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by William Taylor

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RISKO

"If you combine powerful technology with fantasy, you create something very distinct."

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by William Taylor

Nicolas G. Hayek is a rare phenomenon in Europe – a genuine business celebrity. In his home country of Switzerland, and increasingly across the continent, he is an engaging presence in newspapers and magazines and on television talk shows. Hayek, 64, has earned his fame. He and his colleagues at the Swiss Corporation for Microelectronics and Watchmaking (SMH) have engineered one of the most spectacular industrial comebacks in the world – the revitalization of the Swiss watch industry.

The dimensions of the turnaround are staggering. SMH took shape in 1983 when Hayek recommended that Switzerland's banks merge the country's two giant (and insolvent) watch manufacturers. That year, the new company generated revenues of SFr1.5 billion ($1.1 billion) and lost SFr173 million ($124 million). Last year, SMH generated revenue of about SFr3 billion ($2.1 billion) and posted profits of more than SFr400 million ($286 million).

Nicolas Hayek has been involved with SMH from the beginning. In the early 1980s, the banks named Hayek their chief adviser on the troubled watch industry. He was already well-known as the founder and CEO of Hayek Engineering, a Zurich-based consulting firm that is something of a cross between Arthur D. Little and McKinsey & Company. In 1985, the banks proposed that Hayek buy a controlling equity stake in SMH. He assembled a group of investors, retained the single largest stake, and became CEO.

The original investors paid SFr100 per share. Today SMH trades at SFr1,500 per share. Its market value exceeds SFr4.9 billion ($3.5 billion). Hayek's personal stake is worth roughly SFr1 billion ($700 million).

But SMH is more than a turnaround story. It is a case study of Hayek's management philosophy and strategic thinking, both of which are strikingly at odds with the prevailing wisdom about how companies should compete in the new economy.

Conventional wisdom suggests that global companies should become "stateless." They should seek low-cost production wherever they can find it and build operations in many national markets. Yet SMH is committed to its Swiss home base. The bulk of its technology, people, and production remain anchored in the towns and villages around the Jura mountains on Switzerland's border with France – the traditional heart of Swiss watchmaking.

Companies also hear endless advice to become niche players by focusing on ever more-narrow market segments. But SMH is every-

DRAWING BY ROBERT RISKO

where. Its brash and playful Swatch (whose basic models sell for $40) has become a pop-culture phenomenon. Last year, SMH sold an estimated 27 million Swatches. The company's flagship brand on the high end is Omega, whose models retail for anywhere between $700 and $20,000.

Watches in the hotly competitive middle segment sell for between $75 and $350. This is where SMH battles most directly with Seiko and Citizen, the two Japanese giants. SMH recently acquired Blancpain, a niche producer of luxury mechanical watches that retail for $200,000 and higher. SMH has even extended its presence in watches to new product categories such as telecommunications.

Finally, managers increasingly believe they should dismember their companies and retain only those core activities crucial to success. But SMH is a vertically integrated fortress. It assembles all the watches it sells, and it builds most of the components for the watches it assembles.

William Taylor, former HBR associate editor, conducted the interview at the Zurich headquarters of Hayek Engineering and at SMH headquarters in Biel.

HBR: *The revitalization of SMH has generated tremendous attention across Europe. What are the most important lessons?*

Nicolas Hayek: There are two main lessons. First, it is possible to build high-quality, high-value, mass-market consumer products in high-wage countries at low cost. Notice I said *build*, not just design and sell. A Swatch retails for 50 francs in Switzerland and $40 in the United States. The price has not changed in ten years. Yet we build all of our Swatches in Switzerland – where the most junior secretary earns more than the most senior engineer in Thailand or Malaysia.

In fact, it's not just possible to build mass-market products in countries like Switzerland. It's mandatory. This is a principle I am passionate about – and a principle business leaders in the United States and Europe don't take seriously enough. We are all global companies competing in global markets. But that does not mean we owe no allegiance to our own societies and cultures.

Not so long ago, I was in the United States for a meeting with the CEO of one of your big companies. We were discussing a joint venture to produce a new product we had developed. He saw what the product could do, he reviewed the design, and he got very excited: "Great, we'll make it in Singapore." His people had done no research or calculations at all. It was a reflex. I said, "No, we'll make it in Alabama."

But I'm sure you understand the reasoning. In a global economy, companies must source wherever they can get the best people at the lowest cost. Asia is bursting with smart, well-trained workers and engineers. How can you afford not to look there for manufacturing?

We must build where we live. When a country loses the know-how and expertise to manufacture things, it loses its capacity to create wealth – its financial independence. When it loses its financial independence, it starts to lose political sovereignty.

"If labor is less than building a product in

We have to change that reflex: the instinctive reaction that if a company has a mass-market consumer product, the only place to build it is Asia or Mexico. CEOs must say to their people: "We will build this product in our country at a lower cost and with higher quality than anywhere else in the world." Then they have to figure out how to do it.

We do this all the time. We agree on the performance specifications of a new product – a watch, a pager, a telephone. Then we assemble a project team. We present the team with some target economics: this is how much the product can sell for, not one penny more; this is the margin we need to support advertising, promotion, and so on. Thus these are the costs we can afford. Now go design a product and a production system that allows us to build it at those costs – in Switzerland.

