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PROGRAM SUMMARY

Strategic Planning and Management in Retailing Reaches a Milestone

In May 2005, the Strategic Planning and Management in Retailing Program ran for the 20th time at Babson College. It also ran for the 20th time in Australia at the Cape Schanck Conference Center near Melbourne, sponsored by the Australian Center for Retailing Studies (ACRS) of Monash University.

The Australian version of the program was populated primarily by retailers from Australia and New Zealand, while the Babson program featured retailers from 10 different countries. Both programs began with our latest version of the "Eight Ways to Win in Retailing" and included updated versions of the "Strategic Profit Model" and the "Strategic Resource Model." Additionally, we presented updated versions of our "Strategic Thinking" and "Strategic Market Planning" presentations.

Both programs featured our "Integrated Framework for Strategic Resource Management" with levels one, two, and three analyses, where participants worked in teams on Quartile Analysis, the Master Productivity Matrix, and Category Scorecards and Assortment Planning. Across the two programs, we completed case studies on Wal-Mart, Zara, Best Buy, Meijer, Home Depot, Amazon.com, and Kohls.

At Babson, our store tour featured visits to BJ's Wholesale Club, Target, Wal-Mart, Kohl's, Shopper's World Power Center (including Best Buy, DSW, Toys "R" Us, Barnes & Noble, T.J. Maxx, Sports Authority, and others), Walgreen's, Trader Joe's, Staples, Whole Foods, Jordan's Furniture, and the Natick Mall (Filene's, Macy's, Lord and Taylor, Sears, and numerous specialty stores).

Babson's Executive Conference Center made for an ideal learning environment and, of course, the food was excellent. Participants were treated to a lobster and clam bake upon returning from their store tour on Wednesday. Thursday's lunch was the annual Doug Tigert Cheeseburger BBQ. Susan Hartshorn served as program manager and housemother, and looked after all members of the diverse group.

At Cape Schanck, participants enjoyed a beautiful Mornington Peninsula venue highlighted by the closing Thursday dinner, which featured Phil Smith, retail leader of API Priceline and former Myer MD, as our guest speaker. Michael Collins, the founding director of the ACRS and an early sponsor of our programs, was also in attendance that evening, as was Amanda Young, the current ACRS director. Peter Phillips-Rees served as program manager for the week.

Program faculty at Babson included Larry Ring and John Strong from William and Mary, Marty Anderson from Babson, and Guillermo D'Andrea from IAE in Argentina. Larry and John handled those duties in Australia.

This program is offered twice a year in North America (at Babson and at William and Mary), and once in Australia and in Singapore (both sponsored by Monash University). The program will be offered September 17-23, 2005, at the College of William and Mary in Williamsburg, Virginia. Those interested are encouraged to apply early. To register, contact Susan Hartshorn at shartshorn@babson.edu, or at 781-239-2923.

Wal-Mart's New Normal Is Here: Is Everyone Ready to Accept the Future?

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In the first 15 years after its IPO, Wal-Mart grew its sales and earnings 30-35 percent annually and its stock multiple was around 40-50x. In the next 15 years, Wal-Mart's growth slowed to about 20-25 percent per annum, with its P/E still averaging 45-50x. Today, with Wal-Mart entering a new era as a 10-12 percent growth company, what should be the new P/E multiple—10-15x? Wal-Mart's current P/E multiple on 12-month trailing earnings is about 18x, the lowest in 35 years.

This article focuses on a variety of factors which may help explain why Wal-Mart will be struggling to grow its same store sales, and what this may mean for the future of Wal-Mart and its associates, as they begin to navigate uncharted waters in search of a "new normal" for their enterprise.

First, however, let's take a quick look at some of the recent events and headlines that have taken this lumbering giant from its comfort zone in the power centers of North America, and into the center of attention, and the glare of public opinion worldwide.

For a number of years, during most days in Bentonville, Ark., senior management must have felt besieged. Wal-Mart's (market) power with its suppliers and its dislike of labor unions are, of course, well publicized. However, the frequency of headlines—from Wal-Mart employing illegal immigrants to its senior executives misbehaving—is relatively new. Also, the company has been a party to a number of class-action lawsuits—many relating to Wal-Mart's alleged poor labor practices such as off-the-clock work, not paying overtime, and a whole host of other wage and pay disputes. Among these, a class-action lawsuit that alleges widespread gender discrimination covering several million women over many years can really come back to bite Wal-Mart.¹

Another series of Wal-Mart headlines involve communities and ordinary folk in various parts of the country reportedly rising up and saying "no" to Wal-Mart's expansion into their backyard. From New York to California, and from Vermont to




Louisiana, we are now hearing of frequent protests of local folk saying "no, thank you" for yet another Supercenter in their midst. Despite such "protests," however, during the past year alone, Wal-Mart opened 83 new Supercenters, 36 Discount Stores, 21 Neighborhood Markets, 13 U.S. Sam's Clubs, and 232 stores abroad—with plans to add another 55 million "new" square feet this year. Clearly there are also a lot of other communities out there, welcoming Wal-Mart with open arms.

For a company that generates rock-solid numbers on all the key dimensions of high performance retailing, such headlines must be surprising to some, and shocking to more than a few in Bentonville. Indeed, on all the essential components of generating a high return on assets and equity, Wal-Mart continues to be a stellar and sustained performer—managing its margins and asset base well, and doing it all with a balanced and conservative balance sheet.

In fact, every year Wal-Mart handily beats two of its most bitter rivals in the United States by wide margins on both RONW and ROA (see Table 1). On the same table, however, are a few other numbers that are sure to give folks in Bentonville some pause for thought and perhaps the most fear: On the critical dimension of "growth," or more important, "sustainable growth," Wal-Mart may be falling short of the historical expectations.

