blaisdellconsulting
strategic solutions for global leaders

Fighting on Equal Grounds: Eliminating Gateway Country Stores

Michael Renery
Stacy Kend
Lily Chang

Gateway

Table of Contents

Executive Summary

Gateway is suffering from severe financial losses and significant loss of market share. Gateway has two business models, neither of which is working. It is being hammered in Internet sales to experienced- and repeat-sale buyers. The Gateway Country stores lack the economies of scope and scale to compete in the retail market against the larger electronic retail stores. Best Buy, for example has more store locations and a breadth of product line that caters far better to the inexperienced computer buyers than Gateway Country does. The same is true for CompUSA.

Blaisdell Consulting suggests three paths from which Gateway should choose. The first, a turnaround option, calls for Gateway to continue under its current focus. It must shut down unprofitable Gateway Country stores and continue to operate the successful ones. This will enable the company to use the money it saves to introduce new computers, lower prices, and provide enhanced customer service.

A second solution is to focus on a retail strategy that calls for complete shutdown of all Gateway Country stores. Instead, Gateway brand products would be sold through the large electronic retail stores such as Best Buy and CompUSA. This would eliminate the overhead costs that have been killing Gateway while still exposing Gateway products to the market of inexperienced computer users. Gateway would continue to provide online sales to experienced buyers.

A third option is for Gateway to cut its losses and exit the market altogether. The plan would be to merge with another company or sell itself and let another company carry out the aforementioned retail strategy.

Currently Gateway is pursuing the first of these options, the turnaround strategy. Blaisdell Consulting feels this is a failed strategy that will not lead to a profitable future. Blaisdell Consulting also believes that Gateway is not ready for the third option of exiting the market. Gateway has outstanding products. We think realigning with the retail strategy will likely bring more value to stockholders than an exit strategy. The retail strategy is the best option for Gateway. It combines Internet sales for experienced consumers and businesses with existing retail channels, such as Best Buy and CompUSA, to reach the inexperienced consumer market that Gateway would not otherwise be able to target. This should put Gateway in a situation that allows it to compete effectively with other PC companies. The retail strategy has the added virtue that if it does not work Gateway will still have time to pursue the exit strategy at a later time.

Company History

Founded by Ted Waitt in 1985, Gateway began with only a $10,000 loan and three-page business plan. Waitt guided the company to immediate success, and Gateway quickly became a multi-billion dollar company. The cow-spotted boxes helped Gateway receive national acclaim in 1991, and in 1993 Gateway cracked the Fortune 500. Today, over 10,000 of these highly identifiable boxes are shipped every day. Gateway made several ground-breaking strides in the 1990's. In 1992, Gateway offered customers a choice of software at no extra charge. In 1995, Gateway became the first PC Manufacturer to offer online ordering. In 1996, Gateway introduced a nationwide network of retail stores where customers were able to try out products, receive advice from technology experts, and gain knowledge and familiarity of the Gateway technology in innovative, high-tech classes offered on-site.

In addition to their high-quality PCs, Gateway offers numerous cutting-edge products including plasma TVs, digital music, photography, and video products. These Gateway products are marketed to all types of users. Gateway products can be purchased online through the company website or at any Gateway Country retail store. Customers can customize their PC's online or in the stores to meet their specific needs and desires. Pre-configured computers are also available at the retail stores for prompt delivery to customers.

Initially, Gateway went public in 1993, cracking the Fortune 500 and achieving heralded success. After trading on the NASDAQ Gateway began trading on the NYSE in 1997. Stock prices have seen periods of steady and dynamic gains as well as extended periods of decline. Currently GTW trades at just over 2 dollars a share. This is compared to its 2000 level of over 80 dollars per share.

Porter's Five Forces

Internal Rivalry

Gateway, Inc markets personal computers nationwide. The company operates in the Computer Hardware sub-industry, which as a whole has fallen victim to a slow economy. The stock price has fallen dramatically since its 2000 peak near $80 into the two dollar range. Weak PC shipments knocked it further behind U.S. market leaders. Gateway fell to fourth place, behind Dell, H-P, and IBM in International Data Corp.'s first-quarter rankings of U.S. suppliers. After withdrawing from international operations Gateway has announced a plan to strategically reposition itself to expand its presence in the individual, home office, and small business markets. Along with personal computers Gateway also sells many accessories, such as printers, scanners, speakers, computer software, digital TVs, digital cameras, and MP3 players. Most of these products are not developed by Gateway but sold in order to increase its economies of scope. Gateway is also attempting to expand its "beyond-the-box" revenues, which include sales of software and peripherals, Internet access, financing, and warrantee and training revenues.

