KODAK'S SURVIVAL STRATEGY (P.42) | GRIDLOCK AT THE SEC (P.40)

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BusinessWeek

FEBRUARY 19, 2007

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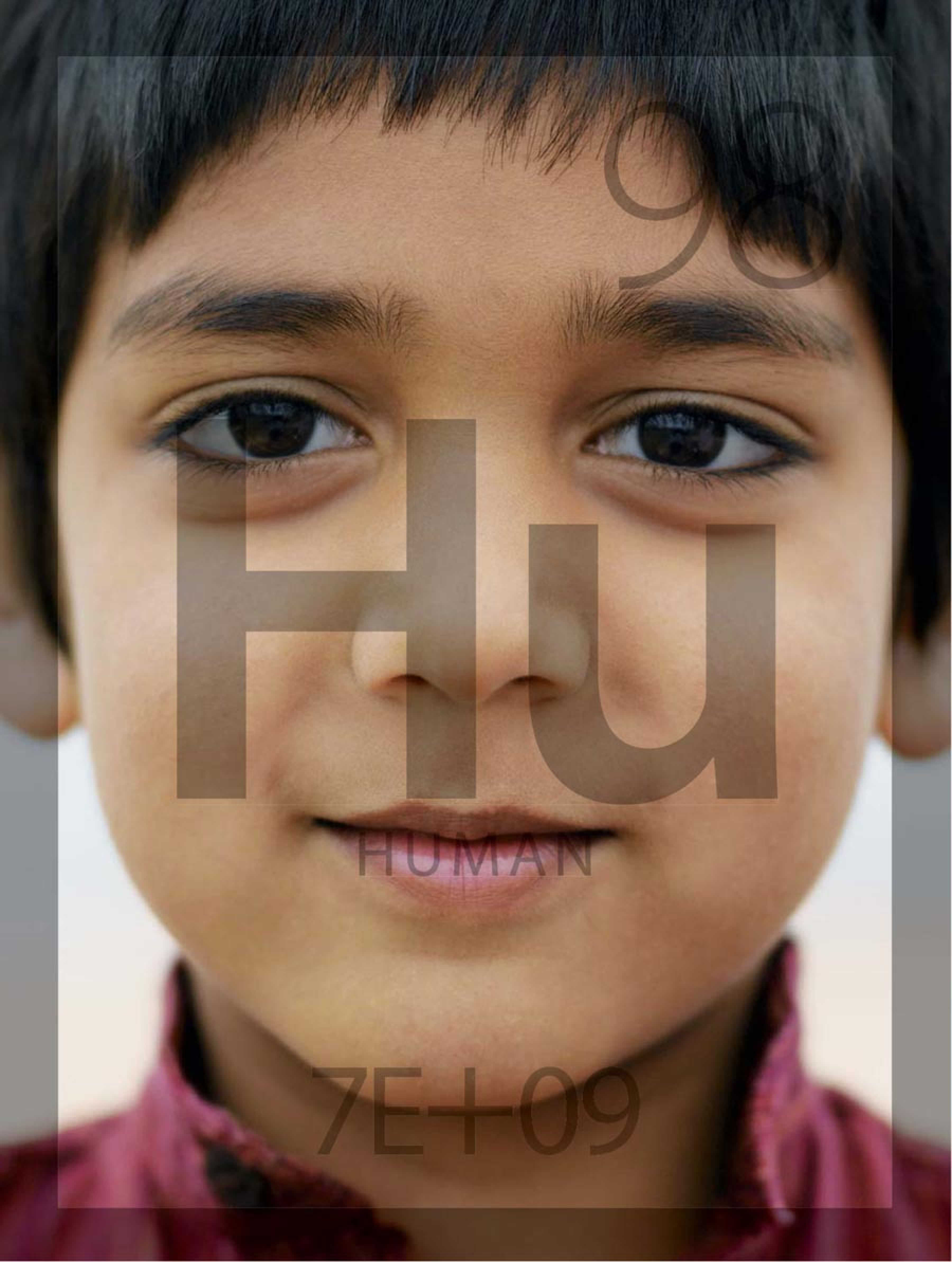
It's a Low, Low, Low, Low-Rate World

Why money may stay cheap longer than you think

BY MICHAEL MANDEL & DAVID HENRY (P.32)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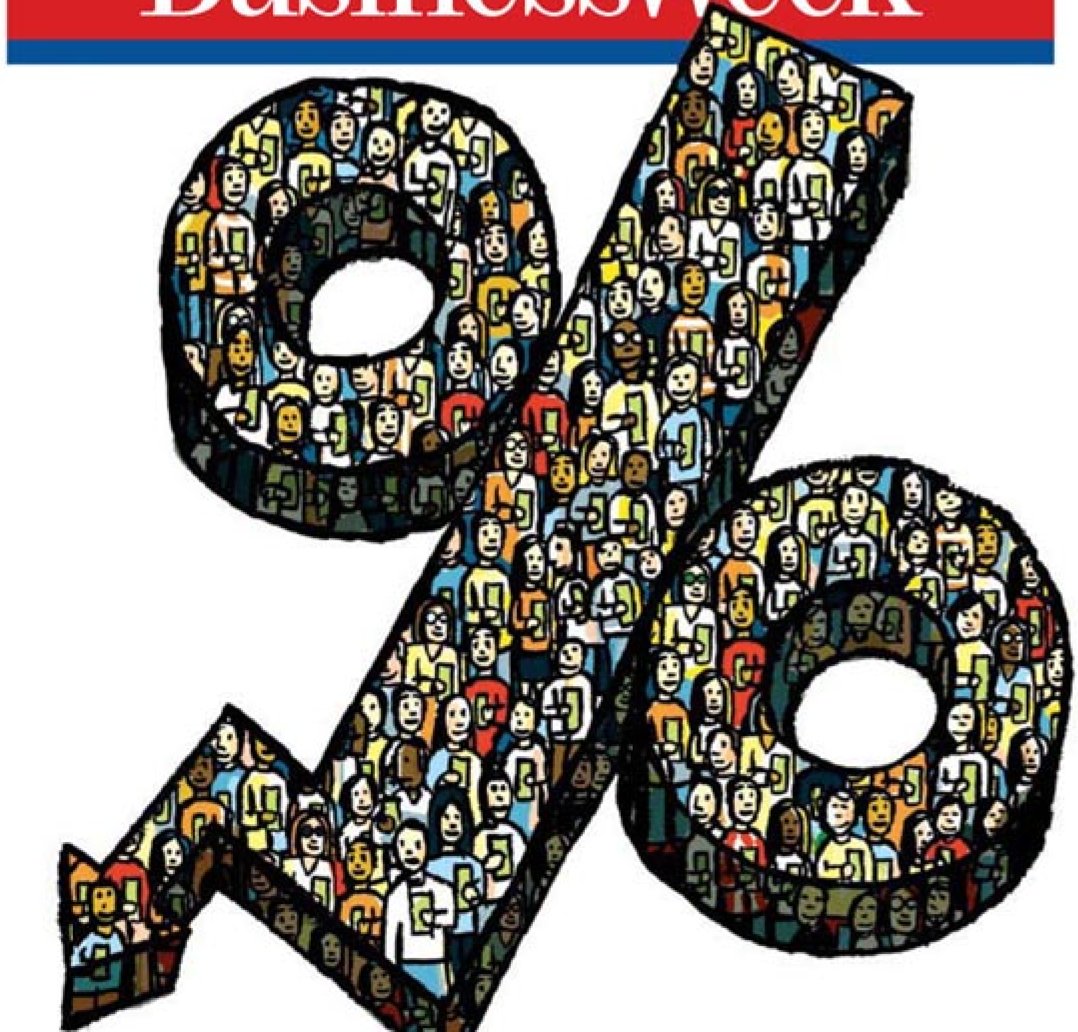

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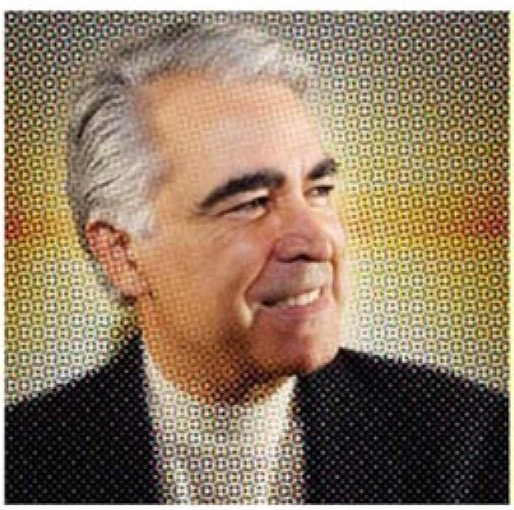

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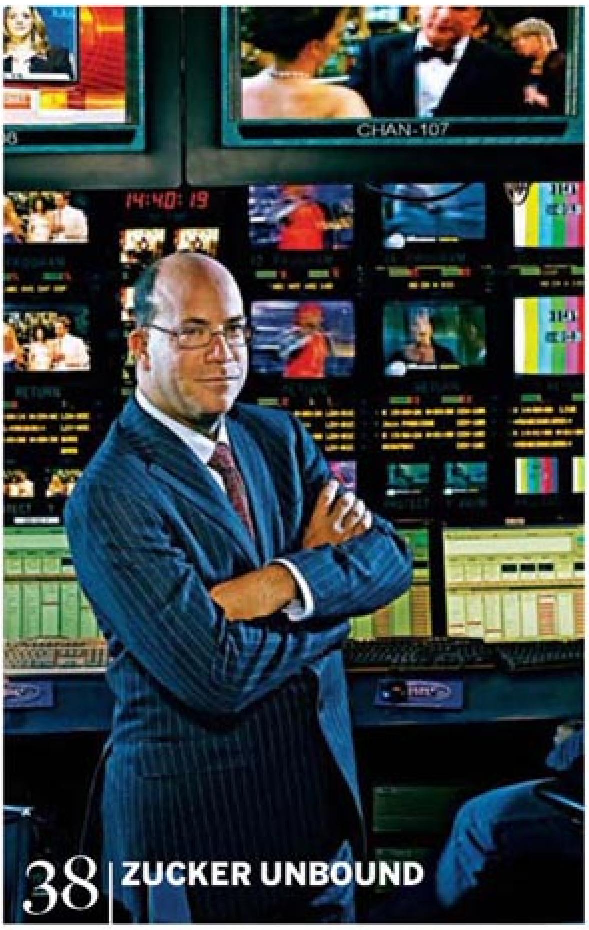

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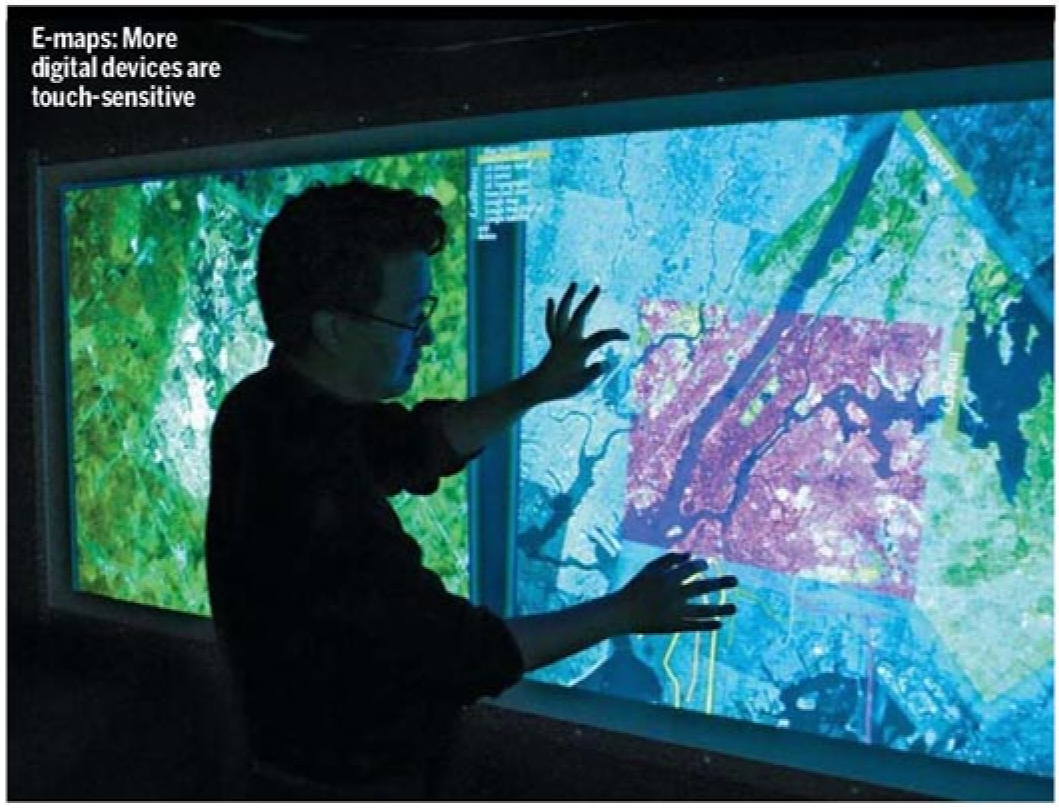

E-maps: More digital devices are touch-sensitive

Getting in Touch with Tech

Apple CEO Steve Jobs set the tone for the year in tech with the iPhone, a phone and music player with a screen that lets users call up features by touch rather than with buttons. It puts Apple at the forefront of a movement toward **touch-sensitive devices** that could reshape consumer electronics—one of several trends we spotlight in a **BusinesssWeek.com Special Report: Eight Top Tech Trends in 2007**. A lot of what's noteworthy will be happening on the Web. Microsoft and other tech titans may realize visions for delivering entertainment via so-called Internet TV. And this could be a breakout year for small business to become big Web advertisers now that companies like Google and eBay have unveiled a host of new services. Back in the physical world, Western companies such as Qualcomm and Intel will step up efforts to woo customers in developing countries. For a look at **the changing face of technology**, see our slide show featuring the big crop of up-and-comers that could be grabbing headlines next year. Go to **www.businessweek.com/go/07/techtrends** for all this and more.

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UPFront

"Piracy helped the young generation discover computers."

–Romanian President Traian Basescu to Microsoft Co-Founder Bill Gates on the role his company's pirated software played in helping Romania build a vibrant technology industry, as reported by Reuters.

EDITED BY DEBORAH STEAD

BRANDS

Ford Goes Back to The Future

FORD'S decision to rechristen what even one if its top executives called "the much-derided Ford Five Hundred sedan" as a Ford Taurus may sound like marketing spin. But it's actually part of new CEO Alan Mulally's program to change the carmaker's wasteful ways.

Ford stopped Taurus production in October after a decade of declining sales and a year of relegating the model to rental and corporate fleets. In the last two years it offered two new sedans, the Five Hundred and the Fusion. But they have 30% public name recognition, vs. 90% for the Taurus. Ford spent more than $1 billion advertising the Taurus. Canceling it "wasted 20 years of investment in a brand name," Mulally told *BusinessWeek* in December, when he was considering resurrecting the Taurus (fresh from a business trip for which he'd rented one).

When it debuted in 1985, the car had a breakthrough design, with softened corners that departed sharply from most sedans' "flying brick" look. A freshening in 1992 rescued slipping sales and kept the model on *Car and Driver*'s 10 Best Cars list. But a 1995 makeover inspired by Ford's oval logo flopped. Round edges gave way to a blobby, egg-shaped car dubbed the "bloated seal" by *Motor Trend*. **Toyota** Camrys outsold Tauruses.

Style may be an issue again. Ford has added a new grille and a peppier 3.5 liter engine to the 2008 Five Hundred-slash-Taurus. But the Five Hundred has been dinged for its bulbous shape—a design meant to give baby boomers with widening waistlines and waning flexibility more room. Last year, **Volkswagen** renamed its flagging Golf hatchback the Rabbit, the name the car had in the 1970s, and sales jumped 89%. Ford will be happy if its revitalized bull runs half as fast. *–David Kiley*

CELL PHONES

GO-GO DAYS FOR WINDOWS ON THE GO

AFTER YEARS of struggling in the mobile market, **Microsoft** may finally be making the right connections. In 2006, according to research firm **IDC**, mobile carriers worldwide sold more Windows Mobile-equipped cell phones than BlackBerry devices. A handful of slick designs created for the Windows Mobile, including **Motorola's** slim Q and the rounder Dash made by Taiwan's **HTC**, have helped the software giant. And *BusinessWeek* has learned that **LG Electronics**, the world's fourth-largest mobile-phone maker, is developing new Windows Mobile phones slated for launch this year. That means Microsoft will have three of the top five handset makers in its camp.

IDC's estimates of 2006 global market share for mobile phones with e-mail and Web access puts Microsoft's share at 9.8%. BlackBerry devices pioneered by **Research in Motion** came in at 7.3%.

RIM Chairman and co-CEO Jim Balsillie disputes those figures, asserting that proprietary data show that BlackBerry's worldwide share still tops phones running Windows Mobile. (He declined to provide numbers.)

Granted, BlackBerry held the U.S. lead in 2006's first nine months, with a 49% share, vs. Windows Mobile's 29%. And worldwide, both trail **Nokia**-backed **Symbian**, which is huge in Europe and Japan. But with LG on board, Windows Mobile's days as an also-ran may be over. *–Jay Greene*

(TOP TP BOTTOM) DAVID RUDES/BW; RAY VELLA/BW

ORDER UP

YOU WON'T WANT FRIES WITH THAT

Americans are being drawn to Japanese fast food for much the same reason they like Japanese cars: The deals are good, and the products seem better than what some American rivals dish up.

Sales at Japanese and other Asian-fare chains jumped 15% to 20% in 2006, compared with 6% growth for quick-serve chains overall. "There's absolutely potential for more growth," says Darren Tristano, executive VP of Technomic, a Chicago restaurant consultancy.

Yoshinoya, a Tokyo-based fast-food company with more than 80 California outlets, plans to double that number by 2010. Hibachi-San Japanese Grill, a fast-food unit of Panda Restaurant Group in Rosemead, Calif., plans to add a half-dozen sites this year to its 27 restaurants in 13 states.

Japanese food is seen as a low-fat fast-food choice, industry experts say. And younger consumers, who eat ramen (and Asian salads at McDonald's), find the food appealing. Not to mention cheap: At Yoshinoya, a bowl of grilled beef or chicken with steamed rice costs $3.07.

–Michael Arndt

SPORTS BIZ

LE FOOTBALL GETS SOME NEW PLAYERS

INVESTORS are finally invading the soccer fields of France. The country's top-ranked **Olympique Lyonnais** team will be listed on the Paris bourse this month—the country's first club to go public. While teams elsewhere on the Continent and in Britain have floated shares, France had long prohibited such listings, saying smaller clubs would be at a disadvantage in attracting investors. But European Union regulators recently ordered an end to the ban, calling it a "barrier to the free movement of capital."

Olympique Lyonnais, the national champion for the past five seasons, hopes to raise $130 million to help finance a new stadium and to develop merchandising.

Investors may be feeling cautious, though. **The Dow Jones** STOXX football index of 27 European clubs is down 3% since 2002. Recently, after shares of Germany's **Borussia Dortmund** team tumbled 76%, a hedge fund bought a major stake in the club and is trying to turn it around.

Deep-pocketed new owners may be the best hope for troubled clubs. Even as Olympique Lyonnais prepares its IPO, nearby Olympique de Marseille is being sold to Jack Kachkar, a Canadian pharma tycoon, for $148 million.

–Carol Matlack

GOAL The team hopes to raise $130 million in its IPO

MERC WATCH

WINDY CITY, FAIR-WEATHER TRADERS

IN A STUDY entitled *Gone with the Wind*, three finance professors from **Texas Christian University** and Bangkok's **Chulalongkorn University** found that windy conditions have a measurable effect on **Chicago Mercantile Exchange** futures traders. The study looked at 354 S&P 500 index futures traders judged to be "highly active." It examined the traders' transaction records from 1997 through 2001, matching them with **National Oceanic & Atmospheric Administration** weather data for Chicago.

Gusty mornings tended to correlate with a poor day of trading, the study found. On calm days, income from trades was higher. Researcher Peter Locke, associate finance professor at TCU's Neeley School of Business, says he's not sure why. But he notes that elsewhere in scientific literature, strong wind is linked to fatigue, headaches, and irritability. Thus some traders who step out for lunch or a smoke, he theorizes, may "lose their concentration" in blustery weather. (He says the study controlled for variables like market return, daily trading volume, and time of year.) The research is just the latest in a string of studies looking at the weather's effect on markets, with earlier papers probing the influence of sunshine, the lunar cycle, and geomagnetic storms.

–Elizabeth Woyke

(CLOCKWISE FROM TOP RIGHT) STEPHANE GUIOCHON/LE PROGRES/PHOTOPQR/MAXPPP; KEN TANNENBAUM/SUPERSTOCK

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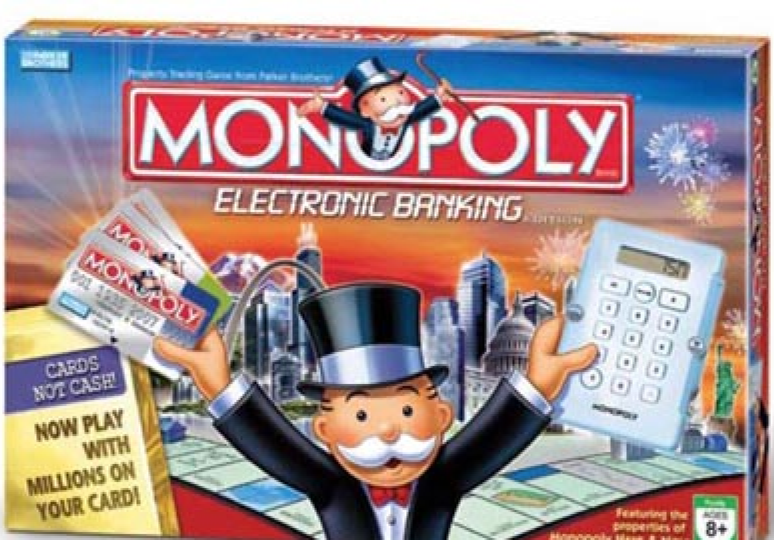

BRANCHING OUT

BRANSON BANKS ON STEM CELLS

SIR RICHARD Branson's **Virgin Group** encompasses planes, trains, spaceships, and comic books. And now, stem cell storage. On Feb. 1 the British entrepreneur launched **Virgin Health Bank,** a venture with London investment firm Merlin Biosciences. The bank preserves stem cells from umbilical cord blood, and Branson says Virgin's 50% profit share will support cord-blood stem cell research. "I'm absolutely passionate about the possibilities of stem cells," he says. "I'd like to make sure the future benefits are open to everyone."

Free of the controversy surrounding stem cells drawn from discarded embryos, cord blood stem cells have been used for years to treat some 75 blood and immune system disorders.

With a shortage of publicly available cord stem cells, Virgin Health points out that it goes beyond private service. It charges about $3,000 for 20-year storage but splits each sample, with 20% kept for the family and 80% deposited for use by anyone worldwide at no charge. Besides goodwill, the bank may give Virgin added credibility as it moves into other high-tech areas such as biofuels.

–Kerry Capell

GAME PLAN

PASS GO. COLLECT $200. HURRY

IT HAS FEATURED different cities, pro teams, and pets along with solid gold pieces and chocolate houses. But one version of Monopoly has been missing all these years: the kind you can play in 20 minutes. Now Hasbro is rolling out variations designed for the time pressed. Monopoly Express ($13) eliminates money and has players accumulate properties with a roll of the dice. Monopoly Electronic Banking ($35) speeds play by substituting an ATM-like card for cash. Phil Jackson, head of Hasbro's games unit, says research showed that people got bored with Monopoly's protracted endgame. Not everyone, of course. Says Stephanie Oppenheim, publisher of consumer guide *Oppenheim Toy Portfolio*: "Monopoly should take forever—until someone cheats or throws the board."

–Christopher Palmeri

BLOGSPOTTING

MISMANAGEMENT

www.hrheroblogs.com

» WHAT IF THE droll antics on NBC's *The Office* occurred in real life? Bumbling branch manager Michael Scott (Steve Carell) would constantly be in court, says Julie Elgar, an employment lawyer who mines the sitcom for legal issues. Elgar's blog, "That's What She Said," is part of an HR site run by M. Lee Smith Publishers, and it's devoted to imagining the lawsuits that would arise if a real company were run like the fictional Scranton (Pa.) office. Writing about a recent episode, Elgar merrily calculates the cost of an on-site bachelor party with stripper. "Litigation value: $800,000+."

–Lindsey Gerdes

(TOP LEFT) PHOTO ILLUSTRATION BY JOE CALVIELLO/BW; (BRANSON) LUKE MACGREGOR/REUTERS/CORBIS; (CARTOON) WALT HANDELSMAN/NEWSDAY/TRIBUNE MEDIA SERVICES

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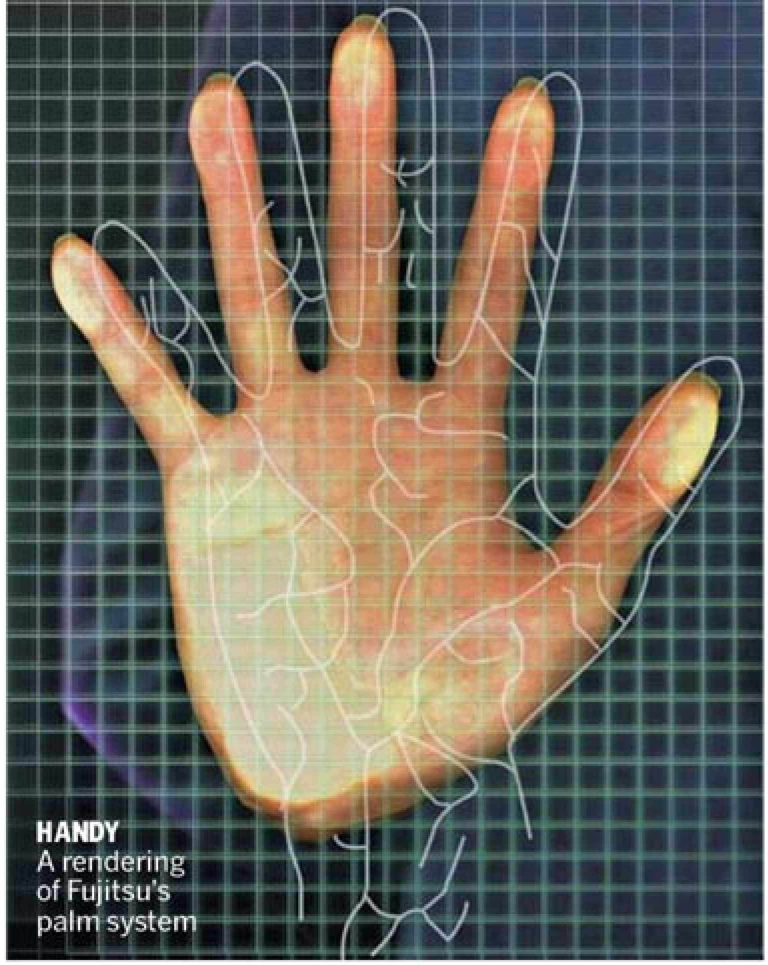


HANDY
A rendering of Fujitsu's palm system

JAPANESE BANKS

READING YOUR PALM FOR CASH

WHEN JAPANESE consumers need lots of cash in a hurry, they go to their banks and raise their right hands—their palms or their index fingers, more precisely.

ATMs at many banks in Japan now have scanners that take a snapshot of the veins in a customer's finger or palm, then compare that picture against a digital image stored on the account holder's bank card. The extra high-tech step allows customers to withdraw the equivalent of tens of thousands of dollars at a time from accounts.

Some 20,000 ATMs in Japan have scanners that read the veins in your hand

Over the past two years, dozens of financial houses have added the biometric security systems to their ATMs in response to legislation passed in 2006 that holds banks liable for ATM withdrawals made with stolen or counterfeit bank cards. Customers have a few complaints: The scanners can't get a reading in bright light, they say, or when one's forefinger is even slightly curled away from the screen. But for most, the extra cash overshadows the extra hassle.

By now, some 20,000 of Japan's 110,000 ATMs have vein scanners, with sales of the technology at $70 million, according to the Japan Automatic Identification Systems Assn., an industry trade group. Not bad for a business that practically didn't exist three years ago.

Will high-tech palm reading come to American banks? Some bankers and ATM makers have looked into the idea, but there are problems. The systems are expensive to install. And security consultants like Chris McGoey of Los Angeles-based McGoey Security Consulting worry that higher withdrawal limits would make ATM robberies more attractive. Perhaps more important, a format war is shaping up in Japan between two versions of the security technology—one that is likely to slow its adoption abroad.

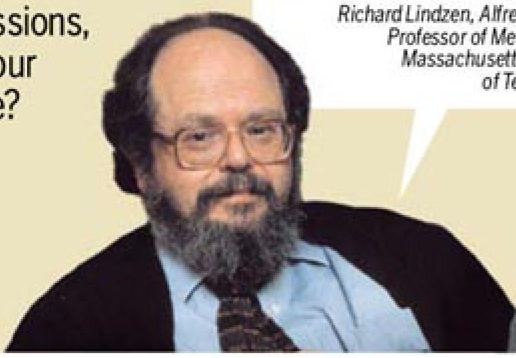
The two incompatible technologies are **Fujitsu's** (which scans palm veins) and **Hitachi's** (which reads finger veins). Because most bank cards still have a magnetic strip that works at any ATM for lower withdrawal limits, the format rivalry has had few casualties. But with banks considering phasing out the strips, that may change. "We're hoping the one we chose will become the standard," says Teisuke Kitayama, financial president of **Sumitomo Mitsui,** which uses Hitachi's system. So far, Hitachi appears to have the lead. Besides Sumitomo Mitsui, its customers include **Mizuho Financial Group** and Japan's soon-to-be-privatized postal system, which also runs a bank with 117 million customers. *–Kenji Hall*

QUESTION OF THE WEEK

A new U.N. report on global warming states with 90% certainty that human activity is the culprit. As a skeptic about policies to cut CO_2 emissions, what's your response?

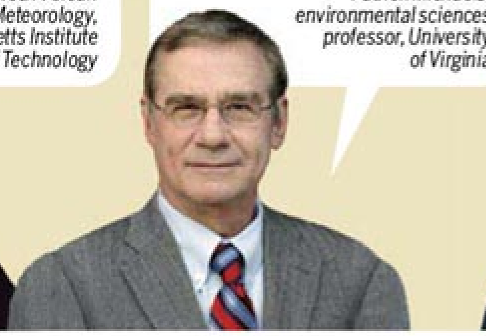
"The report had nothing to lead me to change my view that global warming cannot, at this stage, be distinguished from natural, unforced internal variability. These 'certainties' are bogus."

Richard Lindzen, Alfred P. Sloan Professor of Meteorology, Massachusetts Institute of Technology



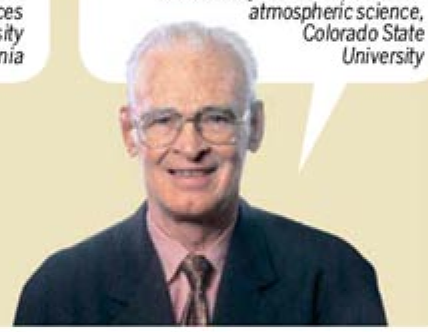
"Saying that humans have a significant role in the warming is like saying there's gambling in Las Vegas. What can you do about it? A lot of politically possible solutions will do less than nothing."

Patrick Michaels, environmental sciences professor, University of Virginia



"Yes, humans have caused the earth to be slightly warmer, but much less than the report says. Many natural forces are not accounted for. I'd make a big bet that in the next 5 to 10 years the globe will start to cool."

William Gray, emeritus professor, atmospheric science, Colorado State University



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ReadersReport

> "The goal of...publicly traded corporations is to grow in perpetuity. Where does that leave us on our finite planet?"
>
> *–Jeff Milchen*
> *Bozeman, Mont.*

ECO-CONSCIOUS COMPANIES: IRRELEVANT OR INEVITABLE?

"BEYOND THE GREEN corporation" (Cover Story, Jan. 29) presents a rather optimistic assessment of the business importance of corporate social responsibility. As the article notes, academic studies have not been able to prove a direct relationship between CSR and corporate financial performance, most likely because there is none.

Ethical investment funds continue to perform no better or worse than those based on other investment strategies. For virtually all companies almost all of the time, their CSR performance, whether leading or laggard, is irrelevant to their financial performance.

Numerous companies have "done good" but not well. This unfortunately long list includes Interface, Levi Strauss, Gap, Body Shop, Ben & Jerry's, Chiquita Brands, and now Home Depot. Until very recently it would also have included Marks & Spencer and Hewlett-Packard, two of the businesses featured in the story's list of those (now) "doing well by doing good" but that recently had experienced serious financial problems. The poor performance of these outfits was not due to their being too responsible, but neither was their leadership role in CSR sufficient to compensate for other management failures. The market has many virtues, but rewarding more responsible companies and punishing less responsible competitors is not among them.

–David Vogel
Haas School of Business
University of California at Berkeley
Berkeley, Calif.

THE BUSINESS MODELS of some corporations cited in your story are antithetical to sustainability.

Decreasing fat in fast-food burgers may aid the health of their customers, but spreading Wendy's and McDonald's incredibly resource-intensive diet of factory-farm-produced meat to people presently eating grain-based diets is irreparably damaging to our planet. And no improvements to fuel efficiency or "green building" by Target or Wal-Mart Stores can compensate for the inherently destructive model of shipping most goods across the globe.

The goal of these publicly traded corporations is to grow in perpetuity. Where does that leave us on our finite planet?

–Jeff Milchen
Bozeman, Mont.

AS A MANUFACTURER of organic maté tea, we're in the arena with other companies using good farming practices, pursuing pesticide-free agriculture, and raising hormone-free livestock.

Recently, however, we decided that organic certification didn't go far enough. We took greater control of our supply chain and changed the source of our main ingredient, yerba maté tea leaves, to a farm that is fourth-generation family-owned and Fair Trade, which means workers in Argentina are paid a living wage for their work harvesting our tea. While our commitment to sustainable Fair Trade farming is good public relations, we're now finding that our new supplier is more stable, more responsive, and more ethical in its dealings with us and our product. Switching was originally a point of great debate in our company. Now it's obvious that the benefits in terms of image and efficiency far outweigh the incremental cost per pound of the maté—and it is the right thing to do.

–Thomas Wollmann
Bombilla & Gourd Inc.
Englewood, N.J.

WHETHER THE CURRENT drive toward corporate sustainability is genuine or mere public relations, the fact remains that, in the long run, sustainability will not merely exist as an option: It will and must become an investor-driven as well as a physical necessity. The human modus operandi is inherently shortsighted, ever overemphasizing the immediate, but as countless indicators have recently demonstrated, issues of sustainability have become very much concerns of the here and now. It is only a matter of time before these concerns garner the scrutiny of the investing public.

