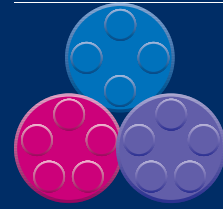


Exploring Corporate Strategy

CLASSIC CASE STUDIES



BMW automobiles

Valeriano Lencioni

The BMW Group is a prominent European maker of prestige automobiles. Its operations also include motorcycles, software products and financial services: this case deals only with the group's automobiles. By 2004 it produced and sold over one million vehicles under three brands: BMW, by far the largest; MINI, a relaunch of the British icon small automobile from the 1960s; and the Rolls Royce, of which they relaunched the 'Phantom' model in 2003. Following the failure to grow market share and the range of models by acquiring the British group Rover, the Group in the early 2000s adopted an aggressive strategy of organic growth. The result was the launch of a large number of models across the price and class ranges, and a robust policy of market development.



THE AUTOMOBILE INDUSTRY IN THE MID 2000S

The first automobiles were produced in the late 19th century but the automobile industry became a significant employer and an economic force only after the Second World War, when national economies began to be rebuilt. With the end of the war, the industrial production and manpower that had fuelled the war effort were deployed to rebuild infrastructures and provide people with the consumer goods that were not available during the war. Automobile production was initially prominent in the US, but soon Europe, later Asia, especially Japan, became equally important forces. By the latter part of the 20th century, the automobile industry was global, mature and heavily consolidated: most of the world automobile production was concentrated in five companies – General Motors, Ford, Daimler-Chrysler, Toyota and Volkswagen (see Exhibit 1).

A number of environmental circumstances affected the industry in the first few years of the 21st century. The global economy experienced a sharp downturn in 2001, which lasted well into 2003 when some signs of acceleration were experienced, especially in the US economy. Equity prices had fallen until late in 2003: this, coupled with geopolitical tensions and concerns about oil supplies, added to the uncertainty about the economic and political environments. In this climate, sales in most automobile markets around the world declined, with the exception of the UK, some Scandinavian countries and China, which grew well above average. The decline in the automobile market in US was particularly severe.

From the mid 1990s automobile producers strove to improve engineering and quality of vehicles as a route to competitive advantage or, in many cases, to catch up with competitors, but ten years later there

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Exhibit 1 The automobile industry

BMW and the five major companies in 2003

Company	No of vehicles (m)	€ (bn)
General Motors	8.5	157.19
Ford	6.7	116.47
DaimlerChrysler	3.85	144.65
Toyota	6.25	125.30
Volkswagen	5.02	87.15
BMW group	1.12	41.52

was very little to differentiate automobiles produced by many of the major companies. Therefore, in the first few years of the 21st century, players in the automobile industry as a whole stepped up price competition. A hefty overcapacity of around 30 per cent in the overall industry meant that ‘a lot of metal chased little money’, making low prices or incentives – mostly in the form of free insurance, zero per cent interest on hire purchase – the prevalent means to displace market share from competitors. However managers were fully aware that competing on price was not beneficial to anyone in the medium term, as it depressed the profitability of the whole industry: customers’ expectations would become a very powerful barrier to increasing prices later. The result was that, as well as selling few cars, car companies sold them at a lower price; the consequent depression of profitability was likely to affect negatively their credit rating, thus increasing the cost of borrowing: a nightmare scenario. This was true especially with regard to the USA’s ‘big three’, Ford, GM and DaimlerChrysler.

But the larger European car companies had also suffered from depressed demand and oversupply, with Volkswagen’s profit falling by 49 per cent in the second quarter of 2003. Fiat was also trying hard to get out of a serious crisis by restructuring the company and renewing the dull model range under the guidance of the CEO who had turned around the fortunes of Pirelli, the tyre maker. In 2003, the jury was still out on Fiat’s chances of comeback.

