THE GAP GAMBLES ON DESIGN (P. 62) | KODAK'S SCARY PICTURE (P. 84)

The McGraw-Hill Companies

BusinessWeek

OCTOBER [illegible], 2005

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ESPN President George Bodenheimer
(Photo illustration)

ESPN THE EMPIRE

Can the hottest brand in sports hold off its rivals?

BY TOM LOWRY (P. 66)

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ESPN GOES DEEP
Its long reach includes TV, radio, a magazine, and a formidable Web presence. Next up? The ESPN cell phone

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THE GOOD LIFE?
Price pressures build in the exurbs

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COVER PHOTO ILLUSTRATION BY MICHAEL ELINS; PHOTOGRAPH OF BODENHEIMER BY EVAN KAFKA; (THIS PAGE, BOTTOM LEFT) KATHERINE LAMBERT

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LUXURY LINERS
At $1 million-plus and $600 to fill up, these well-appointed RVs are the wheels of choice for the privileged few

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Open Source: The Next Generation

This software movement is now sprouting an **entire ecosystem.** It's branching into not just mainstream business applications but also into the associated services that help make all the open-source pieces work. And **venture capitalists** are eager to help. They've pumped nearly $400 million into 50 open-source companies in the past 18 months. Also included in this Technology Special Report: A Q&A with Linux pioneer **Linus Torvalds** and a slide show of **promising open-source startups**

If the Housing Market Slumps, How Safe Are You?

You may be more exposed than you think, especially if your portfolio includes financial-services and consumer stocks. Better take a close look at your bond funds, too

SmallBiz Special Report: Passion for Business

Does your particular passion have what it takes to make it out of the basement and into the big time? Plus: Gadget hawker Ron Popeil's recipe for success and a slide show of the products he made famous

Why Apple Won't Up-Charge for Downloads

Record executives are clamoring for price flexibility in music downloads, but Steve Jobs is adamant that 99¢ per song is perfect

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upFront

"To me, yes, it's worth the money."
–Gregory Olsen, entrepreneur and scientist, on spending a reported $20 million for a 10-day trip in space

EDITED BY CATHERINE ARNST

SECOND ACTS

HANK THE ELDER STATESMAN

BATTLING LAWSUITS hasn't stopped insurance titan Maurice "Hank" Greenberg from continuing to enjoy the spotlight. Even as **American International Group** fights for control of 290 million shares held by Starr International Co., one of three controversial private entities controlled by Greenberg, the ousted chief is busy trying to carve out a new role as the grand old man of insurance.

GREENBERG Still in the spotlight

In recent weeks, Greenberg, 80, has spoken about terrorism risk at a major conference, remarked on the industry's ability to absorb hurricanes, and publicly donated $1 million to Hurricane Katrina victims through the Starr Foundation he heads. That's in addition to discussing how he plans to invest the $17.7 billion pot that's now under dispute. Next up: a trip to China in the coming weeks to meet with the mayor of Shanghai and other high-ranking officials. Greenberg spokesman Howard Opinsky explains that his boss "remains a leading figure in the business community whose insights and experience are tapped regularly by business and political leaders." Opinsky adds that Greenberg "is actively pursuing new ventures." One venture, of course, will be tackling those legal woes. *–Diane Brady*

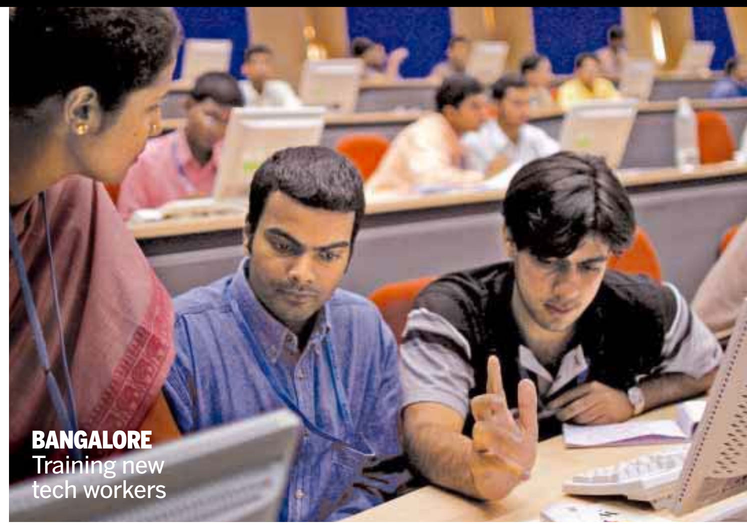
THE BIG PICTURE

WETFEET'S compensation survey found that MBAs expect a starting salary of $93,770, up from $88,840 in 2004. Here's how offers in five industries compare:

CONSULTING	$101,325*
FINANCIAL SERVICES	$90,443
TECHNOLOGY	$86,053
CONSUMER PRODUCTS/PHARMA	$84,184
NONPROFIT	$77,858

* Mean offers, excluding signing bonuses

Data: WetFeet 2005 Student Compensation Report



BANGALORE Training new tech workers

OFFSHORING

Just the Bright Side, Thanks

AFTER HOLDING OFF for more than a year, the Commerce Dept. has quietly released a study of offshoring—the movement of white-collar jobs to low-wage countries. But it's not the even-handed assessment completed by staff analysts in June, 2004, after six months of research. The staff report was largely ditched, say outside experts who heard the staffers' views. Instead, these critics charge, Commerce political appointees put out a 12-page report that portrays offshoring as an unconditional boon to the U.S. economy. The Commerce Dept. did not respond to requests for comment.

Commerce has only released its final report to Rep. Frank Wolf (R-Va.) who ordered it up, but *BusinessWeek* has obtained a copy, as well as a slide show tied to the original research, presented by staffers at a conference last December.

The staff researchers' presentation gave both the pros and cons, comparing factors that favor U.S. high-tech job growth with those that favor offshoring. The official version dispenses with most of the disadvantages. Instead it points to pro-offshoring studies done by McKinsey Global Institute and uncritically cites data from a lobbying group that represents the U.S. subsidiaries of foreign companies. "No objective analysts, even if they were in favor of outsourcing, would write a report like this," says Ron Hira, a professor at Rochester Institute of Technology, who saw the December presentation. To see the slide show and official report, go to www.businessweek.com/extras. *–Aaron Bernstein*

(CLOCKWISE FROM TOP) CHRISTOPHER BROWN/POLARIS; ILLUSTRATION BY DAVID RUDES/BW; MICHAEL PROBST/AP/WIDE

upFront

DAYLIGHT SAVING

RESETTING CLOCKS MAY UPSET PCs

THE ENERGY BILL passed in August will extend daylight saving time by four weeks each year. Could that pose Y2K-like problems for business? Hillel Parness, a litigator at Brown Raysman Millstein Felder & Steiner LLP in New York, who has studied daylight saving time history, argues that every self-adjusting computer or other electronic device will be displaying the wrong time beginning on Mar. 11, 2007, unless steps are taken. He talked with Elizabeth Woyke.

Won't some of these glitches be minor?
Time accuracy on the video of your child's birthday party is probably not very important. But what about security cameras that record who enters a building when? Because the financial markets are international and time-sensitive, there could be serious implications. Prices depend on what time the trades come in. There have been recent investigations with mutual funds that looked at late trading and highlighted the importance of time accuracy.

With PCs, aren't manufacturers likely to develop fixes in time?
They will undoubtedly send out patches to fix things, but a patch is only as good as its installer. If users ignore it or don't know how to upgrade their computers, they're not going to get upgraded. There are sophisticated systems that bring down time from a central location, but a lot of companies don't use them.

What can companies do to prepare?
Companies [should] examine their contracts. To limit potential liability, [they can] add specific protection clauses.

PRIVATIZATION

ROADS TO REVENUE States and cities have a new way to raise money: "For Sale" tags on the Interstate Highway system. On Sept. 28, Indiana Governor Mitch Daniels announced plans to put 157 miles of I-90 up for bids. Daniels also wants to invite private outfits to help build and operate a 142-mile extension of I-69 as a toll road. Meantime, governors of New Jersey and Delaware are urging lawmakers to privatize nearly 400 miles of combined tollways, including some stretches of I-95. The first experiment in a privately owned Interstate shows bright promise: At the start of the year, a Spanish-Australian joint venture paid $1.83 billion for the Chicago Skyway, a 7.8-mile stretch of I-90. The deal took a money-losing toll road off the city's hands, filled a budget deficit, and endowed a rainy-day fund. Seems everything has its price. *–Michael Arndt*

DRAWN & QUARTERED

(CLOCKWISE FROM UPPER LEFT) COMSTOCK IMAGES/ALAMY; JOSEPH SOHM/THE IMAGE WORKS; MIKE LUCKOVICH/ATLANTA JOURNAL CONSTITUTION/CREATORS SYNDICATE

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UP Front

FACE TIME
JEONG KIM

IN SEARCH OF BUZZ AT BELL LABS

Lucent Technologies Bell Labs' new president, Jeong Kim, wants to ensure the vaunted research institute lives up to its reputation for breakthrough technology. He says he's choosing "a selective few bets, so we can make a big impact." That includes using nanotechnology to create speakers and lenses not much thicker than a human hair. Placed on walls and clothes, they could pinpoint a person's location by picking up audio, video, smell, and movement cues. Kim predicts widespread adoption within 5 to 10 years.

Kim, 45, first joined Lucent Technologies in 1998 after the company acquired his communications equipment startup, Yurie Systems. Since his return in April from a teaching gig at the University of Maryland, he has been running the Labs as more of a startup, emphasizing risk-taking, speed, and creativity. Kim believes that his varied experiences will help him promote more new discoveries: "Everything about me is entrepreneurial," he says. *–Elizabeth Woyke*

LIQUID ASSETS
MILLER'S BIG CHANGING OF THE GUARD

IT'S QUITTING TIME at **Miller Brewing,** which means it's also hiring time. The brewer is facing an extreme version of the pending baby boom retirement wave. In the next three years, the Milwaukee beermaker says it has to replace a brewery's worth of salaried staff and three breweries' worth of hourly staff (out of its total of seven breweries). That's because in the 1970s booming demand—including for the new Miller Lite—led to a hiring surge as the company built a factory and staffed up elsewhere. Now those people are ready to call it a day. The average age of a Miller operations worker is 50.

With so many other companies moving their manufacturing work overseas, the brewer has plenty of well-trained workers to choose from. But Miller execs are scrambling to get them in the door before years of beer-making expertise walk out. So managers are hiring brewery workers, including machine operators, three months before they actually take a spot on the line, in order to serve an apprenticeship. And they're debriefing current staff and putting details on how they work into a database. Many top execs have already hit the exits: Since **SAB,** based in London, bought the brewer in 2002, Miller has replaced, among others, its CEO, and heads of finance and marketing. *–Nanette Byrnes*

MILLER LITE The Baby Boom cohort of brewery workers is starting to retire

CLASS NOTES
TEACHING KIDS ABOUT DOLLARS AND SENSE

WHEN IT COMES TO financial literacy, U.S. students typically score an F. Now a for-profit drama group is trying to remedy the problem. The **National Theatre for Children** (NTC) is performing 45-minute shows in New York for middle-school students, using sketch comedy to teach saving, budgeting, and credit.

The Mad About Money program started on Sept. 28 and, with **Citibank** as an initial sponsor, plans to reach 1,000 schools. The NTC has previously created shows on nutrition, energy conservation, and the environment.

Finance may prove a tougher sell, however. Lewis Mandell, a finance professor at the **State University of New York at Buffalo,** was hired by the NTC to evaluate the impact of its new presentation. Mandell oversees a biennial survey of financial literacy among high school seniors. In the 2004 survey, 65% failed a personal finance test. By targeting younger kids, Mandell hopes this show won't bomb. *–Mark Walsh*

THE STAT

95

Percentage of Americans who aren't getting enough Vitamin E in their diets. 40% aren't getting enough Vitamin A. 33% don't get enough Vitamin C.

Data: U.S. Agricultural Research Service's Food Surveys Research Group

(CLOCKWISE FROM TOP RIGHT) DARREN HAUCK/BLOOMBERG NEWS; INDEX STOCK IMAGERY; ANTON + PREHN

ReadersReport

> “Your account of Ballmer's vicious tirade against an employee who had jumped to a competitor was truly frightening to read.”

–Mike Van Winkle
Ridgefield, Conn.

READING BETWEEN THE LINES AT MICROSOFT

HAVING WORKED at Digital Equipment Corp. for 20-plus years before its acquisition by Compaq and eventually by Hewlett-Packard, I find the parallels between Digital and Microsoft Corp. frightening ("Troubling exits at Microsoft," Cover Story, Sept. 26). Both companies were founded and run by singular individuals: Ken Olsen for Digital and William H. Gates III for Microsoft. Both companies relied on one or two products for much of their revenue: Digital on its VAX systems and Microsoft on Windows and Office. Both companies had extremely strong balance sheets. Digital for a while was one of the very few companies with an AAA bond rating.

At their zeniths, both companies had employee benefits that were the envy of the industry: Digital with family days at the local parks, turkeys for employees during the holiday, and exercise facilities at its main plants; and Microsoft as detailed in your article. Both companies began losing their top employees. When the competition got tough and the stock market demanded better results, both companies reduced employee benefits that had little impact on the bottom line but a lot of negative impact on employee morale: bottled water at Digital and towels at Microsoft.

Both companies viewed their stock as undervalued and spent billions buying back shares. Both companies had many reorganizations. I hope the parallels end here—Digital no longer exists.

–Gim P. Hom
Cambridge, Mass.

WITH 25 YEARS of experience as a human resources and organization consultant, I found the hollow phrases of Ballmer and his evasive response to the pointed questions of your journalists very recognizable. I've heard and seen them before in numerous companies where, soon afterward, the chief executive and the organization were in deep trouble and totally "surprised." The obsessive need for good news and confirmation of one's wishes completely cuts some top executives from the reality of their company. The gap between the described reality within Microsoft and the CEO's response is such that a crisis is unavoidable.

If 15% of Microsoft's employees are dissatisfied with the way things are run, chances are that a large number of those

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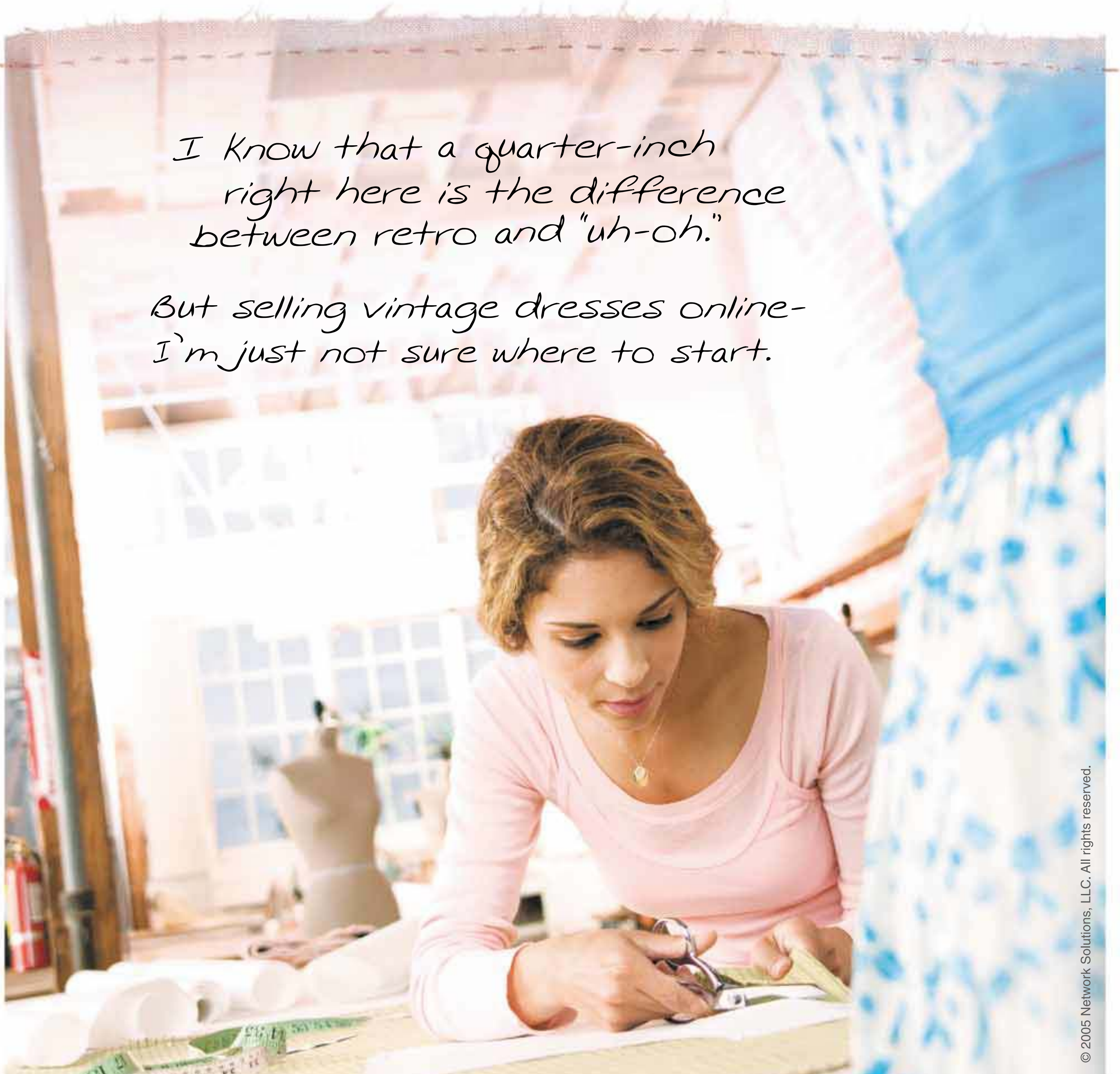

I know that a quarter-inch
right here is the difference
between retro and "uh-oh."
But selling vintage dresses online-
I'm just not sure where to start.

Readers

CORRECTIONS & CLARIFICATIONS

"A vodka from the land of its birth" (Up Front, Sept. 26) should have noted that Stolichnaya brand vodka is distilled in Russia and bottled in Latvia.

"Taking the taint out of giving" (Social Issues, Sept. 26) should have stated that fulfillment of *Zakat,* which requires Muslims to give to the poor, is based on net worth, not income; the accompanying table should have reflected net worth figures.

are among the top new talent of the company. When (not if) they walk, the downward spiral will be impossible to stop. Let Steve Ballmer stop worrying about the short-term "needs" of his shareholders and concentrate on the long-term survival of the company they entrusted to him.

–Herman J. Hoolants
Antwerp, Belgium

READING this was like reading about IBM 20 years ago.

–Cliff Chapman
Hayling Island, Hampshire, England

STEVE BALLMER is not creative or sensitive enough to nurture a culture of America's best and brightest techies. Your account of Ballmer's vicious tirade against an employee who had jumped to a competitor was truly frightening to read. It should have been reason enough for Bill Gates and Microsoft's board to fire him. Taking that action would, indeed, have met some high expectations—those of Microsoft employees, stockholders, and suppliers.

–Mike Van Winkle
Ridgefield, Conn.

A MILES-PER-GALLON INDICATOR COULD HELP FUEL EFFICIENCY

THE MILEAGE gains attributed to the various design changes you reported were indeed impressive ("Getting more miles to the gallon—fast," News: Analysis & Commentary, Sept. 26). However, you—and auto designers, apparently—seem to have overlooked a simple and potentially effective design measure which could also bring savings of as much as 10% to 20%: Why don't all of our cars now have miles-per-gallon indicators in prominent view of the driver? This instantaneous feedback of driving efficiency could quickly train drivers to operate their vehicles in a fuel-sparing manner. An alarm light or sound, activated by wasteful acceleration, could provide behavior-shaping feedback.

Most modern cars get maximum fuel efficiency at speeds between 35 and 55 mph, so an incentive to drive less than 55 would save huge amounts of fuel nationally and would likely reduce the death rate by 5,000 to 10,000 fatalities a year (as the 55-mph national limit did several decades ago). Such a device could potentially repay its costs within a few months.

–Karl Albrecht
San Diego

WHY DEREGULATION AND TRANSPORTATION DON'T MIX

JAMES ELLIS' explanation of the dysfunctional airline industry strengthened my conviction that it's time for Congress to reconsider its 1978 deregulation of virtually every aspect of the industry except safety ("The law of gravity doesn't apply," News: Analysis & Commentary, Sept. 26). Reregulation of capacity would be a first step, and perhaps the only required step, toward bringing sanity to the industry. A combination of entry regulation and route regulation could force capacity out of the system and, long term, buoy prices.

The airlines' knee-jerk opposition to any form of economic reregulation, even though it would be a good tonic for them, has contributed to the long industry slide of the past 27 years.

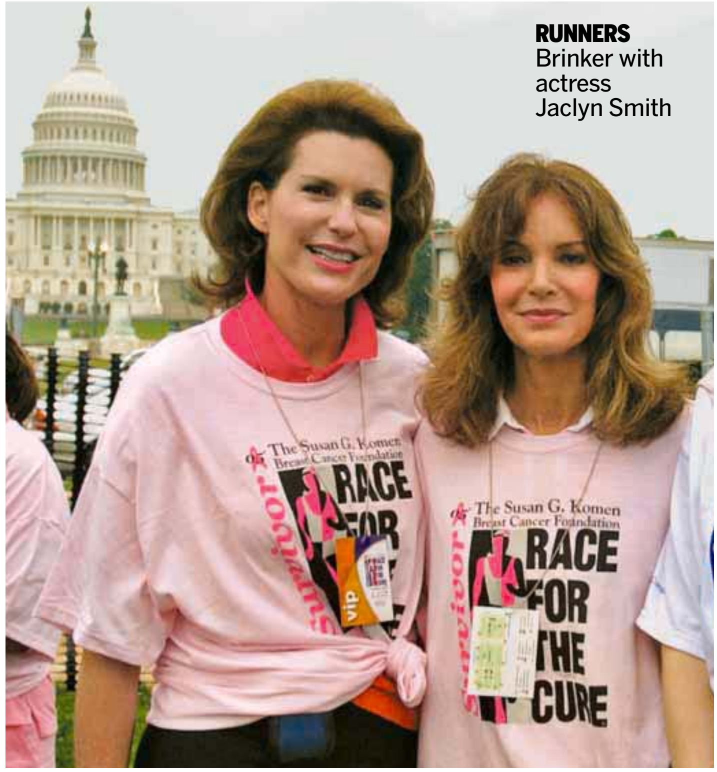
–Tom Woodall
Rockville, Md.

FORGET WIRED. HOW ABOUT A SOUNDPROOF HOTEL ROOM?

THE MOST IMPORTANT feature of any hotel is rarely mentioned: peace and quiet ("Marriott hip? Well, it's trying," Marketing, Sept. 26). I will pay a hefty premium for soundproofing.

–Paula Berinstein
Thousand Oaks, Calif.

Promise Keeper



RUNNERS Brinker with actress Jaclyn Smith

LINDA SPILLER/RACE FOR THE CURE VIA GETTY IMAGES

IN 1981, NANCY G. BRINKER made a promise to her sister, who was dying of breast cancer at age 36. The public relations consultant vowed that she would work to spare other women from suffering in the same way. It was a dramatic gesture, and it led to a dramatic result: A year later, Nancy formed the Susan G. Komen Breast Cancer Foundation, named after her sister. Having no fortune of her own, she needed a way to both raise money and draw attention to the cause. The novel solution, which she arrived at while jogging, was to start a series of five-kilometer charity runs named the Race for the Cure.

Such events are now ubiquitous (BW—Sept. 19), but the 1983 Race for the Cure was one of the first. And it has become one of the largest. Last year 1.5 million people in the U.S. and abroad participated in the Race for the Cure, raising $97 million in the process. Since its inception the Komen Foundation has collected more than $630 million for breast cancer research, education, screening, and treatment, and is considered a prime mover behind the progress in treatment since the 1980s.

Race for the Cure has been key to funding advances in breast cancer research

At the time that Brinker founded the Komen Foundation, breast cancer was rarely discussed in public and was a low priority in oncology research, despite the fact that it strikes one in seven women. Brinker, 58, says: "I told my sister I would change this if it took me the rest of my life." She initially approached various charitable groups, but none was interested in focusing on breast cancer. So in 1982, Brinker gathered 20 women in her living room and asked for their help. "The oil business was booming in Texas back then," she says, and the group was able to raise $1 million in a year. But it was the Race for the Cure that made Komen a mega-foundation. The events also jump-started local chapters, which keep 25% of the money they collect for community education and screening.

Most important, the foundation has doled out more than $180 million in research grants. "There is hardly an advance in the science of breast cancer over the past 20 years that hasn't been touched by a Komen grant. That's what I'm most proud of," says Brinker, who survived her own bout with breast cancer in 1985. Scientists in the field acknowledge that Brinker's fund-raising, and the attention the Komen foundation has drawn to the disease, have played a large part in improving the prognosis for patients. Breast cancer death rates have dropped 2.3% a year over the past decade, a greater improvement than any other of the five leading cancer killers. When the tumor is caught early, women have almost a 100% chance of survival. "The advances we've made and continue to make are directly related to the involvement of the breast cancer advocacy community," says Dr. Larry Norton, chief of the breast cancer program at Memorial Sloan-Kettering Cancer Center. "Nancy is clearly a very early and important part of that effort."

In honor of her work, and for setting a template for other advocacy efforts, Brinker was awarded the prestigious Mary Woodard Lasker Award for Public Service in September. Brinker, said the Lasker Foundation, "dramatically increased public awareness about this devastating disease." Still, Brinker says her promise to her sister is far from fulfilled. "We remain focused on one thing—a world without breast cancer," she says. "We will continue to address causation, as well as the disparities in treatment in medically underserved populations."

So Brinker continues to Race for the Cure. In September she did those five kilometers in Budapest. ■

–By Catherine Arnst

BusinessWeek online For updates on advances in breast cancer screening and treatment plus a Q&A with Monique Doyle Spencer, author of *The Courage Muscle: A Chicken's Guide to Living with Breast Cancer*, go to www.businessweek.com/extras

Technology&You

BY STEPHEN H. WILDSTROM

Laptops: Now the Big Picture

If you have cruised the laptop aisle of an electronics store lately, you've probably noticed that nearly all the models on display sport wide screens like those on large-screen televisions. But if you work for a corporation or in government, you're not likely to see a wide-screen model around the office. Do consumers know something corporations don't?

They sure do. Over the past couple of years wide-screen displays ranging from 14 in. to 17 in. have come to account for the great majority of laptops sold in the retail market, which includes consumers and many small businesses. But when it comes to the enterprise, the three big makers of business laptops, Dell, Hewlett-Packard, and Lenovo, say that most information technology buyers won't even consider wide-screen designs.

The reasons are murky. Part of it seems to be the resistance to change that corporate IT managers show in all sorts of decisions. Part seems to be based on the assumption that the only thing wide screens are good for is playing DVDs—and corporate laptops are for work, not fun.

I was converted to the virtues of wide screens when I began using Apple PowerBooks. These were among the first popular models with screens whose width is 1.6 times their height, versus 1.25 times for a conventional display. For the past couple of weeks I have been using a ThinkPad Z60t—priced at $1,099 and up—a design that I think should be the future of computing for mobile executives. It's especially appealing with the optional built-in radio for Verizon Wireless's speedy, $40-a-month BroadbandAccess service. But because of the corporate disdain for wide screens, Lenovo is pitching the Z60t to small and midsize businesses.

THE Z60T FEATURES a 14-in. wide-screen display. Unlike the screens on most consumer-oriented notebooks, it has a helpful antiglare coating that's optimized for text and graphics rather than video. The computer weighs 4.6 lb., about 5 oz. less than the corporate workhorse T-series ThinkPad. Its 1-in. thickness is the same as the T's, but it's about an inch wider and an inch shallower front to back. The wide-screen design provides several advantages. For one, less depth translates into a lower profile when open. So when you're flying, the Z60t sits comfortably on a coach tray table, while the taller T (or a competitor such as a Dell Latitude D610 or an HP Compaq nc6200) barely fits. The screen offers more than 90% of the viewing area of the 14.1-in. standard display of a T-series. And the Z60t screen is a lot bigger than that of an airplane-friendly ultralight with a 12.1-in. standard display. As a bonus, the extra width allows for a no-compromises full-size keyboard.

LATERAL EXTENSION Adding a sideline lets you see more

Wide screens aren't just for movies. They also open out windows and spreadsheets

Working with the wide-screen display has convinced me that it's not just for movies. Compared with a standard screen, less of a typical page is visible without vertical scrolling. But the width makes it much easier to work with two windows side by side. I find it convenient, for example, to keep my e-mail open in one window with a word processor document or a Web page open next to it. A wide screen also offers room for one of the increasingly popular sidebar programs, such as Google Desktop. You quickly see the efficiency of a horizontal layout. And, of course, it's a big advantage for wide spreadsheets.

I expect that the corporate antipathy toward wide screens will eventually break down. As panel makers crank them out in greater volume, prices will come down—and price is something corporate IT departments understand.

By the middle of next year I think the workhorse corporate notebook will come with a 14-in. or 15-in. wide-screen display. And there will be 12.1-in. wide screens for laptops weighing less than three pounds. You may find the changes a little odd at first, but once you get used to wide screens, there's no going back.

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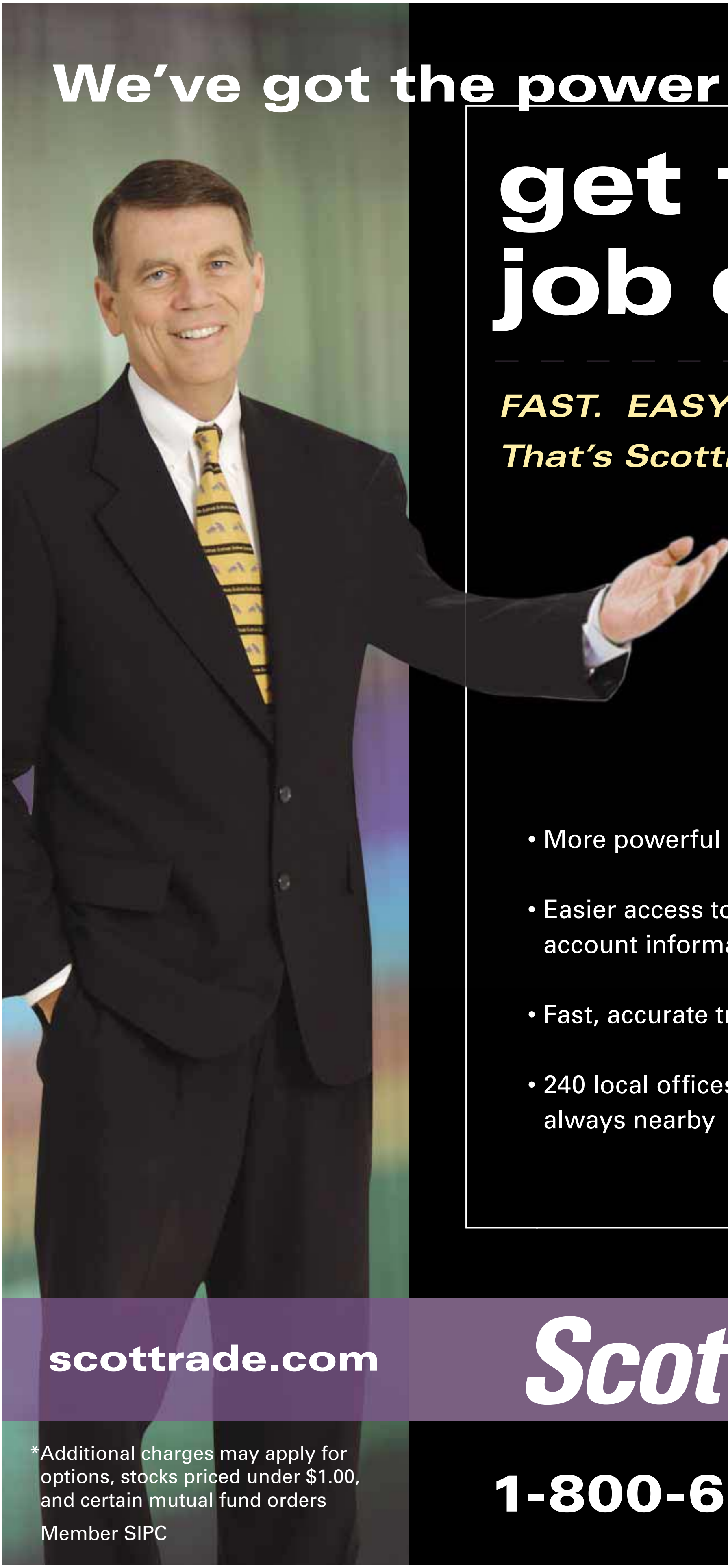
(TOP) PHOTOGRAPH BY ETHAN HILL

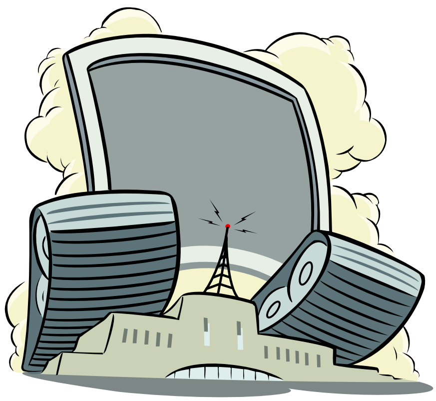


MediaCentric BY JON FINE

Media, Marketing, and Advertising in the 21st Century

Old Media's Lame-Duck Days

Remember merger mania? Remember the bigger getting bigger yet? Remember when the prices of media stocks weren't stalled? ❡ Me neither. ❡ DreamWorks and NBC Universal go deep into talks. Microsoft and Time Warner play footsie over a possible MSN/AOL link-up. In both cases, news of the talks leaks. The gasbags start gasbagging. The headlines get teed up. And...nothing happens.



Welcome to the new modesty. The moment of non-mergers. This is appropriate because the media landscape is slowly repopulating with non-moguls. (Was that Michael D. Eisner walking the halls at an investor conference last month before watching his successor Robert A. Iger from the audience? Yes.)

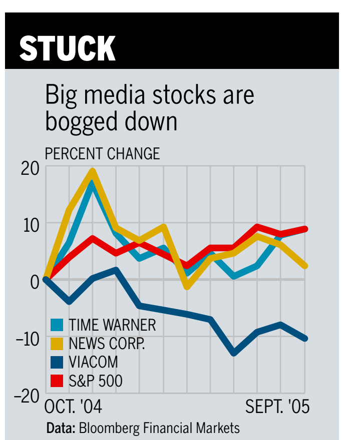
The modesty is appropriate because something existential is happening. The traditional players face big questions: How far do old-media skills get you with new-media consumers? Put another way: Does business sense translate across generations? These have implications for everyone from News Corp.'s Rupert Murdoch to Yahoo! Inc.'s Terry S. Semel, the old-media guy riding the new-media rocket.

LATE 2005 MAY BE REMEMBERED as the interregnum between the era dominated by the old media giants and the one in which Yahoo! and its ilk began running things. (This is the Big Media analogue to the Ford and Carter Administrations.) But it's hard to advance when events keep one rooted in the past, and to a remarkable degree many big old-media guys still live with the aftertaste of deals from a faraway, much happier time.

This is not just about Time Warner's love-hate-love mood swings with AOL or Viacom Inc. splitting itself in two. Tribune Co.—one of the least mogul-y big media conglomerates—now has a tax liability of $1 billion, give or take, from its 2000 acquisition of Times Mirror. That deal, for $8 billion, magically magnified Tribune's presence among major-market newspapers by netting it the *Los Angeles Times* and *Newsday*. It turns out, in 2005, those are exactly the kind of newspapers you don't want to own because new-media competitive pressures are most intense in big cities. (That deal also brought Tribune the Spanish-language daily *Hoy*, which, along with *Newsday*, got the company in serious trouble last year by misrepresenting its circulation to advertisers.) Tribune's stock price just before the Times Mirror deal: $34.92. Today's price at the close of the third quarter: $33.61.

O.K.

So if some big old-media deals look bad, are big new-media deals good? Especially if, let's say, they're for assets teeming with traffic from the young consumers who allegedly shun old media? Well, ask News Corp. and New York Times Co. how well their stocks didn't do after they bought myspace.com parent Intermix Media Inc. and about.com. News Corp. has spent $1.3 billion on young-skewing online buys within two months, and Murdoch has been relentless in discussing the need to grab younger consumers. But so far the Street is skeptical (chart).



If acquiring bits and pieces isn't budging the stock price, what will? It's extremely difficult for an old-media player to build a serious new-media asset. There are established competitors. There are generational issues. (Myspace would not have become myspace had it been launched by News Corp.) And there are the quarterly numbers that Wall Street demands—when it's not whacking the moguls for being too dependent on mature businesses.

To move the needle right now, you need something massive. You need, for instance, to buy Yahoo. Of course, today it's too late to buy Yahoo. Today, Yahoo buys you. Assuming, that is, that Yahoo thinks its business sense can cross the generational divide. Or that it's even worth the bother. ■

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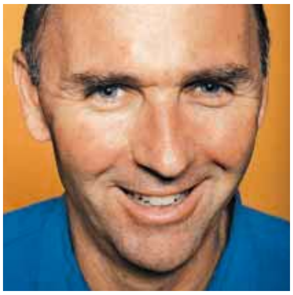
PHOTOGRAPH BY ETHAN HILL; ILLUSTRATION BY MARK MATCHO; CHART BY ERIC HOFFMANN/BW



The Barker Portfolio

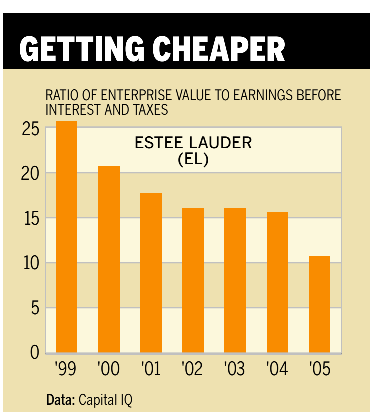
BY ROBERT BARKER

A Beauty in the Bargain Bin

What's the critical difference between a Micro-D Deep Thermal Refinisher and a Resilience Lift Extra-Firming Revitalizing Mask? Don't ask me. But you don't have to be a discerning consumer of Estée Lauder's multitudinous potions to spot an opportunity in the cosmetics maker's shares, which since January have worked their way down some 26%.

The latest blow fell late in September, after the New York company warned investors of weaker earnings in the first quarter of fiscal 2006. The stock sank below 34, a depth not seen in two years. Just the same, a glance at Estée Lauder finds it's hardly about to go the way of its eponymous founder, who died last year. A closer look finds a company of substance that has tumbled into the bargain bin.

YES, LAUDER IS SHOWING some wrinkles and warts, not least the ongoing consolidation of its primary outlets, department stores. Lauder's two biggest customers, May Department Stores and Federated Department Stores, completed their merger in August. That's one reason behind the slowdown in sales. Nor did it cheer investors to learn that Ronald Lauder, one of the founder's sons and a director, sold some stock just days before the company's profit warning. A spokeswoman notes that Lauder's sale amounted to a small part of his stake and that "he continues to be a committed shareholder." Insider sales—at Lauder or any other company—are never bullish. More meaningful to me, however, is what Chief Executive William Lauder (Estée Lauder's grandson) did in September when he exercised options on 50,000 shares, which were due to expire in November. He did not then turn around and sell the shares, as often happens with exercises of employee options, but is holding them.



In any case, the company's financial statements hardly offer a rationale for dumping Lauder. The company has amassed a strong balance sheet. At last report, cash came to $553 million and total debt to $715 million. Its debt-to-capital ratio, a bit below 30%, is less than at rival Avon Products (50%), never mind Revlon (a financial fright with a negative net worth). Even after capital spending of $230 million and paying $90 million in dividends, Lauder still had produced more than $159 million of free cash flow during fiscal 2005, ended last June.

ESTEE LAUDER AD Paltrow stars in a new campaign to lure younger buyers

What's more, Lauder isn't shrinking—it's just growing more unevenly than it had expected. This fiscal year the company still sees sales rising perhaps 6%, not counting foreign-exchange effects, but with a speedier second half making up for a slowing in the summer quarter. Notably, Lauder is now deducting from its reported earnings the cost of granting stock options as employee pay, an expense it figures will come to 14¢ or so per share this year. Even after that charge, Lauder expects that its widening profit margins will produce earnings per share this year of at least $1.95. If reached, that would be a gain of nearly 17%.

