A *diworsefication* case study: Rebuilding LEGO brick by brick

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Abstract

Title: A *diworsefication* case study: Rebuilding LEGO brick by brick

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This paper examines how a company may successfully walk out of a *diworsefication* situation: stage in which a brand has excessively overdiversified over new extensions, to the point it got weaker and its performance started failing. The study explains why companies enter a failing stage, particularly, mature companies which desperately search for innovation. It also concludes that several internal and external factors may lead a company to extend its business and that the idea of leveraging brand awareness and reputation, and spreading business risk over products may be appealing for a company to enter new markets. Yet, hidden costs, the possibility of a bad reputation on the parent brand, and extreme deviation from the core business may lead a brand to become lost, distracted, failing and losing money due to overstretching. Thus, this study provides guidance on when to stop diversifying and how to do it. The presented recovery strategies are content-orientated and process-orientated. The first includes cost efficiencies, asset retrenchment, focus on the core activities and build for the future. The latter involves reinvigoration of firm leadership and culture change. To better understand these concepts, this paper uses LEGO's case as a real-life example of a success story of a company which almost went bankrupt due to a blind chase after a brand extension strategy. Fortunately, the Danish company turned around mostly thanks to a fierce cut on unprofitable adjacencies and a rigid refocusing on the core business product, the bricks.

Resumo

Este estudo explora como uma empresa é capaz de sair com sucesso de uma situação de *diworsification*, termo derivado do inglês diverse + worse: estado que uma marca atinge após ter extendido excessivamente a sua oferta de productos e serviços, tendo por isso ficado mais fraca e com uma pior performance. Este estudo explica o que leva a performance das empresas a falhar, particularmente, empresas amadurecidas que procuram inovar-se. Esta tese conclui que são muitos os motivos externos e internos que levam uma empres a extender o seu negócio, e que a possibilidade de obter maior reconhecimento e de repartir o risco da marca por vários produtos alicia qualquer empresa a explorar novos mercados. Contudo, os custos escondidos destas extensões, e a possibilidade de deteriorização da marca e de que esta desvie o seu foco do negócio principal e se distraia, podem levar ao seu falhanço. Assim, este estudo apresenta várias estratégias de recuperação, nomeadamente estratégias de conteúdo e de processo. A primeira inclui eficiências de custos, foco nas atividades principais da empresa, e construção para o futuro. A segunda inclui uma liderança firme e cultura de mudança. Para melhor compreender estes conceitos, este estudo usa a LEGO como exemplo prático de uma empresa que saiu com sucesso de uma situação de quase falência, devido a uma estratégia desmedida de extensão de marca. Felizmente, a empresa Dinamarquesa, conseguiu dar a volta cortando extensões que apenas davam prejuízo, e adoptando uma estratégia de focalização no producto principal da marca, tijolos.

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Introduction/Situation

In the financial year of 2013, LEGO, the well-known Danish construction toys' company, announced record results. Its revenues increased by 10% to €3.4 billion. Profits before tax reached € 1.1 billion (figure 1). Revenues had tripled in eight years, and LEGO replaced Hasbro in becoming the second largest toy company in the world, following the giant Mattel. Yet, ten years earlier, LEGO was believed to have lost its focus, wandering around businesses other than its core one. The company was about to go bankrupt. In 2003, its net sales suffered an overall decline of 26% and inventory jumped by 40% at some outlets. Among many other unsatisfactory financial results, it also presented a pre-tax loss on earnings of € 188 million, a drop of € 268 million compared to 2002. Back then, LEGO was reported the following way: "We are on a burning platform, losing money with negative cash flow and a real risk of debt default which could lead us to break up of the company" (figure 2) (Ashcroft, 2013).

The problem under analysis in this thesis is business failure due to brands' overextensions, hereby defined as *diworsefication*. Using Lego as the case under analysis, this thesis aims at impacting both the academic and the managerial world. On the one hand, it gathers literature on business performance failure, on the field of brand extensions, highlighting its pros and cons, and supporting methodical strategies for businesses to get out of a *diworsefication* situation. On the other hand, this study adds to the managerial world by helping companies identifying their failure process, allowing them to prevent it, handle it, or not repeat it. Also, this study suggests several reasons for which it would be interesting to bet on brand extensions, while it also refers some downsides. Ultimately, this thesis may be considered a guide for managers of companies with an overstretched brand portfolio, and that now aim to get up and refocus on the core business.

This thesis presents literature on the following four research questions: "Why was Lego performance failing?", "What drives a company to diversify its product range?", "How can a brand extension strategy negatively impact a company?", and "How may a company get out of a *diworsefication* situation?". Then, it presents LEGO's case study, going deeper on the before and after LEGO's 2003 crisis. Also, this paper includes teaching notes, where it couples Lego's case to theory, presenting learning objectives, preparation questions, a roadmap for discussion, and a short wrap up. Finally, this thesis presents its conclusions and future research.

Literature Review

This chapter is dedicated to the study of the research questions mentioned before. It will be divided in four section, each to address each question.

Research Question 1: Why was LEGO performance failing?

According to Sharma and Mahajan, an enterprise has multiple responsibilities. It must achieve certain market performance results, such as sales volume, sales growth, competitive market share, and strength of market position. It also has to produce certain financial performance indicators, such as profitability, growth, and liquidity. And, finally, it also has to achieve certain performance results in what concern stakeholders' (for instance: employees, suppliers, the community) interests, such as employment stability and advancement, creditworthiness, and corporate citizenship. If the firm at stake cannot meet one or more of its responsibilities, it is failing (Sharma & Mahajan, 1980).

To better understand the process of deterioration of a firm, Ooghe & De Prijcker suggest a conceptual failure model in which the lack of success of a company may be attributed to five main factors - variables emanating from outside the business and beyond the control of managers: **general environment** (external causes, such as economics, technology, foreign countries, politics, and social surroundings), **immediate environment** (interactions between the company and its stakeholders: customers, suppliers, competitors, banks and credit institutions, and stockholders), and **company's characteristics** (features such as lifecycle stage, size, and the industry in which it operates); and, variables emerging from inside the firm and from which the firm can take advantage of: **management of the company** (qualities, motivation, personal characteristics, and skills of managers), and **corporate policy** of the enterprise (strategy and investments of the enterprise, its commercial and operational components, personnel, finance, and administration, and also the overall corporate governance of the company) (figure 3). (Ooghe & De Prijcker, 2008).

Ooghe & De Prijcker (2008) described the existence of four types of failure processes, based on the company's maturity and causes of bankruptcy, the ultimate consequence of failure. Processes were named the following away: **the unsuccessful start-up** (figure 4)**; the**

ambitious growth company (figure 5)**; the dazzled growth company** (figure 6)**; and the apathetic established company** (figure 7). The first, second and fourth concern, respectively, companies which fail within five years of their inception, companies in their growth stage, and companies that fail after a lukewarm existence due to apathy and lack of commitment and motivation from management, falling outside of the scope of the project and therefore will not be address in the thesis. Then, Ooghe & De Prijcker (2008) presents the dazzled growth company, which is the term used to describe firms which fail at the mature stage of their lifecycle, and are therefore of utmost relevance for the purpose of this thesis.

Dazzled growth companies are usually at a more mature stage of their life cycle, and so, their failure process usually starts with the desire for growth, to innovate and to bring something new to the company. A new strategy is developed, often involving an innovative product or process launch. The initial reaction of the manager to the new strategy is to become over-optimistic and confident about the results of the new projects. Later on, the growth and capital expenditures increase together with leverage, yet pitfalls are ignored and the organizational structures remain almost untouched. Consequently, it will not take it long for the company to start losing control over its business, becoming unaware of possible issues that affect its operational efficiency and turnover, which culminates in a variety of negative indicators, such as overestimated sales, large overcapacity, and high expenses. Profitability and financial strength thus decline as a direct consequence. Management's dazzle and the company's unbalanced growth will continue until it faces extremely critical difficulties. At that point, the company has little chances to survive unless an internal restructuring takes place (Ooghe & De Prijcker, 2008).

A similar process is also defined by Litter & Sweeting (1985) when describing a radical innovation procedure in a mature company. They defend that this innovation (e.g. a new product development) tends to be seen as part of the corporate strategy and is often highly supported by the chief executive and the board, at first. Yet, this procedure does not usually have a formal charter outlined, and the goals are not defined with precision and the actual procedures to be employed are hazier. When it comes to deciding on which innovation to take, the search for opportunities seems to be more random than systematic, and few are the attempts to fund business ideas from which a rational selection could be made. The evaluation and planning and control procedures used tend to be those employed in the mainstream business, even though the more innovative nature of the new business ventures many times means that much of the data employed is highly questionable and tentative. Finally, the innovation process in a mature firm described above presents a series of factors that contribute to innovations to fail, decreasing the performance of the company.

After having explained the failure process of dazzled growth companies, Ooghe & De Prijcker (2008) explains which factors may or may not contribute to such deterioration. According to the authors, issues in general environment do not affect the survival chances of these firms. Yet, such factor may just affect the duration of the failure process. Thus, even if a company's odds of surviving an internal crisis are not affected by a change on the external environment, such as a recession, it may jeopardize the recovery time of the failing firm (Ooghe & De Prijcker, 2008).

The immediate environment is inevitable to survive, and keeping close interactions with it is fundamental. Therefore, when it comes to the influence of the immediate environment, Ooghe & De Prijcker believe that dazzled growth companies fail because they create feelings of mistrust on their customers. In fact, customers of such firms may just become confused and doubtful about the innovations implemented by the company, which may lead them to abstain from buying the new items (Ooghe & De Prijcker, 2008).

Considering management mistakes, they are the major cause of failures and performance indicators are its symptoms (Sharma & Mahajan, 1980). In what concerns dazzled growth companies' managers, Ooghe & De Prijcker (2008) defends that they do not lack management or industry-related experience, competencies, or skills (Ooghe & De Prijcker, 2008). Yet, these managers are usually confident and over-optimistic, living under the glory of past success, ignoring present signs of performance deterioration. While these types of managers are motivated, they can become distracted by new opportunities, seeing great potential in a panoply of investments, and may underestimate negative performance results. Sharma and Mahajan defend that failures can be predicted either by analyzing the strategic plan and/or its implementation or by observing performance indicators, such as profitability, leverage and liquidity ratios (figure 8) (Sharma & Mahajan, 1980). Thus, controlling the strategic plan at stake and keeping track of performance indicators, even though it is against the typical manager of a dazzled growth company, may soften, stop, or reverse the failure.

Finally, when considering the corporate policy of dazzled growth companies, Ooghe & De Prijcker (2008) defend that it fails majorly as a consequence of extreme gearing, which couples with an unadjusted managerial and operational structure. In fact, dazzled growth companies usually embrace strategies with over-investments and exaggerated risks. This failure process usually results in increased expenses and weak profitability. By the time the company develops its recovery plan, it has already lost financial strength and trust from the immediate environment (Ooghe & De Prijcker, 2008).

Research Question 2: What drives a company to diversify its product range?

A company applies a diversifications strategy when it starts operating in two or more lines of business (Yamoah & Kanyandekwe, 2014). In such processes, if the enterprise decides to use its well-established brand name for the new product or product category, it is applying a brand extension strategy. This poses one of the most challenging decisions for a company as the rewards and risks can be extraordinary. Thus, companies may be interested in a diversification strategy for several reasons.

According to Yamoah & Kanyandekwe (2014), diversification is an interesting solution for enterprises which intend to exploit economies of scope and have under-utilized resources or capabilities with high elimination costs, since economies of scope explore the diminishing unit production costs resulting from diversifying the production portfolio (Panzar & Willig, 1981). Langlotz (2008) suggests that brand extensions allow for cost reduction when brands transfer the image and knowledge about the parent brand to the extensions (e.g. core image dimensions or general quality perceptions are generally easily transferred). Particularly, in low involvement products, a high degree of brand awareness can be enough to make consumers buy the new products. Considering this, it can be inferred that product extensions allow for lower product introduction costs. Coupling that to name and trademark creation costs, this translates into time and money savings with diminished risks of legal action in terms of intellectual property rights (Langlotz, 2008).

