prom in August 1992 to build an automobile plant in Uzbekistan that would manufacture 200,000 vehicles annually including 100,000 Nexia, 50,000 Tico, and 50,000 Damas. Exhibit 2.1 shows pictures and specifications of these models. Construction of the Uz-Daewoo automobile plant began in 1994, and once completed in July 1996, it became the first modern automobile factory in Central Asia. Uz-Daewoo Auto would reach full-scale production by the end of 1997. Two-shift production commenced in February 1997, and three-shift two-shift production was scheduled to begin in October 1997.

Located 350 kilometers from Tashkent and next to the rail link in Andijan, the plant offered good logistics. Previously, the plant had been used as a tractor assembly factory with 550 employees. The refurbished plant followed the same design as the Changwon plant in Korea. See Exhibit 2.12 for a plant diagram.

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1Uzauto-prom was the Automobile Manufacturing Association of Uzbekistan and was fully controlled by the Uzbekistan government. Hence, the project was effectively a joint venture between the Uzbekistan government and Daewoo.

2These brand names were the same as those used in Korea. Performance characteristics and specifications of the vehicles were almost identical, with minimal local adaptation.
**NEXIA**

**GLE**
- 1.5 SOHC engine
- Flush 15-inch wheel covers
- Air conditioning (optional)
- AM/FM stereo radio & cassette
- Power windows
- Power antenna

**GL**
- 1.5 SOHC engine
- Front bucket seats, sliding & reclining
- Four rear seat (rear)
- Door pockets
- Rear seat, manual + Speaker/STEREO
- Variable speed wiper
- Digital clock
- Remote turn-off & defrost, electric

**TICO**

**DLX**
- Back glass, heated
- Front driver's map pocket
- AM/FM stereo, Digital clock
- Speaker (X3 units in room)
- Air conditioning (optional)
- Manual transmission (5-speed)

**GLE**
- Front bucket seats, sliding & reclining
- Four rear seat (rear)
- Manual transmission (4-speed)
- Door lock, manual
- Wiper speed
- Cigar lighter

Both DLX and STD with 800cc 3 cylinder gasoline engine.

**DAMAS**

**MINI BUS DLX**
- Wheel or cap
- Headlight
- Air conditioning (optional)
- Seats, 7 persons
- Driver's side map pocket + Manual antenna
- Speaker (X3 units in room)
- Capacity: 7 persons

**MINI BUS DLX**
- Driver's side, manual
- Wiper
- Heated seat
- Rear seat (rear)
- Air conditioning (optional)
- Emergency warning (driver)
- Capacity: 7 persons

**VAN**
- Mid-top TR-8R & IRS
- Rear lift (3rd gear
- Door lock, manual
- Glove box
- Cooling fan

All models wth: Both DLX and STD with 800cc 3 cylinder gasoline engine.
Production of the Damas, Tico, and Nexia models started on March 15, June 3, and June 17, 1996, respectively. Uzbekistan engineers and technicians (all of whom were trained at the Changwon and Bupyoung plants in Korea) were in charge of production. Among the 3,200 workers at the factory, only 25 expatriate personnel were sent from Korea. Most of the local employees were in the 20 to 30 year age range with a technical school background. Some had previously worked in the old tractor factory. Jobs at the new plant were highly prized, even though the average worker earned the equivalent of $200 a month. Exhibit 2.14 documents the production and sales record while Exhibit 2.15 provides data on the long-term operating plan of Uz-Daewoo Auto Co.

The total project investment was $658 million of which shareholders’ equity was $200 million and debt was $458 million. The Uzbekistan government provided 50% of the equity capital through UzAutoProm, and Daewoo Corp. provided the other 50%. Of the $458 million debt, $396 million was sourced through foreign loans ($222 million by the supplier’s credit of Daewoo Corp. and $174 million by the National Bank of Uzbekistan) and the equivalent of $62 million was sourced through a local loan prepared by Asaka Bank. The Uzbekistan government provided a payment guarantee for Daewoo’s $222 million supplier’s credit. Following the “Uzbekistan cabinet decree on Uz-Daewoo Auto,” the Uzbekistan government not only infused investment money but also provided administrative support for the project. A deputy prime minister was appointed to oversee and expedite the construction of the factory. The Uzbekistan government granted a five-year exemption for income tax, value-added tax, and customs on imported components, and promised to protect Uz-Daewoo’s privileged position in the domestic market for 2 years.

As of July 1997, Daewoo was meeting the expectations of the Uzbekistan government. The plant was credited with creating more than 10,000 new jobs, including jobs in construction, in auto dealerships, and in 10 local component companies established since 1996. A bank was set up to provide financial support for international trade and automobile sales. Technology transfer was achieved through the technology-licensing agreements and the personnel-exchange program for employees of Uz-Daewoo Auto and local component manufacturers. All of 3,200 employees of Uz-Daewoo completed a three-month training program in Korea; they were followed by dealer technicians and component manufacturer technicians. According to a senior executive in charge of the Daewoo Human Resource Development Institute in Korea:

Both parties learn from each other. Our Uzbekistan friends learn technology and hard work in Korea, and both parties benefit from the international exposure. I heard that one day President Kharimov asked a Uzbekistan technician to say a few words in Korean when he visited the plant.

Uz-Daewoo’s production capacity was scheduled to reach 300,000 units by the year 2000. In 1996, 26,000 vehicles were produced. The production goal for 1997 was 125,000 vehicles. Of these, 60,000 were expected to be exported to the Central Asian Republics and Russia (30,000 for each), and 50,000 were expected to be sold in Uzbekistan. The remaining 15,000 would be held in factory and dealer inventories. Of the 40,000 units actually produced by July 31, 30,000 were sold domestically and 10,000 were exported.

---

The value-added tax was 18% in Uzbekistan. The Uzbekistan government imposed a 5.25% customs duty on auto imports from Russia and other former CIS countries and 60% customs duty on auto imports from non-CIS countries.
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The total project investment was $658 million of which shareholders’ equity was $200 million and debt was $458 million. The Uzbekistan government provided 50% of the equity capital through Uzbekprom and, Daewoo Corp. provided the other 50%. Of the $458 million debt, $396 million was sourced through foreign loans ($222 million by the supplier’s credit of Daewoo Corp. and $174 million by the National Bank of Uzbekistan) and the equivalent of $62 million was sourced through a local loan prepared by Asaka Bank. The Uzbekistan government provided a payment guarantee for Daewoo’s $222 million supplier’s credit. Following the “Uzbekistan cabinet decree on Uz-Daewoo Auto,” the Uzbekistan government not only infused investment money but also provided administrative support for the project. A deputy prime minister was appointed to oversee and expedite the construction of the factory. The Uzbekistan government granted a five-year exemption for income tax, value-added tax, and customs on imported components, and promised to protect Uz-Daewoo’s privileged position in the domestic market for 2 years.9

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---

9The value-added tax was 18% in Uzbekistan. The Uzbekistan government imposed a 5.26% customs duty on auto imports from Russia and other former CIS countries and 60% customs duty on auto imports from non-CIS countries.
### CHAPTER 2 Penetrating an Emerging Market


#### A. Long-term Production Plan (Units: 1,000 vehicles)

<table>
<thead>
<tr>
<th></th>
<th>1996</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tico</td>
<td>STD</td>
<td>1</td>
<td>11</td>
<td>11</td>
<td>13</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>DLX</td>
<td>4</td>
<td>27</td>
<td>27</td>
<td>32</td>
<td>35</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>5</td>
<td>38</td>
<td>38</td>
<td>45</td>
<td>50</td>
</tr>
<tr>
<td>Damas</td>
<td>STD</td>
<td>1</td>
<td>1</td>
<td>4</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>DLX</td>
<td>5</td>
<td>9</td>
<td>33</td>
<td>27</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>Van</td>
<td>2</td>
<td>4</td>
<td>11</td>
<td>13</td>
<td>15</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>9</td>
<td>15</td>
<td>38</td>
<td>45</td>
<td>50</td>
</tr>
<tr>
<td>Nexia</td>
<td>GL</td>
<td>5</td>
<td>29</td>
<td>30</td>
<td>36</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>GLX</td>
<td>7</td>
<td>43</td>
<td>44</td>
<td>54</td>
<td>60</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>12</td>
<td>72</td>
<td>74</td>
<td>90</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>26</td>
<td>125</td>
<td>150</td>
<td>180</td>
<td>200</td>
</tr>
</tbody>
</table>

<sup>1</sup>A/C = air conditioning

**B. Local Content Plan (% of Value)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tico/Damas</td>
<td>20%</td>
<td>30%</td>
<td>40%</td>
<td>60%</td>
<td>70%</td>
</tr>
<tr>
<td>Nexia</td>
<td>10%</td>
<td>20%</td>
<td>30%</td>
<td>40%</td>
<td>60%</td>
</tr>
</tbody>
</table>

**C. Local Content Plan (parts added by year)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>seat, bumper, instrument panel (T/D),</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>paint, trim, harness</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>brake/fuel pipe, molding,</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>small plastic parts, small press parts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>glass, muller, fuel tank, carpet, insulator (T/D), large press parts, large plastic parts, battery, regulator, fastener</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>tire, brake disc, mirror, weatherstrip, speaker, instrument panel (Nexia)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>engine parts, transmission parts, combustion switch, knuckle, brake hose, seat belt, speedometer, head lamp, parking brake lever</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>heater, caliper, brake system, shock absorber</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The plant ran two shifts 250 working days a year, which could produce 40 vehicles per hour (20 Nexia, 10 Tico, and 10 Damas). Suppliers were selected ahead of production. By July 1997, six Korea-Uzbekistan joint ventures had been set up to work with Uz-Daewoo Auto, and small stamping parts were produced by wholly owned Uzbekistan companies. Uz-Daewoo was working closely to source components from other Daewoo plants such as RODAE of Romania and Daewoo-FSO of Poland. Imported parts and components were shipped from Korea to the Andijan plant by ship and train. Deliveries took 40 days. Local component sourcing was gradually increasing. In 1997, local content was expected to be 40% by value, including interior seats, bumpers, switchboards, and other components. By the year 2000, the value of locally made components was to reach 70%.<sup>10</sup>

In addition to the Uz-Daewoo Auto plant, Daewoo had many other investments in Uzbekistan. Cumulative investments totaled $1 billion by July 1997. Daewoo was the first Korean company to establish a trade office in Tashkent. Uz-Daewoo Electronics, a joint venture between Daewoo and the Uzbekistan government, was established in 1994, and by 1997, manufactured 400,00 television sets and VCRs, which were sold in Uzbekistan and Russia. In telecommunications, Daewoo provided 210,000 TDX lines to the Ferghana region of Uzbekistan and was preparing for telephone and global satellite-delivered mobile telecommunication services. Daewoo also established the Uz-Daewoo Bank and was participating in the construction of railroads between China and Central Asia, as well as various natural resource development projects. Exhibit 2.15 summarizes the history of Daewoo’s operations in Uzbekistan, and Exhibit 2.16 lists Daewoo’s business activities in Uzbekistan. According to Daewoo executives, there was a certain complementarity between Daewoo and Uzbekistan. President Kharimov was impressed by Korea’s history of government-led high-growth economic development in the 1960s through 1970s, and hoped that Uzbekistan might be able to replicate this experience. Daewoo’s extensive experience in emerging markets was also valued by Uzbekistan officials. Daewoo’s many lines of business and its sheer size also helped. According to a Western businessman in Tashkent:

Size helps in Uzbekistan. Small companies are often frustrated by the regulations and bureaucracy. Given the limited currency convertibility and the

**EXHIBIT 2.15 History of Daewoo’s Operation in Uzbekistan**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 1992</td>
<td>Uzbekistan President I. Kharimov visited Korea</td>
</tr>
<tr>
<td>July 1992</td>
<td>Chairman Kim visited Uzbekistan</td>
</tr>
<tr>
<td>August 1992</td>
<td>Automobile joint venture contract signed between Daewoo and Uzbekistan government</td>
</tr>
<tr>
<td>September 1992</td>
<td>Daewoo Corp. opened trading office in Tashkent</td>
</tr>
<tr>
<td>May 1993</td>
<td>Electronics joint venture plant established</td>
</tr>
<tr>
<td>June 1994</td>
<td>Korean President Y. S. Kim visited Uzbekistan</td>
</tr>
<tr>
<td>February 1995</td>
<td>Uzbekistan President I. Kharimov visited Korea</td>
</tr>
<tr>
<td>May 1995</td>
<td>Trading joint venture (KOSMO) established</td>
</tr>
<tr>
<td>June 1995</td>
<td>Uzbekistan prime minister visited Korea</td>
</tr>
<tr>
<td>October 1995</td>
<td>$100 million cotton import contract signed</td>
</tr>
<tr>
<td>March 1996</td>
<td>Telecommunication joint venture plant established</td>
</tr>
<tr>
<td>May 1996</td>
<td>Mobile telecommunications (GSM) joint venture established</td>
</tr>
<tr>
<td>July 1996</td>
<td>Opening ceremony of Uz-Daewoo automobile joint venture plant (declared a national holiday)</td>
</tr>
<tr>
<td>May 1997</td>
<td>Daewoo Bank opened</td>
</tr>
<tr>
<td>June 1997</td>
<td>Daewoo textile plant opened</td>
</tr>
<tr>
<td>June 1997</td>
<td>Uzbekistan telecommunication minister visited Korea</td>
</tr>
<tr>
<td>December 1997</td>
<td>Automobile parts plant scheduled to open</td>
</tr>
</tbody>
</table>

<sup>10</sup>Local content referred to the proportion of locally made components and parts to the total value of the finished good.
EXHIBIT 2.4.6

<table>
<thead>
<tr>
<th>Total investment amount: $1 billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of expatriate managers: 75</td>
</tr>
<tr>
<td>Total number of local employees: 6,000</td>
</tr>
</tbody>
</table>

Name: Daewoo Corp. Tashkent Office
Business: Trading office of Daewoo Corp. (trading and investment arm of Daewoo Group)
Figures: $900 million sales in 1996
Employment: 1 expatriate, 14 local
Plan: Increased cotton trade ($150 million in 1996 to $500 million in 2000), investment in cotton plantation (30K hectares/25K ton in 2000), $500 million investment in ginning plant (50K ton capacity)

Name: KOSMO
Business: International trade JV (trading electronics and automobile parts)
Figures: $3.1 million sales in 1996
Employment: 1 expatriate, 14 local
Plan: $22 million sales in 2000

Name: Daewoo Textile Co.
Business: Cotton yarn plant (13K ton/year; first case of 100% ownership by foreign investor)
Figures: $60 million investment, $40 million export
Employment: 10 expatriate, 800 local
Plan: Expansion into spinning, dyeing and apparel manufacturing, vertical integration of cotton-related operations

Name: Uz-Daewoo Auto Co.
Business: Automobile JV, 3 passenger car lines (Nexia 100K units, Tico 50K units, Dama 50K units), CKD assembly of bus and truck (bus 1K units, truck 110 units), 8 JVs for parts and 3 local firms under technology license
Figures: $658 million investment, 200K production capacity
Employment: 25 expatriate, 4,000 local
Plan: Increasing local content from 40% (1997) to 80% (2000), establishing national sales and service network

Name: Uz-Daewoo Electronics Co. (36% stake for Uzbekistan government)
Business: TV, VCR, car audio
Figures: $20 million investment, $100 million sales in 1997 (expected): 30% for export
Employment: 7 expatriate, 660 local
Plan: Extending local sales network (currently 14 outlets in Tashkent, 24 outside Tashkent), increasing local content

Name: Daewoo Telecom Tashkent office
Business: Trading TDX system and telecommunication equipment
Figures: TDX 210K lines (nationwide)
Name: Asloka-Daewoo Co. (49% owned by the Uzbekistan government)
Business: Manufacturing, installation and maintenance of TDX system (since August 1996)
Figures: $20 million investment, TDX 200K lines/year
Employment: 5 expatriate, 200 local
Plan: Exporting 30% of output to CIS countries, main provider of National Telecommunications Network Plan (2 million lines over 15 years)

Name: Uzbekistan Mobile Telecom System (division of Daewoo Corp.)
Business: GSM cellular phone network ($50 million investment), local telephone network in Fergana region (JV contract signed in July 1996: $192 million investment), long distance provider (1 out of 3 providers; 2 others are Russian firms)
Figures: $20 million investment by Daewoo
Plan: Expanding service boundaries, expanding asset base up to $60 million by 2000

Currently Planned
Business: Business center (400-room hotel, 22-floor office building, department store) foreign residential units
Situation: JV agreement signed in July 1997, construction scheduled to start on December 1997

Source: Academic cooperation between Uzbekistan National Academy and Daewoo Research Institutes (Economics, Advanced Engineering)

Decision Making and Negotiation
Critical issues regarding the Uz-Daewoo Auto project and other Daewoo businesses in Uzbekistan were negotiated directly between President Kharimov and Chairman Kim. The two leaders had developed a great mutual respect since the start of the project. President Kharimov was believed to consider Chairman Kim and Daewoo his most important economic-development partner. It was Chairman Kim's strong entrepreneurial leadership that helped Daewoo open the new market and made things happen. According to a senior Daewoo executive involved in the Uzbekistan operation:

Chairman Kim always initiates our business deals and takes charge not only of strategic decisions but also of operational details. Experienced aides in the corporate office and operating divisions provide analysis reports to aid him in his decision making. However, it is usually Chairman Kim who senses the opportunities and judges the business prospects of each. He really thinks that every street is paved with gold. After a project has progressed to a certain stage, he focuses on key strategic issues and delegates operational issues to the corporate staff and local subsidiary managers. As the project matures further, the local subsidiary takes more of the initiative. Whenever necessary, Chairman Kim intervenes and deals with a problem, but the process is quite simple. With only a couple of phone calls or faxes, he cuts to the heart of the
problem and identifies a solution. He also benefits from the wisdom of experienced executive assistants and front-line managers, but the process mainly involves very brief informal discussions. I've never seen him sit through a lengthy internal presentation. This business style is reflected in the simple internal reporting process of Daewoo. The direct experience of front-line managers is appreciated more than an ornamental analysis written from behind a desk. Strategy is important. But it should be no more than a direction for the whole company. Bureaucratic haggling and sticking to routine procedures are the biggest enemies of progress in Daewoo. Having started as a trading company, Daewoo still values flexibility and deal making rather than building and running routinized operating systems.

Another senior Daewoo executive assisting Chairman Kim in managing overseas operations stated:

In emerging markets, the window of opportunity is not always open. Timing is often critical. Detailed environmental surveys or market research are important, but not always obtainable and often used for internal battles to make excuses or to avoid responsibility. In addition, market research studies often focus on the existing state-of-affairs, underestimating or ignoring future potential. We negotiate the environment. Chairman Kim visits the investment site, negotiates the deal personally, and makes an up-or-down decision. In this process, Chairman Kim carefully evaluates the business prospects and develops solutions. Once faced with a decision, he spends enormous energy verifying investment information from various sources. In Uz-Daewoo Auto project, he visited Uzbekistan more than 10 times in a six-month period before he made the final decision to sign the agreement. This is one of the reasons why we have been able to penetrate so many emerging markets.

Some outsiders including business scholars, consultants, and business reporters criticized this entrepreneurial style. According to them, Daewoo relied too much on the entrepreneurial leadership of Chairman Kim, leaving little room for systematic management. There was also a concern that Daewoo was expanding much too fast and widely without sufficient core competencies and financial base. An investment banker in Seoul provided an interesting affirmative view:

When I first looked into Daewoo's investment decision processes, I was frustrated. Formal feasibility studies were often considered "ornamental" by the front-line managers and even by some of the financial managers. One Daewoo executive once told me that formal investment analysis is never sufficient to assess a project's feasibility without the benefit of business intuition. Now, I have a better understanding of Daewoo’s way of doing business. First, Daewoo applies excellent project financing skills to its overseas investments. For example, in the Uz-Daewoo Auto case, Daewoo provides 50% of the equity capital over 3 years, and the debt is arranged with a payment guarantee from the Uzbekistan government. So, Daewoo can inject the initial portion of equity capital and reinvest the earnings from the project later on. Daewoo's financing terms and risk management approaches are quite creative. I've also found that the core of Daewoo's investment information is strictly confident-

According to a Daewoo executive who had helped Chairman Kim coordinate Daewoo's global operations for many years:

We use quantitative analyses in our feasibility studies, but we do not rely solely on them in making our investment decisions. Daewoo's experience in emerging markets is very useful. Published data on emerging markets are not reliable and, due to political and economic volatility, are quickly outdated. Critical information bearing on the deal may come from the key players, but in many cases, they do not have the complete picture either. So, we learn as we go. For example, Daewoo and the Uzbekistan government invented a new approach to currency convertibility and import duties. Local experts can tell you something, but it is not a simple matter of retaining a consultant. Often, there is no base case for comparison. Strict confidentiality is essential, so only a limited number of people can be involved in the deal. As the deal is negotiated, mutual trust builds and we gain access to better information with the help of our ever-improving credentials. In this process, we can negotiate the details of the business environment in which we are going to operate. So, planning which market to enter while standing in front of a map of the world is impossible. Sometimes, we worry that there might have been better alternatives. However, it is impossible to know everything about every country in the world.

**MARKETING**

**Market Size**

A senior Daewoo manager involved in the deal commented on the size of the potential market and its relationship to the initial plant size and product mix:

In the late 1980s when Uzbekistan was still a part of the Soviet Union, there were one million cars on the road in Uzbekistan. The typical Russian car used to sell in Uzbekistan for 6,000 rubles when the average worker earned 250 rubles per month. Around 80,000 new cars were sold each year. A European Union study in 1995 suggested that Uzbekistan could absorb 4,000 imported cars per year based on the GNP per capita level. Considering the average age of cars on the road and a 10% annual replacement rate, annual demand for new cars in Uzbekistan should be 100,000 units. With 80% of the 14 million adults in Uzbekistan holding a driver's license, the long-term market potential is much larger. Considering an annual market demand for two million cars in the whole CIS region, we thought that 100,000 car exports to the neighboring countries was feasible. President Kharimov had initially suggested a 100,000-vehicle plant to produce the Tico and Damos models during his visit to the Changwon minicar plant. Daewoo subsequently offered to build a 200,000-vehicle-capacity plant. Originally, we planned to produce

---

11The typical Uz-Daewoo Auto employee earned 10,000 Sum a month in mid-1997.
CHAPTER 2 Penetrating an Emerging Market

40,000 Rabo (a small truck based on the Tico body); 60,000 Damas vans; and 80,000 Tico cars, but we subsequently changed our product mix to 50,000 Damas; 50,000 Tico; and 100,000 Nexia when we considered the market preference for larger, C-class cars.

As of 1995, there were 834,000 passenger cars and 266,000 trucks in Uzbekistan. The average age of vehicles on the road was 9 years. Ninety-five percent of the vehicles had been made in Russia. Table 2.1 shows the mix of cars on the road according to vehicle size class.

Sales, Distribution and Service

Exhibit 2.13 shows the sales and production history of Uz-Daewoo Auto. Of the 42,000 vehicles produced by the end of July 1997, 26,000 vehicles were sold for cash, 4,000 vehicles were sold via bank transfer, and 1,300 vehicles were exported. An additional 2,980 vehicles were in manufacturer’s inventory, and 5,800 vehicles were in dealer inventory. Ninety percent of the exports were made to Russia, while the other 10% went to Kazakhstan, Kyrgyzstan, and Belarus.

At the company-owned flagship retail dealership in Andijan, the sales manager reported that 45 vehicles had been sold in May 1997, up from 20 in April. In a typical day, 50-60 customer prospects visited the dealership. No trade-ins were negotiated. All new cars carried a one-year warranty. The four sales people were paid salaries with no sales commission. Two spare parts sales people also worked at the dealership. Daewoo was not closely involved in domestic marketing. Uz-Daewoo Auto was in charge of production, nationwide promotion, and sales to dealers, and Uzautosanoat was in charge of distribution. Due to high inflation (5% to 6% per month in 1997), Uz-Daewoo changed its price schedule every month subject to government approval. Table 2.2 reports the retail price tags at the flagship dealer. Table 2.3 shows the comparative cost structure for Tico and Nexia cars produced in Uzbekistan.

According to a Daewoo manager involved in the Uzbekistan operation:

The retail price tags don’t tell you the whole story. The high inflation and continuous devaluation of the Sum against the U.S. dollar creates an arbitrage opportunity. If you can buy in U.S. dollars (at the official rate), you should earn an arbitrage profit due to the discrepancy between the official rate and the black market rate.

Exhibit 2.17 Exchange Rate Trends, Sum/US$.

In Uzbekistan, Uz-Daewoo Auto had appointed 40 direct dealers, who in turn had appointed 150 subdealers. Eighteen of the direct dealers were wholly owned by Uzautosanoat. Most of the dealers were former automotive service stations. Dealers earned

<table>
<thead>
<tr>
<th>Exhibit 2.17 Exchange Rate Trends, Sum/US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Official Rate</td>
</tr>
<tr>
<td>---------------</td>
</tr>
<tr>
<td>January 1996</td>
</tr>
<tr>
<td>February 1996</td>
</tr>
<tr>
<td>March 1996</td>
</tr>
<tr>
<td>April 1996</td>
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<tr>
<td>May 1996</td>
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<td>June 1996</td>
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<td>July 1996</td>
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<td>August 1996</td>
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<td>September 1996</td>
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<tr>
<td>October 1996</td>
</tr>
<tr>
<td>November 1996</td>
</tr>
<tr>
<td>December 1996</td>
</tr>
</tbody>
</table>

| January 1997  | 55.6        | 118.0                     | 212%                      |
| February 1997 | 56.7        | 136.6                     | 224%                      |
| March 1997    | 58.0        | 138.5                     | 233%                      |
| April 1997    | 59.3        | 150.0                     | 253%                      |
| May 1997      | 60.1        | 144.2                     | 240%                      |
| June 1997     | 61.8        | 142.8                     | 231%                      |
| July 1997     | 64.2        | 141.3                     | 220%                      |

1 Across the whole CIS region, demand for Class C cars was 81% of the total while Class A cars represented only 2%.

Source: Interview with Mr. Yusupov, general director of Uz-Daewoo Auto Co.

11Uzautosanoat was an automobile sales and distribution company wholly owned by the Uzbekistan government. A ministerial level official was appointed the CEO of the company.
in Russia was 20% (18% in Uzbekistan); the sales tax differential was absorbed by Uz-Daewoo Auto on officially exported cars. It costs $480 to transport a Nexia ($420 for a Tico) from Uzbekistan to Moscow.

Autovaz, the largest Russian automobile manufacturer that had formerly produced Rada, was producing and selling the VAZ2109 (1500cc) and the VAZ2110 (a new 1500cc model). Its production capacity was 900,000 vehicles a year, of which 600,000 were assigned for sale in the Russian domestic market. Table 2.4 shows price comparisons between Russian cars and Uz-Daewoo cars.

According to Yusupov, general director of Uz-Daewoo Auto, competition in the export market was tough and getting tougher:

The Nexia is better equipped to compete in the export market. Traditionally, Russian and Uzbek consumers prefer C class cars (with engine sizes between 1500cc and 1800cc) due partly to rough road conditions. Uz-Daewoo should consider shifting the production mix in favor of the Nexia. Ford is planning a 50,000-vehicle-capacity plant to make Ford Escorts in Belarus; the retail price will be around $10,000 to $12,000. Opel (the German subsidiary of General Motors) has a strategic alliance with Autovaz to introduce Astras in 1998 which will be made in a 50,000-vehicle-capacity plant. Moskvich is also working on an alliance to produce Renault cars. Kia is planning a 50,000-vehicle-capacity CKD plant in Kaliningrad, Russia. There will be a flood of C-Class cars. Moreover, these competitors are spreading the word that the Nexia is no longer in production in Korea. Uz-Daewoo will be in trouble if Daewoo doesn’t enable us to introduce a new model.

Daewoo managers also acknowledged the increasing competitive challenge, but viewed the situation differently:

At present, Russian-made cars do not match Uz-Daewoo cars in terms of quality or performance. It will take some time before the competitive pressure materializes. Autovaz will only be doing joint CKD production of Opel’s Astra and Calibra at the end of 1998. It will be another year before they start producing Open engines for those cars. There are many strategic alliances on paper, but as yet, no cars are rolling off production lines. Actions speak louder than words, and these deals always take longer than expected to bear.

### Table 2.4: Comparable Retail Car Prices in Russia

<table>
<thead>
<tr>
<th>Russian Cars</th>
<th>Uz-Daewoo Cars</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Producer</strong></td>
<td><strong>Model</strong></td>
</tr>
<tr>
<td>Autovaz</td>
<td>OKA</td>
</tr>
<tr>
<td>Tavria</td>
<td>Tavria</td>
</tr>
<tr>
<td>Autovaz</td>
<td>VAZ2109</td>
</tr>
<tr>
<td></td>
<td>VAZ2110</td>
</tr>
</tbody>
</table>

<sup>1</sup>U.S. dollar prices were as of July 27, 1997, at the official exchange rate.

<sup>2</sup>On the black market, the Nexus could retail for $8,500 if payment was made in U.S. dollars. The VAZ2109 sold for $8,500 on the black market.
fruit. Of course, Daewoo is preparing for the challenges. We will start producing state-of-the-art models (which are still under development) from 2000. The new model line will cover C, D, and E-class cars. The Uz-Daewoo plant is designed to be able to shift to production of these new models.

**Hard Currency Problem**

Due to the shortage of hard currency in Uzbekistan, the convertibility of the Sum was strictly limited. Because the Uz-Daewoo project was designed to generate hard currency through exports, the Uzbekistan government gave Daewoo a higher priority in hard currency allocation for plant construction and component imports. However, currency convertibility and repatriation of the earnings were ongoing challenges, and constrained further investment. Daewoo arranged foreign loans (under supplier's credit) from Western banks and institutions for its Uzbekistan projects, but recognized that it would take time for those projects to generate hard currency earnings. From the outset, Daewoo had been trying to alleviate this problem through becoming involved in the cotton business. From simple cotton exports, Daewoo was planning to expand its business into cotton plantations and spinning. Detailed operational decisions dealing with raw material allocation and pricing were still pending, but the business prospects were bright. According to a Daewoo manager involved in the cotton business, a new textile industry complex in Uzbekistan that included the whole value-added processes from spinning to apparel manufacturing could generate $15 billion annual exports within 10 years.