The earth itself is an asset, and profiting at the expense of this resource without accounting for its depreciation is not a practice that can continue unchecked. The present scale and scope of industry has left an ominous environmental footprint, and only the most arrogant of companies could be reckless enough to believe investors will ignore consequences that now loom just over the horizon.

–Ari David Kopolovic
Cambridgeshire, England

YOUR ARTICLE CORRECTLY points out that companies need to wean their products from toxic materials lest such products get shut out by the tightened regulations of European markets. But Europe is just one driver of corporate safer-chemicals policies. Many states in the U.S. are also outlawing specific chemicals for use in products and are adopting environmentally preferable purchasing practices. Additionally, many private-sector companies are implementing such practices, shutting out dirty products and creating opportunities for innovative cleaner ones.

–Richard A. Liroff
Investor Environmental Health Network
Arlington, Va.

ADVERTISERS CAN'T AFFORD TO IGNORE AGING BOOMERS

"FAR FROM HALLMARK'S best moment" (Entertainment, Jan. 29) stated that the median age of the Hallmark Channel's audience is 60, "hardly the demographic advertisers crave." Given the country's more than 78 million baby boomers and their estimated $2 trillion in buying power, according to AARP, perhaps advertisers need to rethink their targets.

My cohorts buy pricey cosmetics, go hiking, and spend lots of money on our leisure pursuits. And those devices attached to our ears? They're iPods, not hearing aids. If the Hallmark Channel is "one of the most-watched offerings on cable," yet it brings in relatively few advertising dollars, then the remedy is to court advertisers who give boomers what we really want, not what someone

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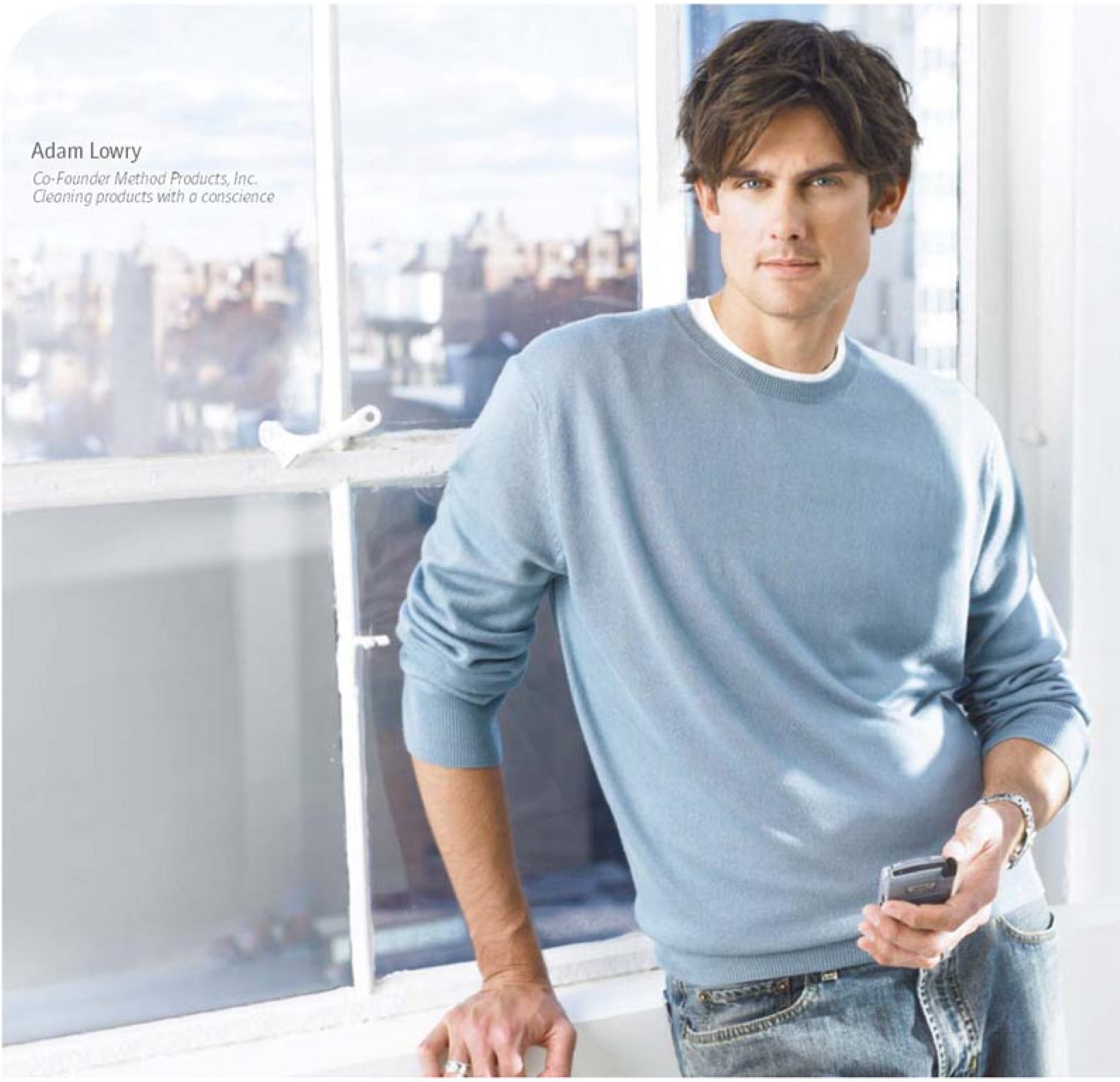
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Co-Founder Method Products, Inc.
Cleaning products with a conscience

thinks we want based on an outdated notion of what it means to grow older.

–Emily Lees
Chapel Hill, N.C.

HOW THE HEALTH-CARE SYSTEM HINDERS ENTREPRENEURSHIP

"HELD HOSTAGE BY health care" (Social Issues, Jan. 29) misses the larger point. It's not just workers, it's the economy that is held hostage by health care.

"Job lock" is the tip of the iceberg. "Growth lock" is on the horizon if we don't make affordable health care available to every American—and not just the poor or children. I'm referring to aging boomers who decide to leave corporate life to start a business, as I recently did.

Those in the 55-to-64-year-old demographic are most likely to start a company. But when we do, it becomes a game of double jeopardy. We risk our savings on the venture, and we risk being told we're ineligible for individual health insurance if we or our spouses become seriously ill.

President George W. Bush and others have proposed ways to make health care more affordable through tax breaks and other means. But tax incentives will not make health care more accessible. As long as managed-care companies can deny individuals coverage based on past or future medical conditions, those who could start ventures, build products, create jobs, and boost the economy will sit tight, locked into their dead-end jobs for fear of becoming uninsurable before Medicare kicks in.

–David C. Loveland
Wilmette, Ill.

CORRECTIONS & CLARIFICATIONS

The photo of Julie Roehm on page 74 of "My year at Wal-Mart" (People, Feb. 12) should have been credited to Santa Fabio.

"Beyond the green corporation" (Special Report, Jan. 29) said Shahreza Yusof of Aberdeen Asset Management PLC rated PetroChina Co. "a buy." Aberdeen, an international investment management group, does not issue stock ratings and does not hold PetroChina in its socially responsible investing portfolios. *BusinessWeek* did not interview Yusof, but misinterpreted comments by him posted on MarketWatch.

"Hello, you must be going" (News & Insights, Feb 12) should have said Joseph V. Tripodi found himself unhappy almost immediately after taking a new marketing job at Bank of New York, not Bank of America Corp.

Tech&You

BY STEPHEN H. WILDSTROM

Mischief-Proofing Your PC

In promoting Windows Vista, Microsoft says its new operating system will help you have "a PC protected from viruses, worms, [and] spyware." Alas, this statement is only partly true. Despite security improvements, Vista users, like those with Windows XP, need to run additional software to keep their PCs healthy and safe. ¶ All operating systems—yes, even

Apple's Mac OS X—have vulnerabilities. Moreover, the nature of the threat keeps changing. Instead of coming from maladjusted kids trying to make a point, security experts believe that most attacks these days are financially motivated efforts to steal data or take control of machines. And the old classification of threats as spyware, viruses, or worms has lost meaning as computer attacks have become multifaceted.

One consequence is that it no longer makes much sense to think in terms of a firewall to stop network intrusions, antispyware software to stop installations of nefarious software, and virus protection to block worms and viruses. Today's blended threats call for a more comprehensive approach.

Vista comes with only some of the necessary tools. The major addition in Vista is Windows Defender, an antispyware program with no antivirus features. And contrary to what I wrote in a Jan. 22 column based on information Microsoft provided, the Vista firewall is not configured to stop so-called Trojan horses—unauthorized programs that transmit information from your PC. In fact, it's almost impossible for average users to set up the firewall to do that.

I THINK YOUR BEST BET, whether you're using Windows Vista or XP, is an integrated package that combines spyware and virus protection with a firewall that watches both inbound and outbound network traffic. (Macs come with a decent firewall and have not been targeted by spyware, so users can get by with just an antivirus product.) Security software companies such as firewall maker Zone Labs and spyware specialist Webroot Software are scrambling to assemble integrated suites, but so far their efforts have felt either stapled together or incomplete. The latest version of Webroot's Spy Sweeper, for example, adds virus protection but lacks a firewall. The bigger players—Symantec, McAfee, and a newcomer to this field, Microsoft—offer users a much better experience. I tried Symantec's Norton Internet Security 2007 ($70), McAfee Internet Security Suite 2007 ($50), and Microsoft OneCare ($50). All run on Vista or XP, include a year of updates, and can be used on up to three computers.

In my tests, Norton emerged as the winner. It was the best at doing its job unobtrusively. It was the only one that didn't pop up to ask obvious questions, such as whether a Web browser should be allowed to access the Internet. Nor did it brag, like a cat dragging in a dead bird, about the threats it had stopped. It has also corrected a problem in earlier versions of the Norton firewall, which blocked a lot of safe uses. McAfee also did a fine job, but it made a lot more noise in the process.

Vista comes with only some of the protection you'll need

OneCare goes further than either of the others, adding data backup and performance tune-ups. (Norton 360, currently in a testing phase, will add similar features, as will the $70 McAfee Total Protection.) I found OneCare's performance and ease of use about equal to McAfee's, but I'm a bit nervous buying protection from the company that created the problems.

Test labs rate these programs based mainly on how quickly they respond to new threats. I'm not convinced this is important, since at any given time the newest threats account for only a tiny fraction of attacks. The important thing is to install the software, maintain the annual subscription, and make sure the program updates itself automatically. ■

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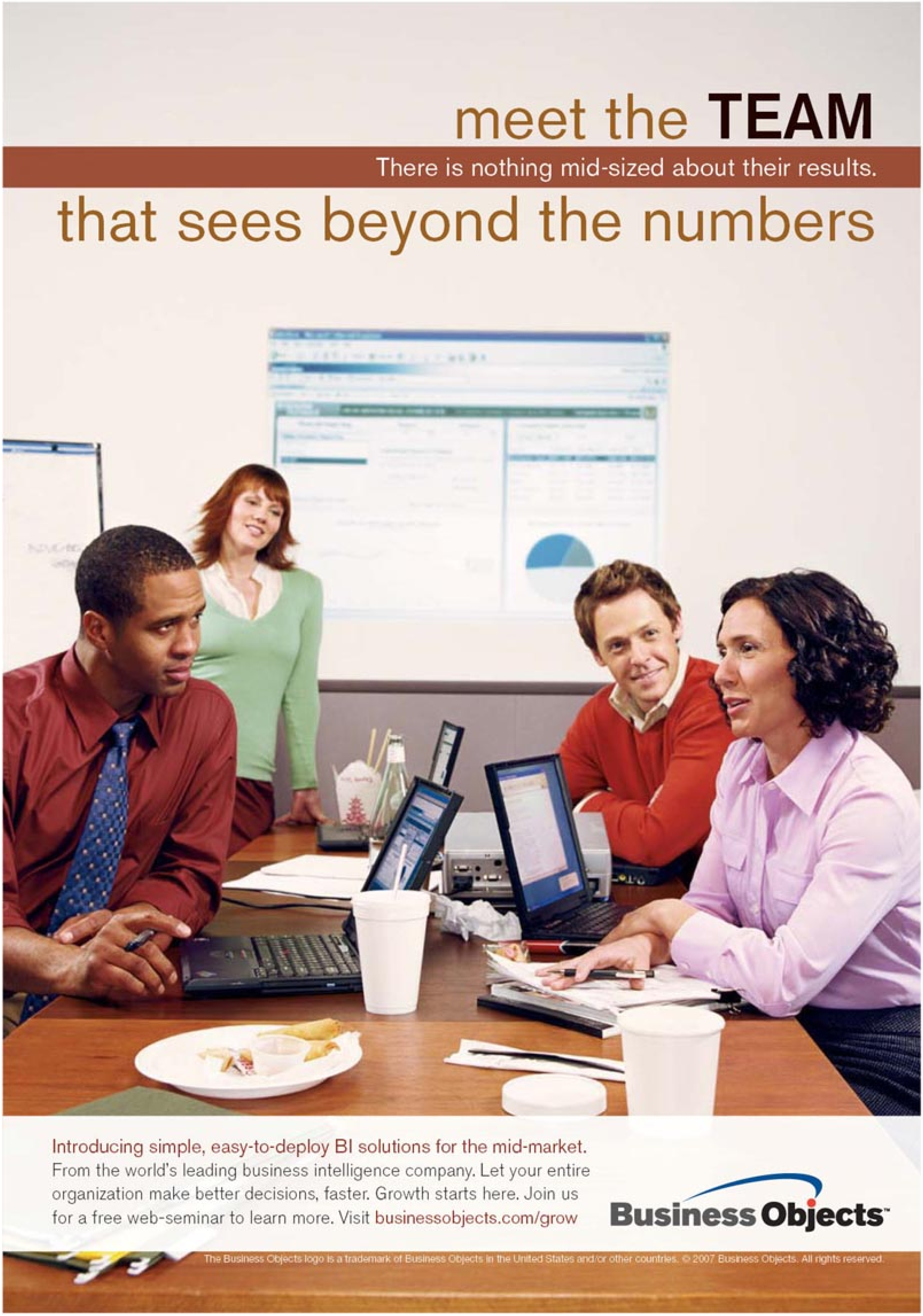
(FROM TOP) ETHAN HILL; MICHAEL WITTE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MediaCentric

BY JON FINE

What Makes 'Citizen Ads' Work

This column requires ground rules in order to avoid hurting your eyeballs. Therefore, instead of the excruciating "consumer-generated advertising" and "consumer-generated marketing," I will use "citizen advertising" and "citizen marketing." In varying ways, all manner of companies solicit or encourage such efforts on the Web. As evidenced by two highly publicized Doritos ads that ran during the Super Bowl, these efforts sometimes cross media platforms to show up on TV screens.

The arguments for citizen ads encompass every current marketing cliché. A company invites consumers to submit ads to its Web site, which means said consumers spend much time thinking about the product (marketing cliché alert: engagement, interacting with the brand). These ads are shown online to let the public chatter and vote on which is best (cliché alert: community). That the ads come from the vox-pop ensures they are (cliché alert) authentic. With luck, what consumers submit is good enough to stand out from the omnipresent ambient marketing noise (cliché alert: breaking through the clutter). And good enough so people come back to the site for more. Also, lest we forget: Letting consumers do the work is cheap. While citizens' efforts are nascent, making it impossible to know how effective they are long-term, early blog buzz on Doritos' Super Bowl ads is easily as positive as what some traditional ads elicited.

PRODUCT PASSION is the reason Doritos' Super Bowl ads clicked

Not every company has wild-eyed devotees. So thus far, citizen ads mostly push products that people adore—Chevy asked fans to submit ideas for its Super Bowl spot—or those that target young men, like Doritos. The people who create them have already joined the fan club and bought the T-shirt (or they're so rabid they make their own). There's a reason why the National Football League asked fans to submit Super Bowl ad ideas. Football freaks get very geeked-out about their sport, as do those who post homemade Apple ads to YouTube.

AND THERE'S A REASON WHY CLOROX HASN'T asked for ideas. Many big advertisers sell commodities—soap powder, paper goods—that lack logos people tattoo on their torsos or paint on their faces. Many big budgets push products with very specific demands. For example, yogurt maker Dannon's marketing strategy dictates that ads must help maintain consistent demand for a perishable product. Yogurt is "live and active," says Chief Marketing Officer Andreas Ostermayr. "We cannot keep huge stocks of it." He fears that citizen ads will elicit a "less predictable" response from consumers.

Wary, too, are some top ad executives. "We are pros, and although it looks easy to create advertising, it isn't," writes Wayne Best, executive creative director of New York boutique agency TAXI, in an e-mail. "User-generated content reminds me that there's a reason I have a job." But I have little patience for arguments equating "pro" with "better." History is full of examples where "pro" turns out to be an artificial construct. (The music and film indie revolutions of the '80s taught us there was more and better talent than the major labels and studios would have had us believe.) Without all the hype, I doubt viewers would have known Doritos' ads were not made by an agency.

Many companies that hire ad firms get this. ("Agencies beware," exulted a Sony executive in *Advertising Age*, in discussing one citizen ad contest.) What they don't get is that not every product engenders fanaticism: I spent much time on the phone last week arguing with marketers about whether or not consumers get excited about soap. I should be sporting and point out that in places where citizen ads may not work, citizen marketing may well. In 2001, Johnson & Johnson bought babycenter.com, a wildly popular community site for new parents. J&J opted, in other words, not to build a site about baby powder. Detergent buyers might not make ads for fun like Apple freaks do. Hanging out at a marketer's getitclean.com site? Well, that's a whole other story. ■

BusinessWeek .com

For Jon Fine's blog on media and advertising, go to **www.businessweek.com/innovate/FineOnMedia**.

(TOP) PHOTOGRAPH BY ETHAN HILL

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BY JAMES C. COOPER

Business is Still In An Expansive Mood

Capital spending, a powerful growth engine, looks set to rebound

U.S. ECONOMY American businesses got a bad case of the jitters last year. You can't blame them: Oil shot above $70 per barrel and seemed to be on its way to $80. Housing fell into a recession with much fretting over a broader downturn in the economy, and the Democrats took over Congress, creating a new uncertainty over the direction economic policy was headed. Business confidence buckled and, by yearend, worries about the future had translated into an outright decline in capital spending, the first quarterly drop in almost four years.

Lurking amid the positive surprises in the government's fourth-quarter report on economic growth, which showed real gross domestic product increasing at a strong 3.5% annual rate, was an unexpected 0.4% falloff in business investment in new machinery and facilities. Spending on equipment and software dropped 1.8%, while construction outlays grew only 2.8%, the slowest pace in five quarters.

All this sets up a crucial question for the 2007 outlook: Will businesses venture out of their foxholes? More specifically, can we count on outlays earmarked for replacement, expansion, and innovation to play their always important role as engines of growth?

Based on the underlying factors that typically drive capital spending, there is every reason to believe last year's slowdown was not the beginning of a lasting pullback that could crimp the economy's prospects. In fact, capital spending is likely to speed up again in coming months and be a growth leader for 2007.

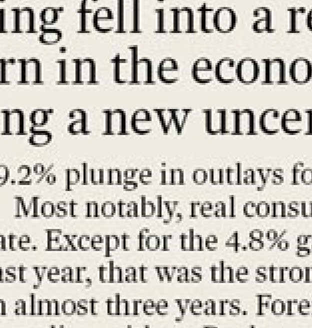
The list of supports already in place is long: The most important, demand, remains strong both at home and abroad. Capacity use is already at a high level. Profits are still making healthy gains. Corporate balance sheets are in great shape, and financial conditions remain accommodating. At the end of last year, CEO confidence ticked up a bit, and capital-goods orders rebounded, as did output of business equipment. Even oil prices, while pushed back up by winter's chill, are still down to where they were this time last year.

IF BUSINESSES WERE CONCERNED about the housing slump putting a damper on demand, last quarter's GDP report buried that notion once and for all. The importance of the GDP data for capital spending was not so much the economy's surprisingly strong overall growth rate but the speedup in total demand for goods and services, which grew at a 4.2% annual rate. That gain was especially impressive because it occurred amid a 19.2% plunge in outlays for residential construction.

Most notably, real consumer spending grew at a 4.4% rate. Except for the 4.8% gain in the first quarter of last year, that was the strongest quarter for consumers in almost three years. Foreigners weren't shy about spending, either: Real exports jumped 10%. Overall, outside of the housing slump, demand in 95% of all spending categories was up 4.4% from a year ago, the fastest annual advance in almost seven years (chart).

CONSUMERS REMAIN ROCK STEADY not just because of lower fuel prices. Yes, cheaper gas and heating oil helped to boost buying power, so fewer outlays for gas meant more income could go for other things. But spending on items other than energy and food also accelerated last quarter, in terms of both actual dollars spent and after adjusting for inflation.

WHERE DEMAND HAS PICKED UP



Data: Bureau of Economic Analysis, Global Insight Inc., *BusinessWeek*

The more important lift for household spending is coming from strong labor markets and income growth. Despite the slower pace of job growth in January, there are few signs that businesses are cutting back their payrolls. That's a positive sign for capital spending because the growth rates of hiring and business outlays are highly correlated.

Payrolls rose by 111,000 workers last month, less than in recent months, but given the Labor Dept.'s recent penchant for revising their initial estimates upward, the smaller-than-expected January gain should be taken with a grain of salt. Labor subsequently lifted the November and December job gains by a total of 81,000.

That's not the half of it. The Labor Dept.'s annual benchmark revisions added 754,000 new jobs from March, 2005, to March, 2006, and Labor raised its earlier numbers on payrolls from March, 2006, to December, 2006, by 179,000. The bottom line: Before these

CHARTS BY ERIC HOFFMANN/BW

revisions, payrolls were thought to have grown by 3.3 million jobs from March, 2005, to December, 2006; after a second look, job growth turned out to be 4.3 million. During 2006, incomes from wages and salaries rose 4.2% after adjusting for inflation, the strongest year since 2000. No wonder consumers have been so resilient.

MORE IMPORTANT for the corporate sector and its future spending, the economy is also generating plenty of profits. Last quarter's drop-off in capital spending is both inconsistent with the vigor in hiring and runs against the strength in earnings. Profits drive capital spending, and earnings are holding up much better than most analysts expected.

Through Feb. 2, with 308 of the 500 companies in the Standard & Poor's 500-stock index having reported for the fourth quarter, earnings are on track to grow 10.4% from a year ago, based on Thomson Financial's blended growth rate, which combines actual reports with the current expectations of those companies yet to report. So far, 64% of companies are beating estimates, which is above the 60% typical for a given quarter.

Perhaps more significant is that the double-digit profit showing has been greatly reduced by the yearend plunge in oil prices, which narrowed the earnings of energy companies. Excluding the energy sector, Thomson says profits in the remaining nine sectors of the S&P 500 are up 14.5% (chart). And there is no sign that overall profit margins face any kind of severe squeeze. Margins appear to be holding close to the record levels posted through the third quarter of 2006. Given the river of internally generated funds and readily available outside credit, corporate financing conditions are very supportive.

There were some signs at the end of last year that businesses were shedding their caution. In December, new orders for capital goods (outside of the big ups and downs in the aircraft sector) rose a solid 3.1% after two declines in a row; and production of business equipment posted a 1.6% gain, the strongest since last April.

PROFITS: STILL STRONG OUTSIDE OF ENERGY

*EST. WITH 308 COMPANIES REPORTING
Data: Thomson Financial

Plans for new business construction in 2007 also look solid, suggesting the yearend slowdown in new-facility outlays does not presage more softness. Prior to last quarter's slowdown, outlays for business construction had grown 14.1% per quarter during the previous year. For 2007, growth is expected to match the 2006 pace, according to the American Institute of Architects' panel of forecasters, with strength concentrated in offices, hotels, and health-care facilities.

Given a healthy economy, high rates of return on new projects, the excellent financial condition of the corporate sector, and the low cost of capital, businesses have every reason to take advantage of growth opportunities in 2007. So look for companies to move forward with their expansion plans at a faster rate as the year progresses.

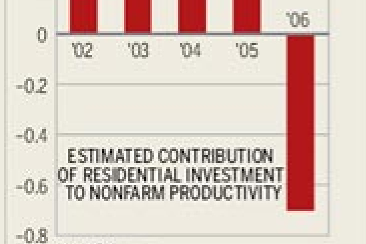
PRODUCTIVITY

The Housing Drag Casts a Long Shadow

DURING 2006, productivity growth was the weakest in nine years, while the labor cost required to produce a given unit of a good or service surged. But don't fret too much: The data on productivity and unit labor costs are being skewed by the housing downturn.

Investment in residential construction plunged in the fourth quarter, posting an annualized decline of 19.2%, the biggest quarterly contraction since 1991. What's more, the housing recession knocked a quarter-percentage point off economic growth in 2006, even though residential investment accounts for less than 5% of the economy. Meanwhile, residential construction and specialty contractor payrolls declined by just 1.4%, or 47,300 workers, in 2006.

PRODUCTIVITY GROWTH LEVELED BY HOUSING



Data: Citigroup

The resulting drop in output per worker in residential construction weighed heavily on the productivity data. The Bureau of Labor Statistics reported nonfarm labor productivity rose 2.1% in 2006; homebuilding pulled that growth rate down by about two-thirds of a percentage point, says Steven Wieting, an economist at Citigroup. And since homebuilders handed out few pink slips as construction activity fell, unit labor costs climbed. Rather than signaling surging wage pressures, though, higher unit costs reflect the same amount of labor building fewer houses.

All this is about to change. Residential construction payrolls don't begin to decline until after the number of housing completions start dropping, which began in the second half of 2006. "The layoffs are going to come," says Wieting, who estimates that job cuts in housing could top 500,000 during 2007. What's more, the declines in residential homebuilding are expected to dissipate. The combination means "productivity measures could rebound measurably over the course of 2007," says Wieting.

A return to stronger productivity and slower unit labor costs would help to reassure economists that the long-running productivity boom is still intact and ease any worries about future inflation.

–By James Mehring in New York

What do you call a year in which you sell 63 million Earth-friendly products? A healthy start.

The Home Depot® is committed to home improvement, including the home we call Earth. We started this initiative in 1990 and brought our vendor partners aboard. Together, we offer customers a wide range of eco-savvy options. Last year, sales of ENERGY STAR® qualified products increased by 25%. And the energy saved by the compact fluorescent lightbulbs we've sold could light the homes in Washington, D.C., for three and a half years. All of which lets us know that we're on the right path. For our people. For our communities. For our planet.

THE HOME DEPOT

The Business Week

News you need to know

EDITED BY HARRY MAURER

Budget Battles Ahead **President George W. Bush** (above, with **Treasury Secretary Henry Paulson Jr.**) dropped his record $2.9 trillion fiscal year 2008 budget on Capitol Hill with a thud on Feb. 5. The plan proposes to steer more funds to defense contractors like **Northrop Grumman** and **General Dynamics** while cutting subsidies to farmers and higher-education lenders like **Sallie Mae.**

Like all Presidential budgets, this one is a political document no one expects to play out in its current form. It eliminates the deficit by 2012, in part by banking $499 billion in **Alternative Minimum Tax** revenue, which may or may not materialize. Congress has tinkered with the AMT, which was originally aimed at the wealthiest Americans but now hits the middle class and small businesses, with one-year patches that shield some taxpayers. The budget assumes that Congress won't extend the fixes past 2007, and that 26.5 million taxpayers will pay the AMT next year—up from 3.5 million last year.

ONLINE *See "A budget with rose-colored glasses," www.businessweek.com/go/tbw*

Blackstone Wins Paper beats rock. And cash trumps stock. Shareholders of **Equity Office Properties** approved on Feb. 7 an all-cash takeover by the **Blackstone Group** valued at $39 billion including debt: the biggest private-equity purchase ever. The deal for the nation's No. 1 office landlord was cinched after **Vornado Realty Trust** gave up on its $56-a-share cash-and-stock bid. Although Vornado's offer was higher than Blackstone's $55.50-a-share proposal, Equity Office preferred the sure thing of cash on the barrelhead.

Can Kodak Print Money? Longtime **Hewlett-Packard** executive **Antonio Perez** lost out in the CEO sweepstakes to **Carly Fiorina** in 1999. Now, as boss of **Eastman Kodak,** he's trying to create a facsimile of HP's profitable printing and imaging group. On Feb. 6 he plunged Kodak into the consumer inkjet printing business with a new wrinkle that could shake up the $50 billion industry: Replacement ink cartridges that retail at half the price consumers typically pay. Revenge? Perez says it's just good business.

See "Kodak's moment of truth?" page 42, ONLINE *"Kodak launches a printer offensive," www.businessweek.com/go/tbw*

Sleuthing on the Street Are some Wall Street firms giving hedge fund customers a leg up? *The New York Times* reported on Feb. 6 that the **SEC** wants to know whether brokers are improperly tipping off hedge funds about block trades by institutional investors. A hedge fund with advance word can make hay because big trades can move a stock's price. Regulators at the agency have asked 10 Wall Street houses to turn over trading information and other data, but the SEC says it's too soon to say whether the inquiry will lead to any action.

Home Depot Makes Peace **Frank Blake's** extreme makeover of **Home Depot** continues. In early February the new CEO ushered out a cadre of executives aligned with ousted boss **Bob Nardelli.** And, on Feb. 5, Blake defused a potential proxy battle with **Relational Investors,** an activist investment firm, by inviting Relational exec **David Batchelder** to join the Home Depot board. The question remains whether Blake will follow Relational's other suggestions, which include selling the $12 billion wholesale supply division.

NBC's New Boss The *wunderkind* has reached the top. To no one's surprise, **Jeff Zucker,** who became executive producer of the *Today* show at age 26, was named head of **NBC Universal** on Feb. 6.

See "Now Jeff Zucker must prove himself yet again," page 38

Unhand Those Videos! **MTV** parent **Viacom** became the first media giant to order online sensation **YouTube** to take down its content, so on Feb. 2 the freebie site said it would yank more than 100,000 snippets of Viacom-owned TV fare. Sources say YouTube, acquired by **Google** last year for $1.65 billion, has been offering media companies $100 million a year for such rights. Viacom says it isn't close to a deal and until one is signed, it doesn't want YouTube profiting from Viacom-made programs.

ONLINE *See "Viacom's high-stakes duel with Google," www.businessweek.com/go/tbw*

Hyundai's Black Eye On Feb. 5, **Hyundai Motor Chairman Chung Mong Koo** was hit with a three-year prison sentence for illegally raising some $75 million for kickbacks, and for costing the company more than $200 million by transacting intragroup deals through affiliates. But even if he loses on appeal, he may not do any jail time because of South

MANDEL NGAN/AFP/GETTY IMAGES

Korea's leniency with convicted corporate bosses. His conviction and planned appeal are sure to further distract already bogged-down top managers: In the past year, Hyundai suffered a production loss of $2 billion because of labor strife, a 0.2% fall in revenues, and a 34% profit plunge because of Korea's strong currency.

ONLINE *See "Hyundai's true trial: Better performance," www.businessweek.com/go/tbw*

Wal-Mart Watch *En garde*, Steve: In a move aimed squarely at **Apple's iTunes** service, **Wal-Mart** launched a test version of a video-downloading service on Feb. 6, becoming the first major retailer to have the backing of all **Hollywood's** big studios; iTunes (see related story below) is backed by only two. Wal-Mart's smorgasbord offers more than 3,000 movie and TV titles. In other Wal-Mart news, on Feb. 6, a federal appeals panel in San Francisco ruled that a sex discrimination suit against the company that involves at least 1.5 million women could proceed as a class action. Wal-Mart says it'll appeal.

ONLINE *See "Wal-Mart enters the movie download wars," www.businessweek.com/go/tbw*

Auto Lows and Highs **Chrysler** has chopped 42,000 jobs since 2001, and it's not done yet. On Feb. 14 the carmaker is expected to announce cuts of 10,000 jobs and at least two plant closures to deal with its red ink and falling market share. Juggernaut **Toyota,** on the other hand, reported a record $3.54 billion profit in the quarter ended Dec. 31, and figures to earn $12.8 billion for the year ending in March.

ONLINE *See "Chrysler: After the cuts, what next?" and "Toyota's engine vrooms on," www.businessweek.com/go/tbw*

Long and Winding Road of the Week

There's a **Beatles** song for every occasion. Take 1965's *We Can Work It Out*: perfect for settling lawsuits, which is what the Fab Four's London company, **Apple Corps,** did with **Apple Inc.** of Cupertino, Calif. The Feb. 5 accord ends the third in a series of spats over the rights to the word "Apple" and related logos. Having agreed to share the rights in 1980, they ended up in a London court in 2003 after the launch of the **iTunes** store. Cupertino now controls the Apple name, while Apple Corps will have licensing rights. It's still unclear when Beatles music will bow on iTunes. One thing that could delay it: On Feb. 6, **Apple CEO Steve Jobs** published a 1,800-word essay arguing that record companies should stop requiring copyright protection technology attached to songs sold online.

APPLE CORPS CONTENT (VINYL)

SANG TAN/AP PHOTO

See "Steve Jobs changes his tune," page 64

ONLINE *"The Apples come together" and "Steve Jobs' music manifesto," www.businessweek.com/go/tbw*

CAPITAL

IT'S A LOW, LOW, LOW, LOW-RATE WORLD

Money is cheap. And some experts say it could stay that way for years. That's creating opportunity —and brand-new risks

BY MICHAEL MANDEL AND DAVID HENRY

WAIT A MINUTE—weren't long-term interest rates supposed to be a lot higher by now?

When the rate on the 10-year Treasury bond plunged from 6.5% in early 2000 to an average of 4% or so in 2003, the explanations were easy: tech bust, recession, weak capital spending, low inflation, steep rate cuts by central banks around the world. The low rates seemed perfectly normal—and sure to reverse on a dime when conditions changed.