To feed growth, Lauder is counting on more gains abroad, not just in Europe but also in such Asian markets as Hong Kong, Taiwan, and China. Back home, it has been developing lower-priced brands, such as American Beauty, Good Skin, Grassroots, and Flirt!, which it's pushing through Kohl's, a growing chain. All told, including its core Estée Lauder and Clinique lines, Lauder now has a total of 26 brands, including many it is selling via the Web or in their own stores. One such brand is Origins, a line of natural-ingredient lotions and cosmetics with 131 freestanding outlets. Finally, the company is hoping to attract younger women to the flagship Estée Lauder line with the face of actress Gwyneth Paltrow, soon to appear in holiday ads for the fragrance Pleasures.

Any of these initiatives may falter, but such risks today strike me as well reflected in Lauder's price. Near 35, the stock goes for a multiple of enterprise value to operating earnings of under 11 (chart). The stock also yields 1.1%. Think of the payout as a gift with your purchase.

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TOP PHOTOGRAPH BY ETHAN HILL; CHART BY ERIC HOFFMANN/BW

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IS WAL-MART TOO POWERFUL?
Page 100

BY JAMES C. COOPER & KATHLEEN MADIGAN

Rate Pressure Starts Leaving a Footprint

A turn in bond-market sentiment will help to tamp down the housing boom

U.S. ECONOMY Has the bond market blinked? After more than a year of resistance to rate hikes by the Federal Reserve and continued economic strength, bonds finally seem to be giving some ground. And unlike other short-lived sell-offs that pushed bond yields higher, this recent pickup in long rates appears to reflect a more lasting shift in bond market sentiment. If so, then the Fed's efforts to keep the economy from overheating will take hold. And importantly, housing will continue to cool off.

What's different now? One, the Fed has made it clear that it stands ready to lift short-term rates more than the bond market had expected. Two, new reports suggest that the industrial sector is not rolling over in the wake of Katrina and higher energy prices. Three, inflation outside of energy may not be as tame as previously thought. And finally, post-hurricane relief efforts from Washington promise to swell federal financing needs, putting additional upward pressure on yields.

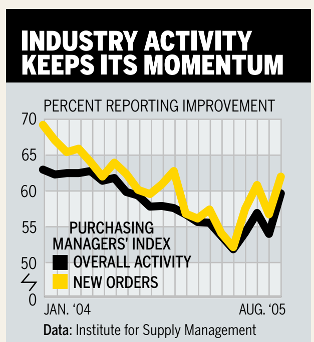
All this means that prospects for an end to Fed tightening and the continued quiescence of inflation are not as certain as bond investors once thought. Except for temporary breakouts in 2003 and 2004, the yield on a 10-year Treasury note has been in a tight range of 3.5% to 4.5% for over three years. Already the yield on a 10-year Treasury bond has risen from 4% in late August to nearly 4.4% in early October before backing down a bit by Oct. 5.

To be sure, a weak output or inflation number will always cause at least a brief rally in the bond market. But if Fed actions and economic data continue to reinforce the idea that inflation is a threat, long rates, including mortgage rates, will keeping rising well into 2006.

AFTER ALL, inflation expectations are, for the most part, what determine bond prices and yields. And the latest words from the Fed sound unexpectedly hawkish about inflation prospects, with increased concern over the possible pass-through of higher energy costs into prices generally. For example, on Oct. 4, Federal Reserve Bank of Dallas President Richard W. Fisher, a voting member of the Fed's policy committee, said: "Now, the inflation rate is near the upper end of the Fed's tolerance zone, and it shows little inclination to go in the other direction."

This new tone highlights a change in Fed thinking about the possible impact of higher oil prices on the economy, a view now being echoed in the bond market. Previously the mindset was that costlier oil hurt economic growth more than it lifted inflation outside of energy. Spiking oil and gasoline prices tended, therefore, to bolster bond prices and keep yields low.

But the economy has only bent, not cracked, under $3 per gallon gasoline. The Institute for Supply Management's index on activity in the nonmanufacturing sector fell sharply in September from August, but it still indicated continued growth. And the ISM's index of manufacturing activity was a real head-turner (chart). That index showed that the industrial sector's momentum accelerated last month. It scored its largest monthly gain since 1991, reaching the highest level in more than a year. Readings on orders, production, and employment all strengthened from August. The advance suggests industries outside the storm-affected areas are on the upswing and that they are starting to benefit from relief and rebuilding activity.



The ISM results are in line with a survey by the Business Roundtable, which shows that corporate leaders aren't overly concerned about the hurricanes' impact on their companies. Clearly, the business sector, with a big assist from government spending, looks ready to make up for whatever consumer demand the economy may lose.

BUSINESSES MAY FEEL MORE SANGUINE about the future because higher energy costs, along with an economy growing near its full capacity, give them more cover to mark up prices. Indeed, a worrisome part of both ISM reports for bondholders was the fact that the prices of an increasing number of goods and services are rising.

Pricing power will be heightened by the additional supply constraints caused by the hurricanes. The ISM reported a large increase in companies reporting slower delivery times for goods ranging from textiles to furniture to metals to various types of industrial equipment. Those delays suggest production and distribution bottlenecks that make it easier to pass along price increases.

One important test of companies' ability to cope with

CHARTS BY ERIC HOFFMANN/BW

costlier energy will be the performance of third-quarter profits, on which reporting will begin soon. If earnings outside of energy companies hold up well, then greater pricing power is undoubtedly helping to shore up the bottom line. But evidence of more pricing power will only add to the bond market's uneasiness.

IF SO, THEN WATCH for higher rates to bring about an end to this decade's housing boom. Indeed, it's looking as if housing peaked this summer. Of course, anecdotes aren't enough to indicate a slowdown, since sales typically fall off after the summer because families want to move before the school year begins. But the seasonally adjusted data also show housing's roar is quieting down.

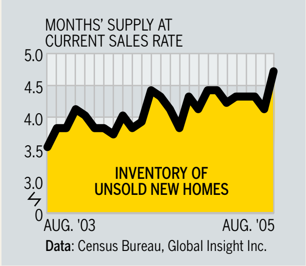
For one thing, more homes are available for sale. Builders are holding a 4.7 months' supply of unsold new homes, the highest rate in more than five years (chart). And the inventory of unsold existing homes, as seasonally adjusted by Business Outlook, shows that months' supply has been trending higher since April.

Moreover, the National Association of Home Builders/Wells Fargo housing market index fell to 65 in September, the lowest level in more than two years. The NAHB said the report did not include responses from Katrina-hit areas, which make up just 2% of the survey. But builders elsewhere are increasingly concerned about mortgage rates, buyer resistance to high home prices, fuel costs, and lot shortages.

A cooler national housing market would come at a good time, since much of housing industry's resources will shift to the Katrina rebuilding effort in 2006. That means measures of housing starts and residential investment, which go into the calculations of real gross domestic product, won't slip by much next year.

But outside the hurricane area, higher mortgage rates will dampen home sales and price increases. Remember that affordability is a function of monthly payments. At 5.5%, home buyers face a $557.75 monthly payment for every $100,000 borrowed on a 30-year fixed mortgage. At 6.5%, the payment jumps to $618.83. Given the squeeze on budgets from higher energy bills (page 36), buyers will have less leeway to bid up prices. And with the rising inventory of homes out there, some local markets may be shifting to favor buyers over sellers.

ONE SIGN THAT HOUSING IS COOLING OFF



Data: Census Bureau, Global Insight Inc.

Credit is the lubricant that keeps the economy moving smoothly. But with price pressures growing at a time when the federal government may be borrowing at a record pace, investors are likely to want a fatter return on their money, slowing the demand for big-ticket items such as cars and homes. Higher rates won't cause a big slump next year, but expect them to pour some sand into the economy's gears.

FRANCE

Consumers Lose Their *Joie de Vivre*

WITH ENERGY PRICES soaring, the outlook for French consumers will depend greatly on the labor markets.

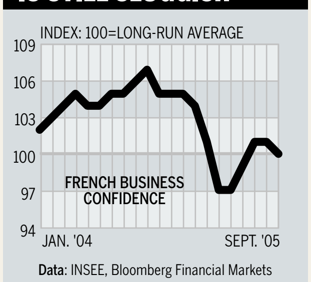
Consumer spending was healthy over the summer, with price-adjusted demand for manufactured goods up 1.2% in July and 1.9% in August. But retailers had to use discounting to draw in shoppers, and incentives helped to lift vehicle sales in September as well.

Consumers are more price-conscious because rising fuel bills are eating into their budgets. Higher energy costs pushed total yearly inflation from 1.7% in July to 1.9% in August, and given the September oil spike, inflation probably rose further last month.

Consumer confidence inched up in September thanks to better-looking job markets. The jobless rate held at 9.9% in August, staying below 10% for the second month in a row. But public subsidies to hire entry-level workers helped cut the number of jobless workers younger than 25 by 1.2%. The number of unemployed workers aged 25 to 49 rose.

Future progress on the job front will depend on the private sector, and here the news is mixed. Business confidence remains sluggish, although hiring plans have picked up a bit. And purchasing managers were slightly more upbeat in September, but their view on jobs fell to the lowest reading in two years.

BUSINESS SENTIMENT IS STILL SLUGGISH

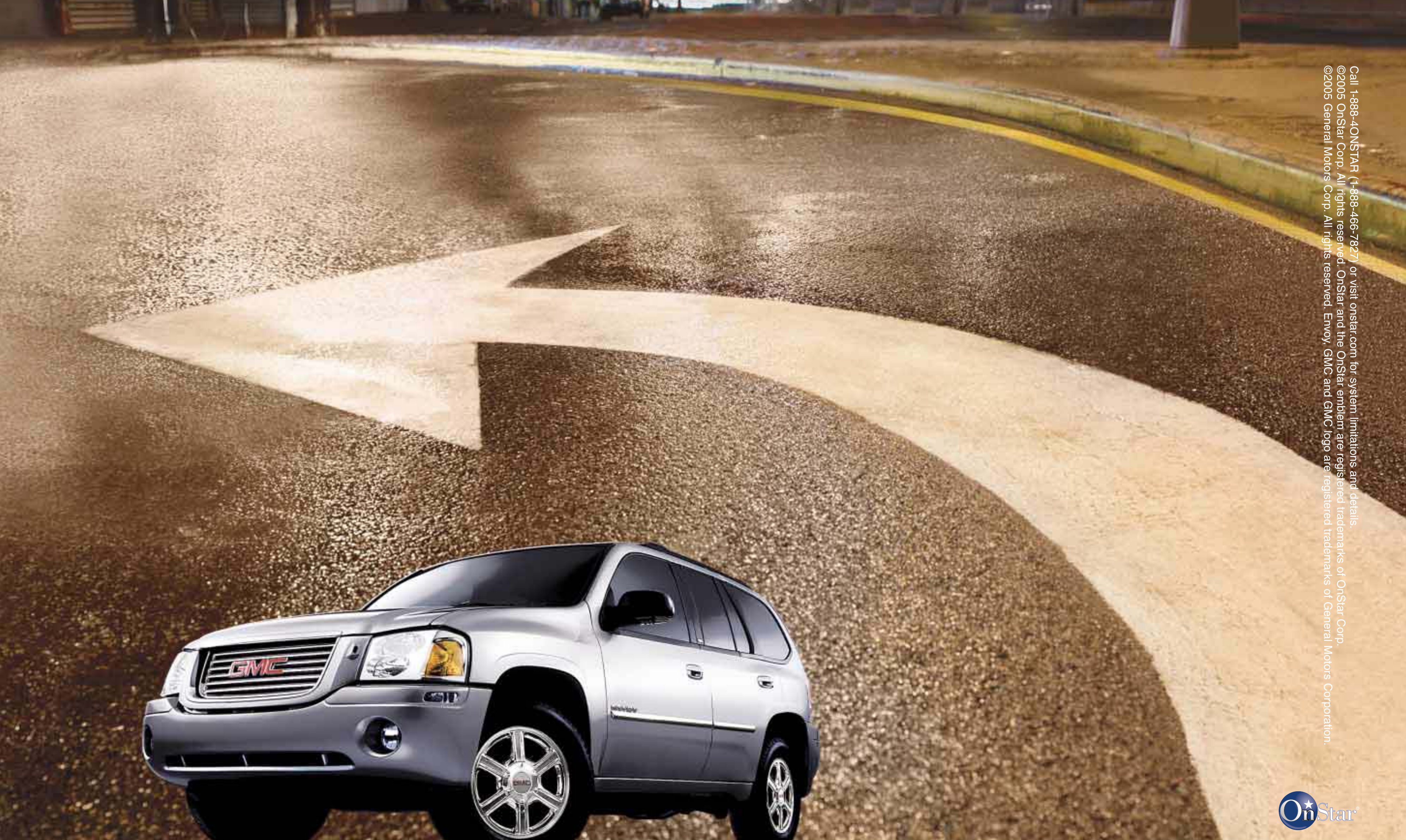


Data: INSEE, Bloomberg Financial Markets

What may hold back hiring in coming months is that businesses have so little pricing power. The September purchasers' survey showed energy costs helped push up input prices, but the index for output prices declined. The imbalance is squeezing profit growth.

Private economists expect that French real gross domestic product will struggle to meet the government's growth forecast of 1.5% to 2% this year. Prime Minister Dominique de Villepin has proposed tax cuts and spending increases to lift growth over the next two years.

Such budget changes guarantee that France will—once again—miss the European Union's target of keeping a fiscal deficit to less than 3% of GDP. But the government may be willing to bust the budget. After all, presidential elections are set for 2007, and France has not met the deficit requirement since 2001.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THE ECONOMY

LIVING TOO LARGE IN EXURBIA

Big houses. Big cars. Now, bigger bills. A lifestyle built on cheap energy and cheap credit is jeopardy

BY MARK MORRISON

FOR THOSE WHO MADE THE exodus to the rolling farmland of Loudoun County, Va., over the past decade, the trade-offs were well understood. Stake a claim to the exurban dream in newly sprouted developments with bucolic names like Farmington on the Green and Hirst Farms (going price: $600,000 and up), and you got a brand new house on a quarter acre. Excellent schools, the small-town charm of antique shops, and historic courthouses were also part of the package. And just watch your home value soar, by an average 23% in the past two years.

The downside? Everyone wanted to join you. Population in Loudoun grew 41% between 2000 and 2004, faster than any other county in America. Road construction couldn't keep up, so traffic is often a nightmare. Even on the weekend, the drive into Washington takes an hour and a half. At rush hour, figure on two. Caterpillar tractors and orange highway construction cones have taken the place of the horses and cattle that used to dot the hillsides. Still, it all seemed worth it to those like Andrea O'Hara, who moved from Pittsburgh with her husband and three children a year and a half ago. "We love it here," says O'Hara.

DIVERSE INCOMES

THESE DAYS, THOUGH, a chill is sweeping through the fast-growing exurbs that have popped up like mushrooms on the outskirts of established cities and suburbs all across America. A lifestyle built on cheap energy costs and low mortgage rates is in jeopardy. Consumers who hardly gave a thought to gassing up when regular was $1.50 a gallon are abandoning their hulking sport-utility vehicles and pickups, signing up for carpools, and leaving the motorboat in the backyard now that prices are stuck at nearly twice that. And with heating bills expected to jump as much as 70% for many this winter, more pain is on the way.

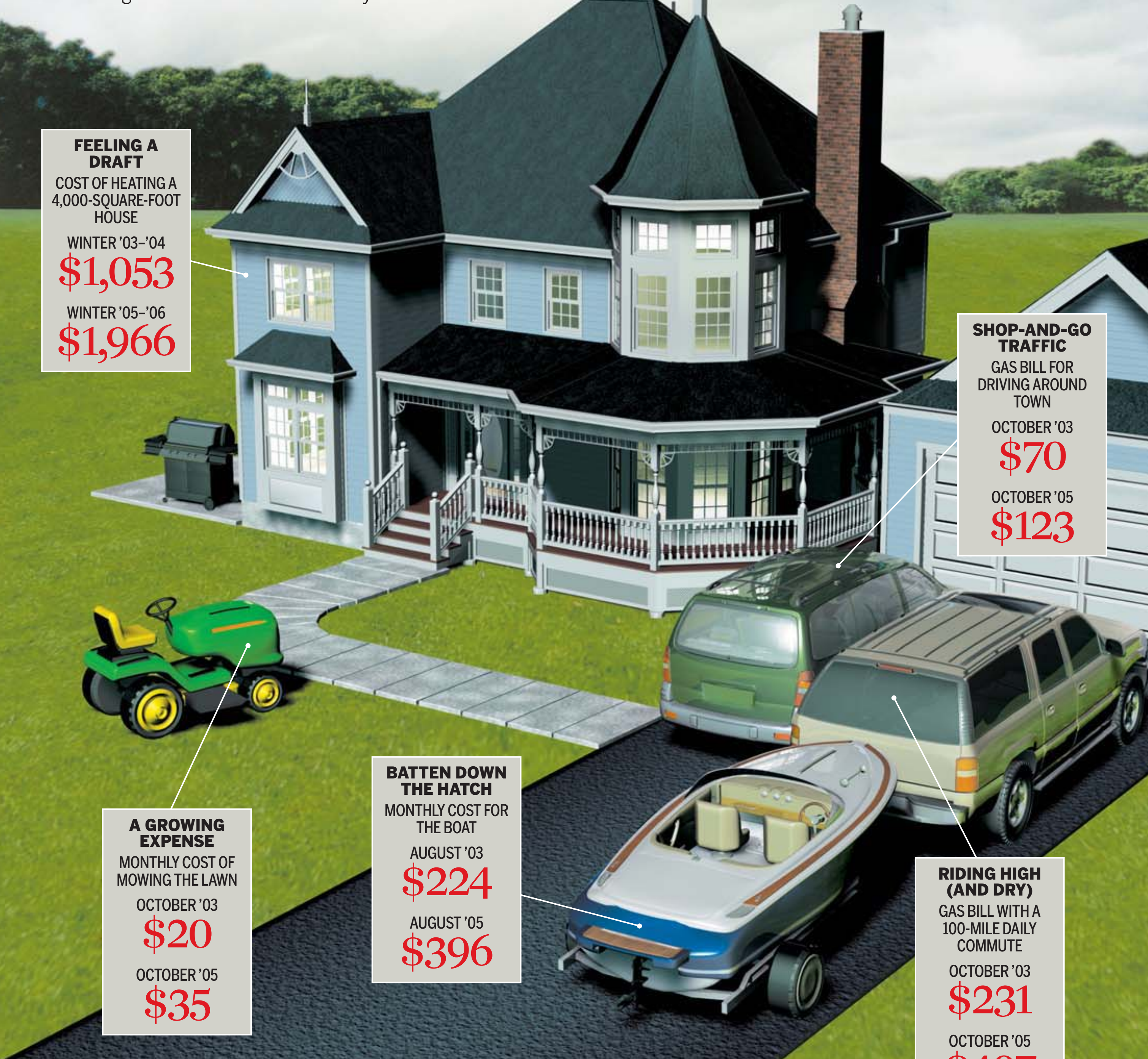
Experience says that most Americans will turn down their home thermostats and break out the fleece. But if super-high energy prices persist for the next few years, as now appears increasingly likely, they will put a world of hurt on the thousands who already were stretching their budgets to live in the outer suburbs and rural fringes. As exurbia struggles with this new hurdle, what has grown into a huge new social and economic force will face its first real challenge.

Love them or hate them, the exurbs are

ILLUSTRATION BY ROGER KENNY, JOE CALVIELLO/BW; BACKGROUND PHOTOGRAPH BY CHARLES GULLUNG/GETTY IMAGES

Pricier **Dreams**

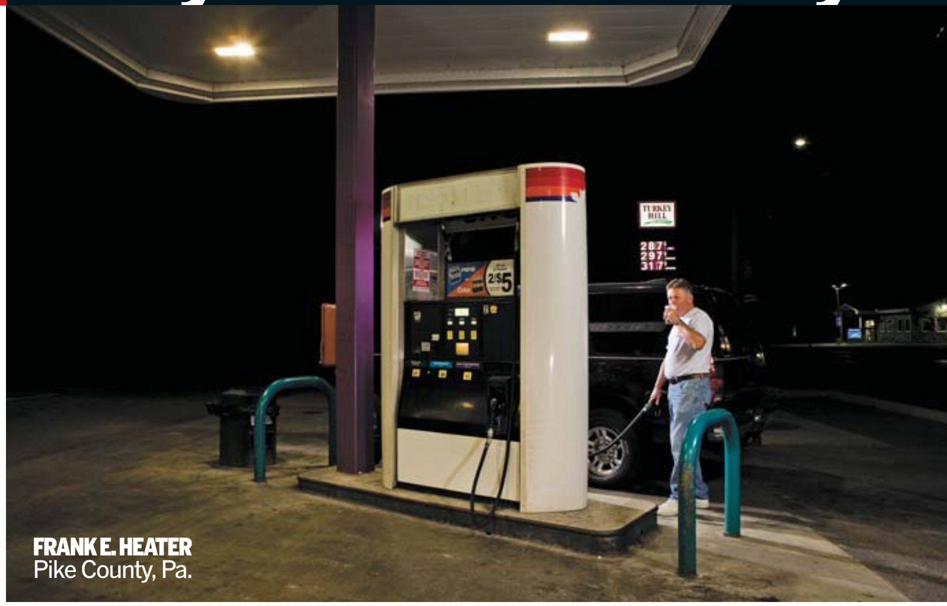
The Exurban Dream is all about freedom—a spacious house, powerful SUV and roomy minivan in the two-car garage, and lawn as far as the eye can see. But rising prices of gasoline and heating fuel, viewed here through a hypothetical Chicago exurb, are forcing some to reconsider their lifestyle.*



* Numbers based on a 2004 Chevy Suburban 4WD with 16 mpg used to commute 100 miles a day during the week and driven 30 miles a day on the weekend; a 2004 Pontiac Montana FWD with 22 mpg driven 30 miles a day; a 20-foot Chris-Craft Speedster taken out 4 days a month and refilled once per outing; a John Deere L100 riding mower used 4 days a month on a 2-acre lawn; natural gas heating **Data:** Energy Information Administration, U.S. Energy Dept., Chris-Craft Corp., *BusinessWeek*

playing an increasingly important role in America's cultural landscape. In the minds of critics, the exurbs tend to attract conservative young families whose communities and lives often revolve around megachurches. Liberals blame the exurbs for reelecting President Bush in 2004. Conservationists blame them for spoiling the landscape with ugly sprawls of look-alike houses and promoting wasteful lifestyles.

> "The gasoline is killing me"



FRANK E. HEATER
Pike County, Pa.

BRETT LUCCKETTA
With his wife, Kristy
Enterprise, Nev.

Supporters of exurbs see a much different picture. Author David Brooks, whose book *On Paradise Drive: How We Live Now (And Always Have) in the Future Tense* examines the exurban phenomenon, often points out that exurbs are highly diverse and getting more so. They provide a high quality of life for many, including millions of immigrants. Indeed, exurbia has attracted both upper-income families who live expansive lifestyles and middle- and lower-income families who move to the far fringes of metro areas because it allows them to step up the ladder to a bigger house, better schools, and a nicer life than they could afford closer in.

ECONOMIC ENGINE

WHILE MANY OF America's biggest cities continue to lose population, and inner suburbs are suffering symptoms of old age, out in the exurbs it's a different world. Between 2000 and 2004 exurbia accounted for 17 of the 20 fastest-growing counties in the nation with more than 10,000 people. The population has mushroomed in once-rural counties near Atlanta, Dallas, Reno, and other cities. And that's certainly reflected in commute times: According to the Joint Center for Housing Studies at Harvard University, the number of workers in the 49 largest metro areas commuting an hour or more increased by 2 million between 1990 and 2000; in the rest of the nation there were 1 million more hour-away commuters.

But with energy costs soaring and a hike in interest rates likely in the months ahead, all of a sudden the Exurban American Dream is looking a whole lot tougher for many. Just ask Frank E. Heater, a carpenter who lives in Pike County, Pa., a fast-growing exurb of New York City. To afford his 3,500-square-foot ranch home, planted on five wooded acres, Heater pulls out of his driveway at 4:15 each morning to drive his Ford Expedition 86 miles to New York. In the best of times, his routine was grueling: "Come home, eat, shower, sleep, and you're back on the road again." But his gasoline bill now hovers around $180 a week, about double what he paid two years ago and an ever-growing big bite

> "I am living the American dream, but it hurts some months"

out of Heater's take-home pay. Now he wishes he could take the bus, tools and all. "The gasoline is killing me," he says.

The economic consequences of a slowdown in exurban exuberance is difficult to measure. Clearly the exurbs' rapid growth has been one of the main engines of U.S. economic expansion in recent years. Consider all the home-building plus the malls, box stores, restaurant chains, fire departments, and

(CLOCKWISE FROM TOP LEFT) ROGER HAGADONE; KATHERINE LAMBERT; STEVE LABADESSA


ANDREA O'HARA
Loudoun County, Va.

> **"We just sat down ...and tried to figure out how to cut back"**

schools that have popped up on cheap farmland beyond the suburbs. The new arrivals provided huge growth for retailers and other service companies, hundreds of thousands of new jobs for teachers, firemen, and the like, and entrepreneurial opportunities galore. Indeed, it is unlikely that the U.S. economy could have outperformed every other major industrial country in recent years without the explosion of exurbs and their ripple effects on business.

Even if the exurbanization of America isn't likely to end anytime soon, the dizzying double-digit growth that has been taken for granted in many markets could be slowing. Some homebuilders have already started to hedge their bets by turning to close-in locations. Houston developer Sam Yager III is still aggressively expanding in exurbs like Rosenberg, 37 miles southwest of Houston. But after years of developing primarily on the outskirts, he is now also creating City Park, a project near Houston's medical center, featuring $90,000 to $140,000 homes. Sales are strong, even though the lots and homes are much smaller than those for comparable money in the exurbs, and they are in the Houston Independent School District, which some young families want to avoid.

Higher energy bills and mortgage rates are not as likely to affect the more affluent. In Beacon Hill, a new development in exurban Purcellville, Va., carved from the former estate of the late Arthur Godfrey, homes are gigantic—up to 14,000 square feet, with libraries, wine cellars, and see-through fireplaces—and sell for up to $3 million. Says Mitchell S. Freedman, an insurance broker who moved to Purcellville in July: "Those of us who live here are in economic circumstances where we don't worry about $3-a-gallon gas or the price of propane."

But plenty of other exurbanites do have to worry. In Loudoun, the cost of feeding a van and a Subaru Outback SUV already has Andrea O'Hara consolidating her errands into one trip. Heating the family's four-bedroom, three-bath house with propane figures to be 50% more costly this year. "We just sat down and looked over our budget and tried to figure out how to cut back," says O'Hara. One idea: consolidate several local carpools into one van to help beat the daily $6 tolls and pricey gasoline. A neighbor says families are buying wood-pellet burning stoves to supplement their heating this winter. And the rising costs are already having an impact on the real estate market. "Houses here, once gas hit $3, started to stay on the market longer," says Robin Frank, owner of nearby Brown-Carrera Realty. "A house that would have had multiple bids suddenly just got one bid in three weeks. People are being cautious now."

Some are also starting to have second thoughts about the size of those expansive new houses they've bought. Since 1992 the average new house has expanded 12% and the number with four or more bedrooms has climbed dramatically to 37%. Now the bill is coming due. Brett Luccketta, 32, moved from high-cost Orange County in Southern California to Enterprise, a fast-growing Las Vegas development last March. Even with some $10,000 of energy-saving adds-ons to his new four-bedroom, $285,000 home, Luccketta was shocked when his electric bill topped $300 one month. Now he and his wife Kristy use ceiling fans and keep the thermostat at 77F to save money. Still the Lucckettas, who plan to have children soon, are thinking about trading down from their 2,200-sq.-ft. home to a 1,600-sq.-ft. townhouse. "Babies don't need giant bedrooms," he says. "I am living the American dream, but it hurts some months."

HERE TO STAY

IT MAY TAKE MANY MONTHS of hurt before big numbers of city dwellers seriously start to consider reversing their exodus to exurbs. As transportation consultant Alan E. Pisarski notes, a two-decade stretch of extremely low-cost transportation has conditioned commuters to accept longer drives. For the time being, even extreme commuters who spend a total of four hours each day going back and forth to work will probably try to avoid moving closer to town. Joel Kotkin, an urban planner and author of *The New Geography: How the Digital Revolution Is Reshaping the American Landscape*, says that many exurbs are fast moving beyond the inefficient model of bedroom towns. Instead, they're fulfilling the original purpose of a more traditional city, with high-quality jobs and cultural amenities. That's why he believes the exurbs are here to stay, no matter how high energy prices go. Exurbanites may "get smaller cars," he says. "But they are not going to pack up and move to the city."

As the exurbs take root and evolve

into communities in their own right, more new jobs are likely to find their way to these outer areas. In many U.S. labor markets where skilled workers are in short supply, exurbanites will likely get relief as more companies move operations closer to the outlying areas where workers live or encourage more telecommuting. But until enough of those jobs show up, Pisarski predicts, "shifting to smaller homes that are closer to jobs could become the trade-off that many workers prefer."

Even if current residents hold tight to their exurban life, a big question in the near term is whether new families will keep flooding to the outskirts. Any hesitation by buyers could leave developers and homebuilders in a bind.

Unsold homes are at their highest in five years

The availability and price of mortgages will also weigh heavily, and some economists believe that the Federal Reserve, with its frequent rate increases, is determined to apply the brakes to the runaway housing market. Long-term interest rates have jumped by nearly a half percentage point over the past month on growing fears of faster inflation and tough talk from Fed officials about the need to contain it. The higher borrowing costs are starting to put a damper on the overheated housing market. Builders now hold a 4.7 months' supply of unsold homes, the highest level in more than five years. If housing cools off, the exurbs could be among the first places to feel the pain.

The moment of truth for many exurbanites may be coming soon, says Vern S. Lazaroff, an attorney in Milford, Pa., and Port Jervis, N.Y., who specializes in personal bankruptcy. "A lot of people here get mortgaged up to their necks," he says. Once winter comes, "there's no way to pay for the fuel oil and the mortgage in the same month. There's just no way. I expect to see a huge number coming to my office."

If Lazaroff is right, it could mean a nasty winter for folks living way out in the 'burbs. The American Dream of a better life away from the city is hardly over. But it could be in for a few tough knocks.

–With Paul Magnusson in Loudoun County, Va., Peter Coy in Pike County, Pa., Christopher Palmeri in Los Angeles, and bureau reports

CARMAKERS

SUDDENLY, SMALL IS BEAUTIFUL

Buyers are flocking to little cars—and not just because of high fuel prices

IT HAS COME TO THIS: EVEN Texans are having second thoughts about their big trucks. In Fort Worth, deep in the heart of truck country, the Mortiz Kia used-car lot is packed with big sport-utes and minivans that buyers have traded in for cars that look pint-size by comparison, including the Sportage small SUV and Spectra compact. During the big-SUV boom, many buyers stretched their monthly budgets to lasso one of the monsters. But as gas prices jumped 50%, sending the cost of filling up the tank of a large SUV north of $70, those gigantic gas-eaters stopped looking so alluring. Customers, says Kia new-car sales manager David Benker, "want something smaller to drive to work every day."

America is still a far cry from Europe, where the family car is often a compact. In the U.S., downsizing often means trading a huge SUV for a slightly smaller one. Still, for those willing to truly trade down, the good news is that a fresh crop of little cars is making small cool again. While soaring prices at the pump are probably the single most important factor drawing buyers back, small cars are also benefiting from smart designs and youthful, edgy marketing. The boldly styled Mazda 3 is one of the hottest cars on the market, with sales up 45% this year. High-end small autos such as the Mini Cooper convertible and the all-new Audi A3—as well as dirt-cheap Korean-made Chevys, Kias, and Hyundais—pushed sales of small cars up 23% in September. They now make up 18% of the U.S. market, a major leap from the 13.6% they claimed a year earlier, according to Edmunds.com Inc., a Santa Monica, Ca.-based auto research firm.

At the same time, car buyers are abandoning SUVs in droves. With sales off 33% in September, sport-utes grabbed just 14.5% of the U.S. market, down from 19.4% a year ago. Is this the big shift away from SUVs that has long been predicted? Tom Libby, an analyst with J.D. Power & Associates Inc.'s Power Information Network, says defections from larger vehicles to compacts picked up last month. Yet experts like Libby believe gas prices will have to stay at today's levels or even rise higher to force a wholesale change in what Americans buy.

However significant the change, one thing is clear: Auto makers are moving

BMW 1 SERIES

More *joie de vivre* for compact buyers: BMW's sporty 1 Series will hit U.S. roads in 2008

PRICE: NA
MPG: 29

NISSAN VERSA SEDAN

Next June, Nissan will bring out the Versa as a smaller, more efficient alternative to its Sentra compact

PRICE: STARTS AT $12,000
MPG: 35 (APPROX.)

MINI CONCEPT CAR
A stretch version of the popular motor mite will arrive in 2007 featuring more room and the same retro styling
PRICE: NA
MILEAGE: NA

swiftly to put renewed focus on their small-car offerings. Gone are the days of churning out econoboxes. Now the push is on to add splashy styling and make downsized cars roomier and more fun to drive. Carmakers are betting that, by offering up sporty compacts, small wagons, and crossovers, they can get better prices and, ultimately, higher margins.

DOING IT RIGHT

IT'S NOT SURPRISING, then, that fleets of diminutive new vehicles will be rolling into dealers' lots before too long. Chrysler Group will replace its old Neon compact with a trio of small, spiffy Jeep and Dodge entries starting next year. BMW plans to bring its new sporty compact 1 Series to the U.S. and launch a roomier Mini in 2007. Ford is toying with some new compacts, and Nissan Motor Co. will launch the subcompact Versa next June. Says Johan de Nysschen, executive vice-president of Audi of America Inc.: "Companies are trying to build good cars that just happen to be small."

It has taken awhile, but other carmakers are finally catching on to what Chrysler and BMW proved several years ago: Done right, small cars can make money. The PT Cruiser, built on the underpinnings of the Neon, was a hit when it launched in early 2000. The Mini proved that stylish compacts are no fluke—and that they can sell for as much as $30,000.

The PT Cruiser's success prompted General Motors Corp. Vice-Chairman Robert A. Lutz to develop the Chevrolet HHR, a rival retro compact wagon which hit the market in July. Lutz, who came up with the PT Cruiser back in his Chrysler days, is boasting strong initial sales numbers, saying the HHR is on a pace to beat its 60,000-a-year target. Insiders say GM dumped plenty into rental fleets. But Lutz claims GM sees enough demand to double production. "There used to be a view that no one cared about small cars, but that's a defeatist's strategy," Lutz says.

To make their pint-size offerings more profitable—and to hedge against continued stratospheric fuel prices—auto makers are putting more resources into small-car development. Take Chrysler, which is betting its trio of more aggressively styled cars will sell more for their fashion than their fuel economy. Next year the Neon plant in Belvedere, Ill., will stop making tinny boxes and start building three new models: the Dodge Caliber, Jeep Patriot, and Jeep Compass. Chrysler figures all three can fetch fatter prices than the Neon ever did. "Conventional wisdom says you can't make money selling small cars," says Jeep Vice-President Jeff Bell. "We're defying conventional wisdom."

THE STAT

18%

Small-car share of U.S. auto market, up from 13.6% a year ago

Data: Edmunds.com

Some companies even think subcompacts can thrive in the U.S. Jed Connelly, Nissan North America's senior vice-president for sales, says the company's Versa subcompact, which is smaller than the compact Nissan Sentra and is built on the frame of the European Renault Clio, should pull in buyers who have been looking at used cars. Honda Motor Co., just launching its new Civic, will make a similar play with the Fit hatchback. Toyota also will bring out the Yaris subcompact. All three will sell in the $13,000 range.

Cars like the Versa and Fit may only sell in big numbers if gasoline prices stay above $3 a gallon well into next year. "There seems to be some growth in this market," says Connelly. "I don't know if it will last." But other carmakers are trading on style—and that will sell no matter what.

–By David Welch in Detroit

JEEP COMPASS
Chrysler's next-generation Jeep, with its "boy racer" looks, promises to bring some street smarts to an off-road icon
PRICE: NA
MPG: NA

DODGE CALIBER
Say goodbye to the boring Neon and hello to this brawny replacement, which resembles the Magnum wagon
PRICE: NA
MPG: 34

HONDA FIT
The small five-door wagon could give young buyers a thrifty option to low-priced Korean cars
PRICE: $13,000
MPG: UP TO 40

TAG TEAM For McNealy and Schmidt, a nice fit

KIM KULISH

THE INTERNET

A DEAL PREGNANT WITH POSSIBILITY

A Google-Sun alliance could one day loosen Microsoft's hold on the PC industry

It was a chance for Microsoft's many rivals to dream. Google Inc., Microsoft Corp.'s current archenemy and perhaps its most dangerous to date, teamed up with a fierce rival of yesteryear, Sun Microsystems Inc., on Oct. 4. Despite high expectations, the companies agreed to just a modest software-bundling deal, with Sun planning to offer some Google technology to its customers.

But what the announcement lacked in substance, it made up for in possibility. Google CEO Eric E. Schmidt and Sun CEO Scott G. McNealy vowed to promote each other's technologies, including Google's search, Sun's Java software for the desktop, and an open-source suite of office applications dubbed OpenOffice.org. The vague promise: to align more tightly the three biggest threats to Microsoft: Google, Java, and open-source software.

If reality approaches the grand proclamations, it could mean a more concerted effort to break Microsoft's lock on desktops. Some analysts expect Google to challenge many of Microsoft's strongest products, such as Office, its suite of word-processing and spreadsheet applications, with software that resides on the Net. "Google is recrafting itself from a search company to a broad-based services company," says Dwight B. Davis, software analyst at Summit Strategies Inc. A deeper alignment with Sun and OpenOffice could hasten that shift.

What exactly does this mean? No specifics have been unveiled, and its possible the partnership will amount to little. But one scenario has Google helping to promote and distribute OpenOffice and then tightly integrating it with its own search toolbar. Google's toolbar—the technology that Sun will begin to distribute—is a tiny software application users download to search the Web without going first to Google's home page. Some analysts speculate that Google could use the toolbar as a foundation to a Web-based programming world, giving users a way to sidestep expensive PC programs.

> **The biggest threat to Microsoft: A rival, Web-based ecosystem**

To become a real threat to Microsoft's desktop dominance, Google and its allies would have to offer much more than just an Office alternative. The more software apps that move online, instead of residing on Windows machines, the more Microsoft's position in the computing universe is threatened. That could surface in forms such as an online music service or an online product that lets users showcase a slideshow from a recent family vacation. Already, key business applications are hosted online, with Salesforce.com's customer-relationship management application leading the way.

Instead of buying software and installing it, users would turn to Google and others to rent programs delivered from anywhere on the Internet to any Web-connected device. "It's Competition 101," says former Sun exec Shahin Khan, now marketing chief at startup Azul Systems. "You want to commoditize what your competition is good at, and the Internet turns what Microsoft's good at—distribution of software—into a commodity."