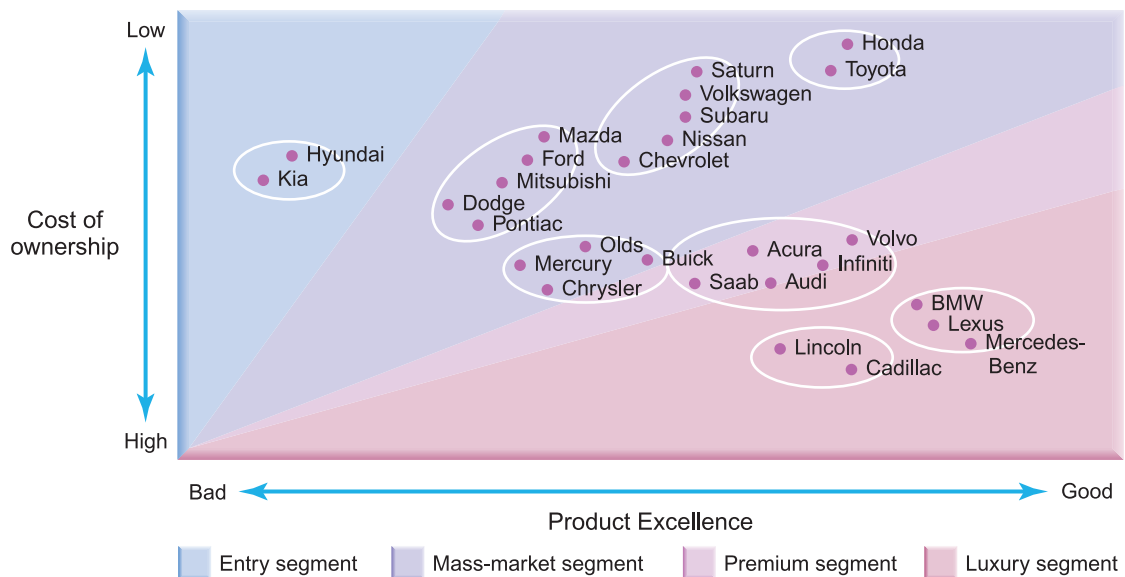
Changes in the basis of competitive advantage

By the mid 2000s the car market was teeming with good quality cars, but consumers found very few ways to distinguish between many of the available brands and models. Quality was no longer an issue in the industry: most models were well built and reliable. For example, the quality of US automobiles had improved 24 per cent from the late 1990s. ‘The gap between the best and worst US performers, which was 212 defects per 100 vehicles in 1998, has narrowed to 53 defects.’¹

Almost inevitably, the distinguishing elements, and customers’ choice factors had become design and brand appeal, as demonstrated by the fact that companies that had given attention to the ‘look’ of their automobiles or had built powerful brands made small gains, rather than losing market share.

This realisation made design the first weapon in the fight for market share, as the feature that grabbed customers’ attention. Naturally, boardrooms took up design as a major plank of their strategy and sparked a hunt for top-level designers. The promised rewards were rich enough to lure the best talents, who were then provided with lavish high-tech design laboratories and art studios. This strategy was trodden by companies across price and vehicle type ranges.

¹ C. Dawson and K. Kerwin, ‘Designer Cars’, *Business Week*, 16 February 2004.

Exhibit 2 Average performance of car brands*

* Data represents 2001 image attribute scores, except for Infiniti and Subaru data, which is based on 2002 scores.

Source: E. Hirsh *et al.*, 'Reality is perception: the truth about car brands', *Strategy+Business*, Fall 2003.

However, pursuing quality and appeal in design was putting pressure on companies' resources. So was brand building and management, which was even more demanding and with less certain results. It had become clear that a brand identity was one of the most effective ways to be more competitive in an industry where more and more products came to the market. But simple advertising was not enough. In the US carmakers had spent more than \$50bn ($\approx$ €41bn) on marketing, equivalent to \$2,900 for every car sold. Yet their combined US market share had fallen by more than 4 per cent, amounting to a \$15bn loss.

Effective branding establishes emotional connections between customers on one side and products, salesmen, other users on the other. A prime example of successful branding was Toyota. It conveyed the perception of high quality and fuel economy, creating the emotional connections of reliability and smart environmental awareness. BMW conveyed the image of the 'ultimate driving machine', even to those customers who bought models with small engines and automatic transmission, say a 3-series. The reason for this was that every model raised a set of general perceptions and emotional connections generated by the mother brand, as well as some specifically related to the model in question. The common theme of the brand conferred even to the least representative model a certain aura. This process had moved a long way from the concept of product as brand, for example Ford Model T.