During the last five years, compounded annual rate of growth (CARG) in sales for Wal-Mart was the same as Costco at 10.5 percent per annum. Though Wal-Mart's sales CARG appears much higher than Target's in this table (10.5 percent vs. 5.9 percent), on the more important measure of comparable (or comp) store basis, it is Target who has been outperforming Wal-Mart by a wide margin. During its last fiscal year, for example, Target's comp sales were 5.3 percent to Wal-Mart's 3.3 percent. In fact, for more than 18 months, Target same stores have been

TABLE 1 STRATEGIC PROFIT MODEL AND GROWTH RATIOS FOR WAL-MART, TARGET, AND COSTCO FOR 2000–2004

	2004	2003	2002	2001	2000	CARG 04-00	
Target							
Net Income After Tax + Net Sales	4.1%	4.4%	4.4%	3.5%	3.5%	Sales	5.9%
Net Sales + Total Assets	1.4x	1.3x	1.3x	1.6x	1.9x	Gross Margin	7.2%
Net Income After Tax + Total Assets	5.8%	5.8%	5.7%	5.7%	6.5%	Operating Profit	10.2%
Total Assets + Net Worth	2.5x	2.8x	3.0x	3.1x	3.0x	Net Profit	10.5%
Net Income After Tax + Net Worth	14.5%	16.3%	17.2%	17.4%	19.4%	Current Assets	17.5%
Net Income After Tax & Dividends + Net Income After Tax	91.2%	86.3%	86.5%	84.7%	84.1%	Total Assets	13.5%
Net Income After Tax & Dividends + Net Worth	13.2%	14.0%	14.9%	14.7%	16.3%		
Costco							
Net Income After Tax + Net Sales	1.9%	1.7%	1.8%	1.8%	2.0%	Sales	10.5%
Net Sales + Total Assets	3.1x	3.2x	3.3x	3.4x	3.7x	Gross Margin	11.3%
Net Income After Tax + Total Assets	5.8%	5.5%	6.0%	6.0%	7.3%	Operating Profit	7.5%
Total Assets + Net Worth	2.0x	2.0x	2.0x	2.1x	2.0x	Net Profit	8.7%
Net Income After Tax + Net Worth	11.0%	11.0%	12.3%	12.3%	14.9%	Current Assets	20.3%
Net Income After Tax & Dividends + Net Income After Tax	89.2%	100.0%	100.0%	100.0%	100.0%	Total Assets	15.0%
Net Income After Tax & Dividends + Net Worth	10.3%	11.0%	12.3%	12.3%	14.9%		
Wal-Mart							
Net Income After Tax + Net Sales	3.6%	3.5%	3.5%	3.2%	3.3%	Sales	10.5%
Net Sales + Total Assets	2.4x	2.4x	2.4x	2.4x	2.4x	Gross Margin	12.3%
Net Income After Tax + Total Assets	8.5%	8.6%	8.4%	7.9%	8.1%	Operating Profit	10.6%
Total Assets + Net Worth	2.5x	2.4x	2.4x	2.4x	2.5x	Net Profit	13.0%
Net Income After Tax + Net Worth	20.9%	20.8%	20.2%	18.8%	20.1%	Current Assets	9.7%
Net Income After Tax & Dividends + Net Income After Tax	78.4%	82.6%	83.2%	81.0%	82.9%	Total Assets	11.5%
Net Income After Tax & Dividends + Net Worth	16.4%	17.1%	16.8%	15.2%	16.6%		

outperforming Wal-Mart same stores nearly every month. What must be equally disturbing to Wal-Mart senior management is the fact that Costco has been doing the same thing (to Sam's Club), virtually every month for the past five years!

Headline Risk

For the largest and, arguably, one of the best performing companies in the world, this spate of bad press and bad news is certainly taking its toll. In fact, some industry observers now label Wal-Mart as one of the biggest "headline risk" companies. (This is typically a phrase reserved for pro athletes who suddenly take a "wrong turn" in their off-the-field antics, and create major issues for their sponsors).

Some even argue that this risk may be one of the major reasons for the dormancy in Wal-Mart's stock for the last several years (See Figure 1).

It is certainly true that Wal-Mart's stock has not been very exciting for some years now (see the upper right boxed area, framed 2000–2005 in Figure 1). After peaking at almost \$70 at the end of the dot-com (and the beginning of the dot-gone) era, Wal-Mart stock has recently settled into a narrow band between \$50 to \$60 and has been doing the stock market version of a yo-yo. This period is somewhat similar to another period in Wal-Mart's history—during the early to mid 1990s—when Wal-Mart virtually was a landlocked U.S. company (see the lower left boxed area, framed 1993–1997 in Figure 1). During that time as well, there were discussions of Wal-Mart already being too big, and that there was little room left for it to grow in the United States. Then came the international expansion, and Wal-Mart's entry into the food sector with the Supercenters, and the rest as they say, is history. (Or, as we shall soon see, perhaps the beginning of yet another chapter!)

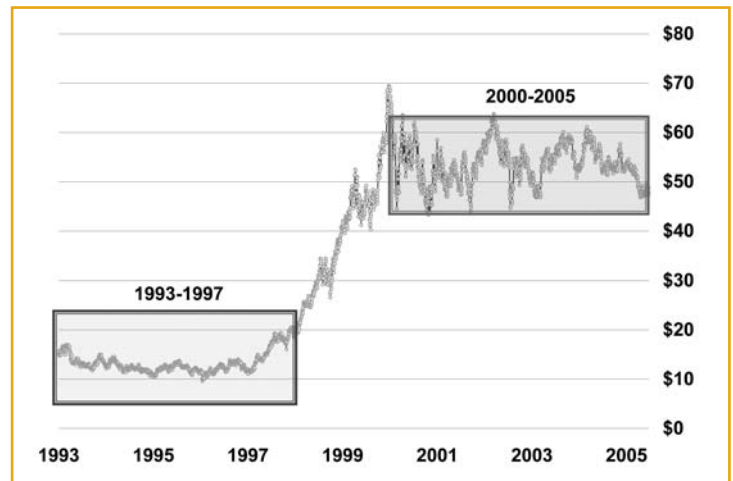
What is quite clear, however, is that this latest "slow-down," especially in both the stock market and the comparative store-sales gains—and their collective impact on the Wal-Mart organization—is something much more worrisome to senior management, and to the observers and followers of Wal-Mart.

Wal-Mart Is a Big Company!

As everyone now knows, Wal-Mart is a very big company. It is big in sales, big in assets, big in profits, big in labor force, and predictably, big in "headline risk." Some of this is reflective purely of a "spurious correlation," where big things generally correlate highly with big things, and many times such associations mean nothing in terms of causality.

With a labor force fast approaching 2 million people (probably more like 5 million to 6 million when you include their families), Wal-Mart is now bigger than some of the largest state bureaucracies found in large nations, possibly including that of the United States! So, if there is one bad apple in 100, that means Wal-Mart has nearly 20,000 of them (or more likely 50,000, if you include their extended families)! If the worst offenders were to number one in a million, there are likely two of them lurking somewhere in a Wal-Mart uniform (while another family member or two plot at home). This is unfortunately the law of large numbers, and for that reason alone, Wal-Mart will always (and increasingly) be in the news.