"DEDICATED"

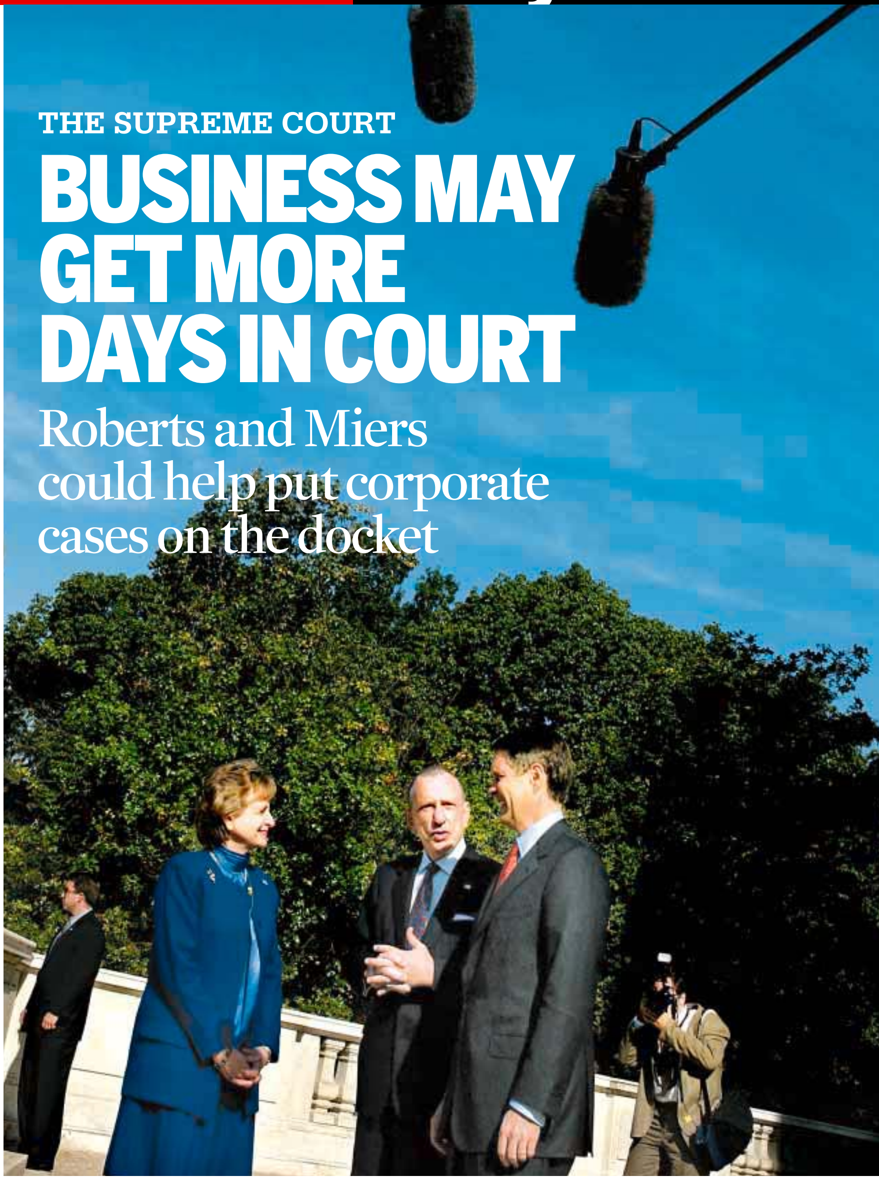
That's where Sun's Java technology comes in. It's used by millions of developers to create programs. And those applications can run on almost any operating system, along with cell phones and other devices. "Both companies are dedicated to software as a service, to network as the computer," says McNealy.

Perhaps one day Java developers will write programs that will run on top of Google technology, such as the toolbar. It's this possibility that's a threat to Microsoft. After all, Microsoft's strength comes from that sort of ecosystem: As millions of developers create programs for Windows, Windows itself becomes ever more key.

The threat to Microsoft is hardly immediate, even if Google throws its remarkable brand strength behind an alternative. Windows and Office hold more than 90% of their respective markets in the U.S. "Microsoft's biggest competition is people holding on to older versions of its software," says Laura DiDio, research fellow at Yankee Group.

But if the partnership sparks a wave of applications delivered over the Web, it could loosen Microsoft's hold on PCs. The Oct. 4 deal may have lacked blueprints to make it happen. But it didn't fall short of offering Microsoft rivals that hope.

–By Ben Elgin with Peter Burrows in San Mateo, Calif.



THE SUPREME COURT

BUSINESS MAY GET MORE DAYS IN COURT

Roberts and Miers could help put corporate cases on the docket

ON THE HILL Miers with Senators Arlen Specter and Bill Frist

ON OCT. 3, AS CHIEF JUSTICE John G. Roberts Jr. presided over his first day at the Supreme Court, President George W. Bush was in the West Wing introducing the woman who might soon take her own seat on the court—White House Counsel Harriet Miers. "Senators of both parties will find that Harriet Miers' talent, experience, and judicial philosophy make her a superb choice," Bush said, kicking off the lobbying drive for his surprise pick.

Clearly, not everyone, including members of Bush's own base, shares that opinion. But one segment of American society is cheering: Big Business. Sensing that Miers might be a boon, the boardroom set is hoping her confirmation could herald a sea change on the high court. The addition of Roberts, who spent years as a corporate litigator, was heartening to them. The prospect of Miers, who has defended the likes of Microsoft Corp. and Walt Disney Co. and has been a leading advocate for tort reform, has many executives downright giddy.

No one knows how Miers might vote on key issues such as federal preemption of state law or caps on damage awards. What's important is that she and Roberts bring a one-two punch of practical business experience to the bench. That won't necessarily always mean a win for business. Rather, execs hope their real-world perspective will help them persuade the high court's other justices to hear more cases of interest to business. The expectation is that the duo will help reverse a trend set by the Rehnquist Court, which had little appetite for such cases. "The court takes less than 2% of the cases that come its way. Of that 2%, very few are business cases, so the ones that get accepted are critical," says Robin Conrad, a senior vice-president at the U.S. Chamber of Commerce. "That's where we think a John Roberts or a Harriet Miers could be most helpful."

Indeed, one of the defining characteristics of the Rehnquist Court was its lack of zeal for resolving conflicting appeals court opinions. These circuit court splits have dogged business for years as it has watched the high court repeatedly rebuff appeals to settle conflicts in such areas as federal preemption and antitrust. That benign neglect has allowed the nation's 10 circuit courts to effectively establish different rules of engagement for different parts of the country. "You end up in a situation in which whether you win or lose depends solely on where the case is brought," says Gregory Coleman, a partner at Weil, Gotshal & Manges LLP in Austin. "It creates this huge pressure for forum-shopping."

SAFETY STANDARDS

THE CURRENT STATE of affairs means actions that are acceptable in one part of the country might be unacceptable in another. Case in point: the hundreds of product-liability lawsuits filed every year in state courts that seek to hold companies to a standard above and beyond federal safety regulations. In one pending case, consumers sued Nokia Corp. in Louisiana, claiming that the radio frequencies emitted by its phones were "unreasonably dangerous" despite the phone's compliance with federal safety standards. The lower court found that oversight of the technical aspects of wireless communications traditionally falls to federal, not state, regulators. The U.S. Court of Appeals for the Fourth Circuit disagreed, creating a conflict with a different ruling from the Seventh Circuit on a similar issue. Nokia has asked the Supreme Court to use the case to clarify when a federal regulatory scheme can preempt a tort claim in state courts.

Circuit splits are nothing new, but the patchwork of case law gives companies that operate nationally a particular headache. Miers and Roberts can't solve the problem on their own; they bring only two of the four votes required for the high court to accept a case. But business hopes that they will persuade other justices to hear critical appeals that might otherwise be rejected. "The court benefits from having someone who knows what it's like out there," says Nathan Hecht, a

ALEX WONG/GETTY IMAGES

Texas Supreme Court justice and longtime friend of Miers. "She understands the realities of the legal world, how litigation costs people and what it does to their businesses."

Corporations also are grappling with the high court's refusal to hear disputes over the certification of class actions. Massive class-action injury claims can become bet-the-company lawsuits, often leading to huge settlements if a company's lawyers can't convince a judge that plaintiffs have too little in common to be designated a class. Despite a statute explicitly making it easier to appeal class-certification complaints to the Supreme Court, the justices have demurred, most recently turning back a class-action dispute in 2004.

TORT REFORMER

EVEN AS CRITICS bemoan Miers' lack of bench experience, she brings critical expertise in one key area dear to many executives: tort reform. Back in Texas she was on the front lines of the tort-reform revolution in 1988 when she helped Hecht win election to the Texas Supreme Court. He is credited with spearheading the tort-reform movement in the Lone Star State. Miers was on the campaign trail again in 1994, this time throwing her support behind Raul A. Gonzalez, a tort reform-minded Democrat who was facing a tough primary in his bid to retain his seat on the Texas Supreme Court. A year later the Texas Civil Justice League hired her to lobby for legislation to cap punitive damage awards and discourage medical malpractice claims. But it was a short-lived gig. Miers felt uneasy lobbying her former client, George W. Bush, who had just been elected governor, and withdrew.

DAY ONE Roberts, with Justice John Paul Stevens, spent years as a litigator

JOE RAEDLE/GETTY IMAGES

In recent years, as the top White House lawyer, Miers has been intimately involved in the Administration's drive to limit jury awards, create an asbestos-claims trust fund, and pass business-friendly rules for class actions. In April she spoke at an annual meeting of the American Tort Reform Assn., delivering a crowd-pleasing rallying cry to take on plaintiffs' lawyers.

Given that history, Miers, more than the other high court justices, could be amenable to considering cases involving limits on punitive damages or class certification. Since gaining a 2003 Supreme Court victory in *State Farm Mutual Automobile Insurance Co. v. Campbell*, which set caps on punitive damages, business has seen lower courts poke holes in the high court ruling. Despite Big Business' entreaties, the high court so far has declined to revisit the issue.

Miers allies of all stripes compare her to another pro-business judge: Justice Sandra Day O'Connor, long the court's swing vote and a fount of pragmatism. Miers "will fill the role that O'Connor is leaving," says Tom Dunning, a Dallas insurance executive, Democratic activist, and longtime friend. "She will decide cases from a legal standpoint, not from her personal feelings." Others call her an "originalist" who will decide disputes based on a broad reading of the letter of the law without confining herself to a strict constructionist interpretation à la Justice Clarence Thomas. That's bad news for the GOP's right wing, many of whom swiftly denounced Miers' nomination, but good news for pragmatism-minded executives.

The Right might not like her, but Miers wins praise from many on the Left who know her. "The biggest compliment I ever heard about a lawyer is: You can shoot dice with him over the phone," says Franklin Jones Jr., a Marshall (Tex.) trial attorney and self-described "bomb-throwing" Democrat. "The only problem with that description is that she's probably too virtuous to shoot dice."

That penchant for straight-shooting will come in handy on a divided high court. But beyond that, many executives are hoping that the business-savvy pairing of Roberts and Miers might herald a new day—and finally give corporate interests their day in court.

–By Lorraine Woellert, with Richard S. Dunham, in Washington

Friends on the Court

The Rehnquist Court's reluctance to take on business cases led to varying legal standards across the U.S. on key issues. That could change with former corporate lawyers John Roberts and Harriet Miers on the bench. Some examples:

FEDERAL PREEMPTION When do federal standards override claims made in state courts? Federal circuit courts disagree, creating different rules for various parts of the country and for different industries, such as rail and telecommunications. Companies want a single national standard. A case involving Nokia could help resolve the matter.

RETIREMENT What are companies' pension obligations? Pirelli Armstrong Tire was sued when it cut retirement benefits after telling workers pensions wouldn't change. The Fourth Circuit ruled against Pirelli, but the Eighth Circuit, in a similar case, granted companies more leeway. The high court declined to hear Pirelli's appeal. Business wants another chance.

ANTITRUST What is restraint of trade? How is a monopoly defined? Given the vague wording of antitrust statutes, courts have given conflicting answers. Business hopes the Roberts Court will be more inclined than the Rehnquist Court to take these cases and resolve the discrepancies.

INTERSTATE COMMERCE Must an animal cross state lines to be protected by the Endangered Species Act? Courts differ on how broadly Congress can use its power over commerce among states to, say, regulate the environment. Business wants uniform environmental enforcement.

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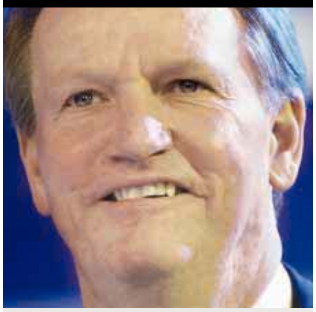
HEADLINER

RICK WAGONER



PEDAL TO THE METAL

The pressure is ratcheting up on General Motors Chairman Richard Wagoner Jr. Billionaire Kirk Kerkorian has raised his stake in the auto maker to nearly 10% and wants a board seat, most likely for deputy Jerry York. At the same time, Wagoner is coming down to the wire in talks with the United Auto Workers about cutting GM's $5.6 billion annual tab for health-care costs. In exchange, the union wants GM to help bail out Delphi and save the jobs of UAW members who work for the parts maker.

If a deal isn't struck before Oct. 17, Delphi could file Chapter 11. That means GM would have to absorb some of its former subsidiary's pension and retiree costs. There are signs a deal may be in the works: On Oct. 4, GM said it will sell its 20% stake in Japanese Fuji Heavy Industries, Subaru's parent. That should raise around $725 million, which could help GM fund Delphi's fix-it plan and buy out some of the auto maker's own excess workers.

–David Welch

A PICK-ME-UP FOR MERCK

Oct. 6. brought some much-needed good news for **Merck**. The embattled drugmaker released data on a new vaccine called Gardasil aimed at preventing infection by the human papilloma virus, a cause of cervical cancer. In the study, which followed more than 12,000 women between 16 and 26, Gardasil prevented precancerous lesions and cervical cancer in 100% of vaccinated women. The vaccine, which could hit the market in 2006, is expected by many analysts to become a $1 billion-plus product. The drugmaker, which is fending off thousands of lawsuits over its withdrawn painkiller Vioxx, desperately needs a hit.

CHIP OFF THE OLD REDSTONE

Succession planning doesn't have to leave home if you're Sumner Redstone. The 82-year-old **Viacom** chairman and majority shareholder will make daughter Shari vice-chairman of both Viacom and **CBS** when the two split sometime next year. The elder Redstone, who will continue to own 71.2% of the companies upon their split, will be chairman. Leslie Moonves will be CEO of the CBS unit, which will include the **Infinity Broadcasting** radio chain, while longtime **MTV** boss Tom Freston will be CEO of the remaining Viacom, which will include its cable channels and Paramount Pictures studio. Shari, 51, who runs the family-owned **National Amusements** theater chain, has long been viewed as her father's heir apparent despite his statements to the contrary.

IS MICROSOFT BEHAVING?

Eighteen months after ruling that **Microsoft** violated antitrust laws, the **European Commission** has finally appointed a computer scientist to help determine if the company is complying with ordered remedies. Neil Barrett is a visiting professor at Britain's Cranfield University and serves as technical director for London consultancy **Information Risk Management.** He will advise, not decide, if Microsoft is meeting the terms of the antitrust finding, which required the company to release a version of Windows without Media Player and reveal secret communication protocols between Windows servers and PCs. Some critics are unhappy with Microsoft's compliance, despite a deal it reached with the EC last June to obey the decision.

P&G: STORM AND STRESS

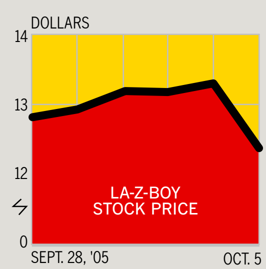
Headquarters for **Procter & Gamble** is some 800 miles from New Orleans, but the back-to-back hurricanes in the Gulf Coast are being felt in Cincinnati. On Oct. 4, **Citigroup** downgraded **P&G** stock to "hold" from "buy" in part because raw material costs soared after Katrina and then Rita shut down energy and chemical production. **Bear Stearns** in September trimmed its forecast for P&G's fiscal first quarter for similar reasons. P&G, which uses oil and natural gas derivatives to make its products, concedes that earnings will be reduced by the hurricanes, but says that higher sales and cost-cutting will help it make up the difference.

ET CETERA...

- **Freddie Mac** said it will buy back $2 billion common and $2 billion preferred shares.
- **Yum! Brands** reported a 16% third-quarter earnings gain and raised its yearly forecast.
- **FedEx** will raise its overnight delivery rates by 3.5% beginning next year.

CLOSING BELL

The recent hurricanes have taken some of the comfort out of La-Z-Boy's growth. The furniture maker's shares reclined 7% on Oct. 5, to $12.37, on the news that it would miss quarterly earnings targets. La-Z-Boy is dealing with a foam padding shortage and plant damage.



Data: Bloomberg Financial Markets

WAGONER: STAN HONDA/AFP/GETTY IMAGES; REDSTONE: BOWERS/GETTY IMAGES


Somewhere west of Topeka, someone's getting out for a breath of fresh air.
Which is why a farmer is harvesting corn. And why a train is transporting that corn.
And why ADM is turning corn into ethanol, a renewable, cleaner-burning fuel.
Somewhere west of Topeka, someone's getting out for a breath of fresh air.
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Why Treasury's Next Chief Won't Be a CEO

A YEAR AGO, ADMINISTRATION hard-liners tried to force out Treasury Secretary John W. Snow by leaking reports of his imminent ouster to the media. The rap: The former business chieftain was too pragmatic—and deficit-obsessed—to play a starring role on a supply-side squad. Unfortunately for them, the plotters forgot to tell President Bush, who rallied behind Snow. The ex-CEO of CSX got to stay on, helping to lead the ill-fated push for Social Security private accounts. Now, the talk is that Snow, 66, will voluntarily depart not long after he tidies up a last bit of outstanding business—handing his boss the Nov. 1 recommendations of a bipartisan commission that's weighing tax-reform options.

It's clear from the internal chatter that the next chief is almost certainly going to be cut from a different bolt of pinstripes than the two CEOs who have held the top Treasury job. Former Alcoa boss Paul H. O'Neill, an outspoken maverick, was dumped in 2002. Snow, a genial traveling salesman for Team Bush, has endured sniping from critics who think he falls short as a key policymaker. White House insiders say the President is inclined to junk the industrialist model in choosing his next Treasury chief.

In most of his second-term appointments, Bush has shown an inclination to reward trusted insiders with key jobs. Among them are Secretary of State Condoleezza Rice, Attorney General Alberto R. Gonzales, Education Secretary Margaret Spellings, and now Supreme Court nominee Harriet E. Miers. Two low-profile loyalists fit the bill to succeed Snow: Budget Director Joshua B. Bolten, a former Goldman Sachs executive whom insiders say is not happy with his job, and Chief of Staff Andrew H. Card Jr., Transportation Secretary under the first President Bush. "The President is comfortable with these guys," says one adviser.

BUSH LOYALISTS Budget Director Bolten and Chief of Staff Card

(L TO R) CHRIS KLEPONIS/BLOOMBERG NEWS; ALEX WONG/GETTY IMAGES

One drawback to Card: His nomination could upset the currency markets because he was an advocate for a weaker dollar when he lobbied for the automobile industry in the mid-1990s.

Bolten's downside? He shuns the limelight and might not be at ease in the role of chief economic spokesman. Besides, Bush may prefer to have him just down the hall as his next chief of staff.

If he wants a policy wonk with a track record of loyalty, the logical choice is R. Glenn Hubbard, dean of Columbia Business School and a *BusinessWeek* columnist. Hubbard, who served as White House chief economist in the first term, was the architect of Bush's plan to slash taxes on dividends and capital gains. He's also in the running to be chairman of the Federal Reserve when Alan Greenspan steps down next year.

A Wall Streeter at Treasury also could help fill the void left by Greenspan. Two financial industry veterans in the mix are Goldman Sachs CEO Henry M. Paulson Jr. and Merrill Lynch CEO Stan O'Neal. But the smart money—inside and outside the Administration—is betting that confronted with these choices, Bush will forgo the big name in lights and opt for the comfort of a lieutenant he can trust.

–By Rich Miller

CAPITAL WRAPUP

AN OLD CHINA HAWK'S NEW MISSION

AS A CONSERVATIVE GOP congressman from Southern California, **Christopher Cox** blasted the Chinese government for trampling on its people's political freedom. Now, as the new chairman of the Securities & Exchange Commission, Cox will press Beijing to safeguard a different kind of freedom—the kind that could foster the growth of its nascent capital markets.

In a mid-October visit to China, his first trip abroad as SEC chief, Cox promises to preach the gospel of disclosure, transparency, and good corporate governance. "There is a relationship between the freedom of information and transparent capital markets," says Cox. "Frictionless markets require information as a lubricant." He intends to prod Chinese regulators to adopt international financial reporting standards and help combat securities fraud in global markets. And Wall Streeters hope he'll address Beijing's insistence on a controlling interest in financial joint ventures. *–Amy Borrus*

WHEN IS A BUDGET CUT NOT A BUDGET CUT

THE SENATE Appropriations Committee claims to have trimmed **President Bush's** Pentagon spending request for 2006 by $7 billion. In reality lawmakers shifted some of the spending to a supplemental bill for the Iraq War. That's not the only accounting sleight-of-hand. The committee moved $10 billion in future retiree health benefits costs from the Pentagon to the Treasury Dept. The nonpartisan Congressional Budget Office blew the whistle on the gambit, leaving the committee $10 billion over the mandated defense spending cap of $439 billion.

Building Business Around Customers:

Let Customers Lead the Way

Most executives would agree that building a customer-focused business makes good financial sense. After all, customers are the ones who pay the bills, select your company over the competition, and generate value for your shareholders. To be sure, every company focuses to some extent on its customers. But there is a key distinction—often missed—between merely considering one's customers and building a business around them.

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In too many businesses, "focusing on the customer" has come to mean little more than high-level speculation about customer needs and preferences, often by well-intentioned people who nevertheless have had little contact with real customers. Even when actual customer opinions are collected, they are frequently forced to fit within a preexisting corporate mindset, with contradictory or inconvenient input quietly set aside.

Designing Around Customer Needs

One company that has truly built its business around customers is Virgin Mobile USA. A joint venture between Virgin Group and Sprint, Virgin Mobile is the first mobile virtual network operator (MVNO) in the United States—and the nation's first wireless service to solely target the youth market. Not only did Virgin Mobile reach its 3 million customer milestone in less than three years, but it has posted a stellar customer service rating: More than 90% of Virgin Mobile customers say that they would recommend the service to their friends.

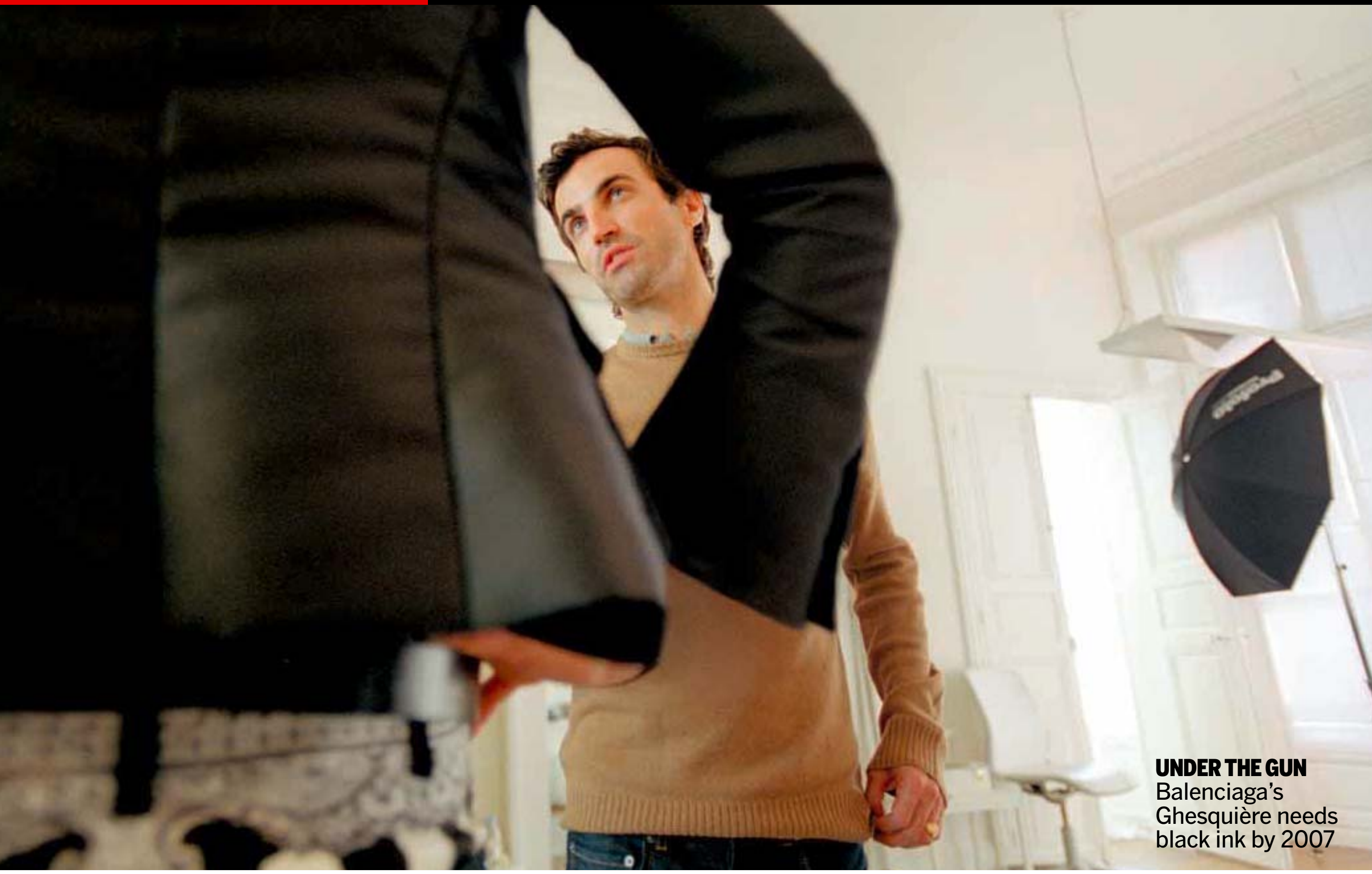
How has the company achieved such impressive results in a short period of time—operating, no less, against some very entrenched competitors? Two principles are at play. First, Virgin Mobile USA realized early on that providing the best customer service in the industry would be vital to its success. "We are fundamentally different from any other operator in North America," says Mike Parks, CIO, Virgin Mobile USA. "Although we are running on top of the Sprint network, everything that happens—in terms of customers' interactions with our user interface, Web site, and customer care environment—is supported by systems that Virgin Mobile, working closely with technology partner Patni, integrated, built, or customized, resulting in a uniquely Virgin Mobile experience."

Second, Virgin Mobile listens carefully to its customers—and designs its products accordingly. One key feature: a low-price-of-entry, pay-as-you-go plan that's perfectly suited for young adult budgets and aversions to long commitments. "Because we are Pay As You Go, we need to be very real time. If a customer's balance goes to zero, they want to put additional money into their account and make another call instantaneously—they don't want to wait 24 hours. Our Siebel-based customer management system enables us to meet these demands and deliver a truly 'now' offering."

If that wasn't enough, Virgin Mobile packs each of its phones with the extras that young people most want: two-way text messaging, fun content from the likes of MTV and Comedy Central, and even a "rescue ring" to extricate users from unpleasant social situations.

If customer satisfaction numbers are any indication, Virgin Mobile users must like the results. "Customer service is our most important measure of success," explains Parks. And that success, to coin a phrase, speaks for itself.

To learn more about how leading companies are building their business around customers, please visit www.businessweek.com/go/customer and www.siebel.com/thecustomer.



UNDER THE GUN Balenciaga's Ghesquière needs black ink by 2007

STUART ISETT/POLARIS

EUROPE

TIGHTER BELTS ARE IN FASHION

Global luxury houses are looking to cut loose their unprofitable labels

KNEELING ON THE FLOOR of his studio at Paris fashion house Balenciaga, Nicolas Ghesquière stares intently at a lacy sleeve on a model's arm. An assistant stands by, ready to whisk away the detached sleeve so it can be stitched onto an evening gown. Balenciaga's Oct. 4 ready-to-wear show is less than 48 hours away, and Ghesquière's face is etched with fatigue. The studio is filled with leggy models waiting for final fittings. Yet the place is eerily quiet, mirroring Ghesquière's intense focus as he gently tugs on the filmy fabric to make sure the sleeve hangs from the shoulder in a fluid line. It's that kind of attention to detail that has made Ghesquière, 34, a fashion superstar, according to *Vogue* and others.

Yet the runway show is only part of the pressure Ghesquière faces. Gucci Group, which acquired the storied fashion house of Balenciaga in 2001, recently announced that it will put the company up for sale if it doesn't turn a profit by 2007. Balenciaga had been losing money well before Ghesquière became its chief designer in 1997. Together with Gucci CEO Robert Polet, the designer has hammered out a plan, and both say the recovery is on track, with a 115% sales increase during the first six months of 2005 over the same period in 2004. But Ghesquière admits that when he first took up fashion design he never foresaw spending hours in budget meetings. "The rules have changed," he says. "Now you have to get involved in the strategy of the house."

RAG-TRADE REALITY

GHESQUIÈRE IS FEELING the effects of years of overindulgence by the luxury-goods industry. Fueled by double-digit sales growth through much of the 1990s, global groups such as Gucci, Prada, and LVMH Moët Hennessy Louis Vuitton loaded up on prestigious but profitless brands. Gucci's purchases included Balenciaga, Yves St. Laurent, and the Stella McCartney, and Alexander McQueen labels. LVMH picked up Fendi and Emilio Pucci, Prada took Jil Sander and Helmut Lang. The groups figured that with the right knowhow they could replicate

A brand-buying binge in the '90s remains a drain

their flagship brands' success.

Yet turning around the new acquisitions has proved more costly and time-consuming than expected, a task complicated by the post-September 11 slump in luxury-good sales and the strengthening of the euro. During the first half of 2005, Gucci's six smallest brands, including Balenciaga, McCartney, and McQueen, posted a $30.9 million loss on $160 million in sales. McCartney and McQueen also have been warned that their brands will be sold if they aren't profitable by 2007.

The financial squeeze intensified just as Ghesquière was achieving global recognition for reviving Balenciaga, a legendary couture house that had languished since the retirement of founder Cristóbal Balenciaga in 1968. After a stint at Jean-Paul Gaultier, Ghesquière had joined Balenciaga at age 23. When the chief designer was fired two years later, Ghesquière got the job. It wasn't long before his designs were drawing rave reviews from the fashion press, and his elegantly cut, pencil-slim trousers began turning up on stars such as Nicole Kidman and Chloe Sevigny. Then Gucci's design chief Tom Ford and CEO Domenico De Sole approached. "They offered support, logistics, a broad shoulder to lean on," Ghesquière recalls.

But the relationship soon grew tense. Ford and De Sole wanted Ghesquière to close the atelier, a workroom on the upper floor of Balenciaga's Left Bank townhouse where eight employees turn out prototypes of designs and experiment with fabrics and tailoring. Gucci considered this an unnecessary expense since its factories in Italy provide such services. Ghesquière argued that taking the atelier away would be like robbing a scientist of his laboratory. Gucci relented, but then told the designer that it would no longer finance his runway shows, forcing Balenciaga to stage small shows at headquarters. Ghesquière was ready to call it quits when in late 2003 Gucci announced De Sole's and Ford's departure. Ghesquière says he has a more cordial relationship with Polet, who was named Gucci CEO by parent PPR Group. But Polet, a former Unilever executive, admits to being a tough boss: "I told him, 'You are going to have to make a profit, or you will close.'"

The two men struck a deal: Ghesquière could keep his atelier, but he would have to hold the line on other costs and boost sales. To attract customers, Balenciaga this year introduced "Capsule Collections" of some of its most popular designs, made without the costly embellishments, such as hand-stitched insets, that are often shown on the runway. The price tags range from $345 to $575—well below the $2,000-and-up prices many Balenciaga ready-to-wear creations command. About half of Balenciaga's sales now come from the Capsules and other derivatives of runway designs. The simpler clothes are quicker to produce, so that Balenciaga can get its merchandise into stores more quickly, as do "cheap-chic" retailers such as Spain's Zara and Sweden's H&M Hennes & Mauritz. The more often new clothes arrive, the more often customers come in, increasing the odds they'll spurge on something like a $7,200 fur-trimmed coat, a Balenciaga best-seller.

SHOULDERING ON A gown from Balenciaga's 2006 lineup

Balenciaga has also scaled back plans to open its own boutiques, opting instead to set up shop at upscale retailers such as Barneys in New York and Harvey Nichols in London. To compensate for a slim advertising budget, Ghesquière generates free publicity by making discreet gifts to celebrities. This strategy has helped it drive sales of Balenciaga's Lariat handbag. "Nicolas really does have a business head," says James McArthur, a senior Gucci executive who recently became CEO of Balenciaga .

Could Balenciaga turn profitable even before 2007? The reaction to Ghesquière's Oct. 4 show bodes well. "C'est magnifique," *Women's Wear Daily* said of the collection, a mix of frothy gowns and sleek pantsuits with baroque collars. Adding to the buzz, the Paris Museum of Fashion & Textiles is planning a major Balenciaga retrospective. That's likely to spur demand for updates of classic designs that Ghesquière is selling under the Balenciaga Edition label. As Ghesquière is learning, even the ritziest clothes look better beside a beautiful balance sheet.

–By Carol Matlack in Paris

Gucci Group's Profitability Gap

While the flagship spins profits, most of Gucci's smaller brands lose money*

GUCCI	BOTTEGA VENETA	YVES SAINT-LAURENT	YSL BEAUTE	OTHER BRANDS**
$228.4 MILLION	$2.5 MILLION	-$48.2 MILLION	-$22.6 MILLION	-$30.9 MILLION

*1H 2005 operating earnings

**Balenciaga, Bédat & Co., Boucheron, Stella McCartney, Alexander McQueen, Sergio Rossi

Data: PPR Group

GERMANY

MERCEDES' NEW BOSS ROLLS UP HIS SLEEVES

Layoffs are just the beginning. Can Zetsche fix production and quality woes?

ONLY FOUR WEEKS into the job, Mercedes Car Group chief Dieter Zetsche stunned employees on Sept. 28 by ramming through a program to cut 8,500 jobs at the German auto maker—9% of its German workforce. Zetsche's move heralds a new era at parent DaimlerChrysler, where the affable 52-year-old who turned around Chrysler takes over as CEO on Jan. 1 in addition to his job running Mercedes. "Mercedes has become flabby," says Garel Rhys, director of the Centre for Automotive Industry Research at Cardiff University Business School in Wales. "Management has woken up to the fact that they have to tackle their cost base."

And how. Industry experts estimate the cost of producing a car at Mercedes now runs $2,400 to $3,000 higher on average than at No. 1 luxury carmaker BMW. "Mercedes' whole mantra has been: 'We build the best luxury cars in the world—at any cost,'" says Morgan Stanley analyst Adam Jonas in London.

With Zetsche in the driver's seat, those days are over. "A long hard road lies before us. Our costs in every part of the production chain are clearly higher than those of our best competitors," he said in a Sept. 28 letter to employees. Mercedes lost $1.1 billion in the first half and is likely to finish the year with a loss. Analysts say the job cuts will add momentum to efforts to save $5.6 billion by 2007 and restore an operating margin of 7%, up from analysts' forecast of negative 0.8% this year.

Downsizing the workforce is just the first step. Zetsche's German plants lag behind rivals BMW and Toyota Motor Corp. by a generation in cutting-edge factory design and processes, say analysts. They also figure BMW's plants run at 95% of capacity, vs. 80% at Mercedes' German plants. One reason is declining sales of the E-Class and C-Class models, which have suffered quality problems.

A face-lift for the E-Class in 2006 and a new C-Class expected in late 2007 should help. But union contracts that reduce flexibility are also to blame for the relatively low output. Production lines in the Sindelfingen plant, for example, stop during the lunch hour, while BMW uses staggered lunch breaks to keep its line flowing. In addition, BMW employees work much less during periods of slow demand and bank the unused hours, paying them back during peak periods and thus eliminating a lot of overtime pay. Mercedes only recently instituted more flexible schedules and got union agreement to shuttle workers among plants.

CLS ASSEMBLY Some plants run at just 80% capacity

MICHAEL LATZ/AFP/GETTY IMAGES

Decline of an Icon

How Mercedes got caught by spiraling costs

- Management bought labor peace by avoiding job cuts. Now, eliminating 8,500 slots will cost $1.15 billion.
- Quality problems caused warranty costs to explode.
- Fixing quality problems means running production lines at lower speed, crimping factory productivity.
- Engineers design new electronics for each model, adding to complexity and cost.
- Management failed to make incremental improvements in productivity as new models were introduced.
- Sharply declining sales of the E-Class and the C-Class lowered the utilization rates at Mercedes factories because of quality problems .

ELECTRONICS BACKBONE

IMPROVING QUALITY is also vital. The drive to lead in technology has produced cars packed with different electronic systems, which all must be integrated into a core system that functions harmoniously, a hard task. By contrast, BMW has installed common electronics backbones, or architecture, across many model lines. It also saves money by sharing more components among models. Mercedes says its cars use the same electronic architecture but that many parts vary across its array of models.

Zetsche's predecessor, Eckhard Cordes, added hundreds of engineers and slowed production lines to allow for additional testing, but that torpedoed productivity. The real fix lies in designing less complex cars and improving test procedures before a model launches. The new $96,000 S-Class will test whether Mercedes has its electronics problems under control. Testers drove 500 new S-Class cars some 5 million miles to search for potential failures.

Redesigning and reengineering all Mercedes models for better quality could take two years or so—assuming Zetsche can push through changes as fast as he would like. "Mercedes needs new products that are engineered with a different philosophy," says James N. Hall, vice-president of AutoPacific Inc. in Southfield, Mich. The hardest job will be changing the Mercedes mindset and convincing a proud workforce they have been lapped by the competition. ■

–By Gail Edmondson in Frankfurt

CHINA

LET A THOUSAND BRANDS BLOOM

Multinationals are competing with locals for a more discerning Chinese consumer

FIVE YEARS AGO GENERAL Motors Corp. offered just a handful of car models in China—mostly large, high-end Buicks costing around $40,000. That limited selection worked in a market dominated by fleet sales to government offices and enterprises: What these customers wanted were large sedans for hauling around big shots. "We were targeting institutional buyers, who were our big market back then," says Kevin Wale, president of GM China.

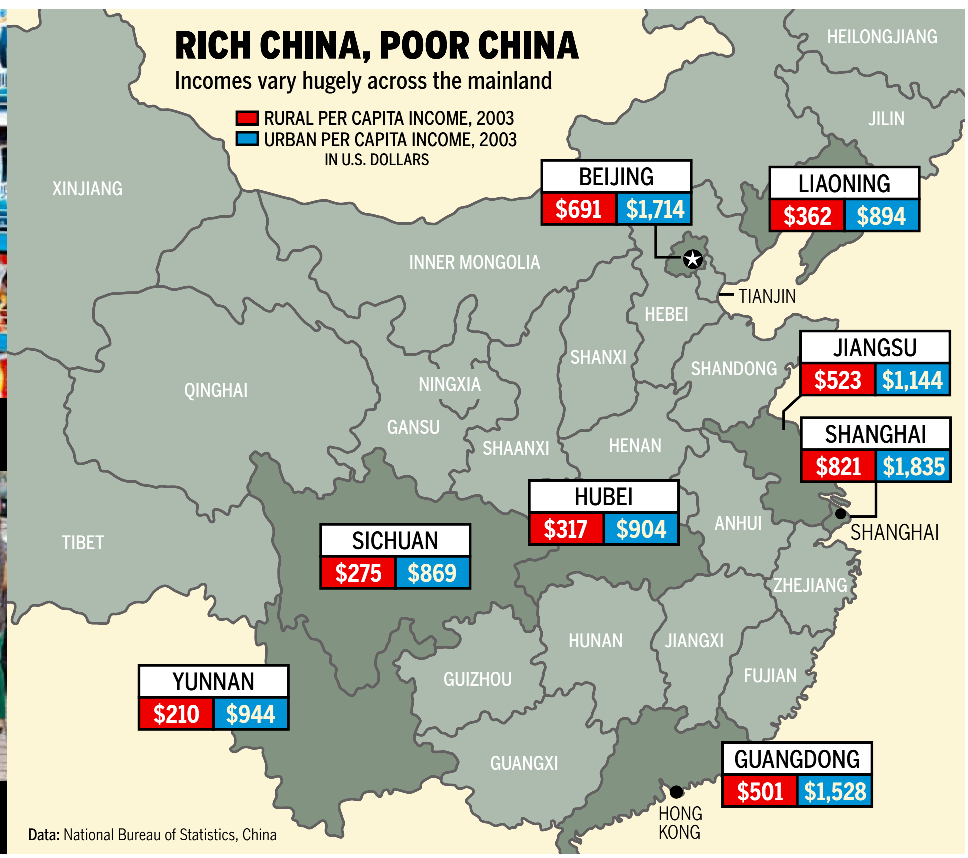
Fast-forward to the present, and it's hard to believe that GM is the same company. The auto maker now offers a range of models aimed at various customer segments. For China's newly rich, there are $75,000-plus Cadillac SRX sport-utility vehicles and $55,000 CTS sedans. A bit lower down, the $30,000 Buick Regal is positioned as the vehicle for cost-conscious entrepreneurs who want a prestigious car. For their midlevel managers, there's the $15,000-to-$20,000 Buick Excelle—offered in various models. And for younger urbanites buying their first cars, GM's Chevrolet marque now offers the $19,000 Epica sedan, the $10,000-to-$12,000 Aveo hatchback, and the $5,700 Spark minicar. Meanwhile, in the countryside the Detroit carmaker offers the Wuling, which goes for $4,000 to $6,500. This boxy minivan can carry seven passengers, a couple of hogs, or a dozen sacks of potatoes. "We had a very limited product line in China," says Wale, who took over GM's top China job in March. "Now we have an extremely well-developed range of brands and cars." And they're available at nearly 1,000 outlets across the country, up from just nine in 1998. Add it all up and it means lots of metal moving off the lot: GM China's vehicle sales this year are expected to grow by 20%.

