Teaching Note

Walmart Stores: Gaining and Sustaining a Competitive Advantage

Teaching Objectives

This case is intended to be used as the first case in an introduction to strategy course or as a case to discuss cost advantage. The purpose of this case is for students to examine Walmart's strategy using the framework outlined in the textbook that defines strategy as a plan to achieve competitive advantage that involves making four strategic choices:

a) markets to pursue/compete in,
b) unique value (low cost or differentiation) the firm will offer in those markets,
c) the resources and capabilities required to offer that unique value better than competitors, and
d) ways to sustain the competitive advantage by preventing imitation." (see Real World Strategy, Chapter 1: What is Business Strategy?)

The case offers multiple reasons why Walmart has achieved a cost advantage but what students typically miss is the fact that many aspects of Walmart's cost advantage stems from Sam Walton's early decision to compete in rural markets where labor, rent, advertising costs were low (and where Walmart could price higher because of no competition from competitor discount stores because they avoided such markets because they weren't deemed large enough to support a discount store).

The Decision portion of the case is introduced towards the end of the case with the primary question being: How should Walmart respond to the growth of online purchases, and specifically to Amazon.com as a competitor? Is the acquisition of Jet.com enough to help Walmart successfully respond to the Amazon threat, or are more actions needed? This discussion allows for an examination of whether the resources and capabilities that Walmart developed to succeed in brick and mortar retail are transferable to online success (including a discussion of what new resources and capabilities Walmart must develop to succeed on line).

Study Questions

1. Why has Walmart been successful? What is the single most important factor that has contributed to Walmart's phenomenal success? [LO1] [AACSB Reflective Thinking] [Difficulty: Easy] [Bloom's 2 Comprehension]

2. Why exactly are Walmart's costs lower than its competitors? Examine each element of the cost structure (e.g., COGS, labor, rent, advertising, distribution,

technology, etc. as a percentage of total sales) and assess where Walmart's costs are lower than competitors—and why. [LO1] [AACSB Analysis] [Difficulty: Medium] [Bloom's 4 Analysis]

3. Why can't Walmart's competitors (e.g., Sears, K-Mart) imitate Walmart and realize similarly high profits? If you were running Sears-Kmart what would you do differently? What, if anything, from Walmart would you want to imitate? [LO1] [AACSB Analytic] [Difficulty: Medium] [Bloom's 3 Application]

4. Why do you think Walmart has had difficulty succeeding in foreign markets, especially in emerging markets like Brazil and South Korea? [LO1] [AACSB Reflective Thinking] [Difficulty: Hard] [Bloom's 5 Synthesis]

5. What should Walmart do to respond to the emerging trend of online purchases, and more specifically to the threat of Amazon.com as the dominant online retailer? [LO1] [AACSB Analytic] [Difficulty: Hard] [Bloom's 6 Evaluation]

Multiple Choice Questions

1. Why has Walmart been successful?
    a. Store costs
    b. Distribution
    c. Supplier relationships
    d. All of the above

"Answer:" D

2. What is the single most important factor that has contributed to Walmart's phenomenal success?
    a. Choice of markets
    b. Differentiation
    c. Branding
    d. Innovation

"Answer:" A

3. Why exactly are Walmart's costs lower than its competitors? Examine each element of the cost structure (e.g., COGS, labor, rent, advertising, distribution, technology, etc. as a percentage of total sales) and assess where Walmart's costs are lower than competitors—and why.
    a. Because Walmart has very low store costs due to location
    b. Because Walmart has an extensive distribution network
    c. Because Walmart has great supplier relations
    d. Because Walmart uses cutting-edge information technology

"Answer:" A

4. Why can't Walmart's competitors (e.g., Sears, K-Mart) imitate Walmart and realize similarly high profits?
    a. Because of Walmart's economies of scale
    b. Because of Walmart's economies of scope
    c. Because of Walmart's brand awareness
    d. Because of Walmart's market locations

"Answer:" D

5. If you were running Sears-Kmart what would you do differently? What, if anything, from Walmart would you want to imitate?
    a. Imitate Walmart's scale
    b. Imitate Walmart's marketing efforts
    c. Imitate Walmart's human resource practices
    d. Imitate Walmart's distribution methods

"Answer:" D

6. Why do you think Walmart has had difficulty succeeding in foreign markets, especially in emerging markets like Brazil and South Korea?
    a. Because emerging markets do not recognize the Walmart brand
    b. Because emerging markets do not have sufficient suppliers
    c. Because emerging markets do not offer rural markets with growth potential
    d. Because emerging markets do not have the necessary infrastructure

