

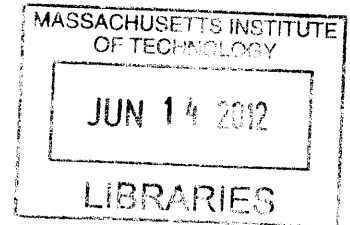
# The Strategic Importance of the “Stakeholder Approach” in the Service Industry

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## **ABSTRACT**

In countries with a market economy it is generally agreed that companies should pursue economic profitability to survive and to provide shareholders with maximal value. The view is generally summarized as “the shareholder approach” in the management of businesses. However, not many people would disagree that companies also have certain social responsibilities. Unlike the shareholder approach, “the stakeholder approach” emphasizes responsibility over profitability and sees that company’s success should be measured by the satisfaction among all stakeholders around itself, not by one stakeholder- shareholders.

In this thesis, I examine how the stakeholder approach is beneficial for corporation’s sustainability and competitiveness in the service industry by analyzing some empirical evidences in leading companies in it; Enterprise Rent-a-Car, Whole Foods, and Trader Joe’s. In the service industry, companies can’t help continuing interactions and relationships with all the stakeholders in daily business operations. Without supports from them, companies are hard to succeed. The analysis finds that the stakeholder approach is a legitimate management strategy and helps companies building trust and maintaining a sustainable competitive advantage, even giving better financial return in the long term.

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## PART I: The Stakeholder Approach vs. The Shareholder Approach

### Section Ia: The Corporation in the Capitalism

A corporation is one of the most important creations of the capitalism. It is the most common form of the business organization and is given many legal rights as an entity, separated from its owners. This form of business is briefly characterized by the limited liability of its owners, the issuance of shares, easily transferable ownership in the market, and the existence as “the going concern”. The incorporation, the process of being so, gives the company separate legal standing from its owners and protects them from being personally liable when the company is bankrupt or prosecuted. These features allow them to have only a limited liability. The incorporation also provides the company more flexible ways to manage its ownership or funding structure. In these respects, corporations differ from sole proprietorships and limited partnership. After the institution of corporation, everyone could be an owner of any company with a limited liability.

There is a shareholder system in the nexus of corporation system. Shareholders own parts of the companies through stock ownerships which could be easily transferred. It enables people to do business with a limited liability. Regardless of the whole risks of companies, shareholders are exposed only to the amount they invested. With the shareholder system, corporations could increase the scale, scope and depth of the business

through engaging in the riskier yet more rewarding businesses. Therefore, the shareholder system has been the biggest driving force for the growth of corporation and capitalism.

#### Section Ib: Shareholder Advocacy throughout the History of Capitalism

As the roles of corporation in capitalism have been increasing, the importance of shareholder in a corporation has become stronger as the “Laissez-faire” system has spread. Triggered by the industrial revolution in England, and the British victory over Napoleon in 1815, capitalism began to flourish. It was characterized as “Laissez-Faire” and was known to be regulated by the “Invisible Hands” depicted by Adam Smith.<sup>1</sup> The principle was so convincing to be taken for granted and remained so until the First World War occurred.

According to Anatole Kaletsky(Capitalism 4.0; The birth of a new economy, 2010), capitalism is not a static set of institutions, but an evolutionary system that reinvents and reinvigorates itself through crises and recoveries.<sup>2</sup> It is equivalent with the concept of Joseph A. Schumpeter, “Creative Destruction” (Capitalism, Socialism and Democracy, 1950). Schumpeter argued that creative destruction is the endless process of replacing old products and services with new ones and he presented it as the essential fact of capitalism.<sup>3</sup> In fact, capitalism itself has been a target of creative destruction, too.

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<sup>1</sup> Adam Smith, “Wealth of Nations” book 1, ch. 7; The idea of markets automatically channeling self-interest toward socially desirable ends is a central justification for the laissez-faire economic philosophy

<sup>2</sup> Anatole Kaletsky, “Capitalism 4.0; the birth of a new economy” (PublicAffairs, 2010)

<sup>3</sup> Joseph A. Schumpeter, “Capitalism, Socialism and Democracy” (1950)

Back to the Kaletsky's classification of history of capitalism, he called the initial capitalism, the "Laissez-Faire" capitalism, as the "Capitalism 1.0." After the First World War and the Great Depression in the United States, the Capitalism 1.0 was destroyed by "Keynesianism" capitalism represented by Roosevelt's New Deal policy and European welfare states. The capitalism 2.0 embraced the intervention of governments in markets and emphasized a role of government to fix the failure of market. However, it was overruled by "Neo-classical Economics" representative of "Thatcherism" and "Reaganomics." The capitalism 3.0 has been dominating modern society and economy, reemphasizing the importance of the free market fundamentalism and negating the needs of governmental intervening. It remained strong until the financial crisis occurred in 2008.

Throughout the history of capitalism, shareholders were regarded as the most important to be served in the management of company although the degree varied depending on the time. It was believed that the purpose of a corporation is to maximize profit for shareholders. The history of the shareholder advocacy has been long. The origin dates back to 1600s to Dutch East India Company.<sup>4</sup> Since the inception of corporation, the shareholder advocacy had been prevailing. Especially, during the Thatcher-Reagan capitalism, liberalism and neo-classical economics scholars advocated the role of corporation and its shareholders. The consensus of the shareholder advocacy had been acknowledged broadly in the most developed economies. Public became to take it for granted that company exists solely for its shareholders.

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<sup>4</sup> Johathan GS Koppell, "Origins of Shareholder Advocacy" (Palgrave Macmillan, 2011), pp. 61-64.

Since the 1970s, the value of shareholders was believed to be invincible, when several scholars and businessmen published and practiced remarkable works. In academia, the obsessions with the shareholder value began in 1976, when Michael Jensen and William Meckling published "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," which argues that the owners of companies were getting short shifts from professional managers.<sup>5</sup> As the most cited academic article about business, it inspired seemingly irresistible movement to get managers to focus on the value for shareholders. In addition, Murray Rothbard and Robert Nozick, popular scholars in liberalism, claim that actors in the market have the right to do with their property and to enter into any contractual arrangement, unless they violate others' rights to do so.<sup>6</sup>

According to the arguments, most management classes have been teaching the very same logic of the shareholder advocacy as they define that "The goal of management is to maximize the current value per share of the existing stock."<sup>7</sup> To justify the reason of maximization of the stock value, scholars explain that the current value of stock should be reflective of the value of a company according to the Gordon's Dividend Discount Model (DDM) and Efficient Market Hypothesis (EMH). In the management theory, managers have a duty to serve shareholders and their goal is to maximize a stock price.

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<sup>5</sup> Michael Jensen, William Meckling, *The theory of firm: Managerial behavior, agency costs and ownership structure*, 1976

<sup>6</sup> Murray N. Rothbard, *The Ethics of Liberty* (New York: New York University Press, 1982), Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974).

<sup>7</sup> Ross, Westerfield, Jordan "Fundamentals of Corporate Finance"



Among the business professionals, one of the strongest proponents of the shareholder advocacy is Jack Welch, once-CEO of General Electric for almost last three decades. He is regarded as the incarnation of the idea that a firm's sole aim should be maximizing returns to its shareholders. Upon the shareholder advocacy, he managed the GE empire, succeeded and was regarded as icon of modern management. This idea dominated American business community for the past three decades, and spread rapidly around the world.

By the same token, a well-known economist, Milton Friedman, played a great role to spread the shareholder advocacy. In 1970, he wrote an influential article about the reason of corporation's existence. He argued the divine responsibility of managers to the shareholders. Since the release, numerous business scholars cited the Friedman's article for the shareholder advocacy.<sup>8</sup> Friedman argued that when corporate managers allow considerations of social responsibility to influence their decisions, they violate their fiduciary obligations to the corporation's owners, the shareholders.

*In a free-enterprise, private-property system a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom.*

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<sup>8</sup> Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," *New York Times Magazine*, 13 September 1970;

Since shareholders presumably invest in a corporation in order to make money, the primary responsibility of a corporate manager is to maximize returns to shareholders; any socially worthy goals whose promotion would conflict with that primary responsibility must be forgone. A corporate manager may be as charitable as one pleases, on one's own time and with one's own money; but the manager violates the contractual obligations to the shareholders as soon as such considerations begin to sway the management decisions and so diverts shareholder resources to purposes incompatible with the shareholders' wishes. Such, in essence, is the Friedman's argument and one of strongest logic of the "Shareholder Approach"

#### Section IC: The Origins and Backgrounds of the Stakeholder approach

On the contrary, there is another approach which rejects the shareholder approach. It is called the "Stakeholder Approach". It was originated by Edward Freeman in "Strategic Management: A Stakeholder Approach." In this book, he identifies and models stakeholder groups of a corporation, and describes and recommends methods by which management can give due regard to the interests of those groups.<sup>9</sup> In short, it attempts to address the "Principle of who or what really counts."

Although shareholders may be the largest stakeholder group because they are affected directly by a company's performance, it has become more common for additional groups also to be considered as stakeholders. The stakeholder approach claims that corporate

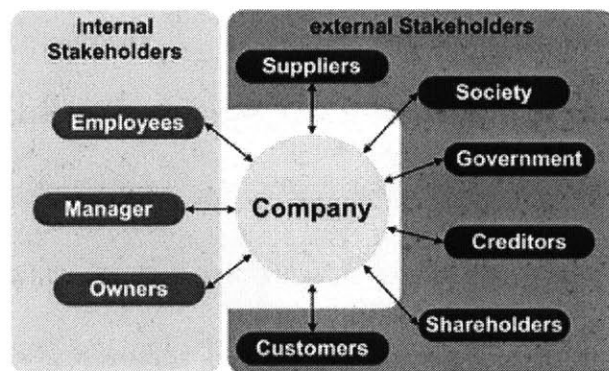
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<sup>9</sup> Edward Freeman, "Strategic management; Stakeholder approach, 1984"

decisions should be guided by concern for the interests not only of the shareholders, but also of all groups (e.g., employees, customers, suppliers) whose interests are vitally affected by the corporation's actions – all those who “have a stake” in the outcome of corporate's decisions.<sup>10</sup> Although there are debates regarding which stakeholders deserve considerations, widely accepted interpretation refers to shareholders, customers, employees, suppliers, and local communities.<sup>11</sup>

While some narrower definitions of stakeholders prevailed initially, the arguments later expand the scope of stakeholders from primary stakeholders inside corporations into peripheral or secondary stakeholders, which includes the governmental bodies, political groups, trade associations, communities, and public at large. Depending on the scholars, the composition of stakeholders varies.

Figure 1. Example of Stakeholder



(Source : stakeholdertheory2011.blogspot.com)

For example, by the boundary of a company, stakeholders could be classified into internal or external stakeholders. Regardless of its origin, initially, the stakeholder approach was understood as just a counter-argument against the shareholder advocacy, since Friedman regarded the contractual obligations to owners as legitimately overriding broader concerns with the social responsibility.

<sup>10</sup> William M. Evans and R. Edward Freeman, “A Stakeholder Theory of the Modern Corporation: Kantian Capitalism,” in DesJardins and McCall, (Englewood Cliffs, New Jersey: Prentice-Hall, 1988) p. 77-85.

<sup>11</sup> Ibid. p. 97–106.

Figure 2. Depiction of Dichotomy between Shareholder and Stakeholder



(Source: Economist, "New Idolatry", Apr 22nd 2010)

According to those counter-argument perspectives, two theories seem completely conflicting. Unlike the shareholder theory, which allows managers only to serve the interests of the owners, the stakeholder approach asserts that managers have a duty to both the corporation's shareholders and "individuals and constituencies that contribute, either voluntarily or involuntarily, to companies' wealth-creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers."<sup>12</sup> According to the stakeholder theory, managers are agents of all stakeholders and have two responsibilities: to ensure that the ethical rights that no stakeholder is violated and to balance the legitimate interests of the stakeholders when making decisions. The objective is to pursue the profit maximization with the long-term ability of the corporation to remain "the going concern". The

<sup>12</sup> J.E. Post, L.E. Preston and S. Sachs, "Managing the Extended Enterprise: The New Stakeholder View," California Management Review 45, no. 1 (fall 2002): 5–28.

fundamental distinction is that the stakeholder approach demands that the interests of all stakeholders are considered even if management has to give up some of the profits. In other words, under the shareholder approach, the other stakeholders can be viewed as the “means” to the “ends” of profitability; under the stakeholder theory, the interests of many stakeholders are also viewed as the “ends.”

From the perspective of the dichotomy, people tend to understand that the conflicts between the two approaches have something to do with the normative discussion. How people acknowledge the stakeholder theory at the early stage was to look for what could be the “right” theory. When people experienced several series of corporations’ frauds and scandals, such as Enron, Global Crossing, Tyco International and WorldCom, they are concerned about the trust of corporation and its incentive system. After the financial crisis, some people even have claimed that those events exemplified the failure of the shareholder theory because it resulted from the beliefs that managers primarily have a duty to maximize the shareholder returns. At the same time the failure reminded people of the importance of the stakeholder theory, which believes that a manager’s duty is to balance the shareholders’ financial interests against the interests of other stakeholders such as employees, customers and the local community, even if it reduces the shareholders’ returns. Upon these arguments, people are divided into two groups; proponents of each approach, that is, the shareholder or the stakeholder.

Under many arguments followed by the division of ideas, there is an understanding that both approaches are normative theories, dictating what a corporation's role ought to be.<sup>13</sup> By extension, two ideas can also be seen as normative theories of business ethics, since the executives and managers of a corporation should make decisions according to the "right" theory.

People often regard the stakeholder approach as corporate social responsibility (CSR) issue. The argument of CSR has encouraged companies to take the interests of all stakeholders into a consideration during their decision-making processes instead of making choices based solely upon the interests of shareholders. General public could be one example of such consideration under the CSR governance. When a company carries out operations that could increase pollution or take away a green space from its community, for example, the general public is affected. Such decisions may be right for increasing the shareholder profits, but the stakeholders will be negatively influenced. Therefore, CSR creates a condition for corporations to make choices that protect the social welfare, often using methods that reach far beyond some basic legal and regulatory requirements.

However, true meaning of the stakeholder theory was not intended for normative nor CSR argument. Edward Freeman asserts that the argument of traditional CSR has outlived its usefulness, because it is flawed in two respects.<sup>14</sup> First, it promotes the "separation thesis," the idea that business issues and social issues can be dealt separately. This endorses the destructive idea that the underlying structure of business is either not good or is morally

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<sup>13</sup> T.M. Jones and A.C. Wicks, "Convergent Stakeholder Theory," *Academy of Management Review* 24, no. 2 (April 1999): 206–221.

<sup>14</sup> Edward Freeman, BRIDGE PAPER™: Company Stakeholder Responsibility: A New Approach to CSR, 2006

neutral. By discussing the business and social responsibility as if they are two separate things, we unintentionally promote the idea that they involve discrete thought processes and activities. The challenge is to promote a different way of doing business that integrates considerations of business, ethics, and society. Herein lies the problem with CSR. The stakeholder approach acknowledges the intertwined nature of economic, political, social, and ethical issues. Centered in the practice of management, it provides the manager with a pragmatic framework for an action. The second flaw with CSR is its focus on a corporation. Social responsibility does not only apply to corporations—it applies to all organizational forms. The stakeholder approach applies as much to an entrepreneurial start-up and to a mid-sized closely-held firm as it does to a corporation with diffuse ownership it is taken. Freeman criticized the old CSR argument and, at the same time, initiated a distinct CSR—Company Stakeholder Responsibility—outlines a new capability for organizations to develop based on the stakeholder approach.<sup>15</sup>

It is time to replace the “corporate social responsibility” with an idea of the “company stakeholder responsibility,” assigning a different meaning to CSR. This is not semantics, but a new interpretation of the very purpose of CSR. “Company” signals that all forms of value creation and trade need to be involved. “Stakeholder” goes back to the first paragraph of this paper and suggests that the main goal of CSR is to create value for the key stakeholders. Finally, “Responsibility” implies that we cannot separate what we do in the workplace from ethics.<sup>16</sup>

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<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

In addition, there is a study to show the true intent and purpose of the stakeholder theory and to contrast it against one of CSR's. By tracing several arguments followed by Freeman's stakeholder theory, scholars concluded that the stakeholder theory has different meaning from CSR because the stakeholder theory has very different perspectives on four the following characteristics; level of theory, identification theories, texture, and source of normative claims. <sup>17</sup>

Table 1. Different Perspective between CSR and the Stakeholder Theory

	CSR	The Stakeholder Theory
Level of Analysis	Systemic impacts on society (Wood 1991a/b; 1994)	Outcomes within organization set (Freeman 1984/2010; Post, Preston & Sachs 2004)
Identification Theories	Broad (Carroll 1977/1989; Starik 1994)	Narrow (Freeman 1984; Clarkson 1995; Phillips 2003)
Texture	Universal (Waddock and Graves 1997; Orlitzky, Schmidt and Rynes 2003)	Particular (Freeman 1984; McVea and Freeman 2005)
Source of Normative Claims	Obligation to society (Wood and Logsdon 2001; Hsieh 2004/2009)	Obligation to members of cooperative scheme (Jones and wicks 1999; Werhane and Feeman 1999; Phillips 2003)

(Source: Elms, Michael Cramer, Shawn Berman, Stakeholder theory: Impact and Prospect)

It seems like Freeman, himself, believed that it is the way of doing business, not that the normative argument to seek for an ideal form of corporation. The stakeholder theory should be treated as a theory of organizational management and business strategy that addresses values in managing an organization. It will be later discussed more in detail.

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<sup>17</sup> Heather Elms, Michael Cramer, Shawn Berman, Stakeholder theory: Impact and Prospect



Section Id: Refocus on Importance of the Stakeholder Theory after the Financial Crisis

The seemingly invincible neo-liberalism flourished until very recent. Even with several economic ups and downs existed throughout history, such as oil crisis, Internet bubbles, the global economy kept growing significantly owing to developing new technologies, rising consumer power, and exploring new markets. Unstoppable double-digit growth in the BRICs markets, Goldilocks economy in the United States, and integration of EU with Euro currency seemed to prove the success of the global economy for that period.

However, global economy met a big windfall, the global financial crisis of 2007 to 2009. It ruined the businesses and banks, individuals and even nations, and seemed to land a mortal blow to the capitalist system. However, capitalism was not destroyed. Rather, it was irrevocably altered: the forces that precipitated the crisis are now contributing to the evolution of new, strong version of capitalist model. According to Kaletsky, we are observing the change of capitalism to correct the market failures and to create a better capitalism.

As mentioned earlier, he insisted that capitalism is an adaptive system that evolves in response to a changing environment. The emerging politico-economic system can therefore be described as the fourth major systemic transformation in the capitalism's history "Capitalism 4.0" followed by the inflationary crisis of the 1970s, the Great Depression of the 1930s, and the Napoleonic Wars of 1803–15.<sup>18</sup> The Schumpeter's mechanism of creative destruction will occur again. What, then, will replace the global capitalism that crumbled in

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<sup>18</sup> Anatole Kaletsky, "Capitalism 4.0: the birth of a new economy" (PublicAffairs, 2010)

the autumn of 2008? The answer is again a global capitalism, but of a new kind. The traumatic events have neither destroyed nor diminished the fundamental human urges that have always powered the capitalist system—ambition, initiative, individualism, competitive spirit, and so on. However, the environment surrounding the nature will change.

