

Perspective: Wal-Mart's Mixed Signals – Who's running the Store???

By Thomas H. Hicks, Managing Partner, Renaissance Partners, L.C. (June 24, 2007)

Lawsuits run rampant. Julie Roehm (ex-marketing executive) alleges Wal-Mart's CEO violated company ethics rules. Wal-Mart ("WM") filed a defamation suit against Roehm and her two Michigan law firms. Alleged gift giver to Lee Scott, Irwin Jacobs, filed a defamation lawsuit against Roehm. Does not Wal-Mart have bigger fish to fry? The real issue here was strategic direction – upscale move designed to attract higher income customers, push toward apparel and home décor with tasteful designs to appeal to a different customer than WM's core, engagement of a new ad agency, their firing, and then re-instituting price reduction ads. Legal and press battles continue regarding employee matters, non-US manufactured goods and initiatives to build stores in communities opposed to Wal-Mart.

Q1 profit rose 8.1% due to international sales gains and cost cutting, but US sales (over 75% of WM revenue) weakness persisted in home-décor and higher-margin apparel, outdoor equipment and sporting goods. Q2 estimates put profit at the low end of WM's stated range with comp store sales in the 1-2% plus range. Wal-Mart faces general economy factors of a slowing economy and weak home sales. Also its low-income customers have been hurt by high gas prices. WM inventory rose sharply, probably in part due to apparel, its resumption of price-rollback marketing has not boosted sales, and gross margin rate of 24.4% is lower due to mix shift to food and drugs and reportedly shrink. In the current decade share price is negative versus a strong gain in the Dow Jones Wilshire Retail Index.

Granted, May comp sales continued to show a split between customer segments:

- Luxury retailers fared well
- Moderate customers slowed down spending
- Lower end lagging due to reduced spending power

But strong performance still exists in the moderate (Kohl's) and lower (Target, TJX) segments where they offer more than the price-driven pure discounters.

The Wal-Mart response? – Financial Services. Given it won't get a bank charter WM is carving out floor space for its existing financial services (check cashing, bill payment, money transfers – all non-banking services that were at customer service desks) that exist under "MoneyCenters" in about 170 of its US stores. WM has committed to further pursue non-banking services that fit its customers that are "unbanked" (little or no access to banking services). WM's President-Financial Services stated that 20% of the US population fit that description and are well-represented in WM's customers (42% of WM's shoppers have household incomes under \$40,000 – the low-income and immigrant populations). This initiative at least focuses on the WM bread and better customer (lower income, ethnic) and some (Mexican/South American) may fear true banks due to their experience with devaluations and government disruption. See insert below:

Wal-Mart to expand financial services

By Abigail Goldman, Times Staff Writer

June 21, 2007

Wal-Mart Stores Inc. said Wednesday that it would dramatically expand low-cost financial services such as check cashing and money transfers for its millions of customers who don't have bank accounts.

The giant retailer, which this year dropped efforts to formally enter banking amid opposition from Congress and regulators, said it would open 1,000 Wal-Mart MoneyCenters by the end of next year, up from about 225 in stores now.

Fair-lending advocates and others questioned Wal-Mart's intentions, saying the company may be trying to pursue a back door into banking because the front door was blocked.

"Do you really want to concentrate all that economic power if they make that transition into full banking?" asked Stephen Andrews, chief executive of the Bay Area's Bank of Alameda. "The Senate and the House throughout time has said no."

Wal-Mart executives, however, said the company would be providing a much-needed service at a significant savings for its customers.

"It is right at the heart of a need of our customers — we have so many customers who are outside the mainstream banking system," said Jane Thompson, Wal-Mart's president of financial services. "We know we can add value to their lives and also save them money."

In California, check cashing can cost as much as 3% of the amount of a check. That means that a worker whose take-home pay is \$25,000 a year could spend \$749 annually to cash weekly paychecks — a service that costs nothing for someone with a free checking account.

At Wal-Mart, which charges 1% for check cashing — with a maximum fee of \$3 a check — that same worker would pay \$249.60 a year.

Money orders typically cost 75 cents to \$5 in California, said Alan Fisher, executive director of the California Reinvestment Coalition. At Wal-Mart, a money order costs 46 cents, the company said.

Wal-Mart, which processes more than 2 million financial-service transactions each week, has long sought to expand the business.

