

# **Why did *Wal-Mart* fail in Germany?**

Andreas Knorr and Andreas Arndt

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## **Abstract**

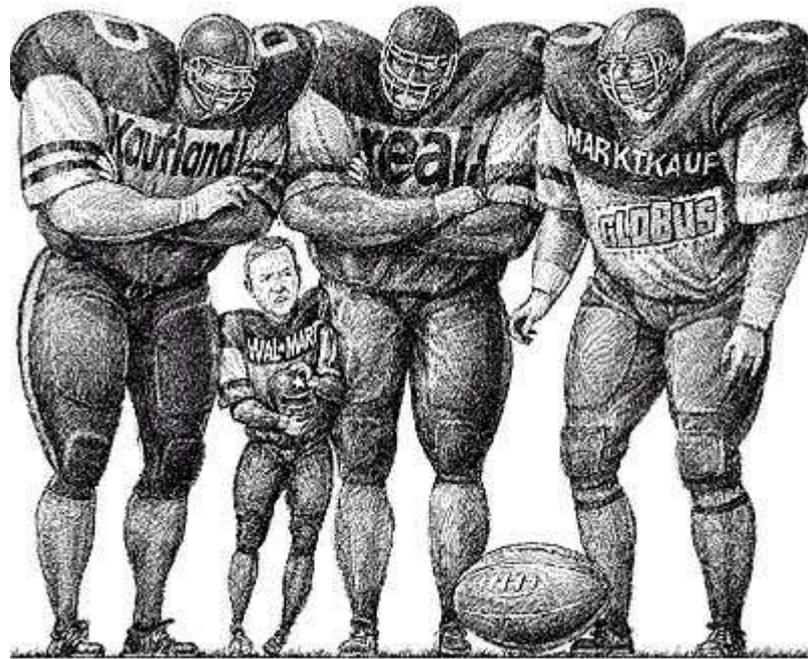
Clearly dominating the US retail market, *Wal-Mart* expanded into Germany (and Europe) in late 1997. *Wal-Mart's* attempt to apply the company's proven US success formula in an unmodified manner to the German market, however, turned out to be nothing short of a fiasco. Upon closer inspection, the circumstances of the company's failure to establish itself in Germany give reason to believe that it pursued a fundamentally flawed internationalization strategy due to an incredible degree of ignorance of the specific features of the extremely competitive German retail market. Moreover, instead of attracting consumers with an innovative approach to retailing, as it has done in the USA, in Germany the company does not seem to be able to offer customers any compelling value proposition in comparison with its local competitors. *Wal-Mart Germany's* future looks bleak indeed.

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Wal-Mart Deutschland: Ein Problem der Größenordnung.

“Wal-Mart Germany: A Problem of Size” (Source: *Lebensmittelzeitung*)

## Introduction

Even by American standards, *Wal-Mart* must be considered as a success story without precedent (rivaled probably only by *Microsoft's* rise). Forty years after its humble beginnings in 1962, when Sam Walton and his brother Bud set up store No. 1, a five-and-dime outfit, on Walnut Street in tiny Rogers, Arkansas, continuous double-digit growth rates have not only transformed it into the world's largest retailer. Having been the biggest private-sector employer in the world for a few years already, with around 1.38 million staff on its payroll, *Wal-Mart* recently also overtook *General Motors* and *Exxon* to become the world's largest corporation in terms of revenue. After establishing itself as the dominant player on its homemarket, *Wal-Mart* decided, in the late 1980ies, to embark upon an ambitious internationalization drive to sustain its brisk corporate growth. The stated strategic goal was to have its foreign operations contribute a third of *Wal-Mart's* total profits by 2005. In 1991, the first store outside the USA, a SAM's Club membership warehouse, was opened in Polenco, a suburb of Mexico City. Today, *Wal-Mart* is active in 9 more countries, and as early as 1993, a separate division – *Wal-Mart International* – was created to supervise and manage the company's international operations.

