

Kodak: On its way to a prettier picture

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Executive Summary

Present Situation

As one of the 25 largest companies in the United States, Eastman Kodak is the world's leader in photographic film and has the potential to maintain its leadership in this industry through the digital age. In response to the digital revolution in photography, Kodak has started devoting resources to digital imaging media and other products for both amateur and professional photographers. Kodak still faces fierce competition in the Photography segment with the emergence of the digital market.

Eastman Kodak appears to be on the right path with the growth of their digital segment. Even so, Kodak confronts difficulties maintaining its position as the market leader in the photography segment. The company's revenues and margins have been at risk as consumers shift from conventional to digital photography. Blaisdell Consulting is convinced that Kodak must concentrate on augmenting its position as a leader in the various forms of digital output given that the number of digital camera owners is escalating quickly. Trends suggest that integrated portable devices will be successful and profitable. Blaisdell Consulting advises that Kodak cultivate relationships with the key firms in order to uphold its reputation and market position with the increasingly digitized world.

Recommendation

Recognizing Kodak's strengths and current limitations, Blaisdell Consulting concludes that in the near term the company should expand aggressively into the digital market with the following strategies:

- ?? Bring together Perfect Touch processing system with Ofoto
- ?? Partner with other key players in the digital multi-media revolution, such as Motorola, Nokia, and possibly the PDA manufacturers

Blaisdell Consulting is convinced that Kodak has an excellent opportunity to broaden its brand reach to the digital market through its Perfect Touch processing system and through more investment in organic light-emitting diode (OLED) technology. The Perfect Touch processing system can help Kodak to increase processing prices and margins without harming levels of customer satisfaction with the product. OLED technologies should be incorporated into Kodak products in order to give those products a competitive advantage over rival offerings. Another promising technology that will present Kodak with opportunities to generate increased revenues in the future is wireless imaging solutions. Blaisdell Consulting believes that at this time the best strategy for Kodak will be to partner with current service carriers to pioneer both of these technologies.



Company Profile

In 1888, George Eastman introduced the first easy-to-use camera with the slogan “you press the button, we do the rest,” after having developed a method for dry-plate photography and establishing The Eastman Dry Plate and Film Company in 1884 with Henry Strong.¹ The Kodak camera was pre-loaded with enough film for 100 exposures, and owners mailed the whole camera back to the company to be developed, then Kodak returned the cameras to their owners with the pictures and more film. Eastman made an inconvenient and intricate process simple and accessible to nearly everyone.

The company was called Eastman Kodak Company since 1892, when Eastman Kodak Company of New York was organized. The popular Brownie camera was introduced in 1900, and three years later Kodak presented a home movie camera, projector, and film. The company established plants in the U.S. to produce the chemicals, plastics, and fibers used in its film production. In 1963, Kodak introduced the Instamatic, which had a foolproof film cartridge that eliminated the need for loading in the dark. The Instamatic proved to be a huge success for Kodak, who sold an estimated 60 million of these cameras.

By the time Eastman had embarked on his dry-plate business in the late 1880s, European interest in photography was fervent, but its practice was restricted mostly to professionals. Recognizing the potential of the world market for amateur photographers, a sales office was established in London. Today the company has manufacturing operations in Australia, Brazil, Canada, China, England, France, Germany, India, Indonesia, Mexico, Russia, and the United States. Kodak products are marketed by subsidiary companies to people in more than 150 countries.

On the more recent digital front, Kodak formed deals in 1997 to expand its digital offerings, including a collaboration with Intel and Adobe Systems allowing consumers to manipulate, prints, and send personal photos from their PCs. In 2000 Kodak formed a joint venture with Hewlett-Packard to develop photo-finishing equipment for digital photography. Kodak also expanded its force to the online photo business by buying the remaining shares (it already owned 51%) of PictureVision, a digital image storage service. In 2001, Kodak and Sanyo Electric Co. announced the formation of a business venture to manufacture OLED displays for cameras, personal digital assistants (PDA), and other devices.

Today Eastman Kodak is a part of the S&P 500, the Dow Jones Industrials and #155 on the Fortune 500. Kodak has more than 70,000 employees in its worldwide operations. Kodak has led the way with scores of new innovative products and processes that have made photography effortless, more useful and more enjoyable.



Financials

The continuing economic slump in the U.S. and Europe and many other countries have reduced sales growth. Conservative consumer spending and a slow travel and vacation industry, along with the continuing growth of digital technology, impacted traditional photography sales in the U.S. and Western Europe, especially in the fourth quarter. Eastman Kodak (EK) ended 2002 as the Dow's top performer, but the negative sentiment and the downward trend that Kodak has experienced during the past year reflect worries about Kodak's future in the digital age.ⁱⁱ

In the category of info-imaging, Kodak will attempt to gain a strong position in the burgeoning digital industry. The U.S. base for the digital revolution is growing rapidly, as marked by having surpassed the 15% penetration level that signals mass-market acceptance at the end of 2002. To keep growing, the photography industry must successfully navigate through a major transition as digital technology continues to spread through the world. Despite the growing popularity of digital cameras, more than 90% of all exposures worldwide are made on film. Forecasts suggest that growth in emerging world markets will keep worldwide film volumes stable for many years to come.

