

Stern Stewart Research

The Americas

HERMAN MILLER: Growth In The New Economy

David Glassman
(212) 261-0606
dglassman@sternstewart.com

- The office furniture company transformed a failed business plan—refurbishing used furniture for the small-office market—into a successful niche player called SQA (for Speedy, Quick and Affordable) that relied on new technology to bring a service orientation to what had been a product-driven market.
- SQA, in turn, is transforming the way Herman Miller's core business sells and delivers product. Herman Miller has adapted SQA's design software and leveraged it against e-commerce technologies to offer a new value proposition to its traditional big-company market. And another new venture, called Herman Miller Red, will take on the office supply category killers with direct e-sales of office furniture to the smallest of small businesses.
- The SQA case teaches that success in the New Economy requires more than just technology. Other key business processes—marketing, procurement, manufacturing, distribution, invoicing and customer service—all must be in synch to fully leverage the technology investment across the value chain.
- Management of the transition to new practices should emphasize speed but minimize disruption, internal resistance, conflicts with suppliers and dealers and confusion to customers. The Herman Miller case also teaches that development of a new business model generally is not a straightforward linear execution of a grand strategic vision. More often, it involves learning from and adjusting to false assumptions about costs, demand, technology trends and the competition.

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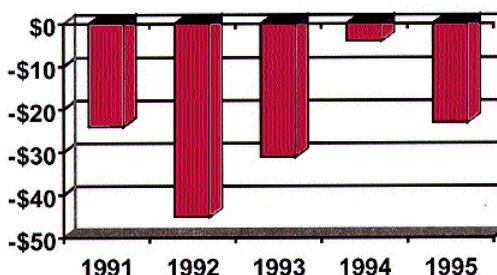
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Herman Miller Combines EVA and SQA: A Case Study of Growth in the New Economy

With sales of almost \$2 billion, Herman Miller is the second largest office furniture company in the U.S., trailing only Steelcase's \$3.3 billion in revenues. Some 70% of Herman Miller's sales are made by an independent dealer network; its primary customers are companies represented in the Fortune 1,000.

**Herman Miller: EVA 1991-95
(\$Millions)**

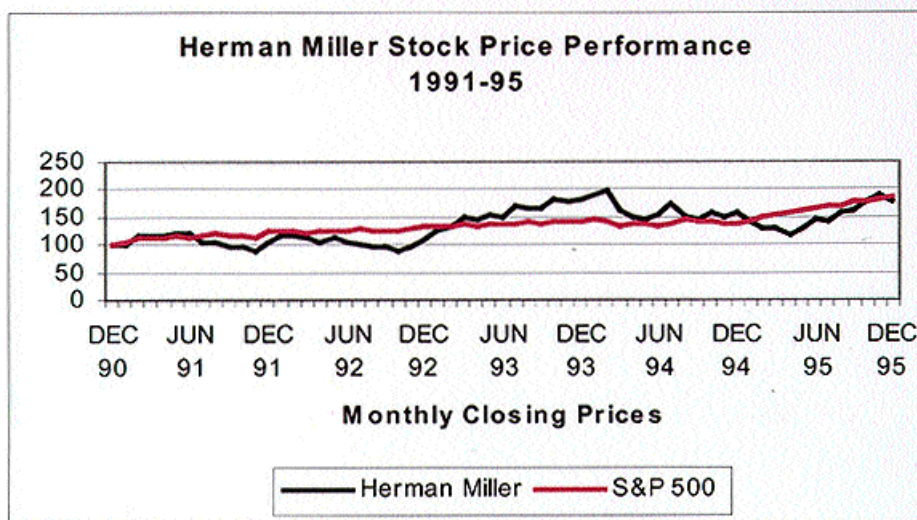


After a half-decade of disappointing performance, Herman Miller made the move to EVA in 1996.