The

The clearest consequence of the crisis is therefore a transformed relationship between the public policies and markets. Recognizing the fallibility of both markets and political institutions may seem paralyzing, but it is, in fact, empowering.<sup>19</sup> Imperfect knowledge implies a balanced collaboration between politics and economics, rather than an adversarial relationship. It also creates a scope for leadership, creativity and experimentation in both government and business. If the world is too complex and unpredictable for either markets or governments to be perfect mechanisms for achieving social objectives, then the system of checks and balances, reflecting both private incentives and public interests, will have to be devised. Experimentation and pragmatism must therefore become the watchwords in public policy, economics and business strategies, even if this means loss of consistency and coherence. The ability to operate by trial and error, to correct any mistakes before they do too much social harm, is the greatest virtue of the market system. A similar pragmatism will have to be extended in years ahead of the political decisions and to of the interaction of government with the economy. Political and business leaders are acknowledging the shift from a world of rationalist predictability to one characterized by the ambiguity,

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<sup>19</sup> Anatole Kaletsky, "Capitalism 4.0; the birth of a new economy" (PublicAffairs, 2010) ch.13.

unpredictability and fuzzy logic, and economists will have to follow suit. The mainstream economic assumptions of rational expectations, neutrality of money and efficient markets left only one important role for the macroeconomic policy: to keep the inflation under control. But if the financial cycles, banking crises, and self-reinforcing economic slumps are recognized as natural features of the capitalist system, then governments and central banks must again accept the broad responsibilities they abandoned in the 1980s for managing growth and employment, as well as maintaining financial stability and keeping the inflation under control.<sup>20</sup>

These vast new responsibilities may suggest that government will grow ever larger, but the opposite is more likely. Size of the government will have to shrink, even as its responsibilities expand for the following two reasons. First, budget deficits and tax burdens have reached the limits of public acceptance. Second, the complex demands of the advanced society, ranging from the healthcare and higher education to the energy independence and stable mortgage financing, can only be satisfied by a profit enterprise acting through the competitive capitalist markets. The expanding role of the government will not replace markets, but change incentives, so that the profit-seeking businesses pursue politically-desired objectives, in the financial markets, healthcare, education or energy investment.<sup>21</sup> Under these interdependent relationships between the governments and markets, the importance of the stakeholder approach will be greater in the Capitalism 4.0, a

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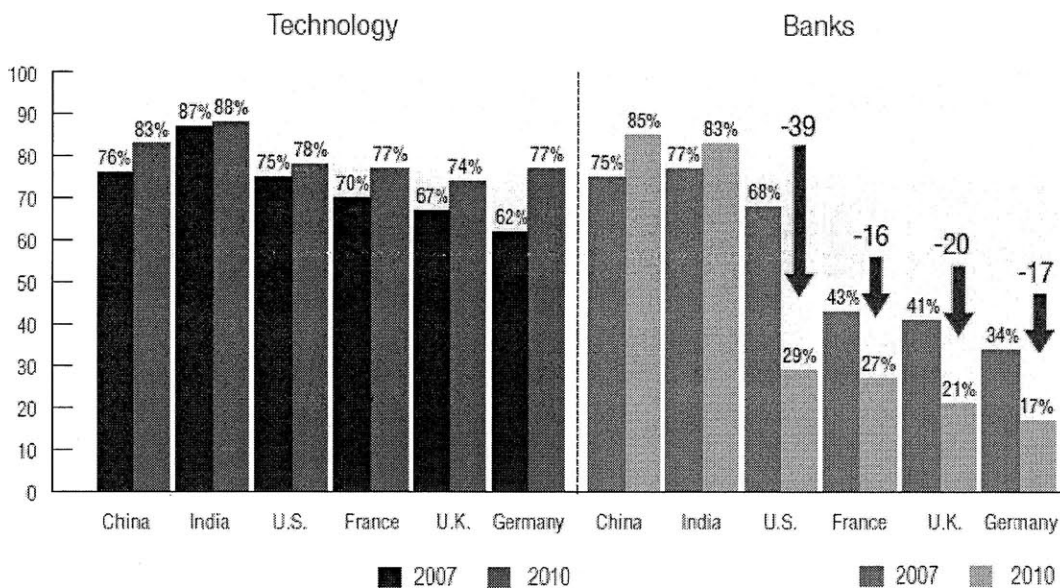
<sup>20</sup> Ibid. ch.13

<sup>21</sup> Ibid. ch.14

new and adaptive mixed economy. It is because the government's new incentive system and policy should give more favors to the corporations that could provide benefits to the whole stakeholders than to the government itself, whatever the stakeholders are; employments, environments, educations, co-prosperities, and more.

In addition, a lack of trust is another point to be considered in the perspective of the stakeholder approach. Since the financial crisis, people lost their trust on businesses and corporations. According to Edelman's 2012 Trust Barometer, business, mainly in banking industry, has been losing trust from people.<sup>22</sup>

Figure 3. Change of trust since 2007



Responses 6-9 only on 1-9 scale; 9=highest  
Informed publics ages 35 to 64

(Source: Adelman 2012 Trust Barometer)

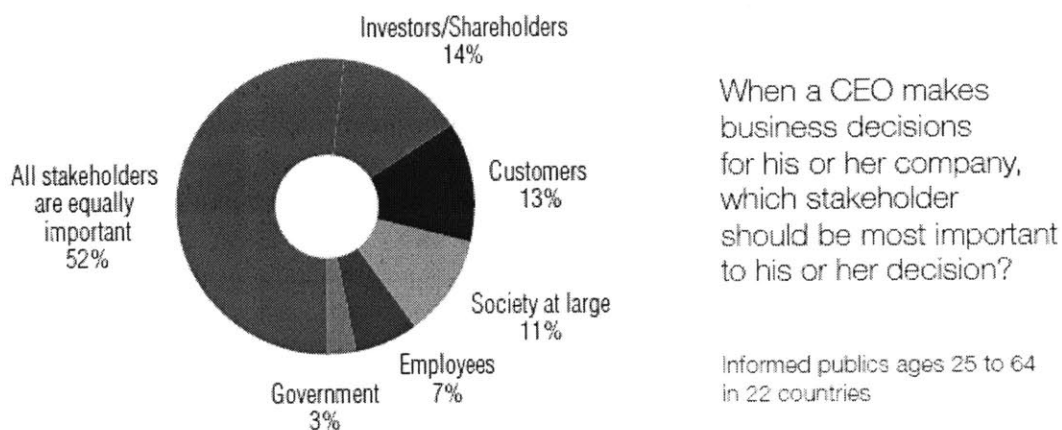
On the top of the distrust, the perception of people on corporations becomes different.

Since the financial crisis, all kinds of people; politician, academics, business people, investors

<sup>22</sup> Adelman Worldwide, Adelman Trust Barometer 2012 Adelman has been researching and reporting on trust in institutions worldwide for 12 years.

and ordinary consumers, began to change how to understand the market and further the capitalism. No longer did they believe in the supremacy or necessity of the free market and shareholder advocacy. The trust in corporations and governments plummeted endlessly and people regarded the value of stakeholder more importantly. According to the Adelman 2012 Trust Barometer findings, only 14% of the survey responders replied that the investor/shareholder is the most important when a CEO makes business decision while 52% of them did that all stakeholders are equally important.<sup>23</sup>

Figure 4. "Which Stakeholder should be Considered?"



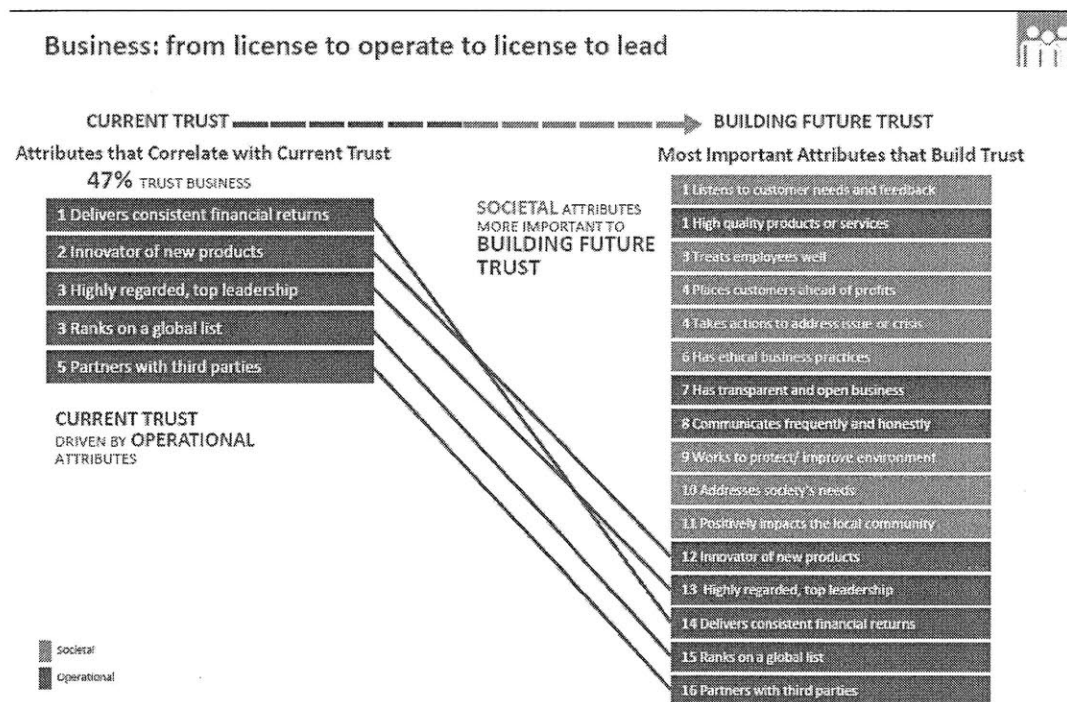
(Source: Adelman 2012 Trust Barometer)

These findings indicate that the business has the license to operate. Adelman interpreted it that the business successfully engaged with stakeholders and established strong company leaders. However, to lead, businesses must become not only good operational performers but also societal trailblazers. The Edelman’s research on a trust-building process details 16 key drivers, - the mixture of operational and societal

<sup>23</sup> Ibid.

attributes, businesses must adopt in order to earn a license to lead its industry. Existing trust was based only on how the operational attributes perform in defined jobs. However, the trust in the future will be obtained from how some societal attributes react and resolve the stakeholders' needs and problems beyond the operational attributes. Moreover, the importance of the societal attributes will increase. <sup>24</sup>

Figure 5.16 Key Drivers to Build Trust



(Source: Adelman 2012 Trust Barometer)

If we believe that the society entered new era in which the sustainable growth is most critical, management's mission and decision would also begin to shift toward the stakeholder theory. Upon the change, the stakeholder approach should be refocused more than ever.

<sup>24</sup> Ibid.

## Section Ie: Stakeholder theory as Management Strategy

As mentioned earlier, the start of the stakeholder theory was pretty concentrated on normative issues such as “how to find the right model of corporation and even more broadly one of market system” or dichotomous views which theory should be the effective “shareholder theory” or the preferred “stakeholder theory”. However, several business leaders advocate that the stakeholder approach is to benefit the business itself, rather than hurting the shareholders’ interests. One of the proponents for the stakeholder approach as a business strategy is John Mackey, the founder and CEO of Whole Foods. He is a representative businessman who disagrees with the Milton Friedman’s famous argument. As a successful businessman, he asserts; <sup>25</sup>

*I'm a businessman and a free market libertarian, but I believe that the enlightened corporation should try to create value for all of its constituencies. From an investor's perspective, the purpose of the business is to maximize profits. But that's not the purpose for other stakeholders--for customers, employees, suppliers, and the community. Each of those groups will define the purpose of the business in terms of its own needs and desires, and each perspective is valid and legitimate.*

*My argument should not be mistaken for hostility to profit. I believe I know something about creating shareholder value. We have not achieved our tremendous increase in shareholder value by making shareholder value the primary purpose of our business.*

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<sup>25</sup> John Mackey, *Rethinking the social responsibility of business*, Reason Oct. 2005 Issue

He understands the virtuous cycle of value chain well by managing his own business successfully. He believes that the most successful businesses put their customers first, even ahead of investors. In a profit-centered business, customer happiness is merely a means to an end, maximizing profits. In a customer-centered business, customer happiness is the final goal and it will be pursued with a greater interest, passion, and empathy than the profit-centered business is capable of. Mackey's company measures its success by how much value they can create for all six of the most important stakeholders: customers, team members (employees), investors, vendors, communities, and environment. In his view, Friedman's argument that a company's assets do belong to the investors, and its management does have a duty to manage those assets responsibly seems reasonable but it is too narrow due to the following reasons.

First, there can be little doubt that a certain amount of corporate philanthropy is simply good business and works for the long-term benefits of the investors. For example, the 5% donation policy usually brings hundreds of new or lapsed customers into stores, many of whom then become regular shoppers. Hence the policy not only allows the company to support worthy causes, but also is an excellent marketing strategy that has benefited Whole Foods investors immensely.<sup>26</sup> Secondly, such programs would be completely justifiable even if it produced no profits and no P.R. This is because the entrepreneurs, no longer own company's stocks, have the rights and responsibilities to define the purpose of the company.

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<sup>26</sup> Ibid.



It is entrepreneurs who create a company, who bring all the factors of production together and coordinate them into a viable business. It is the entrepreneurs who set the company strategy and who negotiate the terms of trade with all of the voluntarily cooperating stakeholders--including the investors. At Whole Foods, they "hired" the original investors. They did not hire the management.<sup>27</sup> Furthermore, according to one of the fathers of free-market economics, Adam Smith explains human nature is not just about self-interest in his book "The Theory of Moral Sentiments." It also includes the sympathy, empathy, friendship, love, and desire for the social approval.<sup>28</sup> As the motives for human behaviors, these are at least as important as self-interest.<sup>29</sup>

The business model that Whole Foods embraced could represent a new form of capitalism, one that contributes the common goods more instead of depending solely on the "invisible hand" to generate the positive results for society. Following many successes of companies adopting the stakeholder approach, strategic interests in the stakeholder theory has increased. Now, we shall observe many companies, which are seeking for the "profits with a principle (or purpose)", not just the "profits" itself such as Southwest Airline, Body Shop, Trader Joe's, Costco, and so on. It could be interpreted as sustainable value. In academia, many scholars believe that the stakeholder approach could function well as management strategy, enabling business get sustainable value. For a narrower perspective,

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<sup>27</sup> Ibid.

<sup>28</sup> Adam Smith, *The theory of moral sentiments*

<sup>29</sup> John Mackey, *Rethinking the social responsibility of business*, Reason Oct. 2005 Issue

it is related to the operation tools, which manage stakeholders to create a comparative advantage. For a broader view, creating a sustainable value is a way for companies to advance their business priorities, drive innovation, and achieve competitive advantage. In today's competitive context, leading companies need to carefully consider the social and environmental dimensions of the business activities.

The need for the sustainable value approach reflects the emergence of a new, stakeholder-rich competitive environment. The growth of the stakeholder's power has been driven by the quantum increases in information combined with the rising societal expectations about social issues, leading to a tighter interface between the business and civil society.<sup>30</sup> Therefore, the stakeholder approach as a management strategy could create a sustainable value. Rising societal expectations would change the reputation of a company as a creating stakeholder value in the past, to one as destroying it in the future even though there is no change in itself.

The stakeholder approach is given a sudden attention after E. Freeman's great book in 1984, which insists that companies should pursue to leverage it to create a competitive advantage and sustainable value in the long-term. The Porter's five-force theory, well-known as a competitive theory could be interpreted as a reflection of the stakeholder approach. Since 1980, Michael Porter has explicated a way to think about the business that takes the

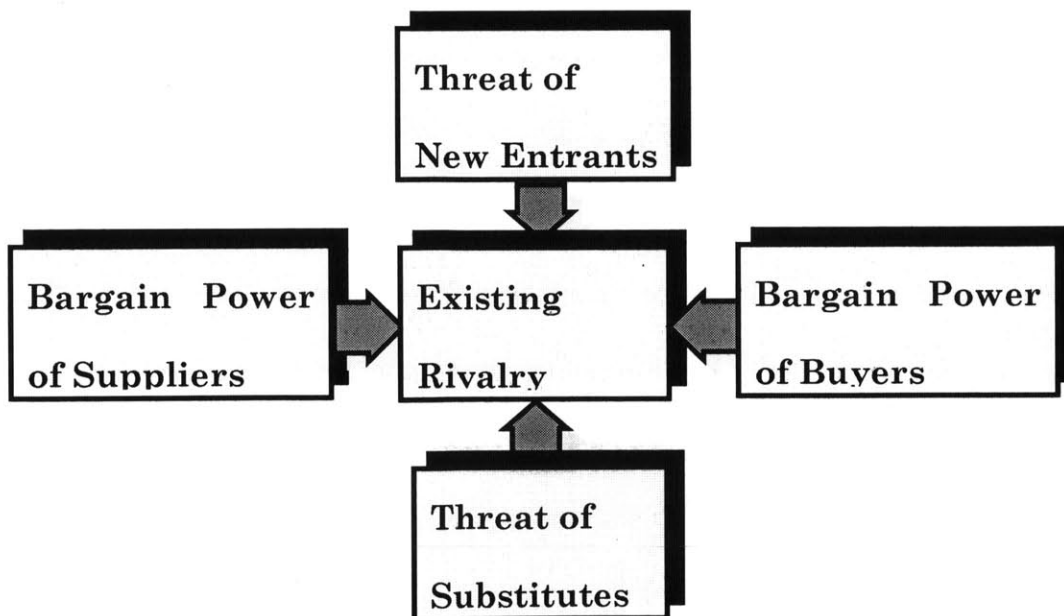
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<sup>30</sup> s. waddock "responsibility: the new business imperative" academy of management executives 16.2(2002), pp. 132-148.

metaphor of “competitive strategy.” He developed the theory of “Five Forces” that determines the nature and level of competition in an industry, as well as suggestions for how to use this information to develop a competitive advantage. While he puts more emphasis on “industry” and “competitive strategy” than on the stakeholder approach, there is much compatibility between the two approaches. For example, Porter recognizes this fact in making the “bargaining power of customers and suppliers” a critical force.<sup>31</sup>

From the perspective of the broader view of “value chain”, the theory could be interpreted to contain further considerations of the stakeholders. Bargaining power of employees, ability of a community to approve regulations or legislation that affects value chain, and emergence of other value chain actors such as NGOs that call for responsibility and sustainability, are all sources of advantage.<sup>32</sup>

Figure 6. Five forces of competitive advantage in an industry.



<sup>31</sup> R. Freeman, J. Harrison, A. Wicks, B. Parmar, S. Colle, “Stakeholder theory: the state of the art” Cambridge, 2010  
<sup>32</sup> Ibid. pp. 15

Since the establishment of the stakeholder theory, the study on the theory as a management strategy has flourished. According to Chris Laszlo, the business's sustainability is only possible way when it aligns the stakeholders' interest as much as possible.<sup>33</sup> In the past, it was sufficient for managers around the world to use their individual judgment to decide on which societal and sustainability issues to tackle. Based on the local needs and to a large extent, the decisions were personal choices. In recent years, however, the globalization of businesses, the massive changes the world is undergoing, the escalation of consumer concern about sustainability issues, and the changing regulatory and political environment, have all prompted managers to introduce a more formal process to integrate these issues as an important fact for a business.

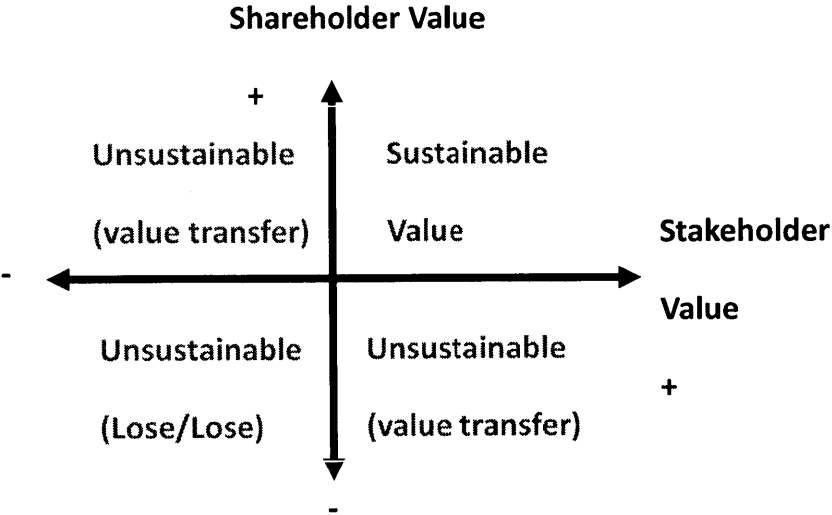
However, sustainable value is not about creating the stakeholder value at the expense of shareholder value. Instead, it is about doing better by doing good and it is about finding opportunities for innovation and business development. The idea is well explained by the Rosabeth M. Kantor's statement. Companies that break the mold, are moving beyond the corporate social responsibilities to social innovation and viewing some community needs as opportunities to develop ideas and demonstrate technologies, in order to find and serve new markets, and to solve many long-standing business problems.<sup>34</sup>

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<sup>33</sup> Chris Laszlo, *From the sustainable company, 2005*

<sup>34</sup> *Ibid.* ch. 9

Figure 7. Sustainability by Satisfying Both Value of Shareholder and Stakeholder



(Source: Chris Laszlo, "From the sustainable company" 2005)

More specifically, Rajendra S. Sisodia, David Wolfe and Jagdish Sheth (Firms of Endearment; How world-class companies profit from passion and purpose, Wharton school publishing, 2007) mention stakeholders directly. In the book "Firm of Endearment", a company needs to have internal and external supports from all stakeholders. The authors bring a concept of "SPICE", which refers the five major stakeholders of modern corporations. They used the acronym of SPICE as a memory tool. <sup>35</sup>

<sup>35</sup> Rajendra S. Sisodia, David Wolfe and Jagdish Sheth, Firms of Endearment; How world-class companies profit from passion and purpose, Wharton school publishing, 2007

Table 2. SPICE Model explanation

	Stakeholder	Explanation
S	Society	Local and broader communities as well as governments and other societal institutions like non-government organizations (NGOs)
P	Partners	Upstream partners such as suppliers, horizontal partners, and downstream partners such as retailers
I	Investors	Individual and institutional shareholders, lenders
C	Customers	Individual and organizational customers; past, current and future
E	Employees	Current, future, and past employees and their families

(Source: Firm of Endearment, Ch. 1)

As the figure 8 shows, each stakeholder is important in its own way, and each is also linked to all of the other components. As with any good recipe, the individual ingredients come together to form something completely new; as the expression goes, the whole is greater than the sum of the parts.

