BREAKAWAY Q&A

Jim D’Addario, D’Addario & Company, Inc.

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By Orlaith Farrell for Bloomberg

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BACKGROUND

D'Addario manufactures musical instrument strings, primarily for guitars and other musical instrument accessories. It's a family-owned and operated business that goes back four generations in America, but its history can be traced back to 1680 in Italy when the family first started making music strings. The company as it is known today was born in 1973 in New York.

JIM D'ADDARIO, CHIEF EXECUTIVE OFFICER, D'ADDARIO & COMPANY, INC.

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Bloomberg: The company, as it is known now, was born in 1973. Talk us briefly through the evolution since then.

Jim D'Addario: Prior to this iteration of the business, my dad had taken over from his dad, and it was a small company of about 30-40 people. In 1969, he sold it to Martin Guitars, and they were supposed to go public, and it never happened. They got into financial trouble. My family ended up not really getting the money from the acquisition until 1994. So, we were kind of broke, and we started over. We borrowed some money and started over in 1973.

My dad never utilized the family name, D'Addario, on the product because in the early part of the 1900s, there was still quite a bit of discrimination against immigrants and Italians, and he felt that they were always embarrassed. They tried to cover up that they were Italian all the time. My grandfather worked hard to learn English and not have an accent and changed his name from Carmine to Charles, and all those kinds of things. So, they never used the family name on the product. In 1974, when we were going to start putting out our own brand of music strings, I kind of insisted that we use our name and my father said, "Well, that's going to be a mistake, people in the south aren't going to buy an Italian name from New York." It was a bit of an argument, but I stuck to my point of view. I had more of a natural intuition for marketing than my dad or my brother did. I always kind of took charge of the direction the marketing went in, and we introduced the strings in 1974. We were bold about it. We were making private label strings for lots of other companies. That's what my father always did. The reason he sold to Martin was [that] they were 30 percent of his business, and they wanted to buy a string company. He was afraid he would lose that business. You don't really have control of your destiny when you're a job-shop and you're making product for other people. Of course, your margins are skinny because you're supplying another level of middleman there, and you don't have control over the way it is marketed. I kind of insisted that we take the profits from private label strings and invest in heavy advertising for our product. By 1975-1976, we were starting to sell significant quantities of product.

Bloomberg: How old were you at this point, in 1974?

D'Addario: (Laughing) I was 25. I had gotten great experience at [CF Martin, maker of Martin Guitars] because when I was in high school and college, I worked for them part-time and then when I graduated. I ended up being the advertising manager. I learned a bit about brand image and how important it was to have a great brand name.

I learned a lot there, and when I came to this position of having this new start-up, I had some pretty good experience. I had the experience of calling on dealers and seeing how they sell accessories—they used to just hide them in drawers; you had to go in there and ask for things. There was no point of purchase display, so we really innovated. We made point-of-purchase displays, we did lots of advertising, and we took full-page ads for strings, which was unheard of. People thought we were crazy, but they had an instant effect of people thinking we were much bigger than we really were, and [they] had confidence in our brand. We came through with better quality products at the same time, so it was a formula for success. Pretty quickly, by the end of the 1970's, we had established ourselves as a strong brand name on our own.

We still do today a lot of private label work and original equipment manufacturing supply: 30 percent of the strings we make go on guitars, and they're shipped all over the world. We're so competitive with our manufacturing that we're able to ship to Chinese factories—Vietnamese, Indian, Korean—so hundreds of thousands of sets go out every month which go on guitars. But the most profitable part of our business obviously is our branded merchandise that is sold into retail stores, and we focus our marketing on that. Our slogan in the 70's was 'Making Fine Strings Is Our Only Business,' and today, strings are only 50 percent of our business, because we've acquired other accessory companies. We make Evans drumheads, Promark drumsticks, Rico reeds—D'Addario-branded reeds now. We have Real Feel practice pads. We have D'Addario accessories like cables, picks, capos, straps, and tuners.

We have a broad range of accessories, so that's half the business now, and what that did was make us really more valuable to the retail store. So if you go in a retail store like Guitar Center—our biggest client—they have 280-plus Guitar Center stores in the U.S.–and we have more SKUs in their stores than any other supplier because we have such a broad range of small goods. Every one of their departments has a very good selection of our stuff. We've become a more significant supplier to all the retailers because we have so many brands, and we don't make instruments, so we don't have to deal with any exclusivity. We decided to stay Switzerland as a brand name, kind of like the Gillette model; you don't go into a drugstore where there isn't a Gillette razor and razor blades. So we established our vision, that we would stick to being the experts on accessories, and we would make improved products that help musicians to create their music in a better way and solve problems for them—cables that don't break, cables that sound better, tuners that are more accurate or work more intuitively, capos that don't pull your guitar out of tune when you put them on the neck—all those kind of things. We invent and innovate in every one of those categories so that our product is better, and we make it easier for musicians.