Gateway competes with Dell, Hewlett-Packard/Compaq, Apple Computer, IBM, Palm, and Sun Microsystems in the computer hardware industry. The Information Technology industry has faced a 29.9% decline. This is compared to the 22.2% decrease in the market as a whole. Although the outlook remains promising for the industry, Gateway's future remains questionable.

The graph below illustrates the competition Gateway faces within the computer hardware sub-industry. Important points to note are Gateway's $1 billion stock market capitalization. This compared to HP at $58 billion, Dell at $64 billion, and IBM at $137 billion. Standard and Poor's gives Gateway a C in its quality ranking. This suggests that Gateway is struggling to keep up with the top competitors in the industry.

SUB-INDUSTRY: COMPUTER HARDWARE
*PEER GROUP: COMPUTER HARDWARE - LARGE SYSTEM VENDORS

Peer Group	Stock Symbol	Recent Stock Price	P/E Ratio	12-mth. Trail. EPS	30-day Price Chg %	1-year Price Chg. %	Beta	Yield %	Quality Ranking	Stk. Mkt. Cap. (mil. $)	Ret. on Equity %	Pretax Margin %	LTD to Cap. %
Gateway	**GTW**	**3.09**	**NM**	**-0.71**	**-3%**	**-55%**	**NM**	**Nil**	**C**	**1,001**	**NM**	**NM**	**Nil**
Apple Computer	AAPL	14.10	NM	0.05	-3%	-37%	1.69	Nil	B-	5,064	1.6	1.5	6.8
Auspex Systems	ASPX	0.31	NM	-0.95	-16%	-81%	1.79	Nil	C	14	NM	NM	Nil
Dell Computer	DELL	24.83	34	0.74	-7%	-14%	1.79	Nil	B+	64,042	24.2	5.6	10.0
Handspring Inc	HAND	0.95	NM	-0.46	-11%	-85%	NA	Nil	NR	138	NM	NM	Nil
Hewlett-Packard	HPQ	19.23	NM	-0.36	2%	-18%	1.55	1.7	A-	58,680	4.4	1.6	21.1
Int'l Business Machines	IBM	81.30	39	2.10	3%	-32%	1.47	0.7	B	137,404	35.1	12.8	40.3
Intergraph Corp	INGR	17.60	3	5.85	3%	24%	0.72	Nil	B-	812	7.0	5.4	0.4
NCR Corp.	NCR	19.08	14	1.38	-20%	-55%	1.61	Nil	NR	1,861	11.7	2.1	0.5
NEC Corp ADR	NIPNY	3.87	NM	-1.41	8%	-59%	1.48	1.0	NR	6,401	NM	NM	69.6
Palm, Inc.	PALM	17.29	NM	-9.57	3%	-80%	NA	Nil	NR	503	NM	NM	6.7
Silicon Graphics	SGI	1.30	NM	-0.09	7%	-50%	1.89	Nil	C	260	NM	NM	121.5
Sun Microsystems	SUNW	3.75	NM	-0.74	20%	-70%	NM	Nil	B+	11,683	NM	NM	12.6
Xybernaut Corp	XYBR	0.55	NM	-0.50	0%	-75%	NA	Nil	NR	62	NM	NM	Nil

Gateway faces direct online competition from several companies. Dell leads this group. Gateway and Dell have a very similar product lines in that both offer similar quality products and use the Windows operating system in their PCs. Peripheral electronic devices are also sold online by Dell and Gateway.

Additionally, other competitors such as Apple, HP, and IBM have product overlap with Gateway in a several areas, such as affordable home computers. However, Gateway does not offer server options such as UNIX and LINUX. Further distinctions within the companies reflect different target markets as well as distribution venues. Apple, HP, and IBM all sell their PCs in retail stores such as CompUSA and Best Buy. Because these companies are all outperforming Gateway, this venue will be a suggested distribution channel for Gateway to explore.

Dell paces the industry in terms of total PC sales. HP/Compaq challenges Gateway in the sales of many accessory goods, such as printers, scanners, and other external accessories. Since these goods are very similar the price-elasticity of demand is high. Gateway, as well as its competitors, is looking to develop innovative and unique products.

In addition, prices in the computer industry have little room to fluctuate. The products are very similar and online sales make immediate price comparisons very easy. A consumer can specify nearly identical computer configurations and choose the one that is cheapest. For this reason, companies have very little pricing power.