$37 WASHING MACHINE

GM ISN'T ALONE in discovering that China is not a monolithic market. The country, with 1.3 billion citizens speaking more than 100 dialects, is wildly diverse. What people eat, wear, and drive differs greatly from north to south, east to west, rich to poor, young to old, city to countryside. Urumqi in the northwest is further from Guangzhou in the southeast than Oslo is from Rome. "It's clear that you can't treat China as just one country," says

COST-CONSCIOUS P&G sells two brands of Tide

PRESTIGIOUS GM aims Buicks at executives



(TOP TO BOTTOM) PHOTOGRAPHS BY MA JIAN/IMAGINECHINA.COM; QIN JIANGYING/IMAGINECHINA.COM; MAP BY ALBERTO MENA/BW

Glenn Murphy, managing director of ACNielsen China in Shanghai.

And while it was once enough for companies to focus on the 100 million or so Chinese living in Beijing, Shanghai, Guangzhou, and a handful of other big cities, today they're scrambling to offer products tailored to more segments of the population. That means an explosion of choice for consumers. Appliance- and electronics-maker Samsung has discovered that customers living in steamy Guangdong Province need larger refrigerators than those in the more temperate north, so it started shipping bigger fridges south. Household-goods company Procter & Gamble Co. has won over consumers in China's hinterlands with a budget detergent called Tide Clean White, while holding onto city customers with the more expensive Tide Triple Action. And Nokia Corp. now pumps out scores of phone models aimed at every conceivable type of user, and has more than 100 sales offices in every corner of China, up from just three in 2002. "We were trying to run China by just managing it centrally as one market," says Colin Giles, Nokia's senior vice-president for sales and marketing in China. "When we started to roll out local distributors, we realized how diverse the market really is."

It's not just the multinationals that are segmenting the market. Chinese companies are doing the same. Appliance maker Haier Group, for instance, sells dozens of washing-machine models in China, including a tiny one targeted at rural customers that costs just $37. Lenovo Group Ltd. manufactures not only $2,000 PCs that double as home-entertainment centers, but also simple machines costing a couple of hundred dollars aimed at poorer rural families. And Geely Automotive Ltd. today offers five models, up from just two in 2003. The $17,000 Mybo is marketed as a family sedan, while the $3,700 Haoqing is aimed at recent college grads just buying their first set of wheels.

Shoppers of all incomes are being wooed in rural and urban areas

Learning about these emerging groups of consumers is the No. 1 task for multinational and domestic companies alike. They're meeting it by conducting focus groups and surveys across the country. To succeed in China, you have "to understand the psychographic profile of Chinese consumers, their emotions, and what they identify with in a brand," says Viveca Chan, brand expert and former China head for the advertising agency Grey Global Group. Grey has divided young Chinese into 11 categories—everything from independent types who don't follow consumer trends to shoppers on the cutting edge.

Other companies are spending lots of time with customers. Last spring, GM designers and engineers flew to Guangxi Province to visit van buyers and to see their homes and farms. James Shyr, director of design, recalls sitting on the sidewalk, smoking with drivers and talking about the features they like. "They use their microvans to run around from Monday to Friday hauling a lot of goods, but on the weekend they clean it up and take it for an outing," Shyr says. So Shyr's designers stuck with a utilitarian design better suited to rural lifestyles.

Similarly, Motorola Inc. dispatched teams of researchers to far-flung locales. The company, which stumbled in China two years ago when local rivals started to eat into its market share, discovered that even consumers far from the bright lights of Shanghai and Beijing are becoming more discerning. "In the lower-tier cities, the young people look at value, but they're also very individualistic," says Motorola China boss Michael Tatelman. The result: Motorola designers are devoting more time and energy to the lower end of the market, and even the company's least expensive phones allow users to download MP3 songs and customize ringtones. And while Motorola doesn't design phones specifically for rural China, it is now better at getting the right handsets to each location. "The demographic differences have always been there, but we've become more sophisticated in our ability to identify them," Tatelman says.

As marketers figure out how to reach China's variegated consumers, rural China looms ever larger. It has some 750 million residents, and in the first half of this year per-capita incomes in rural areas were up by 12.5%. Local rivalry is stiff. Wahaha, for instance, is China's largest beverage producer because it developed its distribution in rural areas. Wahaha's marketing sometimes consists of simply painting the company's logo on village walls.

Yet the multinationals keep getting more sophisticated in tailoring their message for both urban and rural consumers. P&G, for instance, reaches China's city strivers by sponsoring a popular reality TV show called *Absolute Challenge*, which has contestants vying to win jobs as product representatives for Crest or Cover Girl. At the same time, it blankets village kiosks and mom-and-pop stores with advertising emphasizing the value offered by Tide Clean White and low-end versions of Crest and Oil of Olay skin cream. Breaking out of China's cities is a challenge, but one that more and more companies, local and foreign, know they must take on.

–By Dexter Roberts in Beijing and David Rocks in Shanghai

Segmenting China

How top consumer-goods companies are playing the China market

GENERAL MOTORS The car company now targets the wealthiest with the Cadillac, middle management with the Buick Excelle, office workers with the Chevrolet Spark, and rural consumers with the Wuling minivan.

MOTOROLA The phonemaker has deployed thousands of salespeople to flog its handsets deep within China. Motorola designers are devoting more time and energy to the low end of the market, and even the cheapest handsets allow users to download MP3 songs and customize their ringtones.

PROCTER & GAMBLE The packaged-goods maker has developed bargain-priced versions of Tide, Crest, and Oil of Olay, and regularly relies on groups that live in the countryside for consumer information.

HAIER China's top appliance maker makes larger washing machines for Chinese cities, but has also developed a tiny model costing just $37 for poorer areas.

SAMSUNG Its white-goods division discovered that customers living in steamy Guangdong Province in the south needed larger refrigerators than those living in the more temperate north.

Data: Company reports

It Sure Ain't Old Navy

Gap's new chain, Forth & Towne, is a bet that store design can lure women 35 and over—and keep them hanging out for awhile

IN 2003, WITH SALES JUST RE-covering from a deep slump, Gap Inc. set its sights on the one slice of the market it wasn't reaching: women 35 and older. But executives knew that a new brand had to offer far more than the loose-fitting tunics and pants with roomy waistbands that are already on the market in abundance. "You can get great-designed clothes at Target if you want," says Gary Muto, president of the company's new brand, called Forth & Towne. "We wanted to create an environment that was distinctive, a place where you'd feel inspired, a place where you'd want to spend time."

The goal was lofty: To create a store so well-designed that it would become for busy Baby Boom women a sort of "third place," a destination other than home or work where people enjoy spending free time. Gap wanted the store's physical space not only to facilitate the sale of clothing but to embody the new brand, much as Starbucks and Apple Stores do. In doing so, Gap is placing a big bet on the growing importance of social shopping, the notion that shopping can be transformed into a pleasurable communal experience.

The first five Forth & Towne stores opened in August at malls in New York State and Chicago, with a range of upscale goods from tailored blazers to blue jeans, priced roughly on par with Gap's Banana Republic brand. Before the doors opened, Muto, chief executive Paul Pressler, and other Gap managers spent three years trying to come up with a design vision that fit their business plan. In the process, they abandoned many of the traditional appointments of a mall store. The result: a bold design by New York architect David Rockwell that places in the middle of each store a grand round "salon" of fitting rooms, furnished like a little hotel lobby. At its center are comfortable chairs and a "style table" laid out with fashion magazines, fresh flowers, and bottles of water. Forth & Towne's success will largely depend on whether women in its target demographic choose to linger in that salon.

It's a necessary gambit for Gap, which posted $16.3 billion in revenue last year. After flagging for almost three years, Gap's same-store sales began to recover in late 2002. But with the market almost saturated with Gap's existing three brands—Gap, Old Navy, and Banana Republic—Pressler needed a new source of long-term sales growth. Pressler's strategy: Launch another outlet, a move that Gap had pulled off before with the opening of Old Navy in 1994.

It may be an architectural success, but it's still too early to know if Forth & Towne will become a billion-dollar brand. The type of critics Pressler has to face can be rougher than Rockwell's. "I think it will be successful initially because it's new and different," says Todd Slater, director of retail research at Lazard LLC. "But long-term, I don't think the business has a great

DRESSERS' DUMMIES are intended to evoke the design process.

Decoding The Design

The "fitting salon" at Forth & Towne takes center stage, smack in the middle of the store. Here are some of the features designed to make it a fun place to shop and spend some time:

chance of succeeding in its current incarnation—not from a design point of view but from a merchandising point of view. I don't know that the merchandise outperformed the competition."

CREATING BY FEEL

BUT FOR GAP, the experiment hinges as much on how women connect with the stores as with the clothes. Pressler, who used to run Walt Disney Co.'s theme park business, tapped into his former life for his answer. He decided Forth & Towne needed a "wienie." That's Walt Disney's term for a visual magnet—the ur-example of which is Sleeping Beauty Castle, the iconic centerpiece of Disneyland that guides people around the park. And he knew just the guy for the job. In winter of 2004 he called on Rockwell, who had worked for Disney during Pressler's tenure there. Rockwell designed the Animator's Palette, a restaurant on Disney's cruise ships whose lighting, walls, tableware, and wait-staff uniforms morph over the course of the meal from black and white to color, like a cartoon being colored in.

Rockwell is unusual among architects in that he's more interested in how something feels than how it looks. A low-key, affable man who wears his hair long, his architecture is marked by a sense of theatrical extravagance—on display, for instance, in the thousands of abalone shells dangling from the ceiling at Nobu 57, a Manhattan sushi restaurant, and the giant red wig in his set for the Tony-award winning musical *Hairspray*. "The notion was, 'how could we use someone like David to start to think about the store environment as being as important as the clothing?'" says Pressler.

The first step was getting a first-hand understanding of the customer. They invited onto the design team Karen Davidov, the wife of Henry Myerberg, a principal at the Rockwell Architecture, Planning & Design Group, an architect herself and squarely in the target market as a woman in her late 40s. She and Lizzie Sayner, a 31-year-old designer at the Rockwell Group, would visit the Garden State Plaza in Paramus, N.J., to check out the competition—stores like J. Jill, Coldwater Creek, and Ann Taylor. They would snap pictures on the sly, try on clothes, and hang out. "We all had such empathy for this woman," Sayner says of

THE SPARKLING CENTRAL CHANDELIER—recalling the heyday of the department store—is updated as banks of hanging stainless steel rods tipped with clear filament bulbs.

THE CIRCULAR SHAPE of the fitting salon is meant to encourage interaction—like a gazebo in a small-town park.

A REFRIGERATOR tucked off to one side holds bottles of Forth & Towne-labeled water. Chocolates on the table are another come-on.

NARROW, CURTAINED ENTRYWAYS emphasize intimacy, making it conducive to hanging out with friends, other shoppers, men in tow, and Forth & Towne's "style consultants."

EACH FITTING ROOM is decorated uniquely—implying that shoppers aren't simply getting cookie-cutter style.

DECO-STYLE STOOLS encourage lingering; a styling table with accessories and lifestyle magazines are intended to provoke ideas about style in other forms, like gardening or home decor.

(L TO R) PHOTOGRAPHS COURTESY OF GAP; ROCKWELL GROUP/ADRIAN WILSON

FOCAL POINT The fitting salon also acts as the store's beacon

the archetypal Forth & Towne shopper.

Sayner and Davidov tried to invent a back story for her, shading in where "she" lives, where she shops and gets style ideas, and how she balances work and family. They decided Forth & Towne had to accommodate a woman with myriad impulses, one who was comfortable in urban and suburban environments, a social shopper but often a harried one.

Sayner pulled touchstone phrases and images into a scrapbook, with categories such as "careers," "friends," "worries," and "what I want." It had photos of Ally McBeal, Condoleezza Rice, and the women from *Dynasty* in the "careers" section. In other sections: a "balanced life quiz" clipped from a magazine; an Amazon.com shopping cart with Norah Jones in it; the cover of *Divine Secrets of the Ya-Ya Sisterhood*; and phrases like, "I have zits, a spare tire, self respect, and dignity." In April of last year they gave the scrapbook, like a gift, to Jenny Ming, brand president of Old Navy and part of the small, high-level team shepherding the Forth & Towne project prior to Muto's appointment.

FINDING THE CENTER

WITH THE NEW STORE'S DNA established, Rockwell and his team now had to design the actual space. No plan would succeed if it cost $500 a square foot to build—not when hundreds of stores were ultimately envisioned. So there was no room in the budget for giant interactive displays or grand stairways.

As is typical in the design process, the team pondered a variety of possibilities, creating iterations of an idea until it either reached a dead end or was clearly a winner. Execs dismissed a typical mall store's "main street," where racks of clothing are arranged along a central path. They thought of designing "gates," ceremonial entryways to each of the four separate labels of clothing Forth & Towne carries, but that ate up too much floor space.

What every store needed, the designers knew, was an iconic center—something that played the role of a clock tower, a gazebo, or a village green in a small town. In Disney parlance, they needed a wienie. First, they tried using a chandelier to create a central beacon for the store, recalling the heydey of the department store. But "the overarching frustration that women in this segment have is fit," says Muto. "So if you want to be known for having a great-fitting product, and you want them to go to the fitting room, then why not make that experience the best it possibly can be?" So, gone were narrow, anonymous fitting-room hallways. In came the elaborately decorated fitting salon.

With that key design element in place, in January, 2005, Gap built a full-scale mock-up of a section of the store in a warehouse near the San Francisco airport. Over the next several months, working closely with Gap execs, Rockwell fine-tuned the layout there—"like a fashion fitting," Rockwell says.

The last, and perhaps hardest, decision was what color the store should be. At first everyone was determined to avoid pink—fraught with meaning for a generation of women who saw the start of the feminist movement. But emboldened by the recently launched women's magazine *Pink*—whose slogan is "a beautiful career, a beautiful life"—they reclaimed a dusty hue as a statement of femininity come of age.

Pressler will be watching closely to see if the strategic design lures women away from stores such as Chico's, Talbots, and Ann Taylor, which all have long-term relationships with their shoppers. But even if Forth & Towne doesn't blossom the way Old Navy did, Pressler says the process has already yielded benefits for Gap Inc. "It's not that I think we would do a center fitting room for the other brands," Pressler says, "but the importance of the fitting room as a destination that people really want to hang out in is certainly something we take away." If the ambitious plans take hold, expect more wienies from Gap. ■

–By Andrew Blum in New York, with Louise Lee in San Mateo, Calif.

PLAYBOOK: BEST-PRACTICE IDEAS

Design by **David Rockwell**

Rockwell values experience over look. Here are some of his guiding principles:

THE DESIGN COMES LAST
His first presentation about Forth & Towne was about the rituals of shopping, not architecture. "It allowed us to evolve a more ambitious plan than if we went right to a design solution."

BE OPEN TO THE EUREKA! MOMENTS
Inspiration comes from unexpected places. With Forth & Towne, for example, the idea of putting the fitting rooms in the center of the store began by trying to design a central chandelier.

FOCUS ON THE UNIQUE
Though Forth & Towne could grow to many locations, Rockwell assumed there would be only one. "If you start out thinking about the replication, you probably never get to the unique thing."

EXPERIENCE OVER AESTHETICS
The spaces Rockwell designs are beautiful, but they're also emotional. "What something looks like comes after a very detailed conversation about ... what it will do," Rockwell says.

(TOP TO BOTTOM) ROCKWELL GROUP/ADRIAN WILSON; BRAD TRENT

The Making of A Track Star

Canadian National's chief talks about why the railway is the industry's most profitable

CEO HARRISON Seeking a role in Katrina reconstruction

AS HURRICANE KATRINA WAS HURTLING toward New Orleans, E. Hunter Harrison was overseeing Canadian National Railway Co.'s emergency preparations from his home in suburban Chicago. The company, through its Illinois Central Corp. subsidiary, has hundreds of miles of track and more than a dozen facilities along the Gulf Coast, including a big freight yard just west of New Orleans. Working through the weekend, crews hurried locomotives and other equipment out of the area and then halted all traffic.

CN and Harrison, its 60-year-old chief executive officer, were lucky. The storm took down its intermodal facility near New Orleans, where trailer-size containers are transferred between train cars and trucks. Two weeks later, Hurricane Rita washed out a rail section that had just been repaired. But by Sept. 30 the line was open once again. As a result, industry analysts are sticking with their bullish forecasts, projecting a 31.5% increase in earnings in 2005 and another 16% rise next year.

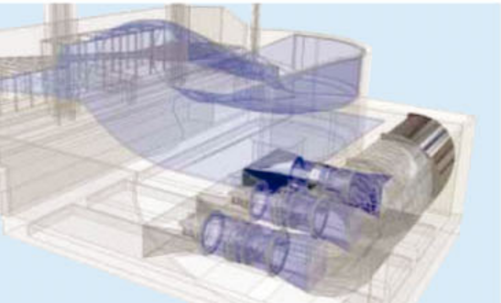
With 22,500 employees and $5.5 billion in 2004 revenue, CN is dwarfed by the industry's Goliaths. Union Pacific Corp. produced revenues of $12.8 billion last year, while Burlington Northern Santa Fe Corp. hauled in $11.9 billion. But CN tops them and every other major railway in North America in operating margins and total profits, with $1.22 billion in net income last year.

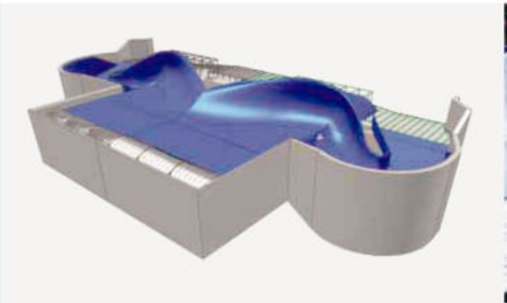
SPECIAL FEATURE
Manufacturing, Technology & Logistics

The railroad has also been a rocket for investors. Founded in 1922, CN was privatized by the Canadian government in 1995 in what was at that point the biggest IPO in Canadian history. It then stretched into the U.S. through a series of acquisitions, starting in 1999 with Illinois Central, where Harrison was chief executive. On a split-adjusted basis, the stock began trading at $6.67. Shares closed on Sept. 30 at $70.99.

Timely service is the secret to success. Under Harrison, Illinois Central became a model freight line by running scheduled service, a surprising rarity in an industry known better for low costs than punctuality. Copying passenger railroads and airlines, Harrison guaranteed pickups and deliveries to the hour, even across thousands of miles. He introduced the same plan at CN when he came on board as chief operating officer. Today the Montreal-based railway is No. 1 in efficiency.

Harrison, who was promoted to chief





executive in 2003, is a railroad man from way back: He hired on as a laborer with St. Louis-San Francisco Railroad Co. in 1963 when he was still in high school in Memphis. Today, he splits his time between CN's headquarters in Canada and an office outside Chicago. He recently discussed Katrina, and the future, with Senior Correspondent Michael Arndt. An edited transcript follows.

Let me start with the hurricanes. You've just been through two of them in three weeks. How are you faring?
We were very fortunate compared to others. We're on higher ground in New Orleans. We did have some outages because of Katrina, for about a 30- or 40-mile stretch north of the city. And we lost six or eight miles of that again because of Rita. Grain shipments have slowed down because of disruptions to employees, power supplies, and communications lines. There's still not a lot of activity at our intermodal facility in New Orleans, frankly.

But from a financial standpoint, it's a non-event. Most of the revenue loss is more of a timing issue. For example, grain. We're still going to haul the same amount of grain—it's just going to move later than usual. There's a little more that will fall over into the fourth quarter instead of the third. By the end of the year, it will all be a wash.

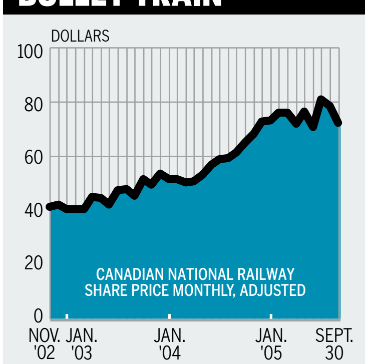
Longer term, some economists think the hurricane will be a boon to the economy as reconstruction proceeds.
I don't think there's any doubt about that. We're the largest hauler of forest products in North America. I would imagine there will be a lot of building products moving into the New Orleans area for the reconstruction, so we're making preparations for that. We're looking at putting in new infrastructure for transferring lumber from railcar to truck, somewhere in the New Orleans area.

We're also doing a lot of exploring for potential opportunities to remove debris out of New Orleans. Somebody has to haul the debris. I don't know who will want the stuff. That'll be quite an issue because of environmental concerns, but we're there and positioning ourselves.

What about the economy?

MANIFEST DESTINY

BULLET TRAIN



Data: Bloomberg Financial Markets

It is not quite as strong as it was 18 months ago. But there's pretty steady growth right now. The only soft spot is the auto sector, and we anticipated that. Our business is going well. We're exceeding our revenue expectations for the year.

Are there any issues that—pardon the pun—could derail you?
Energy prices worry me because of the impact on the economy. We have been very successful with our fuel surcharge and hedges. Basically, fuel is a pass-through for us. We adjust our charges every month based on average diesel fuel prices, so our customers pay fuel costs, not us. All of the railroads have surcharges that are similar.

But the longer-term implications of rising energy prices do give me concern. Obviously, somebody has to foot the bill.

Your company is growing, as you noted. Is that because the economy is growing, or are you taking market share from other railroad companies and trucking?
It's a little bit across the board. We have made market share gains over the past five years. Most of that, we think, is the result of our service, which has become more competitive and more consistent. If you're asking for shipment from Toronto to Baton Rouge, for example, we'll quote it at 103 hours, not six to seven days. And we consistently are on time 92% to 93% of the time.

That change of service has given us the ability to capture share that we had previously lost to the highway.

I had thought that over the years trucking was eroding rail's market share. So rail is starting to take that back?
I think there's a turnaround. Particularly at Canadian National, that has been the case over the past five to six years. We move a lot of bulk goods like grain and coal. But we're different from most rails, where most of what they carry is bulk. Eighty percent of our business is nonbulk, such as lumber, consumer goods, steel products, and chemicals, and trucks certainly are competitive for most of that business.

CN has done a number of acquisitions, starting with Illinois Central. Is there much left to acquire?
Not much. There are some regional short-line carriers. But the opportunities are not like they used to be. When I first went to work, there were probably 50 Class I railroads. Today that number is seven.

That said, if there were two carriers that decided they would like to get together, I don't think a combination would run into antitrust issues. We think we're pretty good railroaders, and we're pretty disciplined in our acquisition strategy. If we can acquire rails and extend our reach at the right price, we'll continue to do that.

You have been in the rail business more than 40 years. How did you originally get into it?
I was just an 18-year-old kid looking for a place to work, and the rails paid more money than anybody else. I was fortunate to be at the right place at the right time. A rags-to-riches story? I know the rags; I'm not sure about the riches.

What are the most significant changes you've seen over your career?
Probably the most significant was the deregulation of the rails with the Staggers Act of 1980. Before that, the rails were struggling and it was not a lot of fun in the business. The second was probably the megamergers of the 1990s.

CN is a Canadian company. You are an American. Has that raised any problems for you?
I think a few people would like to see it otherwise. But we like to think of ourselves as a North American company. It has worked very well for us. ■

MAP BY ALBERTO MENA/BW; CHART BY LAUREL DAUNIS-ALLEN/BW

TCS ENGINEERS Broad design skills offer an edge

Designing Dream Machines—in India

India's Tata Consultancy and other outfits are taking on more complex jobs for Detroit

SPECIAL FEATURE
Manufacturing, Technology & Logistics

FEW FOLKS ARE SURPRISED to learn that their PC or cell phone was designed by a no-name Asian electronics contractor. But what about something really complex? Could Detroit, say, outsource the design of a whole passenger car to low-cost engineers in Asia? Not yet. But visit the engineering operations of outfits such as Tata Consultancy Services, a showcase of India's fast-evolving design capabilities, and that day seems closer than you may think.

At TCS labs in India, engineers are working on virtually every aspect of car design for an array of foreign clients. In Bangalore, for example, engineers are tweaking the designs of a drive train for a passenger car to be built by a Western auto maker. Using virtual 3D prototypes, ergonomics experts run complex analyses of design changes to the car's interior, helping determine whether the steering wheel or radio controls are at an optimal distance from the driver. "Just one millimeter off can irritate the driver," explains R.G. Prasad, who heads TCS' 850-engineer industrial design operations in Bangalore. TCS experts also scrutinize the structure of a car's outer body, devise embedded software to monitor an engine's performance, and analyze crash-test results. And they help design factory production lines that will be built back in the U.S.

Scaled Down

Engineering services, cost per hour

INDIA	U.S.
$15	$70

Data: Nasscom

Nobody is saying the Big Three are planning to outsource the conceptual design of whole vehicles anytime soon. For now, auto makers tend to farm out less creative, more tedious engineering tasks such testing for design flaws. But clearly, the volume and sophistication of engineering design work is growing rapidly in India. Bangalore's Harita Infoserve Ltd. is developing interior parts and conducting computer tests on components for General Motors Corp. Bangalore's Plexion Technologies has worked on the interior design and windows for a DaimlerChrysler bus. Toyota, Ford Motor, Ferrari, and Honda Motor all are boosting Indian outsourcing, as are key component makers such as Robert Bosch, TRW Automotive, Visteon, and Collins & Aikman.

Detroit's enthusiasm is providing a new boost to the subcontinent's fast-growing info-tech services sector. Within five years, India's contract industrial engineering revenue is expected to grow from around $500 million now to $10 billion. Worldwide, the product engineering services industry is expected to double, hitting $53 billion annually by 2009, predicts market research firm IDC.

It's unclear how much engineering de-

RAGHU RAI/MAGNUM

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sign work is reflected in these numbers, but it won't be trivial. Last year, for example, auto makers accounted for some 60% of the industrial design work done by Indian suppliers, according to Indian software services trade group Nasscom.

Design outsourcing contracts are sweeping into numerous industries. U.S. producers of everything from machine tools and farm equipment to heavy-duty power generators are rushing work to India as well. At one end, the wave is likely to encompass more midsize companies such as MarquipWardUnited, a $125 million manufacturer based in the small town of Phillips, Wis. To speed up development of the company's $300,000 machines that create cardboard packaging, executives turned to St. Louis design partner Barry-Wehmiller International Resources (BWIR), which in turn employs 200 industrial engineers in Chennai, India, and an additional 50 in the U.S. BWIR intends to boost its Indian design engineering force to 300 by yearend. Likewise, Chicago's Fleetwood Goldco Wyard Inc., a $100 million manufacturer of factory equipment, used BWIR to develop expensive pasteurizing machines for a leading U.S. packaged foods company.

TRAINER PLANE Many TCS staffers are aerospace vets

The big goal: Homegrown industrial designs for export

OPPORTUNITY TO GROW

WITH MIDSIZE EQUIPMENT makers struggling to fend off mounting competition from China, outsourcing arrangements pay off mainly by cutting development time and costs. Many of these manufacturers have had to pass up orders with tight delivery times simply because they lacked the necessary engineers. "Where we are, it's hard to hire and train people in a hurry," says Operations Manager Blake Pluemer of MarquipWard United, which supplies production lines to the likes of Weyerhouser Co. and Georgia Pacific Corp. "Now we can shrink and expand as needed. This gives us an opportunity to grow."

In Detroit, economics is driving the move to India, which has an abundance of engineers and design outfits that charge less than $15 an hour for their services.

And advanced, interactive design technologies are becoming simpler and less expensive. These are the tools that enable engineers around the world to use the Internet to swap, test, and modify virtual products that may have thousands of components. Prices of basic computer-aided design software from the likes of Needham (Mass.)-based Parametric Technology, Cincinnati's UGS, and France's Dassault Systems have dropped from $20,000 per copy in the mid-1990s to as little as $3,000 today.

These factors have played to the strengths of big Indian design houses, which can afford to hire hundreds—even thousands—of engineers. What's more, huge operations such as TCS, one of India's leading software-services giants, can offer a breadth of engineering services unmatched by U.S. rivals. Most independent engineering firms serving Detroit have fewer than 10 engineers, who specialize in just a few niches. Because such expertise is expensive, carmakers "tend to outsource very high-end jobs," says PTC Chief Product Officer Jim Heppelmann. In contrast to Detroit boutiques, the Indian outfit has 2,000 industrial engineers, 400 of whom specialize in auto electronics and embedded software. As a result, "virtually every part of a product can now be affordably outsourced," he says. PTC says it sees a sharp drop in design software sold to U.S. engineering operations—and rapidly rising sales in India.

Indian companies also offer a broad range of technical capabilities. Among the strengths of TCS is expertise in developing software tools and algorithms to analyze all sorts of engineering challenges. For clients setting up auto factories in the U.S. and Europe, TCS engineers, many of whom have experience in the Indian auto and aerospace industries, simulate the production processes under various scenarios and suggest the optimal method to configure the assembly lines and work areas and the best way to program assembly robots. They also develop models to study the impact of a collision on any part of a car body at different angles.

BROAD EXPERTISE

WHEN IT COMES to a car interior, such broad expertise is especially valuable. "Every tweak in the design of a car interior has a cascading effect on every other parametric that then has to be analyzed," such as the configuration of the dashboard or the space between a passenger's head and the ceiling, says Ravi Gopinath, TCS vice-president for engineering and industrial services. "We can then come up with solutions very quickly."

It's not hard to discern where these diverse capabilities converge. Ultimately, Gopinath says, TCS and other Indian engineering contractors would like to win jobs to develop an entire vehicle. "It would be our dream if a car manufacturer just said: 'Here are the specs. Go and do the complete job,'" he says. That's unlikely. The design of a car engine, body, and interior are too central to a carmaker's competitive edge and require an intimate feel for the preferences in the home market. But, Gopinath notes, "we are getting into larger parts of the development cycle." IDC analyst Joe Barkai confirms the trend: "We'll see manufacturing companies giving much more ownership of design to their trusted partners in India."

Ultimately, TCS and other Indian engineering houses say they hope to sell their own conceptual designs for industrial products. If so, a future economy car could well carry a label saying "designed in India."

—By Pete Engardio in Bangalore

Remotely Engineered

Big carmakers account for some 60% of the contract industrial engineering work done by Indian suppliers:

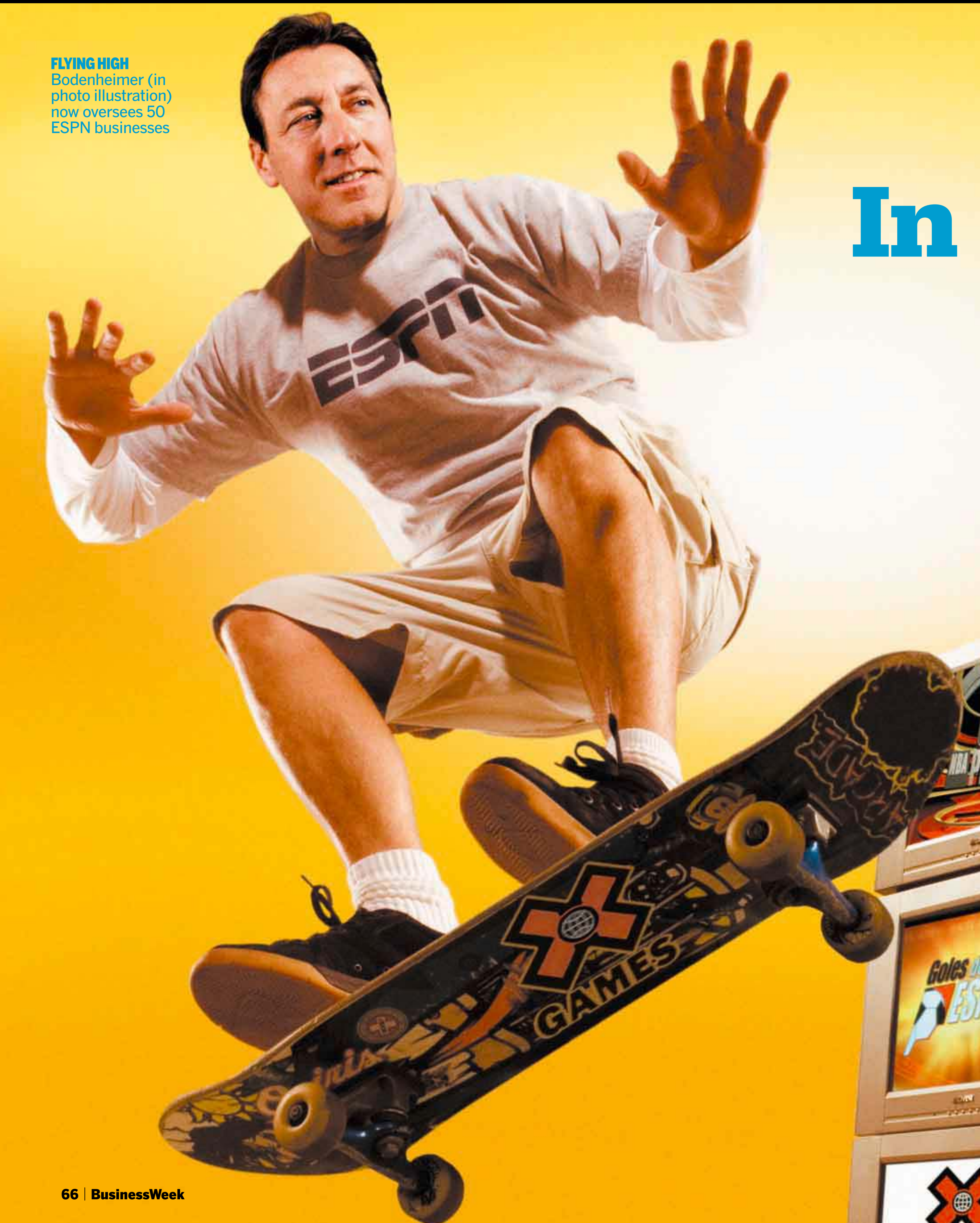
GENERAL MOTORS

Nearly 100 projects have been completed or are in the pipeline. Work includes modeling interiors, doing crash simulation analysis, factory planning, and designing molds and tooling parts.

FLEETWOOD GOLDCO WYARD

This midsize manufacturer uses Indian engineers of partner Barry-Wehmiller International Resources to help custom design automated factory equipment for big U.S. drug and packaged-food makers.

Data: *Detroit Free Press*, Fleetwood Goldco Wyard, PTC



FLYING HIGH Bodenheimer (in photo illustration) now oversees 50 ESPN businesses

In

the Zone

As rivals circle, ESPN boss George Bodenheimer is trying to push his world-beating brand even deeper into the lives of sports fans

BY TOM LOWRY

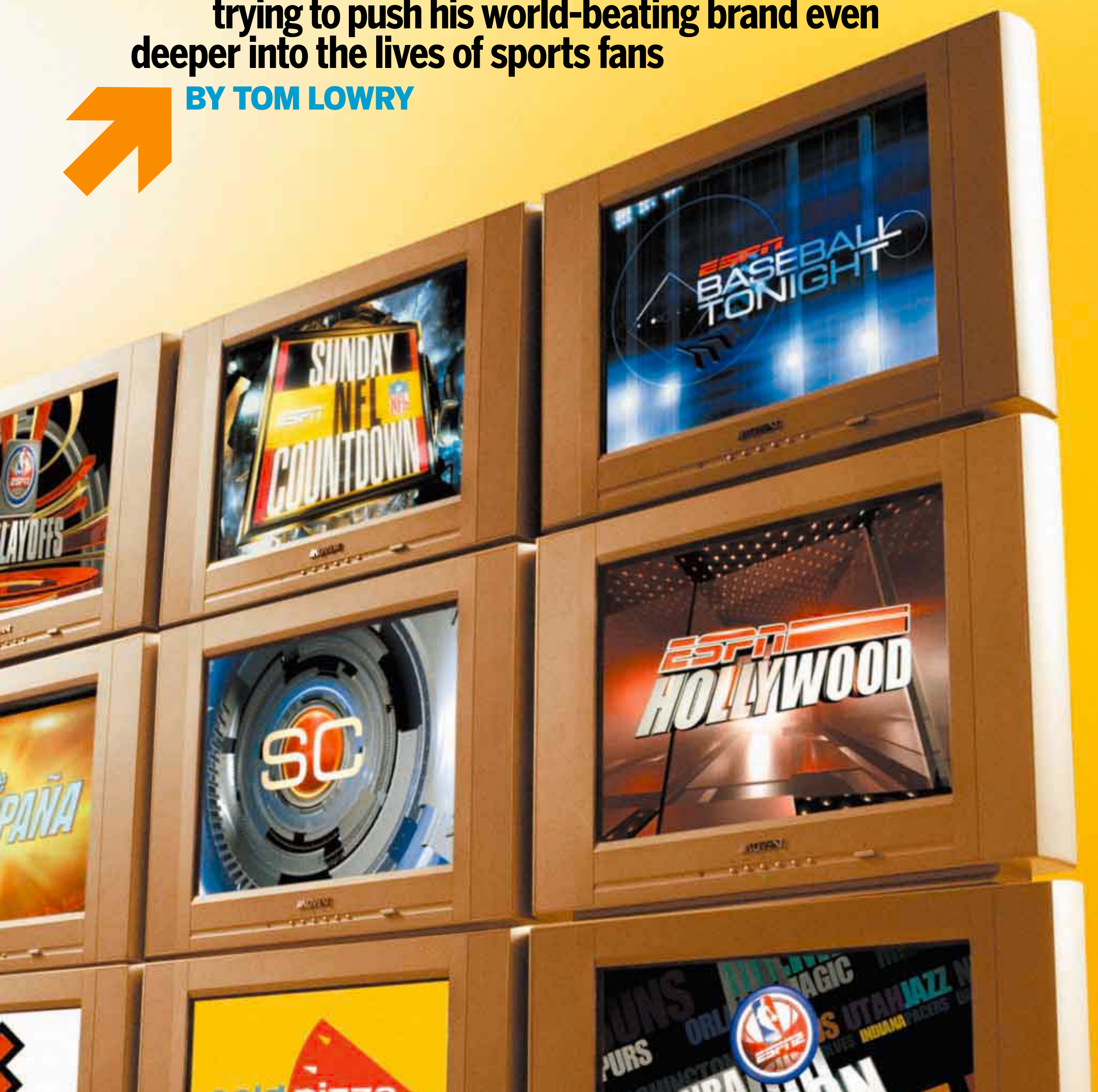


PHOTO ILLUSTRATION BY MICHAEL ELINS, USING BODENHEIMER PHOTOGRAPH BY ERICA BERGER

O N SEPT. 19, MILLIONS OF FANS TUNED in to a rare Monday night pro football doubleheader. Interlaced with plays were cutaways to a telethon to help victims of Hurricane Katrina. Viewers of ESPN and ABC saw some of the biggest legends in sports fielding calls from a studio in Manhattan's Times Square: Frank Gifford, Bart Starr, Gale Sayers, John Elway, Eric Dickerson, Donovan McNabb, George Bodenheimer... huh? George Boden-who?

What most folks watching didn't realize was that the stiff-looking guy with the phone in his ear is perhaps the single most influential person in all things sports. As president of the ESPN Networks and ABC Sports, George W. Bodenheimer runs one of the most successful and envied franchises in entertainment, the jewel of Walt Disney Co., and among the most powerful brands of the last quarter-century. While his round-the-clock networks are all about being brash and in-your-face, Bodenheimer is the rare media mogul who is adamant about staying behind the scenes. ESPN's top public-relations executive had to practically drag Bodenheimer out of a production booth and push him in front of the cameras to make an appearance at the Katrina telethon, which he helped pull together with the National Football League in a matter of days. "It's just not about me," he could be heard mumbling as the PR chief made sure his tie was straight.

That modesty has worked well for the 47-year-old Bodenheimer, and ESPN has flourished in his seven years at the helm. Sure, the ESPN he inherited had already extended itself from TV to print, the Internet, and other platforms. And its smart-aleck, testosterone-laden culture was already a trademark. But Bodenheimer's vision of his company, where he started in the mailroom, is as a ubiquitous sports network—and more. To really understand ESPN, you need to see it as a cluster of feisty, creative enterprises under one killer brand. Its units, spread out mostly over offices in Connecticut, New York, and Los Angeles, act like startups, full of passionate staffers who are given the freedom to drive forward but always with a mission to keep the customers (rabid and tech-savvy fans like themselves) happy. Bodenheimer "realizes ESPN has to be fast-paced," says Simon Williams, CEO of consultant Sterling Branding. "In his realm, if you stand still you're dead."

