THE WALL STREET JOURNAL.
WEDNESDAY, OCTOBER 3, 2007 - VOL. CCL NO. 79

Wal-Mart Era Wanes Amid Big Shifts in Retail

Rivals Find Strategies To Defeat Low Prices; World Has Changed

By GARY MCWILLIAMS

The Wal-Mart Era, the retailer's time of overwhelming business and social influence in America, is drawing to a close.

Using a combination of low prices and relentless expansion, **Wal-Mart Stores** Inc. emerged from rural Arkansas in the 1970s to reshape the world's largest economy. Its co-founder, Sam Walton, taught Americans to demand ever-lower prices and instructed businesses on running a lean company. His company helped boost America's overall productivity, lowered the inflation rate, and strengthened the buying power for millions of people. Over time, it also accelerated the drive to manufacture products in Asia, drove countless small shops out of business, and sped the decline of Main Street. Those changes are permanent.

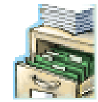
View a flash map of Wal-Mart's growth since 1962[0]

Today, though, Wal-Mart's influence over the retail universe is slipping. In fact, the industry's titan is scrambling to keep up with swifter rivals that are redefining the business all around it. It can still disrupt prices, as it did last year by cutting some generic prescriptions to $4. But success is no longer guaranteed.

Rival retailers lured Americans away from Wal-Mart's low-price promise by offering greater convenience, more selection, higher quality, or better service. Amid the country's growing affluence, Wal-Mart has struggled to overhaul its down-market, politically incorrect image while other discounters pitched themselves as more upscale and more palatable alternatives. The Internet has changed shoppers' preferences and eroded the commanding influence Wal-Mart had over its suppliers.

As a result, American shoppers are increasingly looking for qualities that Wal-Mart has trouble providing. "For the first time in a long time, quality has a chance to gain on price," says Lee Peterson, vice president at Dublin, Ohio-based brand consulting firm WD Partners Inc.

Now, the big-name brands that fueled Wal-Mart's climb to the top are forging exclusive distribution deals with other retailers, or working to reduce their reliance on its stores. **PepsiCo** Inc., which favored mass-market campaigns a decade ago, recently skipped Wal-Mart when launching a new energy drink in favor of Whole Foods Market Inc. Consumer-products giant **Procter & Gamble** Co. gets 15% of its revenue from Wal-Mart, down three percentage points from 2003.

RELATED READING1 

University of Minnesota economics professor Thomas J. Holmes has researched Wal-Mart's growth patterns and "economics of density" as they apply to the retailer. **Read his research**[2] and **see more animations**[3] of Wal-Mart's store openings.

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QUESTION OF THE DAY

Vote: Has Wal-Mart been good or bad for the American economy?[4]

INDEPENDENT STREET BLOG

Has Wal-Mart been good or bad for small businesses?[5]

Wal-Mart's effort to expand internationally has had mixed success in affluent markets. Last year it exited South Korea and Germany after failing to adapt to local tastes and achieve economies of scale. In Japan, the company's low-price, high-volume approach has struggled in a country where low prices often equate to low quality.

Wal-Mart remains an enormous force in retailing, of course. Its world-wide sales are almost three times those of France's Carrefour SA, the world's second-largest, publicly traded retailer. Wal-Mart's U.S. revenue is 4½ times that of discount-store rival **Target** Corp., and four times that of second-largest U.S. food retailer **Kroger** Co. Its clothing and shoe sales last year alone exceeded the total revenues of Macy's Inc., parent of Macy's and Bloomingdale's department stores.