Substitutes

There are few alternative products to a personal computer for consumers to surf the Internet or utilize a word processing. There is little in the way of direct substitutes for the personal computer as its functions are very specific and unique. Cellular telephones now have limited Internet access and have email capabilities. Palm Pilots can also simulate certain but limited personal computer functions. It is difficult to compare cell phones or palm pilots to personal computers, as there is a substantial difference in price and capabilities. Wireless technologies are also being incorporated in personal computers with the development of the wireless mouse and keyboard. Also, PC users can now have the option of using wireless Internet access.

Complements

The Windows operating system is one of the most important complements to the personal computer. Gateway exclusively uses Windows for its computers. It enables most personal computers to be compatible with each other, allowing files to be easily transferred. Internet access is another important complement, which allows users to communicate and obtain information at high-speeds.

Gateway's many accessory products are also compliments to its personal computer. First-time buyers will be very likely to buy a printer from the same company they buy their personal computer. Experienced buyers tend to research in hopes of finding the best deals, which makes competitive pricing an important factor.

Customer service is another important complement that first-time buyers value when choosing a computer. Consumers are able to obtain fast and efficient turnaround on their computers when they bring them in to retail stores. New computer users can obtain basic computer knowledge and navigation skills, as well as higher-level training courses.

Entry

Gateway, Dell, HP, Compaq, and Apple are among the leading names in the Computer Hardware industry. These companies operate with large economies of scope which makes it tough for another company to compete comprehensively. A company that specializes selling a single product is likely not threatening to Gateway or any computer companies. For example, it would be easy for a company to make and market MP3 players to compete with that particular section of Gateway's sales. The same is true for software and video games that Gateway sells. These markets hardly define Gateway as a whole.

Entry can occur within the industry as well. It seems within the computer industry companies begin specializing in certain areas. For example, HP, has its ink and printer technologies. This Gateway is trying to do this with its plasma TVs. Another company

may have difficulty trying to enter the segment of a market that is already developed and controlled by a competitor.

Further barriers to entry are high start-up costs involved in creating manufacturing plants as well as developing research and design to compete with the ever-changing industry. A new company would also need to invest into establishing advertising campaigns.

Brand loyalty plays another important factor in dissuading start up companies from trying to enter the market. Many buyers have preferred companies. This loyalty may stem from real experience with the company products or perhaps from a particular advertising scheme a viewer enjoyed.

Supplier Power

In the computer industry there is significant supplier power. Microsoft, which produces the Windows Operating System, and Intel, which produces the computer processors are the two main players in determining comp uter prices. Consumers pay a premium every year for developed and updated processors and operating systems. This keeps the price of a new computer very high. Manufacturers must bear the cost of advertising these upgrades, as well as updating inventories whenever new upgrades are introduced. Faster and better services ensure a steady stream of new computer buyers.

Buyer Power

The buyer power in the consumer computer hardware industry is small. With the existence of the direct sales method by Dell, customers can get exactly what they want out of a PC or system of PCs without costs to the manufacturer. Other manufacturers use indirect distribution channels such as retail outlets. The retail outlets, no matter the size, do not possess significant buying power. A large commercial customer could potentially gain some buyer power. Large businesses requiring high end enterprise solutions in particular could gain power in a computer company attempting to grow in this business

Financial Overview

Net Sales

Between the third quarter and first nine months of 2002, Gateway, Inc. showed sales of $1.1 billion and $3.1 billion. When compared to the same periods of 2001, sales reflected a decrease in sales of 21% and 37%, respectively. Gateway's personal computer shipments increased by 12% in the third quarter of 2002. However, this increase was at a lower rate than its competitors. It had been reported that in the second quarter of 2002, the company would experience a drop in sales of approximately $200 million due to the discontinuation of retail stores and changing the international market. During this time, Gateway shut down nearly all of its international operations. Consumer sales declined 9% and 29% in the third quarter and first nine months of 2002. This was following the second quarter of 2002 where sales were able to increase 20% while unit shipments increased 26%. These increases were due to changes in pricing and marketing. The business segment sales showed similar results to the consumer net sales, with a decline of 20% in the third quarter and 29% in the first nine months of 2002 when compared to the same periods in 2001. The Company inferred that state and local governments, as well as educational sales, were affected by budget constraints in the third quarter of 2002, which resulted in the decrease of net sales for Gateway. Gateway's Digital Technology Solutions, such as Internet access and financing solutions, saw a decrease comparable to 2001. In the third quarter and first nine months of the second quarter, this area represents $176 million and $529 million of sales. Yet in 2001, sales were higher with $242 million and $968 million. Digital Technology Solutions, also known as "beyond-the-box" revenue is most likely due to the decline in the number of units shipped, ending certain actions that were not profitable, and bringing back service plans that were once outsourced to a third party.