"Answer:" C

7. What should Walmart do to respond to the emerging trend of online purchases, and more specifically to the threat of Amazon.com as the dominant online retailer?
    a. Imitate Amazon by eliminating brick-and-mortar stores
    b. Develop a web presence as ubiquitous as Amazon
    c. Leverage advantages through existing distribution
    d. Use brick and mortar presence as notes in a distribution network

"Answer:" D

Teaching Plan

I. Aspects of Walmart's competitive advantage	15-20 min
II. Sources of Walmart's competitive advantage	20-25 min
III. How Should Walmart respond to Amazon?	15-20 min
IV. Summary of Key Ideas	10-15 min

I. Aspects of Walmart's competitive advantage

Question: Assume that you are hired by Sears/Kmart to identify the key elements that drive Walmart's success. What is the single most important aspect of Walmart that you would recommend that Sears/Kmart imitate in order to experience similar success?

Examples of Facilitating Questions:

- How does (____) help lower Walmart's cost?
- How much lower is Walmart's cost because of (____)?
- What does (____) have to do with Walmart's success?
- Walmart spends less than the competition on advertising. How do they get away with that?

While students may or may not identify the key aspects of Walmart's strategy initially, the instructor should help students identify and quantify the varying aspects of Walmart's competitive advantage. A summary of Walmart's advantages, as well as questions to help facilitate discussion, is found below.

Distribution

- Each distribution center serves roughly 150 stores within a 150-mile radius. Technological innovations enable Walmart's efficient distribution. Analysts estimated in the mid-1990s that Walmart's inbound logistics expenses were roughly 1 percent less as a percentage of sales than its direct competitors. In 2011, Walmart was the world leader in cross docking procedures.

Supplier Relationships

- Walmart's ability to put a supplier's product on the shelves of over 10,900 stores gives it tremendous leverage with suppliers. Walmart's 'Worldwide Sustainability index' uses various methods to track all stages of the product life cycle, from raw materials to disposal, and holds suppliers accountable for any unnecessary costs added to the supply chain. Walmart's Electronic Data Interchange and RetailLink systems provided all of its suppliers with up to the minute, point of sale data from all Walmart locations worldwide. Walmart's Scan 'N' Pay system made it possible for each product to be owned by the supplier until the product was actually sold by Walmart.

Information Technology

- Walmart spent .1-.3% more on information technology, as a percentage of revenues, than competitors (5 to 10 times more than competitors in absolute dollars). Walmart was known to invest more in information technology to facilitate effective communication between its stores, distribution centers, and suppliers, thereby leading to more efficient distribution, fewer stock-outs, and lower inventories.

Human Resource Management

- Walmart's labor costs were 10.1% of sales compared to 11.2% of sales for its direct competitors. Walmart had no regional offices, which was estimated to save Walmart .5-1% of sales each year. Regional managers were located at Walmart's headquarters and spent roughly 200 days a year visiting stores. Members of the top management team typically earned more than 90% of their compensation from incentives based on their performance, and less than 10% as salary. Walmart's lower labor costs were possible in part because a large percentage of stores were located in rural markets where labor costs were lower than in suburban markets. In addition, Walmart worked actively to prevent its labor force from unionizing. In one example, Walmart simply closed its meat cutters division and outsourced the entire operation to an external supplier rather than allow a meat cutters union to form.

Marketing and Merchandising

- Walmart started with almost no investment in advertising which was unnecessary in small rural towns where advertising was unnecessary because EVERYONE in the town new Walmart had come to town. It was such a big deal, and advertising costs in 2010 were only 0.6% while Target's were 2.0%. To ensure prices were low every day, Walmart conducted weekly price checks in nearly 99% of its competitors' stores. In rural locations where Walmart was the only discount retailer in town, Walmart's prices were 6% higher than in locations where a direct competitor was nearby.

Store Costs

- A much larger percentage of Walmart's stores were located in rural towns where land is cheaper than in suburban areas. Thus, Walmart's cost of stores (land/rent) has been roughly .4% lower than for competitors.

Benchmarking Walmart's Cost Advantage

Inbound Logistics	+1%
Information Technology	-.1% to -.3%
Labor Costs	+1.1%
No Regional Offices	+1.5% to +2%
Advertising Costs	+1.4%
Higher Rural Prices*	+2.9%
Store Cost/Rental Rates	+0.4%
Total Cost Advantage	8.0%

*'Higher Rural Prices' advantage was calculated by multiplying the average price increase in rural Walmart stores (higher by 6%) by the percentage of total Walmart stores in rural areas (48.6%).