FIGURE 8. Firm of Endearment(FOE) Stakeholder Model



(Source: Firm of Endearment, Ch. 1)

More recently, Michael A. Cusumano, one of the most influential scholars in management strategy, made a great argument of the stakeholder approach as a management strategy. He emphasized the “Ecosystem” approach to maintain a competitive advantage in his recent book, “Staying power”. He researched the best way to survive and thrive in an uncertain, competitive world by analyzing and understanding how global companies succeed to perform well over several years and decades. He reached a conclusion that those companies have some management strategies in common, so he summarized the common strategies as six enduring principles of “Staying power”; 1) Platforms, Not just Products, 2) Services, Not just Products, 3) Capabilities, Not just Strategy, 4) Pull, Not just Push, 5) Scope, Not just Scale, and 6) Flexibility, Not just Efficiency.<sup>36</sup>

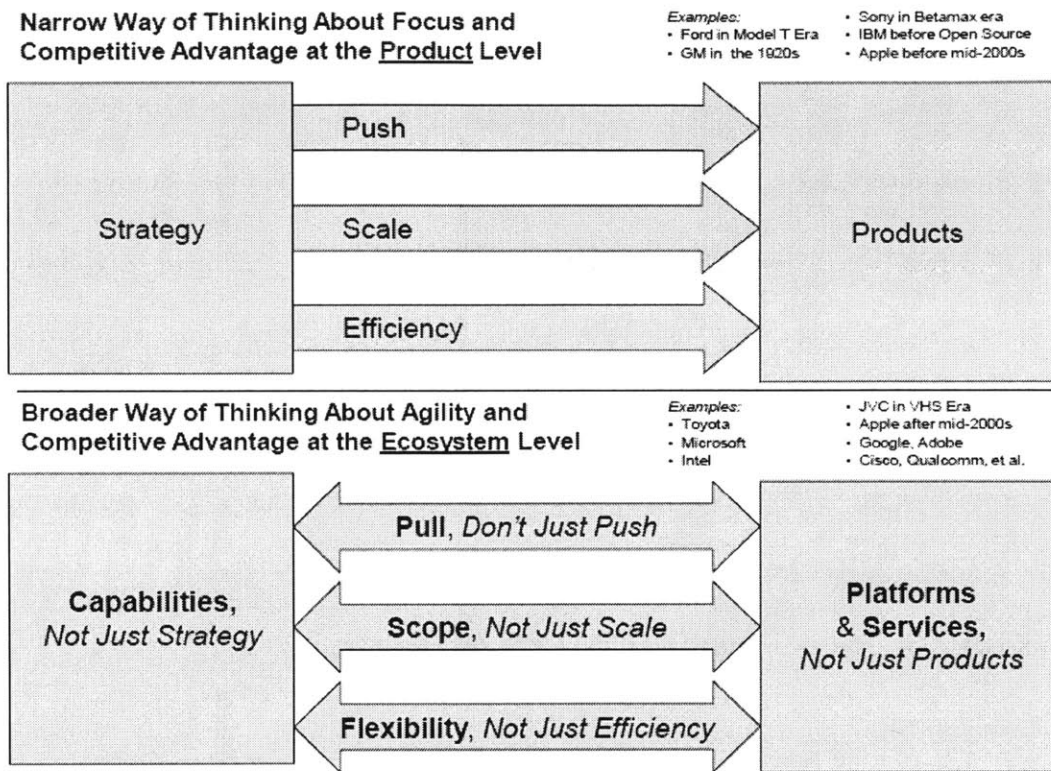
The core concept of his findings is the “agility”<sup>37</sup> and the competitive advantage comes from “Ecosystem”, which contain the six enduring principles. He found that globally successful companies should have the agility to respond and utilize ecosystem, filled of interactions between the platform and complements. His findings reinforce the importance of the stakeholder approach because agility could be created only through implementing the stakeholder approach. Without caring for stakeholders around companies, they cannot create and maintain any significant and beneficial “Ecosystem”.

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<sup>36</sup> Michael A. Cusmano, *Staying Power; six enduring principles for managing strategy and innovation in an uncertain world*, oxford university press, 2010, pp. 10~16

<sup>37</sup> Michael A. Cusmano meant that “agility” is a term similar to flexibility but with strong connotations of quickness. Ibid

Figure 9. New Perspective for Staying Power?



Source: Michael A. Cusumano, "Staying Power" pp. 12 figure 1.

Borrowing his useful concept of the 'six enduring principles' the reason why the stakeholder approach is beyond beneficial but indispensable for the long-term business strategy can be explained. First of all, the stakeholder approach could create more beneficial platform or complementary environments. Cusumano explains that a platform or complement strategy differs from a product strategy for the following reason. The complement strategy requires an external ecosystem to generate complementary product or service innovations and build a "positive feedback" between the complements and the platform.<sup>38</sup> A good relationship with the stakeholder, especially with the customer and

<sup>38</sup> Ibid, ch 1.



supplier, helps to form a better process of feedback. As Cusumano said that the reality is not only products but also common services from banking overnight have already become commodities; “productized” services. In these businesses, the major source of differentiation for firms may have already shifted to customization and the quality of innovativeness of their service.<sup>39</sup> Good relationships, internally with the employees and externally with the customers, could foster a better customization ability and in turn, a power of differentiation.

Cusumano’s third principle is about the “capabilities”, distinctive capabilities center on people, processes, and accumulated knowledge that reflects deep understanding of business and technology, and how they are changing.<sup>40</sup> Without a good labor relation, main sources of capabilities could not be accumulated. Especially in the service industry, the experiences of frontline employee are hardly accumulated by the firm nor transferred to other employees because it tends to transcend from the frontline employee to new-employee through on-site training processes.

What about the principle of the “Pull”, the fourth principle? The strategy can be possible only with an active and frank relationship with the external stakeholders. Cusumano explains that the goal of “pulling” should be to link each step in a company’s key operations backward from the market to management in order to respond in real time to changes in demand, customer preferences, competitive conditions, or internal difficulties. The continuous feedback and opportunities for adjustment also facilitate a rapid learning,

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<sup>39</sup> Ibid, ch 2.

<sup>40</sup> Ibid, ch 3.

elimination of waste or errors, and at least incremental innovation.<sup>41</sup> In reality, companies have difficulties incorporating feedbacks and learnings from the customers, competitors, suppliers, partners, and internal operations. All of them are main stakeholders. The reason maybe varies depending on the situations. However, the most common issue is the loss of trust. Once managers start focusing on the business efficiency and cost-reduction, the stakeholders' trust on management diminish.

The fifth principle is the "scope". Several functions in companies does not follow rule or get any benefits from the economies of scale, such as, research, product development, service design and delivery of such. The deeper economies of scope require systemic ways to share the product inputs, intermediate components, and other knowledge across the separate teams and projects.<sup>42</sup> However, a recent management trend emphasizes on the internal competition and independent Role & Responsibility(R&R), and set the "Zero Sum" game to compete against each other to maximize outputs. This trend prevents each team from cooperating with others. Only with a trust from the proper internal relationship between the employees, deeper economies of scope can be realized.

The last principle is the "flexibility, not just efficiency". Managers often neglect the potential benefits of investing in the flexibility more broadly throughout the organization and in decision-making process. Under the pressure from investors, who seek for a short-term capital gain, management tends to overemphasize the efficiency to minimize the cost and to maximize the profit by allocating the resources to the right place and at the right

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<sup>41</sup> Ibid, ch 4.

<sup>42</sup> Ibid, ch 5.

time. It is not a bad phenomenon; in fact, it rather is desirable in management processes.<sup>43</sup> However, it might not cope with changes and interruptions well. As technology advances and customer preferences quickly change, business planning could not reflect needs of the market in the right timing. If we consider the time-consuming procedure from the idea concept to market research, development, commercialization and marketing, the reality and planning can be aligned in the mean time.

To resolve conflicts in-between, the flexibility matters. However, it might be very costly because it requires management set aside the business resources, such as time, people, capacity and so on. In the narrow perspective, it could be viewed as a trade-off relationship between the flexibility and costs. Unlike the prejudices, flexibility is possible without much cost by using voluntary contributions from the stakeholders. Employees are the front-liner with a market and always face needs of the market. Customers are the market itself. In addition, the government or regulator should be the rule setter. By capturing the voluntary contribution from stakeholders, it could reduce the response time and create a natural flexibility. Therefore, the stakeholder approach could allow companies to build the six enduring principles, foster them to function better inside them, and, in turn, help the companies to keep a competitive advantage in an uncertain world.

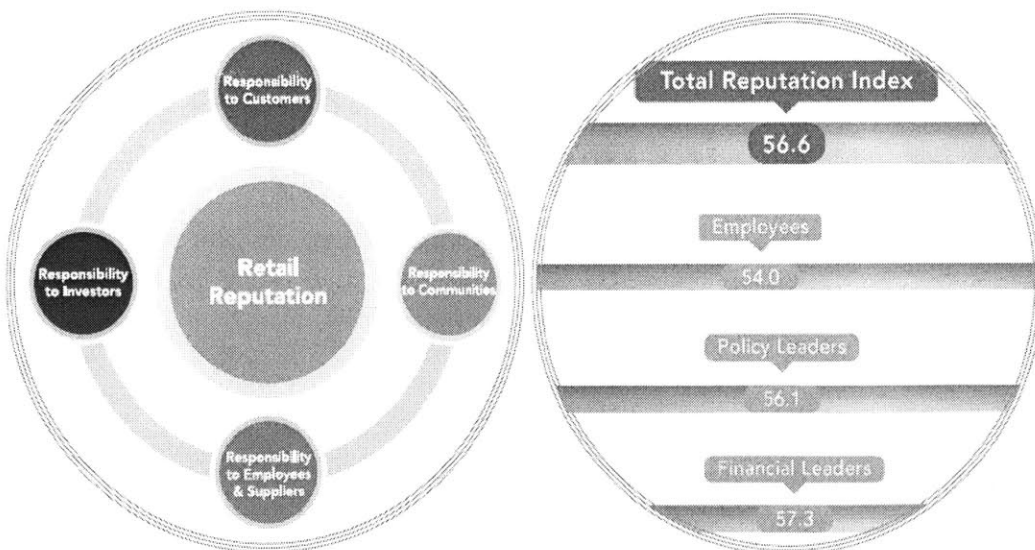
These analyzing tools might be a little abstract and mainly a qualitative focus. For the management strategy, there are several efforts to measure the effectiveness of the

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<sup>43</sup> Ibid, ch 6.

stakeholder approach quantitatively. One of the examples is the APCO's Return on Reputation(ROR) in the retail industry. The APCO's ROR indicator study of the retail sector was conducted among nearly 10,000 respondents, offering a 360-degree view of the reputation across all stakeholders, including the consumers, community activists, policy-makers, retail employees, and investors and analysts. The indicator reveals that the reputation can increase the consumer spending and loyalty, drive community support, improve the support of policy-makers on proposals favorable to the industry, help the industry earn benefits of doubts in event of litigation, and engage employees in ways that help avoiding high replacement costs and has a tangible effect on a company's market capitalization. <sup>44</sup>

Figure 10. APCO's Reputation Index Example



(Source: APCO, return on reputation, state of the retail industry, 2010)

<sup>44</sup> APCO worldwide, Return on Reputation indicator, *State of the Retail Industry, 2010*

Specifically, according to the APCO's, for every one point increase in the reputation index, the average consumer will spend \$133.05 more per year and the average retail company's market capitalization increases by 0.4%.<sup>45</sup> There are more general evidences to show that we could argue that the stakeholder approach sometimes better serves the traditional shareholder objectives from the view of the shareholder approach, that is, the investment return for the shareholders. According to Rajendra S. Sisodia, David Wolfe and Jagdish Sheth (Firms of Endearments, FoEs; How world-class companies profit from passion and purpose), return of public trading companies which they chose as firms of endearment outperformed one of the index, S&P 500 by a significant margin. As discussed earlier, FoEs could be defined as companies which adopt the stakeholder approach very well. Although it is a little outdated, FoEs returned 1,026 percent over the 10 years ending June 30, 2006, compared to 122 percent for the index. The research showed that the return varied depending on the time horizon (128 percent to 13 percent over five year and 73 percent to 38 percent over three year).<sup>46</sup>

In addition, it compared the return of FoEs with the one of 11 companies which Jim Collins chose as "Good to Great". The 11 companies were described as going from "good" to "great" by virtue of their having delivered superior returns to the investors over an extended period of time. Actually, they had delivered cumulative returns respectively at least three times greater than the market did over a 15-year period according to the Jim Collins'

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<sup>45</sup> Ibid

<sup>46</sup> R. Sisodia, D. Wolfe, J. Sheth, *Firms of Endearment*, Wharton School Publishing, 2007. Ch. 6

research.<sup>47</sup> Surprisingly, comparing to them, FoEs still outperformed them by 1,026 percent to 331 percent over 10 year horizon, by 128 percent to 77 percent over 5 years.<sup>48</sup> The result was possible because the FoEs' stakeholder approach helped them to withstand the market fluctuation better than others did. By the same token, the alpha return could prove that the stakeholder approach is not a normative theory, but a very powerful management strategy.

Since 1999, long-term investors created indexes tracking the financial performance of the leading sustainability-driven companies worldwide such as Dow Jones Sustainable indexes (DJSI) and following FTSE4GOOD index series, which launched in 2002.

Along with it, the number of socially conscious investors has been increasing. Dow Jones Sustainability Index Asset increased nine fold from under US\$1bil in 1999 to almost

US\$9bil in 2010. FTSE4Good did five fold in 8 years from US\$2.4tril in 2002 to US\$10.1tril in 2010. Up to now, the performance has been just matching with the return of market index.

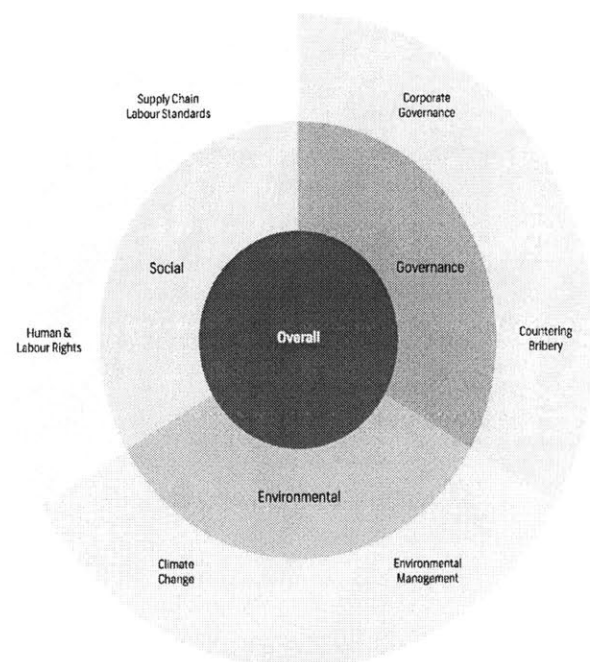
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<sup>47</sup> Jim Collins, *Good to Great*, New York: HarperCollins, 2001.

<sup>48</sup> R. Sisodia, D. Wolfe, J. Sheth, *Firms of Endearment*, Wharton School Publishing, 2007. Ch. 6

<sup>49</sup> Dow Jones Sustainability Index 2011 report, FTSE4GOOD 10 year report

Figure 11. FTSE4GOOD Value Proposition



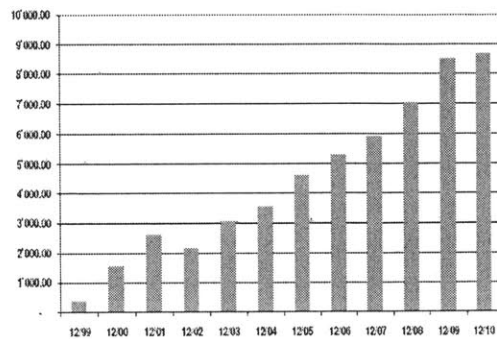
(Source: FTSE4Good 10 year report)

Figure 12. Increase of asset size in DJSI

Figure 13. Historical performance

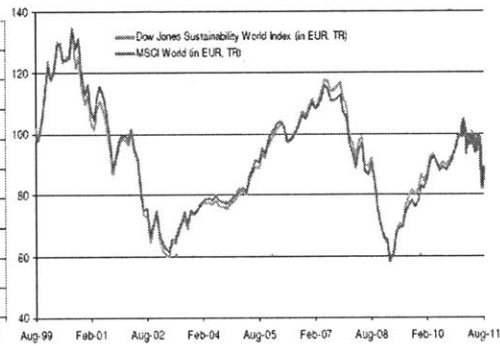
DJSI Assets

Assets based on DJSI (in million USD)



DJSI World – Performance

Since Launch, 08/99 – 08/11 (EUR, Total Return)

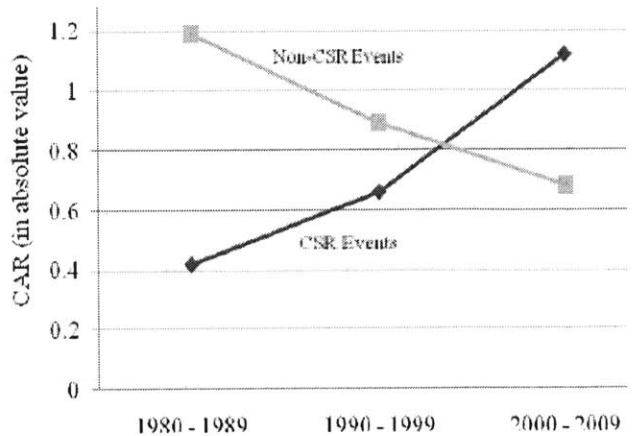


(Source: Dow Jones Sustainability Indexes 2011 report)

On top of that, as people are more conscious of the social value, the impact from the irresponsible and ignorant behaviors are directly related to the negative market return and the extent has been increasing. As an evidence, Caroline Flammer analyzed whether the shareholders reward or penalize corporations for the behaviors by calculating the stock market reaction to environmentally responsible(CSR) and irresponsible(Non-CSR) events.

She found that investors concerned about environment and are more demanding towards the CSR. Specifically, the negative impact of eco-harmful events on stock prices increased: the abnormal return is -0.42% in the 1980s, -0.66% in the 1990s, and as high as -1.12% in the most recent decade, 2000s.<sup>50</sup>

Figure 14. Cumulative abnormal return(CAR) reacted by CSR events



(Source: C. Flammer, CSR and Shareholder, figure 2)

<sup>50</sup> Caroline Flammer, Corporate social responsibility and shareholder value : the environmental consciousness of investors, 2011 p.3. I believe her argument is related to Stakeholder approach to communities, not only CSR.