Moreover, diversification may also be suitable when companies find their managerial skills to be transferrable to other markets (Yamoah & Kanyandekwe, 2014). Then, a company may expand into different businesses keeping the same reasoning and managerial procedures, which enables a more efficient expansion process. Also, Langlotz defends that brand extensions allow for faster market access (Langlotz, 2008). Thus, facilitated access to new markets and effectively leverage of managerial skills and procedures, may improve profits from brand extensions.

Jaulent et al (2007) suggest brand extension is an efficient strategy for companies to reach new consumers and penetrate new markets, supporting that extensions allow marketers to serve other segments. So, when looking into financial risk, diversification may be a good way for companies to spread their risk into different products and markets, so that success is not dependent on a single bet (Yamoah & Kanyandekwe, 2014). Diversification makes it easier for a brand to shift its positioning, so even if one product line or market is struggling, the company may leverage on others with more security and better results, and pull from or even abandon failing projects (Langlotz, 2008).

Moreover, according to Aaker & Keller (1990), a brand extension may be very attractive to firms that face high new product failure rates, since such strategy provides a way to take advantage of brand name recognition and image to enter new markets. Langlotz (2008) supports such point of view when stating that consumers who have no personal experience or knowledge regarding a product's quality are likely to use brand perception as a quality indicator. Therefore, consumers' knowledge about the parent brand image and name recognition can be leveraged to new markets, which can reduce new product failure rates, making extensions attractive for companies with high failure rates. All in all, leveraging strong brand names can substantially reduce the risk of introducing a product in a new market by providing consumers with the familiarity of an established brand, increasing initial sales volume and creating higher consumer acceptance. The advantage of applying a brand extension strategy goes hand in hand with the fact that companies applying a diversification strategy also take advantage of the possibility of cross-subsidizing one product with the surplus of another (Yamoah & Kanyandekwe, 2014).

On the field of brand perceptions and equity, Balanchader defends that a company may feel motivated to extend its product range as extensions may favorably affect the image of the parent/umbrella brand, which influences sales in other categories (Balachander & Ghose, 2003). Balanchader & Ghose support a positive spillover effect from advertising of a child on the choice of a parent brand. This is a particularly relevant find since these authors see little to no use on own advertising.

Additionally, Broniarczyk & Alba (1994) believe that the salient attributes of the original brand introduce new attributes into the representation of the extensions, as people may draw inferences about features of the extension that previously did not exist in the extended product category. If these attributes are positive, the inferences about the characteristics of the extensions will also be positive. Also, Aaker & Keller (1990) defend that brand extensions can decrease the costs of distribution and/or increase the efficiency of promotional expenditures. Bringing it to the next level, Langlotz defends that the parent brand can benefit from a successful brand diversification strategy in a much broader way (Langlotz, 2008), as positive effects from the brand extension may be felt by both the parent brand and the extensions. When looking into a successful parent brand, its sales are already maximized among highly loyal purchasers, thus positive reciprocal effects of extensions occur especially among prior nonusers and non-loyal users. Among prior non-users and consumers with low to moderate brand loyalty the experience of extensions can foster brand familiarity, lead to stronger brand attitudes and therefore change brand evaluation and increase the likelihood of purchasing the parent brand, eventually causing increases in market share of the parent brand. On the other hand, if the extension is a failure, negative reciprocal effects towards the parent brand are better absorbed if the parent has a very strong market position.

Finally, another interesting result by Nobeoka and Cusumano (1997) states that firms seem to do better when they leverage core technologies and designs across multiple product lines, while these designs are still relatively new. In other words, not only the application of technology leveraging but also the speed with which firms transfer new technologies across multiple projects seems to have an impact on corporate performance. Keeping such findings in mind, to increase sales, it seems useful for firms not only to develop new designs but, at the same time, to leverage these new designs quickly in overlapping projects that produce new products.

Nevertheless, not all types of diversification are the same. According to Yamoah & Kanyandekwe (2014), two types of diversification strategy may be pursued: **related diversification and unrelated diversification**. The first takes place when companies expand their operations beyond current markets and products, yet still operating within existing capabilities or their already existing value network. Conversely, unrelated differentiation exists when enterprises extend their operations into markets or products beyond current resources and capabilities. Aaker & Keller (1990) also defend the existence of two equal strategies on brand extensions, being the first the use of the brand name to enter a new market segment in its product class (related product diversification), and the second the use of the brand name to enter a completely different product class, unrelated product diversification. For the purpose of this study, the focus will be towards the latter.

According to Chang & Wang (2007), a company may apply an unrelated differentiation strategy when it is able to provide different businesses with managerial knowledge and expertise that reinforces the individual business, increasing the company's overall profits. Alternatively, Chang & Wang (2007) also find it suitable for a company to pursue an unrelated product differentiation strategy when it may reinforce the chances of increasing the strength of the economy of the different markets it plays in and developing competencies that may be shared among diverse markets and products.

When considering the possible benefits of applying a specifically unrelated brand extension strategy, such benefits are in line with the advantages of applying a general diversification strategy presented above. Firstly, this type of diversification allows companies to continue to grow after their core business has matured or at least it has started to decline. This goes together with the fact that unrelated product diversification may also mitigate cyclical fluctuations in sales revenues and cash flows (Yamoah & Kanyandekwe, 2014). By having more than one product to rely on, the company can allocate its resources into more promising products when the mature products' lifecycle comes to an end. Langlotz supports this idea, defending that brand extensions allow for uncoupling product life cycle and brand life cycle, stating that transferring image and brand awareness of phasing-out products to successors is the only way to uncouple product and brand life cycle, and make the capital invested in a brand last longer than just the product lifetime (Langlotz, 2008). The same applies to a product suffering from fluctuations in sales and cash flows, so that when sales are on a low, another product may compensate by having its sales on a rise, and vice-versa.

Moreover, expanding into unrelated products or markets spreads the business risk over different industries, allowing for financial resources to be directed to those industries offering best prospects, and stabilizing profits, as hard times in one industry may be compensated by better times in others (Yamoah & Kanyandekwe, 2014).

Additionally, Aaker & Keller (1990) suggest that subjects' perceptions of the difficulty of making the extension have a positive relationship with the evaluation of the extensions, supporting the hypothesis that an extremely easy-to-make extension, on average, is less likely to be accepted. Consumers may attribute placing a quality brand into what is viewed as a trivially easy-to-make product class as an effort to capitalize on a brand name image to command higher than justified prices, or that it is incongruous to introduce a quality brand name in a trivial product class. Considering this and perceiving an unrelated product differentiation strategy as more difficult to apply than a related one, it can be concluded that unrelated brand extensions may be better accepted than related ones, as expanding into unrelated markets usually involves leaving the company's comfort zone and explore non-dominant fields. (Aaker & Keller, 1990)

Last but not least, it may be interesting for a company to consider that unrelated diversifiers with high global market diversification achieve higher corporate profit growth than unrelated diversifiers with low global market diversification (Kim et al, 1989). Such finding may be regarded as an opportunity for firms which have a strong presence in the international market and which aim to extend their product range into new and unrelated to the core businesses.

Research Question 3: How can a brand extension strategy negatively impact a company?

Having already explored the advantages of applying a brand extension strategy, it is now important to present its negative side. The aspects below apply for both related and unrelated product extensions.

According to Langlotz, the primary risk when applying a brand extension strategy is uncertainty of success (Langlotz, 2008). Indeed, both product and geographic diversification fuel the complexity of multinational operations (Sambharya, 1995). Moreover, companies facing the decision to bet on diversification are usually inserted in an atmosphere not prone to thoughtful deliberation, which may make it more abrupt and its results more unpredictable (Markides, 1997).

According to Sambharya (1995) and Bausch & Pils (2009), product diversification is not profitable by itself and, per se, it will hardly influence performance. In fact, extensions per se rarely expand category demand and retailers cannot provide more shelf space to a category just because there is more product (Hardie et al, 1994). Biggadike (1979) even suggests that the odds for companies which aim to apply a brand extension strategy are often unattractive. Such strategy is not an activity for the impatient or the fainthearted.

When considering the position that brand extension reduces costs, many are against. In fact, extensions carry several hidden costs (Rust R., et al, 2006). Peckham (1981) suggested a study by The Nielsen Company, formerly known as A.C. Neilsen, in which 115 new product launches in five UK and US markets were compared in terms of market share of products released as new brands and those released as brand extensions. The brand extensions performed significantly worse, which was attributed essentially to the lower levels of promotional support of the extensions. Obviously, firms subscribing the argument that brand extensions meant savings in promotional costs, to their own detriment. So, the cost saving argument does not appear to stand up, as in fact brand extensions performed worse and may require brands to incur in some hidden and unconsidered costs. Also, according to Sharp (1991), since many of the costs associated with brand extension are incurred in the long term, many managers who operate under short-run sales and profitability budgets are incapable of giving a balanced estimation of the overall impact of this strategy on a business. Hardie et al (1994) add to the idea that brand extension may have a negative impact on costs by stating that the costs of wanton line extensions are dangerously high, as the strategic role of each product becomes muddled when a line is over-segmented. To say the least, multi-item lines are 25% to 45% higher than the cost of producing only the most popular item in the line (Rust et al, 2006).

From another point of view, Jones H. defends that if a brand is stretched too far, the rubberband may snap and the core value of the name devalues (Jones, 1995). In fact, brand extensions may cause dilution of the core brand, causing negative effects on brand image, making it lose meaning. According to Sharp (1993), continuing on betting on brand extension exposes a greater range of brands to the possible spillover of negative publicity, and bad publicity for one brand may spill over to the other brands sharing the umbrella name. Langlotz (2008) additionally suggests that negative reciprocal effects may appear if the extensions fail to meet consumers' expectations or are inconsistent with consumers' feelings or attitudes towards brand image (Langlotz, 2008). This may harm the brand equity and lead to decreases in sales for some or all products offered under the brand. Furthermore, negative reciprocal effects also work the other way around, in the sense that the beliefs about the parent brand can be harmful to the extensions, as some attributes are highly valued in one product class but associated with low quality on other. Finally, it is important to refer that though negative reciprocal effects are particularly likely if the extension is a failure, they can even occur in case of success. The wrong extension can always create damaging associations that may be expensive and impossible to change (Sharp, 1991).

When it comes to positioning, Langlotz (2008) points to the increased difficulty of positioning new products towards specific target segments. This risk is particularly felt in unrelated product extensions. Due to the high degree of brand integration, it becomes harder to position new products and to target them into specific customer segments. Also, the higher the number of product offerings under one single brand, the greater the coordination efforts, in particular for marketing and advertising activities (Langlotz, 2008).

Another diversification risk Langlotz (2008) suggests is the chance of cannibalization effects, when sales volumes of one or more products suffers due to the launch of an extension. This raises problems if losses in sales extend sales generated by the brand extension (Langlotz, 2008).

Moreover, managers' lack of expertise and knowledge about their companies when considering a brand extension is always a serious risk, especially when considering unrelated product diversification strategies (Schoar, 2002). To bet on brand extensions is a decision that involves an important growth trust. If the judgment is wrong, then substantial time and resources were lost and other market opportunities might have been missed (Aaker & Keller, 1990). According to Schoar (2002) and Aaker and Keller (1990), a successful unrelated diversification strategy is highly dependent on the manager's ability to develop skill and competency at managing such strategy. Schoar (2002) defends that if this managers' ability fails, coordination among activities will become highly complex, jeopardizing the possibility to achieve synergies and making it harder to effectively allocate resources. According to Aaker & Keller (1990), the success of a brand extension often relies upon assumptions made about consumer behavior, which are not always correct. Managers often mistakenly assume that the consumers hold positive beliefs and attitudes toward the original brand, many times also assuming that negative associations are neither transferred nor created by the brand extension, yet assuming positive associations with the parent brand facilitated the formation of positive beliefs and attitudes toward extensions (Aaker & Keller, 1990).