FIGURE 1 WAL-MART STOCK DAILY CLOSING PRICE PER SHARE (\$) 1993–2005



The good news is, to counteract this acquired proclivity, the Wal-Mart organization finally appears to have awakened to the fact that another story has to be told to the public at large—and to its own.²

There is, for example, now a walmartfacts.com site on the Web, and a host of big-name PR firms, lobbyists, publicists on the payroll—all helping the company channel some of the better news on Wal-Mart. As part of this newfound commitment to better public relations, the company has also quietly begun to publicize their new store openings through extensive fact sheets that now accompany the launch of every Wal-Mart store. In these, Wal-Mart extols the benefits of the new store for the community, the local and state economies—including all the civic and charitable groups in the immediate neighborhood. These and many other "fact sheets" are, of course, directed as much to the public and market at large, as they are to Wal-Mart's new or prospective associates.

And herein lies the crux of the issues for Wal-Mart, both in its meager comp sales growth and in its stalled stock price.

The Wal-Mart “Contract”

Explicitly or tacitly, Wal-Mart and its associates share a very simple “contract.” Some of it is spelled out very clearly in its corporate communications, and some is imbedded in its corporate culture and folklore. It goes something like this:

- You will give Wal-Mart your very best, work very hard, and we will pay you ... perhaps not very much at first, but well, if you prove yourself to us.³
- We will give you unending growth opportunities, personally and professionally, if you help us grow this business.
- To grow this business, however, we all know and accept that we have to be collectively relentless on costs. Therefore, we agree and accept that the rate of growth in our sales has to exceed our costs *and* our investments in inventory.
- Hence, you will help us lower our costs, personally through some early wage sacrifice, and professionally by working very hard at these Wal-Mart principles. In return, we will see to it that you are well compensated for your labors as you progress in this organization, and our enterprise grows in its competitive space. Consequently, there is no need for you to form, organize, or join any unions except the one you will have with Wal-Mart.
- And if you help us do all that, we will, through an ever rising Wal-Mart stock, assure you a safe, rich, and a very happy retirement.

We would argue that anybody who has ever been associated with Wal-Mart, listened to its senior management, or read one of its annual reports, but has failed to understand this simple five-point Wal-Mart contract has no clue as to the basis of competitive advantage for Wal-Mart or what makes this organization tick. The simple phrase found on the backs of every Wal-Mart store associate, “Our People Make the Difference,” is certainly true in more ways than one!

So we believe that it is not the unsavory “headlines” that put Wal-Mart at risk going forward, but it is the ability of Wal-Mart to hold up its share of the bargain with its associates. Therefore, the recent slowdown in comp store sales growth—and the momentum of the Wal-Mart stock over the last several years—has to be seen through these lenses.

We think most readers will agree that if there is no more comp sales growth or a very meek one, and/or no more stock appreciation, or a very weak one, the Wal-Mart contract can not and very likely will not be sustained.

Clearly, the rate of overall sales growth for Wal-Mart has been as good as, or better than its key competitors in the market. But that is a weak test of the viability of a happy and healthy Wal-Mart work force. A stronger test is whether Wal-Mart will enjoy healthy and happy rates of *comp store sales* in the future.

Low Comp Store Sales: A Current Funk or a Future Fact?

In Figures 2 and 3, we have two comparative charts, where we summarize the historical facts, and what we believe to be some of the emerging trends on this issue.

Figure 2 is a five-year, monthly comp store sales growth chart for Wal-Mart Discount Stores Division, compared to Target (Discount) Stores. Note here that the comparatives are between like-market competitors, and not the corporate aggregates. So this is truly an apples-to-apples comparison, and a fair reflection of these two organizations’ core sales growth, and hence, market momentum.

IF THERE IS NO MORE COMP SALES GROWTH OR A VERY MEEK ONE, AND/OR NO MORE STOCK APPRECIATION, OR A VERY WEAK ONE, THE WAL-MART “CONTRACT” CANNOT AND VERY LIKELY WILL NOT BE SUSTAINED.

The second chart is for Wal-Mart’s Sam’s Club stores only, and their monthly comp store performance, compared to their main rival, Costco. Once again, note here that the chart is for like competitors and during the identical five-year period as before.

In essence, this is an examination of the overall sales and market momentum of Wal-Mart’s U.S. businesses, which collectively account for 80 percent of their sales, and likely a similar proportion of their associate base. The implicit argument here is the following: If Wal-Mart is under stress in this part of its portfolio, chances are the stress will be even greater globally. Or more simply, if Wal-Mart were to implode, it is likely that it will happen here than elsewhere in the world.

As Figure 2 clearly shows, starting roughly in the second quarter of 2003, the darker bars—indicating Target’s comp store sales—have begun to outstrip those of Wal-Mart Discount Stores and Supercenters which are colored lightly in the background. In fact, past the middle of 2003 and to fiscal year-to-date, you can hardly find a month where Wal-Mart’s comp store sales have exceeded Target’s.

Very simply and very powerfully what Figure 2 illustrates is what most retail analysts already know: Target has been beating

Wal-Mart in the U.S. with no pause or change in the momentum for nearly two years now.

Is this an aberration of the recent past? If high oil prices are taking a big bite out of Wal-Mart's customers, why not out of Target's? Or is any of this reflective of the U.S. consumers' changing choices in the marketplace? In other words, could it simply be that Wal-Mart's market offer is somewhat tired, and people just want some variety? Or worse, could it be that it's the Wal-Mart's associates and executives who are tired—with their work, the headlines, and the legend or "promise" of Wal-Mart?

Regardless, and perhaps more to the point of this article—is what we are seeing here the beginning of a long-term, enduring trend for Wal-Mart?

These are intriguing questions, some of which are tantalizing, and some probably banal. But a few, clearly and deservedly go to the very heart of the Wal-Mart "contract." If the domestic growth stalls or becomes very labored, and if the stock market lowers its earnings multiple and keeps it low, then the contract is essentially broken, and all bets are off for Wal-Mart going forward.

The Only Company Wal-Mart Fears⁴

When we study the Sam's vs. Costco chart, the picture is even clearer: On Figure 3, the lighter bars now represent Sam's Club comp store sales growth though the years, while the darker ones track the same quantities for Costco.

If you are having difficulty seeing many of the "lighter" bars rising above the darker ones in Figure 3, it is not your eyesight that is at fault. You can in fact count the number of lighter bars here on your hand, which will not collectively equal a full year!

