A Deloitte Research Viewpoint

RETAIL TSUNAMI?

*Wal*Mart comes to Japan*

Deloitte Research

EXECUTIVE SUMMARY

Increasingly, the world of retailing is becoming Wal*Mart's world. It is one of the most global retailers in the world, operating in 11 different countries, with multiple formats, all tied together by a state-of-the-art retail distribution system known as Retail Link. This report examines the sources of Wal*Mart's competitive advantage and the challenges it faces in going to Japan.

Wal*Mart's acquisition of Seiyu was a great buy and the first step in what will be a long process of transforming the company and most likely, Japanese retailing. First and foremost, the Wal*Mart is a consolidator of both retailers and suppliers. This has happened in the US, Mexico, Canada and most recently in the U.K. As Wal*Mart expands in Japan it will drive retail, wholesaler and supplier consolidation in that country.

Wal*Mart upgrades the retailing experience by forcing businesses to implement better practices to stay competitive. Wal*Mart creates better suppliers in a marketplace because it focuses on doing more business with fewer suppliers and requires steady improvement in the performance standards for all of its suppliers.

Driving prices down is key to Wal*Mart's success. They achieve this objective by having an all encompassing passion for driving down costs in all aspects of their business in order to become the low cost provider in the market. Cost advantages are obtained in a wide array of areas including: logistics, distribution, advertising, branding, merchandising, store design, pricing and supplier strategies. Wal*Mart works closely with their suppliers to achieve many of these cost reductions, the benefits of which are shared with their suppliers.

Top line growth is being driven by expansion and innovation in the areas of food, fashion and foreign acquisitions.

Wal*Mart has moved aggressively to expand outside of the US, opening stores and making acquisitions in North America, Mexico, Europe and Asia. Mexico, Canada, and the UK are great success stories. Germany has been problematic while Indonesia was an outright failure.

The biggest barriers to market entry in Japan are the multi-tiered distribution system, and real estate, followed by the high quality and selection demands of the Japanese consumer.

Wal*Mart will likely acquire a Japanese wholesaler while working with global suppliers to implement its Retail Link systems. Complete implementation of Retail Link may take up to a decade.

Solving the real estate dilemma will require at least one more acquisition in Japan and probably more than that. With Japanese retailing struggling in the current economic environment, there are many acquisition candidates from which to choose.

In going to Japan, Wal*Mart will become a major competitor of retailers, wholesalers and suppliers. There will not be a consumer business in Japan that will not have to take Wal*Mart into account in making their strategic plans.

TABLE OF CONTENTS

Wal*Mart's Competitive Strengths (and Weaknesses?) 1

Wal*Mart as a Learning Organization 1

The Wal*Mart Model 2

It Begins With EDLP 2

Cost Reduction: *Logistics* *3*

Cost Reduction: *Advertising* *4*

Cost Reduction: *Store Design* *4*

Cost Reduction: *Supplier Strategies* *4*

Cost Reduction: *Merchandising Strategy* *6*

Pricing Discipline: *Every Day Low Prices* *6*

Creating a Virtuous Cycle: *Low Costs,*
Low Prices and the Productivity Loop *7*

Top Line Growth: *Food and Fashion* 7

Innovation: *Managing the Retail Lifecycle* 9

Wal*Mart's Foreign Expansion Track Record 10

Adapting to the Japanese Market 12

Pricing 14

Merchandising 15

Wal*Mart's Global Experience: *Two Possible Outcomes for Japan 15*

Implications for Japanese Retailers 16

Implications for Japanese Suppliers 17

Conclusions and Observations 18

Will We See Wal*Mart in Japan? 18

About Deloitte Research 19

RETAIL TSUNAMI?
WAL*MART COMES TO JAPAN

Wal*Mart's Competitive Strengths (and Weaknesses?)

Wal*Mart's competitive advantage begins with the business philosophy of founder Sam Walton — a philosophy that still drives the organization and is perhaps best expressed in this quote:

"There's only one boss — the customer. He can fire everyone in the company, from the chairman on down, simply by spending his money somewhere else."

Sam Walton used to talk about Wal*Mart's organization structure as an upside-down pyramid, with the customer at the bottom — and everybody in the organization there to serve him. And you get this sense the minute you walk into the store when you are welcomed by the now famous Wal*Mart "greeter", a retail institution that has been copied by many other retailers.

While a great deal of attention has been paid to Wal*Mart's Retail Link system, Wal*Mart's cost advantage does not come solely from logistics. The entire business is focused on being the low cost supplier of basic goods.

Wal*Mart as a Learning Organization

First and foremost, Wal*Mart is a learning organization. It is not that Wal*Mart never makes a mistake. Over time, they have made many mistakes. What Wal*Mart rarely does is make the same mistake twice. They have the unique ability to take learnings from one part of their organization or from one part of the world and transfer it elsewhere. For example, when Wal*Mart acquired ASDA in the U.K., they moved quickly to eliminate ASDA's customer reward program, having found similar programs ineffective and costly in other parts of the world. At the same time, Wal*Mart took the George apparel brand that ASDA had and brought it to the U.S.

Another way in which Wal*Mart's ability to learn shows up is in their ability to innovate. Innovation and size are very often not compatible. What differentiates Wal*Mart from just about every other large business organization is its continuing ability apply what it learns as an organization to the process of innovation. While all large businesses will pay lip service to the need to innovate, Wal*Mart is still able to consistently innovate despite its size.

Wal*Mart is well known for its innovation in supply chain logistics. But Wal*Mart innovates in many other areas of its business that are less well known, but just as critical to Wal*Mart's success. Wal*Mart has been a very successful incubator of new businesses based on very different formats. This capability will be of critical importance in coming to Japan as real estate constraints will force Wal*Mart to be innovative with respect to store size in expanding their Japanese business.

Wal*Mart was very successful in the 1990s in developing and rolling out their supercenter concept. More recently, they have been innovating with a more traditional supermarket format called Neighborhood Market. With just over 100 of these stores today, Wal*Mart has plenty of growth potential left in this business. They are also experimenting with a convenience store concept that they are locating in the parking lots of many of their Supercenters. A smaller 'dollar store' concept that is 10-15,000 square feet in size is also rumored to be in the works.