During the first half of the 1990s Herman Miller's performance was undistinguished. Sales grew at an annual rate of just 4.2%, and EVA® was negative every year, summing to a negative \$127 million for the five years 1991-95. The stock outperformed the S&P 500 Index when EVA approached break-even in 1994, but then fell back when EVA declined the following year. For the entire five-year period the stock performed about in line with the broad index.

The change coincided with the development of a new business model in a tiny subsidiary called SQA that stressed rapid and reliable delivery—a level of service the industry had not provided before.

**Herman Miller Stock Price Performance
1991-95**



Herman Miller began a change program in 1996 by adopting economic value added (EVA) as its primary metric for performance measurement, decision-making and incentive compensation. Today all associates have their pay influenced to some degree by EVA. Management reaffirms its commitment to EVA in the annual report each year. For example, the 2000 report states:

We use Economic Value Added (EVA) to measure the value we have created for our employee-owners and shareholders. We evaluate all of our business decisions using this metric...Making EVA such an important part of our overall compensation structure has driven a much higher level of business literacy throughout our workforce, providing better decision-making throughout the company.



The move to EVA coincided with a new business initiative that evolved from an experiment begun in the late 1980s. Herman Miller's challenge was to grow sales in the face of a substantial installed base. Its answer was to repurchase used furniture from its large-company customers—making room, so to speak, for new purchases by them—and refurbish and resell the used goods to smaller companies. Herman Miller created a new subsidiary, called Tradex, to carry out the mission.

As it turned out, the Tradex business model wasn't viable. Remarkable as it seems, it proved more expensive to refurbish than to manufacture new furniture. But Tradex was important for what its marketing people learned about service. Tradex almost always delivered the finished product in four weeks, vs. the industry standard of about 12. This rapid and reliable order-to-delivery cycle resonated with customers. It was a level of service the industry had not provided; instead, furniture manufacturers focused on design and product features. The Tradex experiment led to a different approach, one that emphasized three qualities: Simple, Quick, and Affordable, or SQA for short.

Developing SQA

Our ultimate strategy was discovered almost by accident. With Tradex we found that "This idea isn't a good one, but lo and behold, this methodology for serving customers seems to be attracting an audience." So then we went about making a science out of great service.

-- An SQA manager

SQA created a three-dimensional software package that enabled the sales force to configure office space—and place and confirm orders—on the spot.

Success often begins with a serendipitous discovery, but swift follow-through is necessary. After discovering an under-served market, Tradex was re-christened SQA and managers set about creating a business engineered for speed using state-of-the-art technology. They began by developing a simpler manufacturing process, focusing on light assembly and a build-to-order capability. Among other things, this required SQA to streamline selection. The division produced about 20% of the product line offered by Herman Miller's main business, but this accounted for about 80% of demand. In effect, SQA traded off selection to gain speed.

In partnership with a Seattle firm, SQA began developing proprietary three-dimensional software to enable the sales force to configure office space on the screen of a notebook computer while meeting with the customer. Reaching agreement on the design is typically the biggest bottleneck in the sales process, and SQA aimed to shorten this considerably. The software project, called Z-Axis, started small—the initial investment was only \$240,000—but it quickly grew to become SQA's largest and most important investment.

By 2000 the Z-Axis program was the biggest item on SQA's balance sheet, but SQA is more than just software. It redesigned all of its key processes to make speed its differentiating capability.

Z-Axis now is a highly sophisticated system that not only handles design, but also processes orders and helps facilitate production scheduling. Once the design is finalized, the program lists all of the necessary components and the final price. The order is then submitted using an Internet connection with the salesman still on site. SQA's purchasing managers and its suppliers receive the order instantaneously, enabling them to mobilize their work forces accordingly. With the supply chain coordinated and working off the same information, a delivery date is set, space on a truck reserved, and order confirmation sent to the customer within two hours of its submission.

By 2000, SQA had invested "tens of millions of dollars" in Z-Axis, and it had become the biggest item on the division's balance sheet. But SQA is more than just software. The division redesigned all of its key processes to make speed a differentiating capability. As an SQA manager says:

A salesman can do what it used to take six people to do, because processes are linked up electronically. That is backed up by a five-to-seven-day shipment engine, and we're the only ones with this 3-D software technology that embeds all the information in a laptop.