The story in this part of the Wal-Mart business, however, has always been bleaker *when it is compared to Costco*, so the "shock value" in this chart is perhaps not as dramatic to some of the readers.⁵ However, we can assure you that this chart has been in the nightmares of many of Sam's current (and former) senior managers for many years. And no wonder—Sam's executive group has been the most volatile team within the Wal-Mart enterprises, and in the organization's history.

According to Helyar (2003), "[Costco] ... 20% the size of Wal-Mart has made a monkey of the 800-pound gorilla. In the retail niche of warehouse clubs, the irresistible force is an irresolute flailer. During the past ten years Wal-Mart has gone through five CEOs and countless stratagems at Sam's Club trying to assume its customary command. All have been thwarted by Costco Wholesale, the master of the cavernous space."

In the balance of his article, Helyar (2003) does a much better job explaining how and why Costco dominates Sam's so thoroughly on many of the key metrics and dimensions of warehouse retailing than we can do in our allotted space. Suffice it to say; though both businesses have been in the market about the same length of time, Sam's still does a sales-per-foot at around \$500, whereas Costco doubles that easily in many of its stores. And as Costco's employee turnover averages 20-25 percent, Sam's Club easily doubles that! So, we think you get the picture.

The Darker Bars vs. The Lighter Bars

In the final section, we turn to the most important yet the most elusive of issues for Wal-Mart: Why is there a preponderance of "darker" bars over the "lighter" ones on our charts? Or, where have all the lighter and taller bars of Wal-Mart gone recently?

FIGURE 2 WAL-MART STORES VS. TARGET STORES MONTHLY COMP SALES GROWTH (%) 2000-2005

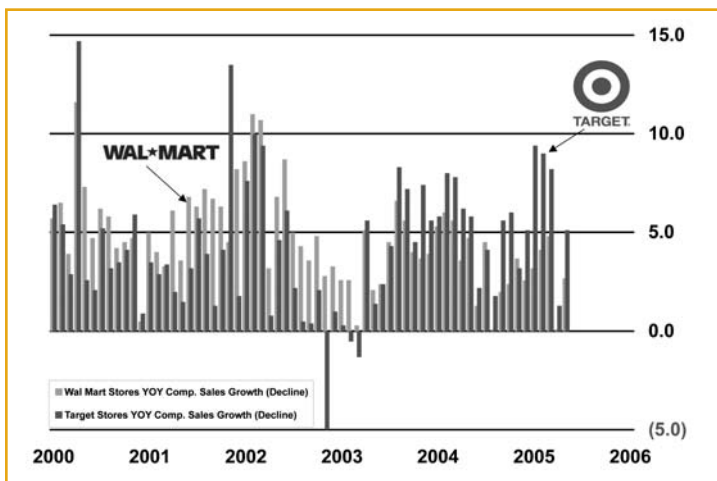
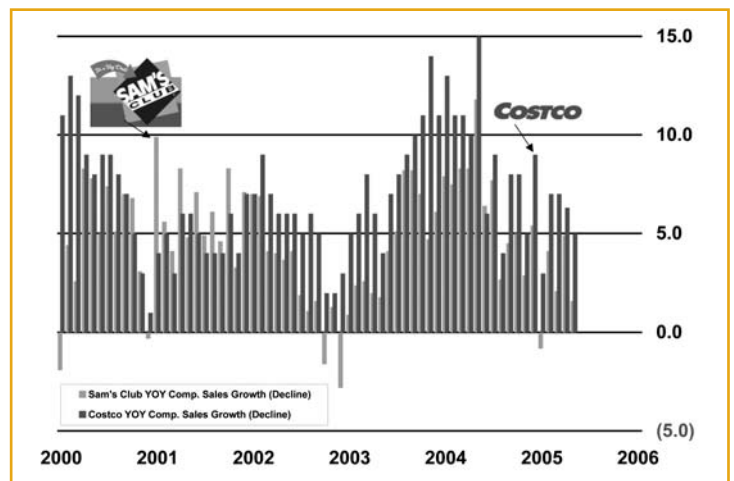


FIGURE 3 SAM'S CLUB VS. COSTCO MONTHLY COMP SALES GROWTH (%) 2000-2005



And, most important, will they ever come back, and if they do, how tall will they be this time around?

We do not claim to have all the answers to these questions. But we do have some plausible alternative explanations (or PAEs). We start first, however, with Wal-Mart senior management's own explanation.

The View From Bentonville

It is a well known fact that in-filling markets with Supercenters (and doing it rapidly) do lower the comp sales for other Wal-Marts. But according to Wal-Mart management, this is only a short-term phenomenon.

According to Wal-Mart Chief Financial Officer Tom Schoewe, cannibalization of older Wal-Mart store sales by new Wal-Mart stores lowers the company's overall same-store sales by about 1 percent annually, (but improves its overall profitability by an unstated percentage).

This phenomenon occurs because the negative initial effect from new stores wanes with the passage of time, as older stores return to the sales levels they had seen prior to the opening of neighboring Wal-Mart Stores—estimated to be within 24 months. However, the incremental new sales that come with the new stores, and the operational efficiencies that accrue to replenishing these stores which are now situated closer together, endure forever. In the end, the Wal-Mart enterprise at t+2 is richer not only in market share, but also enjoys a higher operating profit as well.⁶

Certainly, that is a plausible explanation. However, when we look at Wal-Mart Stores Division comp sales, we see that they were much higher during the 2000–2003 period than they have been since. In other words, if the new Supercenters had been maturing within two years and the affected Wal-Marts were reverting to their pre-opening sales levels, shouldn't we see the early signs of a trend reversal? Or should we wait for all Discount stores to be converted to Supercenters before seeing the overall positive comp sales impact?

Tom Schoewe and other senior Wal-Mart managers, including President and CEO Lee Scott, have been making this argument for several years now, and some analysts are starting to ask how many more years they'll have to wait before the comp store trends revert to some sort of a "normal?" Or is there, in fact, a "new normal" to which everyone needs to start adjusting? It seems that there is a story line here, but it just does not seem to come in a neat and complete package. In the latest Wal-Mart annual report, Lee Scott tries to tackle this issue head-on one

more time, but his commentary reads a bit more defensive, as he appears to introduce some new caveats as to when and how this "reversion to normal" happens.⁷ Our take on all this is a bit different.

