

CHAPTER 1

INTRODUCTION

1.1. Company Background

1.1.1. Overview PT Hanjaya Mandala Sampoerna Tbk. (HMS)

The history of PT Hanjaya Mandala Sampoerna Tbk. ("the Company") and its current stature as one of the biggest cigarette manufacturers in Indonesia are inseparable from the history of its founding family, the Sampoerna family.

In 1913, Liem Seeng Tee, a Chinese immigrant, began his business by producing and selling hand-rolled kretek (clove) cigarettes, at his home in Surabaya, Indonesia. His small business was among the first to manufacture and market kretek as well as non-clove cigarettes. Kretek cigarettes grew quickly in popularity.

By the early 1930's, Liem Seeng Tee had changed his family name and the name of his company to Sampoerna (Indonesian for "perfect"). With his business firmly established, Seeng Tee moved both his family and his factory to an abandoned complex of buildings in Surabaya, which he subsequently renovated. The new factory and family residence, which still produces the Company's hand-rolled kretek cigarettes to this day, is now known as Taman Sampoerna.

In 1959, three years after the passing of Seeng Tee, Aga Sampoerna (Seeng Tee's second son) was appointed to lead and reinvigorate the company. He succeeded in furthering the family business through his skilled leadership and management, and by building good relationships with employees, suppliers, cigarette sellers and the surrounding community.

Aga's son, Putera, then took over the helm of HM Sampoerna in 1978. During Putera Sampoerna's tenure, the company established a modern corporate structure and became a public company in 1990, embarking on a period of investment and expansion. In the process, PT HM Sampoerna Tbk. consolidated its position as one of Indonesia's top-tier companies.

With its business success, PT HM Sampoerna Tbk. drew the interest of the world's leading international tobacco company Philip Morris International Inc. ("PMI"). This led to PT Philip Morris Indonesia (a subsidiary of PMI) acquiring majority ownership of PT HM Sampoerna Tbk in May 2005.

Guided by an experienced Board of Directors and management that combine the talents of PT HM Sampoerna Tbk. and PMI, the Company continues to effectively leverage the synergies derived from the Sampoerna acquisition, while maintaining the unique Indonesian culture, heritage and tradition that have been passed on for almost a century.

1.1.1.1. Company Profile

As of end of 2007, PT HM Sampoerna Tbk. and subsidiaries employed about 30 thousand people. The Company operates five cigarette manufacturing facilities in Indonesia: one machine-made production facility in Pandaan, three hand-rolled production facilities in Surabaya and one hand-rolled production facility in Malang. By 2007, PT HM Sampoerna Tbk. had additionally contracted the production of its hand-rolled kretek cigarettes to 37 Third Party Operators (TPOs) throughout Java, which collectively employed almost 65 thousand employees.

The Company sells and distributes cigarettes through 59 offices under its subsidiary PT Perusahaan Dagang dan Industri Panamas ("PT Panamas"), and through cigarette selling agents throughout Indonesia. Beginning in February 2005, PT Panamas was appointed as distributor by PT Philip Morris Indonesia to sell and distribute the white cigarette brand *Marlboro* and other brands.

In addition to PT Panamas, the Company also has several subsidiaries supporting the business of cigarette manufacturing and selling. These include PT Handal Logistik Nusantara, a shipping and warehousing company, and PT Sampoerna Printpack, a printing and product packaging company.

In a small proportion to its overall consolidated sales, the Company through its subsidiaries abroad also manufactures and sells kretek cigarettes in a number of countries such as Malaysia, Singapore, Brunei Darussalam, and in a number of duty free markets. The contribution of the international segment to the Company's consolidated sales in 2007 was about 1.7%.

In comparison to its initial stock market listing in 1990, the Company's capitalization has grown significantly. At the end of 2007, the Company's market capitalization was about Rp62.7 trillion, calculated according to the share closing price at the end of 2007 of Rp14,300 or US\$6.7 billion at an exchange rate of US\$1 = Rp9,419.13

1.1.1.2. Corporate Vision and Mission

The vision of PT HM Sampoerna Tbk. is embodied in the Three Hands philosophy. The philosophy takes a snapshot of the Company's business environment and puts it into perspective. The Hands, which represent adult smokers, employees and business partners, and the society at large, are those we need to embrace to attain our goal of becoming the most respected company in Indonesia, thereby generating long term shareholder value.