That means focusing on labor. If we can design a manufacturing process in which direct labor accounts for less than 10% of total costs, there is nothing to stop us from building a product in Switzerland, the most expensive country in the world. Nothing.

But you know consumer markets are fiercely competitive. How can you absorb even a modest cost disadvantage?

This is not commodity competition. Let's say you have three similar watches. One says "Made in

Japan" and sells for $100. Another says "Made in Switzerland" and sells for $110. A third says "Made in Hong Kong" and sells for $90. Which watch will consumers prefer? In Europe, between 75% and 95% of all consumers will prefer the Swiss watch – in spite of the 10% premium. In the United States, depending on which region you are talking about, between 51% and 75% of all consumers will prefer the Swiss watch. Only in Japan itself will a majority of consumers prefer the Japanese watch to the Swiss watch.

What does that mean? If you have a manufacturing process in which direct labor is less than 10% of total costs, you have eliminated those costs from the competitive equation. When we created SMH, our direct-labor costs, on average, were more than 30% of total costs. Today they are well below 10%. If we paid our workers full salaries and the Japanese paid their workers nothing, we could still compete.

This same logic applies beyond watches. CEOs must understand this point. If you can design a system in which direct-labor costs are less than 10% of total costs, it is cheaper to build mass-market consumer products in the United States than in Taiwan or Mexico.

What's the second lesson of SMH's comeback?

It's related to the first. You can build mass-market products in countries like Switzerland or the United States only if you embrace the fantasy and imagination of your childhood and youth. Everywhere children believe in dreams. And they ask the same question: Why? Why does something work a certain way? Why do we behave in certain ways? We ask ourselves those questions every day.

People may laugh – the CEO of a huge Swiss company talking about fantasy. But that's the real secret behind what we have done. It's an unusual attitude for Switzerland – and for Europe. Too many of Europe's large institutions – companies, governments, unions – are as rigid as prisons. They are all steel and cement and rules. We kill too many good ideas by rejecting them without thinking about them, by laughing at them.

Ten years ago, the people on the original Swatch team asked a crazy question: Why can't we design a striking, low-cost, high-quality watch and build it in Switzerland? The bankers were skeptical. A few suppliers refused to sell us parts. They said we would ruin the industry with this crazy product. But the team overcame the resistance and got the job done.

The Swatch is based on radical innovations in design, automation, and assembly, as well as in marketing and communications. One of our plants in Grenchen makes up to 35,000 Swatches and millions of components a day. From midnight until 8 A.M., it runs practically without human intervention. Swatch is a triumph of engineering. But it is really a triumph of imagination. If you combine powerful technology with fantasy, you create something very distinct.

Let's go back to the beginning of SMH – the dark days – and work forward to the two main lessons. It's the early 1980s. Swiss watchmaking is on the brink. The banks call you in. What do you find?

A chaotic jungle. An absolute mess. Most people who analyze the destruction of the Swiss watch industry in the 1970s emphasize price and technology. They point to the arrival of hundreds of millions of cheap quartz watches from Japan and Hong Kong and our decision to ignore quartz, a technology we invented. But we had huge problems beyond technology. There were problems of strategy, structure, management.

The two companies that became SMH were the flagships of the Swiss industry. One was SSIH, a company that had Swiss-French origins. Omega was the crown jewel of SSIH. Up until the early 1970s, Omega was one of Switzerland's most prestigious brands – more prestigious than even Rolex. But Omega was so successful for so long that it ruined SSIH. The company got arrogant. It also got greedy. It wanted to grow too fast, and it diluted the Omega name by selling too many watches at absurdly low prices.

SSIH had no discipline and no strategy. It had its own distribution in countries like Germany and France. It worked through agents in other countries. It even let some agents contract with outside manufacturers to build their own Omega models! It made no sense.

Then there was ASUAG, a company with Swiss-German origins. ASUAG was a manufacturing company. ASUAG owned a few brands, including

10% of costs, there's nothing to stop us from the most expensive country in the world."

Rado and Longines. But its heart and soul was an operation called Ebauches S.A., which supplied components to the whole Swiss watch industry. Ebauches was very capable. Over the years, however, as various small Swiss brands faltered, they went to ASUAG looking for a rescue package. ASUAG was the rich uncle: "Please, we are going broke. Why don't you buy us? It won't cost much. You can't let us disappear."

ASUAG felt a certain responsibility. Also, it didn't want to lose its customer base. By the late 1970s, then, ASUAG owned much more than Rado, Longines, and Ebauches. It owned all kinds of brands. It also owned lots of little companies that made components and had run into trouble. Many of these companies had been family-owned for generations. ASUAG rescued them but left most of the family managers in place.

By 1982, ASUAG owned more than 100 separate companies – some big, some small, some modern, some backward. Most of these companies did their own marketing, their own R&D, their own assembly. It was crazy.

The banks agree to merge SSIH and ASUAG to create SMH. It's time to sort through the jungle. Where do you begin?

We began with the products themselves. We had to understand our strategic positioning, where we stood in world markets. We made a big study, written in German, that became known as the Hayek Report. As you can imagine, the report got lots of attention in Switzerland. It was very controversial.