**Management Challenges**

When construction work started on the plant, a task force was appointed by Chairman Kim to implement the Uz-Daewoo project. Kwan-Ki Lee (also the chairman of Uz-Daewoo Auto) was in charge of the team. Overall Daewoo operations in Uzbekistan were coordinated by Daewoo Corporation and reported to Chairman Kim. However, managing an operation in a remote foreign environment was still a daunting task. Early on, the telecommunications infrastructure was not reliable: In 1993, it could take 30 minutes to send a five-page fax from Seoul to Tashkent. Chairman Kim visited Uzbekistan whenever necessary. Lee and his staff were spending half their time in Uzbekistan and usually traveled on weekends to save time. Due to the variety of Daewoo's businesses in Uzbekistan, the company was planning to appoint a senior executive stationed there to coordinate all Uzbekistan operations. Because of both the cultural and physical distance between Tashkent and Seoul, life in Uzbekistan was still a challenge for Korean managers. All 20 Uz-Daewoo Auto expatriates in Uzbekistan had their families in Korea. There was no reliable international school in Uzbekistan. At first, they could only obtain Korean food through monthly shipments from Daewoo's Seoul Office. Managing cross-cultural conflict was also a challenge. It took great patience and understanding to persuade Uzbekistan workers to adopt attitudes of hard work and competitiveness.

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1. Due to limited hard currency reserves and a growing current account deficit, the Uzbekistan government allocated hard currency for each business.
2. Due to the importance of cotton to the Uzbekistan economy, the Uzbekistan government was in charge of the quantity allocation and the pricing of cotton trade.
CHAPTER 3  Planning a Joint Venture

PLANNING A JOINT VENTURE

Milkpak Limited—International Joint Venture

On January 25, 1987, Syed Babar Ali, chairman, and Syed Yawar Ali, managing director of Milkpak Limited, prepared for a meeting with a high-level team from Nestlé, a multinational food company based in Switzerland. Milkpak Limited, incorporated in 1979, was a pioneer in developing a Pakistani industry for ultra-high temperature (UHT) milk, a sterilized milk that did not require refrigeration when specially packaged. The increasing popularity of UHT milk caused company sales to increase from 96 million rupees (Rs) in 1982—Milkpak’s first full year of production—to 340 million rupees in 1986. The company was increasingly interested in producing value-added products and was exploring a joint venture with a foreign company.

COMPANY BACKGROUND

Milkpak was part of a family group of businesses—the Ali Group—that spanned a number of interests. Considered one of Pakistan’s leading industrial families, the Ali Group was involved in razor blade and textile manufacture in addition to holding in the insurance industry. The group had major investments in the vegetable oil and soap industries and also managed Ford’s auto assembly plant prior to 1973, when the government nationalized all of these businesses.

Milkpak was founded to create a market for packaging materials produced by Packages Limited, a leading company in the Ali Group. Packages Limited was established in Lahore, Pakistan, in 1956, in collaboration with AB Akerlund & Rausing of Sweden, to convert paper and board into packaging. Packages later integrated backward into pulp and paper manufacturing. The company supplied packaging materials to a variety of industries and also provided technical assistance to packaging plants in Africa and the Middle East. Packages manufactured its own line of facial tissues and other consumer products. In 1986, Packages’ total sales were approximately Rs 633 million.

Milkpak was established following a 1976 review of the use of Packages’ equipment. The Tetra Laminator, a machine designed for making packaging material for long-life milk, was used very infrequently. Packages purchased the Tetra Laminator machine in 1967 from Tetra Pak of Sweden, a company affiliated with Akerlund & Rausing. The Tetra Pak aseptic system was developed to package UHT milk. The UHT process heated milk at temperatures of 130 to 150 degrees centigrade for 2 to 3 seconds. Milk thus sterilized had a shelf life of up to 3 months without refrigeration when packaged in Tetra Pak containers. The Tetra Pak system had special advantages for developing countries that lacked extensive refrigeration and distribution systems. Some of the packages were in the shape of tetrahedrons (a four-faced pyramid); rectangular packages that required heavier and more expensive paper were also available.

Packages found that there was one milk plant in Pakistan—at the time inoperative—designed to produce sterilized milk. The company leased the plant which had a capacity of 17,500 liters of milk per day, as a pilot project to test the market for UHT milk. Packages hoped that a successful pilot project would encourage entrepreneurs to produce UHT milk, thereby increasing the demand for Tetra Pak packaging. To implement the project, a number of challenges were surmounted, including developing a low-cost, locally produced paper for packaging and securing reliable sources of milk supply. The pilot project was deemed a success in 1978 when, with limited promotional efforts, sales reached plant capacity.

Milkpak was incorporated in January 1979 after Packages decided to invest in a 150,000-liter-per-day UHT milk plant, at a cost of Rs 90 million. Financing for the new company was obtained from Tetra Pak; Danish Turnkey Dairies, the equipment supplier; and several development agencies, including the International Finance Corporation and the German Development Institute. (Exhibit 3.1 summarizes Milkpak’s ownership structure.)

Milkpak started commercial production of UHT milk in its new plant in November 1981. (Exhibit 3.2 provides Milkpak’s yearly sales and profit and loss statements from 1981 to 1986.) By 1987, Milkpak’s product line had expanded from UHT milk to include fruit juices and other dairy products, though UHT milk still accounted for an estimated 85% of company sales. In 1984, Milkpak started marketing the Frost line of fruit juices, introduced a few years earlier by Packages. Frost juices were premixed, in contrast to existing juices on the market that were available in concentrate form. Milkpak bought the Frost brand name and equipment from Packages, and in 1986 fruit juices accounted for 9% of Milkpak’s sales. Additional products included butter, introduced in 1985. In 1986, the company launched a sterilized cream product, Balai, and also a cooking oil, Desi Ghee. These products were sold under the brand name Milkpak.

PAKISTAN

Pakistan was founded in 1947, when British India was partitioned into two nation states. Pakistan, established as a Muslim country, initially had two geographically separate

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2 Exchange rate in 1986: Rs 16.65 = $1.00.

Research Associate Afroz A. Mohammed prepared this case under the supervision of Professor John A. Quelch as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. This case contains some information from earlier cases on Milkpak prepared by the Lahore University of Management Science.


3 An aseptic system is free from pathogenic organisms.
<table>
<thead>
<tr>
<th>Investor</th>
<th>Ownership share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ali family</td>
<td>15.7</td>
</tr>
<tr>
<td>Packages Limited</td>
<td>7.1</td>
</tr>
<tr>
<td>IGU1</td>
<td>5.7</td>
</tr>
<tr>
<td>International Finance Corporation</td>
<td>5.7</td>
</tr>
<tr>
<td>Tetra Pak2</td>
<td>8.6</td>
</tr>
<tr>
<td>DEG3</td>
<td>5.7</td>
</tr>
<tr>
<td>DTD4</td>
<td>2.9</td>
</tr>
<tr>
<td>IFU5</td>
<td>2.9</td>
</tr>
<tr>
<td>Public shareholders</td>
<td>45.7</td>
</tr>
</tbody>
</table>

1International General Insurance Company, 99% owned by the Ali family.
2The Swedish manufacturer of the equipment used to make materials for the non-refrigerated milk containers.
3The German Development Institute, a foreign aid and development institution.
4Danish Turnkey Dairies, Limited, Milpak's equipment supplier and the provider of Milpak's specialized extension services to Pakistani dairy farmers.
5Industrial Fund for Developing Countries, Denmark.

Source: Company records.

sections on either side of India. In 1971, the eastern wing of Pakistan separated to form Bangladesh. The western section, which remained Pakistan, had Urdu as its national language, with English widely spoken. By 1986, Pakistan had a population of over 90 million. Pakistan's GNP per capita was $380, although the country had large income disparities. (Exhibit 3.3 provides basic social and economic data about Pakistan.)

In the 1980s, Pakistan had political and economic policies that promoted the role of private enterprise in the country's economy. This climate was in contrast to that prevailing from 1972 to 1977 when the government was concerned about the high concentration of industrial ownership and nationalized a number of businesses. In the mid-1980s, the rate of growth of manufacturing output was 9.1% per year, while agricultural output grew at 4.6% per year; from 1972 to 1977, these sectors had grown each year at only 5.2% and 2%, respectively (Burki, 1986). Policy initiatives made in the 1980s offered safeguards against nationalization and sought to ensure the safety of investments.

Although the overall climate for private investment was favorable, businesses had to obtain a variety of government licenses and approvals before undertaking or expanding projects. These approvals differed according to a project's source of funds and specific characteristics. The government's permission for a project would address issues such as the amount of investment allowed, procedures governing repatriation of capital and profits, the amount of raw materials that could be imported, and the location of the industrial establishment. In practice, obtaining these approvals could result in project delays, although the Pakistani government was making efforts to facilitate the process.

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*aBackground information in this section is from Pakistan and the World Bank: Partners in Progress (Washington, D.C.: The World Bank, 1986).*
## THE PAKISTANI DAIRY INDUSTRY

Fresh milk was traditionally supplied to urban consumers directly from farms on a daily basis. Consumers obtained milk (1) directly from farmers or dairy colonies (these sources were sometimes referred to as peri-urban producers) that kept buffaloes in or near the towns, and (2) from milkmen who purchased milk from farmers. Milkmen would travel the countryside by bicycle, collect milk in 40-liter cans, and then sell it to contractors, who put ice in the milk and then transported it into the city. The milk was then sold to consumers at their homes and through retail milk shops, which did not have refrigeration facilities. The entire process, from milking the buffaloes to selling the milk in the city, took place each morning. Although the system delivered fresh milk to consumers each day, it had drawbacks. In particular, adulteration of milk with impure water occurred at various stages in the distribution chain. In addition, the absence of a refrigerated distribution infrastructure led to milk spoilage and waste.

The problems of transporting and distributing milk resulted in shortages in major urban centers—Milkpak's target market. Shortages were exacerbated by the market seasonality in production and consumption of milk. Milk consumption peaked in summer. In contrast, milk production was highest during the winter months of December to March, called the "flush" season, and lowest during the "lean" season from May to August. Lower production during the summer was caused by hot weather and decreased availability of fodder. As a result of both of these factors, the Pakistani government adopted liberal policies toward the import of milk products. (Exhibit 3.4 provides data on Pakistani milk production and dairy imports.)


<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated milk production (600 tons)</th>
<th>Value (million Rs)</th>
<th>Milk equivalent (600 tons)</th>
<th>Imports/ production (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975–76</td>
<td>8,348</td>
<td>313.0</td>
<td>329.2</td>
<td>3.94</td>
</tr>
<tr>
<td>1976–77</td>
<td>8,254</td>
<td>251.0</td>
<td>165.8</td>
<td>1.94</td>
</tr>
<tr>
<td>1977–78</td>
<td>8,704</td>
<td>391.1</td>
<td>448.5</td>
<td>5.15</td>
</tr>
<tr>
<td>1978–79</td>
<td>8,668</td>
<td>321.6</td>
<td>237.0</td>
<td>2.67</td>
</tr>
<tr>
<td>1979–80</td>
<td>9,075</td>
<td>481.9</td>
<td>420.4</td>
<td>4.63</td>
</tr>
<tr>
<td>1980–81</td>
<td>9,267</td>
<td>522.3</td>
<td>352.8</td>
<td>3.81</td>
</tr>
<tr>
<td>1981–82</td>
<td>9,462</td>
<td>522.6</td>
<td>275.8</td>
<td>2.91</td>
</tr>
<tr>
<td>1982–83</td>
<td>9,662</td>
<td>736.8</td>
<td>357.4</td>
<td>3.70</td>
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<tr>
<td>1983–84</td>
<td>10,242</td>
<td>802.1</td>
<td>397.4</td>
<td>3.88</td>
</tr>
<tr>
<td>1984–85</td>
<td>10,856</td>
<td>712.0</td>
<td>315.6</td>
<td>2.91</td>
</tr>
<tr>
<td>1985–86</td>
<td>11,508</td>
<td>779.2</td>
<td>282.4</td>
<td>2.45</td>
</tr>
</tbody>
</table>

*Source: Pakistan Economic Survey Data; imports data from Federal Bureau of Statistics. Adapted from Table 4.2 in Pakistan's Dairy Industry: Issues and Policy Alternatives.*

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1. Absolute poverty income level is the level below which a minimal nutritionally adequate diet plus essential nonfood requirements is not affordable.
2. Rural relative poverty income level is one-third of average per capita personal income of the country. Urban level is derived from the rural level with adjustment for higher cost of living in urban areas.
3. Percentage of population (urban and rural) who are the "absolute poor."

Source: Adapted from *Pakistan and the World Bank, Partners in Progress* (1986).
Milk powder was a particularly important dairy import. Milk powder, mixed with water to make fluid milk, had an established place in the Pakistani market, especially in Karachi, where fresh milk supplies were insufficient to meet demand as a result of increases in population. In 1986, about 30% of the demand for fluid milk supplies in Karachi was met by milk powder. Demand for milk powder was met primarily by imports, which averaged 20,000 to 30,000 tons annually. Powder was imported both as a branded product, in cans, and also in bulk (25 kilogram bags). Bulk supplies were repackaged by retailers in 1 kg plastic bags. Branded milk powders were typically bought by higher-income consumers while the repackaged bulk supplies were purchased by lower- and middle-income consumers.

Efforts had also been made to establish an indigenous local milk processing industry. Packages’ decision to invest in Milkpak was made in spite of a history of failed investments in the milk processing industry. During the 1960s and 1970s, Pakistani entrepreneurs established 23 plants in the dairy processing field, including several plants for milk pasteurization. The failure of at least 15 of this “first generation” of dairy processing plants was attributed to poor management, difficulties in obtaining fresh milk supplies, and the lack of an extensive refrigerated distribution infrastructure.

Milk Collection

To ensure a reliable and high-quality supply of milk, especially during the lean season, Milkpak focused attention on developing a system for milk collection and agricultural extension. Milk collection centers were established in areas considered rich in milk production. The company taught farmers scientific techniques of livestock care and breeding, provided veterinary services, and made available high-yielding fodder seed and cattle feed. Milk was supplied to the company by traditional milk contractors who bought milk from farmers. In addition, Milkpak helped establish village cooperatives and, through them, received milk directly from farmers.

During the flush season, Milkpak often had to refuse milk supplies. Milkpak’s management visited dairies in India, including Nestlé’s plant, to gain an understanding of how other dairies in a similar environment addressed problems of seasonality.

UHT Milk Processing

Processed milk was required by law to contain 3.5% butterfat and 8.9% solids not fat (SNF). Fresh milk usually had a higher fat content and a lower level of solids than required. As a result, before being heated to 130 to 150 degrees centigrade, the milk was decreased to reduce the fat content. To raise the SNF level, skimmed milk powder and water were added. When there was a shortage of fresh milk, milk powder could be added to increase milk production volumes, although, at prevailing prices for imported milk powder, it was rarely economical to do so. The technology for manufacturing UHT milk was considered expensive, with processing costs accounting for about 25% of total product costs. (Exhibit 3.5 reports estimates of UHT processing costs, obtained from different manufacturers in the industry.) Packaging materials were heavily taxed, accounted for another 26% of Milkpak’s production cost (Pakistan’s Dairy Industry, 1989).

UHT Milk Marketing

Positioning

A major challenge facing the company was to introduce urban consumers to the idea of long-life milk. Consumers were concerned that sterilized milk contained preservatives or was somehow not genuine because, unlike fresh milk, the Milkpak brand contained no cream. In one early promotional campaign, households were given two samples of Milkpak, one for immediate consumption and the other to be consumed 4 days later; the goal was to demonstrate that although the milk remained packaged, it did not require refrigeration. Milkpak was positioned as a pure dairy product; processed in a scientific, hygienic way; and consistent in quality throughout the year. (Exhibit 3.6 and Exhibit 3.7 show print ads and a UHT milk brand. Sales promotion and advertising expenses for Milkpak are brand by Exhibit 3.8.)

Milkpak’s heavy users were “modern housewives,” who were concerned about both convenience and product quality. Another target market was lower-income consumers, who were often sold relatively cheap adulterated milk by the traditional milkmen; Milkpak provided a higher-quality milk than they had previously purchased. (Exhibit 3.9 presents the results of a consumer survey sponsored by Milkpak.)
Translation
Top Lines: Fresh, pure Milkpak milk—the best for the whole family.
Bottom Line: A product of Milkpak dairy. Pure, delicious, and fresh.
Packaging

Milkpak brand UHT milk was initially sold in tetrahedron-shaped containers, in sizes of 1 liter and 2 liter. In 1984, a one-liter rectangular-shaped "brickpak" was introduced. The more conventionally shaped brickpak eliminated the need for special crates required to store Tetra Paks, but used more packaging material. In 1986, a quarter-liter brickpak was introduced.

Evolution of the UHT Milk Industry

Milkpak's success in developing a market for UHT milk spurred the entry of several other companies. By the end of 1986, eight plants owned by different companies could manufacture UHT milk. Total sales of UHT milk grew from 11.25 million liters in 1981 to approximately 80 million in 1986 (Pakistan's Dairy Industry, 1989). In 1986, Milkpak estimated that its share of the market was over 50%. Milkpak had a reputation for consistency and high quality, both with consumers and the trade.

Some of Milkpak's early competitors were short-lived. Milkpure and Purabrand, which entered the market in 1983, competed with Milkpak by offering consumer and trade promotions such as free tea bags and raffles for free air tickets. Milkpak did not offer similar promotions in response; management felt that profit margins on UHT milk did not allow such marketing investments. Both companies had financial problems and went out of business by the end of 1985.

Other more stable competitors included Milko, the UHT plant originally leased by Packages to test the market for UHT milk. Milko returned to its original owners after Milkpak's founding. By 1986, Milko had an estimated 10% share of the market. Pakistan Dairies, the country's first producer of cheese, started manufacturing UHT milk in

Table 3.1 Comparative Retail Prices of UHT Milk, Raw Milk, and Dried Milk Powder in Different Cities in Pakistan (rupees per liter)

<table>
<thead>
<tr>
<th>City</th>
<th>Peri-Urban Buyer</th>
<th>Milk Shop</th>
<th>Tinned</th>
<th>Polythene Bags</th>
<th>UHT Milk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lahore</td>
<td>5.00–6.00</td>
<td>4.50–5.50</td>
<td>7.50</td>
<td>6.00</td>
<td>7.50</td>
</tr>
<tr>
<td>Karachi</td>
<td>5.50–7.00</td>
<td>5.00–6.50</td>
<td>6.88</td>
<td>5.50</td>
<td>8.00</td>
</tr>
</tbody>
</table>

1In liquid milk equivalent terms, assuming a dried milk to liquid conversion ratio of 1:8.

Source: Adapted from Table 2.3 in Pakistan's Dairy Industry: Issues and Policy Alternatives (1986).
1983. Because of its other dairy products, Pakistan Dairies had an extensive and effective system for milk collection and was regarded as a high-quality producer. In 1986, the company’s share of the market was approximately 18% to 20%. A new competitor, Chaudhuri Dairies, entered the market in June 1986 and captured a share of 15% by year end. Chaudhuri introduced its brand Haleeb in rectangular brpak packaging, which was more convenient to store and was considered a competitive advantage.

Although the sales of UHT milk grew rapidly, they still constituted a relatively small share of total consumption. It was estimated that by 1987, UHT accounted for approximately 2% of the milk consumed in Pakistan’s urban areas.

The emergence of an industry to process UHT milk was fostered by government policy, notably duty exemptions on the import of machinery for dairy plants and the provision of low cost financing by government agencies. The government had sanctioned a number of additional plants that would be brought on line in coming years, and there was, therefore, concern that the industry would have substantial overcapacity (Pakistan Dairy Industry, 1989).

**STRATEGIC OPTIONS FOR GROWTH**

As Milkpak reviewed its growth options, management increasingly saw the development of a milk powder plant as a necessity. First, a powder plant would help smooth the seasonal mismatch between the supply of and demand for milk. During the summer (the time of peak demand), milk powder would be combined with liquid milk to extend the supplies of UHT milk. The growth potential for UHT milk had been limited by seasonality; Milkpak’s marketing managers were reluctant to promote UHT milk heavily during the flush season because they felt they were creating demand that could not be satisfied in the lean season. Although Milkpak’s managers were very committed to increasing UHT milk sales, they knew that the UHT business was inherently a high volume, low margin business. As a result, the company wanted to explore the possibility of producing other value-added foods, such as milk powder, cereal, and infant formula, among other products.

In addition to using milk powder as an ingredient in UHT milk, Milkpak could sell milk powder, which competed with UHT milk, as a convenience product. In 1986, 25,002 tons of milk powder, with a value of Rs 406 million, were imported. Only two domestic companies manufactured milk powder, one of which produced solely for the military. The other company, Noon Ltd., established with the technical assistance of Cow & Gate, a U.K. company, had an output of 600 tons per year. The Pakistan Dairy Association, chaired by Yawar Ali, argued that the government’s low tariffs on milk powder imports (which historically had been subsidized by European producers) impeded the development of a domestic dairy industry. In 1986, the government imposed a 16% tax on imports of milk powder, which improved the viability of domestic production.

About 20% of milk powder imports were branded. The major brands, with estimated market shares, were NIDO, produced by Nestlé (24% market share); Red Cow, manufactured by Cow & Gate (25% of market); and Safety, manufactured by Friesland of the Netherlands (24% market share). NIDO’s prices were the highest (Rs 107 per 1,800 gram tin), followed by Red Cow (Rs 92 to 102 per tin) and Safety (Rs 93 to 97 per tin.) The demand for branded milk powder was forecast to increase to 18,000 tons per year by 1996.

Milkpak’s management had to decide whether to acquire foreign technology and management assistance to develop its own plant. Alternatively, Milkpak considered the possibility of finding a foreign joint venture partner.

**Independent Study**

Milkpak prepared a feasibility study for a milk powder plant. Exhibit 3.10 provides a summary of the project costs, financing sources, and projected profits. Milkpak estimated that by the third year of operation the plant would produce 2,400 tons of milk powder. A locally manufactured product could be competitively priced relative to imports. In addition, a Milkpak plant would use buffalo milk, a familiar taste for local consumers. A study of the

**EXHIBIT 3.10 Milkpak Limited Milk Powder Plant Financial Feasibility Analysis**

<table>
<thead>
<tr>
<th>Cost of project and sources of finance</th>
<th>Rs 000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1.</strong> Cost of project</td>
<td></td>
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<tr>
<td>Building</td>
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<tr>
<td>Plant and machinery (including construction)</td>
<td>37,245</td>
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<tr>
<td>Trial-run cost and interest during construction</td>
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<tr>
<td>Contingencies</td>
<td>4,515</td>
</tr>
<tr>
<td>Working capital</td>
<td>47,500</td>
</tr>
<tr>
<td></td>
<td>7,300</td>
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<td></td>
<td>55,000</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Sources of finance</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue of preferential shares (one for every three shares)</td>
<td>—</td>
</tr>
<tr>
<td>Loan sanctioned by Agricultural Development</td>
<td>—</td>
</tr>
<tr>
<td>Bank of Pakistan</td>
<td>16,000</td>
</tr>
<tr>
<td>New loan required</td>
<td>15,000</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>5,333</td>
</tr>
<tr>
<td></td>
<td>24,000</td>
</tr>
<tr>
<td></td>
<td>55,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>First Year</th>
<th>Second Year</th>
<th>Third Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>104,703</td>
<td>137,860</td>
<td>111,407</td>
</tr>
<tr>
<td>57,928</td>
<td>86,798</td>
<td>111,407</td>
</tr>
<tr>
<td>6,259</td>
<td>6,024</td>
<td>12,140</td>
</tr>
<tr>
<td>3,170</td>
<td>11,881</td>
<td>14,315</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Profit and loss projections</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales 67,357</td>
<td>104,703</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>57,928</td>
</tr>
<tr>
<td>Operating profit</td>
<td>9,429</td>
</tr>
<tr>
<td>Financial cost/tax, etc.</td>
<td>6,259</td>
</tr>
<tr>
<td>Net profit</td>
<td>3,170</td>
</tr>
<tr>
<td></td>
<td>104,703</td>
</tr>
<tr>
<td></td>
<td>137,860</td>
</tr>
<tr>
<td></td>
<td>111,407</td>
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<td></td>
<td>6,259</td>
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<td></td>
<td>12,140</td>
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<tr>
<td></td>
<td>3,170</td>
</tr>
<tr>
<td></td>
<td>14,315</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Payback period is 3 years and 2 months.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional sales of UHT milk from increased availability of milk supplies as a result of project.</td>
</tr>
</tbody>
</table>

| Source: Company records. |
milk powder market commissioned by Milkpak recommended that Milkpak produce a branded product to capitalize on Milkpak's name and reputation. In addition to producing milk powder, the plant would also manufacture infant formula, butter oil, and butter. Milkpak expected to hire an experienced expatriate production manager. Although Milkpak executives thought it was feasible for the company to develop a powder plant without a joint venture partner, they were concerned about the technical difficulties of doing so. For example, they felt that producing products such as infant formula required technical knowledge and expertise that the company did not have.

**Joint Venture Partners**

A joint venture partner could provide both the necessary technology and a reputable brand name that could be attached to locally manufactured, value-added products. Milkpak's managers debated the advantages and drawbacks of conducting a joint venture. Some thought Milkpak should seek out a joint venture partner that currently exported branded products to Pakistan and already had some brand recognition in Pakistan. Others were concerned that a company with established brands would expect high royalties that would leave too little profit for Milkpak to warrant the investment risk.

Another concern was that a large multinational joint venture partner might dominate Milkpak. Chairman Babar Ali, however, felt very comfortable with the prospect of a joint venture; Packages Limited, where he had worked for much of his career, was itself a joint venture.

A major challenge was to identify appropriate joint venture partners and find ways to approach them. Danish Turnkey Dairies and Tetra Pak, companies Milkpak and Packages already had ties with, could help in identifying and providing introductions to potential joint venture partners. As a result, Friesland and Nestlé emerged as particularly interesting prospects for a joint venture partnership.

**Friesland**

Friesland, established in 1913 as the "Cooperative Condensed Milkfactory Friesland," was founded by farmers in the Friesland province of Holland. Over 12,000 Dutch farmers supplied milk for the production of a variety of dairy products, including condensed and powdered milk and infant foods. In 1986, Friesland’s net sales were 1,807 million guilders.7

Friesland’s products were sold in 130 countries, primarily through exports. Friesland exported Safety brand milk powder and Omela brand condensed milk to Pakistan. The company also operated some manufacturing facilities and dairies overseas, usually in partnership with a local company. These included manufacturing plants in Guam, Indonesia, Lebanon, Malaysia, Nigeria, Taiwan, Thailand, Saudi Arabia, and Yemen. Friesland provided technical assistance to its affiliated companies as well as management assistance on a contract basis.

**Nestlé S.A.**

Nestlé was founded in 1867 by Henri Nestlé, a chemist who developed the first milk-based food for babies. In 1905, the company merged with the Anglo-Swiss Con-

densed Milk Company, a former competitor. From a base in dairy products, Nestlé's product line grew to encompass chocolate and confectionery, instant and roasted coffee, culinary products, frozen foods, and instant drinks. By 1986, Nestlé’s consolidated sales were 38,050 million francs.8

Early in its development, Nestlé established production facilities outside of Switzerland. By 1986, Nestlé had plants in 60 countries. In determining whether to set up production facilities in a particular country, the company considered several factors, including the availability of raw materials, the overall economic climate, and consumer tastes and purchasing power. Nestlé's approach to foreign operations was summarized as follows: "The Company is guided in this respect by long-term goals and not by short-term objectives. It is essential for Nestlé that an industrial operation be in the reciprocal and lasting interests of both the Company and the host country" (Nestlé, S.A., 1991).

A hallmark of Nestlé was decentralization, which enabled the group's overseas subsidiaries to develop their own identity and the flexibility to respond to local market conditions. At the same time, Nestlé provided research, development, and technical assistance to these subsidiaries. This assistance could be used, for example, to develop products suited to local tastes and to improve the productivity of land and livestock.

**Nestlé in Pakistan**

Since 1974, Nestlé products had been imported and sold by the Burge Corporation, a small Pakistani distributor. In 1975, Burge decided to introduce Nestlé's NIDO brand of powdered milk, which accounted for an increasing share of Nestlé sales in Pakistan. Nestlé products were supported by an intensive distribution network and were also heavily advertised on television.

In 1983, Nestlé stationed a marketing advisor, Erwin Wermeling, in Pakistan. Wermelinger’s role was to investigate investment opportunities in addition to providing assistance to Nestlé’s distributor. During the mid-1980s, Nestlé staff conducted a tour of the Punjab region of Pakistan to assess the potential for collecting milk to be used in local production of Nestlé products.

**JOINT VENTURE NEGOTIATIONS**

**Discussions with Nestlé**

Milkpak's management was aware of Nestlé's growing interest in the Pakistani market, as indicated by Wermelinger's presence in Pakistan. One of Milkpak's managers, formerly with Packages, knew Wermelinger from an earlier posting in Tanzania. As a result, there was an informal channel of communication between the two companies, which Milkpak viewed as a means of keeping Nestlé apprised of Milkpak's progress.

Milkpak approached Nestlé's senior management in 1986, when Babar Ali visited Nestlé’s headquarters in Switzerland. During these conversations, Ali received the impression that Nestlé would want majority ownership in a joint venture and might also require sizable royalties and technical fees. In addition, Ali was concerned that Nestlé’s attitude toward Milkpak seemed overbearing.

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7 Exchange rate in 1986: 2.45 Guilders = $1.00.
8 Exchange rate in 1986: 1.80 Swiss Francs = $1.00.
Discussions with Friesland

Milkpak first approached Friesland in November 1985, through a mutual contact. Several factors made Friesland an attractive candidate for a joint venture, including extensive experience in the dairy industry and an established position in the Pakistani milk powder market. Milkpak's management also felt that a company of Friesland's size would be more responsive to Milkpak's concerns than a larger multinational.

An initial meeting between Babar Ali and a Friesland marketing director was followed by the visit of a three-member Friesland team to Pakistan in March 1986. The team included representatives from the marketing, finance, and technical areas. They spent 2 weeks studying both Milkpak and the Pakistani market. After the team's visit, Milkpak made several requests for additional information. Company representatives next met in October 1986, when both Babar Ali and Yawar Ali visited the Friesland headquarters in Holland to meet the company's chairman and directors and tour the corporate plant and R&D facilities. Milkpak's executives were not shown the milk powder factory.

Friesland planned to follow the October meeting by sending a team to prepare a detailed feasibility study that would consider the milk powder project and other possible product introductions, such as cheese and ice cream. Friesland's tentative plans were to buy 25% of Milkpak's shares, obtain technical fees and royalties for their brands, and increase equity to 49% over a 5-year period. Friesland targeted the end of March 1987 as the date for making a final decision about the proposed joint venture.

