



University  
of Victoria

**PETER B. GUSTAVSON**

School of Business

The world looks different from here.



Photo: Carly Paracholski – Azores, Portugal

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**BACHELOR OF COMMERCE  
BEST BUSINESS RESEARCH PAPERS**

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## Note from the Editor

International experience, cross-cultural awareness, and critical thinking skills are essential for professional success in today's globalized and complex business world. The UVic Peter B. Gustavson School of Business is *international at heart*, hence it comes as no surprise that every year more than 70% of our Bachelor of Commerce (BCom) students participate in an **international exchange program**. While overseas students attend classes at a partner university and develop their professional and personal networks, but most importantly, they explore. They not only experience new cultures and engage in the local society, but also learn how business works abroad. The *International Business Research (COM470)* course is a great way to engage in a **deep analysis of foreign business** practices.

This year we asked our students to focus on specific challenges business organizations face on their local markets or while expanding overseas. The papers cover not only a very wide range of issues – corporate social responsibility, human resource management strategies, money laundering, aging workforce, and many more, - but also span over three continents: Asia, Europe, and North America. The top COM 470 papers continue to be showcased (since 2008) in a published collection titled **Best Business Research Papers**. Past papers have discussed subjects such as candy marketing, and chocolate and automobile manufacturing, to Chinese credit cards and Czech telecommunications. Regardless of the focus, these **best-in-class** papers highlight the experience our students gain through significant and thoughtful research with a focus on business around the world. We also hope that these excellent papers inspire more students to participate in the exchange program and to engage in international business research.

The UVic Gustavson School of Business is proud to present these best research papers from our 2015-2016 COM 470 students. As always, this would not be possible without the hard work of a group of dedicated individuals. Thank you to the International Programs team of Dr. A.R. Elangovan, Director; Brian Leacock, Associate Director; Jane Collins, Manager, International Exchange; Elsa Yan & Radhika Nair, Outgoing Exchange Student Advisors; Allen Sun, International Recruitment Officer and China Specialist; Christina Hernandez, International Student Advisor; Giordi Giacomelli, International Programs Clerk; Audrey Audebert, BCom Advising Officer; and to Shannon Perdigao, Academic Projects Officer, for coordinating and compiling Volume 9 of the BCOM Best Business Research Papers.



**Mike Szymanski**

COM 470 International Business Research Instructor  
Editor, *Best Business Research Papers, Volume 9*

## International Business Research Experience

*Japan is a very unique country in many ways, and the histories of the long-standing companies are no exception. There is a common believe that CSR is lacking in Japan, so I was curious to find a company that exemplified what Japanese classic CSR practices are as well as innovative ones. I owe much thanks to Professor Scott Davis at Rikkyo University, as his vast knowledge of Japanese CSR practices and culture, as well as the resource she provided me were an enormous help during this process. This project was a great opportunity to deepen my understanding of Japanese CSR practices, culture and a chance to reflect and think about how these best practices could translate into the Western style of CSR.*

**Katlin Aarma**

*Sitting at a plain white desk in my new apartment, I contemplated what I had just done. Over the course of twenty-four hours, I had traveled over eight thousand kilometers to the capital city of Austria. In this strange, yet breathtakingly beautiful city, I knew nothing of the customs, I could not speak the language, and, besides two other exchange students, I knew no one. I could not keep myself from thinking, what have I done? What's more, I had to begin researching a business phenomenon within the context of this strange new country, a country to which my knowledge was limited to the First World War. The task was exciting, but daunting all at once. Throughout my research, I was able to not only glimpse into the business context of Austria, but also gain valuable insights into the culture and attitudes of the local people. I am not so naïve to say that researching a local company can give you a comprehensive understanding of a country or people, however it is an excellent start. Overall, the research process provided me with a deeper appreciation for Austria, its culture, and its incredible people.*

**Carson Bell**

*I thoroughly enjoyed the process of conducting research regarding the topic of money laundering whilst being on exchange at the University of St. Gallen in Switzerland. The research process strategy I used was to gather as much credible information as time allowed. I learned that this was the best way to gain insight from various perspectives and to really become in tune with the complex issue of money laundering. Overall, the research process went very smoothly due to living abroad in a country considered to be one of the largest international financial centres in the world; resources were easy to find. Lastly, I must credit my fascination and inquisitive nature towards exploring the topic of money laundering for making my international research experience successful.*

**Karlina Fortier**

*My international research experience was easier than I had anticipated and allowed me to open up my learning experience to new perspectives. Living in Austria, while simultaneously researching their culture and work place views, gave me the opportunity to broaden my perspective and add to my research in a way that would not have been possible back in Canada. In today's globalized world it was not difficult to find information and sources for my research, however being abroad aided in my work being less biased or too narrow in focus. I would definitely recommend international research for students as it exposes you to unique experiences distinct from traditional learning.*

**Megan Griffin**

*While I was on academic exchange, I found my international research experience to be engaging and fun. The inspiration for my topic derived from when I toured a perfume factory in Grasse, France, the perfume capital of the world. I learned about the history of the perfume industry and the importance that the company Chanel brought to the industry and to the region of Grasse. I began to research the company online to gain more of a base understanding. I was able to take fashion and luxury goods management courses at SKEMA Business School, and these courses were extremely applicable to the topic of my paper. I found it interesting and useful to speak with professors in the industry, and to use their knowledge and the concepts learned in class as a source for my paper.*

**Andrea Jones**

*I'm a 4<sup>th</sup> year Bachelor of Commerce student at the Peter B. Gustavson School of Business at the University of Victoria. I wrote this paper while studying on exchange at the University of Economics, Prague. I was introduced to Pilsner Urquell on my first day in the Czech Republic when a local student greeted me at the airport with two tall cans of the beer and a Kolonada – a traditional Czech wafer filled with hazelnut or chocolate. This pairing soon becomes my late night snack of choosing for the succeeding months. I was inspired to research and write on beer, as it was a constant topic of conversation amongst Czech's along with Hockey and the cold weather. Crack open a cold one and enjoy.*

**Bowen Macy**

*Being able to do research on a company such as Volkswagen while in Germany was the best complement to my international experience. I would not have had the opportunity to work with such a globally recognized company if it had not been for this process. My favourite part of the research was my hands on experience at the Volkswagen headquarters. I was able to view the production line of the Volkswagen Golf from beginning to end and the personal opportunity solidified my interest in my research topic. While, I was very fortunate to work with Volkswagen, I know that if this opportunity did not arise I would have had to spend a lot more time researching the country.*

**Riley Paddock**

*Researching and writing about a business in China came with many challenges, however, upon completion it came with an incredible feeling of accomplishment. The greatest obstacle I faced while completing my international research was the Internet in China, which some days chose not to work at all and other days chose to work on a "selective" basis. There was an obvious lesson to be learnt from this and that was that researching China from within China comes with unique difficulties. The highlight of my research experience was my visit to the Lululemon store in Hong Kong, where I was able to witness the company's growth into a foreign market first hand. Writing a research paper while on exchange was a fantastic opportunity to leverage skills that have been under development throughout my undergraduate degree and I have come out of the experience with a piece of work I am very proud of!*

**Lorna E. Richards**

# Sumitomo Chemicals in Japan and Africa:

## Differences between active-transformational and passive-transactional CSR initiatives

Katlin Aarma

### ABSTRACT

The Olyset Net is a revolutionary malaria preventative bed net. Its fibers are tear-resistant, fast-drying, and porous on the inside as they are filled with mosquito repellent. Its slow-release of the repellent enables it to last for five years upon installation, and was the first of its kind to be created. Sumitomo Chemical, the Japanese firm behind the technology, could have reaped the rewards by placing a high dollar patent on the product and sold the net themselves to the malaria stricken countries. Instead they invested in the local Tanzanian economy by providing the Olyset technology royalty-free to A to Z Textile Mills in 2003. Two years later, their partnership turned into a 50:50 joint venture under "Vector Health International", building a R&D research facility while A to Z Textiles runs production in two factories in Arusha and Kisongo. Sumitomo Chemical enabled a positive economic impact in these communities resulting in an increase overall production for A to Z Textiles and creating an additional 8,000 job opportunities for Tanzanians. Sumitomo Chemical also has provided various support initiatives for those affected by the "Great East Japan Earthquake", supporting the reconstruction of various Japanese communities affected. This case demonstrates the difference between two Corporate Social Responsibility strategies (active-transformational and passive-transactional initiatives) by presenting two different examples of Sumitomo Chemical's CSR initiatives. Furthermore Sumitomo Chemical's CSR structure will be compared to the foundations of the Japanese CSR.

### INTRODUCTION TO SUMITOMO CHEMICAL

#### Sumitomo Corporation: the Parent Company

Sumitomo Chemical is under the parent company Sumitomo Corporation. Sumitomo Corporation's origins date all the way back to the Edo Period, at the time when its founder Masatomo Sumitomo (1585-1652) in the 17th century had opened a medicine and book shop in Kyoto. The concept of proper business etiquette was present in Sumitomo from the beginning, as he wrote the "Founder's Precepts" describing the importance of developing trust with all stakeholders, and focused on conducting business with honesty, prudence, and sound management as oppose to profit-maximization. During the Edo Period (1603-1868) Japan was one of the leading producers of copper in the world. Masatomo's extended family member, Tomomochi Sumitomo (1607-1662) had opened the "Besshi Cooper Mines" in 1671, and expanding as a lead trader in thread, textiles, sugar and medicine. This was the backbone of Sumitomo's business, as they continued operations for 283 years. Masatomo's philosophies were congruent in all of Sumitomo's future business actions. As Sumitomo survived through the Meiji Restoration, First and Second World War, they gained significant market share and affluence in various sectors of business that they are known for today. Their areas of expertise and product lines include: Metal Products, Transportation, Construction, Environment, Media, Network, Lifestyle Related Goods and Services, Mineral Resources, Energy, Chemical and Electronics.

## **Sumitomo Chemical**

Sumitomo Chemicals was established in 1913 in order to manufacture fertilizers from the sulfur dioxide emitted from the operations at the Besshi Copper mine. At the time, the goal was to reduce the environmental impact that the emissions had caused. It is now a multi-national corporation, with a total net income of 52.2 Billion Japanese Yen and a combined total asset worth of 2,880.4 billion Japanese Yen for the most recent fiscal period March, 2015 (financial statements can be viewed in Exhibit 1#). They currently have 31,039 employees as well as over 100 subsidiaries and affiliates, specializing in hybrid chemistries, such as plastics technology and insecticide manufacturing (Sumitomo Chemicals, 2015). They focus on producing innovative technologies that create sustainable developments that ultimately help solve environmental and social problems, locally and internationally (Jennings, 2011).

## **A to Z Textile Mills Ltd.**

A to Z Textile Mills Ltd., was founded in 1966, Arusha, Tanzania by the Shah family. They began operating as a small garment manufacturer, moving into the manufacturing of polyester bed nets in 1978. It is now one of the largest vertically integrated plants in East Africa, with their product lines including Bed Nets, Garments, Mineral Water Plastics, Polypropylene Woven Bags, Specialty Mesh, Agriculture & Horticulture and Value-Addition Services. The company has had a long-standing presence in the textile and plastic industry for decades, but they attribute their international recognition to the manufacturing of Olyset Net's. A to Z runs two factory plants, "A to Z Unga Ltd Area Factory", located in Arusha and "A to Z Kisongo Area Factory" located in the neighbouring village of Kisongo, for the production of their products.

A to Z Textile Mills Ltd has focused on conducting business in a socially reliable manner, in order to positive impact to customers by increased accessibility to vector control and public health solutions. By striving for the lowest time-to-market, they have established progressive, long-term partnerships with suppliers, such as Sumitomo Chemicals in order to source the raw materials to maintain a timely network distribution of their products. The relationship between the two requires a fair amount of trust, as Sumitomo Chemicals is dependent on A to Z to manufacture and distribute the product, while A to Z requires the raw materials four months in advance to deliver the products in a timely manner. For their employees they aim to attract and retain productive employees by fostering positive moral, encouraging innovation and creativity and treating one another with respect and honesty.

## **A Partnership is Formed: Vector Health International**

The beginnings of the partnership between A to Z Textile and Sumitomo Chemical began in September, 2003, when Sumitomo Chemicals provided A to Z Textile Mills Ltd with a royalty-free technology transfer of the Olyset Net. In 2005, the 50:50 joint venture legal entity Vector Health International was formed between the two companies. The production of the Olyset Net's was then transferred to A to Z Textile Mills. Vector Health International is the link between the two companies for informational transfer. In 2012, Vector Health built a state of the art R&D facility, Africa Technical Research Centre (ATRC), in Kisongo. ATRC aims to improve the livelihoods and quality of life by improving and developing innovative products. The centre is broken up into four parts: Vector Biology, Agronomy, Analytical Chemistry, and Molecular Biology. They test the efficacy of the agricultural pest and vector control products (including the Olyset), as well as conducting chemicals analysis for further products (full press release can be found in Exhibit 2#).

### **The Product: Olyset® Net**

Before Olyset, the only types of bed nets available in the prevention of malaria were the “coated” polyester nets, where the insecticide is applied directly on the outside of the net and regular polyester nets, which require regular six month re-treatment of the insecticides from the user. Coated nets last a total of three years, as over time with repeated washing and use, the concentration of the repellent lessens.

The technology behind the Olyset Net was created by Sumitomo in 1978, and was meant to create a long-lasting insecticidal affect so the users would not have to regularly treat their bed nets with insecticides. The insecticide used to treat the Olyset Net is permethrin, and is actually put inside the fibers of the bed net itself, therefore no reapplication of insecticide is needed on the outside of the fibers. Since the fibers of the Olyset Net are a blend of polyethylene (flexible plastic) and permethrin, the result is a regular dispersion and continual supply of the repellent for five years. This classifies the Olyset Net as a “Long Lasting Insecticidal Net” or more commonly referred to as LLIN. Even as the top layer of the Olyset Net is worn through wash and wear, the insecticide surfaces from the inside of the filaments in order to maintain a controlled, steady dispersion. The plastic fiber itself is very durable, resistant to tears and dries more quickly than its polyester counterparts.

The effectiveness and convenience the Olyset Net did not go unnoticed. The World Health Organization approved it’s usage to combat malaria in October 2001. It was the first of three LLIN’s to have a full WHO recommendation, passing the four tests to ensure efficacy and longevity. (Jennings, 2011) To date WHO has approved a number of technologies from specific LLIN manufactures.

The main suppliers and brands of LLINs are:

- BASF (Interceptor®)
- Bestnet Europe (Netprotector®)
- Clarke Mosquito (DuraNet®)
- Sumitomo Chemical (Olyset®)
- Tana Netting (DawaPlus®)
- Vestergaard (Permanet®)

Olyset, DuraNet and Netprotect are the polyethylene varieties. The others, Permanet, DawaPlus and Interceptor are polyester based. (USAID, 2007) Of all the LLIN manufacturers, Olyset to date is the only manufacturer operated and located in Africa.

## **BACKGROUND OF THE AFRICAN MARKET**

### **Overview of Malaria in Tanzania**

Malaria in Tanzania is a widespread pandemic. With a total of 43.2 million habitants at risk, 14-18 million episodes of malaria are recorded annually and 120,000 deaths occur annually in Tanzania, making it the largest disease related burden for the government. Studies have estimated that 39% of the total health expenditure of Tanzania and approximately \$12 billion US annually from the GDP is devoted to fighting the disease (Jowett & Miller, 2005). Furthermore, more than half of the deaths of children under the age of five are caused by Malaria, according to Tanzania’s Ministry of Health (Kaufman, Rweyemamu, Koenker, & Macha, 2012).

Historically, Malaria in the 20<sup>th</sup> century had seen a decline from 1990-1970 from 223 to 107 per 100,000 people of malaria caused deaths occurring. However, the genetic mutation of the malaria parasite, Plasmodium Falciparum, made it resistant to anti-malaria drugs in 1970. Since then, the deaths have risen to 165 per 100,000 people, reversing over 30 years of progress that had been made (Refer to Exhibit 3#, Chart) (Jowett & Miller, 2005).

Currently there are three main malaria prevention tools used in Tanzania:

1. Indoor residual spraying (IRS)
2. Anti-malaria drugs
3. Bed nets (Regular or Long Lasting Insecticide Nets LLNIs)

As mentioned above, the Olyset Net falls into the third “Bed net” category as a LLNI.

### **Financial Costs of Malaria**

The funding for combating Malaria in Tanzania is comprehensive, as there are three main sources of malaria-related invention expenditures:

1. The Tanzanian Government (Ministry of Finance, MoF and Ministry of Health, MoH)
2. Donor Organizations (non-governmental, multilateral and bilateral)
3. Households

In 1998/99 it was estimated that the majority of malaria spending is from households at 71%, the Tanzanian Government at 20% and the remaining 9% is donor funding. The largest expenses were bed nets (46%) and anti-malarial drugs (33%) (Refer to Exhibit 3#, Figure) (Jowett & Miller, 2005).

### **Households**

At the individual level, it is estimated the cost of fighting malaria for a working adult is between one and five days of work at an average of \$15.5US per household (6% of annual income). This does not include the variability of the distance and fee transportation to closest health facilities as well as taking care of younger ones who fall ill. (Kaufman, Rweyemamu, Koenker, & Macha, 2012).

### **The Tanzanian Government**

In terms of the government, cost efficiency is the priority for the majority of malaria control interventions, as it is estimated they cost less than \$100/ DALY averted.<sup>1</sup> (Hanson, 2004). Furthermore, of the 20% contribution to the total malaria control expenditures, the majority are in-kind form as opposed to cash. (Alidina, et al., 2015) This makes it very difficult for the local infrastructures, and businesses to be able to depend on their government for support in the battle. There are also large information gaps in the system that lead to inefficiencies. For example, up to \$10 million dollars was spent annually treating all fevers as if it were malaria, when in reality it was around half (Jowett & Miller, 2005). The reality is that companies cannot rely solely on the government, as they do not provide adequate support for business development in Tanzania.

### **Donor Funding**

Donor funding from any non-governmental enterprise, multilateral (unrestricted funds that are wholly or partially developmental or humanitarian in their mission), or bilateral (funds given to a developing country government from other donor countries) also accounts for a portion of the funding spent on malaria

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<sup>1</sup> The Disability-Adjusted Life-Year (DALY) is the primary metric used by WHO measuring the burden of morbidity (non-fatal health concerns) into a single number.

prevention projects. A significant amount of the initiatives taking place in Tanzania to combat Malaria rely upon the funding of external donors to sustain their enterprises. (Alidina, et al., 2015)

### **Problems with Donor Procurement Policies**

A to Z Textile's looks mainly to procurement policies for security of their assets. The ultimate goals of donor procurement policies are to achieve the greatest impact while doing so in the way that is most cost efficient way. Differing priorities such as accountability and transparency when receiving or giving funds and ensuring cost efficiency in delivering goods or service are the main areas they focus on promoting.

The Procurement policies in Tanzania currently in place do not prioritize sourcing locally-manufactured goods, as they encourage acquiring the most cost-efficient Free on Board<sup>2</sup> price and quickest delivery, leaving out A to Z Textiles, who is very close in proximity in the consumer market. Therefore major donors have had the tendency to gravitate towards products that are FOB versus delivery duty unpaid (DDU) or delivery duty paid (DDP) for product quotes. As a result, narrow guidelines have been drawn that do not address the broader developmental goals that projects such as A to Z Textiles' Olyset Net LLINs address, and therefore encourage cost-efficient production companies such as those in South-East Asia. (Jennings, 2011) These goals need to be prioritized and compensated for in order to build up the manufacturing capacity, which in turns builds the economic development, such as new infrastructure, education opportunities for the younger generations and generating more employment for Tanzania.

### **Is the Olyset Net Sustainable?**

Questions remain as to whether "Olyset Net" will be sustainable for the future. Currently A to Z Textile's annual production capacity for the Olyset Net is 30 million. As it was the first on the market of its kind, the demand soared and Sumitomo Chemicals and A to Z Textiles experienced great success from 2005 onwards. As time has moved on, other competitors have been quick to adapt their product lines to match the Olyset Net and provide it at a lower cost.

Secondly, the concerns that the interests of the donor are price driven have implications for the futures of the employees of A to Z Textiles and Vector Health, ultimately putting the production of the Olyset Net at risk. The financial landscape for the African manufacturing companies is heavily dependent upon donor funding, as the Tanzanian government provides little to no support for these companies. Furthermore, this is compounded by the fact that the procurement policies in Tanzania favour the most cost-efficient FOB price, therefore leaving A to Z Textiles out and guiding donors towards lower priced products overseas.

As the Director of A to Z Textiles, Anuj Shah describes:

*Donors are looking at the price. If the price is going to be cheap they are going to get the nets. The goal is "this is what we want. This is the programme, how many nets have been delivered, how much money has been given, have we reached our target?" But this is an African company, an African manufactured net. The problem is here in Africa ... I think the priority should be given here.*

(Anuj Shah, as cited in Jennings, 2011, p.22)

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<sup>2</sup> Where the seller is required to deliver goods on the buyer's designated vessel.

This feeds into the next problematic factor: the price of A to Z Textile’s Olyset Net is higher than its South East Asian produced counterparts, solely because of the fact that production costs are higher in Tanzania due to the lack of infrastructure. The reality is donors may want the lowest cost price in order to purchase larger volumes in LLNI’s to be able to help a larger number of malaria stricken communities. What is not realized is the significant positive impact that investing, or buying the products, of A to Z Textiles, or any ethical Tanzanian company, has on the its immediate surrounding community. For example, A to Z Textile was able to expand their production, employ more of Tanzanian citizens, and provide stable income for them to better their lives, due to the increase in the demand and profits received from their products.

### DEFINING ACTIVE-TRANSFORMATIONAL VS PASSIVE TRANSACTIONAL CSR STRATEGIES

The two terms, transformational and transactional processes describe two approaches that corporations can take to meet the demands for greater socially responsibility within their company. Based on Professor Scott Davis of Rikkyo University’s findings, these terms are dependent upon two factors:

1. Is the initiative for engagement: Active or Passive?  
 Meaning what is the level of engagement the company is willing to invest into the CSR initiative.
2. Level of engagement: Transactional or Transformational?

Meaning the level of engagement the company has during the lifespan of the CSR initiative, ranging from transactional to transformational.

<b>Level of engagement</b>	<i>Transformational</i>	<b>Compliance</b> Conformity with external codifications of responsibility	<b>Market innovation</b> Innovating business relationships to realise new opportunities for social value creation
	<i>Transactional</i>	<b>Social support</b> Seeking moral legitimacy by exchanging resources for social support and approval	<b>Equitable trade</b> Searching for business opportunities acceptable within existing relationships
		<i>Passive</i>	<i>Active</i>
<b>Initiative for engagement</b>			

**Figure 1: Davis’ (2010) Matrix of the Active-Transformational and Passive-Transactional Processes.**

### **Passive-Transactional**

A passive-transactional process entails that the direction of the course of the CSR initiative is mainly decided by the other entity, therefore the company “passively” allows the other partner to assume control. Both entities, throughout the lifespan of the initiative both entities identities remain the same and are left unchanged. The cost of the initiative is seen as expenditure, in that they not expect to receive a potential gain but an (eventual) loss of the resources provided. (Davis, 2010) The goal is to achieve social support and approval from the company’s stakeholders to boost the firm’s trustworthiness and credibility.

### **Active-Transformational**

An active-transformational process entails the company is active in their involvement, and therefore collaborates with the partner to integrate social needs into their business strategies and operations in order to generate a processes and results that will benefit all stakeholders involved. The company’s identity and values are altered as a result. The implication for companies is that it takes a lot more resources and time, as identifying common ground between the two players is critical in order to move forward. The cost of the initiative is considered an investment by the company, as they anticipate a gain, through value-creation (increasing net-worth and/or the value of the corporation and its assets). (Davis, 2010)

## **MANUFACTURING AND SALES OF OLYSET NET: AN ACTIVE TRANSFORMATIONAL CSR INITIATIVE**

### **Impact on the Local Economy and Livelihood in the Kisongo and Arusha Regions**

The qualitative benefits of the production of A to Z Textiles was measured on behalf of SOAS, the University of London (Refer to Exhibit 4# for a summary of SOAS’s findings). There was evidence that the development of the Kisongo factory stimulated new income-generating activity in the area for small-scale business owners, due to the large number of employees who now reside in the area. In Arusha, the majority (70%) believed that the factory had had a positive impact on the employees as well as the surrounding area. Numbers alone, the Arusha factory represented 20% of the manufacturing jobs in the area. Furthermore all employees believed that the wages they received (well-above the national minimum) were sufficient in providing for themselves, as well as their families and other members of their support networks. This in turn allowed for employees, and prospering small-scale business owners to be able to save some of their earned income to ultimately provide for life’s events such as: children’s education, money for emergencies, unexpected events etc. (Jennings, 2011).

### **How is this An Active-Transformative Innovation?**

Sumitomo Chemicals was very active in the initiative, having created Vector Health International Ltd. With A to Z Textile Mills, the ownership is split down the middle and therefore the gains (and potential losses) are shared by both companies. Sumitomo Chemicals realized that in order to help prevent malaria effectively and empower the Arusha community, ownership of the manufacturing and the product technology had to be shared. Vector Health tests the efficacy of the products produced and has conducts further analysis for different products to be created. This demonstrates integrating the social need to help combat malaria into their business strategy by changing their operational structure (forming Vector Health) in order to generate positive results. Various stakeholders also benefited from the Olyset Net initiative. In the Kisongo region, new businesses opened due to the increase of people in the community working at A to Z Textile’s production plant. There was also an improvement of the town’s infrastructure, as a roadway was paved to the factory, increasing economic activity in the area such as private buses (known as daladaldas) commuting between Kisongo and Arusha. Having more income to spend, A to Z

Textiles brought in water tankers of 50,000L for the local community to use free-of-charge. (Jennings, 2011) These outcomes were a result of the increase in production and improvement of quality in their products that A to Z Textiles achieved by the partnership with Sumitomo Chemicals.

## **MENDING THE AFTERMATH OF THE EARTHQUAKE AND TSUNAMI IN 2011: A PASSIVE-TRANSACTIONAL CSR INITIATIVE**

### **The Great East Japan Earthquake**

In 2011, on March 11, Japan was hit with an earthquake (magnitude 9), followed by a tsunami that devastated the North Eastern coast of Japan. What is now known as the Great East Japan Earthquake, took the lives of 15,891 people with more than 2,500 still reported as missing. About 230,000 people are still in temporary homes four years later and the total damages from the tsunami and earthquake are estimated at \$300 billion dollars (Oskin, 2015).

Sumitomo Chemicals rolled out numerous initiatives to help put the pieces back together for the communities in Japan that had been hit, through in-kind donations and sponsorship of events. For example, the Olyset Net had been donated to coastal regions throughout Japan in July and August in 2011. They were needed as the infestation of flies and other insects were proving troublesome at the garbage collection points (list and pictorial representation of transactional initiatives can be viewed in Exhibit 5#).

### **How is this A Passive-Transactional CSR Initiative?**

The number of initiatives that Sumitomo Chemicals took part in were mostly donations of materials and sponsorships. That being said, what was to be done with those materials and/or events was primarily decided by the other parties who were on the receiving side.

For example in the Kamaishi City in Iwate Prefecture, Sumitomo Chemicals helped build an area of farm plots for local residents by partnering with Kamaishi City Social Welfare Council and others. Sumitomo Chemical provided various materials and supplies needed for vegetable plots to the citizens. By allowing the Council and the locals to have control over the resources and supplies, Sumitomo Chemicals “passively” allowed them control. Sumitomo Chemicals was not expected to receive a significant gain from the transaction, as the supplies were a donation for the locals to be able to utilize the plots made. Ultimately, through their various initiatives Sumitomo Chemical was trying to build trust and credibility in their stakeholders by helping those affected by the earthquake/tsunami and creating positive moral for Japanese society at the time of crisis.

## **CSR IN JAPAN: WHERE DOES SUMITOMO CHEMICALS FIT?**

### **Japanese Conceptualization of a “Good Business”**

Japan has various historical moral philosophies and ideologies that are transposed into the protocols and culture of the business. The non-Western worldview of CSR differs that of the Westerners. Japan’s companies’ social responsibility has been criticized in the past, exposing public scandals that are not congruent with western standards of business. As they are facing increased pressures to translate their actions into measureable results, there has been an increase in their CSR initiatives such as creating reports, positions, training programs etc. in order to prove their credibility as a responsible organization to the rest of the world. (Davis, 2010)

The unique relationship between business, society and stakeholders in Japan overlaps with overarching goals of the western perception of CSR, but the vessels used in order to achieve these goals differ greatly, having been influenced by historical philosophies on what constitutes a responsible business in Japan. The roles and responsibilities accepted within corporations in different countries differ greatly, therefore the nature of CSR is not standardized and concrete, but fluid and should be re-evaluated constantly to see how it affects the relationship with various stakeholders (Tanimoto, 2013).

### **Philosopher's Influence**

The foundations for Japanese business ethics stemmed from various philosophers during the Edo Period, Meiji Period and onwards. Namely, Shibusawa Eiichi (1840-1931) known as the “father of Japanese Capitalism” as he was associated with over 500 businesses in Japan. He advocated strongly for business interests while the Japanese government was preoccupied with military concerns at the time. Eiichi led the first Japanese national bank (Dai Ichi Kokuristu Ginko) in 1873, and from there helped create and grow economic institutions like banks, insurance companies, and stock exchange in railroads, textile mills, shipping companies and other industries. His omnipresence in the majority of business sectors made him very respectable, and therefore his philosophies were and are still, highly respected. The basis of his moral towards business was based on the Confucian principles, in that building and maintaining the public's trust was the highest priority. Building trust would insure long-term prosperity for all stakeholders involved. (Sagers, 2014) This relates to the transactional-passive goal of trying to receive social support of the company by building trust and credibility with stakeholders through “transactional” initiatives.

### **Buddhist Influence**

In Japan, Buddhism is a prominent religion that is followed by the citizens, and therefore the moral principles taught have influenced certain businesses values. In brief, Buddhism is a framework that is taught, learned and followed in order to live life in a moral and ethical way, therefore every thought and action of a Buddhist should be good and pure. One of the main principles known as the “Middle Way” has been directly transposed into the Japanese business context as “Doing Business in the Middle Way”. This is defined as maintaining an equilibrium between indulging in all the worlds pleasures and desires and suffering and depriving oneself. This is not to say that business should not gain profits, as wealth is not considered greed unless the intention behind the acquisition of the wealth was impure. (Cheng & Low, 2014) For example, companies that constantly cut off suppliers in order to acquire cheaper goods from different suppliers (commonly referred to as “the race to the bottom”) would not be “doing business the middle way” as the intent was to profit maximize without thinking about the implications for their suppliers. Therefore an example in Japanese companies would be the continuous long term relationships with suppliers that are formed and built. The cause and effect of the Japanese's firms actions are taken very seriously, considering all stakeholders (investors, individual employees, customers, society and environment) involved in the process. (Cheng & Low, 2014)

### **Kyosei: “Prosper Together”**

Kyosei is a Japanese philosophy that is literally translated into English as working together (kyo) and life (sei), that is companies and their stakeholders will prosper and support one another through the entirety of their existence. Western companies have only recently vocalized the concern that should be taken with all of the stakeholders who come into contact, whereas it has been realized and adopted in Japanese business as “Kyosei” for centuries. (Boardman & Kato, 2003)

Kyosei is also derived from the Confucian philosophy, focusing on a couple of key points:

1. One should treat others the way you would like to be treated
2. The superior man should pursue virtue, not profit
3. Balance between self-interest and altruism should be achieved
4. Harmony can be achieved by acting appropriately within the large complex of relationships
5. By operating near the average (“golden mean”), risk will, and should be avoided

These are some of the guiding principles that Japanese companies may realize. The full list of principles can be viewed in Exhibit #6.

### **Sanpo-Yoshi: “Good for Three Parties”**

Sanpo-yoshi is a root of CSR in Japan, meaning “good for three parties” seller, buyer and society. The concept behind this is that buyers must be satisfied and contribute the local community for merchants to be able to benefit from a transaction. This derived from the Ohmi (Center of Japan Kyoto and Osaka) merchants during the Edo period based on their experiences. The idea of building trust with the community was essential for these merchants to be able to sell their products in different cities. (Tanimoto, 2013) Their business was to be conducted with the aim of creating mutual satisfaction for both themselves and their customers by making modest profits that at the time was argued to cover the cost between traveling to different cities. In Japanese companies there is an understanding of a company as being a public entity of society. Sanpo-yoshi is more of a moral construct for Japanese business professionals, as they should not profit from their business at the expense of society (Davis, 2010).