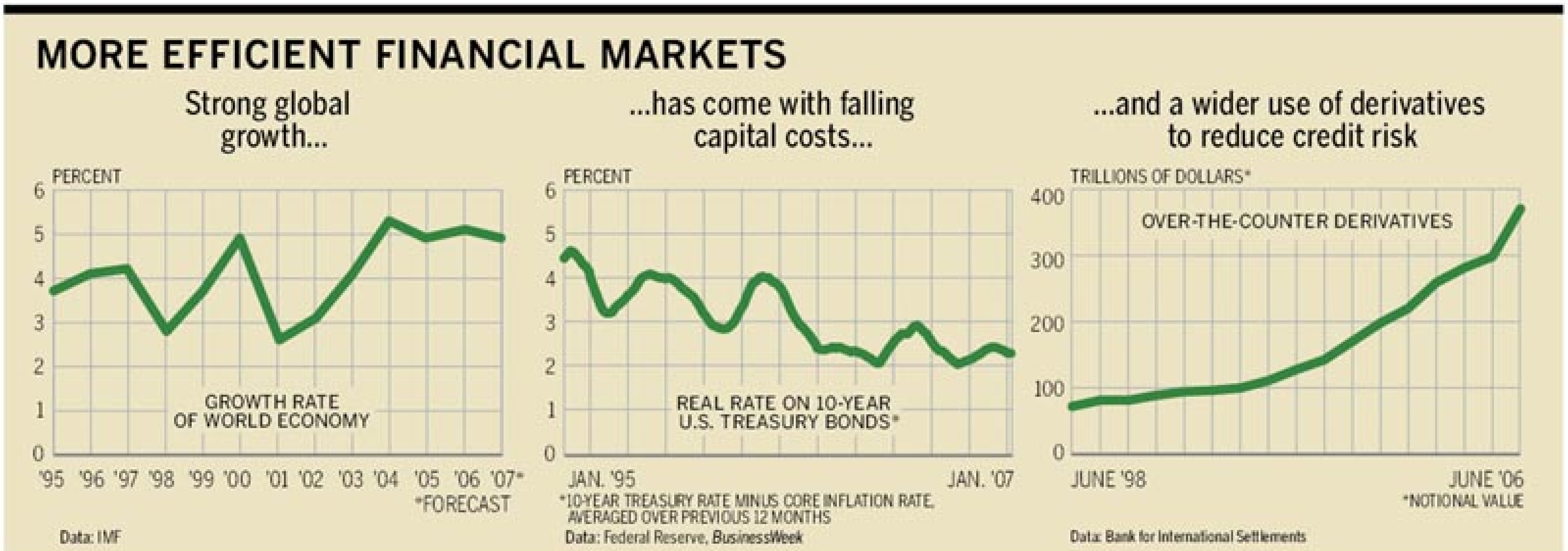
Since then, plenty has changed. The Fed has hiked short-term rates by more than four percentage points. The global economy grew by 5.1% in 2006, the second-strongest performance in 25 years. Europe and Japan have recovered. Even tech spending seems to be on the rise, judging from Cisco Systems Inc.'s strong earnings report on Feb. 6. And yet—and yet!—10-year Treasury rates have risen only three-quarters of a percentage point. Real rates, which adjust for inflation, have barely budged.

It isn't only a U.S. phenomenon. Ten-year euro bonds are yielding around 4% today, no higher than in 2003, despite much faster growth in the region. Real rates in the euro zone are up only a bit.

Borrowers, of course, are deliriously happy. Even the shakiest companies are seeing their debt costs plunge. The spreads on triple-C rated bonds and lower—the junkiest of junk—are at a record low 4.7 percentage points over ultrasafe Treasuries, compared with the previous record of 5.2 percentage points in 1997, according to Merrill Lynch & Co.

Most remarkably, the craziness isn't likely to stop anytime soon. The low

ROBERT NEUBECKER



cost of capital is probably going to last "five to seven years," says Samuel Zell, who as chairman of real estate firm Equity Office Properties Trust watched bidders wield cheap debt in a fight over his company. (Blackstone Group, with a $39 billion bid, won out on Feb. 7.) James W. Paulsen, chief investment strategist at Wells Capital Management, sees an even longer horizon: "This could be a prolonged cycle where the cost of capital is low [for] 10 or 20 years."

It is, indeed, a low, low, low-rate world. Easy money is creating all sorts of economic benefits. Corporations are making capital investments again—and with their borrowing costs so low, profits are still zooming. Private equity firms are using loads of cheap debt to buy companies at jaw-dropping prices. Even the housing market, which boomed for five years on cheap money, hasn't fallen apart. It's gliding to a soft landing rather than a hard crash, allowing consumers to keep spending (page 35). "We are in this era where financial innovation and product structuring, particularly in the debt markets, has been very stimulative," says Henry H. McVey, chief U.S. investment strategist at Morgan Stanley. Zell puts the state of rates in similar terms: "I think that's going to be a growth accelerant around the world."

'FUTURE TURBULENCE'

BUT THE EASY MONEY also brings a slew of unexpected problems. Historically, risky borrowers have had to pay much higher interest rates on their debt. Now there's little penalty—and that means there's less incentive for companies to stay fiscally sound. Low rates aside, other borrowing terms are getting easier, too. Many debt deals being made today have fewer protections for investors in case companies can't pay. "I've never seen issuers have this much power," says Raymond G. Kennedy, a bond fund manager at PIMCO with 26 years' experience under his belt. Kingman D. Penniman, founder of KDP Investment Advisors Inc., a bond research firm, sees a dark side to this: "You're laying the groundwork for future turbulence."

The shift to a low-rate world doesn't mean lower volatility. In fact, excesses, crack-ups, and bad investments are not only possible but guaranteed. "Over the next several years there's likely to be some event that will widen out the spreads," says Zane Brown, director of fixed income at mutual fund manager Lord, Abbett & Co. But when the dust has cleared, he says, the world economy will likely be left with a lower cost of capital than the average over the past 5 to 10 years.

The shift to a low-rate world doesn't mean lower volatility

In some ways, it's the 1990s all over again. Back then, the info-tech boom created an unexpected boost in productivity that persists today. Now it looks like something analogous has hit the global financial markets. A combination of globalization, innovation, and good old-fashioned competition among markets has made it easier and cheaper to raise and deploy money. Borrowers now can draw funds from around the globe. And derivatives let financial institutions and traders manage their risks with mind-blowing precision. With Chicago, London, New York, and Frankfurt all jostling to be the world market leader, exchanges and financial institutions have an incentive to be cheaper, faster, more innovative (page 36).

At the same time, the low rates reflect major imbalances in the global financial system. The developed countries, led by the U.S., have systems that are good both at raising money and allocating it. Emerging markets such as China have only half of that equation: They can collect the money, but they don't have the financial institutions that can put it to the best use. According to a November, 2006, survey of executives by McKinsey & Co., only 40% of respondents in China and Latin America said their company's access to external funding is good or very good.

Eventually the financial systems in China and India will improve, and a lot more of their capital will be used at home. That won't happen anytime soon, though. In a new book, *The Next Great Globalization*, Federal Reserve Governor Frederic S. Mishkin writes: "It takes a long time for any nation to achieve strong property rights and an effective financial system."

For now, China and the other emerging markets are serving as key suppliers of capital in increasingly connected markets. "People are more willing to throw their money across borders and across currencies to get the highest yields," says David A. Wyss, chief economist at Standard & Poor's. Indeed, in just the past year, the value of outstanding international debt securities—debt raised in foreign countries or foreign currencies—has risen by 20%.

It's a continuation of a long-running trend. Since 1990, cross-border capital flows have been rising at a 10.7% annual rate, adjusted for inflation and exchange rate fluctuations, says a January, 2007, report from the McKinsey Global Institute. That's up from just 4.3% from 1980 to 1990.

An essential part of the globalization story is the adoption of the euro in 1999, which created a huge pool of highly mobile capital from lots of smaller pools.

CHARTS BY ERIC HOFFMANN/BW

"The euro markets are today much bigger than what they would be if we had not had the euro," says Jerry del Missier, co-president of London-headquartered investment bank Barclays Capital.

The second key factor is the development of new trading instruments. Financial innovation isn't new, of course. Mortgage-backed securities date to the 1970s, and junk bonds came to life in the '80s. But innovation seems to have reached a fever pitch with the recent advances in collateralized debt obligations (CDOs), which keep borrowing costs low by dividing risks into big buckets and then reallocating them among hundreds of investors. With nearly half a trillion dollars' worth issued in 2006 alone, and with the risks widely dispersed, investors are willing to put more skin in the game. "Financial innovation in the form of CDOs has changed the risk premium associated with the bond market," says McVey.

MARKET FUEL

PUT THE TWO TOGETHER—bigger markets and innovation—and you have the makings of a global financial revolution. Adding more fuel, exchanges are becoming more entrepreneurial—which, as always, brings down costs. There's bustling competition from online exchanges as well. "When oil prices were very high and airlines needed to hedge the prices of jet fuel with options, they had no idea if investment banks were ripping them off, because there was no transparency in the price," says David Gershon, CEO of SuperDerivatives Inc., an online derivatives and options exchange. Gershon's outfit is among a handful of startups that allow investors to trade sophisticated instruments online. He argues that exchanges like his make markets more transparent and create more liquidity.

These changes have helped reduce the real cost of capital, best measured by the interest rate on low-risk Treasury bonds. Economists don't expect much of a change over the medium term. The Congressional Budget Office projects 10-year rates will average just 5.0% over the next three years, compared with 4.8% today.

Even more important is the decrease in the risk premium on corporate borrowing. Investment-grade bonds, issued by the healthiest companies, might enjoy a quarter-point decline in their spread over the low-risk Treasury rate long term. For junk bonds, says Wyss, "we could get a bigger permanent impact on keeping those spreads lower, maybe 100 basis points"—one full percentage point.

The increased efficiency has been ben-

ILLUSTRATION BY OTTO STEININGER

Why Housing Hasn't Hit the Skids

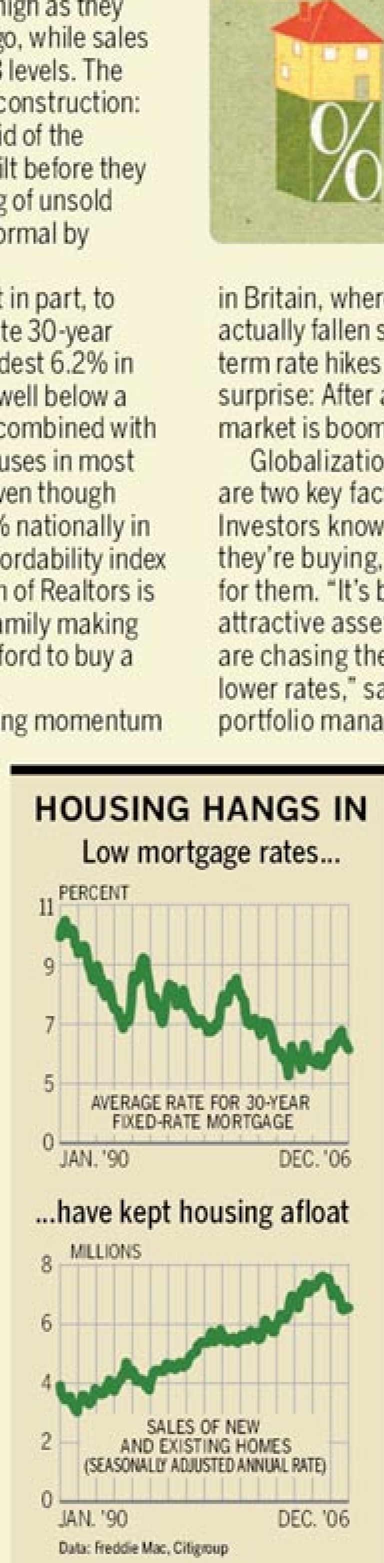
BY PETER COY

So this is the much-feared "housing bust"? Bust Lite is more like it. Existing-home prices are as high as they were a year ago, while sales have receded only to 2003 levels. The only extreme decline is in construction: Builders are trying to get rid of the houses they've already built before they put up more. The overhang of unsold homes could be back to normal by around midyear.

The credit goes, at least in part, to low interest rates. Fixed-rate 30-year mortgages averaged a modest 6.2% in the last quarter of 2006—well below a decade ago (chart). That, combined with income growth, means houses in most areas remain affordable even though prices rose more than 50% nationally in the past five years. The affordability index of the National Association of Realtors is still over 100, meaning a family making the median income can afford to buy a median-priced house.

The market began gaining momentum in 2001 when the Federal Reserve started lowering rates to end a recession. Corporations cut back on borrowing, but homebuyers exploited the low-cost money. Says Citigroup economist Steven Wieting: "The housing sector acted as a bottom feeder, taking advantage of cheap capital flows."

The surprise is that low rates are still keeping a floor under housing. Thirty-year mortgage rates are no higher than in June, 2004, even though the Fed has since pushed up the federal funds rate by 4.25 percentage points. It's the same in Britain, where long-term rates have actually fallen since 2004 despite short-term rate hikes by the Bank of England. No surprise: After a brief lull, Britain's housing market is booming again.



Globalization and financial innovation are two key factors in keeping rates low. Investors know more about the loans they're buying, so they will pay more for them. "It's become a much more attractive asset class, hence more dollars are chasing the mortgage market, hence lower rates," says Bryan Whalen, a portfolio manager at Los Angeles-based Metropolitan West Asset Management. As recently as three years ago, he says, investors in mortgage-backed securities received two-page summaries of the portfolio. Now they get data on each loan.

Credit default swaps, which let people bet for or against a bond or loan's creditworthiness, have also improved transparency. If investors bet heavily against an issuer's securities, its lending costs are driven up. "This pushes out the marginal lenders," says Whalen. That creates a healthier market—and ultimately, lower rates.

eficial so far. Companies gain from a lower cost of capital in the form of lower interest payments and higher profits. If rates had not stayed so low, corporate earnings would be about 10% lower than they are today.

Naturally, lower capital costs have made it easier to borrow. Duke Energy Corp., a $16.3 billion electric and gas utility based in Charlotte, N.C., plans to boost capital spending by $1 billion a year over the next three years to build new power plants to keep up with the growing demand. Duke may borrow the money instead of drawing down its cash, says David L. Hauser, chief financial officer, since "interest rates have remained surprisingly low." Robert M. La Forgia, chief financial officer of Hilton Hotels Corp., says low rates were critical to his company's ability to purchase its international hotel operations last February, uniting Hilton brands that had been apart for over 40 years. The company put together a $5.5 billion bank line at just 1.5 percentage points above the rate London bankers charge one another. "It's part of what made this deal possible," he says.

But the downside of the long-term trend is short-term financial market excess. It's here, and it's real. "The economy is robust, [but] we've entered into this new phase where the markets are financing riskier transactions," says Mariarosa Verde, head of the Credit Market Research team at Fitch Ratings Inc. Excess is especially evident in the corporate credit markets, where covenants, which protect investors by requiring companies to maintain healthy financial ratios, are becoming less restrictive. Some companies are jamming investors in other ways. When Pittsburg (Tex.)-based Pilgrim's Pride Corp. raised money to buy another poultry processor in January, it issued bonds that allow it to use projections rather than actual results to meet certain financial tests for borrowing more money. Pilgrim CFO Richard A. Codgill notes that the projections have to be "reasonable." Hospital chain HCA Ltd.'s latest bonds include some with provisions that let the company use debt instead of cash to make interest payments to bondholders. It works essentially like an IOU that increases HCA's debt down the road. Says Kennedy of PIMCO: "The bottom line is that when there's too much money in the market, [investors] lower [their] standards." What's more, many are depending on instruments that are highly leveraged, numbingly complex, and untested by a market downturn.

Then again, derivatives might cushion the blow when the reckoning comes. When hedge fund Amaranth Advisors went under, says Brown of Lord Abbett,

The Triumph of the 'Pork-Belly Crapshooters'

BY JOSEPH WEBER

Years from now, this decade might come to be viewed as the golden age of high finance. New markets are sprouting up everywhere, drawing huge amounts of capital and helping hold down rates. And the action is no longer confined to New York. Chicago in particular has emerged as a financial hub in its own right—with plenty of other cities coming on strong.

At the center of the explosion of markets and capital is vigorous competition. Banks, exchanges, and cities are vying for lucrative new trading business by focusing on three selling points: price, speed of execution, and innovation. The result can only benefit borrowers, who end up with a lower cost of capital.

The rise of Chicago's financial exchanges—and their current plans to expand—is emblematic of the creativity and entrepreneurial zeal worldwide that have helped create today's low-rate environment.

In the 1970s, Leo Melamed was casting about for some way to increase the Chicago Mercantile Exchange's competitive edge against its crosstown rival, the Chicago Board of Trade. But the notion of looking beyond cattle, pigs, and other farmland products to currencies and financial instruments seemed crazy. "The world thought it was foolish," recalls the CME's former chairman and current *éminence grise*. "How could a bunch of pork-belly crapshooters be trusted with foreign exchange?"

Undaunted, Melamed went on to develop financial futures, arguably the most important new financial product since the rise of stock markets. Now futures on everything from Treasury securities to European weather allow corporate treasurers, investors, and traders to lay off risks. This allows capital to flow more freely, which is essential to keeping rates low. The growth has been staggering: Chicago's two big exchanges handled more than 2.1 billion contracts last year, or 9 million

PARTNERS Duffy and Donohue will face stiff competition

MATTHEW GILSON

contracts a day, up from 700,000 a day in 1986. And their innovations spurred the global market for over-the-counter derivatives, which has ballooned to around $300 trillion.

Like lots of revolutionary ideas, the notion behind financial futures is simple. For decades farmers would sell off parts of their crops months in advance to traders in the Chicago markets. The farmers got cash up front and didn't have to fret as much over bad weather or poor harvests. The traders got contracts they could then sell to others, making or losing money as harvest day neared and the crop looked more certain. By applying the same principle to currencies, first in 1972, the CME helped executives of multinational companies lay off the risk of fluctuating pounds or francs. Since then, the CBOT and CME have expanded to other types of derivatives and are still adding more. Soon traders will be able to wager on the price of commercial real estate and the likelihood that companies such as Tribune Co. will go bankrupt.

But the global competition is forcing the Chicago exchanges to look for bigger scale and more efficiency to offer investors and borrowers better deals. Not only do they do battle with energy-oriented futures bourses in the U.S. but they also face Eurex, a European market that now leads the world in derivatives trading. Soon, China will step up its participation in futures with a new bourse in Shanghai expected to open this year. The appeal of futures is even blurring the lines among exchanges, as the New York Stock Exchange, armed with a new derivatives unit that will come in with its Euronext acquisition, looks to expand.

All that competition is the reason the CME and the CBOT plan to merge by midyear in an $8 billion deal. The CME hosts stock index and currency futures, while the CBOT is home to Treasury contracts. CME Chairman Terrence A. Duffy and CEO Craig S. Donohue will hold the same positions at the combined CME Group. Together, the two exchanges will shoot past Eurex, with as many as 600 million more contracts traded yearly.

Chicago's innovations are driving growth in other markets

The exchanges are also hungrily eyeing expansions into the OTC market, a move that could provide investors and borrowers with more choices. Eurex soon plans to start trading a contract based on European credit default swaps, itself a multitrillion-dollar market. "The new Chicago entity is going to be under terrific competition as global alliances appear," says Michael Henry, a senior executive in the capital markets practice at consulting firm Accenture Ltd. For its part, the CME has teamed up with Reuters Group to push into the foreign exchange market and the OTC market for other derivatives known as interest-rate swaps.

Bold ideas in finance underlie all the growth. And thanks to expanding global competition, there's plenty of reason to believe it will continue. "If we weren't innovative throughout the years, we'd still be trading butter and eggs," says CME's Duffy. As long as there's money to be made and the ideas keep coming, the cost of capital will drop even further.

part of its losses were covered in the derivatives markets. "It barely caused a ripple." Adds del Missier: "We haven't done away with dislocations in markets, but markets are much more able to deal with dislocations, and their impact will be less."

Over the long term, the big issue is the development of better financial systems in China, India, and other emerging markets. Right now money is pouring into real estate rather than infrastructure, education, and other essential investments. As financial systems improve in these countries, they will likely make better use of their own money. When that happens, the cost of capital around the world will go up.

But that's a long way off. In the meantime, rates are likely to remain low. "Whatever shocks are ahead," says del Missier, "the markets are better positioned to deal with them than they've ever been."

–With Mara Der Hovanesian in New York, Christopher Palmeri in Los Angeles, and Stanley Reed in London

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MEDIA MOGULS

NOW JEFF ZUCKER MUST PROVE HIMSELF YET AGAIN

The rap on the wunderkind: He lacks the strategic vision to lead NBC Universal in a volatile digital world

BY DIANE BRADY

FOR TWO YEARS, IT WAS THE worst-kept secret in the media and entertainment world. Jeff Zucker, the boy wonder with the P.T. Barnum shtick, was General Electric Co.'s slam-dunk choice to replace Bob Wright as chief executive of NBC Universal Inc. Reading the tea leaves wasn't hard. GE CEO Jeffrey R. Immelt had barely bothered to interview outsiders for the job. Besides, so many top executives had left NBC Universal in recent months that few of Zucker's internal rivals were left standing.

Still, by Feb. 6, when GE finally got around to announcing what everyone already knew, skeptics had spent months wondering aloud if Zucker, 41, had the strategic vision and background to lead the $16 billion media company in a YouTube universe. Even Immelt acknowledges that complacency was partly to blame for NBC's slide from first to fourth place in prime-time ratings during Zucker's three years as head of the TV group. "It's actually hard to go from No. 1 to No. 4. When we were on top, we didn't take enough risks to get the next generation going," he says. "[We] stayed too true to what was *Friends*, what was formulaic."

Hence all the head-scratching among industry insiders, who continue to ask:

BRAD TRENT

AT THE CONTROLS
Zucker seems to focus on the big splash

Is Jeff Zucker the right guy to lead NBC Universal?

No one would deny that Zucker has had an extraordinary run. From the moment he took the reins of the *Today* show as executive producer at age 26, he impressed superiors with his energy, smarts, and willingness to take risks. While insiders credit former news chief Andy Lack with starting *Today*'s turnaround, Zucker created buzz with features like outdoor concerts and fought hard to bring in the biggest names of the day. "Zucker made the first 20 minutes of that show must-watch TV," says an industry executive. Former co-host Katie Couric credits him with making the show "smart, hip, innovative, edgy." Zucker liked being in the control room, making things happen. "The show really played to my interests," he says. "I'm interested in everything."

By most accounts, Zucker had a rougher time when he headed to Hollywood in late 2000. He went there largely to re-energize a demoralized team—and won kudos for getting that done. But his new role as president of NBC Entertainment also required him to choose shows for the prime-time schedule. While Zucker characterizes his years in Los Angeles as an unalloyed success, his tactics were not universally applauded. Zucker earned a reputation for rubbing the town's delicate egos raw, and he raised eyebrows by switching shows around, including *Scrubs*, which ran in several time slots.

STRETCHING *FRIENDS*

AS HE DID AT *Today*, Zucker instinctively went after the big splash. He made tactical moves that let NBC prolong its dominance. Keen to maintain the *Friends* advertising juggernaut, he extended each show by 10 minutes. In one stroke, he made it hard for people to tune in to rival networks. That was great for NBC; not so good for viewers. He also paid *Friends'* stars huge sums to stick around.

What he didn't do was dream up the next generation of programming. When it comes to picking hits, Zucker has had a decidedly mixed record. He championed *Father of the Pride*, an animated series about a family of lions, that made its debut in 2004. It bombed. What attracted him to the show, insiders say, was the pedigree of producer Jeffrey Katzenberg—another echo from his *Today* days, when getting the celebrity *du jour* was his stock in trade. A much-hyped *Friends* spin-off, *Joey*, was a disappointment, too. "People [tried] to criticize me for not finding the next *ER* or *CSI*," says Zucker. "We [hit] a bunch of doubles."

Maybe so, but his choices helped push NBC's prime time into free fall in 2004—sparking rumors that Zucker could be fired. Instead, he was promoted to head of the television group, adding the strong cable assets to his portfolio. Once again, Zucker had demonstrated a striking ability to win maximum applause for coups—bringing *The Apprentice* to NBC, for example—while deflecting heat for failure. Listen to him talk about NBC's ratings slump. "We had 10 unprecedented years of being on top," says Zucker, "followed by two years when we were not."

> "People [tried] to criticize me for not finding the next *ER* or *CSI*," says Zucker. "We [hit] a bunch of doubles"

But Immelt himself was becoming frustrated with the poor performance at NBCU. After all, it was the only GE business to post shrinking profits last year. Before long, Immelt was coaching his protégé in weekly phone calls. Zucker got GE religion, embracing efforts to boost the bottom line. Mostly that meant taking an ax to production and marketing costs, and laying off 700 people, under a campaign benignly labeled NBCU 2.0. Meanwhile Zucker savvily demonstrated public support for such GE imports as Beth Comstock, who now oversees digital media, and new ad sales chief Michael Pilot, who came from GE's equipment-financing business.

NBC has clawed its way back up in ratings, thanks in large part to the success of the series *Heroes*. But there are other heroes, too. One is NBCU Sports & Olympics Chairman Dick Ebersol, who came up with the idea of bringing back *Sunday Night Football*, giving NBC a ratings boost and a place to promote new shows. Another is current entertainment chief Kevin Reilly. Zucker began giving him public support as ratings began to recover last fall.

But the big winner is Zucker, who sits astride an empire that includes a movie studio, theme parks, cable properties, the iVillage Web site, and NBC. Much of the business is doing fine—from the hugely profitable USA Network to the still dominant *Today* show. But to keep NBCU growing, Zucker will have to move beyond the short-term urgency of TV to deal with issues like piracy, globalization, new distribution models, and a shrinking audience for network TV. Wright, 63, was brilliant at looking around corners—positioning NBC for the onslaught of cable and launching CNBC before the market boom. "Bob had a great way to conceptualize the unknown," says Immelt. Wright is as comfortable talking about regulatory trends in Washington and Beijing as the latest technologies in Silicon Valley.

While Zucker acknowledges that "the biggest challenge for us to figure out is what we will look like in five years," some wonder if his DNA remains rooted in thinking about today. "He cares more about getting a rise out of [CBS chief] Les Moonves than figuring out what YouTube does to his business," says one observer. Under his leadership, Zucker predicts NBCU will emerge more "optimistic, competitive, very sunny-side-of-the-street, very encouraging." Less certain is how he'll fare as a strategist.

Immelt, of course, expresses confidence Zucker will make NBCU a winner again. He says Zucker has the edge and creativity to make the best of a bad situation. "I like how tough he is," says Immelt. "I watched Jeff go to the bottom of the ocean, around the middle of last year. He never got negative." Immelt believes Zucker is a fast learner, noting that every CEO has to grow into the job. But Immelt also acknowledges the media and entertainment industry faces the toughest challenges of any of GE's businesses.

The question for Zucker is how long he has to prove his mettle. Although GE says it is in for the long haul, insiders buzz that Wright and others have looked hard at selling NBCU. As Zucker knows all too well, it will take more than bravado and political savvy to impress his boss. ■

COX Trying to build consensus among commissioners

CHRIS GREENBERG/BLOOMBERG NEWS

CORPORATE GOVERNANCE

PROXY-SEASON GRIDLOCK AT THE SEC

By not ruling on investor power in board elections, it's setting the stage for a fracas

BY LORRAINE WOELLERT

IN THE 18 MONTHS CHRISTOpher Cox has led the Securities & Exchange Commission, he's made great strides toward unifying a fractured agency, racking up a string of unanimous votes on even polarizing issues such as executive pay disclosure. But now Cox's drive for consensus is slowing the agency's response to one of the most urgent issues in business: the growing power of shareholders in corporate elections.

In September a federal appeals court attacked an SEC policy that for years had effectively blocked investors from getting their candidates for the board of directors on the ballot. Cox promised swift action to create "one clear rule" to govern board elections. But the commission failed to take up the matter at its October meeting and punted again in December even as executives pleaded for guidance on the eve of proxy season. "The SEC has allowed this to fester, and it now is simply getting out of control," says Peter J. Wallison of the American Enterprise Institute, a free-market think tank in Washington. "It has left companies just hanging out there, completely without any defenses."

Activist shareholders are gleeful to have the upper hand. "This is the accountability mechanism shareholders have been searching for for at least 30 years," says Richard C. Ferlauto, director of pension policy at the American Federation of State, County & Municipal Employees. AFSCME had challenged the long-standing SEC rule in a 2005 lawsuit against insurer American International Group Inc., ultimately prevailing at the U.S. Court of Appeals for the Second Circuit.

NO RETURN TO THE OLD DAYS

ARMED WITH THE Second Circuit opinion, investors are pushing proxy proposals at Hewlett-Packard, Reliant Energy, and UnitedHealth Group. All three sought the SEC's blessing to omit the proposals from their proxies. But in a Jan. 22 letter to HP, the SEC declined to take a side. AFSCME sued to ensure HP would include the proposal, which the company did.

HP's experience prompted Reliant to file its own lawsuit. On Feb. 5 the company asked the U.S. District Court in Houston to block an election proposal from Seneca Capital Investment Partnership. UnitedHealth, based in Minnetonka, Minn., hopes to use state law to exclude a similar resolution from its proxy.

Corporate lawyers blame the SEC for the chaos. "We were surprised by the SEC response to Hewlett-Packard," says Reliant attorney Michael P. Rogan, a partner at Skadden, Arps, Slate, Meagher & Flom. "We didn't expect to get to this point." Nor did business lobbyists, who are hammering the SEC to issue a new rule that will give business the means to fight back.

Business shouldn't count on a speedy fix or a return to the old days. As Cox works to build support among commissioners evenly split between Democrats and Republicans, he makes clear his intent to expand shareholder rights: "We have any number of special committees telling us that in order to be more competitive, the U.S. has to sharpen its edge," the SEC chief says. That means not only lightening the regulatory load "but also making sure that shareholder rights are thoroughly respected." ■

Proxy Problems

Activist shareholders at three companies want to change corporate bylaws to make it easier for investors to propose their own slate of candidates for the board of directors. Here's how the companies are responding:

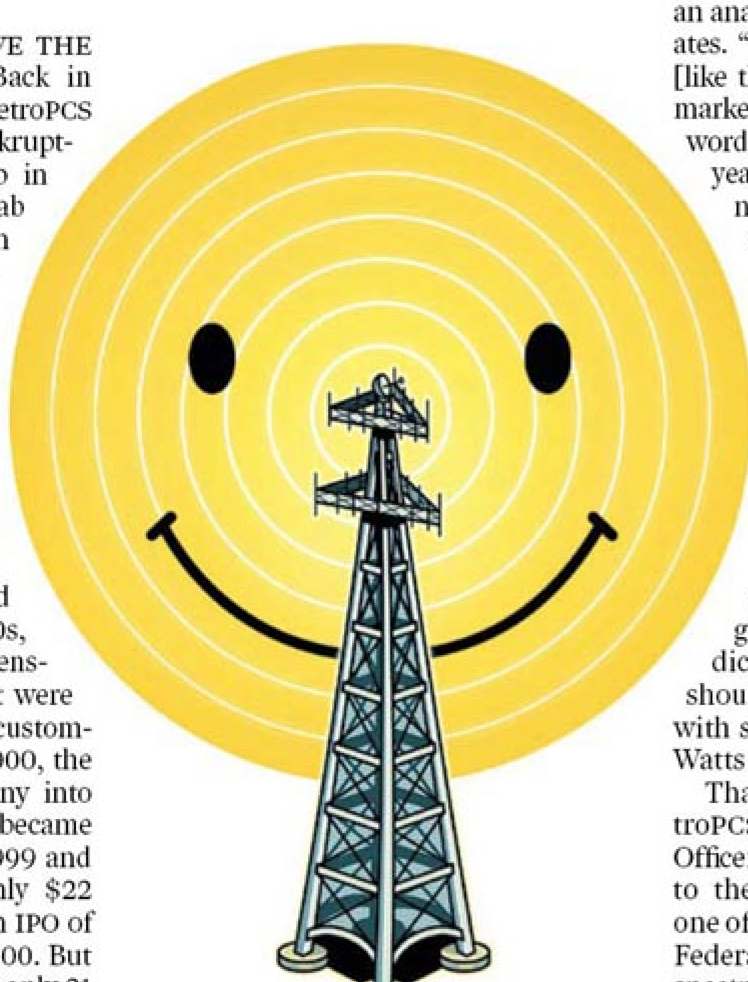
HEWLETT-PACKARD	RELIANT ENERGY	UNITEDHEALTH GROUP
HP included a proposal in its proxy after the SEC refused to weigh in on the company's behalf	After witnessing HP's loss at the SEC, Reliant filed suit to block a resolution from Seneca Capital	The company is using Minnesota state law to try to exclude a proposal from CalPERS

Data: BusinessWeek

FINANCE

TELECOM: UP FROM THE IPO ASHES?

Maybe it's not 1999, but an offering from MetroPCS could fetch $1.2 billion



BY AARON PRESSMAN

IT DOESN'T EXACTLY HAVE THE makings of a hot IPO. Back in the 1990s, Dallas-based MetroPCS Wireless Inc. filed for bankruptcy after getting caught up in the industrywide land grab for network licenses. Then it had to cancel plans to go public in 2004 when company auditors found accounting problems. Still, if MetroPCS raises $1.2 billion from the equity markets in the next couple of months, as it hopes, the deal would be the biggest U.S. telecom initial public offering since 2000.

It's little wonder why telecom IPOs have dried up. In the mad rush to expand in the late 1990s, most players overpaid for their licenses and constructed networks that were too big for the existing pool of customers. When the bubble burst in 2000, the companies crashed, sending many into Chapter 11. After that, telecom became a dirty word on Wall Street. In 1999 and 2000, 62 telecoms raised roughly $22 billion, including the $10.6 billion IPO of AT&T Wireless Group in April, 2000. But over the next five years there were only 21 IPOs in the sector, totaling $5.6 billion, according to Thomson Financial.

Yet analysts think investors will embrace MetroPCS. For one thing, telecom stocks, led by mobile players, gained 35% in 2006, compared with 15% for the Standard & Poor's 500-stock index. And among fast-growing wireless companies, MetroPCS stacks up nicely. The company, which serves seven metropolitan regions including Atlanta and San Francisco, doubled its customer base in a year, to 2.6 million as of September, 2006. Revenues jumped 46%, to $1.1 billion, for the first nine months of 2006. Its accounting problems have also been resolved: The company restated its revenues and income modestly for 2003 and 2004, while overhauling its accounting procedures and replacing some of its top finance people.

In this crowded market, MetroPCS has also managed to distinguish itself from the big boys like Verizon Wireless Inc. and Cingular Wireless. Rather than offering calling plans with bundled minutes, hefty overage fees, and annual contracts, MetroPCS charges customers a flat, prepaid rate of $30 to $45 a month for unlimited calling. Its phones are cheaper, too. "It may seem like every man, woman, and child has a cell phone, but the next leg of growth will be with the lower-income, younger people, and the undocumented," says Ric Prentiss, an analyst with Raymond James & Associates. "You need a unique way to do that [like the MetroPCS plans]." It also keeps marketing costs down by relying largely on word of mouth and local advertising. Last year, MetroPCS spent just $116 to add a new customer, less than half what big carriers pay.

FULLER SPECTRUM

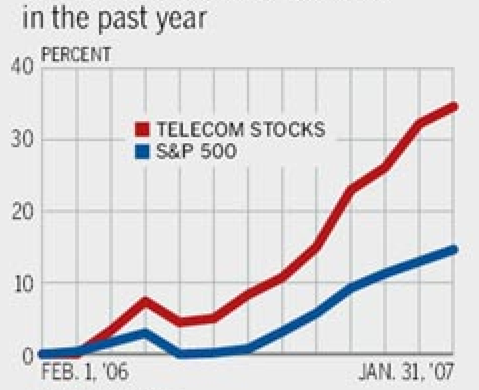
IT'S A SIMILAR MODEL to that of San Diego-based Leap Wireless International Inc. Although the two have been locked in legal battles over a patent since the summer, there's room for both to thrive, says Christopher Watts, an analyst with Atlantic Equities. If Leap's 79% stock gain over the past year is any indication, it's a model that investors should like. "These are growth stocks with straightforward expansion plans," Watts says.