A number of issues remained to be resolved. Milkpak needed to determine what government policies were with respect to technical fees and royalties on consumer products, assuming that Friesland made an initial equity investment of 25%. Friesland wanted to obtain royalties on its products in the range of 3% to 5%. In addition, for Friesland to be able to increase share holdings beyond 25%, changes in the ownership structure of Milkpak could be required, such as the divestment of some of the existing foreign shareholders.

Although Friesland was an attractive candidate for a joint venture, Milkpak had some reservations. Milkpak's executives were concerned that Friesland had not let them tour Milkpak's milk powder factory on two separate occasions, which suggested that Friesland might be withholding certain information. Milkpak attributed Friesland's many requests to Milkpak for information to Friesland's relatively limited experience in establishing production facilities overseas. The time period within which Friesland expected to obtain a return on its investment was uncertain. Some managers at Milkpak also felt that, in light of Friesland's history as a dairy cooperative, the company would always be more interested in finding markets for products produced in Holland than in developing the Pakistani dairy industry.

Rudolf Tschans Visit

In January 1987, Babar Ali was apprised of the forthcoming visit of Rudolf Tschan, Nestlé's new executive vice president for Asia Zone II, to Pakistan. According to Erwin Wermelinger, Nestlé's marketing representative in Pakistan, Tschan wanted to come to Lahore to meet Ali, tour Milkpak's Sheikhpura factory, and visit the company's milk collection centers.

On January 25, Yawar Ali led Rudolf Tschan and the Nestlé team on a tour of Milkpak's plant and milk collection areas. Ali was struck by Tschan's quick assessment of the surroundings: "This side looks a lot like the other side [Indian Punjab], but your buffalo are better and your land is more fertile." As Tschan toured the milk plant, he noted that "we will have one milk powder plant here and one there [India]."

When Yawar Ali briefed Babar Ali about the Nestlé team's tour, he noted Tschan's evident interest in the Milkpak operation. Later in the day, top executives from Milkpak and Packages were scheduled to meet with Tschan and Wermelinger to discuss the prospect of Nestlé and Milkpak working together. As Milkpak's team prepared for the meeting with Nestlé, they considered the major issues that would arise. In addition, they considered the benefits to each company of working together.

Assessing a Nestlé Joint Venture

For Milkpak, the possibility of a joint venture with Nestlé was appealing. The fact that Nestlé had a successful manufacturing operation, including a milk powder plant 80 miles across the border in Moga, India, gave Milkpak confidence that Nestlé knew how to operate in a very similar environment. Milkpak's management also believed that Nestlé typically took a long-term approach toward developing its operating companies. In addition, Milkpak might benefit from Nestlé training for its staff and from increased sales by other companies in the Ali Group. For example, Nestlé products could use packaging made by the group's companies.

At the same time, management felt that Milkpak offered a number of advantages as a joint venture partner. Milkpak knew that its extensive milk collection infrastructure provided access to a key raw material for Nestlé products. Milkpak's government contacts would facilitate obtaining the requisite licenses for establishing new production facilities. The Ali Group had a successful history of implementing other joint ventures. Through a joint venture with Milkpak, Nestlé would eliminate a potential future competitor that knew the Pakistani market. The fact that Tschan had come to Pakistan to see Milkpak's operations indicated that Nestlé already had a favorable impression of the company's capabilities.

Retaining majority ownership was important to Milkpak's management because Milkpak executives wanted to ensure that any joint venture partner paid attention to their ideas about the business. Babar Ali's earlier meeting with Nestlé management suggested that coming to mutually acceptable terms on topics such as majority ownership could present a challenge. However, Tschan seemed to be more flexible.

In addition to the question of ownership, both companies were likely to be concerned about management control of the operation. For example, Nestlé might want to appoint the milk powder plant manager. In addition, Nestlé already had an effective existing system for distributing its products in Pakistan, which would need to be integrated with Milkpak's marketing system.

Another agenda item concerned the products to be produced and sold by the joint venture and the location of their manufacture. Some Nestlé products currently imported could be manufactured locally in the new plant; others would continue to be imported. The new plant might also permit local manufacture of other Nestlé products not currently exported to Pakistan. Finally, there existed the possibility of introducing new products tailored more precisely to the consumption preferences of Pakistani consumers.
CONCLUSION

As Milkpak's management approached the meeting with Rudolf Tschau, they contemplated the key issues that would be addressed. Milkpak's objective was to increase its penetration of and success in the Pakistani market. The company was already involved in an extended negotiation with Friesland, a fact they would tell Nestlé, and one that gave Milkpak some additional leverage. At the same time, they needed to carefully evaluate what terms would make a joint venture with Nestlé more appealing than one with Friesland. The Milkpak executives had to decide what negotiating positions to adopt. Milkpak's executives were aware that, should they conduct a joint venture with Nestlé, today's meeting would set the foundation for a relationship that was likely to change and evolve over time.

References


CHAPTER 4
EXPLOITING MARKET LEADERSHIP

Koç Holding: Arçelik White Goods

In February, 1997, the top management team of Arçelik, the major appliance subsidiary of Koç Holding, Turkey's largest industrial conglomerate, assembled in Cologne, Germany, for the biannual Domotechnica, the world's largest major appliances trade show. The team was led by Hasan Sabas, president of Koç Holding's durables business unit, and Mehmet Ali Berkman, general manager of the Arçelik white goods operation, which accounted for two-thirds of the durables business unit's turnover.1

The Arçelik stand was in a prime location in Building 14; nearby were the booths of Bosch, Siemens, and Whirlpool. The Arçelik stand displayed 236 products carrying the Beko brand name, 35% of them refrigerators and freezers, 25% washing machines, 20% ovens, and 15% dishwashers.2 Several innovative products were on display including washing machines that were more water and energy efficient than competitive products, as well as refrigerators made from materials that were 80% recyclable and incorporated special insulation panels for greater operational efficiency. In 1996, Arçelik's Beko brand had received a Green Dove award from the European Union (EU) for attention to the environment in design and production.3

The trade show exhibit, costing $1 million to organize, reflected Arçelik's determination to become a major player in the global white goods industry. There was, however, still debate in the company regarding how much emphasis to place on international sales; which geographical markets to concentrate on; and whether to focus on supplying appliances on an original equipment manufacturer (OEM) basis, building the company's own Beko brand, or both.4

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1“White goods” was a term used to describe major kitchen appliances. The corresponding term, “brown goods,” described major household appliances used outside the kitchen, such as televisions and stereo systems.
2Most Arçelik products sold outside Turkey carried the Beko brand name.
3In 1997, the European Union comprised 15 member countries with a combined population of around 350 million people.
4An OEM (original equipment manufacturer) sold products to other manufacturers, distributors, or retailers; these products typically carried brand names specified by the purchasing companies.

Research Associate Robin Root and Professor John Quelch prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Confidential data have been disguised.

CHAPTER 4 Exploiting Market Leadership

COUNTRY AND COMPANY BACKGROUND

Turkey

In 1997, Turkey, a country of 63 million people, was positioned at the historical crossroads between East and West, communism and capitalism, Islam and Christianity. Turkey bordered Eastern Europe, the Caucasus, the Balkans, North Africa, and Middle East—all regions in various states of political and economic flux in the 1990s. In this context, successive Turkish governments promoted domestic and foreign policies that would nurture its still modest private sector yet promote the pursuit of global competitiveness so that Turkey would be a credible candidate for entry into the European Union.

The establishment of the Republic of Turkey by Mustafa Kemal Atatürk as a secular nation state in 1923 marked the end of 600 years of sultan rule. Atatürk aimed to move Turkey quickly into the ranks of industrialized Western nations by anchoring the republic's constitution in a parliamentary democracy. From the start, a strict division between religion (Islam) and government was constitutionally guaranteed and backed by the Turkish military. To build the economy, Atatürk set up temporary state-run enterprises that would later be turned over to private sector management. Privatization, however, did not get fully underway until the mid-1980s, when the government also formally established the Istanbul Stock Exchange.

During the 1980s, the Turkish government established the convertibility of the Turkish lira, and promoted exports to improve its balance of payments. Turkey's rapid growth and relative economic stability, although the envy of other developing countries, was long overlooked by Western governments which focused instead on its strategic role as a NATO firewall against Soviet expansion. The possibility of membership in the European Union changed the business mentality within Turkey. Large family-run industrial conglomerates, the engines of Turkish modernization, started to emphasize professional management and to apply global manufacturing standards.

In 1990, the growth in Turkey's gross national product reached an all-time high of 9.2%, sparking the interest of investors from Europe and North America. After a slowdown to 0.9% growth in 1991, the Turkish government stimulated consumer demand and increased public investment; the economy grew 5.9% in 1992 and 7.5% in 1993. A major recession in 1994 that saw 5.0% negative growth was followed by 7.3% growth in 1995 and 7.1% in 1996. Despite the political uncertainties that accompanied Turkey's first Islamist government, sustained GNP growth of 8% was forecast for 1997. The country was, however, afflicted by high inflation (80% in 1996 and 75% forecast for 1997), high interest rates, depreciation of the lira, and a deepening budget deficit. Data on the Turkish economy between 1992 and 1996 are presented in Exhibit 4.1.

Koç Holding

Vehbi Koç began his business in 1917 with a $100 investment from his father, who was a shopkeeper. Seven decades later, he left behind one of the world's largest private fortunes and the now advanced industrial conglomerate in Turkey, Koç Holding, which was established in 1963. Until the death of Vehbi Koç in early 1996, at age 95, Koç Holding had been the only company on the Fortune 500 list of international businesses to still be owned and operated by its founder.

EXHIBIT 4.1 - Turkish Economic Data: 1992-1996

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP growth rate (%)</th>
<th>GDP per capita (US$ at PPP1 rates)</th>
<th>Inflation (%)</th>
<th>Exchange rate (lira/US$)</th>
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</thead>
<tbody>
<tr>
<td>1992</td>
<td>6.4</td>
<td>4,991</td>
<td>70</td>
<td>8,555</td>
</tr>
<tr>
<td>1993</td>
<td>8.1</td>
<td>5,562</td>
<td>66</td>
<td>14,458</td>
</tr>
<tr>
<td>1994</td>
<td>-5.4</td>
<td>5,271</td>
<td>106</td>
<td>38,418</td>
</tr>
<tr>
<td>1995</td>
<td>7.3</td>
<td>5,411</td>
<td>94</td>
<td>59,501</td>
</tr>
<tr>
<td>1996</td>
<td>7.1</td>
<td>5,634</td>
<td>80</td>
<td>81,995</td>
</tr>
</tbody>
</table>

1Purchasing Power Parity (PPP) refers to the rates of currency conversion that equalize the purchasing power of different currencies. The GDP and PPP per capita in Istanbul were thought to be double the national average.


The legacy bequeathed by Vehbi Koç was as philosophical as it was financial. Shortly after Atatürk established the Republic of Turkey in 1923, Koç became the first Turk to challenge the trading power of the Republic's Greek, Armenian, and Jewish minorities. By age 22, he had discerned that the higher living standard enjoyed by these groups was a function of their dominance in commerce—a vocation that most Turks had been discouraged from entering. Koç went on to become one of the first Turkish businessmen to realize the benefits of foreign partnerships. In the late 1930s, he became a sales agent for companies such as Burroughs, Mobil Oil, and Ford, and in 1948 he built his first factory to manufacture light bulbs with General Electric. Half a century later, Koç Holding controlled close to 100 companies in nearly every sector of the Turkish economy, the total output of which accounted for approximately one-tenth of the country's GNP.

As a testament to the passions and principles he cultivated over his 7 decade reign, the Koç patriarch circulated a letter among his three grandsons just 3 months before he passed away in 1996. In it, he exhorted them to rise to the challenge faced by most third-generation managers in family businesses, namely, to rise single-mindedly focused on enhancing further the company's financial and social value.

In 1996, the 36,000 employees of Koç Holding generated $12 billion in revenues. Koç was a major player in the automotive industry, household appliances, consumer goods, energy, mining, construction, international trade, finance, tourism, and services sectors. The company grew three times faster than the Turkish economy between 1985 to 1995. Its corporate logo, a red ram's head (Koç means ram in Turkish), was visible on street corners, shops, and office buildings throughout Turkey. Koç Holding had a nationwide distribution network of 9,400 dealers, and 23 overseas offices responsible for achieving $884 million in foreign exchange earnings. As the leading taxpayer in Turkey, Koç Holding initiated and underwrote numerous philanthropic projects in the areas of education, health, cultural heritage, and environmental conservation.

Arçelik

Arçelik was established in 1955 to produce metal office furniture. In 1959, the company began manufacturing washing machines. Arçelik subsequently began manufacturing refrigerators, dishwashers, air conditioners, and vacuum cleaners in five Turkish factories. Unit sales across these five categories reached 2,110,000 in 1995, making Arçelik the

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1Arçelik (pronounced arch-e-lik) is a Turkish word meaning clean steel.
AVELIK, manufacturing capacity, actual production, and unit sales for 1992-1996 in the three most important white goods categories are summarized in Exhibit 4.3. Avelik's unit sales grew from 6.5% in 1994 to 1996, and unit sales are projected to reach 24% of total market share in 1998.

AVELIK's position in the European market is strong, with unit sales growing from 5.6% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the American market is also strong, with unit sales growing from 4.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the Asian market is also strong, with unit sales growing from 3.6% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the Middle Eastern market is also strong, with unit sales growing from 2.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the African market is also strong, with unit sales growing from 1.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the Latin American market is also strong, with unit sales growing from 0.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the Caribbean market is also strong, with unit sales growing from 0.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the Pacific market is also strong, with unit sales growing from 0.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the European Union market is also strong, with unit sales growing from 5.6% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the North American market is also strong, with unit sales growing from 4.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the South American market is also strong, with unit sales growing from 2.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the Central American market is also strong, with unit sales growing from 1.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the Caribbean market is also strong, with unit sales growing from 0.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the Pacific market is also strong, with unit sales growing from 0.5% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.

AVELIK's position in the European Union market is also strong, with unit sales growing from 5.6% in 1994 to 9.8% in 1996. This growth is projected to continue, with unit sales reaching 20% of total market share in 1998.
between 1990 and 1995. The corresponding increases for washing machines and dishwashers were 50% and 20%. Arçelik had no manufacturing plants outside of Turkey.

In addition, Arçelik also invested heavily in R&D. During the 1970s and 1980s, Arçelik licensed technology from General Electric and Bosch-Siemens. Arçelik paid unit royalties but was only permitted to sell its production in Turkey. Over time, Arçelik developed its own appliance designs, often at lower cost than the licensed technologies. Starting in 1989, Arçelik transformed itself from a manufacturer that used licensed technologies to one of the leaders in white goods research and development. The company sponsored master’s theses at Turkish engineering schools on subjects relevant to its research agenda, and secured World Bank funding to research how to eliminate CFCs from refrigerators. Between 1990 and 1995, $69 million or 1.5% of sales was allocated by Arçelik to R&D. The fruits of these investments were evident in the innovative technology-based features on display in the Arçelik booth at Domoteknik in 1997.

In the area of human resources, Arçelik prided itself on lean management with only four levels in the organization. The work force was highly educated and many Arçelik managers had attended business schools in North America and Europe.

### WHITE GOODS MARKETING IN TURKEY

#### Demand

As of 1996, 99% of Turkey's 13 million households owned refrigerators, the same percentage as in the European Union. The corresponding percentages for other major appliances were 47% for automatic washing machines (90%), 15% for dishwashers (31%), and 56% for ovens (70%).

Demands for white goods in Turkey was influenced by the pace of household formations and urbanization, interest rates, retail price levels, and the rate of economic growth. Sensitivity analyses estimating the effects of changes in some of these variables on unit sales of appliances in Turkey are presented in Exhibit 4.8. Consumer purchases of appliances increased dramatically in the first half of 1996 as shown in Exhibit 4.9. Arçelik sales increased 21% in this period. Berkman commented:

Domestic demand is strong and will remain so. Annual population growth is 1.7% and the number of households increases by 2.5% each year. Around 50% of the population is under 30 and an increasing percentage (currently 63%) live in cities and towns which makes it easier for us to reach them.

#### Exhibit 4.5: Turkish Market Share and Unit Sales for White Goods

<table>
<thead>
<tr>
<th></th>
<th>Refrigerators</th>
<th>Washing machines</th>
<th>Dishwashers</th>
<th>Ovens</th>
</tr>
</thead>
<tbody>
<tr>
<td>Koç</td>
<td>54.6%</td>
<td>56.5%</td>
<td>64.2%</td>
<td>59.7%</td>
</tr>
<tr>
<td>Peg</td>
<td>38.2%</td>
<td>30.9%</td>
<td>23.5%</td>
<td>23.5%</td>
</tr>
<tr>
<td>Merloni</td>
<td>4.3%</td>
<td>4.1%</td>
<td>4.0%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Others</td>
<td>2.9%</td>
<td>8.5%</td>
<td>8.3%</td>
<td>11.3%</td>
</tr>
<tr>
<td>Unit Sales</td>
<td>868,197</td>
<td>1,039,519</td>
<td>856,890</td>
<td>1,135,669</td>
</tr>
<tr>
<td></td>
<td>263,570</td>
<td>231,030</td>
<td>446,591</td>
<td>509,493</td>
</tr>
</tbody>
</table>

1Unit sales include imports so Arçelik market share reported here are lower than the company's share of domestic production.

Source: Company records.

#### Exhibit 4.6: Brand Share Breakdowns for Two Principal White Goods Marketers in Turkey: 1996

<table>
<thead>
<tr>
<th></th>
<th>Refrigerators</th>
<th>Washing machines</th>
<th>Dishwashers</th>
<th>Ovens</th>
</tr>
</thead>
<tbody>
<tr>
<td>Koç Group</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Arçelik</td>
<td>39.2%</td>
<td>39.9%</td>
<td>53.7%</td>
<td>44.4%</td>
</tr>
<tr>
<td>Beko</td>
<td>17.3%</td>
<td>19.8%</td>
<td>16.7%</td>
<td>22.9%</td>
</tr>
<tr>
<td>Peg Group</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AEG</td>
<td>8.3%</td>
<td>5.6%</td>
<td>2.4%</td>
<td>5.1%</td>
</tr>
<tr>
<td>Profilo</td>
<td>18.9%</td>
<td>10.6%</td>
<td>2.8%</td>
<td>13.1%</td>
</tr>
<tr>
<td>Bosch</td>
<td>3.3%</td>
<td>6.1%</td>
<td>13.7%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Siemens</td>
<td>0.4%</td>
<td>1.2%</td>
<td>1.6%</td>
<td>0.4%</td>
</tr>
</tbody>
</table>

Source: Company records.


Source: Company records.

#### Exhibit 4.8: Impact of Changes in Interest Rates, Consumer Prices, and GNP per Capita on Arçelik Sales and Profits

<table>
<thead>
<tr>
<th>Change in Arçelik's</th>
<th>Interest rates increase by 10%</th>
<th>Consumer prices increase by 10%</th>
<th>GNP per capita increases by 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refrigerator unit sales</td>
<td>-12.5%</td>
<td>-12.7%</td>
<td>+1.3%</td>
</tr>
<tr>
<td>Washing machine unit sales</td>
<td>-8.1%</td>
<td>-7.1%</td>
<td>+4.3%</td>
</tr>
<tr>
<td>Dishwasher unit sales</td>
<td>-10.4%</td>
<td>-10.1%</td>
<td>+21.6%</td>
</tr>
<tr>
<td>Total sales revenues</td>
<td>-6.9%</td>
<td>-8.1%</td>
<td>+3.7%</td>
</tr>
<tr>
<td>Total profits</td>
<td>-13.3%</td>
<td>-14.1%</td>
<td>+11.5%</td>
</tr>
</tbody>
</table>

Source: Adapted from a Schroeders investment report, 1996.
Imports satisfied some of the increase in domestic demand, reaching 3% of white goods sales in Turkey in 1993. In 1994, when the Turkish lira devalued sharply and the economy went into recession, imports of white goods declined while exports increased. In January, 1996, with the import tariffs cut to zero and the economy strengthening, imports increased. For example, between January and July of 1996, 20% of dishwashers sold in Turkey were imported. Analysts estimated the sustainable import penetration rate at 5% for refrigerators, 10% for washing machines, and 15% for dishwashers.

### Competition

Arçelik’s principal white goods competitor was Peg Profilo. Facing increasing competition, Peg Profilo had been sold to Bosch-Siemens of Germany in 1995. Peg Profilo sold its products under the Profilo and AEG brand names. Imports of premium-priced Bosch and Siemens appliances began in 1996. Although penetration was limited to date, Arçelik managers noted heavy advertising behind the Bosch name aimed at challenging Arçelik’s dominance of the premium end of the white goods market. Several Bosch shops were opened to supplement the existing network of Peg Profilo dealers. There was some evidence of strained relations as Bosch-Siemens tried to impose formal contracts on dealers used to the handshake-style agreements of Peg Profilo.

Peg Profilo’s market shares in 1996 were 31% in refrigerators, 24% in washing machines, 23% in ovens, and 20% in dishwashers. Profilo capacity utilization was only 60%. Arçelik managers expected that Profilo would become more competitive in washing machines and dishwashers (in which the firm had not invested in new production technology) as a result of the acquisition. Units carrying the Profilo name could be imported from Bosch-Siemens’ efficient German or low-cost Spanish plants. In addition, Profilo refrigerators, which were more up-to-date, were expected to be exported through Bosch-Siemens’ overseas network.

The number three competitor, Merloni, was a joint venture between the Italian consumer durables producer and Pekel, the Turkish white goods company owned by Vestel, which was originally owned by Polly Peck International. Merloni had obtained majority control of the refrigerator factory in 1993. Arçelik managers believed that Merloni competed for market share with Peg Profilo’s brand more than with the Arçelik and Beko brands.

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4 AEG was an Electrolux brand sold under license in Turkey by Peg Profilo. After the Bosch-Siemens acquisition, little effort was put into promoting the AEG brand.

### Consumer Behavior

Relative to per capita income, the penetration of white goods in Turkish households is high. This was attributed to the desire of Turkish consumers to buy prestigious durables for their homes and to sustained marketing efforts on behalf of the Arçelik and Beko brands.

When buying a new or replacement appliance, 50% of consumers believed that the decision-making processes involved. Replacement purchases were invariably triggered by the breakdown of an existing appliance and were therefore especially unlikely to shop around. High inflation also encouraged consumers to shorter decision-making processes. In 1996, wage increases were outpacing inflation so demand for white goods was especially strong.

A consumer’s perceived risk and brand sensitivity varied according to the white goods being purchased. As explained by Arçelik’s marketing manager:

Refrigerators are nothing more than boxes and consumers are familiar with them. There’s little that can go wrong. Dishwashers, on the other hand, are more complex appliances and first-time dishwasher purchasers are more risk averse.

### Arçelik Marketing in Turkey

#### Brand Building

Arçelik sold white goods under two brand names, Arçelik and Beko. A third brand, Aygaz, that Arçelik had inherited through the acquisition of an oven manufacturer, was discontinued in 1995 and its product line absorbed into the Beko brand family.

In 1996, there were 33 million Kč white goods appliances in use in 13 million Turkish households. Arçelik was a trusted brand. However, some older consumers did not remember fondly the product quality of Arçelik’s early appliances sold in the 1960s; to them, the quality of Turkish-made products was still doubtful. Though the product lines of both brands were similar, except for external design differences, Beko brand managers claimed their brand had a more “high tech” image that appealed to younger consumers. The strong penetration of Beko in brown goods (25% market share) was believed to reinforce this perception. Beko was also marketed in Turkey as a “world brand”; Beko retailers capitalized on the brand’s penetration of export markets as a signal of quality to Turkish consumers.

In 1996, Arçelik and Beko advertising and promotion budgets accounted for 2% and 4%, respectively, of both brands’ sales. Advertising included both television and print advertising. The print component included some cooperative advertising with the cost shared between Arçelik and its retailers on a 50/50 basis. Promotions included “trade-in” offers designed to accelerate consumers’ repurchase cycles.

#### Pricing

Arçelik’s product lines covered a full range of price points; the most expensive, fully featured item in the product line was typically double the price of the least expensive. With an inflation rate of 80% in 1996, Arçelik prices were increased that year by 9% every 2 months. Reductions in unit manufacturing costs, stemming from improved productivity and declines in world plastic and stainless steel prices, increased below the rate of inflation.
Arçelik white goods were priced consistently nationwide. They were the highest priced among domestically manufactured white goods but retailed at prices lower than imported models. Exhibit 4.10 compares white goods retail prices (including 23% value-added tax) across a variety of brands.

As shown in Exhibit 4.11 Arçelik’s average operating profit before interest and taxes was 13%. Arçelik’s operating profit on exports was considerably lower. Although registering strong profits on refrigerators, Arçelik unit margins on washing machines and dishwashers in 1996 were lower than competitors’ margins due to depreciation charges associated with Arçelik’s heavy investments in plant modernization and the fact that several lines were still ramping up to efficient volumes of production.

### Exhibition 4.10

<table>
<thead>
<tr>
<th>Brand name</th>
<th>Refrigerators</th>
<th>Washing machines</th>
<th>Dishwashers</th>
<th>Ovens</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arçelik (Arçelik)</td>
<td>100</td>
<td>94</td>
<td>58</td>
<td>42</td>
</tr>
<tr>
<td>AEG (Peg)</td>
<td>91</td>
<td>89</td>
<td>64</td>
<td>38</td>
</tr>
<tr>
<td>Bosch (Peg)</td>
<td>112.5</td>
<td>102</td>
<td>87</td>
<td>—</td>
</tr>
<tr>
<td>Miele (import)</td>
<td>123</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>G.E. (import)</td>
<td>320</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Westinghouse (import)</td>
<td>147.5</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Electrolux (import)</td>
<td>116</td>
<td>127</td>
<td>90</td>
<td>—</td>
</tr>
</tbody>
</table>

Source: Company records.

### Exhibition 4.11

<table>
<thead>
<tr>
<th>Cost structure</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail selling price(^1)</td>
<td>125</td>
</tr>
<tr>
<td>Wholesale price(^2)</td>
<td>112</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>3</td>
</tr>
<tr>
<td>Selling and distribution</td>
<td>5</td>
</tr>
<tr>
<td>Factory price</td>
<td>100</td>
</tr>
<tr>
<td>Variable costs</td>
<td>58</td>
</tr>
<tr>
<td>Direct materials</td>
<td>51</td>
</tr>
<tr>
<td>Direct labor</td>
<td>4</td>
</tr>
<tr>
<td>Variable overhead</td>
<td>3</td>
</tr>
<tr>
<td>Research and development</td>
<td>4</td>
</tr>
<tr>
<td>Depreciation</td>
<td>10</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>15</td>
</tr>
<tr>
<td>Operating profit (before interest and taxes)</td>
<td>13</td>
</tr>
</tbody>
</table>

\(^1\)The price at which exclusive Arçelik retailers sold to the end consumer excluding value-added tax. Retailers generally made 5% to 6% pretax profit.

\(^2\)The price at which Atilim, Koç’s captive marketing company, sold the product to the exclusive retail network in Turkey.

Source: Company records.

### Distribution and Sales

Ninety-five percent of white goods were sold to individual consumers through retail stores; only 5% were sold by manufacturers direct to building contractors. Single brand retailers accounted for 60% of retail unit sales of white goods in Turkey; the remaining 40% were sold through multibrand outlets. In addition to traditional appliance specialty stores, new channels such as Carrefour and Metro hypermarkets were opening in greater Istanbul. Selected Beko products (but no Arçelik products) were sold through these outlets. Around 28% of Turkish white goods were sold in Istanbul.

Arçelik delivered products to the Turkish market through exclusive retailers. There were 1,650 outlets carrying only the Arçelik brand, of which 700 accounted for 70% of sales. Another 1,050 outlets carried only Beko products. Beko also reached consumers through a further 2,500 to 3,000 non-exclusive outlets, which accounted for 30% of Beko sales. Arçelik was not available in any multibrand outlets. Arçelik typically added 100 new outlets per year and discontinued 30. New outlets included existing multibrand appliance dealers who applied to become Arçelik dealers, stores established by the sons of existing Arçelik dealers, and stores started by sufficiently well-capitalized entrepreneurs. New outlets had to be established in new residential areas and in areas where appliance demand increased with disposable income. According to Arçelik’s national sales manager:

Being the Arçelik dealer in a community is a much sought after position of importance. We have many applicants to choose from. Our dealers are loyal because our brand pull results in inventory turns three times faster than for our nearest competitor. As a result, our unit margins at retail can be narrower.

The product mix varied according to the size of each store and the demographics of the neighborhood in which it was located. An Arçelik store manager commented:

Consumer demand for appliances is strong. People are switching from semi-automatic to automatic washing machines. First-time purchases of dishwashers are strong. Consumers living in apartments often have big families and need large refrigerators.

One hundred salespeople visited the Arçelik dealers, typically once every 2 weeks. Beko sold through 150 salespeople. Sales force turnover was a modest 5% per year.

A strong Arçelik retailer might carry $100,000 worth of inventory in the store and $500,000 in a warehouse, all on 100-day payment terms from the manufacturer. Typically, 15 sales would be made each day including six washing machines, four refrigerators, and two dishwashers. An average dealer might make 5 sales per day and hold $50,000 in floor inventory.

Ninety percent of Arçelik white goods were sold to consumers on credit installment plans of between 3 and 15 months. In addition to factory-sourced finance, a newly established Koç finance company also offered credit, often at interest rates slightly below the rate of inflation.\(^3\) Each Arçelik dealer was liable for payment on the units sold on installment. The bad debt rate was less than 1%. Arçelik’s competitors such as Bosch

\(^3\)Securitizing receivables and installment loans through Koç Finans reduced Arçelik’s working capital needs and, therefore, its average cost of capital.
were obliged to offer the same terms Carrefour stores in the major cities could only offer their consumers bank credit at rates significantly higher than Arçelik.

Service
With the average white goods appliance in use for 12 years, the quality and availability of after-sales service was important to Turkish consumers in influencing other brand purchase decisions. Service for Arçelik and Beko white goods was provided by 500 authorized dealers who serviced only these two brands. Another 450 dealers serviced the brown goods of the two brands. There was no joint ownership of sales outlets and service dealers, though informal ties were common. Forty percent of service dealer revenues was generated by installations of newly purchased appliances; delivery and installment costs were included in the retail price. The service organization was especially challenged when there was a surge in consumer sales, as in 1996.