WITH PROGRAMMING LIKE THE X GAMES, ESPN DRAWS LEGIONS OF YOUNG MALES

So, through 50 different businesses, Bodenheimer has pushed ESPN into broadband, on-demand video, wireless, high-definition, even books. His company has the X Games. It has burgers and fries at ESPN Zone restaurants. Video games are coming soon. All the while, the daily news and highlights show, *SportsCenter,* is as much must-see TV for millions of Americans as the nightly news shows were a generation ago. Put it all together, and Bodenheimer's competitors can't help but express awe. So ESPN has become a model for a wide range of companies, media and others, struggling to make their

ESPN The Empire

First, a TV channel, and now.....

MORE CHANNELS Nine TV outlets, including ESPN2, ESPN HD, ESPN Deportes, and ESPN Classic.

ORIGINAL PROGRAMMING ESPN develops its own shows and movies, including ESPN2's *ESPN Hollywood*, *Cold Pizza*, and the new *Bound For Glory* high school football reality series featuring Dick Butkus.

RADIO The largest U.S. sports-radio network, with more than 700 affiliate stations, features hit shows *Mike & Mike in The Morning* and *The Dan Patrick Show*.

ONLINE ESPN.com gets more than 16 million unique users a month. Includes ESPN Motion, an online video service, and ESPN360, offered via broadband; Verizon is one carrier.

PUBLISHING The biweekly *ESPN The Magazine* won a National Magazine Award for general excellence in 2003. It launched a China edition (right) in the fall of 2004.

WIRELESS Mobile ESPN is an ESPN-branded phone (left) and customized service that rolls out in February.

GAMING Video game leader Electronic Arts has a 15-year deal to be the sole licensee of the ESPN brand in sports games, which will include console, handheld, PC, and wireless games.

X GAMES Annual extreme sports competition features motocross, bike stunts, and skateboarding.

ESPY AWARDS Athletes and celebs recognize top achievements in sports and to support The V Foundation for Cancer Research founded by ESPN and late college coach Jim Valvano.

ESPN ZONES Eight sports-themed restaurants operate nationally, with a new one set to open in ESPN's planned $100 million studio facility near the Staples Center in Los Angeles.

INTERNATIONAL The world's largest distributor of sports, ESPN makes its programming available in 11 languages in more than 180 countries.

PHOTOGRAPH BY VAUGHN YOUTZ/ZUMA PRESS; DIGITAL ILLUSTRATION BY DAVID RUDES/BW

brands work in new markets. "They have always had a halo to do things like a *SportsCenter* really well," says Jeff Price, chief marketing officer at *Sports Illustrated*. "Nobody has created those touchpoints with consumers like they have." Adds Adam Silver, the top TV executive at the National Basketball Assn.: "George lets others shine, but don't be fooled by the aw-shucks manner. He's an extremely effective manager who has put his company at the cutting edge of the digital revolution."

REMEMBER TO HAVE FUN

NEVER ONE TO GLOAT about the successes, the understated Bodenheimer confesses that the track he has been pounding is getting a whole lot steeper lately. At his back is a slew of rivals gaining momentum. First among them is Comcast Corp., the No. 1 U.S. cable operator. Looking to build a cable sports network to rival ESPN's, Comcast is also ESPN's biggest distributor, so its plans could aggravate what's already a delicate relationship. Right about now, Bodenheimer is placing a hefty bet on an ESPN-branded cell phone and has said that making the new business a winner will be one of his biggest challenges of the year. The cell phone is a move into an alluring market—delivering sports data and images to insatiable fans at all hours. But the payoff is uncertain at best, and the venture, announced on Sept. 27, could ultimately dent earnings and tarnish the brand. Bodenheimer's angst was turned up a notch or two higher when a key executive, Mark Shapiro, resigned in August. As head of programming and production, Shapiro was seen as a driven ideas guy who kept new shows flowing and viewers tuning in. He was also an effective bad cop to Bodenheimer's good cop at the negotiating table.

Shapiro is often compared with Bodenheimer's high-energy predecessor, Steve Bornstein, ESPN's president during much of the 1990s. The 26-year-old network's initial blast of growth came under Bornstein, whose swagger infused the place with the cocky culture so strong today (page 78). Bodenheimer's core strength, say longtime staffers, has been to preserve and encourage that vibe without making it all about George. His message to the staff is something like: ESPN isn't mine, it's yours, so run with it. And remember to have fun.

Bodenheimer is in Brooks Brothers most days, but his operation is anything but buttoned-down. It's more about hoodies and DC skateboarding shoes, which is to say it's all about being young. When *ESPN The Magazine* launched in 1998, designer F. Darrin Perry gave its pages a bold look with bright colors and unconventional type. That high-octane feel extends even to the magazine's offices in midtown Manhattan, which are designed to look like a gym, complete with an old school scoreboard. On any given day at the main ESPN campus in Bristol, Conn., now encompassing 100 acres dotted with dozens of satellite dishes, you might find former All-Star second baseman and *Baseball Tonight* host Harold Reynolds waiting in line for brick-oven pizza in the fancy staff cafe, or *SportsCenter* anchor Stuart Scott looking for someone to spot him on the bench press in the state-of-the-art gym. A new $160 million digital center and studio, crammed with robotic cameras and lighting rigs, is ringed with flat screen TVs beaming sports in crisp hi-def. A central control room houses producers at computers editing a constant stream of digital-video game feeds.

The whole scene is NASA meets the bleacher creatures. "People have a passion for sports," says Rich Weinstein, the ESPN account director at ad agency Wieden + Kennedy, which has captured the spirit of ESPN through its award-winning spots for the network. "If your job is your passion, it brings a new perspective to the creative process. George was here when this was a startup, and he has preserved that feeling." True to form, at a strategy session this summer for the new phone, the boss rolled up his sleeves, snapped open a Diet Coke, and burrowed down into every marketing idea the team pitched. Un-mogul-like, he never checked his BlackBerry or cut off discussion. Then he took the group out to a swanky trattoria.

Bodenheimer, who squeezes in a golf game when he can, loves to break the ice by talking about —what else?—sports. He tries to stay engaged with workers across the company without micro-managing. "The great thing about George is that he can stand back and let his managers create," says Gary Hoenig, editor-in-chief of *ESPN The Magazine*. Going up against venerable *Sports Illustrated*, ESPN's seven-year-old biweekly has made great strides. Since 1999, circulation has grown by about 1 million, to 1.8 million, while *SI* has held steady at 3.3 million, according to the Audit Bureau of Circulations. Hoenig also credits Bodenheimer with granting him the freedom to develop lucrative specialty newsstand magazines like one on fantasy football.

Tanya Van Court, whom Bodenheimer hired from Cablevision in April, 2004, to oversee a revamp of broadband service, insists, too, that the boss never meddles. During the eight months that the new product ESPN360 was in development, "he would send hand-written notes with suggestions every week and a half or so," she says. "He would offer up [notes like], 'make it the ultimate on-demand product for the sports fan and one that is as flexible as possible.'" When ESPN360 launched last January with programming tailored for broadband—including short clips recapping Sunday games—it just may have hit on a new model (page 74). ESPN insiders liken it to cable TV in its infancy in the 1970s. So far, ESPN360 is available to nearly 5 million users through 14 different broadband providers.

Branding, By George

George Bodenheimer oversees one of the great brands not only in sports but in all of Corporate America. Here are his tips for nurturing a top brand:

1. **DEFINE YOUR MISSION** "Serve the fans. That's why we are launching our new cell phone and service, to be able to reach fans wherever they are."
2. **KNOW WHAT YOUR BRAND IS** "We view ourselves as the world's biggest sports fan. Be fun. That's why we try to keep our programming lively without taking ourselves too seriously."
3. **CULTIVATE RELATIONSHIPS WITH YOUR CUSTOMERS** "Talk to fans, not at them. We try to do that with our award-winning ad campaigns."
4. **DEVELOP AN INCLUSIVE CULTURE** "I came up from the mailroom, so I had managers who were listening to me. You need to let everyone contribute."
5. **CONTINUALLY ENHANCE YOUR PRODUCT** "We have launched three new channels in the past two years, a broadband service, and a cell-phone service. And we are always tweaking our franchise show, *SportsCenter*. We've added more music and highlights recently."

IRRESISTIBLE ECONOMICS

CAN BODENHEIMER THE DELEGATOR and his decentralized, free-thinking culture keep up the winning streak? "The next two years will be a real big test for George," says Sean McManus, head of competing CBS Sports and a friend of Bodenheimer's. All around it, companies are imitating ESPN's cool and edgy packaging of sports. And if live sports is the last great mass market to lure advertisers, then how long can ESPN expect to dominate? Throw in a sports-crazed, often-elusive audience of young men bordering on the fanatic, and the economics are irresistible. That's why so many players are pushing into Bodenheimer's domain, from teams and leagues launching their own channels to cable and satellite operators creating new offerings. "ESPN listens to its audience very closely," says Sterling's Williams. "If it keeps doing that, [that] should be the glue that holds it together."

Even so, the ESPN chief these days finds himself playing more defense than offense to keep games out of competitors' hands. One sign of the times: big hikes in the prices ESPN is paying to lock up new pro football and Major League Baseball rights contracts. The $2.4 billion, eight-year MLB deal announced on Sept. 14 represents a 50% annual increase in fees. And in April, ESPN ponied up $8.8 billion for a new eight-year *Monday Night Football* deal with the NFL for only one night of football. ABC will no longer broadcast games, including the lucrative Super Bowl; NBC grabbed ESPN's old Sunday night spot. The bottom line: ESPN will pay nearly twice as much a year than it did last time around, though other goodies were included, such as wireless rights that will allow ESPN for the first time to deliver Monday night highlights to cell phones. "You have to ask yourself how much growth will be left if they keep spending like this," says Richard Greenfield, an analyst at Fulcrum Global Partners LLC. Counters Bodenheimer: "Look, we are a sports-media company, and we program sports. It's like saying a seafood restaurant is being defensive when it reorders lobsters."

Bodenheimer, of course, lives in a world that's not totally of his own making. His ESPN is part of a tempest-rocked ship known as Disney. For years, ESPN has been able to do its own thing for one reason: It was the outfit former CEO Michael D. Eisner could count on for the numbers. Now, with Eisner gone, Bodenheimer will work closely with an old friend, new CEO Robert A. Iger, a onetime exec at ABC Sports. The bond between Bodenheimer and Iger is strong, one pro league executive suggests, because they see themselves in each other—"two executives who have always been underestimated." Says Iger: "People sometimes mistake being polite for being easy. That's not the case with George. He's a man of great integrity, but he can be tough." Some speculate that Iger might bring Bodenheimer to Burbank, but for now he needs his friend to stay put, keeping ESPN the financial bulwark it is to counterbalance the fickle businesses of theme parks and hit-driven TV and movies.

Indeed, ESPN revenues alone this year could be about $5 billion, with operating earnings of nearly $2 billion, according to projections from various analysts. The revenues—about 60% from distribution fees and 40% from advertising—would represent about 15% of Disney's total. Analysts estimate that revenues could grow to nearly $6.8 billion in 2008. More important, ESPN is so central to cable menus that it gives Disney bargaining power with distributors to pick up other Disney channels, be they SOAPnet or the ABC Family Channel. Emblematic of

Youth Rules

ESPN wins out vs. *Sports Illustrated* when it comes to drawing younger audiences.

MEDIAN AGE OF VIEWER/READER

31	ESPN THE MAGAZINE	40	SPORTS ILLUSTRATED
32	ESPN.COM	38	SI.COM
35	SPORTSCENTER*		NO SI TV OUTLET

*11 p.m. show **Data:** ESPN, *Sports Illustrated*

ESPN's clout, its longtime head of affiliate sales, Sean R.H. Bratches, was promoted a year ago to oversee distribution for all of Disney's cable channels and broadband services. Using ESPN's leverage was a favorite tactic of Eisner's. So precious was ESPN to the Mouse House that the former CEO told investors several years ago: "We bought the ABC media network and ESPN for $19 billion in 1995. ESPN is worth substantially more than we paid for the entire acquisition."

MUSCLES FLEXED

IT'S ALL THE MORE remarkable, then, that ESPN was created with such modest intentions. It was founded in 1979 by former Hartford Whalers play-by-play man Bill Rasmussen on a patch of mud in the blue-collar central Connecticut town of Bristol by putting $9,000 on several credit cards. Rasmussen started the Entertainment and Sports Programming Network (ESPN) as a way to beam University of Connecticut Huskies games to a larger audience using satellite dishes. But it soon became clear to Rasmussen and his son, Scott, that they were on to something with national potential. Getty Oil would kick in $100 million a year after Rasmussen put on the first shows. Five years later, ABC bought out Getty's position (then owned by Texaco Inc.) and in 1988, Hearst Corp. bought a 20% position that was held at the time by RJR Nabisco. Hearst still has a 20% stake, but Disney is the active manager. "Nobody could have anticipated how much of a financial juggernaut ESPN would become," says Fulcrum analyst Greenfield.

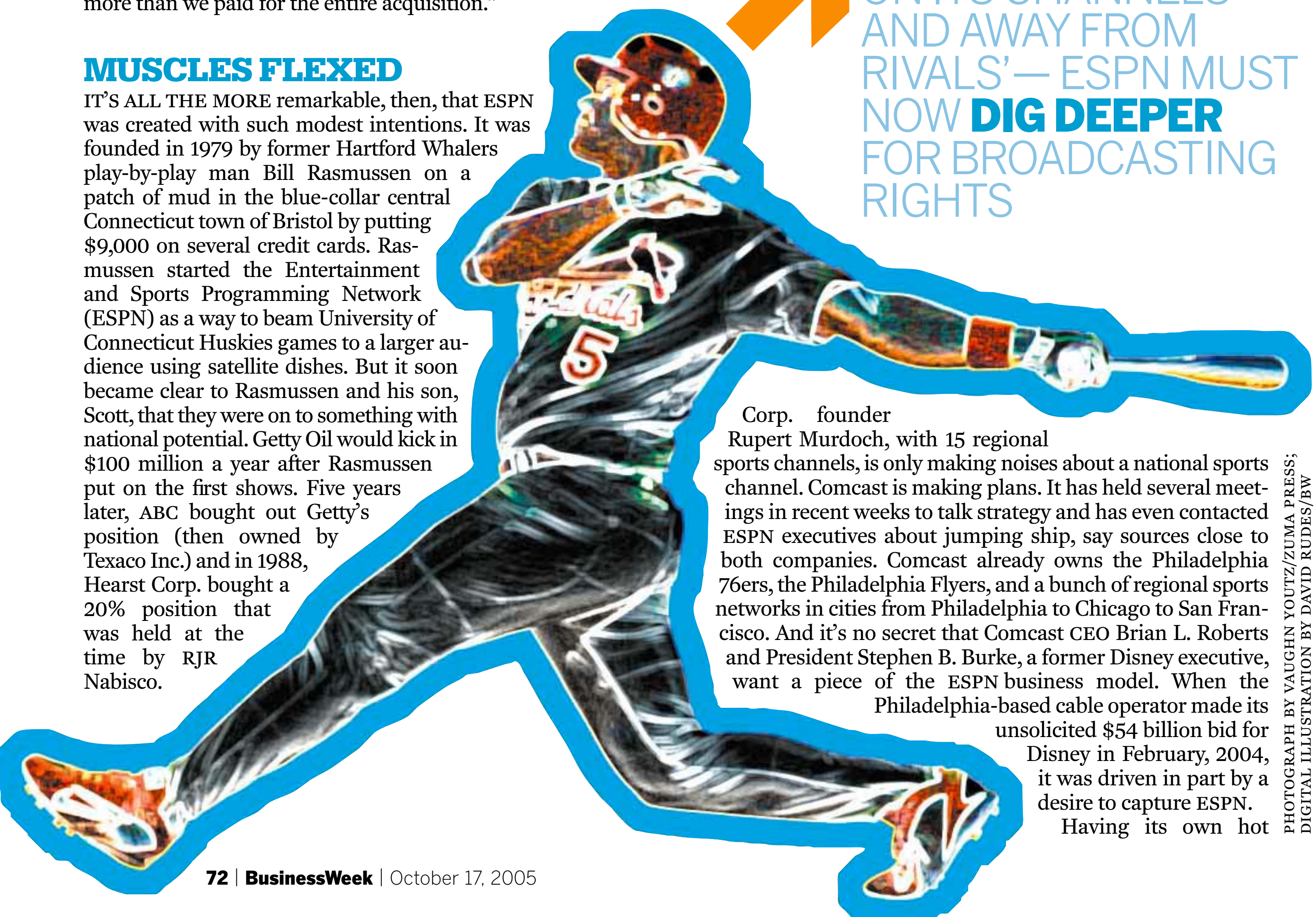
Over the years, ESPN began to flex its muscles like the jocks it had helped turn into celebrities. It charged its cable and satellite distributors nearly twice as much for its service than any other channel fetches. (Today, ESPN gets an estimated $2.80 per subscriber per month, vs. about 40¢ for CNN, according to Morgan Stanley). Double-digit hikes each year created a lot of ill will, culminating in a showdown two years ago that erupted in the halls of Congress. The battle pitted Bodenheimer against James O. Robbins, the outspoken CEO of cable operator Cox Communications Inc., who, acting on behalf of his industry, complained to lawmakers about the steep fees.

The brawl put Bodenheimer in an unwelcome spotlight, where he defended ESPN's pricing by blaming the high cost of rights deals with the leagues. Eventually Cox won lower annual fee increases, down from about 20% to about 7%. But ESPN claimed victory, too: New agreements included the operators' carriage of the latest ESPN channels, such as its Spanish-language outlet ESPN Deportes. "We achieved everything we wanted in that negotiation," says Ed Durso, ESPN's top executive for government and public affairs. "George rose to the occasion."

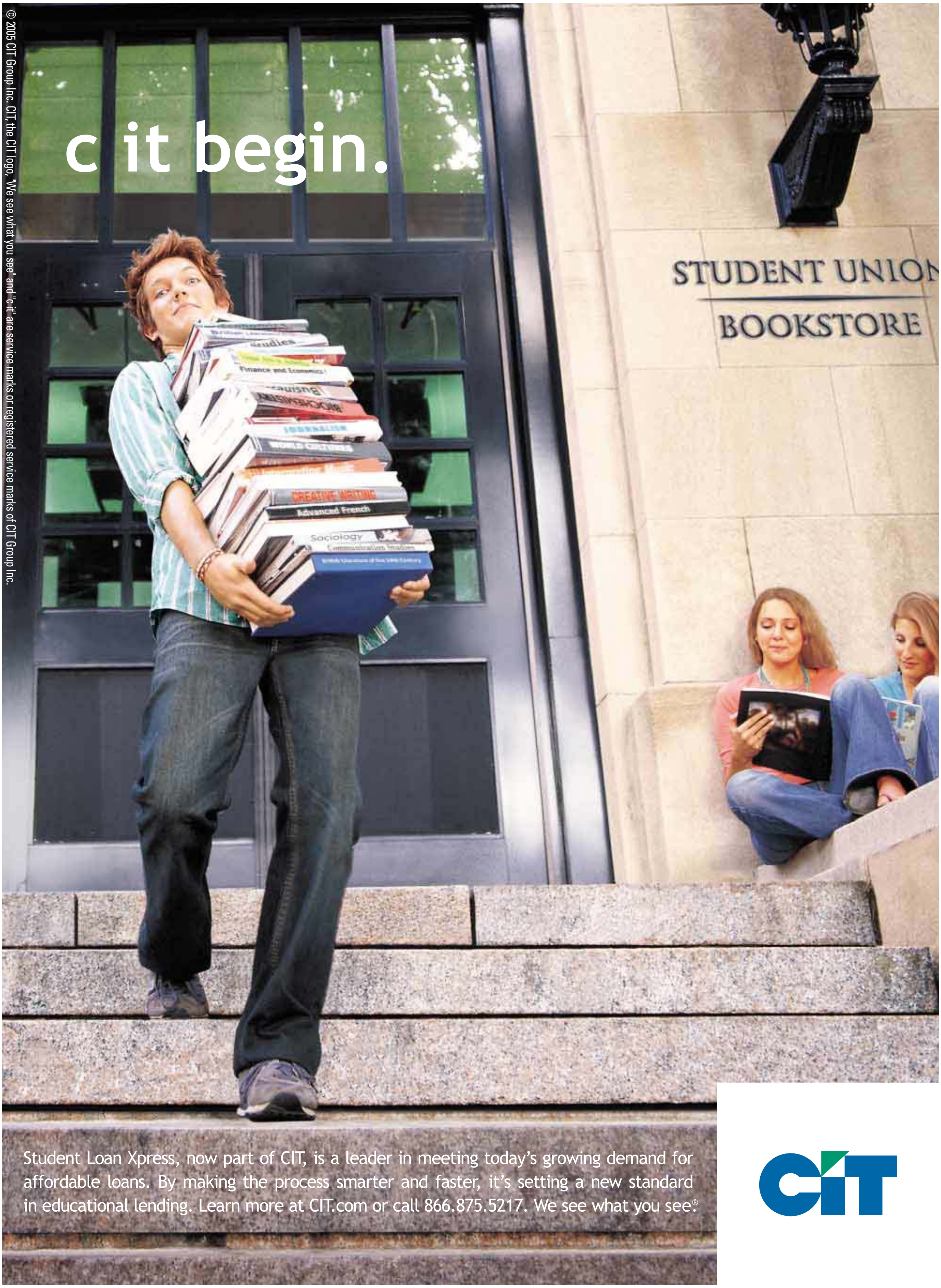
TO KEEP PRO GAMES ON ITS CHANNELS—AND AWAY FROM RIVALS'—ESPN MUST NOW **DIG DEEPER** FOR BROADCASTING RIGHTS

Bodenheimer knows the next battle is the big one. News Corp. founder Rupert Murdoch, with 15 regional sports channels, is only making noises about a national sports channel. Comcast is making plans. It has held several meetings in recent weeks to talk strategy and has even contacted ESPN executives about jumping ship, say sources close to both companies. Comcast already owns the Philadelphia 76ers, the Philadelphia Flyers, and a bunch of regional sports networks in cities from Philadelphia to Chicago to San Francisco. And it's no secret that Comcast CEO Brian L. Roberts and President Stephen B. Burke, a former Disney executive, want a piece of the ESPN business model. When the Philadelphia-based cable operator made its unsolicited $54 billion bid for Disney in February, 2004, it was driven in part by a desire to capture ESPN.

Having its own hot



PHOTOGRAPH BY VAUGHN YOUTZ/ZUMA PRESS; DIGITAL ILLUSTRATION BY DAVID RUDES/BW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ESPN.COM: GUYS AND DOLLARS

The ESPN cable channel, seen in 90 million households, is a must-stop for any channel surfer. But espn.com is the real boys' club. Young men don't show up *en masse* to anything very often, but where they do, advertisers will spend. That's what makes espn.com, with its devoted audience of guys 18 to 34, a coveted spot.

But luring Web users with hot commentators (*Sports Guy* columnist Bill Simmons), cool streaming video (ESPN Motion), the latest scores, and top-notch fantasy-league services, ESPN can use in-house promos to send them back out to its other platforms. "We look at our Web site as being like a bazaar with something always going on," says John Kosner, a senior vice-president.

SPORTS ON THE NET
The site is tops for males 18 to 34

The 10-year-old site is the biggest Internet draw for sports. In August, espn.com had 16.6 million unique visitors, says ComScore Media Metrix. That's far more than its closest rivals, Fox Sports on MSN (with 12.6 million uniques), nfl.com (12.6 million), and Yahoo! Sports (12.3 million). SI.com, the Web site of ESPN's magazine rival *Sports Illustrated*, trails at 5 million. The median age of an espn.com user is 32 vs. 38 for Net users in general.

ESPN doesn't disclose revenues, but Kosner says the Web site makes most of its money from ads. "It offers the big three," says Tim Hanlon, a senior vice-president at media-buyer Starcom MediaVest. "Young guys. Sports. And a powerhouse media brand. That's just a home run for advertisers." Subscription revenues at espn.com are growing, too, through its $6.95-a-month Insider and with fantasy services. Broadband's rise will accelerate offerings. And espn360, a customizable high-speed service, showcases super-sharp video and behind-the-scenes coverage. As for rivals, such as a revamped CBS SportsLine, ESPN's Kosner says: Bring it on. "I'd rather be where we are sitting." No kidding.

–By Tom Lowry in New York

sports channel would give Comcast ESPN-like leverage, amplifying its powerful 22 million subscriber base—even if its expertise is largely that of a distributor, not a programmer. For now, it's sticking to plans to convert its relatively unknown Outdoor Life Network, available in 64 million homes, into an ESPN for the new millennium. OLN got some buzz by airing Lance Armstrong's cycling feats every summer from the Tour de France. The rest of the channel's programming, from bull-riding to fishing shows, has niche appeal at best.

But Comcast is moving fast. It signed a $300 million, five-year deal in August to broadcast National Hockey League games on OLN starting this fall, with an option to bail out after two years. (ESPN ditched the sport after its contract expired this year following the acrimonious lockout.) Now, Comcast needs to cinch some of the remaining 60 games available from MLB and win a package of Thursday and Saturday games from the NFL, which draws the largest TV audiences in sports. "Without the NFL, I don't see anybody being a threat to ESPN," says John Mansell, a senior analyst at Kagan Research LLC.

Inside One of the Biggest Baseball Deals Ever

Grand Slam: A behind-the-scenes account of ESPN's latest big deal, its eight-year, $2.4 billion deal with Major League Baseball

Making a Mark: ESPN's outgoing programming chief, Mark Shapiro, talks about leaving "one of the best jobs in America," his next venture, and why ESPN said no to the NHL

Entertainment, Sports…Journalism? A look at journalism as practiced by ESPN—and at the sports network's new ombudsman, George Solomon, who's cheering and jeering from the sidelines

Not Just an American Play: From the wrestling rings of India to the skateboarding competitions of South Korea, ESPN is forging an Asian strategy to capture a piece of the region's fast-growing advertising market

Get the story on the Cover Story: For a podcast interview with Senior Writer Tom Lowry by Executive Editor John A. Byrne, go to businessweek.com/search/podcasting.htm

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GAMES IN YOUR POCKET

EVEN AS HE FENDS OFF RIVALS, Bodenheimer is about to lead his troops into ESPN's trickiest brand extension so far. The idea is that ESPN could be missing the chance to stay in touch with fans who get off the sofa or walk away from their computer screens. Says Bodenheimer: "We want fans to know you don't have to let the rest of your life get in the way of being a sports fan. You can take it with you." In the past year he has met frequently with the Mobile ESPN development team to sign off on everything from the phone's black-and-red design on a Sanyo handset to the special displays constructed for big retailers. ESPN is leasing network time from Sprint Nextel Corp. and will outsource billing, messaging, and customer service (its price is yet to be announced). The opportunity to partner with ESPN was a no-brainer for Sprint Nextel CEO Gary Forsee. "As proud as we are of our brand, we'd be hard pressed to say Sprint can successfully go after the segments that ESPN [does]," he says. "But ESPN is the world leader, right?"

Still, the risk for ESPN is that if the phone bugs out, users won't be cursing some wireless outfit—they'll be blaming ESPN. "Content providers need to focus on what they do best," says one TV executive. "Hardware plays are fraught with problems." And the venture will require patience. "Sometimes it is up to two years with this kind of business before you reach enough scale with subscribers to be able to turn a profit," says Marina Amoroso, a wireless analyst with researcher Yankee Group. Bodenheimer says he's aware of the perils, "but it is a riskier move not to do this."

The last thing Bodenheimer needs now is to worry about top talent. Yet shortly before programming whiz Shapiro quit, Chief

ESPN'S SECRET WEAPON MAY BE **THE PASSION** OF ITS STAFF FOR SPORTS

Marketing Executive Lee Ann Daly resigned as well. Losing Shapiro, who quit to join Washington Redskins owner Dan Snyder in remaking Six Flags Inc., is the most problematic. Shapiro's handiwork is all over the network. ESPN Original Entertainment, the cable network's venture into movies, episodic dramas, and talk shows, was his creation. He gave juice to *Sports Century*, the Emmy Award-winning series of profiles of top athletes (and a horse, Secretariat).

In June, Disney heaped new responsibility on Shapiro, promoting him to executive vice-president, overseeing programming at both ESPN and ABC Sports. To all the world it looked as if his next step would be into headquarters. Then, in early August, Shapiro met with Bodenheimer to tell him he was thinking about leaving. He'd had a feeler to head news operations at NBC. A few weeks later he accepted the offer from Snyder. "I knew at some point I was going to go entrepreneurial. It was just a question of when," says Shapiro.

Questions remain about why Bodenheimer and Iger waited so long to lock Shapiro into a new contract. But it is known that top executives at ESPN had been fielding complaints from the brass at pro sports leagues for some time that they could no longer work with Shapiro. Several league officials said they had never dealt with a negotiator as aggressive or as eager to pass himself off as the smartest guy at the table. "ESPN had just had tough relations with their customers, the cable guys," says one TV executive. "They could ill-afford to have bad relations with their suppliers, too. They need the leagues." Shapiro shakes off such criticism. "Of course I'm going to be tough in negotiations. That's my job...not to say to [the leagues]: 'Here's a check, fill out how much you want.'" Still, by the end of Shapiro's tenure at ESPN, officials in at least two leagues refused to deal with him unless Bodenheimer was in on the talks.

George Ward Bodenheimer

TITLE President, ESPN/ABC Sports; co-chair, Disney Media Networks.

BORN May 6, 1958, Meriden, Conn.

EDUCATION BA in economics, Denison University.

FAMILY Wife, Ann, an events planner; children Kate, 18; George Jr., 16; and James, 14.

FIRST JOB Pumping gas at a Hess station.

FIRST JOB AT ESPN Started in 1981 in the mailroom and used to drive on-air talent like Dick Vitale and Greg Gumbel back and forth from the airport in Hartford to ESPN studios in Bristol, Conn.

HOBBIES Golf (handicap: 21) and shallow water "flats" fishing in the Florida Keys. Caught a 6-foot tarpon once.

LAST BOOK READ *Striper Chronicles* by Leo N. Orsi Jr.

FAVORITE MUSICIANS Bruce Springsteen and the Rolling Stones.

HEROES Mother and father. She was a homemaker and bank teller. He was the manager of a department store in the Howland-Steinbach chain.

"MINUTE-TO-MINUTE BATTLE"

SHAPIRO MAY HAVE ALSO TICKED OFF Disney top brass when he turned down an offer last year to become president of ABC Entertainment, the No. 2 job under then-ABC executive Susan Lyne, who would have become chairman, say sources within the company. The plan was to eventually move out Lyne and put Shapiro in charge, those sources say. Shapiro told Iger he was excited about running prime time—but ultimately turned him down flat. Bodenheimer denies that there was any ill will toward Shapiro at Disney.

Bodenheimer says he is confident that the culture he has fostered, one of tapping ESPN's inner strengths, will ultimately make Shapiro's departure less of a blow. "Mark was obviously a significant contributor," says Bodenheimer. "He's a great talent, but we have a tremendous reservoir of talent here." In fact, Bodenheimer used Shapiro's departure to realign top management in early October into new segments: content, technology, sales and affiliates, and international. John Skipper, the much-admired senior executive who oversaw advertising and new media, will now run content, assuming much of Shapiro's programming mantle.

How Bodenheimer leads will go a long way in determining

(TOP) PHOTOGRAPH BY BRIAN BAHR/GETTY IMAGES; DIGITAL ILLUSTRATION BY DAVID RUDES/BW

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whether ESPN remains preeminent, especially as competitors zoom in on niches like volleyball, tennis, you name it. "ESPN will always be a general store of sports," says Brian Bedol, co-founder of college sports channel CSTV, "but it may have to learn to coexist with the leagues and new media companies [that] want to reach fans with very special interests. Technology today is allowing for a direct relationship with those fans."

Nobody wants to understand fans more than Bodenheimer, who will often leave the luxury boxes at games and walk through arenas studying the crowds—unrecognized, of course. "It's a minute-to-minute battle to retain viewers in today's media world," says Bodenheimer. "That's why I want to know what fans are saying—about sports, about ESPN." It's also why the most powerful man in sports needs to stay at the top of his game. ■

–With Mark Hyman in New York, Ronald Grover in Los Angeles, and Roger Crockett in Chicago

MR. TOUCHDOWN FOR NFL TV DEALS

If you want to beat the other team, what better way than to put someone in charge who knows their plays? No surprise, then, that when National Football League Commissioner Paul Tagliabue was looking for an executive to renegotiate the league's TV contracts and expand its media presence, he drafted former ESPN President Steve Bornstein.

A 22-year veteran of ESPN and ABC, Bornstein knew every network exec's head fakes and stutter steps. The payoff has been tremendous for the NFL at the bargaining table as well as with the launch of its own cable channel, the NFL Network. Since his arrival at the league in late 2002, Bornstein, 53, has negotiated $24 billion worth of new rights contracts—resulting in a 53% hike over earlier deals. "He's a great auctioneer," says Stephen B. Burke, president of cable operator Comcast. "The NFL has tremendous value. He gives it more."

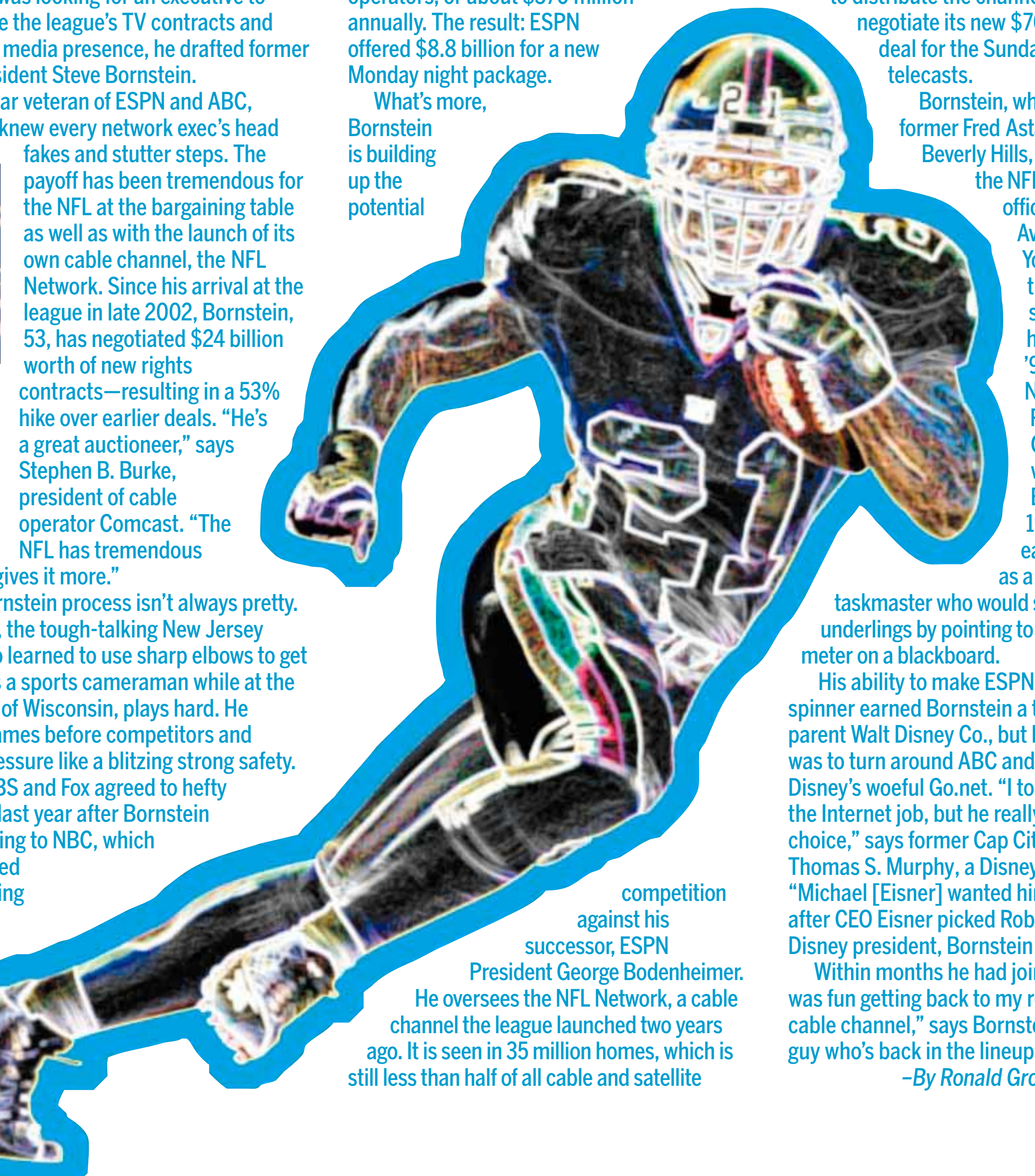
BORNSTEIN His years at ESPN taught him how to play networks off one another

The Bornstein process isn't always pretty. To be sure, the tough-talking New Jersey native who learned to use sharp elbows to get his shot as a sports cameraman while at the University of Wisconsin, plays hard. He dangles games before competitors and applies pressure like a blitzing strong safety.

Both CBS and Fox agreed to hefty increases last year after Bornstein began talking to NBC, which had dropped broadcasting football but got back in this spring. And heading into talks with his old employer, he knew how much ESPN needed football. If it lost the NFL, the network would have had to pay a 35¢ monthly fee per subscriber back to cable operators, or about $370 million annually. The result: ESPN offered $8.8 billion for a new Monday night package.

What's more, Bornstein is building up the potential competition against his successor, ESPN President George Bodenheimer. He oversees the NFL Network, a cable channel the league launched two years ago. It is seen in 35 million homes, which is still less than half of all cable and satellite households. "He brought a perspective we didn't have," says NFL Executive Vice-President Roger Goodell. The NFL's channel doesn't air regular season games yet, but its shows, like *NFL Total Access*, have that ESPN feel.

What's more, the NFL Network is a strategic asset. The NFL can simply threaten to put its own games on its own channel if it is not getting high enough offers from others. It's also a great way to boost distribution. Satellite operator DirecTV Group, for instance, agreed to distribute the channel to help it negotiate its new $700 million-a-year deal for the Sunday Ticket telecasts.



Bornstein, who lives in the former Fred Astaire mansion in Beverly Hills, shuttles between the NFL's West Coast offices and its Park Avenue digs in New York. "He's still got the entrepreneurial spirit that ESPN had in the '80s and '90s," says NASCAR Vice-President Dick Glover, who worked with Bornstein in the 1990s. Bornstein earned a reputation as a no-nonsense taskmaster who would shoot down underlings by pointing to a "bull-****" meter on a blackboard.

His ability to make ESPN into a money spinner earned Bornstein a ticket upward at parent Walt Disney Co., but his thankless task was to turn around ABC and jump-start Disney's woeful Go.net. "I told him not to take the Internet job, but he really didn't have a choice," says former Cap Cities Chairman Thomas S. Murphy, a Disney board member. "Michael [Eisner] wanted him to do it." But after CEO Eisner picked Robert A. Iger as Disney president, Bornstein resigned.

Within months he had joined the NFL. "It was fun getting back to my roots, starting a cable channel," says Bornstein. Spoken like a guy who's back in the lineup.

–By Ronald Grover in Los Angeles

(L-R) PHOTOGRAPHS BY STEVE LABADESSA; RICH KANE/ICON SMI; DIGITAL ILLUSTRATION BY DAVID RUDES/BW

And Now, the Chief Endurance Officer

More execs are shunning the golf course for triathlons and adventure races

KARBE Sometimes, he'll squeeze in an "easy" 12-mile run at lunchtime

PETER DASILVA

FRANK KARBE, CHIEF FInancial officer of San Francisco biotech outfit Exelixis Inc., has been spinning his wheels for more than an hour and getting nowhere. It must be 100 degrees in this room jammed with 13 other people, all sweating, all staring at the wall.

Fortunately, this isn't a presentation to a nervous bevy of investors but a 90-minute heat-adaptation cycling class. It's the second of three workouts Karbe, 37, has scheduled for the day. During lunch, he squeezed in an "easy" 12-mile run. After a business dinner, at a restaurant he chose for its proximity to The Sports Club/LA in downtown San Francisco, he'll swim 3,500 yards—that's just under two miles—while most people are home raiding the fridge before bed.

"Sometimes I'm out there training until midnight," says Karbe, who qualified for the Ford Ironman Triathlon World Championships on the Big Island in Hawaii on Oct. 15 by finishing his first Ironman, in Coeur d'Alene, Idaho, with one of the fastest times in his age group. He swam 2.4 miles, biked 112 miles, and ran 26.2 miles in a swift 9 hours and 46 minutes. "I'm pretty ambitious," he says, with no shortage of understatement.