Operationally, the design for speed has given SQA a significant competitive advantage. Its manufacturing lead times range from two to ten days while its closest competitor has a four-week lead time. SQA delivers in 12 to 15 days against an industry average of eight to 12 weeks.

Successfully managing a start-up like SQA is more than a technology challenge, especially when it is part of a larger, established parent. Executives must decide the relationship with the parent's management, its products and its customers.

SQA turns inventory more than 40 times per year, compared to Herman Miller's corporate average of 27 turns and an industry average of less than 20. And SQA's primary financial measure is ideally suited to its business model. Because EVA measures the profit after charging for capital employed, faster inventory turns—and the resulting reduction in capital employed—translate directly into a financial gain. Conventional measures of earnings and EPS ignore the cost of capital, shortchanging operational gains and making it more difficult to motivate managers.

Organizing SQA: Separate or Integrate?

The lesson in the whole thing is that in most businesses you can't mess around with the core engine because that is designed to do a certain thing and people who work in it think a certain way. You have to find a balance between incubation, which has to be done off to the side, with management sitting on top of it and protecting it, while at the same time letting the core engine run.

-- Comments of an SQA executive.

Successfully managing a start-up company like SQA is more than a technology challenge, especially when it is part of a larger, established parent. Strategically, executives must decide what the relationship should be to the parent. Is the start-up targeting the same customers? Is it developing competing or complementary products? Will it sell through the same channels? Use the same suppliers and manufacturing facilities?

A key decision behind the success of SQA was to allow it to grow as a separate entity, free to pursue its own ways and methods. Some at Herman Miller wanted to stamp it out because they didn't understand how profoundly technology could affect the business.

The culture and management processes supporting the start-up also are important. Will established procedures slow decision-making and limit resources allocated to the new business? Does the start-up need a more aggressive incentive compensation program to attract talent and create an exciting entrepreneurial culture? Will the new initiative be undermined by executives of the parent competing for a limited pool of human and financial capital?

The challenge of gaining corporate support was particularly acute for SQA. According to one SQA manager, some at Herman Miller wanted to “stamp it out.” They failed to appreciate how profoundly technology could impact the business, and so were reluctant to support the necessary investment. Says an SQA manager:

In this industry there is a cultural barrier to understanding a strategy based on service performance as opposed to product differentiation. And they [Herman Miller managers] would devalue and diminish it.

As a result, much of the funding for technology development had to be generated from SQA's internal cash flow. “We had a vision of what we wanted to do long before we could afford to do it, because we still had to deliver the returns to the corporation,” says the same SQA executive. As SQA grew its cash flow, it allocated a larger and larger amount to making Z-Axis more powerful.

SQA was left on its own during the 1990s as a separate subsidiary. Because it aimed for a different value proposition—coupling technology with high-speed manufacturing and assembly—a separate sales force and separate manufacturing facilities were necessary. Another consideration was the target market of small businesses below the radar screen of Herman Miller's dealers. In the spirit of start-up entrepreneurial firms, SQA's management incentive plan was based only on its EVA, not on the EVA of Herman Miller's other activities. In fact, SQA began using EVA to determine bonuses as early as 1993, several years before it was formally adopted by the other parts of the company.



SQA's growth over the last five years has far outpaced the industry and the parent company.

SQA flourished outside of the main Herman Miller structure in a way that it probably could not have if it had been inside. As long as it met corporate targets, SQA was left alone to test its value proposition in the marketplace. As one executive describes those years:

The customers kept saying, "This is great." The customers got it first. And the business was growing at a 35% compound rate. Eventually, it sunk in [at the parent], like, "Oh, maybe there is something here."

SQA's Integration into Herman Miller

Herman Miller designs the products, the web experience, and the order fulfillment engine that performs for our customers. Once we've built that, we'll win. And then we can begin to expand and bring other people into it. So we're taking a different strategy than most of our competitors. We're building a deep engine. They're just trying to put a front-end on it, which we see as adding very little value. The analogy is when Ford Motor Company finally gets in the game of being able to do cars on the web, are you going to go to Carpoint? Not a chance. You're going to go to Ford.