INTERNATIONAL EXPANSION

Opportunistic exports of Arçelik white goods began in the 1980s through Koç Holding’s export company, principally to the geographically neighboring markets of the Middle East and North Africa. Arçelik models did not have to be adapted to local requirements. In 1983, an export department was established within Arçelik. One of its tasks was to develop bid proposals on foreign government tenders and for foreign contract builders of low-income housing. In 1988, Arçelik’s export department contracted to supply refrigerators on an OEM basis to Sears Roebuck for distribution in the Caribbean and Latin America under the Kenmore name. Though Arçelik’s exports were a modest percentage of total sales during the 1980s, Arçelik was the largest exporter among Koç Holding companies.

In 1988, the Turkish government’s tariff reduction agreement with the European Union prompted an increased interest in exports. Berkman explained:

We needed to find out more about our likely future competitors. One way to do so was to sell Arçelik products in the tough developed markets. The Americas were too far away, in terms of both transportation costs, product adaptation requirements (for 110 volt current), and our ability to understand consumers. Western Europe was much closer. We thought we would learn a great deal by competing against the best in the world on their home turf and better prepare ourselves to defend our domestic market share against the likes of Bosch and Siemens.

As of 1996, almost half of the 990,000 Arçelik and Beko refrigerators produced were exported. In that year, 7.6% of Arçelik’s total sales (by value) were exports, up from 2.4% in 1991. A breakdown of exports by destination is presented in Table 4.1. Arçelik exported to the countries listed in Exhibit 4.12, which reports 1996 unit sales of refrigerators and washing machines by market. Arçelik’s most successful European market was the United Kingdom, where it had achieved 8% market penetration. In the Middle East and North Africa, Arçelik had achieved almost 20% market share in Tunisia. The firm held between 1% and 4% market share in most of the other product markets listed in Exhibit 4.12.

In 1996, Arçelik exports of white goods were principally refrigerators and washing machines, as shown in Table 4.2. Technology licensing agreements precluded exports of

| TABLE 4.1 Value of Arçelik Exports by Destination: 1996 |
|-----------------|-----------------|-----------------|
| Destination     | Percentage      | Destination     | Percentage      |
| United Kingdom  | 28              | North Africa    | 17              |
| France          | 18              | Eastern Europe and Central Asia | 6 |
| Other European Union | 14          | Other          | 17              |

<table>
<thead>
<tr>
<th>EXHIBIT 4.12 Total Refrigerator and Washing Machine Unit Sales in Arçelik Export Markets: 1996</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refrigerators</td>
</tr>
<tr>
<td>1996 unit sales</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>European Union</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refrigerators</td>
</tr>
<tr>
<td>1996 unit sales</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>United Kingdom</td>
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Source: Company records.

| TABLE 4.2 Arçelik White Goods Exports and Mix: 1996 |
|-----------------|-----------------|-----------------|
| Export units    | % Beka          | % OEM           |
| Refrigerators   | 430,000 | 70              | 30              |
| Washing machines| 55,000  | 50              | 50              |
CHAPTER 4 Exploiting Market Leadership

most dishwashers. In 1996, Arçelik’s refrigerator plants were operating at full capacity. By 1998, an extra 350,000 units of capacity were expected to come online. Management expected to double exports of washing machines in 1997 without any addition of capacity. Dishwasher exports were expected to increase to 110,000 units in 1997 when Arçelik was to supply the first of five annual installments of at least 100,000 OEM units to Whirlpool for distribution in Europe. This was the first time Arçelik had agreed to an OEM contract with a global competitor; Arçelik was not permitted to sell similar models in Europe under its own brand names.

Arçelik in Western Europe

Starting in 1989, Arçelik opened sales offices in the United Kingdom, then France, then Germany, reasoning that, in these larger European markets, there might be more opportunity for a new brand to establish a sufficient volume of sales to be viable. At the same time, the export effort to other markets continued. In all export markets, Arçelik focused on building the Beko name (because it was easier to pronounce than Arçelik in a wide variety of languages).

United Kingdom

A sales office was established in the United Kingdom in 1989. The U.K. market was selected for this initial effort because it was price sensitive and not dominated by domestic brands. By 1997, there were one million Beko appliances in use in the United Kingdom, two-thirds of which were refrigerators and one-third televisions. Sales of 30,000 Beko refrigerators were expected in 1997, of which two-thirds would be tabletop-refrigerators and one-third full-size refrigerators. In addition to refrigerators, Beko was beginning to sell dishwashers, washing machines, and ovens. Management had focused from the outset on building the Beko brand; only 10,000 of the units sold in 1996 were marketed on an OEM basis.

Melvyn Goodship, managing director, explained Beko’s success in the United Kingdom:

We exploited an underserved niche for tabletop refrigerators. Our factories in Turkey had spare capacity in the early nineties, so could promptly fill our orders and deliver consistent product quality. At first, we were accused of dumping but lower priced brands from Eastern and Central European countries are now criticized for that. Through patience and persistence, we have built our brand reputation and distribution.

By 1996, Beko had penetrated the three principal specialty appliance chains in the United Kingdom—Curry’s, Comet, and Iceland. Beko appliances were also sold through the principal mail order catalogs—Empire and Littlewoods. Management believed Beko appliances were available through 65% of selling points in the United Kingdom. Beko maintained a warehouse in the United Kingdom to serve its retail accounts.

In 1996, the Beko brand was supported by £500,000 of advertising, including £100,000 to launch Beko washing machines and £150,000 of cooperative advertising.

France

Arçelik opened a French sales office in 1993. By 1996, annual sales were up to 75,000 units. However, according to the French sales manager:

The French market is in a recession and is cluttered with competitors. It is hard for us to break into new accounts. 1997 will be a crucial year.

The French white goods market was highly competitive. Fifteen trade accounts controlled 75% of consumer sales. Thirty percent of white goods units sold came from store brands. Appliances specialty stores accounted for 45% of unit sales, hypermarkets for 30%, and mail order companies and department stores for 25%. There were no dominant national brands. The long-standing French brands, Thomson and Brandt, each accounting for 20% of unit sales, were, by 1997, owned by Italian manufacturers.

Arçelik pursued a two brand strategy in France. Management believed that, if the Beko brand was launched at a low price, it would be impossible to raise it later. The Beko brand was therefore positioned and priced similarly to the mainstream Candy brand from Italy. The Beko brand accounted for 25% of the company’s unit sales in France. Other Koç or OEM brands were priced lower than Beko to attract volume orders.

Of 75,000 units sold in France in 1996, 68,000 were refrigerators and 7,000 were washing machines and ovens. Of the 75,000, 15% were sold to kitchenette manufacturers and 15% were sold on an OEM basis to Frigidaire. Seventy percent of the remaining units were shipped to hypermarkets, notably Leclerc (the third largest hypermarket chain in France) and 30% to appliance specialty stores. The French sales office had not yet been able to break into any department stores or mail order accounts. A 2 year test, involving telemarketing Beko white goods to high street retailers, was currently underway. The only advertising for Beko in France appeared in the Leclerc catalog.

Germany

Arçelik opened a German sales office within an existing company called Interbrucke GmbH in 1994 under a general manager which had previously been an importer of Beko televisions.

Well-known, premium-priced German brands such as Bosch, Siemens, AEG, and Miele held a 60% unit market share of white goods. The remaining 40% was divided among numerous lower-priced Italian and East European manufacturers, none of whom held more than a 4% share.

About 60% of white goods were sold through traditional appliance retailers, almost all of whom were members of retail buying groups or served through regional wholesalers. Twenty percent of white goods were sold through mail order firms like Quelle, usually at prices below those in the specialty retailers. Of the remaining units, 10% were...
sold through mass merchandisers, 5% through hypermarkets, and 5% through traditional department stores.

In 1996, Beko sold 30,000 refrigerators in Germany, up from 10,000 in 1995, and 20,000 washing machines, up from 5,000 in the preceding year. Unit sales of refrigerators and washing machines in Germany in 1996 were 3,600,000 and 2,600,000 respectively. Management predicted sales of 70,000 and 30,000 for the two Beko lines in 1997. To date, 80% of Beko sales had been made to retail buying groups and regional wholesalers, the remaining 20% were made to the manufacturers of prepackaged kitchenettes that were sold to home builders. By the end of 1996, Beko white goods were being bought by 12 accounts, in all cases on an OEM basis. Beko white goods were imported from Turkey and stored in a rented warehouse in Germany. The average retail price of a Beko refrigerator was DM 599. Comparable Bosch and Siemens refrigerators sold for DM 499 to DM 599.

Beko had no resources for a consumer advertising campaign, though some funds were available to buy advertising space in retailer catalogs. The general manager commented on Beko's prospects in Germany:

The German economy is weak right now and population growth is flat. Demand for appliances is soft but fairly predictable. Consumers and, therefore, distributors are more price sensitive, especially in the former East Germany. This plays to our strength as a value brand. More retailers than ever before are scrambling to sell appliances, so that's putting further pressure on margins.

In this price sensitive climate, I believe Beko's prospects are good. Germany is Turkey's largest trading partner. The challenge is to develop relationships with the big customers and persuade them to switch to Beko. If we can build unit volume by supplying OEM (or private label) product to these customers, we may be able to make enough money to invest in building the Beko brand.

Assessing Progress
Progress in Western Europe was slower than some executives expected, leading them to question the strategy. A senior manager at headquarters in Istanbul commented:

We should not focus on breaking into Western Europe where growth is limited and where five companies control 75% of unit sales of white goods. Instead, we should focus on the emerging markets of Russia and Central Asia where foreign brand names are not yet entrenched in consumers' minds. We are geographically well-positioned to supply these markets. The fact that our products are made in Turkey will be a plus in those markets whereas, in Western Europe, we have to avoid mentioning it. However, another supported the emphasis on Western Europe:

The former communist markets of East and Central Europe will be important but, right now, they are too volatile. Tariff rates change overnight and we have no tariff advantage over Japanese and Korean competitors in these markets like we do in Western Europe. We would have to make risky investments in local manufacturing and distribution; finding the right local partners and sufficiently skilled workers would be difficult. I would rather focus on Western Europe for the moment. The markets are tough to crack and our unit margins are lower than in Turkey but at least our goods enter duty free and demand is predictable.

CONCLUSION

In between hosting visitors to their Domotechnica booth in Cologne, Arçelik's managers continued to discuss informally whether or not they were placing the correct emphasis on international markets, and whether their brand-building and market selection strategies were appropriate. Some of the comments at the booth included:

In 1996, we showed we could hold our own in the Turkish market against the top brands in the world. In fact, our market share in refrigerators actually increased. This means we can now push our international exports more aggressively.

Wait a minute. Capacity is tight. If the Turkish market continues to grow at the current rate, we'll need most of our planned capacity for 1997 to meet domestic demand. And we know that we make at least twice as much unit margin if we sell an appliance in Turkey than if we export it.

The current rate of economic growth is not sustainable. The government, in anticipation of a general election, is pumping money into the economy. The economy will probably slow down, maybe even go into recession in 1997. I don't think we'll have a capacity problem.

We've got to emphasize building the Beko brand worldwide. We'll never make big money on OEM business, whether we are making to order for other manufacturers—who are, in fact, our competitors—or for retail chains. Special orders add to complexity costs in our plants and we lose our R&D edge when we simply follow the customers' blueprints. Occasionally, you can build up a long-term relationship with an OEM customer through consistent on-time deliveries but, more often than not, OEM orders are one-shot deals which the customer is trying to exert leverage on his or her other suppliers or cover against a strike threat.

I'm not sure. Selling OEM production is more profitable than selling the equivalent number of Beko branded units. Marketing costs per unit are lower and we don't have to invest in full advertising support through our national distributors.

You don't understand. We're making products of outstanding quality these days. Because Turkey's reputation for quality manufacturers is not well-established, we've had to work doubly hard to achieve recognition. We shouldn't be wasting any more time doing OEM production of lower-priced, simple models when we have the quality to take on the best in the world at the premium end of the white goods market.
CHAPTER 5 Achieving International Expansion

Hikma Pharmaceuticals

On May 19, 1996, Samih Darwazah, chairman of Hikma Investment, the holding company for Hikma Pharmaceuticals, proudly announced that the Jordanian company had begun exports of approved drugs to the United States:

The shipment is of $100,000 worth of prescription drugs to four U.S. distributors. Hikma is the first Arab-owned drug company from the Middle East to obtain Food and Drug Administration (FDA) approval to sell to the U.S. market, following inspection of its plants in Jordan by an FDA team. This is a vote of confidence which will not only enable us to sell in the United States but also boost our sales in Jordan and the Arab world. It’s the latest in a long series of marketing challenges that we’ve overcome.

Hikma was already selling drugs in the United States manufactured by its Westward subsidiary, acquired in 1991 and run by Sami, Darwazah’s son. Hikma’s top management team was keenly debating the appropriate strategy for the company’s U.S. operations, how they should fit with Hikma’s other operations in Jordan and Portugal, and how important a role they should play in the company’s overall growth.

COMPANY BACKGROUND

Samih Darwazah, Hikma’s founder, was born in Palestine. He came to the United States in the late 1960s on a scholarship to the St. Louis College of Pharmacology, earned a master’s degree in industrial pharmacy, and joined Eli Lilly on graduation. After 14 years in a variety of international marketing positions in Europe and the Middle East, Darwazah decided in 1977 to settle in Amman, Jordan. His objective, with the assistance of his two sons, was to create a pharmaceutical company to serve the Arab world. Darwazah explained:

Jordan is a small country—only 4.3 million people—and a relatively poor country with per capita income of only $1,650. Yet the multinational pharmaceutical companies were already selling here, so we had to think internationally from the outset.

First, Darwazah established a joint venture in Amman with an Italian firm. The joint venture negotiated a license from Fujisawa Pharmaceutical Corp. of Japan to manufacture in Jordan and market in the Middle East cefazolin, one of the world’s top-selling injectable (rather than oral) cephalosporins (cephs). In addition, the company manufactured and marketed its own formulation of another common, but less technically advanced, class of penicillin-based antibiotics called amoxicillin. However, because the Jordanian market was already well-served by multinational pharmaceutical firms, Darwazah knew he had to differentiate his new firm if he was to succeed. He built credibility among local physicians, who were skeptical of the quality of locally manufactured products, by emphasizing the company’s commitment to research and new product development, by inviting them on plant tours, and by stressing added-value customer services delivered by highly trained salespeople, most of whom were former pharmacists.

He identified three keys to the company’s success: procure additional manufacturing licenses to expand the firm’s product line; develop cutting-edge generics that were more than just “me-too” products; and market these product lines in ways that would make his firm an indispensable source to physicians in the Arab world.

Production began in 1978. Over time, manufacturing licenses were obtained from Fujisawa, Chugai, and Dainippon of Japan for a range of additional drugs including antiinfectives, cardiovascular drugs, tranquilizers, antiinflammatory drugs, antihypertensives, and analgesics. The factory was expanded in 1984 to include a sterile area for the production of injectables. To comply with best practices and avoid cross-contamination, a separate plant was set up in 1988 for production of cephalosporins and penicillins.

During the 1980s, Hikma supplemented the production of licensed products with branded generics to leverage further its sales and distribution organization. Hikma became the first Arab drug company to perform bioequivalency studies. The company expanded the dosage forms for amoxicillin. First, Hikma developed a more convenient twice-a-day dosage form with a single daily dosage that was more patient compliant. Hikma also developed a chewable version of amoxicillin, previously unavailable even in the United States. As a result, Hikma enhanced its reputation as a quality company with a growing research and development capability.

Hikma gradually increased its focus on cephs. In 1985, the firm secured a second license from Fujisawa to manufacture Cefzoxo, another injectable cephalosporin. Shortly thereafter, the company signed a manufacturing agreement with Smith, Kline, and French Laboratories for a third injectable cephalosporin (which needed to be administered to a patient...
only once a day). In return, Hikma furnished these multinationals with royalty payments on its sales.

As the focus on cephs increased, Darwazah decided that Hikma should backward integrate into the production of raw materials. Although supplies of the necessary raw materials were plentiful, he wanted to tighten quality control by backward integration and to ensure Hikma’s independence from outside sources. In 1990, a sterile plant was established with an initial annual production capacity of 24 tons of bulk cephs but with expansion potential to 48 tons. Only a few plants in India could produce bulk cephs at lower cost.

By 1995, Hikma was making 40 drug products in Jordan. The top five sellers accounted for 50% of sales. Oral cephalosporins accounted for 30% of sales, drugs manufactured under license for 30%, and branded generics for 30%.

INTERNATIONAL EXPANSION

By 1994, Hikma Investments included wholly owned manufacturing operations in Portugal and the United States as well as four plants in Jordan. Exhibit 5.1 details Hikma’s sources of revenues between 1990 and 1996, while Exhibit 5.2 breaks down Hikma Jordan’s sales by drug class in 1990 and 1996. In 1996, the proportion of total company profits generated by Hikma Jordan was 45% and its capacity utilization rate was 70%. The corresponding figures for Hikma Portugal were 10% and 30%, and for West-ward (the United States operation) the figures were 30% and 95%.

Hikma employed around 500 people in Jordan, 70% of them college graduates; many managerial positions were held by women. Hikma also owned Arab Medical Containers, a health care-related plastics manufacturing company that supplied Hikma and other companies with containers, tamper-resistant bottles, and other drug packaging. A manufacturing joint venture had been established in Tunisia in 1992 to produce cephs and penicillins under the Hikma name for supply to the French-speaking countries of North and West Africa. Through a second joint venture, Hikma provided technical support for the manufacture and marketing of products in Egypt, the largest pharmaceutical market in the Middle East. A third joint venture had been signed to build a $35 million plant in Saudi Arabia, completion of which was expected at the end of 1997. Hikma had marketing offices in 20 countries, including Russia, Slovakia, and China.

The pharmaceutical industry was the second most important exporter in Jordan. Hikma, as the largest pharmaceutical company in Jordan, was, therefore, one of the country’s most significant exporters. In 1995, the Jordanian pharmaceutical industry produced $225 million worth of drugs of which $120 million were exported. Hikma exports in 1995 accounted for $50 million of the company’s $60 million in sales. In contrast to exports, Hikma sales in Jordan were only $10 million in 1995. Despite Hikma’s efforts, locally made drugs accounted for only 30% of Jordan’s consumption. In 1996, Hikma was trying to persuade the Jordanian government to approve increases in local drug prices. Margins were so low that Hikma’s ability to invest in research and development was limited. Hikma was contemplating curtailing the production of certain drugs, which would leave only the more expensive imported substitutes available to the Jordanian consumer.

The Arab World

Darwazah’s initial vision was to develop “an Arab company that serves the Arab world.” In the early 1980s, he found markets for his joint venture’s generic products in the Middle East and North Africa, winning government procurement contracts in Iraq, Syria, and Tunisia. The firm’s growth was restricted, however, as Saudi Arabia, a key market in the region, only allowed originator manufacturers to sell their drugs in the market. Hikma was the first company to secure permission from Saudi Arabia to market generic drugs, but then faced the further obstacle that Saudi Arabia only provided tax exemptions to 100% Arab-owned firms. To achieve this exemption, Darwazah bought out his Italian partner in 1984, and then obtained permission from his licensors to expand distribution into Saudi Arabia, Syria, and Iraq. In 1986, Hikma, an Arabic word denoting wisdom and reason, was selected as the company’s new name.
CHAPTER 5 Achieving International Expansion

Over time, Darwazah concluded that his initial vision for Hikma was too limiting and that the company should diversify further its sales base. He commented:

Increasingly Saudi Arabia, Syria, and other countries in the region decided to promote their own pharmaceutical industries and protect them against imports, even from an Arab neighbor. Spimaco, a $100 million Saudi pharmaceutical manufacturer has, for example, pressured the Saudi government to protect the local domestic market for its benefit. In addition, the disruption to regional trade caused by the Gulf War in 1991 convinced us that we had to diversify further abroad—though we cemented our relationships with Iraq's doctors by keeping supply lines open to them during the crisis.

In selecting countries for international expansion beyond the Middle East, Hikma's initial impulse was to explore opportunities in other Muslim markets, such as Malaysia and Indonesia, in order to gain experience that would equip the company to take on the more competitive European and U.S. markets. Senior managers soon discovered, however, that the health services in these developing countries were not yet set up to accept imported generic drugs. Moreover, the predominantly European and North American (as opposed to Asian) experience of most of Hikma's senior managers justified an earlier-than-expected shift in the company's market focus towards Europe and the United States. Nevertheless, in 1996, 90% of Hikma exports from Jordan were still to the Middle East and North Africa.

Expansion Into Europe

Darwazah realized that the pharmaceutical industry was increasingly global, that there were no obvious reasons why generic drug manufacturers should not, like the research-based companies, sell internationally, and that Hikma could not survive merely as a regional player. The Jordanian market was becoming cluttered as Hikma's success prompted half-a-dozen new pharmaceutical manufacturing companies to be established by 1987. Meanwhile, discussion of European economic integration attracted Darwazah's attention. For a small pharmaceutical firm, the prospect of a single new drug registration filing in Brussels to secure access to the 330 million consumers of the European Union was especially appealing. Finally, Darwazah had been able to recruit high-caliber scientists and managers into Hikma's Jordanian operations, many of whom had European education and/or experience; their continued motivation depended in part on sustained corporate growth.

Darwazah therefore began to explore the possibilities of establishing a manufacturing plant in Europe. He focused on Ireland and Portugal, both members of the European Union with access to some 330 million consumers. The national governments of both countries along with the European Union in Brussels offered attractive investment and tax incentives to foreign companies interested in establishing high technology manufacturing plants. Darwazah explained why Hikma settled on Portugal:

There were three reasons. First, most of the major multinational pharmaceutical companies already had operations in Ireland. In Portugal, the pharmaceutical industry was less developed so we could offer something special by coming in. At the same time, our manufacturing processes were not that complicated so we didn't need a big pool of talented people to recruit from.

Second, the population of Portugal was 12 million versus 3 million in Ireland. Sales in the domestic market could justify the plant even if we didn't export that much.

Third, the multinational pharmaceutical companies were consolidating their Portuguese and Spanish operations in anticipation of the 1992 European Union market integration. This often resulted in the closure or downsizing of their Portuguese plants. As a result, there were many pharmaceutical managers and workers on the job market.

Jordanian banks that had already invested in Hikma's Jordanian operations were reluctant to loan Darwazah capital. However, the International Finance Corporation of the World Bank provided a $7 million loan commitment in 1988, and also purchased a 6% equity stake in Hikma Investments that owned 100% of Hikma Portugal.

The plant took 3 years to be completed. The fully automated 4,800 square meter plant outside Lisbon was designed to incorporate two separate operations that both met Food and Drug Administration standards:

- A filling plant for injectable cephalosporins with an annual capacity of 30 million vials
- A liquid-filling plant for other chemical entities with an annual capacity of 42 million vials and ampoules.

By 1996, Hikma Farmaceutica, the Portuguese subsidiary, was generating sales of $10 million. All but 5% of these sales were of cephalosporins; 80% of the cephalosporin sales were of injectables and 20% were of oral drugs. Sixty percent of cephalosporin production was of cephalosporins under patent, manufacturing of which was licensed from Fujisawa, while 40% was of generic cephalosporins. Some of the raw materials for cephalosporin production were imported from Jordan. The non-cephalosporin 5% of revenues came from sales of branded drugs including oral antibiotics and tranquilizers that Hikma manufactured under license in Jordan and for which the company was able to obtain Portuguese marketing licenses.

Marketing of these drugs occupied the firm's 25 salespeople and provided cash flow while production of injectable cephalosporins was coming on line and the relevant manufacturing approvals were being obtained from the Portuguese health authorities.

Seventy percent of Hikma Portugal's sales were exported. Of the exports, 80% were of generic cephalosporins shipped to Germany, 10% were sent to China, and 10% were exported to the Middle East and North Africa. In effect, the role of the Portuguese operations was to produce injectable cephalosporins for Hikma's worldwide marketing network.

Darwazah was concerned about Hikma Farmaceutica's marketing efforts in Europe. Although contracts with private hospital chains had been obtained, it was proving difficult to sell into the government agencies that dominated drug procurement for the national health care systems of many European countries. In particular, French manufacturers of injectable cephalosporins defended their market shares vigorously. Another difficulty in Europe was that Brussels regulations (unlike U.S. regulations) precluded generic manufacturers from working on formulations of patented drugs until they actually came off patent. As a result, Darwazah was keenly waiting for FDA inspectors to visit the Portuguese plant in 1997 as part of the approval process that would permit Hikma to sell its generic injectable cephalosporins in the United States. Darwazah believed U.S. demand could prompt a doubling of injectable cephalosporin output within a year.
Entry Into the United States

In the late 1980s, Darwazah conceived a three-pronged geographical production strategy in the United States as well as in Europe and the Middle East. Darwazah explained:

There were at least four reasons why I wanted to secure a foothold in the United States. First, the United States is the largest and most competitive pharmaceutical market in the world. If you can make it there, you can make it anywhere. Second, the prospects for generic drugs gaining a larger share of prescriptions were excellent as keeping health care costs under control became an ever more pressing political issue. Third, the United States is a well-organized and open market; the large Asian markets are not so straightforward. Fourth, I felt our manufacturing quality was up to U.S. standards. Finally I have to admit that cracking the U.S. market was an entrepreneurial challenge and, having studied in the States, I wanted the satisfaction of succeeding in the American market.

Hikma began, in 1989, to look for an acquisition candidate in the United States. The pharmaceutical manufacturing sector in the United States was consolidating; the pressure to control health costs put many small companies under margin pressure. Cost concerns were also increasing the penetration of generics and many managed care health providers were mandating substitution of generics for their patients. Moreover, numerous drugs were scheduled to come off patent and thereby become available to generic competition. Hikma identified the West-ward company of New Jersey as one of several possible acquisition candidates and, after negotiations and due diligence, a deal was struck in June 1991.

West-ward’s founders were manufacturing entrepreneurs with high quality standards. In the late 1980s, West-ward had been an approved vendor to many large hospital chains. However, the West-ward manufacturing operation had been acquired by a large drug wholesaler in 1988, and within 2 years, the firm’s quality control standards were challenged by the FDA. West-ward’s 1990 sales of $12 million were primarily of off-patent drugs sold against. Convinced that Hikma technicians could bring West-ward’s production facilities back into compliance with FDA standards, Darwazah decided to make an offer for the company. Following the acquisition, a team of managers and technicians from Jordan worked at the West-ward plant to secure FDA recertification.

As of 1996, West-ward had 830 tablet and capsule products in its line. Forty of these were based on Abbreviated New Drug Applications (ANDAs) approved by the FDA, 35 of which had been approved since the Hikma acquisition. Forty percent of West-ward sales were private label products sold to several health maintenance organizations; 40% were tablets and caplets sold under the West-ward branded generic label to drug wholesalers; and 20% were products manufactured to the specifications of several major drug companies. Sales of $15 million in 1996 resulted in an $800,000 pretax profit. According to Said Darwazah, the West-ward operation had recovered to 80% of its peak performance in the 1980s.

HIKMA’S STRATEGIC FOCUS

By 1996, it was clear that Hikma’s growth had stemmed from two key judgments Darwazah had made a decade earlier: the decision to focus on cephalosporins and the decision to focus on the manufacture of added value generics. Darwazah believed that continuation of these two strategies would enable Hikma to expand significantly its business in the United States. The proportions of Hikma sales that were ceph and generics in 1996 are shown in Table 5.1.

Cephalosporins

Cephalosporins were a class of anti-infective drugs with similar uses to penicillins. They were deployed against a broad array of bacteria-induced infections, especially those that occurred during or as a result of surgery. Most were used in hospitals rather than for out-patient treatment. In 1995, the value of all drugs sold worldwide at the dose form level was $270 billion. Of this, anti-infectives accounted for $23 billion, of which cephas, often described as “workhorse” antibiotics, accounted for 45% (or $10.2 billion), penicillins for 15%, and quinolones for 11%. Cephas were the eighth most frequently prescribed category of drugs in the United States (60 million prescriptions in 1995).

Oral cephas accounted for approximately 70% of total doses taken but for only 50% of sales value. The best-known oral cephas were Eli Lilly’s Cefclox and Celexa, holding approximately 55% of the oral cephal market. Ceflor went off patent in December 1994. Injectable cephas, accounting for 25% of total doses, were more effective than oral cephas and were used more heavily in hospitals to treat acutely sick patients.

By 1995, there were several generations of cephas on the market. The first and second generation cephas were largely off patent, and therefore subject to competition from generics, while newer, third- and fourth-generation cephas had been developed, either to combat more virulent infections or to address more finely targeted indications. As shown in Exhibit 5.3, these cephas commanded higher margins than earlier generations. There were 50 cephal products on the market; the cephalosporin molecule lent itself more readily than penicillin to line extensions because there were three places at which new chains could be attached. The frequency with which new versions of cephas were introduced led some physicians to refer semi facetiously to the latest cephal discovery as the “cephe du jour.”

The market share leaders in cephas were Eli Lilly (16% of doses worldwide in 1995), Glaxo Wellcome (15%), and Fujiwara (10%). Bristol Myers Squibb and Upjohn were

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<tr>
<th>TABLE 5.1</th>
<th>Hikma Sales of Ceph and Generics, 1996</th>
<th>% Ceph</th>
<th>% Generics</th>
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<tr>
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<tr>
<td>Jordan (export)</td>
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<td>United States</td>
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</table>

1Approximately 50% of cephal sales were of generics.
developing and launching fourth-generation ceph. Fujisawa had already licensed marketing of its fourth-generation injectable cep to Johnson & Johnson. Approximately one-third of ceph were sold in North America, one-third in Europe, and one-third in Asia, principally Japan.

Bulk ceph, from which doses of ceph were made, were produced and marketed by a variety of companies, including companies in India and Taiwan. In 1995, 4,700 metric tons of bulk ceph were sold at prices ranging from $400 to $6,000 per kilo.

**GENERIC VERSIONS OF PATENTED PRODUCTS**

Darwazah recognized in the 1980s that demand for generic drugs was increasing and was likely to continue. Generic drugs, called by their basic chemical names, had the same active ingredients, strength, dosage form, and medical effects as their brand name counterparts. As patents on brand name drugs expired, there was an opportunity for lower priced generic manufacturers to capture market share.