### **Where does Sumitomo Chemicals fit in?**

As CSR is a newly termed concept, it is in a continuous, developing state, as its bounds and constructs have various genetic make ups depending on which country you are in. As the Western concept of CSR is still relatively new to Japan, Sumitomo Chemicals has been quick on their feet to responding and morphing their pre-existing “Japanese good business” principles and repackaging it into a typical CSR business model. This includes CSR reports describing their efforts to nurture stakeholder relationships, reduce environmental impacts, results of social projects and so on. Sumitomo Chemicals’ CSR strategy is compliant with international standards like the United Nation’s ten principles of the Global Compact, as well as having collaborating with them for a number of their projects (Sumitomo Chemicals).

Japanese traditions and morals also play strongly into their philosophy, as their CSR philosophies and goals are congruent with certain aspects of the good Japanese business philosophies. For example their basic CSR Policy states they will aim to achieve an “equitable balance between profitable business operations, preservation of the environment, safety, product quality and positive social activity” which correlates with the Middle Way of doing business. Kyosei is the foundation of Sumitomo Chemical’s business relationships, as grouping or conglomerates of businesses was and still is, present in Japanese corporations today. Sumitomo Group was historically a horizontal corporate network that includes 20 of the nation’s biggest and well-known companies. These conglomerates of companies “prospered together” by minimizing the risk for themselves by buying a certain portion of another member’s shares (known as “cross-shareholding”) (Cutts, 1992). This way, they could achieve stable long-term growth while smoothing out the rough parts across all members. As Japan has been internationalizing in their markets, there have been many reforms put into place to open up the selling of their shares to the public.

The mutual pro-growth relationships that Sumitomo Chemical holds with its business partners have been critical for the long-term success of the company. For example, in order to have achieved their goal of helping combat the social and economic problems that malaria has been causing in Tanzania, they required the local expertise and distribution networks that A to Z Textiles Mills knew and was familiar with. In other words as the abilities, knowledge, and assets of a corporation's partner are needed in order to complete their own goals. This mutual dependency binds the two companies together for the long term as long as both parties consistently share the common interest in completing the goal. (Davis, 2010)

The two examples presented in the case demonstrate that Japanese companies, depending on their size and resources, can engage in multiple forms of CSR. Sumitomo Chemical exemplified this through their Olyset Net initiative (active-transformational) and post-earthquake aids (passive-transactional). Traditionally, most Japanese companies have been found to adopt the passive-transactional approach. This can be attributed to the pressure companies' face to prove their social responsibility within the various standardized measures that have shaped the CSR movement to date. (Davis, 2010) In other words, they shape their CSR initiatives as transactions of resources in order to gain "social legitimacy" for their company in a timely manner. The Japan Association of Corporate Executives had done a study with numerous Japanese CEOs showing that over 50% considered CSR added little or no value and was simply a modern day cost of business. Therefore, active-transformational CSR initiatives, such as the Sumitomo Chemicals support and engagement with A to Z Textile's to create Vector Health and produce Olyset Nets, are considered rare. However when implemented properly, both parties involved are left better off than before (value-creation), presenting a large scope for learning and innovation.

## **CONCLUSION**

The CSR initiatives between company to company differ due to a number of internal and external reasons (size, capacity, resources availability, stakeholder priorities, to name a few). Sumitomo Chemical has demonstrated that even within the same company, different CSR initiatives can range from active-transformational to passive-transactional, and fall anywhere in between. The type of initiative affects the amount of impact it will have, as a passive-transactional is reasonable in impact, an active-transformational has a much farther reach. Sumitomo Chemical and A to Z Textile demonstrate this through the success in their partnership, with the development of Vector Health International, production of Olyset Net, and helping the fight against malaria. But the question remains for the future direction of the Olyset Net, due to the competition and Tanzanian financial landscape barriers. Should Sumitomo Chemicals utilize Vector Health's ATRC and push for R&D in new innovative products that help a social cause? Try to further carve out their place in the market with the Olyset Net? Withdraw their involvement with A to Z Textile altogether?

The Olyset Net initiative has bound together these two companies, and as described in the Japanese context, the dynamic between business partners is dependent and long-term. Japanese CSR is a continual, changing process that is constantly shaping the roles and actions of the company's actions, so the future of this active-transformational CSR initiative is lies in the hands of both partners.

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## APPENDIX

### EXHIBIT #1: Consolidated Financials, Sumitomo Chemicals, Fiscal Year Ended March 31<sup>st</sup> 2015

## Consolidated Balance Sheets

Sumitomo Chemical Company, Limited and Consolidated Subsidiaries  
 March 31, 2015 and 2014

	Millions of yen		Thousands of US dollars (Note 1)
	2015	2014	2015
<b>Assets</b>			
<b>Current assets:</b>			
Cash and cash equivalents (Notes 5, 9 and 20)	¥ 201,997	¥ 132,321	\$ 1,680,927
Short-term investments (Note 5)	3,013	2,091	25,073
Securities (Notes 5 and 7)	18,549	30,333	154,356
Trade notes and accounts receivable (Notes 5 and 9)	456,054	448,415	3,795,074
Inventories (Note 6)	439,880	429,450	3,660,481
Deferred tax assets (Note 15)	60,526	56,909	503,670
Other (Notes 5 and 21)	82,804	144,572	689,056
Allowance for doubtful accounts	(1,917)	(1,564)	(15,952)
Total current assets	1,260,906	1,242,527	10,492,685
<b>Property, plant and equipment</b> (Notes 9 and 12):			
Land	82,765	83,200	688,733
Buildings and structures	660,694	639,961	5,497,994
Machinery and equipment	1,833,432	1,762,526	15,256,986
Construction in progress	44,342	50,463	368,994
	2,621,233	2,536,150	21,812,707
Less accumulated depreciation	(1,926,798)	(1,813,310)	(16,033,935)
Net property, plant and equipment	694,435	722,840	5,778,772
<b>Investments and other assets:</b>			
Investment securities (Notes 5, 7, 8, 9 and 21)	518,800	450,094	4,317,217
Long-term loans (Notes 5 and 21)	74,766	63,988	622,169
Net defined benefit asset (Note 13)	68,276	58,645	568,162
Deferred tax assets (Note 15)	17,701	21,495	147,300
Goodwill	95,249	86,813	792,619
Patents (Note 12)	5,200	21,069	43,272
Software	12,204	11,542	101,556
In-process research and development (Note 12)	64,456	56,072	536,373
Other (Notes 8 and 21)	69,262	54,330	576,366
Allowance for doubtful accounts	(859)	(908)	(7,148)
Total investments and other assets	925,055	823,140	7,697,886
Total assets	¥2,880,396	¥2,788,507	\$23,969,343

See accompanying notes.

	2015	2014	2015
<b>Liabilities and Net assets</b>			
<b>Current liabilities:</b>			
Short-term debt (Notes 5 and 9)	¥ 147,805	¥ 216,148	\$ 1,229,966
Long-term debt due within one year (Notes 5 and 9)	138,736	126,859	1,154,498
Trade notes and accounts payable (Note 5)	258,161	296,072	2,148,298
Income taxes payable	14,357	18,540	119,472
Reserve for sales rebates	36,352	26,421	302,505
Reserve for bonuses	29,236	26,376	243,289
Other (Note 15)	245,198	238,798	2,040,426
Total current liabilities	869,845	949,214	7,238,454
<b>Long-term liabilities:</b>			
Long-term debt (Notes 5 and 9)	693,632	731,591	5,772,090
Deferred tax liabilities (Note 15)	96,253	84,110	800,974
Net defined benefit liability (Note 13)	34,178	31,065	284,414
Other	68,272	58,021	568,127
Total long-term liabilities	892,335	904,787	7,425,605
<b>Contingent liabilities (Note 17)</b>			
<b>Net assets (Note 16):</b>			
Common stock:			
Authorized — 5,000,000,000 shares			
Issued — 1,655,446,177 shares at March 31, 2015			
1,655,446,177 shares at March 31, 2014	89,699	89,699	746,434
Capital surplus	23,695	23,695	197,179
Retained earnings	477,445	444,671	3,973,079
Treasury stock, at cost			
21,075,315 shares at March 31, 2015			
20,955,700 shares at March 31, 2014	(8,870)	(8,816)	(73,812)
Shareholders' equity	581,969	549,249	4,842,880
Accumulated other comprehensive income			
Valuation difference on available-for-sale securities	104,841	78,604	872,439
Deferred losses on hedges	(97)	(358)	(807)
Land revaluation reserve (Note 18)	4,363	4,130	36,307
Foreign currency translation adjustment	82,284	(1,420)	684,730
Remeasurements of defined benefit plans	17,959	13,092	149,447
Total accumulated other comprehensive income	209,350	94,048	1,742,116
Minority interests	326,897	291,209	2,720,288
Total net assets	1,118,216	934,506	9,305,284
Total liabilities and net assets	¥2,880,396	¥2,788,507	\$23,969,343

See accompanying notes.

Management Strategy

Our Operations

CSR & Governance

Financial Section

Corp.

# Consolidated Statements of Income

Sumitomo Chemical Company, Limited and Consolidated Subsidiaries  
Years ended March 31, 2015 and 2014

	Millions of yen		Thousands of US dollars (Note 1)
	2015	2014	2015
<b>Net sales</b>	<b>¥2,376,697</b>	¥2,243,794	<b>\$19,777,790</b>
<b>Cost of sales</b>	<b>1,727,803</b>	1,639,649	<b>14,377,990</b>
<b>Selling, general and administrative expenses</b>	<b>521,548</b>	503,303	<b>4,340,085</b>
Operating income	<b>127,346</b>	100,842	<b>1,059,715</b>
<b>Other income (expenses):</b>			
Interest and dividend income (Note 21)	<b>14,141</b>	7,956	<b>117,675</b>
Interest expenses	<b>(13,483)</b>	(12,837)	<b>(112,199)</b>
Equity in earnings of affiliates	<b>23,931</b>	12,027	<b>199,143</b>
Net gain on foreign currency transactions	<b>9,957</b>	4,837	<b>82,858</b>
Cost of inactive facilities	<b>(3,296)</b>	(2,462)	<b>(27,428)</b>
Gain on sale of property, plant and equipment	<b>16,241</b>	2,586	<b>135,150</b>
Gain on sale of investment securities	<b>4,090</b>	3,414	<b>34,035</b>
Compensation income	<b>2,700</b>	—	<b>22,468</b>
Compensation income for damage	<b>1,711</b>	—	<b>14,238</b>
Gain on bargain purchase	—	1,740	—
Fair value adjustment of contingent consideration	—	1,284	—
Impairment loss (Note 12)	<b>(33,258)</b>	(21,823)	<b>(276,758)</b>
Restructuring charges (Note 14)	<b>(32,196)</b>	(10,648)	<b>(267,920)</b>
Loss on valuation of investment securities	—	(1,462)	—
Other, net	<b>(1,182)</b>	746	<b>(9,836)</b>
Income before income taxes and minority interests	<b>116,702</b>	86,200	<b>971,141</b>
<b>Income taxes</b> (Note 15):			
Current	<b>37,772</b>	30,867	<b>314,321</b>
Deferred	<b>7,826</b>	373	<b>65,125</b>
	<b>45,598</b>	31,240	<b>379,446</b>
Income before minority interests	<b>71,104</b>	54,960	<b>591,695</b>
<b>Minority interests</b>	<b>18,912</b>	17,983	<b>157,377</b>
<b>Net income</b>	<b>¥ 52,192</b>	¥ 36,977	<b>\$ 434,318</b>

Yen

US dollars (Note 1)

## EXHIBIT #2: Press release of the opening of Vector Health International

July 11, 2012

### Research Center Built at Joint Venture in Tanzania

Vector Health International Ltd. (Vector Health), a joint venture in Arusha, Tanzania, between Sumitomo Chemical Company (Sumitomo Chemical) and an A to Z Textile Mills Ltd. group company, has set up a research laboratory to equip itself with research and development functions, in addition to production capabilities, for the Olyset® Net insecticidal mosquito net for malaria prevention.

The newly established Africa Technical Research Center (ATRC), located also in Arusha, Tanzania, will conduct efficacy trials, development and analysis of vector control (\*1) products and agricultural products.

Of all cases of malaria, about 90% occurs in sub-Saharan Africa. As malaria is transmitted to a human through the bite of a mosquito infected with malaria parasites, the use of insecticidal mosquito nets has been recognized to be effective for the prevention of the disease. Olyset® Net, developed with Sumitomo Chemical's proprietary technology, is the first net endorsed by the World Health Organization (WHO) in 2001 as a long-lasting insecticidal net. Vector Health, a major manufacturing base for Olyset® Net, has contributed significantly to prevention of malaria infection.

A means perceived to be useful in reducing malaria victims further effectively lies in a comprehensive approach that employs not only insecticidal nets, but other related products in combination as a set of protective measures against insects. On the other

hand, an increasing number of findings are reported in certain regions that mosquitoes are showing resistance to pyrethroid insecticides that are used in the mosquito nets, and it is much needed to also develop a new type of insecticidal net. Under these circumstances, Vector Health has decided to set up ATRC as its research arm, aiming to expand the product lineup the company can offer.

Meanwhile, decreasing Africa's starving population is among the high-priority challenges that the international community has constantly addressed, as stated in the United Nations' Millennium Development Goals (MDGs)(\*2). Going forward, increasing crop productivity will be all the more needed with the appropriate use of agricultural chemicals and other related products. Given the situation, ATRC will also work to develop agricultural products geared specifically to countries of Africa, such as netting for crops, by capitalizing on Sumitomo Chemical's advanced technological

expertise as well as a variety of know-how cultivated through implementing the Olyset® Net business over many years.

ATRC is the Sumitomo Chemical Group's first research facility ever built in Africa. It is currently hiring researchers from within Tanzania and its neighboring countries and will soon begin activities. The research center will contribute importantly to accelerating early development of new products by conducting on-the-spot efficacy trials, development and analysis in the African environment where products are actually used.

Sumitomo Chemical will continue to exert unabated active efforts in promoting malaria rollback and decreasing the starving population, both of which are accountable for Africa's retarded economic development, by advancing its development initiatives and business expansion with respect to vector control products and agricultural products.

(\*1) vector control: Limiting the spread of diseases such as malaria and yellow fever that are transmitted by mosquitoes and other insects.

(\*2) Millennium Development Goals (MDGs): Adopted as an action plan by the United Nations in September 2000 based on the UN Millennium Declaration, the Millennium Development Goals include goals to be achieved in eight categories such as poverty, education, the environment, and human rights.

### EXHIBIT #3: Malaria Statistics

#### < Company Profile >

Name: Vector Health International Ltd.

Location: Arusha, Tanzania

Establishment: September 2005

Capital: US\$3 million

Investment ratio: Sumitomo Chemical Co. 50%, Net Health Ltd. 50%

President: Kalpesh Shah

Number of employees: Approximately 2,800

Business: Production of Olyset® Net

#### < Profile of Research Facility >

Name: Africa Technical Research Center

Location: Arusha, Tanzania

Establishment: June 2012

Director: Dr. Johnson O. Odera

Number of researchers: Approximately 30

Research activities:

- (1) Efficacy trials of vector control products, including long-lasting insecticidal nets
- (2) Efficacy trials of agricultural pest control products
- (3) Chemical analysis that supports these two areas of development

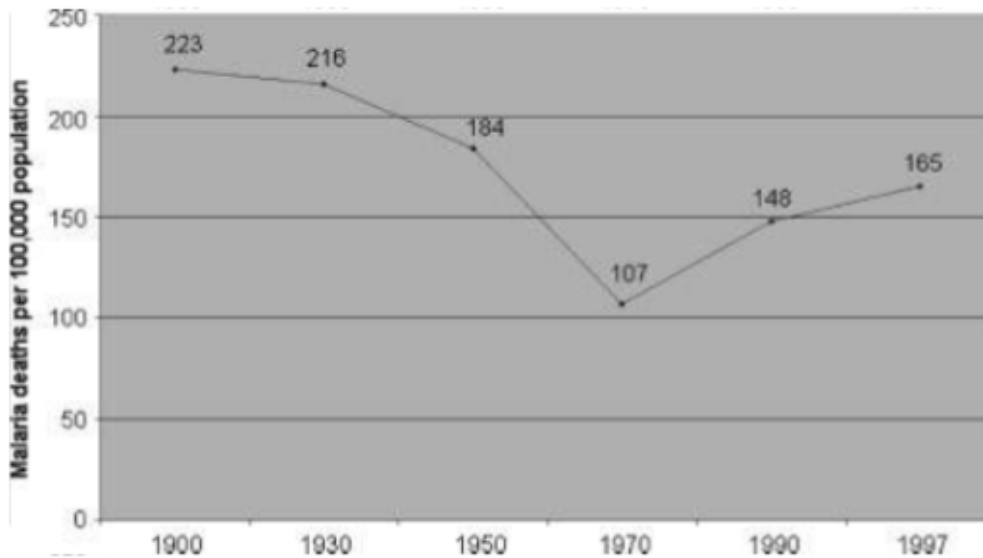


Chart: Malaria Caused Deaths per 100,000 Persons from 1900-1998 (Jowett & Miller, 2005)

Table 2. Total malaria expenditures in Tanzania 1998/9 (US\$)

Item	US\$(1998)
Total malaria expenditures in Tanzania	64 580 000
Malaria as % total health expenditures	39%
Malaria expenditure per capita	2.20
<i>Of which GoT =</i>	0.44 (20%)
<i>Of which donors =</i>	0.21 (9%)
<i>Of which private =</i>	1.55 (71%)

Figure: Total Malaria Expenditures by Source 1998-1999 (Jowett & Miller, 2005)

**EXHIBIT #4: Summary of SOAS’s findings**

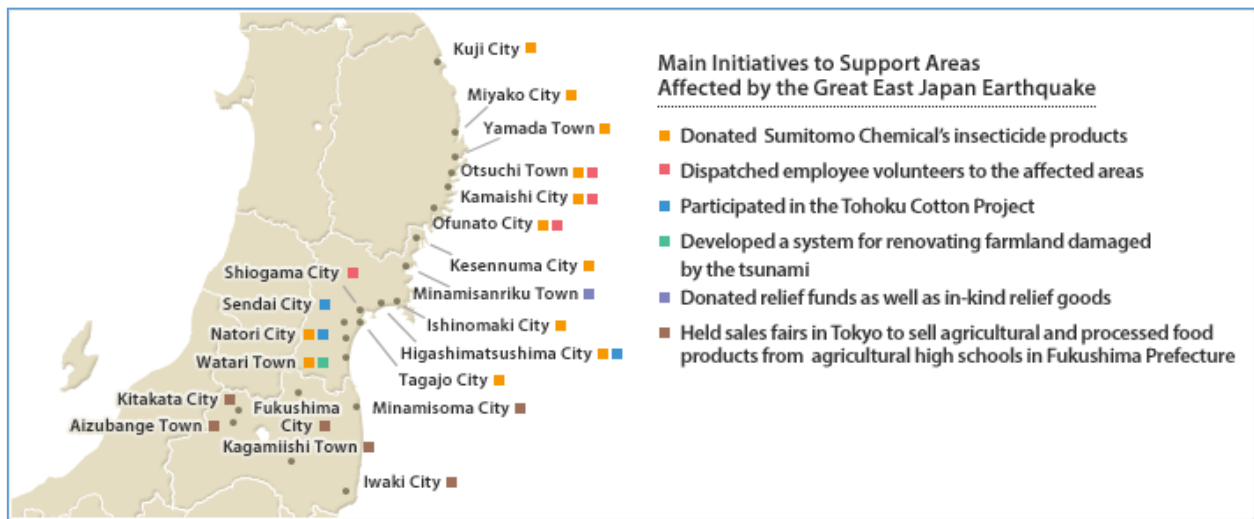
Employees and managers from all levels in the in the organization were asked a series of questions in an interview style. Separate surveys were also carried out amongst 40 local businesses in the area around the Kisongo factory, and in Arusha Town. It found:

- 75% of employees are able to save money from their wages (with 44% saving on a monthly basis);
- 64% said that they could now plan for the future, with 55% saying that their regular income had enabled them to apply for credit;
- 71% said their wages enabled them pay for their children’s education, with 75% confirming that their wages were supporting their immediate family and other relations;
- 68% of local businesses indicated that they received most of their income from factory employees’ custom;
- 13 businesses had been established in Kisongo in the past 12 months, specifically in response to the needs of the employees.

**EXHIBIT #5: Sumitomo Chemical’s “Great East Japan Earthquake” Initiatives:**

1. Support in Combating Fly and Other Insect Infestations  
In July 2011, we donated our insecticides SUMITHION™ and SUMILARV™ to areas suffering damage from insect pests, such as from fly infestations, through local governments (12 municipalities in Iwate and Miyagi Prefectures).
2. Installing Highly Functional Insecticidal Nets  
In July-August, 2011, we installed highly functional insecticidal nets at garbage collection points in temporary housing areas to keep out pests in coastal regions affected by the earthquake and tsunami, where outbreaks of fly infestations and other insects had become a significant problem.
3. Donating Functional Innerwear  
In November and December of 2011, Sumitomo Chemical individually distributed HEATFACT™ innerwear, a product of retailer AEON primarily made from acrylonitrile manufactured by Sumitomo Chemical, to people living in temporary housing and other public apartments. Roughly 10,000 units were distributed.
4. Participating in the Tohoku Cotton Project  
Sumitomo Chemical has been participating in the Tohoku Cotton Project as one of the supporting companies since December 2011. Under this project, farmers cultivate cotton in paddy fields that were devastated by the tsunami, where rice cultivation is no longer viable, and participating companies jointly engage in spinning, commercializing and marketing the cotton. Sumitomo Chemical is contributing to the project by utilizing both its products and its long-accumulated expertise to make proposals for the removal of harmful insects and weeds and to obtain pesticide registration as required for the cultivation of cotton.
5. Sumitomo Chemical Employees Teach Science Experiment Classes  
Using Sumitomo Chemical products, science experiment classes were held for elementary school students to teach them the wonders and joys of chemistry. (Two rounds of classes were held: July-August 2012 and March 2013.)
6. Supporting the Operation of Resident Farm Plots in Tsunami-Ravaged Area  
In Kamaishi City in Iwate Prefecture, an area of farm plots for local residents called Hakozaki Farm was established in June 2013. In collaboration with the Kamaishi City Social Welfare Council and others, Sumitomo Chemical helped sponsor an opening ceremony as well as, in October 2013, a harvest event. Volunteers from Sumitomo Chemical were dispatched to attend those events, and they provided various materials and supplies needed for vegetable plots.

Taken from: [http://www.sumitomo-chem.co.jp/english/csr/disaster\\_recovery/](http://www.sumitomo-chem.co.jp/english/csr/disaster_recovery/)



**EXHIBIT #6: Kyosei Guiding Principles (Based on Confucianism) (Boardman & Kato, 2003)**

1. Reciprocity should be practiced throughout one's life. In short, one should treat others the way you would like to be treated.
2. Virtue, not profit, should be the goal of the superior man.
3. There should be a balance between self-interest and altruism.
4. We do not exist in isolation; we are a part of a larger and more complex family (literally and figuratively) where harmony can be achieved by acting appropriately with one another.
5. Risk should be avoided by operating near the average, or the "golden mean," of possibilities.
6. With respect to relationships, filial obedience to and respect for one's parents are paramount. At the same time, one should be cautious about becoming too intimate with women.
7. One should love learning, live the simple life, practice what has been learned, and seek good teachers from whom one could continue learn throughout one's life.
8. These beliefs, or philosophies, have become the legacy and "the way" of Confucius.

# **Acquisition of Major League Sport Teams: Red Bull's motives behind the unprecedented move and why other corporations should be careful when doing the same**

Carson Bell

## **ABSTRACT**

The purpose of this paper is to examine the energy drink producer Red Bull and its motives behind major league sport team acquisition and management. In doing so, we discover that the business opportunity was largely successful for the energy drink producer, however, organizations must be cautious should they decide to follow suite. The energy drink corporation's motives were found to be largely marketing and business diversification related. Arguments are also introduced positing that the corporation's intentions also included those of an altruistic nature. Though the acquisition of teams was assessed to be largely successful, it was determined that Red Bull did face prominent opposition from fans and consumers. Because of Red Bull's existing history in extreme sport sponsorship, this opposition may have been less severe than if the company had not been associated with sport. With this in mind, companies seeking to acquire sport teams should conduct extensive research regarding how the public may react to the new ownership, and specifically which teams best reflect the company's brand and values. Methods of the analysis include gathering research from various sport analysts, examining interviews with Red Bull co-founder Dietrich Mateschitz, and compiling empirical data on Red Bull's various sport teams.

## **INTRODUCTION**

Corporations have had a long-standing involvement within the world of sport. In the past thirty years alone there have been annual conferences whose sole purpose is to facilitate partnership agreements between companies and major sport teams (Belzer, 2013). Although corporations have become more and more involved within the sport industry, no company has had as active a role as the energy drink giant Red Bull. Since its inception, the Austrian based company has found new and innovated ways to integrate itself into the world of sport. Largely focused on extreme athletics, Red Bull's strategies have included sponsoring individual athletes, hosting entire sporting events, and even creating new sport categories of their own (Kerr, 2014). One of the largest leaps the company has taken, however, is the outright acquisition and rebranding of sport teams. Throughout this paper we examine the energy drink giant Red Bull and its decision to break away from traditional sponsorship models, and move instead into sport team ownership. The paper begins with a brief summary of Red Bull's history, followed by an examination of the three motives regarding the corporations' acquisition of different teams: Marketing, business diversification, and corporate social responsibility. The paper concludes with a brief discussion of the effectiveness of this unprecedented move by Red Bull, and if other companies should be following their lead.

## **BACKGROUND**

Working as an international marketing director for a German Multinational, Austrian born Dietrich Mateschitz was forced to travel across the globe (Dolan, 2005). Frequently traveling not only between countries, but also continents, Mateschitz was faced with drastic changes in time zones, and often succumbed to jet lag (2005). After a long haul flight from Europe to Thailand in 1982, however, Mateschitz discovered a tonic drink called Krating Daeng marketed as a stimulating agent (Owen, 2012). After sipping on one of these drinks over ice, his jet lag would “all but disappear” (Dolan, 2005). Astonished by the products effects, Mateschitz quickly discovered that these small tonic drinks were being produced and sold “extremely well all over Asia” (2005). After meeting a Thai Pharmaceutical owner who sold the product, Chaleo Yoovidhya, the two teamed up and decided to bring the Asian based drink to international markets (Owen, 2012). Both Mateschitz and Yoovidhya invested approximately \$500,000, and took an equal stake in their new business venture (Soloman, 2012). Not too long after, Red Bull, and the beginning of an energy drink movement, was formed (2012).

On April 1, 1987 the first can of Red Bull was sold in Austria (Red Bull GmbH, 2015a). Since then, the company boasts that it has been “giving wings” for over 27 years (2015a). Since its inception, Red Bull has sold over 50 billion cans in over 167 different countries (2015a). When Red Bull was created, the company didn’t introduce simply a new product to market, but an entirely new product category (2015a). That being said, the energy drink tycoon was not an instant success. According to Jordi Benitez, shortly after the launch of Red Bull, there was a very real possibility that the company would go “belly-up” almost as quickly as it had started (Benitez, 2012). According to Benitez, energy drink sales were struggling, as “the market was not ready for this new product” (2012). However, the President of the Institute for Advertising and Marketing Research at the University of Vienna, Wolfgang Mayerhofer, stated that things begin to change for the company after Mateschitz “ ‘introduced the drink into the then-emerging world of mountain biking and snowboarding clubs’ ” (2012). After Mateschitz bold move, Red Bull began to flourish and become the hugely successful corporation it is today.

## **MARKETING**

When discussing energy drinks, it is not surprising that Red Bull surfaces to the top of most conversations. Leading the industry with 43% market share, Red Bull consistently overshadows competitors in the production and distribution of product (Mitchell, 2015). In order to maintain market share and customer loyalty, competitors such as Coca-Cola have gone so far as to safeguard its “secret formula” (Mikkelson, 2011). Red Bull, however, freely displays their ingredients on their website and cans, and has not actively pursued any patents for components of their energy drink (Red Bull GmbH, 2015b). How then has Red Bull been so successful, consistently barring competitors from becoming the industry leader? The answer is simple: Unique marketing strategies. In this section, we examine how the acquisition of sports teams provides the energy drink titan with a promotional edge over traditional sponsors. We begin by examining Red Bull’s rebranding of acquired sport teams in order to increase brand awareness and exposure. From there, we continue by assessing Red Bull’s use of teams to progress the brand’s lifestyle image. Finally, this section concludes by taking into consideration additional marketing strategies Red Bull employs in conjunction with the acquisition of teams.

### **Introducing Red Bull to the Masses**

Red Bull is no longer satisfied with simply having their logo displayed neatly on the side of jerseys and uniforms. The company has chosen to expand beyond traditional sponsorship models and acquire teams in order to change all aspects the team’s identity; this includes “names, colors, and, in some cases, even

erasing club records” (2014). This complete overhaul of sport teams is in an effort to create as much brand exposure as possible (Louvet, 2011). Though we acknowledge that this is not ground-breaking insight, it is worth noting the overall effectiveness of the strategy. Take, for example, the company’s two Formula One racing squads. Infinite Red Bull Racing and Scuderia Toro Rosso (“Red Bull” in Italian) are equipped with motor vehicles embroidered with the company’s analogous red and blue design (Hall, 2009). According to one estimate, the Formula One teams generated the equivalent of over \$283 million in on screen-exposure in 2013 alone (Sylt, 2014). Although this figure is quite high, it is still a conservative estimate of the teams’ overall advertising generation. Since Infinite Red Bull Racing and Scuderia Toro Rosso are both named and owned by Red Bull, it is virtually impossible to speak of the team or athletes without also mentioning the parent company. These racing squads, however, are only a small piece of a much larger picture. Almost all of Red Bull’s acquired sport teams compete in the highest possible league within their respective category. This means that many of the sporting events are broadcast globally to millions of potential viewers (Fox Sports, 2015). With each team embodying all aspects of the company’s brand, Red Bull receives an insurmountable amount of marketing exposure annually. Although this surface level brand exposure is one of the principle reasons behind Red Bull’s rebranding of sport teams, the company’s marketing objectives extend beyond rudimentary advertising practices.

### **Part of the Team**

In the realm of marketing and advertising, professionals employ various techniques in order to connect with current and potential consumers. The goal is often to create brand loyalty and preference for their product over competitors. This often takes shape in the form of popular marketing strategies such as product differentiation, or cost leadership. In the case of Red Bull, however, the company took a more indirect approach: Team Identification.

According to an analysis of the relationship between spectators and sport teams, the greater an individual identifies with a given team, the more likely it is that this individual will engage in “direct, and indirect sport consumption, such as event attendance and purchases of team products” (Theodorakis et al., 2012). In essence, if Red Bull is able to integrate themselves with sport teams to the extent that the two become synonymous, individuals who identify with Red Bull’s teams will also likely identify with the corporation as well. This may lead to improved brand perception along with increased sales of Red Bull products. Furthermore, the analysis revealed that individuals often use sport games as a manner of satisfying social interaction needs with other fans (2012). By merging the Red Bull brand with specific sport teams, the company has effectively become a component of many sport fans social interactions. As described in an Article by Brandon Gutman, this is akin to the marketing strategy where corporations attempt to connect with consumers through memorable and noteworthy experiences (Gutman, 2012).

By fully incorporating Red Bull within action filled sports, and their resulting social contexts, the company is attempting to associate themselves as much as possible with a fast-paced and fun-loving lifestyle (Perlut, 2012). Hopefully the next time you see a case of Red Bull sitting on the grocery store counter, you’ll think of the way you felt after watching the New York Red Bulls score last night’s incredible game winning goal, or back to the day you and your fellow EC Red Bull fans hosted that playoffs party together. With any luck you’ll decide to pick up those slim blue and red cans, and shift from a potential customer to product consumer.

