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NEWS: ANALYSIS & COMMENTARY

Wal-Mart Eases Its Grip

The retailer isn't squeezing suppliers as hard -- or slashing its own prices as much

PENNY-WISE

The cost of a typical basket of Wal-Mart goods fell roughly 3% in 2003, but that didn't spark strong enough sales gains. So this year, the retailer will ease the pressure on prices.

The chief executive of a U.S. plastic-goods maker recently got the shock of his life. He had asked Wal-Mart Stores Inc. (WMT), his biggest customer, to absorb a 5% to 7% price increase. The exec had good reason for the hike: The cost of resin, a key raw material in plastics, was going through the roof. Still, he didn't expect Wal-Mart, with its fearsome reputation for squeezing suppliers, to go along with the increase. Yet Wal-Mart allowed the supplier to lift its price for the first time in a decade. "If your argument is strong enough, you can actually win," says the executive. "It's a huge change."

Say what? Wal-Mart, which has come to dominate American retailing largely through its ferocious drive to push down prices, is easing up? Apparently so. Not only is it lessening the pressure on its suppliers, it also appears to be less fixated on slashing its own retail prices for everything from blue jeans to DVDs.

`A BATTLE WITH ITSELF'. So should rivals and suppliers breathe a sigh of relief? A small one, perhaps, but only that. While Wal-Mart will be a bit more flexible in giving its suppliers a break, it will continue squeezing costs on many products, especially those it orders directly from manufacturers. Says Jay Fitzsimmons, Wal-Mart's senior vice-president for finance: "Prices will continue to

go down, but not as fast." Indeed, the overall price on a typical basket of Wal-Mart goods is still likely to fall this year. It just won't drop the 2.5% to 3% it did last year.

Some see Wal-Mart's shift on pricing as a way to answer critics who argue that its endless squeeze on suppliers is forcing production offshore. But the company denies that's the reason, saying it realized the relentless price-cutting is hurting it almost as much as rivals. The self-imposed deflation, which holds down revenues, was making it harder for Wal-Mart to show healthy same-store sales gains. Moreover, the chain's lower prices didn't always create enough new volume to cover rising costs and stoke earnings; indeed, weaker-than-expected sales and profits have left the stock lagging the market recently. "Wal-Mart over the last few years has been in a battle with itself," says analyst Gary Balter of UBS Investment Research in a recent report.

But if its goal is to improve its profitability, why ease up on suppliers? Vendors say Wal-Mart realizes that, after years of absorbing rising costs, they too need some relief. With suppliers in any given industry often facing the same pressures on raw materials costs, many are also more willing to push for a price increase without fearing Wal-Mart will pass them over for a cheaper rival. And with the economy picking up, the retailer will likely find it easier to pass along those hikes to consumers.

NOT DOING ANY FAVORS. It's not clear how much Wal-Mart will allow suppliers to raise prices. Some analysts believe the gains aren't likely to be big. Instead, Wal-Mart will still push them to cut costs but may be willing to let suppliers keep more of the savings from any efficiencies they eke out. When branded goods producers do win price increases, Wal-Mart typically passes them along to consumers and holds its own margin steady. Fitzsimmons says that approach won't change. But where Wal-Mart oversees the sourcing of its own products --

now less than 10% of sales but growing -- it's expected to keep more of whatever savings it earns by driving out middlemen and consolidating production. That should lead to better gross margins while still reducing prices for consumers, figures UBS' Balter.

Will a less aggressive Wal-Mart provide relief for rivals such as Target Corp., which have struggled to keep up with the giant's rock-bottom prices? Lehman Brothers Inc. (LEH) analyst Robert S. Drbul believes it will. "If Wal-Mart is not as aggressive on pricing, it bodes well for most of retailing," he says. But Fitzsimmons points to Wal-Mart's hefty price advantage over rivals. "I don't think [Wal-Mart's new pricing stance] gives any room for competitors," he says. Now that sounds more like the old Wal-Mart.

By Wendy Zellner in Dallas and Robert Berner in Chicago

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STREET WISE

By Amy Tsao

The Two Faces of Wal-Mart

Loved for its low prices, the retail behemoth could become the object of scorn, thanks to a growing list labor-relations woes

Persuading Americans to use dollar coins has never been easy. So, to get the Sacagawea dollar into circulation in 2000, the U.S. Mint came up with an unconventional plan. It chose not just banks and post offices to distribute the coins but also Wal-Mart (WMT), where the gold-tinted coin went into customers' change. That says a lot about Wal-Mart's "credibility in our culture," says Barbara Bund, a senior lecturer in customer relationships at the Massachusetts Institute of Technology. The Mint chose the Bentonville (Ark.) chain not only for its ubiquity as the world's largest retailer but also for its status as a trusted, all-American company.

Wal-Mart's Sacagawea experiment was a mixed success: The coins are circulating, but

they haven't been a big hit with the public. Surprisingly, perhaps even ominously, the retailer's performance isn't living up to its image in another area: employee relations.

Most recently, on Jan. 18, *The New York Times* reported that Wal-Mart has been locking in late-shift workers for security reasons. That was preceded by news of an internal Wal-Mart audit that showed, in a single week, more than 1,300 instances of minors working at the chain's stores during school hours or later than labor laws permit, plus more than 60,000 instances of workers not taking scheduled breaks.

BACKLASH AHEAD? Those headlines followed last fall's federal investigation into Wal-Mart's use of a cleaning contractor that employed illegal immigrants. And all of that came on top of ongoing suits alleging that, at some stores, Wal-Mart has practiced sex discrimination and failed to pay required overtime (see BW, 10/6/03, "Is Wal-Mart Too Powerful?").