The shift toward digital has cause Kodak much suffering in the recent years. Kodak's U.S. film sales fell 5% in the fourth quarter, and its overall sales fell 3% for the year, to \$12.8 billion. Profits rose to \$770 million, from \$76 million in 2001, when they included \$659 million of restructuring costs.ⁱⁱⁱ

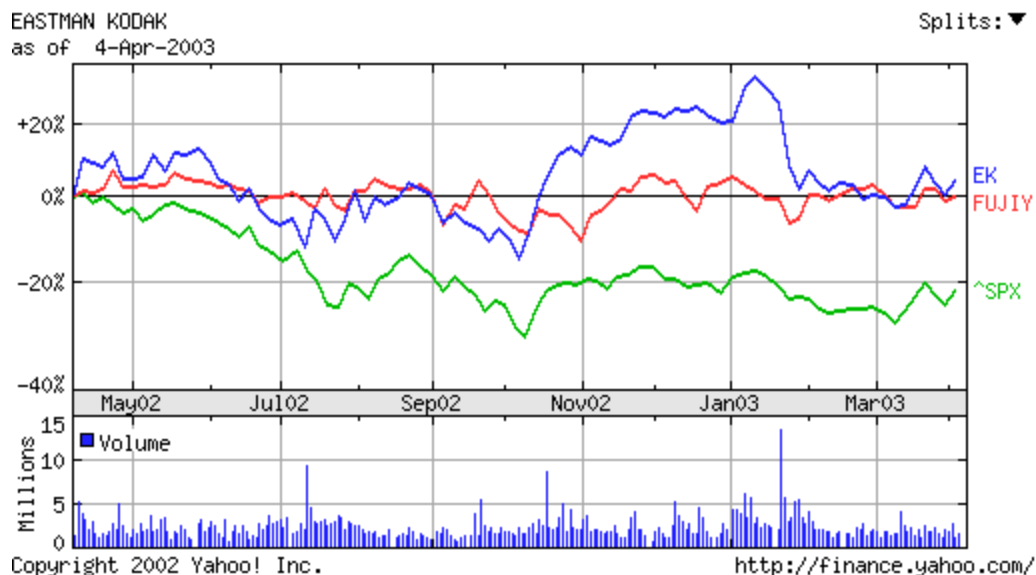
Kodak's Photography segment will benefit from the digital camera trend, which has increased an interest in all types of photography, both traditional and digital. This has accounted for an increase in sales of all commercial products. Kodak digital imaging was driven to record revenues with consumer-friendly products and services, including online and retail photo printing and the Kodak EasyShare consumer digital camera launch at the end of 2001. The company's digital operations are not expected to yield profits until later this year, at which time they may take sales away from Kodak's traditional film products.

Kodak maintained full-year market share in the U.S. consumer film business and increased it slightly worldwide. Having gained market share in the Health Imaging segment, Kodak is still struggling to maintain market share in other key segments of their business. Pricing pressures and some operating issues led to margin declines. Although Kodak revenues and earnings were down for the year, continuing aggressive cost-reduction programs produced a strong balance sheet and healthy dividend payouts. Consistent with current economic reality, Kodak has reduced their cost base and increased their focus on cash generation. Kodak's financial strategy focused on generating cash to support the underlying value of the company, pay down debt, and enable cautious investments for growth. By the end of the year, Kodak delivered \$948 million in operating cash flow by lowering inventories, reducing receivables and



restricting capital expenditures. Kodak drove inventories down by 34 percent, or \$581 million. Their tight restraint helped capital expenditures decrease 21% year-over-year.

On the cost front, they took a number of steps to reduce worldwide employment by about 9% and expect to see much of the resulting savings in their full-year 2002 results. Kodak expects to continue the worldwide workforce reduction by an estimated 2,200 jobs, or about 3% in 2003. A significant part of these reductions will result from consolidation of photo-finishing operations in the U.S. and Western Europe as the company continues to downsize and align its investments under their growth strategies.



The market value of Kodak stock has mirrored trends in market fluctuations throughout the past two years, declining drastically after September 2001's terrorist attacks. Kodak continues the downward trend experienced through the first month of 2003 after the increases experienced through the holiday season. As of April 7, 2003, Kodak closed at \$31.64 per share down from \$35.84 on January 2, 2003. Worldwide fourth quarter sales were \$3.441 billion, an increase of 2% from fourth quarter, 2001 sales of \$3.358 billion. Fourth quarter sales in the U.S. were \$1.637 billion, down 1% from fourth quarter, 2001 sales of \$1.649 billion. The breakdown by segment is as follows:

- ?? Photography segment sales totaled \$2.301 billion, up 1%.
- ?? Health Imaging sales were \$619 million, up 9%.
- ?? Commercial Imaging sales were \$396 million, up 3%
- ?? All Other sales were \$25 million, unchanged from the year-ago quarter.