This result showed that the eco-friendly behavior has earned significant abnormal returns in all three decades. Interestingly, the magnitude of abnormal returns has declined. This phenomenon can be interpreted that people takes the stakeholder approach for granted broadly as time goes by and the market price before CSR events already reflects the value of it. Therefore, if we consider the negative volatility, the trend was more supportive for the market value of companies which take care of the stakeholders and believed to be the value of sustainability in the near future. In overall, the stakeholder approach as a well-defined management strategy should create a value of sustainability by aligning the self-interest to the social responsibility or integrating the profits with the values into the interests of stakeholders. Orin Smith, CEO of Starbucks delivered the same message “aligning self-interest to social responsibility is the most powerful way to sustaining a company’s success”

## PART II: Characteristics and Management Issues in Service industry

### Section II a: Characteristics in Service Industry

How different is management of operations in the service industry in contrast with one in the manufacturing industry. Basic management principles are the same for both services and manufacturing systems. However, there are some characteristics of service that require a different emphasis on some of the principles. According to Gabriel Bitran, there are several distinct characteristics as follows; intangibility, perishability, heterogeneity, simultaneity,



transferability, and cultural Specificity.<sup>51</sup>

First of all, in contrast to the manufacturers, service firms usually sell bundles of goods and services, composed of both physical items and intangibles that are both explicit(having sensual benefits) and implicit(having psychological benefits). Intangible nature of service products makes it difficult to promote consumption exclusively on the technical grounds. <sup>52</sup> From that characteristic, the consumers' expectations and perceptions matter specifically in the service industry. The fact that most tangible goods have an extended life means that goods can be stocked and distributed through a network of outlets. For example, manufactured durable goods can be produced long in advance of its consumption and stocked at the strategic distribution centers. Manufacturing managers can use the inventories for a wide variety of purposes, including the seasonal inventories, cycle stocks, inventories to separate two machine centers, and safety stocks to absorb fluctuations in demand and forecast errors. However, intangible nature of services means that they are perishable and cannot be inventoried in traditional sense. As a consequence, managers in the service organizations are often faced with situations in which their facilities and other assets are idle for a long period of time, which is very costly. Hotels in resorts may stand a half vacant during low tourist seasons and subway systems tend to be idle during the night. Telecommunication systems have very low utilization in the early morning hours. <sup>53</sup>

Although the technology provides many opportunities for services to be delivered by

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<sup>51</sup> Gabriel Bitran and Muareen Lojo, *European Management Journal* Vol. 11, NO. 4, 1993

<sup>52</sup> *Ibid.* pp. 272

<sup>53</sup> *Ibid.* pp. 273

machines, it is still fairly common to encounter services delivered by human beings. Humans, however, tend to be inconsistent in their behavior, delivery and consumption of services.<sup>54</sup> This fact creates a major challenge for the manager of quality in the service firms. In general, extensive trainings and organizational supports are required to ensure that workers behave consistently and be well prepared to deal with the customers' diversity.

Along with those characteristics, many services are produced and consumed at the same time. Like heterogeneity, this characteristic presents a challenge for the quality managers since services cannot be inspected before the customers consume. Once a server commits a blunder with a customer, it may be very difficult to correct. Since it is impossible for managers to be present with every worker all of the time, the firm will be lucky, if the blunder is even recorded for a corrective action and for learning a lesson on how to improve the future encounters.<sup>55</sup> Another characteristic in the service industry is the transferability. Diverse services tend to have more in common with each other than diverse goods do because there are so many similar elements among the distinct types of services. For instance, the customer interactions with the dry cleaner services and fast food restaurants share common features of standing in line at counters, making payments, possibly giving special instructions to the server, waiting for the goods, and then picking them up. The level of personal contact between customers and employees and the length of time spent are about the same.<sup>56</sup>

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<sup>54</sup> Ibid. pp. 274

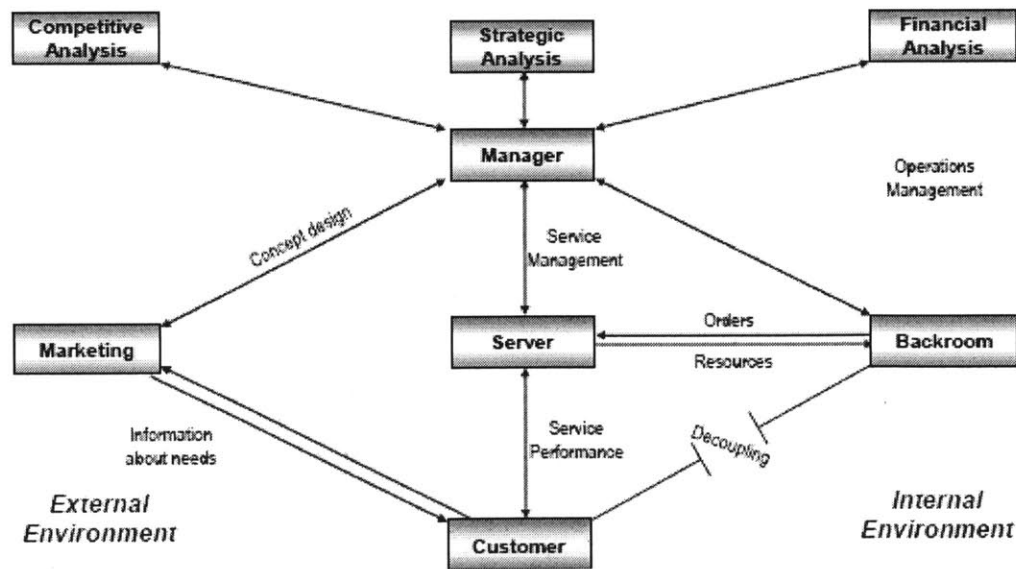
<sup>55</sup> Ibid. pp. 275

<sup>56</sup> Ibid. pp. 275

Lastly, cultural context of consuming service can be viewed as an attribute of the service itself. Culture influences the expectations and behavior of the customers and the service providers. For example, a 'good service' in restaurants in the northeast region of the US means keeping a formal distance between the servers and the customers. However, in the south, servers tend to be more informal and friendly. This can be a bit disconcerting to the non-natives, who may feel that such behavior is intrusive. Although the familiarity and shared culture is reassuring and comforting for the customers, the differences can also be interesting and satisfying.<sup>57</sup>

Along with the characteristics, the service industry is clearly different from the manufacturing industry in terms of the customer interface.

Figure 15. Framework for Analyzing Service Operation



(Source: G.Bitran, M. Lojo, A framework for analyzing the quality of the customer interface)

<sup>57</sup> Ibid. pp. 276

According to Gabriel Bitran and Maureen Lojo, the customer interface means the environments in which the service is delivered. It involves a contact with customers, encompassing interactions that are person to person, via mail, telephone, fax, computer, or some combination of all. This interaction will shape the customer's perception of the service received to the great extent; therefore, it can be viewed as the firm's 'moment of truth'. It is at this point that a firm can jeopardize millions of dollars of investment in creating its offerings, because if its representatives are not well trained with good understanding of products and services they can destroy the firm's image and lose customers. <sup>58</sup>

In the service industry, the fact that a quality of services relies on the customer's perception is critical. It depends not only on the offering products that meet the customers' needs and delivering them efficiently, but also on creating an atmosphere and satisfying overall experience. The quality of services is much more difficult to measure, inspect, and control than the quality of manufactured goods. Among the six common characteristics in the service industry, mentioned above, the three characteristics of services account for this difficult: intangibility, heterogeneity and simultaneity as ones mentioned earlier. The intangible nature of service products makes it difficult for the firms to simply measure characteristics and ascertain whether the products meet the specifications. This is because psychological benefits provided by the services are often not easily observable, much less measurable. The service products are heterogeneous because customers and servers are the critical components of the product, and they are diverse individuals that can not be

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<sup>58</sup> Gabriel Bitran and Maureen Lojo, A framework for analyzing the quality of the customer interface, European Management Journal Vol. 11, NO. 4, 1993

completely standardized and controlled. Simultaneity refers to the fact that services are produced and consumed at the same time, thereby preventing firms from inspecting their product before it is sold to their customers.

In addition, the service industry has a distinct feature in terms of the processes to be involved with a customer interaction. While a traditional manufacturing industry has one or a few phases; point of product sales and after services,<sup>59</sup> the service industry in nature has a multiple service encounters. The service industry can be structured to have multi-phases with a customer; for example a series of access, check-in, diagnosis, service delivery, check-out, and follow-up. Every phase involves personal interactions between the service provider and the customer. Therefore, the role of employee is critical because the attitude and the ability of employee decide the service quality.<sup>60</sup>

## Section II b: Issues in Managing Service Industry.

The biggest issue in the service industry is how to manage its frontline employees. They are the face of company and critical factors, which decide the quality of service provided because they always encounter the customers. The attitudes and behaviors of employees and customers are clearly major factors in their interactions. If either party is friendly, rude,

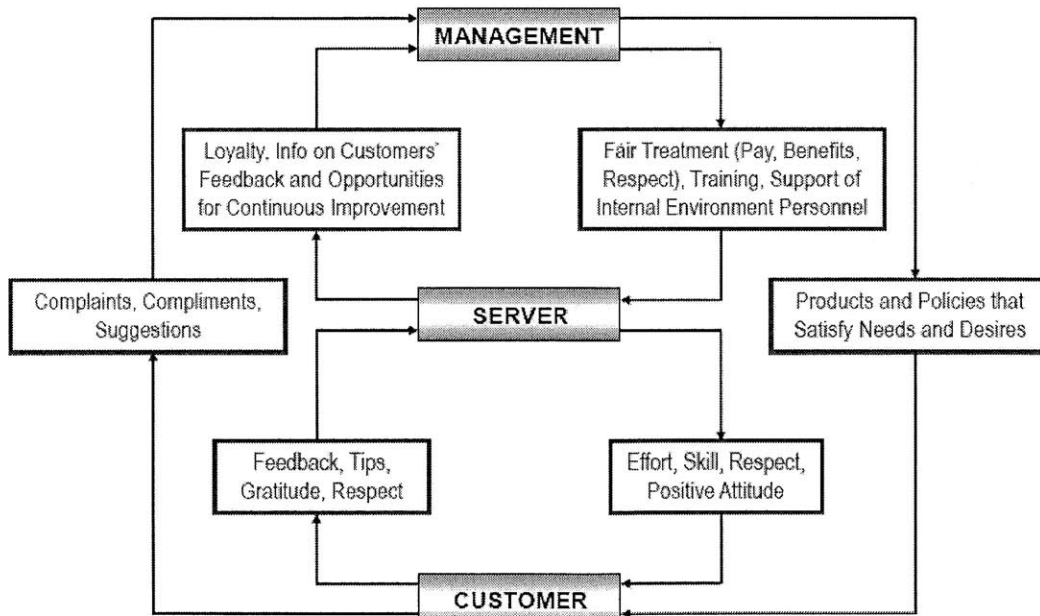
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<sup>59</sup> Ibid. pp. 385, Recently, the trend is quite changing in that consumer and IT industry tend to increase exposure to consumers through integrating its product with service such as sample distribution, class how to use, and show-room to increase consumer experience of its products

<sup>60</sup> Ibid. pp. 387

irritable or else, it will most likely be noticed by the other party and may invite a similar response. Influence of management in these encounters is less direct, but nonetheless powerful. Managers' treatment of both servers and customers will be observed and often imitated. For this reason, it is imperative that managers set an example of respectful, courteous behavior not only to the customers, but also to their employees. The figure 16 illustrates a dynamic relationships and interactions between customer, server, and management. Therefore, companies need to invest in the frontline employees to drive the profits through changes and improved culture.

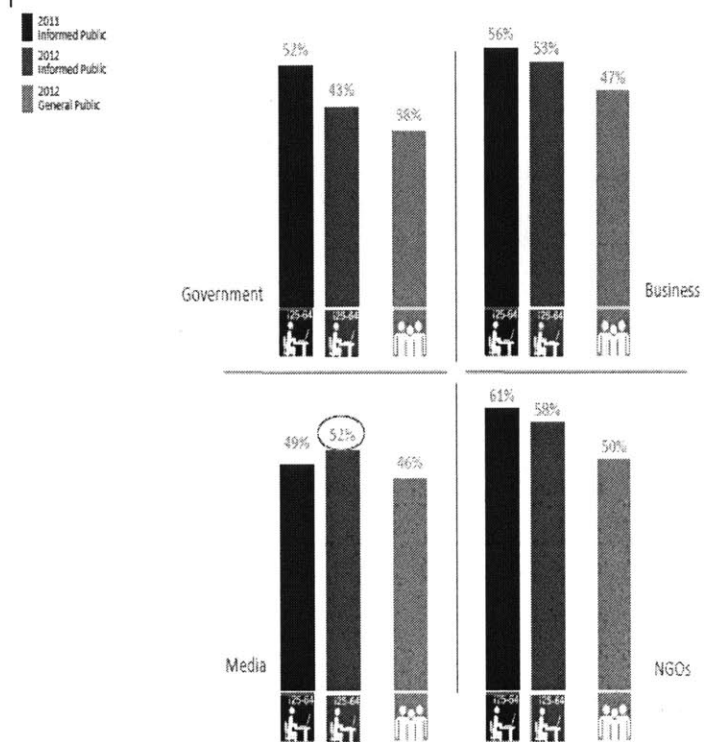
Figure 16. Relationship and Interactions among Management, Server and Customer



(Source G.Bitran, M. Lojo, A framework for analyzing the quality of the customer interface)

Over the decades, symptoms of the precipitous decline in trust have become increasingly visible. After the financial crisis, people's distrust on corporation bursted out and still remained high. Recovering trust is the biggest issue in the future. The Adelman Barometer looked at the number of times people need to hear something to believe it. Against the backdrop of increased skepticism, 63

Figure 18. Change of trust in various institutions



(Source: Adelman 2012 Trust Barometer)

percent say that they need to hear somewhere between three and five times, which represent a four-point uptick from last year. Lost trust is hard to recover. Regardless of the business, government, media, and even NGOs, people still keep losing their trust in the 2010s. Except for NGOs, less than 50% of people, trust various institutions.

In addition, customers become a part of an extended enterprise and co-producers of firms' marketing, enabled by the global telecommunications and ubiquitous computing in the rise of the network economy. This trend is projected to rise over the next decade and thus enterprises need to learn not to fear but to embrace it as a healthy part of the highly networked market economy. Moreover, a recognition and trust on social media is increasing.

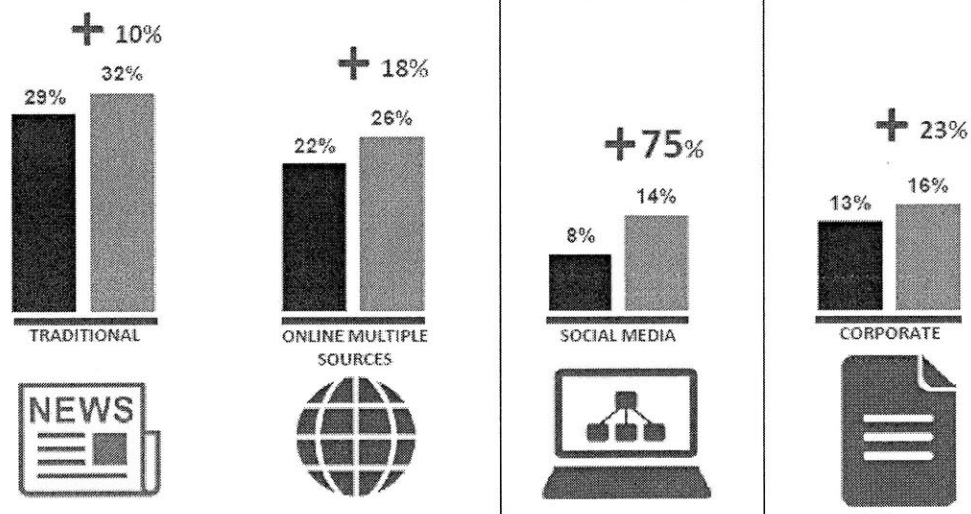
Historically, posts on the social media, such as social network sites, content-sharing sites, and blogs, were considered just personal opinions with some prejudices. However, the posts are getting more trusts and showed the biggest percentage increase, 75 percent in trust among the media sources. Therefore, companies' need to keep their reputation on the new media with the traditional media becomes more critical.

Figure 19. Change of Trust on Diversified Media

### Diversification of Media

TRUST IN INFORMATION SOURCES

2011 Informed Public  
2012 Informed Public



(Source: Adelman 2012 Trust Barometer)

The other issue is how to keep the company's services competitive or how to innovate more. Services are not the same as products or technologies. As explained earlier, services are not physically tangible, are usually consumed when delivered, cannot be inventoried,



and often require a close interaction between the provider of the service and the consumer. Facing high competitions, companies must learn how advanced innovation in the services businesses to keep the competitive advantage.

However, advanced innovation is not an easy task. Understanding the services innovation requires rethink the business in the fundamental ways. Product-based businesses utilize the artifacts to convey to the suppliers what kinds of requirements are needed, and those same artifacts help the customers determine whether or not the product meets their needs. In the services businesses without those artifacts, the relationship with the customers and suppliers shifts. A company cannot fully specify its needs in advance to the supplier. The company also cannot fully describe its capabilities to meet the needs of customers. Customers become partners, as do suppliers. Competitors become collaborators. Strangers become important, even vital. Therefore, the role of integration, of bringing together a variety of possible items on behalf of one's customers, becomes a source of value in such a world. Such drastic changes are costly, risky, and time consuming for the companies. Yet these changes are clearly worth it. Companies, that have embraced a service's logic to organize their businesses, have found the new sources of growth of business and profits. <sup>61</sup>

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<sup>61</sup> P.P. Maglio et al. (eds.), *Handbook of Service Science*, Service Science: Research and Innovations in the Service Economy, Springer Science Media, LLC 2010

### PART III: The Importance of the Stakeholder Approach in the Service Industry

#### Section III a: Stakeholders' Impact on the Service Industry.

Especially, in the service industry, customers and other stakeholders become increasingly involving in businesses. This emerging involvement extends well beyond “word-of-mouth” advertising. While customers were the target of marketing traditionally, more proactive involvement of stakeholders including customers is emerging recently. We need to understand that the enterprise and the customer are no longer seen as a separate but rather as the integrated economic system. Both customers and firms co-create by sensing and experiencing together, integrating resources for the individual and collective benefits, and learning how to better serve each other.

The retail industry is one of the best examples. It has realized that the business sustainability is determined by a combination of economic growth, environmental balance and social progress and has strategically incorporated the sustainability principles as a part of overall vision and mission. If a company cares about the sustainability, the management results in a positive impact on the business competitiveness, economic performance and stakeholder relations. If a retailer focuses on the profits and efficiency only through a cheaper cost base, there will be various side effects. For example, to the trend of lower labor compensation, shrinkage in inventory and fraud might occur frequently. As to the overseas outsourcing trends, the criticism might reduce the customer's loyalty and other

stakeholders' support. Retail and consumer goods companies deal with compensation decisions including both of monetary and non-monetary, given the relatively high levels of staff turnover, the issues of recruitment, the staff retention, and skills. As employees represent a significant cost to business, employers are increasingly looking for innovative methods to reduce this cost. Also, employers must fully consider risks and rewards, if they decide to depend on the outsourcing from and investing in the emerging markets such as China and the Far East and Eastern Europe. In response to a heightened focus from a variety of stakeholders on how businesses manage the social, ethical, and environmental risks throughout supply chains. Not only has the retail industry recognized that the sustainability is to stay, but many leaders within the industry have moved from looking at sustainability as a cost center to seeing it as an opportunity to reduce risks, improve relationships with customers and employees, and deliver better products.

In addition, stakeholders are indispensable for the innovation process. As mentioned earlier, service innovation clearly matters. Though, realizing the needs of innovation is only the first step on a long journey to actually creating sustainable innovations in services. How to innovate in services is a challenging question, in part because the research has only recently begun to address this question. Even companies at the forefront of services admit that they lack a deep understanding of how to keep advancing their services offerings over time. If they do not alter their offerings or change the way they create and deliver the services, these companies' survival and growth will be threatened. Competitive pressures to

innovate in services is high because new ideas in services are easier to imitate and harder to protect. For example, despite being much smaller than its rivals, Southwest Airlines' strong position in the US market as a low-cost carrier was achieved by innovations in the operational processes, such as rapid aircraft turnaround times and a simple "no thrills" service. The stable world of airline industry was radically transformed by the influx of many new firms, such as EasyJet that emulated this low-cost carrier business model.<sup>62</sup> If a business is unable or unwilling to build on an initial innovation, it risks being left behind as other firms change their offerings, modify their processes, and underlying models which drive their businesses.