-- Comments of a Herman Miller executive.

Herman Miller is integrating SQA into the main business with an initiative called eZ-Connect, an electronic interconnection with customers that is all about "shared business processes."

SQA has now evolved from a start-up to a successful business. Its growth over the last five years has far outpaced the parent and has been six to seven times the industry growth rate. SQA now represents a significant percentage of Herman Miller's total sales without encroaching on its core market, the Fortune 1,000 companies.

By the end of the 1990s, the opportunity that SQA offered for improving the mainstream business had become too important to ignore. Accordingly, management folded SQA into the traditional business, with an ultimate objective of transforming the entire company's value proposition.

The integration into the Herman Miller mainstream is driven by an initiative called eZ-Connect. Part of eZ-Connect's mission is to deliver the new service capability developed by SQA to Herman Miller's traditional large-company customers. But eZ-Connect aspires to be more than just SQA for a different market. As Herman Miller executives say, eZ-Connect is all about "shared business processes."

Herman Miller creates a special web site that integrates into the customer's purchasing systems, complete with the customer's purchasing rules embedded in the software.

The critical work is accomplished up front, working with the customer to formulate tradeoffs and make decisions. The tradeoffs typically require balancing the interests of the customer's design firm and facilities managers, who focus on product features, with its purchasing executives homing in on costs. eZ-Connect representatives describe for the purchasing manager the cost and delivery times for accommodating the design firm's recommendations. Then they offer alternatives, such as, "If you are willing to change the size and finish, the price comes down by x%. And if you are willing to substitute a particular product, the price is reduced by even more and you are guaranteed delivery in under two weeks."

The tradeoffs offered by eZ-Connect are a hit. Consider the case of a company that had been buying all its furniture from a major competitor. Says a Herman Miller executive:

We have gone 500 days with this client and I think we missed two orders, and that was because the dealer was on vacation and had a problem. We have done \$24 million of business in 26 months, and it was the service system that sold it.

To further tighten connections with customers, Herman Miller creates personalized web sites that are integrated into the customers' purchasing systems. After agreeing on a specific selection and pricing arrangement, a customer's purchasing manager establishes internal policies that, among other things, allocate spending authority to selected executives across the company. Designers and facilities managers are even provided with Z-Axis to help them configure office space.



Connecting to Herman Miller then becomes as simple as going to the customized web page on the Herman Miller site, which already has the purchasing rules dictated by management embedded in the software. The buyer can configure his order with or without the assistance of Herman Miller representatives. Once the order is received, Herman Miller zaps it to manufacturing, and follows up with an electronic invoice sent to the customer's accounts payable department. Control is put in the hands of the user. A complex furniture order is made as simple as buying pens and pencils. eZ-Connect establishes deep, enduring relationships instead of merely selling products.

Once embedded in the customer's purchasing system, even more opportunities emerge for Herman Miller. For example, Herman Miller can offer products of other companies on the customer's special web page. As a Herman Miller manager describes it:

Now Herman Miller is defining the methodology for bringing alliance companies into the relationships with customers.

Once we own the relationship with the customer, we've got our technology and process embedded. Now we've got people working on defining the methodology by which we bring other alliance companies and complementary manufacturers into the model that we've established.

Meanwhile, SQA still exists, but as a separate channel to reach middle-market businesses. Herman Miller is signing up new dealers, providing them with technology, training and support, and urging them to substitute Herman Miller products for their traditional offerings. SQA and eZ-Connect are now part of the Herman Miller mainstream with a mission to evangelize the new business practices and transform the sales force.

The Critical Challenge: Changing Behavior

Our biggest challenge is still the sales and distribution people. It's getting them to understand what it is we're trying to do, why it's different, and how to get out there and sell it. They're much more comfortable talking about edge details and finishes.