Kodak expects per-share earnings in 2003 to range between \$2.35 to \$2.95. Kodak's forecast for 2003 reflects the expectation that economic conditions will remain weak, but



since “sharing pictures is a part of peoples’ lives,” Kodak is confident that the industry will resume growing when world economies recover from the current economic downturn. The earnings outlook also reflects increased consumer use of digital photography, as well as the difficulty of making forecasts as global tensions arise during the war. The war with Iraq is likely to reduce travel in the short term, and with it photo consumption. The company expects revenue in 2003 to increase slightly, and projects that cash flow after dividends will range from \$450 million to \$650 million. For the first quarter of 2003, Kodak expects operational earnings to be approximately in line with first quarter 2002 earnings of 13 cents per share.

Internal Rivalry

Industry

Kodak is a major participant in "info-imaging," which is a \$385 billion industry composed of devices (digital cameras and PDAs), infrastructure (online networks and delivery systems for images) and services & media (software, film and paper enabling people to access, analyze and print images). Kodak harnesses its technology, market reach and a host of industry partnerships to provide innovative products and services for customers who need the information-rich content that images contain. The company, with worldwide sales last year of \$12.8 billion, is organized into four major businesses: Photography, Health Imaging, Commercial Imaging and the new Display Group.

The company has had four reportable business units since the beginning of the fourth quarter of 2002 when EK changed its operating structure. It was formerly comprised of seven business units, to be centered around strategic product groups. These groups have since then been integrated into four segments that share common technology, manufacturing and product platforms, and customer sets. Along with this change, certain product groups were realigned to reflect how senior management now reviews the business, makes investing and resource allocation decisions and assesses operating performance.

Photography Group

The primary segment, which accounted for 70% of 2002 revenues, is the Photography unit. This division includes traditional and digital product offerings for consumers, professional photographers and the entertainment industry. This segment manufactures and markets films, photographic papers, processing services, cameras and projectors. The company has also developed products that bridge traditional silver halide and digital offerings, including kiosks and scanning systems to digitize and enhance images, digital



media for storing images, and a network for transmitting images. Traditional and digital products are sold direct to retailers or distributors throughout the world, while entertainment products are sold direct to studios, labs, independent filmmakers, or commercial houses for producing advertisements.

Products and Services
Consumer Photography

Kodak offers a variety of traditional cameras, film, digital cameras, accessories, printing paper, and software for consumer photography.

Kodak offers over 20 easy-to-use cameras in APS, 35 mm, and one-time-use models. The Advantix cameras and film use the features of the Advanced Photo System (APS), which include a more advanced and new generation camera, film, and photo-finishing process, enabling consumers to have fewer errors and to get more successful pictures from a single roll of film. The Advantix film enables users to choose the size of the picture, whether it be similar to that of a regular camera (35 mm), panoramic or a group picture, and the Advantix film provides an index print to easily view thumbnails of all the prints. The mid-roll film change option is available in some Advantix cameras where an active light lock and the magnetic information in the APS film cassette allows the film to be wound and rewound countless times. This enables users to exchange rolls anytime to adjust film speed to lighting conditions, swap color for black and white, or to keep cassettes organized by subject. The Kodak 35 mm cameras are easy to load and use so that consumers can concentrate on picture taking, rather than the complications of photography. The preloaded one-time-use models enable consumers to take a camera anywhere to shoot almost anything where traditional cameras do not dare to go. Designed to meet every need, there are outdoor, indoor, underwater and panoramic options. Kodak also offers high quality film for every need for Advantix and 35 mm cameras.

The Kodak EasyShare cameras enable beginners and professionals to benefit from the new technologies of the digital world. Photographers simply take pictures, place the camera on the docking station, and the pictures are uploaded onto one's computer. Kodak has recently just introduced the first consumer digital camera featuring an OLED display, the Kodak EasyShare LS633 zoom digital camera with a large 2.2" OLED display that presents bright, sharp on-camera images. In May, the EasyShare printer dock 6000 will ease the printing process so that users can place the camera directly on the printer, and push a button to print borderless 4"x6" photos with or without a computer, all while charging the EasyShare camera. Kodak Inkjet paper allows users to make prints on high-quality, lasting paper. Kodak also provides EasyShare software for users to upload and share their digital photos on their computers through the Internet. The new EasyShare 3.0 software has several new features that enable consumers to organize their pictures with a new album feature, burn CDs of their photos and import their Windows Outlook address book to the EasyShare software address book.



The Picture CD is available to create digital photos from traditional film. The software provided enables customers to easily zoom and crop, remove red-eye, share and print at the consumers desire. Similarly, the self-serve Picture Maker kiosks are available in 23,000 locations nationwide for consumers to make quick reprints of a few selected photographs, to reduce red-eye, to add borders, to print from a digital camera and to zoom and crop without any negatives in just a few minutes.

Kodak acquired Ofoto Inc., the online photo processor, in 2001 for \$58 million. Ofoto's 6.5 million members can store photos online or request prints, while Ofoto mails to them. Digital photos can be edited, shared, stored and reprinted on Ofoto. The Kodak picture center online network enables users to bring their traditional film to a photo-processor and their prints will be uploaded online. The Kodak picture center online and Ofoto are fundamental to Kodak's image output strategy.