Delivering high quality cigarettes with fair value to adult smokers

The Company is fully committed to delivering the highest quality product at fair value. This we do by creating relevant innovation and building the right image for our products and the Company.

Providing good compensation and working conditions to employees and building a good relationship with business partners

Employees are the Company's most important assets for whom good compensation and working conditions are merited. Concurrently, our business partners play an essential role in contributing to our business success through which we seek to work together towards a bright long term future for them and our employees.

Giving back to the society at large

The Company owes its success to the support of communities throughout the country. And we make sure that we give back—focusing our efforts on training and small business support.

1.1.2. PT Philip Morris Indonesia (PMID)

Long before the acquisition, Philip Morris has established the business in Indonesia under PT Philip Morris Indonesia (PMID). The company had her own complete business unit functions: sales, marketing, operations, human resources, finance, etc.

After the acquisition, there were a lot of synergies between HMS and PMID across all function. Although PT Philip Morris Indonesia was the acquirer company but in reality a lot of functions in PT PMID were consolidated into PT HMS, this is mainly due to the bigger operations size of PT HMS. PT PMID is still maintaining her own legal entity.

Early of 2006, PMID relocated its production facility from Malang, East Java to Bekasi, West Java due to the land lease was expired. The relocation preparation was started back in mid of 2005. In parallel with recruiting new local hires in Bekasi, PT PMID also relocated more than 100 employees from Malang.

The new facility in Bekasi was designed with higher level of automation and higher speed equipment. That enabled PT PMID to reduce the headcount from the Malang

days, around two-third of the Malang employees were terminated. Although willing to be relocated, the 100 people from Malang had guaranteed termination package too.

During 2006 – 2007 the relocated people, who has experience and skills gradually resigned from the company, mainly to liquidate their compensation package. PT PMID was backfilling the vacancy with new hires.

1.2. Performance Management Theories

1.2.1. Introduction to Performance Management

Competitiveness in many of today's industries is based on the effectiveness of human assets – on the ability of employees to create, to apply their skills and accumulated knowledge, to work effectively together, and to treat customers well.

The importance of human assets in business competition explains why every company and every manager needs a system for making the most of the company's people resources. Everyone benefits when an organization has effective performance management:

- Shareholders get better yield, because the human assets of the organization are top-notch and working in unison toward key goals.
- Managers are more successful, because their subordinates are doing the right things well.
- Employees experience greater job security, career advancement, and fatter paychecks.

Performance management begins with goals. Goals define the results that people should aim to achieve. Goals are touchstones for performance planning, appraisal, rewards, and improvement. Without goals, time and energy would be wasted on activities that contribute very little to organizational success.

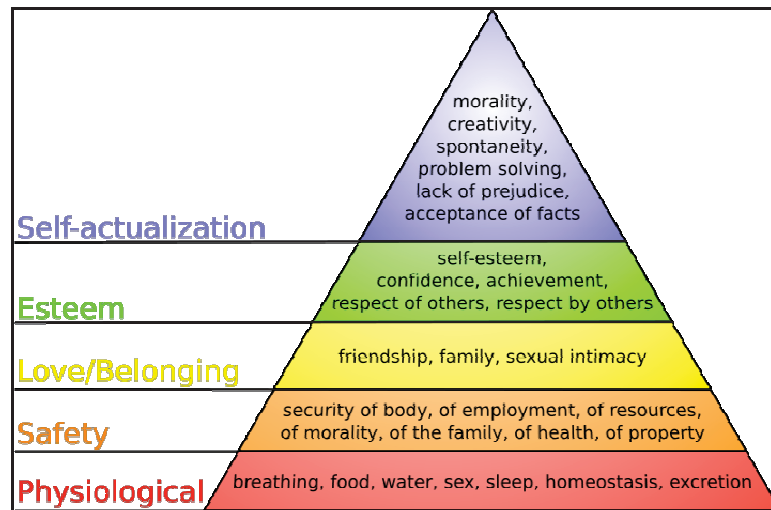
Rewards are a facet of performance management that aims to encourage a particular behavior or outcome. They include anything that employees value: pay increase, bonuses, promotions, plumb assignments, and even travel junkets. Rewards should be aligned with goals.