That expansion is the reason MetroPCS founder and Chief Executive Officer Roger D. Linquist is reaching out to the equity markets. MetroPCS was one of the most aggressive bidders at the Federal Communication Commission's spectrum auction back in November. The company picked up licenses for eight areas, including New York, Las Vegas, and San Diego—representing 117 million potential new customers. MetroPCS raised $1 billion in the bond market to help pay the $1.4 billion tab for new licenses. It plans to use the proceeds from the stock offering to build out services in those new regions, according to IPO filings. MetroPCS executives declined to comment.

Last year's big telecom IPO, Vonage Holdings Corp., was a dud, with the money-losing Net telephony outfit down 70% since its May debut. But with growing revenues and profits, MetroPCS should fare much better.

TAKING OFF

The telecom sector has soared in the past year



Data: Morningstar Inc.

PETER HOEY

Kodak's Moment of Truth

How the ailing film giant, led by a refugee from HP, embarked on a risky strategy to reinvent the inkjet printer

BY STEVE HAMM

ANTONIO M. PEREZ left the consumer inkjet printer business seven years ago after he lost out to Carly Fiorina for the top slot at Hewlett-Packard. But it has never been far from his mind. That's why, a few weeks after he joined a struggling Eastman Kodak Co. as president on Apr. 2, 2003, he was peering into a microscope in a lab on Kodak's sprawling Rochester (N.Y.) campus. Perez was amazed at what he saw: droplets of a new ink Kodak scientists had produced promised to yield photo prints with vivid colors lasting a lifetime. "It was the Holy Grail of inkjet printing, and they had it here," he recalls.

Ever since then, Perez and Kodak have been working on a top-secret plan, code-named Goya, to make a big entrance into the consumer inkjet printer business. For the past year a Kodak development team has been putting the finishing touches on printer technologies in a nondescript building across the street from HP's inkjet printer lab in suburban San Diego. On Feb. 6 it became clear what they were up to when Perez, now Kodak's chief executive, rented out the *Saturday Night Live* studio in New York to unveil a line of multipurpose machines that not only handle photographs and documents but also make copies and send faxes.

The Kodak printers are designed, first and foremost, to print high-quality photos: The ink is formulated so prints will stay vibrant for 100 years rather than 15. Most impressive of all, replacement ink cartridges will cost half of what consumers are used to paying. The new printers will arrive in stores in March, priced at $149 to $299. Black ink cartridges will cost $9.99, color $14.99. If consumers buy Kodak's economical Photo Value Pack, which combines paper and ink, the cost per print is about 10¢, vs. 24¢ for HP's comparable package. "It's really a revolution of thought in how to bring the price of printing down and encourage people to print more," says David Morrish, senior vice-president of merchandising for Best Buy Co., which has an exclusive on the product for three months.

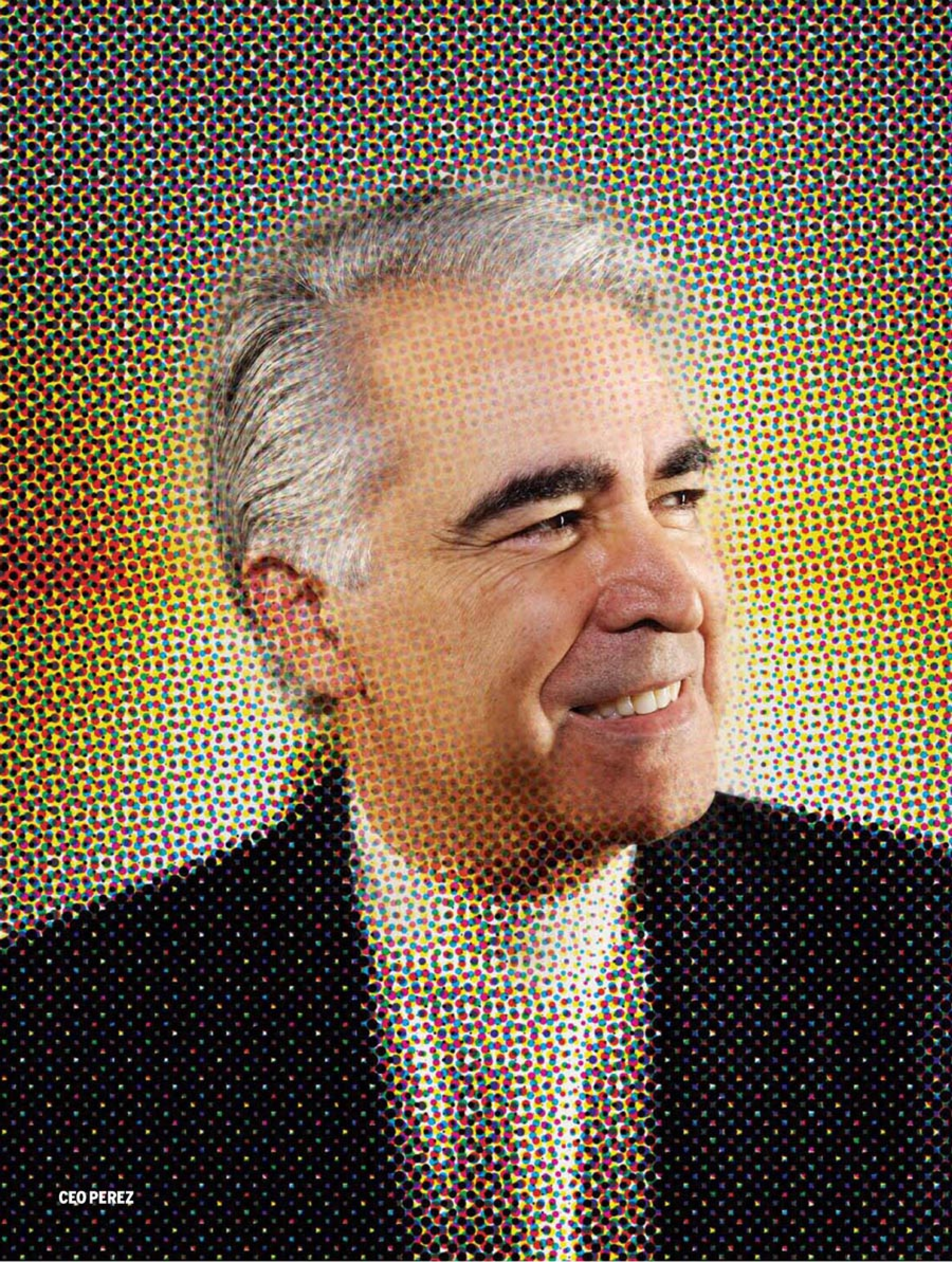
UPENDING THE MODEL

IF KODAK PULLS THIS off—and that's a big if, considering the forces it's up against—it could pose a huge challenge to the $50 billion printer industry. Those companies now rely on a razor-and-blades strategy, often discounting machines and making most of their profits on replacement cartridges. "We're very proud that we're coming to market 20 years late," Perez says with a grin. "We think it will give us an opportunity to disrupt the industry's business model and address consumers' key dissatisfaction: the high cost of ink."

> The cost per Kodak print could be as low as 10¢, vs. 24¢ with HP's system

In particular, Kodak's

PHOTOGRAPH BY ROGER HAGADONE; PHOTO DIGITIZED BY LAUREL DAUNIS-ALLEN/BW


CEO PEREZ

"QUEEN OF THE GEEKS" Inkjet R&D head Tousi kept sending the engineering staff back to the drawing board until they got it right

CHRIS CASABURI

strategy is an assault on the profit engine of industry leader HP. Printing supplied 60% of HP's $6.56 billion in operating earnings last year. Yet Perez claims he has no malice toward his former employer. "I spent my life there. I respect them," he says. "I'm doing this for Kodak."

Perez predicts the inkjet printers will become a multibillion-dollar product line. He'd better be right. Kodak has struggled for years to find a replacement for its rapidly declining photofilm business. In the fourth quarter the company posted its first profit in two years, a reflection of cost cuts, not rising sales. If he doesn't show growth soon, investors could bail out.

SCANNING OPTION

HIS LAST, BEST HOPE is to create a multifaceted printer-and-imaging business, a smaller version of the one that generated $26.8 billion in revenues for HP last year. Consumer printers are just the latest piece of that strategy: Perez already has a fast-growing but low-margin lineup of digital cameras, docking-station printers for cameras, an online site for managing and printing pictures, and a commercial inkjet business. Perez is cooking up such services as one that lets people run shoeboxes of old prints through a store scanner, quickly organizing and enhancing the images. And all the while he's been accumulating cash by shucking such major businesses as his medical imaging unit, whose sale to Onex Healthcare Holdings Inc. for $2.5 billion was announced in January.

What's been missing so far is anything that replaces the once-huge profits Kodak made on film. Perez insists that even while charging lower ink prices, he can extract double-digit operating margins from consumer inkjet printing within three years. He says Kodak cut costs by putting its print heads in the machine rather than in the replacement cartridges, which saves on materials and manufacturing. Plus, Kodak is using a lot of off-the-shelf parts.

But Kodak is up against a juggernaut. HP enjoys a huge advantage in shelf space at stores ranging from office supply chains to supermarkets and has done a masterful job of sharing some of its printer profits with retailers. All told, HP spends about $1 billion a year on printer research and development alone, which helps it continually find ways to improve printing speed and quality. Industry analysts expect HP to sit back and wait to see if Kodak's new machines get traction. If they do, HP could respond with selective discounting. Already, there are signs that HP is ready to defend its turf with tough tactics (page 48). "[Perez] is going into a gunfight with a knife," says Nils Madden, marketing director for HP inkjets.

The Feb. 6 unveiling of Kodak's printers signals the end of a remarkable 3½year forced march to get a potentially revolutionary product out the door. Perez built his team by matching a slew of former HP colleagues with Kodak chemists and nanotechnology experts. Perhaps never before has a challenge to a major company been launched by a rival that knew it so well.

Seeds of the project were planted in

What Makes Printer Ink So Pricey

Kodak could disrupt an industry that profits by selling replacement ink cartridges at $30 a pop. Kodak will halve that. Here's how printer makers have kept ink prices so high:

RAZORS AND BLADES

All of the major inkjet printer makers have chosen the same strategy, selling printers for low prices and more than making up the difference on replacement cartridges.

TO EACH HIS OWN

Each inkjet printer company tunes its printers, paper, and ink cartridges to work well together. If consumers mix and match, they risk getting a crummy print.

COPYCATS

Independent outfits make replacement cartridges for HP, Canon, or Epson printers but lack access to secret ink and printer technologies, so quality varies. And they seldom offer much of a discount.

the late 1990s, when HP briefly considered acquiring Kodak. During a 15-day due-diligence process, Perez looked over Kodak's patent portfolio. Although HP's board nixed the merger, Perez' prowling later resulted in a joint venture, established in 2000, to produce high-quality inkjet photo printers for retail outlets.

The project, Phogenix Imaging, was ultimately a bust, a victim of conflicts between its owners. On May 14, 2003, with the first machines ready for shipment on the loading dock and only a month after Perez had joined Kodak, the two sides announced they would part company.

But Phogenix wasn't all for naught. Perez had hired two former top HP printer executives, Bill Lloyd and Philip S. Faraci, to help him evaluate the consumer inkjet business for Kodak. In 1979, Lloyd had led the HP team that came up with the key advance in inkjet printing that created the industry. As soon as the Phogenix news came down, Lloyd and Faraci were on the phone with about 40 key employees, many of them former HPers. They couldn't talk about Perez' ambitions yet, but "we called them up and asked them not to take other jobs," recalls Lloyd, who is now Kodak's chief technology officer.

The crucial go/no-go meeting came on June 25, 2003, in Perez' conference room on the 19th floor of Kodak headquarters. Lloyd and Faraci laid out the arguments, pro and con. The risks were enormous. Kodak would be entering a mature business already dominated by a handful of leaders. And with Kodak's turnaround in question, Perez couldn't afford an expensive failure. But the rewards were huge, too.

Perez decided to sleep on it. He tossed fitfully all night at his home in the posh Pittsford neighborhood of Rochester. By morning he had his decision. "The industry had been doing things the same way for 20 years, and it was time for a change," he says. "I called up Bill Lloyd and said: 'Go ahead. Let's launch a full program.'"

A few days later a dozen former Phogenix employees were invited to lunch at the suburban San Diego home of David Clark, who had been the Phogenix R&D chief. They sat by Clark's backyard pool with a view of the rugged Poway Hills in the distance, munched on chicken salad, and listened raptly while Clark laid out Perez' audacious plan. "At first we thought it was a far stretch. We know how capable HP is and how much technology it has and how much money they spend," recalls Susan H. Tousi, a 10-year HP veteran who now runs R&D for Kodak's inkjet business. Still, within a few days, all but one of those who had sat by Clark's pool decided to sign on. Tousi did so because she liked the startup mentality and wanted to keep working with people who had become close friends.

Perez wanted to get to market quickly, with a target of three years, so the InkJet

SHANNON TAGGART

STRATEGIES

A Totally Different Picture

In its heyday, Eastman Kodak Co. was an icon of innovation. Now that its core film business is fading like an old photo, Kodak is fighting to climb back as a leader in digital photography. Its new line of inkjet printers is a critical piece of that strategy. "This is a do-or-die product for Antonio Perez," says Charles LeCompte, president of Lyra Research Inc., an image research firm in Newtownville, Mass. "If they want to make money in consumer imaging, they had to get into printing."

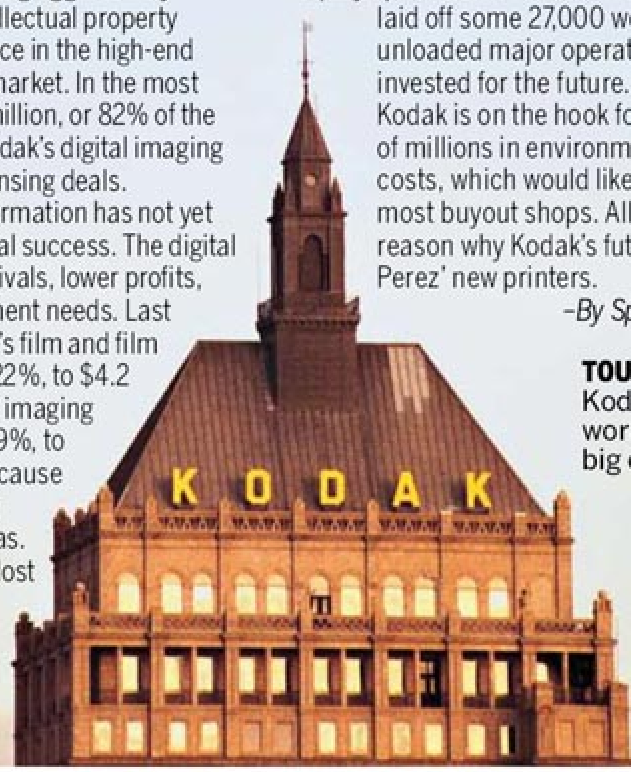
Perez is attempting the most difficult challenge of a CEO: revamping his company's business model. His answer has been to position Kodak as the Apple Inc. of pictures. He is building a portfolio of digital cameras, Web services, and retail photo kiosks that will help consumers manage their proliferating collection of digital photos. And he is moving aggressively to license Kodak's intellectual property and beef up its presence in the high-end commercial printing market. In the most recent quarter, $123 million, or 82% of the operating profits of Kodak's digital imaging group, came from licensing deals.

But Kodak's transformation has not yet translated into financial success. The digital world brings tougher rivals, lower profits, and increased investment needs. Last year sales from Kodak's film and film printing business fell 22%, to $4.2 billion, while its digital imaging group saw sales drop 9%, to $2.9 billion, largely because Kodak stopped selling low-end digital cameras. Overall, the company lost $600 million in 2006 and $1.4 billion the previous year.

That's what makes the consumer printing effort so important. If inkjet printers and cartridges prove popular, they could provide the kind of ongoing, high-margin revenue that film once did. "The profit potential is compelling," says Matthew Troy, an analyst with Citigroup Global Markets. And if the new printers don't catch on? Kodak may well be relegated to bit-player status in the consumer market. Says LeCompte: "They would end up as the rump of a company in commercial imaging."

That definitely would be a blow to investors, who have bid up Kodak's shares from a five-year low of 19.09 last August to about 26 today. Kodak's strong brand and $1.2 billion in cash flow from operations last year might suggest it's a candidate for a buyout. But Perez already is making many of the tough choices that private-equity specialists are known for: He has laid off some 27,000 workers, unloaded major operations, and invested for the future. What's more, Kodak is on the hook for hundreds of millions in environmental cleanup costs, which would likely scare off most buyout shops. All the more reason why Kodak's future rides on Perez' new printers.

–By Spencer E. Ante



TOUGH CHOICES
Kodak has laid off workers and sold big operations

EQUITY RESEARCH

RATINGS

Since 1987, Standard & Poor's 5-STARS stock recommendations have outperformed the S&P 500 in 15 of 19 years and tied once, and have outperformed the Dow Jones Industrial Average and NASDAQ Composite Index in 14 and 13 of those 19 years, respectively. The above chart represents the hypothetical growth attributable to price appreciation of a $100 investment in the 5-STARS recommendations for the period shown. Since 1987, S&P has ranked a universe of common stocks based on a given stock's potential for future performance. Under our proprietary STARS (STock Appreciation Ranking System), S&P's equity analysts rank stocks according to their individual forecast of a stock's future total return potential versus the expected total return of the S&P 500 index, based on a 12-month time horizon. STARS are ranked 1 to 5, with 5-STARS stocks expected to outperform the S&P 500 index by the widest margin. ***** 5-STARS (Strong Buy): Total return is expected to outperform the total return of the S&P 500 index by a wide margin over the coming 12 months, with shares rising in price on an absolute basis. "S&P," "S&P 500," "STARS," and "Standard & Poor's" are trademarks of The McGraw-Hill Companies, Inc. The 5-STARS model performance graph is only an illustration of S&P's research. The 5-STARS portfolio is not an actual portfolio and 5-STARS performance does not represent the results of actual trading. Thus, the performance shown does not reflect the impact that material economic and market factors might have had on decision-making. While 5-STARS ranked stocks performed better than the above indices for the period shown, the performance during any shorter or longer period may not have, and there is no assurance that they will perform better than the indices in the future. STARS methodology does not take into account any particular investment objective. Investments based on the 5-STARS methodology may lose money. There is no guarantee that model performance of 5-STARS recommendations made in the future will equal past performance. STARS performance does not take into account reinvestment of dividends, capital gains, taxes, or brokers' commissions and fees. The imposition of these fees and charges would cause actual performance to be lower than the model performance shown. The stocks ranked 5-STARS will change over time, and some


1999
2005
★★★★★
S&P 5-STARS
STOCK PORTFOLIO*

Once the initial ink recipe was concocted, there was a lot of resistance to changing it

Products Group leaders made choices designed to speed up the development process. They worked with technology partners, such as chip-design specialist SigmaTel Inc., rather than trying to design everything from scratch. And once they established their market goals, in late 2003, they never swerved from them. The result: a process that took years less than it might have and required just a $300 million investment.

One of the key decisions was choosing pigment as the basis for Kodak's ink rather than the usual dye. Pigment-based inks hold their colors longer, but typically the colors aren't as vivid. So Kodak engineers had to come up with innovations in ink chemistry, nozzle technology, and paper to produce vivid colors that also last. Software in the printer evaluates each image and determines what's in it (faces, trees, sky), optimizing the process based on that analysis.

FORMULA CHANGE

INK IS BOILED AND sprayed through 3,840 nozzles at a rate of 24,000 drops per second. The tiny pigment particles are designed to sit on the surface of porous paper while the liquid they're suspended in is absorbed. Drying takes just 15 milliseconds, so there are no worries about smearing the prints, which take 28 seconds to produce.

With any new technology, there are invariably glitches. The team faced a near-disaster a year ago when they discovered that the pigment particles in their inks were settling at the bottom of the storage containers, like sediment in a wine bottle. Unless the situation was remedied, image quality would suffer. The problem came fairly late in the development process; the team had already "frozen" the ink formula so they could design other components of the printer to go with it.

The temptation was to try to fix things without changing the ink recipe. The scientists considered putting a small mechanical mixer in the storage tank. But in the end they decided it was too risky to do anything but reformulate the ink. That led to a day-and-night work marathon. A month later the team had its answer: milling the pigment particles much smaller, so they would stay suspended in liquid. The formula was set, and Tousi came up with a new motto: "Don't dink with the ink."

Throughout the whole process Tousi was the stickler for quality. Dubbed "Queen of the Geeks" by her employees, Tousi carries a loupe for magnifying photographs practically everywhere she goes. She even takes prints into the parking lot to study them under harsh sunlight. Time and again, Tousi sent engineers back to the drawing board because their results weren't up to her standards.

Last June it was Tousi who had to tell Perez that they weren't going to be able to begin marketing the printers for last year's holiday shopping season. She thought more tests were necessary to assure the highest print quality. In an effort to boost the team's morale, Perez flew to San Diego to meet with the entire engineering staff. He stood on a table so he could see over their cubicle partitions. He recalls telling them: "Slipping by a quarter doesn't matter that much, but you have to promise me that these printers will work perfectly. We have only one chance to do this right. If our first introduction fails, we fail."

Analysts who have seen Kodak's printers have come away impressed. "The print quality is really good. They're at least as good as everybody else," says

(TOP STRIP) PHOTOGRAPH BY ROGER HAGADONE; IMAGING BY RAY VELLA/BW

TURF WARS

Rivals Say HP Is Using Hardball Tactics

Cheaper store-brand inkjet printer cartridges have come on strong recently and now make up about a quarter of the market for replacement cartridges in the U.S. That poses a serious threat to Hewlett-Packard Co., the worldwide leader in consumer printers. Now, according to printer industry and retailing executives, HP is fighting back.

Those executives say the company has approached chain stores that sell store-brand cartridges compatible with its printers and offered them incentives if they end the practice. Since those replacement cartridges typically sell for 10% to 15% less than HP's, consumers could be the big losers if a lot of retailers take the printer giant up on its offer, they say. "HP has a huge share and market power. By limiting the alternatives a consumer has, it's a tough strategy," says one executive in the ink cartridge remanufacturing business. (The independent and store brands sell recycled cartridges that they refill.) None of *BusinessWeek*'s sources would allow their names to be used because they didn't want to damage their relationships with the industry leader.

Asked to respond to the complaints, an executive for HP says it provides incentives to retailers so they will aggressively market its products. But the executive, Pradeep Jotwani, head of supplies for the HP Imaging & Printing Group, wouldn't provide details of those marketing programs. "We don't try to stop the availability of non-HP supplies," Jotwani says. He adds that the Palo Alto (Calif.) company has the customers' interests in mind, and purchasers will get the best results if they use all HP-original technology and supplies.

ON CAMERA Kodak CEO Perez (center) at the printer launch on the *Saturday Night Live* studio

AARON LEE FINEMAN

Larry Jamieson, director of industry-watcher Lyra Research Inc.

But Perez and Kodak are challenging a giant competitor that has a 33% worldwide market share and a sterling reputation among PC and digital-camera users. HP not only gets prime merchandising spots for its printers and ink in stores, but also gets to display its printers in the computer sections, because it bundles printers with its PCs. "HP has a lot of customer loyalty. They build a great product. The printers don't break," says analyst Alyson Frasco of market researcher Interactive Data Corp.

It's up to Perez and Kodak to show they have a truly game-changing product. Perez seems immune to negative thoughts. He tells a story that shows just how confident he is of success. "J. Paul Getty said you have to do just three things to be successful: get up early, work hard, and strike oil," says Perez. "I didn't strike oil in my career, but I did strike ink."

–With Louise Lee in San Mateo and Spencer E. Ante in New York

"We want to provide the best customer experience," he says.

Staples Inc., the country's largest seller of replacement ink, confirmed to *BusinessWeek* it plans on phasing out sales of store-brand inks for HP printers, but won't say whether the electronics giant asked it to make the move. It says HP has invested heavily in optimizing its printers, ink, and paper, so the two work well together. "We'll focus on HP-original technology," says Scott Rankin, vice-president for technology merchandising at Staples. "Selling that system is going to enable us to offer our customers the best solution."

Yet Staples will continue to sell store-brand replacements for cartridges from Epson, Canon, and Lexmark International. Rankin says customers still have opportunities to save on HP-compatible ink purchases by buying multicartridge packages and getting $3 each for recycling cartridges.

Jotwani says he's experimenting with programs that would make for more efficient cartridge recycling and would also boost the volume of returns. HP takes the cartridges and separates the materials for recycling, rather than refilling them like remanufacturers do. He denied the company is trying to deprive remanufacturers of the cartridges they need to do business.

THE STAT

10%

The price differential on store-brand printer cartridges vs. HP-brand cartridges.

Data: *BusinessWeek*

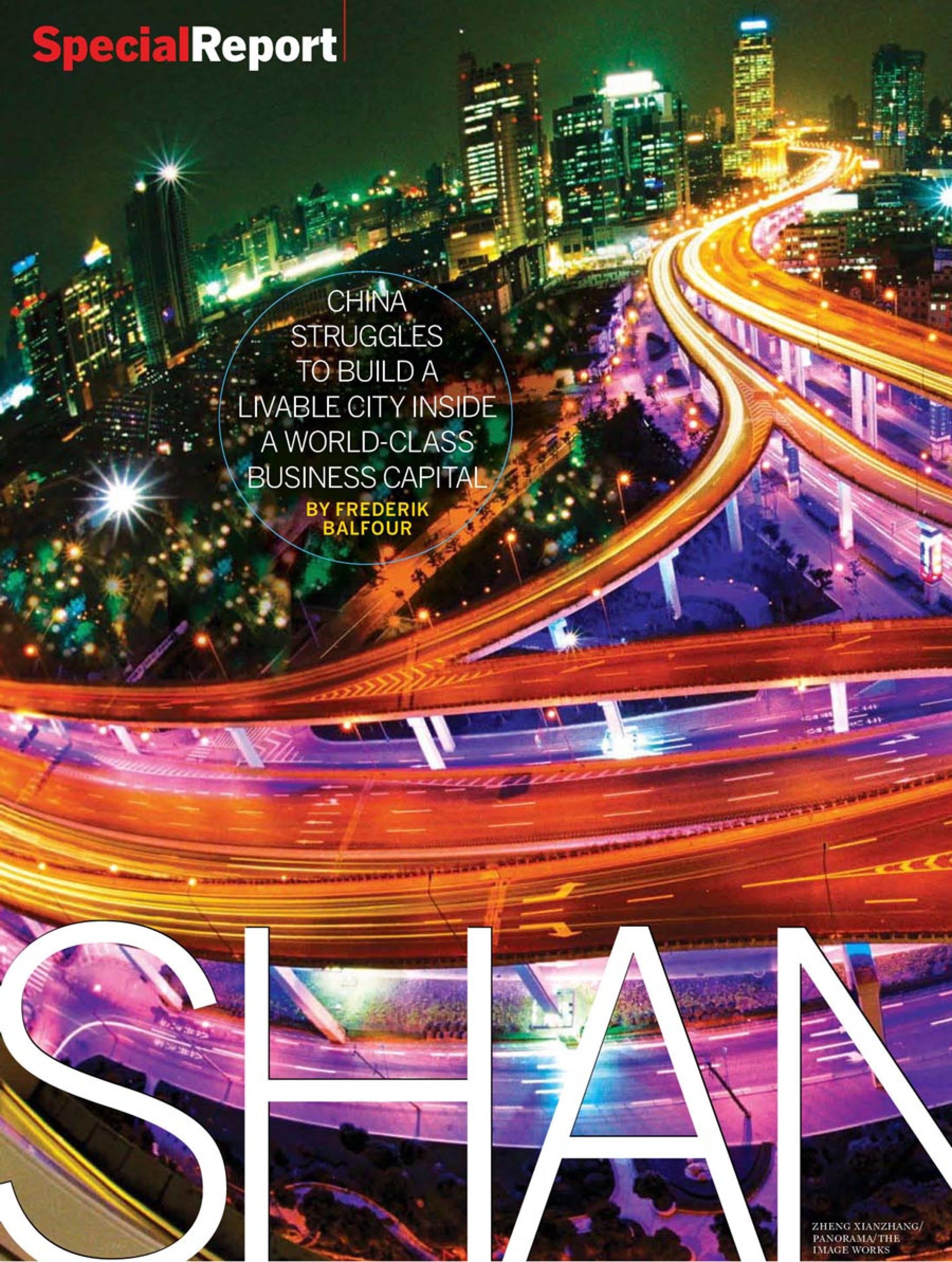
Industry analysts are watching the action closely. "The speculation is that [Staples] reached a deal with HP and got increased margin and soft money for marketing," says Charles Brewer, managing editor of *The Hard Copy Supplies Journal*, a trade publication that first wrote about Staples' move. "That line is selling very well for Staples. They wouldn't drop it without compensation."

Staples' move has already had reverberations. InkCycle Inc., a Lexena (Kan.) company known to supply ink cartridges that Staples sells under its store brand, has reduced its workforce from nearly 800 last summer to 400 today. InkCycle officials would not comment on HP or their relationship with Staples.

Other retailers, including Best Buy Co. and Office Depot Inc., say they will continue to sell store-brand HP-compatible ink. "We carry what the customers ask for," says Scott Koerner, senior vice-president for merchandising at Office Depot. "As long as the customers continue to ask for it, we intend to continue to carry it. This is about providing customer choice." Asked if the industry behemoth approached Office Depot and asked it to stop carrying store-brand ink, Koerner said: "I can't comment on any conversations with HP one way or the other."

Executives in the ink cartridge remanufacturing industry say they are discussing whether to complain to regulators about the moves, which the executives say may harm consumers. Do these alleged tactics raise antitrust questions? "Antitrust law would only be violated if HP does something that significantly eliminates alternatives from the market and gives it enhanced market power as a result," according to Steven C. Salop, professor of economics and law at Georgetown University Law Center. "Right now, there are alternatives being sold at other office superstores, and other printer brands are being sold at Staples."

–By Steve Hamm

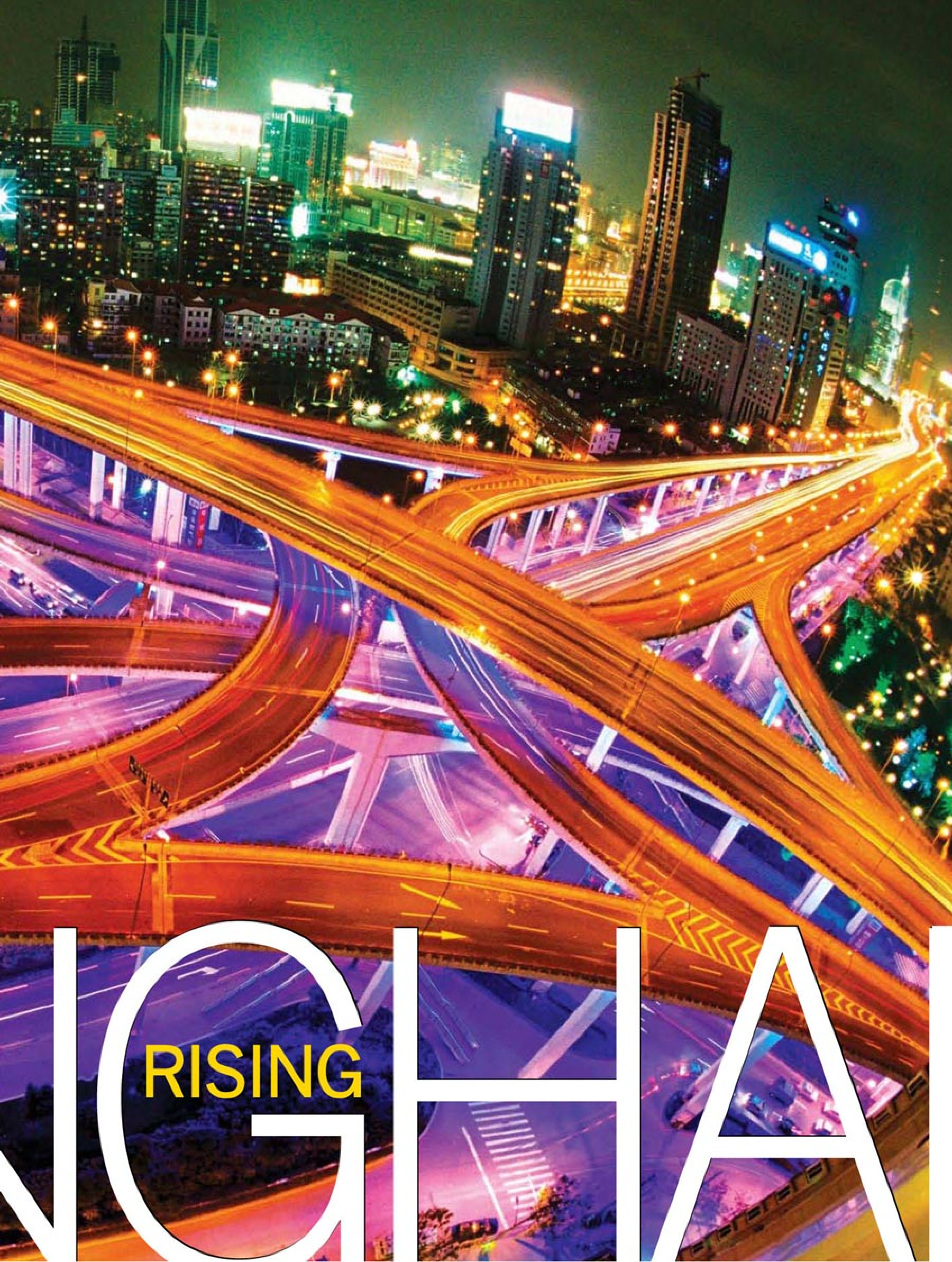


CHINA STRUGGLES TO BUILD A LIVABLE CITY INSIDE A WORLD-CLASS BUSINESS CAPITAL

BY FREDERIK BALFOUR

SHAN

ZHENG XIANZHANG/PANORAMA/THE IMAGE WORKS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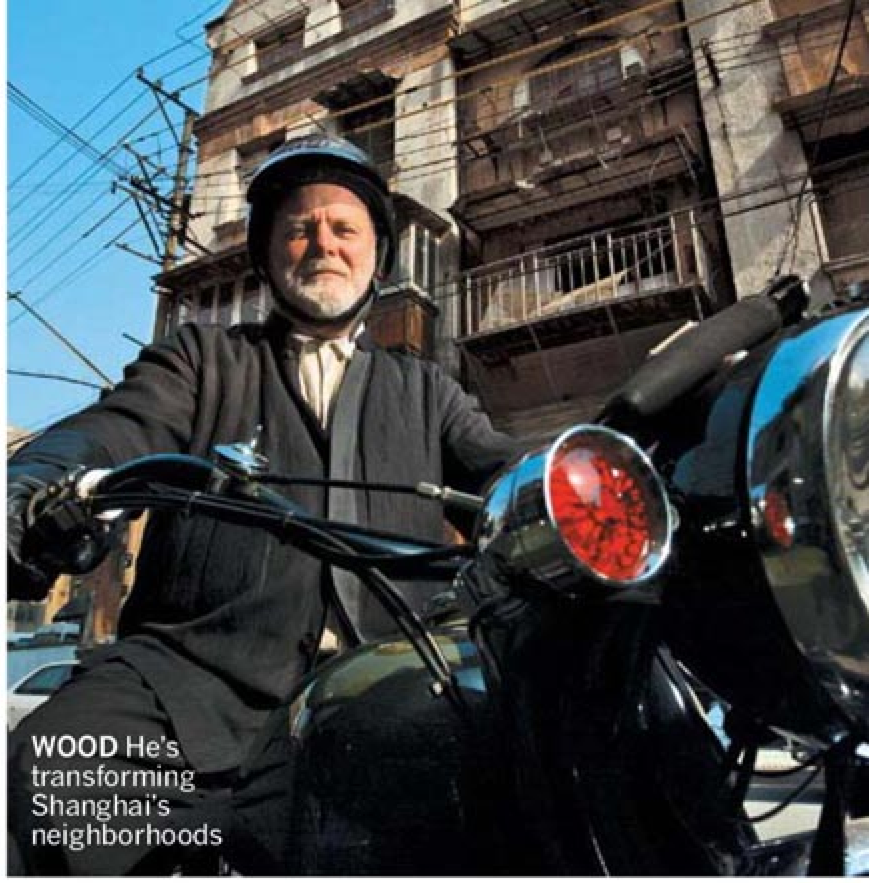


WOOD He's transforming Shanghai's neighborhoods

BENJAMIN WOOD SWINGS his bulky frame over the saddle, straps on his helmet, and settles onto a vintage motorcycle with sidecar. The American architect kicks the engine into life with a single thrust and pulls into the rush-hour traffic coursing through Shanghai's trendy Xintiandi district. He soon steers down a narrow street and enters another world. While Xintiandi is all luxury shops and outdoor cafés, in surrounding neighborhoods the sidewalks are full of people playing mah-jongg in their pajamas, washing dishes at outdoor taps, or popping dumplings into bubbling oil. Life goes on much as it has for the past half-century.