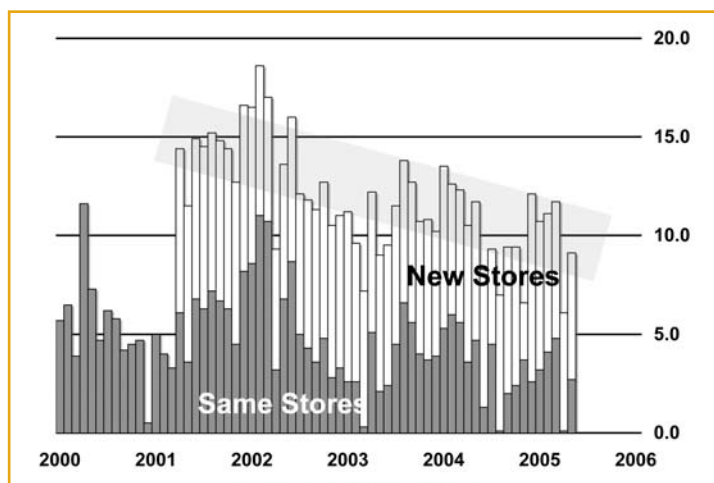
The View From Toronto and Maine

Fiscal 2004 (or calendar year 2003) marked the first year when the Wal-Mart Supercenter count in the U.S. portfolio passed the traditional Discount unit count. The actual square footage attributable to Supercenters already had surpassed Discount store space a few years back—during 2000–2001. Interestingly, if one looks at the chart in Figure 4, which separates the total sales growth due to the same stores (in dark) and the new stores (the lighter stack), clearly what dominates the sales momentum of Wal-Mart Stores Division are the sales from the new stores. However, it is equally clear that the levels of both the total sales growth and the comp or old store sales growth have been declining during the last several years. In fact, the major reason Wal-Mart enjoys the levels of sales growth it now does, is because it is adding new space in both the United States and internationally at unprecedented levels.⁸

Not surprisingly, then, we read in the latest Wal-Mart annual report, Lee Scott's bold statement that "[in] the U.S. alone, [they] estimate there is room for almost 4,000 more Supercenters."⁹

Four thousand additional Supercenters in their present configuration, if all new, correspond to about 750 million square feet of new Wal-Mart space—which is well in excess of the global Wal-Mart square footage as at January 31, 2005! Even if we were to assume that 135 million of that number corresponds to a complete conversion (to Supercenters) of the traditional Discount space, that still leaves us with 615 million new square feet in the United States, or roughly Wal-Mart Discount division

FIGURE 4 SOURCE OF OVERALL SALES GROWTH FOR WAL-MART STORES (%) 2000–2005



reaching an astounding 1 billion square feet in the United States for this division alone. Knowing what we know of the dynamics of retail trade and the consumer spending patterns in the United States, we believe that this is simply not a sustainable number in this country. If the argument here is that this can happen sometime in the future, then that will have to be one very long future indeed.

More realistically, we think that Wal-Mart, having knocked off all the regional Discount Department Store (DDS) players, may have now captured about 70-80 percent of the DDS business—and more than that in the trading circles tightly surrounding its stores.¹⁰ Consequently, it is no longer feasible for Wal-Mart Supercenters and the traditional Wal-Mart Discount units, to grow the nonfood business in the same stores by more than the growth of population + incomes, or roughly the real growth of the GNP + inflation. The growth in GAFO or Department Store Type Merchandise (DSTM) sales, which are reflective of this momentum, at about 4-5 percent in North America, is a more realistic figure to track Wal-Mart's comp sales growth against.

What this means, then, is very simple: If Wal-Mart's comp sales in the United States, Canada, and Mexico are at about 4-5 percent for the year, that would mean Wal-Mart probably has held onto its market share in its existing stores. Anything less, it probably lost some, and anything more, it has gained share in its existing stores.

On the other side of the coin, one might have expected that the transition, in big cities, from DDS units to Supercenters would have given these Wal-Mart stores another kick-up in same-store sales because shopping for groceries is once a week and the grocery side was supposed to increase the shopping frequency and thereby cause increased sales in the nonfood side of the store. That apparently has not happened, or may not be happening to the extent that senior management would have liked because of the points above.

This story, of course, does not end here as there are equally compelling developments on the supply side as well.

The New Competitive Space

Moving on and into the expanding competitive space of Wal-Mart, we observe that such chains as Chico's, Kohl's, J.C. Penney, Best Buy, Lowe's, Home Depot, Bed Bath and Beyond, and Gap's Old Navy, (and all the other dollar stores and value-oriented retailers previously identified in our article in the last issue of this newsletter¹¹), are all growing and opening new stores. These are the winners, the survivors, or the innovators of

the last major retailing cycle (i.e., the value era). Many of these fighters will not give up market share easily, for they have learned their lessons well, having matured in the previous retail cycle—the Wal-Mart era!

WITH EXTREME VALUE RETAILERS AT THE LOWER END, AND TARGET AT THE HIGHER, WAL-MART IS PROBABLY MORE IN CHECK TODAY THAN IT WAS AT ANY OTHER TIME IN ITS HISTORY.

In fact, some, such as Dollar General and Family Dollar think that they, too, can take a bite out of the food business in the United States, as they expand their stores to accommodate convenience food departments! These extreme value players are exceedingly nimble in entering and exiting markets, and in the design and execution of their stores and merchandise offer, are highly focused and disciplined retailers. Almost all of these players also are playing the cost/price leadership game as well as Wal-Mart, and have been enduring players who have historically thrived in the same market spaces as Wal-Mart. Think "natural selection" here to understand the power of some of these merchants. We think there is only one place for all these "value retailers" to go—up!

Target, the only remaining viable discounter in Wal-Mart's competitive space, is increasingly differentiating itself from Wal-Mart, primarily in more fashionable apparel, as well as in other product lines where they bring smart, sensible, and up-to-date "designs" to bear on their market offer. Now that it has shed its portfolio of the traditional department stores, Target is a much better and focused company today—focused on meeting and beating Wal-Mart at its own game.¹² During the 2004 holiday season, for example, while Target was advertising such hot items as a 4 megapixel Samsung digital camera for \$97 (regularly \$159), the least expensive digital camera in Wal-Mart's circular was a 3.1 megapixel Kodak EasyShare for \$149 (regularly \$198)!

In short, with extreme value retailers at the lower end, and Target at the higher, Wal-Mart is probably more in check today than it was at any other time in its history.