Kodak has 100 digital minilabs, the \$100,000 computer and processing machines that can produce 2,000 4"x6" prints per hour, currently in service at various retail stores and plans to sell 1,000 more this year.

Kodak Perfect Touch processing from Qualex, their U.S. high-volume photo-finishing operations, began in the fourth quarter and will continue into the second quarter of 2003 to the U.S. and to parts of Europe. This new service should be recognized as a distinct advantage for Kodak as they join film and digital technology to deliver better, more satisfying photo experiences to consumers. This premium digital processing service scans film negatives and applies special software to create a digital photo. It then uses this software to identify and correct a number of common errors, even within a single print. These corrections include adjusting for over and under exposure, and improving flesh tones and other lighting problems, automatically providing more vibrant color, richer detail and fewer dark shadows in pictures. Perfect Touch increases the dynamic range of both film and paper, allowing images hidden in deep shadows that typically appear black in photographs to print as they appeared in life, and another benefit is greater range using flashes. Kodak's joint venture with Hewlett-Packard, Phogenix, is currently underway, working to provide innovative new photo-finishing products to these markets.

Professional Photography

Kodak offers a variety of digital cameras, scanners, Picture CD and thermal printers as their digital imaging products line for professionals. Kodak also offers special films, papers and photo chemicals, as well as digital software, color management consulting, and professional processing labs. The Kodak Professional DCS 14n digital camera provides a cost-effective way to capture ultra-high resolution pictures.



Cinematography

Kodak also supplies motion imaging photographic products such as camera films, post-production products, and digital and special effects tools for the motion picture industry. Kodak's second-generation Vision2 motion picture film has received enthusiastic reception among cinematographers.

Competition

In the Photography segment, Kodak has been facing pricing pressures by Canon, Sony, Agfa and Fuji. Kodak has a strong position in the single-use cameras category; the one-time-use camera continue to be a major factor in film photography, helped by innovations such as the Kodak Ultra compact model introduced in Europe and a new underwater model now available in world markets. Kodak has recently introduced its High Definition 400 ISO consumer lines, as well as the Kodak Professional Portra 400BW film. Fuji recently announced that it will display new consumer versions of the Fujicolor Superia X-TRA 400 and Fujicolor Superia 1600 35mm color negative films, as well as an expanded line of single use cameras, and new professional films. Agfa is expected to highlight its ISO 100, 200, 400, and 800 35mm films, which on the packaging offers a link to free image editing and archiving software, as well as a link to the AGFAnet print service.

Both Kodak and Fuji's new consumer 400-speed roll films claim to be the world's finest grain 400-speed color print film, incorporating new advanced technologies. Kodak's film employs a new packaging scheme that differentiates the product's premium qualities. This high-end consumer roll film will be priced at a premium, with a retail price of \$10.99 for a three-roll pack. Both companies are attempting to squeeze out the maximum revenue potential from their film-based businesses.

Kodak is ranked third to Sony and Olympus America Inc. in manufacturers of digital still cameras. With the EasyShare camera, Kodak expects to gain market share in the digital imaging industry as the digital age becomes more easily accessible. In the U.S. market, Kodak, with 13.3 %, is behind Sony and Olympus with a 24.4% and a 14.9% share in digital cameras, but above Canon at 11.4%.^{iv} The free EasyShare software is currently competing with Adobe Photoshop Album, the new consumer version of the professional digital software, which sells for about \$50. Its organizing capabilities are considerably more sophisticated. Canon's bundled ZoomBrowser software is also competitive with Kodak's EasyShare bundled software.

Canon, although ranked fourth, is a quickly growing competitor. Canon Corporation's digital camera units grew a strong 91% in the fourth quarter of 2002, and it expects unit growth of 72% in 2003. This will affect Kodak negatively since Canon has potential for sharp gains in market share, and Canon's expected growth will suggest accelerated digital



camera adoption. Fuji's strategy appears to target higher image quality as it recently introduced the first consumer 6.2 megapixel digital camera, the FinePix F700, which will carry Fuji's new Super CCD SR technology and captures 2,832-by-2,128 recorded pixels. Fuji also unveiled its FinePix F410 with its fourth-generation Super CCD HR, and includes ImageMixer VCD for FinePix 1.0 software so that consumers can create CD albums and video CDs.

Kodak's Picture Maker kiosks and minilabs will be challenged by Fuji's new Printpix DigiCam Picture Center 400, which is a stand-alone digital imaging kiosk that focuses on retailers as the end user, whereas Kodak has targeted consumers as the user. Kodak also continues to fight Fuji for distribution and market share at the key retailers: Wal-Mart, Costco, Sam's Club, Walgreens, Ekerd, and others.

Digital photo print processing is far from a niche service offered by online services such as Kodak's Ofoto Inc. and Shutterfly. In addition to photo specialty retailers like Wolf and Ritz Camera, major retailers and discount stores have added digital photo processing services to their online and retail presence. Even though traditional roll film developing has a lower cost per print, digital print prices are more competitive now as players in the market increase. Wal-Mart may become a stronger player in this market since it will have Fuji's Frontier digital minilabs installed in most of its U.S. stores by the end of the year.