## **Extending Beyond Acquisitions**

As noted above, after the acquisition of a sports club, the energy drink company weaves their brand into every aspect of the team. In regards to the New York Red Bull's, the energy drink corporation went even further and purchased the sports team home stadium, renaming the venue the Red Bull Arena (Carter, 2011). What's more, the company mandated that arena staff attend Red Bull seminars in order to acclimatize them to the organization's expectations and brand (2011). In this instance, spectators who attend New York Red Bull games are fully immersed within the Red Bull culture and brand image. Sport team, venue, and staff, Red Bull has successfully moved from sport sponsor to sport provider. Even when events and sport games are held at the arena that do not include the New York Red Bulls, attendees are nonetheless inundated with Red Bull advertisements and continuously reminded of the company's very own soccer club, and more importantly, their brand (2011).

A large part of Red Bull's considerable success has been largely attributed to the company's marketing efforts (Pangarkar & Agarwal, 2013). Since the acquisition of Red Bull's various sport teams, the company has experienced increased sales and considerable growth (2013). Unfortunately, due to the various other marketing strategies the company employs, it is not possible to determine to what extent the acquisition and rebranding of sport teams contributed to this growth. Nevertheless, as demonstrated by the company's Formula One Teams, we can firmly assert that the company's actions have generated considerable marketing exposure for the corporation. Later on, we discuss whether all the attention Red Bull has received through its teams has been positive, and potential problems that may arise for companies who choose to follow the same marketing strategy. Before that, however, we move forward by examining the second reason behind Red Bull's acquisition of sport teams.

## **BUSINESS DIVERSIFICATION**

Looking beyond the obvious marketing gains that are derived from Red Bull's sport team acquisitions can be difficult. After all, it would make sense for marketing to be the sole motive behind Red Bull's above normal sponsorship into these teams. But what if the acquisitions are not only a way to help endorse and promote their energy drink, but also a way to broaden the scope of Red Bull's overall business model.

In the early 2000's, co-founder Dietrich Mateschitz was quoted in an article suggesting that "[i]t makes no sense to build a company on one product" (The Economist, 2002). At this time, Red Bull had only secured one Austrian ice hockey team known now as the EC Red Bull Salzburg (Red Bull GmbH, 2015c). In the next four years, however, Red Bull would go on to acquire four soccer clubs, an additional hockey team, along with two Formula One racing Teams (Conway, 2014). Though this may seem like a sizeable entry into the business of sports, these are only some of the more popular teams; Red Bull has also entered a team into an Extreme Sailing Racing Series (Carson, 2014), along with inserting itself into the arena of electronic sports (Gaudiosi, 2015). As noted by Bartie et al., with the value of sport teams on the rise, and the potential profits that can be achieved, sport teams are beginning to be "run as sophisticated enterprises" (Bartie, Etna, & Kishner, 2015). In this section we address two of Red Bull's teams, Red Bull Racing and New York Red Bulls, and illustrate how the acquisition of these teams demonstrates an expansion of the corporation's business model.

### **Red Bull Racing**

In 2004, Red Bull took a major leap and purchased Jaguar's Formula One racing team (BBC Sport, 2004). Although this was a major risk, organizations were not shocked by Red Bull's entrance into Formula One, as it provided the energy drink corporation with considerable marketing opportunities. What is surprising,

however, is the additional corporate benefit Red Bull is able to reap beyond marketing strategies. Even if Red Bull had not rebranded the team at all, and made no move to exploit the team for advertising purposes, the acquisition of the Formula One racing team would still have been a smart business venture. This is due to the fact that “prize money is the main reason why Red Bull Racing is now worth \$640 million... More than half of Red Bull [Racing’s] revenue stems from on-track winnings, which topped \$125 million last year” (Smith, 2014). Irrespective of marketing potential, the formula one team is largely valuable in and of itself. Some may raise the argument, however, that these revenue streams are quite large, but so are the subsequent costs. In 2011, Red Bull Racing’s total revenue reached \$374.6 million, but the cost incurred surpassed to \$367.1. Nevertheless, this still yielded an annual profit of \$7.5 million (Sylt, 2014). Furthermore, one must keep in mind that the costs include considerable investment by Red Bull with research and development costs surpassing \$122.3 million by the year 2012 (Sylt, 2014). This investment in the team’s development has helped place the team at the top of the standings, ultimately causing the increase in team valuation by 60% from 2012 to 2014 (Smith, 2014). One can view Red Bull Racing as a marketing tool, yes, but also as an extension of the company’s business that is not only yielding profit, but also increasing considerably in value.

### **New York Red Bulls**

Although Red Bull’s Formula team has proved to produce a healthy sum of profit, not all of the organizations teams are quite so lucky. In 2012, the New York Red Bulls brought in an estimated \$22 million in team earnings, however the team’s costs surpassed their revenue, and the Red Bulls finished their season with a negative operating income of \$9 million (Smith, 2015). Examining the team’s income statement, the New York Red Bull’s appear to be an unfavourable investment in terms of business diversification. Nonetheless, a factor that must be taken into consideration is the team’s overall value. Described once as “stragglers” in the Major League of Soccer (Kerr, 2014), the club has been able to make an astounding recovery and, at the time of writing, sit prominently at the top of the Eastern Conference (New York Red Bulls, 2015). This drastic shift is largely attributed to Red Bull’s acquisition, and subsequent support, of the team (Kerr, 2014). From 2012 to 2015 alone, the team has experienced an increased valuation of \$30 million (Smith, 2013; Smith, 2015). This is a relative increase of over 26%. Therefore, although the soccer club experiences periods of negative profit, New York Red Bull’s unrealized gains exceed the club’s monetary outlays. In short, if Red Bull were ever to choose to sell the club, the company would expect a considerable return on their investment.

By acquiring sport teams, Red Bull is able to expand beyond traditional sponsorship and marketing arrangements and instead develop their enterprise to include team ownership and management. As illustrated by the organization’s Red Bull Racing team and U.S. based soccer club, Red Bull has been successful in transforming their teams into valuable assets. Although some sports analyst predict that Red Bull will soon divest from some of its teams (Iapicco, 2015), it seems far more likely that the company will continue to pursue this extension of their business model, and acquire further teams.

### **CORPORATE SOCIAL RESPONSIBILITY**

Although a clear business case exists behind Red Bull’s acquisition of sport teams, a potential third more altruistic motive exist that could be a driver for the company’s actions: Corporate social responsibility (CSR). Within this section, we examine arguments to support the assertion that, at least in part, Red Bull’s acquisition of sport teams is altruistic.

Before we begin, however, we would like to address the concept of Corporate Social Responsibility in and of itself. CSR is not the easiest subject to broach. It is a widely debated topic with individuals found to both support and oppose the idea. On the one hand, it has been argued that CSR is used by corporation as simply a guise to advance the organizations own agenda, and that benefits provided to society are merely a by-product (Rangan et al., 2015). Others, however, believe that CSR is in fact utilized positively and reflects “pure corporate philanthropy” (Hopkins, 2004). To clarify this issue, CSR in the context of this paper, and when applied to Red Bull, is referred to as an action taken by an organization to improve economically, socially, or environmentally the state of one or more stakeholders regardless of individual corporate benefit, and without diminishing the state of any other entity.

### **Not a Sponsor, a Vehicle**

As one critic, Danny O’Leary, has stated, “Red Bull is not a sponsor of sports, it is its vehicle” (O’Leary, 2013). O’Leary argues that Red Bull is not a traditional sponsor concerned only with what the athlete or team can provide for them, but instead a “philanthropist” with a genuine interest for its “athletes and the advancement of sport” (2013). O’Leary’s views are largely attributed to the fact that Red Bull listens to the athletes and sport teams it sponsors, and invests in their “growth as much as their own marketing benefits” (2013). This sentiment is echoed by one of the first American athletes sponsored by Red Bull, Travis Pastrana. The extreme sport athlete describes how Red Bull approaches all of its sponsored athletes yearly and asks “how can we help you progress your sport, and in doing so, how can you help us take something and make it bigger that it’s ever been done. Not just by a little bit, but by a lot.” (HBO, 2013). Red Bull’s approach to sponsorship and team acquisition is to progress athletes, teams, and sports to the point where they are the biggest and best. In order to do so, Red Bull is continuously seeking ways to support and assist their athletes and teams. A large part of this, is taking the time to hear directly from athletes what their needs are, and how they believe Red Bull can help them. It cannot be denied that one of the principle reason Red Bull wants their athletes and teams to be at the top of their respective league is the marketing and business diversification reasons listed above, however the corporation also seems to have a genuine interest in advancing a community that is much larger than themselves. Instead of the customary top down approach many traditional sponsors take, Red Bull appears to form a two-way partnership with their athletes and teams. The organization’s goal is not to direct, but assist in creating outstanding athletes and sport teams (O’Leary, 2013). Pastrana attributes much of his success to the energy drink giant, expressing that “Red Bull gives me the opportunity to live my dreams, and not just imagine what it would be like” (2013).

Pastrana is not the only athlete praising the energy drink company. Red Bull’s Formula One driver David Coulthard has stated that having Red Bull as the owner of the racing team “allows you to be, for better or worse, yourself” (Ho, 2006). Traditional formula racing teams are endorsed by numerous companies each with a set of criteria for how athletes should behave both on and off the track. Coulthard commented that when driving for a team such as “Mercedes, you represent Daimler and you represent Mobil Siemens, Hugo Boss” and that there is a “much finer line of what is politically correct” (2006). Red Bull’s goal, however, is for athletes to be the best they can possibly be, regardless of their personal endeavours.

When it comes to Red Bull, Travis Pastrana and David Coulthard are not unique. Countless athletes and teams have come forward to praise the energy drink corporation and the advancements the company has made in the sports industry. Without Red Bull, numerous athletes and sports teams would not be at the level they are today, and the world of professional sports would be drastically different.

## **Commitment through Acquisition**

When viewing Red Bull from a socially responsible perspective, critics may argue that if Red Bull really were a sport “philanthropist”, as O’Leary has suggested, there would be no reason for the company to fully acquire sport teams. If the company wished to support the sport industry altruistically traditional sponsorship, or even donations, would suffice. It is the position of this paper, however, that by acquiring sport teams outright, Red Bull has signalled a greater commitment and support of athletes and various sport categories. In a New York Times article, Julie Bosman notes how team names are “like a tattoo”; it is possible, but very difficult, to change. By acquiring and rebranding sport teams with their name and image, Red Bull has effectively made a pledge to support the team far beyond any traditional sponsor or owner.

Further arguments may be raised that Red Bull’s actions cannot possibly be regarded as CSR as the company reaps considerable financial benefit in terms of brand exposure and team earnings. Financial gain, however, is a necessary component of supporting the sport industry altruistically on a global level. Jensen et al. discussed that revenue streams, including that provided by the rebranding of a sports team, “are needed to keep up with the exponentially growing cost of running a professional sports franchise” (2008). If Red Bull were to invest in sports teams across the globe and not make any attempt to earn revenue from their investment, the company would suffer large financial outlays. Though this would be a very generous donation on behalf of Red Bull in the name of sport, by gaining marketing exposure through their teams, Red Bull is able to access additional revenue that they are then able to reinvest into teams; the more exposure the company receives, the more teams they are able to support, the more growth and development of clubs and overall sport.

Red Bull has supported countless athletes and teams around the world, allowing individuals to push the boundaries of sport and pursue their dreams (Vinton, 2013). Though it is naïve to believe that the actions of the multi-billion dollar organization are completely selfless, it is hard to deny the advancements Red Bull has made for the sports community. As the wife of one former extreme sport athlete, Shane McConkey, stated, “[Red Bull] treated him like family. It’s such a huge company, and I’m amazed they treat all their athletes like that” (2013).

## **DISCUSSION**

This paper has so far only focused on the motives behind Red Bull’s acquisition of sport teams and the ensuing benefits derived from the company’s action. To provide a more complete analysis, we examine the reaction from the general public over Red Bull’s acquisitions, why the company was well positioned to make the move, and if other companies are able to successfully follow the energy drink giant’s lead.

### **Red Bull Backlash**

Almost immediately after acquiring a new sport team, the energy drink tycoon changes the team’s logo and colours to reflect that of Red Bull. The organization even went so far as to change the New Jersey Metro Stars name to the *New York Red Bulls*, regardless of the fact that the team continues to be based in New Jersey (Havsy, 2006). Sport critics have argued that this sort of rebranding destroys the clubs culture and traditions (Jensen et al., 2008). Critics, however, are not the only ones disapproving of Red Bull’s actions. In Leipzig Germany, the acquisition and rebranding of local soccer club SSV Markranstädt was met with “in-stadium protests and match boycotts by some opposition teams” (Kerr, 2014). Some fans even went so far as to use “weed-killer to burn protest slogans into the team’s home turf” (2014). Although it may seem as though the public is unfairly criticizing Red Bull, in some cases it is actually long-

standing team supporters who become the victim in the wake of the new team ownership. After Red Bull acquired the soccer club SV Salzburg, the organization instituted guidelines meant to prohibit fans from wearing the team's former violet and white colours (Jensen et al., 2008). At matches, those who refused to head Red Bull's policies were "harassed and assaulted with beer bottles"; not surprisingly, this led to damaged relationships with these devoted fans (2008). Although the backlash may seem extreme, many view Red Bull's acquisition as a positive step forward. In an article by Paul Joyce, former professional soccer player and past vice-president of the German Football Association, Franz Beckenbauer, rebuffs many critics stating that "[w]hether you play in purple, blue or green is irrelevant; the only thing that matters is the team being successful" (Joyce, 2005). It can be argued that being a sport fan is not about team names or colours, but supporting a group of athletes to do their best. Red Bull has enabled many teams to prosper within their respective leagues and could be classified as one of the ultimate sport fans.

Regardless if criticism is directed either towards Red Bull or towards sport fans, it is clear that the acquisition and rebranding of teams has created notable backlash for the organization. That being said, in comparison to Red Bull's fans across all sport categories, those who feel negatively affected by Red Bull's actions form a small percentage of the total. In the next sub-topics we explore why Red Bull did not face a larger backlash following its acquisition of various sport teams, and why other corporations may.

### **Red Bull Compatible with Sport**

Through Red Bull's association with extreme sports from a very early stage, the company has successfully "branded itself a lifestyle product" (Ho, 2006). Even before the acquisition of sport teams, Red Bull has already been closely linked with several major athletes, and successfully introduced numerous sporting events of their own (Vinton, 2013). This may lead spectators to view the energy drink corporation as an already existing component of the sport industry, and have fewer objections to the companies take over and rebranding of teams. Critics have even gone so far as to say that Red Bull "is more robust than a lot of other brands in that category" (Ho, 2006), implying that the energy drink company is able to absorb and recover from consumer backlash much easier than other corporations. Others have commented that changing the name of a team to a corporate sponsor is more likely to be accepted by fans if "it connotes an image associated with a sporting endeavour", or "is similar to names used by other teams" (2008). With several teams already employing "Bulls" in their name, the consensus of the article was that Red Bull meets this specific acceptance criterion (2008). Conversely, companies who do not meet this criteria often fail in the rebranding of team names, such as the refusal of FedEx's bid to rename the Memphis franchise of the National Basketball Association "The Express" (2008).

### **Replicating Red Bull's Success**

Though Red Bull did face backlash from fans, the decision to progress beyond traditional corporate sponsorship was largely successful. At first glance, managers may believe that by following in Red Bull's footsteps, their organization can enjoy the same marketing, business diversification, and CSR results as the energy drink giant has; this, however, may be misleading. As noted above, Red Bull as an organization was compatible with the sport industry long before any acquisitions took place. The company had already a long-history of sponsoring and developing the sport industry for a number of years (Shakeri, 2008). Nevertheless, even if there was an organization virtually identical to Red Bull in every respect, there is no guarantee that the organization's acquisition of a sport team would yield similar results. Variables such as team selection, team performance, and relative sport consumption over time, are unknowns that can have a significant effect on the parent company. Although research should be conducted to mitigate

uncertainty, it must be noted that, like many large corporate investments, there will always be a degree of risk.

In summation, the decision to outright acquire a sport team is dependent on a multitude of factors: First of all, the parent company should already have strong ties to sport, athletes, and events, or have the ability to develop an association with the community. Second, the parent company should engage in exhaustive research to determine exactly which teams, and sport categories, would best reflect the company's brand. Finally, an examination of alternative options, such as traditional sport sponsorship, or other business ventures, should be conducted to provide the company with a complete picture of all possible avenues.

## CONCLUSION

Leading the energy drink industry for over 25 years, Red Bull has been a pioneer in exploring and developing new business ventures; the acquisition of sport teams is no different. One of the first corporations to pursue the opportunity, Red Bull has demonstrated that team ownership can provide significant marketing and business diversification benefits. The organization has been able to generate global brand recognition through their various teams while simultaneously developing their teams into valuable corporate assets. Additionally, one of the reasons behind Red Bull's shift from sponsorship to ownership was the company's CSR effort. By moving into a more concrete partnership with teams, the company is beginning to play a more active role within the tight knit community. It is important to note, however, that throughout the procurement of various teams, Red Bull has been faced with notable backlash from fans and consumers. Although the effects were mitigated by the energy drinks pre-existing involvement within the sport industry, organizations who are considering following this uncharted business move must be aware of how their involvement of team acquisition may be interpreted and of additional variable costs. Overall, Red Bull's decision to acquire sport teams has been a successful move by the corporation.

Since its decision to follow team ownership, the energy drink giant has also moved into other industry such as music and entertainment with the introduction of the company's Red Bull Media House. A similar examination and comparison of Red Bull's entrance into this industry may reveal further insights concerning the organization's overall business objectives.

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# Money Laundering in Switzerland

Karlina Fortier

## ABSTRACT

The paper presents an in-depth look into the complex issue of money laundering in Switzerland. What will be presented are findings pertaining to who is involved or responsible for carrying out, or mitigating money laundering. Particularly, inefficiencies arise in the way the conviction process for money laundering scandals are carried out for big banks such as UBS and HSBCs Swiss subsidiary. Furthermore, Simon Zedek's Civil-Learning Tool will be used to identify how much social responsibility UBS and HSBC have when money-laundering scandals do occur. The evidence will provide that UBS and HSBC both react in the "denial" stage and deny any wrongdoing to the bitter end. Another comparison between Switzerland and Canada will be made to illustrate that regulating money laundering is difficult to control even in other parts of the world. What will be revealed towards the end of this paper is that the lack of regulation from the Swiss Financial Market Supervisory Authority (FINMA) isn't the issue. Alternatively, the issue arises in the end process where there is lack of enforcement and control by Swiss law authorities and intelligence agencies in carrying out harsh consequences for money laundering.

## What is Money Laundering?

Money laundering is a scheme that involves disguising the origin of illegally acquired money to make it appear as if was derived from a valid source. With the rise of economies attracting global funds, criminals take advantage of the complex inadequacies, and grey areas of the financial options available for international customers. Therefore criminals set up international bank accounts where there are loopholes such as rigid bank secrecy rules, lack of "know your customer" requirements, and scarce monitoring for cross-border currency movements (FATC, n.d.). Additionally, countries that are considered tax havens and have little to no reporting requirements for large cash transactions are especially attractive for launderers.

## Three Phases of Money Laundering

There are three steps to the money laundering process: placement, layering, and integration.

*Placement:* First, the introduction of assets such as "dirty money" is placed into the financial system. This is meant to alleviate the inconvenience of carrying around large sums of money. The money is placed in foreign bank accounts by either smuggling cash, or using many individuals (called "smurfs") to turn the illicit money quickly into liquid assets such as bank drafts or bank notes. However, during this stage the criminal is most susceptible to getting caught. This is due to the action of placing the initial deposit of a large sum of money into a bank account; thus, raising suspicions of the financial institution. One strategy meant to reduce suspicion levels is a process called smurfing (About Crime Business Solutions, n.d.). Smurfing involves using multiple runners to exchange smaller amounts of illicit funds for liquid assets such as traveller cheques or bank drafts. Therefore instead of depositing one large lump sum, multiple liquid

assets are used to be able to deposit money into the savings account in smaller, less suspicious amounts (About Crime Business Solutions, n.d.).

*Layering:* Next, this stage entails spreading illicit funds around in order to obscure the audit trail and conceal the origin of the crime. The process involves electronically transferring funds into different international bank accounts that are most often set up as bogus companies (About Crime Business Solutions, n.d.). Alternatively, funds can be split up and placed into advanced financial options or overseas markets. Ultimately, this step is completed successfully by exploiting discrepancies in countries where there is legislation and delays in legal conducts regarding the banking sector.

*Integration:* In this last step the money is returned to the criminal. The goal is to return the money back to economy by appearing as legitimate earnings (About Crime Business Solutions, n.d.). Thus, criminals do this in a way that doesn't draw too much attention. One way that the criminal collects his illicit profits is by establishing a local bank account and having it appear as a business. Therefore final placements of high amounts of laundered money can be disguised as accounts receivable transactions being collected from bogus customers. Once the illicit funds reach this bank account, the criminal now holds the profits from the illegal activity conducted and is in control of using the illegal earnings in any which way. An illustration of this conduct can be seen in Figure 1.

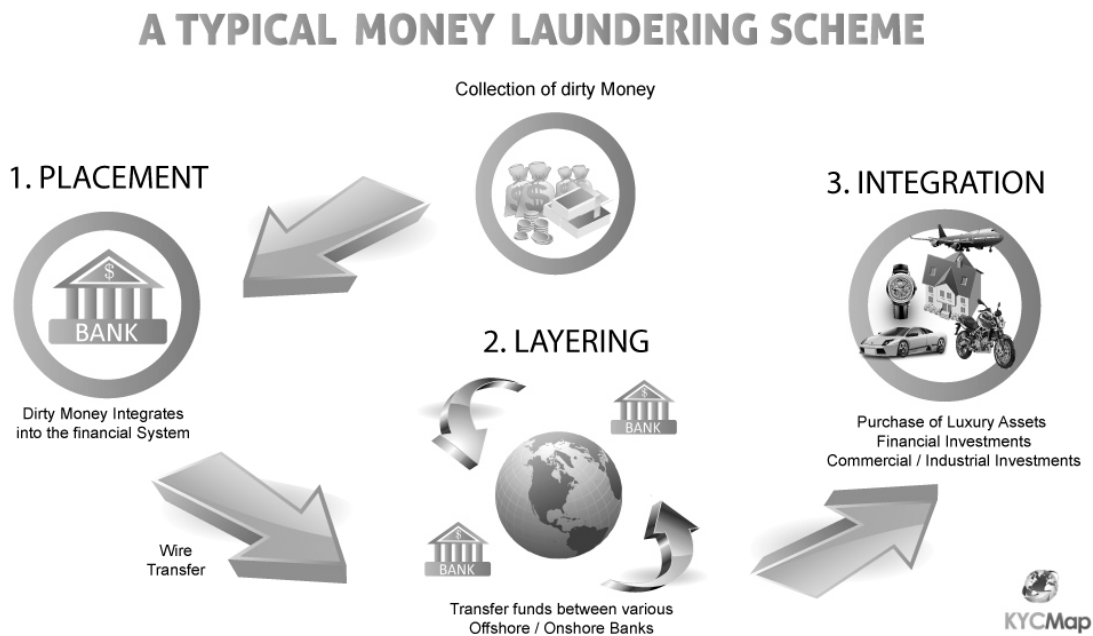


Figure 1. A Typical Money Laundering Scheme (KYCMap, ND)

### Type of Crime Associated With Money Laundering

Money laundering is a huge component for serving the conduct of serious crimes such as embezzlement, tax avoidance, illegal gambling, prostitution, drug trafficking, human trafficking, and terrorism (FATC, n.d.). Clearly some of these activities associated with money laundering are more serious than others. However, money laundering is a serious criminal offence no matter what the launders intention may be. Whether for own personal benefit or to fund activities aimed at causing harm to other human beings. When money laundering successfully occurs, the criminal is profiting from illegal activity that is taking place within the black market.

## **Why Money Laundering in Switzerland?**

Switzerland is well known, specifically by money launders for being a world-renowned financial hub. Furthermore, Switzerland is a geographically central country in Europe that uses the relatively stable currency of the Swiss Franc (CHF), has a strong political structure, and is home to financial institutions that still offers highly valued privacy protection (U.S Department of State, 2013). Overall, these characteristics contribute to the success of the financial sector in Switzerland. However, these noteworthy characteristics that Switzerland has developed, also attracts money launderers looking to exploit opportunities within the financial sector.

The political and economic stability that characterizes Switzerland is another reason for being an attractive place to conduct money laundering within the land of neutrality. For more than 150 years, peace and independence has characterized the political characteristics of this country. Which makes it attractive for those looking to place funds into a Swiss bank account due to a strong legal framework and political structure that has gained a very trusty economical reputation. This contributes to giving those a peace of mind when holding large sums of money in Swiss bank accounts. Additionally what will be later be looked at in another section, is the corruption that takes place when the Swiss government enforces consequences on financial institutions caught aiding launders.

For more than 10 years, the Swiss Franc (CHF) has proven to be a valuable currency due to its strong stability. The Swiss Franc has increased in value over the years mainly due to the European debt crisis and the accommodative monetary policy initiated by the US Federal Reserve (Blystone, n.d.). Also, as of January 15<sup>th</sup> the Swiss National Bank (SNB) removed the peg of 1.20 CHF per EUR, which initially made the Swiss Franc worth more than both the EUR and US dollar (Blystone, n.d.). Ultimately, this attracts investors or criminals looking to gain an advantage in holding funds valued in CHF in Swiss financial institutions.

As of 1934 a law has restricted Switzerland from sharing account activity of clients within financial institutions to tax authorities, foreign governments, and Swiss authorities (Nestmann, 2014). However, in 2013 Swiss governmental authorities have agreed to sign an international agreement with the Organization for Economic Co-operation and Development (OECD) to end bank secrecy for clients that will be fully in place as of 2018 (SWI, 2015). This is meant to alleviate the reputation of Switzerland being the world's largest place for offshore accounts that run the high risk of being used for acts of money laundering. Of course the transition that Swiss financial institutions have to go through in order to completely dismiss bank secrecy services from their operations will take time. Such changes will include alternating banking services that are meant to create a more transparent financial system. Features offered in the Swiss banking industry that will be better regulated are accounts that are enlisted numerically. Furthermore, numerical accounts will come with tight restrictions, valid reasoning for the need or use of a numerical bank account, and a large annual cost.

In the meantime Swiss banking systems still offer optimal privacy protection services when compared to most other countries. However, recently Swiss officials have been forcefully trying to defeat money laundering specifically in financial institutions due to external pressure. As a result, rules have been tightened regarding the process to opening up a Swiss bank account. In order to open up a Swiss bank account at one of the bigger financial institutions (UBS, Credit Suisse, HSBC) one has to go through quite the process. With the intention to sift out criminals looking to open up a bank account, an extensive documentation package is required by financial institutions. This package is to be filled out in order to

reveal the clients' identity, address, professional status, and the source of the funds deposited (Premium Switzerland, n.d.). Although, after a Swiss bank account is set up, it is currently herby considered illegal for the staff of the financial institution to reveal any information about the activity of their clients' accounts to anyone other than judicial authorities with a valid reason or warrant. On the contrary, international governments have placed a lot of pressure on Swiss authorities to reveal personal data of clients in order to follow through with the convection process for their national citizens suspected of laundering money in Swiss bank accounts. Therefore, routine compliance checks for all Swiss banking accounts are carried out by Swiss financial institutions that are meant to crack down on unlawful activity that is occurring in financial institutions (Expatica, 2015). Conclusively, bank secrecy characteristics that Switzerland possessed for many years has attracted launders from all over the world. However, due to recent legislative reformations and tightening of internal security measures within financial institutions aimed at dismissing bank secrecy within the financial sector, the crack downs on launders is on the rise. Although, as mentioned before, the change in Swiss legislation to fully enforce a law to end bank secrecy won't go into full effect until 2018. Which ultimately gives those laundering illicit funds in Swiss bank accounts a chance to take advantage of bank secrecy rules for a couple more years.

### **Money Laundering Is Still A Growing Problem**

On June 6<sup>th</sup> 2015 a meeting was held in Bern, Switzerland (Switzerland's capital) by the Federal Council regarding a report that has been conducted with retrospect to money laundering and terrorist financing within Switzerland (Swiss Federal Council, 2015). According to this report, Switzerland is still susceptible to financial crime and serves as a geographically attractive location for the laundering of assets coming from crime that is commonly committed abroad. Furthermore the report states that the crime most associated with money laundering in Switzerland is embezzlement, fraud, corruption, and organized crime. Additionally, the report also covers the level of risk in different areas where money laundering occurs such as in financial institutions, casinos, payment services, and insurers. The highest risk area being universal banks. However, overall Switzerland possesses a medium risk when considering all areas as a whole (Swiss Federal Council, 2015).

### **Universal Banks in Switzerland: Money Laundering Case Examples**

As mentioned earlier, the highest risk areas for money laundering are universal banks due to the variety of different financial services they offer, which simultaneously increases the likelihood of money laundering activity. These banks include services such as credit/lending, deposits, asset management, investment advice, payment transactions, stock exchange transactions, bond issuing, and financial analysis (Investopedia, 2015). Additionally, the other parties or components associated with the money laundering scheme are of course the criminals, and sometimes as well as employees who participate in the aid of the money laundering process.

The two universal banks that will be explored in depth regarding money-laundering activity are UBS and HSBC. Both UBS and HSBC have experienced negative attention in the media regarding money-laundering scandals.

Starting with using one of Switzerland's largest banks, UBS is a universal bank that was founded in 1862 and is co-headquartered in Zurich and Basel. This case will illustrate the discrepancies in UBS's management to uncover suspicious account activity. Which will be seen, leads to the opportunity for money laundering. It must be noted that some bank employees work on behalf of clients instead of working to sustain a positive image for UBS. Often times, in order for criminals to successfully launder

illicit funds, employees of financial institutions are coerced or bribed into aiding in the process to carry out this form of illegal activity. In a case involving UBS, the largest drugs money laundering case in Switzerland was brought to the public's attention in the 90's. This scandal included a vice-president of UBS who was suspected, and later suspended from aiding an international client from Columbia who was a part of a notorious drug cartel. The bank account that was used to hold CHF 150 million was opened in the 1980's, and had little activity for 10 years. After 10 years the account was unfrozen and used to launder illicit funds (Rodgers, 1994). UBS stated that there was little reason for suspicion, as it appeared to be set up as a large, legitimate business account. However, it was soon uncovered by Swiss authorities that the account was used for holding profits derived from drug trafficking.

Swiss authorities in Zurich notified UBS of this criminal case long before the account was investigated. The CHF 150 million was eventually seized and the case went under investigation by The Swiss Banking Commission in order to discover UBS's overall procedure for detecting money laundering. This case shows the delay on UBS's behalf to conduct investigation regarding money laundering within their institution. Furthermore, the slow detection process serves as a loophole for those storing illicit funds in a financial institution such as UBS.

Another case that involves UBS is designed to illustrate the risks of being a whistle blower in financial institutions. Bradley Birkenfeld blew the whistle on a tax evader, which may not be directly related to money laundering. However, his story can still influence other financial industry insiders to remain silent with information that could capture those currently involved in unlawful activity such as money laundering. Bradley Birkenfeld was a former employee at UBS that revealed 19,000 accounts that were used for purposes such as tax evasion (Javers, 2014). However, Bradley wasn't a saint as he was initially involved in helping a US client evade millions in taxes. He was eventually caught and soon after he decided to blow the whistle on other tax cheaters and the illegal business conducts that were going on within UBS. Bradley Birkenfeld revealed illegal practices within UBS to the U.S Department of Justice, the Securities and Exchange Commission, the IRS, and the Senate Permanent Subcommittee. He then spent two years for his wrongful involvement, but the most noteworthy fact was that he was the only one charged in this controversy. As a result, Bradley's case influences other potential insiders throughout financial institutions such as UBS from coming forward with information pertaining to accounts used for not only tax evasion, but money laundering as well. Furthermore, Bradley risked his career in the banking industry to come forward with confidential information that would eventually expose his former employer, UBS of insider information. This ultimately displays a sense of disloyalty to keep information confidential. With this reputation it will be hard to find a job in a banking institution again. Nevertheless Bradley exemplifies how whistle blowers are treated, and this can definitely prevent others who know information about money launders from stepping up. Money laundering as said before is often times related to serious crimes. Therefore, the prevention and better protection for whistle blowers who come forward could be handled better; Brad Birkenfeld's case is a prime example.