This is not to say that the product was unimportant. Research conducted in 2003² demonstrated that consumers, based on their direct and indirect experience, measured different brands' performance against two overarching criteria: product excellence and cost of ownership. The researchers also added that 'the relative magnitude of product excellence and low cost of ownership determines a brand's value proposition in the marketplace'. The brands that are positioned in a crowded area of the competitive space suffer particularly from competition, and their profit is reduced. The positions reported in Exhibit 2 tend to be rather stable over time.

² E. Hirsh *et al.*, 'Reality is perception: the truth about car brands', *Strategy+Business*, Fall 2003.

BMW GROUP

Origins

BMW was established during the First World War to manufacture engines; in 1945, the company was still Germany's leading manufacturer of aero-engines. Subsequently it diversified into what in 2000 were its main products, automobiles and motorcycles. By then BMW was one of Germany's largest and most successful companies. But BMW's road to sustained success was a troubled one and in 2000 the horizon was not all rosy. The group's activities were concentrated almost exclusively on two product ranges: high-performance saloon automobiles and motorcycles. The focus of this case is on automobiles.

The march to success

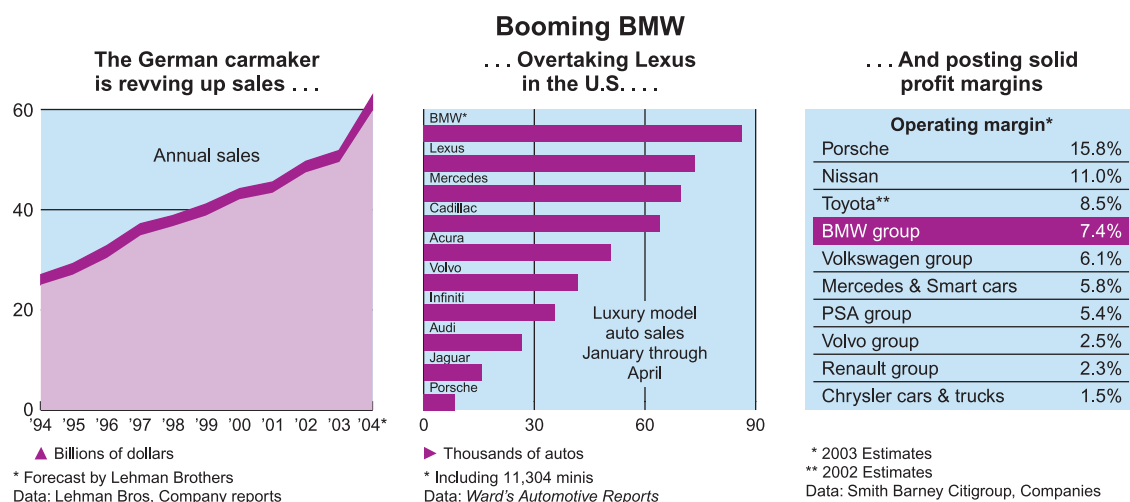
At the end of the Second World War, both its aero-engines market and its capital equipment were under serious threat. The demand for aero-engines, Germany having lost the war, had temporarily disappeared, and its main factory was now in the Soviet occupation zone. Therefore, whilst post-war West Germany experienced an economic miracle, BMW struggled. Uncertain of its destiny, the company concentrated on automobile production, but without a focus, its products ranging from small bubble cars, built under licence, to large limousines. In 1959 BMW faced bankruptcy, when it found a powerful shareholder, Herbert Quandt, who could see the company's inherent strengths beyond the current difficulties. The turning point came in 1961, when it launched the BMW 1500, which soon established the BMW automobile brand as one with a reputation for engineering excellence.

In the 21st century, the scarce resources that most influence national competitiveness are likely to be the skills displayed by the workforce. One of Germany's distinctive national resources was a highly qualified labour force that could be used by German manufacturers as a source of competitive advantage. Most of such advantage went to companies that, like BMW, managed to build a perception of valuable differences in the minds of their buyers.

It was difficult to single out a specific resource that underpinned BMW's success: it was rather a series of factors, and the way they combined to sustain its competitiveness. BMW automobiles are powerful, reliable and luxurious, but not exceptionally so. BMW's technology had been advanced, but not exceptionally innovative (when compared, for example, with Citroën). Its automobiles were conventionally designed and traditionally styled, yet they were expensive, even considering the high level of specification offered by most models, with retail margins comparatively high. The company had tightly controlled its distribution network, to the benefit of brand management, communication and after-sales service. Being close to the buyers had also allowed them to segment the market effectively: for example, BMW automobiles have been positioned differently and priced differently in the various national markets. BMW also exercised a firm control on the supply chain and dealings and relationships with suppliers, who mostly had maintained a long association with the company. That combination, a system of production that gave the company advantage in its chosen segment, a reputation for product quality and a brand which immediately identifies the aims and aspirations of its customers, by the mid-1990s had built BMW into one of the most profitable automobile manufacturers in the world.

