Wal-Mart's Mexican Adventure

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Introduction

Wal-Mart is America's and the world's largest retailer. It was founded by the legendary Sam Walton in the 1960s, and by 2001, Wal-Mart generated over $100 billion in annual sales from 4,000 stores, more than 1,000 of which were now located outside the United States. The company operates three basic store formats: the traditional Wal-Mart stores, which sell a wide range of basic consumer merchandise, from household products to clothes and electronics; Wal-Mart supercenters, which are larger stores that have groceries added to the basic merchandising mix; and Sam's Clubs, which are deep discount stores that carry a limited range of low-priced merchandise and food. Although the company was still opening new stores in the United States in 2001, it had recognized since the early 1990s that its U.S. growth prospects were ultimately limited by market saturation. Believing that its unique culture, format, and operating systems would give it a competitive edge in many foreign markets, Wal-Mart embarked on an international expansion strategy in 1991, when it opened the first Sam's Club store in Mexico City. A decade later, Mexico is the brightest star in the company's international division, with over 500 Mexican stores generating $9 billion in sales. Getting to this point, however, was not easy. Wal-Mart had suffered several setbacks along the way that might have discouraged a less ambitious and nearsighted rival from continuing.

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Wal-Mart's Competitive Advantage

Wal-Mart's spectacular four-decade growth from a small Arkansas retailer to a national powerhouse was based on a first-class management team that pursued several innovative operations strategies. These strategies backed up the company's commitment to deliver a large selection of high-value merchandise at low cost to consumers.

The firm's early success was based partly on a strategy of locating in small southern towns that had no other major retail presence. When Wal-Mart entered most of these towns, its primary competitors were small mom-and-pop stores that had a much higher cost structure than the discounter. Wal-Mart quickly gained significant share in these towns and did not have to face competition from other discounters, such as Kmart, which were focused on large urban areas.

As the number of stores grew, Wal-Mart pioneered the development of a hub-and-spoke distribution system, where central distribution warehouses were strategically located to serve clusters of stores. This system allowed Wal-Mart to replenish stock in its stores rapidly and to keep the amount of store space that needed to be dedicated to inventory to a minimum. The results included higher sales per square

foot and more rapid inventory turnover. This combination helped to increase store sales and drive down inventory and logistics costs. The firm was also one of the first to utilize computer-based information systems to track in-store sales and transmit this information to suppliers. The information provided by these systems was used to determine pricing and stocking strategy and to manage inventories better. The combination of state-of-the art information systems and the hub-and-spoke distribution system allowed Wal-Mart to build the leanest supply chain in the industry. Wal-Mart is still a leader today in information systems. All Wal-Mart stores, distribution centers, and suppliers are linked together via sophisticated information systems and satellite-based communications systems that allow for daily adjustments to orders, inventories, and prices.

Wal-Mart is also famous for a dynamic and egalitarian culture that grants major decisionmaking authority to store managers, department managers, and individual employees (who Wal-Mart refers to as "associates"). Wal-Mart is renowned for treating its employees extremely well, but at the same time, for demanding commitment and excellent performance from them. This culture is backed up with generous profit sharing and stock ownership plans for all employees, including associates, which makes every employee "think and behave like an owner of the company." Wal-Mart has thus developed a culture and a control system that create incentives for associates and managers to give their best for the company. The result is higher employee productivity, which again translates into lower cost.

As Wal-Mart has grown, it has also garnered significant leverage with its suppliers, whether they are small manufacturers or global enterprises, such as Procter & Gamble, for whom Wal-Mart is the largest single account. Wal-Mart has used this leverage to demand lower prices from its suppliers, and it passes the savings on to its customers in the form of "everyday low prices."