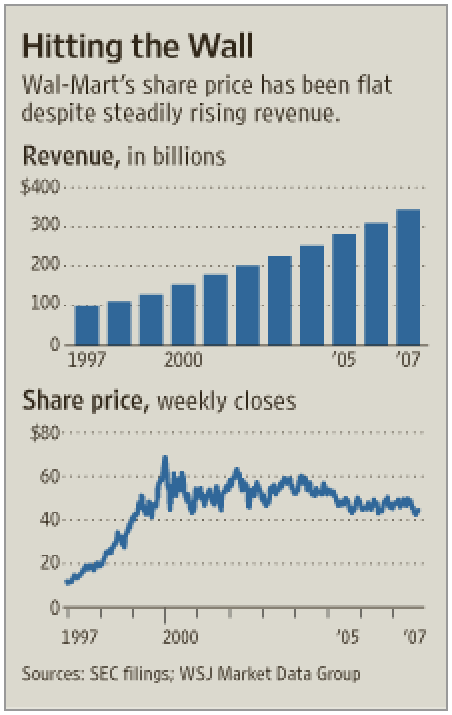
The company's unquenchable thirst for scale has been the secret to its market-changing power. "What we are is a 'supercenter' with one-stop shopping," said Wal-Mart's Vice Chairman John Menzer at an investors' conference last month. The company expects each year to build another 170 to 190 of the 200,000-square-foot supercenters that are its hallmark and convert 500 smaller discount stores to the bigger format over the next five years. "We would love to wave a magic wand and [make] every one of our discount stores a supercenter," he says.

But that very focus on scale is now a weakness, for the world has changed on Wal-Mart. The big-box retailing formula that drove Wal-Mart's success is making it difficult for the retailer to evolve. Consumers are demanding more freshness and choice, which means that foods and new clothing designs must appear on shelves more frequently. They are also demanding more personalized service. Making such changes is difficult for Wal-Mart's supercenters, which ascended to the top of retailing by superior efficiency, uniformity and scale.

"All retailers have a formula. They grow as far and as fast as they can with that formula," says Love Goel, a former Fingerhut Cos. executive and now chairman and CEO of Growth Ventures Group, a Minnetonka, Minn.-based private-equity firm that invests in retail businesses. Wal-Mart has outgrown its supercenter recipe, but efforts to win growth from more affluent consumers have fallen flat, he says. "They have hit the wall."

Wal-Mart declined to make an executive available for an interview and declined to respond to written questions, citing an upcoming meeting with Wall Street analysts.

Business history is littered with companies that grew to enormous size and used their girth to re-arrange the world to fit their strengths. Think International Business Machines Corp. in the mainframe business, General Motors Corp. in autos, or Microsoft Corp. in personal computers. For a time, their success bred an ecosystem that sustained their status. In the 1970s, independent software companies piggybacked on IBM's mainframes, resulting in greater demand for mainframe computers.



Such orchestration can produce solid growth for decades. But it can also produce corporate blinders. Over time, IBM's grip on the corporate data center left it unable to anticipate the decentralizing effects of personal computing. GM's knack at brand creation and frequent model changes left it vulnerable to the incremental quality approach of Japanese auto makers. Microsoft was so busy cramming features into its Windows operating software that it lagged others in the shift to the Internet. Each remains among the top in its industry; yet each has relinquished the role of industry definer -- IBM to Intel Corp., GM to Toyota Motor Corp., Microsoft to Google Inc.

Wal-Mart's great insight was perfecting the so-called "value loop" in retailing. At its most basic, the system works like this: Lower prices generate healthy sales gains and profits. Some of those profits went into further price cuts, generating more sales. The lower the price, the more consumers flocked to Wal-Mart.

But the value loop is beginning to unravel. For 10 years through 2005, Wal-Mart's sales gains at stores open at least a year averaged 5.2%. So far this year, its comparable-store sales, a measure of market share, is up just 1.3%. The pricing gap between Wal-Mart and rivals has narrowed, and more customers are now choosing convenience over wading through a supercenter.

That compares with comparable-store gains of 4.6% at Target, which markets itself as a trend-setting discounter, and 6% at membership-club rival **Costco Wholesale** Corp., which peddles $500 Bordeaux wines and $4,000 Cartier watches. While Wal-Mart has been portrayed as a ruthless employer, Costco has been praised for providing some of the best employee benefits in retail.