*"The fact that I am the only person behind bars as a result of the international banking scandal sends a chilling message to future financial whistleblowers: if you come forward to expose illegal banking practices, you could go to jail. The previous administration did not take full advantage of the information I gave them."*

*-Bradley Birkenfeld (Birkenfeld, 2012)*

A recent money laundering case featuring HSBC's Swiss subsidiary will now be used as another example to illustrate which parties were involved and how prosecution measures were carried out. In June 2015 it was announced that HSBC has recently paid 40 million CHF and has been given a final warning for "organizational deficiencies" by Geneva authorities (Garside, 2015). These "organizational deficiencies" were brought to the Swiss authorities' attention in 2006 by a whistleblower by the name of Herve Falciani, who was hired to reorganize and construct better security measures to protect the database of HSBC. Instead, he took the data to uncover thousands of clients suspected of tax evasion through money laundering in HSBC Swiss bank accounts. What was also uncovered was that the majority of these accounts belonged to international clients, making this case the largest global investigation that involved many different government officials around the world. International authorities from countries such as the US, Belgium, and France were the primary countries involved in the investigation process. These countries were looking to obtain information about their nationals who were found by Herve Falciani to be using their HSBC Swiss bank account for illegal activity such as money laundering. These suspected launders obtained an account at HSBC's Swiss subsidiary through one of six ways: Swiss residency, having non-domiciled status, having an off-shore trust in Switzerland, converting personal accounts into corporate accounts, smuggling, and the simplest being to have an account and not informing the government or tax authorities about (Garside, 2015) it. Furthermore, these clients involved in money laundering acts were tied to marijuana sales, Chinese triad counterfeiters in Spain, and Mexican cartels (Garside, 2015). HSBC was under investigation for the period of 2006-2015 regarding this case, however an agreement has been made to not follow through with any charges due to the large financial settlement that has been made. Additionally the amount paid was called "compensation" rather than a fine. Later, HSBC made a public apology to its clients and investors for its faults and has promised to make reformations in the tightening of management to evade money laundering. Additionally, HSBC took the initiative to reduce its client base from 30,000 accounts to 10,000 during the period of 2006-2014 that was meant to sift out suspicious accounts (Garside, 2015).

*"This affair demonstrates the weakness of Swiss law at the point where funds enter the system. When we have a law that doesn't punish financial intermediaries accepting doubtful funds then we have a problem. This problem dates from long before the HSBC affair".*

*-Olivier Jorrot (Garside, 2015)*

The fact that HSBC was able to get away with not being charged with acts of money laundering creates question as to how serious the financial laws are taken in Switzerland. When financial compensations are enough to dismiss charges due to the involvement in money laundering, this exemplifies yet another loopholes in the financial sector. One primary grey area in HSBC's operations that seen in this case was that some clients who possess enough wealth can pay their way into obtaining a HSBC Swiss bank account. By living in Switzerland for a couple months a year, a permanent Swiss address can be obtained, which grants a client authorization to open a Swiss bank account. Alternatively, wealthy clients from places such as the UK who have been granted non-dom status can enjoy tax benefits for foreign income (Ball, 2015). Launderers can exploit this non-dom status by claiming their illicit funds to be a source of legitimate foreign income. Therefore the wealthy have the opportunity to purchase their way into obtaining a Swiss bank account by paying a large fee; thus displaying corruption in the business operations of HSBC. Another area where corruption is seen is in the way Swiss financial laws are conducted. The reason being that HSBC was able to pay a hefty fee without the requirement to admit any guilt or endure any charges. Also, as a result clients that were, or still are associated with money laundering can also hide behind the financial law due to the conviction process being dropped after HSBC paid its fee. Thus, Swiss authorities

have dropped the case and no individual charges have been made as of late. However, Swiss authorities did follow through with convicting Herve Falciani for being a whistleblower in the case, which will later be discussed. Meanwhile, the Swiss government received a nice payout amount, and HSBC was essentially able to pay its way out of avoiding negative publicity that may have been detrimental to HSBC's value to shareholders or investors if charges were made. Furthermore, the clients that were involved in laundering of illicit funds are free to continue their operations with no consequences for their wrongdoing.

*“Banks such as HSBC have created a system for making themselves rich at the expense of society, by assisting in tax evasion and money laundering”.*

*Herve Falciani (Buck & Stothard, 2015)*

The conviction process for Herve Falciani is one that can be related to Bradley Birkenfeld. Being a whistleblower in Switzerland doesn't make one a hero as some may think. As seen from Bradley Birkenfeld and Herve Falciani, Switzerland doesn't reward whistleblowers to any extent. Instead, Swiss authorities seek to penalize those that are courageous enough to come forward with information leading to those suspected of using their bank account for illegal activity. Furthermore, when a whistleblower isn't involved in any wrongdoing such as aiding clients to tax evasion like Bradley Birkenfeld, it becomes very clear that there are some deficiencies within the way Swiss authorities handle financial related cases. For Herve Falciani, he wasn't convicted by Swiss authorities for aiding any clients for accounts held for use of money laundering. Instead he was convicted for the responsibility of publicly revealing 130,000 accounts that were suspected to be for use of money laundering. Herve took this information over to share with French authorities and other European governments. As a result Herve was convicted and arrested on a Swiss arrest warrant in Barcelona, Spain where he was living in the summer of 2012 and was detained for more than 5 months (BBC, 2015). However, it was under Spanish authority's decision to let Herve go without any charges as revealing information regarding corruption due to bank secrecy is not a crime in Spain.

*“The OAG (The Office of Attorney General) accuses the former computer technical analyst at the HSBC Private Bank in Geneva of having transmitted data, from February 2008, from his erstwhile employer's database to Lebanese banks, to the Paris-based Direction nationale d'enquêtes fiscales (National Directorate of Tax Investigations), and to other foreign authorities. The data in question concerned bank-internal processes as well as information on bank accounts of HSBC clients.”*

*(Office of Attorney General of Switzerland, 2014)*

## INTRODUCTION OF SIMON ZEDEK’S MODEL – CIVIL LEARNING TOOL



**Figure 2. The Civil Learning Tool. (Zadek, 2004)**

The civil learning tool is useful for analyzing the intensity of a particular societal issue (money laundering) and accessing what stage of social responsibility an organization is at compared to their competitors. The two dimensions of the original civil-learning tool are organizational and societal learning (Zadek, 2004). The x-axis of the civil-learning tool is “Issue Maturity”, which is influenced by the level of society’s concerns and criticism towards a matter. The “Issue Maturity” can be rather influenced by “Societal Learning”. Furthermore, the higher the societal concern and awareness, the greater the stage of “Issue Maturity” becomes. The four main stages of “Issue Maturity” are latent, emerging, consolidating, and institutionalized; all of which are listed respectively. In the ‘latent’ stage the issue is very weak and most likely ignored. When in an issue is considered ‘emerging’ there is media awareness and a heightened amount of research; however, hard evidence is still very weak. The third stage is ‘consolidating’, which signifies the growing amount of need for a legislation concerning a particular issue and adopting an emerging body. The last stage is when a social issue becomes ‘institutionalized’, to which legislation is in place and ethical standards are heightened. When a social issue arises the matter is placed into a designated stage accordingly. Conclusively when an issue moves towards higher levels of maturity, it becomes mainstream. Thus, resulting in debates and business commitments of ethical reformation to which laggards must follow suit.

The y-axis of the civil-learning tool is that of “Organizational Learning”. Organizational learning exemplifies that when an issue arises, institutions go through five stages that gradually leads to stronger corporate responsibility initiatives. The first stage is the ‘defensive’ stage to which a company is in complete denial and refuse any wrongdoing. The second stage is ‘compliance’ and exemplifies that a company does the bare minimum to avoid a reputational catastrophe, such as agreeing to accept a policy-approach to better business standards. The third stage is that of ‘managerial’ and relates to a company adopting standards at a managerial level to introduce into everyday business practices. The fourth stage is ‘strategic’ and involves taking the initiative to adopt a particular societal issue into the core business strategy. The fifth and final stage is that of ‘civil’, and pertains to a company being proactive and actively taking the roll to promote industry wide participation in obliging by rightful participation in ethical standards (Zadek, 2004).

## **APPLYING THE CIVIL-LEARNING TOOL TO UBS AND HSBC**

The application of the civil-learning tool is intended to analyze the comparison between the two competitors, UBS and HSBC, with regards to organizational learning (y axis) and issue maturity (x-axis). The two cases presented earlier on HSBC and UBS will be used to apply to the model and exemplify how each financial institution responds to money laundering scandals.

First, the issue maturity (x-axis) of money laundering in Switzerland will be focused on. It can be seen that as of right now, money laundering in Switzerland is in the “consolidating” stage. As of right now there is a growing amount of need for legislation to tighten up its laws on money laundering within financial institutions. As seen from the HSBC case, financial compensation overrides the need to go forward with a conviction process, which poses the thought of corruption in the way Swiss authorities handle financial issues. Thus, showing how much power big financial institutions located in Switzerland have over Swiss authorities. Which gives the need to call for the implementation of better legislative initiatives. However, Switzerland does have the potential to increase the issue maturity of money laundering into the “institutionalized” phase by the year 2018. Which will simultaneously force financial institutions in Switzerland to adopt better ethical standards due to the fact of the Swiss government signing the international agreement with the OECD. Which is meant for Switzerland to promise to enforce stricter legislations pertaining to the increase in transparency within the financial sector.

Moving onto the organizational learning (y-axis) of the separate cases of UBS and HSBC. This significance of organizational learning is to create a better understanding as to how these institutions respond to money laundering scandals. Thus, showing how serious money laundering is taken in these institutions.

First, the exploration of UBS’ case on Columbian clients using their accounts to launder money will be explored. UBS’s response to this scandal was in the “defensive” stage. The spokesman of UBS, Gertrud Erismann states: “it was a normal account – a big one, but we have other big ones. We had no reason to be suspicious” (Rodgers, 1994). Erismann’s statement signifies that UBS denies any wrongdoing, involvement or responsibility in the scandal. Gertrud Erismann also stated “at all banks in the world there is criminal money but the problem is you do not see it” (Rodgers, 1994). Thus, further providing evidence that UBS was certainly in the denial stage and chose to turn a blind eye to the fact that an employee was arrested in the case.

Moving onto using the example of the HSBC case which, involved thousands of accounts used for money laundering being revealed by Herve Falciani. HSBC denied being associated with aggravated money laundering, and the case was ultimately was closed without any admission of wrongdoing (Titcomb, 2015). Which suggests that HSBC reacted in this case in the “denial” stage given that they don’t wish to acknowledge any case of unethical conduct, or organizational deficiencies that had recently been brought to the attention by Swiss authorities. HSBC stated after the money laundering investigation was dropped that, “in recent years the Bank has undergone a radical transformation. It has implemented numerous initiatives designed to prevent its banking services being used to evade taxes or launder money” (Titcomb, 2015). However, this statement proves to be very vague with no exact reasoning or specific event that initiated the reformation of HSBC’s business operation. Therefore HSBC remains in the “denial” stage in this case.

As a result, what can be seen from applying the civil-learning tool to these cases is that UBS and HSBC react quite similar to the issue of money laundering. Which suggests that UBS and HSBC take the same

level of social responsibility when money-laundering issues arise. Since money laundering can be seen as a mainstream issue, it is interesting to know UBS and HSBC don't seem to take the initiative to adopt higher levels of organizational learning.

### **COMPARISON OF MONEY LAUNDERING REGULATORS: CANADA**

Canada has been facing increasing pressure in recent years to enforce better efforts to mitigate money laundering (Macdonald & Trichur, 2015). In 1999 the National Initiative to Combat Money Laundering as to further provide more support on combating money-laundering acts (About Business Crime Solutions, 2015). However, recently Canada was listed by the U.S State Department for being of "primary concern" for money laundering (Macdonald & Trichur, 2015). Furthermore, it has been announced in the media that Canada's top money laundering controls have failed on many occasions. The Office Superintendent of Financial Institutions (OSFI) has discovered that between the years 2009 and 2014, there had been 72 failures of money laundering scandals (Macdonald & Trichur, 2015). However, the names of the banks involved couldn't be included in the document and it wasn't clear if any of the banks involved received any charges (Macdonald & Trichur, 2015).

The primary regulator for money laundering in Canada is Financial Transactions and Reports Analysis Centre of Canada (FINTRAC). The responsibilities that FINTRAC has include taking on an important position in the constellation in relation to the organizations involved in Canada's fight to combat money laundering and terrorism (FINTRAC, 2015). FINTRAC focus on financial intelligence and looks to provide strategic measures to uncover important trends for money laundering. Furthermore, when FINTRAC gathers a sufficient amount of information that would be useful in the conviction process of a money laundering case the findings are then handed over to law enforcement and intelligence agencies (FINTRAC, 2015). The law enforcement and intelligence agencies that are responsible for carrying out the conviction process include Royal Canadian Mounted Police (RCMP), provincial and municipal police agencies, Centre of Strategic and International Studies (CSIS), Canadian Revenue Agency (CRA), and Citizen and Immigration Canada (CIC) (FINTRAC, 2015).

In Switzerland, mechanisms to combat money laundering were set in place with an Agreement of Due Diligence in 1977 (Swiss Banking, ND) primary regulator is Swiss Financial Market Supervisory Authority (FINMA). Furthermore, Switzerland is in compliance with the Financial Action Task Force (FATF). The FATF is an inter-governmental body that is responsible for carrying out third country evaluations. The 2012 revised areas of concern were in the field of bearer shares, establishing the beneficial owners of legal entities, politically exposed persons, serious tax offences as a predicate to money laundering, and improved efficiency of the reporting system (Swiss banking, n.d.).

Switzerland's main regulator for money laundering in Switzerland is FINMA. The main purpose of FINMA is to regulate all financial service providers and to make sure that they comply with the rules. Furthermore, FINMA is responsible for authorizing banks, insurance companies, stock exchanges and other market participants (FINMA, 2015).

It is clear that Canada and Switzerland put forward effort into combating money laundering with the initiation of regulators. However, there are still inefficiencies in the regulatory system of each country. This shows how difficult it is to fully combat money laundering due to its complexity.

## CONCLUSION

The phenomenon of money laundering in Switzerland can be seen to be an area of concern in the financial sector. The lack of control in the conviction processes was seen in the presented cases of UBS and HSBC. Furthermore, due to the fact that these universal banks react with the attitude of denial shows that there is no willingness to accept social responsibility. Alternatively, banks such as HSBC can buy their way out being charged with convictions related to money laundering. Furthermore, the way whistle blowers are treated doesn't set a good example for other potential whistleblowers that potentially would come forward. These whistleblowers could help the Swiss government to control money-laundering issues, but instead they are penalized. Overall, this report showed the inefficiencies in the way money laundering cases are handled by Swiss law enforcement.

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# **Crystal Clear:**

## **An Analysis of Swarovski Crystals' Human Resource Management Strategy and the Influence of Generation Y**

Megan Griffin

### **ABSTRACT**

The purpose of this paper is to develop a better understanding of how Generation Y's new expectations of their work life is affecting change in Human Resource management strategies. Swarovski, an Austrian based crystal company, will be used as an example of a business that has developed successful human resource strategy in the face of global market recruitment and retention changes. McKinsey's 7S Framework and Hofstede's Cultural Dimensions will provide basic models for how Swarovski can best approach both a global market of talent and the new demands of Generation Y recruits. Through this analysis it can be determined that Swarovski's focus on innovation is essential to their successful strategy overall. Additionally, it can be recommended that they look to become an Employer of Choice for continued future achievement.

### **INTRODUCTION**

The answer to "How can you attract and retain top talent?" is changing dramatically as Generation Y begins to command the workforce, and companies must rebrand their recruitment and retention strategies to meet this new demand. Swarovski faces not only this challenge, but also is tasked with creating an appealing workplace for their employees located across the globe, while holding true to one overall company culture.

Generation Y (also known as Millennials) are the demographic cohort born in the 1980's up until as young as the very early 2000's. They are the first generation to have spent their entire lives in the digital environment and therefore information technology profoundly effects how they live and work (Bolton, 2013). Since technology has always been easily accessible to this generation, companies must change their strategies to adapt to technological advancements. Generation Y workers have vast capabilities to bring about dramatic positive change in a company - mobilizing their networks, quickly analyzing volumes of relevant information, pulling together solutions and generally working against the status quo. However true commitment is needed and without engagement at work, Gen Y employees won't utilize their unique skills to make a difference. Managers today need to not only appeal to Gen Y workers' desire to be change agents, they also need to give them enough influence to initiate and implement their innovative ideas. When leaders create Human Resource Management Strategies they need to absolutely ensure they are allowing employees to span organizational boundaries and enable young workers through coaching rather than directing (Nayar, 2013).

To look at how Swarovski approaches these changing demands a brief history of Swarovski will be presented to create a better understanding of the company and what was fundamental in its development over the past one hundred years. Following this the McKinsey '7-S' Model will be utilized to fully examine

Swarovski's strategy on each individual level of the model. This will also allow the strategy to be analyzed as comprehensive functions, as this model is built on the foundation that each function is interdependent on the others and lacks hierarchy.

As a global company Swarovski faces the changing demands of the workforce while also facing the challenge of appealing to potential employees in the many countries in which they operate business. Therefore, following an in-depth examination of the company's strategy, the use of Hofstede's Cultural Dimensions Framework will be utilized to pinpoint challenges from globalization and identify any tactics the company uses to combat these. This framework can also be used to identify if the cultural dimensions of the company are appealing to Generation Y recruits.

Finally, after a brief look at competitors' strategies, this paper will try to determine if Swarovski has a valuable strategy currently in place and offer any potential recommendations to improve its policies.

## **HISTORY**

In 1895, in the small Austrian town of Wattens, a man named Daniel Swarovski was driven to create crystal that would be accessible to more people. More than a hundred years later Swarovski crystals are globally recognized as the world's leading manufacturer of cut crystal. The company, whose headquarters still remain in Wattens, continues to be guided by Daniel's innovative spirit and drive to create a 'a diamond for everyone'. Swarovski is still run by family members, currently the fifth generation, and has grown tremendously throughout the years using the brand's innovative foundation to become a multi-brand, multi-billion euro business with a brand presence in over 170 countries. Today Swarovski includes companies such as Swareflex for glass reflectors and road safety solutions, Tyrolit for tools, Swarovski Optik for binoculars, telescopes and even scopes of hunting rifles, Swarovski watches, and most recently in 2011 its own perfume line (Swarovski Website, 2015).

While Swarovski is a company with physical products, they have embedded these products into the everyday culture of our society. Their lighting designs are showcased from the Metropolitan Opera House in New York to the chandelier in the Palace of Versailles. Thousands of Swarovski crystals adorn the iconic costumes of Marilyn Monroe in "Diamonds are a Girl's Best Friend" and more recently Nicole Kidman in "Moulin Rouge". Without realizing it Swarovski has built its brand around our society and behind that brand are thousands of people working in departments ranging from management to sales and production to marketing (Swarovski Website, 2015). The development of the company into numerous branches certainly has expanded Swarovski around the globe with employees working in every corner. Over 25,000 employees work solely for the Swarovski Crystal Business and another 30,000 under the Swarovski Group. With their founder's innovative spirit driving the company's success it is crucial that Swarovski continues to hire and retain the creative minds that will lead the company down the next path of innovation. Modernizing their recruitment strategy, as generational trends alter, is imperative to obtaining this talent. Swarovski makes an excellent case because they have been developing and growing as a company for over 100 years and have established very strong Human Resource Management Strategies to match their company's culture while appealing to the potential workforce.

## **STRATEGY**

Moving into the next generation of recruitment and retention Swarovski needs to assess and prepare a complex and comprehensive Human Resource Management Strategy. Recruitment is the process of attracting an adequate pool of qualified candidates to sustain qualified and talented staff for specific job

requirements now and in the future (Cunningham, 2015). In recruiting Generation Y candidates it is crucial that managers are creative and adjust to changing economic and social environments.

In the following pages this paper will approach each of McKinsey's 7 S's. This framework allows for the analysis and recommendation to be holistic, as the lack of hierarchy among the factors demonstrates that each part of the organization is interconnected and dependent on the success on progress of the other parts.

### **Strategy**

The high brand awareness of Swarovski keeps it competitive among consumer markets. Within recruitment, through the same strategy of high awareness, they are also able to be competitive by appealing to mass markets and having strong brand viability. Swarovski is active and works to stay relevant on multiple social media platforms. The company currently uses Facebook, Twitter, YouTube, and LinkedIn pages dedicated solely to career recruitment and engagement. These practices keep them not only relevant in the sea of recruiting companies, but it also allows them to demonstrate their competitive advantage to their talent pool. What is also vital about having a high social media strategy is that Swarovski becomes globally visible as an employer. Swarovski operates in 170 countries and it is crucial that they keep an international perspective on their recruitment strategy.

### **Structure**

Swarovski has always been and continues to be a family owned and operated business. Five fifth-generation Swarovski family members run the executive board and they pride themselves on having kept this aspect of their structure throughout development. It is the nature of a family company to think in terms of generations rather than in calendar quarters and this creates a long-term orientation in their structure and daily practices (Swarovski Group, 2013).

Having multiple companies under the Swarovski brand, it is critical that they all focus on open communication and working towards the major company priority of innovation. Innovation is a priority across the company and across all functions. Innovation in all business areas is what drives the company and it is what the structure is based around (Swarovski Website, 2015). This spirit is something that is highlighted in recruitment material, as it is something that is attractive to Generation Y.

### **Systems**

Swarovski maintains its head office and operations in Wattens, Austria. They are one of the biggest employers in Austria and employ almost 5000 people in Tyrol. Their office in Austria specializes in areas ranging from marketing to manufacturing, finance to product management. Although they also have global departments and the organization has main offices around the globe, Austria continues to be the base of from where the organization is run.

From the recruitment standpoint the company is well versed in social media methods for the management of potential future partners. Social media also creates a new communication option where potential recruits can communicate with the company through a tweet, Facebook message, or LinkedIn post. This system allows for a significantly faster flow of information to potential recruits and a more direct way of communicating company needs and goals.

## **Shared Values**

Although each section of the framework is equally as important as the next for the overall success of a company's strategy, shared values is arguably the single most important factor when it comes to the recruitment of Generation Y. Applicants are more likely to be attracted by employers who have a good reputation and embrace corporate values in line with their own (Economist Intelligence Unit). The fact the Swarovski has had a core value of innovation from the conception of the company creates authentic and trustworthy appeal from Generation Y talent. These young workers are looking for greater access to knowledge and collaborative networks so that they can initiate and implement innovative ideas (Nayar, 2013). This is a value already shared and respected throughout the company's culture and therefore can be assumed it will help to achieve results in attracting and retaining talent from Generation Y.

Along with the value of innovation, Swarovski also commits to a high degree of corporate social responsibility and gives back to the community as much as they are capable of. By having a genuine structure already created around this, they have developed as a trustworthy brand to which young talent can relate. A small but significant example of this social responsibility can be seen through a recent tweet sent out by the Swarovski Careers Twitter account sending prayers for Paris in the midst of the terrorist attacks there. This act allows the community to see that the company is not only compassionate, but also shows that their accounts are relevant and not solely for company promotion.

Generation Y seeks out companies that they feel will share the same values as them and will provide them a company culture that allows them to grow and develop their skills. The majority of these young people will decide their opinion of a company as a future employer based on the degree to which a company is seen as an innovative workplace. The fact the Swarovski already has an attitude of welcoming and adapting to the changes innovation brings places them above the competition in this degree.

## **Style**

As already discussed Swarovski as a company and as a brand, is extremely dedicated to a culture that promotes and exemplifies innovation. This is reflected in their leadership style and the communication functions between and amongst teams.

Currently their recruitment style is very much based in the social media medium. Because of their global brand presence and the high traffic through their website, they rarely need to use job boards or paid advertisements, and instead appeal to this generation by using Facebook and Twitter (Burgess, 2014). Having a recruitment style that is current with technology trends allows the company to more successfully recruit employees from Generation Y who are much more technologically savvy.

They are very supportive of the next generation and believe that at the end of the day it's nothing but creativity and innovation that helps their industries move forward, from fashion to art, jewellery, architecture, and design (Swarovski, 2015).

To facilitate open communication and give employees a voice on how improvements can be made, Swarovski began using an employee survey in 2012. With a response rate of 74% the company looked to measure levels of engagement and enablement across the organization. Conducting this survey contributes to the vision Swarovski has of being an attractive employer by identifying the areas where the company is succeeding and where it needs to improve. Based on the results of the survey and its feedback, targeted actions plans are now in place locally and globally (Swarovski Group, 2013). Initiatives like

feedback surveys are crucial to the happiness of Generation Y employees, as they need to be heard, and for their concerns to be recognized, in order to be content in a work place. Swarovski not only has these surveys, but acting on the results demonstrates their responsibility as an employer.

### **Staff**

The continued success of Swarovski is constantly credited to their complex and diverse staff. Being a multi-faceted company they have people operations in many different areas from Retail, Design, Production and Supply Chain to corporate functions such as Sales, Finance, Human Resources, IT, Marketing and Retail Architecture (<https://www.linkedin.com/company/swarovski/careers>).

Swarovski's employs an extremely diverse workforce. Although they have offices and sales units across the globe their head office, which remains today in Wattens, Austria, will be used as a primary example of this. Sixty nationalities and 16 languages were registered as working at the Wattens site in 2012. Female employees represent 43.88% of the staff at Wattens and 2% of their workforce are employees with disabilities. At senior management level 9.23% are female, while at middle management level 32.36% are female (Swarovski Group, 2013).

Diversity is a driving factor of success in today's globalized business world. Culturally diverse work teams are better able to attain high levels of financial profitability and it has been found that work-place coherence can stunt creativity (Ng & Tung, 1998). A broad definition of talent will allow the company to draw on diverse sources of talent to create successful campaigns and procedures.

### **Skills**

Swarovski supports a workplace that maintains a continuous effort to manage and develop their employees' skill sets. Various programs for skills management are offered including internal training courses, funding support for external courses, the provision of sabbatical periods, retraining, and more. Welcoming and encouraging employees to develop and learn new skills works as an intrinsic motivational tool as well as acts as an incentive to stay with the company over a longer period of time. Many Generation Y employees, unlike the previous generations, do not feel an obligation to stay with a company over a long period of time if their career interests are not being advanced. These training programs would create a more long-term orientation in Generation Y workers at the organization.

The use of these programs creates better motivational measures at the company. Motivation is internal to each individual and a self-generated process that causes behaviour to be energized, directed, and sustained. Rather than expecting managers or others to motivate people, the essence of motivation results from redesigning the job so it is motivating (Cunningham, 2015). Having different avenues for skills training (external, internal, sabbatical, etc.) allows each employee to direct their own training path to ensure maximum satisfaction and overall engagement.

Performance of employees at Swarovski is monitored with performance appraisals to 100% of office employees (Swarovski Group, 2013). The size of the company makes the monitoring of skills important to future success. As stated in the above writing, the company not only carries out performance appraisals, but they also consult their employees through discussions and surveys to assess how progress is being made.

Being a global company, management at Swarovski must ensure that it is developing its employees' skills among its many countries of operation. The Swarovski Leadership Academy acts as a Competence Center for Leadership and helps to develop leadership skills and shape leadership culture. In 2012, the Swarovski Leadership Academy delivered 23 academy classes to 312 participants from 26 countries (Swarovski Group, 2013). This academy allows the skills of worldwide employees to be developed while continuing to stay true to the company's overall corporate culture and values.

## **CULTURAL DIMENSIONS**

Looking at a global company like Swarovski it is crucial that cultural dimensions are analyzed so that the company can develop best practices for its employees and consumers all over the world. Hofstede's Cultural Dimensions offers a framework to compare the culture of various countries and how each individual country responds to workplace culture. This paper will analyze five of the model's dimensions below in how they relate to Austria, the headquarter country, and how that affects their global identity.

### **Power Distance**

Power distance is defined as the extent to which the less powerful members of institutions and organizations within a country expect and accept that power is distributed unequally (Hofstede, 2015). Austria scores an extremely low score of 11 in this dimension. This categorizes them as a country where workers value their independence, superiors are accessible, and hierarchy is for convenience only. Control is disliked in this culture, as power is generally decentralized as managers look to the experience of their team. Additionally, communication styles would be both informal and direct within a company in Austria.

The above characteristics very much suit the overall attitude of Swarovski as a company. This isn't a surprise as they were founded and continue to be based out of Austria. However they do work to ensure this style is representative of this management across the globe. This can become difficult in Arab and Asian countries where power distance is generally quite high, but utilizing training programs for leadership can help ease this difference. Generation Y would find the low-level power distance within this company appealing. Having open communication, independence and little to no hierarchy is something that they value in work and this would make Swarovski an employer of choice.

### **Individualism**

Individualism has to do with whether people's self-image is defined in terms of "I" or "We". It is the degree of interdependence a society maintains among its members (Hofstede, 2015). Austria scores right in the middle in this category. This creates a high preference for a loosely knit social framework where individuals are expected to take care of themselves. In terms of work-based decisions this culture would promote contracts based on mutual advantage and promotion or hiring decisions would be based on merit only. Although there can be some degree of "in-groups" and taking care of one another, in general the working culture is based around individual goals.

Austria's stance in individualism would meet Generation Y's general need to receive validation for the work they have accomplished as individuals (Erickson, 2009). However, Generation Y also is comfortable in very collaborative and open environments. Swarovski, although overall fits in Austria's ranking of Individualism, continuously works in collaborative teams and has open communication among management and individuals. As a global company being in a fairly middle ground in this dimension, it allows them to relate to both ends of the spectrum and communicate appropriately with global partners.

## **Masculinity**

Societies that are driven by competition, success, and being defined as a 'winner' are ones that can be described as having a high ranking of the Masculinity dimension (Hofstede, 2015). Austria is a very masculine society. With a score of 79 they are highly success oriented and driven. In masculine countries people "live in order to work" and there is an emphasis on competition and performance. This competitive value generally starts in school and continues throughout organizational life.

Globally it is hard to insert a competitive nature in those countries which are much more feminine and therefore Swarovski must ensure different motivational measures are put in place in these locations. Although ambitious, Generation Y graduates put great value into having a work-life balance and only basing value in work success is not enough to keep them engaged. Multiple studies find that a good work-life balance ranks as high as 3<sup>rd</sup> most important in a Generation Y'ers working life (Syrett, 2014). Swarovski found in its 2012 employee survey that in terms of work-life balance they are currently below the level of global high-performing companies. Therefore, they have begun to work on specific initiatives to allow employees greater flexibility, which should lead to a better work-life balance and reduced stress (Swarovski Group, 2013).

## **Uncertainty Avoidance**

Uncertainty Avoidance can be defined as the extent to which the members of a culture feel threatened by ambiguous or unknown situations and have created beliefs and institutions that try to avoid these (Hofstede, 2015). Austria has a high preference for avoiding uncertainty as reflected in its score of 70 in this dimension. Cultures with high scores are intolerant of unorthodox behaviour, have an emotional need for rules, precision and punctuality are the norm, and innovation may be resisted.

Resistance of innovation conflicts with the core of Swarovski's company culture. The term "innovative spirit" is used constantly on their website and throughout company information. Although they value precision and work within rules, overall the company does not match up with its country's ranking. Not fitting into their country's norm allows them to be extremely attractive to Generation Y, who thrives on innovation and companies that value and encourage those pursuits. Taking this culture globally may prove difficult as they agree with some definitions of this dimension and vastly oppose others. The key for Swarovski will be ensuring the value of innovation is maintained to wherever they expand. Additionally they will need to recognize that rule-based structures may need to be relaxed in countries with low uncertainty avoidance. Having less stress placed on rules will also be beneficial in other locations when encouraging innovation – as a stress on both innovation and rules would be very unclear.

## **Long Term Orientation**

Long Term Orientation describes how societies prioritize maintaining links with their own past while dealing with the challenges of the present and future (Hofstede, 2015). Austria, who ranks relevantly high in this dimension, is a pragmatic culture that encourages efforts in modern education to prepare for the future. Traditions are adapted easily to changing conditions and there is a tendency to be thrifty in achieving results.

