HARVARD BUSINESS PUBLISHING

ONLINE SIMULATION FOREGROUND READING

Change Management: Power and Influence

Overview

You operate within Spectrum Sunglass Company, a ten-year-old, privately held company that designs, manufactures, and sells sunglasses. Headquartered in Tremont, California, all of Spectrum's design and production capabilities are in southern California. Two years ago, a relatively short, mild recession caused revenues to fall nearly 7%, to $91 million, and profitability to fall to essentially breakeven. As a result, the company initiated significant cost cutting. Last year, sales rose to $101 million after the economy emerged from the recession, and the company returned to normal profitability. **Exhibit 1** contains selected financial information for the previous two fiscal years.

The company currently employs 580 employees. Eight people are members of the top management team, and 20 individuals help lead the overall organization. The organizational chart for Spectrum is depicted in the Prepare Tab of the simulation.

In recent years, the retail value of the domestic sunglass industry has been approximately $3.4 billion. Analysts normally divide the U.S. market for nonprescription sunglasses into three price segments: low-end, moderate, and high-end. Low-end sunglasses are priced at less than $25 retail, and sold primarily through mass merchandisers, drugstores, grocery stores, and department stores. This segment represents roughly 50% of the industry dollars and 85% of the industry units sold. Moderately priced sunglasses range between $25 and $100 per pair. These glasses are sold through warehouses and sporting-goods stores, but they represent only 8% of the industry dollars and 5% of the industry units sold. High-end sunglasses are priced above $100 per pair. These are sold through sunglass specialty outlets and optical stores. These glasses represent 42% of industry dollars and 11% of industry units. **Exhibit 2** contains a summary of the prices, volumes, and channels involved with the sunglass industry.

Sunglasses address two basic functions in the marketplace. The first function is to protect the wearer's eyes from harmful ultraviolet light. This is particularly important because of the earth's thinning ozone layer, and it requires special expertise in eyewear manufacturing and sales. The second function focuses on fashion and aesthetics, and design expertise and celebrity endorsements help drive industry sales.

Spectrum offers a moderately priced brand of prescription and nonprescription sunglasses that are sold primarily in the United States. All sets of sunglasses feature UV-ray blocking polarized lenses, and all lines are marketed with an oceanic, sporty theme. Building upon the company's proprietary polarization technology, the polycarbonate lenses offer superior optical quality, color enhancement, and scratch- and impact-resistance. Crafted with the company's proprietary production technology, the frames are lightweight, durable, and available in a wide variety of unique shapes and colors. Originally targeted to swimmers and surfers, its products are expanding into other outdoor users. Retail price points for its nonprescription products range from $59 to $99 per pair, and they are sold on the Internet and through sporting goods stores. Prescription sunglasses are sold through optical stores for $75 to $100 per pair.

Spectrum's polycarbonate lenses require highly specialized resins, and the company has only one vendor that has been able to consistently deliver to its manufacturing specifications. As a result, the vendor has been able to pass through 100% of the incremental costs associated with rising oil prices. The rising oil prices, combined with Spectrum's inability to effectively hedge against the resulting increases in raw material costs, accounted for approximately 3.25% of the erosion in its earnings before interest and taxes (EBIT) margin[1] in the past fiscal year. This year, as oil prices have moderated, the company's margins have rebounded.

The recent volatility in Spectrum profitability resulting from softening demand has alarmed both management and the company's bank. Spectrum has a $10 million term loan and a revolving credit facility available for working capital with a maximum draw equal to another $10 million. Loan covenants associated with the borrowings require the company to maintain an interest coverage ratio of 3 x.[2] In the event that Spectrum is out of covenant for more than two consecutive quarters, the bank can require the firm either to pay down the loan immediately or raise additional equity capital.

The company's business is very seasonal, with peaks occurring in late May and December. During both of those periods in the past fiscal year, Spectrum was at risk of being out of covenant with its loan agreements.

[1] Historically, the company has had a 7.5% operating margin.

[2] The interest coverage ratio is calculated as operating income divided by interest expense.

Exhibit 1

Selected Financial Information for Spectrum Sunglass Company

Operating Results:	Last Fiscal Year	%	Current Fiscal Year	%
Net Revenue	**91,000**	**100.0%**	**101,500**	**100.0%**
Less: Cost of Goods Sold	50,050	55.0%	53,873	53.1%
Gross Profit	**40,950**	**45.0%**	**47,627**	**46.9%**
Less: Operating Expenses	40,040	44.0%	39,195	38.6%
EBIT	**910**	**1.0%**	**8,432**	**8.3%**
Less: Interest Expense	830	0.9%	900	1.4%
EBT	**80**	**0.1%**	**7,532**	**6.9%**
Less: Taxes	0	0.0%	226	3.0%
Net Income	**80**	**0.1%**	**7,306**	**4.4%**

Assests:	Last Fiscal Year	%	Current Fiscal Year	%
Cash & Cash Equivalents	1,820	2.9%	2,030	3.2%
Accounts Receivable	11,375	18.4%	12,688	19.8%
Inventory	7,583	12.2%	8,458	13.2%
Total Current Assets	**20,778**	**33.5%**	**23,176**	**36.2%**
Net Property, Plant & Equipment	41,200	66.5%	40,850	63.8%
Total Assets	**61,978**	**100.0%**	**64,026**	**100.0%**
Liabilities & Owners' Equity:				
Accounts Payable	10,511	17.0%	10,858	17.0%
Accrued Expenses	7,508	12.1%	7,756	12.1%
Total Current Liabilities	**18,018**	**29.1%**	**18,614**	**29.1%**
Long Term Debt	17,854	28.8%	18,802	29.4%
Owners' Equity	26,106	42.1%	26,610	41.6%
Total Liabilities & Owners' Equity	**61,978**	**100.0%**	**64,026**	**100.0%**

Exhibit 2

Adult Sunglasses Channel Report

Channel	Total Dollars	% Dollars	Total Units	% Units	$/Unit
Sunglass Specialty	$1,046,940,000	31%	7,640,000	8%	$137.03
Optical	$404,550,000	12%	2,780,000	3%	$145.43
Mass	$379,510,000	11%	24,720,000	25%	$15.35
Other	$819,770,000	24%	46,310,000	47%	$17.70
Sport	$136,830,000	4%	2,540,000	3%	$53.84
Drug	$134,450,000	4%	7,810,000	8%	$17.21
Grocery	$12,420,000	0%	860,000	1%	$14.52
Department Stores	$363,850,000	11%	3,480,000	4%	$3.48
Warehouse	$125,770,000	4%	2,160,000	2%	$58.34
Total	$3,424,090,000	100%	98,300,000	100%	$34.83

Price Range	Dollars	Units
< $25	50%	85%
$25-100	8%	5%
> $100	42%	11%

Source: JOBSON/VCA - VisionWatch; 12 months ending December 2009