The Wal*Mart Model

Go into any Wal*Mart store in the world today and what is so remarkable about the store is that it is so unremarkable. The stores are plain. Most of the merchandise is undifferentiated from what is sold by their competition. While the check-out process is usually efficient, once you get beyond the store greeter, the level of store service is nothing special.

In the late-1980s and early 1990s, foreign retailers of all stripes made a homage to the U.S. to visit a Wal*Mart store. Most left shaking their heads unable to grasp the factors behind Wal*Mart's stunning success. And Wal*Mart's global success is eye-popping. The company is the most successful public company in the history of capitalism. It was the first global retailer to hit $100 billion in sales in 1996, a feat still unmatched despite the passage of time.

It Begins With EDLP

If there is one competitive element that differentiates Wal*Mart from its competitors, it is EDLP, every day low pricing. While simple in its conceptualization, EDLP is probably one of the most difficult pricing strategies for any retail business to execute. It requires a level of discipline that most retailers do not have.

To successfully execute EDLP, retailers must go against the competitive tide of using promotional activity to drive traffic. Trust has to be built with the consumer over a period of years convincing them that the business will not promote and that the consumer is actually better off, day-in, day-out, receiving the lowest price for a basket of goods.

In order to deliver on this promise of low price, an EDLP retailer also has to be every day low cost retailer in the market. Wal*Mart achieves this objective by having an all encompassing passion for driving down costs in all aspects of their business. Their goal is to be the low cost provider in the market. Their basic business model is probably best illustrated by the productivity loop

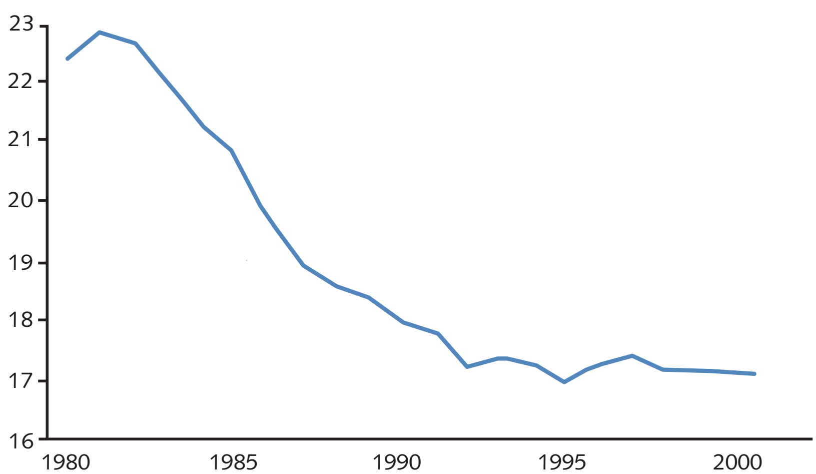
EDLP offers many operational advantages as well. EDLP allows for more accurate forecasting and combined with POS data sharing with suppliers, helps reduce inventory throughout Wal*Mart's supply chain, improving inventory efficiency for both Wal*Mart and their suppliers. A second cost advantage of EDLP is that it does not require the kind of continuous price-item advertising that hi-lo pricing retailers must do.

Cost Reduction: *Logistics*

The effects of the Retail Link are apparent in a lot of places in the company, but perhaps none more dramatic than in inventory. Wal*Mart turns inventory much faster than its competitors, and the gap between the two is increasing.

When Wal*Mart began to develop Retail Link, one of the first items put into the system was the disposable diapers, Pampers. At that time, Wal*Mart was turning Pampers 25 times per year, roughly twice a month. After Retail Link, Pampers inventory was turned 125 times per year — or about every three days. This dramatic improvement in inventory productivity cuts costs, not just for Wal*Mart but for its suppliers, as well.

CHART 1. WAL*MART SG&A AS A % OF SALES

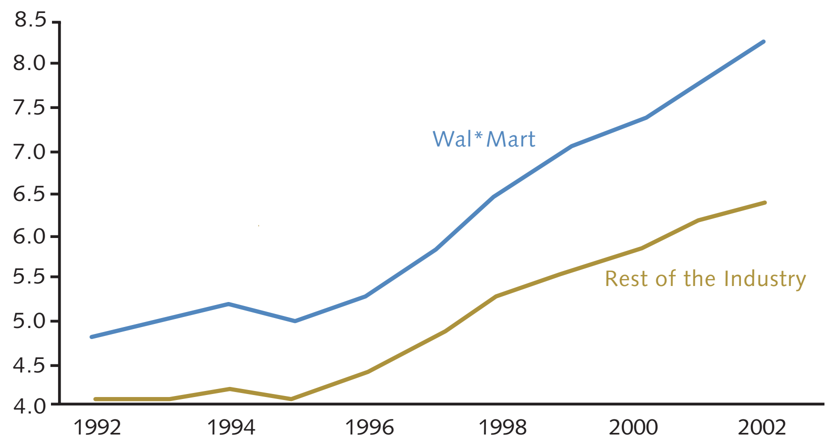


SOURCE: WAL*MART ANNUAL REPORTS

In many ways, Retail Link is a just-in-time inventory system that Wal*Mart has borrowed from Japanese auto manufacturers who pioneered JIT — and as Wal*Mart enters Japan, it will reintroduce just-in-time concepts and methods.

Supplier direct is key to Retail Link — and that will be a challenge to the company operating in Japan, with its multi-tiered distribution system making it hard for retailers to work directly with suppliers. It is possible that Wal*Mart will have to adapt its Retail Link system to work with wholesalers in Japan. This is not unheard of in the Wal*Mart system. In a couple of product categories, like music CDs and books, Wal*Mart in the U.S. works with wholesalers instead of going directly to the manufacturers.

CHART 2. INVENTORY TURNS
COST OF GOOD SOLD/AVERAGE INVENTORY



SOURCE: RETAILFORWARD YEARBOOK DATABASE

Cost Reduction: *Advertising*

Wal*Mart's advertising strategy also provides a competitive cost advantage. The company spends less than one percent of sales on advertising —dramatically less than its main competitors, some of whom spend six or seven percent. This strategy derives from the company's "every day low pricing" philosophy and its "no deal" merchandising strategy. This reduces costs in other ways. Promotions put an enormous strain on logistical and distribution systems, and Wal*Mart doesn't have that, reducing complexity and taking cost out of the business.