However, on the international scene *Wal-Mart's* proven US success formula – everyday low prices due to the extensive use of advanced IT, sophisticated logistics and inventory management techniques, a strong emphasis on customer service, and highly-motivated personnel (helped by a quasi-religious corporate culture) – so far paid off only in neigh-

boring Mexico and Canada, where *Wal-Mart* has become the undisputed market leader. It is therefore no exaggeration to state, as a report by London-based investment bank *WestLB Panmurne* did, that "*Wal-Mart* has not yet succeeded in markets that it cannot drive a truck to."<sup>1</sup> Not only does this verdict include the company's activities in Indonesia, which were suspended after two years of heavy losses – while *Wal-Mart's* remaining operations in Asia, a few outlets in China, South Korea, and, since 2002, Japan, are considered to be profitable (albeit far less so than its North American activities) – and in Latin America (Brazil and Argentina). In particular, its foray into the German market, the third biggest retail market in the world after the US and Japan and by far also the most important one in Europe, has so far turned out to be a "fiasco" (according to *Commerzbank Securities'* European retail research analyst *Jürgen Elfers*<sup>2</sup>). As we will argue in this paper, it even offers a textbook case how not to enter a foreign market. Our analysis is organized as follows: After a brief company profile of both *Wal-Mart, Inc.* and *Wal-Mart Germany*, and an excursus on the dimensions of competition in retailing we will discuss the sector-specific approaches and impediments to internationalization in the retailing industry. After that we provide a survey of the German retail market including an overview of the relevant institutional and legal framework. Finally, we will perform a critical assessment of *Wal-Mart's* entry and business strategy in Germany.

## **Wal-Mart: A Company Profile**

### **Wal-Mart, Inc.**

*Wal-Mart* has revolutionized retailing in the USA.<sup>3</sup> As the company's spectacular revenue growth since 1962 illustrates, it has spread like the proverbial bushfire across the country, in particular in formerly un(der)served Rural America. In 1979, its annual turnover reached \$1 billion for the first time. In 1993, it achieved this feat for the first time in a mere week, and, in November 2001, even in a single day.<sup>4</sup> In the year ending January 31<sup>st</sup>, 2003, *Wal-Mart, Inc.* reported sales of \$244.5 billion (around 16.5 per cent of which were earned abroad) – up 12.3 per cent versus 2002, and a whopping 107 per cent increase since 1998. This translated into earnings (before extraordinary items) of \$8.04 billion, or 3.3 per cent of sales and a 22.9 per cent return on equity.<sup>5</sup> With sales of \$25 billion and \$57 billion respectively *Wal-Mart* has grown to become the dominant

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<sup>1</sup> As quoted by *Grose* (2001, p. 49).

<sup>2</sup> As quoted by *Ernsberger Jr.* (2002, p. 51).

<sup>3</sup> For a detailed account see *Slater* (2003).

<sup>4</sup> See *Wefing* (2003).

<sup>5</sup> See *CorporateInformation.com* (2003). This return contrasts markedly with a paltry ROI of just 6 per cent for its international operations (*Grose* 2001, p. 49). – Notice to readers: As *Wal-Mart* refuses to publish the profits or losses of its international subsidiaries, and does not report them to the SEC either, all such figures quoted in the text are estimates by analysts and other retail experts. The same is also true for some major players on the German market, notably the *Aldi Group* and the *Schwarz Group*.

clothing/textile and food retailer on the US market.<sup>6</sup> Every week, around 100 million shoppers frequent its stores: 1.647 Discount Stores (non-food general merchandise items only), 1.066 Supercenters (general merchandise plus full-line food departments), 500 SAM's Clubs (membership warehouse stores) and 31 Neighborhood Stores (small convenience stores) in the US alone, plus more than 1.100 outfits abroad – most of them in the Supercenter and SAM's Club formats. In the past few years, *Wal-Mart* has begun a large-scale conversion program with the long-term aim to transform most of its Discount Stores into Supercenters. The Supercenter format being roughly comparable to the hypermarket store which was invented by *Carrefour*, a French retailer, in the 1960ies, it also became *Wal-Mart*'s format of choice in Germany.