The BMW brand also acquired a distinctive identity as a symbol for young, affluent European professionals: most drivers perceived high-performance saloon automobiles as synonymous with BMW. They had been able to structure their production around an easy to summarise theme: 'The ultimate driving machine'. Ealey and Troyano-Bermudez wrote in 2000: 'When a person walks into a BMW showroom, the question isn't, "Which model do I want?" It's, "How much BMW can I afford?"'³

³ L. Ealey and L. Troyano-Bermudez, 'The automotive industry: a 30,000-mile checkup', *The McKinsey Quarterly*, no. 1 (2000), p. 74.

Exhibit 3 BMW Group position in 2003

Source: G. Edmondson, 'BMW', *Business Week*, 9 June 2003.

BMW's position in 2003

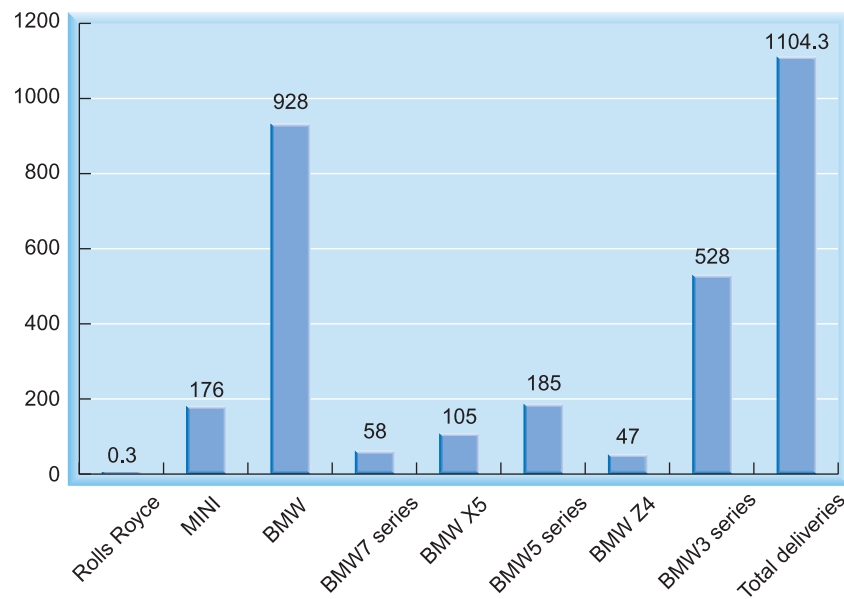
In 2003, Bayerische Motoren Werke (BMW), the group that owns the prestigious BMW brand, was one of Europe's top automakers. BMW automobiles accounted for about three quarters of the group's sales. The company's operations also included motorcycles, software and a growing financial services division. The turnover of the Group in 2003 was over €41.53bn ($\approx$ £27.5bn), down 2.1 per cent over 2002 mostly due to the strength of the € over the US\$ (discounting this effect, the growth in revenue over 2002 would have been 4.2 per cent). Gross margins, of €3.2bn, were down 2.8 per cent from 25.4 per cent of 2002, a reflection of the growing expenditure in product and market development. The group produced an annual surplus of €3.2bn, 3.6 per cent lower than 2002; the difference was mostly due to changes in the legislation for tax provision.

These results were even more remarkable if considered in the light of the generally downwards trend in the automobile industry's profitability.

BMW automobiles in 2003 employed over 104,000 workers in plants in Dingolfing, Munich and Regensburg in Germany, Spartanburg in the US, Rosslyn in South Africa, Oxford in the UK and in China. They produced over 1.1 million BMW, Mini and Rolls Royce cars. Of these, 928,000 were BMW automobiles, up 1.6 per cent on 2002.