As the bike gathers speed, Wood's white silk jacket flaps in the wind. Passing between some of the fast-disappearing courtyard houses of Shanghai, he waves at locals making dinner. "They know me pretty well in this neighborhood, because I like to ride through here a lot," he says, raising his voice to be heard over the growling motor. "What they don't know," he adds with a hint of regret, "is that I'm also the guy who is going to make this way of life disappear."

Although few might recognize Wood, virtually anyone who has spent more than a day or two in Shanghai will know Xintiandi. The rebuilt neighborhood is Wood's first and best-known work in China, a collage of cobblestone streets, narrow alleyways, and graceful tiled roofs. Xintiandi, which translates as "New Heaven and Earth," has become one of Shanghai's top tourist destinations. Foreigners love it because it evokes the colonial era and is one of the few neighborhoods to escape the wrecker's ball, while locals are drawn to the bistros, bars, and boutiques that lend it a Western cachet.

Wood's work at Xintiandi has become a symbol of the changing aspirations China has for Shanghai. In 1992, Deng Xiaoping declared that Shanghai would be "the head of the dragon" pulling the country into the future, and the Chinese have poured tens of billions of dollars into rebuilding the city after a half-century of neglect. The pace has slackened after a a scandal over municipal pension money spent on questionable real estate deals, but the city is still booming.

Problem is, Shanghai has long preferred megaprojects that blindly ape the kind of high-rise developments that scream "modernity" but have little to do with traditional Chinese culture. Until Ben Wood, that is. Xintiandi represents Wood's signature style: Instead of calling in the bulldozers, he imagines a rundown neighborhood as something refreshed. He refurbishes old buildings, saves the facades of others while gutting their interiors, and designs new structures that blend in.

That graceful melding of old and new fits Shanghai's ambitions as it steams toward its third decade of hypergrowth. Like Renaissance Florence, London in the 1800s, or New York early in the 20th century, Shanghai aims to muscle its way into a top spot in the global economic order—a role it played back in the 1920s. Today, Shanghai is the mainland's most populous city, with 18 million residents. It's home to the Asia headquarters of more than 150 global corporations, including General Motors, IBM, and Alcatel-Lucent. And multinationals are boosting their commitment. GM today employs some 1,800 white-collar workers in the city, 60% more than in 2004, while Citibank now has 2,000 employees there, up from 80 in 1999. "Shanghai has very visible ambitions to be a major financial center in the region and perhaps beyond," says Richard Stanley, CEO of Citigroup China.

City of Dreams

Key Projects in Shanghai

«XINTIANDI

American architect Benjamin Wood's first project in Shanghai has become popular with tourists and locals alike, who are drawn to its narrow lanes, outdoor cafés, and tony boutiques.

ROCK BUND

This colonial district is being developed by New York's Rockefeller Group and planned by Wood. An art deco theater and 1930s buildings will become apartments, shops, and a boutique hotel.

Expatriates love Shanghai's nightlife, while skilled young Chinese and migrant laborers have rushed to cash in on the city's surging economy. Shanghai is growing at 12%—even faster than the 10.7% expansion that China as a whole saw in 2006—and the city's gross domestic product was $136 billion last year. That's less than half of London's, but Shanghai's growth is three times as fast the British capital's. And Shanghai has attracted some $120 billion in foreign direct investment since 1992, including commitments of $14.6 billion last year, or 23% of China's total FDI for 2006. "You are witnessing the greatest transformation of a piece of earth in history. It's mind-boggling," says Greg Yager, vice-president of Baltimore design firm RTKL Associates, which has done planning work in the city.

The opportunities in Shanghai have attracted scores of foreign architects, who have helped craft one of the world's most extraordinary skylines. In the financial district of Pudong, which until two decades ago was little more than rice paddies and small factories, the 88-story Jin Mao Tower (designed by Chicago's Skidmore, Owings & Merrill) is home to GM, Credit Lyonnais, and IBM. Next door, the 101-story Shanghai World Financial Center (from New York's Kohn Pederson Fox Associates)—originally planned as the world's tallest building, but now eclipsed by Taiwan's Taipei 101—is about three-quarters completed. Across the Huangpu River, the 66-story Plaza 66 (by Atlanta-based John Portman & Associates) houses General Electric, BP, and KPMG. And the once-dilapidated Bund, the erstwhile Wall Street of Asia on the riverfront, has been reenergized with packed nightclubs, tony boutiques, and trendy restaurants. "Shanghai is a dynamic, exciting, increasingly multicultural city," says Robert Pallash, president for Asia at auto-parts maker Visteon Corp., which moved its regional headquarters to Shanghai from Japan in 2003. One reason the city won out over Bangkok, Hong Kong, and Singapore: It's an easier sell for expats. "It's very important to attract people from the global organization," Pallash says.

Attracting locals is equally important. The legions of migrants flocking to Shanghai are filling Visteon's factories, as well as those of Intel, Philips, Honeywell, and scores of other multinationals. And the city's universities are churning out thousands of engineering grads every year, which provides a steady supply of researchers for labs run by corporations from around the world. At its facility in Zizhu Science Park, 18 miles southwest of the center, Intel Corp. now employs 1,000 people, up from about 40 in 2000. A decade ago, "it was difficult to find a high-quality office building," and qualified workers were scarce, says Wang Wen-hann, general manager of the lab. Today, "all these factors have matured," he says.

(TOP) DAVID HARTUNG; MAPS BY RAY VELLA/BW

Global Ambitions

China's largest city is the Asia headquarters of more than 150 multinationals, including GM, IBM, and Alcatel-Lucent. Other Shanghai facts:

POPULATION: 18 MILLION

HIGHWAYS: 347 MILES

CARS: 1.1 MILLION

CELL PHONE SUBSCRIPTIONS: 16.3 MILLION

STARBUCKS OUTLETS: 82

GDP PER CAPITA: $7,550*

FOREIGN INVESTMENT: $14.6 BILLION**, 23% OF CHINA'S TOTAL FDI

*2005 **Approved projects, 2006 Data: *China Statistical Yearbook*, *BusinessWeek*

OVERSTRETCHED INFRASTRUCTURE

IN NEIGHBORHOOD AFTER neighborhood, though, eight-lane expressways and steel-and-glass behemoths crowd out gracious townhouses and tenements dating to the early 20th century. The city has doubled its housing stock over the past two decades, but most of those new homes are in soulless skyscrapers. And many of Pudong's towers stand alongside the 100-yard-wide Century Avenue, a thoroughfare that's nearly impossible to cross and lacks so much as a kiosk selling newspapers, let alone a sidewalk café. The district represents "a failure to create a livable urban environment," says Tom Doctoroff, the chief executive for Greater China at ad agency JWT Co.

That's a problem for a place with mega-ambitions. If companies find that Shanghai has become too pricey or too congested for the kinds of employees they want to attract, it may quickly fall from the global hot list. Top-quality office space today costs more than in Midtown Manhattan, and expatriates typically pay $5,000 to $10,000 or even more in monthly rent. The air can be unbreathable, and the highways are clogged much of the day. "You have a city whose infrastructure is totally stretched," says Steve Mullinjer, managing partner at executive search firm Heidrick & Struggles in Shanghai. "It's like a wild horse...with no way to rein it in."

Controlling that runaway horse is Job One in Shanghai, and how Shanghai grapples with that issue is important for all of China. Hundreds of millions of migrants are likely to move to the mainland's cities in coming decades, and much of the rest of the country looks to the city for cues. So if Shanghai bulldoz-

LUJIAZUI

Shanghai's answer to Wall Street sports one of the world's most spectacular skylines. Soon, the 101-story World Financial Center, designed by New York's William Pederson, will join the lineup.

SHANGHAI 2010 EXPO

The city is spending $8 billion to relocate 50,000 people and transform shipyards and steel plants into an exposition highlighting "21st century urban models."

QINGPU

This satellite city is building homes for 250,000 new residents. Wood is planning new housing along the district's ancient canals that fits in with its traditional architecture.

21st Century Icons

Shanghai has become a proving ground for ambitious architects from around the world

« SHANGHAI WORLD FINANCIAL CENTER

101 STORIES

- Designed by New York's Kohn Pederson Fox
- To be completed 2008
- Originally planned as the world's tallest building, but since eclipsed by Taiwan's Taipei 101. The original design had a circle carved out of the top, but was changed to a trapezoid after complaints that it looked like the Japanese flag.

JIN MAO TOWER

88 STORIES

- Designed by Chicago-based Skidmore, Owings & Merrill
- Completed 1999
- With its pagoda-like shape and richly textured exterior, the Jin Mao is both the most "Chinese" of Shanghai's skyscrapers and currently its tallest.

es its history to build highways, you can bet that many other cities will follow suit. Since 2000 the number of cars on the mainland has tripled, and Shanghai and Beijing are already ringed with single-family homes and new communities accessible only by car. With 1.3 billion people, the mainland can ill afford the kind of suburban culture that many seem to want. "The government is now more aware of quality-of-life issues," says Daniel Vasella, chairman of pharmaceutical giant Novartis and head of the International Business Leaders Advisory Council for the Mayor of Shanghai. "They realize that if you can't deliver [a good standard of living], people won't want to live there."

Perhaps that's why the Chinese have taken so readily to Ben Wood. The 59-year-old architect, whose white beard and ruddy complexion make him seem more like a good ol' boy from his native Georgia than a hotshot designer, was drawn to Shanghai's street life and the crowded tenements known as *shikumen*. These two-story buildings, a mélange of Chinese and Western styles with carved stone details, had remained largely untouched since the Communists took over in 1949. But when Wood arrived in Shanghai in 1998 to design Xintiandi, they were rapidly being razed.

At the Xintiandi site, Wood suggested saving the structures and creating a walking district that would preserve the sense of community of old Shanghai. That was a revelation to the city fathers, who until then had struggled to find an alternate way of expressing Shanghai's newfound confidence and affluence. Having proved it can replicate the West in districts such as Pudong, the city was looking for a second wave of development that wouldn't just import styles wholesale, but could give shape to its aspirations as a world-class metropolis. Wood "understands the relationship between new and old buildings," says Wu Jiang, deputy director of the Shanghai Urban Planning Bureau.

If Wood has been good for Shanghai, Shanghai has been equally good to Wood. He kept a relatively low profile in the U.S., but in China he's a true star. Xintiandi's success has spawned countless imitators on the mainland, and Wood has received more than a dozen major commissions. Today he runs a studio of 30 draftsmen and designers, and inquiries from prospective clients roll in almost daily. He is working on a mountain resort, a development similar to Xintiandi in the western city of Chongqing, and another in Hangzhou, a lakeside city 120 miles southwest of Shanghai. Wood "is totally different from other foreigners practicing in China," says Ma Qingyun, a Shanghai architect and now dean of the School of Architecture at the University of Southern California. "He is quite into the human side."

TRICKY POLITICAL LANDSCAPE

TO KEEP SHANGHAI'S GROWTH from tearing apart its urban fabric, the city is building nine new communities on the periphery that are expected to house a total of a million or more newcomers by 2020. These projects, called "One City, Nine Towns," were planned as self-sufficient satellite cities where residents can live, work, and shop, without having to travel into central Shanghai. Each was also designed thematically to resemble the cities of other countries or cultures—a notion some dismiss as frivolous. In Fencheng, for instance, a Spanish group is creating streetscapes inspired by Barcelona's Ramblas promenade. Albert Speer, son of Hitler's favorite architect, is the brains behind Anting, a community modeled after small cities in Germany and home to the Shanghai Formula One circuit as well as Volkwagen's joint-venture auto factory. And Thames Town looks like an English village with cobblestone streets, half-timbered Tudor buidings, red telephone boxes, and a statue of Sir Winston Churchill. "It's farcical," Wood says. "Why pretend you are living in some fantasy land?"

Wood's contribution to the nine towns effort is less garish. In Qingpu, on the southwestern edge of Shanghai, he is working on an 830-unit residential complex that draws its inspiration from the area's ancient canals, bridges, and walkways. His aim, he says, is to create buildings on a human scale that relate to their environs. "The biggest problem in China is that the Forbidden City is burned into every brain," says Wood. "It's symmetrical, monumental, and out of scale."

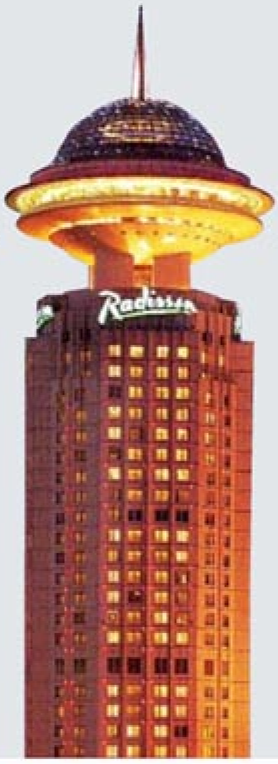
China's modern-day mandarins can be equally intrusive. In 2004, Rockefeller Group International, the New York-based

(LEFT TO RIGHT) EUGENE HOSHIKO/AP/WIDE WORLD; GREG GIRARD/CONTACT; YANG QITAO/IMAGINECHINA.COM

TOMORROW SQUARE

60 STORIES

- Designed by Atlanta-based John Portman & Associates
- Completed 2003
- This building, with apartments and a Marriott hotel, is a square tower that is rotated 45 degrees into a pincer-like spire. Said to have the world's highest library.



RADISSON SHANGHAI NEW WORLD

46 STORIES

- Designed by East China Architectural Design
- Completed 2005
- This hotel on Nanjing Road appears unremarkable until you see the roof, where a revolving restaurant looks like a just-landed UFO.

ORIENTAL PEARL TV TOWER

1,535 FEET

- Designed by Shanghai Modern Architectural Design Co.
- Completed 1994
- Built as a telecommunications tower, this icon is a top draw for Chinese tourists who love the views. There's also a shopping mall, a revolving restaurant, and a hotel.

property development arm of Mitsubishi, hired Wood to plan a 30-acre site the developers call Rock Bund. The project will incorporate a 1928 art deco theater and more than two dozen colonial-era buildings. Rockefeller seemed to have everything going for it, including the support of Shanghai Communist Party Secretary Chen Liangyu.

But in a city changing as rapidly as Shanghai, you never quite know when you might end up building on political quicksand. Last September, Rockefeller executives got a disturbing call from their lawyer, saying, "Our friend is in the slammer." The friend was Wu Minglie, the chairman of New Huangpu Group, a Chinese company that was working with Rockefeller. He had been detained and accused of misappropriating city pension funds for property development. Shortly thereafter Secretary Chen was sacked in what many believe was a power struggle with China's central leadership in Beijing. Rockefeller Group executives declined to comment on the record about the affair, which a company spokesperson calls "extremely delicate." Though most projects have been delayed since Chen's ouster, there's no indication that Rock Bund is in danger of being scuttled.

Despite the headaches, Wood isn't one to shrink from a challenge. A latecomer to architecture, he didn't start practicing until he was 36. By that time he had flown fighter jets with the U.S. Air Force and founded a mountaineering school and a French restaurant in Colorado. At 31, he enrolled in a graduate architecture program at the Massachusetts Institute of Technology. He soon started his own firm with Ecuadoran Carlos Zapata and broke into the big leagues in 1998 with a commission to rebuild Soldier Field, the Chicago Bears' stadium.

When Wood was in the middle of the Soldier Field project, he got a call from Hong Kong. Would he pick up a business-class ticket waiting for him at the airport and come ASAP? Two days later, Wood was being whisked by limo to the offices of Vincent Lo, chairman of property group Shui-On. The meeting lasted five minutes. "He told me, 'I want you on the next plane to Shanghai and back here tomorrow morning,'" Wood recalls.

After a few hours wandering the dilapidated neighborhoods that would become Xintiandi, Wood returned to Hong Kong to make his pitch. He cited Boston's Faneuil Hall Marketplace and mountain villages in Italy as potential models. As luck would have it, Lo was a fan of the Boston development and had spent time in Tuscany. "After half an hour, I said, 'This is the man I want to work with,'" says Lo, who gave Wood the job over three competing architects. Within six months, some 1,600 families had been relocated to new developments far from their old homes—not always happily, despite having indoor plumbing and their own kitchens for the first time. "We did things like take off their roofs to speed up the process," Wood says.

The irony of Xintiandi's success is that surrounding blocks have been bulldozed for luxury developments, spelling the end of the local charm that attracted Wood in the first place. Lo now wants to turn adjacent property into a theater district that will rival Broadway or London's West End. Although a few handsome brick buildings will be saved, the expanded site will also include four theaters, a 68-story office tower and high-end apartments. The outdoor dining, meanwhile, won't be at dumpling stands, but at upscale restaurants. "The real tragedy is not the disappearance of the [old buildings], but of life on the streets," Wood says.

As Shanghai's transformation continues apace, Wood is likely to be there to watch it unfold and lend a hand where he can. In 2003, he moved full-time to Shanghai, one of the few foreign architects to make such a commitment. On any given evening, you're likely to find him holding court in the DR Bar, a Xintiandi watering hole he designed and owns, or treating guests to grilled salmon and steaks in his two-story penthouse, followed by a soak in the outdoor hot tub with views of the city's ever-changing skyline. Will he ever go back to the U.S.? Don't bet on it. Shanghai's growth still offers plenty of opportunities, especially for an architect who understands that it takes more than tall buildings to make a truly global capital. "If Shanghai is unable to provide the quality of life of a world city like Paris or London, it will never become a major financial center," Wood says. "But the wild west atmosphere is being replaced by more sophisticated development strategies. And this will ultimately be to Shanghai's advantage." ■

(FAR RIGHT) ANDREW ROWAT

BusinessWeek.com

ONLINE: For slideshows on Shanghai's changing skyline and the Nine Towns initiative, please visit **www.businessweek.com/extras**.

A Dynamo Called Danaher

The Rales brothers' sprawling conglomerate makes everything—especially money

BY BRIAN HINDO

DANAHER CORP. IS not nearly as big, famous, or influential as conglomerates such as General Electric, Berkshire Hathaway, or 3M. It owns such a mundane and sprawling portfolio of sleepy, underloved industrial businesses—companies that make dental surgery implements, multimeters, drill chucks, servomotors, and wrenches, just to name a few—that it seems deliberately assembled to be as unsexy as possible.

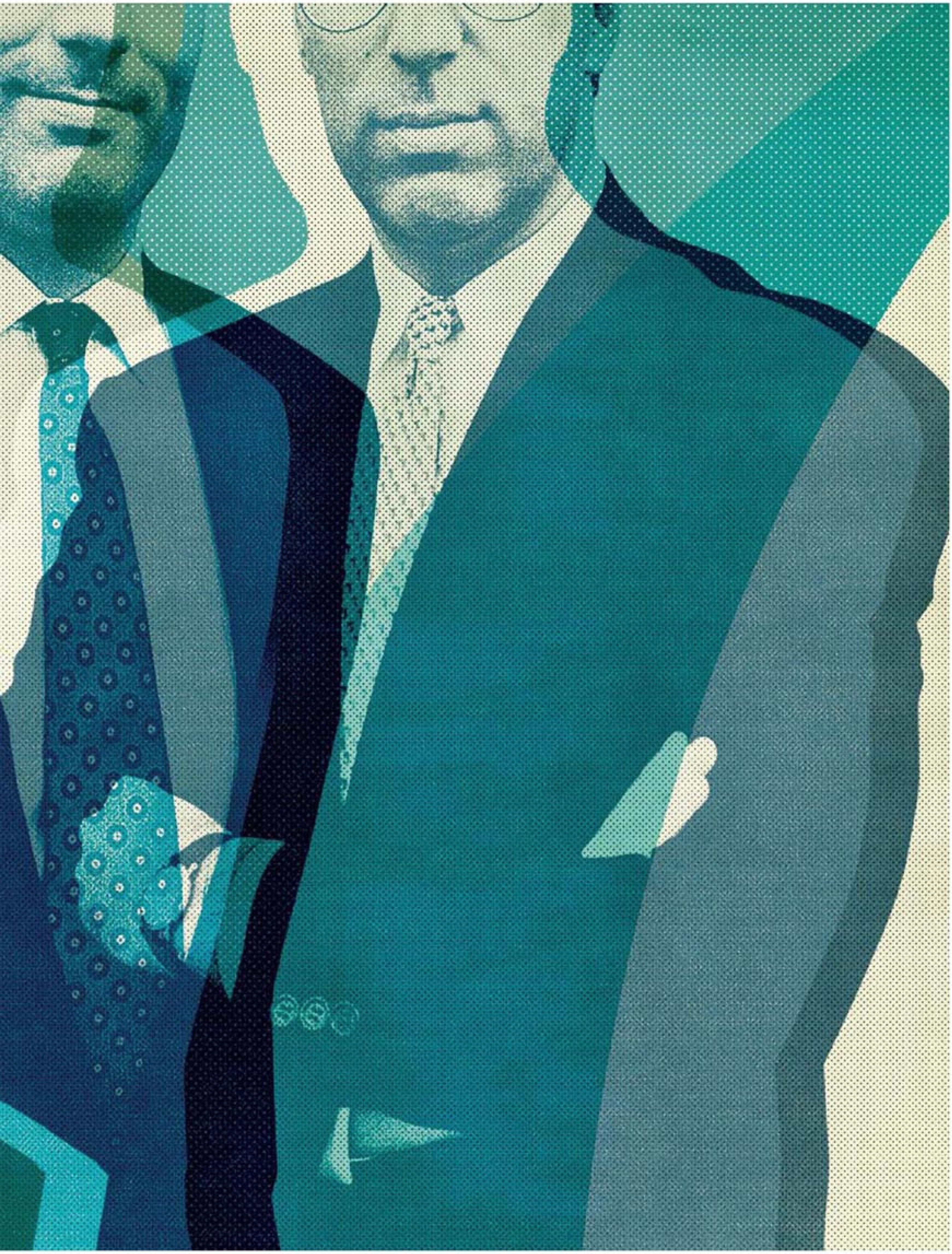
But despite its low profile, Danaher is probably the best-run conglomerate in America. It's clearly the best performing: Over 20 years, it has returned a remarkable 25% to shareholders annually, far better than GE (16%), Berkshire Hathaway (21%), or the Standard & Poor's 500-stock index (12%).

The Washington (D.C.) company is the brainchild of the obsessively private brothers Steven M. and Mitchell P. Rales. The onetime corporate raiders, who have not spoken to the media in more than two decades, have pulled off an unusual corporate metamorphosis. They have turned Danaher from a mere acquisition vehicle into a true-blue, cash-producing, publicly owned industrial manufacturer. In the process, the Rales brothers have become two of the richest people in the U.S., worth more than $2 billion apiece.

Unlike most other '80s-era raiders, Steven, 55, and Mitchell, 50, are so publicity-shy that it's almost impossible to find a photograph of them, alone or together. Many businesspeople have never even heard of them. But among both industrial and private-equity cognoscenti, their

Photo illustration from a 1988 picture of camera-shy Mitchell and Steven Rales

SEAN MCCABE



reputations are as big as their fortunes. "These guys are really good. There is no luck involved," says Mark D. Ein, a private equity investor at Washington's Venturehouse Group, who has known the Raleses for many years.

Steven and Mitchell Rales, who now serve as chairman of Danaher's board and chairman of its executive committee, respectively, declined comment. But in a rare interview, Danaher Chief Executive H. Lawrence Culp Jr. described the hard-charging business culture that has produced such remarkable results. In 2006, Danaher posted revenues of nearly $10 billion and net profit margins of 16%, truly astounding for a company still in such Old Economy businesses as heavy-truck braking systems and hand tools. Its return on invested capital is 15%, way ahead of its industrial peer group, which is near 9%.

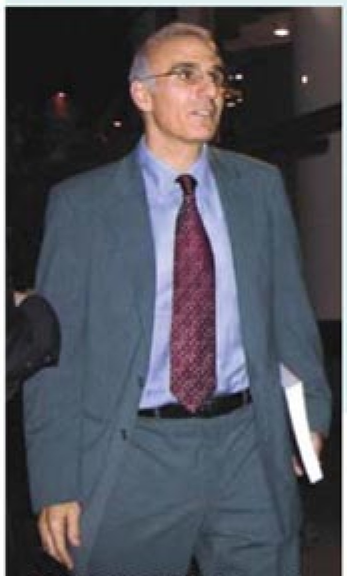
THE ANTI-BUFFETTS

SITTING IN DANAHER'S unassuming headquarters on the top floor of a glass office building (there's no sign announcing the company's presence), six blocks northwest of the White House on Pennsylvania Avenue, Culp sounded like a man who is hard to please. "There are a lot of companies where if you win 10-9, nobody wants to talk about the nine runs [they] just gave up," Culp says. "We'll celebrate the win, but we'll talk about 'How did we give up nine runs? Why didn't we score 12?'"

Think of Danaher as the anti-Berkshire Hathaway. Warren Buffett runs his empire like a benevolent curator. The Rales and their management team are "the polar opposites" of that model, says Ann Duignan, an analyst at Bear, Stearns & Co. These conglomerateurs have built their portfolio not by buying undervalued companies and holding them but by imposing on them the "Danaher Business System."

DBS, as it's called, is a set of management tools borrowed liberally from the famed Toyota Production System. In essence, it requires every employee, from the janitor to the president, to find ways every day to improve the way work gets done. Such quality-improvement programs and lean manufacturing methods have been *de rigueur* for manufacturers for years. The difference at Danaher: The company started lean in 1987, one of the earliest U.S. companies to do so, and it has maintained a cultish devotion to making it pay off.

BIOS MITCHELL P. RALES



COLLECTOR Mitch is on the National Gallery's board

AGE 50

EDUCATION BA, Miami University (Ohio), 1978; pledged Beta Theta Pi.

OUTSIDE INTERESTS Noted collector of modern and contemporary artists, including Mark Rothko and Willem de Kooning. Turned his Potomac (Md.) estate into Glenstone Museum, an invitation-only art sanctuary.

DEPTH OF POCKETS Danaher holdings worth approximately $2.2 billion.

Even before a deal is done, the DBS team, made up of managers throughout the company steeped in training, works with the acquisition target to inject a heavy dose of Danaher DNA. For employees at the newly acquired companies, it can be a jarring experience. It wouldn't be at all unusual for a Danaher manager clutching a clipboard, a tape measure, and a stopwatch, in a search for wasted motion, to tick off how many steps a data analyst has to take to get to the copier. Danaher also isn't afraid to swing the ax; it has, at times, bought certain product lines and shuttered the rest of a company. "Those guys have a very well-defined model of how to do M&A," says Jim McTaggart, founder of strategy consulting firm Marakon Associates, now part of Trinsum Group. "They do the strategy well, they price [deals] in a disciplined manner, and they integrate these things superbly."

Danaher's portfolio—with more than 600 subsidiary companies—reflects a move away from its hand-tool legacy to more technologically advanced products. The newest of its four units, accounting for 23% of sales, specializes in medical technologies. It includes Sybron, a dental-equipment maker, and Leica Microsystems, which makes high-end microscopes

TOP: DAVID VELASCO

From Microscopes To Periscopes

Industrial conglomerate Danaher is made up of a vast array of unsexy businesses, more than 600 in all. Here's a look at where it gets its nearly $10 billion in revenue:

INDUSTRIAL TECHNOLOGY
32.5% of sales
Parts for industrial machinery, such as actuators, motors, and ball screws. Aerospace and defense units make ejector seats and submarine periscopes.

Accu-Sort camera

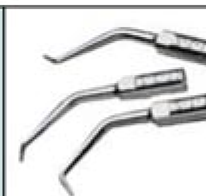
Kollmorgen motor

PROFESSIONAL INSTRUMENTS
30.3% of sales
Fluke manufactures test tools such as multimeters. Hahn and Trojan Technologies make water treatment systems. Gilbarco sells gas pumps.

Fluke clamp meter

Hach Guardian Blue Event Monitor

MEDICAL TECHNOLOGIES
23.1% of sales
The most recent strategic thrust, this unit includes Sybron, which makes dental tools, and Leica Microsystems, which makes high-end medical microscopes.



Sybron Endo CT tips

Leica microscope

TOOLS & COMPONENTS
14.1% of sales
Brands include Jobox industrial storage boxes, Craftsman tools, Jacobs Chuck drill parts, and Armstrong tools for professional mechanics.

Data: Company reports, Friedman Billings Ramsey

STEVEN M. RALES

AGE 55

FAMILY Oldest of four brothers; father, Norman, was a successful real estate investor.

EDUCATION BA, DePauw University, 1973; played football and pledged Beta Theta Pi. JD, American University, 1978.

OUTSIDE INTERESTS Named to *ArtNews'* top 200 collectors in 2006 along with brother Mitchell; recently began financing movies, including a forthcoming project by Wes Anderson, director of *The Royal Tenenbaums*.

DEPTH OF POCKETS Danaher holdings worth approximately $2.2 billion.

for pathology labs. Its most profitable division, professional instrumentation, includes Fluke, known to engineers for products such as multimeters. The company's industrial-tools division, though it only accounts for about 14% of sales, houses Danaher's most well-known brand, Craftsman hand tools. The rest of Danaher's business comes from industrial technologies, including machinery components and product-ID devices, such as Accu-Sort package scanners.

The Raleses didn't set out to build an empire. In the early 1980s they took a former real estate investment trust, turned it into a leveraged-buyout vehicle, and swashbuckled through the next few years, tacking assets on to their shell company through hostile bids, greenmail, and junk-bond financing, with Michael R. Milken's Drexel Burnham Lambert and First Boston as their bankers. They even crossed swords with Buffett, who swooped in as the white knight buyer of ailing consumer-products company Scott Fetzer Co. after Danaher tried to snatch it.

GOOD COP/BAD COP

ALTHOUGH THEY WERE NEVER flamboyant, their brash deal-making rubbed some people the wrong way. A 1985 *Forbes* article headlined "Raiders in Short Pants" suggested the Raleses were "callow youths," "more like real estate speculators than industrialists," and "cocky to the point of foolishness." Neither Mitchell nor Steven has spoken to the media since.

Around 1988, with the leveraged buyout market tanking and their fledgling company struggling under a heavy debt load, the brothers changed course. After a group of managers in one of their divisions, Jacobs Vehicle Systems, found early success by mimicking Toyota Motor Corp.'s lean manufacturing, the brothers decided to implement the Toyota system companywide.

Within a year, Danaher was reborn as a bona fide operating company. Soon after, in 1990, the Raleses ceded daily control to a chief executive, George M. Sherman, whom they hired away from Black & Decker Corp. Danaher, then and now, makes plenty of acquisitions, but it barely uses any debt to do so, even as the LBO market has swung back into favor. It's not that the company is debt-averse all of a sudden. It's the luxury of $1.4 billion in free cash flow.

Although they have long worked in tandem, Steven and Mitchell have distinct managerial personalities. "Steve is more strategy-oriented," says Friedman, Billings, Ramsey Group Inc. analyst Ned Armstrong. "Mitch is more operations-oriented." In practical terms, says ex-Danaher executive John A. Cosentino Jr., that meant "Steve was sort of the good cop and Mitch was the bad cop. If someone needed a course correction, Mitch might do that talking."

Jobox storage box

Armstrong wrench

TOP: COURTESY OF WALT WHITMAN HIGH SCHOOL; CHART BY ERIC HOFFMAN/BW

Despite their lack of industrial background, the Raleses had a near-instinctive affinity for lean manufacturing, say ex-managers. The process breaks from the traditional "batch-and-queue" manufacturing system, in which big lots of product are assembled in discrete steps. In a lean environment, a company moves a smaller flow of items through production. Wasteful steps are easier to spot. And if a mistake creeps into the process, it won't affect a huge amount of inventory and can be fixed quickly.

In a typical Danaher factory, floors are covered with strips of tape indicating where everything should be, from the biggest machine to the humblest trash can. Managers determine the most efficient place for everything, so a worker won't have to walk an extra few yards to pick up a tool, for instance. The lean attitude permeates the culture at Danaher—only 40 people work in the Washington corporate headquarters, at a company of 40,000.

Danaher takes great pains to instill its values in new employees. New managers are often sent to Japan, where they soak up the attitude of *kaizen*, or continuous improvement. In fact, Culp himself, fresh from Harvard Business School, started his tenure in 1990 at Danaher's Veeder-Root Co. unit by spending a week in Japan building air conditioners in a lean manufacturing plant.

TRACK RECORD

Danaher has outpaced bigger, better-known conglomerates such as Berkshire Hathaway and GE. Here's a look at its performance over 20 years.

Despite the company's early success at mimicking Toyota's operational acuity, the Raleses didn't seek distinctions like the Shingo Prize for Excellence in Manufacturing or the Baldrige Quality Award. "There was an active strategy of keeping it under the radar," says former Jacobs Vehicle president George Koenigsaecker, who now runs a private-equity firm, Lean Investment, in Muscatine, Iowa. They had two good reasons. First, according to former managers, the Raleses worried others would notice their results and copy the strategy. Second, they didn't want to be raided for talent.

Former Danaher executives credit the Rales brothers for having the smarts and self-confidence to cede daily company responsibility. Still, the two have influence over Danaher's direction and hold about 20% of the shares. Culp and his directors talk about strategy regularly, although the Raleses don't come into the office often. Nor do they sweat the day-to-day minutiae.