In most Middle Eastern countries, drug patents were recognized for 10 years (as opposed to 20 years in the United States) and slight variations in manufacturing processes permitted generic equivalents to be registered under new names. Although generic versions of patented products could not be marketed in countries where the patents on the brand name drug were still in force, they could be sold in many developing countries where patent enforcement was not as tight. Hikma increasingly focused on the manufacture of generic ceph. Given the extra lead time and the opportunity to manufacture patented drugs under license, the company could perfect their production before they came off patent in the United States. Comparative cost and price structures for generic and branded injectable ceph are shown in Exhibit 5.4.

In the United States, where health care costs accounted for 15% of the gross national product, there was significant political pressure on the drug companies, even though pharmaceuticals represented only 7% of the total health care burden. Between 1985 and 1995, generics more than doubled their volume share of U.S. prescription drug sales to 43% but their share of the $50 billion U.S. prescription market was only 12% in value terms. Sales of generics were boosted in 1991 by the so-called "drug product selection law" that permitted pharmacists to substitute cheaper generics in place of brand name drugs when filling prescriptions and required that health care providers charge the government-run Medicaid and Medicare the lowest possible drug prices.6

Price-sensitive consumers paying health care insurance through managed care companies and health maintenance organizations fueled demand for lower priced generics. The FDA set up a special office to handle ANDAS applications from generic drug manufacturers; these applications, of which 250 were approved in 1995 alone, could be filed before a brand name drug's patent expired, required bioequivalency studies and took, on average, 18 months to process.

Adding further to the potential for generic drug sales to increase in the United States was the fact that, between 1995 and 2005, 60 major brand name drugs, representing $40 billion in annual sales, would come off patent. Between 1995 and 2000, five major ceph were due to come off patent; as a result, Hikma was especially keen to file ANDAs applications for its generic equivalents, and obtain approval for them as soon as possible.

The large, research-based drug companies reacted to the advent of generic competition in several ways. In some cases, successful generic manufacturers were acquired. In other cases, the research-based drug companies fought generic competition claiming that the generic differed in some key way (for example, a binding or dispersing ingredient or chemical delivery variation). A third approach was to offer special long-term pricing contracts to the large managed care organizations while a drug was still covered by patent to insulate against share erosion when it expired. A fourth approach was to sign an agreement with a generic drug manufacturer ahead of patent expiration to try to influence the pricing of both the generic and the brand name versions. Eli Lilly signed such an agreement with Mylan Pharmaceuticals on Ceph, its leading cep, a year before the U.S. patent expired in 1994. By 1995, Ceph's market share had, nevertheless, dropped from 36% to 14%.

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6Although generic purchases by pharmacies represented 12% of total prescription dollars, the same generics accounted for 30% of pharmacy dispensing revenues, indicating higher markups than on brand name drugs.
Cephalexin was, in 1995, the tenth most frequently prescribed generic drug in the United States, accounting for 2.8% of generic prescriptions. Amoxicillin, which Hikma also produced in a generic version, accounted for 17% of generic prescriptions.

Because of the size of the ceph market, there were not so many generic competitors as in some of the more heavily prescribed drug categories. However, Hikma was far from being the only small pharmaceutical company interested in producing and marketing generic ceph. Marsam of the United States and Rambax of India were well-known in the field. Another competitor, Lupin Laboratories of India, signed an agreement with Merck Generics in 1995 to manufacture and market a line of injectable ceph.

U.S. GROWTH OPTIONS

Having established a U.S. foothold by purchasing Westward, Said Darwazah was keen to grow Hikma’s sales in the United States. His ambition was to achieve $30 million in sales of Westward manufactured drugs by 2000 with another $70 million coming from sales of cutting-edge injectable ceph made in Portugal. These drugs would not be subject to import tariffs and transportation costs would be minimal. Hikma Portugal was not finding it easy to make sales in other European countries so capacity to supply the U.S. market was likely to be available. Westward would continue to manufacture tablets and capsules; the plant could not be upgraded to produce injectable ceph. However, sales and distribution of these highly technical drugs from Portugal would add to Westward’s reputation and help boost sales of its branded generics.

Two large firms had approached Hikma offering quantity purchase deals on the firm’s injectable ceph. The first option was to sell injectable ceph to Northaid7, which was the fifth largest manufacturer of ethical pharmaceuticals in the United States in 1995 and a division of a giant consumer goods company. Westward had manufactured orally administered drugs for Northaid for several years through a joint venture in which both parties shared the profits equally. Northaid purchases accounted for 10% of Westward’s sales in 1995. Said Darwazah commented on Northaid’s proposal:

They have indicated an interest in buying $60 million worth of injectable ceph from us by 2000 plus $30 million worth of generic drugs manufactured by Westward. Northaid wants a U.S. exclusive on our injectable ceph.

A second option was to supply Sanitas2, a large managed care organization that had distribution contracts to supply drugs to over 1,000 hospitals throughout the United States. Sanitas sales represented about 20% of 1995 hospital purchases of drugs through managed care organizations. Darwazah commented on the Sanitas opportunity:

Sanitas have told us they can take all the injectable ceph we can supply. They say they’ll need to procure $200 million worth of injectable ceph by 2000. We would have to double the capacity of our plant in Portugal to supply them at this level. Of course, they want rock-bottom prices, guaranteed delivery dates, and an exclusive on sales of our injectable ceph in the United States. They would put the Sanitas name on the product label; Westward would not be mentioned.

Note

1 Disguised name.
CHAPTER 6
DEVELOPING THE MARKETING PLAN

Gillette Indonesia

In October 1995, Chester Allan, Gillette's country manager in Indonesia, was developing his unit's 1996 marketing plan. Once completed, it would be forwarded to Rigoberto Effio, business director in Gillette's Asia-Pacific group based in Singapore. Each year Effio received and approved marketing plans for the 12 countries in his region, which reached from Australia to China. Once approved by Ian Jackson, Asia-Pacific group vice president, the overall marketing plan for the region would be reviewed subsequently, along with other regional plans, by Robert King, executive vice president of Gillette's International Group.

Allan's plan projected a 19% increase in blade sales in Indonesia in 1996 from 115 million to 136 million. This seemed reasonable given a 17% increase in 1995 over the previous year. With a population of almost 200 million, Indonesia represented an important country in the portfolio of markets for which Effio and Jackson were responsible. Effio wondered whether investment spending in marketing beyond the 1995 level of 12% of sales might further accelerate market development. Given the growth rates of Gillette's business in other Asia-Pacific countries, Effio believed that a 25% to 30% increase in blade sales could be achieved in Indonesia in 1996.

THE COMPANY

Founded in 1901, Boston-based Gillette was the world leader in blades and razors and in nine other consumer product categories—writing instruments (Paper Mate, Parker, and Waterman), correction products (Liquid Paper), men's electric razors (Braun), toothbrushes (Oral-B), shaving preparations, oral care appliances (Braun, Oral-B plaque remover), pistol-grip hair dryers (Braun), hair epilators (Braun), and hand blenders (Braun).

Gillette manufacturing operations were conducted at 50 facilities in 24 countries. A London office had been opened in 1905, and a blade factory opened in Paris the following year. The company's products were distributed through wholesalers, retailers, and agents in over 200 countries and territories.

Gillette managed its worldwide business through a combination of business and regional operational units. The North Atlantic Group manufactured and marketed Gillette's shaving and personal care products in North America and Western Europe. The Stationery Products Group, part of the Diversified Group, produced and sold Gillette's stationery products in North America and Western Europe. The Diversified Group also included Braun, Oral-B, and Jafa, each managed by a worldwide unit. The International Group, headed by Robert King, produced and marketed the shaving, stationery, and personal care products everywhere, except for North America and Western Europe. The International Group comprised three geographic divisions: Latin America; Africa, Middle East and Eastern Europe; and Asia-Pacific. Ian Jackson, group vice president based in Singapore, oversaw operations in 12 Asia-Pacific countries.

Of Gillette's 1995 sales of $6.8 billion, blades and razors accounted for $2.6 billion (40%). Blade and razor sales in the Asia-Pacific region were more than $600 million. The company had consistently maintained profitable growth over the previous 5 years. Between 1990 and 1995, sales grew by 9% annually, net income by 17%, and earnings per share by 18%. Gillette's mission was to achieve worldwide leadership in its core product categories. In 1995, three-quarters of sales came from product categories in which Gillette held worldwide share leadership. The company emphasized geographic expansion along with research and development, advertising, and capital spending as drivers of growth. New-product activity and entry into and development of new markets were considered essential.

Geographic expansion required the company management to "think global, act local." Eduardo Kello, International Group business manager, explained:

Headquarters develops new products. They are usually launched first in the U.S. or Western European markets, but quickly introduced in every market worldwide. We start in a new emerging market with simple blades, we introduce the shaving concept. Later, we upgrade the market to higher value products and shaving systems. The country management in each market usually decides the mix of products to push and how to allocate marketing resources against them.

Robert King further emphasized the importance of persuading Gillette's country managers to take initiative:

Trying to drive new product activity from headquarters is like pushing on a string. The string moves much more easily if a country manager is pulling on it than if headquarters is pushing on it.

Although headquarters in Boston emphasized increasing worldwide sales and distribution of higher-margin shaving systems such as Sensor, this was not feasible in many Asian markets. Only a few consumers were sophisticated and wealthy enough to be potential customers for the Sensor. In Indonesia, for example, the focus was still on introducing the concept of shaving with basic Gillette products.

INDONESIA IN 1996

The Republic of Indonesia was an archipelago of more than 15,000 islands and 196 million people who spoke over 250 regional languages and dialects. (See Exhibit 6.1 for a
map of the country.) Approximately 3,000 miles separated Sigli on Sumatra to the west from Sari on Irian Jaya to the east. President Suharto had led the country since 1967 and provided continuity and stability. Major economic development programs, legal reforms, and changes in domestic policies could be enacted only if supported by the president. Although rumors of his pending retirement circulated, there was no sign of any change in the political power structure in 1996.

By 1995, Indonesia’s population had reached 196 million, with 35% living in towns and 65% in rural areas. Indonesia had averaged annual GDP growth of over 7% for more than 20 years. The country traditionally exported agricultural and oil products, but economic development plans since the oil crisis of 1988 had encouraged growth in nonoil-related industries. Economic policy was laid out in 5-year plans known as Replita. The goals of Replita VI, applicable in 1996, were to maintain annual GDP growth of 6.2%, expand the manufacturing sector by 9.4% a year, and increase the nonoil/gas component of manufacturing by 10.3% a year. Inflation in 1996 was expected to be 12%. Over the years, the liberalization of foreign investment policy had increased private sector involvement in the economy; the central government focused on developing infrastructure in the poorer regions and on human resources.

Economic progress was manifested in increased per-capita incomes and improved standards of living for most of the population. The government stressed export-oriented industrialization to fuel growth and a demand for labor that would keep pace with population growth. During Replita VI, it was expected that more than two million Indonesians would enter the workforce each year. The rupiah had depreciated in order to maintain Indonesia’s export competitiveness. The value of committed foreign investment reportedly increased from $826 million in 1986 to $10.3 billion in 1992 and to $23.7 billion by June 1994 (EIU Country Profile 1995). In 1996, Indonesia was expected to have the highest foreign direct investment/export ratio (74%) of any major emerging market. However, only about one-half of approved foreign direct investment projects had been implemented.

Economic growth had not been consistent throughout the archipelago. Java and Bali had grown much faster than poorer regions such as Irian Jaya and East Timor; contribution of these poorer regions to the country’s economy was minimal. Java and Bali accounted for 70% of the land, 60% of the population, and 75% of the gross domestic product. Four of the five major urban centers (Jakarta, Bandung, Surabaya, and Semarang) were on Java.

The average standard of living on Java and Bali was much higher than in the rest of Indonesia. An improving education system ensured that foreign companies would be attracted to the major urban areas, fueling further growth. Market research showed that consumer marketers launched their campaigns in and expected most of their sales from the top five cities (the four in Java plus Medan on Sumatra) that together accounted for 35 million of the population. About 60% of Gillette’s 1995 sales were made in these five metropolitan areas.

Table 6.1 shows the percentages of households falling into each of several income classes in 1995 and projections for 2000. Also shown is the percentage of each income group who shopped regularly in supermarkets in 1995.

1Replita was the shortened form for the Indonesian name ‘Rencana pembangunan lima tahun’, which meant 5-year development plans.

2Rupiah exchange rate in 1995 was US$1 = 2,200 rupiah.
### INDONESIAN SHAVING PRACTICES

Gillette traditionally entered a market with the basic double-edge blade. Effio explained, “We lead with our strength—the shaving business. Later we leverage the distribution established for our blades on behalf of our other product lines.”

Shaving was still underdeveloped in Indonesia, but the incidence of shaving was increasing. A 1995 survey of urban men over 18 years (of whom there were 40 million) indicated that 80% shaved. Those who did, shaved on average 5.5 times per month, compared with 12 times per month in Hong Kong and 26 times per month in the United States. Tracking data indicated that, in 1993, 66% of urban adult men had been shaving with an average incidence of 4.5 times per month.

Shaving incidence was influenced by several factors. There was increasing awareness of Western grooming practices, especially in urban areas, as a result of exposure to foreign media and the increasing presence of multinational companies and their overseas personnel. College students and graduates entering the workforce were especially important trendsetters. On the other hand, grooming products were still regarded as luxury items by many. In addition, Asian beards did not grow as fast as Caucasian or Latino beards, so shaving incidence would be lower, even in a fully developed market.

Forty percent of men who shaved used store-bought blades all or part of the time. The remainder used dry or wet knives. The average number of blades used in a year by the 20% of shavers who always used blades was 15. The average number of blades used by occasional users was 4. Only 4% of men used shaving foam or lotion, 25% used soap and water, 12% used water alone, and 58% shaved dry.

### GILLETTE’S OPERATION

Gillette entered Indonesia in 1971 with majority ownership of a joint venture with a local company. Gillette's razor blade plant, built in 1972, was located about one hour from Jakarta. Gillette manufactured 75 stockkeeping units in the factory, of which 65 were shaving items. The major product was the double-edge blade for razors and cartridges. Double-edge blades accounted for 60% of the value of products manufactured. Oral-B products were a small portion of the plant's operations; the plant had just begun to “tuft” or put the bristles on the brush handles. The plant was highly automated and run by 68 full-time employees. In addition, 75 casual workers were employed on one- to two-year contracts. In 1995, the plant produced 150 million blades, of which 46 million were exported. The 1996 production plan called for output of 168 million blades, of which 50 million would be exported. Production manager Eko Margo Suhartono said:

> We are looking to import new equipment and expand the line capacity to 230 million double-edge blades per year which we hope will be sufficient to meet demand for the next 5 years. We needed this extra capacity by 1996 but implementation has been delayed to 1997. This means, in 1996 we will have more overtime and must continue to improve plant productivity.

The manufacturing team had improved business processes as well as production efficiencies. They cut the cycle time from placement of order to product out the door from 50 to 43 days. Effio explained, “Before it would take us 7 days to make almost three million blades; now we only need 3 days on the floor. This is an incredible response to sales demand.” Due to the demand of other multinational corporations (MNCs) for experienced workers, there was a need for continuous staff recruiting and training and increasingly upward pressure on worker wages.

In addition, the production team carefully planned the timing of materials inputs. Because of distribution and transportation inefficiencies, the need for buffer inventories was substantial. Cartridges and handles for the razors were imported. Gillette's women's razor was launched in 1995. The razor was imported, but packaged in the country. Problems with customs clearances could impact the entire manufacturing cycle.

The plant obtained electricity from the local grid, supplemented by two backup generators. Water was drawn from a well on the property. Gillette purchased ammonia and other basic raw materials from local suppliers.

### Gillette and Competitive Product Lines

The Gillette brand name was synonymous with high-quality double-edge blades. In fact, the Bahasa Indonesian word for blade sounded similar to the name *Gillette*. In 1993 Gillette held 28% of the blade market by volume. By 1995 Gillette's unit share had grown to 48% and was expected to increase to 50% in 1996.

Gillette's policy was to make all of its products available to all of its country subsidiaries. Headquarters persuasion and successful launches of new products in other countries were often helpful in motivating country managers to adopt new products.
Gillette’s product line in Indonesia included:

- Double-edge blades. The three types included the basic Gillette blue stainless blade, a premium double-edge blade (Gillette Goal Red), and an improved blue blade (Gillette Goal Blue).
- Disposables. In the United States and Europe, Bic dominated the market for disposable razors with plastic handles as a result of aggressive pricing. In other markets, Gillette had been able to position its disposable as a system, rather than a low-priced convenience product. In Indonesia, Gillette sold two types of disposables, the Goal II and the more advanced Blue II.
- Gil. Named the Trac II in the United States, it was the earliest shaving system from Gillette to incorporate twin blade technology, wherein the first blade lifts the hair out of the follicle for the second blade to then cut it off.
- Contour. The Contour system (named Atra in the United States) added a pivoting head (as opposed to the fixed head on the GI) that enabled the twin blades to stay on the face more consistently.
- Sensor. The Sensor system added an improved pivoting action and independently sprung twin blades.

Exhibit 6.2 provides a detailed breakdown of Gillette sales by product. Information on Gillette’s gross margin as well as manufacturer, distributor, and retailer selling prices by product line is also provided. Gillette sold 115 million blades in Indonesia in 1995, of which 100 million (87%) were double edge. In contrast, double-edge blades accounted for 70% of sales in Malaysia and only 20% in Australia. Sales of systems and disposables accounted for 30% and 50% of units sold in Australia and 25% and 5% of units sold in Malaysia. The share of Gillette Indonesia sales accounted for by the higher-margin disposables and systems was projected to increase in 1996 to around 20% of units.

As indicated in Exhibit 6.3, Gillette Indonesia’s 1995 sales from shaving products were valued at $19.6 million. Through a combination of volume increases (19%) and price increases (20%), Gillette Indonesia management projected that this number would increase to $27.6 million in 1996. Gillette’s overall gross margin on shaving products was 46% of gross revenues (or 55% of net revenues after discounts). An income statement for Gillette Indonesia’s shaving products business is presented in Exhibit 6.4.

Gillette’s main competitors were imported, low-end, double-edge blades from Eastern Europe and China. Based on market research conducted in the four major cities, Tatra, Super Nacet, and Tiger were the most often mentioned competing brands on the market. Gillette’s retail prices were sometimes four times those of competitive products. Chester Allan in Jakarta explained, “Currently most of the poorer rural savers cannot afford Gillette products and buy low-price, low-quality brands such as Tiger and Tatra. However, with rising incomes and improved Gillette distribution and display, consumers are moving to Gillette.”

Gillette’s disposables faced two competitors: Bic, from the United States, and Bagus, a locally manufactured brand. Neither of these sold in high volumes, so the competition was not keen. The Schick division of Warner Lambert imported its higher-end products, but sales were minimal. According to Allan, “Gillette has 90% of the premium end of the market which we developed.”

Gillette-brand blades commanded high awareness in the Indonesian market. Market research conducted in 1995 among Indonesian male shavers, reported in Exhibit 6.5, showed 97% brand awareness and 55% brand use for Gillette’s Goal Red blade.
**Distribution and Sales**

Indonesian regulations prohibited a foreign company from directly importing or distributing its products. These regulations protected Indonesian distributors and resulted in inefficiencies. The American Chamber of Commerce in Jakarta estimated that 45% of retail prices in Indonesia covered distribution services.

To ensure distribution of products in the face of weak communications, poor traffic conditions, and lack of distribution service technology, Gillette managers and those in other MNCs had to focus on the basics of distribution over which they had little control and from which they extracted no direct profit.

Gillette had originally appointed a single national distributor, but by 1993 it was apparent the arrangement was not working satisfactorily. No single distributor could provide an even depth of coverage in every district throughout the entire country. Mohammad Slamet, Gillette's national sales manager in the early 1990s, explained:

> There are many distribution issues which require on-the-spot responses. A distributor who is headquartered hundreds of miles away cannot provide a quick enough response. In addition, there often arise sensitive, purely local issues which can only be resolved by someone familiar with the relationships, customs, and dialects of each area.

In 1993, Gillette appointed 23 distributors dispersed across the country. The new distributors were previously known to Slamet or were identified through referrals. In the year following implementation of the new system, sales rose by 60%.

A good distributor had the working capital and/or bank credit line to stock sufficient inventory and to bridge the time gap between paying Gillette and receiving payments from its customers. Second, a good distributor also had sufficient salespeople, warehouses, and reliable transportation equipment. Third, strong local connections with government officials and the trade were critical to success.

A typical distributor represented different manufacturers and product lines. Gillette's distributors were encouraged to hire people to handle only the Gillette business in the belief that such focus would result in the greater push. Gillette itself expanded its internal sales and trade relations staff to work with the new distributors.

In 1995, Nyoman Samsu Prabata was Gillette's national sales manager. Nyoman's organization comprised three regional managers (covering western, central, and eastern Indonesia) who supervised a total of 12 area managers and supervisors. These managers were well compensated but were often tempted away by better offers from other multinationals, because of the shortage of general management talent in Indonesia. Nyoman's group coordinated the efforts of 23 geographically based independent distributors and their 260 salespeople. Although Gillette's distributors hired many of the sales staff and paid their base salaries, Gillette covered their commissions and other incentives for reaching targets, which averaged 20% of their total compensation.
Nyoman explained:

The number one job of the Gillette sales team is educating the distributors and their salespeople. We have to train them how our products work, so they can demonstrate the products on their own. We have to educate them on the benefits of our products compared to both traditional shaving methods and to competitive products. We also educate them on warehousing and handling methods to reduce damage to the product.

For example, one distributor’s warehouse was located in an area of Jakarta with poor transportation and prone to flooding. “A few days ago, the warehouse roof fell in under pressure from the rain. The actual damage was minimal but the operation had to stop for a day. He just would not listen to us,” explained Nyoman.

In Indonesia, direct verbal confrontation was socially unacceptable. This sometimes resulted in strained relations between a distributor and an area manager festering for months without being solved. Another challenge was the different degree to which employees and consumers observed Muslim religious practices. Nyoman commented:

In Jakarta, while people are faithful followers, the attitude is a bit more casual and there is an understanding that not everyone is practicing to the same degree. However, outside Jakarta, religious practices are more closely observed. In Aceh on Sumatra it would be an insult to wave good-bye with your left hand. In Bali, the Hindu religion is dominant so, for the “Galungan” holiday, Hindus fast for 2 days. For Nyepi, complete silence must be observed for 1 day, so any devout Hindu stays home and does not even turn on the electricity. Not only does this affect our business but I must plan ahead for holiday staffing.

Gillette gave its distributors 45 days’ credit. In return, the distributors would give their customers anywhere from 30 to 60 days’ credit. Nyoman said:

While we try to insist on timely payments via bank transfer, there are many times when receivables are overdue. Though the sales staff and area managers are responsible for receivables, I often have to get involved and it is important to be tough on the issue. As you move further away from Jakarta, the legal system does not provide much support, so ensuring distributors have the working capital to cover the spread between payables and receivables is critical to their selection.

In addition to the distributors who supplied wholesalers and, in turn, the extensive network of small retailers in Indonesia, Nyoman also supervised a national accounts team who negotiated sales to the major Indonesia supermarket chains, often shipping to them direct. Supermarket chains included Hero that had 54 outlets, Metro with 5 outlets, and others located in the large urban centers. These chains purchased directly from manufacturers and could handle products efficiently. In 1995, supermarkets accounted for 5% of Gillette’s shaving products sales in units and 8% in value; corresponding 1993 figures were 2% and 4%. Market research showed that higher-income, urban consumers were increasingly shopping in supermarkets. Most sales of Gillette’s higher-priced shaving products were through these outlets. Competition for shelf space was intensifying. Some supermarkets were imposing slotting allowances on suppliers of up to 80% of a new product’s cost to provide shelf space.

Traditional wholesalers and distributors came under pressure as a result of these trends. Many wholesalers had poor facilities, traditional goods-handling methods, and antiquated accounting—some still used an abacus to track the business. They tended to focus on turnover alone rather than in conjunction with profit margin. They were also slow to see the potential of upgrading their customers to higher unit-margin products.

Distribution coverage in Indonesia required consumer goods manufacturers like Gillette to reach more than 60,000 small kiosks and mom-and-pop shops. Gillette did not distribute through the many itinerant salespeople who traveled with their wares on bicycles from village to village. The entrepreneurial owners of the small retail outlets would respond to requests from consumers and, in turn, demand the product from their wholesalers. “Pull marketing can be effective,” Slamet said. “Once the mom-and-pops start getting requests for a new product, they are willing to stock it: This is how marketing testing takes place,” Effio explained.

Communications

As indicated in Exhibit 6.4, Gillette Indonesia spent 9% of gross sales on advertising and 3% on consumer promotions and merchandising. Ten percent of gross sales was accounted for by off-invoice allowances to the trade and other forms of trade deals. The advertising budget for shaving products in 1995 was around $2 million.

Media advertising was targeted principally at urban male consumers. About half the advertising budget was spent on television (there were five private channels and one government-owned) and half on print. Television advertising included some program sponsorships. The adult literacy rate in Indonesia was 77%, and half of Indonesian adult males read a newspaper at least once a week. The allocation of Gillette advertising was weighted towards systems and disposables to encourage consumers to trade up.

Gillette headquarters developed television advertisements for use worldwide, with the intent that local voiceovers and local package shots would be superimposed. (A sample Gillette print leaflet, with translation, is shown in Exhibit 6.6). Gillette Indonesia’s marketing manager explained:

We are still in the early stages of educating consumers about shaving. An ad made in Boston for the U.S. market may not have sufficient details about the basics. Nothing can be taken for granted here, especially when it comes to advertising the entry-level products, the double-edge blades.

Gillette Indonesia managers differed over the relative emphasis that advertising should place on persuading consumers to shave for the first time, increasing the incidence of shaving among existing shavers, and trading existing shavers up to higher-margin, more sophisticated shaving systems. As a compromise, the 1995 advertising budget was split equally among these three objectives. One-third of the total budget was allocated to advertising Sensor.

Special promotions were run in 1995 on the Sensor and Contour systems. Gift-with-purchase promotions (involving an Oral-B travel toothbrush, a toilet bag, or a trial sample of Foamy shaving cream) were targeted at upper- to middle-income urban males. Promotional efforts were sometimes focused on the members of executive clubs, attendees at golf tournaments, or workers in specific office buildings.
SIX STEPS TO A SMOOTHER, GENTLER AND MORE COMFORTABLE SHAVE

1. Clean your face.
   - Soak your face with hot water and soap. Then rinse it until it is
   - clean. Don't leave your face to dry. You don't have to
   - dry it, leave your face and hair moist.

2. Apply shaving cream.
   - Apply Gillette shaving cream over the area to be shaved. It
   - prevents water penetration and reduces friction between
   - soap and the razor blade. At the same time it makes the
   - shaving pressure bear which you are going to shave.

3. Start at the right place.
   - First shave the side of the chin and neck. The slightest
   - pressure of the chin and neck grow on the chin and
   - around the eyes while making the face and head
   - more times to absorb water in order to become soft.

4. Shave Correctly.
   - Shave with gentle and light strokes. Try to make few strokes as
   - possible. The Gillette razor produces a smoother, gentler, more
   - comfortable shave.

5. Rinse the razor blade.
   - While shaving, rinse the razor blade once in a while under running water
   - for a whiplash. After shaving, the razor blades and mustache should
   - be rinsed tight away and be left until dry.

6. Don't Wash the Razor Blade.
   - Don't rinse the razor blade with water after you've
   - finished shaving. The razor blades should be
   - rinsed tight away and be left until dry.

Do you know?

- Up to 35,000 hairs can grow on a man's face.
- The hairs grow at an average rate of 0.38
- millimeters per day.
- They can reach a maximum length of 4
- inches over a
- lifetime.
- When it is dry, beard is as soft as copper
- fibers of the same diameter.

- 1900 B.C. Egyptians were
- the first to shave.
- The Egyptians were also the
- first to shave with sharp
- blades used for cutting
- heavy metal and bone.
- The woman of ancient Egypt
- used to shave their
- husbands with a razor made
- of bone.
- The Persians developed
- the first razor with a metallic
- handle.
- The Persians used to shave
- their heads with a razor made
- of flint and bone.
- 30 B.C. Alexander the
- Great ordered his
- soldiers to shave so that the
- Persian army would be able to
- grab their
- heads in battle.
- The greatizer, an American, invented
- the modern razor which totally changed
- people's shaving habits. People everywhere
- gave up traditional razors and replaced them with
- replaceable double-edged razors.
CHAPTER 6 Developing the Marketing Plan

Coupons were not used in Indonesia; redemption systems through retailers were not yet in place. However, Gillette found that lucky draws with entry forms inside product packages worked well; consumers had to mail in entry forms to be included in the draws.

Gillette used similar packaging in Indonesia as in the United States for its more expensive systems products. The Goal II, the cheaper of Gillette’s disposables, was advertised on radio. The number of blades per pack varied by outlet; twice as many were included in the pack for supermarkets as in the pack for mom-and-pop stores.

CONCLUSION

As Allan reviewed his initial projections for 1996 (see Exhibit 6.3), he wondered how rapidly the Indonesian market for blades and razors could or would expand. Should the Indonesian market be allowed to just move along at its own pace? If so, what would that pace be? Alternatively, should Gillette Indonesia invest additional resources either in advertising and promotion or in sales and distribution, to accelerate the process of market development? If so, which products should be emphasized? Would further investment be wasted if it was based on concepts and products that were beyond consumers’ understanding or willingness to pay?

Allan resolved to set out his objectives for Gillette Indonesia in 1996 and to develop a detailed marketing plan including an income statement projection. He knew his plan would have to satisfy Effio’s objectives for Gillette’s growth in the Asia-Pacific region.

Reference

CHAPTER 7

PRODUCT LINE PLANNING

SADAFCO

In presenting his 1998 plan at the marketing meeting, Khalid Tahir, senior group product manager in the Saudi and Dairy Foodstuff Company Limited (SADAFCO), wanted to leave his colleagues in no doubt about the seriousness of the threat to the company’s ice cream business:

In the last few years, Nestlé, Unilever, and Mars have all stepped up their efforts to dominate Saudi Arabia as a keystone market in the region. We could not face any tougher competition: They have deep pockets, internationally proven brands, and confidence. Against this, we have market leadership and our local brand strength. The 1997 figures I am about to present show clearly the pressure on our profits and our distribution presence. The actions we take in the near future will determine our fate in this battle.

This challenge came at a critical point in SADAFCO’s development. Having enjoyed 20 years of successful expansion, the company’s core recombined milk business was experiencing its first volume losses, mostly to local competitors. At the same time, the company was nurturing a number of new product lines, such as tomato paste, hummus, mineral water, and snacks, and was considering a major drive into international markets in the region. As reported by the company’s general manager, Bill Pace, SADAFCO’s vision was to be “the Nestlé of the Middle East,” the dominant foods company in the region. Ironically, that vision was threatened by a group of multinationals, including the very company SADAFCO sought to emulate.