-- AHerman Miller executive

The challenges to implementing a new business model go beyond developing technology, finding financing, and gaining organizational support. Another, and perhaps the most important, is changing the behavior of the sales force. At Herman Miller, the sales force generally calls on a customer's facilities manager, describing the product's features and state-of-the-art design. Salespeople typically avoid the purchasing manager, primarily because Herman Miller products are viewed as relatively high priced.

Instead of the traditional approach to facilities managers and designers, eZ-Connect is aimed directly at purchasing managers and other financial executives, giving Herman Miller more visibility at higher levels.

But the new model is aimed squarely at the purchasing manager and other financial executives, giving Herman Miller more visibility at higher levels. Customers choosing from a more limited selection are guaranteed fast delivery and an attractive price, but getting the salesperson to understand and make the pitch has been difficult. It is counter to habits formed over many years. In the words of a marketing executive:

Presenting and selling the tradeoffs is something that most of our sales force isn't proficient at. We're saying, "Go talk to the purchasing people and the leaders of the business because these folks are interested in the performance of the system. They will make the tradeoffs." But how do you get you people to make the shift to selling something different to customers? How do you get them to change who they're talking to? Because most contract furniture salespeople run away from the purchasing people. They don't want to talk to them; they're their worst enemies.

Technology, in short, is the easy part. The human factor—changing behavior, shedding old habits and attitudes, adopting new methods—is tough. This requires commitment, leadership, training and on-going reinforcement. Culture can be an impediment or an ally. Culture governs behavior; it prescribes what is acceptable. Some companies have particularly strong and inflexible cultures that support their strategies and business models, but not when some major change disrupts the



In 2000 the company launched another web-based business called Herman Miller Red. This one aims direct e-selling to start-up companies that are too small to interest its dealer network.

Managers of Red still get bonuses based on the results of North America and the total company, with an additional kicker if Red meets its performance targets. This helps resolve conflicts in ways that serve the total enterprise.

industry. These companies, like IBM in the early 1990s, change only when faced with a crisis that threatens to push them over the abyss.

Management's challenge is to drive change before the life-threatening crisis arises. This does not necessarily mean abandoning the old culture. Instead, management should seek opportunities to build on the old while weaving in the new values and practices that will be important to remaining competitive.

Of course, nothing succeeds like success. A few major deals closed with new clients get everyone's attention. These triumphs can be leveraged to demonstrate that the new strategy can work to the benefit of all stakeholders—customers, employees, suppliers and, of course, shareholders. That generates demand from the sales force and other associates to understand better how to employ the new technologies.

Herman Miller Red

With the integration of the SQA methodology underway, Herman Miller has launched a new and even more revolutionary initiative. The new start-up, called Herman Miller Red, is an e-commerce business-to-business channel. Unlike the mainstream business, Red sells direct to the customer, dispensing with both distributors and a corporate sales staff. The e-commerce unit was established as a separate subsidiary of Herman Miller in January 2000, and opened for business in November.

As the company understands, setting up the e-business requires more than creating the Web site.

Herman Miller Red is a complete business model designed from the ground up, everything from the technologies to the web experience to the products to the service system, to the order fulfillment engine. That doesn't mean we're not stealing some of the ideas and the learning that we've had inside the company, particularly SQA, but Red is optimizing in a different way. The products tend to be more freestanding, they're at different levels of performance and durability. They're more I-Mac-like, if you will.

-- AHerman Miller executive

Part of the vision is a new way to provide service. For example, a customer struggling to fit 20 workstations into the available space can press the Help key, and a customer service representative comes online and takes control of the machine. The service rep can assist in configuring the layout and, once the customer is satisfied, enter the order. The order is transmitted real-time to manufacturing and in seconds a message comes back confirming the delivery date.