Emerging markets

Sales in emerging markets such as China and Russia had solid double-digit growth, enabling more people to benefit from the remarkable capabilities of film technology. Kodak has already invested more than \$1 billion in China to manufacture film and cameras, and will continue expanding its foreign markets. China is the world's fastest growing market for film sales and it is Kodak's second largest market after the U.S., where traditional film sales are tapering off.^v In a country with an expanding middle class and where sentimentality is an important factor in their culture, expanding sales in China will be an important factor in Kodak's profit gains.

Having received government support and generally favorable press coverage, Kodak's name has been doing very well in China. Kodak has recently encouraged independent owners to open 8,300 Kodak Express shops, successfully triumphing over rivals Fuji of Japan and Lucky Film of China. Additionally, last year Kodak offered inexpensive photography starter kits, which include a camera and four rolls of film for around \$12, in this country where only one-fifth of the people own cameras. Kodak is promoting photography in general in this country so that it can maintain brand leadership as technology advances to offer less expensive photography options, such as digital cameras.



Strategy

The photographic products industry faces opportunities and threats from digital imaging, versus traditional silver-halide photography. In 2001, Kodak experienced a breakthrough with image-amplifying capabilities of silver-halide film, which is called “two-electron sensitization.” Kodak also developed micro-electro-mechanical (MEMS) system technology to produce smaller ink droplets for higher quality color inkjet printing. However, the rise of the digital camera has created a strong demand as they become easier to use, less expensive, and of higher quality. Competition in this industry has thus far proven to be intense. Established companies, such as Kodak, will have an advantage, due to brand awareness and product positioning.

Kodak expects to generate increased sales from its image output products and services such as inkjet paper, the photo printer, Ofoto, Kodak picture center online, and the kiosks. The Kodak picture center online is offered in more than 20,000 retail outlets in the U.S. and 5,400 in Western Europe. More than 39,000 Kodak picture maker kiosks are in place worldwide. Some retail partners include CompUSA, CVS, and Target. Kodak is currently testing non-traditional venues for this service, such as hotels and office products stores, to determine the potential for wider placements of these kiosks.

In the professional photography front, Kodak moved aggressively to implement the professional products and services workflow productivity solutions for professional laboratories and photographers.

In the entertainment industry, Kodak holds a leading position as a supplier to the motion picture industry despite the fact that the sales of Kodak’s products and services were affected by the economic factors impacting commercials and independent feature films. Research and development scientists are working on the future of digital cinema operations since the eventual replacement of movie exhibition film by digital projectors is likely.

Health Imaging Group

The Health Imaging segment, which accounted for 18% of 2002 revenues makes products that are used to capture, store, process, print and display images and information in a variety of forms for customers in the health care industry, for both primary and referral diagnoses. Products include medical films, chemicals, digital print films, laser imagers, and computed and digital radiography systems. This segment serves health care customers for general radiology products and specialty health markets, including cardiology, dental, mammography and oncology imaging.



Products and Services

Kodak provides an extensive portfolio of products to serve the needs of the health imaging market. The digital products and services, including digital printers, media, capture systems and picture archiving and communications systems (PACS) helped this segment grow 1% from 2001. The laser printers for digital x-ray hardcopy films are market leaders. Sales of traditional x-ray films were lower due to pricing pressures and lower volumes, but specialty films for oncology and mammography showed strong gains year-to-year.

Competition

Kodak leads the market in high-speed production document scanners and in dry laser imagers for the Health Imaging segment. Kodak is ranked third to 3M and Applied Materials in the industry category Most Admired Scientific Photographic and Control Equipment. Kodak increased its market share in both traditional analog x-ray media and digital output for diagnostic medical imaging. Sales of digital capture and PACS products and DryView media grew rapidly. Agfa, along with GE and Seimens, leads the PACS market, suggesting that Kodak may have to make acquisitions to gain market share.

Strategy

Operating margins improved steadily throughout the year in the Health Imaging Business as the group reduced SG&A expenses and welcomed the benefits of restructuring and cost control. The main focuses were to increase manufacturing productivity, reduce material and distribution costs, and to improve equipment quality and reliability. Health Imaging introduced a range of new products intended to drive growth for Kodak, including a next-generation PACS system, a flagship dry laser imager, and a top-of-the line computed radiography system.

Kodak was recently chosen as a preferred supplier of X-ray materials to Consorta, a health care group purchasing organization, which provides resource management solutions to shareholders and their facilities.^{vi} The deal took effect in November 2002 and runs for five years. Kodak will provide all medical X-ray films, DryView laser imaging systems and service for any Consorta member facility that selects Kodak as its preferred supplier.

Health Imaging benefits from strong secular growth characteristics due to aging populations in the developed world and rising incomes. Improvements in treatment and diagnosis are coming from better information systems and algorithms that extract more information from images.