In the report, we drew a diagram to describe our competitive environment. It looked like a three-layer wedding cake. Back then, the world market for watches was about 500 million units per year. The low-end segment, the bottom layer of the cake, had watches with prices up to $75 or so. That layer represented 450 million units out of 500 million. The middle layer, with watches up to $400 or so, represented about 42 million units. That left 8 million watches for the top layer, with prices from $400 into the millions of dollars.

The Swiss share of the bottom layer, 450 million watches, was zero. We had nothing left. Our share of the middle layer was about 3%. Our share of the top layer was 97%.

We were cornered. The Swiss spent much of the 1970s reacting to quartz by retreating: "Why should we compete with Japan and Hong Kong? They make junk, then they give it away. We have no margin there." Of course, as we retreated, the Japanese moved up to the next layer of the cake. Then the retreat would start again.

I decided we could retreat no longer. We had to have a broad market presence. We needed at least one profitable, growing, global brand in every segment – including the low end. That explained why we had to control and sell Swatch ourselves rather than license it or sell it through agents, as some people had proposed. It also meant we had to reinvigorate Tissot, the only global brand we had in the middle segment.

The banks studied our report and got nervous, especially about Swatch. Some of them worried that Swatch would cannibalize Tissot. Others were more emphatic: "This is not what consumers think of when they think of Switzerland. What the hell are you going to do with this piece of plastic against Japan and Hong Kong?" But we were adamant: if we did not have mass production, if we did not have a strong position in the low end, we could not control quality and costs in the other segments.

The banks thought Swatch would fail?

Not fail, necessarily. Many thought it might survive – but barely. After all, we were going to battle at the low end. Who could make real money there against people from Japan or Hong Kong? That's when they proposed that I buy 51% of the company.

What did you see that others didn't?

I understood that we were not just selling a consumer product, or even a branded product. We were selling an emotional product. You wear a watch on your wrist, right against your skin. You have it there for 12 hours a day, maybe 24 hours a day. It can be an important part of your self-image. It doesn't have to be a commodity. It shouldn't be a commodity. I knew that if we could add genuine emotion to the product, and attack the low end with a strong message, we could succeed.

How do you "emotionalize" a watch? Do you mean to say that Swatch turned something that was mundane and functional into a fashion statement?

That's how most people describe what we did. But it's not quite right. Fashion is important. The people at our Swatch Lab in Milan and our many other designers do beautiful work. The artists who make our Swatch special collections design wonderful watches (see the first insert, "Franco Bosisio: In the Eye of the Swatch Storm"). But take a trip to Hong Kong and look at the styles, the designs, the colors. They make pretty watches over there too.

We are not just offering people a style. We are offering them a message. This is an absolutely critical point. Fashion is about image. Emotional products are about message – a strong, exciting, distinct, authentic message that tells people who you are and why you do what you do. There are many elements that make up the Swatch message. High quality. Low cost. Provocative. Joy of life. But the most important element of the Swatch message is the hardest for others to copy. Ultimately, we are not just offering watches. We are offering our personal culture.

You mean people can look at a watch from Hong Kong and then look at a Swatch and sense a different culture?

It's not just the mechanics of the product. It's also the environment around the product. One thing we forget when we analyze global competition is that most products are sold to people who share our culture. Europeans and Americans are the biggest groups in the world buying products from Asia. So if you can surround your product with your own culture – without ever denigrating other cultures or being racist in any way – it can be a powerful advantage.

We are offering our products to a sympathetic audience. The people who buy Swatches are proud of us. They root for us. They want us to win. Europeans and Americans are damn happy if you can show that their societies are not decadent – that every Japanese or Taiwanese worker is not ten times more productive or more intelligent than they are.

What is a concrete example of embedding culture in the message around Swatch?

How did we launch Swatch in Germany? Did we saturate the airwaves with paid advertisements? No. Anyone can do that. We built a giant Swatch. It was 500 feet high, weighed 13 tons, and actually worked. We suspended that giant Swatch outside the tallest skyscraper in Frankfurt, the headquarters of Commerzbank. It was really something to see!

I remember asking the chairman of the bank for permission. He thought we were crazy. We were crazy, but we had already gotten authorization from the city engineers and the local government. And we persuaded him that this giant Swatch would show his customers that his bank had heart and emotion. So there it hung. And all it said was: Swatch. Swiss. DM60.

"We don't offer an image. We offer a message."

That outrageous display communicated the essence of the Swatch message. It was high quality – Swiss. It was low cost – what could be more affordable than DM60? It was a big provocation to hang a watch from a huge, grim skyscraper. And it was funny, fanciful, a joke – joy of life. Believe me, when we took it down, everyone we had wanted to reach had received our message.

We also hung a giant Swatch in Tokyo, in the Ginza. This message can work in Japan as well. By value, Swiss companies account for more than 50% of all the watches sold in Japan. SMH accounts for 75% of that 50%. Do you think we broadcast these figures? Or that we act arrogantly in Japan? Of course not. The Japanese are sympathetic to us. We're nice people from a small country. We have nice mountains and clear water. They like us and our products, and we like them.

So you're really talking about advertising and promotion?

I am talking about everything we do. Everything we do and the way we do everything sends a message. Let me give another example – our "Swatch the World" celebration in Zermatt last fall. This was a huge occasion for us. It celebrated the production of our 100 millionth Swatch. It was a very public event. Political leaders came to Zermatt. There was lots of hoopla, lots of excitement.