Wal-Mart's shares trade about where they were at the start of the decade, when the company produced less than half its current revenue. Shares closed yesterday up 40 cents at $44.87, and down 9.3% from the stock's year-earlier price. Earlier this year, Wal-Mart took the extraordinary step of ratcheting down its U.S. expansion plans because its new stores were stealing too much revenue from existing ones. That wasn't a concern in the 1980s and 1990s when Wal-Mart was regularly flattening competitors.

In some ways, Wal-Mart's loss of clout is a reflection of a more fragmented world. Retailing is a mirror to how we live and work. Big-box stores thrived by selling highly recognizable national brands, which themselves were fed by two phenomena: the growth of mass media and freeways, which encouraged large stores in remote areas. Stores and brands together achieved scale efficiencies that allowed them to overwhelm local chain stores and regional brands.

But the Internet is transforming the retail definition of scale. The once-stunning compilation of 142,000 items found in a Wal-Mart supercenter doesn't seem so vast alongside the millions of products available on the Internet. At the same time, the cost of creating and sustaining a national brand is rising because of media fragmentation. Niche brands, created by Internet word of mouth, are winning shelf space and sapping profits required to fund big brands' advertising. Manufacturers such as Apple Inc. and Phillips-Van Heusen Corp., lacking the retail distribution or presentation they crave, are opening their own stores. One result is that retail giants hold less sway over their customers -- and over their suppliers.

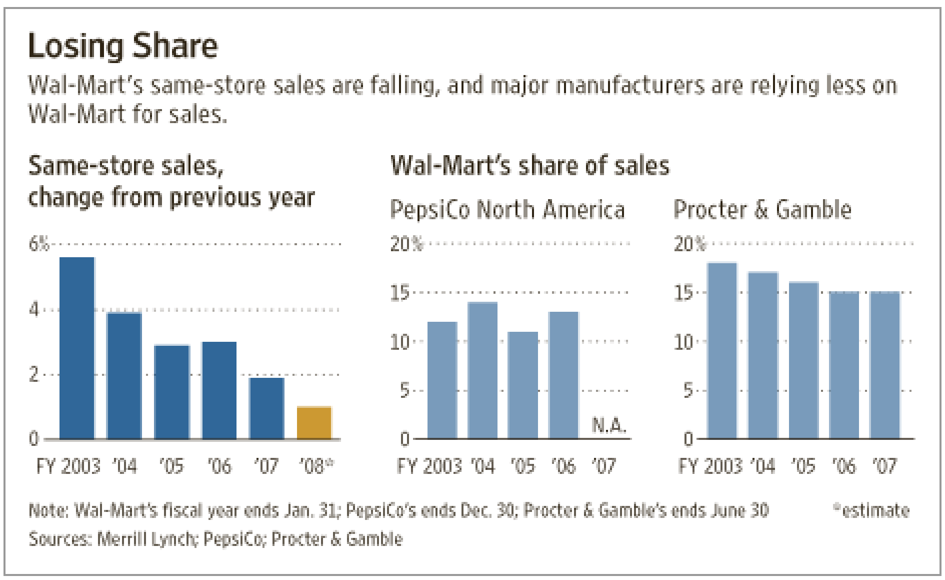
And across the landscape, numerous rivals are using a form of competitive jujitsu to keep the Bentonville behemoth off balance.

Grocery-store chains such as Kroger are resurging on sales of prepared or semicooked meals, which people can grab on their way home. Cincinnati-based Kroger projects sales at stores open at least a year will climb between 4% and 5% this year, on top of a 5.3% increase last year.

Thomas Kim, a financial analyst for a St. Louis scrap-metal firm, describes his family as frugal shoppers who check prices on the Internet. But he and his wife most often shop in local retailers. "It's the convenience factor," says Mr. Kim. His family avoids supercenters, describing them as too large and too crowded.

When Wal-Mart pushed heavily into consumer electronics earlier this decade, many industry observers expected it to flatten electronics chains. But five years ago, Best Buy Co. began aggressively marketing installation and other services alongside flat-panel TVs and PCs. Last year, Best Buy's total sales rose 16%. Wal-Mart, which has struggled to sell big-ticket HDTVs, has only recently begun selling installation services at a few stores using an outside supplier. It doesn't break out consumer-electronics sales, but analysts estimate sales last year rose 7.6% to $22.6 billion.