Commercial Imaging Group

Commercial Imaging, which accounted for 11% of 2001 revenues encompasses Kodak's expertise in imaging solutions from image capture, printing, archiving and analysis to custom imaging solutions for commercial markets, such as banking and insurance, to state, local and federal government applications. Products include aerial, industrial and micrographic films, large format inkjet printers and high-speed production document scanners. Kodak also derives revenues from graphics film products sold to the Kodak Polychrome Graphics joint venture, which is a joint venture of Kodak and Sun Chemical. Kodak Polychrome Graphics is a \$1.5 billion provider of digital and conventional graphic arts solutions worldwide.^{vii} Another joint venture operation in the Commercial Imaging group is with Heidelberger Druckmaschinen AG to form NexPress digital printing.

Products and Services

Kodak offers a new line called the Innovation Series scanner for low volume document scanning. The Kodak i260 scanner was named a Product of the Year by *Transform* magazine.^{viii} The NexPress 2100 printer, a result of the joint venture between Kodak and Heidelberg, stands alone in the color printing market for digital variable on-demand production equipment and has potential for professional laboratory markets.

Strategy

In the Commercial Imaging segment Kodak benefited from the 2001 acquisition of the imaging services business of Bell & Howell Company that helped expand the existing services portfolio in document imaging. Kodak has become the market leader in document scanning and preservation. Their Innovation Series scanners are bundled with application software for document management, text recognition and photo management.

In the graphics product offerings, the Kodak Polychrome Graphics joint venture contributed to positive earnings and expanded its growth opportunities by acquiring the color proofing and software businesses of Imation Corp.

Display Group

The new business group was created and organized in the fourth quarter of 2002 to guide Kodak's expanding role in OLED image display. Kodak estimates that this technology will generate and cultivate a \$2.3 billion market by 2008. The group includes the display products business, Kodak's participation in the SK Display Corp. joint venture with



Sanyo Electric Co. Ltd., large-size flat-panel display initiatives and new display businesses developing from the research laboratories.

Substitutes and Complements

Numerous substitutes exist for the products and services of Kodak's various segments. The commercial products for the Photography segment are readily available online and in diverse retail stores. Cannon, Sony, and Fuji products are offered at competitive prices, which have recently hindered Kodak's sales.

There are several substitutes for digital printing output. In May, Kodak is launching a campaign for its \$199 photo printer that links directly to the EasyShare digital camera. Its competition will be Canon's \$99 machine that does both general purpose and photo prints. The high cost of color ink cartridges and photo paper may hinder the sales of Kodak's new printer.

Video and digital video may become more popular in the future, but will probably not substitute pictures, since consumers seem to still want hardcopies of their pictures. Digital cameras will not fully replace traditional cameras and film since there are still many photographers who prefer the simplicity and familiarity with traditional film and processing. As digital technologies become cheaper, more and more consumers will purchase digital cameras.

Many of the complements to the photography segment exist within the industry. By expanding interest in all types of photography, Kodak expects its traditional film business to benefit from an increase in the sale of commercial products.

Kodak's second-generation of EasyShare digital cameras has induced the popularity of home printing products, and online and retail printing services. A necessary component to the online digital retailer, Ofoto Inc., is a high-speed Internet connection for fast and efficient online photo transfers.

Photo processing services vary from retailer to retailer and could potentially effect the sale of Kodak's products and services. Some of the giant retailers such as Costco, Wal-Mart and Target offer different prices for their own brand name photo-finishing services, which may cause some consumers to opt for their brand film and photo-finishing services due to the higher priced Kodak products and services.



Buyer and Supplier Power

There does appear to be a small amount of supplier power in the photography industry. In 1989, Kodak strategically created a supplier diversity program, because Kodak considers it vitally important to have a diverse supplier base. Engaging diverse suppliers gives Kodak the advantage of tapping the best, most agile and innovative companies, while the firm remains power over the supplier.

However, Kodak did run into problems with a German imaging company, Gretag, that through an alliance since 1997 was supposed to make the hardware for Kodak's digital minilabs, while Kodak provided the software. Gretag filed for bankruptcy in 2002, and Kodak has since landed a new partner, Japan's Noritsu Koki Co. Kodak has only begun collaboration with Noritsu. Kodak currently only has 100 digital minilabs in service nationwide. Kodak projects that it will sell 1,000 minilabs this year.

Fuji has more than 5,000 labs in place, already 60% of the U.S. digital minilab market, including deals to put machines in 2,500 Wal-Mart and about 800 Walgreen stores. These two chains handle about 40% of the U.S. photo-processing market. The minilab dilemma clearly illustrates the supplier and buyer power that exists in the consumer Photography segment. Kodak has customized and co-branded online services with key retailers, such as CVS, Costco, and Rite-Aid to provide customers with easily accessible solutions to their traditional and digital photography needs. These retailers have gained some buyer power in recent years through the joint services. Kmart, which filed for bankruptcy on January 22, 2002, was supposed to be a key retail partner for the Picture Maker digital photo developing kiosks.^{ix} With 6-8% of U.S. retail film sales and an exclusive offsite processing deal with Kodak, K-mart closed one-sixth of its U.S. stores. The large retail stores such as Wal-Mart, Sam's Club, Walgreen, CVS, and Target could potentially use their leverage against Kodak.