Further corporate superlatives include the following:

- *Wal-Mart*'s Retail Link-system, the backbone of its sophisticated inventory management and logistics infrastructure, is the biggest civilian database in the world (second only to the *Pentagon*'s, but holding three times more data than the US *Internal Revenue Service*'s mainframes).
- It is operating the world's biggest private satellite communications system, allowing it, amongst other things, to track sales, to replenish inventories and to process payments in real-time, and even to regulate the temperature in individual stores.
- *Wal-Mart*'s 2003 turnover is three times higher than *Carrefour*'s, the world's no. 2 retailer (Table 1), and equivalent to the combined revenues of Germany's Top 30 retailers.<sup>7</sup>

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<sup>6</sup> See Heuer (2002).

<sup>7</sup> See Brück (2002).

**Table 1: The World's Top Retailers (2001)**

Rank	Company	Country	Revenues (\$ billion)
1	Wal-Mart Inc.	USA	217,8
2	Carrefour	France	62.2
3	Royal Ahold	Netherlands	59.6
4	The Kroger Co.	USA	50.0
5	Metro	Germany	44.3
6	Albertson's Inc.	USA	38.2
7	Kmart Corp.	USA	34.6
8	Safeway Inc.	USA	34.3
9	Costco Wholesale Corp.	USA	34.1
10	Tesco	United Kingdom	34.1
11	Rewe Group	Germany	33.6
12	Aldi Group	Germany	29.0*
...			
16	Edeka/AVA Group	Germany	25.1
...			
18	Tengelmann Group	Germany	23.1
...			
25	Schwarz Group	Germany	16.7*

Source: *Lebensmittelzeitung (Internet edition)* (2002a) (\* = Estimates)

A true giant on the huge US domestic market, *Wal-Mart*, however, still is only a minor player in international retailing – both in terms of foreign sales as a percentage of total revenues and of the number of countries served (Table 2 and Table 3). A substantial degree of geographical coverage has only been achieved in North America, i.e. on the adjacent markets of Mexico (date of entry: 1991; 563 stores), Puerto Rico (1992; 17), and Canada (1994; 196). This contrasts markedly with its minuscule operations both in Latin America – 11 stores in Argentina plus 22 in Brazil (both entered in 1995) – and Asia, with 19 stores in China (1996), 11 in South Korea (1998), as well as a 6 per cent share in *Seiyu*, a Japanese retailer, since 2002. In Europe, *Wal-Mart* has so far only expanded into Germany (1998; 93 stores) – which was then heralded as its bridgehead into Europe – and the United Kingdom (1999; 252).<sup>8</sup>

<sup>8</sup> See Ernsberger Jr. (2002: 50).

**Table 2: Top 10 Int'l Retailers: Foreign Sales (2000)**

Rank	Company	Country	Foreign Sales (in % of Total Sales)
1	Delhaize Lion Group	Belgium	83.5
2	Royal Ahold	Netherlands	80.8
3	IGA Inc.	USA	62.4
4	Otto Versand	Germany	55.0
5	Tengelmann Group	Germany	48.5
6	Carrefour	France	47.5
7	PPR	France	47.5
8	Metro	Germany	42.1
9	Kingfisher Plc	United Kingdom	40.0
10	Aldi Group	Germany	37.0

Source: *PricewaterhouseCoopers* (2001, p.2)

**Table 3: Top 10 Int'l Retailers: Foreign Countries Served (2000)**

Rank	Company	Country	Number of Foreign Countries Served
1	IGA Inc.	USA	41
2	Marks & Spencer	UK	37
3	PPR	France	28
4	Toys-R-Us	USA	28
5	Carrefour	France	27
6	Royal Ahold	Netherlands	24
7	Otto Versand	Germany	23
8	Metro	Germany	22
9	Ito-Yokado	Japan	20
10	Office Depot	USA	19

Source: *PricewaterhouseCoopers* (2001, p.2)

*Wal-Mart* is serving Argentina, Canada, Germany, South Korea, Puerto Rico and the UK through wholly-owned and Brazil and Mexico through majority-owned subsidiaries. It has preferred, however, to forge joint ventures to enter the Chinese market, and a small minority shareholding in an established local retailer in Japan.<sup>9,10</sup>

<sup>9</sup> See *Wal-Mart* (2002 and 2003).