Wal*Mart's advertising is image-oriented, national, and focused on re-enforcing a low-price image. It does no store specific ads or promotions. You will not find an item specific flyer in your local Sunday newspaper for Wal*Mart as is the common practice for most of their competitors.

Cost Reduction: *Store Design*

In the late 80s when Wal*Mart began to show up the radar screens of non-U.S. retailers, European and Asian retailers would make a pilgrimage to Wal*Mart stores expecting a retail experience that was consistent with the dramatic increases in sales that Wal*Mart was posting. In virtually all cases they came away puzzled and even shocked by the austerity in Wal*Mart's store design, construction, and signage. That austerity, however, has several purposes. It keeps costs down and, just as important, it sends a message of savings to the customer. Low cost store design is another way that Wal*Mart keeps prices down and conveys a value message to its customers.

Cost Reduction: *Supplier Strategies*

Wal*Mart not only works closely with suppliers, it focuses on its best suppliers. The goal in all cases is to significantly reduce supply chain complexity. Wal*Mart does this by running a "best price, no deal" business: no markdowns, no allowances, no promotional money. This reduction in supply chain complexity is a critical component in Wal*Mart's focus on reducing the cost of doing business. Inventory never has to be built up for a special promotion. Store layout need not be changed for the same reason.

The Retail Link system enables Wal*Mart to share information with their suppliers on a real-time basis. Everyone — the company, its merchandisers, its inventory managers, its sales people, and its suppliers — are looking at the same data, at the same time.

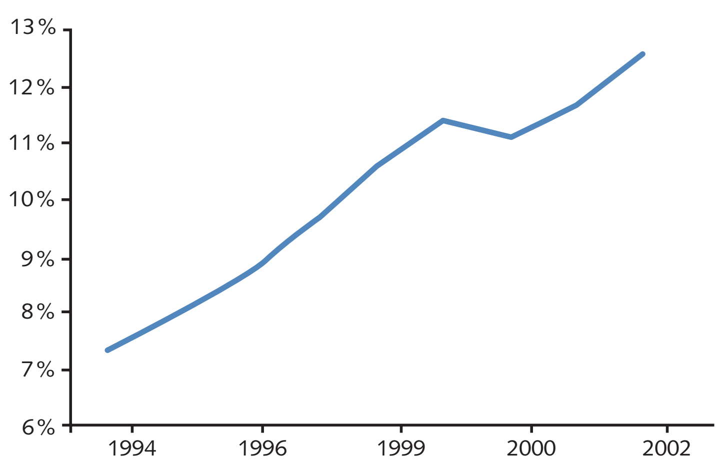
Suppliers know their inventory position in every store, on any day. Over 70% of this inventory is owned by the supplier, which gives them an added incentive to improve productivity and sell-through. The benefit to the suppliers is that they get paid as soon as the product gets scanned. Invoices, purchase orders and other documentation are processed through a more commonly used Electronic Data Interchange (EDI) system.

All this requires a substantial investment in technology — technology to enable both Wal*Mart and their suppliers to capture, process, understand and act upon information. At the end of the day, Retail Link is the key to Wal*Mart's success. Without Retail Link, there would be no Wal*Mart as we know it today.

Wal*Mart's competitive position in the marketplace does not depend on them squeezing their suppliers ever harder, for more and more concessions. Wal*Mart relationship with their best suppliers is a win-win for both Wal*Mart and the supplier. By conforming to Wal*Mart's standards for doing business, suppliers increase their market share and become better suppliers.

Procter & Gamble, Wal*Mart's largest supplier, is a great example of this. By working closely with Wal*Mart, Procter and Gamble has gone through an aggressive process of brand and SKU reduction. The result for P&G has been sustained sales growth and a near doubling of margins over the past eight years, not an easy task to accomplish in a market place where price deflation has been common.

CHART 3. COST OPERATING MARGINS: PROCTOR & GAMBLE



SOURCE: PROCTOR & GAMBLE ANNUAL REPORTS

Through Retail Link, suppliers can:

- Download purchase orders from Wal*Mart.
- Check the status of their invoices to Wal*Mart.
- Determine how many of their products were sold at Wal*Mart the previous day.
- Examine the effects of markdowns or returns on their inventory.
- Access reports on sales over a period of up to two years.
- Access sales forecasts for their products for up to one year.
- Upload reports and updates for Wal*Mart.

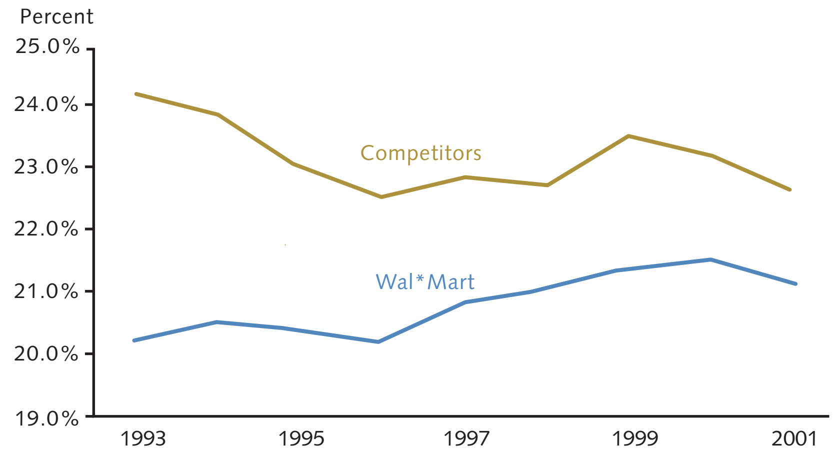
Cost Reduction: *Merchandising Strategy*

What Retail Link has allowed Wal*Mart to do, in a very competitive environment of decreasing margins, is both slowly raise margins and still under-price the competition. They are able to do this by consistently pushing down the cost of goods sold.

Wal*Mart's merchandising strategy is also aligned to its supplier strategy, to RetailLink, and to the store formats. Wal*Mart offers a broad assortment of merchandise, but no depth, as the stores carry a very limited number of brands — usually the national best seller and its own private label — within each product category. Indeed, Wal*Mart is becoming the biggest competitor to its own supplier base.