1.2.2. Motivation Theory

Motivation is the very heart of performance management. A person can understand goals and why they are important, but must also be motivated to pursue them. There are plenty of them and here are some of the key theories of workplace motivation and the impact of rewards and incentives. The classic theories of industrial management and organization were formulated in the late 1800s and early 1900s.

1.2.3. Maslow Hierarchy

Maslow's hierarchy of needs takes the form of a pyramid: in ascending order, the needs are physiological, safety, social, esteem, and self actualization. Lower-order needs (physiological and safety) motivate employees toward earning direct financial compensation to buy shelter and do things like provide for retirement.



Source: Wikipedia, free encyclopedia, Abraham Maslow.

Fig 1.1. Diagram of Maslow's Hierarchy of Needs.

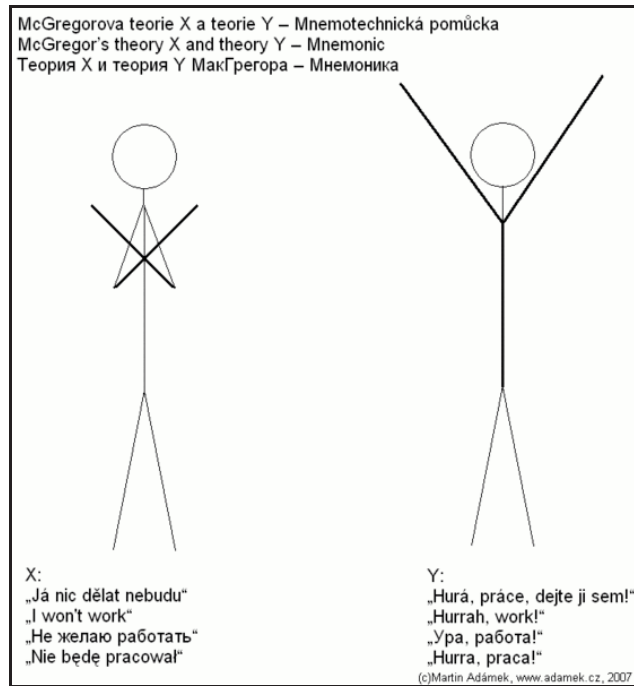
1.2.4. Herzberg's Two-Factor Theory

Herzberg's two-factor theory of motivation tries to find out what people want from work. According to this theory, two sets of factors influence work behavior: dissatisfiers (hygiene factors) and satisfiers (motivators). Hygiene factors relate to the context of jobs and include pay, working condition, supervision, and so on. Motivators include factors like achievement, recognition, responsibility, advancement, growth and the work itself. Motivators become operational only when dissatisfiers are removed. Herzberg concludes that changing pay will not motivate. But if pay is inadequate, or of the wrong type, or mismatched to employees' needs in any way, dissatisfaction results.

1.2.5. McGregor's Theory X and Y

Formulated by Douglas McGregor, the theory X view of human nature sees employees as lazy and untrustworthy – motivated solely by pay (the carrot) and fear of dismissal (the stick). Derived from Frederick Taylor (1856-1915), the father of scientific management, defined work in terms of coordinated, highly specified tasks designed for optimal efficiency, with almost nothing left to the judgment of production employees. This theory was less concerned with worker motivation than with the mechanisms of efficiency, predictability, and control.

Theory Y view of human nature postulates that people are not naturally slackers, but eager to work, to accept responsibility, and to produce good results. Pioneering research by Elton Mayo indicated that work output was influenced by social norms, management – employee communications, and the level of employee involvement in workplace decision.



Source: Wikipedia, free encyclopedia, Theory X & Theory Y

Fig. 1.2. Mnemotechnic of Theory X and Theory Y.