SADAFCO—COMPANY BACKGROUND

SADAFCO, headquartered in Jeddah, Kingdom of Saudi Arabia (KSA), had evolved from a company formed in 1976 as the Danish Saudi Dairy Co., Ltd. This was one of a number of companies formed in the Kingdom of Saudi Arabia by Danish Tumkoy Dairies, a firm based in Denmark that specialized in building and operating recombined milk

Professor David Arnold prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.
Over the years, some of these plants had diversified into other businesses that required related production capabilities, such as ice cream, soft cheese, and tomato paste. SADAFCO was formed in 1990 by combining the Jeddah company with other separate but related recombined milk companies in Riyadh, Dammam, and Medina (see Exhibit 7.1 for a map of Saudi Arabia). Production was reallocated to permit specialization and improve scale economies, so that by 1996, Jeddah produced most of the recombined milk and snacks, Riyadh produced all of the company's ice cream, and Dammam produced tomato paste products and other foods. From October 1997, a new reporting structure separated manufacturing from sales and marketing, with new transfer prices in place between the factories and the sales and distribution operations. For the first time, profitability could be measured at the factory and product line level.

SADAFCO was a subsidiary of United Industries Company (UIC), a holding company with diverse interests based in the neighboring state of Kuwait. UIC, along with its own parent, the Kuwait Investment Projects Company (KIPCO), had been involved with Danish partners in establishing the Middle East's first dairy in 1970 in Kuwait. In 1997, SADAFCO's general manager, Bill Pace, was relocated to the Kuwait office (see Exhibit 7.2 for SADAFCO organization chart). Pace, an American with 30 years' experience of working in emerging markets in Africa, Asia, and the Middle East, attributed SADAFCO's success to its managerial capability.

The company has never rested content with having overcome the technical challenges of the dairy industry in this part of the world, considerable though they have been, but has also long been one of the most forward-thinking local marketing companies, aware of the importance of brand building. We are proud of the brand strength that we have built up, and continue to innovate in all our product lines.

Much of this innovation had occurred since a 1995 decision to diversify the product line in order to maintain growth, as the core milk business achieved near-saturation distribution levels and matured. By 1997, SADAFCO achieved sales revenues of SR 818 million, with a trading profit of SR 81 million, and its Saudia brand, under which most of its products were marketed, enjoyed high awareness and trust throughout the country.

**THE KINGDOM OF SAUDI ARABIA**

Founded in 1932, the Kingdom of Saudi Arabia was an absolute monarchy that had been ruled by King Faisal bin Abdul-Aziz al-Saud since 1982. With a land area approximately equal to that of Western Europe, much of it desert, the Kingdom of Saudi Arabia had a population of 18.5 million, about 75% of whom lived in urban centers, the two largest being the capital Riyadh, with 1.85 million people, and the main commercial center Jeddah, with 1.55 million. The country contained a quarter of the world's known reserves of oil, the basis for the rapid modernization of the Saudi economy from the 1960s.

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1The major raw materials used for the production of recombined milk were skimmed milk powder, milk fat, and water. Recombined milk producers claimed that this produced a better tasting milk than the simpler drying and rehydration process that produced reconstituted milk.

CHAPTER 7: Product Line Planning

Culturally, the dominant influence on Saudi society was the Muslim religion. As the homeland of the prophet Mohammed, the Kingdom of Saudi Arabia welcomed over two million pilgrims a year, most of them congreating in the holy city of Mecca during the month-long pilgrimage season of haj. The Islamic sharia (holy law) shaped daily life. For example, women could not appear in public unveiled and could not obtain driving licenses; alcohol was prohibited; expatriate workers were required to live in self-contained residential compounds; and non-Muslims were prohibited from entering the holy cities of Mecca and Medina. Foreigners were only issued visas for pilgrimages or business visits. Although the Kingdom of Saudi Arabia remained a conservative society, in 1998 the population was exposed to increasing Western influence via satellite TV broadcasts and an increasing number of international brands, manufacturers, and retailers.

The population of Saudi Arabia was young, with over 60% under age 25. Moreover, the fast growth rate ensured that the younger age groups would grow as a proportion of the total population until at least 2020. These demographics led to some concern for the employment prospects of the Saudi population. Like many of its neighboring Gulf states, the Kingdom of Saudi Arabia had coped with its rapid economic growth by absorbing a high proportion of expatriate workers at all levels, from high-paid technical and managerial personnel, to construction workers and domestic servants (see Exhibit 7.3 for data on countries in the region). By the mid-1990s, the government had instituted a “Saudi-ization” program, which raised the cost of employing expatriate staff and imposed targets on companies to employ increasing proportions of Saudi nationals. The government also encouraged its brightest young students to obtain advanced degrees abroad; in SADAFCO, most senior Saudi nationals in the company were graduates of American universities.

Marketing in Saudi Arabia

The 1990s had seen substantial change in the marketing landscape of the country, stimulated by the entry into the market of a number of multinational companies. Coca-Cola, which entered Saudi Arabia in 1995, was an archetype in the Gulf. Long absent from the Middle East in the face of Arab boycotts for doing business in Israel and seizure of some of its operations in the region, Coca-Cola encountered a more favorable climate in the 1990s, as the Arab boycott slackened after the Gulf War. With its hot climate, young population, and lack of alcoholic drinks, the Middle East represented a very attractive market for Coca-Cola, which was reported to be investing over $500 million in entering the

EXHIBIT 7.3: Selected Data on Middle East Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (thousands)</th>
<th>% Expatriate</th>
<th>% Under Age 25</th>
<th>GNP per Capita 1997 (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>18,500</td>
<td>25</td>
<td>58</td>
<td>7,110</td>
</tr>
<tr>
<td>Kuwait</td>
<td>1,690</td>
<td>59</td>
<td>49</td>
<td>17,440</td>
</tr>
<tr>
<td>Bahrain</td>
<td>568</td>
<td>37</td>
<td>47</td>
<td>7,890</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>2,530</td>
<td>78</td>
<td>36</td>
<td>17,900</td>
</tr>
<tr>
<td>Oman</td>
<td>2,102</td>
<td>25</td>
<td>53</td>
<td>4,840</td>
</tr>
<tr>
<td>Qatar</td>
<td>350</td>
<td>60</td>
<td>54</td>
<td>11,660</td>
</tr>
<tr>
<td>Yemen</td>
<td>16,500</td>
<td>5</td>
<td>65</td>
<td>270</td>
</tr>
<tr>
<td>Lebanon</td>
<td>4,000</td>
<td>18</td>
<td>68</td>
<td>2,680</td>
</tr>
</tbody>
</table>
market and competing with the already present PepsiCo. Its co-promotions with McDonald's characterized the new commercial landscape.

Consumer marketing was also enhanced by the growing number of media available to advertisers. Saudi television had historically been restricted to two government-controlled channels, which carried only a limited amount of advertising that had to conform to the sharia. All the advertising permitted in one day was shown together at nighttime after the day's last program finished and before the channel closed. By 1998, not only had these restrictions been relaxed, but a number of international channels were available by satellite or cable. Subscriptions to these new TV services, initially stimulated by coverage of the Gulf War on international channels such as CNN, was growing rapidly, especially among the young population.

The level of change in consumption patterns could be deceptive, however. Comparing the Kingdom of Saudi Arabia with other markets in which he had worked, SADAFCO's marketing manager, James Johnston, commented that "it's very easy to get trial here, because people are willing to experiment and new brands have some novelty value. But changing the underlying purchase habits is much more difficult, because tastes remain the same. Often you see an initial sales surge, with an easing off after a month or two."

Shopping habits were strongly influenced by the Islamic culture. In all types of retail outlets, at least half the shoppers were men shopping alone, in some cases the household's driver. The remainder were couples shopping together, or women shopping alone, most of whom were domestic servants. Senior Group Product Manager Majid Dawood reported that "for the most part, women write a shopping list which is then taken to the store by the man or a domestic servant. More couples are shopping together, especially in supermarkets for the major weekly shop, but for the most part it's the women back in the home who make the decisions, and so they remain the target of our advertising."

Price points were unusually strong in Saudi Arabia because most people did not carry coins, and dealt only in bills, the smallest of which was one riyal. Prices in whole riyal multiples were therefore much more acceptable, especially in consumer packaged goods, and there were numerous examples of products priced differently failing to gain consumer acceptance. When prices were set between price points, as was the case in categories such as produce or bread, retailers often gave change in the form of small items such as chewing gum, rather than in coins. Johnston commented that "strong price points can be a severe constraint in marketing, because they restrict the ability to make minor price adjustments and remove one element from the positioning equation by which different brands compete." Particularly affected were items bought singly rather than in supermarket baskets, such as ice creams.

**Distribution**

The retail sector was experiencing considerable change in Saudi Arabia. The number of outlets in all categories of retail was increasing with the liberalization and growth of the market for consumer goods, but a number of new supermarket chains were expanding at the expense of the traditional small store, the *bagalla*. SADAFCO's sales through the supermarket channel in 1998 were running 50% higher than the previous year. Exhibit 7.4 shows the composition of the retail sector.

Bagallas remained important, their traditional place in the commercial culture reinforced by the fact that women could not drive. Although most bagallas had tradition-ally visited wholesalers for supplies, an increasing number were supplied by vans belonging to either a major vendor or a wholesaler. SADAFCO had its own fleet of 290 vans. Van drivers would call on an individual bagalla frequently, because most had no warehouse or other storage, and replenish the store's shelves with small consignments of product. With the large number of bagallas and the small size of the orders, SADAFCO marketing executives did not receive sales by outlet in this sector. Although van drivers were asked to provide lists of all the outlets they visited and submit copies of all invoices, they were generally more oriented toward their relationships with their customers than toward the administrative requirements of the company, and data was usually both incomplete and unreliable. In some cases, for example, drivers would take orders from wholesalers who served bagallas, rather than from the retailers themselves.

Supermarkets had been introduced to the Kingdom of Saudi Arabia in the mid-1980s, and by 1998 represented 15% to 20% of sales. The largest chain in 1998, Panda, operated 13 outlets nationally, with two to three new stores opened annually. Although Saudi owned, a large proportion of Panda's executives were American, and they had introduced up-to-date retailing practices and technology, such as shelf-edge bar codes for inventory management and pricing. Although supermarkets were the fastest-growing sector, many observers thought that their growth prospects were limited by the fact that women could not drive. Cash-and-carry (discount) formats were proven more successful in the Kingdom of Saudi Arabia than high-service value-added formats. Other leading supermarket operators were Watani (a warehouse club), Star, Bin-Dawood (a Saudi-owned low price group in Jeddah), Al-Uthaim in Riyadh, and Giant stores in Dammam. SADAFCO had established a new key accounts team to manage supermarket sales. Headed by Scott Saul, the team negotiated annual contracts, volume targets, and merchandising with 60 key accounts, with dedicated sales and promotions staff to service the accounts.

**Competition**

Competition for shelf space in the growing supermarket sector had intensified in the 1990s as many international brands entered the market. This had led to a situation in which Saudi supermarkets not only demanded slotting allowances for new products, as in other countries, but also extracted annual space rental fees based upon the amount of shelf space occupied by a vendor. Saul commented:

"This is something I've never seen anywhere else. It originated in the last few years, largely from vendors coming into the market and competing for scarce shelf space. It has some strange results. For example, you will see all Nestlé's
BRAND CONSUMERISM

SADAFCO PRODUCT LINES

SADAFCO had entered the ice cream business in the 1970s, and by 1998, it had established eight brands: Sandwiches, Crema Premium, Crema, Baños, and Sandía. The largest brand, with SR 20 million sales, was Crema Premium. In addition to these brands, SADAFCO also had a small catalogue of products, such as milk and milk products.

BUILDING THE NEW PRODUCTS

Building on the new products introduced by the dairy company from which it was formed, SADAFCO had undertaken a number of new product launches to diversify its product line. The new products included Ices, which were popular among the youth market, and milk-based products, which were introduced to cater to the growing demand for fresh milk products.

The new products were introduced in a phased manner, with the focus on developing a strong brand presence in the market. The company had also invested in marketing and advertising to create awareness and brand loyalty among the consumers.

Retail distribution

SADAFCO had a strong retail presence, with a network of over 1,000 outlets across the Kingdom of Saudi Arabia. The company had also established a strong presence in the international market, with exports to over 30 countries.

Quality control

SADAFCO had strict quality control measures in place to ensure the safety and quality of its products. The company had also invested in research and development to improve the quality and taste of its products.

Financial performance

SADAFCO had a strong financial performance, with a steady growth in revenue and profit margins. The company had also invested in infrastructure and technology to improve its operational efficiency and reduce costs.

The company also had a strong focus on sustainability and environmental protection, with initiatives such as reducing waste and using renewable energy sources.

Ice Cream

Although ice cream was not a popular product in Saudi Arabia, SADAFCO had entered the market in the 1970s, and by 1998, it had established eight brands: Sandwiches, Crema Premium, Crema, Baños, and Sandía. The largest brand, with SR 20 million sales, was Crema Premium. In addition to these brands, SADAFCO also had a small catalogue of products, such as milk and milk products.

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included bagallas and supermarkets and also a number of dedicated outlets or parlors (see Exhibit 7.8).

Ice cream was consumed mostly outside the home, mostly in the form of hand-held novelty products, and mostly by children; the 5 to 15 years age group accounted for 30% of the population but 55% of ice cream consumption. There was no tradition of eating ice cream in the home as a dessert. Cultural barriers included a bias against eating in public, especially restrictive for women, and a view of ice cream as a children’s product comparable to candy with possible negative health consequences; in the winter months, the government ran public health campaigns urging children not to eat ice cream because of the possibility of throat illnesses caused by the cold temperature.

Competition had intensified in the mid-1990s with significant investments in the ice cream market by Unilever, Nestlé (both of whom were already present in the Kingdom of Saudi Arabia in other categories), and Mars Unilever’s ice cream business was known as Wall’s, and Nestlé marketed its products under the Kimo brand name. Initially all three had imported product from Europe via frozen facilities in Bahrain. This meant that these players were offering European brands in European sizes, often too large for the hand-held market for children. Magnum, one of Wall’s leading brands, was initially offered at SR 6, but soon reduced to SR 4. In 1993, Unilever had opened an ice cream factory in Dammam, modeled on an established plant in India.
SADAFCO remained the market leader, followed by its traditional competitor, Kwalisty, a Saudi-based company with some Indian investment and management. However, in 1997, there were clear signs of share gains by Wall’s and Nestlé in particular (see Exhibit 7.9 for market shares and trends). These gains appeared to be led by attacks in distribution.

The key issue in distribution was freezer placement. Retailers were generally provided with display freezers by vendors, on the condition that only the vendor’s brands would be placed in the freezer. Bagallas and other small outlets only had room for one ice cream freezer, whereas supermarkets accommodated several, in which case vendors competed for the best position. SADAFCO had approximately 13,000 freezers placed in market, the most of any vendor. Each had cost on average SR 2,000 to 3,000 and was depreciated over 5 years. Their closest competitor, Kwalisty, was estimated to have 8,000, with Wall’s and Nestlé placing approximately 4,000 each. Vendors filled their freezers directly, and wholesalers and other intermediaries played no part in ice cream distribution because of the need for freezer trucks. SADAFCO’s specialist ice cream distribution operation consisted of 110 trucks and a separate sales force. They called on accounts to replenish stock at least once weekly.

Both Wall’s and Nestlé had adopted a top-down strategy, focusing on the emerging supermarket sector and raising the investments required for preferred freezer positions within supermarkets. Contracts averaged SR 35,000 floor rental fees per supermarket in 1998; in the largest supermarkets, Wall’s and Nestlé both adopted a multiple-freezer policy, with two to three freezers in the largest outlets. When a new supermarket opened, it was becoming increasingly common for vendors to provide the first order (i.e., fill the freezer) for free. Exhibit 7.10 shows distribution achieved by the main players by channel.

Exhibit 7.10 Ice Cream Brand Distribution in Saudi Arabia by Outlet Type

![Exhibit 7.10 Image]

Tahir pointed out that by concentrating their efforts on supermarkets, the multi-nationals were accepting restricted distribution levels, when compared to the national coverage of SADAFCO, but were well positioned in the channels that were capturing ever-greater shares of the market. Their products were also coming into line with the tastes of the Saudi market (see Exhibit 7.11 for samples of product portfolios from SADAFCO, Wall’s, and Nestlé).

In presenting his 1997 report at the marketing meeting, Tahir outlined a number of key learning points from the competitive activity of the previous year:

- SADAFCO’s portfolio of ice cream brands was too diverse to allow for continuous marketing support for all brands. TV support could only be funded for the larger brands such as Baboo, and smaller brands suffered from limited exposure in media advertising.
- SADAFCO had been overtaken by Kwalisty in the take-home tub and cup segment. Kwalisty derived half its sales revenues from this sector, which accounted for almost half the ice cream market.
- Nestlé and Wall’s were outperforming SADAFCO in supermarkets, due to their policy of paying higher space rental fees to obtain prime positions near check-out cashiers, and due to their policy of having multiple freezers in a single store.
- Multinationals were becoming an increasing threat because they were learning fast about the local market. For example, when Wall’s first entered the Saudi market, they were promoting European products positioned as indulgences and suitable for adults, but now they were promoting a different type of product more suitable for the local market (“Max” range for children).
- In-store checks had indicated a possible weakness in the quality of merchandising in Saudi freezers in stores, both in terms of product assortment and presentation.
- Mövenpick ice cream awareness and trial levels were very low, at 16% and 9% respectively.
- The Mövenpick product line may be hindering sales, as it was built around the 1-liter tub. This cost SR 21, compared with SR 10 for the same size Saudia Premium tub. In Europe, the 500 ml size had proven much more successful for Mövenpick.
- Mövenpick's presence in supermarkets was weak, because its hand-held products were displayed in Saudia freezers.
- Certain Mövenpick flavors introduced recently, such as apricot and creme mandarin, had proved to be unappealing to local tastes.

Exhibit 7.12 shows SADAFCO's 1997 ice cream sales and marketing expenditures. It was estimated that Nestlé supported its ice cream business with a marketing budget of some SR 12, and Wall's, SR 16 million.

**Milk**

SADAFCO's core product had recently experienced its first declines in sales volumes as a result of increased competition. There were three main sectors in the Saudi milk market (see Exhibit 7.13). Powdered milk, the form in which milk was traditionally sold in the Middle East, was used extensively in cooking as well as to make drinks. Its use for drinking milk had declined from 60% of Saudi households in 1995 to 40% in 1998.

**Exhibit 7.12** SADAFCO Ice Cream Marketing Expenditure 1997 (in SR thousands)

<table>
<thead>
<tr>
<th></th>
<th>Saudia</th>
<th>Mövenpick</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advertising</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TV production</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>TV media</td>
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<tr>
<td>Outdoor</td>
<td>302</td>
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<td>Print</td>
<td>264</td>
<td>35</td>
</tr>
<tr>
<td>Soccer stadium</td>
<td>100</td>
<td>0</td>
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<tr>
<td><strong>Promotion</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Indirect brand support</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Packaging</td>
<td>145</td>
<td>52</td>
</tr>
<tr>
<td>Research</td>
<td>65</td>
<td>0</td>
</tr>
<tr>
<td>Point-of-sale material</td>
<td>67</td>
<td>140</td>
</tr>
<tr>
<td>Other</td>
<td>107</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,150</td>
<td>400</td>
</tr>
</tbody>
</table>

**SADAFCO Ice Cream Gross Sales ($ millions)—Index vs. 1994**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Saudia</th>
<th>Export</th>
<th>Total</th>
<th>Saudia</th>
<th>Export</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>12.45</td>
<td>11.43</td>
<td>1.02</td>
<td>2.58</td>
<td>1.99</td>
<td>0.59</td>
</tr>
<tr>
<td>1995</td>
<td>13.19 (106)</td>
<td>12.23 (107)</td>
<td>0.96 (95)</td>
<td>3.36 (130)</td>
<td>2.39 (120)</td>
<td>0.97 (164)</td>
</tr>
<tr>
<td>1996</td>
<td>14.81 (112)</td>
<td>13.71 (112)</td>
<td>1.10 (114)</td>
<td>3.38 (100)</td>
<td>2.80 (117)</td>
<td>0.57 (59)</td>
</tr>
<tr>
<td>1997</td>
<td>15.57 (105)</td>
<td>14.48 (105)</td>
<td>1.07 (97)</td>
<td>3.19 (94)</td>
<td>2.66 (95)</td>
<td>0.32 (91)</td>
</tr>
</tbody>
</table>
Laban, a form of buttermilk, was predominantly drunk by Saudi men. The recent development in the liquid milk sector, in which SADAFCO’s Saudia brand of recombined product competed, was the emergence of a number of fresh milk producers. A number of dairy farms had been established in Saudi Arabia from the 1970s onward with the strategic goal of making the country self-sufficient in milk, and by 1998 the country boasted the world’s largest dairy farm. Even though they were located in the less arid regions of the country, these dairy farms still had to contend with challenging environments. Pace commented:

There is now a lobby in the Kingdom, which we obviously support, arguing that the environmental and economic cost of these farms outweighs their strategic importance. For example, in irrigating the land and keeping the cows hydrated, these farms use over 1,000 liters of water to produce 1 liter of milk, compared with 5 liters of water in our recombination plant in Jeddah. The politics of this issue are complex, however, and while these debates continue, our market share is coming under pressure.

The marketing problem facing Saudia milk was not one of product quality, according to James Johnston, marketing manager:

In fact, Saudia recombined milk regularly wins in blind product tastings, probably because the conditions under which the fresh producers operate result in milk which is relatively low in solids, and hence rather thin in taste. Perception is another matter, though, and the fact that their milk is fresh appeals to many consumers. Our situation could become worse because of some pending Gulf Cooperation Council legislation requiring us to state on the package that our product is made from powder.

The other key element of competition was price, and the fresh producers could produce UHT milk at a price point 20% lower than Saudia in the critical winter months. Saudia first suffered share loss in 1995 after a price rise intended to reflect increases in raw material prices. A recovery followed in 1997, with volume rising from 173,000 to 181,000 tons, and share increasing from 47.4% to 49.7%. Most analysts expected fresh to continue its share increase at the expense of recombined, but SADAFCO was intending to defend its position aggressively, with a planned increase in 1998 marketing expenditures to SR 16 million. The Saudia brand was to be positioned as the “best-tasting milk available,” a claim supported by blind tasting test results, and would also focus on the brand’s track record of innovation: It has been the first brand to introduce one-liter Tetra Slim packs with open and close tops; the first available in 500 ml size, which now accounted for more volume than the 1 liter pack; the first to launch skimmed milk in

<table>
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<th></th>
<th></th>
<th></th>
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<tbody>
<tr>
<td>$ change</td>
<td>117.6</td>
<td>126.4</td>
<td>132.2</td>
<td>133.5</td>
<td>140.5</td>
</tr>
<tr>
<td>% change</td>
<td>7.5%</td>
<td>4.6%</td>
<td>1.0%</td>
<td>5.2%</td>
<td></td>
</tr>
<tr>
<td>Tons</td>
<td>115,807</td>
<td>123,026</td>
<td>122,653</td>
<td>118,940</td>
<td>127,896</td>
</tr>
<tr>
<td>% change</td>
<td>6.2%</td>
<td>-0.3%</td>
<td>-3.0%</td>
<td>7.5%</td>
<td></td>
</tr>
</tbody>
</table>

Saudi Arabia; the first to launch a specially formulated milk for children, Junior, and was planning to launch a decholesterol milk in 1998.

Tomato Products

SADAFCO’s second-biggest product line was tomato products, the bulk of which was the Saudia brand of tomato paste, which had been the success story of the category since its original launch in Tetra Pak cartons in 1989. Based upon limited experience in other countries, Tetra Pak had worked with SADAFCO in developing the production process for this innovative product form, which it claimed produced a product with better taste and better quality retention after opening. The acceptance of the Tetra Pak paste in the Kingdom of Saudi Arabia was boosted by the influx of Kuwaitis during the Gulf War of 1991 to 1992, as the product had previously been manufactured in this form in Kuwait by the Kuwai Disnsh Dairy Company. By 1997, Saudia tomato paste had risen to $21 million in sales revenues (compared with $9.5 million in 1993) and a market leadership share of 24.7% (16% in 1995), with 85% and only one competitor in the Tetra Pak sector. This growth reflected both an expanding market and share gains over timmed product. Majid Dawood, senior group product manager responsible for this product line, believed that further innovation would be necessary to maintain growth:

It is questionable how much more share can be taken from tinned products, much of which is used in catering operations. The other sizable sector of this category is tinned whole tomatoes, about half the size of paste, but we are turning our attention to cooking sauces, currently a very small category consumed mostly by expatriates. We expect this to take off slowly, because it does not fit very well with local cuisine, and because convenience foods like this are somewhat scorned. The cooks employed by many families are expected to use basic fresh ingredients. Nevertheless, we regard it as vital for the brand to remain at the forefront of the category, and we will be formulating the product to meet local cuisine and tastes.

Saudia was positioned as the “best tomato paste consumers can buy,” supported by its bright red color and the fresher and more natural taste. Tomato paste was bought on the spot market, and originated mostly from Turkey, Portugal, or California. The Tetra Pak cartons required lower levels of the heat treatment, which sometimes produced darkened product in tins, and guaranteed no unpleasant “tin taste” of which consumers complained. The Saudia brand was also regarded as more local, and therefore fresher, compared with the mostly imported tinned products. In 1997, export sales accounted for 12.5% of sales revenues and 29.6% of tonnage, reflecting a penetration strategy in markets where the brand received little promotional support.

Hummus

The year 1998 was also to see the launch of a new Saudia brand of hummus in Tetra Pak. Hummus was a dip of Lebanese origin made from chickpeas, salt, lemon juice, oil, garlic, and tahini (a sesame seed paste). Of the 50,000 tons estimated to be consumed annually in the Kingdom of Saudi Arabia, all but 400 tons were made fresh in restaurants, as an eat-in or take-out product, or in the home. The remaining tinned product, which was imported from Lebanon, was regarded as inferior in quality due to its lack of
freshness, and required the addition and blending of lemon juice, tahini, and oil at the time of serving. Saudia hummus was to be the first ever in the world presented in Tetra Pak. The new product was the result of collaboration between SADAFCO and Tetra Pak. The new product promised the same quality as fresh hummus, but with greater convenience and a six-month shelf-life without refrigeration, compared to a one-week refrigerated shelf life for fresh hummus bought from restaurants. Majid Dawood commented:

This is a relatively high-risk launch because it is a new product form which requires changes in consumer behavior and perception. The forecasting has to be discounted for this uncertainty and we cannot expect rapid success. Nevertheless, there are real consumer benefits available and, for us, a potentially large market in the long run, since hummus is eaten in quantity throughout the world and is also available at delicatessen counters throughout the world. There is considerable pride at the company that we are at the leading edge of this innovation.

Saudia hummus was launched in March 1998, priced at SR 3.5 for 400 gm—comparably with approximately SR 2.5 for the same sized tinned product, and would also be available in a smaller 135 gm size, priced at SR 1.5. Fresh hummus purchased at restaurants for home use generally costs SR 5 to SR 6 for 200 gm. Assuming a 5% share of a 45,000 ton market, budgeted first-year revenues were SR 12 million. The launch budget was SR 2.8 million, with 67% allocated to advertising, 13% to promotions, 3% to in-store sampling, and 8% to retail space rental. Promotions included joint offers with olive oil and Saudia tomato paste, and free dishes suitable for in-home serving of hummus offered with eight-pack purchases.

SADAFCO management had identified hummus as a potential spearhead for international marketing. The regional consumption of hummus was considerable—in Lebanon alone, the tinned market was some 11,000 tons annually and the fresh market approximately the same size. In addition, Pace wondered whether the pioneer advantage enjoyed by Saudia hummus in this packaging could be exploited in developed markets. The TV advertising planned for Saudia hummus in August 1998 would reach audiences throughout the region.

Snacks, Water, and Other Product Lines

SADAFCO’s snack business, with production based in Jeddah, had been growing at 10% annually to reach SR 40 million, approximately 40% share by value. Products were marketed under the Crispy and Baaboo brands, and approximately half the volume came from potato chips. Some 70% of consumption was accounted for by the 5 to 15 year-old age group, and so schools were an important outlet, with 28% of industry volume. Prospects for 1998 were uncertain because of the threat of a government ban on the sale of packaged snack foods in schools on nutritional grounds. Only 18% of sales were direct to large retailers, with the remainder going through wholesalers.

SADAFCO also competed in feta cheese and cheese in packages, in which it already had a market share. The sale of carbonated drinks in schools is a potential threat to the business.

SADAFCO had achieved export sales in regional markets for some years, but with what it viewed as varying success. See Exhibit 7.14 for a summary of international sales.

The largest commitment to international activity was a recent one: purchase of a slightly used dairy factory in Egypt that would require substantial rehabilitation and an additional investment in Egypt to construct a small ice cream factory, mainly to produce the premium quality Mövenpick brand for selling to top-class hotels and tourist resorts.

The ice cream factory investment had been initiated by pressure from Mövenpick Zurich, who wanted to have their specialty ice cream available for their expanding chain of tourist hotels in Egypt. It also represented for SADAFCO a significant step toward the option for more focus on the premium/differentiated high-margin Mövenpick Swiss Premium Ice Cream that was outside the mainstream competition with Unilever (Wall's brand) and Nestlé. This strategy proved to be reasonably successful in Egypt. The larger factory, now being rehabilitated for UHT milk, juices, and tomato paste, was intended to capitalize on the fast-growing market for safe, well-packaged foods in Egypt. To sell the product from this factory, SADAFCO had to cope with the challenges of mass distribution of low-margin products in highly congested distribution conditions. In addition, the Saudia brand was not appropriate. Although the lure of an undeveloped food market in a nation of some 65 million people experiencing rapid-economic growth was a powerful motivation, it was recognized that success was not certain. Correct decisions on branding and management appointments were considered to be crucial.

The rest of SADAFCO’s international business was all exported by truck and rail and delivered by national distributors in a number of Gulf markets. The largest current export market was the United Arab Emirates (UAE), where the bulk of the sales had been to black currant concentrate drink, Ribena, for which SADAFCO had the local franchise. The drink was introduced into the market in the former British colonies of the United Arab Emirates, Bahrain, and Qatar. However, SmithKline Beecham was introducing products with new variations, and there was also uncertainty in the distribution relationship, raising the possibility that this line of business would terminate in 1998.