The result is a polarization of suppliers between those who work with Wal*Mart and those who don't. Those who work with Wal*Mart share its high growth and by adopting Wal*Mart required business processes, become better suppliers, and like Procter & Gamble are able to raise margins; the others are threatened as Wal*Mart gains more market share in the industry. This broad but shallow merchandising strategy reduces supply chain complexity along with the cost of doing business.

CHART 4. GROSS MARGINS:
WAL*MART VS. THEIR DIRECT COMPETITORS



SOURCE: RETAILFORWARD YEARBOOK DATABASE

Pricing Discipline: *Every Day Low Prices*

Wal*Mart has long been known for their EDLP strategy. They are able to be the every day low price offer in the market because they are the every day low cost operator. A number of retailers in the past have tried to emulate Wal*Mart's EDLP strategy and all have failed. Consumers, accustomed to sales at these once promotional retailers, simply stopped shopping them in anticipation of the next sale.

Wal*Mart does price the same product differently from store to store. The Retail Link system details customer demand on a store-by-store basis. If one store, because of demographics, competition, local economics or some other reason, consistently sells more of a product, that product will be priced a little higher in that store.

While Wal*Mart tries to be the low price offer in the market, they do not have the lowest price on every item in the store. Instead, Wal*Mart does have the lowest price offer on a "market basket" of goods that they feel is reflective of what their core customers expect of the store. In Japan, Wal*Mart is currently studying what this right 'market basket' of goods is for Japanese consumers.

Creating a Virtuous Cycle: *Low Costs, Low Prices and the Productivity Loop*

In theory, the productivity loop is a virtuous cycle where investments in technology, merchandising systems, alternative approaches to advertising, and focused supplier strategies, reduces the cost of doing business, enabling them to lower prices. Lower prices drive gains in market share and sales. Higher sales translate into more margin dollars, which in turn gives them more capital to invest in further cost reduction.

Wal*Mart has imbedded this productivity loop philosophy into their operating strategy. While Retail Link is a part of this cost reduction strategy, it is not the entire story. Being an everyday low price retailer has forced them into a never ending effort of reducing costs across a wide range of business processes: logistics, merchandising, store design, advertising, human resources. If Wal*Mart can not be the lost cost provider in a market place, they can not effectively execute their EDLP strategy, as has been the case for them in Germany.

The practical application of Wal*Mart's productivity loop can be seen in the steady reduction in selling and general administrative expenses as a percentage of sales. Particularly in the 1980s, the company was very aggressive in driving down costs. Then, there's a plateau in the early 1990s, as its globalization initiatives gained momentum. As these initiatives become more mature and the new businesses get up to speed in using the Retail Link, we will see SG&A as a percentage of sales renew its decline.

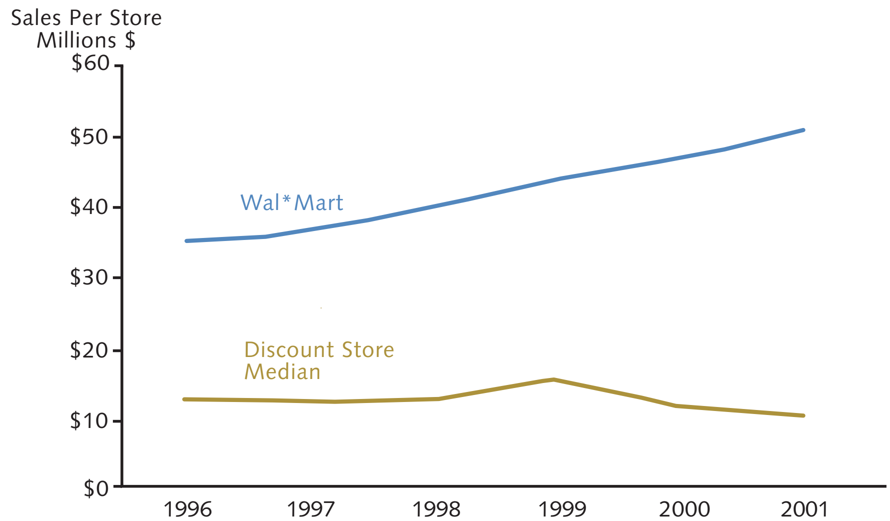
Top Line Growth: *Food and Fashion*

In a few key product areas, Wal*Mart is trying to expand its offerings and grow sales. Food is one. In less than 10 years time, Wal*Mart has gone from selling no food to being the largest food retailer in the US. The real challenge in the Japanese market is the quality of the food Wal*Mart offers; the fresh food, in particular, falls short of that found in Japanese grocery stores.

Another new foray is fashion, something Wal*Mart has not traditionally been known for. Over the past few years, Wal*Mart has been trying to break out of the commodity apparel business, first with a brand called Kathy Lee, which was popular in the US. With the acquisition of a brand called George which came with the purchase of ASDA in the UK, Wal*Mart dropped the Kathy Lee brand, despite the fact that it was one of the best selling labels in the US. This is a clear example of how Wal*Mart innovates to keep its leadership position. George was seen as a brand that had the potential of having international appeal, while Kathy Lee did not.

Wal*Mart's fashion strategy and the quality of the George brand have been favorably written up in Women's Wear Daily, the New York Times, and the Wall Street Journal. With George, Wal*Mart even acquired a fashion design team that will give them on-going fashion innovation for the first time.

CHART 5. REAL ESTATE PRODUCTIVITY



SOURCE: RETAILFORWARD YEARBOOK DATABASE

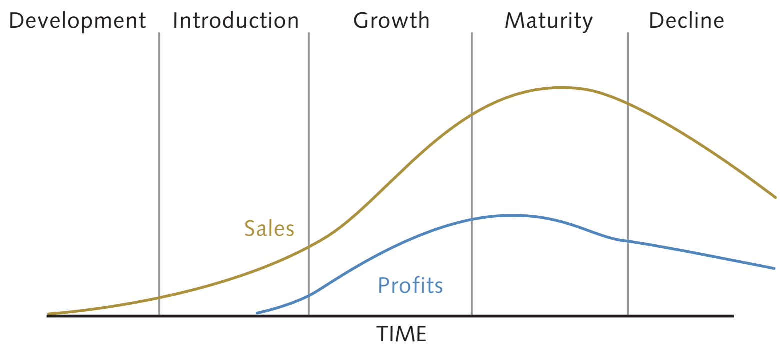
Wal*Mart gets a better price from its better customers, and yet it is still the low-price retailer in its market. Each store is responsible for shopping competitors' stores and comparing market-basket prices. The store manager has the authority to roll back prices if a competitor is under-selling a product on a day-in, day-out basis.