Karbe is not alone. He'll be in the company of about 1,800 athletic overachievers at the championships, among them 18 high-level executives whose path to Hawaii began by signing up with CEO Challenge LLC in Boulder, Colo. Growing numbers of businesspeople like Karbe are defying the stereotype of the well-padded executive whose idea of exercise is a stroll around the links followed by a much-deserved stop at the 19th hole. Instead, they're vying for a new title—"chief endurance officer"—by rising at 4 a.m. and pursuing brutal training schedules while juggling family and corporate duties.

Not all extreme execs are into Ironman events. Kevin Mahaney, the 43-year-old CEO of real estate developer Olympia Cos. in Portland, Me., captured an Olympic silver medal in sailing in 1992, skippered an America's Cup syndicate in 1994, and won a national age-group snowboarding championship in 2004. This July, just for fun, he rode all 2,241 miles of the Tour de France in 21 days, keeping a day ahead of the actual race, in a custom trip put together by Destination Cycling in Marblehead, Mass.—and he's planning to do the same thing next year.

Or take Seagate Technology CEO William D. Watkins. He started doing "adventure races" six years ago and has

RAHAL Intense training is a natural outgrowth of professional hard work, says the Washington lawyer

since completed several 24-hour and two multi-day events. Such races, typically requiring teams of three or four to navigate difficult terrain via mountain bike, kayak, and foot, "force people to take a hard look at themselves in an environment out of their comfort zone," says Watkins.

But the largest group of would-be chief endurance officers seems to aim at triathlons. This year, 45 executives signed up with CEO Challenge. To do so, an exec must have the rank of chief financial officer or above in a company with $5 million in sales (for men) or $2.5 million (for women)—the lower number for women is an attempt to induce more of them to enroll. For $6,250, the exec buys entry into one of three Ironman events. The fee includes meals, accommodations, custom wetsuits, and the chance to rub well-defined shoulders with the top professionals in the sport, such as Chris Legh or Kate Major. Execs who qualify for Hawaii get VIP passes and have the option to pay an additional $1,400 for other perks.

BEAT YOUR PEERS

THIS YEAR, SIX of the CEO Challenge entrants, including Karbe, made the championships by posting fast-enough times in a preliminary Ironman to qualify under the general rules; the other 12 made it by beating their CEO Challenge peers, thus winning one of the special slots allocated to the company. Among the competitors are Peter Lazar, CEO of Bank Austria Creditanstalt Financial Services; Alex May, a managing director at Citigroup; and Ted Philip, former president of Lycos and now head of consulting firm Decision Matrix Group Inc.

So how do typically overworked CEOs find time to train for one of the most demanding sporting tests on the planet when most Americans struggle to get to the gym a couple times a week? Basically, by focusing the same energies on athletics that they pour into their profession. "Ironman training and racing is how I approach life: Set high standards and work extraordinarily hard," says Linda A. Rahal, 41, president and COO of Washington (D.C.) law firm Trow & Rahal. She started training for her first marathon while studying for the bar and plans to finish her fifth Ironman in Hawaii. Observes Ted Kennedy, a former marketing manager with Ironman North America who started CEO Challenge five years ago: "A lot of these people have achieved everything they've ever tried. They love challenges."

That includes the challenge of time management. Erik Blachford, 38, former CEO of online travel giant Expedia.com, did his first Ironman in 2003 and is competing in Hawaii with a slot he bid on and won on eBay. While at Expedia—he left in December of last year—Blachford ran or swam first thing in the morning, then commuted to work via bike. "I knocked off an awful lot of miles just biking the 16.7 miles to and from work, with extra loops if I had time," says Blachford, who now sits on four boards, including that of bike tour operator Butterfield & Robinson.

Is it fun? Only when crossing the finish line

Although he managed to fit training into his tight schedule, Blachford says he wouldn't do an Ironman again while holding a CEO position because "the demands of the job and training end up taking away from the rest of your life, such as family and social activities." Blachford's wife, Maryam Mohit, found her own ironic way of making peace with it: "When your kids are sick and your husband is pulling out on his bike for a long ride, you just have to tell yourself that as midlife crises go, it beats the alternatives."

Mike Dannelly, CEO of Costa Mesa (Calif.) online mortgage banker American Interbanc Mortgage LLC, and a sponsor of three pro triathletes, is unusual in this group: Many weeks he trains less than 10 hours. Dannelly, 47, took up triathlons in 1985 after a cocaine-induced heart attack ("It was a low point in my life," he says) and has since done more than a dozen Ironman distance events. "Last week a buddy of mine and I ran up Mount Whitney and back in seven hours and three minutes," says Dannelly, speaking of the 14,491-foot peak in California. "This is the kind of thing that excites me. But the word 'fun' is not applicable, except when you're crossing the finish line."

The notion of top managers moonlighting as endurance athletes might not thrill some shareholders, but these endorphin junkies make a compelling case for their training and racing. Olympia Cos.' Mahaney logs 20 hours some weeks and considers his bike a much-needed office away from the office. At work, "people are banging down your door," he says. "When I'm on the bike I can think of new business ideas. No distractions. No phones. I bring my cell, but only in case I get a flat I can't fix." John G. Macfarlane, 51, COO of Greenwich (Conn.) asset management firm Tudor Investment Corp., completed his third Ironman this summer and cites another benefit of training: It helps ward off insomnia. "One to two hours of exercise a day often cuts into sleep time, but when your head hits the pillow, there's no tossing and turning," he says.

HEART RATE

ALTHOUGH EXELIXIS' Karbe trains an average of 15 hours a week, his strategy is to focus on quality rather than quantity. Every few months he goes to Endurance Mill Valley, a sports lab in his Bay Area hometown, to test his oxygen consumption, power output, and heart rate—and adjust his workout. "The key question we are trying to answer is how much power can I generate over a 112-mile bike ride and still be able to run a marathon in under 3½ hours," says Karbe.

Some executives even link their extreme athletics to achieving social or corporate goals. James Maguire Jr., CEO of Philadelphia Insurance Cos., and seven of his company's staffers will compete at the Florida Ironman in November. Besides crossing the finish line, they plan to raise money for Hurricane Katrina victims by

MAGUIRE A veteran of five Ironman events, he has seven staffers joining him in Florida in November

collecting pledges of $10 per mile—and to set a *Guinness Book of World Records* mark for the most company employees competing in an Ironman distance event.

"I was the instigator," says Maguire, 45, who has finished five Ironman events since taking up the sport a decade ago. He inspired other officers to follow in his footsteps and hopes that the fitness culture will catch on with the rest of his 1,100 employees. Besides reimbursing them for gym membership and giving them a longer lunch hour if they work out, the company sponsors several races, including the Ironman World Championships.

At Seagate, Bill Watkins sends 200 of his 40,000 workers to the annual "Eco Seagate," where they learn adventure racing skills and compete in one-day races. "It helps break down barriers, teaches people how to take a risk and ask for help, and it promotes teamwork," he says.

Ex-Expedia CEO Blachford argues that endurance training can change something more intangible but even more important than physical health: a CEO's whole approach to business. "In a world where you expect immediate results for everything you do, it's very satisfying to slowly but surely put time in and build up to do something you couldn't do six months before," he says. "That's a lesson you lose track of in business, especially when throttled on quarterly results." Now he just has to avoid getting obsessed with beating every other executive triathlete in the world.

–By Sarah Max in Bend, Ore.

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A Tense Kodak Moment

Low-margin digital sales aren't picking up the slack of disappearing film profits, and debt is coming due

EASTMAN KODAK SELLS 22% of the digital cameras in the U.S. annually, making it the biggest player. Its 65,000 yellow, blue, and red printing kiosks seem to be everywhere. And on Sept. 27 the 125-year-old company shipped what it says is the world's first Wi-Fi pocket camera, which lets consumers send good-quality photos directly to the Internet. So you might imagine that the Rochester (N.Y.) company has made a seamless transition to the digital age from the messy analog world of film and chemicals.

Kodak's financial reports show a much darker picture. The company is barely breaking even on its digital cameras. It is scrambling to drum up enough cash both to shut down most of its film and paper capacity—at an estimated cost of nearly $1 billion over this year and next—and to repay $750 million of debt that comes due next year. Its credit ratings, which fell below investment grade in April, were marked down again on Sept. 30 by Standard & Poor's even as it is finalizing a $2.7 billion loan facility.

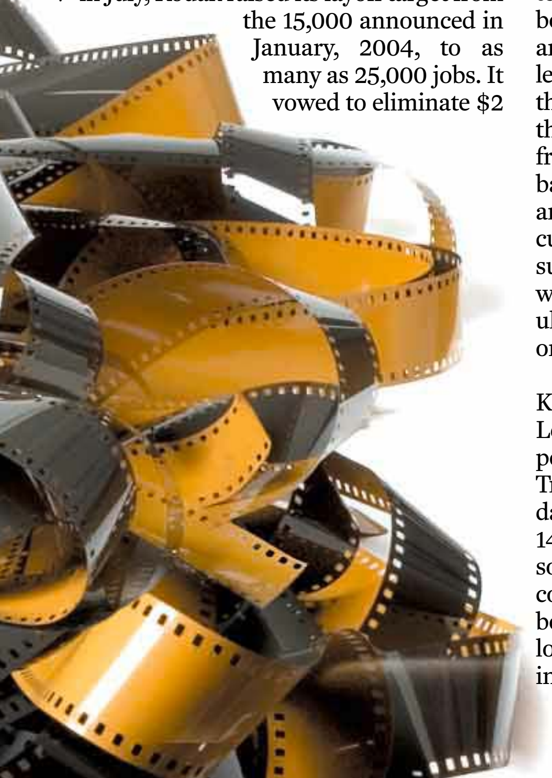
Senior executives at Kodak concede that the company's balance sheet is "stressed." But they say Kodak will turn up from this financial low point in its massive transformation to digital. By the end of 2006, according to Chief Executive Antonio Perez's plan, the total $1.5 billion cash cost of laying off workers and shutting down factories will be pretty much paid. Besides, no significant amount of Kodak's remaining $2.7 billion of debt is scheduled for repayment until 2010. Chief Financial Officer Robert H. Brust says earnings will start to turn up sometime next year. "We're at a difficult point, but coming along pretty good," he adds. "As digital earnings start increasing faster than traditional [film] earnings are falling, we will repay debt."

Investors have heard such predictions before. But the company's forecasts have often been unreliable, says S&P. About a quarter of Kodak's consumer film business is disappearing each year—more than three times faster than executives envisioned in September, 2003, when they declared they would transform the company into a maker of digital products. Kodak missed its targets for operating earnings in the first two quarters of this year and has now stopped issuing them at all. Profits from consumer digital products—cameras, home printers, kiosks, and the ink and paper for them—are scant two years after they were held up as the salvation of the core consumer business. And the health-care division, often portrayed by the company as a future source of big profits, stumbled recently on several counts, including a delay in getting a digital radiography product to market and the slow installation of software being sold to hospitals. Executives warned on Sept. 28 that Kodak will fall short—they didn't say by how much—of their July projection that digital products would produce $275 million to $325 million of operating earnings this year, vs. $46 million in 2004. Brust says forecasting amid so much change is difficult. "There are a lot of moving parts, but we're more in a steady state now," he says.

CHINA GOES STRAIGHT TO DIGITAL

KODAK'S WOES highlight the financial strains faced by established companies when disruptive technologies erode their traditional revenue streams. As many media companies, music retailers, and video-rental chains can attest, the problems are compounded by the speed at which digital technology spreads around the globe. "Digital was supposed to be the promised land, and it is turning into a swamp," says James S. Chanos, founder of money manager Kynikos Associates, who is betting that Kodak shares will fall. "Businesses with these major paradigm shifts to digital products just see their cash flows from analog products evaporate much faster than people are used to."

At Kodak, executives had hoped that emerging markets such as China would give them more time to wind back the film and photographic-paper business as Americans switched to digital cameras. Instead, buyers in new markets skipped over film and went straight to digital. So in July, Kodak raised its layoff target from the 15,000 announced in January, 2004, to as many as 25,000 jobs. It vowed to eliminate $2 billion, or two-thirds, of its traditional business assets by the end of next year. It is even cutting capacity in China.


JOHN KUCZALA

The speed of the collapse of its traditional business lines has pushed Kodak into a cash bind. Severance and other restructuring bills will gobble up $300 million in the second half of this year and $650 million more next year, when the $750 million of debt comes due—for a total of $1.7 billion. At the beginning of July, Kodak had just $553 million in cash on hand. Brust predicts he will have enough money to close the gap. Typically, Kodak generates most of its cash in the second half of the year—$1.1 billion last year. He plans to raise $600 million by selling real estate and patent rights; he's also liquidating inventory and cutting capital expenditures.

Then there's Kodak's surprising decision to make fewer consumer digital cameras and printers in case holiday sales falter. Even so, Brust is taking no chances. He has negotiated a bank commitment to refinance $500 million of debt if he needs to.

Should things not go as planned, Kodak would be unlikely to find it easy to raise cash in the bond or stock markets. Its shares are down 27% this year, to 2003 levels. Bond investors are dumping the company's debt, too. Besides the missed projections, what's frustrating them is that Kodak is giving banks security for the new loan package and putting their $2.2 billion of unsecured debt at a disadvantage. Pessimists such as Chanos think Kodak's write-offs will continue and that the company will ultimately have to restructure its debt—in or out of bankruptcy court.

Not everyone on Wall Street is down on Kodak. Bill Miller, chief executive of Legg Mason Capital Management and portfolio manager of Legg Mason Value Trust, the only mutual fund to beat Standard & Poor's 500-stock index for the past 14 years straight, is a big fan. He holds some 42 million Kodak shares, 15% of the company's equity, including 3 million bought earlier this year. Despite having lost money on the stock—he began buying in 2000 when it was twice as high as its recent $23—he believes the shares will turn around. "Once these cash charges are gone, we expect [Kodak] will have free cash flow of more than $1 billion, conservatively," says Miller. He figures that will make the company worth more than $16 billion and $50 a share. Then, Miller says, double-digit profit growth will kick in, thanks largely to Kodak's commercial-graphics business. Built up with a half-dozen acquisitions over the past two years, the division is getting ready to sell more machines capable of personalizing slick junk mail and printing everything from colorful store merchandising banners to lottery tickets. "The real payoff begins after 2008," Miller predicts.

BIG SELLER
Kodak has 22% of the U.S. market

All the same, there are risks to his rosy scenario. Some people are turning away from printing photos at home or anywhere else. Doctors in U.S. hospitals are increasingly viewing X-rays on video monitors, while youngsters are looking at one another's digital pics over the Internet without bothering to make prints.

Kodak executives, while exuding optimism, are preparing a change in the company's organization that could make it easier to sell off assets. Starting in January they'll divide the company into four distinct units—consumer digital, commercial printing, health care, and traditional film—each with its own financial report. "It will be up to the board to decide what is the best option," CEO Perez recently told securities analysts. "We don't have anything for sale." At least not yet. ■

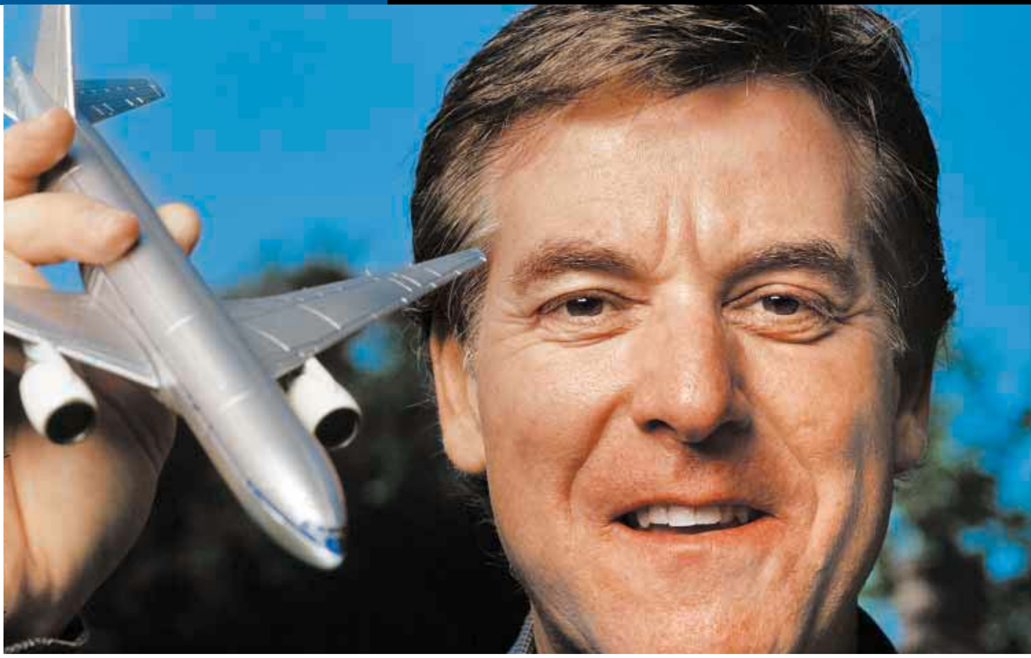
–By David Henry in New York

Painful Transition

The speed at which digital technology has spread is putting Kodak's finances under increasing stress:

- Its **film biz** is declining by 25% a year—more than three times faster than expected
- Profits from new **digital ventures** are falling short of targets
- **Plant closures and layoffs** will cost $1 billion over the next 18 months
- **Debt** of $750 million is scheduled for repayment next year

Data: Company reports, *BusinessWeek*



ROSENTHAL Saybrook could help shape the airline industry's future

The Sweet Smell Of Chapter 11

Saybrook Capital specializes in 'big, ugly' bankruptcies. Today, that means airlines

NESTLED 3,000 MILES from Wall Street in the beachside town of Santa Monica, Calif., Saybrook Capital is an unlikely player in the rough-and-tumble world of bankruptcies. But since it started in 1990, the 60-person boutique investment bank has carved out a key role in some of the country's largest bankruptcies, advising creditors of Pacific Gas & Electric and shareholders of Kmart and Adelphia Communications. Often it competes against much bigger firms such as Lazard and Rothschild. "We tend to get the deals that are big, ugly, and complicated," says Jonathan Rosenthal, who runs the firm's bankruptcy practice.

Now the firm is knee-deep in the airline industry, where three of the four largest carriers are in Chapter 11. Saybrook has been advising the official committee of creditors of United Airlines parent UAL Corp., which filed for bankruptcy in 2002. Saybrook is short-listed to do the same with both of the two carriers that filed on Sept. 14—Delta Air Lines and Northwest Airlines. Creditors will choose advisers in the next few weeks. Saybrook may have the inside track over three rivals for the Delta job because it has been representing creditors informally for 15 months.

So Saybrook figures to have a seat at the table as the U.S. airline industry is reshaped. "Advisers have a lot of say over who wins and who loses" in bankruptcy court, says Rosenthal. "Bankruptcy is a powerful tool and can be used for all kinds of things, including mergers." He expects carriers will emerge from bankruptcy with drastically reduced costs to enable them to compete with low-cost carriers such as Southwest Airlines. And he foresees mergers over the next couple of years: "You're going to take seats out of the system, and that will improve yields."

Rosenthal has proved adept at molding reorganization plans. In the 2001-04 PG&E bankruptcy, the utility wanted to sell its assets to wholly owned subsidiaries—a plan that Saybrook considered doomed. In an unusual move, Rosenthal, who has a law degree from Southwestern University, persuaded the judge to terminate PG&E's right to set its own plan and submitted an alternative that kept the company intact. "Jon was extraordinary at crafting something that worked for the creditors and could bring the utility and regulators into consensus," says Jerry R. Bloom, a lawyer at White & Case LLP who co-chaired the unsecured creditors' committee. PG&E eventually accepted the alternative. Creditors got one of the largest U.S. bankruptcy settlements ever—$15 billion, or $1.06 on the dollar (the market value of their bonds rose as interest rates fell).

Taking on the problems of the airlines comes naturally to the 50-year-old Rosenthal. In the 1980s he founded and ran NetAir International Corp., then the largest U.S. charter jet company. It was one reason he won the UAL assignment.

The UAL case has turned into a behemoth. Saybrook has spent 21,000 hours on it—advising on the renegotiation of 660 aircraft leases and collective-bargaining agreements with seven unions, and on the largest pension-plan terminations ever. Just when UAL thought it had costs under control, fuel prices

Disaster Recovery

Saybrook Capital has won billions for creditors and shareholders in major bankruptcy cases

DEBTOR	CLIENTS	RESULT
KMART	Shareholders	Market cap rose by $6.9 billion
PACIFIC GAS & ELECTRIC	Unsecured creditors	Won $15 billion, or 106% of outstanding claims
ORANGE COUNTY, CALIF.	Municipal bondholders	100% of creditors' claims, or $5 billion

Data: Saybrook Capital

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soared, forcing more cuts. "UAL has taken longer and has absorbed more resources than we had anticipated," Rosenthal says. UAL expects to emerge from bankruptcy in February. Creditors may not be so happy with the outcome: UAL projects unsecured creditors will recover between 4% to 7% of their $28 billion in claims. But Rosenthal says he's pleased: UAL's bonds are trading at 14¢ on the dollar, vs. 6.5¢ when Saybrook took the case.

RISKY MOVE

DELTA COULD BE the next order of business. Last year, Rosenthal expected its troubles to get worse and accepted an invitation to begin organizing unsecured creditors, which includes banks, aircraft companies, and unions. It was a risky move. Saybrook worked for free, betting that Delta would seek bankruptcy-court protection and that creditors would tap Saybrook as their paid adviser. The assignment could be lucrative. Saybrook typically gets a flat monthly fee and a share of what's recovered. It has collected $6.9 million from UAL so far.

Extracting money from bankrupt concerns isn't a cheery way to make a living. "It's like being the coroner," says Rosenthal, who lives in Los Angeles with his wife and two children. "I've had friends drive up when I'm standing outside Starbucks, roll down the window, and say, 'Is there something wrong here?' " It doesn't help either that bankruptcy advisers often have sharp elbows. However, Rosenthal is known as a bit of a diplomat. "J.R. has a personal touch that helps him achieve things that someone at a small firm would otherwise have difficulty doing," says James S. Feltman, senior managing director at Mesirow Financial Consulting, a competitor and occasional ally of Saybrook's.

Surprisingly, many of Rosenthal's most valuable assignments have come from former opponents. While advising Lehman Brothers Inc. in the 1990s, he locked horns with Andrew Clare, who represented Lehman's creditor, First Interstate Bank. "We fought like cats and dogs, really screaming and yelling," Rosenthal recalls. The day after the case closed, Clare called to ask Rosenthal to advise First Interstate on another matter. "I was stunned," Rosenthal says. Despite the fighting, Clare had admired Rosenthal's deportment. "He was very smart, but he didn't shove his intellect down your throat," Clare says. It pays to be diplomatic when you're the coroner.

–By Justin Hibbard in San Mateo, Calif.

RESEARCHERS

Analyze This: A Vanishing Portfolio

Spare a thought for beleaguered airline analysts. During the industry's four-year slide they've put in endless hours, mastering every issue from jet-fuel hedges to pension fund deficits. Their reward? With three of the country's top four airlines now in bankruptcy, airline analysts are left with little to analyze.

So they're scrambling to survive any way they can—reinventing themselves as airline debt experts, branching out into foreign carriers, or boning up on discount and regional outfits. Their goal: avoid the fate of their colleagues at Credit Suisse First Boston, which jettisoned airline coverage in January. Zacks Investment Research tracks just 32 airline analysts now, 11 fewer than in 2002. "It's been very volatile," says David Strine, Bear Stearns & Co.'s airline analyst. "Sleep has been really hard to come by."

SEAN KELLY

Airline analysts turn to aerospace or debt

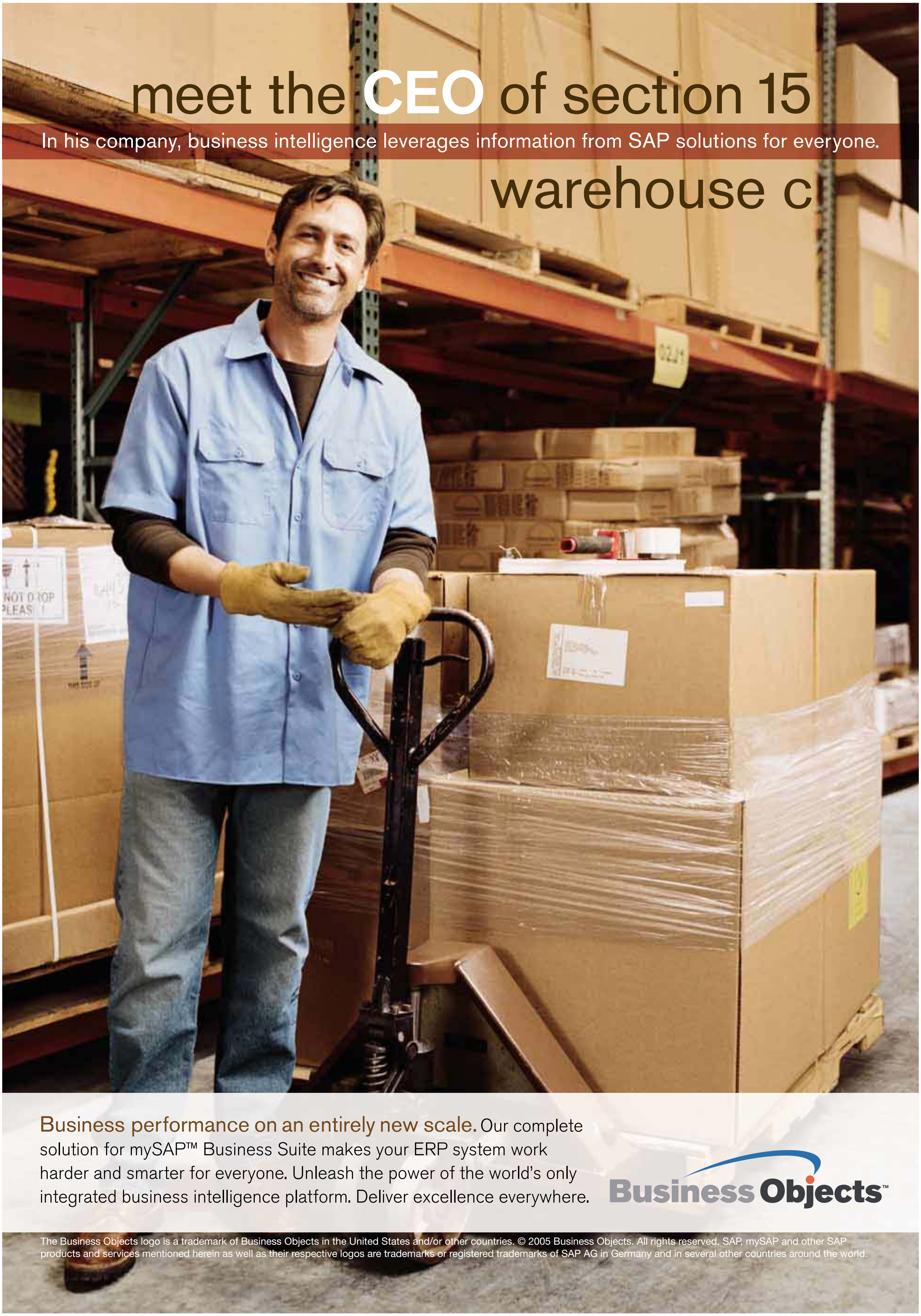
Strine is rebranding himself as an Asian specialist, with carriers such as Korean Air and Taiwan-based China Airlines Ltd. now representing nearly half of his coverage list. "We're going global," he says, "and we're going more global." The move was a natural for Strine. He started as an analyst for Bear Stearns in Hong Kong in 1997, just before the Asian economic turmoil began. Strine says the experience of sizing up companies in crisis mode came in handy when he moved to New York and later took over the firm's airline coverage in the spring of 2003—when the industry was in the midst of its post-September 11 crisis.

Calyon Securities Inc.'s Raymond Neidl is casting a wider net: He's diversifying into aerospace manufacturers such as Boeing Co. and Brazil's Embraer. "That's how you survive—expand," he says. Neidl, a former junk-bond analyst who's based in New York, is also trying to make himself indispensable by being the go-to guy on distressed airline debt. "There's just a lot of hedge-fund interest in all the busted debt," he says. He still covers Continental Airlines Inc. and AMR Corp., two U.S. majors not in bankruptcy court, but he doesn't recommend either. He'd rather chat up clients about profitable regional carriers such as Mesa Air Group Inc. and Republic Airways Holdings Inc., and foreign upstarts like Brazil's GOL Linhas Aéreas Inteligentes and WestJet Airlines Ltd. of Canada.

Hedge funds and private equity firms have joined mutual funds as big consumers of airline research. At AirlineForecasts, a Washington research firm, a hedge fund recently commissioned a 10-year forecast of probable survivors and failures. Another, says CEO Vaughn Cordle, ordered a 33-page analysis of likely mergers—which he prepared with the help of a furloughed CSFB analyst. "I can't handle all the work," says Cordle, an active pilot and chartered financial analyst. "I'm working my butt off."

With more airline bankruptcies expected and hints of more analyst layoffs in the air, many Wall Streeters are reluctant to talk. But some folks are hopeful. "These are essential service providers, and half of them are profitable," says Merrill Lynch & Co. analyst Michael Linenberg, who co-heads the New York Society of Airline Analysts. "There will be winners that emerge from the crisis," adds Strine. "The airline industry is not going to disappear." Even so, he's hedging his bets: He also covers a Chinese railway.

–By Roben Farzad in New York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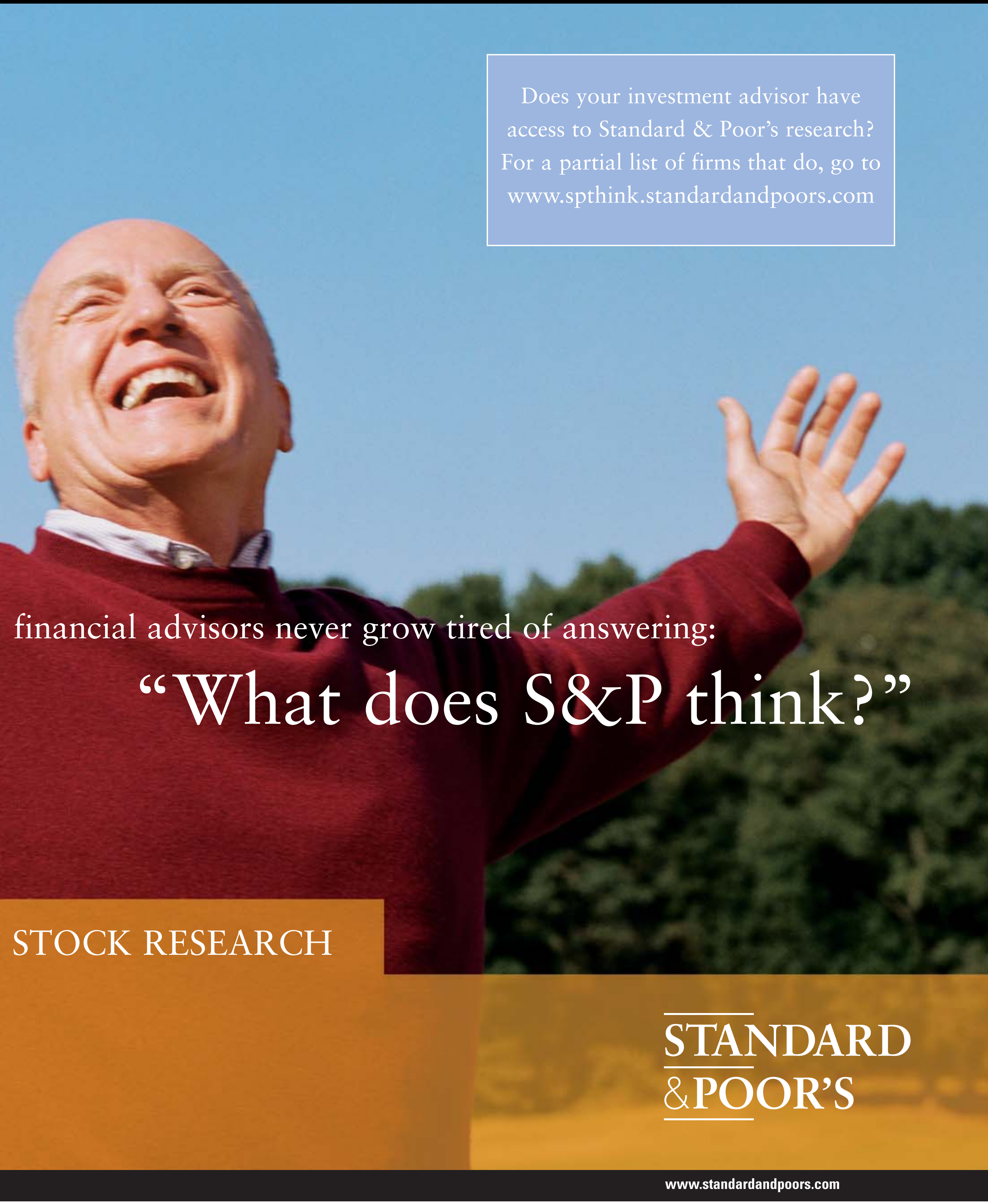

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JAMES PORTO

Daggers Drawn Over DVDs

How Sony gained an edge in its fierce battle with Microsoft over video formats

EVERY JULY, 400 OF THE most powerful media and tech industry chieftains meet at investment banker Herb Allen's conference in Sun Valley, Idaho, for what are usually convivial discussions of megatrends and megamergers. But this year, Microsoft Chairman William H. Gates III laid into Sony Chief Executive Howard Stringer, according to two sources, including one who witnessed the exchange in a private room. Gates argued that Sony's new high-definition DVD standard, called Blu-ray, needed to be changed so it would work smoothly with personal computers running on Microsoft's Windows operating system. Stringer and two lieutenants defended the technology, insisting Blu-ray would work fine in PCs. Yet Gates's ire only grew. "There must be something much deeper going on," Stringer said later, according to another person who heard the comment. A Microsoft spokesman acknowledges that Gates and Stringer talked at the conference, but says things did not become "heated."

Gates's efforts to derail Stringer's plans soon became public, though. On Sept. 27, Microsoft Corp. and Intel Corp. fired a broadside at Sony Corp., suggesting publicly the company's Blu-ray technology couldn't deliver what it promised, and they pledged their support for a rival technology from Toshiba Corp. The news touched off a torrent of recriminations and finger-pointing. Several movie studios quickly voiced their support for Sony. Two major Chinese DVD makers backed the Toshiba standard, which is called HD DVD. And Dell Inc. and Hewlett-Packard Co. took the highly unusual step of issuing a joint statement denouncing the move by Microsoft and Intel, the PC makers' two most important suppliers. "Desperation" is the way Brian Zucker, a technology strategist at Dell, characterized Microsoft's move.

CRITICAL MASS

IT MAY AMOUNT to little more than that. Despite the backing of the PC industry's two biggest titans, it looks as if HD DVD'S days are numbered. Sony is lining up strong support among Hollywood studios as well as other consumer-electronics companies. On Oct. 3, Paramount Pictures Corp. announced it would end exclusive support of HD DVD and support both standards. Warner Bros. Inc. is expected to follow suit in the next few days, sources say. That'll give Sony six of the seven major studios. Sony may negotiate a deal to give a slice of Blu-ray royalties to Toshiba, and perhaps even Microsoft, but that would largely be a face-saving compromise. Sony appears to have a critical mass of support for its standard.

A major factor swaying these companies is Blu-ray's massive capacity. Its disks will hold at least 50 gigabytes and perhaps 100 gigs or more. HD DVD will start at 15 gigs, and top out at 45. "We want a standard that's going to be around for 10 or 15 years," says one studio exec. Microsoft's criticism is that Blu-ray disks will be more expensive to manufacture and may be impossible to make in large volumes. Yet the technology's supporters are convinced costs will be similar over the long term. "We don't see any big cost difference, and we know a thing or two about volume manufacturing," says Michael S. Dell, chairman of PC giant Dell.

Fighting words: Gates said Stringer's Blu-ray format wasn't going to live up to Sony's hype

(GATES) JUSTIN SULLIVAN/GETTY IMAGES; (STRINGER) TORU YAMANAKA/AFP/GETTY IMAGES

Why is so much vitriol spilling from behind closed doors over one tech standard? The shiny little disk that Gates and Stringer tangled over has the potential to alter the landscape of the entertainment and technology industries. Next-generation DVDs will feature high-definition movies, extras like movie-themed computer games, and the ability to download film trailers from the Internet. Tech players, media companies, consumer-electronics giants, and retailers are brawling to take advantage of the new financial and strategic opportunities. "It's like the old Irish saying: 'Is this a private fight, or can anyone jump in?'" says Paul Saffo, director of the Institute for the Future.

For each side, the stakes are huge. Movie studios, struggling with a sudden slowdown in the $18 billion-a-year U.S. DVD market, are salivating over the chance to entice consumers with movies on new high-definition disks. Consumer-electronics makers—which increasingly include Dell and HP—are banking on people thirsting for more high-definition gear, from DVD players to big-screen TVs. And Microsoft and Intel, hungry for new growth opportunities, want to expand their roles in people's lives, helping them manage digital photos or download the next Batman flick off of the Net.

Behind the brinkmanship lie two vastly different views of where entertainment in the home is heading. Microsoft and Intel paint a futuristic picture of the digital home, with sleek PCs powered by their software and chips in the central role. The PC would shuttle music, photos, and video from room to room—and grab off the Web everything from the latest Tom Cruise blockbuster to a National Public Radio podcast.

Sony and its supporters are skittish about the latest movies being zipped around the house. Blu-ray disks can hold more content than today's DVDs, but they would be used in much the same way. The new disks would be plopped into a DVD player, and copyrighted material, like Hollywood movies, couldn't be ripped to a computer's hard drive without a studio's permission. Blu-ray equipped devices are even designed to recognize and refuse to play pirated movies. Such protections are another big reason Sony has won the support of studios, such as News Corp.'s Fox.

No company has more at stake than Sony. Long one of the most innovative companies in electronics, it stumbled badly in recent years. With Blu-ray, it has the opportunity for a triple play. It'll reap royalties from all the disks sold with its technology. Its movie business could see a resurgence in lucrative DVD sales. And it could see sales soar for its electronics gear, including HDTVs, movie cameras, Blu-ray optical drives, and especially its new PlayStation game consoles, which will include a Blu-ray drive for playing movies. Sony's people have "bet the entire future on this," says analyst Michael Pachter of Wedbush Morgan Securities. "It's too important for them to lose, so they will do everything they can to win."

HIGH-TECH INTRIGUE

THE STORY OF how Sony and Stringer maneuvered their way into what looks like a winning position in the DVD wars includes enough intrigue to fill more than a few disks. The backdrop is Sony's famous failure two decades ago to establish Betamax as the standard for videotape, despite its widely recognized technological edge. It lost out to Matsushita's VHS, in part because its onerous licensing terms alienated the Hollywood studios.

Then in the 1990s, Toshiba outmaneuvered Sony to establish the standard for today's DVDs. The Japanese company teamed up with Time Warner Inc. on the technology, using the media giant's clout to get other Hollywood studios on board. The result is that Toshiba and Time Warner rake in the lion's share of the royalties generated by DVDs. No one has disclosed precisely what those royalties are, but they run into the hundreds of millions of dollars.

Toshiba looked as if it could win the battle for high-definition DVDs too. After Sony and partners Philips and Matsushita began work on Blu-ray, Toshiba in 2003 hired former Warner Bros. video chief Warren Lieberfarb to lobby for studio support. It was a savvy move, since it was Lieberfarb who had won the studios backing for the first DVD standard. By November, 2004, the assault appeared to be working—with Warner, Paramount, Universal, and New Line Cinema seemingly firmly in the Toshiba camp.

With so much at stake, Sony went on its own recruiting campaign. It quickly signed up some of the biggest names in consumer electronics, including Samsung and Sharp. By early 2005, Dell, HP, and Apple Computer joined the industry standards group. The electronics makers think Blu-ray has the greatest chance to prompt consumers to start opening their checkbooks for new gear.

Microsoft at first stayed out of this tug-of-war. Instead, it focused on selling its software to both sides. The Toshiba camp first agreed to use a piece of Microsoft software, its VC-1 codec, that squeezes content onto the disk, then decodes it for viewing. Then, in September, 2004, the Blu-ray backers adopted this chunk of code as well—in exchange for a public pledge of neutrality from Microsoft. "We wanted them to join us," says an insider who is close to the Blu-ray Disc Assn. "But we compromised on neutrality."