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Bloomberg: You've enjoyed strong growth. Where do you think the growth is going to come from over the next ten years? Are you looking at innovation? Are you looking at acquisitions? What does the future look like for you?

D'Addario: There are several ways that we're going to grow our business. We're not exactly in an industry that is rapidly growing right now. In fact, the music instrument business itself, over the last decade, has not grown very much. There are many reasons why it hasn't grown in revenue. One of the big reasons is instruments are cheaper [to make] today because people have automated and also gone to Asia with low labor rates, so the dealers might be selling more quantity of instruments today, but the actual revenue is not as high. Then of course, the online retailers have driven prices down and made the brick-and-mortar dealers suffer on their profit margins a bit, so that makes the industry look like it's not exactly growing, when in quantity it probably has. The accessory business has grown more than other parts of the business because people still are consuming strings, drumheads, sticks, and all those things. So for us, we see the growth from three things: number one, we love organic innovations, things that we develop from the inside. We have 30 engineers now. A very strong part of what I do is managing the product development with the engineers and the innovation. I like to do some product design myself. I've taken courses learning how to use 3D-design software, and actually I'll kick things off sometimes. I have so many really creative, competent people that are kicking things off without me, but I am intimately involved in what projects are being run through the process. So I think innovating organically on things we have today, or inventing new product in our product groups and brands today, is a really good one. The other is, in the global market, our business is about 40 to 50 percent export. We still see global sales as a big, big opportunity because we've never really done the multilingual, international marketing that we should do. We have certain countries where we have our own distribution firms. We own our own distribution companies in the UK, Canada, Australia, and China now. Not that we're going to expand in every market—that's not our goal. Our goal is to take charge of the marketing, so when we're partnering with a distributor in a particular country, we want them to take this beautiful creative work we're doing here in this office in Brooklyn and in Farmingdale [NY] and utilize it in their vernacular, but we want them to stick to our brand guidelines.

We did this huge rebranding five years ago with the VSA partners firm in Chicago. It was a five-year plan to become an iconic brand, truly iconic. It's really working because our sales are way up now and the recognition of our brand name is great. So now we want to make sure that we apply all of that success into the international markets. We really believe that's a tremendous opportunity for us to take charge of that marketing and get more out of those markets. We've hired a marketing manager in Europe who is now setting up systems to translate everything ourselves, instead of relying on the independent distributor to do it.

The third area where we haven't applied resources is to our digital ecosystem. By that I mean tying in a pretty good back-end business system which we have, which is solid and we have great data—no problem there—but we haven't tied that to a very current modern content management system online that can serve all of our content up in any language very quickly. Instead of waiting six months after we create a beautiful campaign for it to get into France or Germany, we want to create a system where when we launch, we launch in every language—or ten major languages—right away, and we will take that responsibility to do that. So we're going to be improving all of that digital stuff, and that's the discovery phase that we're in now. We knew we had to this, we were just doing so much other stuff like creating this office and the whole team that's here for creative stuff, that we didn't have the resources to do it all at once. So, we're excited about this new kind of focus. A lot of it comes from what the themes were at the Bloomberg summit that we went to: digitization and globalization. Clearly we knew that, but to see it affirmed by really smart people and illustrated to us kind of gives you that confidence and courage to go back and say, yeah, we need to focus in a bigger way and we need to put millions of dollars on this here instead of hundreds of thousands of dollars. So those three areas are how I think we're going to grow our business.

Bloomberg: So you have a big focus on digital then.

D'Addario: Huge. It's been my focus since my last board meeting, and we're probably going to have to add a lot of resources here for that department because we're skinny-staffed there. For instance, we don't really have an SEO expert on staff. That alone could change your business. We're buying search words to get at the top of lists, but people like to see the organic search come up. We want to come up with ways where our products are the first you see because they're the most popular, and we did a great job with the search. So that's really a big, big focus right now.

Bloomberg: How do you balance being a family and being a business? You have a family constitution. Can we talk about that for a moment?