Herman Miller Red has had to manage sensitive relations with dealers that fear losing sales to the web. But Red is targeted at start-up businesses that are too small to afford the services of traditional dealers. The competition here is primarily Home Depot, Office Depot and the like. And, as the start-ups grow, they may provide more opportunities for the traditional dealers. Moreover, synergies between the web channel and dealers may emerge. It is uncertain whether customers will purchase furniture from a distance without seeing and feeling the product. They may wish to visit a dealer and use on-site kiosks to place the order.

After its launch, managers of an e-business venture sometimes become excessively focused on preparing for an initial public offering (IPO). A casualty can be the customer focus, product development, and alliance development necessary to execute the strategy. This is unlikely to be a problem at Herman Miller Red, even if the IPO market surges back to life. Herman Miller's e-business subsidiary is staffed with former long-time managers of the parent company. Further, at least at the outset, their incentive compensation is determined primarily by the results of North America and the total company, with an additional "kicker" paid if Red meets specific e-business performance targets. This ensures that conflicts are resolved in ways that maximize the value of the total enterprise for the benefit of Herman Miller's shareholders.



Building Manufacturing Alliances

Why would you want to invest [in low margin manufacturing] if somebody else is willing to take a lower return?

AHerman Miller executive

In focusing on core competencies, including product development and high-speed assembly, Herman Miller has stopped doing plastic injections and other primary manufacturing.

With initiatives like eZ-Connect and Herman Miller Red, the company's focus has shifted to technology. Over the last five years technology spending has increased at a faster rate than sales. New investment totals almost \$500 million, and R&D has increased from 2.4% of sales to 5%.

This change has brought a reassessment of the processes Herman Miller should operate versus those that are better managed by outside parties. For example, product development is considered a differentiating capability and will continue to be a key focus. High-speed manufacturing and assembly has also distinguished Herman Miller. On the other hand, primary manufacturing does not make Herman Miller unique. In the words of one manager:

A company focused on that as a core competency will do it faster, better and at lower cost than us. Which is why we don't do plastic injections, for example, because somebody who thinks about that every day is going to do it better.

Similarly, to advance its portal strategy, Herman Miller is aligning with other companies interested in selling to its customers. Again, Herman Miller controls the customer relationship, but does not need to make the products itself. As this same manager says:

Let other companies make the products. We'll just bring them into our marketplace digitally and move electrons for them. We don't need to go buy the manufacturing assets. That's a simple EVA decision. We're much better off investing our money in the innovation. We can link them up and get a kind of sales and marketing fee. And we get an astronomical EVA on that.

In the five years since going on EVA, Herman Miller's sales growth has tripled, it's EVA is up \$111 million, and its five-year increase in share price has jumped from 2.2% to 28.4%.

Value Creation

The most meaningful gauge of success for key initiatives is whether they help a company to create value for its investors. Herman Miller is certainly pointed in the right direction, and EVA and SQA are part of the success. EVA has provided the framework for evaluating decisions, and concentrated management's attention on the economic tradeoffs involved in forming a strategy.

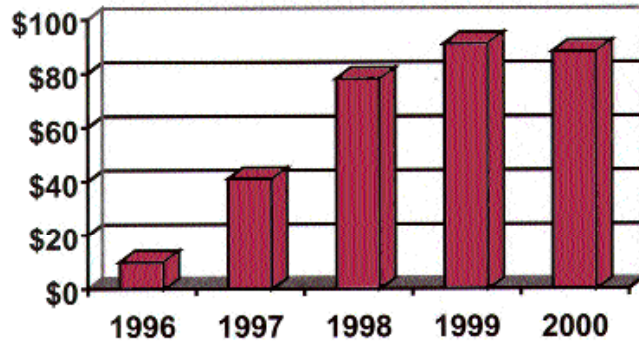
Herman Miller Financial Highlights

	1991-95	1996-00
Sales Growth (Avg.)	4.2%	12.3%
EVA (last year in millions)	-\$23	\$88
Stock Price Growth	2.2%	28.4%

EVA decision-making has elevated economic substance over accounting cosmetics. For example, management recently was debating the merits of a development initiative. A brief discussion focused on the accounting expense in the current year, but this ended when one participant asked, "Would we spend the money if it involved an acquisition that could be capitalized?" The answer was yes, indicating that people were comfortable with the economics, but bothered by the accounting. Management quickly decided to proceed with the development initiative.