This is why dynamics are so important to understand. Models of innovation have largely been derived from the studies of manufacturing rather than services. However, providing a service is distinct from making a physical product. It is important to consider; therefore, whether managing and organizing the innovation process in services represents a different or similar model to those of manufacturing. The recent progress in the service innovation has been achieved by identifying influential dynamic models of innovation that, with appropriate modifications, can be applied to the services. The voluntary contributions from the stakeholders will nourish the innovation with a lower costs and a faster process.

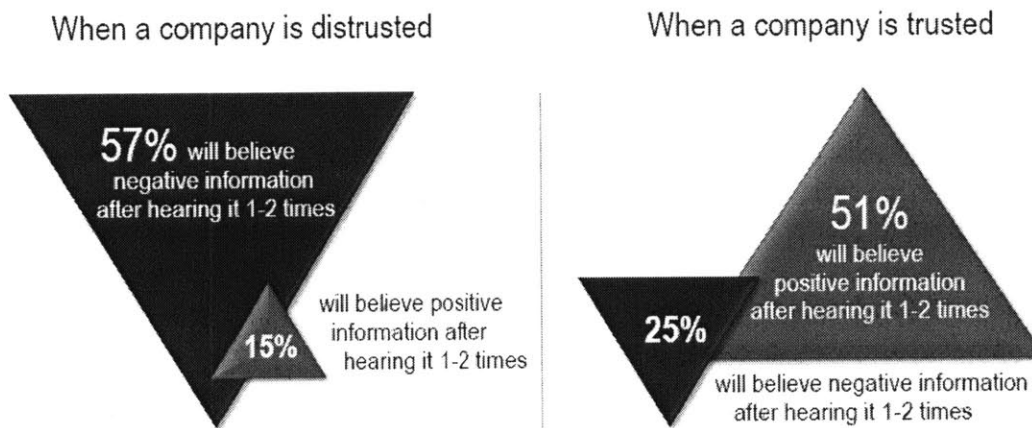
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<sup>62</sup> Ibid. P. 73

### Section III b: Potential Benefits of the Stakeholder Approach in the Service Industry.

One of the most important benefits from the stakeholder approach is the trust-building between the company and stakeholder. According to Edelman 2012 Trust Barometer report, the customer reactions to information regarding a company can drastically change its perception. People tend to accept any positive information easily from a company when it is trusted while they do not otherwise. <sup>63</sup>

Figure 20. Different Information Perception Depending on Trust



Source: Edelman 2012 Trust Barometer

Process of trust-building is the most critical for creating brand and loyalty to business. For the most companies, not only for the service industry, the brand names they own are their most important assets. James Burke, former CEO of Johnson & Johnson, once described a brand as “the capitalized value of the trust between a company and its customer.” <sup>64</sup> In the marketing theory, a brand itself can give some added value to the

<sup>63</sup> Gabriel Bitran and Muareen Lojo, European Management Journal Vol. 11, NO. 4, pp. 385-396, 1993

<sup>64</sup> Ibid.

underlying product or company. The concept of “brand equity” explains well the value of brand. Brand equity could be understood that the marketing effects and outcomes that accrue to a product with its brand name compared with those that would accrue if the same product did not have the brand name. Marketers have long understood the value and importance of the brand equity. An enormous amount of time and money is spent to maximize the brand equity of products and services. Therefore, brands tend to be regarded as the company itself.

However, the power of brand has an impact not only on the customers but also on other stakeholders, such as employees, suppliers, distributors (or dealers) and even regulators. In the perspective of marketing, strong loyalty from the customers matter. However, from the perspective of a management strategy, a brand is an aggregate of trust from all stakeholders and functions not only as a marketing tool but also the sustainable value, which encourages stakeholders to be a part of it voluntarily. Now, the reputation, the overall brands of company, should also be considered instead of not just brand of product. Therefore, companies need to focus not only on the brand equity but also on the reputation equity. While the brand equity is essential to drive a consumer behavior, the reputation equity shapes the entire environment, in which companies operate. In other words, the brand equity is focused on driving the outcomes for one stakeholder audience (consumers), while the reputation equity drives the outcomes across all stakeholder audiences.

Internally, employees could have a voluntary loyalty to their company if they trust it and the trust and loyalty are converted into an intrinsic culture inside the company. The culture

could be built in its brand. That is the reason why the brand with an internal support from the employees tends to be stronger than one without the support. In addition, a good relationship with the employees could be led to the voluntary involvements of employees with problem-solving processes and result in better processes or services.

Externally, not only the customers but also other stakeholders, such as suppliers, should be great sources of the sustainable value. Needless to say, there are several studies, which show that companies do better businesses with the loyal customers. According to James V. Putten of American Express, the best customers outspend others by ratios of 16 to 1 in retailing, 13 to 1 in the restaurants, 12 to 1 in the airlines, and 5 to 1 in the hospitality industry.<sup>65</sup>

There are more quantitative studies in the retail industry about the impact of reputation. According to the APCO's Return on Reputation Indicator<sup>66</sup>, a reputation has a statistically significant impact in three areas: how much consumers are willing to spend, how loyal they will be to a store, and how likely they are to be "promoters" recommending the store to others. It shows that for every 1-point increase in the reputation Index, the average consumer will spend \$133.05 more per year, the brand loyalty increases 0.48% points in average, and the number of "promoters" increases in the average of 4 percentage points. Thus, the consumers will be more loyal and spend more at the companies they respect and admire. On the contrary, there is much less interest on other stakeholders' contribution on a

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<sup>65</sup> Quoted in Don peppers and Martha Rogers, *The One-to-One Future*, Currency Doubleday, 1993, p. 108

<sup>66</sup> APCO worldwide, Return on Reputation indicator, *State of the Retail Industry, 2010*

business. The reason why is that other stakeholders' contribution is less visible in the process of production and factored in the cost of goods sold or SG&A while the customers are much transparent because of a direct relations to the sales revenue.

The interests have been increasing to capture the value of stakeholders' contributions. In the area of marketing, one of the definitions of marketing could be 'the management process is responsible for identifying, anticipating and satisfying customer requirements profitably.' This definition shows that, in order to be successful, an organization should find out what the customers seek. Knowing what they want, a company should then attempt to satisfy these needs. Simply knowing helps the business organizations to meet their mission, purpose and values. In recent years, many companies have taken a wider view of marketing concept. This implies that they should balance all the things they do against the needs of the society where they operate.

By the same token, Philip Kotler, a famous marketing professor, acknowledges the importance of stakeholders other than just customers.<sup>67</sup>

*Companies can no longer operate as self-contained, fully capable units without dedicated partners. Companies are becoming increasingly dependent on their employees, suppliers, distributors and dealers and their advertising agency. This dependence involves some loss of company freedom of action, but it increases the prospect of higher*

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<sup>67</sup> Philip Kotler, Marketing Management 11st Edition, PrenticeHall, 1993, p.118



*productivity and profitability. The key is for the company to form close relationships with its stakeholders. The company needs to build a network of partners that all gain from their joint strategy and behavior. Mutual trust is the bond. Selecting good partners and motivating them is the key to stakeholder marketing.(Philip Kotler, Marketing Management 11e)*

By building trust with their stakeholders, corporations will be able to perform better through a strong loyalty and mitigate any negative impacts from the unexpected troubles. Therefore, trust from all stakeholders must be a sustainable value and a competitive advantage. For instance, in the retail industry, a value of other stakeholders is more important. According to the APCO's retail reputation model<sup>68</sup>, the potential benefits from having a positive reputation is not only a stronger loyalty but also a consumer behavior as broader concept of loyalty, positive effect on the community activism, policy and potential litigation environment, employee engagement and overall financial value. The success story of the Whole Foods and Trader Joe's give a strong evidence of that argument. Those companies are famous for a friendly relationship with their employees and suppliers and often compared with Wal-Mart, an incarnation of efficiency, once-role model in the retail industry. Through friendly relationship with all stakeholders, they built a strong reputation and leveraged even stronger customer loyalty from it. Different management approach practiced by Whole Foods and Trader Joe's and their success stories will be discussed in detail later in the section of the industry analysis.

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<sup>68</sup> APCO worldwide, Return on Reputation indicator, *State of the Retail Industry, 2010*

As mentioned earlier, one of the most important characteristics in the service industry is the customer-employee interface. The service industry usually focuses to deliver its service at an affordable price depending on the target customers. With a better customers' perception of service, customers don't mind being charged more. However, people believe that there is a trade-off between the quality and cost. Therefore, once a company chooses a target market, it should decide on the equivalent quality of service within the level of price that the customers can feel afford in the market. However, in the retail industry, a typical industry should focus on the lowest price, several companies outperform their competitors while maintaining a loyal workforce and higher customer perception. Among those highly successful retail chains are Trader Joe's, Whole Foods, QuikTrip convenience stores, and Costco wholesale clubs. At these companies, workers enjoy the above-average wages, job security (the chain has never had layoffs), and benefits including the health insurance, performance bonuses, and paid vacation—all relatively rare in the industry.

Retailers are obsessed with cutting cost of labor because labor is often a retailer's largest controllable expense and can account for more than 10% of the revenues—a considerable level in an industry with a low profit margins. In addition, many retailers see labor as a cost driver rather than a sales driver and therefore focus on minimizing labor costs. Accordingly, managers often evaluate store managers on whether they meet monthly (or weekly) targets for payroll as a percentage of sales or not. These managers do not have much control over the sales as they almost never make decisions on merchandise mix, layout, price, or promotions, but they do have a fair amount of control over the payroll. So,

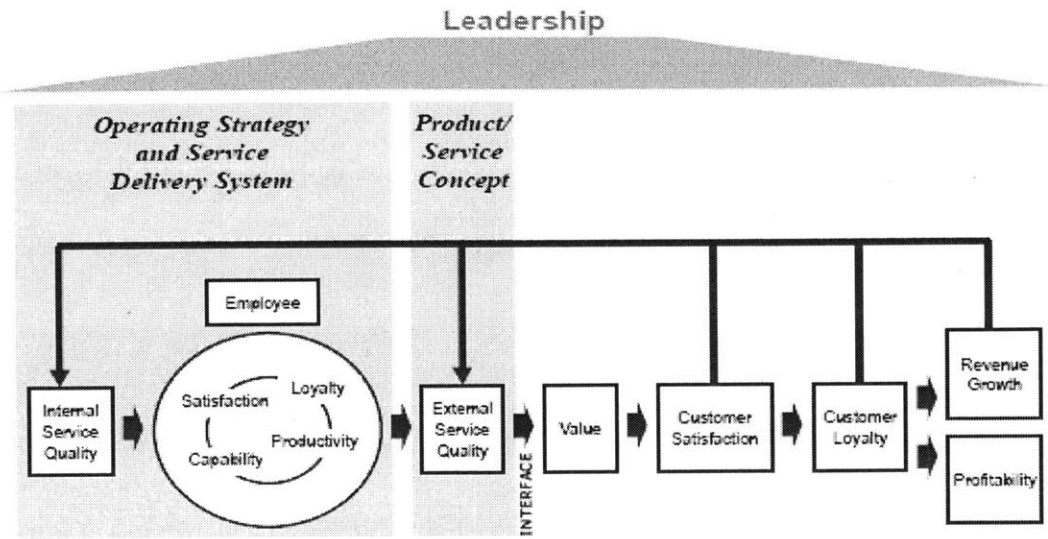
when the sales decrease, managers immediately reduce the staffing levels. The pressure to reduce the payroll expenses is so high that the store managers at several large chains, including Wal-Mart, widely reported to have forced employees to work off-the-clock, paying them for fewer hours than they actually put in. Moreover, the financial benefits of cutting employees are direct, immediate, and easy to measure, whereas the less-desirable effects are indirect and long.

In the industry, a conventional wisdom is that many companies have no choice but to offer bad jobs, especially those retailers whose business models entail competing on prices. It is assumed if the retailers invest more in their employees, the customers will have to pay more. However, a company with above exemplified managers might lose money from its labor policy overall. Wal-Mart has 5 times turnover than one of Costco which pays its employee much better and has a friendlier labor policy. Turnover usually entails a lot of training costs and profit losses associated with the inexperienced and those with a lower loyalty. Wal-Mart eventually pays more for the labor expenditure. According to the Lichtenstein's study on the labor cost in the retail industry, Wal-Mart could pay at the level of Costco and other unionized retailers if it raised its prices only by 2.2 percent.<sup>69</sup> With a lower payroll and inconsiderate treatment of its employees, Wal-Mart could bring a vicious cycle to have a lower loyalty and quality of labor; hence, a lower satisfaction from the customer, which then leads to lower sales and profits and again pressures to decrease the payroll budgets.

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<sup>69</sup> Lichtenstein, labor cost and employee satisfaction, 2009, p.247

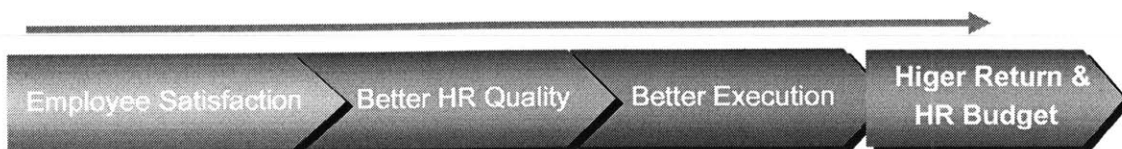
Figure 21. General Virtuous Cycle in Company



(Source: class note in "Management of service" by Jeynep Ton)

The presumed trade-off between the investment in employees and low prices can be broken into the highly successful retail chains. Companies not only invest heavily in the store employees but also have the lowest prices in their industries, solid financial performance, and better customer service than their competitors do. They have demonstrated that, even in the lowest-price segment of retail, bad jobs are not a cost driven necessity but a choice. They also have proven that the key to breaking the trade-off is a combination of investment in the workforce and operational practices that benefits the employees, customers, and company.

Figure 22. Virtuous Cycle in the Service Value Chain



Not only the internal stakeholder but also the external stakeholders play a significant role in creation of the value for the companies. In the perspective of the shareholder approach, society and environmental sustainability are only areas of philanthropy. Therefore, the activities for the external stakeholders had been regarded as a way of risk mitigation and as a cost center. However, if we see the interdependence between the companies and society, the issue of sustainability could turn from a risk mitigation and cost center into an opportunity for the business growth. In addition, the governmental regulations and NGOs' active involvements also require companies to take care of such sustainability. For example, public watchdogs now expect them to have a full responsibility for the social and environmental policies at their factories and even at the suppliers' level such as the child labor and inadequate working condition issue in NIKE and IKEA's overseas suppliers. For the global companies, a compliance with sustainability is no more an optional choice, but became an obligation. Sustainability programs are increasingly seen as a source of opportunities and a key method to differentiate in a competitive market.

Long-gone are the days of focusing on the low hanging fruits like the energy efficiency by saving money on the energy costs. Reducing waste is a good example of opportunities for sustainability. When the business operations are viewed through the lens of sustainability, a whole host of environmental and financial efficiencies become visible, for example, the reduction of energy, fuel, materials, waste, packaging, and other resources. Decreasing the dependence on natural resources like fuel and materials, both internally and in the process

of supply chain, reduces the exposure to the price fluctuations and the market volatility. Ensuring proper labor standards, managing at-risk suppliers, and ensuring safe manufacturing system mitigate further the brand risk. Sustainability can drive a new way of looking at the problems, identifying opportunities to save money and building a brand value. In an interview with the RILA sustainability report, a manager in Safeway said; <sup>70</sup>

*“Last year, Safeway diverted approximately 490,000 tons of materials....To achieve their waste reduction objectives, Safeway has engaged its stores, corporate offices, distribution centers, and manufacturing plants in a range of diversion programs. The company has developed a compost program and performed trash audits in each of its U.S. divisions. Store sustainability champions help ensures recycling procedures are followed and training programs reinforce proper recycling practices. Certain messaging has also proven to foster employee enthusiasm: framing the importance of recycling as “how Safeway is making a difference” and “how you can make a difference.” Its stores recycle materials like cardboard, plastics, compostable, food wastes, paper, construction materials, and more. In its southern California (Vons) operations, it is also piloting an initiative to turn fryer grease into biodiesel fuel.”*

On top of that, a strong sustainability program helps companies recruit and retain the top talents. Employees wish to work for companies that they can be proud of. It makes sense

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<sup>70</sup> RILA Retail Sustainability report 2011

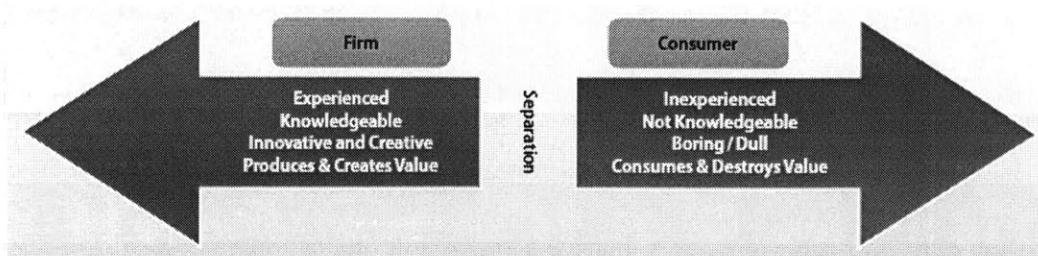
given how much time people spend at work. Sustainability initiatives, including the employee engagement, keep the top performers happy and be loyal to the company. Strong sustainability programs attract and retain top employees by providing them with the opportunities to positively influence the society. Also, companies that constantly reinforce the value they bring to the communities, beyond that of simply economic value or job creation, are more likely to be welcomed in new locations. For example, in the retail industry, an aggressive behaviors such as the WalMart's predatory moves into the communities in the 90s, is long-gone, as companies realize that they can save a lot of time and effort by working with the communities to make sure that their presence is mutually beneficial for the company and the community. As customers continue to look for healthy and sustainable product, retailers see their market share growth.

Moreover, the stakeholder approach could also help an innovation process in the service industry. As mentioned earlier, innovation matters to the service businesses. If they do not alter their offerings or change the way they create and deliver their services, often provided in combination with the products, their survival and growth will be threatened. Competitive pressures to innovate in services may be stronger than in manufacturing because new ideas in services are easier to imitate and harder to protect. People have thought that only producers/providers played a major role in the process of innovation. However, the services—both other firms and individual consumers—become easily adaptable to innovation for themselves and, recently, customers' interests on the

user-oriented innovation have been increasing.<sup>71</sup>

The user-centered innovation processes offer great advantages over the company-centric innovation development systems in the service industry. The reason why is that, in the services businesses, companies cannot fully specify their needs in advance to the supplier or describe fully their capabilities to meet the needs of its customers whereas product-based businesses could utilize artifacts to convey to the suppliers what kinds of requirements are needed. Those same artifacts help customers determine whether or not the product meets their needs. In this sense, the stakeholder approach could be beneficial for the innovation of service allowing the stakeholders to voluntarily join the process. In more detail, the users' impact on the service innovation has been ignored for a long time. The service industry always regarded users as target consumers, who just consume given services.

[Figure 23. Traditional Understanding of Consumer in Service Industry]



(Source: P.P. Maglio et al., Handbook of Service Science: Research & Innovations in the Service Economy)

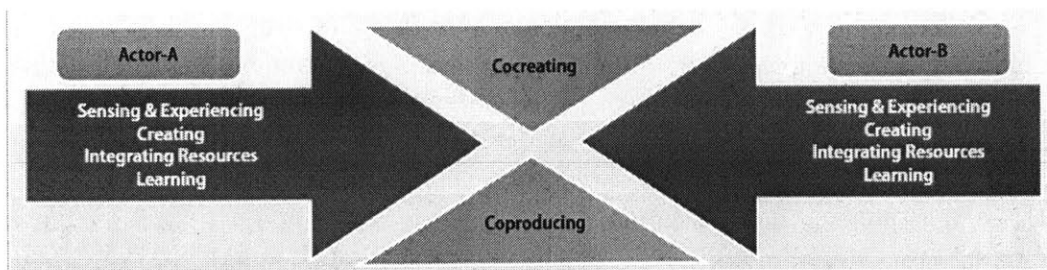
<sup>71</sup> Eric Von Hippel, Democratizing Innovation, MIT press, 2005



In reality, customers are becoming increasingly involved in businesses in the service industry. This emerging involvement phenomenon extends well beyond a traditional understanding about the consumers as marketing objects or the word-of-mouth advertising. As to be seen in the Figure 24, a well recognized open-innovation in the service industry totally changes the innovation process. No longer are users defined only as consumers, they should be regarded as one of the major actors in the process of creation and production of the new services.