1.2.6. Social Comparison Theories

Suggests that motivation is greatly influenced by how fairly an employee feels or thinks he or she is being paid. These theories are very important tools for developing compensation systems. Include here are: Homan's distributive justice or exchange theory, Adam's equity theory. The main idea behind Social comparison theories is perceived fairness: Does the employee think he or she is being paid fairly?

1.2.7. Expectancy Theory (Tolman and Vroom's)

According to this theory, motivation depends on the expectation that effort will produce performance. Humans form a mental picture about the likelihood that a given level of effort will result in a desired outcome. Various outcomes have different levels of desirability or valence. A direct application of expectancy theory to compensation is the idea of earning days of vacation or sick leave, the longer year they work for a company the more vacation days they can claim.

1.2.8. Reinforcement, Behavior Modification, Other Social Behaviorist Theories (Pavlov, Watson, Thorndike, and Skinner)

Motivation results from the direct interaction of the individual with the external environment, not from internal processes like needs or perceptions. Behavior is contingent upon the presentation of rewards, delivery of punishment, or withholding of rewards. Human behavior is motivated by the extent to which it has been rewarded or punished, on the basis of automatic stimulus-response. When managers reward, punish, or withhold rewards like raises, the desired behavior should result.

1.2.9. Types of Rewards

There are basically 2 types of rewards: intrinsic and extrinsic. Intrinsic rewards are those that produce non quantifiable, personal satisfaction, such as a sense of accomplishment, personal control over one's work, and a feeling that one's work is appreciated. Extrinsic rewards are external, tangible forms of recognition, such as pay increase, promotions, bonuses, and sales prizes. Both types of rewards have a place in performance management.

1.2.10. Compensation

Compensation is the human resource management function that deals with every type of reward individuals receive in exchange for performing organizational tasks. Total compensation includes the following three elements:

- Based pay: serves as a platform for variable pay.
- Variable pay: is the centerpiece of total compensation approach. Methods include gain sharing, lump-sum bonuses, individual variable pay, and so forth.
- Indirect pay : benefits.

Compensation is the main reason why most individuals seek employment. It is an exchange relationship. Objective of compensation is to create a system of rewards that is equitable to the employer and employee alike. The desired outcome is a motivated employee to do a good job for the employer. Patton suggests seven criteria for compensation effectiveness. Compensation should be:

1. Adequate. Minimal governmental, union and managerial levels should be met.
2. Equitable. Each person should be paid fairly, in line with his or her effort, abilities, and training.
3. Balanced. Pay, benefit, and other rewards should provide a reasonable total reward and package.
4. Cost-effective. Pay should not be excessive but take into consideration what the organization can afford to pay.
5. Secure. Pay should be enough to help and employee feel secure and aid him or her in satisfying basic needs.
6. Incentive-providing. Pay should motivate effective and productive work.
7. Acceptable to the employee. The employee should understand the pay system and feel it is a reasonable system for the enterprise and himself or herself.

Among the factors that influence pay and compensation policies are those outside the organization: the labor market, the economy, the government, and unions.

1.2.11. Pay for Performance

Methods for paying employees on the basis of their output or performance are usually referred to as incentive compensation or pay for performance (P4P). P4P can be paid individually, to the work group, or on an enterprise-wide basis. Several type of P4P:

- Simple piece rate
- Differential piece rate
- Bonus
- Merit Pay
- Organization bonus.

In order to implement successful variable pay system, companies must be sure that their plans are based on clear goals, unambiguous measurements, and visible linkage to employees' efforts. Key design factors include:

- Support by management: executives and line managers must demonstrate commitment.
- Acceptance by employees: employees must accept the plan as equitable.

- Supportive organizational culture: the organization culture must be based on teamwork, trust, and involvement of employees at all levels when setting performance goals.
- Timing: the plan must be launched when there is minimal risk of economic downturns that would affect the size of the awards.

1.2.12. Pay and Motivation

Does an incentive system motivate employees to perform better, or does it create greater satisfaction? Various comments were obtained from the yes from Aristotle in ancient Greece and of scientific management in the early 1900s to the no of human relations theorists in 1930s.

Variable pay: measures of success:

- Did the plan gain acceptance among employees?
- Was the plan well implemented and integrated?
- Did employee behavior change?
- Did the plan achieve operational improvements?