During the first nine months of 2002, Gateway closed 22 retail stores, reducing the total number to 274 stores across the United States. They are reevaluating the profits and capabilities of each store in order to determine whether their locations or existence is favorable to the company. If they are determined to not be favorable, then more closures are likely.

Gross Profit

Gross profit for the third quarter of 2002 was $168 million, while profit in the first nine months of 2002 was $436 million. Profit as a percentage of sales in the third quarter of 2002 increased from 8.5% in 2001 to 15% in 2002. An increase from 12.1% to 14% was seen in the first nine months of 2002. These percentage increases are reportedly due to the larger volume of unit sales, cost reductions in technical support, improvements in products, price reductions and tighter inventory controls.

Operating Income

Gateway reported an operating loss in the third quarter and first nine months of 2002 of $81 million and $393 million, which can be compared to the losses in 2001 over the same times of $555 million and $1.2 billion. The losses are suggested to have resulted from the reduction of the workforce, the closure of retail stores, and other charges. Without the restructuring and other charges, the operating loss would have come to $294 million in 2002 compared to $134 million in 2001. The increase of the operating loss is most likely due to the decrease in the number of units sold, the value pricing and marketing strategies and "de-leveraging of expenses."

The consumer segment showed an operating loss of $55 million for the third quarter of 2002 and $147 million for the first nine months of 2002, while in 2001 the operating losses were $1 million and $5 million over the same time periods. The increases in losses from 2001 to 2002 are due to the decline in the gross margin percentage because of value pricing and marketing. Business segment operating losses during the third quarter and first nine months of 2002 were $56 million and $118 million compared to the losses of $41 million and $162 million in 2001. Non-segment operating losses showed similar results with the third quarter and first nine months of 2002 showing losses of $82 million and $363 million, while the 2001 periods represented losses of $562 million and $1.3 billion.

Strategy

Turnaround Strategy

Gateway's situation is grave. Gateway consistently reports negative profits as well as dwindling market share. Gateway is trapped behind a strong obstacle in two separate markets. First, Dell has overpowered Gateway in the direct online PC sales, leaving Gateway to fight within the retail sector. Second, Gateway is losing market share there too, as stores such as Best Buy and CompUSA are currently outperforming Gateway with regards to profits and market share while selling other lines of computers. If Gateway is to rebound, it must continue to improve upon its current policies as well as redirect its strategy for regaining market share in both markets.

Gateway initially opened 300+ Gateway Country stores as an experiment to see where successful markets would be. It began closing unsuccessful stores. There are certain aspects the stores provide that are central to Gateway's current focus on offering great service. Without the stores Gateway would not have any customer service or repair centers. However, for stores where costs are currently greater than revenues, continued store closures are inevitable. Store closures will not only reduce costs, but revenue as well. Furthermore, exiting from the retail sector would leave Gateway head up against Dell and, currently, Gateway is not ready to be in that position. Thus Gateway is in the unfortunate situation where it cannot exit retail, but it is losing too much profit by operating its Gateway Country stores.

Moreover, it is uncertain the distance one is willing to drive in order to purchase a computer. Although computers are considered large, expensive buys, will a consumer drive an extended distance to learn about Gateway PCs, when he or she can more readily drive to a computer superstore? Blaisdell Consulting thinks not. Further store closures will likely eliminate those consumers unwilling to drive the extra distance for a Gateway. Similarly, Gateway's boasts of eased maintenance may be made less attractive if the consumer is forced to drive long distances for in-store repairs. In this sense, the opportunity cost of driving to the further Gateway Country store may be greater than taking a PC to the nearby Best Buy and paying for the repairs. For Gateway to get that business, consumers would have to believe that service at Gateway is worth the added time spent in distance between stores.

Though it is competitive in certain areas, such as corporate sales, Gateway is so far back in the learning curve behind Dell it cannot expect to compete effectively against Dell in online and corporate sales. If Gateway chooses to remain as an operating business, the company must conquer the market of first time buyers. Experience goods are commonly sold in retail stores. In order to be successful in this market segment, Gateway must demonstrate that its computers are simple to operate and have all the capabilities one wants in a home computer. Buyers must be informed about Gateway's exclusive benefits

and services. They must feel that Gateway's staff is helpful and should be encouraged to utilize the customer support options. This might start with an appropriately targeted advertising campaign. Currently Gateway advertisements have been sparse and misdirected. Dell commercials appear regularly on TV as well as in pop-up ad form on web browsers. Gateway television commercials are catered toward the corporate user. The computers are presented so they look sophisticated and professional. This type of campaign likely deters novice computer users. Certainly a Gateway advertising scheme should have mention of the excellent customer serving offerings available to its users. Right now, customers do not know what they are getting when they buy a Gateway computer, unless they investigate online or go into a Gateway Country store.