In addition, a company could no longer decide by itself what kinds of services to provide and innovate, but co-create and coproduce a new service with its users. Together, they sense and experience the actual needs of the users in a real life. After finding them, they create an innovation to satisfying those needs together. Service companies need to understand better the true meaning of open-innovation in the service industry if they want to keep their competitive advantage and expand their businesses. The stakeholder approach is a lubricant to enhance an open-innovation platform to commercialize it faster than the competitors.

[Figure 24. New Ways of Understanding of Consumer in the Service Industry]



(Source: Ibid.)

Overall, the stakeholder approach in a management of a company is more important in the service industry than in the manufacturing industry because the involvements with the stakeholder are more essential and frequent in the daily operations in the service industry. With a better framework for involvements, companies could get many benefits such as a virtuous cycle of service chain through trust building, relationship management, and open-innovation.

### Section III c: Industry Analysis

To explain the potential benefits of the stakeholder approach, this paper offers analysis of two leading companies each in different industries, a car-rental service and a retail industry.<sup>72</sup> By examining successful companies in each industry, this paper shows how distinct management perspective can yield different results. As for rent car industry, this paper compares two leading companies; Enterprise and Hertz. These two companies have very different approaches on the primary stakeholders; customers, employees and other stakeholders. Through comparisons, we could understand why the strategic fit with business does matter and how the stakeholder approach helps to foster it.

Regarding the retail industry, this paper focuses on uncovering the virtuous cycle in the service chain by researching two untraditional yet successful retail companies; Whole Foods and Trader Joe's. Unlike many traditional retailers, these two companies set up a unique mission and nourished the distinct culture to care for the stakeholders. By building trust

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<sup>72</sup> The section of industry analysis includes empirical researches which are partly based on my team papers for the class of "Management of Services" in Sloan school with Olumide Ogunsanwo, Pranab Sharma and Kumares Athmaram.

from all stakeholders, they could take advantage of the virtuous cycle which is a great source and a sustainable competitiveness for success. Through these analyses, this paper reveals how the stakeholder approach could be beneficial to enforce the virtuous cycle.

#### [Rent Car Industry: Enterprise Strategic Fits in Comparison with Hertz]

Founded in 1918, Hertz car rental grew from its base in Chicago to one of the leading players in the car-rental industry in nationwide by the early 1990s. The car rental market, at that time, had a well-defined target markets, business and leisure travelers, and Hertz succeeded in the market by growing its presence at the most major airports, building the economies of scale and customizing its pricing strategy to match the demand. Enterprise, on the other had, started off with just seven cars by Jack Taylor in 1957.<sup>73</sup> and grew steadily until it overtook Hertz as the leading car rental company in the United States in 1996.<sup>74</sup> Enterprise successfully differentiated itself in this market by serving the local city population while Hertz and the rest of its competitors continued to focus on the business traveler's market segment. The difference in the focus led two companies to develop different business models and choose different operating decisions to support their objectives. Hertz focused on the efficiency and the consistent experience to its customers while Enterprise focused on the relationship management with the local residents and business partners, such as body-shops and insurance companies. Different ownership structure also drives the

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<sup>73</sup> [http://aboutus.enterprise.com/who\\_we\\_are/milestones.html](http://aboutus.enterprise.com/who_we_are/milestones.html)

<sup>74</sup> [http://www.thetimes100.co.uk/downloads/enterprise/enterprise\\_12\\_full.pdf](http://www.thetimes100.co.uk/downloads/enterprise/enterprise_12_full.pdf)

different operating strategy decisions. Hertz is a publicly held company while Enterprise is a private company. Without the growth pressures from investors, Enterprise is able to build its corporate culture to foster decentralization and encourage balance between the short term and the long-term performance. However, as a publicly traded company, Hertz had to be sensitive to pressure from its investors and hence had to focus more on the short-term performance.

The reason why Enterprise could overcome Hertz's long standing market-reign was to create a new market by targeting different customer base with new business strategy. Although Enterprise and Hertz covered overlapping geographical areas, they target different customer segments. Enterprise's initial main customers were the local customers in the home city market and it provided 'pick-up service' ("We'll pick you up"), which was a critical factor for rental car users to choose Enterprise over its competitors. The pick-up service was particularly valuable when customers had car malfunctioned or were in car accidents. Therefore, Enterprise's business model may be described as a "pull" strategy.

Hertz, on the other hand, targeted travelers who may be in locations for a shorter period of time and hence it focused on providing an efficient service from/to the airport. The customer value proposition was to provide a consistent service for its customers. Therefore, the Hertz's model may be described as a "push" in contrast to Enterprise's model described above. However, the customer loyalty programs at Hertz reduce the customer attrition. However, in the last few years, Enterprise acquired National and Alamo car rental

companies and built up a strong presence at the airports. Hertz, on the other hand, started building up the city offices looking to attract the urban customers as well.

However, the background of conducting successful businesses and creating a new market is Enterprise's unique culture, value, and perspective of the business. It is the stakeholder approach. For example, an interesting aspect of these two rental companies is that the actual payer is not the end customer. Enterprise's real customers are the auto insurance companies and based on the interviews with the employees at the Cambridge office, approximately 80% of its customers were referred from the insurance companies and body shops. Enterprise has corporate level tie-ups with the most major auto insurance companies. It also has strong partnerships with the local body-shops that call on Enterprise when a customer brings in his/her car for a repair. In recent times, Enterprise has also started building relationships with hotels in areas it serves.

Hertz travelers are more involved in a one-shot trust game with the specific Hertz showroom/outlet. Hence the focus at Hertz is to ensure that there is a repeatability of customer service across the branches wherever it serves its customers. This model is similar to the Four Seasons customer service model. Many travelers use company's loyalty program from Hertz and build their relative status in the program to get better services and privileges. On the other hand, Enterprise does not have such constraint. As it serves the local customers, the customers keep building trust with the local Enterprise customer agents. Hence, serving local customers became a repeatable trust-game. Consistency and quality of

services among Enterprise branches are important for this trust-game to be possible. At Enterprise, the opportunity to lock-in the customer through relationships is higher than that of Hertz. It is a great strategy because repeat customers would yield significantly higher lifetime revenues. Difference of two companies is a business strategy for “One-Shot Trust-Game (Hertz) vs. Repeatable Trust-Games (Enterprise)”

Because of its strategy to build trust in the long-term, Enterprise names customer satisfaction as No.1 objective in its operations. Enterprise measures its customer satisfaction through a survey tool called “ESQi”. The survey containing just two questions (and hence has very high response rates) is constantly used as a measure of success for its employees and is linked to Enterprise employees’ promotional opportunities. This aspect is further explored in the employee section below. Constant focus on customers has helped Enterprise to win the external recognition. Enterprise has been the JD Power Customer Service Champions winner in the rental car segment for the last seven years except for the year 2011.<sup>75</sup> Enterprise has been consistently awarded the maximum score in the overall satisfaction, reservation process, pick-up process, vehicle, and return process. Similarly, Hertz had strong performance with the external agency ratings but came in the second place in most occasions. Hertz scored 761 where Enterprise scored 787 against a national average of 758/1000 in the 2011 JD Power survey.<sup>76</sup>

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<sup>75</sup> <http://www.jdpower.com/autos/ratings/rental-car-ratings/>

<sup>76</sup> <http://www.jdpower.com/news/pressrelease.aspx?ID=2011192>

Enterprise focuses on the customer service and sees it as the company's core competency (as mentioned before, it has been repeatedly rated by independent bodies such as JD Power as having the best customer service in the car rental industry by a margin). Enterprise employees rate each other on the customer service performance levels and the best overall and best-improved employees are recognized in the publicized announcements monthly. Promotions at Enterprise are only possible if the ESQi (Enterprise Service Quality Index, outlined in the section below) is above the corporate average. To meet the high customer service levels, Enterprise has set itself up operationally to achieve this aim, and employees have a relative flexibility to do what they think is appropriate to satisfy their customers. Despite this perceived flexibility, workers do have some specific guidelines that they must follow, such as suits and ties dress code.

Hertz also focuses on the customer service, but it is less emphasized than Enterprise does. Promotions are not based on the customer service, and Hertz's employees do not rate each other monthly based on the customer service levels. Hertz's employees have stricter guidelines and relatively less freedom to modify their process guidelines to satisfy their customers. The difference of promotional criteria between two firms changes the amount of attention that is placed on the customer service from the employees of each company.

Over the years, Enterprise has optimized its operations process to match its customer service focus. Enterprise hires an independent survey company to call a random sample of customers (about 1 in 15) to answer two simple questions; 1 – How would you rate your last Enterprise rental experience?, 2 – Would you rent from Enterprise again? These questions

comprise the ESQi which is the yardstick used by Enterprise to measure the customer service levels. It was shortened and simplified to its current form to increase the participation level by making it easy and straightforward for customers to understand. The ESQi data is important to employees because it is segmented by branch and an important factor for the promotion.<sup>77/78</sup>

Different business strategy affects the way of staffing. The main difference between the recruitment at Enterprise and Hertz is that Enterprise has a strong preference for a college degree for its entry-level management trainee positions while Hertz has a less emphasized preference for college education. Enterprise states that the reason for this is because its employees do more than just rent cars out to customers and must be ready to have the mindset of running their own businesses. Enterprise has strong preference on recruiting employees who were actively involved in the social activities during their education. Enterprise values these interpersonal skills more highly than the academic excellence. The type of individuals who would fit in at Enterprise is described as, “highly motivated, positive, energetic, and enthusiastic” by a careers executive. Generally, Hertz recruits employees in a similar manner with Enterprise but does not have such a strong focus on the social skills. Overall, Hertz and Enterprise are both interested in the same type of employee to join the management trainee starting position - desirable employees who have good communication skills, drives and have an aspiration to go the extra mile to succeed.

Based on the nature of the job (long hours, manual labor and low initial pay) almost half

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<sup>77</sup> <http://www.creditunions.com/article.aspx?articleid=1196>

<sup>78</sup> [http://chiefmarketer.com/crm\\_loop/enterprise-story-061406/](http://chiefmarketer.com/crm_loop/enterprise-story-061406/)



of new Enterprise employees leave the position by the end of the first year. Despite the early high levels of attrition, employees who make it past the first year, have the opportunity to become a future leader at Enterprise because of its strong policy of internal promotion. Hertz has very similar levels of attrition; however the promotions at Hertz are a combination of both internal promotion and external hiring. This has the potential to negatively affect recruitment and reduce the incentive for workers for staying longer at Hertz since they know that their hard work is less likely to lead to a promotion at Hertz.

At Enterprise, almost all members of the senior executive team started off as trainees and are thus aware of the range of challenges faced by the management trainees. This means that they are positioned (than the Hertz management team) to make the operating decisions that better reflect the challenges faced by the front line employees. Enterprise's managers, who have risen through the ranks, handle a variety of tasks during the time they spent at Enterprise and thus develop their individual specific knowledge and skill-sets as they progress through several levels of positions. On the other hand, Hertz has more specific company knowledge as their tasks are specific to roles. As a result, there are differences in the skill-set development between the two organizations. Enterprise employees are better suited to the job given in the future that emphasize the flexibility and give them the freedom to act whereas Hertz employees would be better suited to the roles with more rigidity and clearly defined work tasks. Employees at both firms described work life as "boot camp for adults" and said "you will get out what you put in and will be rewarded for your success and hard work" further emphasizing the growth opportunities available for those

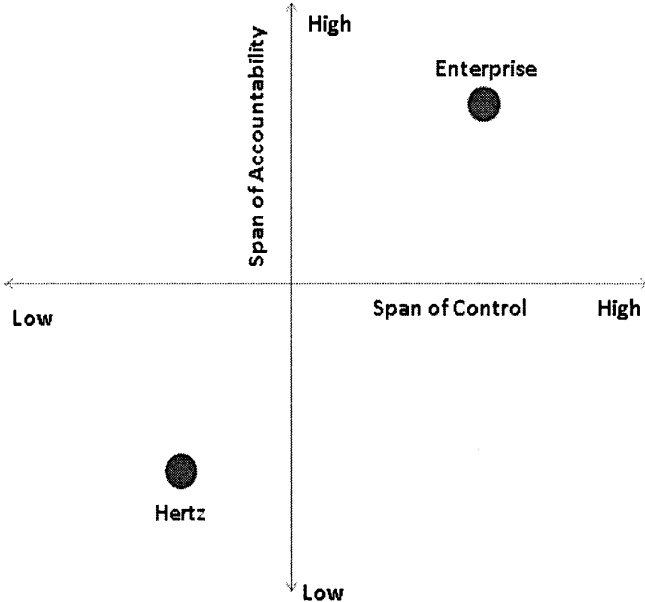
who are able to make it through the initial rigorous process. Benefits and salary are also considerably higher at both companies for those who make it into the managerial positions. Enterprise employees stated that they were treated with respects by their fellow employees and managers (although they were sometimes asked to stay back and work long hours). Similarly, Hertz employees stated that they were treated well by fellow co-workers and managers.

Overall, there seemed to be a duality in Enterprise employee opinions – both agreed that the work was difficult at first for trainees but some said that this initial tough period was worth it because of the leadership training and opportunities available afterwards while others stated that the initial period was too tough and unbearable. These conflicting opinions are very similar at Hertz and may be responsible for the high attrition levels at both organizations.

Due to the decentralized structure of Enterprise branches, managers are given a high degree of freedom to run the branch as they saw fit (P&L responsibility, vehicle purchase and even rental price control). For

Enterprise, employees were empowered to a greater extent when compared to Hertz and the alignment with the employees’ judgment and accountability is very high. For Hertz,

Figure 25. Employee Span of Control Vs Accountability

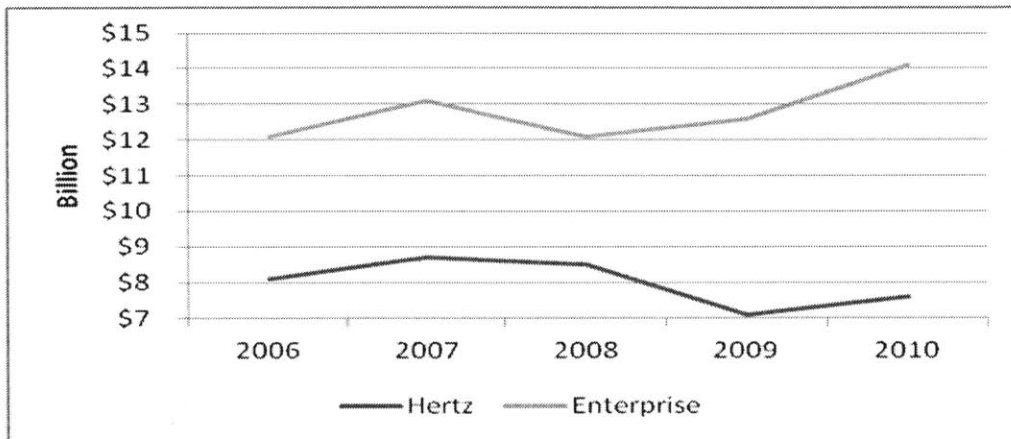


employees were less empowered; driven more by the process discipline and the alignment between the control and accountability is not strong.

The rental car price is contextual and negotiable at Enterprise. Employees have higher span of control to discount some of the prices or offer a free upgrade for the customers. Enterprise's online prices are updated every hour to maintain prices below those of the competitors. Hertz prices are relatively fixed and the scope of negotiation is very limited. Hertz online prices are almost always cheaper than booking directly in person at the offices. Hertz employees have a lower span of control compared to Enterprise employees in terms of providing any discounts or adjusting prices.

Regarding the corporate governance, publicly-traded companies, such as Hertz routinely face the agent-principal problems that are non-existent at privately owned companies such as Enterprise. Based on the different profile of investors, there is a tendency for the management of the companies to have different priorities. Management team at Hertz is very sensitive to the investor's pressure and may have a tendency to focus on the short-term performance. Because of this and other similar constraints, the business strategies in Hertz are more focused on the profitability and efficient capital management. There is less of a conflict at Enterprise and thus management can seek a balanced business strategy between the short-term and the long-term performances. Enterprise has therefore sometimes adopted and made changes to its unique decentralization culture and organization structure that may sometimes come at the expense of efficiency.

Figure 26. Revenues - Hertz Vs Enterprise



(Source: Annual reports)

Revenues for Hertz and Enterprise are shown in Figure 6. Increasing trend in revenues shows the Enterprise's stronger growth in the market. The Hertz's trends shows recovering signals from 2009 onwards since the company has started expanding its service in the heavy equipment rentals and also in other international locations. Enterprise does not disclose its net income but said it achieved record growth in profitability in its recently completed fiscal year<sup>79</sup>, and the Hertz's net income for 2010 was \$348 million.<sup>80</sup>

Most interesting point in Enterprise is that it takes advantage of the partner ecosystem. Enterprise is well-known for its good relationships with the insurance companies, body shops, car repair stations and mechanics. Garage service managers recommend Enterprise to their customers when the customer's car is left for a regular service or when the customers' car is broken down, due to accident. Enterprise believes that the garage manager's recommendation would be more credible than those from other sources.

<sup>79</sup> <http://www.bizjournals.com/stlouis/stories/2010/09/27/daily47.html>; Accessed on December 10, 2011

<sup>80</sup> Hertz 2010 Annual Report

Enterprise's employee selection process of choosing "people out of people" such as athletes and socially inclined students helps them build relationships with their partners and helps employees maintain good relationships with others. As mentioned in the customer section, insurance companies contribute the majority of Enterprise's business. When a customer's car is broken down insurance companies and agents recommend the customers to choose Enterprise. Enterprise has specific deals and arrangement with major insurance players and Enterprise employees work as a part of the insurance companies. Since Enterprise market focus is on home/city market, it is imperative to have the good relationships with these partners.

On the other hand, Hertz has the good relationships with the partners of the ecosystem centered on the business travelers. Hertz has a major market share in the airport rentals. Hertz has close tie ups with hotels, restaurants, travel agents and big corporation in and around airports and in various urban locations, too. Several big corporations have contracts with Hertz to provide the business travel and personal travel services to their employees. Though Hertz has not any strong relationships with the insurance companies and auto body workshops, they are now focusing on building rapport and credibility among the urban partners.

Enterprise is primarily located in the urban and rural markets known as home/city markets whereas Hertz has a lion's share in the airport locations. Ex-CEO of Enterprise, Andy Taylor stated that "90% of the American population lives within 15 minutes of an Enterprise

office." <sup>81</sup> It decides its location based the on the following factors: demographics, access to public transportation, location of other supporting partners, such as insurance companies and auto body workshops. Hertz locates most of it offices in the airports and in urban markets near hotels where business travelers stay. Hertz has many offices in downtown markets to help business travelers to leave the rental cars at the prime locations. Additionally, Hertz has some reserved space at the airport parking garages and also in some company operated parking spaces.

In conclusion, the operating decisions of both companies paint a difference in the importance of stakeholders between the two firms. Enterprise's operating decisions are true to its customer focus with a clear stakeholder priority of "Customer first, Employee second and Investor last." The stakeholder priority of Hertz; however, is less clear. As a publicly traded company, it is more directly accountable to its shareholders but also has good levels of customer service. It is likely to have a priority with investor in the first/second place, contrast to Enterprise.

Additionally, Enterprise acquired National and Alamo car rental companies as a part of its strategy to expand to the airport market. Conversely, Hertz's initial operational focus was on airports but has now begun to expand its reach into the urban areas to increase its presence in the local car rental companies. However, the potential success of entry of both companies in these markets will depend on the customer's preferences, competitive

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<sup>81</sup> [http://money.cnn.com/magazines/fortune/fortune\\_archive/1996/10/28/203910/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/1996/10/28/203910/index.htm)

reaction from other players in the industry, and economic conditions.

Above all, new business expansion without an adequate management strategy turns a business into a failure. Hertz, which focuses on the efficiency, might have a hard time because it requires more relationship and trust building processes while Enterprise could be successful because of its agility from its autonomous culture. In the conclusion, the stakeholder approach is better to broaden the scope of business than the shareholder approach because the former enables employee to have the shared values of company and stronger loyalty with bigger autonomy.