<sup>10</sup> Apart from Japan, Canada, South Korea, the UK and Germany were all entered through acquisitions.

## **Wal-Mart Germany**

*Wal-Mart* decided to build its initial presence in Germany through acquisitions. In December 1997, it took over the renowned 21-store *Wertkauf* chain (revenues: €1.2 billion) for an estimated \$1.04 billion, followed one year later by the acquisition of *Interspar's* 74 hypermarkets (revenues: €850 million) from *Spar Handels AG*, the German unit of the French *Intermarché Group*, for €560 million.<sup>11,12</sup> In the wake of these transactions, *Wal-Mart* immediately became the country's fourth biggest operator of hypermarkets. However, with a current turnover of around €2.9 billion, and a stagnating market share of just 1.1 per cent, the US giant still is a *quantité négligeable* on the German retail market (Table 4). Even worse, with estimated accumulated losses of more than € 1 billion,<sup>13</sup> it is literally drowning in red ink – although, according to *Wal-Mart Germany's* current CEO, *Kay Hafner*, its non-food assortment, which accounts for around 50 per cent of its revenues, is profitable.<sup>14</sup> Rumor has it that *Wal-Mart Germany* is making money at only two (!) of its locations.<sup>15</sup> And instead of expanding its network of stores by 50 units by early 2001, as originally planned, the company has been forced to close two big outlets, while at the same time it was only able to fully remodel three locations into its flagship Supercenter format.<sup>16</sup> Due to its problems the company recently also had to lay off around 1.000 staff;<sup>17</sup> further cuts are very likely.

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<sup>11</sup> See *O'Brian* (2002); *Brück* (2002).

<sup>12</sup> Throughout this paper we have assumed, for reasons of simplicity, a \$/€-exchange rate at parity (i.e. 1\$ = 1€).

<sup>13</sup> US-based investment bank *Salomon Smith Barley* estimated a loss of \$350 million for FY 2000 alone (*Wirtschaftswoche* 2001a).

<sup>14</sup> See *Kranich/Rutsche* (2002).

<sup>15</sup> See *Ronke/de Paoli* (2003).

<sup>16</sup> Nevertheless, the biggest one of these, in Pattensen near Hannover, is still operating at a level of 60 per cent of planned revenues only (*Brück* 2002).

<sup>17</sup> See *Wal-Mart Germany* (2002 and 2003).

**Table 4: Germany's Top 15 Retailers (2002)**

Rank	Company	Food Sales (in % of Total Sales)	Revenues in Germany (€ billion)
1	Metro AG	45.1	32.0
	<i>Real</i>	75.0	8.6
	<i>Metro Cash+Carry</i>	75.0	6.6
	<i>Kaufhof</i>	7.1	4.4
	<i>Extra</i>	86.0	2.9
	<i>Others</i>	2.2	9.5
2	Rewe Group	68.6	28.6
	<i>Rewe AG</i>	66.7	26.6
	<i>Rewe Wholesale</i>	95.0	2.0
3	Edeka/AVA Group	83.1	25.2
4	Aldi Group	81.0	25.0*
5	Schwarz Gruppe	80.4	17.2*
	<i>Kaufland</i>	77.0	8.7
	<i>Lidl</i>	84.0	8.5
6	KarstadtQuelle	5.8	16.1*
	<i>Stationary distribution</i>	11.0	8.5
	<i>Mail-order</i>	0.0	7.6
7	Tengelmann Group	62.3	12.5*
	<i>Plus</i>	88.0	5.6
	<i>Kaiser's</i>	93.3	2.6
	<i>kd Kaiser's Drugstore</i>	81.5	0.5
	<i>Others</i>	0.0	3.8
8	Lekkerland-Tobaccoland	85.0	8.2
9	Spar Group	92.3	7.5
10	Schlecker	95.0	5.3*
11	Globus	55.0	3.4
12	Dohle Group	83.5	2.9
	<i>Hit</i>	88.9	1.1
	<i>Handelshof Cologne</i>	85.0	0.5
	<i>Bruelle &amp; Schmeltzer</i>	59.5	0.2
	<i>Others</i>	82.5	1.1
13	Wal-Mart Germany	50.0	2.9*
14	Norma	87.0	2.4*
15	Bartels-Langness	81.7	2.1*

