

Ducati incremental income from cruiser line



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Federico Minoli, after completing a successful turnaround of Ducati, had to decide in which direction to take the firm in the 2000s. By 2000, Ducati was a major player with 7% market share in the fast-growing Sport motorcycle segment.

Ducati's success in the mid-to-late 1990's was driven by three major factors. First, Ducati had a very strong brand with a reputation for unique and beautiful performance motorcycles. This likely led directly to the next major factor: brand loyalty. Slightly more than half of Ducati's customers expressed a desire to purchase another Ducati bike in the future. Third, the engineers and the R&D team consistently created high quality products. This was emphasized by Ducati's near constant victories over Japanese firms in the Superbike Championships.

One of the options Minoli considered was expanding into the Cruiser motorcycle segment. This segment had the lifestyle crowd squarely in mind with its design emphasizing "styling over comfort and speed." Minoli estimated that the cost of developing a Cruiser would be €17 million in R&D investments on top of the additional €26 million in other costs, or roughly €43 million.

Projections

The Cruisers segment represented approximately 22.9% of the worldwide market for motorcycles in 2000. If Ducati was able to eventually match the success it had in the Sport segment and capture 7% of the worldwide Cruiser segment, it would almost certainly be able to quickly recoup its initial investment costs and drive future profitability.

Best Case Scenario:

In order to project a potential “ best case scenario,” the following assumptions were made:

Industry growth in 2001 will be an average of the preceding 5 years, or 13.84%. This puts the total market for motorcycles at 1, 782, 979.

The Cruiser line of motorcycles will continue its previous year share of total market increase and will be 23% in 2001.

Ducati’s Cruiser market share will match its Sports line and quickly rise to 7% in 2001.

Ducati’s cost structure for Cruisers would be similar to Harley Davidson’s overall cost structure in 2000. Cost as a percentage of revenue will be 79.9%.

As per Minoli’s estimate, each bike will sell for between €10, 000 and €20, 000. An average of €15, 000 per bike will be used, and an additional €1, 000 for other accessories/apparel will be considered as part of the bike price.

Ducati will be able to complete its Cruiser design project in time for 2001.

This expansion will have no detrimental impact on Ducati’s Sport segment.

If these assumptions hold, Ducati will have the following Cruiser experience:

Predicted Best Case Scenario in 2001: Ducati Incremental Income from Cruiser Line

Motorcycle Sales

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Cruiser Market

Ducati Bikes Sold

Average Price

Operating Revenue

Operating Costs

Operating Income*

1, 782, 979

410, 085

28, 706

£16, 000

£459, 295, 431

£366, 977, 049

£92, 318, 382

*Operating Income is incremental (in addition to the Sport segment)

In this scenario, Ducati immediately recoups the €43 million investment.

Expansion looks like a very lucrative proposition.

Worst Case Scenario:

In order to project a potential “ worst case scenario,” the following assumptions were made:

The market for motorcycles has become mostly saturated. Sales in 2001 will increase by 3.09%, matching the 44% decline in growth between 1999 and 2000.

The Cruiser line of motorcycles will decline by 0.65% as a proportion of total motorcycle sales, matching the average rate of ‘ growth’ over the previous 4 years.

Ducati will be unable to match its success in the Sport segment. Minoli’s stated goal of competing directly with Harley Davidson will ring too true. Harley Davidson sells 22% of its bikes internationally with an assumed equal split between Asia and Europe. Roughly 95% of Harley Davidson’s sales come from the Cruiser segment. Therefore, Harley Davidson is expected to sell 21,232 Cruisers in Europe. Ducati’s sales in this segment will be 10% of Harley Davidson’s in Europe, or 2,188 (taking into account assumption 1 and 2).

Ducati’s cost structure will be similar to what it had in the Sports segment in 1996 as a result of its lack of expertise in this segment. Cost as a percentage of revenue will be 89.1%

The average price Ducati will be able to charge will fall towards the lower range of Minoli’s estimate. An average of €12,500 per bike will be used. Sales of additional accessories/apparel will be negligible.

Ducati will be able to complete its Cruiser design project in time for 2001.

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This expansion will have no detrimental impact on Ducati's Sport segment.

If these assumptions hold, Ducati will have the following Cruiser experience.

Expansion looks like a very costly, stressful, and ultimately financially distressing decision.

