Wal-Mart's Global Challenge

Wal-Mart has discovered that expanding overseas has high risks, but after some stumbles, high rewards are in the offing.

BY GREG MASTERS, Managing Editor

MAY 01, 2004 -- No one doubts Wal-Mart's progress in expanding its store base overseas, but the road hasn't been without travails. The international division is the company's fastest growing, last year gaining 16.6% while accounting for a fifth of revenue ($47.5 billion). But Lee Scott, the company's ceo, has publicly stated that over the next few years sales from the division must grow to a third of earnings and sales growth.

Wal-Mart's last stated figures auger well for that goal. The International division's sales for the five-week period ending April 2, 2004 were $5.025 billion, up 23.6% over sales in the same period in the prior year. Sales for the nine week period of $8.881 billion were up 23.0% over the similar prior-year period.

Wal-Mart has been generally successful overseas in a number of very important markets, says Patrick McKeever, an analyst at Atlanta-based SunTrust Robinson Humphrey. He points to its success in England with its acquisition of the 232-unit ASDA chain, for which it paid nearly $11 billion. The fact that ASDA had already begun modeling itself on Wal-Mart smoothed the integration. After the acquisition, sales evolved from $16.8 billion in 1999 to $21.7 billion in 2003. "It acquired a strong business and made it stronger," McKeever says.

According to a recent article in *Forbes*, ASDA's operations improved by adding general merchandise, underpricing rivals and ramping up its food and apparel offerings and, of course, bringing in Wal-Mart's state of the art inventory and logistics systems. In fact, sales per square foot in these U.K. units can reach $2,000, four times higher than at a Sam's Club, the *Forbes* piece claims.

By most accounts its partnership with Cifra in Mexico has been successful as well, says McKeever. Wal-Mart de Mexico is now the largest retailer in Mexico. Last month, it reported a higher than expected 33% rise in quarterly net profit. Aggressive expansion combined with price cuts and its "everyday low prices" campaign is credited for its success there.

Wal-Mart's Canadian operation is that country's third largest chain. In fact, more than 80% of Wal-Mart's international revenue comes from the U.K., Mexico and Canada.

Which leaves a lot of room for Wal-Mart to increase its slice of the $7 trillion global retail arena. But it faces formidable competition from France's Carrefour, Germany's Metro and U.K.'s Tesco—all of which have been doing business on foreign soils longer than the Bentonville giant.

Expansion overseas has come with a few stumbles. The chain entered Hong Kong in the early 90s and within two years folded the operation. In the mid-90s it entered Indonesia but soon exited there as well after rioters damaged a unit in the capital city of Jakarta. Its operation in South Korea has experienced difficulties owing to a merchandise mix judged askew from local tastes and the fact that its stores are sited too far from city centers and thus not accessible to many.

The weakest overseas business has been in Germany. In fact, the company finally released earnings figures for four of its 92 stores there, which show a substantial loss. The German publication *LebensmittelZeitung* recently reported those units alone lost the equivalent of $32 million (U.S.) on sales of $404 million (U.S.). Wal-Mart attributes the losses to staffing issues, problems with the implementation of Wal-Mart's distribution system, re-badging of stores, difficulties regarding the adaptation of the assortment and logistics systems, according to the newspaper.

Wal-Mart's troubles in Germany are also blamed on regulations forbidding Wal-Mart to institute its usual loss-leader strategy. It is forbidden to price goods below cost. Poor acquisitions are also cited—the Interspar chain it acquired in 1997, along with Wertkauf, had already been turned over several times. Another challenge has been regulations curtailing weekend hours. While Saturday hours were recently extended, Sunday is still dark for retailing.

"Wal-Mart has not been able to go to market with the same value proposition in Germany as in other markets," says McKeever. "Plus, the market is more competitive and consumers there have proven loyal to strong brands."

While Wal-Mart has stated it expects positive cash flow by the end of the year, no new stores are planned and a few have been shut down. A turnaround may be further off than predicted.