We could have spent millions of francs on champagne, caviar, and dancing. Instead, we created an artistic event, a tasteful event, an honest event. It was set in a village at the foot of the Matterhorn, the symbol of Swiss authenticity. But it was lively and offbeat. We had street musicians, artists, reggae, clowns. We also had Jean-Michel Jarre, the brilliant young composer from France. He wrote origi-

Franco Bosisio: In the Eye of the Swatch Storm

From his office in Milan, Franco Bosisio sits in the eye of the Swatch storm. He established and now runs the main Swatch Design Lab, an ever-changing collection of artists, architects, and industrial designers who turn out many of the 140 new Swatch models every year. Bosisio also runs SMH Italy, where the Swatch phenomenon has reached its most fevered pitch.

"It's almost embarrassing. I go out to dinner, and all I see are Swatches. Swatch now accounts for 40% of the watches sold in Italy. But if you combine the watches we sell here, plus the watches Italians buy when they travel abroad, plus what they buy through auctions and 'unofficial' channels, our market share is even higher.

"It's incredible! And I can't really explain it. We didn't launch Swatch here until 1986. Italy was the last major European country to get it. That's strange, in a way, because Italians are crazy for fashion in general and watches in particular. So people were dreaming about it: When are we going to get Swatch? When we finally made the launch, the market exploded. And it has kept growing. Our average customer in Italy owns six Swatches.

"This was no brilliant strategy on our part. For years, we just weren't happy with the distribution situation in Italy. So we decided to wait until we could do it right. Then came a series of high-profile events. For example, Sotheby's chose Milan as the site of one of its first Swatch auctions. None of us knew what to expect. But the frenzy and the prices and the visibility were incredible. People were pushing their way in, their pockets bulging with bank notes. It was really emotional. My public relations person was in tears because it was so intense. The people from Sotheby's were astonished.

"So luck has played a big role in our success here. But of course there is more. I have always thought the appeal of Swatch rests on four pillars: design, communication in the widest sense, quality, and price. Few people appreciate how and why price has been so important. Everywhere in the world, Swatch is sold at an affordable price. But it's also a simple price, a clean price. In the United States, $40. In Switzerland, SFr50. In Germany, DM60. In Japan, ¥7,000.

"It has also been, in the first ten years, an unchanging price. Despite our incredible success in the market, despite the huge unmet demand in countries like Italy, we have never raised the price of Swatch to our dealers. And we forbid our dealers from marking up the price to their customers. Can you name another fashion product whose price has stayed exactly the same for ten years?

"Price becomes a mirror for the other attributes we try to communicate. It helps set us apart from the rest of the world. A Swatch is not just affordable, it's approachable. Buying a Swatch is an easy decision to make, an easy decision to live with. It's provocative. But it doesn't make you think too much.

"That's also the sensibility behind our designs. There are about 20 people in our Swatch Lab. They come from many backgrounds and from all over the world. We have had designers from Italy, Japan, Germany, France, America, Australia, many other places. A few are trained in architecture. Many are trained in industrial design. A few are right out of university.

"People work with us for many reasons. Let's face it, most people who are serious about a career in design want to spend some time in northern Italy. And they love the product, the idea that millions of people wear it. They also value the chance to interact with Alessandro Mendini, our art director. Mendini is a major figure in European styling. His work occupies a space somewhere between fine art and industrial design. He has long been known for his dramatic furniture, which he makes in very small numbers. Swatch is really his first experience with mass production.

"By the way, Mendini has managed to combine both interests. He designed Lots of Dots, a special Swatch only available to members of our Swatch collectors' club. Then he designed a ceramic armchair that is based on Lots of Dots.

"We rotate people through the lab. Everyone must agree to stay for at least six months. Very few people stay for more than two years. They get tired. We get tired. This is challenging work. Lots of brilliant artists fail when they try to design for us. It's hard to squeeze wonderful ideas into the face and band of a Swatch. In fact, we have more than 3,000 proposed designs that we have never executed.

"We design two Swatch collections each year, 70 styles per collection–140 different models. We always prepare four times the number of models we need. A group in Milan selects half of those proposed designs and presents them to the management committee in Switzerland. In Switzerland, we make the final choices and decide on the collection.

"Four years ago, when we established the Lab, I worried that we would run out of ideas. We asked a group of fashion experts – famous journalists, art dealers, and so on – to prepare reports for us on big themes. We worked with Oliviero Toscani, the photographer who does much of Benetton's advertising. We hired all kinds of consultants.

"We still do that – but we now do much, much more. These experts are so accomplished that they are asked to advise lots of other companies. So it was hard for us to be distinctive. We also came to realize how repetitive fashion can be. With clothing, you change the shape, the length, the fabric. But the basic design elements – the decorations and patterns – don't change nearly as much. For us, of course, it's the exact opposite. The size and shape of the watch stays the same. What varies is what's on it.

"We have no set routines to come up with ideas. We travel constantly, all over the world. We go to the big fashion shows – Première Vision in Paris, for example. We go to the opera, to art exhibitions. You can't imagine how many books and magazines we read, how many painters we study. We steep ourselves in the culture of life. And then things happen.