U.S. supermarkets also may have started to respond to Wal-Mart, by going upscale in fresh foods, and adding such services as gas stations, home delivery, gourmet entrees, etc. Several of the largest chains (Albertson's and Kroger) have announced somewhat sharper pricing actions, as they begin to invest heavily in cost/price reduction campaigns, but admittedly all food retailers are having a difficult time coming back from the Wal-Mart

induced earthquake in California. Safeway is also experiencing difficulties in California, but appears convinced its Lifestyle stores will be its salvation. The important point here is that U.S. food retailers may have finally learned their lessons, and may be able to shrink into a mass that is less vulnerable to Supercenters going forward. Whoever remains a player on the field in this sector will engage Wal-Mart much more vigorously than in the past.

It has become abundantly clear to all the retailers in this country and abroad that they simply cannot match or beat Wal-Mart on price across the board on a sustainable basis. But, they can meet and beat them opportunistically by moving faster than they can move. (Think guerrilla tactics here!)

Also, it has become quite clear to many players that Wal-Mart is very vulnerable to meaningful differentiation in its market spaces. So long as the cost of their differentiation does not exceed the marginal revenues—and the sensibilities of the consumer—many retailers are discovering that they can not only coexist, but thrive alongside Wal-Mart.¹³

Collectively, we believe that a smarter surviving competitive set, coupled with the extreme market share of Wal-Mart in many markets, will put some natural, and market-based boundaries in place to slow down Wal-Mart's growth in the United States. But when we reflect on our own shopping and/or fact-finding missions to our neighborhood Wal-Marts, we believe that the limits to growth for this colossus may still lie within.

In our recent visits to Wal-Mart, there is no question that we still find lower prices on most consumables, and a highly disciplined merchant that appears to be always in stock. But often, we also find:

- merchandise aisles that appear to get a little tighter and harder to navigate,
- floors that are a bit more littered, washrooms a little less clean,
- checkout lines that seem to get a bit longer every day, but most important,
- more frequent encounters with longer faces and more empty stares from Wal-Mart associates.

Are these local problems (store or district managers not on top) or a global issue (the contract is under stress)? It is too early to tell. But we can say, with near certainty that the "three-is-a-crowd" rule definitely does not apply in any of the Wal-Mart stores we have visited over the last several years in the United States or Canada.

Wal-Mart International (It Really Is Not Global—Yet!)

Finally, turning our attention briefly to Wal-Mart businesses internationally, we can't help but wonder if some of the same type of issues may be festering abroad as well.

As it is well known, Wal-Mart's operations in three countries—the UK, Canada, and Mexico—make up more than 90 percent of its international business and virtually all of its international profits. So, though seemingly a vastly "global" operation, the bulk of Wal-Mart's revenues still come from North America and the UK.

In Canada, Wal-Mart took over 123 Woolco stores in 1994, while they were doing less than C\$100 per square foot, and have moved these stores ever closer to C\$500 per foot in sales today. What is often overlooked is that, in the process, Wal-Mart Canada also doubled its square footage in this country—from under 15 million square feet to more than 30 million! The result of these moves is a whopping C\$12 billion–C\$14 billion in sales today in Canada in just a decade, and at whose wake now lie the carcasses of such long-standing retailers as Eaton's, Dylex, K-Mart—and a whole host of other lesser players in the country.

To give some scale to this incredible growth, today Wal-Mart Canada is a larger company than the Hudsons Bay Company (i.e., HBC Department Stores and Zellers, their discount arm), and Sears Canada combined! The downside, however, is that Wal-Mart also may be fast approaching "maturity" in Canada, and growing faster than the GNP here will prove difficult as well.

Recently, Wal-Mart began opening Sam's Clubs in Canada in order to get an additional boost in market share. However, Costco has been in Canada for more than 10 years and has locked up most of the best sites, (as well as a good chunk of the Canadian households and small businesses as members). Predictably, while some of the Costco stores in Canada are enjoying the highest sales volumes on the continent, Sam's Clubs are reportedly still struggling today.

Wal-Mart also is struggling in Germany, Argentina, and Brazil, and now owns 42 percent of a virtually bankrupt company in Japan that is losing money. In Germany, two "baby sharks" (small stores, only about 700 to 1,200 SKUs, little fresh) called Aldi and Lidl dominate the EDLP market position and collectively hold about 35 percent of the grocery market. Both chains are aggressively expanding globally, including the U.S. market.

In the UK, Tesco, not Wal-Mart's Asda, is the superstar. According to the most recent industry data, Tesco leads all food retailers in the UK with a commanding 30 percent share, with

Asda trailing a distant second at 16.5 percent, followed closely by Sainsbury at 15.9 percent. Most industry analysts expect that Sainsbury will soon reclaim the No. 2 spot it lost to Asda in 2003. Even the new boss of Asda, Andy Bond, was recently quoted as saying that rival J. Sainsbury Plc will likely “overtake [them] in the coming months.”¹⁴

In Mexico, however, the first international foray for Wal-Mart, it appears Walmex is virtually unstoppable. According to Bensinger (2005):¹⁵

Since a consolidation in 1997, Wal-Mart de Mexico SA, or Walmex, has steadily gobbled up everything in its path, posting soaring numbers—[where] sales increased 10.5%, [and when it] captured about a quarter of the retail market last year. Today, Walmex runs 411 retailers and 285 restaurants, is Mexico’s largest private employer, and has the second-highest market capitalization of any company on Mexico’s stock exchange. This year it will invest \$750 million, more than all its competitors combined, opening 70 new stores.

[Walmex’s] most recent victim is Carrefour, the world’s No. 2 retailer after Wal-Mart. The French company announced late last Thursday that it would sell all its 29 Mexican stores, plus two under construction, to Chedraui, the country’s sixth-largest chain, for a rumored \$545 million. The retreat comes only two years after Auchan, the world’s 23rd-largest retailer, also gave up on Mexico.

IT WOULD BE GRAVE MISTAKE TO UNDERESTIMATE THE (MARKET) POWER OF WAL-MART, BUT ALSO FOOLISH NOT TO REALIZE THAT IT IS A MATURE COMPANY TODAY—ON THE THRESHOLD OF A “NEW NORMAL” IN ITS LIFE CYCLE.

Eager to avoid such a fate, Soriana, Mexico’s second-largest chain, says it will invest more than \$300 million this year, and will fill its stores with what director of strategic planning Pedro Mejia calls “perks and improvements.” It also plans an enormous emphasis on customer service. “Until 2003, we only had one format: trying to get all clients,” he says. “Now our new stores are oriented to a higher socioeconomic level.”