So far, none of this has dissuaded shoppers from taking advantage of Wal-Mart's famously low prices, nor have the controversies caused even a blip in the $247 billion company's earnings, which analysts expect to come in at close to $9 billion, or $2.03 a share, when 2003 results are reported on Feb. 19. That would be up 12% on a year earlier. That's good enough for Wall Street, where investors' priorities pretty much start and stop with the bottom line, and sympathy for $7-an-hour employees isn't normally a pressing concern.

The question is: Will that hold true indefinitely? The answer, according to labor-relations' experts, is that Wal-Mart's ability to escape controversy and a possible consumer backlash depends on the balance it can strike between its two, distinctly different images: The first is of the big and friendly retailer, ally of the little-guy consumer. The other is of an unfeeling giant putting the squeeze on its little-guy employees.

"There are ways in which Wal-Mart is a good member of the community," says Tom Kochan, professor of management at MIT's Sloan School, who notes that the outfit is a big employer of senior citizens. And like everyone else, Kochan points to its bargain-basement prices. Because of those, he adds, "we have major blinders on when it comes to the broader issues."

HIDDEN COSTS. Sneaker maker Nike (NKE) is a testament to how quickly public sentiment can change. Criticism of Nike for making its shoes in overseas sweatshops took years to develop much momentum. But when such complaints gained traction in the late 1990s, the public reaction hurt profits. Nike, Kochan says, has since set up a corporate responsibility department, adopted labor-practice guidelines, and spent substantial sums on repairing its image. Its business has bounced back. "The market signals got people's attention at Nike," Kochan says. "Until Wal-Mart feels that same market pressure, I don't think it will make changes."

Still, Wal-Mart could be vulnerable. Workers claiming mistreatment live and work in the U.S. -- many are even citizens -- not in out-of-sight, out-of-mind countries like Indonesia

and Mexico, where Nike was accused of using sweat-shop labor. And while Wal-Mart employees may not look downtrodden to the casual shopper, a situation in which consumers, some of them well-heeled, can put a face to a widely publicized complaint carries some added risk for the company.

Sooner or later, argues Adrienne Eaton, professor of labor studies at Rutgers University in New Brunswick, N.J., it may occur to shoppers that "there is a cost for those low prices." Because a cashier's job that pays $7 or $8 an hour won't support a family, or even half of one, retail workers often decline to buy health insurance, even when it's offered, says Eaton.

WEED AND REFORM? She's about to begin a study on the impact of Wal-Mart and other "big box" stores on communities in New Jersey. One of her goals will be to put a figure on uninsured retail workers' health-care costs that are passed along to taxpayers. In theory, consumers who don't shop at Wal-Mart might object if it turns out that they're indirectly picking up the retailing giant's overhead. Wal-Mart officials didn't return calls seeking comment for this article.

Another effect of the recent news, equally hard to quantify, could be the impact on Wal-Mart's marketing budget. According to the retailer's most recent annual report, it spent $676 million in the fiscal year ending in January, 2003, on ads to draw shoppers and burnish its image. At the very least, MIT's Bund says, a drumbeat of unfavorable news might force Wal-Mart to increase those outlays in an attempt to head off potential damage.

Wal-Mart's other strategy might simply be to weed out managers found to have acted improperly and, when necessary, introduce reforms. The drawback, of course, is that the cost of such measures could alarm Wall Street, which usually doesn't award points for being nice to employees. If the cost of such changes amounted to a measly $1 a hour for each of Wal-Mart's 1.2 million employees, the bill would total $2.1 billion a year. That could reduce Wal-Mart's profits by about 25% -- or force it to raise prices and lessen its advantage in the marketplace.

DENTED ARMOR. Wal-Mart is a master at quashing union organizing drives, so history suggests its vulnerability on that front is limited. But as it expands into less rural, more affluent areas, the retailer could find itself facing more demanding employees -- not to mention consumers who are less willing to tolerate what they see as deviations from fair labor practices. In such markets, both shoppers and employees are more likely to turn elsewhere, says MIT's Bund, who suspects that shoppers can find other retailers who will "do better for them." Consumers, speculates Bund, might choose to accept "slightly less aggressive pricing for more palatable policies."

To outward appearances, not much of that has happened yet. But it's significant, says Kate Bronfenbrenner, director of labor education research at Cornell University, that a significant number of Wal-Mart workers have come forward to complain about an employer whose size and reach are so intimidating. And even though unions may not

pierce Wal-Mart's armor, they might, over time, put a dent in it. Ira Kalish, global director at Deloitte Research, the market-research division of consulting firm Deloitte & Touche, notes the impact the United Auto Workers achieved when it lambasted carmakers for unsavory labor practices. Even though the auto union didn't strike, Kalish says those campaigns "did affect consumers' willingness to buy from those companies."

Bronfenbrenner notes that a college-student group, United Students Against Sweatshops, helped bring Nike to heel. "If the right people pull together," she predicts, "the public will turn against Wal-Mart."

Of course, few companies on earth are smarter or more resilient than Wal-Mart. And considering how powerful it is, talk alone isn't likely to make much of an impression. Over the past century, leading U.S. companies that became the center of controversy -- from the monopoly Standard Oil to the union-busting J.P. Stevens -- eventually had to change. So when the largest U.S. employer comes under fire for the way it treats employees, the smart thing to do is likely to become self-evident.

Tsao covers retailing and the markets for BusinessWeek Online in New York