Because of all this — Retail Link, the pricing policies, the supplier relationships, and the inventory management systems— Wal*Mart has very high real estate productivity. The company is not only growing the number of stores, it is also growing sales per store.

Innovation: *Managing the Retail Lifecycle*

In addition to productivity, there's a second key to Wal*Mart's continued success: innovation. One place we see this is in formats. Wal*Mart is consistently putting new concepts and ideas into development for future growth. As one format approaches market maturity, the company rolls out a new one. As a result, the company resembles a portfolio of businesses, which always includes a growth vehicle.

CHART 6. THE RETAIL LIFECYCLE



Sales	Low/growing	Rapid Growth	Slowing	Declining
Profitability	Negative to	High yield	High, declining	Low to B/E
Patronage	B/E Innovators	Special need	Broad market	Special need
Competition	None	Limited	Extensive	Intensive

SOURCE: WILLIAM DAVIDSON, ET AL, HARVARD BUSINESS REVIEW, NOV-DEC 1976

Wal*Mart started out with a traditional 60-80 thousand square foot discount department store format. The company realized that format was becoming a mature business in the mid-1980s and began innovating with the supercenter concept which included general merchandise and food. Wal*Mart started rolling that concept out in the early 1990s; and now, as a result, is the largest grocery retailer in the world.

At the same time, Wal*Mart entered the warehouse club business. Now, that business is aging, and we're seeing the emergence of a neighborhood market from Wal*Mart, a 35,000 square foot, mostly food, format. Wal*Mart is also getting into the gasoline and convenience store business and, last but not least, is looking to experiment with dollar stores of 7,500-10,000 square feet, the equivalent of 100 yen stores in Japan. These small stores are potentially as productive as the large ones, but they're in an unconsolidated market space not known for efficiency or economy of scale.

Over the next year, Wal*Mart plans to build 48 million square feet of additional space — the equivalent of three Sears Towers. Some of that growth will come from foreign expansion.

Wal*Mart's Foreign Expansion Track Record

Over the past six years, Wal*Mart has moved aggressively to expand outside of the US. Expansion in Asia, coupled with acquisitions in the UK and Germany have been at the heart of this expansion process. The pace of new store growth slowed in the late-1990s, particularly in Europe. Here the stores Wal*Mart has already acquired need to be brought up to speed in their technology, and need to be more closely aligned to the Retail Link system and to the Wal*Mart way of doing business.

Among the challenges common to all Wal*Mart's foreign investments, the biggest is keeping local management. The company had some highly visible problems in the UK and Germany in this area. In fact, the problem in Germany, coupled with that country's strong labor union, casts some doubt about Wal*Mart's future in that market.

Developing country-specific merchandise has also been a big challenge and will probably be so in Japan. For example, one of the reasons for Wal*Mart's failure in Indonesia was its failure in adapting its merchandising mix and practices to local tastes and customs.

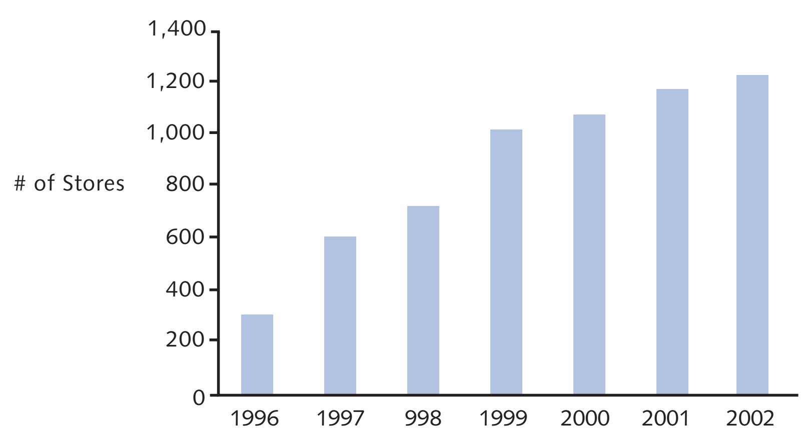
Lastly, but probably the most important challenge, is implementing the Retail Link distribution processes. Those processes are key to Wal*Mart's success.

Wal*Mart in Mexico

Probably the biggest foreign success Wal*Mart has had is in Mexico, although it wasn't always that way. This started off as a joint venture with Cifra, the largest retailer in Mexico. Wal*Mart made a small investment, spent some time studying the Mexican market, and then when confident it could implement Retail Link, acquired Cifra and began rolling out Wal*Mart stores. It took about seven years before the stores in Mexico became profitable.

In many ways, this could be a model for Wal*Mart's success in Japan. We are seeing a small investment in Japan and a serious effort to study the market.

CHART 7. FOREIGN EXPANSION



SOURCE: WAL*MART ANNUAL REPORTS

Wal*Mart in Canada

Canada is another success story, which came about with the acquisition of 122 Woolco stores, which have grown to 196 Wal*Mart stores. The advantage of Canada, not surprisingly, is an enormous amount of supplier overlap. Most of the suppliers operating in Canada were already part of Retail Link, so implementation was easier.

There were a few problems, however, at the top of the list being adaptation to a Canadian market. While Canada may seem very similar to the U.S., when it comes to shopping behavior there are significant differences, particularly in the French speaking provinces of Canada. But today, 88 percent of all households in Canada shop at Wal*Mart, and the retailer holds a commanding 37 percent market in general merchandise, apparel, and furniture. Interestingly, the Canadian Wal*Mart offers no food for sale; perhaps, when the market matures, food will be introduced.

Wal*Mart has, as one would expect given these kinds of statistics, transformed Canadian retailing. We've seen a shakeout in retailers: K-Mart has left the market; Zellers, which used to be the dominant discount retailer, is struggling and fighting for its long-term viability.