So, how can a company know when to stop extending its brand? Posing this question inside an enterprise may be hard, since marketers create extra pressure for extensions to be created to serve an increasingly segmented market (Rust et al, 2006). According to Sharp (1991), for managers operating for the short-run, any technique which might reduce the costs of introducing a new product must be highly tempting, particularly during difficult economic times. And, if the new product is suitably close to the existing brand's image, then the associated advertising is likely to increase overall sales in the short-term, since using an existing brand name tends to induce trial (Aaker, 1990), making related product diversification an interesting strategy. While these factors do not guarantee long or even medium-run survival or an adequate return on launch and development costs, brand extension can certainly make short-run sales figures look impressive (Sharp, 1991).

Yet, managers are not blind to the risks of brand extensions, and nearly 70% of them admit that excessive complexity is raising their costs and hindering their profit growth, according to a 2005 Bain survey of more than 900 global executives (Rust et al, 2006). Product and geographic diversification really are the fuel of the complexity of multinational operations (Sambharya, 1995).

Ultimately, when companies reach overcomplexity, some indicators stand out. Employees struggle to adjust workflows to accommodate new product configurations, error rates creep up, inventories expand, and managing all these symptoms becomes so difficult and costly that margins shrink dramatically (Rust et al, 2006). Worst-case scenario, an overstretched business suffers brand dilution, when consumers lose the original grasp of brand perception and no longer associate the brand with a specific product (Juda). So, why would a company go this far? The truth is that having an over complex business, even though it is common, it is also quite an invisible problem, which never comes to mind when trying to understand business shortcomings (Rust et al, 2006).

Research Question 4: *How may a company get out of a diworsefication situation?*

Business turnaround is the reversal of failing results — sales and profits – through fundamental change. Schoenberg et al (2013) propose two non-exclusive types of business turnaround strategies. **The content-orientated**, which concerns the main hard objectives of the turnaround, namely cost efficiencies, asset retrenchment, a focus on the firm's core activities, and building for the future, **and process-orientated** strategies, emphasizing the process itself to manage the change, including reinvigoration of the firm's leadership and corporate culture change (Schoenberg et al, 2013).

Content-orientated Strategies:

- **Cost Efficiencies:** Cost efficiencies is the turnaround strategy aiming at producing quick results to rapidly stabilize the business. So, this strategy is usually the first step of business turnaround, as it is easily implemented and has an almost immediate effect, requiring little to no capital or resources (Schoenberg et al, 2013). This cost cut strategy is also supported by Dunlap & Andelman (1997), who claim that it is crucial to be extra careful about expenditures to improve the business situation. According to him, companies which aim at turning around should pinch pennies, and attack costs, the main enemies of any business. The most commonly reported cost efficiencies in the literature are decreasing R&D, collecting and reducing accounts receivable, cutting inventory, stretching accounts payable, reducing marketing activity and eliminating pay increases (Schoenberg et al, 2013).

- **Asset Retrenchment:** This strategy usually comes right after the cost efficiencies. It consists of analyzing if underperforming areas can be made more efficient or need to be disinvested completely (Schoenberg et al, 2013). Retrenchment decisions are inevitably difficult, as there is the risk that asset sales will compromise future strategic options, while conversely they may be necessary to generate cash and reduce losses. Dunlap & Andelman (1997) support that to draw a solid business strategy, it is crucial to know in what business the company is playing in, so as to get rid of the assets that are not core ones and focus on the core like a laser. They advise to sell everything which is not in the core business spectrum; what is not in the core business is in what Dunlap and Andelman call the "dirty laundry", to free the business of managing them, redeploying funds into the right investments (Dunlap & Andelman, 1997). Rust et al (2006) also defends that the way to get healthy margins and a good market share is through focusing on the core product lines, instead of continually extending them. The suggested procedure to do this is through the elimination of slow-moving products so that all efforts are put into core offerings, the ones that account the most for sales. To do so, Rust et al proposes the study of the costs of producing and distributing each SKU, from the beginning to the end of the value chain. To do so, the company should ask itself: "What would my company look like if it made and sold just one product?". After having posed this question, the company could start adding variety back into the business, product by product, measuring customer interest and incremental revenues, estimating new costs and weighting complexity. The point where costs start outweighing revenues is what the literature names by "innovation fulcrum", this is, the number of offering that optimizes both revenues and profits. Finally, by identifying the innovation fulcrum, the enterprise would be able to provide precisely the right degree of variety and operational complexity, while also cutting and fattening margins (Rust et al, 2006). Then, it is necessary to develop deletion plans for unprofitable items that cannot be restored to profitability quickly and easily. Thus, if the company bets on extending its product portfolio, it must be careful enough to create adjacencies that make the original brand more exciting and appealing (Clark, 2008).

- **Focus on core activities:** This strategy is frequently associated with the previous one, and it includes determining the markets, products, and customers that have the potential to generate the greatest profits, refocusing the firm's activities in these areas. For that, companies must focus their product portfolio in the ones the firm is best known, or in customer segments that are particularly loyal or less price sensitive, or even in areas where the firm has distinct competitive strength (Schoenberg et al, 2013). The firm may also return to activities for which it was well known in the past, and may also need to redesign or restructure itself to be aligned with its core purpose, rationing, divesting or closuring operations, products or assets that do not fit with this purpose (Schoenberg et al, 2013). Zook (2007) defends that businesses must fight back the tendency to over diffuse over new temptations to avoid getting lost in all the possibilities. Zook and Ormiston (2001) support that the loss of focus leaves the core business undefended, occupies management's time and spends company's resources, and in some cases, even destroys the company's value by confusing investors and damaging share price. So, Zook and Ormiston suggest that companies should first look for opportunities to grow inside. Only afterwards, should companies bet on related business, the so-called, “adjacencies”.

Chris Zook became such a great defender of refocus businesses, he decided to write a book, “Profit from the core”, where he strongly supports that growth and profits are unlocked not by abandon the core business, but to focus on it with renewed vigor and creativity. Strong businesses, many times lose their virtue due to premature abandonment of the core business, miscalculation, or a hurry to search new growth sources. Therefore, according to Zook, a management team developing or adjusting its company’s growth strategy must follow these steps: first, define the business boundaries and the core business; second, identify the differentiation factors that create market power; and, third, evaluate the current core to see if it is working on its full economic potential. Dunlap & Andelman (1997) added to that idea, by defending that businesses should ask two questions before deciding on which products to go for and which ones to drop: “What business are we in?” and “What business should we be in?”. The value of a strategically relevant product-market definition lies in "stretching" the company's far enough so that significant threats and opportunities are not missed, yet not so far as to dissipate information gathering and analysis efforts on "long shots." (Day, 1977).

- **Build for the future:** This strategy usually begins when the immediate crisis has passed and the financial position has been stabilized, working as growth strategy from the core focus that was developed. The idea to build for the future is to create a solid strategy, for one needs to envision its future and plan on how to reach it, looking at short and long-term (Dunlap & Andelman, 1997). So, knowing where the company is today and what to do to improve it is crucial, since its analysis and consequent decisions will impact the long run (Sullivan and Harper, 1996). Many believe that building for the future involves changing with a vision that englobes all team members (Goodfellow, 1985). So, managers need to act as leaders and understand the importance of the individual employee (Ghoshal & Bartlett, 1996).

Process-orientated Strategies:

- **Reinvigoration of firm leadership -** This strategy involves the replacement of the incumbent CEO. Often, it is triggered by the realization that the firm is in serious difficulties and that action is urgently needed (Stopford and Baden-Fuller, 1990). This action comes as a signal of change, both to the external audience and internally to the employees (Daily & Dalton, 1995). When it comes to external considerations, research has found that "the mere presence of a charismatic leader can remove doubts about the survival of a firm" (Flynn & Staw, 2004). Internally, the change of the leadership has a strong symbolic power, as it is sign that the current situation is no longer tenable, and that the firm is serious in its willingness to change for the turnaround to begin. The second common reason for the replacement of the CEO is where the incumbent appears blind to the existence of any problems**,** as their mental models fail to adapt to their firm's changing environment (Schoenberg R et al, 2013). In these situations, the replacement of the CEO can create hopeful assumptions that the new leader's different personal backgrounds, experiences, and innovative ideas will help the company turning around (Barker & Duhaime, 1997). Changing the top management team, along with the CEO, is often advocated, as also many new CEOs will bring their own trusted colleagues with them. This idea is also supported by Dunlap**,** who believes that to draw a solid business strategy, it is crucial to assure the right management team, relying on the best management, magnifying the company's ability by surrounding it with great people (Dunlap & Andelman, 1997). Moreover, a number of reasons have been given to support the change of team along the change of the CEO. First, the existing team is believed to hold a set of beliefs on how the firm should be, which had to be incorrect since they had led the firm to its current position (Hofer, 1980). Zook & Ormiston 2001 global study also came to add to this idea, by proving that even the most sophisticated management teams may be mistaken when identifying adjacent growth opportunities. In fact, these teams may be misled by highly related businesses that, at the end of the day, end up having a very different cost structure and customer base (Zook & Ormiston, 2001). Second, senior managers may reject arguments that highlights they have made poor decisions in the past. Finally, different managers have different skills from those who drive the business to its current position (Dunlap & Andelmans, 1997).

- **Culture Change:** This aspect challenges and confronts past beliefs and assumptions, which may no longer be relevant, and need, therefore, to be changed. Stopford and Baden-Fuller's

(1990) showed that when the CEO and its team challenges past beliefs, it acts as a signal to employees of innovative solutions that would not have otherwise been possible (Stopford & Baden-Fuller, 1990). Others have found that the culture changes are also symbolic, facilitating a change in the cognition and behaviors of employees, which is important for the turnaround to progress swiftly and achieve quick results (Dunlap & Andelman, 1997).

Case Study

LEGO's Origin

LEGO's origins bring us back to 1932. In the Danish town of Billund, there was a humble Carpenter named Ole Kirk Kristiansen who was inspired by his four sons to craft wooden toys, which would, in 1947, be transformed into plastic toys. By 1949, Kristiansen produced over 200 toys which he would sell by the name of *LEGOs*, from the Danish "leg godt": play well (Mortensen, 2017). Ole would assure that his toys were perfectly manufactured, imposing high-quality standards which are still assured to these days (Rivkin and Thomke, 2012).

Working alongside with his father since he was twelve, Ole's third son, Godtfred Kirk Kristiansen, always paid close attention to every detail of the brick-manufacturing and to the company's business development. He saw great potential in LEGO, as the toys were unique, robust, and allow long hours of pure fun. It was during Godtfred tenure that LEGO became the worldwide famous toy enjoyed not only by kids but also by adults. Then, the company's profit margins expanded, achieving a slow and steady growth, which implied a long period of time for new products to be launched. However, this slow pace served the company well. In fact, already in the 80's, under the early command of Ole's grandson, Kjeld, there were even times in which the demand for LEGOs was so high, that executives found themselves discussing how to slow sales down (Rivkin & Thomke, 2012).

LEGO and the '90s toy market

LEGO's history was not always a bed of roses. In the '90s, the toy's industry suffered massive changes. Not only were Big-Box toy discount stores lowering prices dramatically, making the industry highly competitive, but they were also fiercely merchandising the biggest trends of the market (Ashcroft, 2013). In fact, Walt Disney Co.'s "Mighty Morphin' Power Rangers" (figure 9) and "The Lion King" (figure 10) toys, the ultimate market vogues, were backed up by J. C. Penney Co. and Kmart, both Big-Box store companies. Other trends were also invading the market and becoming real competitors for LEGOs, such as the Japanese phenomenon, Pokémon (figure 11) (AdAge, 2003).