D'Addario: Sure. This all started because, in the late 1990s, my brother decided that at 55 he wanted to retire early. It was a shock for me because we were really natural partners, in that I focused on the futuristic stuff. People always asked us what we did, I said I handle tomorrow and John handles today, and we had a very clear line of responsibility division. We overlapped a little, but never raised our voices to each other in the whole time that we worked together in 37 years. We had a great relationship and still do. So, when he wanted to retire that was going to be a real burden for me because I never really was the guy to study, negotiate insurance deals, bank deals, borrowing—John handled all that stuff with the lawyers and the accountants and so on. So I would have to learn all of that and/or find people to replace his area of responsibility. It was puzzling for me. I talked to—at that time—Chemicals Bank, before they were acquired by JPMorgan Chase, and they were very helpful to the middle market. They always had a strong middle market team and I asked them for some advice. They said, you need to work with a family business counselor, and they recommended somebody that we used for about 5 to 6 years. So we started meeting on a monthly basis to work out a transition plan, that was the first thing—a kind of agreement with each other on compensation, how things go on. His family owns half the business and my family owns half the business, and we've kept that the same. But we've done things differently to compensate for me running the business, for mentoring his four children and mine at the same time. It became a much bigger responsibility than I thought it would be, managing the family and the children, and it is a tricky thing. When we were working with the family business counsellors, they recommended bylaws and a family constitution. We take three days every year and go away somewhere together, the whole group of us. That includes the active employees, their spouses, their children—so the fifth generation. We meet and we discuss; we also play together, but we work together. We work on things like educating everybody on the responsibly of the stewardship of this business. It's not the biggest business in the world, but [there are] 1,200 families that are relying on our business to be successful for them to live. We take that very seriously. We like to spend time on that, and we spend time on long-vision strategy for the family. Should we diversify, if this acquisition comes up; big decisions we like to discuss with everybody. My brother John and I have done very proactive estate planning. We only own 15 percent of the business ourselves and the rest of it is already in the children's name. We haven't created a voting trust yet, but that's the next step. If you put a process in place, it makes it easier for the third, fourth, fifth, sixth generation to be successful in a business. I think we've done a very proactive job of educating the next generation, and I think at last count there were 8 or 9 of them involved in the businesses—all of them with unique talents, doing something different and being very successful at it.

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Bloomberg: 95 percent of your manufacturing is done in the US. That's a phenomenally high number. Was that something that you sat down and aimed to achieve?

D'Addario: Before 1998, it was 100 percent. Then we acquired a brand called Planet Waves, a tiny guitar strap company in Plainview, New York, that had beautiful designs. We wanted to have some straps, and we were trying to make some of our own straps, and we didn't really have the cachet they did, so we bought the brand. Then we used it as a platform to launch more accessories, and when we started to design some of these accessories, we realized that we couldn't make them here competitively, so we went to China. We got kind of enamored with that for a little while and, at one point, 87 percent of our product was American and 13 percent was Chinese or imported, mostly from China. When the great recession hit, and all these companies in America had capacity and jobs were being lost, I took the top 25 products we make, that we were importing, and sent them out for quotes all over America. Because people were looking for work, we got some very competitive prices. I was quite shocked, actually. It was around when we were putting in Toyota lean manufacturing in 2009. We trained 12 people to be Toyota lean champions, and we looked at, okay, if we have to do some assembling, let's set up a Toyota lean work cell, and let's buy these molded parts or whatever parts we can't make--stampings or whatever it may be--and let's create really efficient work cells so we can assemble them here. We were able to move back up to 95 percent made here. The only things we don't make here are electronic products like the tuners; our volumes are not millions of pieces where you can automate it completely. We have yet to find American suppliers that can help us with those products. Then there's some metal working products that we've yet to find competitive American manufacturers. We still keep trying. We'd love to make more of it here. We'd love to make some of it ourselves. Sometimes, I have such creative manufacturing people, that if I said to them, these capos that we're making, I want to make them here in America and I want to make a project out of that, they could figure out how to manufacture that stuff here. They really could, but it might not have the ROI that ten other projects have ahead of it, so you just don't get to it. It's a great project, and we could do it, but in the scheme of all the things we're working on, we have bigger opportunities in other areas. So we have to prioritize them every year.

Bloomberg: That post-crash decision to source and tender manufacturing within the U.S., was that based on a business decision or was it based on a patriotic decision? Were you thinking, now's the time to get cheap deals in America, or were you thinking, I'd rather be here?

D'Addario: It was a little bit of a personal, emotional challenge of mine. First of all, at that time we were about 6-8 years into making things in Asia. We were using a buying office in Hong Kong that was a consultant. We didn't have our own engineers on the ground. We had lots of quality problems, and we had long lead times before things would get finished. The iterations and the amount of corrections were enormous because we didn't have boots on the ground yet in China. I felt that there were hidden costs in importing that people didn't realize. I tried to quantify those a little bit and they were very significant. How many times do we airfreight parts in because something was defective or they were late? It was a lot more than I thought it was. How many times do we come to market 4 to 6 months late with a product, and a competitor got a similar product out before us? A lot. You look at all those hidden costs and, believe it or not, we can accept a significantly lower book gross margin on something that we make internally and know we have no problems with it. And I can make less, I can make smaller batches, I can make them as I need them in a very lean fashion and those savings are huge. Over-production and over-inventory are just the biggest wastes you'll ever have in any kind of supply chain. By making and packaging things here, we cut those down. For instance, we could never get our packaging to look perfect. The red would be different from every vendor, and controlling that alone was a pain. If we do buy it, and we buy this tuner in China, we print the box here and we package it here. So we're taking them in bulk, and there's less freight because they're packaged tightly. We can also bundle them with strings or something if we want to do a promo. Having all that extra capability, you can accept a slightly lower gross margin by doing some of it here because you've given yourself flexibility, and you've made yourself more efficient. That was one of the main reasons why I pushed it hard, and you can't sometimes make a reported measure and show people this is what's going to happen. It is a bit intuitive. I think everybody believes in that intuition now and wants to do more. We're constantly looking: what products can we move back if we can? We've reached a point of diminishing returns, and it's harder to do it on some of the remaining things, like these tuners. You can't make 25,000 of those and automate it enough to get it down in America.

