Why Wal-Mart Needs Help

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The world's most successful retailer needs help. Although Wal-Mart generated gross profits of $84 billion on $349 billion in revenue in 2006, its share price has stayed virtually flat since 2000. Domestic same-store sales crept up by just 1.9 percentage points in 2006 — the worst showing in Wal-Mart's history. International growth has been beset by humiliating failures. Public relations gaffes continue to dog the company, and there are few inefficiencies left to squeeze from Wal-Mart's hyper-efficient distribution system. The worst part is, all of these problems are interrelated, and they're coming to a head just as competition from rivals like Target and Costco is heating up. Let's take a closer look at the issues that are dragging Wal-Mart down.

1. Domestic Saturation

The Summary:
After years of U.S. expansion, Wal-Mart is running out of real estate.

The Challenge:
Opening new markets by overcoming opposition in U.S. urban centers.

The Key Fact:
Half of all Americans already live within a 10-minute drive of a Wal-Mart store.

Most retailers will tell you, "If you have the opportunity to grow, you take it." That's just what Wal-Mart did, opening 2,200 Supercenters — its largest and most profitable store format — since 1988. Now, however, the company is confronting the realities of domestic saturation as it becomes harder and harder to find spots to erect new stores. "It's a huge issue for them," says Philip C. Bonanno, a management consultant with Management Ventures Inc.

Typically, when a business dominates a market, it searches for other locations where it can expand. Unfortunately for Wal-Mart, its untapped markets tend to be in densely populated cities where the company's big-box format is an awkward fit. Exacerbating the problem, cities have stricter zoning laws and property is more expensive. Once a site is selected, the company often faces stiff opposition from neighborhood associations concerned about traffic congestion and negative impacts on local merchants, as well as labor groups who turn out against Wal-Mart's union-free policy.

"It's pretty easy to plop a store down on a highway in a small and mid-size rural community or a suburb," says Doug Fleener, a retail consultant with Dynamic Experiences Group. "But the majority of the market opportunities are in more challenging urban areas."

Elsewhere, many Wal-Mart stores are so close together that they now compete with one other. "It's the main reason why same-store sales have been flat," says David Abella, a fund manager and analyst with Rochdale Investment Management, which owns Wal-Mart stock. Analysts and shareholders are nervous — they don't see any easy ways to open up new markets within the U.S.

2. Sluggish Sales

The Summary:
Sales within existing stores have slowed.

The Challenge:
Luring more affluent shoppers.

The Key Fact:
In 2006, same-store sales rose by just 1.9 percent, Wal-Mart's worst showing ever.

When domestic saturation becomes a problem, retailers often try to wring more sales from the stores they already have. But Wal-Mart's price-conscious customer base makes that difficult to do.

Many Wal-Mart shoppers have moderate to low incomes. When gas prices rise or the job market tightens, these customers are among the first to scale back their retail spending. Appealing to more affluent shoppers — as Target and Costco have done — would reduce sales volatility while also increasing sales of bigger-ticket items. Trouble is, the Wal-Mart brand is a turn-off to many upmarket consumers.

Consider Wal-Mart's recent foray into fashion. During Christmas 2006, Wal-Mart went upscale and heavily promoted its Metro 7 clothing line. The effort went nowhere, because "the Wal-Mart customer is not fashion-driven," says Eric Beder, a retail analyst with Brean Murray, Carret & Co. Indeed, Wal-Mart's traditional shoppers shunned the new apparel, and upscale customers never walked through the door. Capping off the debacle, Claire Watts, Wal-Mart's top apparel executive, left the company in July 2007 "to pursue other career interests," according to a Wal-Mart spokesperson.

Wal-Mart is "great at the science of retailing, but they aren't great at the art of retailing," says Patricia Edwards, managing director and portfolio manager at Seattle-based Wentworth, Hauser and Violich. During the 2006 Christmas season, Edwards, whose firm owns Wal-Mart stock, walked into a Wal-Mart to check out its higher-end apparel. The clothes on display were mismatched, she says, and the presentation looked awful.

Wal-Mart's "stay lean" philosophy makes the company reluctant to hire more sales staff. But departments that require lots of hands-on service to succeed — like fashion and jewelry — suffer as a result. And suffer they did. During the 2006 holiday season, fashion was one of Wal-Mart's poorest performing departments.

3. Mixed International Results

The Summary:
Wal-Mart has been unable to steamroll its global competition.

The Challenge:
Succeeding in competitive international markets that are already home to incumbent retailers.

The Key Fact:
In 2006, Wal-Mart shuttered its failing operations in Germany and South Korea.

Another way to offset domestic saturation is by expanding internationally. In 1991 Wal-Mart launched its first international stores in Mexico. By 2005, it operated 6,200 facilities in 15 different countries. The numbers look impressive on paper, but in fact Wal-Mart hasn't been able to gain the upper hand against its international competition. The company has a foothold in Britain, Mexico, and Canada, but in the rest of the world, Wal-Mart has seen mixed results at best — and failure at worst.

The international effort has exposed Wal-Mart's weak spots. "The challenge when expanding internationally is properly assessing the strength of your competitors," says Cynthia Cohen, president of Strategic Mindshare, a retail-consulting firm. "Where there are strong competitors, they're often the hometown favorite because they do a really good job."

In Germany, after Wal-Mart acquired the well-respected 21-store Wertkauf chain of hypermarkets (supermarkets combined with a department store), it also bought out Interspar, another German hypermarket chain. Unfortunately, some of "the stores that Wal-Mart bought and the locations that they were in were not 'winning sites,'" says Bonanno of Management Ventures. Many of the Interspar stores, in particular, were dingy and in need of renovation.