In a report from Columbus, OH-based Retail Forward, a global management consulting and market research firm, *Wal-Mart International: The Challenge Abroad*, author Steve Spivak, senior economist, points out that Wal-Mart's biggest mistake in its global operations may have been to "transplant its U.S. business model and management methods directly to a new market." Local populations can be resistant to "foreign approaches," he says.

Wal-Mart is facing similar challenges in what could potentially be an enormous market opportunity—China. Although the Chinese government recently decreed that it would ease regulations to allow foreign retailers to more easily open stores (in compliance with rules for its entry into the World Trade Organization next year), Wal-Mart is still slow in getting rolled out there.

Wal-Mart must decide which tier of service it will provide in China, says Sidney Li, managing partner at New York and Shanghai-based XL Enterprises. His company works with suppliers wishing to source from China and brand name customers looking to enter the Chinese market.

He agrees with Spivak's assessment, saying Wal-Mart may run into trouble if it thinks it can succeed in China by plopping down its traditional format stores. "Will they offer a deep discount or crank it up a notch and provide more service?" he asks. China is not as homogenous as the U.S., he points out.

The key, Li says, is that Wal-Mart must distinguish itself by presenting itself as a brand, and offer up more than deep discount goods. Chinese people don't have a problem accepting a non-Chinese retailer, he says. Carrefour and Metro have been doing very well there. But they do have to be sensitive to local cultures. For instance, he suggests Wal-Mart develop new designs and bring in higher-end goods because the Chinese consumer requires a bit of style. "It cannot present itself in China as the cheapest option. If they do that, they might have a problem," he suggests.

Wal-Mart faces tough competition from local players as well. Last month it was announced that China's Bailian will merge two department store chains to create the biggest listed retailer. Bailian, created last year as a seven-way merger, will fold Hualian Co. into Number One Department Store Co., creating a local giant with assets of 5.97 billion yuan ($721.4 million). The merged firm would be called the Brilliance Group Co Ltd. Its parent Bailian (Group) Co.—also known as the Brilliance Group—controls Lianhua Supermarket Holdings Co Ltd.

Bailian said in March it aimed to expand sales by 20% this year to more than $13 billion. The new entity will operate 14 department stores and three shopping malls around China's financial hub.

Other multinational retailers are increasing their presence in China as well. Last month, Swedish furniture retailer Ikea announced it plans to open eight additional stores in China over the next five years. In all, 14 Chinese cities have been identified as potential locations. Carrefour opened its first hypermarket in two years in Shanghai in March, its seventh store in Shanghai and the country's 43rd, according to China Economic Net. Carrefour projects opening 12 hypermarkets this year in China. Germany's Metro chain plans 40 more China units bringing its total to 50.

Wal-Mart has to play different in China than it does here in the U.S., Li says, especially in the big cities. But he emphasizes that it's a good time for Wal-Mart to establish itself as there is not a lot of product branding. "I wouldn't be surprised if they purchase some Chinese brands," he says. Wal-Mart has to create a brand or partner with a name brand. Without a brand, it will be tough to compete in China just on price, says Li.

David Schwartz, ceo of Framingham, MA-based Productive Environments, Inc. (PEI), a licensor of stationery products, agrees that branding is a key to Wal-Mart's growth plans. He points out, "Branding has come to mean not only better value but also enhanced function. Branding can be used to leverage a company's distinctive manufacturing strength, and conveys the promise that the user will have a better experience with the product. That's what brand value is all about."

Although Li acknowledges that Wal-Mart is a bit late getting rolling in China, he says it has sourcing leverage and, if it plays it right, sees no way that its competitors can keep them from growing.

China, of course, is vital as a supplier as well. Wal-Mart has doubled its imports from China in the past five years, buying more than $12 billion in merchandise a year, nearly 10% of all Chinese exports to the United States. And China is key to Wal-Mart's strategy of minimizing sourcing costs as well.