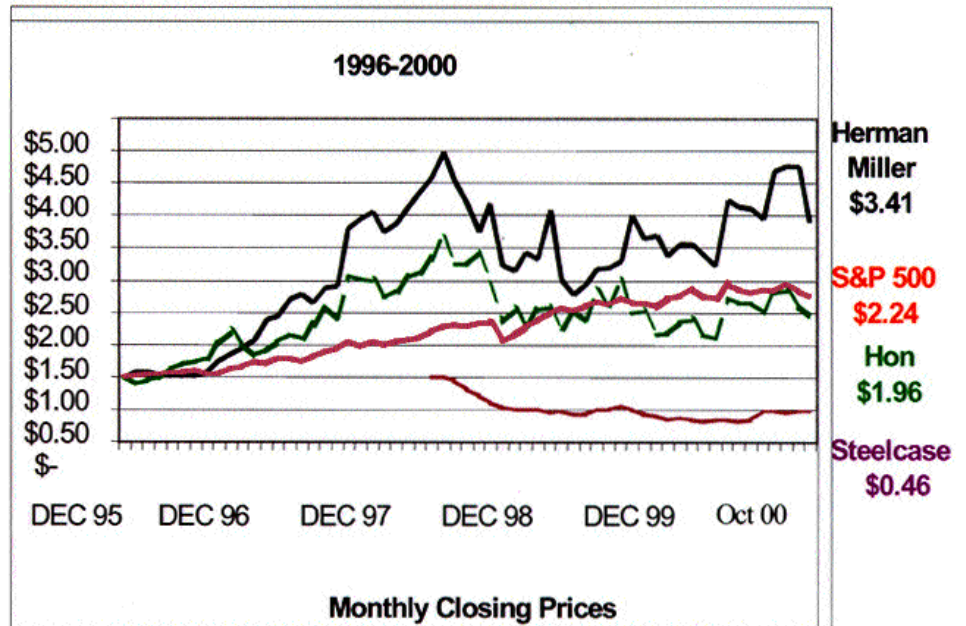


Herman Miller: EVA 1996-00 (\$Millions)



Operating metrics have improved along with the financials. On-time delivery is up from 75% to 98%, and order-entry errors have plummeted.

EVA for Herman Miller has grown from -\$23 million in fiscal 1995 to \$88 million in fiscal 2000, and it has been positive every year since the EVA program was adopted. Sales have grown at nearly three times the pace of the first half of the decade. And the company's stock price has substantially outperformed both peer companies and the S&P 500.



It's not just Herman Miller's financial performance that has improved. Operating metrics also show the benefits of new technology. Herman Miller had been burdened by order entry errors of about 20%, resulting in costly faulty shipments. With direct connections to suppliers, errors at SQA have been almost eliminated. Similar improvements in the core business can be expected. Further, as Herman Miller has adopted the capabilities developed by SQA, on-time delivery performance has increased to almost 98% from about 75% five years ago.



Herman Miller's incentive compensation program requires it to continually improve EVA to justify attractive awards for all associates. For the first time since adopting EVA in 1996, performance declined slightly in 2000. Bonuses also declined, although even in this case the program served the company well. As management points out in the annual report:

Having a percentage of our compensation vary based on EVA simulated an across-the-board pay cut of \$42.6 million. Prior to the EVA implementation, we would have been forced to undergo sizable terminations to experience the same results.

Everyone suffers from an EVA and compensation decline, but Herman Miller's bonus program provides the least painful result—for employees and shareholders alike.

Concluding Observations

The SQA case teaches that success in the New Economy requires more than just technology. Other key business processes—marketing, procurement, manufacturing, distribution, invoicing and customer service—must be in synch to fully leverage the technology investment across the value chain. Management of the transition to new business practices should emphasize speed but minimize disruption, internal resistance, conflicts with suppliers and dealers, and confusion to customers. Of greatest importance is that the strategy be guided by financial benchmarks that reveal the economic tradeoffs among alternatives, and that are readily understood by operating managers, board members, analysts and investors. Inattention to these requirements invariably results in a disappointing outcome.