Source: *Lebensmittelzeitung (Internet edition)* (2003)

(\* = Estimates)

## Excursus: Dimensions of Retail Competition

Retailers act as intermediaries between the manufacturers of goods, and some services, and end-consumers.<sup>18</sup> Typically, the latter can be described as small, immobile and uninformed with the attribute

- small referring to the fact that each of their purchases usually amounts to only a minor share of their total household expenditure and to their chosen retailers' revenues (in other words, in a hypothetical world without retailers end-consumers could not exert any bargaining power with respect to manufacturers or as effectively monitor product quality),
- immobile referring to their inability or, due to high translocation costs, unwillingness to travel far for their routine (small) purchases, and
- uninformed referring to their lack of detailed information about the availability, quality and prices – including special offers – of specific items and about the size and coverage of the assortments of all (local) retailers.

Aside from explaining the existence of retailers, these characteristics also have fundamental repercussions on the way they compete with each other. Accordingly, a retailer's competitive advantage may result from

- lower prices (including a reputation for proven or at least credible pertinent value propositions such as *Wal-Mart's* famous "everyday low prices", or "we sell for less – always"-pledges),
- a more favorable, i.e. near or easily accessible, location (which may, in turn, even allow its incumbent to charge customers higher prices in return for this additional convenience),
- better product selection and category management (i.e. a product range that meets the consumers' specific needs better than its rivals' do), and/or
- superior customer service (real or perceived).

However, legal barriers and some forms of behavioral regulation may effectively shield incumbents from innovative, more efficient and/or more service-oriented newcomers. In particular, these include but are not limited to

- stringent planning regimes and zoning regulations which may delay or even hinder both new entry through greenfield investments and the expansion or re-modelling of existing stores,
- restrictive shopping hour regulations,
- antitrust and (un)fair trading regulations that may restrict price competition or prohibit some forms of advertising or sales promotion.

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<sup>18</sup> See *Office of Fair Trading* (1997).

## Internationalization in Retailing

### *Status quo*

Compared with most other industries, retailers were late in jumping on the internationalization bandwagon. Given the relatively small size of their respective homemarkets, it is not overly surprising that the frontrunners were European companies. *Carrefour* (France) and *Aldi* (Germany) began to venture abroad with their specific formats – hypermarkets in the case of the former, hard discounting (see below) in the case of the latter – more than three decades ago. It was not until the 1980ies, with a significant acceleration during the 1990ies, that the internationalization of retailers began to gain momentum. Still, in our view just a handful of those players with international operations deserve the label “international retailer” in the sense that they realize a significant share of their sales outside their country of origin and that they have successfully established a long-term presence in a large number of culturally diverse and/or geographically distant countries. Again, most of these companies are based in Western Europe rather than in the US or North America.

### *Prevailing Strategies*

All retail is local. Hence, the mail-order/e-commerce segment maybe aside, retailing is special in the sense that exports are not a viable option in order to expand one’s business across national borders. Consequently, other internationalization strategies have to be pursued, i.e. either

- organic growth,
- joint ventures,
- strategic alliances,
- franchising,
- minority or majority shareholdings in established local retailers, or
- mergers and acquisitions.

A large and still growing body of theoretical and empirical literature has evolved to highlight the respective merits, disadvantages and specific risks of either approach.<sup>19</sup> In retailing, however, with increasingly stringent zoning regulations substantially limiting the scope for expansion, at least for operators of the larger formats, relatively low-risk strategies such as organic (internal) growth, have become almost impossible to implement in the extremely dense populated countries of Europe (or East Asia). Its extraordinary failure rate notwithstanding, most retailers have therefore chosen to resort to the riskiest strategy to enter foreign markets: mergers and acquisitions.<sup>20,21</sup>

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<sup>19</sup> See *Kutschker/Schmid* (2001).