That neutrality has unraveled over the past year, as Microsoft increasingly came to see Blu-ray as a risk to its fortunes. In May, Sony confirmed that it would include Blu-ray in the new PlayStation game console beginning next year. Microsoft's Xbox wouldn't have such capability. Then on June 15, the Blu-ray camp decided against using Microsoft's iHD technology to add interactive features to Blu-ray disks, opting instead to stick with software based on Java technology.

FIGHTING PIRATES

IN JULY, SONY DECIDED to refine the Blu-ray standard in a way that would have far-reaching implications for Microsoft. Sony wanted to win the support of Twentieth Century Fox Film Studios, long Hollywood's leading advocate for tough anti-piracy measures. So Sony agreed to add safeguards developed for Fox by San Francisco's Cryptography Research Inc., which could prevent Blu-ray movies from being ripped to a computer's hard drive. Fox execs say their decision became a no-brainer, because of the extra protection and because as many as 30 million PlayStations might be sold in the next three years. "They have a Trojan Horse that will play a critical role in igniting the market for this product, and when they do, we intend to be in that market with them," says Michael Dunn, president of Fox Home Entertainment.

The move was a serious blow for Microsoft's Xbox. The company had decided to hold down costs by not including a next-generation DVD player in the game console. Instead, it planned to stream high-definition content from a PC sitting in one room to the console, which would be attached to a television. But Cryptography's safeguards meant studios could block their content from being taken off the DVD. That was the reason for Gates's exchange with Stringer at the conference. Gates wanted Sony to drop such technology, but Stringer wouldn't budge.

Meanwhile, Sony's camp received help winning over one influential studio from an unlikely source. Raider Carl C. Icahn, one of Time Warner's largest shareholders, began pressuring the studio to find ways to boost its stock price earlier this year. Despite Time Warner's long alliance with Toshiba, CEO Richard D. Parsons asked Jeff Bewkes, chairman of the company's entertainment unit, to reconsider the best way to recharge DVD sales. Bew-

Blu-ray VS. HD DVD

Which technology will be used to deliver next-generation DVD to the masses? Sony's Blu-ray, backed by an army of electronics, content, and technology companies, has the advantage over Toshiba's HD DVD.

CONSUMER ELECTRONICS

SONY A victory for Blu-ray would add hundreds of millions in licensing revenue and propel Sony to the top of the market for high-definition DVD players. And Blu-ray drives in its PlayStation 3 could give Sony an edge over Microsoft's Xbox 360.

PANASONIC, SHARP Two of the leading HDTV makers, both plan to make Blu-ray DVD players exclusively. They believe that Sony's decision to put the technology inside PlayStation 3 consoles will seed the market.

TOSHIBA Having won the standards war that led to current DVDs, Toshiba wants to keep millions of dollars in royalty payments coming from its HD DVD patents. The windfall this time around could be even more handsome.

AMOI ELECTRONICS, CHANGHONG ELECTRONICS In late September, two of China's biggest DVD player makers threw their support to HD DVD, saying they would be cheaper to manufacture and market.

MEDIA

DISNEY, FOX, MGM Eager to boost DVD sales, studios are betting consumers want extra content that can be stuffed onto Blu-ray disks, which hold far more data than HD DVDs. The studios see Blu-ray providing more protection against illegal copying.

TIME WARNER, PARAMOUNT Both companies had been firmly in the HD DVD camp. Now convinced that Blu-ray could be adopted faster, both are considering support for Blu-ray as well.

PC INDUSTRY

MICROSOFT, INTEL The two tech giants are banking on the PC to emerge as a hub for digital entertainment, shooting programming to other players around the home. Microsoft is also loath to give Sony any advantage in the game console war.

DELL, HP, APPLE These PC makers believe Blu-ray will win over users faster than HD DVD, and this should speed sales of higher-margin PCs with high-def DVD players. Dell and HP sell HDTVs as well, and sales of those sets could jump, too.

RETAILERS

WAL-MART The retail giant fears that dueling high-definition formats will confuse consumers and slow sales. So it has told the battling sides that it will stock only one format, though it hasn't picked a side. The loser will find itself shut out.

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kes decided that the studio should forget appearances and back Blu-ray if it was the format most likely to win consumers' hearts. "Blu-ray's potential for more capacity started looking better and better," said one Hollywood executive.

CRISIS MODE

ONCE WARNER STARTED to waver, Paramount Pictures decided to move first in order to negotiate better terms, according to Hollywood insiders. On Sept. 23 one Blu-ray insider saw preliminary contracts written up by Warner Bros. and Paramount to join the Blu-ray board. "It was all going to happen in a day or two," says the source.

Leaked to Microsoft, the news put the company in crisis mode. Execs began working the phones, lobbying retailers about the potential for mass consumer confusion if competing standards came to market. Concerned, CEO H. Lee Scott of Wal-Mart Stores Inc. personally telephoned Stringer and Walt Disney Co. CEO Robert Iger, two Hollywood sources say. Finally, Microsoft issued its joint statement with Intel. Microsoft declined any additional comment for this article.

The public attack may have backfired. One day after Microsoft talked up the importance of Toshiba's ability to hit the market first with its standard, Toshiba announced it would delay rolling out its own HD DVD players until after the holidays. Sony's Blu-ray-equipped PlayStations are scheduled to go on sale early next year, too. The same day, Yoshihide Fujii, Toshiba's corporate senior vice-president for digital media products, said the company remained open to creating a single format.

Such a compromise would avoid the confusion of two technologies coming to market next year. A few components of Toshiba's technology, and possibly Microsoft's, could be incorporated into Blu-ray to make it easier for them to join Sony. While Sony may agree, it is taking steps to avoid any substantial delay in Blu-ray. Sources say the company is considering reducing its royalty take and may underwrite the production costs of Blu-ray disks.

It may not be the Sony of old. But a Blu-ray victory would help the company regain a starring role in living rooms everywhere.

–By Cliff Edwards and Peter Burrows in San Mateo, Calif., and Ronald Grover in Los Angeles, with Tom Lowry in New York and Kenji Hall in Tokyo

BusinessWeek online For additional information on the DVD wars, go to businessweek.com/extras

ILLUSTRATION BY VIKTOR KOEN; (KIDMAN) PHIL BRAY/UNIVERSAL/EVERETT COLLECTION

CONSUMER ELECTRONICS

Definitive Answers On High-Def

Can't wait until you can get the eye-popping detail of a movie at the multiplex right in your living room? Even if you're ready for high-definition DVDs, the market isn't ready for you. That won't happen until next year, when the players and disks will go on sale.

Before then, there's still a lot of behind-the-scenes wheeling and dealing to be done over which formats and features will be offered. But the good news is that the transition to high-definition DVD players promises to be a lot less wrenching for you than technology shifts in the past. The new super DVDs aren't likely to immediately make your DVD movies obsolete in the same way CDs supplanted vinyl LPs and DVDs replaced videocassettes.

But high-definition TV, which gets its compelling leap in picture quality from screens that show three to six times the detail of standard TV, clearly is here to stay. Stations are broadcasting more HD programming, and families are replacing aging TV sets with HD models. Some 10% of U.S. households now have one—and perhaps a third will within three years. So Hollywood figures it needs a way to distribute HD versions of its movies.

Eventually you're going to have to make some decisions about upgrading your DVD collection or adding to it with high-definition disks. Here's what you need to keep in mind:

» **YOU PROBABLY WON'T** be forced to choose between competing formats Blu-ray, developed by Sony Corp., and Toshiba Corp.'s HD DVD. Chances are slim that more than one type of player will make it to market, and Blu-ray is the front-runner. If, come next year, the industry stubbornly offers you a couple of incompatible DVD players and disks, it's best to continue to fence-sit until one side in the battle surrenders.

» **YOU'RE NOT GOING TO** have to replace your DVD library. Both of the proposed schemes will let you play your current movies in the new players, and the new disks probably will work in the DVD player you already own. You won't get the benefit of the richly detailed high-definition picture, but at least your current collection of DVDs won't end up deep in the basement alongside your videocassettes.

» **YOU'RE GOING TO** have to pay more for high definition—for the players, a lot more. The first ones probably will go for \$750 to \$1,000. The cheapest way to get into the game may be to buy Sony's PlayStation 3 game console, also expected next year, for \$500 or less. It will have the new DVD player on board. The longer you can hold off, the better the deal you'll get.

» **YOU'LL SPEND MORE,** but you'll also get more with the new disks. They're pricer—\$20 and up instead of \$20 and down—which means retailers will continue to sell standard DVDs next to the HD versions of most movies. In addition to better picture quality, you can expect more extras, including the ability to connect to the Internet to buy games and knickknacks related to the movie.

Oh, and one more thing: You'll need a high-definition TV to get full benefit from high-definition DVDs. If you're in the market for a new set and you're an avid enough video fan to be worried about your DVD collection, you should start shopping for an HDTV. Unlike the new DVD players, you'll find plenty of HDTV deals around this holiday shopping season. But deals on high-def DVDs and players? Those are still a long way down the road.

–By Larry Armstrong in Los Angeles

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BusinessWeek
IS WAL-MART TOO POWERFUL?
Page 100

Hey, Advertisers, TiVo Is Your Friend

New-Media ad guru Rishad Tobaccowala is showing big-name clients how to get results

IT'S A WARM SEPTEMBER DAY IN Manhattan, and Rishad Tobaccowala is standing in front of about 40 top advertising agency consultants in one of Starcom MediaVest Group's small auditoriums. The consultants, who steer advertisers to the right agencies, are cranky. They have been feted all week by more than a dozen leading agencies in New York—every one, that is, except Tobaccowala's SMG. Instead of lavish trays of food, the ad agency brings in deli fare. SMG is short on chairs, too, so a half-dozen high-powered consultants lean against the walls. As Tobaccowala finishes his riff on how the agency's clients are abandoning consumer demographics in favor of targeting buyers' passions, be they ballet or hunting, he introduces a "real hunter," John Muszynski, one of the top execs at SMG, which is owned by France's Publicis Groupe. "Seriously," Tobaccowala says. "He goes out and kills things." The banter draws nervous titters.

Tobaccowala can get away with this because he's one of the industry's leading media strategists, and that makes him one of the new oracles of Madison Avenue. Media strategists are the people who decide where to spend advertising dollars—across Yahoo's sites, on ABC's *Desperate Housewives*, or in *The New York Times* Sunday Styles section. They used to rank just above accountants as the kind of people advertisers wanted to meet in the industry. In recent years, however, disdain has been replaced with adulation as the attention spans of consumers have shrunk. With the Internet, ad-skipping digital video recorders (DVRs), video cell phones, and portable music and video players all vying for their attention, consumers are getting harder and harder to track. And that's putting media strategists on the speed dials of advertisers befuddled by the changing landscape.

With a sterling track record, Tobaccowala is first among the new stars of ad agencies. What the 47-year-old, India-born

PLAYBOOK: BEST-PRACTICE IDEAS

What Works **Now**

Starcom MediaVest's Rishad Tobaccowala has earned a reputation as one of Mad Ave's freshest thinkers. Here's a look at his philosophy:

MARKET IN A SOCIAL WAY ▼
Starcom clients Best Buy, Sara Lee, and P&G have led the way in embracing the latest Web technologies, including social networking, podcasting, and tagging. P&G worked with CBS to crank out a podcast of the nearly 70-year-old soap opera *Guiding Light*.

THINK VIDEO, NOT TV ▲
The 30-second broadcast TV spot is old hat. Tobaccowala worked with P&G to develop 60-second documentary-style films for its Cover Girl makeup line. The videos run on television, Web sites, and cell-phone screens.

EMBRACE ON-DEMAND ▲
Many in the ad industry think new technologies, such as TiVo, that let consumers watch TV or movies when they want, spell doom for advertisers since consumers can skip over ads. Not Tobaccowala. He's been pushing clients to grasp the opportunity of these technologies since 2003. BMW and GM, for instance, have been experimenting with ads two minutes or longer, with more information and more drama.

MOVE BRANDING ONLINE ►
Two years ago, Tobaccowala began encouraging clients, including Miller Brewing and Kellogg, to build their brands online with video ads and interactive banner ads. In 2003, Starcom pioneered the first "upfront" buying season with Yahoo!, America Online, and others, similar to the way advertisers buy buckets of TV time for the fall season.

(BOTTOM LEFT) KWAKU ALSTON/CBS; (TOP RIGHT) SETH SHERMAN chief innovation officer may sometimes lack in tact, he makes up for with a proven compass. He's a pioneer of online advertising, insisting back in 1993 that his ad agency, Leo Burnett Worldwide Inc., spin off an interactive ad unit that he would head. He persuaded big-name clients, including General Motors Corp. and Procter & Gamble Co., to stay committed to the Web during the downturn. In 2002 he pressed SMG to form a video-gaming unit, getting a jump on rivals in figuring out how to place brands in games. A year later he drove the first up-front buying season for marketers to purchase broadband ad space from Yahoo and America Online Inc., just as they buy buckets of TV time from broadcast networks six months before the new programming season.

MORE SCIENCE, LESS ART

THIS FUTURIST DOESN'T dwell on successes of the past, though. Tobaccowala's message to clients now is that they must get used to being in a permanent state of discomfort. The forces unleashed by tech on the ad world are gaining momentum and leading to ever more unexpected developments. "Blogs and podcasting have gone from 'What are those?' to mainstream in less than two years. Rupert Murdoch paid $580 million to acquire a social-networking business [MySpace.com], and Google's market cap is higher than Viacom's," he says. "So where is the steady state?"

He's less than impressed with some of the supposed solutions offered by others on Madison Avenue. One example: product placements in movies and TV, a common tactic advertisers are using to combat the popularity of DVRs. Tobaccowala dismisses most of them as "lazy" and then adds an expletive that can't be printed in a family magazine. "The spine of our business has collapsed, and what we are looking at are the organs, blood, and connective tissue on the floor in a pile of goo," he says. "We have to imagine what the new structure is going to look like."

He dismisses most product placement as "lazy"

His advice? Adapt to consumers' changing behavior rather than try to cling to the status quo. People's preference for consuming content when they want it will only grow, he says. He predicts 30% of U.S. homes will have DVRs in less than two years. Pair this preference for on-demand content with the ability to search for video on Google or Yahoo, download it over speedy broadband links, and zip it to the living room TV, and traditional TV schedules will be rendered meaningless.

Tobaccowala sees loads of opportunity in this new world. Think of how people get lost for hours surfing the Net now, he says. In the near future they'll start doing that with flat-panel TVs in their living rooms. And advertisers will have much more information they can use to target particular viewers. Rather than knowing simply what percentage of 18- to 25-year-olds watch *Desperate Housewives,* they'll be able to figure out which people watch, how frequently, and what they've been searching for recently on the Net. Advertising can become more science and less art. "[Tobaccowala] talks like a truck driver, but his mind works differently than most people's, and that's what makes him valuable," says Linda Fidelman, president of Advice & Advisors, a consultant for agency searches.

TOBACCOWALA In two years, SMG's media-strategies biz has grown by $5 billion

Traditional media, from television to newspapers, will continue to be plenty important, he says. But he thinks they need to change their ways, too. They have to provide news and entertainment in a greater variety of forms and help advertisers target consumers in the various media. "We are hungry for information and will value those who do a superior job of editing the ocean of material there is," he says.

Several big advertisers are embracing his vision. Over the past 2½ years, Tobaccowala has urged clients, including BMW and Coca-Cola, to cut deals with TiVo and cable companies to create more compelling and targeted messages. GM tried experimental ads on Comcast Corp.'s video-on-demand service in Philadelphia last year. Each month 10,000 people chose to view GM's one- to two-minute ads featuring test-driving segments and in-depth vehicle profiles. Next year, GM plans to roll out slicker ads for most of its vehicles on three more cable systems. "On-demand is going to explode, and we need to be ready for that," says Jack Bowen, GM's general manager for customer relationship marketing.

Other advertisers are experimenting with the most cutting-edge technologies like social networking and podcasting. Earlier this year, Kellogg Co. saw disappointing results from trials of its breakfast cereal Smorz. SMG was able to boost samplings by 500,000 through social networking. Kellogg sent samples and DVDs about the making of cereal and the casting of TV ads to 10,000 influential adolescents.

His ideas may rattle some, but clients and peers pay attention because of Tobaccowala's experience. He has held just about every job at his agency except art director. Before forming Leo Burnett's interactive unit in 1993, he was an account manager, media buyer, and researcher. He joined Leo Burnett in 1982 immediately after earning an MBA from the University of Chicago's Graduate School of Business and an undergraduate degree in mathematics in India.

To stay on top of trends, Tobaccowala reads four daily newspapers: *The Wall Street Journal*, *Financial Times*, *The New York Times,* and the local paper of whatever city he wakes up in. A movie hound, he is addicted to online film trailers. He's also an avid user of RSS, a technology that lets him subscribe to podcasts, blogs, and news sites. He carries an iPod and a Palm Treo.

Tobaccowala does whatever he has to to make sure clients don't miss out, either. SMG CEO Jack Klues says he sometimes sends his chief innovation officer specifically to scare a client. "If they are too resistant to try some things we believe in, that's a good spot for Rishad," he says. It usually works. SMG has enjoyed the best run of account wins in the business in the past two years, jumping from handling about $9 billion in media budgets to about $14 billion, including taking over the media planning and buying for Coke and GM.

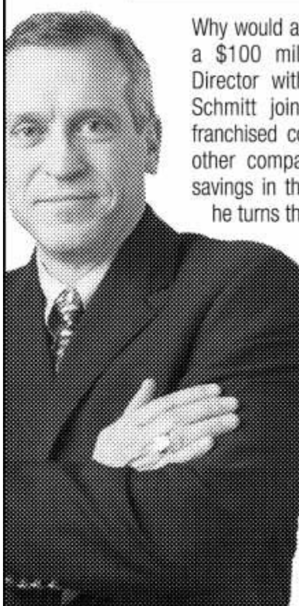
Now Klues has assigned Tobaccowala one of his most challenging tasks to date—restructuring SMG. Despite the performance that has made SMG sought after and Tobaccowala a guru, the futurist says SMG is organized badly and must operate more like a social network than a vertically integrated hierarchy. He wants to infuse SMG with more creative flair, pushing it beyond its media-planning and buying roots. If he does that, the media people may be in charge for good.

–By David Kiley in New York

Franchise Showcase

He Gets It.

Jim Schmitt
Managing Director, Expense Reduction Analysts



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ELI LILLY'S WARE Under pressure to prove prasugrel is a better drug than market leader Plavix

Prescription For Upheaval

How the Medicare drug program is tightening the screws on Big Pharma

IT'S QUITE RARE FOR A PHARMACEUTICAL company to pit its own drug against a rival product to prove its superiority. Never mind that such drug trials can easily cost hundreds of millions of dollars. The bigger risk is that the company sponsoring the trial might find that its drug isn't actually any better than what's already out there. That can mean death at the pharmacy counter.

Nonetheless, it's a risk that Eli Lilly & Co. has decided it needs to take. The company is plowing more than $300 million into a trial designed to determine whether its new anti-clotting drug, called prasugrel, will work better than blockbuster Plavix, which generates $4 billion in sales for Bristol-Myers Squibb Co. If Lilly's drug doesn't win the trial, it'll likely be dead on arrival when it hits the market in 2008. "Lilly is either going to get zero or multibillions" of dollars in sales, says SG Cowen & Co. analyst Stephen M. Scala.

Why would a drugmaker take such an enormous gamble? The answer lies, in part, in a simply named plan that is forcing massive changes across the pharmaceutical industry: Medicare Part D, the new prescription drug program set to launch in January. In essence, the new Medicare plan will lead to survival of the fittest—or at least, survival of the most cost-effective. It's simple economics. Overnight the program will turn the government into an unmatched force in the drug industry, responsible for 40% of all U.S. drug purchases, according to consulting firm Campbell Alliance Group Inc.

SHIFT TO GENERICS

UNDER MEDICARE PART D, insurers and pharmacy benefits managers will offer a variety of prescription plans to seniors on behalf of Uncle Sam. Insurers will get a fixed subsidy from the government for each person they cover. So to avoid losing money on these plans, payers will be looking harder than ever for medications that are both effective and inexpensive. And while the need to prove a drug's worth is perhaps the most dramatic change drugmakers will face, it is far from the only one (table). Drugmakers will see second-wave "copycat" brand name drugs, a key source of growth in the last decade, become less profitable as government plans move more people to generics. Companies will also need to become nimbler about shifting marketing and salespeople around the country depending on whether their drugs are covered in plans in that region. Says Anthony C. Hooper, president of U.S. pharmaceuticals at Bristol-Myers Squibb: "We are

BOB HOWER/QUADRANT

approaching a quantum change in the way that we do business."

TOUGH SCENARIO

AT FIRST, THE NEW Medicare plan will be a boon to drugmakers' bottom lines. Richard T. Evans, an analyst at Sanford C. Bernstein & Co., expects the Medicare drug benefit to give a 2% to 3% boost to drug company earnings in the first two years of the program. That's because, he figures, insurers will offer plans that cover many brand-name drugs in the early years to attract people to sign up. That will trigger an increase in the use of drugs by seniors with little in the way of price pressure.

But in the long run the betting is that the drug benefit has more downside than upside for the likes of Bristol and Lilly. After the first two years, Evans expects insurer plans to become more restrictive, forcing drug companies to slash prices on products in order to keep them covered. That's why, starting in 2008, he expects the bottom line-boosting dynamic to reverse, and for the program to start cutting earnings by 3% or more annually.

Many drug industry executives agree that the going will only get tougher as the government and private insurers grapple with the mounting cost of the Medicare drug program. There's a much higher hurdle for success now. In the go-go days for drugmakers in the 1990s, the need for them to prove that their drugs were worth the price wasn't so acute. That's because managed-care companies had limited success restricting patient access to—and prescribing by doctors of—new drugs. The result: Drugmakers routinely turned "me too" products into blockbusters. So in a pre-Medicare Part D era, if Lilly's drug was shown to be at least as good as Plavix, the company still would have had a good shot at building a big franchise by using its massive sales force and savvy marketing.

But those days are long gone. Now Lilly feels strong pressure to prove that it has a superior product. The decision sparked some internal debate. Dr. J. Anthony Ware, the trial's leader and vice-president of Lilly's research labs, says some insiders initially warned against trying to prove prasugrel was better than Plavix. They worried that it would be too high a hurdle and argued that the company should just prove that the drugs are comparable.

Overnight, Uncle Sam will become the biggest buyer in the market

However, Ware believed Lilly had no choice. Cheap generic versions of Plavix would hit the market no later than 2011. If prasugrel wasn't shown to be better than Plavix, why would anyone pick it over a generic Plavix? So last summer the group recommended to Lilly Chief Executive Officer Sidney Taurel that the company take Plavix head-on. While acknowledging the risk, Taurel adds that "from what we've seen [in early studies] we are hopeful."

RISKY BET

UNDER ITS 13,000-patient trial, which Lilly is doing in partnership with Japanese pharmaceutical giant Sankyo Co., patients who have a variety of cardiac problems, from unstable angina to a recent heart attack, will be given prasugrel or Plavix. They will then be followed for one year to see which drug better reduced the number of heart attacks, strokes, and deaths. Certainly Plavix has shortcomings—an estimated 20% of patients don't respond well to the drug, according to some cardiologists, for reasons that are not entirely clear. But no one will know until the data are in whether prasugrel has an edge. And because many cardiologists use Plavix at doses higher than that being given in the prasugrel study, Bristol may argue that the deck was stacked in Lilly's favor.

Bristol executives won't speculate on the outcome of the prasugrel trial. But they point to Plavix as an example of how they are readying the company for the new age of Medicare. Already Bristol has published a number of studies on Plavix that analyze what the cost-benefit tradeoff is for the drug. One recent paper found that for people with certain heart problems, the drug, in effect, costs about $6,300 for every year of life it adds for patients. In the world of health-care economics, anything below $20,000 is seen as a good buy.

That focus on cost-effectiveness is now being pushed back into earlier stages of product development. Trials for new Bristol drugs will not only show how a drug halts the progression of a disease but may also be designed to prove how the product affects death rates or hospital stays. Generating that data often involves larger and longer clinical trials, which could put even more upward pressure on drug company research and development budgets.

This approach is a fundamental change in the company's mindset, say Bristol execs. Before they had to prove to doctors and patients that their drugs were valuable. Now they need to prove their cost-effectiveness to big payers as well—including those who will be offering plans on behalf of the federal government. "Companies like ours have not been very good at [that]," concedes Dr. David Boyko, Bristol's senior vice-president of global medical affairs. Expect that to change fast.

–By Amy Barrett in Philadelphia and Michael Arndt in Chicago, with Arlene Weintraub in New York

New Rules of the Game

The growing muscle of Uncle Sam in the drug industry will bring about big changes:

GREATER USE OF GENERICS

Over time, lists of drugs covered by Medicare Part D plans will favor generics. In categories where there are such cheap alternatives to brand-name drugs, "copycat" products that don't offer a big performance edge will become less profitable. That could lead companies to develop fewer of them.

RISKIER CLINICAL TRIALS

Insurers will demand more data to show that a pricey drug is a better choice than a cheaper alternative. That will cause drugmakers to run more head-to-head trials and conduct more studies to give hard proof that a drug saves lives. Such studies can be long and expensive, which raises the stakes for drug companies.

REDRAWING THE SALES MAP

When the Medicare benefit rolls out, some parts of the country will become less attractive for pharmaceutical players based on the ways drugs are covered by insurers offering Medicare plans in those regions. So drugmakers will need to be more flexible about deploying salespeople and marketing dollars.

McMansions On Wheels

Million-dollar recreational vehicles—and pricey RV resorts in upscale locales—are luring the wealthy. BY THANE PETERSON

PAULA AND GEORGE LUTTRELL typically vacation in surroundings as sumptuous as a Four Seasons hotel. There's a big difference, though: Their accommodations are on wheels. The real estate developers from Chattanooga, Tenn., travel around in a 45-foot recreational vehicle that has marble steps, five closets, a queen-size bed, a full-size refrigerator, and front and rear 48-inch plasma TVs. Plus, two motorized "slideouts" expand the living area by as much as 30 inches to 11.5 feet, when the RV is parked. ❡ The Luttrells—she's 37, he's 47—are part of a thriving high-end RV culture. Contrary to RVs' blue-collar image—and undeterred by soaring gasoline prices—a growing number of executives (including Liberty Media CEO John Malone), doctors, and other professionals prefer to spend their leisure time in coaches that sell for $1 million to $2 million and have interior appointments reminiscent of old-style Pullman cars. Many owners also tow "toy haulers" behind their RVs—trailers that carry cars, his-and-her motorcycles, golf carts, or motorized Segways.

COMFORT ZONE Wayne and Rebecca Battle in their Liberty RV

(TOP AND BOTTOM)BOB HOWER/QUADRANT

These RVers may spend nights in campgrounds or Wal-Mart parking lots along with the rest of the camper crowd. But their final destination is often a gated RV resort—complete with spa, tennis courts, and pools—in popular vacation spots such as Palm Springs, Calif.; Hilton Head, S.C.; and Naples, Fla., where per-night rates range from $30 to $80. But many RV owners buy lots in these resorts so they can park their rigs for extended stays. At a typical size of 40 feet by 100 feet, this is pricey real estate. Jim Howell, 75, a retired car dealer from Carlisle, Pa., paid $84,000 for his lot at a park near Naples a few years ago and says it's now worth more than $200,000.

This is an elite group.

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114 Going global with real estate

MORE ROOM When parked, this Liberty's sides expand

Only about 325 RVs with million-dollar-plus price tags are bought annually by private individuals, figures Karl Blade, owner of Newell Coach, a Miami (Okla.) maker of luxury RVs. A smaller number are leased or purchased by touring entertainers, NASCAR drivers, and others. The biggest makers, such as Marathon Coach in Coburg, Ore., Chicago's Liberty Coach, and Newell say sales are holding up this year. But as a 200-gallon diesel-fuel fill-up approaches $600, smaller players are feeling the pinch. Monaco Coach, in Coburg, Ore., recently decided to close its faltering million-dollar RV business.

IT SURE BEATS FLYING

LONGER TERM, the industry is riding powerful trends. Soon well-heeled baby boomers will be retiring in droves, while fears about terrorism have made flying and overseas vacationing less attractive. "Unless fuel is rationed, I don't think it will have much of an effect," says Frank X. Konigseder, a vice-president at Liberty Coach. Sure, luxury RVs get only six to eight miles per gallon, but most owners put fewer than 10,000 miles on them annually. In any case, says Jim Neely, who owns Memphis' Interstate Bar-B-Que Restaurants and drives a Newell RV: "If you can't afford to spend a couple thousand dollars on fuel during a trip, you shouldn't own one."

SLEEP WELL A bedroom in a coach by market leader Newell

The million-dollar-plus market is dominated by Newell, which makes 44 custom-built RVs annually, and Prevost (pronounced "pray-vo") conversions, made by 20 or so companies using the shells of European-style tour buses from Quebec's Prevost Car, a Volvo unit. Celebrities who use RVs on tour tend to prefer Prevosts, which have the mechanical guts and suspension of intercity buses and can last a million miles or more.

Private owners have typically been well-heeled retirees. Partial to country music, boating, horse shows, and NASCAR races, "most of 'em made it the hard way," says Liberty owner Sonny Erp, a home developer from Ocala, Fla. That owner profile is changing, though, as RVs get fancier and luxury RV resorts become more prevalent. One exec who's sold on RVs is Liberty Media's Malone, 64. He's usually at the wheel of his Newell when he and his wife, Leslie, 63, travel between their Colorado home and their ranch in New Mexico. "People are intimidated by the size of the things, but they really aren't hard to run," Malone says. The Malones prefer the RV to flying partly because it's easy to travel with their pets—five pugs and a Boston bull terrier.

Making friends is part of the appeal. Companies sponsor owners' clubs that organize tours and rallies, as does an umbrella group with more than 1,000 members called Prevost Prouds. As a result of attending Newell rallies, "many of my best friends are other Newell owners," says Neely. Recently the Luttrells went to a three-day gathering in Kentucky horse country that attracted three dozen Liberty RVs. Their owners took a distillery tour, motorcycled together, and went to a concert by country star Randy Travis, who tours in a Liberty.

The pastime's other big lure is flexibility. "When I was young, my parents had a seaside house, and I hated going to the same place all the time," says Ken Dunsire, 73, a retired Lincoln National executive vice-president. He and his wife, Stephanie, 62, put 20,000 miles a year on their custom-built Featherlite coach. Some people keep their coaches packed with clothes and food so they can take off any time. Wayne and Rebecca Battle, both 71, who own a sawmill in Wadley, Ga., often decide where they're going as they're heading out the driveway. They've ended up as far away as Maine and Las Vegas. "We also have a condo in Daytona [Beach, Fla.]," says Wayne, who drives a Liberty, his fifth. "If I had to give up one, I'd keep the coach." A lot of his fellow luxury RVers would say amen to that. ■

BusinessWeek weekend

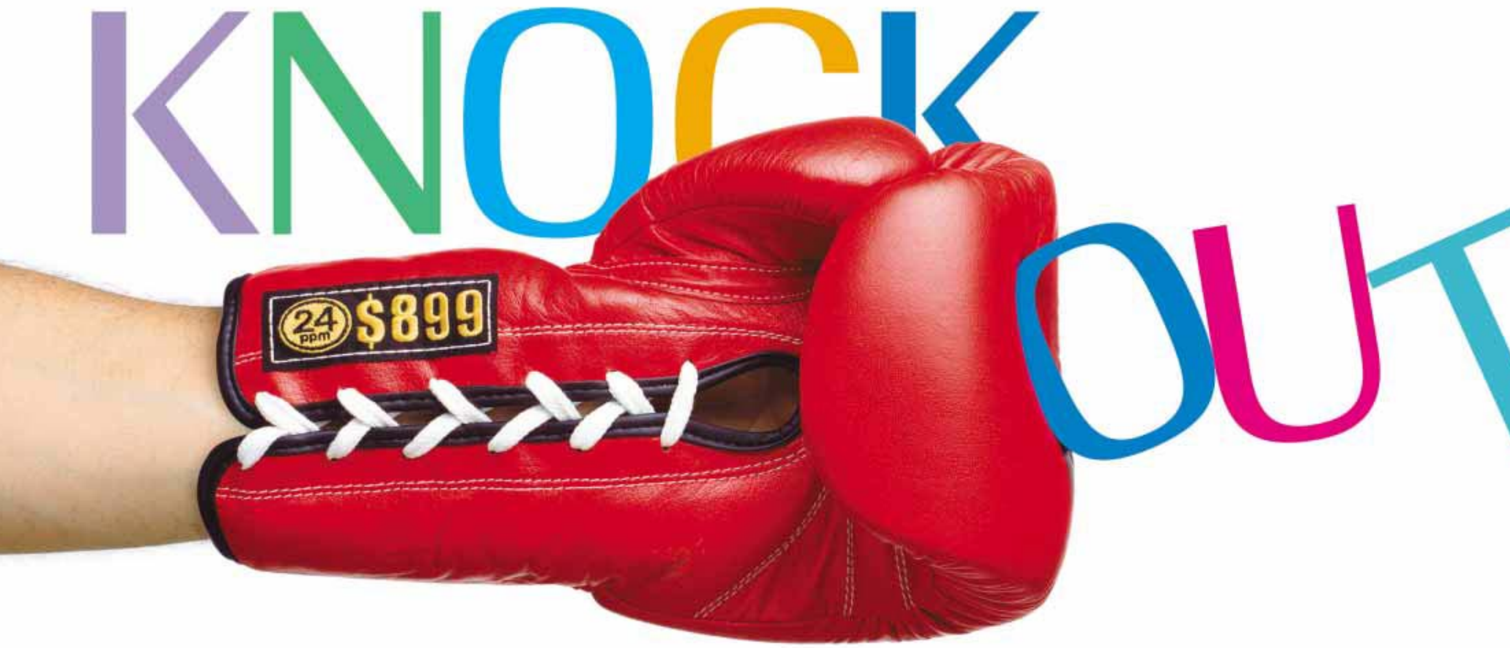
To see more luxury RVs, watch BusinessWeek Weekend. Check your local TV listings or go to businessweekweekend.com to view this and other stories from our weekly TV program

Beyond Best-Sellers

SO YOU HAVE A LONG WEEKEND or a lengthy plane trip coming up—and you're looking for something worthwhile to read. In case you're overwhelmed by the selection at the bookstore, we have identified 10 eclectic book lists that can be found on the Web. The volumes chosen include timeless classics, popular books of today and yesteryear, and a few quirky reads that could be just the thing for those solitary moments. *—Hardy Green*

CURRENT FICTION	
Book club picks powells.com/features/bookclubs.html	Powell's, the large Portland (Ore.)-based independent bookstore, lists choices ranging from Oprah to the *Today* show, *USA Today*, and the BBC World Service. Each list is a mixture of highbrow (Virginia Woolf's *Mrs. Dalloway*) and middlebrow (Ken Follett's thriller *Eye of the Needle*)—and all are fun to browse.
Book critics' picks bookcritics.org	The National Book Critics Circle, an organization of American book reviewers, makes annual awards in the categories of fiction, general nonfiction, autobiography/biography, poetry, and criticism. Its site lists the most recent award winners, including Marilynne Robinson's luminous *Gilead*.
Favorites from bookstore managers booksense.com	Book Sense, an umbrella organization for independent bookstores, offers monthly recommendations. Its October list ranges from E.L. Doctorow's much-publicized Civil War novel, *The March*, to Mary Roach's examination of theories on the afterlife, *Spook.*
Short story collections npr.org/templates/story/story.php?storyId=4868008	Nancy Pearl, a Seattle librarian and author of two popular books that offer reading recommendations, describes eight recent collections of short stories. Included are works by such award-winning writers as Lorrie Moore, T.C. Boyle, and Dan Chaon.
CLASSICS	
Best Novels of the 20th Century randomhouse.com/modernlibrary/100bestnovels.html	In 2003, Modern Library (an imprint of Random House) announced its choices for the 100 best novels of the 20th century. The ranking of admittedly highbrow fiction was put together by a panel of writers and editors. Some examples are James Joyce's *Ulysses* (No. 1) and Wallace Stegner's *Angle of Repose* (No. 82). There's also a list compiled from reader suggestions.
Top Nonfiction Titles randomhouse.com/modernlibrary/100bestnonfiction.html	Modern Library also has a compendium of 100 best nonfiction titles, ranging from *The Education of Henry Adams* (No. 1) to William H. McNeill's *The Rise of the West* (No. 71).
ET CETERA	
Corporate Thrillers www.skokie.lib.il.us/s_read/rd_booklists/finance.html	Writers such as Stephen Frey and Christopher Reich have built a popular following for thrillers situated on Wall Street or in Big Business' corner suites. The Skokie (Ill.) Public Library has a list of somewhat older financial thrillers, most dating from the 1990s. Included are such titles as Michael Crichton's novel of Japanese business intrigue, *Rising Sun*, and Michael Thomas' techno-thriller, *Black Money.*
On Paris parisvoice.com/?fuseaction=article.main&cat_id=44	*Paris Voice*, which bills itself as "the magazine for English-speaking Parisians," suggests a range of diverse volumes on the *ville* of Charles Baudelaire and Alain Delon. There's *Paris Tales*, which includes stories from the likes of Colette and Emile Zola, and Edmund White's collection of Paris vignettes, *The Flaneur*.
On the American South rhodes.edu/NewsCenter/RhodesMagazine/Summer2005/RichTeaching/books-huebner.cfm	The American South has been the setting for shelves of books, from James Agee's *Let Us Now Praise Famous Men* (1939) to Fannie Flagg's *Fried Green Tomatoes at the Whistlestop Café* (1987). Rhodes College offers a selection of five of the greatest of these, from W.J. Cash's 1941 *The Mind of the South* to Anne Moody's 1968 memoir of the civil-rights struggle, *Coming of Age in Mississippi.*
Yesteryear's best-sellers caderbooks.com/bestintro.html	Consider this catalog of best-sellers of earlier decades, beginning with the 1900s and running through the 1990s. These are fun to peruse for oddities—for example, who remembers Douglas R. Casey's 1980 *Crisis Investing: Opportunities and Profits in the Coming Great Depression*? They may also prompt a re-reading of a book enjoyed years back.

ILLUSTRATION BY ROGER KENNY



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Numbers That Blow You Away

An unexpected earnings jump often signals big gains ahead. **BY TODDI GUTNER**

EARNINGS SEASON IS about to start on Wall Street, and what investors want to see is some happy surprises. These are profits that come in higher than expected. Many companies have been obliging investors: Over the past 10 years, 59% of companies in the Standard & Poor's 500-stock index beat analyst forecasts, according to Thomson Financial, a research firm. That number shot up to 69% for the second quarter of this year. Still, "a high percentage of these companies beat only by 1¢ or 2¢," says David Dropsey, a Thomson analyst. And the post-announcement gains from those minimal surprises are, well, minimal.

The biggest stock-price gains go to the companies whose numbers blow away estimates. That's to be expected. But perhaps more eye-opening is that many of the biggest surprises came from little-known companies. Amerco, FreightCar America, and King Pharmaceuticals are hardly household names, but they could be among the superachievers in this reporting season (table).

Finding these companies ahead of their good news is easier than you may think. "The best predictor of companies that will surprise again are those that surprised in the past," says Russell Lundholm, chairman of the accounting department at the University of Michigan's Ross School of Business. And those that surprise investors in a big way often do so because they are low-profile companies with fewer analysts watching them

and making earnings forecasts.

Investing in the big surprisers can be a smart strategy. Lundholm, along with Jeffrey Doyle at the University of Utah and Mark Soliman at Stanford University, studied 160,000 earnings announcements from 1988 to 2000 to measure the stock returns of companies that had large quarterly-earnings surprises. They then constructed a portfolio made up of the top 10% of those with earning surprises. When they bought the companies two days after the earnings announcement and held the stocks for one year, their portfolio beat the market by 9%. When the stocks were held for two years, the portfolio beat the market by a cumulative 15%. Beyond two years, the size of the earnings surprises decrease because more analysts start covering the companies, and the estimates are less wide-ranging.

With his research in mind, we asked Lundholm to screen for the biggest surprisers of the past quarter, figuring they're just at the beginning of a two-year run. We began with all U.S.-based companies that trade on the New York Stock Exchange, the American Stock Exchange, or the NASDAQ. Lundholm screened out stocks with market capitalization of less than $500 million to ensure that the stocks would have some liquidity. That narrowed the list from 5,875 to 1,975. Of those, 651 met expectations precisely—so he dropped them, too.

Searching for a Nice Surprise

Companies that beat Wall Street estimates of their earnings even in just one quarter often have large stock gains in later years. That's why we searched a database for companies that previously had favorable earnings surprises greater than 1.3% of the share price prior to their last earnings report. Then we zoomed in on the top 1% of the list and cut those surprises that stemmed from one-time events or that weren't likely to be sustained.