Entry

When looking at a photo products company, factors to consider include its competitive position, pricing pressures, and the strength of its technology. With the growing importance of digital imaging, attention should be given to product development, and to a company's ability to convert R&D efforts into profits.

As a large and long-established firm, Kodak's competitive advantages include a highly reputable brand name, as well as economies of scale. Kodak is involved in several business segments worldwide, such that it would be improbable for another company to rival it comprehensively. There are large capital fixed costs and the current nature of the photography industry is hyper-competitive with the magnetism of the digital trend. There is, however, a threat of entry in each of the individual business units.



In the consumer Photography segment, the possibility of another firm entering the market is present. Especially in imaging and printing, the likelihood that an entrant from the computing business will enter is high as imaging needs move further towards digital format. Samsung is a good example of a vendor that may plan to jump into the fray of digital cameras, since it recently established an objective of entering the market and obtaining a 10% unit share by 2005.

Branding is an important factor in Kodak's marketing campaign. Name recognition and product quality have enabled Kodak's unbeatable success for more than a century. The firm has established a strong reputation in each of the segments by producing trusted products and advertising heavily. Kodak is among the top three digital marketers in the industry, as well as 2001's fourth-ranking medical radiology advertiser. Kodak should attempt to extend its brand strength and its film and paper reach with its Perfect Touch processing to digital photos by tying Perfect Touch to Ofoto.

As a large, well-established company, Kodak exists in an industry where an entrant would find it difficult to achieve a substantial market share to reach the minimum efficient scale, and thus an entrant would be at a significant cost disadvantage. Kodak benefits from economies of scale, which in turn enables the aforementioned marketing expenses, as well as extensive R&D funding. Kodak will continue significant investments in R&D, since the primary source of future growth is through product innovation. The existence of the economies of scale decreases the risk of entry and the likelihood that Kodak would have to respond with price reductions if entry were successful.

Strategy

Eastman Kodak appears to be heading in the right direction with the expansion of their digital offerings. As the digital age progresses, Kodak struggles to maintain its position as the market leader in the photography segment. As consumers shift from conventional to digital photography, Kodak's revenues and margins have been at risk. In terms of the immediate future, Blaisdell Consulting believes that Kodak should focus on the various forms of digital output as the number of digital camera owners increases. For the long term, trends indicate that integrated portable devices will be successful and Blaisdell Consulting believes that Kodak must develop relationships with the key firms in order to keep up with the increasingly digitized world.

Digital solutions

Kodak has great potential for growth in digital output technology. As digital image capture grows in the many markets that Kodak serves, demand will accelerate for hard



copy images from digital files. Four options currently exist for consumers to print their photos. These options include: home printers, minilabs, kiosks and online services. Lyra Research Inc., an imaging research outfit in Newtonville, Massachusetts projects a \$7 billion market for digital processing by 2005, with 32% of that done at retail.^x Kodak should capitalize on some of these photo output options, but which ones? It is currently unclear which of the methods will be the most popular in the near future, but Blaisdell Consulting believes that the online retailer has a chance to be Kodak's strong force in the growing digital industry.

Currently nearly 82% of all digital camera owners print their digital photos on their PCs, and 7% use retail outlets, but that trend is presently changing. Printing at home is often very costly due to the high priced ink cartridges and paper, and is often slow and tedious for most normal consumers. Kodak's new printer that links directly to its EasyShare digital camera may not be the best photo output solution. The prints will still cost 50 to 70 cents per print, which does not make digital printing any cheaper. Kodak must develop an even less expensive printer that can compete with Canon Inc.'s \$99 machine that does both general purpose and photo prints, or even better, leave the printer manufacturing to Canon and HP. Regardless, we believe that Kodak must establish that it creates higher-quality digital output in an easier and cheaper manner.

While digital minilabs currently account for only 6% of digital printing output, industry experts foresee huge growth potential. Increasingly more consumers are dropping off digital cards at store counters with the minilabs, as they now do with film, because it is familiar and easier than home printing, and often less expensive. As digital photography gradually becomes mainstream, consumers will progressively want someone else to handle the print making, as currently with traditional film. Kodak has missed out on the opportunity to seize the number one position in the digital minilabs to Fuji, which dominates the minilab photo-processing market through its minilabs in Wal-Mart and Walgreen stores. Kodak must get more of its equipment into retail venues such as CVS and Target to prevent the film giant from falling further behind in the consumer end of digital photography. Expansion of Kodak minilabs in smaller chains, mom-and-pop stores, and non-traditional retailers may help Kodak keep a larger position in the digital processing market.

Kodak currently dominates one of the retail processing segments: the self-serve kiosks. As minilab processing becomes more popular all forms of digital output will become more popular, even kiosk output. The kiosks enable customers to customize their prints in a matter of minutes. However, Blaisdell Consulting believe that consumers will soon stop using the kiosks as other digital output options become more readily available and more convenient. We recommend that Kodak slow down the rollout of these kiosks for now.