As a Global company Swarovski must ensure that when moving to countries with a lower score they show a respect for traditions. These more opposite cultures are more focused on quick results and maintaining time-honoured traditions. Generation Y, although not attached to traditions, is keen on seeing quick

results and is likely to become bored or frustrated without visible progress. Swarovski's openness to any kind of innovation would allow the development of ideas whether quick or long-term and new or based in tradition. This creates an environment where, regardless of culture, employees are able to approach problems or ideas in a way with which that they are comfortable.

## **Conclusions**

Cultural dimensions play a key role in the success of a company's international expansion. Austria as a country is extreme on the cultural spectrum of both Power Distance, particularly low, and Masculinity, exceptionally high. Where these extremes may cause difficulty in global reach, measures can be taken to reduce the risk factors that these tendencies bring. With such decentralized power and direct communication as a norm, global managers can work to ensure employees feel comfortable in a more collaborative environment. Additionally with a strong competitive nature in Austria, it is important to ensure that quality of life is high for employees in more feminine cultures, as this is what will be successful in their motivation.

After analysis above it can be determined that Swarovski's culture as a whole generally aligns with that of Austria. The major distinction is when it comes to the company's strong emphasis on innovation against Austria's general preference to strong rules. However, this attention to innovation and drift from typical country norms is a crucial characteristic in the overall long-term success of Swarovski's Human Resource strategy. Generation Y is both motivated and engaged through innovative freedom in their work and Swarovski's culture is therefore a major strength in their recruitment process. Understanding cultural dimensions is vital to the success of a globalized company. The company carries values and has standards that would generally be smooth to transition into new markets. Furthermore, their history of innovation has allowed the company to present principles that increase the company's prospect of being seen as a good "fit" by Generation Y recruits. This cultural fit with recruits will carry into successful retention of talent in the long-term.

## **COMPETITORS**

The luxury jewellery market is particularly competitive; top brands include Tiffany & Co., Cartier, and Harry Winston. Additionally they are in the market with Pandora and brands that meet less extravagant consumer wants. Swarovski must work to not only position themselves in the consumer market, but also as an appealing employer in the job market. Tiffany and Pandora will be discussed as competitors in attracting top talent to the company.

### **Tiffany**

One of Swarovski's biggest competitors in the luxury jewellery market is Tiffany & Co. The company was founded in 1837 and is headquartered in New York City. In sharp contrast to innovative values that Swarovski holds, Tiffany & Co. promotes excellence based in the company's tradition and history. Employee engagement is high at Tiffany & Co. and they work to help employees achieve a strong work-life balance. The Healthy Tiffany and Everyday Resources program supports Tiffany employees in classes and services ranging from meditation and nutrition to confidential family counselling (Tiffany & Co., 2014) Swarovski has an advantage over Tiffany & Co. in their established value of innovation that they share with incoming Generation Y employees and recruits. However, Tiffany has a better position as an employer who promotes and assists in work-life balance, another major value of Generation Y workers. Swarovski has recognized the significance in work-life balance and is currently working to improve its position in this area.

## **Pandora**

Pandora is an international jewellery manufacturer founded in 1982 in Copenhagen, Denmark. Their company culture is based in the values of “Pride, Passion, and Performance.” They focus on the importance of individuals while maintaining low hierarchy and place a high importance on the diversity of its employees. They are currently working on a range of initiatives to ensure that no gender should account for less than 35% of board members and the gender split in senior management positions should be at least 40% (Pandora, 2013).

While Swarovski very much values diversity, compared to Pandora it misses the mark with gender diversity. In their last survey 9.23% of senior management was female, while females in middle management made up 32.36% of the workforce. In comparison to Pandora, having women account for 50% of Vice Presidents, Swarovski needs to work to be more gender inclusive. However, Swarovski does have an advantage over Pandora in that they are better known globally and have a stronger brand presence when it comes to recruitment. Swarovski and Pandora share a weak hierarchical structure, which is something that appeals to Generation Y’s ideal leadership structure.

## **RECOMMENDATION**

Recruitment is often the focus in Human Resource strategies, however it is crucial that retention strategies are also considered for long-term success. Employees from Generation Y are often branded as job hoppers and the majority of Millennials expect that they will stay at a job for three years or less (Meister, 2012). Hiring managers should not look at this trend as a reason to avoid hiring this Generation; a strategy such as that would create a great loss of current talent for the company. However, because of this trend, it is imperative that retention strategies are implemented throughout human resource procedures. New employees require a sizable investment of time and resources, and losing an employee before this investment pays off is immensely detrimental to overall company success.

Successful retention of employees from Generation Y requires that a company ensures employees constantly feel fulfilled by the work they are completing. Job fulfillment is more important to Generation Y workers than it has been to any previous generation and the desire for this is what often leads to the job-hopping tendency. Therefore a recommendable strategy is to allow employees to contribute creatively and have their ideas heard. Swarovski currently has some systems in place for this (employee surveys), but creating a more comprehensive and easily accessible communication plan would support the advancement of employee ideas. Additionally, higher flexibility at work is likely to increase engagement and satisfaction of employees. Understanding and allowing flexible hours, when they are needed, is an excellent and simple step that Swarovski can take to maintain company commitment. However, what is possibly the most important step in creating long-term retention of employees is communicating the company’s values from the very beginning of the recruiting process. Generation Y recruits believe that a positive and shared company culture is one essential. By communicating values during the recruitment process employees that don’t see themselves fitting in with the culture will likely remove themselves from the process before any investment is made. Overall Generation Y is more difficult to retain than the previous generation, who were more focused on security, but the growth they can bring to a company are worth developing a stronger retention strategy.

A credible recruitment strategy that Swarovski should consider developing is becoming an Employer of Choice. An Employer of Choice describes a workplace which all people find attractive. It can be specifically designed to be attractive to one designated group, in this case Generation Y, however a workplace that is

supportive and focuses on this strategy is likely to be attractive to all groups. Such a workplace works to recognize what people value and need in their work to be happy; generally this includes a supportive work environment, challenging work, work-life balance, opportunity for achievement and a company with high values (Cunningham, 2015). The idea of being an Employer of Choice is like developing a brand for the organization as a great place to work in the minds of recruits as well as current employees. When a company is successful in this strategy online recruitment is vastly improved, as employees will search out the company without being approached. If Swarovski markets itself as a good employer, people will come to them, achieving improved recruitment results while also improving overall company satisfaction. Additionally, companies that use language and terms such as striving to be an Employer of Choice indicate their vision of being an ideal employer and thus become more attractive overall. It is a tactical move for Swarovski to work on incorporating being an Employer of Choice into recruitment strategies. They can quickly add their company to nomination lists for awards such as Top Employers for Young People, Most Innovative Company, and other awards that would improve brand image. Even without winning, this movement towards improvement will be acknowledged.

Swarovski is a well-established brand and they continue to be successful through utilizing their top talent. It is recommended that Swarovski increases its promotion of having an innovative spirit and uses technology as a major recruitment method. As the company continues to develop on a global level and recruit talent with demands they have yet to encounter, it will be central to their success that employee engagement and fulfillment are valued. Recruitment and retention are likely to be positive if future and current employees feel that they are appreciated by the company and fit in with its culture.

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# **Chanel and Chanel No. 5:**

## **A Global Marketing and Advertising Strategy**

Andrea Jones

### **ABSTRACT**

Chanel is one of the world's top luxury brands. The company that was founded in 1910 by Gabrielle Coco Chanel has revolutionized the women's fashion industry, and has achieved much success from frequent product updates and new product releases. With the launch of the famous Chanel No. 5 fragrance in 1921, Chanel made its mark on the perfume industry. It is now the world's most famous perfume, and a product that the brand is known for. The perfume industry is fast paced and dynamic; the constant threat of new entrants and substitute products forces companies to innovate in order to differentiate themselves in the marketplace. To achieve this, companies have found success in localizing their advertising and marketing strategies to appeal to the cultural preferences of consumers at a local level. However, Chanel has managed to find success in the marketplace through using a global marketing and advertising strategy. This paper will reveal the details as to why Chanel does not need to localize its marketing and advertising, and how it has achieved positive results from a global strategy. In essence, their success derives from its rich history and strong brand heritage. And through further analysis of Chanel and its advertising for Chanel No. 5, this paper will further prove the strength of Chanel's brand heritage, and how it has been able to effectively leverage Urde, Greyser, and Balmer's five "Elements of Brand Heritage" (2007, p. 9). Chanel uses its brand heritage as its main competitive advantage, and continues to sustain and protect this heritage through a company brand stewardship function.

### **THE PERFUME INDUSTRY**

#### **History and the Beginning of Chanel No.5**

Humans have been using essential oils and scents since the beginning of time (Berger, 2007, p. 1). People were drawn to their aromatherapy benefits, and they were a part of their daily routine (Berger, 2007, p. 1). Scents and essential oils were used in religious practices and rituals, as antiseptic mediums, and to scent general household objects (Berger, 2007, p.1). In the late 19<sup>th</sup> century, scents grew in popularity and advances in chemical engineering began to develop quickly allowing scents to be processed into perfumes (Berger, 2007, p. 1). This was the birth of the perfume industry, and it took place in the small town of Grasse, France (Berger, 2007, p.1).

Grasse "became [the] centre for flower and herb growing for the perfume industry" (Berger, 2007, p.1). Grasse plays an important role in the history of the perfume industry, and to this day, it is known as the perfume capital of the world. The plants harvested in Grasse supply the raw materials to create the world's most famous scent, Chanel No. 5 (Hautala, 2011, p. 20). The jasmine and roses used to complete the formula for Chanel No. 5 come exclusively from the region of Grasse (Hautala, 2011, p. 20). Chanel has continued to nurture its relationship with the jasmine farmers in Grasse, and has even created an extraction facility next to the jasmine fields "where it purchases and processes the entire harvest" (IFA,

2013, p. 13). This “symbiotic relationship” (IFA, 2013, p. 13) alone establishes Chanel and Chanel No. 5’s monopoly over and history in the region of Grasse. When consumers think about luxury perfumes, Chanel No. 5 is one of the first perfumes to come to mind. And it is said that most women will wear the mild and floral scent of Chanel No. 5 at least once in their lifetime (Zeybek, 2013, p. 13).

### **Industry trends**

Over the past six months Europe, and more specifically France, has been under social and economic angst. Due to not only the attacks in Paris and Brussels, the overall stability of France and the European Union has been under question (Reguly & Mackinnon, 2016). In turn, the Economic Sentiment Indicator (ESI) measuring the market confidence indicator in industry, services, consumer, construction, and retail confidence, has logged its “third consecutive drop in both the euro area (by 0.9 points to 103.0) and the EU (by 0.7 points to 104.6)” (European Commission, 2016, p. 1). And more specifically, France’s ESI has dropped significantly by -1.8 points (European Commission, 2016, p. 1). Additionally, France’s GDP growth trend has been slowly decreasing over the past four years, from a 2.0% growth in 2010 to a 0.4% growth in 2014 (MarketLine, 2015, p. 31). As France is “one of the largest members of the Eurozone, much of France’s fortunes are tied to the economic fortunes of the EU trading bloc” (MarketLine, 2015, p. 7). With the continual threat of Britain leaving the EU, the overall economic position of France will continue to remain unstable (Reguly & Mackinnon, 2016).

This decelerating trend has directly affected the growth rate of the French Fragrance Industry (MarketLine, 2015, p. 7). The French Fragrance industry has been growing at a much lower rate since 2010, and is expected to do so over the next five years (MarketLine, 2016, p. 7). Consumer confidence in the EU has dropped by -0.9 (European Commission, 2016), and similarly, French consumers have decreased their spending by -0.2%, “reflecting [France’s] wider economic problems” (MarketLine, 2015, p. 7). This downward trend directly affects the French fragrance industry, as fragrances fall under consumer goods (MarketLine, 2015, p. 7).

Due to the lack of economic and social stability and the decline in EU consumer spending, it is integral for perfume companies to differentiate themselves in the perfume market. Differentiation is integral to the survival of a perfume as many new fragrances enter the industry each year (I. Coste, personal communication, February 25, 2016). In addition, there is a moderate threat of substitution within the industry making it even more crucial for companies to establish themselves and create brand loyalty to stay on top and remain successful (MarketLine, 2015, p. 20) The significance of brand loyalty can be further proven through the breakdown and distribution of the market share within the French fragrance industry (Table 1). A few key players dominate the market share of France’s fragrance industry, with the remaining market share belonging to a variety of other unnamed perfume companies (Table 1). Chanel holds a significant 8.3% of the market share, and is competing alongside three other leading companies: LVMH Moët Hennessy Louis Vuitton SA (16.1%), L’Oreal S.A. (11.4%), and Joh. A. Benckiser GmbH (9.1%) (MarketLine, 2015, p. 12). These four companies hold 44.9% of the French fragrance market share, while the remaining 55.1% is shared amongst the many other perfume companies in France (MarketLine, 2015, p. 12). Companies such as Chanel hold many advantages over the less popular perfume companies. For example, its “robust intellectual property framework” (IFRA, 2013, p. 8), “extensive portfolios” (MarketLine, 2015, p. 19), and relationship networks make it difficult to penetrate. This has given Chanel the ability to protect its R&D, production, and materials, and most importantly its exclusive rights to the jasmine and rose fields in Grasse (IFRA, 2013, p. 8).

Company	% Share
LVMH Moet Hennessy Louis Vuitton SA	16.1%
L'Oreal S.A.	11.4%
Joh. A Benckiser	9.1%
Chanel	8.3%
Other	55.1%
<b>Total</b>	<b>100%</b>

**Table 1: Market share by value as of 2014 (MarketLine, 2015).**

## CHANEL

### History

Chanel is an iconic worldwide luxury brand. It is a privately held company that was founded in France in 1910 by Gabrielle “Coco” Chanel (Nagasawa, 2011, p. 3). Coco Chanel had a surprisingly “humble and undesirable” (Hautala, 2011, p. 4) upbringing, one that most would not assume as the upbringing for the founder of one of the most desirable luxury fashion brands. She was an orphan child who turned into a showgirl actress (Hautala, 2011, p. 4). This was one of the most un-respected positions for women to have in 20<sup>th</sup> century society as its sole purpose was for male pleasure and entertainment (Hautala, 2011, p. 4). This was a perception and an image that Chanel wanted to change not only for her, but also for all women in society (Hautala, 2011, p. 4). With this goal in mind, Chanel opened her first clothing shop in Paris where she sold hats and other simple fashion pieces (Hautala, 2011, p. 4). Some of the most famous French actresses at the time purchased and wore her clothing giving Chanel a more respectable name and reputation (“Inside Chanel,” n.d.). Shortly thereafter, Chanel began to change women’s fashion by designing clothing, clothing that did not complement the “conventional appearance” (Driscoll, 2012, p. 140) of 20<sup>th</sup> century women. Her athletic designs had considerably less fabric and encouraged women to lead a healthy and active lifestyle (Driscoll, 2012, p. 140). The classic 20<sup>th</sup> century corseted silhouette of women began to disappear, abolishing the look of the traditional woman (Driscoll, 2012, p. 140). And in turn “the modern woman was born” (as cited in Driscoll, 2010, p. 140). This modern woman represented Gabrielle Coco Chanel in every aspect. Chanel started the revolution in women’s fashion, and to this day she is recognized and idolized as the creator of the “great fashion empire” (Weifang, 2011, p. 143).

Chanel’s success only continued to increase when she released her iconic fragrance in 1921, Chanel No. 5 (“Inside Chanel” n.d.). This scent was released at a time where women’s fashion was changing drastically. It captured the quintessence of this liberation making Chanel No. 5 “the ultimate symbol of femininity” (“Inside Chanel”, n.d.).

## **Company culture**

“Chanel is not a brand for elitists” (Nagasawa, 2011, p. 56). The brand did not come about for the needs of aristocrats and the upper class, and to reiterate, it is a brand that came from an underprivileged individual and essentially nothing (Nagasawa, 2011, p. 56). In this lies the foundation of the brand, the brand’s identity, and the company culture: liberation.

The brand identity of Chanel and the values of Coco Chanel herself are one of the same. According to Chevalier and Mazzalovo, a brand’s culture are highly aligned to the values of the founder of the company as well as the country culture in which the company was founded in: “The brand’s ‘culture’ is linked to the original values of its creators - often, the culture of the country, the region, or the city where the brand developed” (Chevalier & Mazzalovo, 2004, p. 101). In the case of Chanel, Coco Chanel’s values, France’s cultural values, and the Chanel brand values are interchangeable. Kapferer’s innovative brand identity prism was applied to the Chanel brand, identifying its physique, personality, culture, self-image, reflection, and relationship (as cited in Chevalier and Mazzalovo, 2004, p. 102) (Figure 1). Within this figure, the cultural values of Chanel have been identified as simplicity, sophistication, anticipation, and liberation (Chevalier and Mazzalovo, 2004, p. 102). The key value identified is liberation, as this value is the most highly correlated between Coco Chanel’s values, French country culture values, and Chanel’s corporate values. Liberation is one of the main pillars in France’s national motto: “Liberté, Égalité, and Fraternité”. This motto is highly ingrained into the French culture and everyday life in France. The word “Liberté” or “liberty” can be defined as “the state or condition of people who are able to act and speak freely”, “the power to do or choose what you want”, and “a political right” (Merriam-Webster, n.d.). Similarly, as previously mentioned, Coco Chanel led the way in the liberation of women’s fashion in the early 20<sup>th</sup> century. She was never married and she never had children, something that was very uncommon for women at this time (Weifang, 2011, p. 143). And “this is one of the best example of the liberation of women” (Weifang, 2011, p. 143). She spoke her mind and made her own choices regarding her actions; she defied society’s expectations, and embodied this liberation in every way. Thus, liberation represents and is of great value to Coco Chanel and France ultimately translating this value into one of the key values of the Chanel brand.

## **ADVERTISING AND MARKETING**

When examining the luxury industry, it is important to note that perfumes are one of the most prevalent products to be advertised. This is due to the fact that the perfume designer only receives a small percentage of the sale when a sale is made in a non-specialized retail store (I. Coste, personal communication, February 25, 2016). Even though specialized retailers are the leading distribution channels for perfumes in the French fragrances market (80.1%), non-specialized retailers account for the rest of the market (19.9%) (MarketLine, 2015, p. 12). With sales taking place in non-specialized retail stores where many other brands are present, it is crucial for perfume companies to distinguish their products in the marketplace. In addition, as previously stated, because of the threat of new entrants and substitute products and the continuing downward trend in consumer spending, it is important for perfume companies to differentiate themselves from the competition through the execution of a well-planned out advertising and marketing strategy. These strategies consist of various communication platforms including both print and digital messages (Angelini and Frederico, 1998, p. 110). It is pertinent for companies to come up with innovate campaigns to capture their target market, especially through digital advertisements, as “commercials are one of the most effective media enabling communications between brands and consumers” (Zeybek, 2013, p. 12).

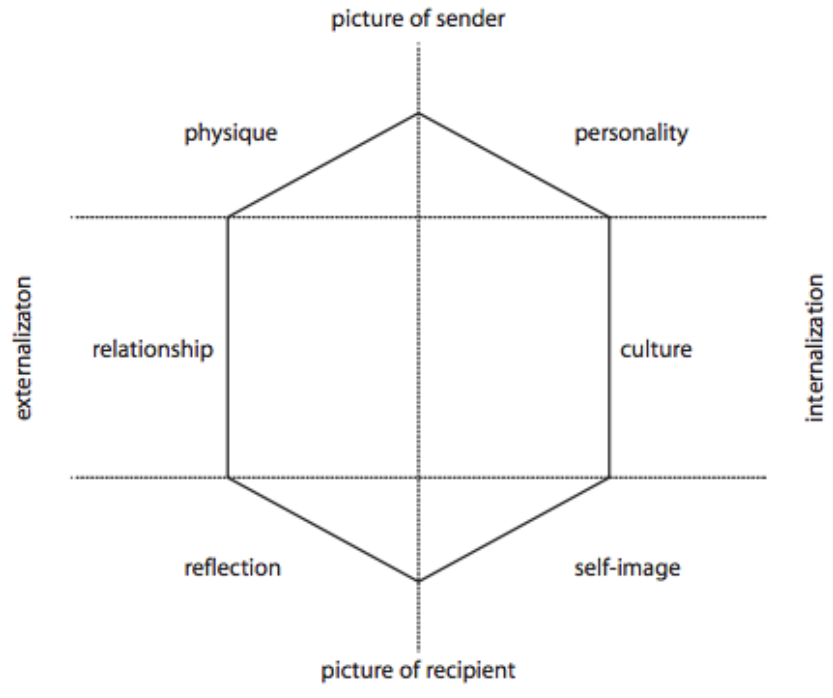


Figure 1. The brand identity prism applied to Chanel.

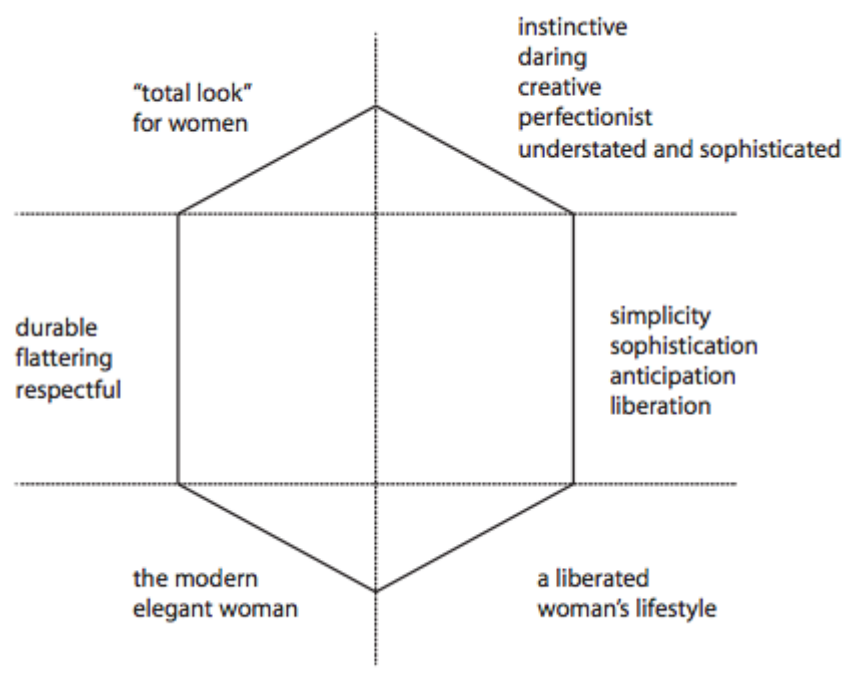


Figure 1 (continued). The brand identity prism applied to Chanel.

## Local vs. global

In order for a brand to have a successful advertising and marketing strategy, it is vital for companies to understand the “cultural, historical, and linguistic variations” and differences of consumers, and adapt their messages to the country and culture they are broadcasting in (Angelini and Frederico, 1998, p. 110). It has been recognized that North American consumers identify better with a well-known celebrity, whereas consumers in Europe, specifically France, and consumers in Asia, specifically Taiwan, recognize and respond to commercials that contain subtle symbols (Angelini and Frederico, 1998, p. 110). Companies have found success when they localize their communication methods and their products as “building the commercial’s relation with the concerned culture and society, which are called cultural signs, are of crucial importance” (Zeybek, 2013, p. 13). Localizing strategies requires extensive work, resources, and research to learn about a specific country’s culture, language, and cultural preferences; however this hard work pays off as a company will relate better to consumers at a local level. In turn, translating the language of the advertisement and appealing to a country’s cultural preferences results in the success of a company’s product and their brand in that country. However, global brands, like Chanel, have found success in having a global marketing strategy, and have not found the need to localize its advertising messages and overall marketing campaigns. This is not to say that Chanel does not analyze the needs of its consumers and their preferences. In fact, Chanel has catered to the preferences of its North American consumers and its European and Asian consumers through the use of cinematographic commercials using both well-known celebrities and symbols (Zeybek, 2013, p.13).

Chanel has been facing the “phenomenon of maturing for several years.” (Chevalier & Mazzalovo, 2004, p. 156). In order to combat this, the company needed to make some changes to revitalize the image of Chanel and Chanel No. 5, and to also stay competitive in the ever-dynamic perfume industry. Since 2004, Chanel turned to cinematography to advertise for Chanel No. 5 (“Inside Chanel,” n.d.). These short films display Chanel No. 5’s long history with “the glamour of Hollywood” (as cited in Hautala, 2011, p. 6). They take consumers on a journey in a dreamlike world and state of mind (Zeybek, 2013, p. 13). These short films star well-known celebrities such as Nicole Kidman, Audrey Tautou, Marilyn Monroe, Gisele Bundchen, and even Brad Pitt (“Inside Chanel,” n.d.). The use of these actors and models appeal more specifically to Chanel No. 5’s North American consumers as North American consumers relate better to celebrity figures. In addition, these advertisements contain understated symbols appealing to the European and Asian market. For example, in the film created in 2009, featuring Audrey Tautou, various historical symbols and common cultural messages are used (Zeybek, 2013, p. 14). The majority of the film takes place on the Orient Express, which is a train that travels from Paris to Istanbul (Zeybek, 2013, p. 15). This train symbolizes and represents a journey of “luxury”, “privilege”, and “prestige” because, in the past, only wealthy and upper class people were able to ride this train (Zeybek, 2013, p. 15). This historical association tells consumers that people who wear Chanel No. 5 are seen as superior and elegant (Zeybek, 2013, p. 15). Furthermore, the Orient Express also symbolizes the connection between Europe and the Middle East, giving Chanel No. 5 a more worldly and global image (Zeybek, 2013, p 15). This global image is how Coco Chanel wanted consumers, employees, and stakeholders to see the Chanel brand (Nagasawa, 2011, p. 55). Seagulls were also present in this cinematographic advertisement; seagulls are a symbol of freedom (Zeybek, 2013, p 16). This symbolic reference to freedom relates the commercial back to Chanel’s value of liberation. It tells consumers that no matter their wealth or position in society that they can feel superior and elegant when wearing Chanel No. 5. With Chanel’s core values, especially liberation, establishing the base of its external communications, and with these values being so closely linked to France, in turn, Chanel is also advertising French values and culture.

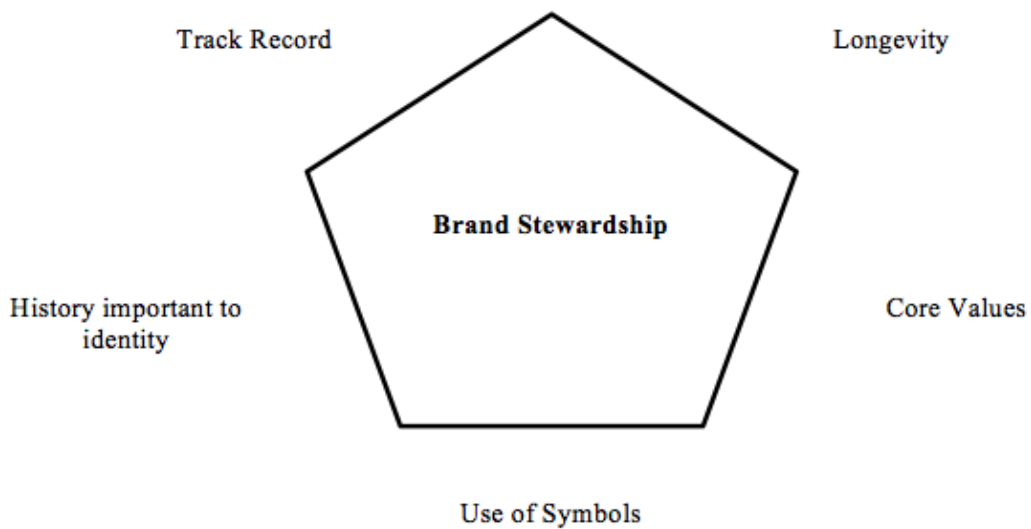
Indeed, Chanel's use of both celebrities and symbols caters to consumers all around the globe; however, this still does not answer the question as to why Chanel does not localize its advertisements, and more specifically for Chanel No. 5. These cinematographic advertisements have been broadcasted all over the world; they have not been changed or altered to adopt local languages and cultural preferences. As previously mentioned, companies have found great success when they localize and adapt their marketing strategies. So how has Chanel been able to achieve such success without the need to localize its advertising and marketing strategies? The main explanation for Chanel and Chanel No. 5's success comes from the rich history of the company, which stems from its founder and founding country. Because of Chanel's well-known rich history and culture, Chanel does not need to localize its advertising to capture its consumers; consumers already know who they are and what they stand for. According to Urde, Greyser, and Balmer, a strong company history "can provide leverage for that brand, especially in global markets" (2007, p. 5). Indeed, all brands have a history and a story to tell, but it is a brand's capability to stay current that determines the positive results of the brand (Urde, Greyser & Balmer, 2007, p. 9). In turn, this effort to stay current and relevant can be defined as a brand's heritage (Urde, Greyser & Balmer, 2007, p. 9). From Urde, Greyser, and Balmer's research on corporate brands with a heritage:

*The difference between heritage and history may seem minor. As Lowenthal cogently articulated, history, however, explores and explains what is often an opaque past; in contrast, heritage clarifies and makes the past relevant for contemporary contexts and purposes. We think much the same applies to brands when viewed through the lens of heritage in contrast to that of history. That is, heritage helps make a brand relevant to the present and prospectively the future. (Urde, Greyser & Balmer, 2007, p. 6)*

Chanel's ability to create innovative, new, and fresh ideas for its advertisements that do not drift away from the brand's history, values, and overall identity is how it has been able to achieve continued success for its products (Urde, Greyser, and Balmer, 2007, p. 5). As for Chanel No. 5, Chanel's new cinematographic advertisements have revived the ageing image of the perfume. They have made the perfume appear current and attractive to consumers ultimately maintaining its top position in the perfume market.

### **CHANEL'S ELEMENTS OF BRAND HERITAGE**

Through Urde, Greyser, and Balmer's case study on corporate brands with a heritage, they created a five element conceptual framework called, "The Elements of Brand Heritage" (Urde, Greyser, and Balmer, 2007, p. 9). This conceptual framework helps to measure for brand heritage and how well a company is using it to its advantage (Urde, Greyser, and Balmer, 2007, p. 9). The more a brand displays the presence and strength of the five elements in the framework, the higher the brand's heritage (Urde, Greyser, and Balmer, 2007, p. 9). These five elements, track record, longevity, core values, use of symbols, and history, revolve around one key component, brand stewardship (Table 3). Urde, Greyser, and Balmer see brand stewardship as being the most important piece of this framework tying all of the elements together and creating "the mindset for nurturing, maintaining and protecting brand heritage" (2007, p. 9). In the case of Chanel and its advertisements for Chanel No. 5, "The Elements of Brand Heritage" can be applied to the company, proving its power and high brand heritage.



**Figure 3: The Elements of Brand Heritage**  
 (Urde, Greyser, and Balmer, 2007, p. 9).

### **Track record**

*Track Record* has to do with how well a company has “demonstrated performance” and “over time has lived up to its values and promises” (Urde, Greyser, Balmer, 2007, p. 9). Creating a track record sets the pace for a brand; it is how the company views itself today and how it will continue to view itself for the future (Urde, Greyser, Balmer, 2007, p. 9). This consistency allows for “accumulated credibility and trust”, in which “are typically part of a heritage brand” (Urde, Greyser, Balmer, 2007, p. 9). Since Chanel was founded in 1910, it has been committed to abiding and living by its values of simplicity, sophistication, anticipation, and liberation (Chevalier and Mazzalovo, 2004, p. 102). Even with its changes in CEO’s, managers, and designers, Chanel has continued to liberate women’s fashion by staying true to its values and carrying out the legacy of Coco Chanel (Chevalier and Mazzalovo, 2004, p. 102).