Wal*Mart in the United Kingdom

In the United Kingdom, Wal*Mart's had success with the acquisition of ASDA, the number three food retailer behind Tesco and Sainsbury. Wal*Mart started out by fully implementing its merchandising strategies and advertising strategies, which allowed for reduced costs and aggressive pricing. Wal*Mart also eliminated the ASDA loyalty programs, again to reduce costs.

Before Wal*Mart entered this market, a consumer campaign took as its theme "Rip-Off Britain" in protest of high food prices. The protest led to a government inquiry into high prices in the UK. Wal*Mart put some of that consumer discontent to rest.

At the time of the acquisition, Wal*Mart estimated that ASDA was seven years behind Wal*Mart in its technology. While the implementation of Retail Link processes has been aggressive, the UK stores are still three or four years away from being up to Wal*Mart capabilities in North America.

Nonetheless, Wal*Mart has already transformed retailing in Great Britain, most particularly putting downward pressure on prices nationwide. Wal*Mart is looking to expand its real estate footprint in the UK with the acquisition of Safeway. With fewer regulatory constraints than its competitors for Safeway, Wal*Mart is in a strong position to win this bidding war. Even if Wal*Mart is not successful in acquiring Safeway, the company will continue to look for additional acquisition candidates in the UK.

Wal*Mart in Germany

Wal*Mart's expansion has been challenged in many places, one most clearly being Germany. The retailer entered Germany with two acquisitions, the Wertkauf stores in 1997 and Interspar in 1998. Both retailers operate smaller stores than Wal*Mart's traditional format. Wal*Mart faces a number of problems in Germany including a unionized labor force, a difficult economy coupled with high unemployment, and a very expensive transition to the euro.

As a result, Wal*Mart has cut back on its expansion plans in Germany and has even closed two under-performing stores. Nonetheless, we have seen some consolidation in German retailing as a result of Wal*Mart's presence, but the market overall is protected by government regulations. In order to gain the economies of scale needed to make their business in Germany successful, Wal*Mart will most likely have to make another acquisition in the German market.

Wal*Mart in Indonesia

The biggest failure Wal*Mart has suffered in expanding internationally was in Indonesia. The company did not understand the local market. In a Wal*Mart store, merchandise was presented in a very orderly way, but the Indonesian consumers think order means high price. They like merchandise thrown out on tables — not the Wal*Mart way.

The company also had a lot of disagreements with local partners about ownership and direct competition; and in 1998, when civil unrest broke out as a result of the Asian currency crisis; one of the Wal*Mart stores was burned down. That's when the retailer decided to leave the Indonesian market.

Wal*Mart in China

Wal*Mart has made a foray into China — one of the really significant opportunities in Asia because of its rapidly growing middle class. Wal*Mart faces the same challenges here that any investor does: getting government approval.

One thing that appeals to Wal*Mart is that the real estate is not all locked up; in China, there would be plenty of opportunity to build green field sites. A lot of investment would be required, but the hope is that, as China develops, the growth opportunity will be enormous.

Adapting to the Japanese Market

In Japan, Wal*Mart is in the process of analyzing the market. After acquiring a minority share of Seiyu, Wal*Mart has already changed Seiyu's advertising to be more image-oriented and less item-oriented. They are also implementing "every day low pricing" in the stores. And the new enterprise is working hard to narrow the breadth of the merchandise selection.

If that were all that Wal*Mart does with Seiyu, it would have a small but significant impact on Japanese retailing, as these changes make Seiyu a more competitive retailer. As the success of these changes become apparent, they will be studied and copied by other Japanese retailers, reducing the Wal*Mart advantage and forcing Wal*Mart/Seiyu to look elsewhere for competitive advantage.

Among the barriers to doing business in Japan, the first and foremost is past attempts by other retailers. Many foreign retailers have come to Japan, few have succeeded. Carrefour went to Japan with great expectations. More recently they have reduced the number of planned stores. Costco has opened several stores in the Tokyo area but is struggling to make the concept work. Toys R Us has been in the Japanese market for some time, yet still struggles. The UK drug store chain, Boots, was not able to turn a profit and has exited the market. Everywhere one looks in Japan, there are serious barriers to any new market entrant.

Logistics and Distribution

Japan's distribution system is a barrier to Wal*Mart's traditional way of doing business. Wal*Mart's direct-supplier system could not be more different in its design, its business philosophy and its operation from Japan's multi-layered system. Will Japan's system change, or will Wal*Mart adapt? This is the crux of the question of whether Wal*Mart will invest heavily in Japan.

In order to create an unassailable competitive advantage in the Japanese market, Wal*Mart will have to create a logistics and distribution system that is lower cost and more efficient than anything currently in use in Japan. Wal*Mart's distribution strategy is likely to follow a multi-stage, multi-method approach. These different approaches should not be viewed as mutually exclusive alternatives but rather as parallel strategies. While the long term vision will be to create over time a direct from supplier, Retail Link system, it will take many years to make this transition.

Initially Wal*Mart will have to work through the multi-tiered system Japanese distribution system, treating wholesalers much as they would suppliers. Wal*Mart will work with the larger wholesalers to upgrade their technology capabilities. Several of the larger Japanese wholesalers, are working hard to develop added value services for their retail clients. To be viable long term, they will have to prove that they are both more efficient and more reliable for retailers to work with than going direct to suppliers.

The second step in this process is likely to involve Wal*Mart acquiring a Japanese wholesaler. Wal*Mart has already done this in the U.S. and is clearly focused on expanding its wholesaling business on a global basis.

Finally, Wal*Mart will begin developing Retail Link with their largest suppliers, particularly the ones they have relationships with either in Europe or the US. This will be a slow process and may take several years before it is initiated as the software for the Retail Link will first have to be adapted to the Japanese language.

Real Estate

Real estate is another barrier to market entry. One, it's expensive. Two, it's not available. And three, most of the store footprints are small. If Wal*Mart is to have a presence in Japan and achieve the efficiencies it needs to grow, another acquisition — and maybe several — will be required.

