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Wal-Mart Rolls Back The Middleman

Bruce Upbin, 04.02.04, 5:44 PM ET

Wal-Mart is famous for its everyday low prices, and just as infamous for maintaining those low prices by negotiating tough deals with suppliers. Its steep, sudden discounts, or "rollbacks," topped \$12.5 billion last year, roughly \$3 billion less than **Gap** generates in total revenue.



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But now doubts are beginning to surface about Wal-Mart's (nyse: [WMT](#) - [news](#) - [people](#)) ability to maintain its gross margins in the face of such continual deflation. So far no perceptible strains are showing. Gross profit has held steady at 21% to 24% of sales each quarter for the past three years. But the issue will only get more acute as commodity prices increase and the juggernaut spreads further into higher-cost regions such as the Northeastern United States and California.

Wal-Mart will only get so far by hammering suppliers such as **Procter & Gamble** (nyse: [PG](#) - [news](#) - [people](#)), **Gillette** (nyse: [G](#) - [news](#) - [people](#)) and **Newell Rubbermaid** (nyse: [NWL](#) - [news](#) - [people](#)). And raising prices will never be a viable option. Archrival **Target** (nyse: [TGT](#) - [news](#) - [people](#)), known more for its merchandising flair than rock-bottom deals, has been steadily closing the price gap. The Memphis-area Super Target store now sells a basket of common household items for 0.8% less than the nearby Wal-Mart Supercenter, according to a recent A.G. Edwards analyst report.

So, to fight margin erosion and keep to its goal of 13% to 15% shareholder return, Wal-Mart is increasingly buying direct from factories. It's a hallowed practice for department store chains such as **Federated Department Stores** (nyse: [FD](#) - [news](#) - [people](#)) and **J. C. Penney** (nyse: [JCP](#) - [news](#) - [people](#)) but, surprisingly, Wal-Mart does very little of it. Only 10% of its purchases are sourced directly from factories. By bypassing a middleman such as a P&G, no-name U.S. importer or Hong Kong-based sales agent, Wal-Mart can add as much as 800 basis points to gross margin, passing some on to the customer and keeping the rest. This is how it got away with selling a coffee maker for \$5.00 on the day after Thanksgiving last year when the next cheapest around was going for \$14.

"Quite frankly, we're late to the party," says Kenneth Eaton, Wal-Mart's senior vice president for global procurement. "But we could easily double the 10% penetration rate."

Wal-Mart plans to cut 20% from its procurement costs over the next five years, according to Stephen Spiwak with research firm Retail Forward. The first step was taking its sourcing business in-house in early 2002, ending a relationship with the Hong Kong-based procurement firm Pacific Resources Export. Ken Eaton's operation, now based in

Shenzhen, China, consists of 1,000 staff spread across 20 offices in more than 18 countries. Most of the effort is focused on China, where Wal-Mart spends \$15 billion on direct and indirect purchases, but buyers are now also scouring for bargains in Brazil, Pakistan, Thailand, Italy and Costa Rica. They're all keenly tied into the company's growing international business (see "[Wall-To-Wall Wal-Mart](#)").

Global sourcing allows Wal-Mart to hedge its China risk by moving demand around the world. And it gives Wal-Mart the ability to introduce bigger-ticket goods without the attending sticker shock. Last Christmas its buyers found a factory that could directly ship a \$99 radio-controlled 1:6-scale Hummer H2. Wal-Mart got the entire production run as an exclusive.

The import quotas on Chinese apparel are phasing out next year, and Wal-Mart's sourcing operation is gearing up to bring

in what could easily be double or triple its current volume from China. Expect a major push in the United States by its private label George line of clothing, designed by Wal-Mart's U.K. subsidiary ASDA, but sourced around the world. George is already the second-biggest apparel brand by volume in Britain.

Wal-Mart's evolution as a direct purchaser is leading to speculation that it may evolve into as much of a wholesaler as it is a retailer, buying or securing great prices on raw materials for its suppliers. Its unprecedented demand, \$256 billion in revenue last year, confers an awful lot of leverage. Last year Wal-Mart began a global fabric initiative, visiting mills around the world and asking them for their best deal on polar fleece and denim. There's no commitment to buy on Wal-Mart's part and no forcing suppliers to shop at those factories. But suddenly the same quality jeans at ASDA stores that were once \$30 are now under \$10. Companies such as **Hasbro** (nyse: [HAS](#) - news - people), **Mattel** (nyse: [MAT](#) - news - people) and **Dandee** have already tapped Wal-Mart's sourcing network to purchase raw materials. "There's no reason we can't be buying oranges for orange juice, paper for notebooks or tomatoes for tomato juice," says Ken Eaton. Scary thought.