Mexican Genesis

By 1990, Wal-Mart was concerned that its growth rate in the United States would inevitably slow down. This trend would slow stock price appreciation for Wal-Mart, which would be bad news for the thousands of Wal-Mart associates who were also stockholders. The company embarked on two strategies to recharge its growth rate. The first was expansion into the grocery business with the opening of Wal-Mart supercenters that would stock food products in addition to Wal-Mart's traditional merchandise. The second strategy was international expansion.

At the time that Wal-Mart was considering going international, the United States was entering negotiations with Mexico and Canada for creating a North American free-trade area (subsequently called NAFTA). This piqued Wal-Mart's interest in Mexico. Historically, significant barriers to cross-border trade and investment, substantial state involvement in business activity, and high inflation had characterized the Mexican economy. Under the government of Carlos Salinas, a Harvard trained economist, however, Mexico had embraced free-market reforms. State-owned enterprises were being privatized. Barriers to trade and investment with the United States had already been lowered significantly by Salinas and would fall much further under the NAFTA proposal. Tariffs on goods imported from the United States had come down from as much as 100 percent in the mid 1980s, to a maximum of 20 percent by the early 1990s. Under NAFTA, many of these tariffs would fall to zero. Many barriers to cross-border investment had been eliminated. Salinas had also imposed a tight monetary policy, which had lowered Mexico's inflation rate into the single digits. The country's economy was growing at a 4 to 5 percent annual rate by the early 1990s, faster than that of the United States, while disposable income had increased by some 70 percent since Salinas took office in 1988. Although Mexico was still a very poor country by U.S. standards, approximately 30 million of its 80 million people could now be classified as middle class. This segment was concentrated in three main urban areas: Mexico City, Guadalajara, and Monterrey.

Although the Mexican retail market was still fragmented and dispersed, four national supermarket chains had emerged and accounted for over 30 percent of the retail market. The largest of these, Cifra, operated about 120 discount and grocery stores in 1991 and generated sales of approximately $2.2 billion. Wal-Mart founder Sam Walton had first met one of Cifra's three founding brothers, Jeronimo Arango, in 1990. The two men immediately hit it off and both agreed that the free-trade deal being negotiated among Canada, Mexico, and the United States opened opportunities for Wal-Mart to cooperate with Cifra in Mexico.

Having decided that Mexico would be a good proving ground for its foreign growth strategy, Wal-Mart employees debated several options for expansion, including licensing its brand name to franchisees, expanding via wholly owned subsidiaries, or entering into a joint venture with a Mexican company such as Cifra. The company quickly concluded that its competitive advantage was based on the combination of corporate culture and its supporting information and logistics systems, and that such a combination would be difficult to transfer to franchisees. The management know-how that underlay Wal-Mart's culture and systems was simply not amenable to franchising. At the same time, Wal-Mart realized that it knew little about the culture and business systems in Mexico, so the company decided to enter into a fifty-fifty joint venture agreement with Cifra.

Teething Problems

Wal-Mart's Mexican expansion began with the establishment of a single Sam's Club store in Mexico City in 1991. In 1992, Wal-Mart established six more stores, all Sam's Clubs, in Mexico. In 1993, the company began to open stores under the Wal-Mart name. When the first store in Mexico City opened its doors, an enormous crowd showed up, and all seventy-two cash registers were ringing constantly. It didn't last. Within months, the sales rate at Wal-Mart's Mexican stores had slowed down considerably, not surprising perhaps in a country where per-capita income was only about $2,000 per year. But according to critics, the problems had more to do with missteps by Wal-Mart than low income levels.

When Wal-Mart opened its first store in Monterrey in 1993, it had to bar the doors to control the crowds. Soon the local press was lambasting the company, however, for charging 15 to 20 percent more for merchandise than it did at its Wal-Mart store across the border in Laredo, Texas, a two-hour drive to the north. A Wal-Mart spokesperson pointed out that the higher prices reflected the transportation costs between the Wal-Mart distribution center in Laredo and its Monterrey store. In addition, the NAFTA agreement had not yet been implemented, and high tariffs contributed to the higher prices. But Wal-Mart also conceded that it was having problems replicating its U.S. distribution system in Mexico. Poor infrastructure, crowded roads, and a lack of leverage with local suppliers (many of whom would not or could not deliver directly to Wal-Mart's stores or distribution centers, as was common in the United States), all led to higher prices and lower margins for Wal-Mart.