Transactions including money transfers, check cashing and bill payment offer a profitable new business for the company that in recent years has suffered from slumping sales and a bruised reputation.

The MoneyCenters are the most profitable part of Wal-Mart's stores, Thompson said.

Just as importantly, the services give cash-strapped consumers — a big part of Wal-Mart's customer base — new reasons to come to its stores.

The centers are open 7 a.m. to 9 p.m. seven days a week, an important benefit for workers who can't take care of personal business during banking hours, Wal-Mart said.

"While we believe these initiatives, given their size, will not materially boost earnings in the near-term, we do see them as a positive long-term driver of customer loyalty," Goldman Sachs analyst Adrienne Shapira wrote Wednesday in a note to clients.

In the face of strong opposition, Wal-Mart this year withdrew its application for what's known as an industrial loan company, the retailer's fourth failed bid to open a bank since 1999.

Although the Bentonville, Ark.-based retailer said it would use the bank to save on credit card processing fees and other back-office transactions, critics including banks, farmers and real estate firms contended that the company was looking to put a toe into retail banking.

Wal-Mart's announcement on Wednesday is a smart sidestep around that issue, said Richard X. Bove, a financial institutions analyst at Punk, Ziegel & Co. in Tampa, Fla.

"Wal-Mart simply made the decision to do the things legally available to it without seeking approval from Congress or any other entity," Bove said. "I think it's brilliant. It makes a lot of sense."

The company also said it would expand a pilot program that offered a Wal-Mart/Visa reloadable debit card, issued by GE Money, to 1,300 stores by the end of June and to all of its more than 3,300 U.S. discount and Supercenter stores by the end of the year.

Wal-Mart's MoneyCard, which costs \$8.94, requires no credit check or bank account and can be used immediately after activation.

The card carries a monthly fee of \$4.94, which Wal-Mart waives if customers load at least \$1,000 on the card in a month. A reloading fee of \$4.64 is waived if customers add funds from a check-cashing transaction at Wal-Mart.

Funds on the card are FDIC-insured and money on lost or stolen cards will be refunded, Wal-Mart said.

Still, some community activists aren't cheering for Wal-Mart's financial services programs.

"Wal-Mart will offer cheaper check cashing, but not the full array of services that any neighborhood needs — mortgages, small-business loans, the kinds of things that are going to jump-start the economy in these neighborhoods," said John Taylor, chief executive of the National Community Reinvestment Coalition.

"What needs to happen is that banks need to be putting payday lenders and pawnshops out of business and making these banking services affordable and available to poor people," Taylor added.

The fact is that Wal-Mart has saturated the US marketplace, new store additions tend to cause sales transfer (cannibalization), the US economy is maturing, population is aging, and wholesale clubs may be a better alternative for some economically impaired large families.

Visit a Wal-Mart store – operating standards are quite different than in the Sam Walton days. Yes the stores are larger, there are more of them, and the assortments are broader. But, consider other factors the customer sees:

- poor housekeeping standards

- minority customers, minority cashiers (reverse discrimination)
- store difficult to shop (large stores, long distances)
- salespeople virtually non-existent, unfriendly, slow to respond, not-knowledgeable (the best time to shop WM is at 3am when the stocking crew is hard at work – they know where everything is located)
- store management totally invisible

And, to heighten the challenge WM can't expect economic help:

- Likely soft fall 2007 – high gas prices, soft home sales, inflation and uncertainty on interest rates dampen spending
- Inventory accumulation (due to softer than expected sales) by retailers cause markdowns that will hurt regular business and planned promotions...look for aggressive promotions in fall
- Food bill rising with CPI food index up 4% year on year and 6% in last three months. Don't look for food and gas to subside
- Consumer spending in the process of slowing...energy costs represent 9% of consumer expenditures for US households and higher for lower income segment (increased cost of necessities)
- Political uncertainty – Presidential election and affect of change given unclear direction and positions of candidates
- Younger population segment have rent/interest/housing taking increased percent of income. If interest rates rise look for layoffs and this group will be affected

Wal-Mart needs to focus on retailing basics and its core customers in the US, with enhanced customer service, inventory cleansing, precise merchandising and mix direction that's right for the customer base. Certain other strategic issues should be up for assessment and establishment of future direction, namely international growth (rifle shot selective markets that it can dominate) and Sam's Club. Positive press and investor embrace flows from performance excellence. Wal-Mart needs to let that be the case.