Moreover, birth rates were decreasing. In the US, they moved from a rate of 1.67% in 1990 to 1.44% in 2000 (Statista, 2018). In Europe, it decreased from 1.24% to 1.06% (Pordata, 2018). And, children were craving for toys that offer instant gratification as their playing period was getting shorter. Back then, kids were growing faster than ever, maturing at an earlier age, losing interest in traditional toys, and shifting their interests towards the Internet, video games, and CD-ROMs. Facing this new demand wave, toy marketers started investing in innovative interactive toys, as "virtual pets": Tamagotchi (figure 12), Neopets (figure 13), and Furby (figure 14) (AdAge, 2003).

Finally, also internally, LEGO was suffering from inside the company threats, as in 1993, Kjeld had to step back from the company during a year due to health issues (Ashcroft, 2013) (Mortensen, 2017).

LEGO market responses in the'90s

Confronted with the '90s threats, LEGO was committed to driving growth and covered all the possible untapped value. The company was not willing leave the toy industry in the hands of Big-Box stores. It was rather devoted to face the challenges that the new decade presented and embrace new projects, hoping to achieve both innovation and growth. For that purpose, LEGO came up with multiple brand extension strategies, such as the creation of its own children's wear (figure 15), books (figure 16), movies (figure 17), and TV shows (figure 18) (Ashcroft, 2013). Additionally, LEGO opened new Legoland parks, such as the ones in Windsor (figure 19) (1996) and California (figure 20) (1999). During these years, the Danish company came up with new initiatives to become closer to its customers. It created its own Imagination Centre (figure 21) (1992), new development departments, such as SPU Darwin (1996), a Mindstorms Learning Center (1997), and it established several Consumer Service Centers (1997). Furthermore, by the end of the decade, in 1999, LEGO also created its first online shop, LEGO World Shop, and its first LEGO products-only store in London (figure 22) (Mortensen T., 2017).

LEGO also invested on overall restructuration of the group, in particular in one made in 1999. Besides, the '90s were also years of great internationalization for the brand, which the following countries: Malasya (1990), Japan (1992), Hungary (1992), South Africa (1993), and

Mexico (1994) (Mortensen T., 2017). Also, LEGO invested in multiple international shows and exhibitions. On top of all these investments, LEGO's bricks were becoming more and more complex (Ashcroft, 2013).

LEGO's first fall

In 1998, Lego felt its first financial losses, as sales were not keeping up with the increasing number of LEGO-branded products, and in 2000, the company lost €107 million on revenues of around €1.29 billion, and its global net turnover was €1.273 billion, compared to €1.313 billion in 1999. (Ashcroft, 2013).

Thus, in 2001, under the tenure of Kjeld, LEGO decided to make some changes in its own strategy. It planned to reduce and abandon certain initiatives outside the core business, such as lifestyle products, Legoland parks, and software investments. The idea was to refocus the brand in its core products and values, while at the same time making it grow. Also, new items, for instance, Bionicle (figure 23), Harry Potter (figure 24), Bob the Builder (figure 25), and Life on Mars (figure 26) were either launched or expanded. (Ashcroft, 2013).

By the end of 2001, LEGO was making profit again: a pre-tax profit of € 71 million compared to a loss of € 144 million the preceding year and a profit from primary operations of € 110 million. The success resulted from an increase in sales and to significant internal changes in areas such as production, control, and the product range (Ashcroft, 2013).

LEGO's second fall

A year later, in 2003, hopes for the company went down again. The market for traditional toys and games market declined in the early 2000s. Consequently, the increasing pressure under the traditional toy industry was forcing LEGO's competitors to pursue a similar strategy to the one LEGO had bet on at the beginning of the millennium, introducing new trendy products. Then, retailers were already developing their own private labels. Coupling to that, both the Legoland parks, which were supposed to increase the brand visibility, and the LEGO own retail stores, supposed to strengthen the consumers' experience, were becoming an expensive distraction. The results for 2003 were unsatisfactory. Net sales decreased by 26%, from €1.57 billion in 2002 to € 1.1 billion. Play material sales also fell by 29% to € 967 million. It also suffered a pre-tax loss on earnings of €188 million, a drop of €270 million compared to 2002. (Ashcroft, 2013).

The focus on the end user ignored the means of access and distribution, making retailers overstocked with products which offered diminishing margins. LEGO inventory had increased by 40% at some outlets to more than twice the amount of stock considered to be acceptable. Overall, sales were extremely slow at the beginning of 2003. This decline was particularly aggressive in the USA, country in which sales dropped by almost 35% compared to 2002. Pairing to that, in Asia the sales faced a decline of 28%. The German market also suffered a reduction in its sales of 20%, and the UK, Holland, and the Nordic markets fell by 13%. These numbers were associated with shortfalls the sales of movie tie-in items, such as Star Wars (figure 27) and Harry Potter, which clearly lacked a follow through at crucial times in their life cycle. In fact, the drop-in sales of such products accounted for more than 50% of the overall sales shrinkage. (Ashcroft, 2013).

All in all, in 2003, LEGO was reported the following way: “We are on a burning platform, losing money with negative cash flow and a real risk of debt default which could lead us to break up of the company” (Ashcroft, 2013).

LEGO’s fresh start – Knudstorp tenure

The year is 2014. LEGO announced remarkable results. In the financial year of 2013 revenues increased by 10% to €3.4 billion. Profits before tax were €1.1 billion. The company’s operating margin was 33% before tax. LEGO achieved €3.26 billion of revenues and profits of €1.08 billion. Revenues have tripled in eight years, and LEGO has replaced Hasbro, and it became then the second largest toy company in the world, following only the giant Mattel. Ever since its crisis years of 2003 and 2004, LEGO increased its gross margins from 56% to 70%, it shrank its operating costs from 70% to 37% of turnover, and it doubled sales per employee. The brand’s return on equity jumped from zero to almost 70% and equity values also follow the pattern, by increasing from 400 million to over €1.47 billion. In 2014, LEGO would be worth €123.5 billion (Ashcroft, 2013). So, how did the company turn around?

Every cloud has a silver lining, and LEGO knew how to ride out of the storm, thanks to Jargen Vig Knudstorp (figure 28), who, not coincidentally, has just become the first non-family member Executive Chairman of LEGO's board, in May 2017 (Bloomberg).

Ever since his childhood, Knudstorp had always been a fan of the LEGO bricks, and as he grew up, he became more aware of the company's heritage. In fact, LEGO was a fascinating case to analyze for a man like Knudstorp, who not only holds a BA degree and a PhD in Economics, but also has served as a Management Consultant at McKinsey & Company from 1998 to 2001. Thus, in September 2001 he joined the LEGO Group, and a year later he became the head of the brand's strategy department. In November 2003, Knudstorp decided he would save LEGO's from the "burning platform" the company was on, and he became Acting Chief Financial Officer and Senior Vice President of Corporate Affairs (Bloomberg). For that purpose, Jargen put into practice what he had learnt at McKinsey: "Fact finding is the first step to problem solving" (Ashcroft, 2013).

By 2003, Knudstorp produced a report which would help him review the problems of the company. It did not take him long to conclude that his job would be to stop the bleeding, by stabilizing sales and cutting costs dramatically. Jargen would also have to deal with the excess of capacity and stock, with the undoubtedly unhappy retailers, and with the fact that LEGO was sitting in the wrong countries. All in all, LEGO was completely out of track, and did not know how out of track it had become (Ashcroft, 2013).

To further explain the reasoning behind what was going on inside LEGO, back in 2003, Knudstorp took several aspects into consideration. The first was communication. It was not like employees or customers were unaware of the problems of the company. They just did not owe any lines to communicate key messages to the top of the hierarchy. Management was out of reach for the major customers and for many employees (Ashcroft, 2013). Moreover, the company was organized in the form of a matrix, in which there were twelve senior vice-presidents in six overseeing regions, each operating in their own structures with little accountability and no assessment on product profitability. When taking a holistic look into the company, it was almost impossible to efficiently manage products, as it became extremely complex to know which products were making money and having an appropriate return on investment. While profit and loss accounts by country were widely used, there were no accountability reports by products. There was no line profitability, and investments such as the Legoland parks were a crash drain which no one could actually justify (Ashcroft, 2013).

On the other hand, ever since the '90s, LEGO feared that kids' interest in playing with traditional toys had completely vanished. Consequently, the brand felt an enormous urge to diversify its business away from the core product, the bricks, betting on products on areas such as: software, learning tools, lifestyle products, girl's toys, books, magazines, television, theme parks, and even its own retail stores. In the 2000's, LEGO was developing an average of five adjacent businesses every year. As Knudstorp would later state: "I think we found there were basically two fundamental challenges that grew out of this period - overstretch and overexpansion. Focus had been lost on basic execution, simple things. We did not know really what we produced on a weekly basis. There was a lack of transparency. We did not know where we made money and where we lost money" (Ashcroft, 2013).

Faced with the 2003 challenges, how would LEGO transform its business performance?

To save LEGO from the burning platform it was standing on, Knudstorp was assisted by "Profit from the core" (figure 29), a book by Chris Zook, partner at Bain & Company. Zook argued that profits arise when businesses focus on their core products and serve them to well-defined customer segments. Additionally, Zook supported that companies could not afford too much diversification, as they would not be able to efficiently develop and manage adjacent markets. To put it in practical terms, Zook suggested that growing companies would maybe afford one adjacent market move every five years. Hence, Knudstorp was willing to focus on LEGO's core business and go back to the bricks. Coupling to that, he would make sure that profitability would be a priority, in particular, the profitability of the core products, towards which he foresaw great potential (Ashcroft, J., 2013).

At the end of 2003, LEGO's strategy was to create an action plan, which would include a set of new initiatives. The goal of this plan would be to cut costs, restore competitiveness, generate cash, and ignore the rush to grow in the immediate future. This would involve producing the right products, the ones with which children actually play, the bricks. But producing them was not enough to guarantee its success. The bricks would need to be placed at the right time in the right place, and its quality would have to be consistently right. In Knudstorp's own words, LEGO had to go through a "process of rediscovery" (Ashcroft, 2013).

The priority of Knudstorp was to develop an action plan to stabilize the business and restore execution. If this task was managed successfully, he would then focus on profitability, and hopefully, the company could go back to organic growth. Yet, the short-term action plan would mainly focus on the following points: the financial aspect of the business, the management of the products, and the development of the relationship with both customers and retailers (Ashcroft, 2013).

When considering the financial aspect of his action plan, Knudstorp was assisted by Jesper Ovesen (figure 30), the then-recent Financial Director of LEGO. Ovesen, a man with experience in Finance did not take long to complete his analysis of the company and make considerable recommendations. Thus, Ovesen and Knudstorp defined as a priority the development of clear financial targets to rationalize product offer, control costs, and manage line profitability (Ashcroft, 2013).

By 2003, Knudstorp decided to cut the product offer by 30%, and focus on selling the classic LEGO bricks. This decision implied a non-recurring cost of € 60 million, which was allocated to writing down operating assets and buildings, and redundancy payments, fruit of the reduction in activities (Ashcroft, 2013). By adjusting the production capacity to the reduced activity level, LEGO did not only cut costs, but also lowered sales.

LEGO's slowdown led to job cuts of 600 employees, number which then escalated to 1000. In 2004, the company decided to shut down its factory in Lättich, Switzerland which, per se, resulted in a reduction of the number of staffs in approximately 100. As hard as these measures may seem, they truly contributed to the reduction on the cost base, as well as towards a satisfactory inventory situation (Ashcroft, 2013).

Other aspect which became crucial for Knudstorp to execute his action plan related to the introduction of specific targets. Knudstorp was committed to manage line profitability, task which became easier along the reduction of the product offering. Particularly, with the help of Ovesen, the goal setting for control products success was the following: have a 13.5% return on sales (ROS) target for all products within the LEGO portfolio. To achieve such numbers, there were services and products which could no longer be part of the offerings line. In fact, when analyzing the capital allocation and the return on capital performance, decisions such as dropping the Legoland theme parks, abandoning the computer sales business, and slowing down the LEGO stores programs, were the options to take (Ashcroft, 2013). A cut on the endless number of investments LEGO has engaged in the past was then conducted (figure 31).