"Let me give you an example. Two of our watches in the latest Fall/Winter collection were called Fairy Tales. They grew out of some books we came across, books of images that inspired some of the great artists of the nineteenth century. On one of the watches there is a teapot, there is a man kissing the hand of a woman, and there is the face of a young woman. The holes in the bracelet look like tears. That watch tells a story. It's like a chance encounter with people from an earlier time.

"We don't get carried away. This is only semi-serious. We want arresting images, but we also wink at the consumer. We don't want people to think too much. We are looking for an immediate emotional reaction – spontaneity. All we can tell is that there is a man romancing a woman and that the woman is crying. Everything else is left to your imagination."

nal music for us and beamed a multimedia light show against the Alps.

More than 40,000 people came to Zermatt from all over Europe. The newspapers and magazines and television stations carried big reports. It was a critically important statement of the Swatch message. And what were we communicating? Our culture. Our sense of ourselves and what we stand for.

Do you use the same logic with all of your other brands too?

Each brand is different, so each message is different. But each brand has a message. My job is to sit in the bunker with a machine gun defending the distinct messages of all my brands. I am the custodian of our messages. I review every new communications campaign for every single brand.

Let's talk about Omega. We built Swatch from the ground up. We had to rescue Omega from near oblivion. Omega is a crucial brand for SMH. We make as much money with Omega as we do with Swatch. Yet no one ever discusses it.

So why was Omega near oblivion?

Omega is one of the Swiss watch industry's great brands. Its history goes back to 1848. You should visit the watchmaking museums and look at the pieces Omega made 50 or 100 years ago. They are wonderful. Few brands had or have Omega's potential power.

The problems started in the early 1970s. There were bad business practices. The people there became arrogant. They treated their agents and dealers badly. If an agent from, say, New Jersey needed 200 units of a particular model, Omega would say: "You're crazy! Don't bother us with such nonsense. We'll give you 50."

Second, and much worse, Omega became greedy. Rolex sells 600,000 watches per year. That's about as many as you can sell before a luxury brand begins to lose its prestige. That's about how many Omega was selling in the late 1970s. But Omega wanted to grow more rapidly. So they took the easy route. They figured, "If we can sell 600,000, why not a million? Or 2 million? Or 3 million?"

Which meant, of course, they had to lower the price radically. A jeweler would say, "Omega is wonderful, but it is too expensive for my clients. How about giving me an Omega that is cheaper?" Now, if you are crazy, or I guess if you are greedy, you agree.

That was the kiss of death. Omega was everywhere: high price, medium price, precious metals, cheap gold plating. There were 2,000 different models! No one knew what Omega stood for. By the end of 1980, the company was again in a deep crisis, its deepest ever.

How did you develop the recovery plan?

It was very painful. Early on, before the SMH merger, we spent days behind closed doors with the company's managers and bankers. Some of the people suggested that we sell Omega to the Japanese, who had offered to buy it. It was still a powerful brand despite the problems, and it would fetch a lot of money. Of course, that would have been tragic for Switzerland.

Some managers from Omega were pleading that we take the brand down-market to face Citizen and Seiko in the middle segment. That was absurd! I fought them tooth and nail on that. At one point, the people at Omega would not even let us on their premises. It was bitter.

We made the investment in SMH in 1985, and we were free to act. I pushed out practically the entire management of Omega. I fired a lot of people. I got the reputation as a brutal guy. I am not a brutal guy. But the organization was so full of arrogance and stupidity that I didn't have much choice. Then we implemented our strategy to give Omega back its message. Not an image, a message. We had to be clear, consistent, and credible.

What is Omega's message?

Omega is an elite watch for people who achieve – in sports, the arts, business, the professions – and help shape the world. It is a watch for people who are somebody because they made themselves somebody, not because their grandfather left them a trust fund or because they made money from insider trading. The astronauts who landed on the moon achieved something. They were smart, healthy, courageous. They wore Omega. So did the Soviet cosmonauts. That message had been destroyed.

You also reorganized manufacturing, assembly, and distribution. Did these changes play a big role in Omega's turnaround?

We did all those things. We paid closer attention to logistics and quality and inventories. We redesigned the manufacturing process. Omega gave up most of its manufacturing when we created SMH and centralized production. There was a lot of resistance. People said we would destroy the brand.

We do treat Omega specially, however. ETA makes movements for Omega as it does for all our brands. But we sell those movements to no one else inside or outside the company. Because those movements are specially made, ETA stamps the Omega name, not ETA, on the movement. This way, when customers or dealers open a watch to repair it or change the battery, they still see Omega. By the way, this is true only for quartz watches. Omega designs most of its own mechanical movements and buys them from Frédéric Piquet, as do most high-class Swiss watches. We own Piquet.

All these reforms were important. But they're not the main story. The main story is the message and the discipline the message imposes. We immediately reduced the number of models from 2,000 to 1,000. We have since cut back to 130. We don't allow anyone to make Omegas under license. We stopped building lavish or showy watches – people who achieve don't care about those things. We stopped making Omegas with gold plating. We make smart watches out of real metal: platinum, titanium, gold, special steel alloys.

Omega started making sense again. This is what an Omega looks like. This is what Omega stands for. We gave Omega back its message.