Although it sounds simple, since different things motivate different individuals and theorists do not agree on what will motivate, linking pay and motivation is a very difficult task

According to HBS, there are several practical suggestions for motivating personnel - things that managers can do – include making pay fair and competitive; demonstrating trust; making jobs more complete; introducing challenge; encouraging some people to become experts; eliminating fear from the workplace; preserving the dignity of subordinates; sacking slackers; empowering people and avoiding micromanagement; hiring self-motivated people; and understanding the importance of being a good boss.

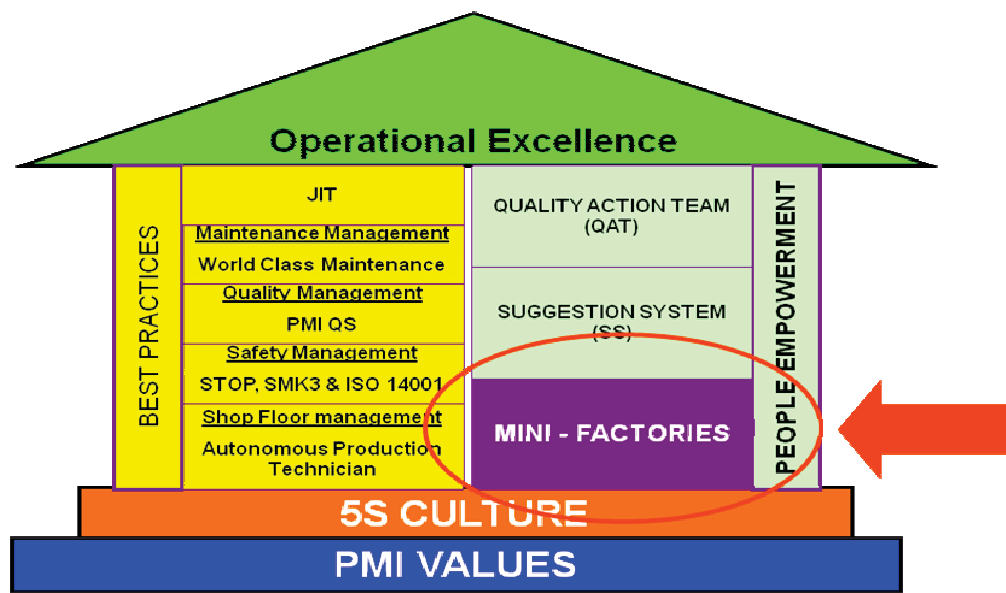
1.3. Mini Company Theory

Introduced by Kiyoshi Suzuki, borrowing idea from the founder of Matsushita Electric, Konosuke Matsushita: Making People Before Making Products. This management

concept essence is empowering the shop floor people to manage their unit. Changing the manager paradigm of Just do what I say to Listen what their people say. Each mini company has its own mission statement and goals.

Mini company develops a sense of ownership and builds teamwork. It also helps people to focus on clear objectives and develop congruent goals to the total organization goals. It also builds strong customer-supplier relationships among units within the organization. Since mini company involves everyone to be actively participating in the business, it certainly motivates the people to be responsible on the results.

Mini company can fit well in the Lean Manufacturing journey as presented in the picture below.



Source: PT HM Sampoerna Tbk., Lean Manufacturing Framework

Fig. 1.3. Operational Excellence Model.

Mini company concept is not merely changing the process but also the leadership structure. The chief of mini company is normally elected by the member and serving the role on voluntary basis. There is no extrinsic reward for being the leader of the group.

A lot of initiatives those are usually driven from the top can be transferred to each mini company. This will create a balance situation of two way management approach: top-down and bottom-up.

There are not many literature can be found on the mini company implementation since the concept published by Suzaki. Several companies have tried to implement but there were no success stories published so far.

1.4. Business Issues and Problem Statement

There are two issues in parallel to be explored in this performance management topic:

1. Global PMI Operations initiative of Pay for Performance (P4P) implementation and
2. PT PMID initiatives to improve her operations performance.

The problem statement is: how to find the right P4P formulation to improve the Operations performance and testing its efficacy in PT PMID.