LEGO's relationships with both its customers and its retailers also suffered modifications in 2003. In Knudstorp action plan, the key point was to put retailers at first place, and customers second. It was not that Knudstorp did not acknowledge the end user any importance. It was rather a matter of quitting the habit of developing new products every time a child could have an interest in a possible toy, and create the habit of caring more for retailers' satisfaction. Yet, children's interests would also be considered, using focus groups and mind storming. Paying more attention to the preferences of adult fans of LEGOs (AFOLS) was also a goal to be accomplished. Knudstorp wanted to maintain a close relationship with the end users of LEGO's products, offering them the items they valued. Knudstorp was running away from the concept of offering as many products as possible. On the contrary, in 2003, LEGO was committed to focus on developing and marketing its more timeless and legendary core products, bricks, that were indeed the source of general great demand thanks to their ability to stimulate children's creativity and intellectual activity (Ashcroft, 2013).

LEGO Duplo was a case of an item which was successfully relaunched in the market in 2004 and which played an important role in the segmentation process. In fact, in 2002 LEGO Duplo was replaced by a new product, also oriented for pre-school children, LEGO Explore (figure 32), which was a failure, resulting in 37% shrink on pre-school sales in the same year. It did not take long for the company to realize its mistake, and relaunch Duplo, a more timeless product with which kids actually enjoyed playing. Additionally, products for specific segments, such as LEGO Friends for girls, were also kept in the market, as they were believed not only to be profitable, but also be valued by the customers, in particular by the young female's segment (Ashcroft, 2013).

Overall, many were the factors which contributed to LEGO’s performance turnaround. LEGO’s case is nowadays a proof that even the most failing businesses may be turned around and become strong again.

Teaching Note

Overview of the case

During the early 2000s, LEGO performance was failing. Yet, it was not always that way. Until this period, the company's sales, cash flows, and return on investment had always been increasing. Only at the beginning of the millennium did the company felt a pressure to grow and innovate its products and processes. Many were the causes of such pressure's feeling. Firstly, the general environment of the company was changing during the '90s: economic factors were a challenge for the company which was dealing with a declining traditional toy industry mined with retailers and Big-Box Stores which offered more competitive prices. Also, technology deviated the focus of children who no longer wish to play with traditional toys, but rather with interactive toys, video games, or surf the internet. Foreign countries were also distracting LEGO. Secondly, the company's immediate environment also played its role: there was an overestimation of the demand, an increase on fierce competition, and an augmentation of the number of unsatisfied retailers who were overstocked with LEGO's products. Thirdly, LEGO's managers, even though full of experience, competencies and skills were not taking the right decisions, as they underestimate negative impacts. Finally, the corporate policy of LEGO was dominated by exaggerated and unthoughtful risk-taking behaviors.

During the '90s, LEGO was concerned with not surviving the rise of new trends and preferences, innovative technology, and increased competition. So, the first driver of LEGO's brand extension strategy really was the pressure it felt from the external environment. But other aspects also fueled this decision. LEGO believed that by having more products to offer, the risk and dependence over the core business would be lower. Thus, even if the bricks lifecycle had come to an end or close to it, the company could still rely on other promising products. Moreover, Kjeld's believed that the good perceptions people had of LEGO could easily be transferred into brand extensions, making product diversification a strategy with reduced costs. Kjeld also believed that the managerial skills, knowledge, and expertise the company already held were easily applied to other markets, facilitating and fastening the new markets' access. Ultimately, Kjeld thought that the brand extension strategy would produce positive results for LEGO with little extra effort on the promotion and managerial procedures. On the other hand, LEGO was attracted by the idea of cross-subsidizing one product with the surplus of another, perfect solution for a company with high new product failure rates: LEGO could use the fame it already had and leverage it, so that the entrance in new markets could profit from strong brand recognition, and the risk of product failure would not be enormous, as such failure could be compensated by a product on a hype. Finally, undertaking a brand extension strategy, particularly into unrelated product areas, might have been very appealing for LEGO, since often consumers perceive such strategy as a brand bravely and innovatively abandoning its comfort zone.

However, brand extensions carry many risks. Firstly, LEGO suffered from the uncertainty of this strategy's results, as no one was sure how it would end up. Especially, because this strategy was not pursued under thoughtful deliberation, but rather, out of despair of remaining a player in an ever-changing market. Moreover, by diversifying its product range, LEGO was putting into question its own brand image. And, at a certain point, LEGO was inserted in so many markets, it was losing control over the business and its values. LEGO was not aware of its product offering, nor could it engage in a proper positioning strategy. At a certain point, the company could not fully commit to any product, as its efforts were diffused among an enormous product portfolio.

Thus, in the early 2000s, it was clear that LEGO had gone too far on extending its brand. The business was over complex, presenting classic symptoms of *diworsefication*. Employees were struggling with the production of new products and unable to communicate it to the top of the hierarchy. Forecasts, in particular, financial ones, were getting harder to perform, and inventory was almost impossible to manage.

In 2003, LEGO inventory increased by 40% at some outlets to more than twice the amount of stock considered acceptable. LEGO's performance was shrinking significantly during its crisis: net sales decreased by 26% in 2003, and in terms of margins, it suffered a pre-tax loss on earnings of € 188 million, a drop of €269 million compared to 2002. In 2003, LEGO hit rock bottom: "a burning platform, losing money with negative cash flow and a real risk of debt default which could lead us to break up of the company".

To make its way out of its deep failure stage, LEGO relied on the leadership of Knudstorp. Knudstorp assumed his role and decided to act on the following fields: stabilizing sales, rationalizing the product offer, cutting costs dramatically, and ultimately restore competitiveness. Also, he would have to bring the focus back to a company lost under a panoply of uncontrollable products and investments.

Learning objectives

Students should:

- Identify and distinguish the various deterioration/ business failure processes
- Identify and provide examples of each of the variables that influence the failure processes
- Identify which are the benefits of undertaking a brand extension strategy
- Identify the risks of undertaking a brand extension strategy
- Identify symptoms of *diworsefication*
- Acknowledge the importance of keeping frequent awareness and track of business performance indicators
- Learn the theory of business turnaround strategies, identifying and distinguish content and process-orientated strategies
- Acknowledge the importance of refocusing an overstretched business for it to turnaround

Preparation questions

1. In your opinion, was LEGO performance failing in early 2000?
2. Which were the benefits for LEGO of undertaking a brand extension strategy?
3. In which risks did LEGO incur when undertaking a brand extension strategy?
4. Which *diworsefication* symptoms did LEGO present? And, how did these symptoms result in business failure?
5. Did LEGO engage in a business turnaround strategy under Knudstorp's leadership?

Roadmap for discussion

The class should take approximately one hundred minutes. To improve the structure of the class, it is suggested that the class will be divided into five blocks of more or less twenty minutes each. Each block corresponds to one of the paragraphs below.

The instructor could start the class by asking students whether they believe LEGO performance was failing at the beginning of the millennium. This question could be conducted through voting, and a short justification of the answers. Afterward, the instructor could ask to state in which stage of the lifecycle do they believe LEGO was in, in 2003. This question it is intended to spark further discussion. Then, the instructor could move on to ask students about what were the variables leading the company to failure. During this part, the board could be filled with the heading: "What influenced LEGO's failure process?", followed by these subtopics: "general environment variables; immediate environment variables; management; corporate policy; company's characteristics; others". This is the part in which the instructor introduces students to theory on failure processes. Finally, the instructor could ask students whether they see a relationship between the company's lifecycle stage and the previously discussed variables. If they do, the instructor might further ask them to match it with the failure process LEGO was in. During this part, the instructor may intervene to explain other failure processes types (such as the unsuccessful start-up, the ambitious growth company, the dazzled growth company, and the apathetic established company).

The class could continue with the instructor asking students about the benefits for LEGO of pursuing a brand extension strategy. These benefits should be written down on the board in such a way that it is possible to link them with the ones mentioned in the literature. After having discussed the benefits of brand extension strategies, the instructor could spark discussion by asking students if they think that brand extending was a good strategy for LEGO to reduce dependence on the core business. Moreover, voting could be conducted to evaluate if students believe that bricks lifecycle was coming to an end in 2003. The final, and ultimate question would be to inquire students if, in their opinion, customers perceived LEGO's extensions positively.

The class may keep running with the following question: "In which risks did LEGO incur when undertaking a brand extension strategy?". The answers for this question may be written down on the board while the instructor introduces theory on the topics being referred.

Then, the instructor may conduct a voting for students to decide whether or not the extension strategy by LEGO was a thoughtful decision. Finally, the instructor could bring up to the table the topic of the pressure under which LEGO was during the ‘90s, and inquire students whether or not Kjeld tried to ignore the risks of extending its product line, while believing on the very positive perceptions people hold on LEGO and the easiness with which they could only be transferred to the extensions.

The class could continue with the instructor asking students to mention some of LEGO’s signs of failure due to overstretched brand extensions during its early 2000s crisis. The instructor should try to match the symptoms identified with literature and theoretical background. After having identified these symptoms, the instructor may divide the class in smaller groups, so that each group discusses one symptom and how it affects business performance, ultimately leading to failure. Finally, the instructor could put the class all back together, to ask if LEGO was keeping track of its performance indicators in the ‘90s and 2000s. The purpose of this last question would be to call students’ attention to the importance of maintaining an open eye in business KPIs.

The class may end with the instructor asking if students think Knudstorp had engaged in any business turnaround strategy when leading LEGO. This question could be responded through a justified vote taking, and the answers for this question may be matched with the literature on the field. During this part, students should display knowledge of LEGO case study and should provide information and examples of Knudstorp turnaround pursued tactics. Questioning if reducing the product offer, cutting costs, and focusing on the core business were all part of a good and strategy by LEGO would be interesting to encourage discussion. The instructor could try to keep the discussion focused on the latter (focus on the core business) and how the two aspects are related to this one. During this discussion, the instructor should try to match students’ suggestions to theory of business turnaround. Additionally, the instructor could make students wonder if LEGO asked itself which were the products worth keeping, and which ones were worth throwing away. The ultimate question would be to ask students how having some knowledge or past experiences on business turnaround strategies could have or did helped Knudstorp managing LEGO.

Wrap up

Since each 20 minutes block of the class introduces students to different learning topics, the main takeaways are also divided according to this structure. Students should keep in mind LEGO's case study, coupling it to knowledge prevenient from literature and theoretical backgrounds.

Firstly, students should identify and explain several failure processes, which may vary depending on the company's maturity stages and on its failure drivers. The drivers for a company lack of success, according to the literature, include the general environment, immediate environment, corporates characteristics, management of the company, and corporate policy of the enterprise. When considering LEGO, students may defend the company was at a rather mature stage, and that all of the above factors end up impacting negatively its performance, leading to failure. That is why, according to the literature, LEGO is considered a dazzled growth company: companies at a more mature stage of their life cycle, and whose failure process usually starts with an internal or external desire for growth and innovation.

Additionally, students should also keep in mind that a brand extension strategy has multiple benefits, such as respond to external pressures and environment changes; reduce the dependence over core products; leverage the company's image, managerial skills, and knowledge, and promotional activities; cross-subsidizing products; and, create an image of innovation and courage from the consumers' point of view. All of these benefits were felt by LEGO to some extent. As for takeaways, students may acknowledge that often businesses under-evaluate the strength and power of their core product (such was the case of LEGO). Students may also remember that the fact that a company is strong in one activity, does not mean it will perform well in other activities. Finally, students should bear in mind that consumers do not always perceive big steps, such as brand extensions, as a good thing. It has to be managed carefully.

Moreover, students must clearly identify the risks driven by a brand extension strategy: uncertainty of the outputs of the strategy, increased by unthoughtful deliberation; damaging the brand's image; loss of control over the business; and too much optimism by the management. Again, all of these risks were embedded in LEGO's brand extension strategy. Students may also keep in mind other risks associated with brand extensions strategies, even if they do not fully apply to LEGO's case study, such as cannibalization.