II. The key sources of Walmart's competitive advantage

The purpose of this section is to help students see that even though there are many aspects to Walmart's competitive advantage, the main source of these advantages has come from Walmart's choice of rural markets and its distribution system that supports its stores in those markets. The line of questioning below is meant to help students arrive at that conclusion.

Question: Assume that I am the owner of Walmart and that you are the senior management of Sears/Kmart. As owner, I am willing to give you some of the things that you identified. If I gave you ( ) would that be sufficient to effectively compete against Walmart?

Question: If I gave you ( ), why or why not would you be comfortable in your ability as Sears/Kmart to successfully compete against Walmart?

Question: What else would you need to be able to effectively compete against Walmart? Would ( ) be sufficient?

(The previous two questions may be repeated as students prioritize which of Walmart's resources and capabilities are most critical to success. The teacher may also volunteer resources to the students, such as offering the Walmart brand, to help facilitate the discussion)

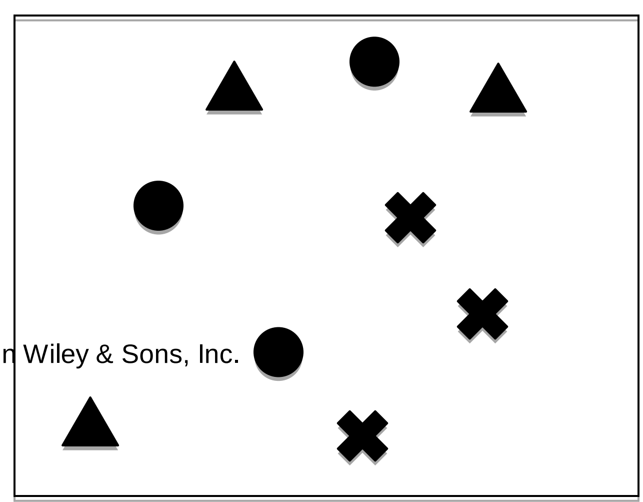
Question: What have I not given you?

Question: Why would Walmart's stores and distribution centers be the key to its competitive advantage?

At this point, it will be beneficial to show how the source of many of the cost advantages Walmart enjoys can be traced back to their choice of markets. Below are examples using each of the quantified advantages listed in the Benchmarking Walmart's Cost Advantage section above.

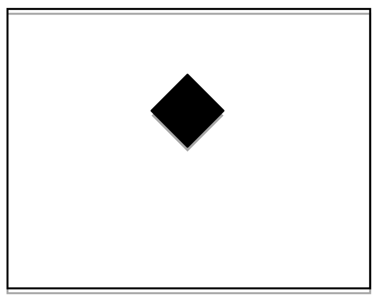
<u>Rural Markets vs. City Markets</u>

- In a typical large city market (such as Atlanta, Dallas, Philadelphia, Los Angeles), one would expect to find multiple discount retailers (an illustrative example of such a market is below).



*Each shape represents a different retailer such as Target, Sears, K-Mart, CostCo, Kohls, etc.

Compare this to a smaller rural city market where Walmart decided to locate, such as Rogers, Arkansas (its first store) or Sikeston, Missouri and Claremore, Oklahoma (its first stores outside of Arkansas).



Question: Which of these looks markets looks closest to perfect competition? To a monopoly?

After establishing the generic benefit of operating as a monopoly compared to operating in a competitive market, it should be much easier to see how many of the cost advantages Walmart enjoys comes from its decision to operate in these smaller markets.

<u>Labor Costs</u>

- Because Walmart is one of the largest, if not the largest, single consumer of labor in rural markets, it has significant bargaining power and can offer lower wages than it would be able to in large cities. It can also offer lower wages because the cost of living is lower in rural markets than larger cities.

<u>Advertising Costs</u>

- When a retailer builds a new store in a large market, they would typically need to not only signal to consumers that they are in that market, but also that they are better than the competition. For Walmart in rural markets, the store itself is most likely sufficient in letting consumers know that Walmart has arrived. There would also be less need, if any need, to signal to consumers that Walmart has lower prices if they are the only large retailer in the market.

<u>Prices</u>

- When there is significant competition and competitors are selling relatively homogenous goods, rivals will most likely compete on price. This leads to lower operating margins in the large city market. In the rural market, where Walmart is the only large discount retailer competing with a group of "mom & pop" retailers, they can raise prices without the worry of losing consumers to competitors which do not have the scale to offer lower prices.