Swatch and Omega have completely different messages. Why does it matter strategically that SMH owns both brands? How does the success of Swatch help Omega?

It's not just Omega. Swatch has helped the entire Swiss industry. It has restored our credibility with the public. It has restored our credibility with the trade. The perception of Swiss watches today is so different from ten years ago. Jewelers and department stores beg us to carry Swatch. If customers come for Swatch, and the shop doesn't have it, they won't accept anything else. They leave disappointed. This has a big psychological spillover to all of our brands – including Omega.

I really believe the phenomenal success of these \$40 watches helps the climate for selling \$500 watches – or \$5,000 watches, for that matter. We

"At Omega, we stopped building lavish or people who achieve just don't care about

have reestablished our technical superiority over the Japanese watchmakers. If we can build beautiful, high-quality watches that sell for only $40, imagine what must be the quality and accuracy of watches that sell for $2,000!

Let's move from products to production systems. This is the age of the lean corporation. Why is SMH so vertically integrated?

We are vertically integrated because it is the only way to maintain our strategic independence and freedom to maneuver in the market. We can't be broad in the marketplace without being deep in our production systems. And we can't support deep production systems without a broad presence in the marketplace.

Here is the strategic reality we face. There are three centers of watchmaking in the world: Switzerland, Japan, and Hong Kong. But only the Swiss and the Japanese build movements, the complex micromechanical and electronic components that are the "guts" of a watch. To build electronic movements, you have to master semiconductor technology, quartz, batteries, miniaturization. For mechanical movements, you have to master intricate micromechanics and the old art of watchmaking in the luxury segment. You either commit fully to the business or get out.

We have some advantages here in Switzerland. We have hundreds of years of experience in the technologies and techniques of watchmaking. Families have spent generations in our factories. They have a feel for this business, a special touch. They are masters at working with parts so small you need a microscope to see them. Not to mention the tooling to build these parts. There are plenty of toolmakers around the world, but not for parts with these dimensions.

showy watches – those things."

When we designed the Swatch factory, we built special machines for injection molding, automated assembly – virtually everything. There were only a handful of people in the world with the know-how to build those machines. They all lived in this part of Switzerland.

If you had all this expertise, why was the company so troubled?

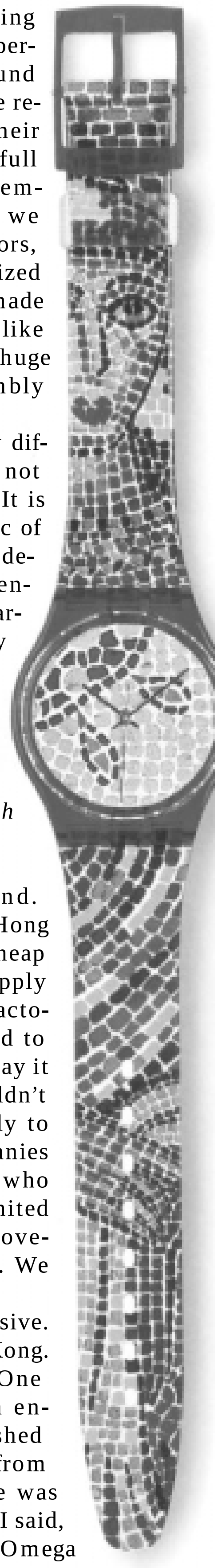
We spent much of the 1980s reinventing our production systems to leverage our expertise. I've already described the mess we found at ASUAG and SSIH. So we made massive reorganizations. Brands no longer build their watches. Our production divisions have full responsibility for manufacturing and assembly. We standardized as many parts as we could among the brands: quartz resonators, stepping motors, and so on. We standardized much of the tooling for these parts. We made huge investments in high-tech operations like semiconductors and batteries. We made huge commitments to automating our assembly lines.

Our cost structure today is completely different from when we created SMH. It is not merely because we are more productive. It is because we have totally changed the logic of our business system. We have radically decentralized marketing and thoroughly centralized manufacturing. There is no comparison between what exists at SMH today and what existed at ASUAG and SSIH (see the second insert, "The Many Faces of SMH").

SMH has invested more than SFr1 billion in technology and factories. Why such enormous investments?

We have been making up lost ground. Throughout the 1970s, as companies in Hong Kong assembled hundreds of millions of cheap watches, Japan made investments to supply them with movements. They built big factories and slashed prices. A movement used to cost, on average, between $8 and $20. Today it costs between $2 and $5. The Swiss couldn't play that game. We sold movements only to very special people in Hong Kong – companies building watches for brands like Timex, who wanted to market to customers in the United States that their watches had Swiss movements. We were uncompetitive on cost. We just didn't have the volume.

So we decided to get much more aggressive. We had to confront the Japanese in Hong Kong. We seized every opportunity we could. One day, for example, I was seated with an entrepreneur from Hong Kong who sold finished watches. He bought all his movements from one of the giant Japanese companies. He was begging me for an Omega agency in Asia. I said, "How can you expect me to give you an Omega



The Many Faces of SMH

Nicolas Hayek runs a competitive juggernaut – one of Europe's most powerful and well-positioned companies. It is also a company of staggering complexity. SMH employs 15,000 people. It sold 100 million finished watches and movements in 1992. With an average of 150 to 200 parts for each watch or movement, this sales volume translates into 15 billion to 20 billion parts. SMH makes most of them, assembles all of them, and ships them to places like Chicago or Buenos Aires or Hanoi.