COMPANY / SYMBOL	INDUSTRY	PRICE*	QUARTER ENDED JUNE 30, 2005 Estimate	QUARTER ENDED JUNE 30, 2005 Actual	QUARTER ENDED SEPT. 30, 2005 Estimate
Agere Systems AGR	Semiconductors	$10.33	$0.05	$0.24	$0.10
Alpharma ALO	Pharmaceuticals	24.70	0.09	0.39	0.13
Amerco UHAL	Vehicle rental	57.76	2.06	2.57	2.96
Ashland ASH	Chemicals	56.07	2.13	3.09	0.94
FreightCar America RAIL	Railcar manufacturing	41.50	0.29	0.90	0.96
Heidrick & Struggles HSII	Recruiting	32.59	0.38	0.69	0.50
Homestore HOMS	Internet services	4.37	(0.02)	0.02	0.00
Inverness Medical Innov. IMA	Pharmaceuticals	27.01	0.20	0.38	0.10
King Pharmaceuticals KG	Pharmaceuticals	15.17	0.22	0.44	0.32
McDermott Int'l. MDR	Oil services	38.11	0.22	0.43	0.32
Parker Drilling PKD	Oil services	9.39	0.04	0.13	0.06
Safety Insurance Group SAFT	Insurance	36.25	0.97	1.46	1.01
Stewart Info. Services STC	Insurance	51.42	1.16	1.94	1.59
TRW Automotive TRW	Auto parts	29.06	0.37	0.73	0.02
ViroPharma VPHM	Pharmaceuticals	21.05	NA	0.11	0.21

*Oct. 3 NA = Not available **Data:** Russell Lundholm, Stephen M. Ross School of Business, University of Michigan, FactSet Research Systems Inc.

CLICKETY-CLACK

THEN FOR EACH COMPANY that beat the consensus of analysts' forecasts, Lundholm calculated the earnings surprise as a percentage of the company's share price. For example, FreightCar America, a Chicago company that manufactures railcars, earned 90¢ per share for the quarter ended June 30, trouncing an expected 29¢ profit. The 61¢ earnings surprise was 3.1% of the company's share price at the end of the quarter.

Lundholm then ranked the companies top to bottom by the earnings surprise as a percentage of stock price. To get the very best, investors can go to the top 10% of companies. In the interest of space, we went to the top 1% of companies. Then we examined each to determine if the strong earnings were sustainable or was the product of a one-time event. So we dropped homebuilder WCI Communities, because its surprise was from a real estate sale, and satellite-TV provider EchoStar Communications, which got its big boost from a tax credit.

The resulting list is a diverse one, including energy, pharmaceuticals, insurance, management recruiting, and Internet service companies. Among the highlights:

» **Amerco.** The company's name is almost generic, but you'll recognize its big brand: U-Haul. Sure, it's a seasonal business, with more people moving in spring and summer. Still, its earnings have some powerful momentum. More specifically, the company, which emerged from bankruptcy in March, 2004, saw a 51¢ earnings surprise for the second quarter of 2005. Operating margins were up 25%, and revenues rose 4%. Improved technology is helping U-Haul get more use out of its fleet, and strong demand is allowing it to increase rental rates. Better marketing has paid off in higher occupancy rates for the company's self-storage unit.

» **King Pharmaceuticals.** A takeover target earlier this year, this maker of branded prescription drugs is starting to look better as a stand-alone enterprise. It turned in a 22¢ surprise for the second quarter. New management is credited with getting inventories under control and with improving the gross margins. Perhaps more important, sales of some products, such as Skelaxin, a muscle relaxant, and Levoxyl, a thyroid-hormone replacement, are proving stronger than expected.

» **Heidrick & Struggles.** In a strong economy, companies turn to headhunters such as Heidrick & Struggles to fill top positions. That's one reason this executive search firm turned in a 31¢-a-share earnings surprise in the second quarter. But more important and long-lasting is that the company is finally undertaking a huge cost-cutting effort. That should help raise the firm's historically low operating margins of 7.3%. The company has typically trailed its competitors' margins by up to 4%.

Of course, there are no assurances that Heidrick or any of the others on the short list—or even those in the top 10%—will continue to be market-beating stocks. But if you are looking for winners, these give you some good odds. ■

BusinessWeek online For an extended list of companies ripe for strong earnings surprises, go to www.businessweek.com/extras

ROBERT NEUBECKER

A Pro Who's Mad for Munis

PIMCO's Bill Gross likes closed-end muni bond funds so much he owns 35 himself. **BY LEWIS BRAHAM**

FROM HIS DESK AT PIMCO'S Newport Beach (Calif.) headquarters, Bill Gross oversees some $500 billion of other people's money—slightly less than the gross domestic product of Thailand. What is this master of the universe doing with his own money? Municipal bonds in general, but closed-end muni bond funds in particular. "I own 35 of these funds personally," says Gross. "You can get a 6% yield on some of these tax-free, compared to just 4% on Treasury bonds. That's a great deal."

It could well be. But Gross's strategy is rife with risk. These funds invest mainly in long-term bonds, and increased tightening by the Fed or a surge in inflation could send prices reeling. That would be especially hard on funds that borrow money to buy additional bonds to juice their yields, a strategy called "leveraging." On top of that, the funds are not cheap. In fact, many trade (closed-end funds are bought and sold like stocks, not like mutual funds) at prices higher than their net asset values (NAV is the market value of a fund's portfolio divided by outstanding shares).

Most analysts who specialize in closed-ends recommend buying only when they trade below their NAVs. "The last time we saw wide discounts on muni funds was at the end of 1999, when no one wanted to own bonds," says Paul Mazzilli, director of exchange-traded fund research at Morgan Stanley. "Today the average discount is only 1.4%, vs. a 3.6% average for the past 10 years." No doubt Gross bought many shares at discounts, but he continues to hold those now at premiums.

To embrace Gross's strategy is to believe that the Federal Reserve will soon ease up. "We've already had 15 months of steady increases, which is the average tightening cycle," says the bond maven. He also argues that the rate hikes are aimed at cooling the overheated housing market, and that's happening.

BUILD A BUY LIST

WHAT IF THE FED continues to hike rates? Higher short-term rates will destroy the ability of leveraged funds to maintain their dividends. "We're already seeing waves of payout cuts in these funds," says Mazzilli. "And when the funds cut, their shares get whacked."

Mazzilli is wary of most closed-end muni funds, but he does have a few favorites. Among them is Managed Municipals Portfolio, which sells Treasuries short to hedge its munis, and has an 8.4% discount. Two others, Muni Intermediate Duration Fund and Nuveen Quality Income Municipal Fund, are also at discounts. In contrast, two of Gross's holdings, BlackRock Municipal Income Trust II and PIMCO Municipal Income Fund, both trade at premiums, in part, some speculate, because Gross owns them.

Perhaps the best strategy is to build a buy list. Thomas Herzfeld of Thomas J. Herzfeld Advisors, which invests solely in closed-ends, says they usually get cheaper near yearend as investors engage in tax-loss selling. While the funds' leverage, fees, yield, and holdings are important, the discount is paramount. "The size of the discount is about half of our decision-making process," he says. By that standard about 10 funds are attractive now. But if you keep your eyes open, discounts should open up on many more. Who knows? By yearend the Fed may be done with its rate hikes—and Gross will have been proved right.

Closed-End Muni Bond Funds: High Yields, No Taxes

FUND (SYMBOL)	PRICE	DISCOUNT/PREMIUM*	YIELD
BlackRock Municipal Income Trust II (BLE)	15.78	2.16%	6.4%
Insured Municipal Income Fund (PIF)	13.17	–12.67	5.0
Investment Grade Municipal Income Fund (PPM)	13.44	–14.18	4.9
Managed Municipals Portfolio (MMU)	10.74	–8.44	5.1
Muni Intermediate Duration Fund (MUI)	14.48	–6.04	6.0
Nuveen Quality Income Municipal Fund (NQU)	14.51	–6.45	5.8
PIMCO Municipal Income Fund (PMF)	15.12	1.61	6.5
Van Kampen Municipal Opportunity Trust (VMO)	14.58	–12.90	5.9
Van Kampen Select Sector Municipal Trust (VKL)	12.59	–12.87	5.9
Van Kampen Value Municipal Income Trust (VKV)	13.73	–12.16	5.9

*Difference from the fund's net asset value. All data as of Sept. 30

Data: Closed-EndFunds.com, Yahoo!Finance

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Amsterdam	01-12-2005	Madrid	26-11-2005	Barcelona	06-02-2006
Paris	30-11-2005	Barcelona	28-11-2005	Mexico	07-03-2006
New York	03-12-2005			Monterrey	10-03-2006
Milan	31-01-2006			Santiago	13-03-2006
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Finding Fertile Ground Overseas

Investors can use international real estate to diversify their holdings. BY ANNE TERGESEN

IN PURSUIT OF HIGHER RETURNS and lower overall risk, savvy investors seek out alternatives such as commodity or real estate funds. Besides their profit potential, alternatives are prized because they don't generally behave like stocks and bonds. Now a small but growing number of mutual funds are making a new flavor of alternative investment available to individuals—international real estate. It's not a must-have for every portfolio. But if you want to be as diversified as possible, it makes sense to spread your real estate exposure around the globe.

Recently, such powerhouses as Fidelity Investments and real estate specialist Cohen & Steers have launched funds that zoom in on overseas holdings (table). They join the Alpine International Real Estate Equity Fund, which has been investing abroad for more than 15 years. The fund companies are betting that individuals, who increasingly view real estate as a core investment, will see overseas funds as a hedge against any downturn at home. Over the past decade, real estate stocks in different countries have moved in tandem with the global market for listed real estate securities just 40% of the time, vs. an 80% correlation for the global stock and bond markets, says Scott Crowe, a global strategist at UBS. "Local factors drive the real estate markets."

Although foreign properties are not, on the whole, cheaper than their U.S. counterparts, fund managers see good growth prospects abroad. Steve Buller, manager of the Fidelity International Real Estate Fund, sees potential annual returns for international property stocks of 7% to 10% over the next decade.

James Corl, Cohen & Steers's chief investment officer for real estate securities, thinks there are opportunities in such countries as Japan and Germany, where banks, utilities, and other conglomerates are divesting properties unrelated to their main businesses. "A lot of that is likely to get picked up by firms that specialize in real estate," says Corl, whose fund's top picks include Mitsubishi Estate, Japan's largest real estate company.

BIG DIVIDENDS

SOME THINK THERE'S more upside for property markets overseas. Since the U.S. led the world out of the 2001 recession, notes Alpine's Sam Lieber, "other economies' business cycles have more room to run."

One difference between domestic and foreign real estate funds is the yield they offer. U.S. funds hold mainly real estate investment trusts, which avoid corporate taxes by passing along big dividends to investors. But REITs are new in some countries and don't exist in others. As a result, in many overseas markets, real estate is held mainly by operating companies, which make lower payouts. Still, with more countries recently allowing REIT-like structures, foreign REITs are likely to become more prevalent.

The funds are not making big bets on single countries. For example, the Cohen & Steers International Realty Fund has 20% of its assets in Britain, 15% in Hong Kong, 13% in Australia, and 10% in Japan. Top holdings are Land Securities, a British office and retail property owner, and Westfield Group, an Australian mall owner that's expanding in Europe. Alpine favors J.M., a large Swedish developer, and Spanish builder Fadesa Inmobiliaria.

To replicate the global market, you'd have to devote about half of your real estate allocation to international holdings. But given the risks in foreign investments—notably, currency fluctuations—some investors might opt for less. Still, even a little exposure to this diversifying asset should help cushion your returns over time.

Buy into Buildings Abroad

FUND (SYMBOL)	YEAR-TO-DATE TOTAL RETURN*	EXPENSE RATIO
AIM Global Real Estate (AGREX)	10.7%	1.40%**
Alpine Intl. Real Estate Equity (EGLRX)	14.5	1.35
Cohen & Steers International Realty (IRFAX)	10.57	1.70
Fidelity International Real Estate (FIREX)	7.58	1.25
ING Global Real Estate (IGLAX)	8.35	1.75**

*Appreciation plus reinvestment of dividends and capital gains before taxes, Jan. 1-Sept. 30, 2005
**Does not include initial sales charges of 5.5% (AGREX), 5.75% (IGLAX), and 4.75% (IRFAX)

Data: *BusinessWeek*, Morningstar Inc.

JOHN KUCZALA

EDITED BY TODDI GUTNER

BENEFITS

WHY THE ROTH 401(k) IS A 'DUD' SO FAR

UNLESS YOUR RETIREMENT plan is managed by **Vanguard Group,** don't expect to see the Roth 401(k) pop up as an option in your benefits package yet. "It has turned out to be a dud," says Michael Weddell, a retirement consultant at Watson Wyatt in Southfield, Mich. "Most employers are not offering them right now."

Roth 401(k)s are taxed differently than traditional plans. When you put money into a conventional 401(k), you reduce your taxable income, but you must pay regular income tax when you take distributions. Participants in a Roth 401(k) pay their taxes up front.

Many benefits consultants thought Roth 401(k)s would be rolled out in January, yet companies are waiting for the **Internal Revenue Service** to clear up some murky tax rules—such as how early withdrawals will be taxed. "There has been no guidance, that's true," says IRS spokesman Bruce Friedland. "The IRS intends to issue guidelines this fall." Vanguard spokesman John Demming said the firm has been talking to corporate clients and studying the Roth 401(k) for more than a year. "We are prepared for the decisions the IRS makes and are ready to offer it on Jan. 1," he says. *–Lauren Young*

RETIREMENT

Patience Pays Off

TIME IS THE INVESTOR'S friend. The truth of this Wall Street adage is reinforced by the latest research on millions of 401(k) participants by the Employee Benefit Research Institute and the **Investment Company Institute,** a mutual fund industry group. They delved into their vast database to focus on those who participated in their company 401(k) plans for the five years ended in 2004—about 4 million people. Although the period included a nasty bear market, the average account balance rose by 36%, from \$67,016 to \$91,042. The gains came from contributions and investment returns.

The findings should assuage concerns that Americans aren't preparing for retirement. Maybe it was inertia, but 401(k) owners never fled stocks or abandoned their long-term goals. At the end of 2004, 67% of the average portfolio was invested in equities (46% in stock funds, 15% in company shares, and the equity portion of the 10% in balanced funds). Among other findings: Life cycle funds are increasingly popular, especially with younger participants. These funds make it easy to get a portfolio appropriate for their age and tolerance for risk. *–Christopher Farrell*

TIME OFF

LOUIS COMFORT TIFFANY'S glass has inspired millions of stained glass knockoffs. But many people have never seen the real thing. The Seattle Art Museum (seattleartmuseum.org) will showcase more than 120 Tiffany vases, window panels (such as *The Reader*, shown here), lamps, and mosaics in the first broad exhibit of the artist's work since the late 1980s. Many of the pieces, which also include metalwork and furniture, have never been publicly exhibited before. The show will run from Oct. 13 to Jan. 4, then moves to Toledo, Dallas, and Pittsburgh. *–Kristina Shevory*

LEISURE

DESIGN 'EM, DEAL 'EM

HERE'S A new product to go with your vanity license plates and personal postage stamps: customized playing cards. For \$26.50 at **newtscards.com,** you can design your own deck by uploading a photo, picking a border, and adding text to the back of the cards. Newt's will print and ship the deck within a week. Try handing those out at your next poker party. *–Larry Armstrong*

(TOP) KEN ORVIDAS; (TIFFANY) RICHARD GOODBODY/COURTESY OF THE NEUSTADT MUSEUM OF TIFFANY ART, NEW YORK


IBM Workplace

BY GENE G. MARCIAL

DEMAND FOR LIQUEFIED NATURAL GAS IS LIFTING CHENIERE.

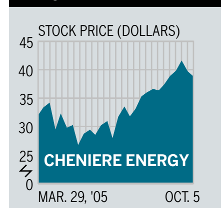
BLUE NILE'S DIAMOND BIZ MAY GET A PROPOSAL FROM AMAZON.

WILL A NEW PULMONARY DRUG LEAD TO A BUYOUT AT ENCYSIVE?

Buoyant at Cheniere

As oil prices spurt up, liquefied natural gas will probably take a growing share of the energy market in the years ahead. So say some pros now investing in LNG. The only U.S. pure play is Houston's Cheniere Energy, whose shares trade on the American Stock Exchange with the ticker symbol LNG. Cheniere is currently building three "regasification" terminals in Louisiana and Texas, with the capacity to transform cheap imported LNG back to natural gas. Chevron and Total have already contracted with Cheniere to treat LNG that they will buy abroad when these terminals start operations in 2008. A fourth Cheniere facility is still awaiting government approval. Cheniere shares have soared—from 25 in May to 39 now. William Harnisch, CEO of hedge fund Peconic Partners, which owns a 1.5% stake and invests heavily in energy, says Cheniere is "way ahead of the curve in gearing up for the jump in demand for liquefied natural gas in the years ahead." He figures the shares will hit 100 in two years, in light of projected revenues and earnings before interest and taxes. His forecast, however, is based on natural gas priced at a conservative $4 per 1,000 cubic feet, vs. today's perhaps unsustainable $14. Samuel Brothwell of Wachovia Securities, who rates Cheniere "outperform," says "LNG is essential to keep pace with the fast rise in demand for gas." He sees Cheniere making money in 2008. Phillips Johnston of JPMorgan Securities, which has done banking for Cheniere, rates the stock "overweight." He sees Cheniere earning 84¢ a share and having cash flow of $2.26 a share in 2008. Johnston predicts that "imports of LNG will expand substantially in the coming 10 to 15 years."

FLOATING HIGHER

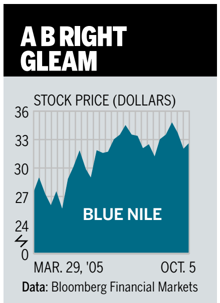


Data: Bloomberg Financial Markets

PHOTOGRAPH BY ETHAN HILL

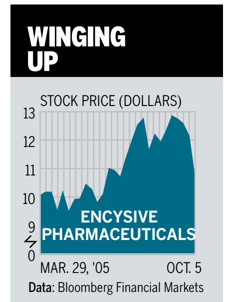
Blue Nile: A Fit for Amazon

FOUR MONTHS AGO, Scott Devitt of Legg Mason Wood Walker downgraded online diamond retailer Blue Nile (NILE) from "buy" to "hold" partly because of slow order growth—and because venture capitalists still owned 15% of the stock. On Oct. 3 he raised it back to "buy." Why? Orders have picked up—to above 11%—and the VCs have moved on. And, in a report, Devitt said that Nile would be a perfect fit for Amazon.com, which also sells diamonds. That lifted the stock from 32 to 35 in a day. It is now at 33. "It's rare that we'd recommend an acquisition for Amazon," says Devitt, but Nile is a unique example of a logical buy for Amazon. Nile's business model is akin to Amazon's, which focuses on inefficient markets, he notes. His target for the stock is 40. Fidelity Investments owns 15%, and Morgan Stanley 9.5%. Devitt expects earnings of 75¢ in 2005 and $1 in 2006, vs. 2004's 56¢. Nile CEO Mark Vadon declined comment. Amazon spokesperson Jani Strand declined comment.



Encysive Is Breathing Easy

AMONG BIOTECHS favored by Mark Monane of investment firm Needham, Encysive Pharmaceuticals (ENCY) may be an early winner for two reasons: Its new oral drug, Thelin, for pulmonary arterial hypertension, or high blood pressure in the lung, may get Food & Drug Administration approval early next year. And Monane sees the company as an attractive buyout. Thelin, Encysive's lead product, has shown good results in recent clinical trials, notes Monane, who rates the stock a strong buy. It has been winging up, from 9 in May to 13 in September, before easing to 11 on profit taking. Monane figures the stock will hit 17, based on his forecast that Encysive will start making money in 2007—with earnings of 99¢ a share, jumping to $2.20 in 2008. He expects its projected sales of $127 million in 2007 to leap to $217 million in 2008. Monane says Encysive doesn't plan to take on a partner to develop and market Thelin. Without a large drugmaker as a partner, Encysive would be vulnerable to big drugmakers looking to land a prize like Thelin—which, he figures, has a potential market of $1 billion. The total market for pulmonary hypertension drugs could be far greater. Patrick Flanigan III of investment bank WR Hambrecht, who rates the stock a buy, says Thelin is the best drug of its kind. In the short run, he figures sales for the treatment of pulmonary hypertension could soar—from $367 million in 2004 to $833 million in 2009. Flanigan expects Thelin will capture 35% of the market by 2009. ■



CHARTS BY ERIC HOFFMANN/BW

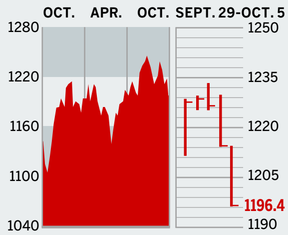
BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/investor at 5 p.m. EST on the magazine's publication day, usually Thursdays.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

Personal Business Figures of the Week

STOCKS

S&P 500



COMMENTARY

The interplay of inflation and higher oil prices spooked stocks to start the final quarter of the year. The prospect of simultaneously slower growth and higher inflation gained currency this week as a result of downbeat business readings and the bearish views on rate hikes of two Federal Reserve officials. Boston Scientific and eBay were among the week's few winners.

Data: Bloomberg Financial Markets, Reuters

U.S. MARKETS

U.S. MARKETS	OCT. 5	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1196.4	-1.7	-1.3	5.5
Dow Jones Industrials	10,317.4	-1.5	-4.3	1.4
NASDAQ Composite	2103.0	-0.6	-3.3	7.5
S&P MidCap 400	696.2	-0.9	5.0	15.6
S&P SmallCap 600	338.4	-1.9	2.9	13.4
DJ Wilshire 5000	11,956.3	-1.5	0.0	7.8

SECTORS

SECTORS	OCT. 5	WEEK	YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	723.3	-3.3	2.6	9.7
BW Info Tech 100**	361.9	-0.5	-3.0	6.6
S&P/BARRA Growth	572.3	-1.7	-1.7	4.4
S&P/BARRA Value	620.0	-1.7	-0.9	6.5
S&P Energy	374.8	-8.1	29.8	32.5
S&P Financials	389.9	-0.4	-5.2	0.6
S&P REIT	147.9	-0.7	2.4	13.7
S&P Transportation	216.9	-1.4	-10.2	2.1
S&P Utilities	164.4	-2.7	16.1	27.3
GSTI Internet	175.7	1.0	-1.5	14.1
PSE Technology	800.1	-0.4	2.7	14.3

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

GLOBAL MARKETS	OCT. 5	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P Euro Plus (U.S. Dollar)	1453.9	0.2	4.1	19.8
London (FT-SE 100)	5427.8	-1.2	12.7	15.3
Paris (CAC 40)	4594.1	-0.1	20.2	21.9
Frankfurt (DAX)	5069.4	0.4	19.1	25.2
Tokyo (NIKKEI 225)	13,689.9	1.9	19.2	21.3
Hong Kong (Hang Seng)	15,161.0	-0.4	6.5	13.7
Toronto (S&P/TSX Composite)	10,748.1	-2.7	16.2	22.2
Mexico City (IPC)	15,720.4	-0.9	21.7	41.4

FUNDAMENTALS

FUNDAMENTALS	OCT. 4	WEEK AGO	YEAR AGO
S&P 500 Dividend Yield	2.05%	2.05%	1.69%
S&P 500 P/E Ratio (Trailing 12 mos.)	18.9	19.0	19.5
S&P 500 P/E Ratio (Next 12 mos.)*	14.4	14.9	16.2
First Call Earnings Surprise*	10.49%	3.82%	2.21%

*First Call Corp.

TECHNICAL INDICATORS

TECHNICAL INDICATORS	OCT. 4	WEEK AGO	READING
S&P 500 200-day average	1200.1	1199.6	Negative
Stocks above 200-day average	59.0%	57.0%	Neutral
Options: Put/call ratio	0.73	0.85	Positive
Insiders: Vickers NYSE Sell/buy ratio	4.33	4.94	Negative

BEST-PERFORMING GROUPS

BEST-PERFORMING GROUPS	LAST MONTH %		LAST 12 MONTHS %
Divsfd. Metals & Mining	11.8	Oil & Gas Refining	100.5
Airlines	11.1	Managed Health Care	64.6
Gold Mining	10.6	Oil & Gas Exploration	58.8
Insurance Brokers	6.0	Fertilizers & Ag. Chems.	58.5
Railroads	5.9	Health-Care Distrbtrs.	52.4

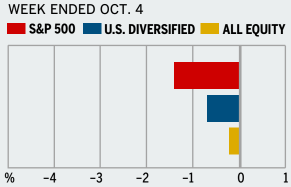
WORST-PERFORMING GROUPS

WORST-PERFORMING GROUPS	LAST MONTH %		LAST 12 MONTHS %
Educational Services	-19.3	IT Consulting	-37.8
Home Furnishings	-19.0	Automobiles	-32.8
Aluminum	-14.8	Aluminum	-31.6
Specialized Cnsmr. Serv.	-12.2	Photographic Products	-30.4
Tires & Rubber	-11.6	Home Furnishings	-30.2

MUTUAL FUNDS

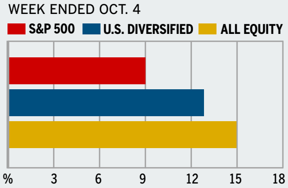
4-WEEK TOTAL RETURN

WEEK ENDED OCT. 4



52-WEEK TOTAL RETURN

WEEK ENDED OCT. 4



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		**LEADERS**	
Precious Metals	9.4	Latin America	69.0
Latin America	8.8	Natural Resources	45.1
Diversified Emerg. Mkts.	5.9	Diversified Emerg. Mkts.	40.6
Japan	5.6	Utilities	31.6
LAGGARDS		**LAGGARDS**	
Real Estate	-2.9	Financial	6.8
Financial	-1.8	Domestic Hybrid	8.0
Large-cap Value	-1.2	Large-cap Blend	9.3
Large-cap Blend	-1.1	Miscellaneous	10.3

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		**LEADERS**	
ProFunds Precs. Mtls. Inv.	17.5	T. Rowe Price Emg. Europe	78.2
ProFunds Ultra Japan Inv.	16.4	Guinness Atkn. Gl. Energy	76.7
ING Russia A	15.3	T. Rowe Price Lat. Am.	75.1
Midas	12.8	iShares S&P L. Am. 40 Idx.	74.3
LAGGARDS		**LAGGARDS**	
American Heritage Growth	-16.7	Ameritor Investment	-54.2
Munder Rl. Est. Eq. Invt. A	-9.4	ProFds. USh. Mid Cap Inv.	-29.4
Rydex Weakening Dollar H	-7.5	American Heritage Growth	-28.6
ProFds. Mble. Tlcmms. Inv.	-7.1	ProFds. USh. Sm. Cap Inv.	-24.5

INTEREST RATES

KEY RATES

KEY RATES	OCT. 5	WEEK AGO	YEAR AGO
Money Market Funds	3.25%	3.21%	1.24%
90-Day Treasury Bills	3.55	3.46	1.71
2-Year Treasury Notes	4.18	4.08	2.63
10-Year Treasury Notes	4.34	4.26	4.17
30-Year Treasury Bonds	4.57	4.50	4.93
30-Year Fixed Mortgage †	5.94	5.84	5.73

†BanxQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR. BOND
General Obligations	3.79%	4.48%
Taxable Equivalent	5.41	6.40
Insured Revenue Bonds	3.93	4.60
Taxable Equivalent	5.61	6.57

THE WEEK AHEAD

INTERNATIONAL TRADE *Thursday,Oct. 13, 8:30 a.m. EDT* » The August foreign trade deficit probably widened to $59.5 billion. That's the median forecast of economists surveyed by Action Economics. The July trade gap was $57.9 billion.

RETAIL SALES *Friday, Oct. 14, 8:30 a.m. EDT* » Retail sales are forecast to have rebounded with a 0.3% gain in September. A slowdown in vehicle sales led to a 2.1% fall in August retail sales. Even excluding vehicles, retail sales very likely grew 0.3%, after a 1% rise in the previous month.

CONSUMER PRICE INDEX *Friday, Oct. 14, 8:30 a.m. EDT* » Consumer prices for goods and services most likely jumped 0.7% in September, following a 0.5% gain during August. Stripping out energy and food, consumer prices probably rose 0.3%, after edging up 0.1% in August.

INDUSTRIAL PRODUCTION *Friday, Oct. 14, 9:15 a.m. EDT* » September factory output probably contracted 0.2%, after a 0.1% gain in August. As a result, the average monthly operating rate probably fell to 79.5%, from 79.8% in August.

BUSINESS INVENTORIES *Friday, Oct. 14, 10 a.m. EDT* » August inventory levels are expected to have grown 0.5%, offsetting the 0.5% decline in July.

The *BusinessWeek* production index rose to 256.7 for the week ended Sept. 24 and stood 12.3% above the year-ago level. Before calculation of the four-week moving average, the index eased to 258.4.

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/extras

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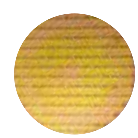

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Index

The Companies

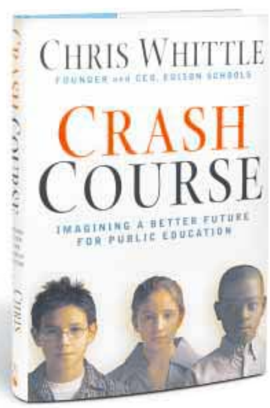
This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

It's Teacher Salaries, Stupid

CRASH COURSE Imagining a Better Future for Public Education
By Chris Whittle; Riverhead Books; 269pp; $24.95

Like many other educators, Chris Whittle, the controversial chief executive of Edison Schools, believes the No Child Left Behind law is heading for a "train wreck." The law mandates that all U.S. schoolchildren must meet state proficiency standards in math and reading by 2014. During an interview held in Edison's New York offices, Whittle told this reviewer that as the law's performance bar is raised, "thousands of schools, with 15 million students," will fail to make the grade.

Crash Course is a provocative look at the radical reforms that Whittle—who runs the largest private company managing public schools—believes are needed if there's to be any hope of reaching the law's lofty goals. To remedy the dire shortage of qualified personnel, for instance, he calls for performance-based pay that would give the best teachers up to $130,000 a year and the best principals up to $200,000. He would scrap the rigid schedules that have governed the school day for decades in favor of giving students far more independent study. And he would vastly increase investment in educational research and development.



Business readers might tend to dismiss everything Whittle has to say because of Edison's smudged track record. He took his company public in 1999 with promises of big profits to come in the business of running public schools. But over the next four years, the red ink never stopped flowing. In late 2003, Whittle finally threw in the towel, taking Edison private in a deal that paid shareholders just 10¢ on the dollar of the initial-public-offering price.

He has little comment about this financial history in *Crash Course*. That's too bad, because a full accounting of Edison's odyssey would have been both fascinating and instructive.

Still, after some 15 years at Edison spent trying to improve public schools, Whittle is well worth listening to as an educator. Although Edison has vanished from the radar since going private, it operates what amounts to one of the nation's largest school systems, with 70,000 students at 157 sites. Most are rough schools, with a majority of students from low-income, minority families. In Philadelphia, for instance, Pennsylvania entrusted Edison with 20 abysmal institutions. At the very best of these, a staggering 88% of students were failing the state's math exam. But as Tom Ridge, who was the state's governor during part of this period, writes in the book's forward, "the results have been extraordinary." Last year, Ridge notes, achievement scores in schools managed by Edison jumped 10.5 percentage points—10 times the gain they enjoyed before the company took charge.

Few would disagree with Whittle's assertion that schools need to adopt a "100% guarantee"—meaning, for instance, that by the third grade, 99.9% of students would be reading well. To deliver on that guarantee, he argues that we need to double the average teacher salary, to $90,000. That may sound like fantasy, but does anyone think we can catch up with other nations while we have a national shortfall of 250,000 qualified math and science teachers? It's a good bet Whittle's performance-based pay would help close that gap.

The biggest surprise in this book is that Whittle, unlike many liberals, doesn't call for massive tax increases to pay for such reforms. Instead, he advocates a sea change in how we spend the billions that schools already get. Thus, to pay for doubling teacher salaries, he would cut the number of teachers by up to one-half. But he wouldn't do that by doubling class sizes. Rather, beginning in about the fourth grade, Whittle would greatly increase the amount of time students spend in independent study. By high school, students would be spending about half the day studying on their own.

Students would also be given a big role in running schools. The best pupils would help tutor younger ones. And all would have the chance to work at such jobs as fixing computers, answering phones, and monitoring study halls. If all students worked just three hours a week, Whittle argues, it would be far easier to get by with fewer teachers and staff.

Whittle has a blackboard full of new strategies for doubling school pay

Whittle reports that the nation is spending only $260 million a year on education R&D—a pittance compared with federal largesse on research for defense and health. He favors gradually raising that to $4 billion a year and using the funds to develop more effective systems for managing schools.

There are many other intriguing ideas here, including the need for instruction on career choices, consumer finance, and health. Few will agree with everything Whittle has to say. But the book should stimulate bold thinking among readers and policymakers—something we require if we're ever going to create public schools that truly leave no child behind.

–By William C. Symonds

BusinessWeek online For an interview with Chris Whittle, go to www.businessweek.com/extras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IdeasViewpoint

BY ROBERT KUTTNER

An Economic Storm Surge

What will be the net impact of Hurricane Katrina on the economy? That question is trickier than it seems. The terror attacks of September 11 did less long-term economic damage than first predicted, in part because the Federal Reserve was induced to keep interest rates very low for nearly three years. But in Katrina's case, the opposite could happen. Katrina's direct and indirect economic costs are likely to be underestimated, and the Fed is compounding the damage by hiking rates.

Katrina brought an added jolt to energy prices that were already rising due to tight supplies of natural gas and oil products and heated demand from China and India. With oil refineries running at more than 96% of capacity, it didn't take much damage to cause gasoline price spikes that will last for months. But consumers also will soon face home heating and electricity bills at least one-third higher than last year's. And that's on top of stubbornly high fuel prices that hit not just private autos but trucks, buses, and airlines. With three-fourths of all goods moved by truck or plane, higher fuel costs will cycle into higher consumer prices across the board.

Additional indirect costs will include insurance industry losses and higher property insurance rates, a run on some building materials, and higher shipping costs for agricultural products that normally use the Mississippi River and the now ruined Port of New Orleans. All these higher prices will function like a tax on purchasing power.

UNFORTUNATELY, THE FED is not behaving as wisely as it did after September 11. Then, central bankers erred on the side of cheap money, keeping short-term interest rates at 50-year lows and flooding the system with liquidity. Even so, the average person didn't benefit much from the resulting recovery. Real median earnings of nonsupervisory workers are where they were four years ago.

The Fed, hiking rates, underplays the economic cost of Katrina

Today's economy is not all that robust to begin with. But this time, the Fed has wrongly ruled in favor of tight money. Why aren't Greenspan & Co. cutting the economy some slack? Apparently the rush of new federal spending on Katrina relief and recovery has alarmed the central bankers. So instead of cueing an end to their recent trend of relentless rate hikes, Fed governors evidently reasoned that all this added fiscal stimulus required an offsetting rate hike. On Sept. 20, with New Orleans still under water, the Open Market Committee ordered yet another quarter-point rate hike—the 11th in a row, raising the federal funds rate to 3.75%.

Yet here is a case where inflation statistics are entirely misleading as economic indicators. The consumer price index will likely rise in coming months, as higher energy, transportation, and borrowing costs work their way through the economy. But these price increases are signs of economic weakness, not the type of overheating that sometimes justifies higher rates. The result of this misguided inflation vigilance: The Fed is leaning against growth, just as growth is faltering due to the hurricane's big hit to purchasing power.

At a deeper level, Katrina increases the stress on the core weakness of the American economy—its ever-greater reliance on foreign borrowing. The U.S. has a dangerous and escalating co-dependency with Asia, most notably China and Japan. They keep lending us dollars to cover our huge trade imbalances and our absence of net domestic savings. We keep using those dollars to keep buying their products. No serious observer thinks this game can go on forever. It's only a question of what event triggers a break, and perhaps a dollar crash. Katrina, whose short-term recovery costs will increase the federal deficit by at least $200 billion and cause America to borrow even more from abroad, intensifies the strain.

Not one of these problems has a short-term cure. True energy independence is a long-term project, which the Bush Administration is failing to take seriously. Restoring fiscal balance will take time and political leadership, yet the Administration is persisting with its program of tax cuts—worsening deficits. Reversing the structural trade imbalance and its huge foreign borrowing could be partly achieved by better fiscal policies, partly by more symmetrical trade rules. But little progress is in sight. Protecting our cities from the escalating risk of global warming and flooding will require a shift in energy consumption policies as well as large outlays for public infrastructure. Here again, there's little awareness at the White House, and less leadership.

For now, the economic costs of Katrina are a slow drip. If markets get panicky—and they have reason to—the costs could turn into a major flood.

Robert Kuttner *is co-editor of* The American Prospect *and author of* Everything for Sale

PHOTOGRAPH BY ETHAN HILL

IdeasOutside Shot

INTERVIEW WITH HASSO PLATTNER

To Innovate, Collaborate

Hasso Plattner, co-founder of SAP, the German business-process software giant, announced on Oct. 3 that he will donate $35 million to fund a design school at Stanford University. It will be called the Hasso Plattner Institute of Design. David Kelley, founder of IDEO in Palo Alto, Calif., and a Stanford engineering professor, led the drive to create this radically new enterprise.

The Institute of Design will teach multidisciplinary innovation and design strategy by bringing together students from business, engineering, medicine, management, the social sciences, and design to form teams to solve problems. Plattner talked to Assistant Managing Editor Bruce Nussbaum about the importance of design, the reason for his gift, and his hopes for the new school. Here are excerpts of their conversation:

Many disciplines together distill the best ideas, says Plattner

What do you expect from the new design school?
I started my career at IBM as an electrical engineer, and I learned in the field that you have to be broader than you thought. You have to work with people. You have to learn to listen. When you study, all the work you do is within your own faculty. You become a specialist. It's common that computer scientists are relatively introverted. It's important for people to learn to work together with other disciplines.

Stanford has already proved that students coming from the medical school, the business school, design, engineering, and psychology, working together for six to nine months on projects, are able to move things forward beyond what any of them could have done within their own faculty.

How did you connect with David Kelley?
Probably through your magazine. More than a year ago, when we had our customer meeting in New Orleans, I gave a keynote speech with regard to development, early prototyping, and how we want to do software design in the future. On the way to the address I got a copy of your magazine with IDEO on the front (BW–May 17, 2004: *The Power of Design*). I just had five minutes to flip through. Many of the ideas talked about were so commonsense, but they work. I went up to the stage, showed the magazine, and said: "There is a company doing exactly what I think we should do." When I came back to the Bay Area, I looked the company up.

Why did your foundation choose Stanford?
I set up shop in the Bay Area 12 years ago to promote more innovation inside SAP. Stanford has played a big role by creating an innovative atmosphere in that area. It helped us tremendously. I wanted to contribute to Stanford but didn't want to just give money. I wanted to have the pleasure of seeing something grow. Then we found this project.

How are you generating innovation inside SAP?
We worked with [design] firms in the past. But it was mostly scratching the surface. IDEO was different. They weren't doing much in software; they were mostly in devices in the physical world. But they were doing a lot with users.

We started a project. We came up with the idea for a design consulting team inside the company focusing not just on the latest stage of how we should present something, but analyzing the whole process of how users work. Now we do a deep dive. We do research. What are other people doing? What's current thinking at 20 universities? What's the competition doing? Talk to people who use competitive software products. Then prototype what you have learned and what you want to provide and discuss this again and again. We found that this process can be repeated (across different businesses).

So SAP has an internal design consulting team?
Yes, and its success is pretty amazing. It works on real projects—and without clashing with the egos of the software developers. An internal consulting team can be efficient when it's not in the middle of an operational division. I think many companies will go that way in the future: have design consulting teams internally that work with actual development teams.

What do you see for the future of innovation?
Innovation will take place between disciplines so that, for example, new medical devices will come out of computer science and mechanical engineering. If we start educating our kids in this direction, and we increase innovation, then we can give away some of our manufacturing to other places in the world.

BusinessWeek online Find out how other companies are fostering creativity at BusinessWeek Online's Innovation & Design channel at www.businessweek.com/innovate/index.html and at www.businessweek.com/innovate/NussbaumOnDesign/index.html

MARTIN LANGER/AGENTUR FOCUS

How to reach retirement and actually get to stay there.

A lot of investors look forward to the day when they can finally retire. Yet the closer they get, the more they wonder how they're going to manage their money.

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