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Bloomberg: Speaking of China, you faced some challenges with counterfeits. Is that still a big issue?

D'Addario: It's still an issue. It has become less of an issue for us because we had so many facets of ways we were attacking it. We've got listening software out there. We're monitoring. We're identifying counterfeiters right away and we're requesting that the sites take down the listings. In some cases, we'll even find out who the manufacturer is and raid the factory. We haven't done that in 2 or 3 years though; we haven't had to. Chuck Schumer helped us dramatically. I think it was four years ago, there were 480 listings of counterfeit D'Addario strings on alibaba.com, and our in-house counsel was challenging them to get them off for close to two years and was just being smoke-screened and was never getting an answer. Steve Israel was very helpful, and he got both Senator Gillibrand and Schumer's office to get involved. Chuck Schumer actually wrote a letter to Attorney General Eric Holder asking that he shut down Alibaba.com—a pretty bold request—because of the listings, and he ran a press conference in our building announcing it. By ten o'clock that night we heard from Alibaba's legal counsel. They said, 'oh there must have been some kind of misunderstanding,' and they took them down and never listed them again. Alibaba has such reach, that alone really stifles the ability for those guys that are making this stuff to have enough critical mass to continue making it. Granted, some of the stuff is still on eBay—you [can] go on eBay and probably find a set of D'Addario strings for a $1.80. It will say from China or Korea or India, and you know it's not real. People would have to be foolish to think that they were getting the real product from those sources. But having Alibaba take it down was one big step. We also created a very smart thing—we put the technology in place to serial number every set of strings and we called it 'Play Real Code.' We have a website on D'Addario.com, and you can type in a code, and it will tell you whether or not you have an authentic set. We had an ulterior motive for that. That was about 8 years ago, and now we have 150 million records in that file because we make that many strings. Now we created a loyalty program called Players Circle where people can register and then redeem those codes and get points in their account to get swag or even accessories from us. We just launched that in January, so we used the same code. That code really deterred a lot of counterfeiters because they didn't have the capability to put a unique code on every package, and they were getting caught. If somebody has a false code or a code has already been redeemed, they're going to get an error message, and they report to us where they bought it, and then we can follow up. But all this costs money, and it's a distraction, but it's what's required in today's global world.

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This is going to be big because now we're putting the codes on drum sticks, drum heads, reeds and there's a big program going on right now where we're adding the capability to put those codes on everything we make. Player's Circle is going to be one of our main marketing themes. In 2018, our booth at the Namm Show will be a big circle. Player's Circle will be a big part of our marketing by then, and it all stemmed out of a problem—counterfeiting—and we came up with a way of minimizing that problem but also created an opportunity.

Bloomberg: Throughout your success, there was never any temptation to go public, cash out?

D'Addario: Not realistically, no. There might come a period where the next generation might want to take some equity off the table. I think if I was a public company, I probably would have been fired 3 or 4 years ago. I'm a long-term guy, so I play the long game, and that doesn't work so well on Wall Street. People are not so patient with the long game. Like this marketing that we're doing, we spent a lot of money on it, and it was at a bad economic time to be spending that much money. The dollar got so strong, the export business weakened–my numbers to Wall Street would have looked terrible. I would have been fired. But now my numbers look awesome because the marketing is really working. My string bookings are up 11 percent this year and the industry is down 2 percent. So we gained 13 points. Our market share in the industry data we get went way up in every category, and it's because of the marketing and sales we're doing. I probably would have been fired because nobody wants to wait three and a half years, and that's what it takes when you do a rebranding. People give up because they get the pressure from Wall Street - what's next quarter? I think I would go out of my mind if I had to deal with that. So, I personally have never considered an IPO as an option. I don't come to work to make $50 million a year for myself, I come to work to make stuff that's really fun and innovative for musicians, and that's our culture. If we can do that, remain profitable and remain in control of our family business without having to bring in outsiders, that would be great. And I think we can.

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