As far as other Asian markets, Japan is no doubt a potentially huge opportunity as well. McKeever says the retailer, through its partnership with Seiyu, has been taking a go-slow approach and has been carefully studying the market. Wal-Mart paid $46.5 million for a 6.1% interest in Seiyu in 2002. "They are slowly rolling out their systems and practices there," he says, putting their supply chain and prices into effect.

The 400-unit chain lost $65 million in 2003. But behind the scenes, Wal-Mart efficiencies may win the company a turnaround. Name brands are being replaced with more profitable store brands, and better integration with some of Wal-Mart's largest multinational suppliers—like Procter & Gamble, Nestlé, Johnson and Johnson and Kellogg—are being encouraged.

Last month, Seiyu opened a new store in a fishing village 62 miles west of Tokyo that features one instead of multiple floors, wide aisles and a long row of cash registers. The store is seen as a test of Wal-Mart-style layout, designs, brands and supply systems in Japan.

Spivak states that Wal-Mart still faces challenges implementing its Retail Link system in Japan as most suppliers there have yet to institute the technology needed to communicate efficiently with Wal-Mart's order and replenishment system. Plus, "retailer-supplier relations have traditionally been based on personal ties that often go back several generations," he says, "Switching to impersonal electronic relations will be a major cultural adjustment."

But Jeff McAllister, coo of Wal-Mart Japan, said in a statement that 36 of Seiyu's 403 stores were now using Wal-Mart systems including one that allows suppliers to monitor product sales.

The key for Wal-Mart overseas, says McKeever, is partnering with locals who know the lay of the land. He points to the recently acquired operation in Brazil, Bompreco. Wal-Mart purchased the 118-unit supermarket chain from Dutch retailer Royal Ahold in March for $300 million. Wal-Mart is keeping the management in place. "They know how to leverage management," says McKeever.

The deal merges the Bompreco stores with the 25 units Wal-Mart already has in Brazil, elevating the chain to the number three position with the potential to become the nation's top retailer. It faces formidable competition from the 500-unit Companhia Brasileira de Distribuicao (which took 14.6% share of the Brazilian food market) and Carrefour (12.6%). Each of the three chains operate multiple formats within the country. But the bulk of the major chains are in the country's southeastern region, while the Bompreco acquisition opens Brazil's northeastern territory to Wal-Mart's distribution systems and EDLP strategy.

Future plans are kept tightly under wraps but rumors circulate and pundits speculate. Most often cited as potential takeovers are an acquisition in India, the Esselunga chain in Italy, France's Auchan, Carrefour, Cora or Casino chains, Poland's Casino Géant stores, Spain's Mercadona and Japan's Daiei or Aeon chains.

The Philippines is an opportunity as well. Regulations there were recently eased to now allow foreign investment, though instability is a cause for concern, as is the fact that Makro has been established there for several years. It's been reported that Wal-Mart has been scouting locations around the capital city of Manila.

A meeting in Russia of 40 Wal-Mart managers to discuss logistical matters and consumer shopping patterns was reported last month. An acquisition or partnering in Russia is seen as particularly important. Spivak says it would allow Wal-Mart to hit the ground running in a marketplace that has quickly moved to a fast stage of growth.

The bottom line, Spivak recently told *RM*, is that Wal-Mart is not going away. Other retailers will need to beef up their supply chains or find a way to compete with Wal-Mart on factors other than price. "Otherwise, they just won't survive."

Consolidation via merger or acquisition is the climate for today's global retailer. As consumers are faced with a choice between lower priced goods and higher-priced brand name goods which offer more caché and perhaps more quality, the shopping experience has become fragmented, Ira Kalish, global director of consumer research for Deloitte Research, pointed out in a recent speech to the housewares industry in Cologne, Germany. This trend will force faster consolidation in the retail sector as stronger survivors gobble up weaker retailers, he said.

"Consumers who shop at Wal-Mart want a quality product at a great price," says David Schwartz, ceo of Framingham, MA-based Productive Environments, Inc. (PEI), a licensor of stationery products. "But at the same time, they need better products just as much. They will know a good price value when they see it. It is expected that programs that build this value-added into their brand will sell up with increased margins and strong volumes."