There are other companies in other industries that cover every market segment and make and assemble most of their own parts: General Motors in automobiles, IBM in computers, Philips in consumer electronics. What these companies have in common is that they are struggling to reinvent themselves in a world in which the power of integration gives way to the nimble flexibility of innovation. Increasingly, scale and success seem to be at odds.

But this is not true at SMH. Why? Because the company has resolved a set of tensions that would cripple most organizations.

Think of the opportunities for misunderstanding and conflict within SMH. There are the language and cultural tensions between workers and managers with roots in the Swiss-German ASUAG and those with roots in the Swiss-French SSIH. There are tensions between SMH's fierce style of competition in Hong Kong, where it wages hand-to-hand combat over millions of $5 watch movements, and the genteel world of Blancpain, which sells a few thousand watches each year for $200,000 and higher. There are tensions between ETA's disciplined production engineers in Switzerland and the free-spirited designers in the Swatch Lab in Milan.

SMH resolves these tensions by creating clear-but-flexible organizational boundaries and encouraging what Hayek calls "conflict of targets." Each unit of SMH operates with clear responsibilities and fixed rules. But no unit can do its job without interacting and negotiating with others. In this respect, SMH looks more like a self-contained industry than a single company. The goal is to surface and resolve differences quickly and without bureaucratic rancor.

For example, Hayek has radically decentralized marketing. SMH has nine major global brands: Blancpain, Omega, Longines, Rado, Tissot, Certina, Hamilton, Swatch, and Flik Flak. Each brand has its own organization, its own management, even its own building. Brands have total authority over design, marketing, and communications. But they play a sharply limited role in manufacturing or assembly. For this, they must negotiate with SMH's technology and manufacturing arms.

One critical manufacturing organization is ETA, which builds all of SMH's quartz movements. ETA, which is based in Grenchen, 20 minutes south of SMH headquarters in Biel, is responsible for all electronic-movement research, manufacturing, and assembly. ETA is a production empire. It runs giant factories that build movements for most of the Swiss watchmakers. It operates highly automated assembly plants throughout the country as well as in Thailand. Of course, none of this matters unless ETA can satisfy its main customers – the SMH brands. So there are ongoing negotiations over style versus quality, design versus manufacturability, speed versus cost.

These strict boundaries and tough negotiations allow SMH to minimize overhead. The company has remarkably few bureaucratic monitors or headquarters referees. Instead, near the top of SMH sits a 16-member Enlarged Group Management Board. The executives on this board work around the world and have direct responsibility for the company's many business units. They include Anton Bally, the powerful head of ETA; Raymond Zeitoun, who works in New York and runs all SMH operations in the United States; Florence Ollivier-Lamarque, who runs SMH France from Paris; Hans-Jürg Schär, responsible for Swatch; and Hans Kurth, who has worldwide responsibility for Omega. (A seven-member Restricted Group Management Board, whose members are drawn from the larger group, is the highest SMH management council.)

When these 16 executives convene, as they do once a month (the restricted board meets twice a month), they share information from key national markets, surface and resolve disagreements among competing business units and geographies, and then return to their organizations with the company's newest game plan. In other words, there are minimal delays between decision and action.

Finally, there is Nicolas Hayek. As CEO, Hayek injects himself directly and visibly throughout SMH – especially on issues of strategy and new products. He receives almost daily briefings and progress reports on new products – watches, pagers, telephones, and others – and constantly works with (and pressures) managers and engineers to cut through red tape. He even has final signature approval over every design in every Swatch collection.

The end result is a company that is solid without being stodgy: a tough, fast-moving competitor whose remarkable turnaround demonstrates the power of SMH's unconventional management principles.

agency when you buy 20 million movements a year from a competitor of mine?" He told me, "I will buy from you if you give me the same price."

I agreed to the order on the spot because the price was profitable for us. ETA worked night and day to produce those movements. But it was an important opportunity for us. We could not allow the Japanese to control movements in Hong Kong. They would have developed enormous leverage over us.

What do you mean?

Imagine if we got so uncompetitive in movements that we had to get out of the business altogether. And imagine if, like so many companies in other industries, we then focused on design and marketing and final assembly. And then imagine if we designed a great new model for Tissot, a watch that was going to be a big hit in the United States and hurt our rivals.

Now, what if our Japanese supplier recognized the appeal of that new model? You can imagine what might happen: "We are very sorry, but we are having capacity problems at our plant. We know we used to charge you $3.50 for that movement. It is now $12." Well, that destroys the economics of the watch. So the next thing the supplier says, "Of course, we can make special arrangements in our plant. But we prefer to deal with partners rather than customers. We are prepared to become 50% owners of the brand and supply movements at more favorable prices."

That sounds conspiratorial. We heard that argument about Japanese leverage in computers because they dominate flat-panel displays and power supplies. The Japanese compete fiercely among themselves, why should they conspire against European companies?

Let me correct myself. It is wrong to talk about "the Japanese" in our business. In movements, there are only two Japanese companies that really matter – Citizen and Seiko. The moment you get five or ten Japanese companies in the same industry, they do fight like hell. But there are plenty of industries where that is not the case, and ours is one.