Wal*Mart will not be able to build Supercenters or Neighborhood Markets in the Tokyo Metropolitan area. There are several acquisition candidates, Daiei in particular, that do have stores that are large enough for this purpose. For the most part, the real estate market in Japan prevents Wal*Mart from opening their traditional formats. This will not be a barrier to success, but will force experimentation and innovation.

Wal*Mart has experimented with convenience stores and smaller grocery stores in the US and has plans for smaller Dollar Stores as well. They also successfully operate a number of smaller format stores in Mexico. Since Seiyu alone does not have the size, stores and right real estate for Wal*Mart to be successful in Japan, another acquisition is necessary. With a number of Japanese retailers struggling financially, there will be many opportunities for Wal*Mart to make another purchase in the Japanese market at a reasonable price.

Pricing

What Retail Link has allowed Wal*Mart to do, in a very competitive environment of decreasing margins, is both slowly raise its margin and still under-price their competition. They are able to do this because they are consistently pushing down their cost of goods sold. It's our expectation that deflation will continue in Japan, the US, and Europe —and Wal*Mart's advantage will continue to be powerful.

Wal*Mart has already moved to an EDLP strategy with Seiyu. To be successful at this they will have to become the low cost provider in the market place. Wal*Mart's success with EDLP forces other retailers to compete on the basis of service, selection or promotions, all higher cost options. In the Japanese market, service and selection appear to be more highly valued by the consumer than in Europe or the US. While EDLP has proven to be a powerful competitive advantage elsewhere, it is not as likely to be as decisive in Japan.

In the U.S., Germany, South America and UK, Wal*Mart appears to have reduced the consumer price index by couple percentage points. Implementing EDLP in Japan will put additional downward pressure on prices, forcing Japanese competitors to try to compete on price or to look to some other element of the retail mix as a way of competing.

Merchandising

Finally, Japanese consumers represent a major challenge for Wal*Mart because of their high demand for quality in apparel and food, coupled with traditional disinterest for value pricing. But the success of the 100 yen stores might mean that the Japanese consumer is ready for value-oriented retailing. The core consumer — the middle class — may still require winning over. Wal*Mart will have to adapt its merchandising offer.

Merchandizing will be a major challenge for Wal*Mart in the Japanese market. Wal*Mart offers a very narrow selection of goods in each product category, limiting consumer choice in a category often to a national brand and its own private label brand. This strategy is in stark contrast to Japanese general merchandise stores that may carry as many as 200,000 SKU's.

While reducing the number of SKU's in the store, Wal*Mart will expand its own private label business. Over time, Wal*Mart will become a major competitor as well as a major customer of their Japanese suppliers. The reduction in product selection will have to be managed carefully as the Japanese consumer values selection.

Wal*Mart's Global Experience: *Two Possible Outcomes for Japan*

One possible outcome for Wal*Mart in Japan could follow along the path of what has happened in Germany. The combination of a difficult economy and an inability to retain local management has made the acquisition of Wertkauf and Interspar less than expected. Wal*Mart has also had problems adapting their inventory and merchandising methodologies to the German market, a clear challenge they will have in Japan. As a result, they are not the low price operator in Germany, making it difficult for them to execute their EDLP pricing strategy. They face a similar pricing challenge in Japan.

The other outcome for Japan could be along the lines of what has happened in Mexico or even Canada. Wal*Mart has been very successful in both countries, although it wasn't always that way. Much as has been the case in Japan, Wal*Mart started off in Mexico by making a small investment in Cifra and then spent several years studying the Mexican market. In Canada they made what was essentially a real estate transaction, buying the defunct Woolco stores. In both countries Wal*Mart was able to implement Retail Link, working initially with Retail Link savvy suppliers from the US, an advantage they will have in Japan. It took a number of years before the operations either in Mexico or Canada became profitable. In the course of doing so, Wal*Mart has become the largest retailer in both countries, driving consolidation in the market but also dramatically improving the quality of both suppliers and retailers.

Implications for Japanese Retailers

Wal*Mart will not change the competitive situation in Japan overnight. They change will come slowly at first. To many businesses it may be imperceptible. This is not the time for either complacency or hyper-concern. Wal*Mart will change the retail landscape of Japan over time. Now is the time for Japanese retailers to begin preparation for a very different future.

Consolidation

Wherever Wal*Mart goes, consolidation follows. By taking its share of the retail business, less is left for their direct competitors. There will be fewer retail businesses on the Japanese retail scene in the future then there has been in the past. While some of this consolidation will come through bankruptcy, a lot of it will be driven by acquisition. Wal*Mart itself is likely to make additional acquisitions as a way of expanding its real estate portfolio in Japan.

Price Deflation

Wal*Mart drives prices down in every market they enter. This is a slow process that builds on itself over time. This does not necessarily mean lower profits as the reduction in prices by Wal*Mart always follows a reduction in costs. What it does mean, however, is a more price competitive market place. Wal*Mart's focus on price spreads to its competitors and to consumers. Wal*Mart will bring about a rise in consumer awareness about relative prices.

Improved Operations

Strong competition raises the bar of performance. Everywhere Wal*Mart goes; the quality of local retailers improves over time. Continuous improvement is one of the keys to success in competing against Wal*Mart.

Search for Differentiation

There are many retailers around the world that are able to compete quite effectively with Wal*Mart. The key to their success is finding a way to differentiate themselves from Wal*Mart in the minds of consumers. While Wal*Mart is nearly unassailable on price, they are vulnerable on just about every other dimension of the marketing mix.

Wal*Mart is particularly vulnerable on merchandise both in terms of quality and mix. There are a number of retailers in The U.S. who follow in Wal*Mart's footsteps, taking advantage of the traffic they generate and offering a broader mix, a higher quality of merchandise or a better quality of service.

Implications for Japanese Suppliers

Channel Strategy

The biggest challenge facing suppliers will be adapting their channel strategy to the emergence of Wal*Mart. For those suppliers that choose to work with Wal*Mart decisions about product mix by channel and even by customer will become more critical.

Distributional Strategy

Multi-tier distribution has always been the generally accepted way of doing business in Japan. Slowly, over time, Wal*Mart will change that. By going directly to their suppliers, Wal*Mart will build a more efficient distributional system. Other retailers will have to follow to remain competitive.