On top of working to maintain a somewhat fancier atmosphere, with more expensive stores in wealthier neighborhoods, both Soriana and Comercial Mexicana have begun developing their own lines of higher-end products, a strategy analysts say was inspired by U.S. chains like Target.

In summary, it appears that as the “world gets flatter” and Wal-Mart’s footprint in many markets mature, many retailers

worldwide are beginning to learn how to “triangulate” from their collective experiences with Wal-Mart, and start connecting some of the dots. Going forward, we believe that it is the scope and speed of this learning—and not the sheer force of Wal-Mart’s market power—that will determine Wal-Mart’s local and global growth potential. Though it sometimes takes a long time to materialize, Newton’s Third Law of Motion still applies: For every action there is [always] an equal and opposite reaction—eventually!

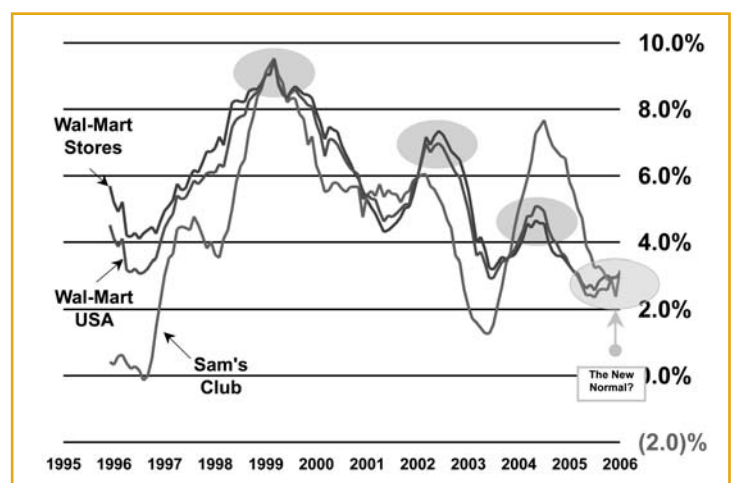
In Closing

We believe most of the PAEs and the underlying factors that might help explain Wal-Mart’s longer-term growth potential are relatively permanent. That leads us to a forecast—where we think Wal-Mart is stuck with a 3-4 percent same store sales growth and another 6-7 percent from its new stores—for a total of about 10-12 percent annual rate of sales growth. And that is likely a rate for the best of times. And that, in essence, may be the “new normal” for Wal-Mart as an enterprise as we go forward.

Certainly any major acquisitions by Wal-Mart such as the (coming) consolidation of Seiyu Ltd in Japan will likely boost its overall growth numbers transitionally. Equally likely, however, is a major economic downturn that could dampen its overall growth rate from high- to mid-single digits. Perhaps more importantly, we believe there will be more checks on Wal-Mart’s market power in the future by more able competitors in its changing competitive space at home and abroad.

There is in fact clear evidence that this process is well under way in Wal-Mart’s own numbers. Figure 5 outlines the comp store sales experience for Wal-Mart from 1995 to date. This is a long-term momentum chart, where monthly comp sales for Wal-Mart’s U.S. divisions—Wal-Mart Discount and Sam’s Clubs—are “smoothed” on a rolling 12-month basis.¹⁶

FIGURE 5 WAL-MART STORES COMP SALES – 12 MONTH MOVING AVERAGES (%) 1995–2005



Growth in Wal-Mart's comp store sales in the United States had peaked during the late 1990s at about 9 percent, and since then, and in fits and starts, has progressively come down to 3 percent today. For reasons we have tried to outline, we think it is unlikely this secular trend can be altered significantly in the future.

The key question for Wal-Mart enterprises as we go forward, however, still remains the following: Will its mid-level managers and associates "buy" into this new normal? In other words, will the new growth numbers translate into ample career opportunities, and will its stock momentum pave the path for them to reach a comfortable retirement in the future? If the short-term pay checks are not rich enough, and the future gains from the stock market are uncertain, what kind of a new "contract" will Wal-Mart need with its associates? And what if a union movement, likely to first evolve out of Canada, takes root, and begins to alter some of the initial assumptions of the economic model that is Wal-Mart today?¹⁷

Certainly, we do not have all the answers to many of these questions, but we do know the following:

This company became a billion-dollar operation during 1980, a \$100 billion company in 1997, and will easily exceed \$300+ billion in sales at the end of this year. Though one may call folks in Bentonville a lot of names, timid, unsure, or undetermined surely are not what first comes to mind!

It would be grave mistake to underestimate the (market) power of Wal-Mart, but also foolish not to realize that it is a mature company today—on the threshold of a "new normal" in its life cycle.

We also know that the world of retailing will never be the same, with or without Wal-Mart. And at the end of the day, whatever fate Wal-Mart enterprises and its associates may come to enjoy or lack in the future together, they will reflect back and be able to say that they made all the remaining retailers better—in their quest to make their own the same.

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ENDNOTES

¹ The company is a defendant in *Dukes vs. Wal-Mart Stores, Inc.*, a class-action lawsuit commenced in June 2001 and pending in the United States District Court for the Northern District of California. The case was brought on behalf of all past and present female employees in all of the company's retail stores and wholesale clubs in the United States. The complaint alleges that the company has engaged in a pattern and practice of discriminating against women in promotions, pay, training, and job assignments. The complaint seeks, among other things, injunctive relief, front pay, back pay, punitive damages, and attorneys' fees. The class as certified currently includes approximately 1.6 million present and former female associates of Wal-Mart.

² Historically, Wal-Mart has shunned PR activities, as it believed that they just added

to its cost structure without any measurable benefit. After a spate of bad-news headlines, a lengthy MSNBC and a PBS *Frontline* piece on Wal-Mart, its attitude appears to be rapidly changing.

³ The implication here is not that Wal-Mart pays its associates substandard wages.

On the contrary, Wal-Mart pay scales are at or above market in most locales. It's, however, a fact of life in retail industry that the entry-level wage scales tend not to be very generous across a whole host of retailers in the United States and Canada.

⁴ This is the title of a *Fortune* (November 10, 2003) essay on Costco, by John Helyar and is a recommended reading for interested parties.

⁵ It should be noted here, in case some readers overlook it, that in the United States, Sam's Club and Costco are "it" in this retail sector. There are no other critical mass retailers that matter. So the only yardstick to measure Sam's Club performance is Costco, and hence, the significance of this comparison. For similar reasons, Target vs. Wal-Mart comparatives are also highly important to analysts.