More importantly, Wal-Mart never developed a feel for the German retail market. "Their culture is in many ways the antithesis of the U.S.," Edwards says. In the U.S., Wal-Mart's friendly greeters and helpful staff were highlighted in ad campaigns. Bargain-hunting Germans, however, prefer to shop unassisted and regard such effusive customer service with suspicion.

Even Wal-Mart's "Always low prices" approach failed to resonate in a country where roughly 30 percent of the retail market is dominated by local discount stores. Wal-Mart couldn't differentiate itself against German discounters like Aldi and Lidle, which offer low-price store-brand products considered as good or better than national brands. In 2006, Wal-Mart gave up and pulled out of Germany.

After years of disappointment, the same thing happened in South Korea, where Wal-Mart also bailed out in 2006. Wal-Mart's Japanese subsidiary continues to lose money. And after a dozen years of doing business in Argentina, the company operates only 13 stores there. Meanwhile, big retailers like Britain's Tesco and France's Carrefour are proving more adept at international expansion because they've been more willing to adapt to local conditions and develop deep relationships with local distributors.

4. Image Problems

The Summary:
Many Americans think Wal-Mart is evil.

The Challenge:
Rebuilding credibility as a good corporate citizen.

The Key Fact:
A 2006 document prepared by Wal-Mart’s longtime ad agency deemed the company’s sagging reputation as its biggest business challenge.

No other company in the United States comes close to receiving the public relations beating that Wal-Mart endures on nearly a weekly basis. Labor activists complain the company underpays its workers. Local activists point to boarded-up Main Street storefronts in hundreds of American towns and complain that Wal-Mart stores kill off mom-and-pop retailers. In 2006, it was revealed that an upbeat blog called “Wal-Marting Across America” was funded by Wal-Mart’s PR firm. Fired marketing executive Julie Roehm, accused of violating Wal-Mart's strict ethics policies by accepting gifts from vendors, recently sued the company, accusing CEO H. Lee Scott of doing the same thing.

Things have gotten so bad that fund manager Patricia Edwards says Wal-Mart has become the Phillip Morris of retailers — many of her clients won’t touch the stock because of the company’s reputation.

The pounding has taken a toll. A leaked copy of an October 2006 report prepared by ad agency GSD&M, which worked with Wal-Mart on its branding and other campaigns from 1987 until early 2007, noted that Wal-Mart’s consumer ratings as a “company I trust and respect” had declined steadily during the previous two years. The report asserted that Wal-Mart’s tarnished reputation has become its biggest business challenge. Indeed, the bad PR fuels opposition in cities and urban areas where Wal-Mart would like to expand and creates even more resistance to the brand for more affluent shoppers.

Wal-Mart felt that responding to its opponents granted them credence they didn't deserve, but “it’s the wrong strategy,” says David Splivalo, president of Freestyle Public Relations. “These are people who influence customers and people on Wall Street. Now Wal-Mart is playing defense and catch up.”

“When Sam Walton was running Wal-Mart, he just kept his head down and kept doing what he was doing. He had his critics, but he thought he was doing the right thing,” Fleener says. “But now the execs over there will tell you, ‘We blew it. We should have fought back, and we didn’t.’”

It’s hard to say how many customers stay away from Wal-Mart because of the bad press. But one thing’s for sure: Many of those people have no qualms about supporting other big-box stores, like Target and Costco.

5. Operational Efficiency

The Summary:
There's not much fat left to squeeze from Wal-Mart's ultra-lean supply chain.

The Challenge:
Finding new opportunities for cost reductions.

The Key Fact:
Wal-Mart missed its goal of installing RFID technology in 12 of its 137 distribution centers by the end of 2006.

As part of its commitment to everyday low prices, Wal-Mart has developed a reputation for logistics perfectionism. That zeal extends to Wal-Mart's suppliers, who are constantly prodded to eliminate inefficiencies from their own operations. If suppliers can't drop their prices enough, Wal-Mart will simply take its business elsewhere. "They will crush you," says Bob Bartlett of Bartlett Joseph Associates, a retail consulting firm.

For the most part, when Wal-Mart spurs suppliers to eliminate supply-chain inefficiencies, the efforts are mutually beneficial. But after years of effort, Wal-Mart has the most efficient supply-chain in the business, so there's little room left for improvement.

Worse, the most recent initiative that Wal-Mart promoted to kick-off a new round of efficiency gains has become a nonstarter. In 2003 Wal-Mart announced plans to embrace Radio Frequency Identification, or RFID, technology. Like high-tech bar codes, RFID chips are tiny electronic transponders that can be scanned from several yards away to provide detailed information about the contents of a box carton. Instead of scanning bar codes on each pallet of product passing through its warehouses, RFID would enable the process to be automated.

Yet implementing the new technology has proven more difficult than expected. Wal-Mart had planned to install RFID technology in 12 of its 137 distribution centers by the end of 2006, but because of continuing technical snags and high costs associated with implementing the system, the goal was never met. Instead, in late 2006, the company announced it was shifting the focus of its RFID push from distribution centers to stores. Today Wal-Mart has installed RFID systems in 1,000 of its 6,500 domestic stores.

"Wal-Mart is going slower with RFID, and I suspect that shows they recognize its weaknesses," says Russell Jones, a retail consultant with AlixPartners.

The go-slow approach may be wise in the long run. In the meantime, however, the RFID failure has been a humbling experience for Wal-Mart, underscoring the need to find new ways to wring more efficiency from the company's operations.