### **Longevity**

Urde, Greyser, and Balmer state that longevity is one of the most difficult elements to measure as it is affected by the remaining four elements (2007, p. 10). In turn, the authors feel that *longevity* can be measured based on how well the remaining elements have been instilled and consistently represented by the company, even with the transitions between CEO’s and company leadership (Urde, Greyser, and Balmer, 2007, p. 10). In the case of Chanel, this is best represented by the smooth shift from Coco Chanel to Karl Lagerfeld as the creative director for Chanel (Nagasawa, 2011, p. 62). After Coco Chanel’s death in 1971, Karl Lagerfeld stepped in as Chanel’s head designer (Nagasawa, 2011, p. 58). As Chanel being one of the top luxury brands in the world, there were many critiques and opinions on this transition. Lagerfeld himself has even said that Chanel “would have hated his work” and what he has done to “[her] fashion house” (Alexander, 2012). On the other hand, the current Chairman of Chanel, Bruno Pavlosky, completely disagrees. Pavlosky has said that he thinks Chanel would be very proud of the work that Lagerfeld has created and that “she would be very satisfied with the way Karl has reinterpreted the things she created” (as cited in Alexander, 2012). It has also been said the transition from Coco Chanel to Lagerfeld was not only a forced transition, but also a necessary one. Coco Chanel was failing to revitalize the image of the

brand to keep it current with consumer demands and trends (Nagasawa, 2011, p. 63). When Karl Lagerfeld started at Chanel in 1983, he described the company as being tired; he called it a “Sleeping Beauty” (Nagasawa, 2011, p. 62). Instead of creating a whole new look for the company and the brand, his mission was to “resurrect the style invented by Coco Chanel” (Nagasawa, 2011, p. 62). His “progressive approach to creativity” and by not abandoning the values and brand image, instilled decades ago, has created longevity for the brand (Nagasawa, 2011, p. 47).

### **Core values**

Urde, Greyser, and Balmer state that a company's *core values* guide “its corporate behaviour and its choices regarding policy and actions” (2007, p. 10). Core values ultimately affect the entire strategy of the brand becoming a key component of the brand’s heritage (Urde, Greyser, & Balmer, 2007, p. 10). As mentioned previously, Chanel’s strong core values created based on Coco Chanel and France: simplicity, sophistication, anticipation, and especially liberation, have kept the company’s image, messages, and actions consistent (Chevalier and Mazzalovo, 2004, p. 102). These values have helped Chanel to keep external communications compatible and in line with the internal actions of the company (Urde, Greyser & Balmer, 2007, p. 10). Over time, these core values have become ingrained in Chanel’s internal and external communications keeping its liberated brand identity alive, and thus, creating an even stronger brand heritage (Urde, Greyser & Balmer, 2007, p. 10).

### **Use of symbols**

Companies use *symbols* to “express the meaning and heritage” of the company (Urde, Greyser & Balmer, 2007, p. 10). In the case of Chanel and Chanel No. 5, the Chanel double C logo, the number 5, and the iconic shape of the Chanel No. 5 bottle, are of symbolic value. Chanel’s double C logo is a monogram logo that is made up of Coco Chanel’s initials (Chevalier & Mazzalovo, 2004, p. 35). The use of Coco Chanel’s initials “stand for the brand” (Urde, Greyser & Balmer, 2007, p. 11) and they reinforce the importance of the brand’s founder, history, and heritage. In addition, when Chanel No. 5 was first created, it was the fifth scent to be presented to Coco Chanel by the “nose”, Ernest Beaux (Hautala, 2011, p. 4). The number five was Chanel’s lucky number, and to this day, holds symbolic significance to the brand and the perfume (Hautala, 2011, p. 4). Additionally, Chanel No. 5 was the first perfume to be sold in a square shaped bottle (G. Harnick, personal communication, March 9, 2016). This square shape bottle symbolizes and differentiates Chanel No. 5 from the rest of the perfumes presently, and when it was first released (G. Harnick, personal communication, March 9, 2016). These symbols have made Chanel and Chanel No. 5 easily identifiable by consumers giving the brand a deeper meaning and a distinctive representation (Urde, Greyser & Balmer, 2007, p. 11).

### **History**

According to Urde, Greyser, and Balmer, *history* is important to a company’s identity because it is the story of who they are and what they represent (Urde, Greyser & Balmer, 2007, p. 11). More specifically, “for heritage brands, the history influences how they operate today, and also the choices for the future” (Urde, Greyser & Balmer, 2007, p. 11). A company can use its history internally, externally, and/or both to communicate with stakeholders, employees, and consumers (Urde, Greyser & Balmer, 2007, p. 11). Chanel is a brand that is “faithful to its roots” (Chevalier & Mazzalovo, 2004, p. 107), and it uses its history to communicate both internally and externally. When compared with other luxury brands such as Hermès and Louis Vuitton, the power and richness of Chanel is much more significant (Nagasawa, 2011, p. 56). Chanel established its label in the 20<sup>th</sup> century and was the frontrunner in liberating the appearance of women (Chevalier & Mazzalovo, 2004, p. 187). This is a history that Chanel is proud of, and it is an integral

piece to its advertising and marketing strategies. For example, the entire history of Chanel is displayed on a separate website from the Chanel product site ("Inside Chanel", n.d.). It lists Chanel's achievements, milestones, and important historical events in a timeline format ("Inside Chanel", n.d.). This web site is called "Inside Chanel". The site also talks about specific product releases and fashion vocabulary. It has even archived its advertisements for viewers to enjoy over and over again, including Chanel No. 5's signature cinematographic commercials ("Inside Chanel", n.d.). Chanel's history is "important to its identity" (Urde, Greyser & Balmer, 2007, p. 11); it is also important to the internal affairs of the organization, and it is has also proven to have external value for its customers and stakeholders (Urde, Greyser & Balmer, 2007, p. 11).

### **Brand stewardship**

In order for a company to utilize its brand heritage to its full potential, it must tie these five elements together through a brand stewardship function (Urde, Greyser & Balmer, 2007, p. 15). This function's primary responsibility is to leverage the company's heritage using it as an asset and protecting its value (Urde, Greyser & Balmer, 2007, p. 15). Through Urde, Greyser, and Balmer's findings they discovered many actions associated with a brand stewardship function, many of which Chanel has demonstrated (2007, p. 15):

- You treat what has been done before you with respect.
- You have a focus on and an understanding of your company's core values and their link to heritage.
- You recognize the value and importance of symbols and symbolic actions, and know how to use them consistent with the core values.
- You have the ability to know when to accommodate change that involves the brand's heritage (Urde, Greyser & Balmer, 2007, p. 15)

Chanel has applied the above actions seamlessly. It has demonstrated its respect for the past by carrying out Coco Chanel's legacy, even with the shift to Karl Lagerfeld as Chanel's head designer. Chanel has also instilled its core values with its internal and external actions ultimately focusing and linking the brand to its heritage. Its use of symbols, such as its double C logo, connects the brand back to its founder and core values. And lastly, Chanel has proven its ability to accommodate change by continually revitalizing the image of Chanel No. 5 to keep up with current consumer trends. It has achieved this through using innovative marketing and advertising techniques for the product while still staying true to its brand heritage. With these demonstrations, it is apparent that Chanel has a strong brand stewardship function that utilizes and capitalizes on its brand heritage.

### **Heritage as a competitive advantage**

Through applying the five "Elements of Brand Heritage" to the Chanel brand, it is clear that the company uses its heritage as a competitive advantage through leveraging it in its global marketing and advertising campaigns (Urde, Greyser & Balmer, 2004, p. 11). According to Urde, Greyser, and Balmer, there are three major reasons as to why Chanel's use of heritage is so powerful:

- Heritage can provide a basis for distinctiveness in positioning, which can generate *competitive advantage*...
- Heritage can add to the brand's value proposition with depth, authenticity, and credibility for the *customer/consumer*...

- Heritage can help build a special relationship with a range of non-customer *stakeholders* ... heritage may make it easier to recruit (and retain) executives and employees. Heritage may also build *internal commitment and pride* to be part of a brand 'bigger than oneself' (2007, p. 12)

Chanel's use of heritage generates positive results because it is "distinctive for the brand" (Urde, Greyser & Balmer, 2004, p. 11) and it is difficult for its competitors to imitate (Urde, Greyser & Balmer, 2004, p. 11).

## CONCLUSION

Localizing advertising and marketing strategies may be necessary for some companies to generate brand interest and loyalty; however, companies with a strong brand heritage can leverage this element allowing them to find success when using a global strategy. Therefore, the reason why Chanel does not need to localize its advertising and marketing strategies is due to its strong brand heritage that is communicated internally and externally through its brand stewardship function. Chanel's continual ability to create modern and innovative advertisements for its products, such as Chanel No. 5, that stay true to its heritage creates consumer interest and in turn brand loyalty.

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# Pilsner Urquell's Response to Craft Beers

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## ABSTRACT

The objective of this research paper is to explore the rise of craft beer in the Czech Republic and the various strategies Pilsner Urquell has responded with. This paper will study the history of the Czech Republic and the beer market to provide a background for the current state of the industry. Various microbreweries will be examined to uncover their competitive advantages and the factors for their growth and success. Furthermore, changes in consumer desires will be examined to further explain the rise of microbreweries. Pilsner Urquell will be studied to explain their domestic success and the steps they have taken to respond to the growth of craft beers and the unique market position taken by microbreweries.

## INTRODUCTION

The state of the beer market cannot be fully understood within first examining the history, demographics, cultural dimensions and economy of the Czech Republic. The unique history of the Czech Republic provides an explanation for the myriad of ways in which business is conducted within the region. Furthermore, the growing number of tourists in the Czech Republic contributes to the large beer market. The cultural dimensions illustrate the general attitudes held by Czechs, shaping the way they interact within society and the business world. The growing economy within the Czech Republic offers a further explanation to the state of the beer market as Czech's disposable incomes continue to rise.

## CZECH REPUBLIC

The Czech Republic has a rich and unique history dating back to 400 BCE when various tribes beginning with the Celts but closely followed by the Germans and the Slavs originally inhabited the region. Christian missionaries arrived to the lands in the 9<sup>th</sup> century bringing with them religious teachings and modern writing. Bohemia – a region that today encompasses the western half of the Czech Republic – was under the rule of the Roman Empire from the 9<sup>th</sup> century until the 19<sup>th</sup> century. Czechoslovakia was formed from the combination of Czech and Slovak lands following the end of the First World War. During World War Two, Czechoslovakia came under Nazi occupation. Following the defeat of the Nazis, Czechoslovakia fell under communist Soviet rule. After the collapse of the USSR, sovereignty in Czechoslovakia was restored. In 1993, Czechoslovakia was dissolved and the Czech Republic and Slovakia were formed. The Czech Republic joined NATO in 1999 and became a member of the EU in 2004, although they still use their own currency, the Czech Koruna.

## Demographics

Despite being a popular destination for foreigners to visit, the majority of the Czech Republic's population is made up by Czechs. Czechs account for roughly 95% of the country's 10.5 million inhabitants, with the remaining 5% comprised of foreigners including Ukrainians, Germans, Poles, and Hungarians. Due to their rich history, unique culture, and low costs, the Czech Republic attracted over 9 million tourists in 2014, a number which has been steadily growing for the past 5 years. The single official language of the Czech

Republic is Czech, with the most common foreign languages being English, German, and Russian. The Czech Republic is one of the most secular countries in the world with the majority of the population not reporting any religious affiliations. Pundits explain that their high degree of secularism is a result of a high degree of nationalism as religious groups were seen as outsiders. Furthermore, this indifference for religious affiliations was amplified during the communist occupation whereby religion was prohibited.

### **Cultural Dimensions**

An evaluation of the Czech Republic using Hofstede's Cultural Dimensions reveals that Czechs are diligent, busy, hard-working people who appreciate precision and punctuality. Despite recent government efforts to reduce inequality within the Czech Republic, they receive a Power Distance score of 57, illustrating that a hierarchical distance still exists. An Individualism score of 58 suggests that Czechs care more about themselves than the collective, albeit not by a sizeable degree. With a Masculinity score of 57, the Czechs dedicate themselves to work, often working 10-hour days. Furthermore, this level of Masculinity suggests that Czechs are motivated, materialistic, and competitive. The highest dimension for the Czech Republic on Hofstede's Cultural Dimensions is uncertainty avoidance, illustrating that Czechs generally do not appreciate change. Hofstede's Cultural Dimensions for the Czech Republic represent the country in an aggregate form; therefore they do not precisely indicate the behavior of each Czech citizen.

### **Economy**

The Czech Republic has an export market economy primarily consisting of their automotive, metal, energy, IT and electronics industries. With a PPP GDP of \$314 Billion USD (IMF 2014) and GDP Per Capita PPP of \$29,925, the Czech economy is one of the strongest and most stable of the post-communist Central European countries. Their economy has been steadily growing since the fall of communism, with a GDP growth rate of 4.4% in August 2015 – the highest in Europe. Following the Velvet Revolution, the Czech Republic's market economy had most of their price controls removed. As the GDP of the Czech Republic grows, the disposable income held by Czechs will also increase, giving the population growing means to be consumers in the beer market.

### **Beer Market**

Beer has a long and rich history in the Czech Republic dating back to the Benedictine Monks who brewed in the Brevnov Monastery in 993CE. Today, the Czech beer market is strong both domestically and internationally. On an annual basis, over 2 million hectoliters of beer is exported out of the Czech Republic. The majority of Czech beer exports are to other European countries, whereby Czech beer accounts for 2.1% of the European beer market. However, beers imported into the Czech Republic have little success representing less than 5% of the market share. Czech beer consumption per capita is amongst the highest world, allowing for a strong domestic market, although this number has declined from 158 to 144 liters per capita, annually. Furthermore, tourists consume 20 million liters of beer annually. Currently, the beer market represents 1.6% of the country's GDP. The Czech Republic is home to over 40 industrial breweries and over 200 microbreweries, the total number of which has doubled since 2005. The majority of beers are brewed in industrial breweries located in Ceske Budejovice, Pilsen, and Prague. The lands of the Czech Republic provide all the necessary traditional ingredients for brewing: water, barley, hops, and yeast. Ingredients from within the Czech Republic account for 90-95% of the raw materials used in the production of Czech beers. Pilsner-style lager represents the majority of Czech beers as the first pilsner was originally brewed in the Czech city of Pilsen. However, the Czech beer market has been changing recently. On-trade sales – sales through bars, restaurants, and hotels – have been declining over the past 4 years with a 4% drop last year. Consequently, there has been a growing trend toward off-trade sales –

sales at stores – as they continue to capture more of the market. Beer festivals have also seen rapid growth whereby attendees can sample from a diverse range of beers. These changes in the economy are driven by younger generations that did not live through communist occupation. A study by Craft Brewing Business Magazine concluded that millennials prefer to purchase beer at off-trade establishments. Younger consumers are also starting to demand a greater variety of choices whereas older consumers still prefer drinking traditional lagers such as Pilsner Urquell in pubs.

## **PILSNER URQUELL**

Pilsner Urquell is the world's original pilsner; adopted by breweries around the world this type of pale lager now represents roughly two thirds of global beer production. Pilsner Urquell was first brewed in Pilsen in 1842 and is still brewed there today. Pilsen has a deep history of brewing as King Wenceslas II gave all citizens of the city the right to brew and sell beer when it was founded. Despite the town's infatuation with beer, a well-received and consistent beer was not being produced. The city council established the "Citizen's Brewery" whereby brew master Josef Groll produced the first Pilsner. The "Citizen's Brewery has had many names throughout its history, today it is the Pilsner Urquell brewery or Plzeňský Prazdroj in Czech. The name "Pilsner" was officially registered in 1859 when European exports began to increase. In 1871, the first Czech pilsner was imported to US, and by 1913 the Citizens Brewery was the largest in Europe, producing 1 million hectoliters per year.

### **The Beer**

Served in bottles, cans, and on tap with a bitterness level of 40 IBU and alcohol by volume of 4.4% the light to medium bodied Pilsner Urquell is made from noble Saaz hops, lager yeast, malted barley, and water. Pilsner Urquell's mild flavour can be attributed to the noble Saaz hops, produced in the Bohemian region of the Czech Republic. Pilsner Urquell also uses local soft water with 50 ppm of dissolved solids drawn from within 4km of the brewery. The golden-coloured beer uses barley from the Bohemian and Moravian regions of the Czech Republic. Pilsner Urquell is produced using a triple decoction mash technique whereby the protein is broken down to produce a slightly darker and stronger pilsner. The beer ferments in large stainless steel fermenters that are each capable of holding 1,800 hectoliters and is lagged in stainless steel tanks for 40 days.

### **The Brand**

As outlined, Pilsner Urquell has a rich history as the original brewers of pilsner. Pilsner Urquell leans on their pioneering narration as the main pillar for their branding. The word "Urquell" is German for "well" and was chosen to illustrate that Pilsner Urquell is the original source of Pilsner. As the Czech Republic values tradition and history, the domestic strategy of illustrating Pilsner Urquell as Czech's original beer is an effective approach. Pilsner Urquell also brands themselves as purveyors of a high-quality product that uses local ingredients, despite most other Czech beers using similar raw materials, and in some cases the same brewery.

### **Growth**

Pilsner Urquell has seen consistent growth in international markets since being acquired by SABMiller in 1999. Exports to Australia increased by 40% in 2012 and the sales in the UK rose by 4% despite a 5.1% decrease in their beer market. SABMiller's 2014-2015 earnings before interest, taxes, and amortization decreased by 1% overall but increased by 6% in Europe in part due to the success of Pilsner Urquell as their other European brands including Gambrinus reported declines in sales. Pilsner Urquell has also

experienced some growth within the Czech Republic, but not on the scale of its international expansion. Currently, Pilsner Urquell is offered in 56 countries.

## **CRAFT BEERS**

Craft beers have seen global growth since the 1980's but the worldwide trend has only recently reached the Czech Republic. Craft beers are those produced in small quantities by microbreweries and often differentiate themselves with high-quality ingredients, unique flavours, and contemporary branding. The Czech Republic was under communist control until the early 1990's during which time the few major breweries were under state control. Furthermore, while under Soviet rule, owning one's business or microbrewery – defined as a brewery with a capacity of 10,000 hectoliters or less – was prohibited. Communist attitudes inhibited the Czech's entrepreneurial spirits, the effect of which was still felt after the collapse of the Soviet Union. Furthermore, after the fall of communism the previously state-owned breweries were acquired leading to even fewer breweries. There was little growth in the number of Czech breweries until 2001 during which time there were only 60 in the country. Today, there are over 250 breweries with new ones being opened almost every month. Many old breweries that were abandoned during the communist rule, were left intact and have recently been renovated and revamped by microbreweries. The demand for craft beer within the Czech has been growing to such an extent that many producers are unable to supply enough beer. Dan Kuntz, co-owner of Unetice says the heightened demand has afforded them the privilege of being selective with which establishments to offer their beer to, a tool used by Unetice for branding.

### **The Rise**

Craft beer in the Czech Republic has been recently experiencing a significant boom. Last year, overall production of microbreweries grew by 30% and is expected to continue. Globally, craft beers rise can be attributed to customers wanting a more high quality or unique product and wanting a more intimate or contemporary beer drinking experiences. Many craft beers use unique flavours and ingredients to differentiate themselves from big beer companies. Furthermore, microbreweries often offer a trendy alternative environment to experience their products. The expatriate beer enthusiast and writer Evan Reil states that while large Czech breweries produce "incredibly high-quality products" they are brewed to appeal to the masses, meaning they are "not too aromatic, not too bitter, not too strong, [and with] not too much character" as opposed to craft beers which can afford to take a more unique approach due to their smaller scale (Prague Post, 2013). With this small scale comes the ability to partner with other small business that may have been overseen by large breweries or which may not have been interested in partnering with large companies. Czech beer writer and enthusiast Max Bahnson believes that craft beers are tapping into a new market in the Czech Republic that was previously unreached by offering beers in independent cafés, theatres, galleries and other trendy places. Czechs have a nationalist pride in their beer, and when the traditional Czech beers such as Pilsner Urquell, Krusovice, and Staropramen began being acquired by multinational corporations some Czechs felt that they had lost their authenticity. Jan Martasak, co-founder of Czech microbrewery Two Tales states that drinking beer in the Czech Republic is a point of Czech pride, which is no longer offered by the big breweries that were acquired by foreign companies. Craft beers are able to distinguish themselves from large-scale Czech breweries on a product level by being more authentically Czech, and by offering more unique products. Czech microbreweries can be seen as more authentic as they are owned and operated by Czech but also because some of these microbreweries have historical relevance that rivals that of traditional Czech beers. Czech microbreweries can also offer products apart from the traditional pilsner, such as IPAs, flavoured beers, and stouts.

Microbreweries also can offer a contemporary, alternative to drinking beer at a pub or buying beer from a supermarket.

### **Microbreweries**

Many of the Czech Republic's leading microbreweries have history that dates back to before Pilsner Urquell and other large Czech beer brands. Those without a deep history, rely on high-quality ingredients or unique flavours to compete with big breweries. Klasterni Pivovar is a microbrewery in Prague that was originally a monastery founded in 1140. The brewery was built in 1628 but closed in 1907. It was renovated and reopened in 2000 now advertises a notable history that rivals Pilsner Urquell. The microbrewery uses the traditional ingredients of water, malt, hops to offer mostly unfiltered 6% and 7% ABV beers with one made using wheat malt. Novomestky Pivovar was founded in 1993 and uses only traditional Czech ingredients to produce their unfiltered beer. The microbrewery distinguishes themselves primarily in their service, offering a contemporary space with excellent service and small beverage tastings. Novomestky Pivovar also recently began production of flavoured beers. Pivovar Narodni is one of the newcomers to the microbrewery scene in Prague having opened earlier this year. This microbrewery also uses only water, malt, hops, and yeast to produce their beers. Pivovar Narodni's most popular beer is a pilsner similar to that offered by Pilsner Urquell. However, they offer a hip place with friendly service, a non-smoking section, and trendy food. Two Tales Brewing was founded in 2012 and uses an active social media presence to promote their flavoured alternatives to pilsner in Czech and in English. U Fleku is one of the oldest breweries in Central Europe dating back to 1499. The brewery was nationalized during the communist rule, but is not in the hands of a Czech brewmaster. U Fleku positions itself as one of Czech's original breweries, now offering a myriad of beers including a dark lager made with four different types of barley malt. Pivovar Clock is another recently opened microbrewery in the Czech Republic. The brewery solely uses water, malt, hops, and yeast, however they import hops from around the world, primarily the UK, USA, and Australia to produce difference craft beers including IPAs, dark lagers and stouts. Vinohradsky Pivovar is another iconic microbrewery that was founded in 1893 that markets their historic Czech past. The brewery underwent major renovations in 2013 and now offers stronger, hoppier alternatives to traditional pilsner. Pivovar Antos opened in 2010, despite not having a rich history, the microbrewery still attempts to brand themselves with tradition. Pivovar Antos takes its name from Ondrej Antos who brewed beer in the same building in 1518. The craft brewery uses traditional Czech ingredients to offer unfiltered and unpasteurized beers. Pivovar Matuska is owned and operated by a Czech family and is the most awarded microbrewery in the Czech Republic. Although their beers use water, malt, hops, and yeast all from the Czech Republic, they distinguish themselves with an alternative decoction mash process to offer stronger and darker alternatives to pilsner. Currently, microbreweries hold 2-5% of the beer market share in the Czech Republic. Although as Czech craft breweries continue to distinguish themselves through authentic Czech branding, unique products, and contemporary experiences that number is expected to grow. Czech-Moravian Association of Small Brewers leader Jan Suran believes that there is room for at least 400 microbreweries in the Czech Republic.

Czech microbreweries are targeting the traditional beer market by branding themselves as historic Czech breweries offering high-quality pilsners. Additionally, Czech craft breweries are also targeting those who are seeking an alternative to drinking traditional pilsner in a Czech bar and who would be willing to pay a little more for it. An increase in beer revenue with a decrease in beer consumption in the Czech Republic demonstrates that the population is less concerned with the quantity and price of their beer and more concerned with quality. In a small survey sent to 42 of my fellow exchange students, 40% of respondents who drank eight or more beers a week reported basing their purchases on low cost, with 0% of them

regularly purchasing craft beer, and only 20% of them stating that they prefer craft beers. However, of those respondents who drank 4-7 beers a week, 67% said they prefer craft beers to macro beers with most citing taste and experience as the reason for their preference (Figure 4). Among those who are willing pay more for an enjoyable beer are women – a demographic historically ignored in the beer market. The Chief Economist of the Brewers Association Dr. Bart Watson states that women consume an above-average amount of craft beer and represent 15% of the total consumption in the US. While these statistics are for the USA, microbreweries are taking steps to appeal to the female demographic through flavoured and lighter beers in addition to aesthetically pleasing spaces.

### **PILSNER URQUELL'S RESPONSE**

Pilsner Urquell has implemented several strategies to respond to the rise of craft beer in the Czech Republic. Following SABMiller's acquisition of the brand, they invested \$50 million into marketing for Pilsner Urquell, with a further investment of \$11 million USD in 2015. A tactic executed through multiple approaches is to make Pilsner Urquell the easiest choice through availability. In many supermarkets and stores, Pilsner Urquell will occupy eye-level shelves with plenty of inventory. As the total demand for Pilsner Urquell is far greater than that of any craft beer, stores will fill their shelves with high volumes of Pilsner Urquell. Furthermore, Pilsner Urquell will pay shelving fees to some stores to have their product placed in the most desired locations. However, a by Craft Brewing Business Magazine concluded that 73% of craft beer drinkers know which brand they are going to purchase before entering the store (Figure 3). Pilsner Urquell will also outfit bars and restaurants with everything needed to serve beer including keg systems, glasses, and prominent signage. In exchange these on-trade establishments will agree to offer no other beer than Pilsner Urquell. In my conducted survey, respondents were asked to comment on why they purchased Pilsner Urquell; most responses pertained to ease of availability. Pilsner Urquell is also able to beat the price of most craft beers as they can exploit economies of scale. At on and off-trade establishments where multiple beers are offered, Pilsner Urquell is usually amongst the lowest. However, there is evidence to suggest that attempting to respond to craft beers on the basis of price is an ineffective tactic as microbreweries customers are willing to pay a higher price. When the Czech government increased the beer tax in 2010 macrobreweries whereas microbreweries continued to gain momentum. In a study published by the Czech Journal of Economics and Management Vratislav Kozak stated that this tax was the most frequent response when macrobreweries were asked to explain the decline in beer consumption in the Czech Republic (Figure 1). However, the low-price of Pilsner Urquell does not come at the expense of quality. Pilsner Urquell is an internationally awarded beer made with some of the highest quality ingredients; a significant portion of comments in my conducted survey cited their reasons for selecting Pilsner Urquell as taste and quality. Through high quality brewing, cost-control measures, and distribution agreements, Pilsner Urquell is able to make a commendable and competitively priced beer that is conveniently available.

Pilsner Urquell has also recognized the desire for unpasteurized beer and has adopted a strategy to offer it in on-trade establishments. As noted above, several microbreweries are able to offer unpasteurized – free of preservatives – because they are selling beer within a shorter time frame as they are selling much at the source or within their municipality with little international shipping. Pilsner Urquell on the other hand is shipped around the world as must be made to have a shelf life too long for it to be unpasteurized. However, realizing the demand and appeal of unpasteurized beer, Pilsner Urquell has been offering to ship tanks of unpasteurized beer to certain on-trade establishments. In addition to this strategy offering a product to combat microbreweries in the high-quality market, SABMiller also reported in their 2015 annual report that such tanks “enhance the reputation of draught beer” (SABMiller, 2015).

## Marketing

Pilsner Urquell has also responded to the growth of microbreweries through thoughtfully constructed marketing and branding strategies. The paramount tool used for branding Pilsner Urquell is their originality. On every bottle or can of pilsner is the slogan “The Original Pilsner”. Pilsner Urquell has advertisements targeting both similar traditional pilsner as well as more trendy flavoured beers. Pilsner Urquell has further targeted other purveyors of pilsner through a marketing effort that displayed billboards with Pilsner Urquell and the caption “Copied But Never Equaled”. A similar advertisement was conducted to target more trendy flavoured beers whereby the caption was “No Lemon, No Cranberry, No Bullshit”. In addition to boasting their originality and tradition through advertisements, Pilsner Urquell also thoughtfully selects how their beer is presented. Taps, glassware, signage and other products provided to on-trade establishments to serve and promote Pilsner Urquell are meticulously designed to corroborate with their historical theme of originality. Pilsner Urquell also offers bartending courses instructing on-trade employees on how to properly pour the beer as well as educating them on its distinguishing qualities.

In an effort to foster their domestic reputation as a historic Czech beer within the Czech community, Pilsner Urquell has adopted several strategies to illustrate their place in the Czech culture. Pilsner Urquell has partnered with various community events and cultural centers to exemplify their celebrated significance within the Czech Republic. The Pilsner Brew Off is an interactive experience led by Pilsner Urquell whereby beer enthusiasts, and influential member of the media are invited to craft and sample their own beers learning the process of how pilsners are made and a few distinguished techniques used by Pilsner Urquell. Pilsner Urquell also sponsors Pilsen Fest, a Czech beer festival. During this festival Pilsner celebrates their historic traditions with traditional music, and cultural activities as well as an educational look into how the beer is crafted. Pilsner Urquell also has a partnership with National Theatre in Prague, whereby a historical look into the brewery is featured. The macro beer has also attached themselves to significant parts of Czech culture through advertisements. A Czech television advertisement by Pilsner Urquell features famous Czech composer Bedrich Smetana using the beer a muse to compose Vltava song. Microbreweries in the Czech Republic are adept at positioning themselves as positive members of an authentic Czech community. Pilsner Urquell looks to partner with influential piece of Czech culture to regain their footholds as a significant part of Czech society.

Many craft breweries have trendy, fun, and engaging digital experiences. The majority of the microbreweries listed above have interactive websites and active social media presences and cooperate with local media in a mutually beneficial fashion. Aware of the growing importance of a social online presence, Pilsner Urquell contracted an American media-marketing agency in 2013. Concept Bakery provided Pilsner Urquell with a digital facelift to bring the brewery’s digital presence into the modern age. The marketing agency created an all new interactive one-page design website for Pilsner Urquell that seamlessly scaled to mobile as well as reconstructing their social media presence through all new brand pages. A recent study by Craft Brewing Business magazine suggests that a paramount demographic for microbreweries is the younger generation, as 49% of millennials and 40% of Generation X’ers find craft beer appealing compared to 29% of Baby Boomers and 22 percent of the Swing Generation (Figure 4). Through revamping their digital presence Pilsner Urquell is looking to engage a younger, more tech-savvy demographic who are also potential customers for craft beer.

Despite the frequency of references to Pilsner Urquell’s history in the brewery’s marketing efforts, Pilsner Urquell may be shifting their focus. Pilsner Urquell’s marketing manager Eoin Cannon stated that they

were too focused on advertising their history and needed to also promote the beer itself. However, Pilsner Urquell is an internationally available beer therefore Cannon's comments address the beer's global strategy. Speaking with a brand manager at Pilsner Urquell, Lenka Tenglerova stated that their positioning strategies abroad and in the Czech Republic are quite different. Despite this, Pilsner Urquell has recently begun attempting to work with local beer enthusiasts, bloggers, and members of the media to showcase the merits of the famous pilsner.

## **CONCLUSION**

Craft beers have competitively differentiated themselves from large Czech beers such as Pilsner Urquell on the basis of tradition, uniqueness, and experience. Many microbreweries within the Czech Republic have a rich history that can be branded to rival that of Pilsner Urquell. Furthermore, as vast majority of microbreweries within the Czech Republic are owned and operated by Czech, they can be advertised as being authentic alternatives to the big beer brands that have been acquired by multinational corporations. Macrobreweries produce beer at such an enormous scale that their product must be appealing to the masses. Craft beers are produced in small batches allowing them to experiment with unique beers that need only appeal to a niche market. Large Czech beer brands such as Pilsner Urquell deliver their beer through an established supply chain consisting of conventional on and off-trade businesses. Craft beers have differentiated themselves by offering contemporary, interactive, and exciting atmospheres to enjoy their products, and have partnered with trendy establishments that offer the same setting to deliver novel and enjoyable experiences alongside their products. Furthermore, microbreweries have adopted strategies to provide a fresh and interactive experience even for those who purchase their products through off-trade establishments with the use of modern digital and social media presences.