Furthermore, students should bear in mind that LEGO, in 2003, was under a *diworsefication* situation. Students must be able to identify the symptoms the company was displaying at that time: employees struggling to adjust workflows to accommodate new product configurations, error rates creeping up, inventories expanding, and, margins shrinking dramatically. These symptoms are common signs of an overstretched company's product line described in the literature. Students may link these signs with LEGO's loss of focus on core activities. Generally, students must identify symptoms of a business which has failed in its brand extensions and its consequences and impact on the company. Finally, students may acknowledge deep relevance to keeping an eye in businesses KPI, so as to better manage and improve them.

The instructor should end the class by reviewing the key strategies pursued by Knudstorp that allowed for LEGO turnaround, making it clear that LEGO actually went through business turnaround. Students, at this point, must be able to identify different turnaround strategies reported in the literature, such as cost efficiencies, asset retrenchment, focus on the core activities, and many others. The ones mentioned are the ones in which LEGO's case study is focused, as these were the fuel for its turnaround. Students should end up the class feeling that the mentioned strategies, in particular focusing on the core business, are actually efficient and apply at real life, such as the case of LEGO.

Main Conclusions and Future Research

Conclusion

LEGO's study is presented in this paper to reflect what happens to companies that go too far on brand extensions, entering a *diworsefication* situation, and then manage its way out of the situation.

Many are the factors that may push companies to diversify its product offerings. The external environment, particularly the general and immediate environment, along with the management of the company and its corporate policy may lead a business to embrace new challenges. In LEGO's case, the external environment of the '90s presented the company to a set of threats. There was the fear that trends and technology would replace bricks, and that big competitors would replace LEGO's place on the toys' market. Consequently, the Danish company decided to go after new business opportunities.

This paper offers a view of the advantages and disadvantages of brand extensions. It highlights pros, such as reduced dependence of the core business, while spreading business risk across products; transference of the positive attributes related to the parent brand to the extensions; little need for promotion activities on the extensions given the strong brand recognition of the parent brand; possibility of cross-subsidizing products; possibility to apply current managerial skills, knowledge, and expertise to the extensions. It also presents the cons of brand extensions, such as: uncertainty of the outcomes of such strategy; the fact that a brand extension strategy assures no improvements on profitability or expansions on category demand; undermining the image of the parent brand; difficulty to find a position for the extensions; carry hidden and unconsidered costs; and, in particular, the loss of focus on the core business, and target specific segments, due to increasing states of complexity and confusion.

Moreover, this paper presents some tipping points for readers to know how to identify when brand extensions become out of control, which was LEGO's case. A company has gone too far on extensions when it is struggling to adjust workflows to accommodate new product configurations, its error rates creep up, inventories expand, and ultimately, managing all these symptoms becomes so difficult and costly, that margins start shrinking dramatically. At this point, the overstretched business is under the situation in which consumers have already lost the original grasp of brand perception on their minds and no longer associate the brand with a specific product.

In this paper, it is demonstrated that the Danish company reflects a case of a business which have seen more of the above presented disadvantages than it saw advantages. LEGO is the example for many companies of a brand suffering from over complexity and presenting classic symptoms of loss of focus and *diworsefication*. The company was considered messy and buried under a set of unprofitable projects. Employees were struggling with the production of new products and were unable to communicate it to the top of the hierarchy. Forecasts, particularly financial ones, were getting harder and harder to perform, and inventory was almost impossible to manage. Also, its performance was shrinking significantly during its crisis: "a burning platform, losing money with negative cash flow and a real risk of debt default which could lead us to break up of the company".

Interestingly, the main added value of this paper is on the solution-side of it. The turning around strategy, where it offers a wide range of solutions for companies to get on their feet again. These include content-orientated (cost efficiencies, asset retrenchment; focus on core activities; and, build for the future), and process-orientated strategies (reinvigoration of firm leadership and culture change). All of them are to some extent possible to see on LEGO's case, under the tenure of Knudstorp. In fact, he did not fear cutting costs, including reducing the number of staffs and plants, nor getting rid of underperforming areas of a firm, such as Legoland theme parks and the computer sales business. By cutting on these, Knudstorp was engaging on a rapid solution for the almost bankruptcy stage of the company. He was focusing on the core business, the bricks, the uniqueness and the essence of LEGO. Knudstorp was building what is today LEGO's empire. For that, he relied on a completely new leadership style and on a culture change, while refocusing on the core business and making it simpler and more organized, creating financial targets, measuring performance, redefining the relationship with both customers and retailers.

May LEGO be an example of a successful business turnaround, as it is now the second largest toy company in the world. This paper intends not only to teach students on the power of business turnaround strategies even over companies which are almost bankrupt, but also to provide guidance and enlighten businesses that are going through difficulties the same way LEGO was.

Future Research

Given the magnitude of LEGO’s case, and its many research possibilities, there were objects which were not covered in this paper. In the future, it would be interesting to study how LEGO is and will be responding to the constant intensification of technology. In fact, the massive use of technology impacts enormously consumer preferences and trends, particularly among the youngsters. Will the brand incur once again on past mistakes, overdiversifying its business to a state of *diworsefication?* Moreover, researchers could study how the Danish company will respond to globalization, and the increasing competition it carries along, since it requires companies worldwide to move extremely rapidly to customers’ demands. Ultimately, globalization pushes businesses to apply information technologies in supply chain collaboration, which completely changes the ways of doing business, reason why it would be so stimulating to study how LEGO would respond to it. Finally, it would be very thought-provoking to study why there are extensions of LEGO that are succeeding today and, in the past, were rather failing, such as LEGO’s films and TV shows.

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Appendix

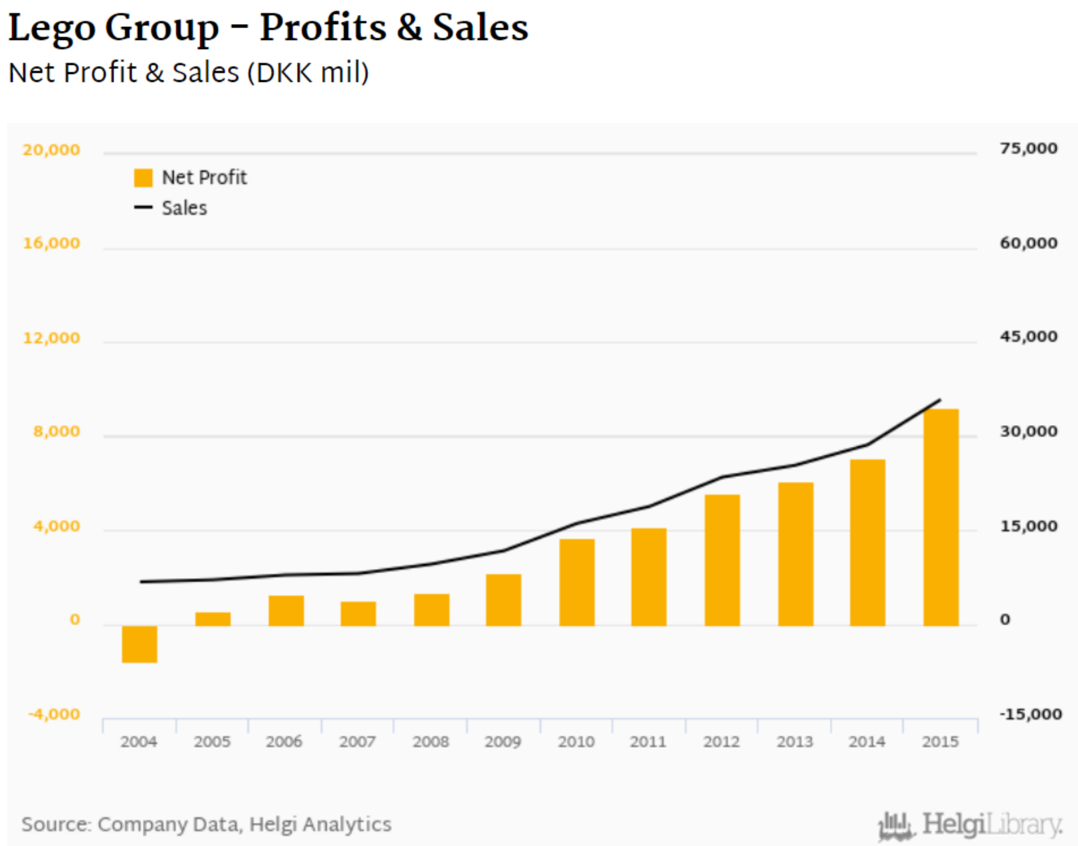

Figure 1 – Lego Group – Profit & sales from 2004 to 2015.

Helgi Library (2018, March). Lego Group - Profits & Sales.

Retrieved from https://www.helgilibrary.com/charts/lego-group-profits-sales/?fbclid=IwAR0y2mwW_cCwtg7uc3zEh9SXY07AAPnVtMC7jQjFlSJpmZuCZbPysujVxhQ.

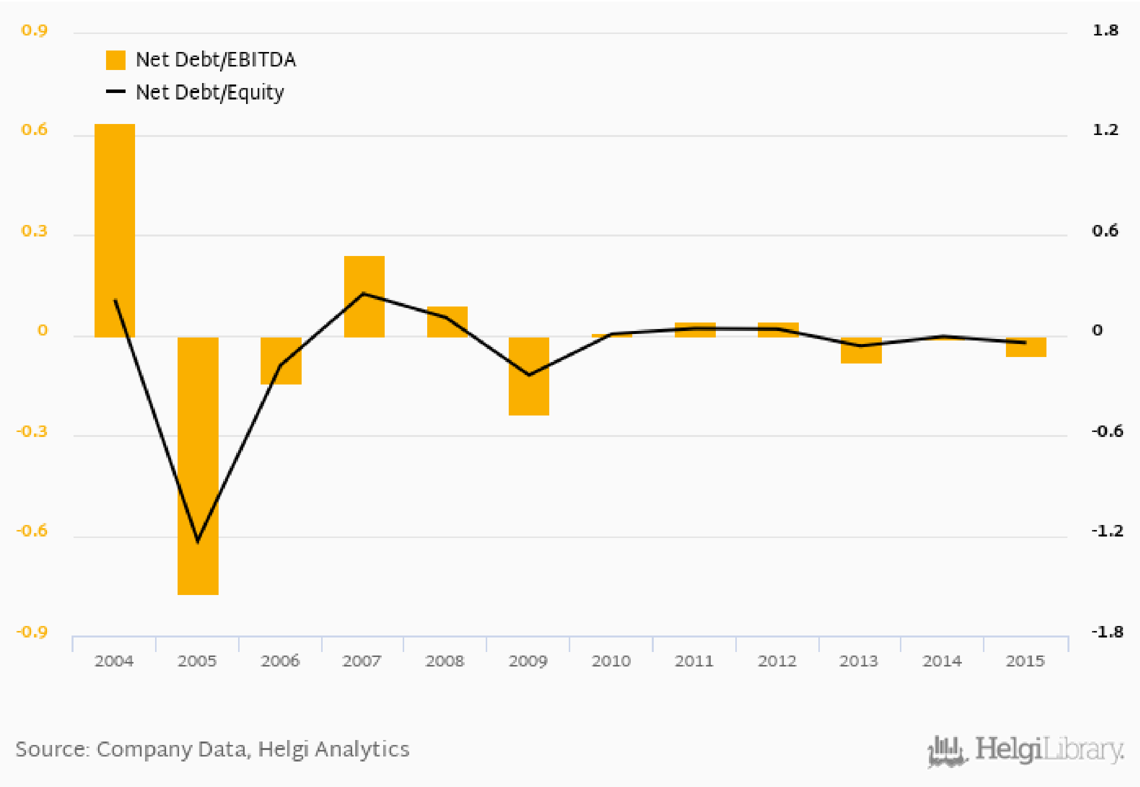

Figure 2 – Lego Group – Indebtedness.