Melissa Morris says Best Buy won her loyalty by gladly accepting a notebook PC return and having trained sales clerks. "I go to a store that specializes or has associates there that know about it," she says. The Erie, Pa., sales executive refuses to go to Wal-Mart, citing its crowded aisles and hurried atmosphere.



Best Buy and specialty retailer PetSmart Inc., which touts pet grooming and kennel stays, put hard-to-copy services at the forefront of their pitch, says Howard N. Jackson, president of retail advisers HSA Consulting Inc., Knoxville, Tenn. "They realize the best way to win a fight is to make sure you don't get in one," he says.

Wal-Mart has long sold prescription drugs, setting up its pharmacy business in 1978. But national drug chains CVS Caremark Corp. and Walgreen Co. reacted by redefining their role and selling basic health services, such as school physicals, diagnostic tests, and flu treatment, alongside drugstore wares. CVS and Walgreen each acquired in-store clinic operations, redefining the pharmacy business as basic health-care centers.

Same-store sales at CVS and Walgreen are running about double that of Wal-Mart this year. Wal-Mart has begun offering leases to clinic operators.

Then there's the host of new entrants. In apparel, smaller retailers with niche market appeal like Hennes & Mauritz AB's H&M, Inditex Group's Zara and Los Angeles-based Forever 21 Inc. are growing by offering consumers rapid style changes. Outside the U.S., Britain-based Tesco PLC is challenging Wal-Mart by cultivating the Tesco brand across five different formats, including convenience stores and urban stores as well as supercenters. This fall, Tesco will open its first U.S. outlets, stores that will offer fresh and prepared foods and staples (see related article[6]).

As Wal-Mart's influence erodes, so does its allure to manufacturers. Burt P. Flickinger III, managing director of retail consulting firm Strategy Resource Group, says Wal-Mart now takes a back seat to regional grocery and national drug chains when it comes to striking deals.

He says some manufacturers now sell their wares faster at other retailers. "Four of the top 10 consumer-products companies say they can move merchandise faster with Walgreen and CVS," says Mr. Flickinger, who came up with the estimate from his talks with consumer-products firms. Such retailers have been rewarded with lower costs and better sales gains.

The change is apparent at PepsiCo. Wal-Mart is PepsiCo's largest customer world-wide, accounting for $3.16 billion in sales of drinks and snack foods. But earlier this year, PepsiCo opted to launch Fuelosophy, a new energy drink, at Whole Foods, a high-end supermarket chain.

"We thought that was the best place to introduce and test it," says PepsiCo spokesman David DeCecco. Whole Foods customers'"health and wellness" profile better match that of likely Fuelosophy buyers than Wal-Mart's, he says. He declined to name which other retailers were considered for the rollout.

Wal-Mart's loss of influence can also be seen in logistics. In 1984, Wal-Mart's decision to embrace bar-code scanners in its distribution centers and stores helped quash the use of a less-efficient technology then used at Sears, Roebuck & Co. and other retailers.

In 2003, the retailer brashly jumped onto the next big logistics technology, called radio-frequency identification, and mandated big suppliers begin slapping RFID tags on products shipped to its warehouses. Wal-Mart installed tag readers at warehouses and stores, hoping to further automate warehouses and lower inventory costs.

Wal-Mart quietly dropped the mandate earlier this year and refocused its development after suppliers complained of the high costs and lack of a return on their investment in the new technology. While the company says it's pushing ahead, Wal-Mart says it realigned efforts to focus on areas where the technology offered the most promise, such as assuring vendors' promotional displays are properly deployed in its stores.

Wal-Mart wasn't able to demand big suppliers continue investing in a technology that was raising their operating costs, says Ken Rohleder, president of Rohleder Group, a Louisville, Ky., supply-chain consulting firm. "There was a time when they could have dictated anything," he says.

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