⁶ Which somehow reminds us of the famous MasterCard commercial: One Supercenter, \$75 million, Two \$150 million, three within a 10-mile radius? Priceless!

⁷ Lee Scott writes "... we locate new stores close to existing stores, a fact some have questioned. We take this approach in *growing markets* for several reasons. First, as the market continues to grow, we are the ones in position to serve customers instead of our competitors. Second, over time total sales from the two stores can almost double the sales of the original store. And third, we can relieve congestion in the first store and create a better shopping experience for our customers." The italics are ours. From *Wal-Mart 2005 Annual Report*, p. 12-3.

⁸ If we were to show you the same picture but for Wal-Mart as an enterprise, the story-line would be nearly identical to the one told here: The sales growth of Wal-Mart today is substantially attributable to Supercenter and international space additions—both of which may be under stress in the years ahead.

⁹ *Wal-Mart 2005 Annual Report*, p. 12-3.

¹⁰ At the end of 2004, Discount Department Stores line of U.S. retail trade was \$127.2 billion, and the Warehouse Clubs and Superstores were an additional \$247.3 billion business. Therefore total retail sales, in the competitive space of Wal-Mart in the United States during 2004, was \$374.5 billion. We do know that Wal-Mart Stores Division sales for the same time frame was \$229 billion, for a national market share of 61 percent!

¹¹ See, An Update on Value Retailing, *Retailing Newsletter*, Summer 2004, p.10-11.

¹² During their most recent annual meeting at Fayetteville, Lee Scott has reportedly told shareholders and employees that company's sales have recently languished partly because the company isn't selling enough merchandise to higher-income customers, and that though Wal-Mart's focus will always be on the less-affluent shopper, it will "need to widen [the] appeal to a broader range of customer."

¹³ In this context, the reader may want to also read the piece in a prior Newsletter (Winter 2003), titled *Some Food for Thought for Food Retailers Everywhere—How Loblaw Companies Is Standing on Guard for Thee in Canada*.

¹⁴ Elizabeth Rigby (2005), "Sainsbury could overtake Asda in months," *Financial Times*, June 3.

¹⁵ Like the United States, Mexico feels Wal-Mart era, *The Christian Science Monitor*, March 15, 2005

¹⁶ As you would suspect, in the United States, as the Wal-Mart Discount Stores go (i.e., Supercenters and the traditional Discount units), so goes the U.S. Wal-Mart Stores Division. The collective weight of these stores still far outweighs the swings Sam's Clubs brings to the U.S. data.

¹⁷ Wal-Mart Canada announced the closure of its unionized store in Saguenay, Quebec, a week ahead of schedule. The store, whose employees formed a union last year but never negotiated their first contract, was slated to close on May 6. Wal-Mart said the store, about 200 kilometers north of Quebec City, was not profitable. Employees at a Wal-Mart in Saint-Hyacinthe, Quebec, were certified as a bargaining unit by the Quebec Labour Relations Commission early this year. Last August, the Quebec labour commission certified the UFCW union at a Wal-Mart in Jonquière, Quebec.

Editor's Note

While this newsletter was in production, Wal-Mart's 2005 annual shareholders meeting took place in early June. Some of the "news" from this meeting adds additional color to the Serpkenci and Tigert article.

During this meeting, according to recent reports, Wal-Mart senior management is quoted as saying:

[It] "needs to clean up its stores, treat employees well and bring in more upscale goods to revive sales and profit growth, [and that] their 'game plan' for this year [will] involve targeting wealthier shoppers who may buy basics at Wal-Mart but look elsewhere for fashionable items, such as clothing and housewares."

"We aren't where we need to be, especially in the Wal-Mart stores in the U.S.," Chief Executive Officer Lee Scott told the annual meeting attendees in Fayetteville, Ark., [where] Wal-Mart [has] set three goals—making the company a better place to work, improving the shopping experience, especially for women, and being more aggressive in buying merchandise.

"We sometimes have inconsistencies in how clean a store is, or how organized," said Mike Duke, head of the U.S. Wal-Mart Stores division, Wal-Mart's largest unit [and] "Sometimes our checkout lines are too long and we're not staffed properly."

Remarkably, nearly all of these issues are topics of discussion in the Serpkenci and Tigert piece as well.

In their article, for example, the authors also argue that the core Wal-Mart issues are concentrated in the United States where 80 percent of Wal-Mart businesses still resides, and where they observe the same issues that senior management now concedes as being problem areas (i.e. Wal-Mart has the goods and at good prices, but most everything else has been slipping).

In other news from Fayetteville, some reports also have pointed to the fact that Wal-Mart has had great success with getting customers into its Supercenters, but the lion's share of sales growth has been concentrated in food—not general merchandise.

Such a trend, of course, is consistent with Serpkenci and Tigert's arguments that Wal-Mart's extreme share in general merchandise is a limiting factor in their sales growth. The authors also point to a number of trends in the competitive space of Wal-Mart, which they suggest "will [further] put some natural, and market based boundaries ... to slow down Wal-Mart's growth" in the years ahead.

It is typical of Wal-Mart to admit to its problems and confront them head on as they have done at its recent annual meeting. One of Wal-Mart's strongest corporate traits is that it is truly a learning organization. This company may not always get it right the first time, but they are quick to recognize problems and are aggressive in their search for solutions. As Serpkenci and Tigert note in their article, "though one may call folks in Bentonville a lot of names, timid, unsure, or undetermined surely are not what first comes to mind."

While slower growth may well be the "new normal" for Wal-Mart, it may be a higher quality growth. And, even if growth is not high in percentage terms, the rest of the retail world can still count on Wal-Mart to add the equivalent of a J.C. Penney to its top line each year, and several additional billions to its bottom line.

But perhaps more important, Wal-Mart will continue to improve its market offerings to its customers, and hence, raise everybody's game in their competitive space both in the United States and abroad.

ENDNOTE

¹"Wal-Mart announces new strategy to woo the wealthier customer," *Reuters*, Reported in *Globe & Mail*, p.B7, Saturday, June 4, 2005. See also, "Wal-Mart CEO Says Retailer Should Court Upscale Shoppers" and "Wal-Mart Shows Ire, Humility at Annual Meeting" *Dow Jones Newswires*, June 3, 2005.

2005-2006 PROGRAM DATES

- William and Mary, September 17-23, 2005
- William and Mary, April 29-May 5, 2006
- Monash, May 28-June 2, 2006
- Singapore, June 11-16, 2006
- Babson, September 9-15, 2006

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