Helgi Library (2018, March). Lego Group - Indebtedness. Retrieved from https://www.helgilibrary.com/charts/lego-group-profits-sales/?fbclid=IwAR0y2mwW_cCwtg7uc3zEh9SXY07AAPnVtMC7jQjFlSJpmZuCZbPysujVxhQ.

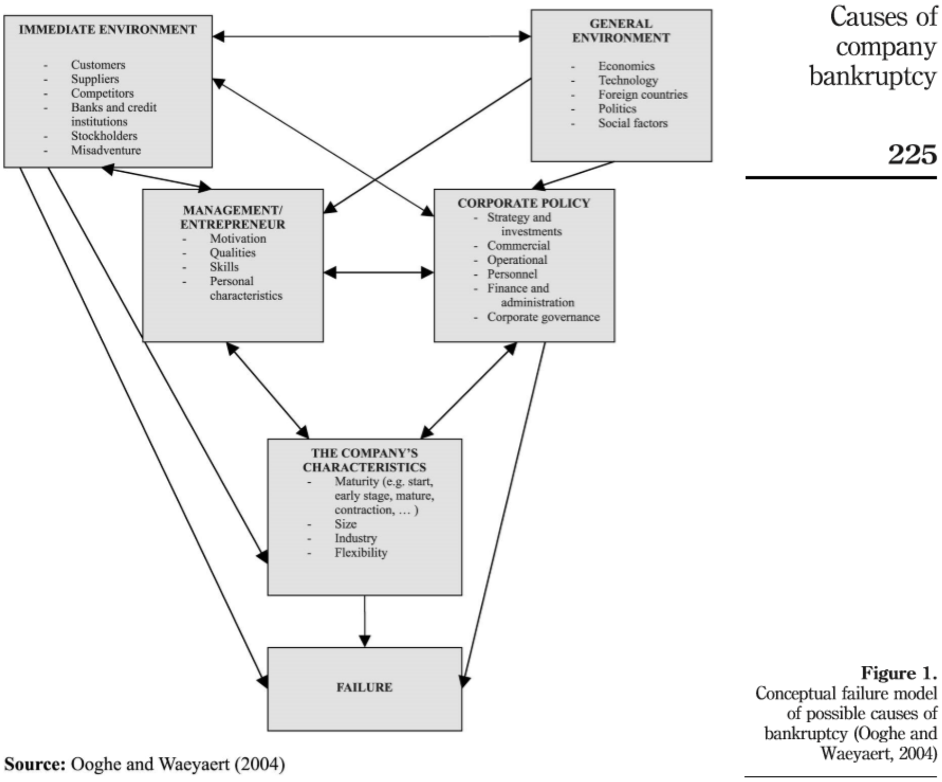

Figure 3 - Conceptual failure model of possible causes of bankruptcy (Ooghe & De Prijcker, 2008).

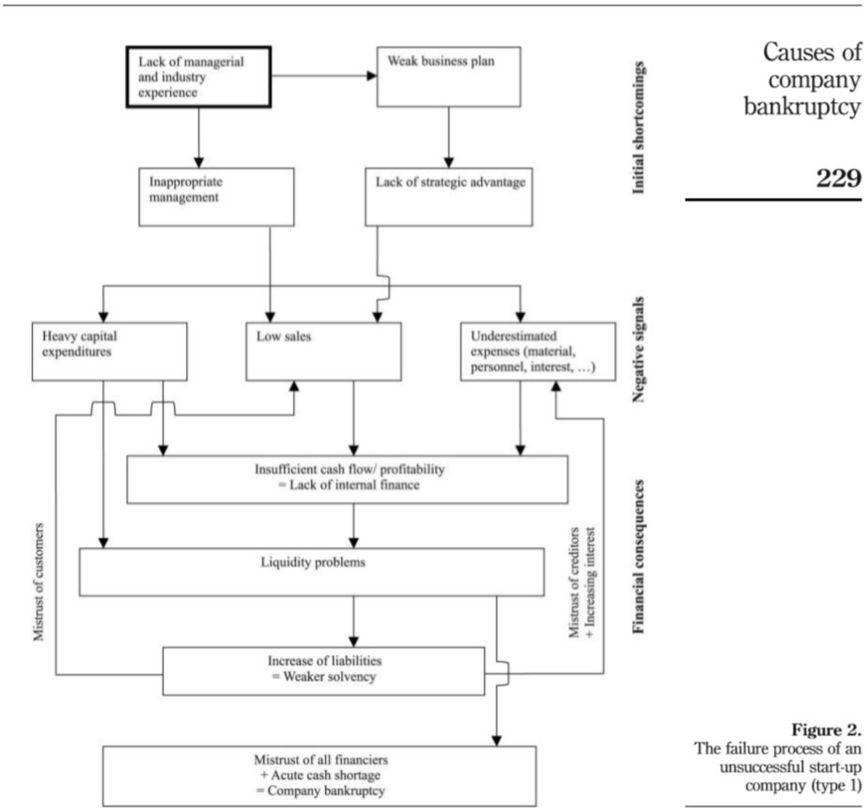

Figure 4 – The failure process of an unsuccessful start-up company (Ooghe & De Prijcker, 2008).

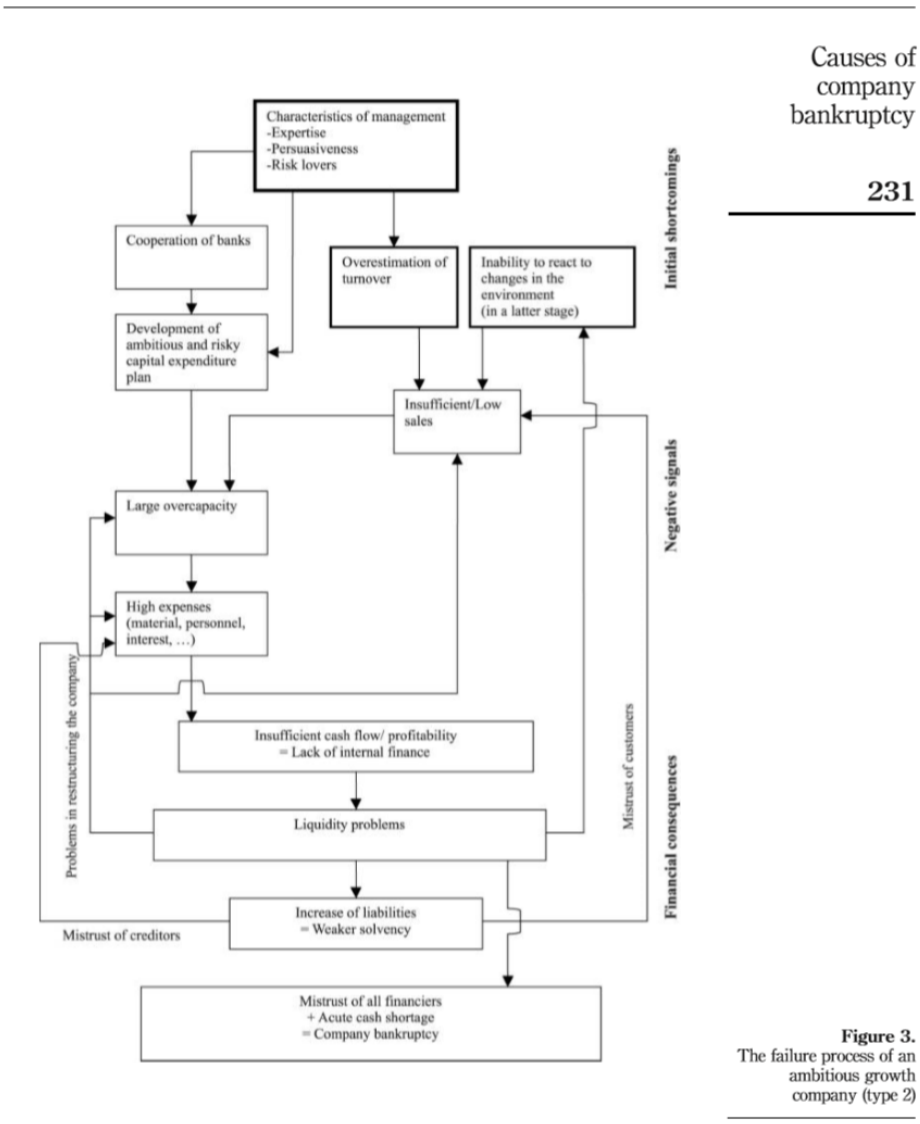

Figure 5 – The failure process of an ambitious growth company (Ooghe & De Prijcker, 2008).

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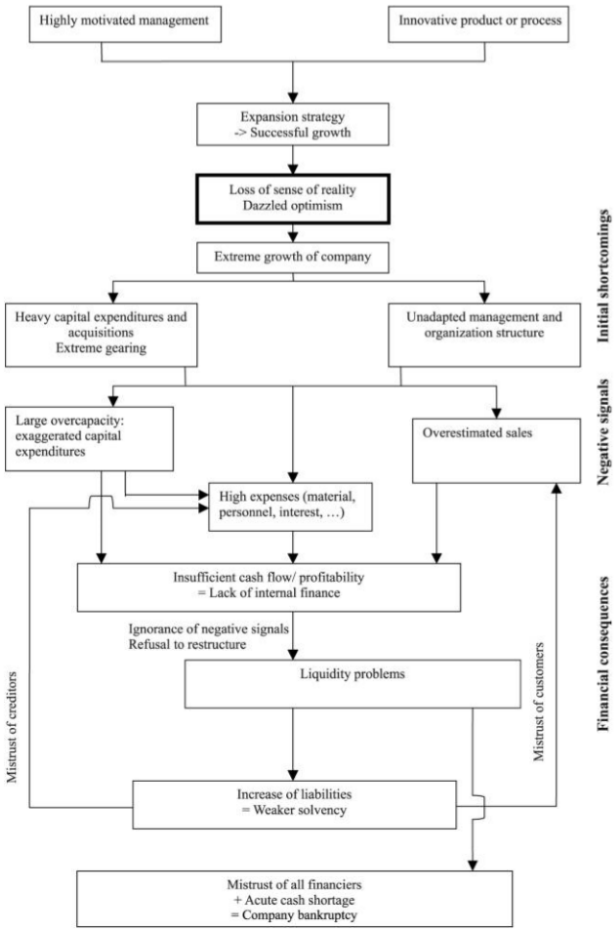

Figure 4.
The failure process of a
dazzled growth company

Figure 6 – The faiure process of a dazzled growth company (Ooghe & De Prijcker, 2008).

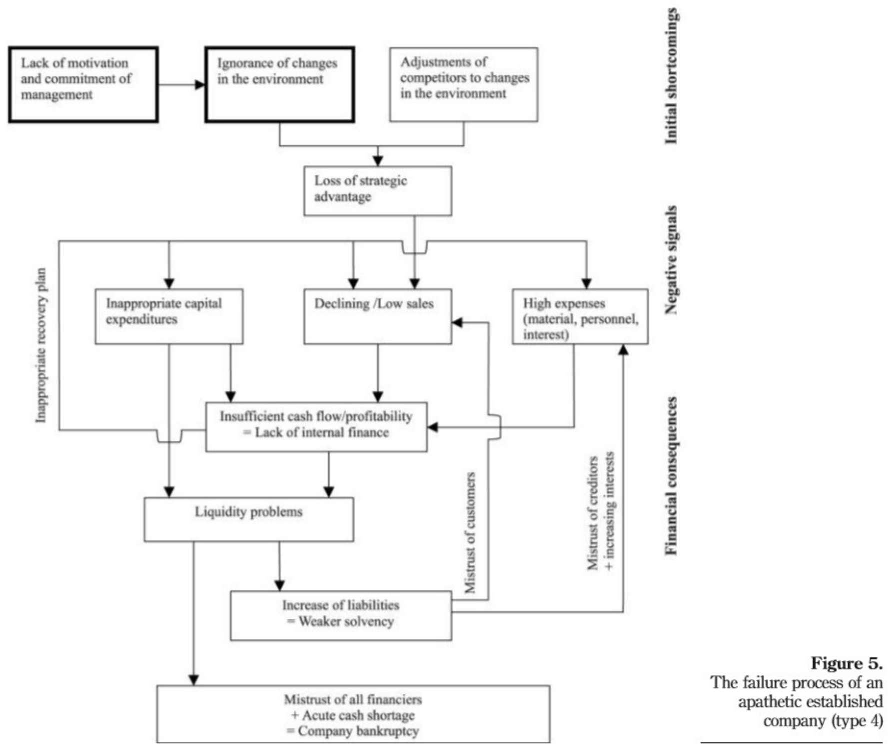

Figure 7 – The failure process of an apathetic established company (Ooghe & De Prijcker, 2008).