Kodak's online photo service, Ofoto, should be paired up with Kodak's new Perfect Touch processing system to link Kodak more broadly with better pictures, not just film and paper. Perfect Touch combines Kodak's branding, software, hardware, and existing



customer relationships to dramatically improve photos. With Perfect Touch, the number of photos that are useless and discarded because of poor exposure should be sharply reduced. This may increase satisfaction with photography and burnish Kodak's brand, not only for film and paper, but also for advanced technologies. Perfect Touch plus Ofoto could be the vehicle that launches millions of durable online photo service relationships with Kodak, bridging the gap between its leading conventional brand and its new digital offerings. Also, we believe that Perfect Touch processing may provide a link bringing digital services to traditional photographers.

The widely held view is that the emergence of digital photography will benefit proven device manufacturers, such as Sony, software vendors, such as Adobe and Microsoft, and printer manufacturers, such as HP and Lexmark. With the emergence of Perfect Touch processing, we believe that Kodak is developing a strategy to deal with this transition. Soon, Kodak can stop subsidizing digital cameras while still gathering millions of digital customers. In addition, possessing the digital files on Ofoto is critical, as print-quality digital pictures are large and hard to move over slow Internet connections. Once Kodak builds customers' digital scrapbooks, they will have incentives to return to Ofoto to add to their scrapbooks. We believe these scrapbooks will generate long-term loyalty to Kodak, or whoever holds them, no matter whose camera or software the customers use.

Kodak should encourage current customers to provide their email address when they submit film for Perfect Touch processing so that Kodak can establish an Ofoto account for the customer and invite them to experience the benefits of digital photography without ever buying a digital camera, scanner, or uploading a file.

Qualex currently processes 300 million rolls per year, about 40-50% of total U.S. rolls. If Perfect Touch is successful, Kodak will be scanning and correcting 10-15% of U.S. rolls within two years. If it attaches Ofoto accounts to these rolls, Kodak could become a stronger player in the U.S. digital photography than it is in conventional photography.

Integration of media devices

In conjunction with Sanyo Electric, through the joint venture called SK Display Corp., as well as with the creation of the new Display Group in the fourth quarter of 2002, Kodak expects that their new display products will accommodate the trend of portable and handheld devices becoming lighter, thinner and overall more popular. The OLED displays use organic films instead of the crystal-based liquid crystal displays (LCD). OLEDs are advantageous in several ways; they are thinner, brighter, lighter, almost unbreakable, they provide a wider viewing angle, have a faster response time and require much less power. It is highly likely that OLED will replace LCD when it becomes less expensive as the company improves materials and expands production yield. OLED displays are expected to turn up in cell phones, PDAs and digital cameras.



Last month, Samsung NEC Mobile Display Co. Ltd., a joint venture between Samsung SDI and NEC Corp. of Japan, agreed to license Kodak's OLED patents to build and sell passive-matrix displays for mobile phones. Kodak should begin developing relationships with firms that are introducing new digitized multi-media devices. The expectations of all-encompassing multi-media devices have ignited an eruption of partnerships and technology agreements as companies race to carve out market position.

We suggest that Kodak form partnerships with the other key players in the digital multi-media revolution, such as Motorola, Nokia, and possibly the PDA manufacturers. It is predicted that eventually a single handheld device will act as a phone, camera, PDAs, music carrier, game console and much more. The digital generation demands the transfer of information to be quick and effortless, while also cost efficient.

The camera-phones that have just recently been introduced by Samsung, Motorola and Nokia are still rather costly to the average consumer and the transfer of these digital photos remains minimal due to expensive connection fees, slow transfer, and poor image quality. Kodak should work to develop a higher quality, low memory solution for the ease of transfer.

Blaisdell Consulting believes that by focusing on the digital trends, Kodak may maintain its position as a worldwide leader in the photographic industry. Additionally, if Kodak is to get back on the growth track, the company needs to identify the essential application or applications in digital processing.

ⁱ From the Kodak.com website.

ⁱⁱ Lashinsky, Adam. "Kodak's developing situation" *Fortune* 20 Jan. 2003: 176.

ⁱⁱⁱ Faith Keenan in Rochester, NY, with Cathy Schottenstein in Atlanta. "Big Yellow's Digital Dilemma." *Business Week* 24 Mar. 2003: 80.

^{iv} Faith Keenan in Rochester, NY, with Cathy Schottenstein in Atlanta. "Big Yellow's Digital Dilemma." *Business Week* 24 Mar. 2003: 80.

^v Wonacott, Peter. "Picture-perfect in China." *Far Eastern Economic Review* 166.10 13 Mar. 2003: 58.

^{vi} "Renewal of X-ray supply deal leaves Kodak as preferred Consorta supplier." *Hospital Materials Management* 28.3 Mar. 2003: 8.

^{vii} Jacobson, Jeff. "Succeeding in a mature market" *Chief Executive* Dec. 2002: 16.

^{viii} Annual report 5

^{ix} Wasserman, Todd. "Moms in Kodak's focus; JVC sings a new tune." *Brandweek* 44.7 17 Feb. 2003: 10.

^x Faith Keenan in Rochester, NY, with Cathy Schottenstein in Atlanta. "Big Yellow's Digital Dilemma." *Business Week* 24 Mar. 2003: 80.