<u>Store/Rental Costs</u>

- Real estate is cheaper in rural markets than it would be in large cities.

III. How Should Walmart Respond to Amazon and the growth of online?

Question: What is the current situation with regard to the online retailing market and Walmart's position in that market?

Walmart's success in the future will require that the company respond effectively to the growing trend towards online purchases and the emergence of Amazon.com as a major competitor. The online retailing market, 11.7% of total retail sales in 2016, is expected to grow from roughly $390 billion in 2016 to over $1 trillion by 2026. According to Internet Retailer, the problem for Walmart, and other companies trying to compete online, is that Amazon.com drove 65% of e-commerce growth in 2016. Walmart is losing to Amazon online in a big way.

In response to this trend towards online purchases, and to attempt to better connect with millennials, Walmart decided to purchase Jet.com for $3.0 billion. Like Amazon.com, Jet.com was an online discount retailer but one that focused on more price sensitive customers by attempting to provide better pricing than Amazon.com using a dynamic pricing model. One of the first things that CEO McMillon did after the acquisition was make Jet.com founder Marc Lore President of Walmart's U.S. e-Commerce business. But the acquisition of Jet.com—and putting Lore in charge of Walmart's e-commerce business—raised a number of questions going forward.

Question: If you were running Walmart, what actions would you take to compete more effectively online?

- Would you continue to run Jet.com as a completely separate site from Walmart.com? If so, for how long?
- Should Walmart.com adopt some of the innovative pricing approaches used by Jet.com?
- What other suggestions do you have for Walmart increasing its ability to compete effectively with Amazon.com?

IV. Summary of Key Ideas

It may be useful to use PowerPoint associated with this case as the key ideas are summarized in this section.

Walmart's Strategy: The inter-relatedness of Walmart's 4 strategic choices.

- **Choice of markets to serve**
  - First to locate stores in cities with less than 50,000 population
  - 1762 stores in rural America vs 476 stores for Kmart and 48 for Target
  - Higher prices in small markets
  - Lower costs in small markets

- **Walmart's Unique Value (Value Proposition)**
  - Everyday low prices for a broad range of goods that are always in stock in convenient locations; this explains WHY customers choose Walmart over other discount retailers.

- **Resources and capabilities to deliver that unique value**
  - Large footprint of rural stores
  - Distribution capabilities
  - Bargaining power over suppliers
  - Fewer layers of management
  - Culture of cost reduction
  - All these things are important, but the key to Walmart's strategy is the choice of Walmart's markets which allowed all of these things to become a success

- **Sustainable competitive advantage; what prevents imitation by competitors**
  - Competitors rationally refuse to enter Walmart's towns
  - First mover advantage which created a barrier to entry through a natural geographic monopoly
  - Success was initially driven by its choice of markets and its ability to offer lower prices than local competitors in those markets due to a more efficient business model

Note: Walmart has struggled globally because much of Walmart's strategy/ business model is hard to replicate in international markets, especially the small-town strategy. For example, this has not worked well in countries like Brazil an S. Korea due to:

- Lack of income in small markets in most countries
- Lack of vehicles for customer to drive to shop at a Walmart store
- Distribution is difficult w/ poor infrastructure in rural areas
- Managing in a foreign market is difficult, but even more difficult to find capable management in small towns