TABLE 2
Description of Financial Performance Indicators

Profitability
1. Return on Assets:
   Earnings Before Interest and Taxes/Total Assets

Leverage Ratios
2. Debt Service:
   Earnings Before Interest and Taxes/Interest Coverage
3. Cash Flow:
   Cash Flow/Total Debt
4. Capitalization:
   Market Value of Equity/Total Capital

Liquidity Ratios
5. Current Ratio:
   Current Assets/Current Liabilities
6. Cash Turnover:
   Net Sales/Cash
7. Receivables Turnover:
   Net Sales/Receivables
8. Inventory Turnover:
   Net Sales/Inventories
9. Sales Per Dollar Working Capital:
   Net Sales/(Current Assets – Current Liabilities)

Miscellaneous
10. Retained Earnings/Total Assets
11. Total Assets (in thousands of dollars)

Figure 8 – Financial performance indicators (Sharma & Mahajan, 1980).

Figure 9 – Mighty Morphin' Green Ranger toy from the 90's.

Retrieved from https://www.amazon.com/Power-Ranger-Mighty-Morphin-Green/dp/B002X9JSF4.

Figure 10 – The Lion King toys from the 90's.

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Figure 11 – Pokémon toys from the 90’s.

Retrieved from https://www.pinterest.pt/pin/311874342919767499/.

Figure 12 – Tamagotchi toy.

Retrieved from https://buyfuturistic.com/product/tamagotchi-90s-virtual-cyberg-pet-toy/.

Figure 13 – Neopets toys.

Retrieved from https://www.amazon.in/Neopets-Collector-Figure-Elephant-Crystacat/dp/B002KBXGG2.

Figure 14 – Furby toy.

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https://www.google.pt/url?sa=i&source=images&cd=&cad=rja&uact=8&ved=2ahUKEwj3j96H0cLgAhXv2OAKHbSQCRAQjRx6BAgBEAU&url=https%3A%2F%2Fwww.amazon.com%2FHasbro-A0006-Furby-Dark-Purple%2Fdp%2FB008C0O56U&psig=AOvVaw11kaWlMIrEnxPpca6QYBRp&ust=1550488262089862.

Figure 15 – Lego’s children’s wear from the 90’s.

Retrieved from https://www.etsy.com/uk/listing/578282925/1994-chillin-with-lego-mania-vintage-t?ref=related-5.

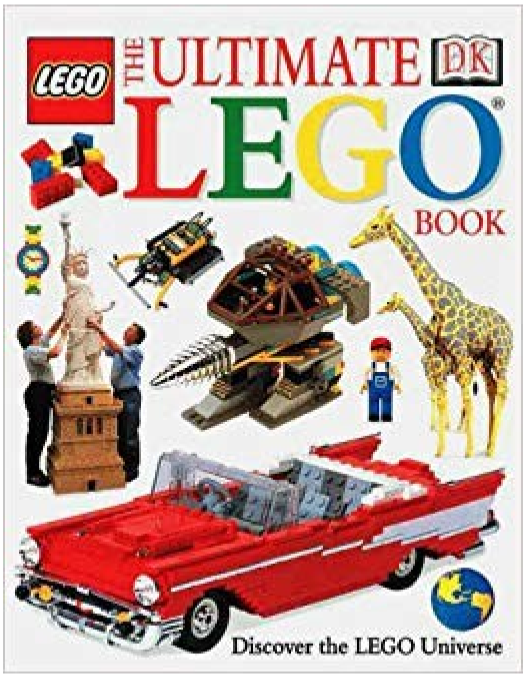

Figure 16 – Lego’s book from the 90’s.

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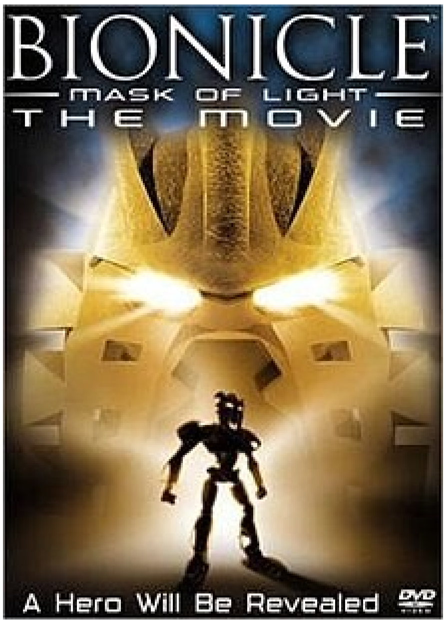

Figure 17 – Bionicle – Mask of light – Film by Lego from 2003.

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Figure 18 - Galidor: Defenders of the Outer Dimension – Lego’s tv show from 2002.

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Figure 19 – Legoland park in Windsor.

Retrieved from https://en.wikipedia.org/wiki/Legoland_Windsor_Resort.

Figure 20 – Legoland park in California.

Retrieved from https://www.tripadvisor.co.za/Attraction_Review-g32171-d103404-Reviews-LEGOLAND_California-Carlsbad_California.html.

Figure 21 – Lego Imagination Centre in 1992.

Retrieved from https://garth.typepad.com/primitive_screwheads/2010/07/lego-imagination-center-1992.html.

Figure 22 – Lego products-only store in London.

Retrieved from https://www.cnet.com/pictures/inside-legos-new-london-home/21/.

Figure 23 – Lego Bionicle Toys.

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Figure 24 – Harry Potter Lego toy from 2002.

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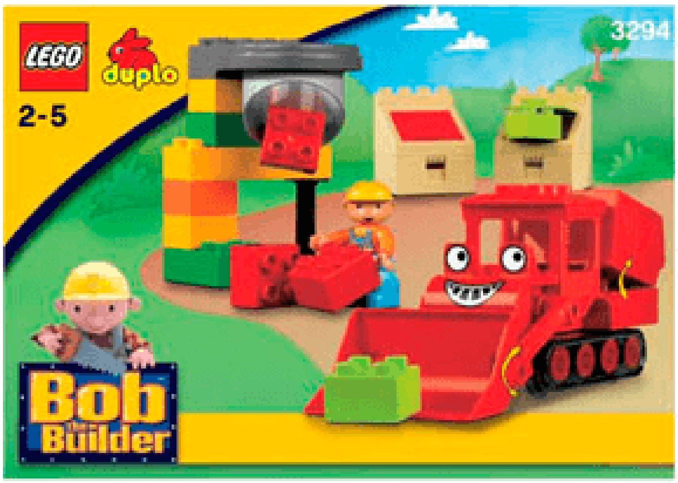

Figure 25 – Bob the Builder Lego toy.

Retrieved from https://www.lego.com/en-us/service/buildinginstructions/search?initialsearch=3294#?text=3294.

Figure 26 – Life on Mars Lego toy.

Retrieved from https://www.amazon.com/Lego-Life-Mars-Recon-Mech-7314/dp/B000056VMK.

Figure 27 – Star Wars Lego toy from 2003.

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Figure 28 – Jargen Vig Knudstorp.

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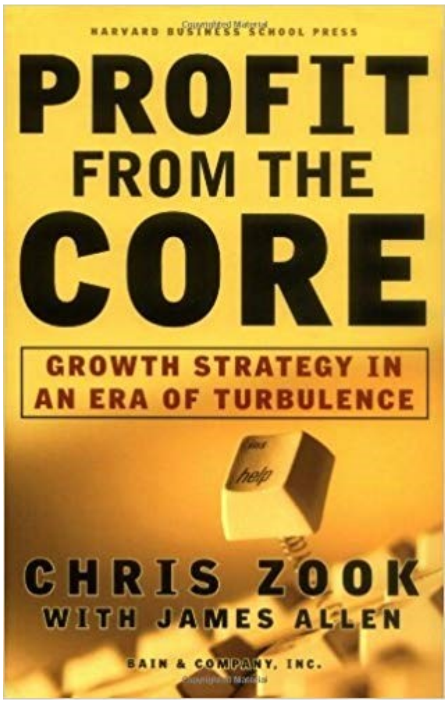

Figure 29 – Profit from the core, by Chris Zook (2001 edition).

Retrieved from https://www.amazon.com/Profit-Core-Strategy-Turbulence-2001-02-02/dp/B01K3KND2S.

Figure 30 – Jesper Ovesen.

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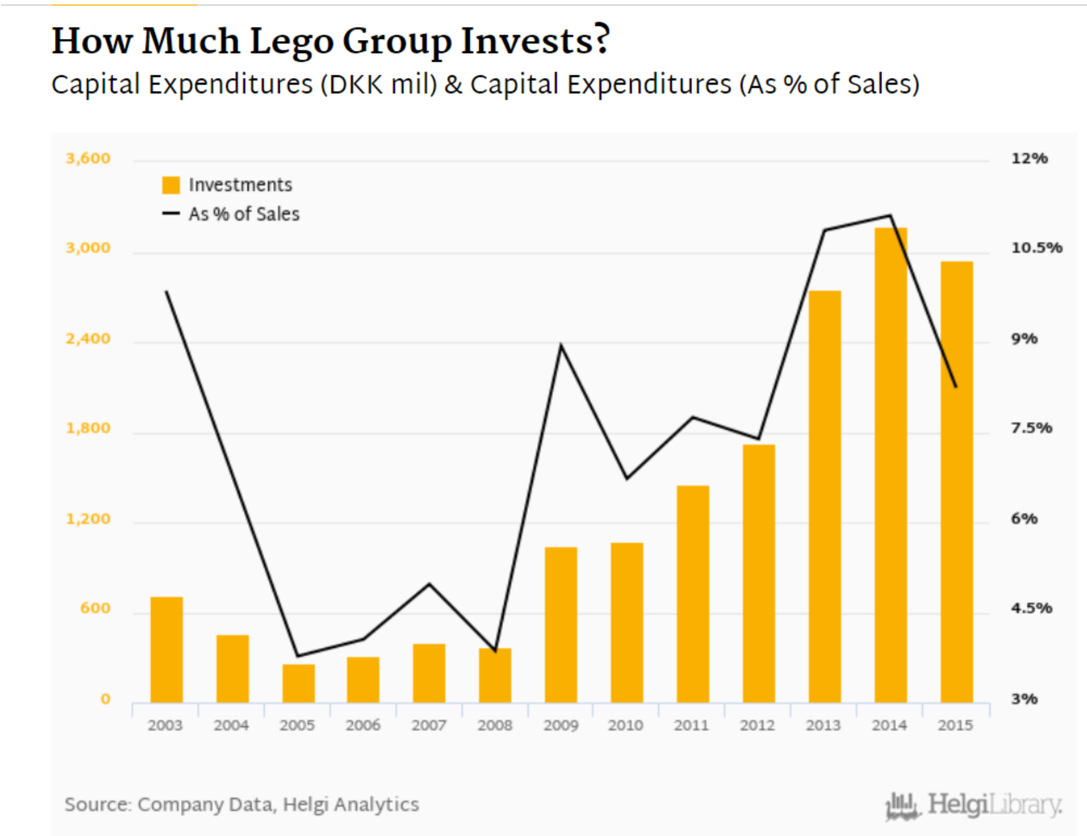

31 – Capital Expenditures (DKK) & Capital Expenditures (as a percentage of sales).

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Figure 32 – Lego Explore.

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