Steven and Mitchell have turned to other pursuits. In addition to Danaher, the brothers also control Colfax Corp., a

PLAYBOOK

M&A The Danaher Way

Lessons from a prolific, successful acquirer

FILL THE PIPELINE Always be on the prowl for deals. Danaher never lacks for ideas and doesn't have to do defensive mergers.

STAY DISCIPLINED Don't get emotional at the negotiating table. If the price gets too high, Danaher walks away.

INTEGRATE WELL Danaher adds value to acquired companies, using its "Danaher Business System" to boost performance.

Data: BusinessWeek, Trinsum Group

smaller, privately held conglomerate that hasn't shied away from using debt to pursue growth. Equity Group Holdings, the Raleses' private equity arm, shares space with Danaher on Pennsylvania Avenue. Both brothers are art enthusiasts and philanthropists. Mitchell, who was named a top 10 collector by *ArtNews* in 2003, recently turned his Potomac (Md.) estate, which housed a number of animals, including alpacas, into Glenstone Museum, a private art sanctuary. Steven has recently begun financing movies.

OPENING UMBRELLAS

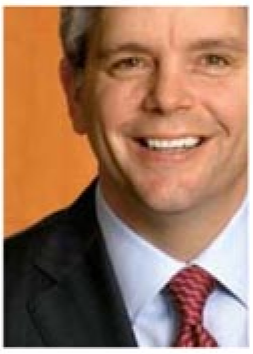
DANAHER HAS REACHED a crucial point in its short history. As revenue creeps toward $10 billion, its market cap has moved past $20 billion. The outfit's goal, set by Culp in the 2002 annual report, is to hit $25 billion in sales by 2012. At current growth rates, it's on track. But of Danaher's average annual 20% sales growth in the past five years, about 14% has come through acquisitions. As M&A gets more expensive, Danaher must either increase the pace of its deals or swallow bigger fish. And it may be more difficult to convert bigger companies with established traditions, entrenched cultures, and larger workforces to its fervent brand of lean manufacturing.

Danaher is a prolific acquirer, averaging about a deal per month. Most are small to midsize and supplement existing businesses. Danaher considers bigger deals, but only if they create new umbrellas under which more deals will fall. Fluke, for one, was a $625 million foray into more tech-intensive instruments.

Some analysts have raised eyebrows at the sizable goodwill on Danaher's balance sheet—$6 billion worth. But there haven't been any writedowns that would call into question the price paid for an acquisition. Part of the reason, perhaps, is the company's exacting, unsentimental M&A process. Before a deal, Danaher executives tour plants and search for ways to improve performance. They estimate how wide an acquisition target's profit margins could get, given the Danaher treatment. "That allowed us sometimes to bid more on an acquisition because we knew we'd get that value back," says Mark C. DeLuzio, president of Lean Horizons Consulting, who used to spearhead Danaher's DBS team.

When it bought Fluke in 1998, margins were 8%, much too thin for Danaher. As part of the team that managed the acquisition, Culp sought to boost that number to 20%. Many employees at Fluke, which had an engineer-centric culture where most good ideas got funding, said that couldn't be done without hurting quality and innovation. But under Culp, Fluke narrowed its product focus, sped up inventory turns, and reduced floor space. Now, margins in that segment are 21.5%.

In recent years, Culp has tried, with limited success, to stress organic growth to investors. Internal, as opposed to acquired, growth has been chugging along at a respectable 6% a year or so for the past few years. But that's not why the company has such a high price-earnings ratio: 23 times trailing earnings, vs. 18 for GE and 17 for 3M. One of the few Danaher bears, Prudential Equity Group analyst Nicholas Heymann, cites concerns over organic growth as a reason for his "underweight" rating. As Duignan of Bear Stearns puts it: "I think the biggest risk is that the acquisition pace slows because of competition."



CULP The CEO worked his way up the ranks

So far, that hasn't happened. The company's pipeline is well-stocked; Danaher walks away from more deals than it consummates. Its managers are determined not to lose their reputation for price discipline and rigorous execution. Of course, a continued ascent into the rarefied air of large conglomerates carries one big risk: It makes publicity-shy Danaher and the Raleses all the more conspicuous for their success.

An Analyst On the Attack

Richard Greenfield is an exception: A demanding and effective activist

BATTLER Recent targets include Viacom and Cablevision

BY ROBEN FARZAD

When Wall Street struck its $1.4 billion settlement with regulators in 2002, the deal was supposed to herald a new era for investment research. The big brokerages erected brick walls between analysts and bankers, and independent research shops popped up everywhere.

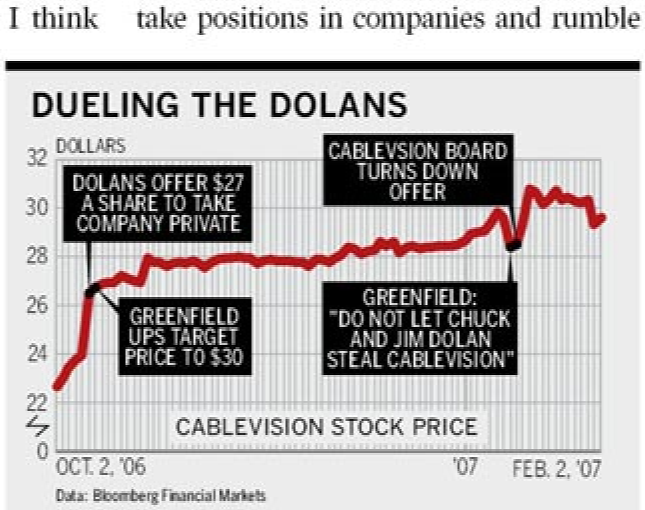
But for all that reinventing, the analytical path of least resistance still reigns. "We're trimming our estimate by a penny and maintaining our intermediate-term, trailing-12-month equal-weight rating, with a going-forward bias toward becoming aggressively neutral," a typical research note might read. There's good reason for the caution (and the kind of obfuscatory language that would rankle Charlie Brown's teacher). Even independent analysts rely on executives for access and information; alienating them can be a bad career move.

So Richard S. Greenfield of Pali Research stands out in the sea of noncommittal analysis by making pointed demands, the sort you hear from an agitating hedge fund manager. "I focus time and effort only where I think we can make clients money," he says. "Can we be activist? Absolutely."

Cablevision Systems Corp.'s controlling Dolan family found themselves in Greenfield's crosshairs in October, after attempting to take the company private for a share price of 27, a 17% premium over where the stock was trading. Greenfield thought the company could fetch as much as 40 if it opened bidding to outsiders, and he took management to task publicly. The Dolans, he argued, were positioning themselves to snag an extra $1.8 billion profit by flipping the company to Time Warner after taking it private. Sensing dissent in the boardroom, he urged the special committee of directors to seek a takeout price of 35, while upping his target twice based on the improving industry. The Dolans came back with a "best and final" offer of 30.

Many viewed the sweetened deal as a *fait accompli*. "A lot of the analysts were just resigned to the Dolans getting their way," says a big stockholder. But Greenfield reemerged to blast out a note entitled: "Do Not Let Chuck and Jim Dolan Steal Cablevision." He argued that the Dolans were "exercising poor corporate governance by publicly stating they would not sell the company [to outsiders]." Cablevision's committee turned down the bid four days later, and the stock shot above 30—vindicating Greenfield's claim the Dolans were holding it back.

Being a sell-side analyst usually entails a daily drip-drip of updating earnings models and issuing commentary on most every company in an industry. Now, like the rash of institutional investors who take positions in companies and rumble for change, Greenfield, a former Goldman Sachs analyst, is picking his battles.



Another recent target: Viacom Inc. In a July note, Greenfield lamented that no one at the lagging media conglomerate was "willing to stand up, communicate a concise global vision...and execute on that vision." Then he mockingly bulleted Viacom's "excuses" for poor growth before basically calling for the head of then-Chief Executive Thomas E. Freston: "If Mr. Freston cannot swiftly reorient Viacom, [the board] needs to find a new CEO and/or consider selling the company."

Two weeks later, Greenfield put out a note directed to Chairman Sumner M. Redstone titled "Dear Mr. Redstone: Take Viacom Private." When Redstone ousted Freston in September, Greenfield kept up the pressure, putting out recommendations tinged with an "I'm-watching-you" tone.

Last year he also flagged DreamWorks Animation SKG Inc. for allowing its majority investor to benefit from the falling stock price, and the IPO of Vonage, which has since plunged 70%. Says Greenfield of his MO: "If I'm not excited about the stock or feel I can't make a difference, then I'm just not going to cover it." The Dolans wish he didn't cover theirs. ■

PETER YANG

Where Dell Went Wrong

In a too-common mistake, it clung narrowly to its founding strategy instead of developing future sources of growth

JUSTIN SULLIVAN/GETTY IMAGES

BY NANETTE BYRNES AND PETER BURROWS

AT DELL, HOW IT ALL began is never forgotten. Even on Jan. 31, as founder Michael S. Dell returned to the role of CEO after 18 months of bad news and faltering financials, the press release trumpeted how, 23 years ago, Dell launched what would become a $56 billion business with just $1,000 and a simple idea. That stroke of genius—to bypass the middleman and sell custom-built computers directly to the customer—was one of the revolutionary business models of the late 20th century. Rivals from Hewlett-Packard Co. to IBM learned to fear its power. And once Dell began using the Internet to let customers configure their own PCs, no phone rep required, the company earned a place among other champions of the New Economy including Wal-Mart, Cisco, and Southwest Airlines.

Dell's storied beginnings have given way to another classic business tale, one far less happy. Like many long-forgotten former champions, Dell succumbed to complacency in the belief that its business model would always keep it far ahead of the pack. While Dell broadened its product line, it never dealt with the vast improvement in the competition or used its lead in direct sales and the cash generated to invest in new business lines, talent, or innovation that could provide another competitive edge. "Dell is a textbook example of single-formula growth: 'We make PCs cheap. This is what we do, and we do it a lot,'" says Jim Mackey, managing director at the Billion Dollar Growth Network, a research consortium focused on large-company growth. "You can grow very fast when you're on a single formula, but when you get to a certain point, you don't have the ability to create new growth."

Long-term success demands constant reinvention. Research done by Mackey and others shows that most fast-growing companies hit a point somewhere over $50 billion in revenue at which they falter. By then, growing apace demands billions of new sales every year. Rarely is the original, unchanged business model up to the job. The only way around the challenge: Nurture the next growth platform long before it's needed.

Most don't. Distracted by the demands of their current success, they are lulled into a false sense of security. "When it's all you can do to keep up with the growth your current business model is providing, you just don't feel that urgency," says Harvard Business School professor Clayton Christensen. "It's hard to get worried." He visited Dell's Round Rock (Tex.) offices in 1998 and again in 2000, and warned Dell and then-CEO Kevin Rollins that they needed to focus on growth five to eight years out, on the model that would augment their built-to-order machines. A great admirer of both men's intellect, Christensen says he naively hoped they would take his advice. Instead, Dell pushed its model into new types of hardware, such as storage, printers, and TVs, in the hopes of making easy profits by selling products made by other companies. In some areas, like printers and TVs, the customization that made a Dell PC seem special isn't a factor. In others, like services, low-cost competitors had a head start.

Dell focused on giving Wall Street what it wants: The highest possible earnings

Michael Dell maintains that his company's business model is still its key advantage. Dell, he says, has acquired too much middle-aged fat and lost the intense focus and drive that made it an icon. In his internal e-mail explaining the recent departure of CEO Rollins, Dell's

DELL He still sees his business model as a key advantage

founder promised that the company will fix customer support problems, boost its services business, and focus more on small and midsize outfits in addition to the megacorporations that bring in the bulk of sales. While he won't rule out big strategic shifts, such as a move into retail, Dell says: "I do think that Dell's core strengths historically will be its core strengths in the future."

Many critics say the problem is that the company didn't begin a more orderly evolution when times were better. For half a decade, it was the only major PC company that earned a profit. By cutting out the middleman and keeping research and development and inventory costs low, it often enjoyed profit margins 10 points higher than money-losing rivals. Rather than use that cushion to develop fresh capabilities, Dell gave its admirers on Wall Street and in the media what they want: the highest possible earnings.

Hubris crept in. In 1999, Dell bought a startup called ConvergeNet, which had a sophisticated storage product that turned out to be not ready for prime time. Dubbing rival EMC Corp. the "Excessive Margin Company," Dell seemed to expect storage to follow the same pattern PCs had, moving from pricey, feature-laden models into a standards-based commodity. Dell underestimated the competition and is an also-ran in the segment.

By 2005, PC rivals, particularly HP, which has taken the market-share lead from Dell, had closed the efficiency gap and were enjoying resurgent sales at retail stores.

PEOPLE-INTENSIVE

DELL'S LOYALTY to its business model could make it difficult to recapture growth. Dell has suggested a new offensive to enlarge its computer services business, which so far has focused largely on repair and upgrading of Dell's hardware. According to Bill Scheer, senior analyst at Kennedy Information Inc., which tracks information technology consulting, such "hardware" services are the slowest-growing segment of the \$147 billion market, currently increasing an estimated 6.3% a year, vs. 7.6% for the market overall. Hardware repair profits can be good, but don't lead to the massive deals that help sell higher-end hardware and software to tie it together.

Consulting experts say Dell will have a hard time moving up the value chain. For one thing, it's a people-intensive business that doesn't benefit from the company's expertise in efficient manufacturing. And when Dell first started making PCs, it entered an industry with lots of built-in fat, namely reseller commissions and retailer markups. Lower-end consulting has already been made far lower-cost and more efficient by companies like Wipro Ltd. and Infosys Technologies Ltd., which sell programmers' time at \$50 a hour that 10 years ago would've billed at \$125 an hour or more.

Dell has struggled to find other growth areas large enough to matter. After a promising start in printers, moving quickly to No. 3, the most recent quarterly data from research firm IDC shows Dell's market share at 3.6%, down from 6.2% the previous year. Its once-promising move into networking gear has fizzled, and its share in the storage systems market is flat compared with a year ago.

And Dell's management bench doesn't seem as deep as it should be. When Dell ousted its chief financial officer on Dec. 19, the company ended up filling the spot with an outsider, board member Don Carty, the former CEO of AMR Corp., the parent of American Airlines. Industry sources say many of the recent management departures were not terminations but rather people burned out by an increasingly dismal turnaround effort. Dell spokesman Bob Pearson says the company has good bench strength and "we feel fortunate that [Carty] could do this."

These are the kinds of challenges Dell was protected from for years. How well its founder handles them will determine whether his legacy is building a great company that lasts—or having a great idea that ran out of steam. ■

–With Louise Lee in San Mateo, Calif.

Second Thoughts

In the 1990s these companies rewrote the rules of business. But their big ideas have undergone a reassessment.

	WHAT WE THOUGHT THEN	WHAT WE THINK NOW
DELL	Merchandise sold directly by phone or the Internet would replace bricks-and-mortar stores.	People like live shopping, even for technology, and bad service makes them angry.
WAL-MART	The king of discounters had conquered supermarkets. Next, the world.	The Wal-Mart way hasn't translated well into all markets.
SOUTHWEST AIRLINES	The hub-and-spoke system was history, and discount airlines, hopping from airport to airport, would rule.	The Old Guard has risen from bankruptcy court, while Southwest's stock is in a holding pattern.
ENRON	"Asset-light" trading strategies can be applied to almost any market.	It's a far more limited idea than the Enron guys would've had you believe.
CITIGROUP	Sandy Weill had created a financial supermarket for the newly democratic world of investments.	Laser-focused traders and bankers at Goldman Sachs make out by sticking with lucrative investments.

Steve Jobs Changes His Tune

Why he's willing to jettison industry restrictions on copying music and video

Apple Chief Executive Steven P. Jobs stunned industry watchers on Feb. 6 when he urged the music industry to rethink its most fundamental antipiracy strategy. With the blessing of music companies, Apple's iTunes music store has thrived under a "digital rights management" system (DRM) that restricts how, when, and where users listen to the songs they purchase.

Now, in an apparent about-face, Jobs has called for a new model in which songs would be bought and sold without these DRM constraints. Here's why his pronouncement is causing such a stir:

What's behind Jobs' call for change?
Apple is under pressure from European governments to remove digital rights management technology from its iTunes Store so audio can be played not just on its dominant iPods but also on music players from rivals. Consumers have also complained that they should be able to do what they want with music they purchase.

What's all the fuss about DRM?
Consumers today have the ability to make pristine copies of music and video and distribute them over broadband connections in a matter of minutes or hours. Without restrictions on copying, content providers say they could be put out of business.

And why is it such a mess for consumers?
The biggest problem is the lack of a single, worldwide DRM standard that works on every device and download service. Right now, music purchased from Apple's iTunes store can be played on any combination of five iPods or computers, but not on any other music players. This is especially irksome when you have to lose or retire one of your legitimate devices. And under some DRM schemes, there are time limits. For example, you may only be able to view a downloaded movie for 24 hours after the first time you play it. Even if you are using only one service, the software may be buggy and confusing. This is all a huge step down from the world of compact discs, where you just buy the music, play it in any stereo, PC, or car system, and copy it as many times as you like.

Consumers want to do as they wish with the music they buy

Doesn't the very idea of digital rights management treat all people as if they were thieves?
It's not quite that bad. Many content providers believe consumers are entitled to fair use of their products, but they don't think people have an absolute right to do whatever they want with them once the money changes hands. Many providers are experimenting with pricing models that would charge a consumer based on intended usage, with some paying more for unlimited use.

But what's the point—haven't pirates and hackers managed to break all DRM schemes anyway?
As Jobs points out, all software can be cracked. Music labels themselves now seem to realize that the lack of a standardized DRM is hurting sales. But while DRM has not stopped rampant piracy, it has helped slow it. And a world with no DRM could be very tough for many businesses. Everybody loves free stuff, but the lost revenue could put some content providers out of business. They are testing out ad-supported revenue and pay-per-view models, but DRM remains a necessary evil until new models are in place.

Is there an alternative that can be used today?
The leading alternative at the moment is electronic watermarking, which allows content to be played anywhere but permits copies to be tracked to their source. It would be more onerous for content providers that need to do all the tracking, but it would create more choice for honest consumers.

If DRM goes away, how would Apple and Steve Jobs benefit?
Jobs' standing as a major advocate for the consumer could rise, even though Apple continues to tie its hardware closely to software and services. With or without DRM, Apple comes out looking like a winner.

–Cliff Edwards in San Mateo, Calif.

RAOUL MINSART/MASTERFILE

GILEAD LAB Its low R&D spending has worried investors

How Gilead Primed the Pipeline

Its $2.5 billion purchase of Myogen offers instant diversification from its HIV drug focus

BY ARLENE WEINTRAUB

THERE WAS PLENTY OF head-scratching on Wall Street last October when Gilead Sciences Inc. announced it would spend $2.5 billion to acquire Myogen Inc., a smaller biotech company. Myogen's annual sales are just $7 million. Its lead experimental drug will address only a tiny group of patients with a rare form of hypertension, and its second-most-promising drug faces an uncertain path to market. Myogen's shares soared 50% after the October announcement, while Gilead's fell 10%.

On Feb. 2 investors put Myogen concerns on the back burner after Gilead announced record annual revenues of $3 billion, up 49% from 2005, and profits that jumped 51%, to $1.2 billion, before acquisition charges and other expenses. Gilead is enjoying robust demand for its new HIV drug Atripla, a pill that combines three treatments in one. Its stock soared 11%, to 71, on the earnings report. Such performance has landed Gilead on the BusinessWeek 50 list of top-performing large companies two years in a row.

The acquisition of Myogen, based in Westminster, Colo., will help answer a question that has been dogging Gilead for years: How can a company that derives 80% of its sales from HIV drugs keep growing at double-digit rates? In the first nine months of 2006, Gilead spent just 13% of revenues on research and development—a level more typical of a stodgy Big Pharma company than a forward-thinking biotech. Myogen, along with a smaller acquisition Gilead made last year, offers instant diversification. Myogen researchers are developing drugs to treat respiratory and heart disease, giant markets with huge potential payoffs. "In one swoop, Gilead solved the pipeline problem," says JPMorgan biotech analyst Geoffrey Meacham.

THE BUSINESSWEEK FIFTY 50 The Best Performers

Myogen's most advanced experimental drug, called Ambrisentan, treats pulmonary arterial hypertension (PAH), a disease that strikes up to 1,000 people per year, causing severe breathing problems and, ultimately, heart failure and death. "It hits people in the prime of their lives," says Gilead CEO John Martin, adding that he hopes Ambrisentan will turn PAH from a death sentence to a chronic disease, much as Gilead's other drugs have done with HIV/AIDS.

GOLD MINE?

AMBRISENTAN MAY BE a niche product, but its advantages over existing drugs could make it a gold mine. Current PAH treatments can be toxic to the liver and sometimes clash with other drugs. Those risks "may be substantially lower with Ambrisentan," says Dr. Lewis J. Rubin, professor of medicine at the University of California at San Diego. Rubin treated patients as part of a clinical trial for which he received consulting fees. Gilead expects a verdict from the U.S. Food & Drug Administration later this year. Analysts estimate the drug could ultimately bring in annual sales of $500 million.

If Gilead can clear some hurdles, it could have an even bigger opportunity with Darusentan, a Myogen drug being tested in patients with uncontrollable high blood pressure. More than 2 million patients aren't helped by current drugs and are at risk of heart attack and stroke. Analysts estimate that Darusentan could be a billion-dollar hit. But the FDA is requesting that patients in the late-stage trial take the drug along with four other blood pressure treatments, all at the full doses. Most patients balk because such a regimen makes them feel sick. "It will be extraordinarily hard to enroll patients. So this is not a viable drug right now," says Gilead CFO John Milligan. Gilead is weighing alternative trial designs.

Investors who need reassurance that Gilead is not totally reliant on HIV drugs can look forward to trial data that the company expects to release this year for three hepatitis drugs and a cystic fibrosis treatment. Putting an exclamation point on its commitment to long-term growth, Gilead just opened a two-story lab that will house 100-plus scientists.

MARKHAM JOHNSON

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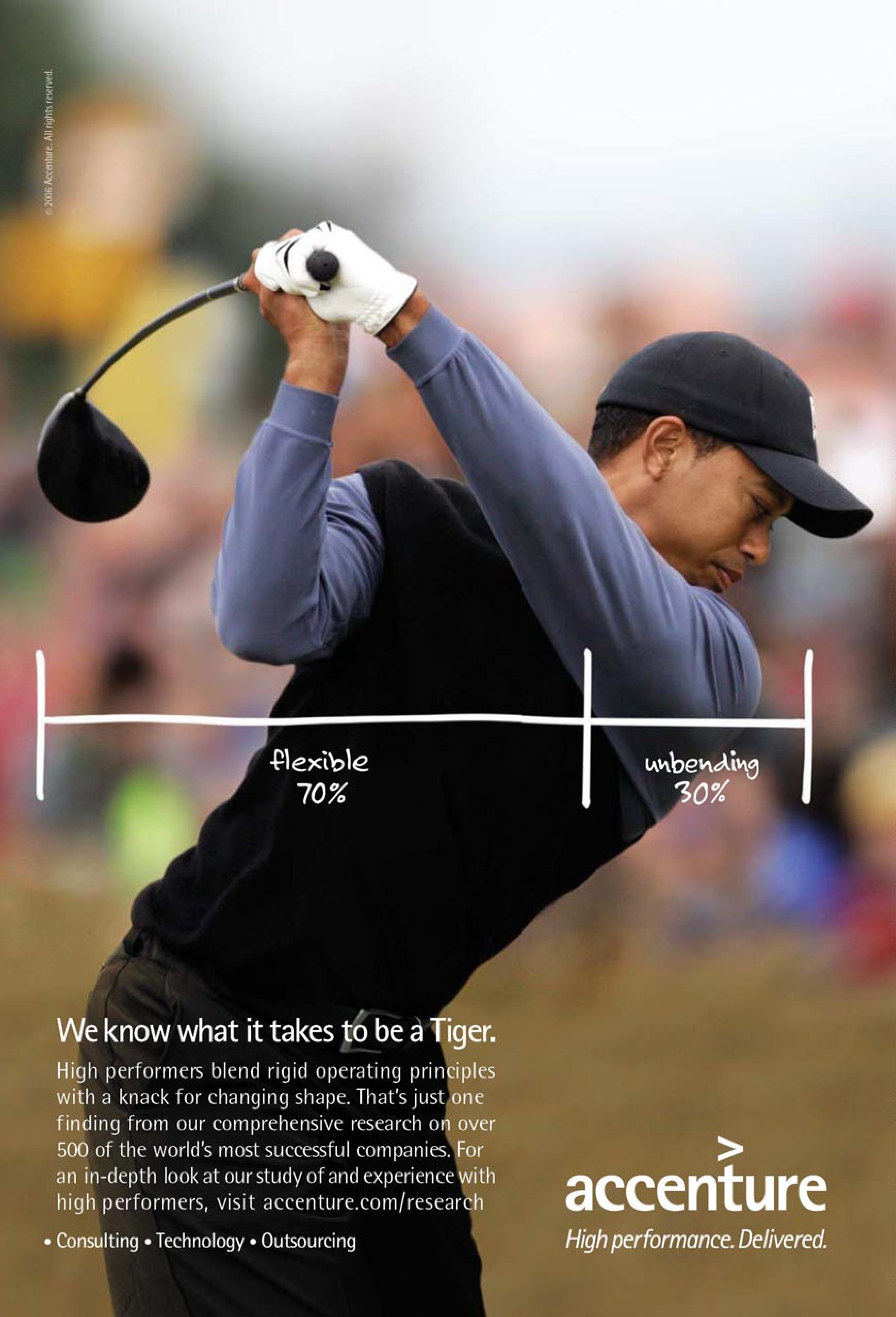
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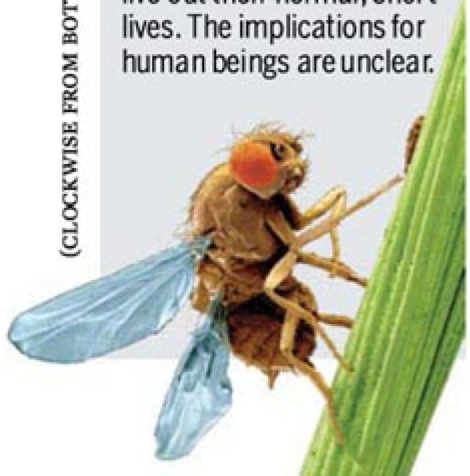
INNOVATIONS

Of compact biorefineries and risky smells

>> The military is always interested in ideas that will reduce the amount of diesel fuel and waste that soldiers must cart around. So Purdue University engineers have come up with a tactical biorefinery that solves both problems. About the size of a small van, it separately processes different kinds of trash—food waste, paper, and plastic—into biofuels. Food scraps are fermented into ethanol in a bioreactor, while paper and plastic are refined into fuel that can be burned in a diesel engine to power an electric generator. In tests last fall, the biorefinery produced 90% more energy than it consumed.

>> Scientists have shown that slashing calories can extend your lifespan, at least if you're a fruit fly. But be careful what you sniff. Experiments conducted at Baylor College of Medicine in Houston suggest the faintest whiff of food may be enough to lessen the benefits of caloric restriction. When the scientists exposed batches of long-living, calorie-starved flies to yeast smells, their lifespans shrank significantly. The smells had no impact on well-fed flies, which continued to live out their normal, short lives. The implications for human beings are unclear.



(CLOCKWISE FROM BOTTOM LEFT) EYE OF SCIENCE/PHOTO RESEARCHERS INC.; JEFF SMITH/ALAMY; STOCKBYTE/CORBIS

VISION THING

CAT'S-EYE MARVELS

IN ADDITION to acting eerily human, cats have something important in common with people: their eye structure. So a team of scientists at the University of Missouri at Columbia is using cats to test tiny implantable microchips that could one day treat patients with retinitis pigmentosa, a disease that causes progressive sight loss. The chips contain thousands of diodes that convert light into electrical signals, which then stimulate still-healthy cells so they can better transmit visual information to the brain. This summer, the scientists will study the cats' behavior to determine how much their sight has improved.

–Arlene Weintraub

SEA BREEZES

PLENTY OF POWER JUST OFFSHORE

A SUPER WEAPON in the fight against climate change is blowing just off the coast. In waters stretching from North Carolina to Massachusetts, there is enough wind power to replace all of the region's fossil-fuel power plants and more, says a new study from the University of Delaware and Stanford University. In reaching this assessment, the group excluded deepwater and off-limit zones, such as shipping lanes and spots visible from tourist beaches. Their model showed 330 gigawatts of potential wind power, or four times the area's existing generating capacity—plenty to heat and cool buildings and to power electric cars for everyone. Offshore energy could help the region's 63 million people cut greenhouse gas emissions by 57%, says team leader Willett Kempton, a professor of marine policy at Delaware.

–Adam Aston

PHARMACOLOGY

BEAMING IN —TO SPOT FAKE PILLS

FRAUDULENT DRUGS place lives at risk and cost the pharmaceutical industry billions every year. The Food & Drug Administration estimates some 10% of all drugs sold are phony, and the percentage may be much higher. Yet it's difficult to spot the fakes, in part because elaborate tamper-proof packaging makes it hard to get at samples to test them.

Now scientists say they have a way to take a "chemical fingerprint" through the plastic or glass that encases the pills. It's a variation on an old technique called Raman spectroscopy, and it works by focusing a laser several

millimeters beyond the pill's packaging to sample the chemicals that make up the medicine itself. Older laser techniques were "like trying to see a candle against the sun," explains Pavel Matousek, a research scientist at Britain's Rutherford Appleton Laboratory in Didcot, where the process was developed. "What we are doing is moving the candle against a darker background." The process could also help find explosives hidden in the packages.

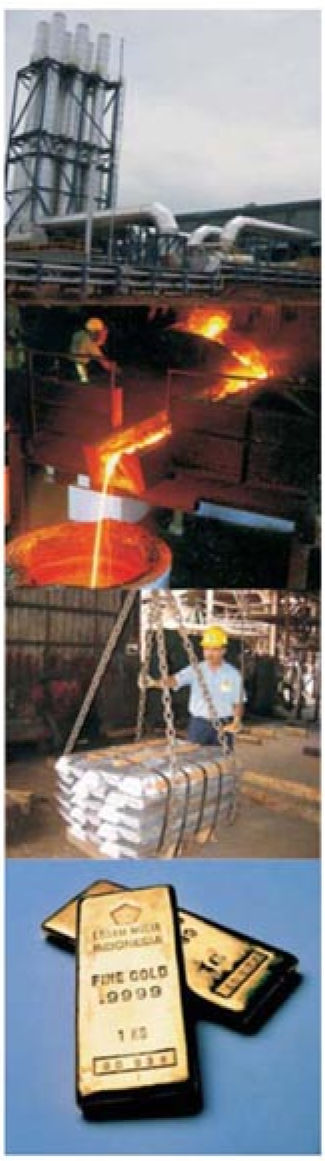
–Eric Schine

Introducing a new symbol of excellence in international mining...

We are Antam, we find, make and export valuable metals to customers around the world and our performance, growth plans and market capitalization* keep getting better.

. . . It was time for a better logo.

We are proud to present our new logo which more accurately reflects where we are now and where we are going. This change is part of the many exciting developments happening at Antam.

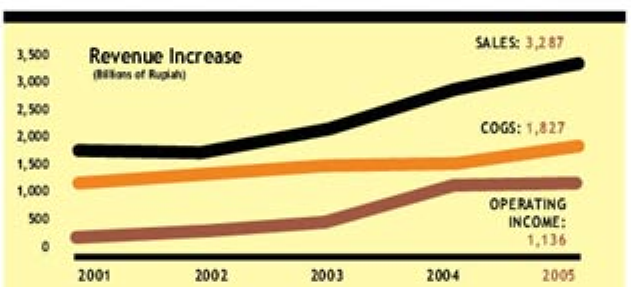


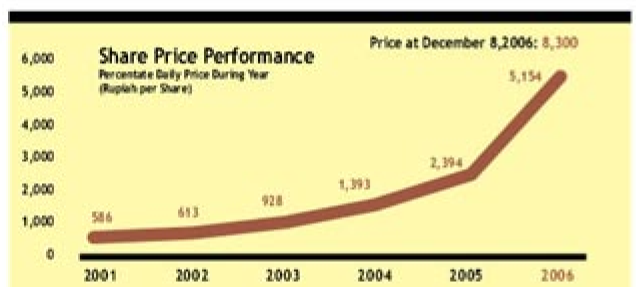
Our new logo is composed of three mountains, representing the rock/mineral source and diversity of Antam's products. The mountains themselves rise from an arc which represents nature with the reflection of the three mountains representing the mineral resources inside the earth. This logo represents a modern dynamic, environmentally responsible and community caring Antam. The symmetrical shape of the logo and the style of the logotype conveys a sense of harmony, stability, strength, and solidity, even friendliness. As well, the logo captures many of Antam's attributes such as mining, diversified, established, professional, prudent, trustworthy, progressive, dynamic and open.

Antam's President Director, D. Aditya Sumanagara said, "we trust our new logo will become a symbol of excellence in the mining and metals processing sector, for everyone from our customers and suppliers, to our local communities and to our shareholders"

We are a vertically-integrated diversified, financially sound, growth-oriented, mining and metals company with vast reserves spread throughout the mineral rich Indonesian archipelago. We are listed in Australia and Indonesia and our shareholders have come to know the value we can deliver, in terms of dividends, profit growth, wide margins and good returns. Our share price has outperformed similar companies and the Jakarta Composite Index for the past three years.

We are experts of mining and metals processing, are expanding our operations and should all go according to plan, we will make more money in 2006 and still more in 2007.





* "Mine Indonesia 2005", PricewaterhouseCoopers, 2006. The average net margin in 2004 was 15% for the Top 40 Global mining companies and 19% for Indonesian mining companies. The average return on equity in 2004 was 19% for the Top 40 Global mining companies and 27% for Indonesian mining companies. Antam beat the industry in terms of margins and returns.

Fully Listed in: Indonesia: (ANTM) / Australia (ATM). This communication is not an invitation to engage in, nor advice related to, any kind of investment activity. It is for information purposes only. Queries related to investment activities should be addressed to a licensed broker.

PLEASE CALL US FIND OUT MORE ABOUT ANTAM AND ITS FUTURE:

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Soaring Where Boeing Struggled

How spin-off Spirit AeroSystems built a new model for worker-management cooperation

BY STANLEY HOLMES

FOR UNION WORKERS, A new corporate owner usually means one thing: mass layoffs. So it comes as quite a surprise that, after buying Boeing Co.'s Wichita aircraft plant, the Toronto private investment firm Onex Corp. kept on most of the 4,000 employees.

Of course, the Machinists union wasn't happy that more than 800 people lost their jobs. But the new owners helped ease the pain by giving the remaining workers $246 million in cash and stock options. The money was a reward for helping the company, now named Spirit AeroSystems, cut costs and pull off a successful initial public offering. "I can't tell you what a thrill it is to give our organized workforce nearly $250 million," says Seth M. Mersky, an Onex managing director.