Strategic Management

Jeff Dyer

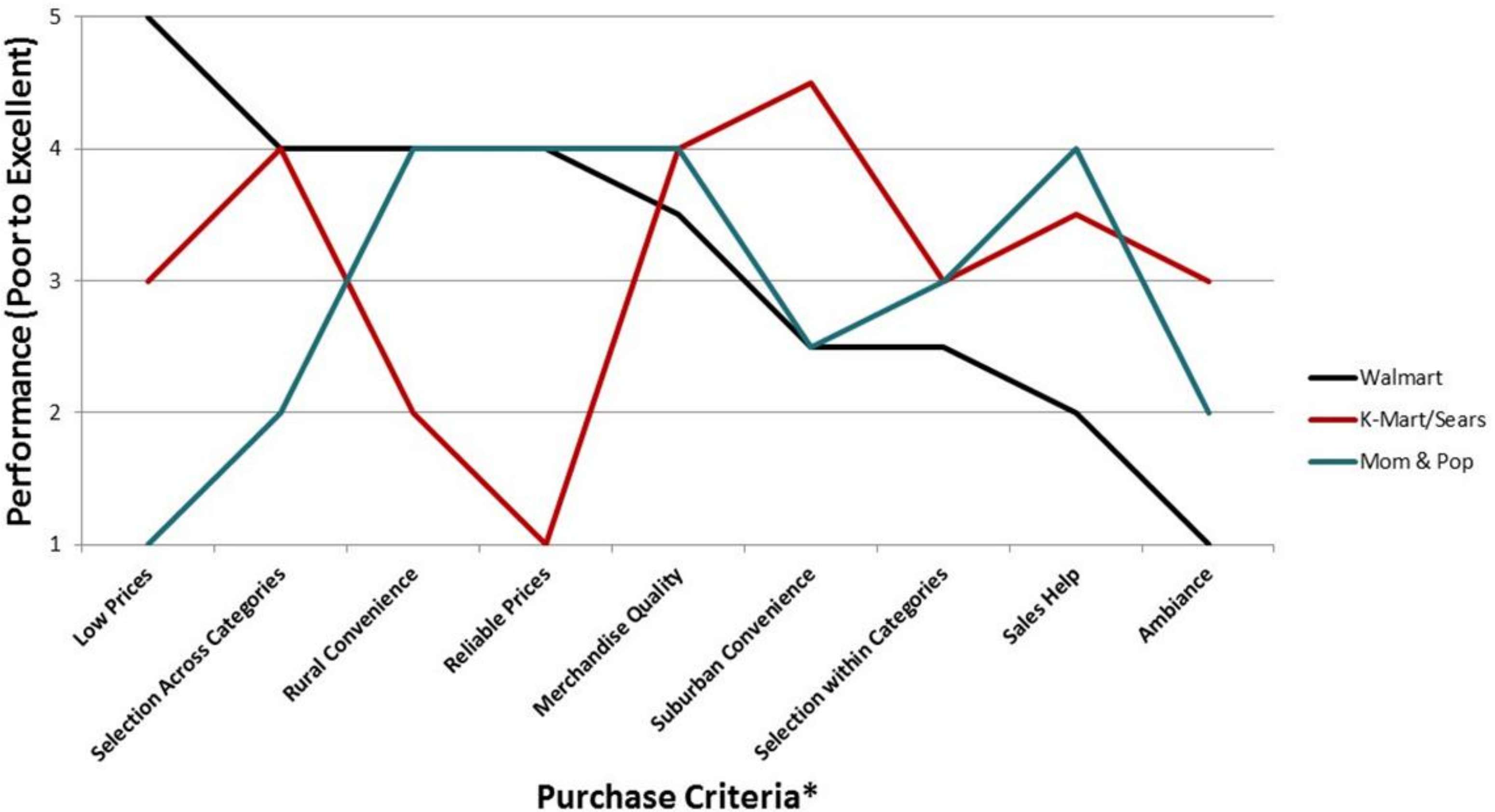
Third edition

Chapter 1

Walmart:

Gaining and Sustaining a Competitive Advantage

Walmart's Value Proposition



- Listed in order of importance to Walmart's target customer group

Why Walmart Wins

Walmart's Unique Value

Every day **low prices** for a broad range of goods that are always in stock in convenient locations.

How Walmart Wins (1 of 2)

Choice of Markets to Serve

- Walmart is first to locate discount stores in cities with less than 50,000 population offering low prices relative to "Mom & Pop" Stores.
- In 2003, Walmart had 1,762 stores in "Rural America" vs. 476 stores for Kmart and 48 for Target.
- Walmart's store prices are 6 percent higher in small town markets with "no competition" from discount retailers (e.g., K-Mart, Sears, Target).
- By locating more stores in small town markets Walmart incurs lower:
  - Advertising costs: by 1-2% of sales
  - Labor costs: by 1-1.5% of sales
  - Store rental / land expense: by .5% of sales

How Walmart Wins (2 of 2)