Wal*Mart will look to the larger suppliers in Japan, particularly those it may already have a relationship in other regions of the world for help in building this new but very different distributional system. The benefits of that improvement in distributional efficiency will be reaped by both Wal*Mart and their suppliers. Achieving this transformation in the Japanese distributional system will require substantially higher levels of investment in information technology on the part of Japanese suppliers.

Consolidation

Over time Wal*Mart will drive a process of consolidation within the Japanese supplier community. This process of consolidation will lag the consolidation that will initially take place in the retail marketplace. But like that consolidation will be driven by a combination of bankruptcy and acquisition by existing players.

Part of the process of supplier consolidation can be viewed as an extension of the SKU and brand rationalization that Wal*Mart's market entry will also bring about. Eventually, Wal*Mart's market impact will force a process of brand and sku rationalization on to Japanese suppliers. In both North America and more recently in Europe, suppliers have been going through their portfolio of brands and eliminating or selling off when possible, their weaker brands. Within each brand portfolio they are reducing the number of SKUs as a means of cutting costs and making the remaining SKUs more profitable.

Price Deflation/Margin Improvement

Wal*Mart achieves lower prices at retail by working with their best suppliers to get a lower price from them. This does not mean that margins are going to have to fall. As is the case with Procter & Gamble, lower prices can mean higher margins if they are achieved through a process of mutual cost reduction and productivity improvement.

Conclusions and Observations

Increasingly, the world of retailing is becoming Wal*Mart's world. It is one of the most global retailers in the world, operating in 11 different countries around the world, with multiple formats, all tied together by a state-of-the-art retail distribution system known as Retail Link. Wal*Mart has had both successes and failures in foreign expansion, but it is important to note that Wal*Mart is a learning organization. When Wal*Mart has problems, they solve them by learning and adapting. They don't make the same mistake twice.

The magnitude of success that Wal*Mart will have in Japan hinges on the degree to which Wal*Mart can adapt Retail Link to Japan's distribution system. Also, Wal*Mart will have to acquire enough real estate to achieve the economies of scale needed to be successful, all the while keeping local management happy. And lastly they will need to be patient. Expansion into Japan will take time. And Wal*Mart has shown such patience in the past.

Will We See Wal*Mart in Japan?

It's not a question of "if" but "how fast." In coming to Japan, Wal*Mart will become a major competitor of retailers, wholesalers and suppliers. There will not be a consumer business in Japan that will not have to take Wal*Mart into account in making their strategic plans. At the end of the day, we will see a shakeout in the Japanese consumer marketplace. As Wal*Mart's way of doing business permeates Japanese retailing, the industry will be transformed with fewer players, better technology and lower prices —much in the way we have seen the retail industry transformed in Mexico, Canada and the UK.

About the Author

CARL STEIDTMANN
Tel: 212 492 3951
e-mail: csteidtmann@dc.com

As chief economist for Deloitte Research, Carl Steidtmann is a writer, lecturer, and consultant on a wide range of issues including technology, culture, and economics. He has been a student, a teacher, a systems engineer, a management consultant, and a Wall Street economist. His research has been quoted extensively in the Wall Street Journal, The New York Times, Business Week and USA Today. He was on the 10-year plan at the University of Colorado where he earned four different degrees in three different subjects: history, statistics and economics.

About Deloitte Research

Deloitte Research identifies, analyzes, and explains the major issues driving today's business dynamics and shaping tomorrow's global marketplace. From provocative points of view about strategy and organizational change to straight talk about economics, regulation, and technology, Deloitte Research delivers innovative, practical insights companies can use to improve their bottom line performance. Operating through a network of dedicated research professionals, senior consulting practitioners, and academic and technology partners, Deloitte Research exhibits deep industry knowledge, functional expertise, and a commitment to thought leadership. In boardrooms and business journals, Deloitte Research is known for bringing new perspective to real-world concerns.

For more information about Deloitte Research, please contact the Global Director, Ann Baxter, at 415 268 1026 or via e-mail: abaxter@dc.com.

Recent Deloitte Research Thought Leadership

- **Ideas Change the Worlds:** Strategic Flexibility in a World of Retail Change
- **Deflation:** The Oversupply of Everything
- **An Outlook for the Holidays in the Age of Anxiety**
- **Bubbleheads:** The Fruitless Search for the Next Bubble
- **Discounting a Double Dip**
- **Looking Forward:** The Deloitte Research Leading Index of Consumer Spending
- **Are We Back on the Road to Normalcy?**
- **Why You Should Have No Confidence in Consumer Confidence**
- **The Case for Recovery:** Retail Outlook for 2002
- **Reinventing Retail:** The Challenge of Demand Chain Innovation
- **This Is Not Your Father's Downturn:** Positioning for Recovery
- **Serving the Networked Consumer:** Strategies for Multi-Channel Marketing and Commerce
- **Digital Loyalty Networks:** eDifferentiated Supply Chain and Customer Management
- **Mobilizing the Enterprise:** Unlocking the Real Value in Wireless

Please visit www.dc.com/research for the latest Deloitte Research thought leadership or contact us at: delresearch@dc.com.

ISBN 1-892384-42-X

For Further Information, Please Contact

GLOBAL CONSUMER BUSINESS PRACTICE

AMERICAS

ED CAREY
Tel: +1 312 374 3048
e-mail: ecarey@dc.com

JIM HAINES
Tel:+ 617 850 2060
e-mail: jhaines@dc.com

ED SPANGLER
Tel: +312 374 2132
e-mail: espangler@dc.com

TARA WEINER
Tel: +215 246 2326
e-mail: tweiner@deloitte.com

ASIA PACIFIC

NIGEL WIXCEY
Tel: +622 673 8001
e-mail: nwixcey@dc.com

KEIJI WATANABE
Tel: +81 3 6213 3493
e-mail: kewatanabe@deloitte.com

EUROPE

EGMONT KOCK
Tel: +44 207 779 5987
e-mail: egkock@dc.com

MICHAEL PREFONTAINE
Tel: +44 207 779 6221
e-mail: mprefontaine@dc.com

GILLES GOLDENBERG
Tel: +33 1 40 88 28 16
e-mail: ggoldenberg@deloitte.com

LATIN AMERICA

FRANCISCO PEREZ CISNEROS
Tel: +52 55 5080 67 20
e-mail: fperezcisneros@dttmx.com