JET PARTS Machinists at the Wichita facility

The comity between Spirit management and the International Association of Machinist & Aerospace Workers is partly a sign of the times. The commercial plane business is booming, which is why Spirit expects to post a 2007 profit of $260 million on projected revenues of $4.1 billion, up from about $3.2 billion in 2006. That won't last forever. But for now the unusual deal is being widely praised as a promising new labor model. No one is more bullish than the man who helped put it all together, former Democratic House Minority Leader Richard A. Gephardt of Missouri. "It is what we are going to have to do in a lot of our industries to be globally competitive," says Gephardt, who is a consultant with Goldman, Sachs & Co. "It aligns [workers] with the company and gives them a fair reward for their contribution."

This improbable story began several years ago, when Boeing, in a bid to shed weak assets and outsource more of its manufacturing work, decided to sell its uncompetitive Wichita plant. Although it was Boeing's biggest internal supplier, cranking out fuselages and nose cones, it suffered from inflexible work rules, high wages, and testy labor relations.

Enter Mersky and fellow Onex Managing Director Nigel S. Wright. Where Boeing executives saw lemons, the two turnaround specialists saw lemonade. They reasoned that if they could cut costs, make the plant more productive, and start working for Airbus, defense contractors, and regional jetmakers, the Wichita plant could become profitable.

INNOVATION CASE STUDY

But first Onex had to get costs under control. The firm saved $40 million annually by slashing corporate overhead costs inherited from Boeing. It negotiated price reductions from Spirit's suppliers and simplified the procurement process. It managed to reduce the complexity of work rules, reducing 160 job classifications to 13. Finally, it asked the unions for a 10% wage cut to better reflect the prevailing wages in the area and told them it would reduce the workforce by 15%.

SHARING THE PAIN

ONEX, WHICH SOUGHT the union's support, lost the first vote with the Machinists. Many workers came from third- and fourth-generation Boeing families and wanted to stay with the giant. "It was tough on people," said Ron Eldridge, the Machinists' aerospace coordinator for Wichita. "It was like an ugly divorce." The managing directors approached R. Thomas Buffenbarger, international president of the union. "They asked: 'What's it going to take?'" Buffenbarger recalls. "I said, 'If you want to share some of the pain, then give us a stake in the enterprise.' They warmed to it quickly."

A new deal was negotiated: For the wage and job cuts, Onex offered union members a 10% equity stake in an eventual IPO. The new owners sketched out a scenario where workers could earn some $30,000 in stock and cash over five years as long as the IPO was successful.

Now, 18 months later, the bargain has exceeded everyone's wildest dreams. An IPO on Nov. 21 raised $1.4 billion. Each Machinist is about to receive $61,440 in cash and stock. Given Boeing's backlog of orders, plus a surge of defense-related spending, analysts figure Spirit's stock will do well in the next few years. That should buy the company goodwill for when the industry hits the skids.

Hot News In Nowheresville

Fortress' GateHouse Media is snapping up small-town papers—and turning a nice profit

BY TOM LOWRY

FOR THE PAST YEAR OR SO, private equity firms have spent tens of billions of dollars acquiring some of America's most storied businesses. Fortress Investment Group, meanwhile, has been doing due diligence in places like Sleepy Eye, Minn., Heber Springs, Ark., and Canandaigua, N.Y. Quietly and methodically, the New York private equity firm has assembled the largest collection of small-town newspapers in the U.S.

Through GateHouse Media Inc., Fortress controls more than 400 publications, from Michigan's Upper Peninsula to the California desert. This year the company is expected to generate \$23 million in net earnings on \$400 million in revenues. GateHouse went public in October, raising \$248 million, before Fortress, which still holds a 60% stake, resumed gobbling up local papers.

Given the parlous state of the newspaper industry, sinking money into print may seem contrarian, crazy even. But as national chains are broken up and young readers and advertisers flee to the Web, Fortress has spotted an anomaly: There's good money to be made publishing newspapers in small towns and exurbs.

These are places where readers are loyal and plentiful. And local advertisers are keen to reach them. GateHouse's growing grip on local advertising dollars could soon be giving big dailies headaches in some markets. It also could put a crimp in plans by Yahoo! Inc. and Google Inc. to colonize the local ad business. Yes, GateHouse lacks the scale of a giant like Gannett Co. But its local papers generate margins of up to 40%, double that of some big-city dailies. "These newspapers are the dominant media in their towns," says GateHouse Chief Executive Mike Reed. "That's why we never look at a market and say it's too small."

Fortress' newspaper play marks its first foray into the media business—and the firm hired Reed for his experience running an Alabama-based newspaper chain. Nine-year-old Fortress, which itself is in the midst of going public, owns seven public companies, including the jet-leasing outfit Aircastle Ltd. and Brookdale Senior Living Inc., a national chain of retirement communities.

CHRIS USHER

'These newspapers are the dominant media in their towns'

FAITHFUL READERS
In Waynesboro, Pa., 70% of the citizenry reads *The Record Herald*

Fortress declined to comment for this story, but it has a reputation for holding and managing companies for the long haul—and paying decent dividends. Peter Appert, a Goldman Sachs Group Inc. analyst who has a buy rating on GateHouse, notes this is unusual in the private equity world. "Others haven't duplicated this widely," he says.

From the start, Fortress has gone after publications with little or no competition and then bolted them together in regional clusters. Doing so allows Fortress to cut costs by consolidating back-office operations and use the savings to build a strong online presence. In June, 2005, Fortress made its first move, purchasing Liberty Group Publishing Inc., a Northbrook (Ill.)-based chain of small-town newspapers, from Leonard Green & Partners. The deal got little attention at the time—which was just fine by publicity-shy Fortress. But the acquisition became a key building block as the private equity firm began constructing its newspaper empire.

What did Fortress executives see that so many didn't? For starters, they noticed that a medical and technology services boom was drawing thousands of people to Rust Belt towns that had once seemed terminal. Take Honesdale, Pa., a former railroad hub. There, a major hospital expansion and flourishing office parks have supercharged the local economy. Meanwhile, the area has become an admittedly distant suburb of New York City. Today the region boasts the state's fastest-growing population. Fortress owns a daily there called *The Wayne Independent* and a weekly, *The News Eagle*.

Fortress noticed that these places, despite their rapid growth, fell into something of a media no-man's-land. The big dailies and network TV didn't provide much in the way of local coverage. Meanwhile, the cable and phone companies so far have deemed it insufficiently profitable to roll out broadband in some of the more remote towns. So people rely on the local rag, and in hamlets like Devils Lake, N.D., and Waynesboro, Pa., 70% of the people are reading it. By contrast, a big-city daily is lucky to get 40% of the market.

BUNDLING THE HYPERLOCAL

HENCE, GATEHOUSE'S so-called hyperlocal strategy. Editorially, that means if a fistfight breaks out at the school board meeting, the news goes on the front page. Pee Wee football? Huge news, especially for parents hoping their ball-spiking kid gets major play on the sports page. *The Bastrop Daily Enterprise* in Louisiana recently featured a front-page story about a man who won a radio station contest and a trip to the Grammy Awards.

Big papers have been losing national advertisers to cable TV and the Internet, and classified listings to the likes of Monster.com and Craigslist. But local hardware and grocery stores rely on the hometown paper to advertise their price specials. "We are in a town of 10,000, and the local paper is maybe 8 to 10 pages. People will read that," says Randall Jones, a dentist in Arkadelphia, Ark., and a regular advertiser in the *Arkadelphia Daily Siftings Herald*. "Our message would be lost in a larger newspaper."

GateHouse is going after regional advertisers as well. For example, 125 of its local publications, including *The Patriot Ledger* in Quincy, Mass., now form a ring around Boston. GateHouse can offer an advertiser, say Macy's, a package deal for all its Boston-area newspapers and Web sites. Look out, *Boston Globe* and *Boston Herald*.

For the time being, Google and Yahoo present no real challenge to GateHouse because they lack sales reps in Smalltown, USA. Not that Fortress is taking any chances. It's starting to publish its online content under Creative Commons licenses, whereby copyrights are waived and anyone can pick up stories for noncommercial use—a boon to local bloggers. Reed says making content freely available will bring more eyeballs, attract new advertisers, and allow it to raise rates.

As Fortress continues to add to the GateHouse empire and consolidate operations, there is always the temptation to take an ax to newsroom operations. Clear Channel Communications Inc., after all, vowed to stay local when it was rolling up stations in the late 1990s, only to homogenize lots of programming to save a buck. "Good journalism is our duty," Reed contends. "If we don't do that, we know we will lose our readership in buckets."

Journalists have heard this before, of course—most recently from Brian P. Tierney. He bought up Philadelphia's newspapers and vowed to do good journalism, but ended up laying off dozens of reporters and editors. Fortress seems less likely than its private equity counterparts to cash out quickly. And it may have bought peace with GateHouse shareholders; in October, Fortress issued an annual dividend of $1.28—not bad for a stock trading at about $19.

Still, the company needs to keep the deal machine revved up. GateHouse must generate sufficient cash flow to pay down $560 million in debt (a debt-earnings ratio that's twice the newspaper industry average), continue to invest in new Web initiatives, and keep those dividends coming. CEO Reed will be spending a lot of time on the road, scouring the country for deals. They shouldn't be hard to find. Fully 8,000 daily and weekly newspapers still roll off the presses in the U.S. And many do business in the outposts that GateHouse considers its sweet spot. ■

Extra! Extra! Private Equity Loves Local

Since buying a local newspaper company 18 months ago, Fortress Investments has been on a tear. Its holdings now include:	75 DAILIES	231 WEEKLIES	230 LOCAL WEB SITES	117 SHOPPING GUIDES	2 BUSINESS DIRECTORIES

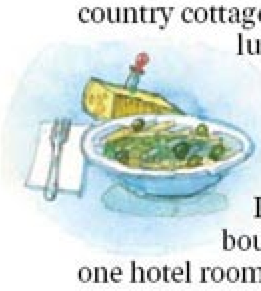
Data: GateHouse Media Inc.

A Villa of Your O

Thanks to the Internet, European vacation rentals from Tuscany to

YOU'VE JUST finished a leisurely gourmet dinner, washed down with the best local wine. Now you and your guests are enjoying coffee on your terrace overlooking...a Tuscan vineyard? A lavender-scented Provençal hillside? The Aegean or the Costa Brava?

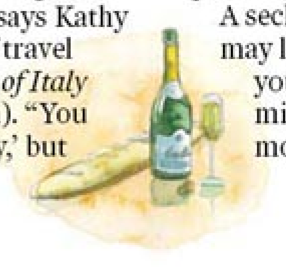
Living like this—for a week, anyway—has never been easier. For decades, Europeans have planned their summer holidays around a rented vacation house, whether a humble country cottage or a luxurious villa staffed with cooks and house-keepers.



Instead of bouncing from one hotel room to the next, they settle in for a nice long stay to unwind and soak up the local ambience.

Before the Internet, this quintessentially Old World experience required considerable resourcefulness or money to plan from afar. But now, tens of thousands of European properties, once advertised only by word-of-mouth or in local-language publications, are listed on English-language Web sites. A bevy of rental agencies with names such as "Tuscan Dream" and "Villa Vacations" has sprung up to service fast-growing demand. Without leaving your desk, you can browse through photos, compare prices, read other travelers' reviews, and book the vacation rental of your dreams.

The hard part is knowing where to start looking. "It's really daunting," says Kathy McCabe, editor of travel newsletter *Dream of Italy* (dreamofitaly.com). "You could say 'Tuscany,' but there are something like six different areas in Tuscany."



Before starting your search, consider a few basic questions. Town or country? A secluded country estate may lose its charm if you have to drive 20 minutes to buy your morning croissants or two hours to the nearest museum. Coastal or inland? If you absolutely must have a beach nearby, count on paying at least 50% more than for a comparable house an hour's drive inland. "On the Côte d'Azur we're talking a minimum 15,000 euros [about $19,000] a week for

ROBERT HARDING PHOTOGRAPHY/PUNCHSTOCK; INSET: COURTESY HOLIDAY RENTALS

wn–for a Week

the Costa Brava are easier to find from afar. **BY CAROL MATLACK**

ITALIAN HOLIDAY Waterfront rentals often cost 50% more than inland properties; (below) a Positano villa

a three- or four-bedroom house," says Janette Gimbert, managing director of the Royal Villas Europe, which handles upscale rentals around the Mediterranean (royalvillaseurope.com).

Most experts advise first-timers to book through a travel or vacation-rental agency. "An agency will work with you to determine what you are looking for," while offering extras such as booking tours or hiring a chef to prepare your meals, says Pauline Kenny, founder of slowtrav.com, a Web site offering tips, travelers' reviews, and classified ads for European rentals.

How do you choose an agency? Reputable ones should be willing to supply references from previous renters. They should also provide numbers you can call for English-language assistance in case of emergencies such as plumbing and electrical problems. If you've already pinpointed the region where you want to rent, find an agency specializing in that area, which will probably have a wider selection of offerings and better-informed staff.

Sure, agencies charge extra. That's why more seasoned travelers often rent directly from owners who offer their houses online, often while listing the same property through an agent who rents it for 50% more.

France has an especially well-organized system for such rentals, or *gîtes*—a term that covers everything from converted garages to châteaux. Stu Dudley, a retired software executive from the San Francisco Bay area, has rented 22 *gîtes* over the past decade, including properties with swimming pools and drop-dead gorgeous views for less than $1,000 a week. More than 44,000 houses are listed on gites-de-france.fr. The site has an English version, and you can search houses by location, price, and amenities. Most can be booked online. The downside of renting directly from owners: the higher potential for unpleasant surprises, from a lumpy bed to a noisy nearby road.

Almost all European properties are rented on a weekly basis, from Saturday to Saturday. Although dishes and cutlery are supplied, household items, such as toilet paper and soap, and kitchen basics, such as salt and coffee, usually aren't. You sometimes have to rent towels and bed linens, and you usually pay extra for a cleaning service at the end of the rental. Most European villas have neither air conditioning nor window screens, so do research on the local climate before choosing when and where to rent.

Some surprises are pleasant. A house I rented in France's Dordogne region was next door to a cave decorated with prehistoric drawings of human and animal figures. The site wasn't listed on local tourist maps, but a small sign in front of the gate directed us to the house of the caretaker, an elderly neighbor who sold us tickets for the equivalent of a few dollars and let us inside to look around.

With a bit of planning, you can join the growing corps of satisfied renters. People who have rented, Dudley says, "never want to do the hotel thing again." One big attraction for Dudley and his wife is the chance to prepare meals with foods bought at local French markets.

Don't delay if you're considering a rental for this summer. Choice properties are often booked up a year in advance. So pour yourself a glass of wine, boot up the computer, and start surfing. ■

–With Daniel Carlin in Paris

BusinessWeek.com

ONLINE: For tips on renting in Europe, go to **www.businessweek.com/extras.**

TELEVISION: Looking for a summer rental in the U.S.? Watch *BusinessWeek Weekend.*

BY MIKE MARRONE

Two Voices that Command Attention

IN MY SIX YEARS at XM Satellite Radio, I have been involved in numerous live sessions. Each time, I asked the artist to do a recorded introduction of his or her favorite songwriters and singers for future use. More pieces of audio at my channel are labeled "Introducing Patty Griffin" than "Introducing [Anyone Else]." I think Steve Earle said it best on a fan Web site, pattygriffin.net: "I suspect Patty Griffin's songs make most people a little uncomfortable—like they've just walked in on a private moment in someone else's life and they know they should turn around and tiptoe away, but they can't. They make me jealous."

Children Running Through is Patty's fifth studio album release since her striking 1996 debut, *Living With Ghosts*. Although Patty has been nominated for two Grammy Awards, her name is still not widely known to the general public. But most people have certainly heard a few of her songs. The Dixie Chicks, Martina McBride, Linda Ronstadt, Mary Chapin-Carpenter, Bette Midler, and Emmylou Harris (who guests on this release) have all recorded versions of her material. Her music has also been used in television and film, including Cameron Crowe's 2005 film, *Elizabethtown*.

FORCES Many artists have recorded Griffin's songs. Gardot's following is growing

Whenever my father caught Ella Fitzgerald on television he would say: "I would pay money just to listen to her sing the phone book." I feel that way about Patty Griffin. Her voice is like a hurricane wrapped in velvet. From the sassy and subtle funk of *Stay on the Ride* on the new album to the stark, heartfelt drama of *Burgundy Shoes* and the delicate beauty of *Railroad Wings*, her phrasing and command leave you holding your breath at the end of the song, whether she is belting it out or whispering in your ear.

PATTY GRIFFIN
Children Running Through
ATO RECORDS

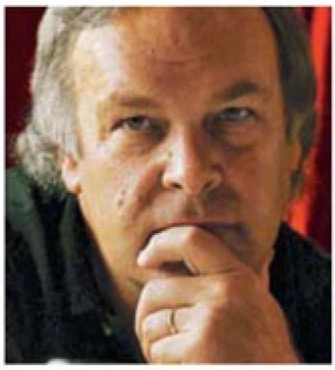
MELODY GARDOT
Worrisome Heart
SELF-RELEASED

Patty co-produced *Children Running Through* with Mike McCarthy. In addition to Emmylou, former Faces piano player Ian McLagan sits in on two highlights: the first single, *Heavenly Day*, and gospel-tinged *Up to the Mountain (MLK Song)*, inspired by Dr. Martin Luther King Jr.'s final speech. If you have never heard Patty Griffin sing her songs, don't wait any longer. This just might be her finest work to date.

TWENTY-TWO-YEAR-OLD Melody Gardot came to my attention through her work with Phil Roy (BW—Nov. 20). Falling somewhere between jazz and blues in a place where Billie Holiday meets Tom Waits, she also has moments that recall pieces of Nina Simone, early Rickie Lee Jones, and even the sophistication of Cole Porter. Only two years removed from a devastating traffic accident (her bicycle was hit by a car) that has left her in need of a cane and dark glasses, Melody has channeled her recovery into a remarkably mature recording, *Worrisome Heart*. Songs such as *Quiet Fire, All That I Need Is Love, Love Me Like a River Does,* and the title track have been causing our request lines to swell, and there are plenty more highlights on the set. Go to melodygardot.com for music and video samples, as well as the full story of this promising new artist. ■

__Mike Marrone__ is program director of XM Satellite Radio's The Loft, a channel that focuses on an eclectic mix of singer-songwriters from the 1960s through the present.

(CENTER) TRACI GOUDIE



BY ROBERT PARKER

From Russian River With Love

TOM DEHLINGER, who has been fashioning wines in Sonoma's Russian River region for over three decades, remains one of Northern California's most unassuming winemakers. A true friend of wine lovers, he makes high-quality wines that sell at fair prices. Like many of the finer California vintners, Dehlinger markets to select distributors, top restaurants, or to the public via mailing lists. Visit his Web site, dehlingerwinery.com, for information on purchasing the wines.

2004 Chardonnay Estate

92 points. A light green/gold color is accompanied by orange and lemon blossom, crushed rock, white currant, and spring flower characteristics. Full-bodied and rich with wonderful acidity, it keeps its fruit and minerality in the foreground, and the oak component (25% new) is well concealed by the intense flavors. This beauty should drink nicely for three to four years or longer. $32

2003 Syrah Goldridge Vineyard

90 points. The dark ruby/purple wine has a big nose of charcoal, blackberries, new saddle leather, and meat scents. Medium- to full-bodied, soft, and supple, it is already accessible. Enjoy it over the next five to six years. $35

2004 Pinot Noir Goldridge Vineyard

90 points. The dark-ruby-hued pinot noir shows the cherry/pomegranate side of this varietal. Spicy and medium-bodied with abundant fruit as well as complexity, it should drink well for seven to eight years. $39

2003 Syrah Estate

92 points. This wine exhibits excellent concentration as well as nuances of acacia flowers and meat. With a terrific texture, loads of blackberries and glycerin, and a heady finish, it should drink well for seven to eight years. $39

2003 Cabernet Sauvignon Estate

92 points. There are only 450 cases of this inky blue/purple-colored beauty. Aromas of blackberries, blueberries, licorice, chocolate, and espresso are followed by a dense, powerful yet elegant cabernet that is reasonably light on its feet. Sweet tannin and fabulous concentration suggest it will age well for 15 or more years. $42

2004 Pinot Noir Estate

91 points. Full-bodied and intense with superb elegance, complexity, and texture, it reveals abundant black fruits in the nose along with hints of forest floor, herbs, and earth. It should drink beautifully for a decade. $43

DEHLINGER Tom and Carole in their vineyard

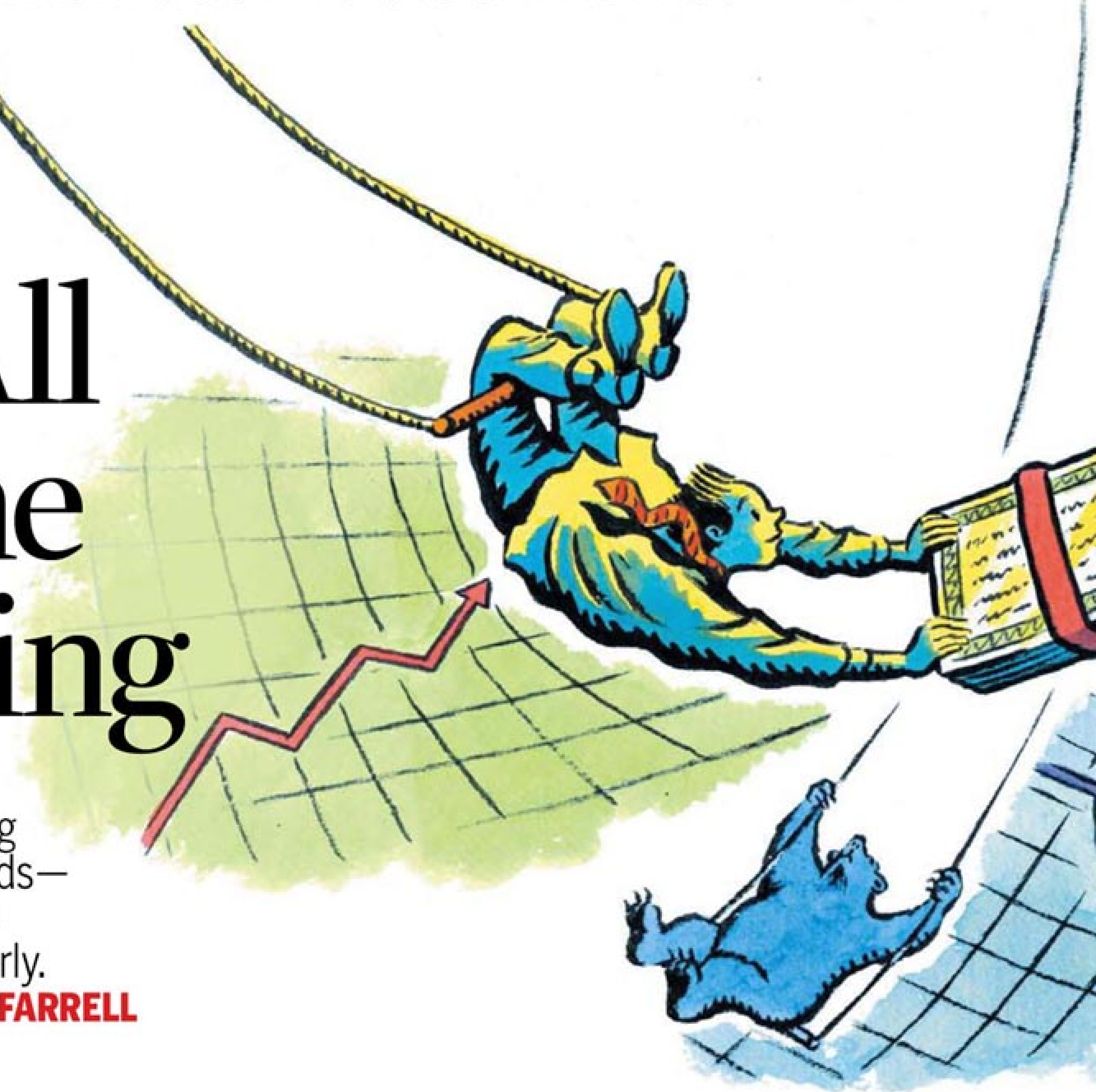
2004 Pinot Noir Reserve

94 points. This small cuvée (just 250 cases) was produced from hillside vineyards. There's a sweet midsection, admirable ripeness, acidity, purity, and texture. This elegant effort has a medium- to full-bodied palate, loads of black raspberry, plum, and black cherry fruit, notions of forest floor, and a hint of oak. It should age nicely for a decade or more. $60

__Robert Parker__ is the world's most influential wine critic. Visit __eRobertParker.com__ to see tens of thousands of tasting notes, buy his books, or subscribe to his newsletter, The Wine Advocate.

(TOP TO BOTTOM) JEROME REY/LA PROVENCE; THOMAS BROENING

Wines rated from 96–100 are extraordinary; 90–95, excellent; 80–89, above average to very good. For more Parker picks, go to businessweek.com/extras.



It's All In the Timing

Sure, you could score big by riding the market's trends—but even the pros fail to do it regularly.

BY CHRISTOPHER FARRELL

HERE'S AN OVERWHELMING ARGUMENT for market timing (the legitimate sort, not the unseemly practice that got some mutual fund companies in serious trouble a few years ago). We asked Ibbotson Associates, the Chicago financial research firm, to see how much $1,000 invested in 1926 would be worth today if the money were always in a broad basket of stocks in months the market went up and in Treasury bills during the others, with dividends and interest reinvested. The answer: $30 trillion, vs. a mere $3 million if the $1,000 were invested in stocks and remained untouched. Far-fetched? Well, $1,000 placed in the Standard & Poor's 500-stock index a decade ago would now be $2,244 for the buy-and-hold investor, but $14,561 for the prescient market timer.

It all sounds wonderful, in theory. These soothsayers are trying to pick the optimal entry and exit points by measuring data that are generated within the market itself, such as changes in prices and trading volume. They're not scrutinizing balance sheets or parsing economic fundamentals. They enact their trades in a variety of ways, using mutual funds, exchange-traded funds, and stock-index futures. Scores of professional timers, most of them mom-and-pop businesses, hawk their get-in, get-out advice to individuals on the Internet, cable TV, and through direct mail.

But the gap between perfect timing and reality is huge. In fact, 2006 should have been a timer's dream since there were powerful trends to ride: up in the spring, down in the summer, up at yearend. Consider the 100 market-timing newsletters followed by *Timer Digest*. The top gun, Mark Leibovit of VRTrader.com, beat the S&P 500 by just 4.5 percentage points (table). William Ferree Jr., the next best, topped it by 3.4 points. Timothy Lutts, the 10th best, was a point behind the S&P 500. (The *Digest*'s returns do not include dividends and interest.)

The top 10 *Timer Digest* numbers are a bit better over a five-year period. Leibovit placed second in that race (up 57%), bracketed by Dan Sullivan of *The Chartist* (91%) and Christopher Cadbury of Cadbury Timing Service (42%). The remaining seven on the list were mediocre to worse, relative to the S&P 500's 23% price gain during the same period.

That's before taking into account any

DAVID GOTHARD

These Are the Champions?

One hundred market timers report their returns to the newsletter *Timer Digest*. Here are the 10 best for 2006. Only four beat the S&P 500. (Returns do not include dividends or interest income.)

	Return
MARK LEIBOVIT VR Trader **VRTRADER.COM**	18.69%
WILLIAM FERREE *Ferree Market Timer* **(727) 736-2053**	17.51
JEFF WEBSTER *Investment Sense* **INVESTMENTSENSE.COM**	13.94
STEVEN CHECK The Blue Chip Investor **WWW.CHECKCAPITAL.COM**	13.70
S&P 500 INDEX	13.62
***MARK BUWEN** *Monthly Market Prospectus* **MARKET-PROSPECTUS.COM**	13.62
***DAN SULLIVAN** *The Chartist* **THECHARTIST.COM**	13.62
***FARI HAMZEI** **HAMZEIANALYTICS.COM**	13.62
***WILLIAM CORNEY** *No-Load Portfolios* **(702) 871-4710**	13.62
***JAMES STACK** InvesTech Research **INVESTECH.COM**	13.62
TIMOTHY LUTTS *The Cabot Letter* **WWW.CABOT.NET**	12.68

*Tied

Data: *Timer Digest*

taxes owed and trading costs. Since market timing can involve rapid shifts in portfolio positions, both costs can be high (although taxes aren't a problem in tax-sheltered retirement plans). Professional timers sell their prognostications largely through newsletters and online services priced between $200 and $1,000 a year. Many manage client money, too.

SHARP DROP-OFF

THE DATA GENERATED by longtime newsletter analyst Mark Hulbert of the *Hulbert Financial Digest* are different. But the result is much the same. Hulbert looked at the record of 103 market-timing strategies over the past 10 years. Several did quite well compared with the 8.3% average annual gain in the S&P 500 (table). For instance, Bob Brinker's *Marketimer* recorded a 13.7% annualized return. But here again, the 10th best timing system only gets you slightly better than the S&P 500 return. Hulbert interprets the data as confirming his 80/20 rule: 80% of timers fail over any reasonable period of time. He adds that the performance numbers got a boost from a bear market in the early 2000s. "Bear markets make market timers look like geniuses because they have some money in cash," says Hulbert. Most mutual funds, for instance, stay nearly fully invested in stocks, so take a hit during bear markets.

What do the more accomplished timers have to say about the market now? Leibovit, for one, is guardedly optimistic. Based in Sedona, Ariz., the veteran timer uses a number of proprietary indicators. "I think 2007 will be an O.K. year with a lot of volatility, and on balance, the market will be up until the fall," he says. "I'm not too happy with the market after the fall and going into 2008. Be careful."

On the other hand, veteran market seer Joseph Granville, the eighth best in *Timer Digest*'s five-year rankings, already is far more bearish. He confidently predicts the Dow Jones industrial average will plunge to 7,100 from its current 12,666. "It will completely surprise Wall Street," say Granville. The octogenarian, based in Kansas City, Mo., achieved celebrity status decades ago when he correctly pegged the 1977-78 bear market. His reputation suffered after wrongly predicting a 1982 market crash.

Interestingly enough, though individual timers can easily err, there is some merit to their collective wisdom. *Timer Digest*, for instance, gets recommendations from its 100 or so timers each week and draws a consensus—bullish, bearish or neutral—from the week's top 10. According to Hulbert's figures, one of *Timer Digest*'s systems produced an 11.3%-a-year return over the past decade, besting the S&P 500 by a full three percentage points. The other was just a shade behind, at 11.1%. Most professional investment managers would kill for those kinds of long-term results. ■

WOODWARD
After 50, switching fields may make sense

You're Older? So Sell Your Wisdom

Ageism is real, but you can beat it by emphasizing your skills and building relationships

AGE DISCRIMINATION IS against the law, but highly qualified people in their 50s and 60s still get passed over for jobs they might have landed easily if they were 20 years younger. Jeannette Woodward, 65, a former university library director who wrote *Finding A Job After 50* (Career Press), says you must get interviewers to look past the crow's-feet and appreciate why your experience and maturity make you the best person to hire. From her home in Lander, Wyo., Woodward spoke to Associate Editor Amy Dunkin about strategies for doing just that.

How is finding a job different when you're not far from retirement age?
This isn't a time to do it the same way you always have. You don't want to end up in the same rut. Make sure it's a job you want. You need to start over and think about what's really important to you.

How do you do that?
Think about how much money you need. Are you burned out? Do you want a major change in occupation or where you live? Many people would be happier if they changed direction. Someone in my book did a total turnaround when he was 57. He went back to school and got a PhD in English. He wanted to do that in his 20s but people told him that he wouldn't be able to make a living. He wound up working for many years in city government in a very responsible job, and when some newcomers came in, he was pushed into a corner and realized that he was terribly unhappy. He's now teaching English at a university and he really enjoys being in the classroom again.

Is there an unspoken bias against over-50 workers?
Oh, yes. I'm not sure that when managers are hiring they intend to discriminate. But when an older person comes along, that's not the person who comes to mind. They may think about older people like their parents, and many managers would rather not supervise their parents.

How do you overcome that bias?
The attitude an applicant takes into a job interview is important. You don't want to treat a manager as "sonny boy" or talk about the last 26 jobs you've had. You need to focus on your skills, to make it clear you have just the right ones for this particular job.

Does how old you look matter?
Yes. As you hit your 50s, one day you can look 40, the next day you can look 70. During your interview you want that to be the day you're looking as close to 40 as possible. Get a good night's sleep. Make sure your outfit and hair are up to date. Try not to lumber around when you walk or look arthritic when you sit in a chair. You need a quick, energetic step.

How else can you deemphasize age?
Make your résumé as neutral as possible. Don't put down dates for your education or go back more than 15 years on jobs. You don't want to call attention to the fact that you were in the work world in 1966. Once you establish a relationship with the interviewer, you'll have less difficulty with age prejudice.

Is there an upside to job hunting when you're over 50?
What's happening in most industries is, as baby boomers retire, they're leaving a hole in the workforce. If managers can't fill the jobs because they can't find the type of people they're looking for, they might be open to older people. Even if salaries aren't great, you may be able to negotiate things that are more important to you: flextime, more vacation time. If you're looking for the job of your dreams, sometimes you can help structure it. ■

JOHN WILTSE

Helping Trusts Keep the Faith

Unitrusts can honor an estate's goals and boost income to survivors. **BY LYNN O'SHAUGHNESSY**

PENNY KAPLAN'S HUSBAND, Edward, came from a close-knit New York family that was bound together by a real estate business. But after Edward died suddenly of an aneurism more than five years ago at age 44, the relationship between Penny and her in-laws began to unravel.

Much of the discord centered around a \$14 million trust Edward had set up, \$8 million of which was tied to the family business. Kaplan had expected the property to throw off considerable income, but that hasn't been the case. Her father-in-law and sister-in-law, Kaplan says, insisted the businesses weren't generating any cash. (Another part of the trust, a \$6 million portfolio of mainly municipal bonds, is yielding about \$178,000 a year for the widow.) "This is very emotional," Kaplan laments. "My hands are tied financially." The in-laws' attorney declined to comment.

Trusts can't be broken, but it has gotten easier to squeeze more money out of them. Kaplan petitioned the Surrogate's Court in Nassau County, N.Y., to convert Edward's trust into a "unitrust." That little-known vehicle would entitle the mother of two college-age children to receive 4% of the value of the entire trust annually, bumping up her total yearly income to roughly \$560,000. That might mean her in-laws would have to manage the real estate differently or even sell all or part of it to get the cash needed to pay her. "In this case, the unitrust is a way to get money to the surviving spouse," says Kaplan's attorney, Stephen J. Silverberg of Certilman Balin Adler & Hyman in East Meadow, N.Y. The unitrust can be a godsend to many trust beneficiaries, he adds. "We're starting to recommend it more and more."

Besides New York, 19 other states allow for a unitrust conversion, which typically locks the trust into generating 4% in annual income. That figure is used in most states because it should provide a fair return to current beneficiaries while preserving enough of the capital to allow the trust to grow for the next generation.