[Retail Industry: Virtuous cycle through Service Value chain in Whole foods and Trader Joe's]

Grocery shopping is more diversified and evolved than ever before. Individuals across the nation have access to everything from exotic products to unique delivery services. Since Wal-Mart dominated the grocery retail industry with its famous slogan of "Always Low price" leveraging its superior chain management, major retailers tried to accomplish economies of scale through mergers and acquisition. Without enough scale of economy, other specialty stores have limited locations whereas specialty services have a limited reach. Wal-Mart is notorious of taking advantage of suppliers and employees to deliver the quality goods at low prices to price-sensitive customers. As for suppliers, it could get an enormous negotiation power and sometimes direct control over suppliers with close to monopsony

power over them. In addition, it turned the eyes to overseas suppliers whenever they no longer provide the lowest price. Some suppliers went bankrupt after losing contract to provide their products to Wal-Mart and local citizen lost their jobs. It does not care about the local community's eco-system. Even it continues to be accused of permitting some overseas suppliers to violate its stated labor policies, even though it had power to stop or at least alleviated any suffering gratuitously imposed.(International Labor Right Forum 2009) <sup>82</sup>

Moreover, it has not always treated its workforces well. The conventional wisdom is that retailers have no choice but to offer bad jobs—especially companies whose business models entail competing on low prices. If retailers invest more in their employees, customers will have to pay more according to the assumption. Wal-Mart not only pays low wages and offers modest benefits, but has apparently condoned gender discrimination.(Only in 2008, it settled 63 lawsuits alleging illegal wages discrimination against women, Greenhouse and Rosenbloom 2008) <sup>83</sup> In addition, its opposition to unions is implacable. The company has spent many millions of dollars in preventing employees from organizing to keep its low payroll and increase the proportion of part time workers.

In a near future, sustainability will become more integrated into the business. As sustainability strategies expand in scope, responsibilities will move from being centered in the sustainability department to being shared across the organization in every department from facilities to purchasing. The retailer-supplier relationship will be transformed. No longer will retailers be hands off and in the dark about where their materials come from.

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<sup>82</sup> Thomas Jones, The nature of firm-stakeholder relationships, Stakeholder impact and prospect ch.3, 2011.

<sup>83</sup> Ibid. ch.3



Every supplier and subcontractor will come into the fold as a key stakeholder, so that the retailers can better control their product quality, sustainability, and brand value. “The retailer-supplier relationship will continue to evolve, using sustainability as an opportunity for generating shared value.” Business models will evolve as the consumption habits change. Business models will embrace a closed-loop product design and manufacture, recapturing resources and products and incorporating the value of ecosystems services. That means shifting away from a disposable culture toward one where products can be fixed rather than thrown away, and re-used at the end of their lives.

At the end of the day, the biggest sustainability challenge for the retail industry is that a business based on the sale of products and the promotion of consumption is not sustainable. That does not mean that one retailer cannot be more sustainable than another, nor does it mean that it is not worth trying to improve. It most certainly is, and this report demonstrates that the retail industry “gets” the benefits of sustainability thinking and is applying them across the board to improve the business. However, two retailers have expanded to hundreds of location while adhering to the unexpected market positioning for previously untargeted market segments. Whole Foods Market and Trader Joe’s have become household names while also innovating beyond regional and national traditional chains. Despite the comparable size in terms of locations, each store’s growth has operated using a very different model. This industry analysis will address the various facets for both Whole Foods Market and Trader Joe’s in order to understand how each business model has won a piece of the market pie and share of wallet through virtuous cycle in service chains.

Table 3. Information of two retailers' operation strategy

Category	Whole Foods	Trader Joe's
Background	Publicly-held, 311 stores, 1976	Privately-held, 344 stores, 1970's
Distribution	Decentralized	Centralized
Supply Chain	Quick, nimble and versatile	Private labels, extreme secrecy
Staffing	Cult-like, employees love it	
Inventory	Similar with large retailers	Smaller SKUs and High Turnover
Quality	Incredible selection and quality	Incredible quality but poor selection
Customer Experience	Appeal to senses	Kitschy and campy
Community	Leader in sustainability/ environment	Laggard but initiate actively Sourcing from Local producers
Locations and Store Layout	Large, open, beautiful Avg. Size ( 35,000 ~ 37,000 Sq)	Cramped, in bad locations Avg. Size (8,000 ~12,000 Sq)

[Whole Foods]

In 1978, John Mackey had a vision to build a store that would meet his desire for whole, natural foods as a part of the movement away from artificial, processed foods. Mackey was a college dropout, but against all odds he was able to borrow \$45,000 in capital financing and open his first store for what would become Whole Foods in Austin, Texas.<sup>84</sup> By all accounts it has been an incredible success and had kept a double digit growth before the financial crisis in 2007. The most recent annual report (2011) reveals that there are 311 stores across most of the United States with a handful in Canada and Great Britain.<sup>85</sup>

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<sup>84</sup> <http://www.wholefoodsmarket.com/company/history.php>

<sup>85</sup> Whole Foods Market Annual Report (2011), pg. 3

Table 4. Financial Data of Whole foods

	2011	2010	2009	2008	2007
Sales (000s)	\$10,107,787	\$9,005,794	\$8,031,620	\$7,953,912	\$6,591,773
Stores	311	299	284	275	276
Store Size (sq.ft.)	38,000	37,500	37,000	36,000	34,000
Same store sales growth	8.4%	6.5%	-4.3%	3.6%	5.8%
Weekly Sales (/store)	\$636,000	\$588,000	\$549,000	\$570,000	\$617,000

(Source: Annual report 2011)

To best understand the Whole Foods' evolution over the last 34 years, it is important to explore a variety of facets of the organization, ranging from its distribution networks to retail location positioning. As Whole Foods has increased the number of retail centers that it operates, it has suffered from concomitant growing pains in efficiently managing the distribution of products to its stores. The chain is growing at such a fast rate that it struggles to keep up with the demand for products and keep shelves stocked. The single biggest reason for inefficiency is the Whole Foods' almost completely decentralized back-end. It has the 12 geographic divisions, a national headquarters in Austin, regional distribution centers, bakery facilities, kitchens, seafood processing facilities, meat and produce procurement centers and a specialty coffee/tea procurement operation.<sup>86</sup> Each geographic division has its own office, regional president, and oversees its own store network. Many outsiders scoff at its supply chain, considering it amateurish and lacking in professionalism. But with ample

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<sup>86</sup> Whole Foods Market Annual Report (2009), pg. 10

margins that Whole Foods commands for its products, it does not face immediate pressure to enhance the efficiencies.

Mackey explained that store managers are empowered to make purchasing decisions independently of the regional offices. As a result, it is possible for Whole Foods to buy potatoes from a local farmer,<sup>87</sup> who would never dream of selling his produce to a large grocery chain. Essentially, Whole Foods is differentiated because all products are sourced locally. The stores operate under a minimal governance and are given maximum freedom to source a product mix that is appropriate for their location. Whole Foods stores operate under the premise that they need these freedoms to meet the unique buying needs of its local customers. The only governing rule put in place by the corporate office is that stores must not stock products with the artificial flavors, preservatives, colors, sweeteners, or hydrogenated oils.<sup>88</sup> A down side to this local purchasing policy is that consistency is compromised across the chain. Every retail location carries a variety of products that distinguishes it from other stores in the same chain. Not surprisingly, it is difficult to achieve the economies of scale.

Mackey describes his consumers as being a “part of a cult.” Whole Foods believes that the company’s emphasis on perishables and locally-sourced produce differentiates their stores from the run-of-the-mill supermarkets and attracts the loyal and devoted customers. However, “fresh produce” is one of the most challenging product categories to operate due

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<sup>87</sup> Whole Foods Market Annual Report (2009), pg. 10

<sup>88</sup> <http://www.wholefoodsmarket.com/values/>

to the limited product shelf life and high cost of spoilage. Whole Foods has tried to circumvent most of the problems inherent in supplying fresh produce to its stores by sourcing locally and having short and flexible supply chains. In the case of fruits and vegetables, Whole Foods has the buying relationships with the local farmers, who supply the store with seasonal produce. Thus, if one farmer is unable to produce a sufficient amount of yellow corn or heirloom tomatoes, another farmer can make up the shortfall. By challenging to be perfect, these short supply chains are agile and difficult for other big retailers to duplicate. The Whole Foods' seafood sourcing strategy is entirely different. The company recently introduced a seafood supply line for getting wild-caught Alaska salmon from stream to plate in less than 48 hours. The company has an on-site buyer in Alaska who travels to various ports fisheries open for the season. He has the long-standing relationships with the fishermen and is empowered to make purchasing decisions for the entire company. The freshest and highest quality "catches of the day" are flown out immediately to fulfill the demand in the local stores.

Due to this focus on quality, customers pay a premium for the Whole Foods' one-of-a-kind produce selection and quality. Whole Foods has been derisively labeled by its critics as, "Whole Paycheck", however, indoctrinated "cultists" are happy to pay them. Whole Foods does not compete with other grocers on price and has no intention of ever competing in that arena. And since many of its products cannot be found anywhere else, Whole Foods exerts enormous leverage in terms of its pricing power. Furthermore, Whole Foods filters its product offerings and only carries pure, unadulterated foods. This is a strong

differentiator, which adds value to the customers. Although Whole Foods operates in a low-margin industry, its operating margins are nearly double of those of other large grocery chains.<sup>89</sup>

Whole Foods encourages decisions to be made at the regional level; regional management is better able to understand the needs of local shoppers. This would seem to indicate that the company's growth is inhibited and that its business model cannot scale. However, Whole Foods solves this problem by decreasing the oversight responsibilities given to each regional office as the company has grown. In 2002, Whole Foods had operations in 9 regions of the United States.<sup>90</sup> Today, Whole Foods has 12 regional offices. Thus, as Whole Foods has gotten bigger, it has actually gotten smaller. Whole Foods has also decentralized the staffing and training of team members. Whole Foods is comprised entirely of inter-related teams; every regional office and every store are considered as a team. Even, the departments within a store are made up of teams with employees assigned to at least one team. Along with being inclusive and specialized, these teams are self-directed. The impetus for driving change and improvements does not come from a corporate mandate, but from a grass-roots effort; excellence is a result of collective success of the subordinate teams working to achieve company goals. Whole Foods views its employees as forming the basis of the company's competitive advantage versus its direct competitors. The workers are passionate and knowledgeable, and infect shoppers with that enthusiasm. In 2010 Whole

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<sup>89</sup> [http://www.businessweek.com/magazine/content/05\\_43/b3956106.htm](http://www.businessweek.com/magazine/content/05_43/b3956106.htm)

<sup>90</sup> Whole Foods Market Annual Report (2002)

Foods was ranked by Fortune Magazine as no. 18 on the list of the “100 Best Companies to Work For”, and is one of only 13 companies to have appeared on the list every year since its inception.<sup>91</sup> Whole Foods provides comprehensive medical care benefits to every one of its employees and their domestic partners, and mandates a “living-wage” of at least \$13.50/hr to the lowest paid workers at its stores. Moreover, the company caps the highest earning manager’s pay at 19 times the average hourly wage, which results in a very flat hierarchy.<sup>92</sup> Many workers exclaim that working at Whole Foods is like being a member of a family rather than working in a traditional job. As for Inventory management, Whole Foods does not use many enterprise-wide systems to manage the inventory or track sales. It is difficult to get information on this aspect of their business because it is not publicly disclosed, but as of 2002 the only company-wide used software was accounting software. This software reports the financial results from the stores, warehouses and regional offices up to the corporate offices and is responsible for making all vendor payments.

In this modern age, it is almost inconceivable for a C-level executive to not have instant access to any individual store’s inventory. Yet, at Whole Foods, the physical inventory is not tracked at the store level. Whole Foods stores use a point of sale system to scan and record product sales, and it tracks the latest pricing for its products with the use of a master price list. However, this software only gives store managers information on what has been sold, and not what is on the shelf. Amazingly, the company orders new product largely based on

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<sup>91</sup> <http://blog.wholefoodsmarket.com/2010/01/18-on-100-best-companies-to-work-for-list/>

<sup>92</sup> Lincoln, Keith. “How to Succeed at Retail: Winning Case Studies and Strategies for Retailers”, pg. 163.

visual inspection or physical count. The company has recently started to update its ordering procedures by the introduction of handheld inventory instruments that can automatically order products as they are run out. However, most store orders are still placed by phone or fax to the distribution center.<sup>93</sup>

Whole Foods was built as a result of acquisitions, and many of the regional offices and distribution centers use legacy software that has yet to be integrated with other regional offices or the corporate headquarters. For example, one regional office uses 18 digits to track UPC codes on products, whereas all of the others use 13 or 14 digits.<sup>94</sup> Even if Whole Foods wanted to centralize its supply chain, it would not be able to until it upgraded and standardized its software at all of the regional offices. Clearly, if the company has not done so, then the lack of investment means that Whole Foods is serious about having a decentralized purchasing model and having individual stores make the purchasing decisions. The first core value listed on Whole Foods' website is "selling the highest quality natural and organic products available." Whole Foods believes that its quality standards are the highest in the industry and realizes that in order to ensure product quality at the customer-facing, store level, they must trace the quality back through the supply chain, all the way to the source. They provide their suppliers with standardized product profiles and systematically test their suppliers' ability to meet specific quality goals. Ingredients, freshness, safety, taste, nutrition, and appearance are some of the key quality metrics that Whole Foods focuses on.

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<sup>93</sup> <http://misbridge.mcombs.utexas.edu/knowledge/cases/wholefoods/MISBridgeCase-WholeFoods.pdf>

<sup>94</sup> <http://www.wholefoodsmarket.com/values/corevalues.php>



<sup>95</sup> In addition to their own internal quality assurance procedures, Whole Foods relies on the third party auditors to ensure the product quality and safety. Even though it was not required, Whole Foods decided to display its commitment to product integrity by becoming the first nationally certified organic grocer under the USDA's organic standards. <sup>96</sup>

In terms of customer side, Whole Foods takes special care to ensure a positive experience for customers on every visit, understanding that customers are significant advocates for the business. <sup>97</sup> They appeal to the customer's senses: sight, smell, and taste. From the customers' first moment in the store, they are greeted by the brightly colored display of fresh fruits and vegetables. As customers walk the aisles, they will often have opportunities to taste samples of certain items on display. Then in many stores, as they approach the check-out line, the smells of the buffet-style, self-serve department might entice them to grab a bite for lunch in the store. Along the way, customers will likely encounter several knowledgeable specialists who are eager to help them pick the best cheese or the perfect slice of meat.

Whole Foods believes that this level of expertise is essential to achieving their goal of providing excellent customer service. When checking out at the cash register, it is Whole Foods' attention to details that sets it apart from the competition. For example, if customers are buying a carton of eggs, the cashier will open them to make sure that none are cracked.

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<sup>95</sup> <http://www.wholefoodsmarket.com/values/organic.php>

<sup>96</sup> <http://www.wholefoodsmarket.com/values/corevalues.php>

<sup>97</sup> <http://www.wholefoodsmarket.com/values/organic.php>

They will even place tape or rubber bands around the containers for some items to secure them for their journey to the customer's home. It is these small gestures that make the customers feel that they are getting superior treatment and perhaps helps to justify the marked-up prices that they will pay.

Whole Foods is a purpose-driven company, striving to make "green choices" since the opening of their very first store. With a powerful mission, "Whole Foods – Whole People – Whole Planet," it is obvious that this grocery chain has a broader vision than simply making the profits.<sup>98</sup> Whole Foods supports the community and environment through four main avenues: sustainability, wise environmental practices, community citizenship, and integrity in all business dealings.<sup>99</sup> Whole Foods has a vision of a sustainable future and chooses to lead by example, creating momentum towards this ambitious goal. The primary emphasis is on organic agriculture with special focus on the use of renewable resources and conservational principles. Whole Foods also works diligently to educate the customers regarding the food properties and safety.<sup>100</sup>

Whole Foods believes in the "golden rule of environmental stewardship" through reducing the company's impact on the earth, reusing materials whenever possible, and recycling and donating items to minimize waste.<sup>101</sup> Additionally, in April of 2010, Whole

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<sup>98</sup> <http://www.wholefoodsmarket.com/company/>

<sup>99</sup> <http://www.wholefoodsmarket.com/values/corevalues.php>

<sup>100</sup> <http://www.wholefoodsmarket.com/values/sustainability.php>

<sup>101</sup> <http://www.wholefoodsmarket.com/values/green-mission.php>

Foods committed to reducing energy consumption by 25% per square foot by 2015. <sup>102</sup>

Giving at least five percent increase of company profits every year to the community and non-profit organizations, Whole Foods is dedicated to supporting the communities in which they serve. <sup>103</sup> Whole Foods understands the benefits of creating strong partnerships based on integrity and fairness.

Regarding the retail Locations and store layout, the first Whole Foods Market was opened as a small natural foods store after founders John Mackey and Rene Hardy saw a need for healthier grocery options in their Austin, Texas neighborhood. Twenty years later, with over three hundred retail locations in North America, Whole Foods continues to design each store with the needs of the local community in mind, and because of this, there is no cookie cutter model for the Whole Food's store layout, every Whole Foods Market is unique. In the words of company executives, "Whole Foods Market does not have a standard store design. Instead, each store's design is customized to fit the size and configuration of the particular location and community, in which it is located." Retail Locations While Whole Foods does customize the design of new stores to fit within the surrounding community and location; they do follow a set of loose standards when selecting the site for the new properties. To ensure the ample access to their target consumer segments, they select communities with a large number of college-educated residents with no less than 200,000 people within a 20-minute drive. In addition, the site must be large enough to accommodate

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<sup>102</sup> <http://wholefoodsmarket.com/pressroom/blog/2010/04/20/whole-foods-market%C2%AE-commits-to-reduce-energy-consumption-by-25-percent-per-square-foot-by-2015>

<sup>103</sup> <http://www.wholefoodsmarket.com/values/corevalues.php>

a 25,000-50,000 square foot facility with an abundant exclusive use parking.

Through its well-organized management strategy creating a virtuous cycle in the service chain, Whole Foods has been very successful. Empowering employee and seeking for profit with value fostered its unique culture and built trust and reputation from all stakeholders surrounding itself. Regardless of its extensive activities for the social and environmental sustainability, its performance is much better than one of competitors.<sup>104</sup> The Whole Foods' success tells us why the stakeholder approach as a management strategy is required for sustainable success in the long-term.

[Trader Joe's]

Started in 1967 by Joe Coulombe, Trader Joe's began as a convenience store but quickly migrated to a more novel design for the adventurous food and beverage shoppers. The retailer's foodie roots and quirky in-store culture date to the first Trader Joe's opening 45 years ago in Pasadena to serve a sophisticated but strapped consumer. He named the store Trader Joe's to evoke images of the South Seas. He stocked it with the convenience-store items and good booze, and at one time his shop boasted the world's largest assortment of California wine. Initially, TRADER JOE'S was comprised of 17 stores in the southern California area. In 1979, he sold the company to Albrecht. The Albrechts, who own Trader Joe's

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<sup>104</sup> According to Morgan Stanley Retail industry report 2010, Whole foods earned a profit margin of 34.29%, compared to an industry-wide profit margin of 19.25%.

through a family trust, have generally stayed out of the business. German grocery mogul Theo Albrecht, coveted Trader Joe's -- not as a part of a major U.S. expansion but as a smart financial investment. They visit the U.S. operation about once a year. Coulombe stayed on without a management contract for a decade; in 1987 he hired John Shields, who was CEO until 2001.

By the early 1980s, the number of stores grew to 26. In 1988 it expanded to northern California. The combination of innovative products along with a service-oriented culture has created a loyal customer base that continues to grow nationally. Under the Shields' reign, Trader Joe's expanded outside California to Arizona in 1993 and to the Pacific Northwest in 1995. Although the executives worried that Northeastern shoppers would not "get" Trader Joe's, the company in 1996 leapfrogged the country and opened two stores in places crawling with the college professors and other bargain-hunting elites: Brookline and Cambridge, both outside Boston. Throughout its 40-plus year history, Trader Joe's has grown to "344 stores in 25 states and Washington, D.C.; and strip-mall operators and consumers alike aggressively lobby the chain, based in Monrovia, Calif., to come to their towns."<sup>105</sup> The annual sales are roughly \$8 billion in 2009, but are growing at a steady rate. Trader Joe's is careful about the unplanned expansion that could put at risk its culture, value proposition, and brand affiliation. Thus, Trader Joe's only opened five new stores in 2010.<sup>106</sup>

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<sup>105</sup> Kowitt, Beth. "Inside the Secret World of Trader Joes." Fortune Magazine.