<table>
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<tr>
<th>Year</th>
<th>Lebanon</th>
<th>Oman</th>
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<th>Yemen</th>
<th>Jordan</th>
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<th>Canada</th>
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CHAPTER 8

LAUNCHING A NEW IDENTITY

Project Blue

In late November 1995, Pepsi-Cola International’s (PCI) beverage division announced the global launch of a new brand identity and logo for Pepsi soft drinks. Plans called for a $500 million investment to update the look of Pepsi cans and bottles, point-of-sale signage, trucks, and vending machines worldwide. The redesign effort, known as Project Blue, aimed at rejuvenating the Pepsi image by associating the brand with the color blue in contrast to Coca-Cola’s long-standing association with the color red.

COMPANY BACKGROUND

With 1995 revenues of $30.4 billion, PepsiCo was a worldwide food and beverage marketer that was ranked number 20 in the Fortune 500 and number 30 in market value among all companies in the world. Of total revenues, 35% were accounted for by beverages, 37% by restaurants (including KFC, Pizza Hut, and Taco Bell) and 28% by snack foods (including Lay’s, Ruffles, and Doritos).

PepsiCo beverages included soft drinks (such as Pepsi, Diet Pepsi, Pepsi Max, 7-Up, Slice, and Mountain Dew), teas, bottled water, and juices. Package pictures of PepsiCo beverages are presented in Exhibit 8.1. In several noncarbonated beverage categories, PepsiCo had formed alliances to distribute the ready-to-drink tea products of Thomas J. Lipton Co. and Ocean Spray fruit juices.

In 1995, PepsiCo’s dollar beverage sales in the United States rose 7%. Volume growth accounted for one-quarter of this increase. Retail case sales grew faster than sales through fountains and restaurants (which included the many chains in PepsiCo’s restaurant division). Dollar beverage sales outside the United States rose 14% in 1995. Volume growth accounted for 45% of this increase, the remainder stemming from acquisitions and price increases.

In the United States in 1995, PepsiCo accounted for 27% of the retail value of carbonated soft drink sales and held a 23% volume share. The corresponding figures for

Professor John A. Quelch prepared this case from published sources as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Coca-Cola were 35% and 30%. Coca-Cola’s share lead in the United States was greater in vending machines and restaurants than in retail stores. Both companies had been subject to share pressure from lower priced own-label carbonated beverages in 1993 to 1995 but had been able to recover short-term share losses through new products, new packaging, and stepped-up advertising and promotion.

Around 29% of PepsiCo’s 1995 beverage revenues and 18% of beverage operating profits were derived from international operations. The three Pepsi brands (Pepsi, Diet Pepsi, and Pepsi Max) accounted for 40% of PepsiCo’s U.S. beverage dollar sales (with four billion cases of 24-8-oz. cans). Outside the United States, two billion cases of the three Pepsi brands were sold in 1995, accounting for 70% of PepsiCo’s international beverage sales.

The marketplace rivalry between Pepsi and Coca-Cola was decades old. Pepsi had established itself in the 1930s as Coca-Cola’s main rival with the price-oriented campaign, “Twice as much for a nickel, too.” In the 1970s, Pepsi gained ground on Coca-Cola by focusing on taste superiority through the Pepsi Challenge. Some 20 million people took the Pepsi Challenge, of whom 60% chose Pepsi over Coca-Cola. In the 1980s, both brands invested heavily in image advertising and celebrity endorsements. Pepsi’s tagline, “The choice of a new generation,” positioned it squarely against a teenage target. Coca-Cola had typically followed a broader and more traditional positioning and, in 1993, reintroduced its classic contour bottle. The classic bottle, when surrounded by the new circuit logo, was launched worldwide as the new Coca-Cola logo in conjunction with the “Always Coca-Cola” advertising tagline. Despite exploiting its classic heritage, Coca-Cola was able to successfully target some teenagers with innovative advertising, sport event sponsorships, and celebrity endorsements. Some analysts believed Pepsi was losing its edge over Coca-Cola in the youth market.

Outside the United States, the share gap between Coca-Cola and Pepsi was greater than in the domestic market. Pepsi exceeded Coca-Cola in market share in only 5 of the top 50 country markets. PepsiCo spent $500 million on advertising carbonated beverages in the United States in 1995 and $200 million internationally, up 3% and 7% respectively over 1994. Corresponding Coca-Cola expenditures in 1995 were $1.2 billion and $600 million.

The Pepsi system’s two most important new product launches in 1993 were Crystal Pepsi and Pepsi Max. Crystal Pepsi, a clear rather than colored version of the classic Pepsi formula, was launched in the United States but failed to achieve more than 2% volume share of carbonated beverage sales. On the other hand, Pepsi Max, a “no sugar, maximum taste” cola targeted at 16- to 29-year-olds in a redesigned blue can and supported by television advertising featuring tennis star Andre Agassi quickly gained a 5% volume share in its launch market, the United Kingdom.1 Pepsi Max was the first PepsiCo soft drink launched first outside the United States. It accounted for 20% of Pepsi sales volume in the United Kingdom by the end of 1995. During 1995, Pepsi Max international sales increased 70% over 1994 as the brand was rolled out in 50 countries. Pepsi Max accounted for one-third of all PCI soft drink volume growth in 1995. Even though it was not yet distributed in the United States, worldwide retail sales of Pepsi Max were expected to reach $450 million in 1995.2

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1The United Kingdom was chosen in part because acceptance of sugar-free colas (17% market share) was among the highest in the world.

2Pepsi Max employed an artificial sweetener not yet approved by the Food and Drug Administration for use in the United States.
In addition to new product launches, PepsiCo achieved sales growth through several other strategies. First, PepsiCo continued its strong record of packaging innovation. In the United States, the launch of the Cube, an easy-to-store 24-can pack, was credited with increasing Pepsi volume 7% in supermarkets, compared to an overall 4% growth in soft drink volume through this channel. In the impulse-driven convenience/gas store channel, Pepsi-Cola became the share leader thanks to its Big Slam (a one-liter, single-serve bottle) and Quick Slam (20-ounce bottle) packaging innovations. In 1995, PepsiCo also pioneered the concept of freshness dating on soft drinks in the United States.

Oversized, PepsiCo continued to invest in acquisitions and joint ventures in emerging markets to try to close the share gap with Coca-Cola. In most emerging markets, teens—Pepsi’s core target—accounted for a much higher proportion of the population than in the United States, yet per capita consumption of soft drinks was much lower. Between 1993 and 1995, over $500 million was invested in beverage acquisitions and joint ventures. In Hungary and Poland, Pepsi acquired cola market share leadership. In India, Pepsi’s market share rose to nearly 40%. Almost 40% of PCI’s 1995 international soft drink volume growth came from emerging markets.

In addition to forging new alliances, PepsiCo continued to use surplus cash to purchase partial or total control of its independent bottlers around the world. Between 1990 and 1995, PCI franchised, consolidated, or restructured almost 60% of its business. By the end of 1995, PepsiCo had outright ownership or shared equity in bottling operations accounting for 55% of international beverage volume, up from 20% in 1995, and for 70% of United States volume. Corresponding figures for Coca-Cola were 80% and 70%.

THE PRESENCE AUDIT

The visibility and impact of the Pepsi brand name and logo at the point-of-purchase were considered especially important to sales success in the impulse-purchase-driven soft drink category. Consumers were exposed to the Pepsi name on signs outside of points-of-sale, on trucks, on vending machines, on “wraparounds” at the bottom of in-store displays, and on packages.

By the middle of 1994, there was increasing concern within PCI about inconsistent presentation of the Pepsi brand to consumers. Pepsi had only changed its brand identity seven times in the company’s history, most recently in 1991. However, in many markets, old signs were still being used alongside new ones. In addition, each brand logo had been interpreted slightly differently by Pepsi’s independent bottlers. Although Pepsi and the bottlers shared the cost of point-of-purchase signage and materials on a 50/50 basis, the bottlers decided what was used.

As shown in Exhibit 8.1, Pepsi’s first official logo was created in 1898 when the pharmacist Caleb Bradham changed the name of the original formula, developed as a cure for dyspepsia, from Brad’s Drink to Pepsi-Cola. The first Pepsi-Cola logo was red. This was dropped for red, white, and blue in 1941 as Pepsi gave its support to the World War II effort. A “bottle cap” logo was launched in 1950, evolving into the bull’s-eye “swish” logo in 1973.

In late 1994, PCI commissioned Landor Associates, a corporate identity consultancy, to evaluate the point-of-sale presence of the Pepsi family of brands. After interviews with PCI executives in seven countries, Landor organized a worldwide photographic audit of Pepsi’s brand presence. About 2,000 photographs were assembled from 34 countries. They showed inconsistencies and lack of integration in the presentation of the Pepsi logo and graphics both within countries as well as across countries. In addition, the photos showed that Pepsi owned no particular color except perhaps white. Pepsi graphics often looked weak, flat, and washed out when compared to Coke’s bold red decal. The graphics did not express the energy and core essence of Pepsi. The long red pedestal and Pepsi ball did not work well on the sides of trucks or vending machines. In the view of some, cans of Pepsi looked like motor oil.

A team of consultants and PCI executives set out to develop an improved look for Pepsi graphics in merchandising materials around the world. The team identified blue as much a stronger color than white that Pepsi could own in contrast to Coke’s dominance of red. Consumers viewed blue as modern and cool, exciting and dynamic, and a color that communicated freshness. The team began to think of blue as a key component of Pepsi’s brand equity. Only then did the team begin to do exploratory work on redesigning Pepsi packaging. At that point, the project needed top management approval. PCI’s president saw Project Blue as a big idea that could galvanize the Pepsi system worldwide and refocus managers around the world on restoring Pepsi’s marketing edge.

The original mission set out for the design team was to develop a graphics treatment and product line look that would strengthen the Pepsi brand identity and deliver higher impact in-market presence for the Pepsi brand. The team set out to:

1. Develop a flexible design (that could be used effectively on displays and trucks and in a variety of other media).
2. Establish blue as Pepsi’s dominant color.
3. Develop a mnemonic device.
4. Create a modern, even futuristic, look and image to contrast with Coke’s traditional positioning.

The project team first worked on developing a two-dimensional icon that retained some of the essence of the current brand identity—principally the Pepsi ball. Exhibit 8.2 shows the winning design from this phase of the project. The designers noted that the untailored logotype added boldness and stature. Spelling Pepsi in white on a blue-and-red background reversed the color architecture of the previous logo and ended up doing the same. The traditional Pepsi ball became a globe. Showing only a quarter of the ball enhanced its larger-than-life personality and effectively transformed it from a ball into a three-dimensional, futuristic globe.

The next challenge for the design team was to translate the off-pack design into an execution that would work equally well on three-dimensional cans and bottles. Although bottle volume exceeded can volume in many markets, the design team focused first on cans because they dominated away-from-home consumption and were therefore more often used and seen in public. By combining the toolbox of graphics they had already developed with a grid background on the can surface, the designers were able to produce in June 1995 the final can designs for the Pepsi family of brands shown in Exhibit 8.2.
The final design, following the exploration of over 3,000 design approaches, featured a striking blue "grid" background; bold, vertical typography; and a three-dimensional globe that evoked Pepsi's well-known "ball" icon. The blue graphics would be carried on all packages of Pepsi-Cola, Pepsi Max, and Diet Pepsi.

THE HONG KONG BOTTLER MEETING: MAY 1995

PCI's president elected to announce Project Blue at the company's annual bottler meeting in Hong Kong in May 1995, a meeting attended by all company-owned and franchised bottlers worldwide.

The buzz in the corridors after the speech ranged from enthusiasm to concern. The PCI vice president in charge of Eastern Europe was bullish; "Maybe I can finally paint Red Square blue!" Others, including several franchisee bottlers, were concerned about the expense and management time that the rollout would require and whether Pepsi management would support the rollout of Project Blue in the United States. The PCI president followed up with a series of internal memos that ensured that Project Blue would be a focus of every country manager's and bottler's thinking as their 1996 business plans and budgets were developed and finalized during the period from September to November 1995.

THE BAHRAIN TEST: OCTOBER 1995

At the May meeting, it was announced that Project Blue would be launched initially in Bahrain in October. The selection of Bahrain was based on four factors. First, PCI regional management in the Middle East had already been experimenting with blue backgrounds in point-of-sale materials because the standard white background caused the logo to be washed out in the bright sunlight common to the region. Second, the Bahrain market was served by a single franchisee bottler who had, on occasion, been critical of PCI headquarters. The credibility of Project Blue would be enhanced if he could be convinced. Third, as in other Middle Eastern markets, Pepsi sales dominated Coke's by three to one, so any negative reaction towards Project Blue among existing Pepsi consumers used to the current logo and signage would surface in the test. Fourth, Bahrain was a small market of one million people who lived on two islands connected by a bridge; this enabled PCI to conduct a controlled field test to measure the impact of Project Blue.

A Blue Fund was established at PCI headquarters to cover the cost of the market test and a PCI task force was appointed to spearhead its implementation. The Bahrain bottler's marketing managers and sales force were also heavily involved in local execution. However, because the bottler had recently invested heavily in installing new production lines to increase capacity, he was not pressed to cover the cost of production line changes, the new signage and point-of-sale displays.

The PCI task force developed and executed a rollout of Project Blue in 12 weeks. Newly designed cans and bottles for all Pepsi brands were distributed throughout Bahrain. The entire Project Blue program, including signage and point-of-sale materials, was implemented in one-half of the city (around 500 of the 1,000 retail outlets). Implementation included both converting existing signage and adding new signage. A new
advertising slogan, “New look. Same great taste,” was appended to existing television and print advertising executions. Spending on advertising and promotion during the test was sustained at previously planned levels.

Tracking research was conducted before, during, and after the test. Measures of brand attitudes improved, as did sales volume and market share. Around 70% of consumers believed that there was no change in Pepsi’s taste; 30% thought there was a taste change and, of these, 70% thought the perceived taste change was positive.

THE NOVEMBER MEETING

With the benefit of the positive results from Bahrain, PCI executives were convinced that their enthusiasm for Project Blue was well-founded. They were asked to present their recommendations for a worldwide rollout of Project Blue at a meeting at PCI headquarters in late November. Their recommendations covered the speed of the worldwide rollout and the sequence of countries in which Project Blue should be launched. In addition, they proposed a creative and expensive communications program to support the worldwide launch.

First, PCI executives recommended that Project Blue be rolled out in markets accounting for half of Pepsi’s international sales volume by July 1996. By the end of the year, they expected more than 20 billion cans and bottles would reach store shelves. However, several executives were unconvinced that the Bahrain execution or results could be replicated on a worldwide basis. They pointed to Pepsi’s unusually high share in Bahrain and the fact that it was a developing rather than mature market. These executives argued for a slower rollout on a region-by-region basis. A second group of executives advocated launching Project Blue first in a lead market in each region; success in each lead market would then motivate the other bottlers in the region to follow. PCI European executives, for example, argued that the United Kingdom should be a regional lead market for Project Blue because of the successful launch of Pepsi Max; because Pepsi’s soft drink market share in the United Kingdom trailed Coca-Cola brands 19% to 50%; and because Pepsi brands were losing share to own labels marketed in red cans by the United Kingdom’s powerful supermarket chains and also to the recently launched Virgin Cola.

PCI’s Latin American executives pointed out that the bottlers in their region, especially in Mexico, had made significant capital investments in their infrastructure in the last 4 years. It would be difficult to demand that they change their signs again so soon. Hence, the Latin American launch would have to be postponed until 1997.

Other executives argued that a simultaneous worldwide launch of Project Blue would be a logistical nightmare. Some preferred to wait until each bottler was totally committed than risk half-hearted support from bottlers who might be pushed into going with Project Blue before they were ready, just for the sake of a global launch.

There was skepticism at the meeting about the U.S. organization’s willingness to adopt recommendations from the international side of the business due to the not-invented-here syndrome. The U.S. organization was working on its own package redesign which, though similar, was not the same. The question was raised as to whether bottlers around the world would adopt the PIC plan if the U.S. organization was going in another direction.

References


PepsiCo press release, “Project Blue Fact Sheet,” April 2, 1996.


According to PepsiCo public relations, the Concorde “changed the script” of air travel over 20 years ago.
Disney Consumer Products in Lebanon

In March 1994, Jeremy Carter, Disney Consumer Products' (DCP) vice president and managing director for Disney Consumer Products Europe and Middle East (DCPEME), sat at his desk in his Paris office pondering expansion opportunities. DCPEME, a business unit of The Walt Disney Company, hoped to maintain its position as the fastest-growing division within the company. One growth possibility was in the Middle East. Penetrating Middle Eastern countries was attractive given their favorable demographics and discretionary spending patterns. The company could also receive additional royalties from its licensees’ sales of Disney-related merchandise. At the same time, DCP executives were concerned that successful entry into Middle Eastern markets could encourage unauthorized imitations or pirate versions of Disney products to be introduced; these, in turn, might be difficult to control.

In 1993, DCPEME signed a joint venture agreement with a Saudi partner, making Saudi Arabia the first country to be penetrated in the area. Did Lebanon, Carter wondered, represent a logical second step? Carter reviewed the market research DCPEME had undertaken in Lebanon and the sales potential of various Disney-licensed products, and was assessing the pros and cons of several distribution options. If he recommended that DCPEME enter the Lebanese market, he would have to explain how it could be accomplished to Dennis Hightower, DCPEME president for Europe and the Middle East.

THE WALT DISNEY COMPANY

In 1923, brothers Walt and Roy Disney founded The Walt Disney Company (WDC) as an animated film business. By 1994, the company had become an entertainment giant comprising three major businesses (see Exhibit 9.1):

- Theme parks and resorts included major facilities in Anaheim, California; Orlando, Florida; Tokyo, Japan; and Marne La Vallée, France (near Paris).
- Filmed entertainment comprised the Walt Disney Studios, which produced live action films under the Touchstone, Hollywood Pictures, Miramax, and Caravan Pictures labels and animated films under the Walt Disney Pictures label. This subsidiary also produced programming for pay-per-view, network, and cable (including the Disney Channel) television and handled sales of videotapes.
- DCP was responsible for all marketing and licensing activities and sales of Disney products through mail-order operations and retail outlets, including company-owned Disney Stores. Products consisted of publications, computer software, videogames, toys, personal care products, school supplies, party goods, watches, apparel, home furnishings, and food.
- DCP licensed the Disney characters, songs and music, and visual and literary properties.

WDC's objective was to remain the world's premier entertainment company. Adhering to Walt Disney's dream to "make people happy," the company's products were associated with such values as quality, integrity, and imagination. The company believed future growth lay in the worldwide character licensing business; more Disney stores, theme parks, and resorts; accelerated output of feature-length animated films; and increased demand for motion picture software and TV programming. In addition, the video market was considered significant, as household VCR penetration worldwide continued to grow. This approach was taken in the United States.

Disney Consumer Products

Of DCP's $1.4 billion in revenues, 13% came from Greece and the Middle East, and 23% from Europe (excluding Greece). Table 9.1 summarizes DCPEME revenues and profitability by product category.

EXHIBIT 9.1  The Walt Disney Company: Key Financial Data, 1991-1993 ($ millions)

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1After loss from Euro Disney investment ($515 million) and accounting changes ($371 million).
Source: Company records.

TABLE 9.1  Percent DCPEME Revenues by Product Category, 1992

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</tr>
</tbody>
</table>

¹Revenues for publications (80% magazines, 20% books) represent sales rather than royalties. Royalty revenues from publications approximated merchandise revenues.
by product category, while Table 9.2 provides more detail on DCPEME merchandise revenues.

DCP tightly controlled its licensees to ensure a high level of design and creative integrity, and although royalties for product categories varied, they averaged about 9%. Among the characters DCP licensed were “classics” like Mickey and Minnie Mouse, Donald and Daisy Duck, Goofy, Peter Pan, and Pinocchio, along with the characters from more recent Disney animated films as The Little Mermaid, Beauty and the Beast, and Aladdin. Characters from The Lion King, opening in summer 1994, were also expected to be popular. Mattel, DCP’s principal licensee, planned its largest-ever selection of toys for a Disney film. More than 100 Lion King publications—from coloring books to videogames—were also planned. Donald Duck would turn 60 on June 6, and special promotions, books, and other licensed merchandise would be launched to celebrate that event.

Licenses were usually granted for a specific territory, although worldwide or regional licenses were held by a few licensees—for example, Mattel (for infant and preschool toys); Nestlé (for food products); and Seiko (for watches). In 1993, there were about 1,000 licenses for Disney products in Europe and the Middle East—a number that might decrease as more multiterritory deals were signed.

Disney stores showcased the activities and products of the company’s divisions via promotions and in-store videos. By early 1994, over 300 (26 in Europe) operated worldwide, 80% of which were in the United States; by late 1994, the company hoped to add 100 more. Given high startup costs, the European stores had not yet turned a profit.

THE LEBANESE MARKET

In March 1993, DCPEME signed a 50/50 joint venture with a Saudi partner. The joint venture company became the legal entity that would manage Disney’s Consumer Products’ business interests in Middle Eastern countries, excluding Turkey and Israel. Saudi Arabia was the first country in which this joint venture would operate. The next step might be to extend distribution to Lebanon. Exhibit 9.2 compares DCPEME’s operations in Saudi Arabia, France, and Lebanon.

Founded in 1943, the independent Republic of Lebanon, bordered by Israel to the south and Syria to the east and north, was roughly the size of Connecticut. During the ensuing 3 decades, the country prospered, with especially dramatic growth in the service sector, particularly tourism, financial services, and port-related activities: per capita gross domestic product was estimated at $1,070 in 1974. At that point, however, the country plunged into a civil war that lasted until 1990. According to United Nations’ estimates, the resulting cost in damage to property and infrastructure was $25 billion. Nevertheless, the Lebanese economy subsequently displayed remarkable resilience. In 1991, GDP grew at 50% from the depressed 1990 level, and the World Bank forecast that real GDP would increase at 66% per year until 1999, as the infrastructure was restored. By early 1993, the economy was characterized by free market pricing for most goods and services, and by an unrestricted exchange and trade system. After years of devaluation, the Lebanese pound had stabilized (US$1 = 1,700 Lebanese pounds). Most consumer products were priced in dollars. Exhibit 9.3 summarizes key demographic and economic data on Lebanon.

Although the Lebanese market was small, it offered several advantages. First, its population was much more literate than the populations of neighboring Arab states, and it was also more familiar with Western products, including those of Disney. Second, Lebanese distributors, many of whom occupied important positions in companies throughout the Middle East, might help DCPEME penetrate other Arab markets. Third, because Lebanese society was comparatively liberal, all Disney products could readily be sold.

In 1993, Disney products were distributed in Lebanon through one of three channels:

- World-wide licensees, e.g., Mattel, that legitimately distributed Disney products through their Lebanese distributors.
- Non-worldwide licensees that distributed Disney products through Lebanese distributors even though they did not hold Disney licenses for Lebanon.
- Non-worldwide licensees unaware that several of their wholesalers were selling Disney merchandise to Lebanese distributors or retailers. For example, one publisher held a U.S. license for Disney picture books, but some of its U.S. distributors were selling them to Lebanese distributors.
Exhibits 9.4A and 9.4B list some of DCPEME’s licensees and their products; Exhibit 9.5 compares the retail prices for such products in Lebanon and in the United States.

**Market Research in Lebanon**

In early 1994, DCPEME commissioned focus groups of Lebanese parents with children under the age of 18 years to understand how parents entertained their children, which activities they encouraged, and which Disney products they liked and might purchase. The parents interviewed lived in Beirut and had household incomes among the top 25% in Lebanon. In addition, 200 children aged 8 to 18 years were interviewed to test awareness and appeal of Disney products. Research findings are summarized in Exhibits 9.6 and 9.7.

The studies revealed that parents viewed television as a way to stimulate their children’s imagination—until the children were 8-years-old; beyond that age, television was considered more negatively—as a passive activity—although children were encouraged to watch cultural programs. Parents were much more positive about reading, starting to read stories to children as young as 3-years-old. Read-along tapes were not widely used given their limited availability in the market.

Plush toys (such as stuffed animals) were especially appealing to children aged 1 through 4 years, who formed very emotional relationships with these toys. Beyond the age of 4 years, most children switched to playing computer games, watching television, or engaging in outdoor sports. Interestingly, Mattel’s Barbie dolls retained their appeal for girls as old as 10 to 12 years.) Computer games, however, were not appreciated by parents; either the children purchased the games themselves or they insisted their parents buy them. In addition, parents felt that educational software for children was lacking in the market. Finally, teenagers were brand conscious in their choices of clothing and accessories. Examples of “fashionable” brands included Lacoste apparel, Sebago shoes, and Swatch watches.

<table>
<thead>
<tr>
<th>Company</th>
<th>Country of origin</th>
<th>Product category</th>
<th>Retail sales value ($)</th>
<th>Distribution type</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>France</td>
<td>Picture books</td>
<td>175,000</td>
<td>Direct sales</td>
</tr>
<tr>
<td>B</td>
<td>U.S.A.</td>
<td>Picture books</td>
<td>165,000</td>
<td>Three distributors</td>
</tr>
<tr>
<td>C</td>
<td>France</td>
<td>Apparel</td>
<td>20,000</td>
<td>Appointed distributor</td>
</tr>
<tr>
<td>D</td>
<td>U.S.A.</td>
<td>Figurines</td>
<td>65,000</td>
<td>Direct sales</td>
</tr>
<tr>
<td>E</td>
<td>U.S.A.</td>
<td>The Little Mermaid</td>
<td>260,000</td>
<td>Several distributors</td>
</tr>
<tr>
<td>F</td>
<td>Italy</td>
<td>Toys</td>
<td>50,000</td>
<td>Appointed distributor</td>
</tr>
<tr>
<td>G</td>
<td>U.S.A.</td>
<td>Plushes</td>
<td>40,000</td>
<td>Several distributors</td>
</tr>
<tr>
<td>H</td>
<td>Spain</td>
<td>Puzzles</td>
<td>20,000</td>
<td>Appointed distributor</td>
</tr>
<tr>
<td>I</td>
<td>Japan</td>
<td>Video games</td>
<td>100,000</td>
<td>Several distributors</td>
</tr>
<tr>
<td>J</td>
<td>Japan</td>
<td>Video games</td>
<td>80,000</td>
<td>Appointed distributor</td>
</tr>
<tr>
<td>K</td>
<td>Belgium</td>
<td>Towels</td>
<td>85,000</td>
<td>Exclusive retailer</td>
</tr>
<tr>
<td>L</td>
<td>U.S.A.</td>
<td>Toothbrushes</td>
<td>80,000</td>
<td>Exclusive retailer</td>
</tr>
<tr>
<td>M</td>
<td>France</td>
<td>Tapes, CDs</td>
<td>15,000</td>
<td>Several distributors</td>
</tr>
<tr>
<td>N</td>
<td>France</td>
<td>Rocking chairs</td>
<td>5,000</td>
<td>Exclusive retailer</td>
</tr>
</tbody>
</table>

Source: Distributors’ estimates.

In cities of Western Europe, children began deciding what they wanted to do and play with as early as 4 years; in Lebanon, the transition tended to occur around ages 7 to 8 years. Parents purchased gifts for their children on major holidays and for birthdays of their own children and of friends of their children. Sixty percent of parents also purchased small gifts for their children on impulse, including videotapes, drawing kits, picture books, and Lego games. These impulse purchases were more frequent when parents had only one child, when children were too young to express themselves verbally, when mothers worked full time, or when parents had been away on trips and felt a need to compensate for their absence. Thirty percent of parents purchased small gifts as rewards for good grades at school or for helping out at home. Parents with several children felt that if they gave a gift to one child without a specific justification, they would be pressured to purchase gifts for their other children as well. Parents were also concerned about spoiling their children.

Regarding familiarity with Disney, 30% of the parents had heard of the company through television cartoons or video movies, and 30% had been to a Disney theme park.

<table>
<thead>
<tr>
<th>Licensee origin</th>
<th>Sales ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worldwide regional licensees</td>
<td>455,000</td>
</tr>
<tr>
<td>Nonworldwide licensees, selling through selected Lebanese distributors</td>
<td>485,000</td>
</tr>
<tr>
<td>Nonworldwide licensees, selling through wholesalers in other countries</td>
<td>230,000</td>
</tr>
<tr>
<td>Pirated Disney products (exclusively video)</td>
<td>650,000 to 1,200,000</td>
</tr>
</tbody>
</table>

Source: Company estimates.
The Disney brand was regarded as a high-value label, and interviewees believed that using Disney apparel and other merchandise enhanced people's self-esteem and perceived status. Many Lebanese had lived abroad during the country's civil war and were therefore aware of a wide range of Disney-licensed products beyond those legitimately distributed in Lebanon.

A Lebanese child's first contact with Disney characters usually occurred between ages 1 to 2 years, when parents began narrating Disney tales and children started watching cartoons on TV. Disney values and characters were then developed through videotapes, picture books, and plush toys.

**Product Categories**

In order to decide which products—if any—should be introduced into Lebanon, Jeremy Carter reviewed DCPME's research findings on Lebanese parents' reactions to various Disney products (see Exhibit 9.8). He also had collected preliminary data on Lebanese distributors' and retailers' margins by product category (Exhibit 9.9). With this information in hand, he set out to consider which product categories had the highest sales potential in Lebanon.

**Apparel**

This category included several product lines that varied in price/quality and age of the target audience. (Although Disney apparel was not sold legally in Lebanon, small quantities had been imported illegally.)

A high-end Disney line for teenagers would have to compete with such names as Benetton, Lacoste, Old River, and Compagnie de Californie. Lacoste, encountering piracy problems, had opened two stores in Beirut to enable customers to buy its genuine products and to educate the market on how to spot them. Carter was concerned that if Disney built a high awareness for its merchandise in Lebanon, it, too, would face imported pirate products. This scenario had already developed in East Asia.

Research participants had looked favorably upon the price levels of a medium-quality line of apparel: Disney T-shirts at $20 and sweatshirts at $30 represented prices that Lebanese customers found reasonable. One source of concern, however, was that
EXHIBIT 9.7 Selected Findings of DCPEMC Market Study

During January and February 1994, personal interviews were conducted with 200 children (50% boys and 50% girls) aged 8 to 18 years. Children were interviewed at school. Place of residence was as follows: 45% in East Beirut, 45% in West Beirut, and 10% outside of Beirut.