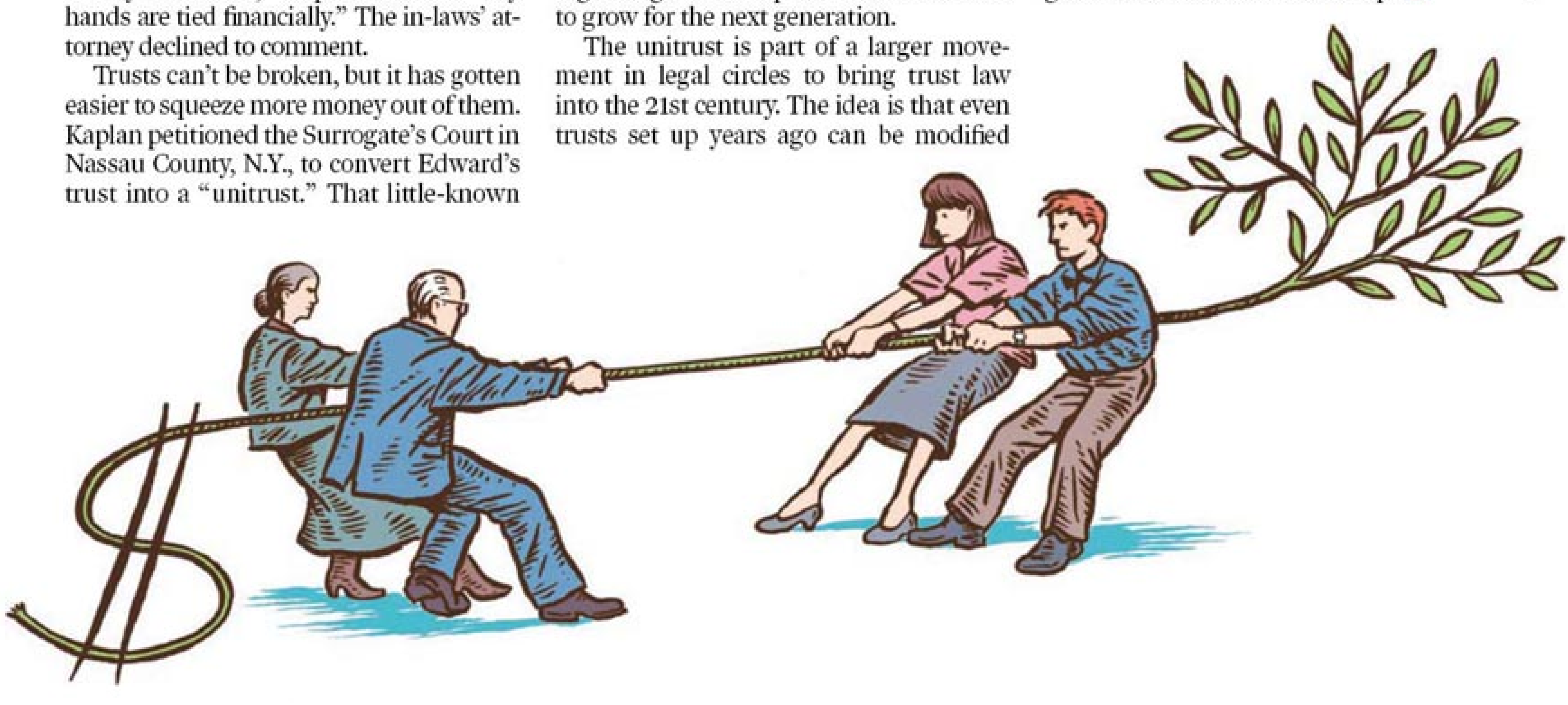
The unitrust is part of a larger movement in legal circles to bring trust law into the 21st century. The idea is that even trusts set up years ago can be modified to solve current problems. For instance, the decades-old practice of splitting trust portfolios between bonds and dividend-paying stocks doesn't always generate enough income in today's low-dividend environment.

KNOW THE LAW

NOW, TO MEET their goals, trusts need to invest for total return and, if necessary, get some of the cash payout by selling assets. In 39 states, trust beneficiaries can ask the trustees for what's called a power of adjustment. That permits trustees to use a measure of investment discretion in generating a trust's payout. In many cases the trustees can take this action on their own.

All of these changes started a decade ago when a panel of law professors and trust experts put forth revisions to the 76-year-old Uniform Principal & Income Act (UPIA) that most states have quietly adopted without publicity. "Most states are silent on the question of telling beneficiaries about unitrusts or the power of adjustment," says Seymour Goldberg, a senior partner at Goldberg & Goldberg in Jericho, N.Y. Goldberg maintains that few estate attorneys, accountants, or corporate trustees are up to speed on their state UPIA laws.

In fact, you can now purchase Goldberg's "The Adviser's Guide to the Revised Trust Accounting Rules" from the American Institute of Certified Public Accountants at cpa2biz.com. "The problem is, no one knows about this stuff, and beneficiaries don't have any idea about their rights under the law," he says. If they did, more trusts might come closer to satisfying the goals of those who set them up. ■



CHRISTOPHE VORLET

Meet Jeanette Davis.
The next great marine biologist.

BY GENE G. MARCIAL

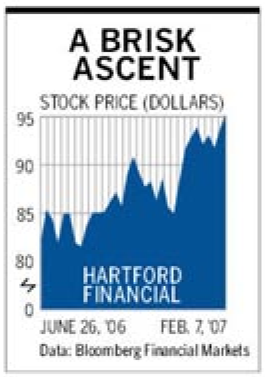
SALES OF RETIREMENT PLANS HAVE HARTFORD GOING STRONG.

CELL GENESYS IS READYING TWO VACCINES AGAINST CANCER.

CHINESE TECH GIANT CDC LOOKS POISED FOR A SPIN-OFF OR TWO.

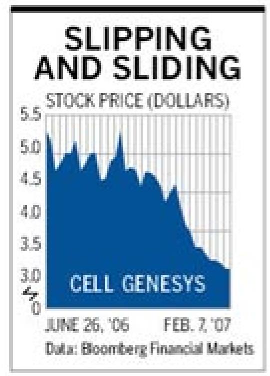
Hartford Is Leaping Up

SHARES OF INSURERS are hardly on fire, but Hartford Financial Services (HIG) stock is lit. It streaked from 84 on Dec. 4, 2006, to 95.90 on Feb. 7—and is still climbing. "The stock has some distance to go, most likely to 150 in 12 months," says Edgar Wachenheim, president of Greenhaven Associates, which owns shares. The multiline insurer easily beat the Street's fourth-quarter profit forecasts and has been racking up annual gains in earnings of 10% since 1995. It has diversified away from the most cyclical and risky lines of property and casualty (P&C) insurance, says Wachenheim. It has increased, he notes, its retirement products, including mutual funds, annuities, and management of 401(k)s. In 2006, assets of its Hartford Life Insurance unit, which include retirement products, grew at 18%. As corporations shift away from defined-pension plans into defined-contribution, says Wachenheim, individuals look for safer ways to provide growing streams of retirement income, such as those Hartford offers. Nigel Dally of Morgan Stanley, which owns shares and has done banking for Hartford, rates the stock "overweight." Hartford is one of "our best ideas for 2007," he says. Some investors may worry about deteriorating prices in its P&C business, he says, but Hartford derives about half of its earnings from its life and annuity lines, and "results there suggest a strong growth story." He foresees earnings of $9.70 a share in 2007 and $10.60 in 2008 vs. $9.06 in 2006.



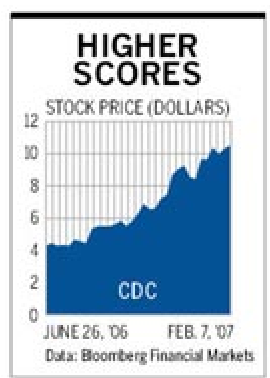
Will Healthy Lab Data Revive Ailing Cell Genesys?

CELL GENESYS (CEGE) is in the midst of clinical trials of vaccines for prostate and pancreatic cancer that analysts believe should catch investors' eyes. But Cell's stock has been in a downspin since its high of 6.24 on Sept. 5. "There is a disconnect between the stock and Cell's fundamentals, which remain solid and on track toward two potential product filings," says Pamela Bassett of Cantor Fitzgerald, who rates the stock, now at 3.07, a buy. Bassett, whose 12-month target for the stock is 12, says the "32-month survival data" on Phase II trials of its GVAX pancreatic vaccine was "positive." She also expects Cell to provide favorable interim data at the next American Society of Clinical Oncology Gastrointestinal Cancers Symposium in June. Data on Cell's GVAX prostate vaccine, in Phase III trials, will also be presented. Mark Monane of Needham, who also rates the stock a buy, says Cell is seeking to team up with big drugmakers on both. The prostate cancer vaccine has won a fast-track designation from the Food & Drug Administration, and Cell expects to provide three-year trial results in 2009. "We're encouraged by the Phase II data we've seen," he says.



Why China's CDC May Climb Higher

ONE TOP PERFORMER on the NASDAQ is CDC (ticker symbol CHINA), whose stock rocketed from 3.95 in June, 2006, to 10.58 on Feb. 7. There are more gains ahead, says David Riedel of Riedel Research Group, who is betting on a restructuring, which he says could kick up the shares by a further 50%. China's CDC is a global provider of enterprise software systems, mobile phone services, and online gaming, its fastest-growing unit. Riedel reckons the gaming—with 15% of estimated 2007 revenues of $351 million and 18% of earnings of 39¢ a share—will be spun off to shareholders and taken public this year. No gambling is involved in CDC's online games, which allow players to compete free of charge. They pay, however, for virtual items such as costumes and weapons. CDC gaming has grown fast and now has 37 million players. Sasa Zorovic of Oppenheimer also rates CDC a buy and expects both software and gaming to be spun off in 2007. He forecasts profits of 52¢ in 2007 and 61¢ in 2008 vs. an estimated 29¢ in 2006.



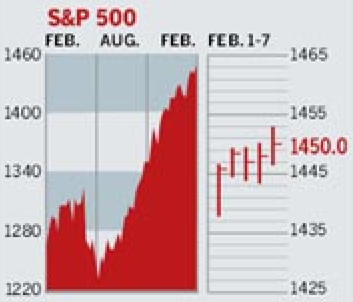
BusinessWeek.com

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.

PHOTOGRAPH BY ETHAN HILL; CHARTS BY ERIC HOFFMANN/BW

STOCKS



COMMENTARY

Earnings season continues to chug along. Shares of Cisco Systems rose after the networking giant revealed a sunny forecast. That good news rubbed off on another techie, Intel, which was up 2.6%. Vornado Realty Trust surged 11% after pulling its bid for Equity Office Properties Trust. Disappointing fourth-quarter sales pushed MedImmune shares down 10.5%.

Data: Bloomberg Financial Markets, Reuters

U.S. MARKETS

U.S. MARKETS	FEB. 7	WEEK	% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
S&P 500	1450.0	0.8	2.2	15.6
Dow Jones Industrials	12,666.9	0.4	1.6	17.8
NASDAQ Composite	2490.5	1.1	3.1	10.9
S&P MidCap 400	850.6	2.1	5.7	11.1
S&P SmallCap 600	416.5	2.1	4.1	12.3
DJ Wilshire 5000	14,622.6	1.0	2.9	15.5

SECTORS

SECTORS	FEB. 7	WEEK	% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
BusinessWeek 50*	819.0	0.8	2.6	9.6
BW Info Tech 100**	450.5	-0.5	0.7	18.7
S&P/Citigroup Growth	664.8	0.7	1.9	11.5
S&P/Citigroup Value	783.9	1.0	2.6	19.8
S&P Energy	448.1	0.2	-1.6	11.9
S&P Financials	506.5	1.6	2.3	20.0
S&P REIT	225.0	4.3	13.1	39.4
S&P Transportation	271.3	1.3	2.9	8.0
S&P Utilities	191.9	3.2	2.8	19.6
GSTI Internet	205.7	1.7	3.0	4.2
PSE Technology	904.3	1.4	3.3	4.8

*March 19, 1999=1000 **February 7, 2000=1000

GLOBAL MARKETS

GLOBAL MARKETS	FEB. 7	WEEK	% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
S&P Euro Plus (U.S. Dollar)	2046.4	2.0	2.8	29.0
London (FT-SE 100)	6369.5	2.7	2.4	10.8
Paris (CAC 40)	5703.0	1.7	2.9	15.6
Frankfurt (DAX)	6915.6	1.9	4.8	21.9
Tokyo (NIKKEI 225)	17,292.3	-0.5	0.4	3.4
Hong Kong (Hang Seng)	20,679.7	2.9	3.6	33.3
Toronto (S&P/TSX Composite)	13,142.3	0.8	1.8	11.2
Mexico City (IPC)	28,123.8	2.0	6.3	50.7

FUNDAMENTALS

FUNDAMENTALS	FEB. 6	WEEK AGO	YEAR AGO
S&P 500 Dividend Yield	1.75%	1.77%	1.81%
S&P 500 P/E Ratio (Trailing 12 mos.)	18.0	17.8	17.6
S&P 500 P/E Ratio (Next 12 mos.)*	15.4	15.1	14.6
First Call Earnings Surprise*	5.11%	4.36%	3.20%

*First Call Corp.

TECHNICAL INDICATORS

TECHNICAL INDICATORS	FEB. 6	WEEK AGO	YEAR AGO
S&P 500 200-day average	1333.6	1330.0	Positive
Stocks above 200-day average	80.0%	77.0%	Negative
Options: Put/call ratio	0.82	0.90	Positive
Insiders: Vickers NYSE Sell/buy ratio	5.82	5.89	Negative

BEST-PERFORMING GROUPS

BEST-PERFORMING GROUPS	LAST MONTH %		LAST 12 MONTHS %
Retail REIT's	22.8	Tires & Rubber	69.1
Constr. Materials	21.3	Steel	63.6
IT Consulting	21.2	Department Stores	46.4
Industrial REIT's	19.9	Broadcasting	43.4
Steel	19.5	Motorcycles	39.0

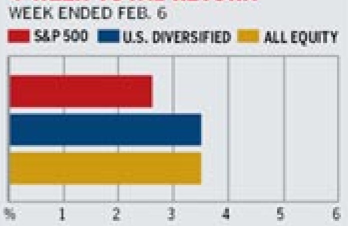
WORST-PERFORMING GROUPS

WORST-PERFORMING GROUPS	LAST MONTH %		LAST 12 MONTHS %
Home Entrtnmt. Sftwre.	-5.6	Gold Mining	-20.1
Wireless Services	-4.4	Electric Mfg. Svcs.	-17.1
Food Wholesalers	-4.3	Education Services	-16.6
Instrumentation	-3.9	Homebuilding	-12.3
Comptr. Stge. & Perphs.	-3.6	Oil & Gas Drilling	-8.0

MUTUAL FUNDS

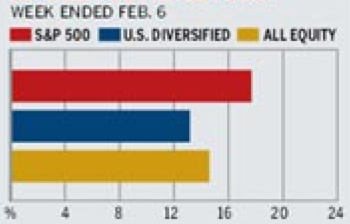
4-WEEK TOTAL RETURN

WEEK ENDED FEB. 6



52-WEEK TOTAL RETURN

WEEK ENDED FEB. 6



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		**LEADERS**	
Latin America	10.4	Real Estate	38.8
Real Estate	9.9	Latin America	33.9
Precious Metals	7.3	Pacific/Asia ex-Japan	33.4
Natural Resources	7.0	Europe	29.4
LAGGARDS		**LAGGARDS**	
Technology	1.0	Japan	-3.0
Japan	1.7	Technology	5.7
Domestic Hybrid	2.0	Natural Resources	6.8
International Hybrid	2.5	Health	6.9

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		**LEADERS**	
DireXn. Lat. Am. Bull 2X Inv.	20.3	Dreyfus Prem. Grtr. China A	64.1
ProFunds Real Est. Inv.	17.0	ProFunds Real Est. Inv.	60.6
DireXn. Cmdty. Bull 2X	16.1	Old Mut. Clay Finlay Ch. A	58.0
ProFunds UltraEmrg. Mkts.	15.7	Oberweis China Opport.	57.4
LAGGARDS		**LAGGARDS**	
ProFds UltSh. Emrg. Mkts. Inv.	-14.4	DireXn. Emrg. Mkts. Short	-40.9
DireXn. Emrg. Mkts. Short	-13.2	DireXn. Dev. Mkts. Bear 2X	-35.3
ProFds. Short Real Estate	-9.7	DireXn. Sm. Cap Bear 2.5X	-27.2
ProFds. USh. Mid Cap Inv.	-9.6	ProFds. Short Real Estate	-25.6

INTEREST RATES

KEY RATES

KEY RATES		WEEK AGO	YEAR AGO
Money Market Funds	4.86%	4.87%	3.99%
90-Day Treasury Bills	5.15	5.11	4.50
2-Year Treasury Notes	4.87	4.92	4.60
10-Year Treasury Notes	4.74	4.81	4.57
30-Year Treasury Bonds	4.85	4.92	4.66
30-Year Fixed Mortgage†	6.17	6.30	6.14

†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	3.91%	4.24%
Taxable Equivalent	5.59	6.06
Insured Revenue Bonds	4.00	4.51
Taxable Equivalent	5.71	6.44

THE WEEK AHEAD

INTERNATIONAL TRADE *Tuesday, Feb. 13, 8:30 a.m. EST* » The December trade deficit will have widened to $59 billion; that's the consensus forecast among economists surveyed by Action Economics. The November deficit narrowed to $58.2 billion.

RETAIL SALES *Wednesday, Feb. 14, 8:30 a.m. EST* » Retail sales most likely improved 0.4% in January, after a solid 0.9% rise in December. Excluding vehicles, December sales very likely grew 0.5% following a solid 1% gain.

EXPORT-IMPORT PRICES *Thursday, Feb. 15, 8:30 a.m. EST* » January import prices probably dropped 1.8%. Export prices likely rose 0.3%.

INDUSTRIAL PRODUCTION *Thursday, Feb. 15, 9:15 a.m. EST* » Monthly factory output probably held steady in January, after a 0.4% rise. The utilization rate likely eased to 81.6%, from 81.8%.

PRODUCER PRICE INDEX *Friday, Feb. 16, 8:30 a.m. EST* » January producer prices are expected to have fallen 0.5%, after posting a 0.9% gain in December. Less food and energy, prices likely rose 0.1%, after a 0.2% December rise.

RESIDENTIAL CONSTRUCTION *Friday, Feb. 16, 8:30 a.m. EST* » Housing starts probably edged up to an annualized rate of 1.65 million in January, from 1.64 million during December.

The *BusinessWeek* production index improved to 293.1 for the week ended Jan. 27, an 8.8% gain from a year ago. Before calculation of the four-week moving average, the index rose to 293.2.

BusinessWeek .com

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

Company Index

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.

Executive Comeback Kit

FIRING BACK **How Great Leaders Rebound After Career Disasters**
By Jeffrey Sonnenfeld and Andrew Ward; Harvard Business School; 306pp; $29.95

Executive Comeback Kit

FIRING BACK **How Great Leaders Rebound After Career Disasters**
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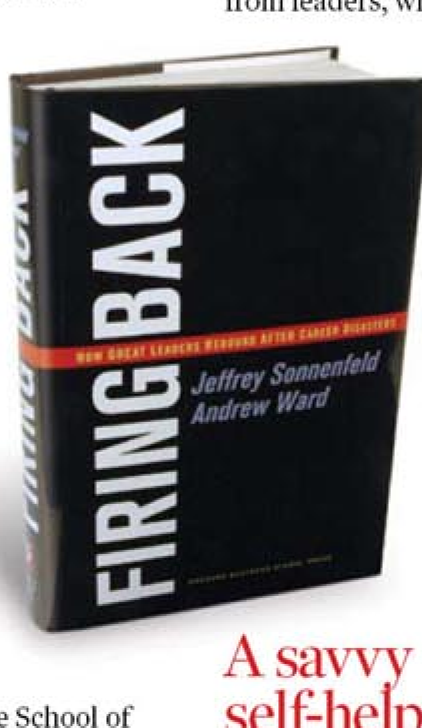
April may be cruel, but January was hardly kind, either, at least to a few high-profile executives. On Jan. 31, Dell announced that founder Michael S. Dell would regain the CEO title, pushing out Kevin Rollins. Just nine days earlier, Gap said its embattled CEO, Paul Pressler, would be leaving the retailer. And on Jan. 3, Home Depot's board started the New Year off with a bang, bidding adieu to controversial Chief Executive Robert L. Nardelli.



Nardelli, of course, did walk out the door with a champagne-toast-worthy $210 million. But if that's not enough to cushion the blow, he, along with the many other managers who've lost their jobs as the rate of executive turnover has spiralled upward, may find further consolation in a new book by Jeffrey Sonnenfeld and Andrew Ward called *Firing Back: How Great Leaders Rebound After Career Disasters.* A sophisticated self-help guide for the fallen chief executive, *Firing Back* is a smart, if at times overwrought, analysis of the leader's road to recovery. Using accounts of tragic failures and triumphant returns, the authors get inside the mind of the humbled executive and provide a framework for rebuilding a reputation that will be of interest to any manager.

Sonnenfeld, a senior associate dean at the Yale School of Management, and Ward, a management professor at the University of Georgia, organize much of the book around a five-step plan for recovery. To begin with, they advise shamed leaders to fight the urge to flee to a remote enclave. Instead, they should recruit acquaintances to speak out carefully on their behalf. The rest of the book is structured around four barriers to recovering from a career disaster: societal, organizational, psychological, and reputational.

One of the most compelling chapters looks at the potentially reputation-damaging causes of a CEO's departure and how these could have an impact on any chance for a rebound. Sonnenfeld and Ward surveyed 45 elite executive recruiters on how different types of forced exits influence a former CEO's career opportunities. Interestingly, these "gatekeepers" said firings for cause, such as poor performance or improper conduct, make it even harder to get seats on boards than to get a chief executive spot at another company. (No word on how such negatives might affect prized private equity postings.)

The authors' examination of organizational barriers that result from company or industry cultures is equally engaging. They begin with a typology of cultures ranging from "baseball teams" to "academies," "clubs," and "fortresses." This provides a fresh perspective on one of the business world's squishiest subjects. Then Sonnenfeld and Ward describe how in industries marked, for example, by "baseball team" cultures, such as software or entertainment, a failure is easier to overcome, because these fields experience constant change and movement of executives between companies.

The book is at its best when it offers personal reflections from leaders, whether famous or anonymous, who have failed and started over. "The day I was fired, I was in tears," says David Neeleman, the founder and CEO of JetBlue Airways who in 1994 was ousted from Southwest Airlines, which had bought his first company, Morris Air. "I was angry and ... determined that we would do something better than Southwest. With nine kids at home, my wife thought there was no need to get right back in."

Still, the volume would have benefited from even more such introspection. The authors often jump quickly from one famous name to the next, and the stories can feel repetitive. The authors also rely heavily on previously reported material. Examples such as Martha Stewart and Jeffrey Katzenberg feel overly familiar.

A savvy self-help guide for the fallen chief executive

Some readers will cringe at the frequent use of the word "heroic" to describe CEOs' "mission" and "stature." Such grandiose terminology may flatter some chiefs, but it's a hard adjective to swallow in an era of scandal-tainted, lavishly compensated executives.

Still, even if the language is sometimes inflated, *Firing Back* makes a persuasive case about the psychological damage firings can cause, and it will resonate with readers whose careers have suffered setbacks. Many leaders' identities are closely intertwined with organizations they've run. And because their firings are often executed by a group of people (the board of directors), victims are less able to rationalize an ouster as due to the whim of an unfair manager. "Add to this the glare of publicity that surrounds the leader's public exit," the authors write, "and the realities ... become inescapable." Fortunately, as *Firing Back*'s authors outline, there is a road to recovery.

–By Jena McGregor

BY MAX B. SAWICKY

Minimum Wage, Maximum Pork

The House of Representatives recently voted to increase the minimum wage, but the measure is being held hostage in the Senate by demands for tax relief for small businesses supposedly burdened by the wage increase. That may sound fair to some, but a closer review shows the tax provisions are clearly more inspired by politics than credible equity considerations or sound economic reasoning.

Yes, a minimum wage hike will have effects. An increase to $7.25 an hour could directly benefit nearly 6 million workers, lifting the incomes of many families currently under the poverty line or not far above it. But critics also claim the boost, estimated to cost employers about $13 billion annually, would result in higher prices and fewer jobs. That's far from certain, and raises an important question: Who would be harmed, and, if they are, should they receive compensation?

Certainly, some companies will be forced to raise wages. But there is no precise way for government to predict which ones will be affected or by how much. Nonetheless, the Senate bill provides liberalized depreciation rules, kinder tax treatment of "S corporations" (which reap many benefits of incorporation without being liable for the corporate income tax), and an expansion of the Work Opportunity Tax Credit as compensation for paying low-wage workers more.

But the proposed breaks pertaining to depreciation and S corps could just as easily benefit owners not affected by the wage increase, those helped by it (say, high-paying restaurant owners whose lower-paying competitors would be forced to raise salaries), or even people who don't currently own a small business but invest in one in the future. In fact, the tax cuts could benefit a business with no minimum-wage employees—or one with no employees at all—because they're unrelated to labor costs, past, present or future.

The breaks could just as easily benefit owners not affected by the wage increase

The more generous treatment of depreciation allows a business to get larger deductions for the purchase of capital equipment or improvement of its facilities. That means, in effect, returns to *new* investment would be subject to lower taxes. But under the Senate bill, this new investment can be undertaken by anyone, and has nothing to do with whether the minimum wage hike affected the benefiting taxpayer.

Even worse, the tax breaks have nothing to do with whether minimum wage workers are retained or added. New investments might well require more workers, but not necessarily low-wage ones. Or the tax break could make feasible an investment that reduced an affected employer's labor costs, allowing him to substitute capital for labor. In that case, it's the tax break, not a higher minimum wage, that levies a terrible cost—on the worker.

The Senate bill provides new tax breaks for S corps on the grounds that, since they're small, they'll be hurt by a minimum wage hike. In reality, lower-wage workers are spread across businesses of all sizes. And while S corps are usually small, that doesn't mean their net income is low or their owners poor. At S corps with receipts exceeding $50 million, for example, average net income per shareholder exceeded $1 million in 2003.

At least the third provision of the Senate bill, the expansion of the Work Opportunity Tax Credit (WOTC), relates to the minimum wage. The WOTC provides subsidies to employers who hire welfare recipients, veterans receiving Food Stamp benefits, ex-felons, high-risk youth, and other disadvantaged persons. Many such workers earn the minimum wage. But, unfortunately, participation rates in WOTC are low, and its impact on employment is questionable. Indeed, recent research concludes the current Earned Income Tax Credit is more effective in bolstering low-wage workers.

Given the flawed logic behind the Senate proposals, why is Congress even talking about them as compensation for a minimum wage hike? In a word: politics. Everybody in Washington knows these tax cuts are just pork, no less than past earmarks for such boondoggles as Ohio's National Packard Museum or Alabama's statue of Vulcan, the Roman god of fire. But rising concern about poverty and income inequality lends support to increasing the minimum wage without considering extraneous tax policy issues. Indeed, these tax cuts would never stand alone, so they ought not stand at all.

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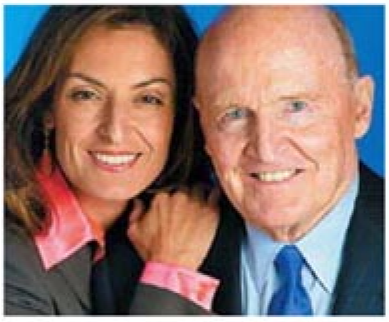

IdeasTheWelchWay

BY JACK AND SUZY WELCH

That's Management!

Since there is such a bias in the markets for short-term results, how can you prepare for the long term?

—Wayne Abernathy, Washington, D.C.

In a word, that's management. Balancing the demand for quarterly results with the pressure for a profitable future is what good managers do for a living. Sorry if we sound exasperated, but every time we hear this question, we wonder: What do you think you were hired for? You were hired to wrestle a paradox—and pin it to the mat. And not just once, but over and over again.

Look, anyone can manage for the short term. Just keep squeezing the lemon, wringing out costs until there's nothing left but the pulp. And anyone can manage for the long term. Just keep telling people: "Be patient. Our strategy will pay off in time." The mark of a leader is someone who has the rigor, vision, and courage to do both simultaneously.

Take the example of managing people, a true short-long balancing act. Of course you want to motivate your team to deliver immediate results. You can do that with incentives and rewards, clear goals, and a passionate attitude about winning—the more passionate the better. But you can never stop thinking about developing your people, too. That means sending them to internal training programs or outside courses, giving them different experiences and stretch assignments, and encouraging them to take risks. Those activities may not deliver instant results, but they're an investment in the future that you must make.

Delivering long- and short-term results at the same time is what it's all about

It's the same story with managing R&D. Obviously, you need to fund projects that will improve and expand your existing products. That's usually money well spent, with relatively quick and certain returns. But some portion of your budget also needs to be earmarked for the kind of research that will deliver results in several years. Now, how much should go to each investment bucket? Your call, boss.

Perhaps the most common managerial balancing act has to do with marketing. With one phone call, you can take the easy way out and cut your advertising budget 20% to 50%. That will drop the savings right to the bottom line, with no sales impact for a quarter or two and no blood spilled in terms of programs or people. But what about the long-term hit to market share and brand? That's the judgment call, and you're the judge.

Work requires dozens of decisions a day, but yours is the *über*-question of them all. As a manager, you'll spend your career answering it.

Companies let go of troublesome employees. Is it ever a good idea to apply the same practice to troublesome customers?

—Matt Silver, Wichita

You mean, is the customer really always right?

The obvious answer is yes. You can't build a business without trying to satisfy every customer, even cranky, annoying, or unreasonable ones. Customers are like relatives. You can't pick them, so you better learn to love them.

But—and this is not an insubstantial but—there are some circumstances where that old adage about customer supremacy can actually be destructive, and it makes sense to say no or even good-bye.

The first is easy: It's when a customer's demand for price destroys your profitability, or worse, creates industry pricing chaos. That's when you have to hold the line and dump the customer even if it drives your salespeople crazy. The second circumstance is similarly unsustainable: It's when a customer demands a one-off product that sends your R&D group in the wrong direction, away from your own strategy and financial goals. Again, this is a case where your salespeople might be hollering for support but where the long-term diversion of resources is a killer. Unless it is an exceedingly profitable customer, you have to just say no.

The third circumstance is more nuanced. It's when a customer disrespects your people. Now, sometimes your big customers—the market-share monsters—can act a little obnoxious. They own you, and they know it. So with them, you may need to endure some rudeness or outrageous demands as part of the cost of doing business.

It's different when the customer doing the berating is not your meal ticket but just a jerk. Then, your first line of defense is to switch the salesperson on the account, putting in someone with tougher skin and the mettle to say: "Hey, this has to stop." If that fails after a good try, it's time to walk.

Bottom line, we're not recommending that anyone ditch their "The Customer Is Always Right" plaque.

We'd just add a little asterisk. ■

Jack and Suzy Welch look forward to answering your questions about business, company, or career challenges. Please e-mail them at thewelchway@businessweek.com. *For their weekly podcast, go to www.businessweek.com/search/podcasting.htm.*

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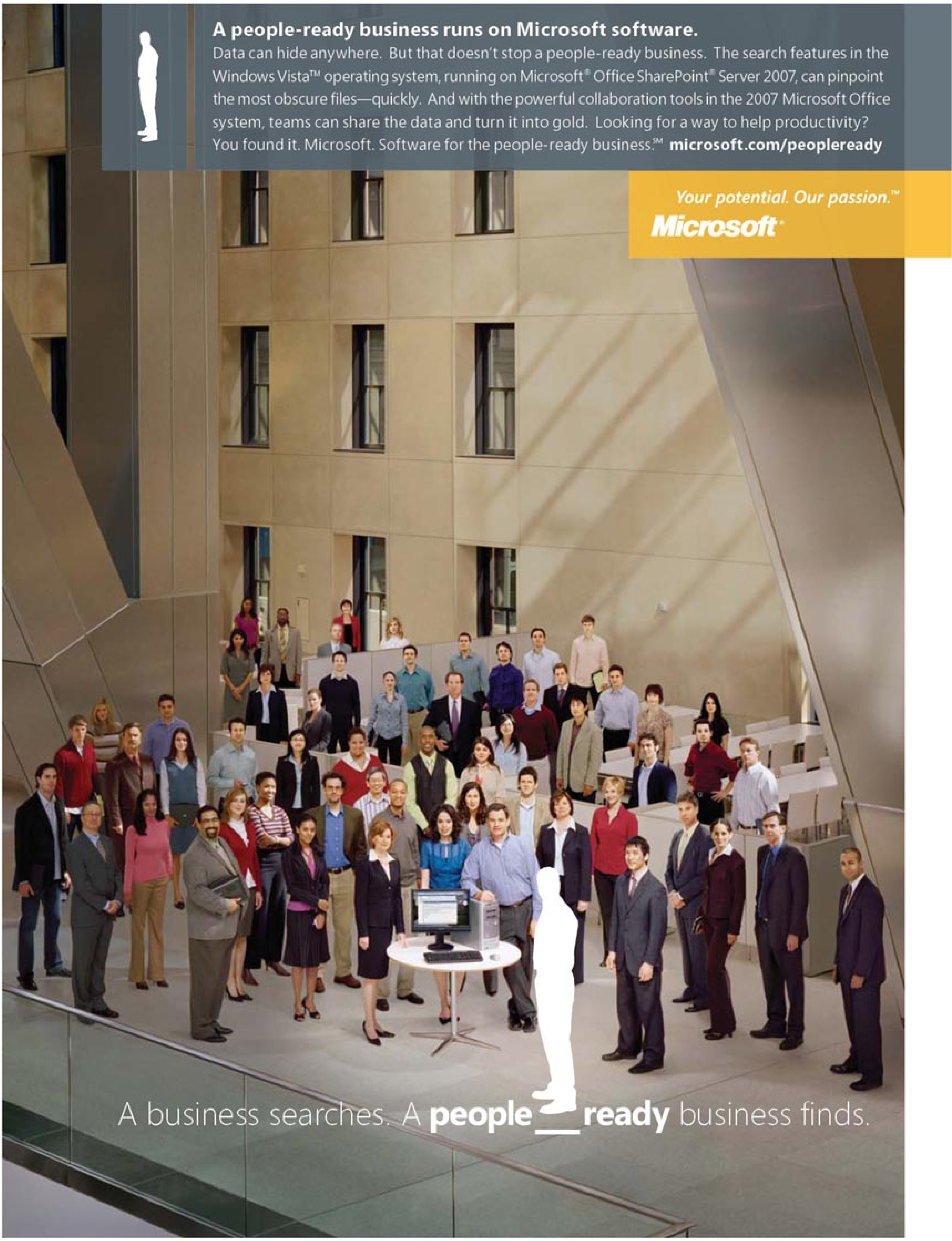
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