[http://money.cnn.com/2010/08/20/news/companies/inside\\_trader\\_joes\\_full\\_version.fortune/](http://money.cnn.com/2010/08/20/news/companies/inside_trader_joes_full_version.fortune/) August 2010

<sup>106</sup> Ibid

The company's success did not go unnoticed. Typically, successful and growing organizations are eager to emphasize their successes. However, the insider information about Trader Joe's is scant, and this is seemingly at odds with its image as a "neighborhood store". This is mostly a result of influence from Aldi, its privately-held parent company. Aldi has been reluctant to peel back the curtain on Trader Joe's business model, and they are highly secretive about its business operations, supplier information and internal logistics. However, enough is known about the grocery chain to take a peek under the hood of the low-cost, yuppie-loved phenomenon.

The success of Trader Joe's is the result of unique business model that has built a national chain of neighborhood grocery stores. This apparent paradox requires the organization to be growth-oriented yet perceived by shoppers as customer-focused similar to "mom-and-pop" operations of the past. They have accomplished this by basing their strategy on the alignment of their unique corporate culture with a clearly defined competitive space.

The relationship between the organizational culture and business strategy that has propelled it to extraordinary success was to create a culture within their own organization that provides a defensible competitive position by incorporating value, rareness, inimitability, and non-substitutability.<sup>107</sup> The unique approach is expressed in its mission, which is to offer value and a dedication to quality service through warm, friendly, committed

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<sup>107</sup> Jay Barney. "Special Theory Forum The Resource-Based Model of the Firm: Origins, Implications, and Prospects," *Journal of Management*, 17, (1991): 97-98

employees along with a pledge to offer quality products. This mission requires a culture that supports loyalty and customer service through personal contact with the consumer. The commitment to the customer is captured on the Trader Joe's website, "Our Product Guarantee: We tried it! We liked it! If you don't, bring it back for a full refund, no questions asked." The underlying message is that Trader Joe's desires to establish a personal relationship with the customer.

In more micro perspective, at the core of the Trader Joe's business is a focus on cost-control, simplicity and fun. These company objectives are woven throughout each aspect of its business that has enabled Trader Joe's to create a truly unique customer experience offering a high-quality gourmet food at low cost in a fun environment that keeps customers coming back for more. To best understand this strategy, we will examine all areas of the organization – ranging from the distribution networks and supply chain, to corporate social responsibility and physical store layout.

Major decisions are carefully scrutinized to determine the extent to which each directly maintains a neighborhood store feel. For example, for a number of years Trader Joe's resisted incorporating the scanners at their check-out stands. The concern was that the customers would consider the technology a move toward becoming a traditional supermarket, and thus a risk losing its image. Continuous change in their inventory mix, however, demanded that they scan bar codes at the check-out. Eight years ago, Trader Joe's began experimenting with this shift in technology. Piloting the technology at a few northern

California stores, they were careful to be sure the sound of the ping during the check-out did not get in the way of cashier/customer conversation. After several weeks of testing, the organization launched the system throughout its store operations. This approach to merchandising provides the customer with an adventure in shopping;<sup>108</sup> the Trader Joe's model attempts to make grocery shopping an exotic experience rather than an obligatory visit to market for staples.

The success of their model is evidenced by the measure of sales per square foot. Trader Joe's believes that the combination of its product line and customer service culture is responsible for revenues that are triple as high as per the square foot sales of a typical supermarket. The privately held company's sales in 2009 were roughly \$8 billion, the same size as Whole Foods'. However, Trader Joe's did not achieve the growth by expansion, but instead of it actually has a deliberately scaled-down strategy: The company selects relatively small stores with a carefully curated selection of items. Typically it will carry around 2,000 SKUs when compared to a typical grocery store that carries upwards of 30,000.<sup>109</sup> The result: Its stores sell an estimated \$1,750 in merchandise per square foot, more than double Whole Foods'. With the greater turnover on a smaller number of items, Trader Joe's can buy large quantities and secure deep discounts. And it makes the whole business from stocking

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<sup>108</sup> Len Lewis. *The Trader Joe's Adventure: A Unique Approach to Business into a Retail and Cultural Phenomenon*, (Chicago: Dearborn Trade Publication, 2005).

<sup>109</sup> Ibid



shelves to checking out customers. So its business got much simpler.

Also, Trader Joe's offers an array of products that are distinct from those sold in the traditional supermarkets and has an innovative approach to ensuring the product quality. They do not carry national brands, but rather a host of food and beverage products along with a number of healthcare selections. The 80% of those products are private label, whereas the typical grocery store carries only 16%. While this means that many big-name brands are not sold in their stores, Trader Joe's instead focuses on developing the customer loyalty to its own brand. Most products are offered at low price (which differentiates Trader Joe's from competitors such as Whole Foods and Bristol Farms) but are considered to be of high quality, both in terms of taste and healthfulness. Because their stores are generally in the 15,000 square foot range, Trader Joe's offers about five times fewer products than conventional supermarkets, and the new products are continuously brought in as others are phased out. To stimulate the customers' interests, Trader Joe's focuses on a constantly changing product mix, which further adds to their uniqueness. This continuous rotation of distinct food and beverage products creates a sense of adventure that appeals to customers, who look forward to new items.

Swapping selection for value turns out not to be much of a tradeoff. Customers may think they want variety, but in reality too many options can lead to the shopping paralysis. According to Barry Schwartz, an author of *The Paradox of Choice*, people are worried that they will regret the choice they made and people do not want to feel that they made a

mistake. Studies have found that buyers enjoy purchases more if they know the pool of options is not quite so large.<sup>110</sup> Having a wide selection may help customers enter the store, but it will not increase the chances they will buy. It also explains why the variety often takes customer out of the purchasing process and puts them into a decision-making process. Trader Joe's always strive to ferret out those wow items. Trader Joe's biggest R&D expense is the travel for those product-finding missions. Trader Joe's does not pick up on trends – It sets them. Through those efforts to satisfy customers' need, Trader Joe's could build the customers' trust on its product and keep its unique merchandising strategy.

Regarding its distribution and supply chain, over the years Trader Joe's has improved the way it distributes Joe's-branded goods to its stores. Management has sought to minimize the number of hands that touch a product; whenever possible, thereby reducing costs and making products quickly available to their customers. Trader Joe's purchases directly from the manufacturers and they, in turn, are responsible for bringing the product to a Trader Joe's distribution center. A U.S.-made cheese, for example, is sent to the distribution centers nationwide, where the products are sometimes cut and wrapped, taking another cost out of the equation. At a traditional supermarket, that same cheese would probably go through a distributor first, tacking on another cost. At the distribution center, trucks leave on daily resupply trips to the local stores. Because of the average store's small size, there is little room for excess inventory, and orders from distribution centers need to be incredibly precise.

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<sup>110</sup> Barry Schwartz, *The paradox of Choice; why more is less*, ECCO, 2003

This quick and efficient distribution process is directly responsible for helping the company identify where to locate new retail stores. Texas and Florida have cities with consumers that Trader Joe's covets, but insiders say the current distribution infrastructure in those states makes it difficult for the company to efficiently resupply products to stores.<sup>111</sup> The Trader Joe's strategy of implementing a low-cost and efficient distribution network has contributed to the democratization of gourmet foods by making them more readily available to the customers at all income levels.<sup>112</sup>

To implement the distribution strategy, Trader Joe's has a unique relationship with its suppliers. Trader Joe's manages its relationship with suppliers predicated on enormous levels of trust and secrecy. By most accounts, Trader Joe's is a "supplier's dream"<sup>113</sup> It pays on time and does not mess with the extra charges for advertising, couponing, or slotting fees that traditional supermarkets charge suppliers to get their products onto the shelves. Additionally, it will offer manufacturers detailed specifications for new products along with the price it will pay, but then leave it up to the vendors to create innovative high-quality items.<sup>114</sup> In return, Trader Joe's expects a high level of secrecy from its suppliers, even

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<sup>111</sup> Ibid

<sup>112</sup> Lewis, Len. *The Trader Joe's Adventure: Turning a Unique Approach to Business to a Retail and Cultural Phenomenon*. 2005.

<sup>113</sup> Kowitt, Beth. "Inside the Secret World of Trader Joes." *Fortune Magazine*.  
[http://money.cnn.com/2010/08/20/news/companies/inside\\_trader\\_joes\\_full\\_version.fortune/](http://money.cnn.com/2010/08/20/news/companies/inside_trader_joes_full_version.fortune/) August 2010

<sup>114</sup> Lewis, Len. *The Trader Joe's Adventure: Turning a Unique Approach to Business to a Retail and Cultural Phenomenon*. 2005.

going so far as to force them to not publicly acknowledge their business relationship. Trader Joe's does this because it does not want other vendors, customers or competitors to know where it gets products. In most cases, vendors agree to this cloak of secrecy because they are typically producing a lower-cost version of a product for Trader Joe's than for their other customers, and they do not want to cannibalize the sales of that product that are sold at other grocers. Another important way that Trader Joe's manages its supply chain is by relying on its successful private-label brands. This strategy not only lets Trader Joe's differentiate against its competitors and reduces its marketing costs, but sells its own in-house brands reducing the number of SKUs in its stores. This collapses the number of supplier relationships and leads to a more efficient and controllable supply chain.

Another strength in Trader Joe's is good employees. One of the most important ways that Trader Joe's has maintained its success is by being sure to pick the right employees. Trader Joe's generally believes that a happy work force creates happy customers, and the company does everything to foster this virtuous circle. Trader Joe's has a very selective screening process and seeks talented and motivated employees who shares its passion for food and can provide a high level of customer service.<sup>115</sup> Trader Joe's invests a significant amount into its employee relationships, making it consistently one of the most popular places to work, as evidenced by the large number of applicants for jobs there. For example,

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<sup>115</sup> Ibid

one store alone received 500 applications for just 50 openings.<sup>116</sup> Why is Trader Joe's such a great place to work? Because it offers an above-average compensation and fosters a company culture, focused on collaboration, autonomy and fun.

"Crewmembers" are selected, in part, because of their expressed enthusiasm and energy. Training includes skills in communication, teamwork, leadership and product knowledge. They handle a multitude of responsibilities including, cashier, stocker, customer interface, and are evaluated on a quarterly basis. Trader Joe's has high expectations from its employees and expects them to multi-task without regard to their job description.<sup>117</sup> This collaborative work environment is valued by employees. Also Trader Joe's has a Leadership Development Program designed to empower employees to make their own decisions about the store operations, and a Trader Joe's University designed to train employees in areas such as marketing and communications.

Fun is a basic tenet of employee management at Trader Joe's. First, Trader Joe's labels its work staff as "captains" and "first mates" for store managers, "novitiates" for supervisors-in-training, and "crew" for the rest of the staff. Employees go to work in Aloha shirts and seem to truly enjoy what they do. Being a part of Trader Joe's is almost like being a member of a cult. It's not only about the product but also an attitude and lifestyle that extends to people in the store. This makes them Trader Joe's people markedly different from

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<sup>116</sup> Ibid

<sup>117</sup> Lewis, Len, "Fostering a Loyal Workforce at Trader Joe's, Workforce Management," <http://www.workforce.com/section/recruiting-staffing/feature/fostering-loyal-workforce-trader-joes/> June 2005

employees in the traditional supermarkets. It is like being a part of a club.”<sup>118</sup>

In addition, Trader’s Joes embodies the entrepreneurial spirit in everything they do. They are fearless in their approach to retailing and they are experts at explaining their unique product offerings to their customers with a clever point-of-sale signage on the shelves that many of their own employees create. The crew members indicated that they felt empowered to make decisions, were collaborative in their relationship with others, and were motivated to the high levels of performance. These characteristics were demonstrated in the extent to which they were enthusiastic, hardworking, outgoing, team and customer oriented. Additionally, they offer the most consumer-friendly monthly newsletter, titled The Fearless Flyer that shares recipes, product origin stories and other non-traditional insights that further promote the treasure-hunt experience. They are passionate about introducing something new that in turn challenges potentially new and existing vendors to remain active in their innovation efforts.

To control costs, Trader Joe’s keeps its payroll down not by giving lower salary and hiring part-time jobs as many as possible, but by having a lower head count in each location per dollar sales than its competitors.<sup>119</sup> But it does not sacrifice the cost for the quality. Trader Joe’s believe that it cannot buy engagement from employees, but the pay at Trader Joe’s helps. Trader Joe’s pays above-union wages: as of 2010 full-time crew members started at

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<sup>118</sup> Ibid

<sup>119</sup> Ibid.

\$40-\$60,000 per year and store managers earn in the low six figures.<sup>120</sup> Trader Joe's also extends significant benefits to its employees that include health insurance, a generous employee discount and performance evaluations every six months with the potential for pay increases. But on top of the pay, Trader Joe's annually contributes 15.4% of employees' gross income to tax-deferred retirement accounts.

Those work conditions seems to satisfy its employees because the turnover among full-time crew is four percent yearly, substantially below that of traditional supermarkets and the operation remains free of union involvement—salaries and benefits are sufficient to ward off labor unrest. Part-time employees comprise 70 percent of the crew members, however, inside promotion is encouraged for those wishing to be promoted to full-time positions.

All of that can lead to a better customer experience. Typically, grocery store shopping is a chore. The original founder, Joe Colombe, decided that going to the grocery store could be radically improved by offering an authentically enjoyable experience to the customer. Joe's vision of making food-shopping fun was enabled by worker adjustments, process redesigns, and some physical changes to the store atmosphere. Product returns are welcome at all times, and the employees are actually helpful. Also, the use of a bell replaces the use of an intercom. Hand painted signs and wood-paneled walls further promote a "getaway" feeling as opposed to the typical aseptic and quotidian grocery store, and the use of conveyor belts

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<sup>120</sup> Kowitt, Beth. "Inside the Secret World of Trader Joes." Fortune Magazine.

[http://money.cnn.com/2010/08/20/news/companies/inside\\_trader\\_joes\\_full\\_version.fortune/](http://money.cnn.com/2010/08/20/news/companies/inside_trader_joes_full_version.fortune/) August 2010

and individual lines do not exist. Because of the customers' loyalty, advertising is limited in Trader Joe's: modest radio exposure and no television or newspaper ads. It does not rely on publicity, coupons, or store cards. A newsletter, the Frequent Flyer, featuring new products and store locations is mailed to the customers three times each year and during the holiday periods. They do not rely on the email advertising.

How they accomplish this is also different from their most obvious competitors, Whole Foods and Bristol Farms. For their customers Trader Joe's provides value not primarily through the quality of its products, as with them, but rather through their distinct shopping experience. Shopping becomes an adventure that takes them into a store whose characteristics are often in opposition to those of traditional markets: casual, low price, high service with a constantly changing and somewhat unpredictable product mix. Their culture, because it involves the customers in an ongoing sense of discovery and adventure, is both unique and difficult to copy. And because it is aligned to their specific target market rather than a broad differentiation built around the quality and service, it is more difficult to replicate by those companies that are serving a more expansive competitive space. Finally, at this moment, there is no substitute for the combination of attributes provided by the Trader Joe's culture and customer experience, because at Trader Joe's, customers become a part of the culture rather than merely experiencing it.

Trader Joe's a perfect example of how to gain a competitive advantage in a crowded space by embracing the immigrant perspective. In fact, they take pride in not doing what



their competitors do. At a time of one of the most profound shifts in America's population, Trader Joe's has proven how the cultural awareness can cultivate the business growth, and a grass-roots marketing niche that draws the viral consumer activity. Trader Joe's is a quiet, private and savvy retailer. Their non-conventional culturally-tailored approach and attitude is one that is deeply embedded in the roots of their business model.

In conclusion, Trader Joe's and Whole Foods have managed to take novel ideas and scale them across the nation, not remained as a niche player. However, the method in which each chain has decided to bring products to the consumers has varied widely. Particularly in terms of inventory management and supply chain organization, these companies vary to a wide extent. But what has made these two chains so successful, in my opinion, is what they have the most in common, the stakeholder approach: their commitment to their customers, to their employees, and to their definitions of quality. Through this commitment, as well as their unique value propositions, they have successfully managed to turn the grocery retailing industry on its head, and have forced traditional grocery stores and their customers to re-evaluate their definitions of what constitutes a positive customer experience. They are the great examples of companies, which take advantage of the virtuous cycle in service chain by adopting the stakeholder approach deeply into their operation and overall management.

As a competition in every industry intensifies, to execute a strategy well will no longer be good enough. This is even more evident for retailers and service providers that cannot erect

patent or other barriers to competition. In Whole foods and Trader Joe's, their unique organization culture that is carefully aligned with both their own competitive business strategy and with the values of stakeholders, can provide an effective defense against incipient competitors. Such a strong and targeted organization culture takes time to develop and provides customers with a valuable and difficult to copy experience. It is always more complicated for competitors to imitate who you are than what you do. They made their own identity and sustainable major competitive advantage through the stakeholder approach.

#### PART IV: Conclusion

Current capitalism has too narrow focus. This runs the risk of ignoring the fact that businesses are populated by human beings in all of their complexity and are deeply embedded into the societal fabric. It also runs the risk of seeing economic language in too narrow a fashion, certainly contra to its founder, Adam Smith. By focusing only on imperfect principles such as maximization output by economic optimization, our society has been losing trust. Building and managing trust is a complex process, nothing to mention recovering trust. We should make many efforts on how to manage reputation and build trust. By understanding the components of trust and keep focusing on it, organizations make better choices about building trust.

To succeed fierce competitions, business needs to build a true trust in society. It will be only possible by understanding and implementing the stakeholder approach in business. The management will help us to build a better society and a stronger economy at the same time and that is the reason why we should rethink about stakeholder approach as a powerful management strategy. By the same token, company should make profits with certain purpose or mission with engagement with stakeholders around it through transparent process. By doing so, it could build and maintain trust.

Therefore, the strategic approaches to stakeholders are no longer confined into the area of philanthropy and instead, it, but are the opportunities for maintaining and developing sustainable businesses and step-stones for building reputation and loyalty. In the future, the strategic approach will be prerequisite to do a business. That is why the stakeholder approach does matter as a management strategy.

In the service industry, the importance is greater than other industries because it is always exposed to all stakeholders at the every step of operation from directly consumers and suppliers to NGOs, regulators and governments and is very dependent on the perception from them. In the service industry, the consumer perception of companies' mark-ups vs. the differentiation and/or convenience is critical in driving long-term returns. The perception is mainly attributed to companies' reputation and relationship with stakeholders.

As we see in the industry analysis, the stakeholder approach as a management strategy allows a company to differentiate itself from its competitors and to gain the market share by building trust and loyalty from all kinds of stakeholders. Moreover, the stakeholder approach enables stakeholders to share their company's culture and philosophy and to apply it to everyday operations voluntarily. The competitive advantages with shared culture will be sustainable both in existing business and even in new business. Therefore, the stakeholder approach can be a great source to expand business. For example, Enterprise has been dominating its rental market in towns and gaining the market share in its new target market in airports.

In addition, the stakeholder approach creates some management strategies to align different interests amongst all stakeholders. To make all stakeholders satisfied, the alignment must be executed by each employee. This requires proper incentives to all stakeholders within an organization. Whole Foods and Trader Joe's operations in the case analysis are ones of the best examples. Two retailers must balance its consumer stakeholders with its supply chain stakeholders (vendor support, wholesaler contracts) with the government stakeholders (food safety, competitive practices) and the shareholders (demand for near and long-term returns). The retailers that can coordinate this dynamic in the best interest of the stakeholders will be long-term winners.

In conclusion, this paper finds that successful companies in the service industry have the most in common, the stakeholder approach: their commitment to their customers, to their employees, and to their definitions of quality. Through this commitment, as well as their unique value propositions, they have successfully managed to turn their business on its head, and satisfied their customers to give positive customer experiences.

It is only possible by taking advantage of the virtuous cycle in service chain by adopting stakeholder approach deeply into their operation and overall management. Without voluntary supports from all stakeholders, any management strategy might not be sustainable. As competition in every industry intensifies, to execute a strategy well will no longer be good enough. This is even more evident for the service industry that cannot erect patent or other barriers to competition.

Companies in the industry analysis, know how to make it. Their unique organization culture that is carefully aligned with both their own competitive business strategy and with the values of the stakeholders, can provide an effective defense against incipient competitors. Such a strong and targeted organization culture takes time to develop and provides customers with a valuable and difficult to copy experience. It is always more complicated for competitors to imitate who you are than what you do. They made their own identity and sustainable major competitive advantage through the stakeholder approach. It is the importance why the stakeholder approach matters in the service industry.

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