Another problem was getting the right selection of merchandise. Many of the first Wal-Mart stores in Mexico carried items that were popular in the United States but were rarely used in Mexico, like ice skates, riding lawn mowers, leaf blowers, and fishing tackle. Managers would slash prices on these items to move the inventory, only to find that Wal-Mart's automated information systems ordered more to replenish the depleted inventory.

Then there were problems with government bureaucrats. After the implementation of NAFTA in January 1994, Wal-Mart believed that things would get easier, but it was not to be. In the summer of 1994, Mexican government inspectors made a surprise visit to Wal-Mart's new superstore in Mexico City. The inspectors found thousands of products that they claimed were improperly labeled or lacked instructions in Spanish. The store was ordered shut for seventy-two hours while the oversights were corrected. This brush with what they saw as overzealous inspectors sobered Wal-Mart's managers. The 200,000-square-foot supercenter that was inspected carried about 80,000 products. Each now had to be labeled in Spanish to indicate the country of origin, contents, instructions, and, in some cases, an import permit number. The inspectors charged that about 11,700 pieces of merchandise lacked such labels. Wal-Mart's managers responded by pointing out that many of the targeted goods—about 40 percent or more—were purchased from a local Mexican distributor. Nevertheless, the regulators insisted that the retailer had ultimate responsibility for the labeling. Some Wal-Mart managers wondered if this kind of bureaucratic red tape was a deliberate attempt by government officials to raise the costs of doing business in Mexico and thereby frustrate Wal-Mart's expansion plans.

The 1994 Peso Crisis

As if these problems were not enough, in late 1994 the Mexican economy took a sharp turn for the worse. The Mexican currency, the peso, had been pegged to the value of the U.S. dollar since the early 1980s and was allowed to depreciate by only about 4 percent per year against the dollar. Since the mid

1980s, prices in Mexico had risen by about 45 percent more than had prices in the United States, making the current exchange rate increasingly difficult to maintain. In 1993 and 1994, the Mexican economy responded to the drop in tariff barriers by importing products at a rapid rate. By late 1994, Mexico was running a $17 billion annual deficit on merchandised trade, which amounted to about 6 percent of the country's GDP. Currency traders began to place large bets that the Mexican government would be forced to devalue the peso against the dollar. Fearing this outcome, foreign investors who had rushed into the country in 1993 and early 1994, buying Mexican stocks and pushing the stock market up to record levels, reversed their course and moved a lot of money out of the country.

The Mexican government stepped into the foreign exchange market to defend its currency, using its foreign exchange reserves to buy pesos. But the outward flow of funds was so great that Mexico soon realized that its strategy would only deplete its foreign exchange reserves. Accepting the inevitable, in December 1994 the Mexican government announced that it would no longer peg the peso against the dollar and would let it float freely on the foreign exchange market. Immediately the peso plunged, losing about 40 percent of its value against the dollar in a matter of days. The Mexican economy plunged into an economic recession.

For Wal-Mart and other American firms that had moved into Mexico to take advantage of NAFTA, this was a severe blow. By this time, Wal-Mart had sixty-three stores in Mexico, but many of them were still stocked with goods imported from the United States. The fall in the value of the peso meant that it now cost even more to bring in goods from the United States, while the economic recession that now gripped Mexico meant that consumers had even less to spend. Over the next two years, retail sales in Mexico were to fall by 16 percent. Wal-Mart, which had planned to open another twenty-five stores in 1995, quickly put its Mexican expansion plans on hold.