Predicted Worst Case Scenario in 2001: Ducati Incremental Income from Cruiser Line

Analysis

It is very likely that the actual figures would fall somewhere between the best and worst case scenarios. In order to determine towards which spectrum the numbers impacting the operating revenues and costs will most likely fall, many factors need to be considered:

How many Cruisers will Ducati be able to sell?

This question, perhaps the most important question, is also the most difficult to project. Ducati's current lineup is perhaps the furthest away from enticing Cruiser customers compared with all the major competitors. Ducati is the only one of 8 (discussed) firms without a presence in at least the Touring line of motorcycles. Therefore, Ducati may not have the market experience and expertise necessary to develop a successful Cruiser bike. Its engineering team is described as a "knees down" kind of team which may not lend itself to developing the proper Cruiser motorcycle. Even if the engineering team can put their biases aside, the type of bikes Ducati develops may be too close to an already existing and popular bike offered by one of Ducati's competitors. If the engineering team chooses to mitigate this risk by creating a larger number of bikes, the amount of time they are able to dedicate to

each particular bike may become so diluted that it reduces overall quality. Furthermore, Ducati's current customers tend to be younger than Harley Davidson's customers. Most of Ducati's riders are between 18 and 35 compared to a median age of 45.6 for Harley Davidson. Another potential problem can be found in customer responses to a 'Brand Attributes' survey. Ducati's customers most closely associate it with speed, an "Italian style," and superbike competitions. For Cruiser customers, speed and superbike competitions are likely unimportant factors. It is unclear how important "Italian style" is to Cruiser consumers in Europe.

On the other hand, there are reasons to be positive about Ducati's Cruiser prospects. First, Ducati probably anticipated that it is unlikely that Cruiser sales will cannibalize Sport sales. In fact, it may be completely the other way around. According to customer profiles, 30% of Harley-Davidson owners also own a competitor's > 500cc bike. Sales of Ducati Cruisers may lead to increased sales of Ducati Sport bikes. Alternatively and conversely, as the typically younger Ducati Sport riders "age out" of the Sports segment, they may be interested in more versatile Cruiser bikes. This plays directly into Ducati's high brand loyalty scores; 55% of Ducati's customer base expressed repeat purchase intentions. Next, the previously discussed 'Brand Attributes' survey also points to uniqueness as being a primary brand attribute. According to the case, "rebelliousness and freedom" are very important to Cruiser customers. These traits might be very well suited towards a unique product. Next, BMW introduces some precedent for a firm that was able to successfully enter the Touring segment which is somewhat similar to the Cruiser segment. Both BMW and Ducati are similar in that they

are differentiators with excellent engineering teams. If BMW can pull it off, it stands to reason that Ducati can pull it off, as well.

There are many additional unknown factors. For example, how do most people decide which Cruiser to purchase? Are these decisions made on the internet or in multi-brand dealerships where the salespeople match the individual to a bike? Ducati may have to expand its retail locations, thus increasing fixed costs, or squeeze more bikes into its current locations.

For purposes of the analysis, a conservative prediction of 2% of global cruiser sales will be used.

Will the overall market for motorcycles continue to grow?

Based on the information available, it is difficult to determine the future growth of the motorcycle market. It seems likely the market will grow, but by how much is basically indeterminable. For purposes of the analysis, it is estimated that the market will grow at the average of the growth over the last 3 years, or 12.18%.

Will the cruiser segment continue to decline as a percentage of overall motorcycle sales?

Since 1996, the Cruiser segment's share of total motorcycle sales has declined from 25.5% to 22.9%. However, in absolute quantities, the market is still expanding. In the past year, the Cruiser segment showed signs of stabilizing and even posted a very slight increase. For purposes of the analysis, it is estimated that the Cruiser segment's share will remain constant at 22.9%.

At what price will Ducati enter the market and with how many products?

Minoli envisioned a line of Ducati Cruiser bikes that would be priced between €10, 000 and €20, 000. Sales of the bikes, along with the corresponding accessories and clothing will probably allow Ducati to enjoy average prices somewhere near the middle of the spectrum. Therefore, for purposes of analysis, it is estimated that average prices will equal the price that BMW was able to charge in the United States, or €14, 500 per bike, on average, including accessories/apparel.

Will Ducati's cost structure remain the same?

Ducati currently outsources an aggressive 87% of its production over 130 suppliers. Entering this new product segment may require Ducati to produce certain parts in-house which would reduce their Just-in-Time efficiencies. For purposes of this analysis, it will be assumed that costs will have to increase somewhat in the first year as developing partnerships and reducing supply costs will probably be a work in progress. Costs as a percentage of revenue will be estimated to be between Ducati 1996 and 2000 levels, or 87. 15%.