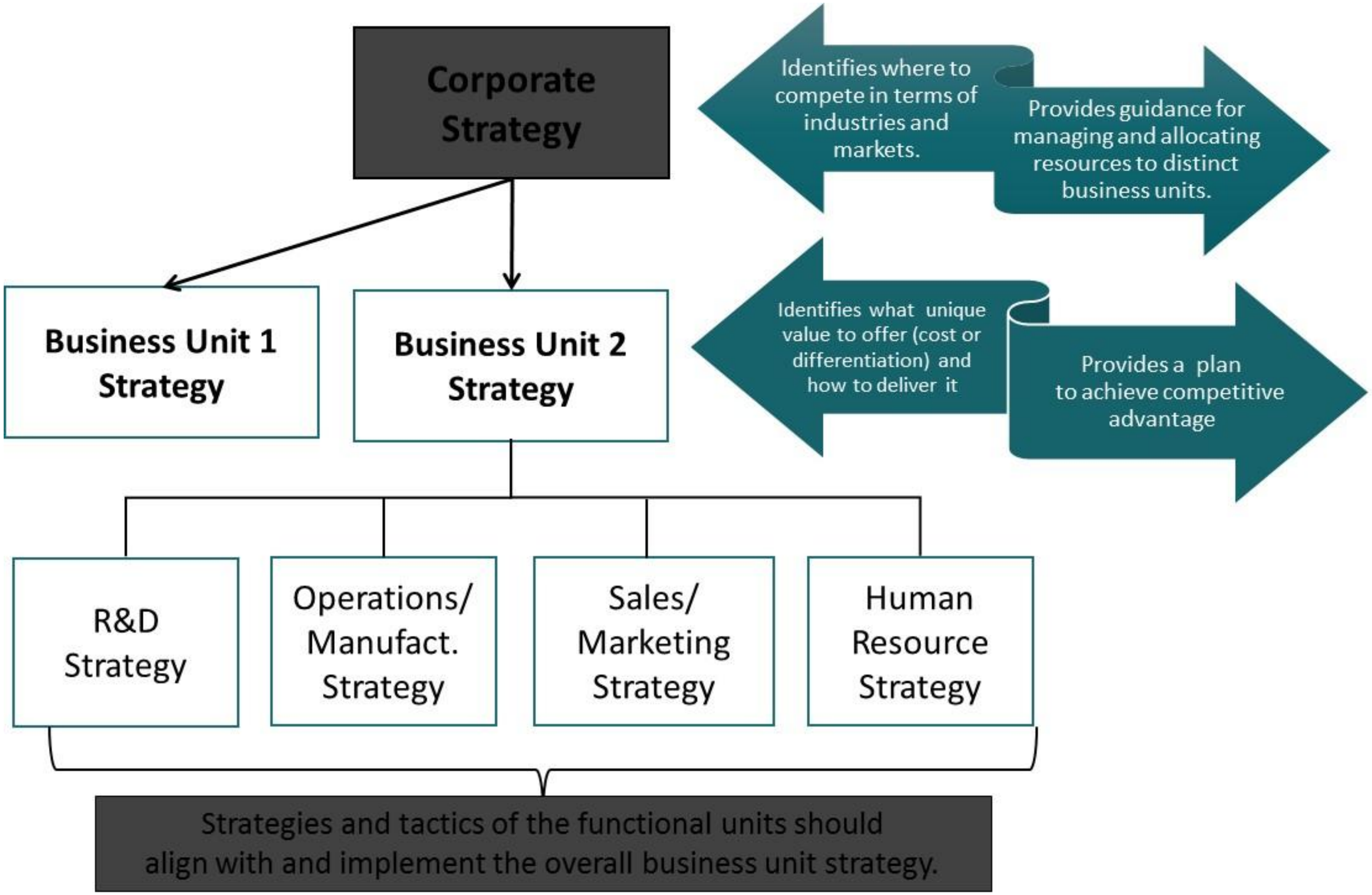
Resources and Capabilities

- **Distribution capabilities:** Walmart spends .5 percent more on technology but has the most technologically advanced distribution network in the industry with 2% lower distribution costs.
- **Bargaining power over suppliers:** Walmart gets low prices from suppliers due to high volumes of goods purchased and effective purchasing tactics.
- **Fewer layers of management:** Walmart spends less on general and administrative costs compared to the competition.
- **Culture of cost reduction:** Walmart's functional areas—human resources, operations, marketing, etc.—pursue low cost tactics that support it's overall low cost strategy.

Why Walmart's Advantage is Sustainable

- Competitors rationally refuse to enter Wal-Mart towns:
  - Wal-Mart is first in the small town with a minimum efficient scale (MES) store.
  - If a 2^{nd} mover builds a store it will create substantial overcapacity of supply; neither firm will make money.
- Wal-Mart's advantage is sustainable due to a first mover advantage which created a barrier to entry through a natural geographic monopoly.
- Wal-Mart's success was initially driven by its choice of markets and its ability to offer lower prices than local competitors in those markets due to an efficient business model.

Multiple Levels Of Strategic Analysis



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