In fact BMW had achieved some remarkably progressive agreements with the workers' unions, and were operating some of the most flexible and productive plants in the automotive industry. A factory being built in Leipzig was planned to swing from 60 hours a week, when demand was slack, to 140 hours a week when demand grew. In the words of the Chief Financial Officer Stefan Krause, 'Our [machines] sweat more than other people's because they work longer hours'. However, given the pressure on prices generated by increasing competition in the premium car market, the most profitable in the industry, there was pressure on keeping cost down if an acceptable profit was to be realised. Moving production into growth markets achieved the double benefit of containing the costs and partially hedging against currency risks. The cost reduction resulted from an increased utilisation of the Spartanburg plant in the US, where they built the X5 and Z4, and the use of well qualified but much cheaper labour force in China. The strong rise of the euro versus the US dollar in the second half of 2003 demonstrated the wisdom of the policy.⁴ BMW was planning to invest \$480m by 2005, to take a 50 per cent share in a joint

⁴ U. Harnischfeger, *Financial Times*, 26 June 2003.

Exhibit 4 Automobiles delivered by the BMW Group in 2003 (1,000 units)

Source: Accounts Press Conference: Statement by H. Panke, CEO of BMW AG, 17 March 2004.

venture in China to produce 3-series cars, to be followed soon by 5-series cars. It aimed to achieve sales of 150,000 vehicles by 2008, from the present 8,000. The move was not a half-hearted one; up to 40 per cent of the parts used in China would be sourced locally, according to CEO Helmut Panke.⁵

The markets

The main markets for BMW automobiles have been Western Europe, the USA, Japan and the Pacific region, with the markets of Germany and the US accounting for almost half the total car sales. Important markets have also been the fast-growing UK, and the Italian, French and Japanese markets. Sales in the USA market have been particularly successful, as they grew by over 8 per cent on the previous year to 277,000, becoming the biggest market for the group and overtaking the Lexus brand for the first time. At the end of 2003, the outlook for 2004 by group management and industry observers was upbeat. This view was supported by the successful launch of the new 5-series, the consolidation in Europe and Asia of the BMW Z4, and the introduction of the BMW X3. The new BMW 1 Series and the BMW 6 Series cabriolet were to be launched early in 2004. By far the most successful models were the MINI, the 3-series and the 5-series, but the other models were also in significant demand. In the Chinese markets there was growing demand for the higher end models of the range, specifically for 7-series and 5-series.⁶

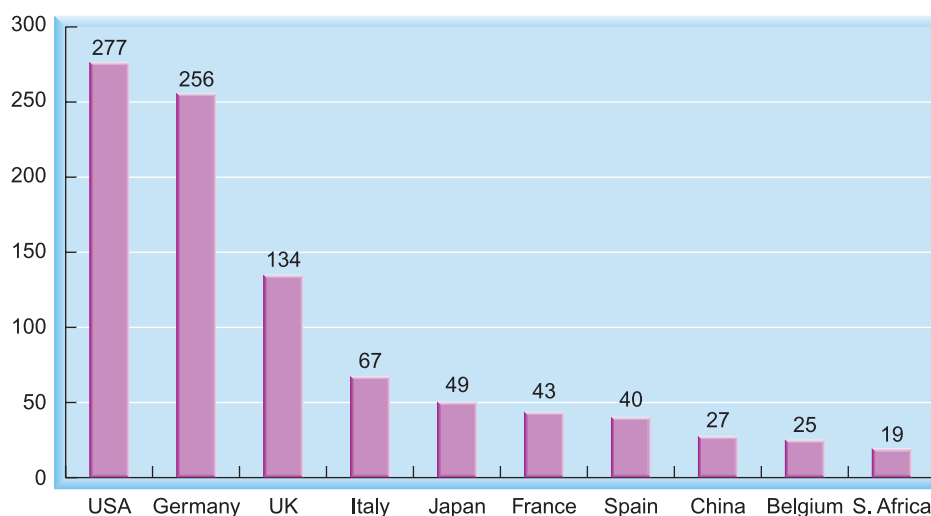
Exhibit 4 shows the details of automobile deliveries in 2003.

THE FUTURE

In the early 2000s, the size of the company and the range of models continued to be causes for concern. In the mid 1990s, they had tackled both problems by taking over Rover of the UK. However, the venture did not work and came to a sorry end five years later, when they had to sell the British company for

⁵ J. Kynge, *Financial Times*, 28 March 2003.

⁶ BMW Group Interim Report to March 2003.