By the way, I am not suggesting that movement suppliers would single out Europeans or Americans. We sell lots of movements to watch companies in Japan. Why? Because Citizen and Seiko sometimes can't or won't supply them. We sold movements to Casio when it started making watches. Why? Because Citizen and Seiko couldn't or wouldn't supply them. That's the reality.

You also invested hundreds of millions of Swiss francs to make semiconductor chips. But the world is flooded with chips. Isn't that a case of unnecessary vertical integration?

No, it isn't. The world is flooded with five-volt and three-volt circuits – the chips used in computers, televisions, and VCRs. But watches use 1.5 volt chips. There are three companies in the world that dominate production of 1.5 volt chips. One is SMH. The other two are in Japan. We must make our own chips to maintain our independence.

We considered all the options before we made this investment. Some of our people wanted to close down the operation and find other companies to build chips for us. We visited companies from Norway to the United States. We showed them our designs and said we would cooperate with them. The best quotes were three times our costs. So that didn't work.

Some of our people wanted us to diversify into computer chips as well, but that was crazy. How would competing in memories or microprocessors help us in watches? And how were we going to go up against companies such as Intel or Motorola or Toshiba?

So we decided to make our own chips and to make them in huge volumes. That meant mass markets – Swatch. It meant pushing harder on movement sales – Hong Kong. It also meant creating new markets for 1.5 volt chips. Today you can find our chips in hearing aids, pacemakers, cellular telephones, even the monitor switch for antilock brakes. In fact, more than 50% of our revenues from 1.5 volt chips come from markets outside the watch industry. Those revenues and profits help us keep investing. And they also keep volumes up and costs down.

"Organizational structure is the most inhuman thing."

Can't you take this too far, though? Why risk diversifying into products like pagers and telephones and building them yourself?

What risk are you talking about? Our pagers grow directly out of our experience with watches. There is tremendous proprietary technology in the Swatch Pager. It uses high-precision injection molding that requires specialized tooling – just like the Swatch. It uses very advanced stepping motors, a technology we mastered in our watches. Who is better suited for this market than we are?

Look at the wristwatch pagers out there today. They have digital displays. They are ugly. They are heavy. It's no accident we will market the world's first successful analog wristwatch pager. We have the technology. We know how to design manufacturing systems that make us competitive. We also know how to design attractive products – and how to market them.

How many worldwide brands can you name for telecom products sold directly to the end customer? Alcatel or Siemens understand how to sell to governments and big companies. We understand how to sell to people. This is going to be a big business for us.

I understand the strategic case for integration. But how do you guard against the bureaucracy it always seems to create?

We don't need elaborate planning bureaucracies or corporate staffs. If we have a big decision, we assemble the best group we can and let them go at it. Then we move on to other things.

Organizational structure is the most inhuman thing ever invented. It goes against our nature as people. So we have clear boundaries and targets. Our brands work independently of one another. The people at Omega and Rado and Tissot have their own buildings. They have their own managements. They are responsible for their own design, marketing, communications, and distribution. They are emotionally connected to their brands, not just to SMH as an entity. I want people at Rado to love Rado. And I want people at Longines to love their brand.

We are big believers in decentralization. This company has 211 profit centers. We set tough, demanding budgets for them. I personally participate in detailed budget reviews for our major profit centers. Then we track performance closely. We get monthly sales figures for all profit centers on the sixth day of the following month. We get P&L statements about 10 or 15 days later. The moment anything looks strange, we react very quickly, very decisively, very directly.

And we are big believers in project teams. Find your best people, let them tackle a problem, disband them, and move on to the next problem. I suppose this comes from my consulting background. Every company needs certain functions. You have to watch costs every day. You have to watch quality every day. But you don't decide every day whether to launch a Swatch Pager or whether to build a new chip plant.

Of course, this approach works only if the whole management team is totally focused on developing products and improving operations, not fighting with each other. Last September, Goldman, Sachs in London issued a report on our company. It said our management is "obsessed with productivity." We're not obsessed. But we do keep our eye on what matters. We don't spend a penny that we don't have to spend.

Is SMH corporation a realistic model for other companies to emulate?

Everything we've done can be done by lots of companies in Switzerland, or France, or Germany, or America. All it takes is the will to do it. Which is, I admit, no small matter. As a consultant, I had been preaching, shouting, writing for years about how European companies could compete with the Far East. At SMH, I got the chance to practice what I preached. But there were some special factors at work here.

For one thing, the Swiss watch industry was completely devastated. People had given up; they were ready to sell our most valuable brands to foreign competitors and sell our factories for their real estate value. If ASUAG or SSIH had been making one franc of profit, they would have thrown me out the window: "You're crazy, what do you know about watches anyway?"

Second, I put my own money on the line, along with money from our investors. The fact that our group controls a majority of the equity means we could make decisions that other people were scared to make.

I inflicted pain, made controversy, created worry. Nobody believed the targets we set back in the mid-1980s. People thought we were crazy to invest SFr1.1 billion in one of the highest cost regions in the world. But it was our investment on the line. There was never any doubt who was running the show – or, for that matter, who would get blamed if we failed.

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