Gateway needs to look to improve margins and bottom line profitability. Blaisdell Consulting feels this could be possible through three factors: a decrease in selling, general, and administrative costs (SG&A), an annual reduction in cost of goods sold (COGS), and increased diversification through digital solutions which have significantly higher gross margins than PCs. Although increased diversification seems to be a potential solution, it would be a risky strategy considering Gateway's uncertain business model. It is important to note that timing is of critical importance in implementing any of these three strategies.

A final, less proactive approach for Gateway would be to wait out the storm of falling stock price and lost market share, and hope the market recovers. The entire computer sector has been hit by a declining stock market. Five years ago Gateway was a Fortune 500 company. Though it seems unlikely that Gateway will be able to challenge Dell for PC supremacy any time soon, perhaps Gateway can run a strong second place while turning positive profits as well as increased market share. Relying solely on the market to instigate this recovery would be foolish. Gateway would need to concentrate on the advice of Blaisdell Consulting as well as its own innovations and R&D contributions.

Retail Strategy

A bolder, more advisable strategy Gateway can adopt would be a complete shutdown of all Gateway Country stores and introduce Gateway products into larger electronic retail stores. With little overhead costs, Gateway would be able to maintain its online computer sales department as well. Currently, Best Buy sells a variety of computers, ranging from HP, Compaq, Sony, Alienware and Matrix. All of these companies also have websites with customizable configuration options. This venue would likely be very beneficial to Gateway, as it would gain significant exposure to the inexperienced computer buyer. The company would be sacrificing certain aspects of its customer service commitment that can only found at the Gateway Country locations. Not all services need to be eliminated, such as the 24-hour customer support and the free AOL subscription. Others must be developed and enhanced. The unbiased salespeople at the large retail store will inform the buyers of the benefits of a Gateway computer just as well as a Gateway Country store employee will.

Gateway would also be able to sell its other products in the large electronics retail stores. The plasma TV, which Gateway also sells, would be a terrific product to be displayed at Best Buy. Those interested in buying plasma TVs would choose the Gateway model whether or not it is being sold in a Gateway Country store. Since many of Gateway's accessory products are not the Gateway brand, these sales would be eliminated from Gateway's profits. This however, would allow Gateway to focus specifically on PC and plasma TV sales.

Gateway already has an advantage in its brand recognition. Many people know of Gateway but they do not don't know where or how to buy or test one. Those that do know will return to the Gateway website. The exposure from selling at large electronics retail stores will increase the number of first time buyers as well as solidify the return customer base.

Exit Strategy

We at Blaisdell Consulting feel the final policy Gateway can realistically consider is an exit strategy to leave the market completely. Gateway is not failing because it has a bad product. Gateway has a very recognizable name and has company strengths that could be utilized properly in the right setting. There are a couple of directions Gateway could take. One option would be to sell to or merge with another company. The other is to sell itself to a private equity firm. A private equity firm could buy Gateway and transform it into a profitable company. Gateway absorbs too many costs due to massive overhead from its retail stores. Currently, Gateway cannot hope to compete with Dell in the online sector nor against the large electronic retailers. Perhaps a competitor within the industry may find it valuable to buy Gateway in order to eliminate it as competition. Less competition could lead to increased profits in the long run.

Conclusion

Blaisdell Consulting has suggested three possible strategies for Gateway. The first, and one we recommend against, is the turnaround strategy. It calls for a continuation of Gateway's current Country Store format. Given the gravity of Gateway's current situation, a change is imperative. The Gateway Country stores are failing and Gateway is having difficulty reaching a desirable target market.

The exit strategy is another option. Exiting the market would not be recommended at this time because we feel Gateway's product should be given the opportunity to thrive in the right setting.

The retail strategy is most preferred. Gateway needs to shift its retail approach from its exclusive Gateway Country stores to the computer supercenter venue. This will eliminate the enormous overhead costs that have been suffocating Gateway while providing an adequate and dependable channel of distribution. Also, this strategy will allow Gateway to market its product lines to the inexperienced consumer. Inability to target this audience is currently one of Gateway's main downfalls. In addition, it will allow Gateway to focus on the quality of its products rather than its stores. This retail strategy will establish a solid base of return buyers, which will eventually allow Gateway to begin tackling the online sector and Dell. This retail strategy has the added virtue that if it fails it will not be too late to pursue the exit strategy.