The following non-operating revenue/cost considerations need to be made, as well:

Will the €43 million invested be a one-off?

Based on Minoli's track record, there is no reason to assume that his analysis will be mistaken. It is likely that the €43 million will be a one-off cost.

However, the potential for delays or research over budget may reduce the

attractiveness of this investment. Also, €43 million is more than 3 years of net income, a very serious investment.

Will 3.7% research and development be enough in a new segment?

Ducati is expanding into a segment it has no experience dealing with. In order to continue developing high quality products that can compete with the competition, R&D costs for the Cruiser line may need to be increased beyond the typical 3.7% of revenue Ducati spends on R&D in the Sports segment. Increasing R&D may make entering this segment more unattractive.

Will competitors fight or accommodate?

Harley Davidson has a tenuous presence in the European market. Despite all of their success developing the Cruisers segment in the United States, their expanding business in Europe is very important. Harley Davidson, and perhaps other competitors, may react to Ducati entering the segment by lowering prices or increasing quality. Perhaps the worst case scenario for Ducati is that one competitor drops prices, another raises quality, and another takes a middle-ground approach. If this happens, Ducati may need to invest even more into R&D and development in order to develop a successful Cruiser or find new ways of reducing costs. Reducing costs may be difficult given the level of outsourcing Ducati already engages in.

Can Ducati carry over substantiated competitive advantages to the Cruiser segment?

Ducati identified “ five core attributes” which in combination with the skilled engineering team may be contributing to Ducati’s sustained competitive

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advantage: a desmodromic distribution system, L-twin engine, tubular trestle frame, Italian style, and a Ducati unique sound. Do these areas of Ducati advantage fit with a Cruiser line?

What other strategic alternatives exist?

The two most sensible options would be for Ducati to continue their planned expansion into the Cruiser segment or to stay the course and continue to make headway into the Sports segment. If Ducati was so inclined, they could also see if there was a market for high-end smaller motorcycles or even scooters, though it is unlikely that demand exists.

Recommended Strategic Alternative

Based on the analysis above, I predict the following outcome for the first year of Ducati Cruiser sales (if they choose to enter the market).

Predicted Outcome in 2001: Ducati Incremental Income from Cruiser Line

Motorcycle Sales

Cruiser Market

Ducati Bikes Sold

Average Price

Operating Revenue

Operating Costs

Operating Profit*

1, 756, 980

402, 348

8, 047

£14, 500

£116, 681, 040. 94

£101, 687, 527

£14, 993, 514

*Operating Profit is incremental (in addition to the Sport segment)

I would encourage Ducati to enter the Cruiser segment even though developing a Cruiser line of motorcycles is expected to cost €43 million (or 3+ years of net income at current levels) and that spending 3. 7% of Cruiser revenue on R&D may be too low for the first few years.

By all indications, Ducati should be able to sustain its growth in the Sports segment then it will be able to better weather the financial strain from this investment. Also, the nature of Ducati's cost structure lends itself very well to expanding its product line. Since most production is outsourced, Ducati doesn't have to be too concerned about fixed costs and idle capacity in the event it doesn't exactly meet its sales figures.

Beyond the hard numbers, Ducati has an excellent name and reputation that it can leverage in order to convince buyers of Cruisers that their product is the best. Ducati has an excellent reputation in Europe which is exactly where <https://assignbuster.com/ducati-incremental-income-from-cruiser-line/>

they are distributing the new Cruiser bikes. The Ducati name, combined with the passion exhibited by some of its customers, should enable Ducati to achieve first year numbers outlined above and experience increasing profits in future years. The €43 million investment should pay for itself in only a few years' time. Then, Ducati will be very pleased it has two segments providing space to grow. In the future, should the Sport or Cruiser segment experience a downturn, this diversification could allow Ducati to better weather sales turbulence as a result of reduced reliance on one sector in particular.

Overall, expanding into the next largest segment of motorcycle sales is a natural step for a growing and profitable firm. I believe it is fair to say that the predicted 2001 operating profit, €14, 993, 514, is a fairly conservative estimate that should grow substantially over time as consumers become more and more aware of Ducati's lineup in this segment. Over the long-term, I consider it more likely that Ducati numbers approach the ' Best Case Scenario' figures as opposed to the ' Worst Case Scenario' figures. Therefore, I recommend that Ducati move forward and expand into the Cruiser segment.