Pilsner Urquell has adopted several strategies to respond to the rise of microbreweries and the growing market that is demanding unique yet traditional products corroborated by contemporary experiences. Through shelf-space domination and partnerships with bars and restaurants, Pilsner Urquell has sought to make their beer the easiest to purchase at on and off-trade locations. Pilsner Urquell is competitively priced at a level below most craft beers, allowing them to further position themselves as the easiest choice. As microbreweries are relatively new to the beer market, Pilsner Urquell has leaned on their history as the original purveyors of pilsner throughout their various branding efforts. To appeal to an emerging market with variable tastes, craft beers have offered distinctively flavoured products. Pilsner Urquell has strategically targeted these trends by marketing their beer as unornate and traditional. Microbreweries are often aware of the growing desire for consumers connect in a digital space and have taken steps to provide engaging and easy-to use platforms for such purposes. Lagging behind in regards to a digital presence, Pilsner Urquell contracted an American marketing agency to revamp their online presence through a new website and social media profile. Pilsner Urquell has responded to the rise of craft breweries and changes in Czech consumer behavior through various advertising and branding strategies to market their original pilsner to a shifting populace while retaining their historical brand image in the process.

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APPENDIX

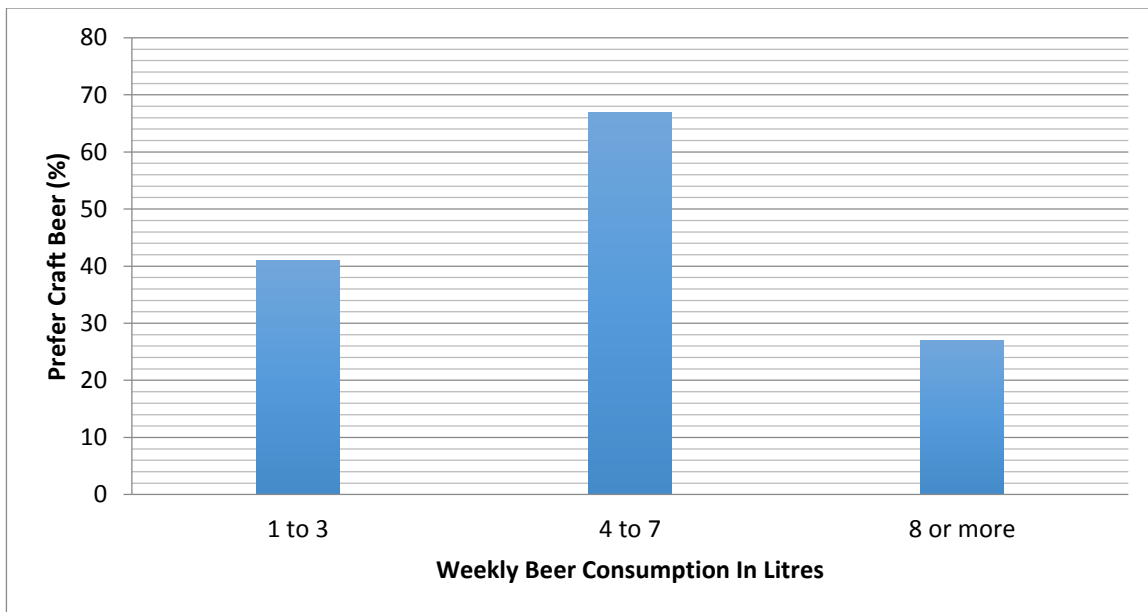
Figure 1: Breweries Reasons for Declining Czech Beer Market. Source: Kozak

**Tab. 1: Rankings of Reasons Influencing Beer Consumption Drop in the Czech Republic**

Reason/importance ranking	1	2	3	4	5	6	7	8	9	Sum of multiples
1. Excise tax increase	35	6								47
2. Alcohol checks in the workplace	3	28	10					1		89
3. Decline of beer consumption in young generation	3		28		3		4			130
4. Obligatory military service cancelling		4		27	10					166
5. Foreign tourists number drop		2	1	5	23	5	4	1		208
6. Breweries owners' efforts to maximize their profits		1	1		2	22	11	3	1	257
7. Export price-policy					4	9	14	9	5	289
8. Marketing concentrated on males			1		1	2	5	21	11	322
9. Euro-beer						3	7	7	24	661
Check sum	41	41	41	41	41	41	41	41	41	2 169

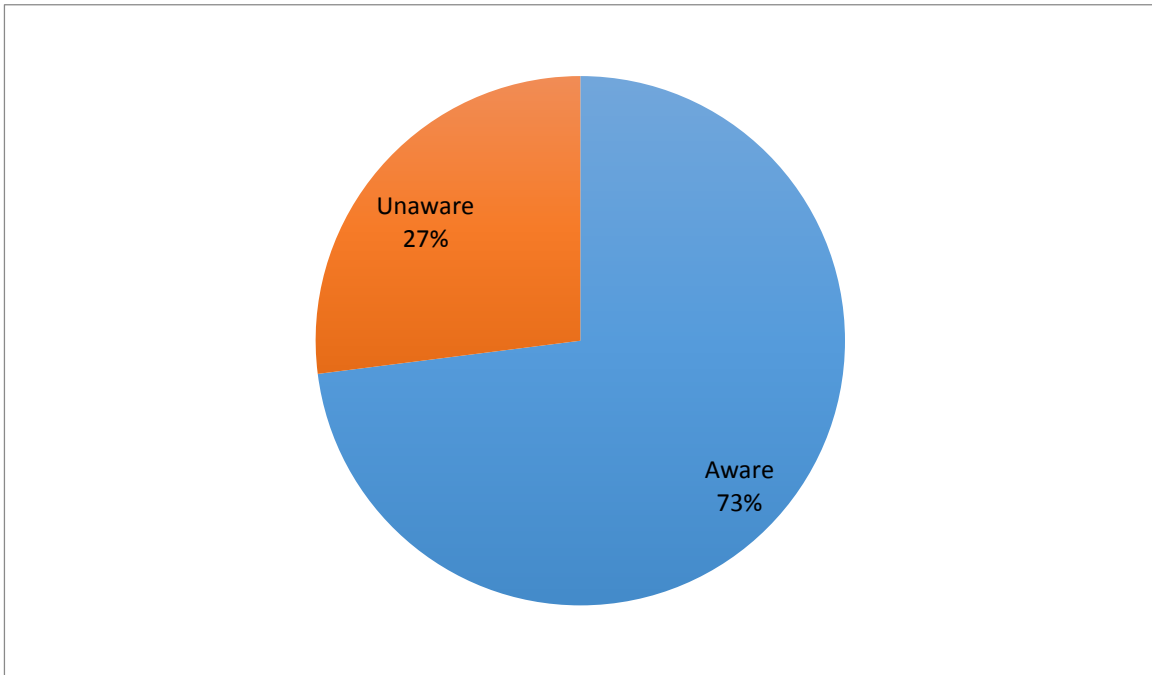
Source: Kozak

Figure 2: Preference of Craft Beers by Beer Consumption.



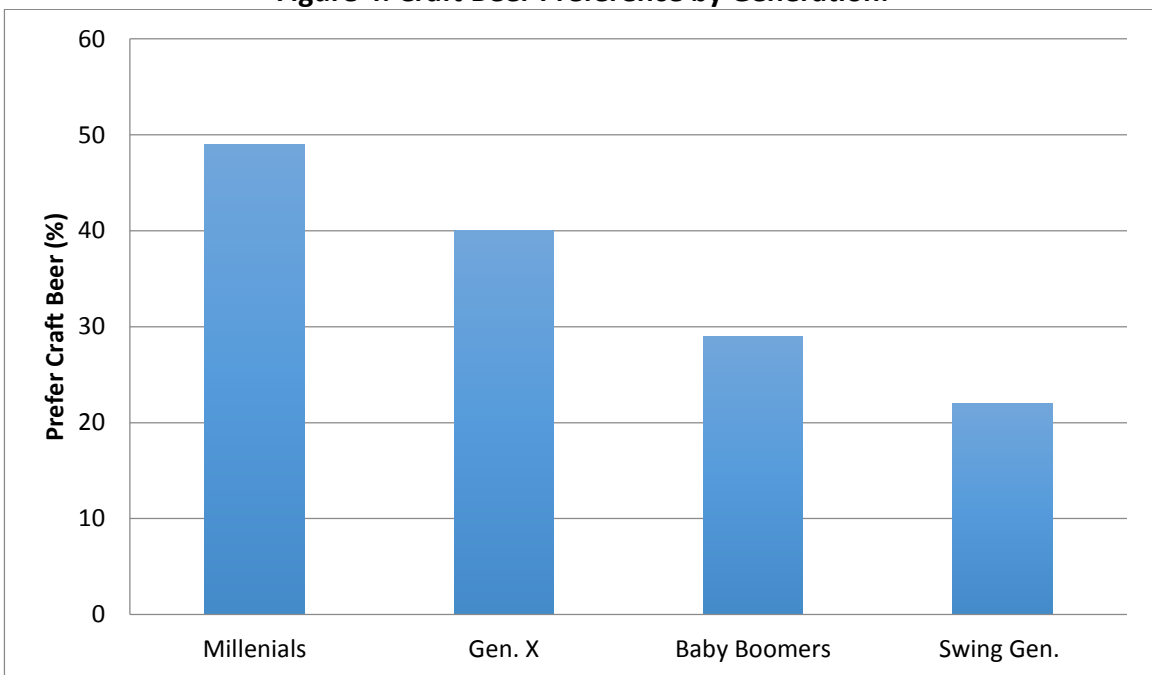
Source: Bowen Macy

**Figure 3: Customers Aware of their Beer Purchase Before Entire Store.**



Source: Craft Brewing Business Magazine

**Figure 4: Craft Beer Preference by Generation.**



Source: Craft Brewing Business Magazine

# **Volkswagen and an Aging Workforce:**

## **The Demographic Changes of the German Population**

Riley Paddock

### **ABSTRACT**

The population of Germany is aging, resulting in blue-collar labour shortages across the country. In a country known for car manufacturing, this has profound implications on the company that is arguably the most recognized German company worldwide: Volkswagen. The Volkswagen factory in Wolfsburg, Germany is faced with finding solutions for the demographic situation that is gripping the country so that they can continue to produce vehicles at an efficient rate. As the production facility's workforce continues to age, due to a lack of young employable people, the factory managers have been forced to find ergonomic solutions that make the work load easier on individuals whom can no longer work to the same efficiency level of their younger days. Technological innovations have had to be implemented in the factory so that production levels do not fall. Volkswagen is faced with finding a solution to a nationwide problem, so that they can continue to produce vehicles when their workforce lowers beyond needed capacity.

### **INTRODUCTION**

Volkswagen (VW) is a company that has been tasked since day one with producing vehicles that are affordable for people while not straying from the engineering piou expected from German products. Interestingly, when translated into English, the word Volkswagen means "people's automobile". Founded in 1937, the Volkswagen company was part of a project lead by the Deutsche Abreitsfront, which was attempting to provide all people throughout Germany with an affordable automobile. While in power, Adolf Hitler wanted to provide the German people with an affordable car that everyone could drive (Bowler, 2015). As a result, the Volkswagen company was born and the automotive industry changed forever. No longer were automobiles only a luxury item the rich in Germany could afford: cars became a family oriented product. The automobile brand is intertwined in the history of the country it comes from and has since become a household name around the globe.

The massive production capabilities of the Volkswagen Group are evident at the headquarters and location of the original VW Factory in Wolfsburg, Germany. The four large smokestacks of the original power plant still, to this day, reach towards the sky showing the power of the company, which began during a dark time in German history. The factory is regarded as one of the largest worldwide, occupying more than six square kilometers and boasting an output of approximately 815,000 vehicles in 2015 (Volkswagen AG, 2016). The Wolfsburg facility includes the company headquarters, the production facility, and the Autostadt (a museum to the history of the company). By December 2015, the facility employed 73,730 individuals in both white-collar and blue-collar jobs. Over fifty percent of the population of Wolfsburg is employed by the Volkswagen group (Volkswagen AG, 2016). The production facility acts as a city within the city, which only existed because of the factory, by holding medical clinics and restaurants for the employees.

## **Baby-Boomer Generation**

A mass influx of childbirths occurred shortly after the Second World War. As a result, this “baby-boomer” generation led to a major accumulation of individuals suddenly entering the workforce. This generation is known to have worked the less than glamorous jobs, because of a great supply of workers available; therefore, a major blue-collar workforce was possible (Taylor, Pilkington, Feist, Dal Grande & Hugo, 2014). As a result, production facilities were able to massively expand and create technological innovations using a workforce that could supply their needs. However, the social landscape has changed since the “baby-boom” and the excess supply of workers willing to work in blue-collar positions has decreased to a supply shortage. The new generation does not want to work assembly line jobs; this has a major impact on the production capabilities of companies such as Volkswagen (Roberts, 2012). As the “baby-boomer” generation has aged there has not been enough new generation replacement to sustain major production facilities, a problem that is progressively growing worse. Especially in a country known for large scale industrial factories.

The median age of employees at the Wolfsburg factory is continually increasing. This trend does not seem to be slowing, as it is a country wide problem across Germany. Each year the average age increases as current employees are growing older and new employees are not entering the workforce in large enough numbers (Paddock, 2016b). Volkswagen has hit a demographic challenge and must develop solutions to combat its aging workforce. The majority of jobs at the factory itself are blue-collar jobs held by experienced employees who have worked for many years in the company. Such employees are aging and replacement has proven increasingly challenging: the younger generation in Germany is not interested in spending their life working along an assembly line (Paddock, 2016b). Rather, according to Roberts (2012), there is an influx of university graduates looking for white-collar work in the new generation entering the workforce, an area that VW does not have a shortage of workforce supply. Employee turnover from old to young employees is not happening at a fast enough rate to keep up with the production demands of such a large factory. Departments within the production facility must implement technological innovations that will make the labour-intensive environment a feasible workplace for an aging workforce. Over the course of the next 10 years, Volkswagen expects to lose a major portion of its workforce, on the basis of retirement alone (Paddock, 2016b). The generation of people who made mass-production of cars possible in Germany will cause its demise if there are not changes made to either keep them working longer or changes in technology that make it possible to produce mass volume of specialized products with a smaller workforce.

## **Why not use Automation?**

The idea of using robots to replace human labour has been greatly considered by Volkswagen, but currently, in the Wolfsburg factory of the early 21<sup>st</sup> Century, this is not possible. The use of robotic enhancements in every stage of production is not an efficient production capability that VW can implement. During the 1970s, the VW factory in Wolfsburg was an almost completely automated production line, using robots at almost every stage of producing VW products (Paddock, 2016a). During that time, there was a belief that the use of machines would result in less human error and less money being spent on employees. Limited employees were needed, as robots could be programmed to do the same thing over and over again, without growing tired. However, the practice of using only robots is not possible in the car manufacturing industry of today, rather the most economical mixture of robots and humans is needed (Gorlach & Wessel, 2007). Back in the 1970s, much of the production process was uniform and the use of robots was possible because there was not as much variety between vehicles as there is today. Cars would all look identical, making it feasible to use robots that continuously completed

the same motions with the same automotive components. It was, therefore, efficient on an assembly line to use robots instead of human labour. The initial investment was higher, but the cost of maintenance was much lower than human capital labour costs. Today, however, car variety is too vast for the use of robots that can only perform one task over and over again. Customers are able to choose between variations of models and instruments within the vehicles, leading to differentiation on the assembly line instead of uniformity. Costs, quality, and quantity must all be studied when determining the effective level of automation along the assembly line of a vehicle manufacturing plant (Gorlach & Wessel, 2008). For example, on any given day in Wolfsburg, thousands of Golf class cars will be produced at the VW factory. Out of the thousands of cars, no more than two will be identical to one another (Paddock, 2016a). Each vehicle must be specially crafted to meet all chosen requirements and the quantity of identical vehicles is too low to warrant a high level of automation. Human capital is necessary to ensure the proper production of a wide variety of models. Machines would not be able to differentiate on such a massive scale, leading to an inefficient factory. In today's vehicle marketplace, human labour is ultimately more cost-effective for Volkswagen. The cost of producing and maintaining machines, that could handle the large scale product variation, would be too high; ultimately, affecting the bottom line of the company. The use of humans gives VW the ability to give customers options within their vehicles, leading to a happy and sustainable customer base.

### **German Labour Law**

Despite the necessity for variation along the assembly line, Volkswagen is still faced with a workforce that is slowly not able to perform all tasks. As a result, automation will become necessary, and with advances in robotic technology, it may soon be possible to use them under the circumstances of VW. However, when determining future steps for an organization to take, it is critical to look at the labour law of the country in which they operate. The Wolfsburg factory is located in Germany, a country with many different laws and policies in regards to employment compared to Canada. In Germany, a company cannot lay off workers because of work shortages or lack of new employable areas, rather they must find a fit for employees within the organization so that they are able to continue working (Jung, 2001). In contrast, North American employment practices involve moving factories to more efficient locations and leaving thousands of individuals without employment, as is common practice in the Ontario automotive industry (CBC, 2008). Volkswagen cannot do similar things in Germany because of the employee legal protections. In addition, the two countries differ on the issue of forced retirement based on aging. The age of retirement in Germany is 67 years-old and employees cannot be forced out of employment based on age or lowered ability, caused by the aging process, any sooner (Jung, 2001). Volkswagen has no grounds to terminate employment if someone could no longer perform a task within the VW factory that they once could. Rather, it is the organization's responsibility to find a new task that said employee could perform and move them to the department.

There are great implications present based on the labour law surrounding the removal of aging employees. The removal of employees and replacement with highly technical robots is not possible for some time. Since employees cannot be forced out of their jobs, the return to automation in certain departments where it is possible and effective will not be a realistic option for VW for quite some time. Volkswagen must prepare for gradual reduction of staff caused by retirement and uncover the areas where automation is possible within the facility. Long-term planning is necessary for successful manoeuvre through labour laws.

## **Transfer to Logistics**

Since there are laws dictating what can and cannot be done in regards to aging employees, the common practice within large manufacturing facilities is to move employees to logistics: an area deemed as easier work (Paddock, 2016b). The concept of logistical work being easier on the body is, however, a flawed idea across most of the production world. Currently, at the Volkswagen factory in Wolfsburg it is common to move aging employees, who can no longer work on the production line, into the Logistics department. The Logistics department has suffered from the misconception that logistical work is easier on the body than assembly line production work, leading to a decrease in efficiency. While there is less repetitive motion in logistics, therefore, leading to less strain on one particular area of the body, logistical work within an automobile manufacturing facility is not easy work. Employees working in logistics at the VW factory in Wolfsburg are on a strict timeline, as every part that is stored within their department must reach its destination on the assembly line at the precise time it is needed (Paddock, 2016b). This is not easy work as massive carts, weighing approximately 50 kilograms when empty, must be moved within the factory and filled with parts. Figure 1 is an example of a smaller cart used within the department; carts are often double or triple the size of the one depicted (Paddock, 2016a). Pushing these carts up and down isles of automotive components will cause strain on any individual, let alone an aging one. Therefore, because the department requires physical labour, the concept of moving aging employees to logistics is not sustainable and will not solve the problem Volkswagen is facing.

The logistics department is currently working to produce a plan that will project the areas of the department that must change now, areas that must change soon, and areas that can change in the future in regards to accommodating an aging work force (Paddock, 2016b). This plan will complement Volkswagen's current plans, which are used around the assembly process to rate the ergonomic level of areas in the facility to determine where changes must be made. Employee aging has become a company-wide issue and Volkswagen is taking many steps to ensure the success of the company in spite of problems that will affect the company for many more years.

## **The Benefits of an Older Workforce**

While there are problems that come from a workforce aging, there are major benefits that a successful firm will recognize and leverage. Older employees have more experience in the working world and because of these years of experience working in the professional world, Volkswagen has a workforce that knows what it takes to be successful. In the working world it is imperative to have a knowledgeable workforce; only then will success be possible. Since Volkswagen has an older workforce, there is a vast amount of knowledge that the company must leverage from employees. The knowledge-based theory of the firm, as described by Spender (1996), lays out knowledge as the vital strategic asset for the success of a firm. He argues that knowledge is the most strategic asset leading to the success of an organization. Therefore, because Volkswagen has such a knowledgeable workforce, the company has the opportunity to gain a competitive advantage in the automotive sector, because of their knowledge development capabilities. While most of the workers within the vehicle-manufacturing factory are blue-collar workers, there is still a great opportunity for the passing of knowledge around the complex of the company. And because the years of experience of employees, this knowledge has can benefit the company greatly by leading to new knowledge creation. Knowledge can be described as what is learned through experience and what is learned through theoretical understanding (Spender, 1996). In the case of Volkswagen, there is a vast amount of knowledge in the first category: knowledge based on experience. Every aging worker at VW has knowledge that leads to the success of the car manufacturing process. This means that there is a great opportunity for Volkswagen to leverage this knowledge to make the company better. The aging

employees cannot be seen as a burden, rather, they are an opportunity for the company. The vast knowledge of these employees can be leveraged for the success of the organization, making the company more competitive over time.

Over time, employee knowledge at VW has increased. This is a result of knowledge increasing over time within the dynamic setting of a firm, through the sharing and developing of information across employees (Spender, 1996). At Volkswagen, employee knowledge has increased and therefore the knowledge of the company as a whole has increased. Over time, the knowledge of the company has become a strategic asset that is imperative for the successful operations of the company. Volkswagen must work to protect their current aging knowledgeable workforce and keep them employed in positions that will benefit the company. Older employees are often seen as burdens to a company, yet, to be successful, a company cannot look at older employees as burdens but as strategic assets. Since knowledge is a strategic asset, and older employees hold knowledge, these employees are therefore a strategic asset. Physical limitations of an older employee lower their ability to be productive in matters of strength and physicality, but their knowledge has proven vital to the success of the company. Thus, action must be taken to keep the knowledge within the company.

At Volkswagen, it is imperative that the knowledge of the older employees is held onto long enough that it can transfer to the much smaller younger workforce. Since the number of employees will drastically decrease over the next years, the transfer of knowledge must take place so that a younger generation will be able to carry out the tasks that make the company the success it is today. This means that technology must be created to keep an aging workforce happy and healthy within the workplace long enough for the transfer of knowledge between generations of workers. Only once the transfer of knowledge takes place will the next generation of VW employees be in a strong enough state that will allow for the success of the company in the future.

Volkswagen is currently in the place where if their strategic asset is not protected, in the form of employee protection, they will not have a good chance at being successful. The aging employees are vital to the success of the car manufacturing giant's Wolfsburg factory. The company has recognized this and is taking major steps to ensure that the successful past that the company has been building for decades does not deteriorate.

### **Role of Leadership at Volkswagen**

Leaders within the firm have the role of creating a corporate culture or team atmosphere that is conducive to the effective transfer of knowledge. It is the role of the leader to create an organizational system that flows and moves with the needs of employees to create a culture that employees fit into and work productively in (Martín-de-Castro & Montoro-Sánchez, 2013). Within the context of Volkswagen, this means that it is management's job to ensure that an aging workforce has the necessary technology at their disposal so that tasks can be done efficiently. The role of the leader is to show employees that becoming integrated in the routines of the organization will better spread the wealth of knowledge that they collectively have and thus benefit the collective organization. This is evident within VW as a leadership style has been implemented allowing the opportunity for teams to get together and discuss not only problems, but also successes. What works and what does not work are equally important to Volkswagen and using leaders to convey this message is what makes the factory in Wolfsburg successful. Daily, within the logistics department alone, meetings take place between teams and their leaders and those leaders and the other leaders. These meetings are often short and are focused on getting the entire

department up to speed. The meetings have led to the successful passing of knowledge from lower employees, who are extremely knowledgeable, to management, who need the expert knowledge of the front line employees in able to make strategic decisions (Paddock, 2016b). The expert knowledge of the aging employees who work on the front-line of the production facility is being passed along successfully so that the company can be made more productive. These daily meetings create a bond within each team and further between teams. Each person is on the same page and knows what must be done for the department to be successful. The creation of this culture has led to a cohesive unit that works together to solve problems, no matter the job title of employees (Paddock, 2016b). A team exists and this means that the employees have a better chance to be successful.

When a leader is able to promote trust, and a sense of belonging within the firm, the firm has a better chance to be successful. Employees will be motivated to share their knowledge to the group for the betterment of the organization (Martín-de-Castro & Montoro-Sánchez, 2013). A competitive advantage can arise within a firm with a strong cohesive culture, because all employees are working on the same page to spread already developed knowledge and create new knowledge as a group. Leaders must recognize that creating a team atmosphere is imperative to the transfer of large amounts of knowledge and without a strong culture within the firm, there would be no chance of turning individual knowledge into collective knowledge. It is the role of leaders within VW to find the information they need to make the company better, and this is only possible if the facility is improved so that aging workers are able to continue working and thus benefiting the company with their years of experience and knowledge.

### **Importance of Ergonomic Solutions**

Since Volkswagen has made a commitment to providing specialized automobiles to its customers, the company has had to make the manufacturing workplace safe and ergonomic for the necessary human employees. Because the use of manual labour is a necessity at the Volkswagen factory in Wolfsburg, focus has had to be placed on ergonomically improving each work place (Volkswagen Aktiengesellschaft, 2015). When workstations are not designed and positioned in a way that is carefully constructed to make the movements of the workforce ergonomic, injuries occur. There is a strong correlation between workplace injuries and repetitive motion. Since an assembly line forces employees to constantly be making the same movements over and over again, it is important for the company to focus on limiting the areas in which injuries can occur (Paddock, 2016a). Workplace injuries cost the company money in the form of injury compensation and missing workforce. For a company to be successful in the long run, taking care of employees is a necessity.

Volkswagen has an aging workforce, which means that there had to be steps taken to ensure that workplace injuries do not take place. It is unfortunately easier for an older employee to get injured than a younger one and this means that the Wolfsburg factory is in danger of losing valuable human resources to injury if the right steps are not taken when improving the workplace and specifically the ergonomics of the workplace (Volkswagen Group, 2015, June 17). Each change that Volkswagen makes to ensure ergonomic standards are improved do more than just fix the problem for an aging workforce: the benefits reach the younger generation of workers as well. Younger employees can put less strain on their bodies in their youth, translating to fewer injuries that will affect their working capabilities when they are older. Each beneficial change will help the older generation of workers today and of tomorrow. While the aging process is not going to slow down at the Wolfsburg VW factory, the rate of injuries will and thus workers will be able to carry out tasks longer and the company will be able to meet each goal that is set. It is the responsibility of the management to invest in developing new technologies to make the factory work

place a better environment so that workers can feel safe and thus succeed in their daily tasks without added risk of repetitive motion injuries. Dr. Horst Neumann, board member for Human Resources, Volkswagen Aktiengesellschaft is quoted as saying.

*Every ergonomic improvement is an investment in the health and performance of our workforce. At the same time, each improvement enhances quality and productivity. That is why Volkswagen sets great store by good ergonomic working conditions. That includes both individual improvements at the workplace as well as ergonomic shift models. We also foster teamwork and individual commitment to preventive healthcare, training and fitness*

(Volkswagen Aktiengesellschaft, 2015).

### **Factory Improvements at Volkswagen**

The Volkswagen Factory in Wolfsburg is constructed of many large concrete buildings. A reminder of the history of the German company. These buildings are very old and hold historical significance to the company, while also providing economic benefits in the form of functional buildings. However, the floor material is not conducive to an ergonomic workplace. The hard concrete that runs the length of the building is not a material that is comfortable to be standing or moving along for extended periods of time (Paddock, 2016a). Thus, the flooring material can result in injuries to individuals who are forced to stand all shift long. To combat this problem, Volkswagen has installed raised wooden floors along the assembly line, as seen in Figure 2, for workers to walk along. Wood flooring offers a level of cushion for workers and is better to walk along than concrete. The more ergonomic platform reduces the chance for injuries to muscle joints due to excessive pounding and strain. To improve this system further, VW introduced the concept of having slow moving areas installed within the raised flooring, providing workers with a platform where they can stand still and work on vehicles as they move down the assembly line (Figure 3). This means that the body can stay in one proper position and there is not any over stretching or sudden movements that can result in injuries due to forced multitasking of moving while assembling the vehicle. Rather the worker just has to move to the beginning of their work area once one vehicle is done and they can start on the next vehicle. Tilting of vehicles to make them easier to work on for employees is another improvement done for the assembly line. As shown in Figure 4, rather than unnatural bending and moving, in ways that will put the body in non-ergonomic positions, the vehicle does all the moving and employees can focus solely on getting their job done properly. The chance for muscle strain diminishes greatly when the body is able to stay in natural positions (Paddock, 2016a).

Volkswagen has recognized that older employees need special changes that make hard jobs possible. Manipulators, as Volkswagen refers to the technologies implemented to make the work of employees less strenuous have been implemented around the factory (Volkswagen Group, 2015, November 27). Each place where an essential production activity poses a threat to personal safety and health is a place where manipulators can be implemented (Volkswagen Group, 2015, June 10). The use of robots along with humans has become quite common as robots are able to move much heavier components, while humans are able to make sure that each process is being done properly. Human and robot interaction allows for the health and safety of employees to be increased while productivity increases as well (Volkswagen Group, 2015, August 20). Work can be done and there isn't a risk of injury based on being in a non-ergonomic position. It is necessary to implement technology to make the workplace efficient despite changes in demographics.

### **Risk of Technological Introductions**

Volkswagen has recognized that there is a major need for improving technology if the aging workforce is to be effectively and efficiently used to produce vehicles in Wolfsburg. The introduction of the technological advances along the assembly line have been widely accepted and appreciated by employees at Volkswagen; however, when introducing technology to an older generation there are risks that it won't be accepted. Volkswagen's logistics department has introduced the use of Google Glass for the use in picking parts for the production process (Volkswagen AG, 2015). The idea behind the introduction of the technology is that employees can use this technology to scan barcodes and reduce picking errors while carrying less papers and scanners, as is seen in Figure 5. The technology essentially frees the hands of logistics department workers so that they can do their job faster and more efficiently. The technology has been accepted and appreciated by the younger generation of workers at the factory who like to see new technology implemented. However, the older generation has taken more time to accept the technology, preferring to do things the way they have always been done (Paddock, 2016b). When dealing with an older work force, it is essential that the workers and management both see technological advances as a productive addition to the workplace. There cannot be a disconnect between management and the employees on the front-line. While this technology has since been widely introduced and accepted at the Wolfsburg facility, Volkswagen is in a position where they are forced to work with the aging workforce to find solutions to problems that not only work, but also do not alienate the workforce and cause them to become frustrated. Technology can be a good addition for making a workplace friendlier for an aging employee. The implementation of the right technological device has the ability to make the job of an employee better and leave them more satisfied with their productivity levels. But, there is a fine line between making a problem better or making it worse based solely on the introduction of a new technology. Management must work with employees to determine which technology is beneficial and which technology is not.

### **CONCLUSION**

Volkswagen is faced with major obstacles in its future at the Wolfsburg factory. The workforce is not getting any younger and will become a major problem for production moving forward. Aging, experienced long-term employees are extremely valuable to Volkswagen, but the manufacturing facility is faced with the fact that changes will have to be made in the future. As the number of employees decrease over the next years, the management at VW will rely on the introduction of new technology that will make the factory run smoothly and productively so that they can continue to be the leader of car production in Wolfsburg that they are today. Volkswagen changes the way car manufacturing takes place, and in a country such as Germany, where the workforce is not growing younger, technological innovations are a must.

The company recognizes the importance of its currently aging workforce, knowing that each aging employee hold a vast wealth of knowledge that is critical for the successful operation of the production facility. Knowledge increases with time and is valuable for companies when it is spread throughout the corporation through a collective community. Volkswagen has taken steps to ensure that the knowledge of each worker in the facility can be passed throughout the company so that the facility in Wolfsburg can be successful. Employee knowledge is key for the future success of the organization. While the company transitions to an older and smaller workforce, each individual is forced to work for the betterment of the organization. Employees will move on, but it is Volkswagen's management's responsibility to work with aging experts to find solutions to problems that will leave the company in a state to succeed. Every

technological improvement that Volkswagen has and will implement is a direct result of working with employees to make the factory a safer and more productive work place.

Volkswagen is a symbol of Germany that employees are proud to be a part of, as reflected through their vast knowledge, loyalty and commitment to the company. Volkswagen was founded during a dark time but has proven it can succeed through difficult circumstances and rise to the top. Through its support to the aging workforce, implementation of technology and transfer of knowledge to the upcoming generation of workers, Volkswagen will be able to sustainably continue to succeed for many years to come.