Technology investment must also be accompanied by a strengthening of sales-force capabilities. Changes to the business model will not benefit the company if the sales force is unprepared to take it to customers. The sales force must see the need for change, share the vision, buy in to the strategy, and champion the new approach in the marketplace. And it is the responsibility of top management to communicate the vision and gain the buy-in. That's leadership.

Herman Miller's experience also teaches that development of a new business model is generally not a straightforward linear execution of a grand strategic vision. More often, it involves learning from and adjusting to false assumptions about costs, demand, technology trends, competition and the like. Herman Miller started with a refurbish-and-resell idea, and ended up with a simpler, speedier order-to-delivery model. Flexibility and experimentation are as important as the initial business plan.

For Herman Miller, SQA and Herman Miller Red are also examples of different types of innovations. The SQA proposition was threatening to the status quo, was not well understood, and did not receive much support from high-level executives. But it persevered below the radar screen by focusing on a lower priority market. As long as performance expectations were met, management and the board left it alone. Now, having proved the concept, SQA has become a catalyst for remaking the entire company and culture.

Herman Miller Red is a potentially disruptive innovation. It aspires to destroy the traditional business model. Accordingly, this start-up is unlikely to ever be absorbed into the core business. Instead, it may ultimately cannibalize the traditional channels. The justification is to seize the opportunity before competitors do.

Innovative technology, process change, a flexible organizational structure and economic performance measures linked to incentive compensation—for Herman Miller, these are the elements contributing to profitable growth in the New Economy. And these are the reasons why its stock has outperformed the market over the last five years

The Herman Miller experience shows graphically that successfully developing a new business is not a straightforward execution of a grand strategic vision. Managers have to learn from and adjust to false assumptions about costs, demand and technology.



Stern Stewart & Co.

NEW YORK

**1345 Avenue of the Americas
New York, NY 10105
T: 212 261-0600
F: 212 581-6420**

LOS ANGELES

**1901 Avenue of the Stars Suite 1245
Los Angeles, CA 90067
T: 310 407-0930
F: 310 407 0937**

PARIS

**10, Place de la Madeleine
75008 Paris
T: 33-01 40 1598 98
F: 33-01 40 1599 66**

LONDON

**13 Saint George Street
Mayfair, London W1R 9DE
T: 44-207 399-3600
F: 44-201 399-3601**

MUNICH

**Salvatorplatz 4
D-80333 München
T: 49-89 2420 710
F: 49-89 2420 7111**

MILAN

**Ambrosetti Stern Stewart Italia
Galleria Pattari,2 20122 Milano
T: 39-02 725-6501
F:39-02 720 99714**

SINGAPORE

**80 Raffles Place
UOB Plaza 1, #28-02 Singapore, 048624
T: 65-538-3532
F: 65-538-7303**

MELBOURNE

**Level 25 55 Collins St.
Melbourne, 3000
T: 61-3 9650 8100
F: 61-3 9650 8155**

MUMBAI

**Sunteck Centrako #8-03 MMTC House
Bandra-Kurla Complex, Bandra (E)
Mumbai 40051, India
T: 91-22 654 1536
F: 91-22 654 1535**

TOKYO

**3F, Toranomon 45 Mori Building
5-1-5, Toranomon, Minato-Ku
Tokyo, 105-0001
T: 813-3431 3310
F: 813-3431 3380**

JOHANNESBURG

**Suite 316, Third Floor South Tower
Sandton Square
Sandton 2196
T: 27-11 883 5894
F: 27-11 883 9320**

SÃO PAULO

**Rua do Rocio, 291 - cj. 91
Vila Olímpia
São Paulo, SP, Brasil 04552-000
T:55-11 3040 0851
F: 55-11 3040 0853**