Expansion Resumes

Although Mexico was to experience a two-year economic slowdown, the United States economy continued to grow. With Mexican goods now costing less in the United States and with trade barriers reduced or eliminated under NAFTA, Mexican exports boomed. Foreign companies began to invest heavily in the country, seeing it as a low-cost location from which to export to its giant neighbor next door. The combination of an export boom and rapid foreign direct investment created jobs and helped to lift the Mexican economy out of its slump. Seeing that the corner was being turned, Wal-Mart's expansion plans were back on track by late 1995.

By mid 1997, Wal-Mart had about 145 stores in Mexico. Unlike several other foreign retailers, it had decided to take advantage of the economic slump to build its market share. The company was also making strong improvements in its operating efficiency. It had opened a distribution center in Mexico City, and it rapidly became the most efficient in the entire Wal-Mart system, in part due to very low labor costs. This allowed Wal-Mart to start reducing its inventory and logistics costs. Wal-Mart had also struck a three-way partnership with EASO, a Mexican trucking company, and MS Carriers Corp, a U.S. trucking company that does significant work for Wal-Mart in the United States. Under the agreement, MS Carriers shared its fleet of modern trucks, as well as its satellite systems designed to help plan delivery times, with EASO. This arrangement helped EASO cut its costs by 25 percent, and it passed the savings on to Wal-Mart, which now uses 200 of EASO's trucks to run its Mexican logistics system.

Wal-Mart also started to sell far more Mexican goods, in part because many of its suppliers had themselves located in Mexico to take advantage of lower production costs and the advantages under NAFTA. In an example of the savings this strategy produced, Wal-Mart officials cite the case of a Vega television from Sony. Imported from Japan, the combination of transportation costs and a 23 percent tariff meant that the television retailed for $1,600 in Wal-Mart's Mexican store, out of the reach of all but the most affluent Mexican consumers. But in 1999, Sony built a Vega television factory in Mexico to take advantage of NAFTA. The television now costs about $600 in Mexico, and sales are picking up.

Wal-Mart had also learned from its early mistakes and thus improved the mix of product offerings at its Mexican stores. Slow-moving items such as leaf blowers had been replaced by items that sold well in Mexico but would not in the United States, such as maids' uniforms. As its scale of operations in Mexico grew, Wal-Mart was also able to use its purchase volume to gain leverage with suppliers and bargain

down prices in return for large purchase volumes. Wal-Mart then passed these prices on to consumers, enabling the company to gain market share and remain profitable even as total retail spending in Mexico shrank during 1995 and 1996. In contrast, Sears and Kmart, two U.S. competitors that had entered Mexico at the same time, left the country.

In mid 1997, Wal-Mart signaled its continuing commitment to Mexico by purchasing a controlling interest in its joint venture partner, Cifra. By combining Cifra's stores with the stores established by the joint venture, Wal-Mart now had 373 stores in Mexico, making it the largest retailer in the country by far. The new company was then listed on Mexico's stock exchange, the Bolsa, as Wal-Mart de Mexico (it soon become known as WalMex). The listing allowed Wal-Mart to begin introducing the same stock-based incentive plans for its associates in Mexico that had worked so well in the United States. Wal-Mart retained a 54 percent stake in WalMex, which it raised to 60 percent in April 2000.

By 1999, Wal-Mart felt that it had improved its cost structure in Mexico to such an extent that it could now start to be more aggressive about passing on cost savings to Mexican consumers. In August 1999, it closed down a supercenter in Mexico City for a single day and marked down all prices by 16 percent. It then reopened under the banner of "everyday low pricing." Sales surged, with the growth in volume more than making up for the lower prices. The experiment was such a success that Wal-Mart rolled out the program in all of its Mexican supercenters a month later. In May 2000, the program was extended to cover all Wal-Mart stores in Mexico. By July 2001, WalMex same-store sales growth exceeded that of competitors for eight out of the last twelve months, and for seven months in a row.

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