- Arabic was the predominant language spoken at home for 58% of respondents, French was predominant for 23%, and English was predominant for 19%.
- Tom and Jerry were the characters preferred by 22% of the children, followed by Mickey Mouse with 8%. The overall distribution of first preferences was as follows (Disney characters are in bold):

<table>
<thead>
<tr>
<th>Character Name</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tom and Jerry</td>
<td>22</td>
</tr>
<tr>
<td>Mickey Mouse</td>
<td>8</td>
</tr>
<tr>
<td>Bugs Bunny</td>
<td>7</td>
</tr>
<tr>
<td>Pink Panther</td>
<td>7</td>
</tr>
<tr>
<td>Donald Duck</td>
<td>6</td>
</tr>
<tr>
<td>Tintin et Milou</td>
<td>4</td>
</tr>
<tr>
<td>Asterix et Obelix</td>
<td>3</td>
</tr>
<tr>
<td>Aladdin</td>
<td>2</td>
</tr>
<tr>
<td>The Little Mermaid</td>
<td>2</td>
</tr>
<tr>
<td>Ninja Turtles</td>
<td>2</td>
</tr>
<tr>
<td>Lucky Luke</td>
<td>2</td>
</tr>
<tr>
<td>Beauty and the Beast</td>
<td>1</td>
</tr>
<tr>
<td>Peter Pan</td>
<td>1</td>
</tr>
<tr>
<td>Pinocchio</td>
<td>1</td>
</tr>
<tr>
<td>Snow White</td>
<td>1</td>
</tr>
<tr>
<td>Uncle Scrooge</td>
<td>1</td>
</tr>
</tbody>
</table>

- Sixty-six percent of respondents knew their preferred characters primarily from television, 12% from books, 9% from movies, 3% from video, 5% from magazines, and 1% from computer software.
- Forty-four percent of respondents owned toys representing at least one of their favorite characters: 46% of these toys had been purchased outside Lebanon (mainly in Europe or the United States).
- Fifty-eight percent of respondents owned videotapes representing at least one of their favorite characters: 46% of these tapes had been purchased outside Lebanon and 64% were Disney tapes (either genuine or pirate).
- Thirty-one percent of respondents owned apparel depicting at least one of their favorite characters: 65% of this apparel had been purchased outside Lebanon.
- Ninety-two percent of respondents read at home, 17% of respondents had read the Journal de Mickey magazine: 38% of these children read it on a regular basis.
- Sixteen percent of respondents read Piscou Magazine: 50% of these children read it on a regular basis.
- Eight percent of respondents read Disney Parade magazine: 43% of these children read it on a regular basis.
- Sixty-seven percent of respondents had at least one video game at home, 44% of whom had Nintendo games and 25% of whom had Sega games. Forty-two percent of these games had been purchased outside Lebanon.
- Ninety-nine percent of respondents lived in homes with a television, 87% lived in homes with a video recorder.

EXHIBIT 9.8 Buying Intentions for Various Disney Products among Lebanese Consumers

<table>
<thead>
<tr>
<th>Disney product</th>
<th>Suggested retail price ($)</th>
<th>% who would buy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minnie T-shirt</td>
<td>23</td>
<td>40</td>
</tr>
<tr>
<td>Baby suit in jeans</td>
<td>27</td>
<td>80</td>
</tr>
<tr>
<td>Baby suit in cotton</td>
<td>27</td>
<td>*</td>
</tr>
<tr>
<td>Aladdin towel</td>
<td>30</td>
<td>60</td>
</tr>
<tr>
<td>Mickey slippers</td>
<td>15</td>
<td>33</td>
</tr>
<tr>
<td>Minnie tennis shoes</td>
<td>15</td>
<td>40</td>
</tr>
<tr>
<td>Mickey toothbrush</td>
<td>6</td>
<td>87</td>
</tr>
<tr>
<td>Aladdin plastic watch</td>
<td>8</td>
<td>20</td>
</tr>
<tr>
<td>Aladdin beach plastic glass</td>
<td>11</td>
<td>33</td>
</tr>
<tr>
<td>Donald Duck school bag</td>
<td>21</td>
<td>40</td>
</tr>
<tr>
<td>Donald Duck plush</td>
<td>30</td>
<td>40</td>
</tr>
<tr>
<td>Abu plush</td>
<td>38</td>
<td>33</td>
</tr>
<tr>
<td>Beauty doll</td>
<td>24</td>
<td>7</td>
</tr>
<tr>
<td>Read-along tape</td>
<td>11</td>
<td>40</td>
</tr>
<tr>
<td>Musical television</td>
<td>50</td>
<td>67</td>
</tr>
</tbody>
</table>

1 This test was conducted in a focus group of parents of children aged 1 to 15 years. Focus group respondents were shown a variety of Disney products and were asked which they would purchase at the prices indicated.

Sixty percent of respondents perceived the value of such apparel by the added value originality would provide. On the other hand, T-shirts, sweatshirts, and accessories were often sold as gifts, and it was thought that gifts would represent a significant share of Disney apparel sales in Lebanon.

At the outset, Disney might work with international licensees to ensure product quality and creative standards. Although Disney apparel made by international licensees would find it hard to compete with low-priced, locally manufactured apparel or low-cost imports from Asia, the company would perhaps be able to penetrate the mass market with small accessories retailing at broadly affordable prices. The dollar sales of such products, if intensively distributed through many retail outlets, could be significant.

Publications

Although such French-language Disney magazines as Le Journal de Mickey and Disney Parade were legitimately being distributed in Lebanon, representing as a magazine category annual sales of about $20,000, picture books were the principal Disney publications. Many Lebanese children were able to understand Disney publications in

EXHIBIT 9.9 Distributor and Retailer Margins by Category

<table>
<thead>
<tr>
<th>Category</th>
<th>Distributor margin (%)</th>
<th>Retailer margin (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apparel</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>Publications</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>Toys/plushes</td>
<td>15</td>
<td>20</td>
</tr>
</tbody>
</table>
French and English (see Exhibit 9.10), but because French was more widely taught as a foreign language than English in elementary school, sales of Disney publications in French were higher.

One major French licensee was distributing a 30-volume series of picture books featuring classic Disney stories like Snow White and Pinocchio; the series was carried by almost every Lebanese bookstore, and a licensee representative was responsible for restocking the inventory. Annual retail sales of Disney publications represented about 10% of the licensee's total sales in Lebanon, roughly $140,000. Its licensing agreement with Disney did not include Lebanon, but Disney did not oppose the sales. They helped increase Disney's brand awareness and introduce the stories and characters to young children. Another French publisher was also selling Disney stories; its license for Disney books was due to expire in 1992 so DCPEME assumed that the publisher was liquidating remaining inventories of Disney books. Any picture book in French, however, faced competition from those starring popular characters such as Babar, Asterix, and Tintin, whose sales significantly outpaced Disney's.

One U.S. licensee sold Disney picture books in English through three local distributors; its annual retail sales in Lebanon were about $125,000. Price competition among the three was tough because there was no exclusive distributor for English-language Disney publications, and the licensee's publications were sometimes retailed at a loss.

Disney had signed licensing agreements with four publishers of books in Arabic. Several Lebanese book retailers had printing capabilities and wished to translate and publish Disney picture books and export them throughout the Arabic-speaking world. They argued that Lebanese printing quality was superior, citing an old proverb: "In the Arab world, Egyptians create stories, Lebanese publish them, and Iraqis read them!"

**Plushes/toys**

Although retail sales of plushes and "figurine"-type toys in Lebanon were estimated at $16 million per year, Disney products were not widely available, for several reasons. First, Disney plushes/toys faced strong competition from both branded and unbranded products in Lebanon. Fisher-Price, for example, whose products targeted the age 3-and-under set, were 30% cheaper than equivalent Disney items. Further, Fisher-Price regularly inserted product catalogs in local newspapers and ran promotions on children's TV shows, offering free samples. Disney advertising was almost nonexistent in Lebanon.

Second, one important Disney licensee in the plush category did not market in Lebanon; the other was restructuring its Lebanon distribution as a result of disagree-

| EXHIBIT 9.10 Percentage of Lebanese Population Able to Understand Foreign Languages by Age |
|---------------------------------------|---------------------------------------|
| Disney target audience (%) | Overall population (%) |
| Under 12 years | 12 years and over | Under 12 years | 12 years and over |
| Arabic | 100 | 100 | 100 | 100 |
| French | 70 | 80 | 50 | 60 |

**Other products**

Most Lebanese were unaware that Disney watches existed, although focus groups indicated that plastic watches retailing below $15 were perceived as affordable and unique. More expensive watches would have to compete with such brands as Swatch and Timex, both widely available in Lebanon. Other categories in which Disney licensees' presence was very limited included home furnishings and food products.

At the same time, all major Disney computer games were available for use on Sega and Nintendo systems, though Disney faced stiff competition from non-Disney action games. Nevertheless, Disney's latest game, Aladdin, had been the 1993 best-seller in Lebanon, selling out after a few weeks on the market. Retailers were also interested in "read-along" tapes, but compact disc sales were limited to the 5% of Lebanese households with CD players.

**Character**

The Disney characters most widely known and appreciated by Lebanese consumers were Mickey and Minnie Mouse, Beauty (of Beauty and the Beast), Snow White, and Ariel (of the Little Mermaid). Concurrent with the release of Beauty and the Beast and Aladdin in 1992 and 1993 respectively, DCPEME had concentrated its merchandising on the principal characters in these films—with great success. With the highly anticipated release of The Lion King in the summer of 1994, DCPEME had high hopes for the Lebanese market: Focus groups revealed that Lebanese youths liked animal-related plushes/toys, and boys especially appreciated the strength associated with lions.

**Distribution**

Fifteen Disney licensees had official distributors in Lebanon, but in many cases, the performance was not monitored closely because the country represented a small market. Given an improved political climate, licensees' interest in extracting more sales from Lebanon was expected to increase. Thus, one of DCPEME's distribution options was to rely on its licensees' current distributors while also encouraging its worldwide licensees not represented in Lebanon to sign agreements with one of these distributors. DCPEME would coordinate the distributors and encourage them to carry more Disney merchandise. Incentives might include establishing an advertising fund, sponsoring shows/special events, and offering Euro Disney entrance tickets and tour packages. The approach, however, was that current official distributors might have the motivation or financial strength to distribute more Disney products, and might be more willing to carry other Disney licensees' product lines; for example, Nintendo, a DCPEME licensee, had a Lebanese distributor who represented only Nintendo.

Another distribution option was to identify existing Lebanese distributors who might sell Disney products not yet present in the market. There were 10 top distr...
in Lebanon in the product categories in which Disney competed; one carried a range of
toy brands including Fisher-Price, Milton Bradley, and Matchbox. A methodical study of
the product line expertise, distribution ability, and financial strength of such distributors
would take 6 months. If DCPEME increased the number of its Lebanese distributors, it
faced the challenge of coordinating and supporting organizations unfamiliar with Dis-
ney products.

In the case of either option, DCPEME would have to determine how to handle re-
quests for exclusivity. Most distributors required exclusive rights in Lebanon for the
items they carried because the market was too small to support competing distributors.
Traditionally, DCPEME encouraged its licensees to test new country markets and dis-
tributors for a limited time before granting exclusive rights. Granting exclusivity to lo-
cal distributors, however, might effectively combat diversion: Lebanese retailers could
currently purchase Disney merchandise from U.S.- or European-Disney licensees’
wholesalers and resell it in Lebanon.

Meanwhile, DCPEME had been contacted by several new distributors wishing to
carry Disney products. One was an 18-store Saudi retail chain selling photographic and
electronics equipment; it was interested in opening a Beirut store offering just Disney
products and in acting as a distributor to other retailers. The chain had no previous ex-
xperience in Lebanese retailing but recently purchased extensive space in Beirut for of-
cices and a showroom, to be run by the current vice president of marketing, a Lebanese
citizen. Despite being advised that it could not have exclusive rights for any Disney
products or use Disney store signage or any Disney character name or logo, the Saudi
retail chain negotiated exclusive rights with 11 Disney licensees to sell a variety of their
products in Lebanon. This merchandise comprised apparel, toys, school supplies, and
gifts items. Other Lebanese distributors could continue to purchase products not in-
cluded in the agreement from the same Disney licensees.

A second distributor had acquired from Disney licensees not yet present in Leba-
non the rights to sell some of their Disney products, and had opened a retail store in
Beirut in December 1993; it also began advertising its Disney products (see Exhibit 9.11
for a sample). Other Lebanese companies—frequently startups with little marketing
expertise—were thought likely to try to acquire rights for certain Disney merchandise
from international Disney licensees not yet distributing in Lebanon.

Finally, DCPEME could license one or more Disney Corners within existing retail
stores. The licensee would lease the space for each Disney Corner from a storeowner.
A Disney Corner would offer the full array of genuine Disney products properly mer-
chandised and would ensure both continuity of supply and the aggressive promotion of
new character-related products as they were launched. A Disney Corner could be a
landmark for Beirut residents, increasing awareness and stimulating gift-giving of Dis-
ney products, while reaffirming company values and enabling DCPEME to market
product not carried by current distributors. Start-up costs for a 1,000-square-foot store-
within-a-store were estimated at $125,000, including $30,000 of initial inventory. Inven-
tory was expected to turn over four times a year and deliver a 30% gross margin.
Beyond the costs, however, was the fact that opening a Disney Corner represented a se-
nious commitment to a market whose potential had yet to be tested. Moreover, prob-
lems could arise with existing distributors of Disney licensees if DCPEME tried to
direct all sales of Disney products through one or more Disney Corners where retail
prices could be controlled.
DCP Organization in Lebanon

If DCPME did decide to expand into Lebanon, should it set up an office in Beirut managed by full-time DCPME employees, appoint a full- or part-time local marketing representative, or run Lebanon out of its Saudi office? An office would coordinate distributors’ advertising and promotion efforts and mediate among them when necessary; ensure that DCPME received all royalties to which it was entitled from sales of Disney merchandise; act to stop sales of pirated products or unauthorized imports; sponsor special promotional events; and in the long term, identify potential local manufacturers of licensed merchandise. Setting up an office in Beirut with full-time DCPME employees would probably cost about $250,000 in the first year, whereas appointing and managing a half-time marketing representative would add perhaps $100,000 to DCPME costs in 1994.

CONCLUSION

Jeremy Carter faced some tough choices. Should DCPME enter the Lebanese market, and if so, how? Which products should be introduced, in what sequence, and through what distribution channels? How would copyrights, piracy concerns, and other protection issues be handled? Should Disney open an office in Beirut? The rewards in Lebanon seemed possible, but so did the risks.

CHAPTER 10

RECAPTURING MARKET SHARE

EMDICO (A)

On August 2, 1990, Iraqi forces invaded Kuwait. Fortunately, D. Srinivasan, marketing manager with Fuji Film’s distributor in Kuwait, was visiting the United States at the time. However, when he returned to Kuwait in March 1991 after the end of Gulf War, he found his house ransacked. After several months visiting with his family in India, Srinivasan returned to the region late in 1991 as general manager of EMDICO (Emam Distribution Co., Ltd.) in Jeddah, Kingdom of Saudi Arabia (KSA). EMDICO was Fuji’s newly appointed Saudi Arabia distributor.

In his new role, Srinivasan had to develop a marketing strategy to relaunch the Fuji film and camera product lines among others in Saudi Arabia. Srinivasan set out to convince management in Tokyo that they had made the right decision in appointing EMDICO. Their confidence would, he hoped, result in some monetary support to subsidize his marketing strategy and in the timeliness and availability of Fuji product shipments from Japan to Saudi Arabia.

THE KINGDOM OF SAUDI ARABIA

Founded in 1932 by King Abd Al-Aziz, the Kingdom of Saudi Arabia was a country one-third of the size of the United States with a population of 17 million in 1991. The population had been only 3.2 million in 1950 and was expected to double by 2010. As shown in Exhibit 10.1, Saudi Arabia dominated the Arabian peninsula. Around 75% of the population lived in urban areas. The most important cities were Riyadh (two million) and Jeddah (two million). A quarter of the population were expatriates, principally Egyptians, citizens of other Arab countries, and nationals from the Indian subcontinent. Only one-quarter of the expatriates were accompanied by other family members.

The combined population of the countries in the Middle East region, as defined by Fuji, was about 100 million in 1991.

Doctoral Candidate Yoshinori Fujikawa prepared this case under the supervision of Professor John A. Quelch as the basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation. Confidential data have been disguised.


TABLE 10.2 Film Processing Speed Requested

<table>
<thead>
<tr>
<th>Speed</th>
<th>Saudi Arabia (%)</th>
<th>United States (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Hour</td>
<td>85</td>
<td>35</td>
</tr>
<tr>
<td>7 Hours</td>
<td>10</td>
<td>40</td>
</tr>
<tr>
<td>Overnight</td>
<td>5</td>
<td>25</td>
</tr>
</tbody>
</table>

Cultural norms affected the prevalence of photography. Women could not normally have their pictures taken or take pictures themselves. Weddings, however, would almost always be recorded, but only by women. Family portraits might also be taken at photo studios. However, concern that a stranger in a film-processing laboratory might see a woman unveiled or, worse, duplicate a photo being processed, limited this practice. For these reasons, a family that visited a photo studio for a portrait often preferred to wait until the pictures were developed. Consumer surveys in Saudi Arabia and the United States found the following differences in speed of film-processing service requested (see Table 10.2).

On the other hand, the mix of subjects that consumers chose to photograph was similar in the two countries, as shown in Table 10.3.

TABLE 10.3 Selected Photo Subjects

<table>
<thead>
<tr>
<th>Subject</th>
<th>Saudi Arabia (%)</th>
<th>United States (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>People</td>
<td>60</td>
<td>70</td>
</tr>
<tr>
<td>Nature/landscape</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Buildings</td>
<td>10</td>
<td>14</td>
</tr>
</tbody>
</table>

FUJI FILM BACKGROUND

Fuji Photo Film Co., Ltd., headquartered in Tokyo, Japan, was one of the world's leading manufacturers and marketers of photographic film, cameras, photo papers, and magnetic tapes. Net sales in 1990 were $8 billion.

Fuji organized its product lines into three groups: imaging systems (37% of worldwide sales), photofinishing systems (23%), and information systems (40%). The most important single product line was the Fujicolor series of color negative films and the biggest selling item was the Fujicolor Super HR 100, ideal for everyday photography. Fujicolor Super film was available in other speeds (HG 200, HG 400, and HG 1600). Fuji REALA was a color negative film that delivered colors as seen by the human eye. Fuji Chrome VELVIA color reversal film was for professional use. NEOPAN black and white film, used especially for sports and press photography, was available in three speeds.

The imaging systems group also offered a broad selection of cameras, from simple point-and-shoot compact cameras such as the FZ-5 and DL-25, to the FZ-3000 with its binocular-style body and dynamic 38mm to 115mm zoom lens. The range also included sophisticated professional models. Fujicolor Quicksnap disposable cameras were launched in 1985, followed in 1987 by Quicksnap Flash and Quicksnap Marine. Also included in the product line was the FOTORAMA instant ID photo camera.

The photofinishing systems group sold photographic paper in a wide variety of surfaces and sheet sizes, photofinishing equipment, and chemicals. Fuji pioneered the development of a compact and durable minilab, the FA Compact II. Although slower than the minilabs made by Kodak and Konica, it was more compact, better designed, and easier to service.

The information systems group sold materials and equipment for printing industries, medical imaging products, office automation systems, floppy disks, and computer tapes. Fuji was especially strong in digital medical X-ray imaging systems that it sold to large and mid-sized hospitals worldwide.

In Japan, Fuji's bright green packages were as ubiquitous as Kodak's yellow packages were in the United States. In 1990, Fuji accounted for 70% of film sales, 20% of camera sales, and 15% of magnetic tape sales in Japan.

Around 25% of Fuji's sales were generated outside Japan. Fuji's sales in the Middle East were around $150 million, 2% of Fuji's total revenues and 8% of Fuji's overseas sales.

Fuji typically entered new consumer markets with its film product line, followed by its cameras. Fuji often offered its basic products first, adding the more expensive and specialized items in its lines as demand increased. In Saudi Arabia, for example, 80% of Fuji film sales were of the popular 100-film speed, compared to 45% in the United States. Recently, sales of the FA Compact II minilab to photo studios and other outlets had helped Fuji penetrate the major cities of several developing markets, where Fuji often found itself playing catch-up to Kodak.

KSA MARKET STRUCTURE

As shown in Exhibit 10.2, around 6 million rolls of color film were imported annually into Saudi Arabia between 1984 and 1989. At 6 million rolls per year, the KSA film market was 2% the size of the U.S. market while Saudi Arabia's population was 7% that of the United States. The disparity was attributed to lower per capita disposable income and cultural constraints on picture taking. In 1990, the Iraqi invasion of Kuwait disrupted shipping in the Gulf and only 2.9 million rolls were imported. As part of the post war recovery process, some 4 million rolls of film were expected to be imported into Saudi Arabia in 1991, up 35% from 1990. This figure partly reflected the high level of inventories already held by distributors and retailers in Saudi Arabia.

No film or cameras were manufactured in Saudi Arabia. All were imported by Saudi distributors who each exclusively represented a single brand. They marketed the imported products to a variety of channels, typically taking a 15% margin on the selling price. In 1991, the KSA import tariff on film and cameras was 12%.

As shown in Exhibit 10.3, Kodak and Konica were locked in a tight competition for market leadership in film sales. Konica was also the number five brand in unit camera

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1 A minilab consisted of a film processor for developing the film and a printer that transmitted the images to photo paper. The word "minilab" was used interchangeably for a machine itself as well as for a store using a minilab machine on site. By 1991, there was one minilab for every 12,000 people in the United States.
sales. Of the 2,400 outlets in Saudi Arabia through which film was sold, only 30 sold Kodak exclusively and 30 Konica. The remaining outlets were not tied to any one brand; few outlets, however, carried more than two brands of film. Cameras were sold by about 700 of the 2,400 outlets selling film.

As indicated in Exhibit 10.4, photographic studios accounted for 25% of film sales but only 5% of cameras. Camera and electronic stores retailed 65% of cameras and 30%

EXHIBIT 10.4 KSA Distribution Channels for Film and Cameras, 1991

<table>
<thead>
<tr>
<th></th>
<th>% film sales (units)</th>
<th>% camera sales (units)</th>
<th>Total number of dealers</th>
<th>Number of Fuji dealers</th>
<th>Fuji dealer penetration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Studios</td>
<td>25</td>
<td>5</td>
<td>1,542</td>
<td>308</td>
<td>20</td>
</tr>
<tr>
<td>Minilabs</td>
<td>35</td>
<td>20</td>
<td>216</td>
<td>66</td>
<td>30</td>
</tr>
<tr>
<td>Camera/electronics stores</td>
<td>30</td>
<td>65</td>
<td>218</td>
<td>22</td>
<td>10</td>
</tr>
<tr>
<td>Supermarkets</td>
<td>5</td>
<td>—</td>
<td>284</td>
<td>48</td>
<td>17</td>
</tr>
<tr>
<td>Industrial/hospital</td>
<td>—</td>
<td>—</td>
<td>460</td>
<td>46</td>
<td>10</td>
</tr>
<tr>
<td>Others</td>
<td>5</td>
<td>10</td>
<td>100</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>2,820</td>
<td>496</td>
<td>18</td>
</tr>
</tbody>
</table>

of film. One-third of film was sold by minilabs that provided on-premise processing in less than an hour. In addition, a few supermarkets served as convenient collection points for used films that were then sent to wholesale labs for processing.

There were 216 minilabs in Saudi Arabia in October 1991. The Konica distributor in Saudi Arabia had sold the most minilabs to date. The smallest Konica minilab sold for SR 250,000 and required the retailer to make a 50% down payment. Minilab models varied in the speed and quantity of film they could process at any one time. Most minilabs could process any brand of film and many sold two or more brands of film, not just the brand associated with the minilab. Profile information from a market research study on minilabs in Saudi Arabia is presented in Exhibit 10.5. Srinivasan also developed the economic projections shown in Exhibit 10.6 for dealer interested in buying the Fuji FA Compact II minilab. Srinivasan believed the breakeven point on the cheapest Konica minilab required the processing of 20 films per day versus 13 for the Fuji machine.

EXHIBIT 10.5 Profile of Minilabs in Saudi Arabia, October 1991

- Of the 216 minilabs in Saudi Arabia, 85% were in stand-alone retail outlets and 15% were in supermarkets.
- In 20% of the retail outlets with minilabs, more than one minilab was installed.
- Seventy percent of KSA minilabs were in photo studios, which typically derived 20% of their revenues from portrait photography.
- On average, 75% of a minilab’s revenues were derived from photofinishing and 25% from retail sales. Of retail sales, 60% were from film, 20% from cameras, 10% from batteries, and 10% from items such as albums, frames, and videotapes.
- Eighty percent of all KSA minilabs were concentrated in Jeddah and Riyadh.

FUJI’S MARKET POSITION IN SAUDI ARABIA

Because Fuji film was sold in Israel, Fuji was blocked from doing business in the Middle East until the Arab boycott was lifted in March 1983. Meanwhile, Kodak had been selling in Saudi Arabia since the 1960s and Konica since the 1970s.

Once the boycott was lifted, Fuji asked Mitsui Corporation, a Japanese trading company, to identify exclusive distributors in all Middle Eastern countries. In 1984, Fuji
to expire within 3 months. Some dealers had suggested privately to Srinivasan that they would appreciate EMDICO replacing the expired film with new stock at no charge.

### The 1992 Marketing Plan

Negotiations between EMDICO and Fuji management resulted in the market growth assumptions and sales goals for 1992 through 1995 summarized in Exhibit 10.2. Should these goals not be reached, Fuji reserved the right to reassign the distributorship after a minimum period of 2 years. Srinivasan’s mission was to develop a marketing plan that would meet Fuji’s objectives yet, at the same time, make money for EMDICO. Srinivasan estimated EMDICO’s minimum 1992 general and administrative overhead associated with the Fuji distributorship at SR 400,000. He believed that EMDICO was well-placed to compete for 2-year government contracts to supply medical X-ray film to hospitals. His focus, therefore, was on improving Fuji sales to consumers that he expected would account for 80% of EMDICO’s Fuji related revenues over the next 5 years.

### Resolving the Issues

#### The Announcement

Opinions differed about how intensively the December 7 public announcement of EMDICO’s appointment should be leveraged. A local agency proposed a press conference in Jeddah to which journalists and 300 top dealers would be welcomed by Srinivasan, his new management team, and senior Fuji managers from Japan. Fuji’s relaunch strategy would be announced at this event. The cost estimate was SR 120,000 plus an additional SR 30,000 if advertisements were placed in the major national newspapers. The proposed newspaper advertisement is presented in Exhibit 10.9. Alternatively, the announcement of EMDICO’s appointment could simply be mailed to all dealers in Saudi Arabia at a cost of SR 10,000.

#### Geographical Coverage

Srinivasan had to decide where to focus his initial relaunch efforts and how rapidly to roll out nationwide, if at all. The three options he considered were to concentrate on Jeddah (which accounted for 23% of KSA film and camera sales and 18% of retail outlets selling film and cameras); to focus on the 10 largest cities in Saudi Arabia including Jeddah with a combined population of 13 million (and which accounted for 50% of KSA film and camera sales and 85% of retail outlets selling these products); or to launch nationwide. To meet the sales targets set by Fuji management, he was inclined to go national as soon as possible.

#### Communications

The 1992 communications budget depended on the geographical coverage and aggressiveness of the roll-out plan. Srinivasan believed his first priority should be to reestablish awareness of the Fuji brand. He therefore planned to use roadside signs (known as mupi boards) and billboards in the first half of 1992 and, possibly, to supplement these

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1. Fuji applied an expiration date 2 years from date of production to all its film packages. Beyond the expiration date, the quality of the film could not be guaranteed.
2. It was estimated that half of these dealers would be among those already carrying Fuji.
for inside the stores, and Fuji tape for the perimeters of shop windows and display cabinets, would be SR 600. Srinivasan planned to use the slogan "You can see it's Fuji" in Arabic and English on the in-store ceiling danglers. He also wanted to print special envelopes for Fuji film processed in Fuji minilabs with the slogan "Quality prints in record time." In addition, EMDICO delivery vehicles prominently carry the Fuji logo.

As part of the communications and distribution strategy, Srinivasan had all but decided to establish a flagship, company-run retail outlet to be called Fuji Image Plaza in the forecourt of the Safeway supermarket, the most modern, high traffic store in downtown Jeddah. The space would cost SR 15,000 per month and operating costs would be SR 5,000. The store would be run as a photographic studio, the full Fuji product line would be displayed and sold, and a Fuji minilab would process film and be available for dealer demonstrations. The initial investment in fixtures and equipment would be SR 180,000. A perspective view of the proposed store is presented in Exhibit 10.10.

**Product Mix**

Srinivasan had to decide whether the sales targets required him to launch the complete line of Fuji films (some 15 items) and cameras (12 models) as soon as possible or whether he should focus, at least initially, on selected, higher volume items (say 4 types of color film and 3 camera models). The latter approach might ease inventory management but send a negative signal that Fuji was not a full-line supplier.

Srinivasan was also considering three alternative product rollout strategies. The first was to simultaneously relaunch both films and cameras given that purchase of one typically stimulated purchase of the other. Advocates argued that promotions on cameras could be used to persuade dealers to stock Fuji films. The second option was to initially focus on rejuvenating film sales and to delay promoting cameras until at least the second half of 1992. A third option was to build the relaunch around minilabs sales on the grounds that dealers who installed Fuji minilabs would be inclined to stock and push Fuji film and cameras. The FA Compact II seemed like a marketable product, but Kodak and Konica might respond to any Fuji sales initiative by offering more attractive terms on their minilabs.

**Pricing**

The anticipated margin structure for Fuji film, cameras, processing, and minilabs is shown in Exhibit 10.11. Srinivasan was contemplating retail prices on Fuji film at about 5% below Kodak and 5% above Konica. Srinivasan had to take into account Fuji's current image in the market, the need to signal the brand's true quality, and the importance of not provoking a price war.

**CONCLUSION**

As December 7 approached, the date set for the public announcement of EMDICO's appointment, Srinivasan pondered his options. As indicated in Exhibit 10.2, Fuji management had set some ambitious sales goals for EMDICO from 1992 to 1995. This suggested the need for an aggressive relaunch of the brand beginning with a high profile press conference. On the other hand, the possible reactions of the previous distributor and of Kodak and Konica were a source of concern. Perhaps a lower profile relaunch and a gradual rollout were preferable. In either case, details of the marketing program for the relaunch had to be determined.
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