Exhibit 5 BMW's top ten markets

Source: Annual Accounts Press Conference: Statement by H. Panke, CEO of BMW AG, 17 March 2004.

the sum of £10 ($\approx$ €8.30). The Quandt family had put pressure on the Group's managers to stop Rover's haemorrhagic losses: it is estimated they were in the region of €900m per year. The CEO, B. Pischetsieder, resigned after a stormy meeting with the shareholders. J. Milberg, the new CEO, had to deal with the messy acquisition and dispose of it. They retained the MINI brand and sold Land Rover, previously part of the Rover Group, to Ford.

The failure, as well as causing the loss of a great deal of money and of public face, had also left the group with two problems still unresolved. They were still little more than a niche player, competing with a handful of models. Also, their size was still modest when compared with that of the big five, and left them vulnerable to acquisition if the Quandt family were to decide to dispose of a sufficient amount of their shares.

In 2002, Helmut Panke, a nuclear physicist, had become the new Group's CEO, and started a strategy of internal growth through market and product development. In 2003, BMW was planning to launch a new model every three months through to 2005, providing a range of premium automobiles that ranged from the Mini to the Rolls Royce. The aim was to raise sales by 40 per cent a year for the next five years, and to achieve sales of 1.4 million vehicles. Mercedes-Benz would then become number two producer of premium cars, and BMW's long term ambition of being number one would be finally realised.⁷

To achieve the targets it had set itself, the company was pushing hard in the US and Asian markets to find buyers for the high-end models that they had found difficult to sell in the flat and saturated European market. Difficulties in dealing with labour cost control in the European political climate had also led BMW to expand its production facilities in the US, where the Spartanburg plant was not running at full potential, and China, where a well qualified labour force cost much less than in the West.⁸ It was an ambitious plan that, if successful, as well as giving the group greater prominence and profitability would also effectively cure the problem of vulnerability to acquisitions.

But the strategy was not without risks. Three interconnected issues related to BMW's declared strategy.

First of all, increasing the output at the level planned by the company, could threaten the very reason for BMW's great success: a strong, but simple, theme summarised by the line 'the ultimate driving machine'. They had been able to exploit this brand identity very profitably and globally, wherever their niche could be found. There was no doubt that the brand could be extended and that the theme would

⁷ G. Edmondson, 'BMW', *Business Week*, 9 June 2003.

⁸ U. Harnischfeger, *Financial Times*, 26 June 2003.

BMW automobiles

still be recognisable and effective in the brand communication. However, how far it could go without causing damage was a matter of speculation. How would the launch of the 1-series be perceived by buyers, and perspective buyers, of the high-end BMW models? Would their perception of the value of the BMW brand be negatively affected? Related to this threat, there was also the risk that any model positioned in the proximity of a more expensive model could cannibalise it. For example, could the 1-series model cannibalise the 3-series?

Secondly, increasing the production of smaller cars could have the effect of reducing the historically high margins enjoyed by BMW (see Exhibit 3). Moving into smaller cars meant earning the lower margins that were typical of those market segments. But competitors in those segments were volume producers with lower costs than BMW. Would BMW be able to reap price premiums large enough to maintain their profitability level? The premium price automobile market, being one of the few profitable ones, was increasingly crowded, so new models came out, and new entrants nudged closer, all the time. The result was that price competition, which started when Lexus had entered the US market in the mid 1990s, was gaining pace. In such a competitive climate, the pressure was on to save costs by sharing components and platforms amongst models, for example between 3-series and X3. However, this sharing could lead to a flattening of the features of the different models, thus encouraging the cannibalisation of the more expensive model.⁹

A third concern was that of quality. With pressure on costs, the risk of quality lapses was bound to increase. The consequences of quality defects in the premium segments can be very heavy, as BMW learned when customers found it very difficult to use the iDrive they had installed in the 7-series. Expanding production with increasing contracting out of manufacturing processes could make quality control more difficult than it had been when a handful of models made BMW's reputation worldwide.

If H. Panke was mulling over any of these concerns, he did not show it at the *Annual Accounts of Press Conference* on 17 March 2004, when he said:

We offer our customers emotional products, which, through the strength of the brand and the substance of the product, fulfil the customer's wish for individualisation and differentiation. The BMW Group will never build boring products.

⁹ G. Edmondson, 'BMW', *Business Week*, 9 June 2003.