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## APPENDIX

**Figure 1: Small component cart**



([http://www.volkswagenag.com/content/vwcorp/info\\_center/de/news/2013/11/p/roduction\\_logistics.html](http://www.volkswagenag.com/content/vwcorp/info_center/de/news/2013/11/p/roduction_logistics.html))

**Figure 2: wooden flooring along assembly line**



([http://onlineathens.com/sites/default/files/imagecache/full/Germany%20Volkswagen\\_Mor a.jpg](http://onlineathens.com/sites/default/files/imagecache/full/Germany%20Volkswagen_Mor a.jpg))

**Figure 3: Moving floors along assembly line**



([http://vistanews.ru/uploads/posts/2016-02/1455857016\\_201301281124\\_no\\_copyright\\_passat\\_plant.jpg](http://vistanews.ru/uploads/posts/2016-02/1455857016_201301281124_no_copyright_passat_plant.jpg))

**Figure 4: Rotated vehicles**



(<http://www.goauto.com.au/mellor/mellor.nsf/story2/7C658CB5CE2D2726CA257F18000B3D3E>)

**Figure 5: Google Glass introduced in logistics**



(<http://www.digitaltrends.com/wearables/vw-makes-high-tech-specs-standard-issue-for-logistics-staff/>)

# **Economic Realignment: From made in China to made for China**

Lorna E. Richards

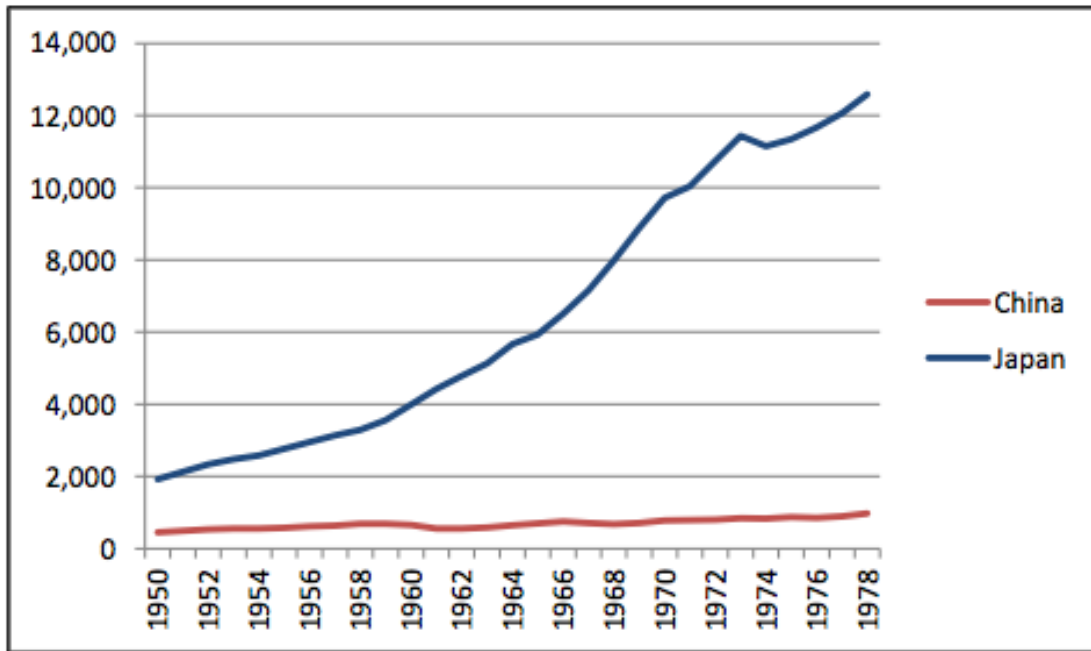
## **ABSTRACT**

This report discusses the *made in China to made for China* phenomenon and how the Vancouver born company, Lululemon Athletica, could leverage this trend. The report begins with a summary of the economic reform movement in China and how this movement increased the inflow of Foreign Direct Investment, specifically manufacturing firms, into the Chinese market. Further discussion of the Chinese economy, from 1978 to the present day is included and how the Chinese economy evolved away from exports into one focused on domestic consumption. This trend, the discontinuation of goods produced in China, and the up rise of products sold to Chinese consumers is referred to as *the made in China to made for China* phenomenon. Various forces that increased consumption habits in China are evaluated, such as government incentives, higher disposable incomes and urbanization. Next, the report focuses on the specific consumption trends that could be leveraged by Lululemon Athletica. These trends include the rising interest in the health and fitness sector and the increased purchasing power of female consumers. Lululemon's current presence in Hong Kong is evaluated and how this puts them in a favourable position to enter Mainland China and cater to the rising demand for fashionable fitness apparel. The report evaluates three areas the brand may be able to capitalize on in China, including e-commerce, the luxury market and services. Lastly, three unique challenges the company may face in China are discussed and include sustainability, imitation and brand imaging.

## **INTRODUCTION**

### **Evolution of the Chinese Economy**

China has undergone a drastic economic transformation over the past four decades. One of the key forces driving the transformation was the implementation of policies that increased China's appeal as an investment and operational destination for Multinational Corporations (MNC's). The transformation began in 1978, as this was the year the Chinese government initiated the economic reform movement following the death of Chairman Mao Zedong in 1976. Up until this point, the market had been centrally controlled and the government determined production targets and resource allocation (Morrison, 2015). During this command economy, research suggests (Morrison, 2015), the standard of living in China was significantly below that of its' neighbour to the east, Japan, as measured by Gross Domestic Product (GDP) per capita.



**Figure 1: Comparison of Chinese and Japanese (1950-1978) per capita GDP (\$ billions, PPP basis) (Morrison, 2015)**

To address the country's economic standing, the Chinese government began the economic reform movement.

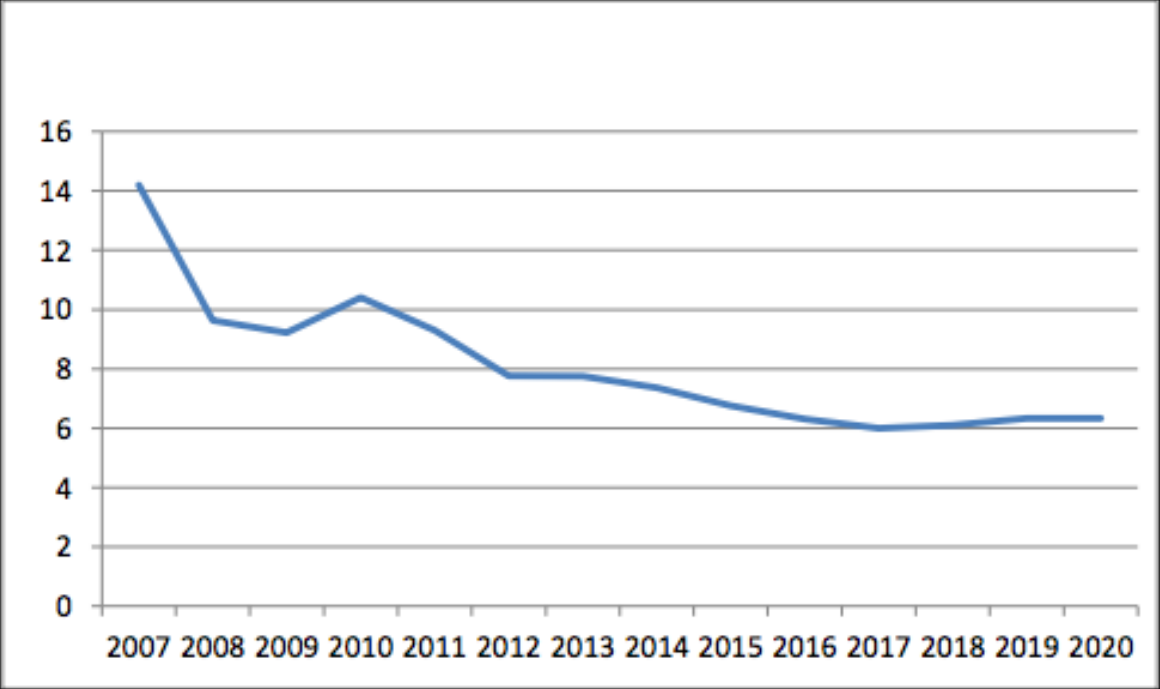
A defining characteristic of the reform included the allowance of Foreign Direct Investment (FDI) into the country starting in 1978, following a strict closed-door policy. Prior to 1978, the participation of foreign firms in China had been banned and trade was limited to products China could not produce within the country (Morrison, 2015). Permitting FDI into the country created an opportunity for MNC's to leverage an untapped market with a large amount of human capital and resources, and for China to increase its GDP. To further integrate into the global economy, the People's Republic of China joined the International Monetary Fund and World Bank in 1980 (Lewis, n.d.). To support trade and FDI, the Chinese government created economic zones along China's east coast that were deemed "developmental" and were permitted to experiment with free market principles. The creation of these zones concentrated FDI entering China in the east and Chinese workers migrated to these developing zones giving foreign firms a large workforce to source from. The creation of these zones, ultimately, established world known economic centers such as Shanghai within China. China's economic evolution continued and in 1992, the government endorsed China as a socialistic market economy (Lewis, n.d.). Despite China's status as a socialistic market economy, the privatization of industries occurred across many sectors and foreign firms that entered China managed to do so in the growing private sector. Foreign firms leveraged the manufacturing, finance and technology sectors, as these were minimally dominated by state owned enterprises in comparison to other sectors (Morrison, 2015). The privatization of industry, in combination with the introduction of new technology by foreign firms rapidly increased productivity within China. The increased productivity and low labour costs made China a popular destination for foreign firms looking to outsource production to cut operational expenses. Both foreign and domestic firms entered the manufacturing sector and created an economy reliant on the export and manufacturing of goods.

Further reforms increased China’s appeal as a destination for firms looking to invest globally or relocate their production. This included China joining the World Trade Organization in 2001, which demonstrated that trade liberalization and FDI were priorities in the country’s economic future.

**Chinese Economy Today**

Since the economic reform began in 1978, China has experienced an average annual growth rate of 10 % and is currently the world’s second largest economy by real GDP following the United States (The World Bank, 2015). In addition, data indicates (International Monetary Fund, 2015) China is the largest economy by purchasing power parity (PPP) and is the largest manufacturer, exporter and importer of goods. A key success in the reform of China’s FDI policy occurred in 2014 when it overtook the United States as the top destination for FDI in the world. Research by the United Nations Conference on Trade and Development (2014) indicated that China took in 128 billion dollars worth of FDI, compared to 86 billion dollars in the United States.

Despite the success of China’s economic transformation, the country’s explosive growth rates started to decline in 2007 and the year 2014 brought the lowest growth rate since 1990 at 7.4 % (The World Bank, 2015). Predictions by the International Monetary Fund (IMF) for China’s growth rate continue to decrease for 2015 and 2016 at 6.8% and 6.3% respectively, as shown in the Figure 2.



**Figure 2: China’s real GDP growth (2007-2014) and projections though 2020 (plotted as %) (Morrison 2015)**

The decline in the growth rate occurs as China’s exports plummet and the industrial clusters where MNC’s once manufactured their goods move to lower-wage countries such as Vietnam.

Although China's growth rate is decreasing, according to Farrell et al. (2006) China is the fastest growing consumer market in the world and is predicted to be the third largest consumer economy by 2025. China's era of consumerism ensues as families increase spending on discretionary goods and decrease the percentage of their disposable income allocated for savings. In addition to the change in spending habits of individuals, the Chinese government has made a conscious effort to increase consumption within the country. In an attempt to stabilize GDP growth, China's 12<sup>th</sup> Five-Year Plan, set in place from 2010 to 2015 prioritized domestic consumerism in an effort to restructure the country's economy. Predictions for the 13<sup>th</sup> Five-Year Plan which includes 2016 to 2020, conclude emphasis will be placed on consumer spending and continue to steer China away from exports and manufacturing as the sole contributors to GDP.

The shift in the characteristics of the Chinese economy has changed the motivation for foreign firms looking to enter the country. In addition, foreign firms with operations already in the Chinese market are altering the way in which they make a profit. As the ability to manufacture goods in China at a low cost is decreasing, numerous firms that entered China to set up manufacturing plants are now moving these operations to neighbouring Asian countries where labour costs remain a fraction of those in China. Some retail companies that initially entered China solely to produce their goods and export them are now realigning their strategy to capitalize on China's era of consumerism. The rising trend in China, where firms do not simply make their goods in the country, but rather sell them to Chinese consumers was described as *the made in China to made for China* phenomenon (Atsom & Magni, 2010). Companies such as Nike and Apple have shifted their strategy away from only manufacturing products in China and now sell their brand within the country as well.

## **SHIFT TO CONSUMERISM**

### **Manufacturers Move Out**

For decades after FDI was permitted into China, foreign firms were attracted to the country solely as a destination to manufacture goods at low cost. The country had a surplus of labourers willing to move to the industrial clusters where goods were produced and minimum wage was often a fraction of that the firms incurred in their home country. For many garment companies such as Nike, the Gap and even some luxury brands, attire was labeled "made in China". Retailers leveraged China's ability to manufacture goods both cheaply and efficiently. The retailers would then immediately export the goods out of the country and into consumer markets. The trend to manufacture goods in China, however, is decreasing and firms are either moving out of China or capitalizing on the country's consumer spending versus manufacturing capabilities.

Many forces are driving manufacturers out of China and include, but are not limited to rising wages and a decrease in the desire by youth to work in factories (Roberts, 2010). From 2009 to 2012, China's labour costs rose by an average of 20% per year in the eastern provinces, where the majority of manufacturing plants are located ("The End of Cheap China", 2012). Media outlet, The Economist, discussed that when American Chamber of Commerce members were questioned about the greatest challenge facing firms in China, 91% responded with rising costs, prior to corruption or piracy ("The End of Cheap China", 2012). To combat rising labour prices, foreign firms that initially entered China to manufacture goods are moving their operations to lower-wage countries such as Vietnam, Indonesia and the Philippines. Another attractive destination for American firms looking to set up manufacturing operations is Mexico, where research shows labour costs are actually decreasing (Bureau of Labor Statistics, 2012). A second factor, moving production operations out of China is the workforce. Access to an abundant workforce, a key factor that once motivated firms to enter China is now declining. The one child policy has led to less young

people joining the workforce, and those who do, would rather work in the service industry - not factories (Roberts, 2010). Many manufacturing operations do remain in China, but are focused in specific industries that require a highly skilled workforce and complex infrastructure such as technology and biomedical supplies ("Still Made in China", 2015). Labour-intensive industries, such as clothing and footwear are following the trend to move out of China, and into countries where low labour costs increase the profit margin. For example, the majority of Nike footwear is now produced in Vietnam, having surpassed the amount produced in China in 2010 (Adam, Case, Lester, Li, & Uyen, 2014).

Simultaneously, the "made in China" label is losing its appeal in the European and North American markets where home made products are increasingly desired for their sustainable attributes. For many companies, manufacturing goods in China has drastically decreased the credibility of their brand, as many products produced in China are questioned for their quality and are regarded as exploiting poor work conditions.

Factors mentioned above, in compliment to others are changing the economic landscape of China for foreign firms. China is no longer an economy characterized by the ability to manufacture and export goods and is evolving into an economy of domestic consumerism.

### **Forces Driving Consumerism**

Despite a decrease in manufacturing, China's spending habits have increased and the country has entered an era of consumerism. Factors contributing to the country's consumption include urbanization, a growing middle class and initiatives set by the government to encourage the Chinese population to spend their disposable income on goods and services.

There is evidence of a strong effort by leaders to realign the Chinese economy into one that prioritizes domestic consumption, and leverages the *made in China to made for China* phenomenon. In its most recent Five-year plans, the Chinese Government refocused the economy away from exports and domestic investment towards services and consumption. Specifically, the government implemented policies that would encourage the population to save less of their earnings. A defining characteristic of the Chinese economy is the high proportion of earnings that workers put directly into savings. In the United States, on average only 5% of a household's earnings are placed into savings, but in China, on average 35% of a household's income are placed into savings (Roberts, 2015). By decreasing interest rates, the government aims to decrease the incentive to retain earnings. Before, 1978 Chinese families saved little to none of their earnings because there was no incentive to do so in a centrally controlled economy. Following 1978, when the economic reform movement was implemented, the amount of money families placed into savings increased significantly. This trend has continued to the present day, where the Chinese people see savings as a precautionary measure for healthcare, education and retirement (Roberts, 2015). In the past ten years alone, the percentage of earnings placed into savings has risen 7% in China, despite efforts by the government to build schools, improve healthcare and expand the pension structure. Researchers suggest that the continued motivation to save comes from China's extreme inequality. High-income families save around 70% of their earnings in order to uphold status and lower income families save their earnings because they recognize this to be a way to overcome poverty (Roberts, 2015). With a rise in consumption and the service sector however, many economists suggest China's inequality gap will decrease.

Although savings as a percentage of income remains relatively high, the trend of consumption in China is evident. Consumption contributed to 60% of the GDP growth in the first half of 2015, in comparison to in

50% in 2014 (The World Bank, 2015). Evidence suggests that consumption will continue to rise in China, as seen in other consumer markets such as the United States. As mentioned above, last year consumption in China contributed to 50% of the country's real GDP compared to the United States, where consumption contributed to over 80% of the country's GDP. In India, where the middle class is also rising, consumption contributed to over 70% of the country's GDP in 2014 (The World Bank, 2015). These numbers indicate, that should China follow the trend of the United States and India, where consumption plays a defining role in the economy, consumption habits have yet to peak and stabilize. The increase in consumption contributes to the *made for China* phenomenon, and companies willing to adapt to China's growing consumption preferences have an opportunity to leverage retail ventures in the market.

### **A Rise in Retail**

With the rise in consumption in China, the retail landscape of the country has changed considerably and emerged forcefully. There has been an increase of both physical and electronic retail shops catering to the *made for China* phenomenon. China's retail market structure, however, is highly fragmented and the country's eastern provinces contribute to most of the country's retail sales. China's retail shops are focused in the eastern provinces, due to the country's increased urbanization. China's ten most populated cities are all located in eastern provinces and include economic centers such as Shanghai, Beijing, Hong Kong and Guangzhou. Urbanization is suggested to continue, and a McKinsey research study (Woetzel et al., 2009) predicts that by 2025 two-thirds of China's population will live in an urban center. The up rise of urban centers has increased retail and urban consumers are willing to increase their spending on discretionary goods in order to increase their quality of life. The spending of urban consumers is centered on clothing, transportation, telecom services and healthcare. With an increase of spending on clothing, both domestic and foreign stores have catered to the demand and opened up numerous locations across eastern provinces. Foreign brands, however, still only make up a very small portion of retail firms in the country, and the entrance of foreign clothing shops is expected to increase. Notable European brands, which have opened stores in China, include H & M, Zara and Benetton. H & M's entrance into China has been highly successful and in 2014 China had the 5<sup>th</sup> highest sales figure ("Full Year Report", 2014), out of the 53 countries the brand is sold. Retail in China, specifically apparel has also increased due to the amount of money young consumers are willing to spend on clothes. Research shows that young consumers, under the age of 25, spend around 40% of their income on fashion (Zhang, 2011). Vincent Lui, a partner at the Boston consulting group said the following about brand awareness in China, "about 40 million international trips are made by Chinese now and that number expected to reach 100 million by 2020, combined with Internet exposure, Chinese fashion consumers have pretty high awareness of brands" (Zhang, 2011). Many young consumers in China prefer western brands because they are perceived as being of a higher quality and better design. This preference makes Chinese consumers willing to spend extra on foreign brands in comparison to the cheaper home market retailers. The *made for China* phenomenon has created both a competitive and dynamic retail market. Opportunities continue, for foreign firms willing to take advantage of the phenomenon within certain domains, especially within the eastern provinces, which are affluent with expatriates and wealthy Chinese consumers. One of the trends increasing the retail sector is health and fitness. This next part of the report will highlight the Canadian born company Lululemon Athletica Inc., and how it may be able capitalize on the "made in China to for China" phenomenon.

## LULULEMON IN CHINA

### Health and Fitness

Increased consumption and income, as mentioned earlier in the report, has caused an increase in China's expenditure on health and fitness related services. It is expected, that in 2015 the fitness industry will have had a revenue exceeding \$5 billion dollars (Gym, Health and Fitness Clubs Market Research Report, 2015). The growth of the industry has been significant in the last five years with an annualized growth of rate 13.7% from 2010 to 2015. The term "fitness fever" has been used to describe the rise in fitness related activities in China, specifically among women. A rising interest in health and fitness in China has created a unique opportunity for apparel stores willing to cater to the trend. Consumption has been on the rise in China for years causing traditional clothing stores to saturate the market, however, fitness apparel has yet to dominate the market in such a force. American brands found across China's urban centers such as Shanghai, Hong Kong and Beijing all carry fitness attire, however, this is merely a complement to their sole fashion line. These retailers include the Gap and Old Navy, both of which operate stores in China and carry a "side" of fitness apparel, generally near the back of the store. There are currently few foreign fitness apparel stores, however, leveraging the *made for China* phenomenon. Chinese consumers, known for a desire of both luxury and western goods lack a fitness retail shop, which combines these characteristics, especially in Mainland China. Mintel, a market intelligence agency with offices across the world has identified four key trends to appear in the Chinese consumer market in 2016 ("China Consumer Trends 2016", 2015). Two out of the four trends, directly relate to the *made for China* phenomenon and more specifically trends which fitness retailers can leverage. The first of these two trends is the health conscious consumer, the result of numerous health threats such as pollution and food safety affecting the country. To counter these threats, Chinese consumers have taken a proactive approach to health. Research by Mintel, proposes that exercise has become both a trendy and essential part of Chinese life, with 64% of the population believing that regular exercise is the number one combatant to health problems, up from 51% in 2014. This research, suggests that the need for fitness apparel among Chinese consumers is on the rise, as the importance of exercise increases in the daily lives of China's population. The second trend, identified by Mintel, which can also be leveraged in fitness retail, is the *woman only* trend. The report describes the trend as follows, "Chinese Women's rising education level and workforce participation allow them to live more independently and further contribute to the consumer economy, presenting more opportunities for brands to tap into 'the women's market'" ("China Consumer Trends 2016", 2015). The report indicates that while female consumers are becoming more financially independent and dominant within the workforce, their desire to show dominance has carried over to physical aspirations as well. As the number of women joining gyms, yoga studios and health clubs is increasing, Mintel indicates that there is a driving demand for fashionable attire and leisure services catering to 'women only'. The market research also proposes there is a considerable advantage for firms willing to demonstrate their understanding and appreciation for the 'she-economy'. The report noted, "Chinese female consumers will affiliate themselves with companies that share their ethical values and take steps to increase gender equality-either domestically or globally" ("China Consumer Trends 2016", 2015). For foreign brands, these trends create an opportunity to leverage an untapped component of the *made for China* phenomenon. For many fitness apparel stores, their clothes are manufactured in China and across Asia, but are immediately exported from the market. A rise in consumption, fitness and women with purchasing power, has created a lucrative opportunity specifically for the Canadian based firm Lululemon, to expand into Mainland China.

## **Current Position**

Lululemon Athletica Inc. is a Vancouver born, yoga-inspired apparel company. The company has demonstrated an interest in becoming a global brand through the expansion to over nine countries since it was first established in 1998. It currently operates stores in two Asian countries, including Malaysia and Hong Kong (Lululemon, 2015). Defined as a Special Administrative Bureau of the People's Republic of China, Hong Kong is often used as a test market for firms looking to enter Mainland China. With an autonomous administrative system, lean Internet policies, and a large number of expatriates, the region has attracted a substantial amount of FDI over the past few years. Hong Kong is currently ranked as the tenth highest earning city in terms of GDP per capita (The World Bank, 2015) and one of the top three financial centers in the world next to London and New York. The qualities listed above, often make Hong Kong the middle ground for firms looking to expand out of or enter Mainland China.

Lululemon first entered Hong Kong with a showroom in 2013 and due to the success of the venture, opened its first Boutique store in the city in 2014. Since the first store opened, a second location has been added to the city. The locations offer both men's and women's apparel and are found in the city's most affluent neighbourhoods, which house high earning Chinese business people, expatriates and tourists. The stores carry Lululemon's entire collection including yoga, cardio and swim wear and turn over regularly to cater to seasonal inventory. The stores' layout resembles those in Vancouver; minimalistic, organized and covered with inspirational quotes. There is evidence, however, of local branding and leveraging the "made for China" phenomenon. As one enters the store located in Hong Kong's International Finance Center (IFC), a sign directly relating to the health of Hong Kong people has been placed beside the register. The sign states that in the World Happiness Report the country is rated 72<sup>nd</sup>, out of a 158 countries and territories. The sign recommends that this ranking can be improved through increased health and fitness initiatives, motivating consumers to purchase new apparel. The store's décor suggests a strong effort to combine both local and global marketing without straying from the company's core values of delivering high-end fitness apparel in a positive environment. The store, however, is not without competition in the finance and fashion-focused city and differentiates itself with its signature yoga inspired, high-end and fashionable alternative for fitness wear.

Economists predict (Jackson, 2013) the next step for Lululemon may be to expand further into the Asian market, specifically into Mainland China. A successful entrance into Hong Kong has increased brand awareness on the continent and may have been a strategic step by the company to enter the mainland. With fewer fitness retailers having taken the step to Mainland China, versus Hong Kong, Lululemon has positioned itself to be a first mover in accommodating the *made in China* trend. In addition, the Vancouver based company, is able to specifically accommodate the health conscious and female consumer discussed in the previous section. The brand just recently expanded their men's apparel in 2013, before which the company focused mainly on female attire. Lululemon's deep understanding of female attire, may prove valuable in China where Mintel predicts that one of 2016's defining trends will be that of the female, health conscious consumer.

## **Areas for Success**

There are three key areas Lululemon may be able to capitalize on in Mainland China. These areas include e-commerce, luxury branding and services.

E-commerce is one of the defining tools contributing to increased consumption among the Chinese population. The Chinese website, Taobao, has popularized e-commerce in China, and is one of the 12

most visited sites in the world (“The Top 500 Sites on the Web”, 2015). With the Chinese public familiar with e-platforms, and often preferring them as the mechanism to purchase goods, Lululemon’s ability to leverage the trend is evident. Operating one physical location in an urban center such as Shanghai could greatly boost e-commerce sales. A physical location would allow shoppers to try on and size goods and once shoppers are familiar with the items, their confidence to purchase the goods online would increase, ultimately boosting e-commerce sales. Lululemon already has a well-developed web platform and therefor would not need to build a new tool. Many other foreign brands have followed a similar strategy; where a physical location is set up for consumers to become familiar with items with a goal of increasing online sales.

Second, Lululemon can leverage luxury branding in Mainland China. High-end brands are often favoured among Chinese consumers and Lululemon’s fashionable designs and high-end fabrics may be able to cater to this trend. Specifically, Lululemon is within a niche, given that its main competition comes from mainstream apparel stores such H & M and Old Navy. Nike has included fitness apparel in their Chinese stores, but the apparel is marketed towards running and basketball. This leaves a gap in the market for Lululemon to fill with yoga attire catered to the female consumer looking to accommodate a health conscious lifestyle.

Lastly, Lululemon’s highly regarded classes may be able to cater to the growing fitness and service sector within Mainland China. As mentioned earlier, the Chinese population is taking precautionary steps to mitigate health problems. One of Lululemon’s core value propositions is delivering complimentary fitness classes within their store. These range from yoga to running clubs and develop a sense of community for those who shop at the store. By opening up the store to classes, brand awareness will increase and may motivate class goers to fill their wardrobe with Lululemon attire. By offering classes, preferably taught by both local and expatriate instructors, the brand will be able to build a strong sense of community and be viewed as a global brand catering to local needs. This strategy will specifically leverage the *made for China* phenomenon, by catering to the rise of the health conscious consumers in China’s urban centers.

### **Challenges in China**

Should Lululemon enter Mainland China as a next step in their global expansion, there are three key areas where the apparel company may face challenges. These include sustainability, imitation and brand image. Although Japan and China’s economic climate differ, a failed attempt by Lululemon to enter Japan emphasizes the caution the brand must take should it enter China.

If the brand were to enter China, its values regarding sustainability may clash with those of the country’s.

For Lululemon, sustainability is an important part of their strategy and the following is written on their website:

*We’re a values-based company with a mission to create components for people to live long, healthy and fun lives. Carrying out our mission is only possible with a healthy planet and thriving company; we’re taking steps to reduce our footprint across all areas of our business while also creating a positive, lasting impact in the world.*

(“Our Sustainability Vision”, Lululemon, 2015)

The website also describes, in detail, numerous initiatives the company is taking to incorporate environmental, social and economic health into their brand and operations. These initiatives, however,

may struggle within China, where businesses often exploit lenient policies around the environment. The drastic rise in manufacturing and consumerism in China since the economic reform has led the country to become be the second largest polluter in the world in absolute terms (World Resource Institute, 2014) and is predicted to be the number one polluter by 2050. For a company, such as Lululemon which brands itself as a leader in community based sustainability, the Chinese market may prove challenging. Conversely, entering the retail market in Mainland China may give Lululemon a unique opportunity to set precedence for a healthier, more sustainable consumer. Through education, and the branding of their core values, Lululemon may be able to challenge China's current approach to consumption and leverage an opportunity to practice their vision. The following is an excerpt from the company's website:

*Our sustainability vision is to elevate the world from mediocrity to greatness by embracing social, environmental and economic health in every part of our organization and in all our global communities. We are working to be part of an elevated world that operates within nature's boundaries and provides for human needs everywhere on Earth — including the opportunity for everyone to lead a happy and fulfilling life.*

(“Our Sustainability Vision”, Lululemon, 2015)

Entering the Chinese market creates a unique opportunity for Lululemon to practice and further implement their vision, as described above.

The second struggle Lululemon may face entering the Chinese market is imitation. One study (Li & Spink, 2012) writes that up to 70% of the world's counterfeit goods are sourced from China. Fake markets can be found throughout China both in large and small centers. Imitation Lululemon apparel is already present among some of these markets and should the company enter the market with a physical store, the ability of counterfeiters to imitate the brand's products would increase. In addition, both Chinese and foreign consumers may seek out fake goods to acquire the apparel at low cost, versus in stores or online where Lululemon prices reflect the companies high-end branding.

Lastly, the company may have to overcome being labeled solely as a “foreign brand” and adopt a “global brand” image to succeed in China. Many foreign firms, specifically luxury brands, have failed in the Chinese market because they are only seen as being foreign, and those who can afford to buy the brand will do so abroad, to prove its authenticity. For many of China's wealthiest consumers, vacations abroad are increasing and these opportunities are reserved to purchase foreign brands. This adds a level of prestige and status to the item, because it was purchased in the country the brand is affiliated with. To overcome this challenge, Lululemon will have to leverage the “made for China” phenomenon, ensuring Chinese consumers the brand combines both global and local values. The store in Hong Kong's International Finance Center demonstrated the value of purchasing goods from the Hong Kong store with its reference to the city's happiness index, discussed earlier in the report. Although not an exhaustive list, these struggles demonstrate that entering the Chinese market comes with unique challenges.

## CONCLUSION

The *made in China to made for China* phenomenon is one outcome of China's drastic economic evolution and realignment since the country's open-door policy was initiated in 1978. Initially, China was a country only attractive to Multinational Corporations for its ability to manufacture goods at a low cost, but quickly progressed into an era of consumerism. When the government recognized a need to rebalance China's economy and stabilize the growth rate it steered the Chinese population toward consumption. A rise in disposable incomes has enabled the Chinese population to indulge in discretionary goods, a new trend for the nation known for its high savings rate. A rise in consumption has created a unique opportunity for companies willing to leverage the made for China phenomenon, specifically in niche areas that are underdeveloped. Research suggests, that the health conscious consumer is on the rise and this will increase the demand for high-end fitness apparel. For the yoga-inspired apparel company, Lululemon Athletica Inc., Mainland China may be a strategic move in their global expansion. The company, which already operates in Hong Kong, is in a favourable position to make the move to the Mainland. This report identified three key areas the company can leverage on the mainland including e-commerce, luxury branding and the growing service sector. In addition, unique challenges within China's retail market were discussed including sustainability, imitation and brand awareness. In conclusion, the demand for *made for China* goods and services is on the rise, and a company such as Lululemon Athletica Inc., which aligns with the rising trends, could leverage the phenomenon.

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