<sup>20</sup> See *Zentes/Swoboda* (1998); *Arthur Andersen* (2001).

## ***Impediments to Retail Internationalization***

By and large, the internationalization efforts of most retailers do not deserve to be called unqualified success stories; many have even failed in and have therefore had to withdraw from at least some countries. While the underlying causes are indeed a “mixed bag” – aside from the general barriers to entry in retailing which we will discuss in the next section, aggressive (price and foreclosure) reactions by the incumbent oligopolies were always a major contributing factor –, valuable lessons can be learned from the successful few, i.e. the likes of *Carrefour*, *Tesco*,<sup>22</sup> *Aldi*, *Metro*, *Hennes & Mauritz (H&M)*, and *Ikea*.<sup>23</sup>

- All of them discovered, stuck to and exploited a specific market niche neglected or overlooked by their local competitors. They were thus in the favorable position to offer their customers a very distinctive value proposition which their local competitors found very difficult to emulate.
- Most of them relied upon organic growth or joint ventures or other forms of cooperation with locals. Some others preferred to enter new foreign markets by acquisition. However, all retailers which were successful in doing so, took over a leading local incumbent in order to build (large) scale fast.
- However, their individual entry strategies notwithstanding, all of them were willing to and adept in fine-tuning their proven business formulas, operations and product ranges to reflect and cater to the different tastes and preferences of a critical mass of local consumers.
- They primarily harnessed the superior market knowledge of local managers and kept investing in local talent to bridge the unavoidable intercultural gaps.
- To minimize their exposure to political risk, they did not become engaged in politically unstable geographic regions and countries.

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<sup>21</sup> Depending on definition and statistic between 50 and 80 per cent of all mergers have failed to deliver the desired results (*Ravnescraft/Scherer* 1989; *Hviid/Prendergast* 1993; *Ernst/Halevy* 2000).

<sup>22</sup> Of course, there are exceptions to every rule, including this one: Even very experienced international retailers like *Carrefour* and *Tesco* failed (miserably) in Germany.

<sup>23</sup> For details see *Incandela/McLaughlin/Smith Shi* (1999), *Child/Heywood/Kliger* (2002) and *Child* (2002).

## The German Retail Market

### **Some General Background Information**

Germany accounts for around 15 per cent of Europe's \$2 trillion-a-year retail market.<sup>24</sup> At a GNP of €2 trillion and populated by around 80 million affluent consumers, it is by far the biggest national retail market in the old world. As in most other Western European countries, the birthrate, however, has been slightly negative since the mid-1960ies. Currently, the German (and, albeit to a lesser degree, the European) retail market is in a state of deep crisis. From the 1950ies until the early 1990ies – when the post-reunification boom drew to a close – retail sales in Germany had traditionally grown slightly faster than GNP. Since then, they have stagnated before plummeting since 2001.<sup>25</sup> 2002 is widely considered to have been the worst year ever for German retailers,<sup>26</sup> with 2003 looking even worse.<sup>27</sup> On average, consumers spend 30 per cent of their available income with retailers, down from 40 per cent only ten years ago,<sup>28</sup> because households shift an ever increasing share of their expenditure into areas such as housing, tourism, and communications.<sup>29,30</sup> As a result, the number of employees declined from 2.75 million to 2.5 million between 1996 and 2001, 50 per cent of whom work on a part-time basis.<sup>31</sup> Finally, the German retail sector primarily relies upon skilled and semi-skilled labor, around one fourth of whom are unionized.

### **Oligopolistic Market Structure – The Key Players**

Concentration of the German retail market is gradually increasing with the Top 10 now representing around 84 per cent of sales. The Top 5 alone – *Metro* (19.7 per cent), *Rewe* (13.6 per cent), *Edeka/AVA* (12.7 per cent), *Aldi* (10.1 per cent) and *Tengelmann* (7.6 per cent) – are accounting for a market share of 63 per cent.<sup>32,33</sup> Food (and drug) retail-

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<sup>24</sup> See *O'Brian* (2002).

<sup>25</sup> See *Lambertz* (2002).

<sup>26</sup> See *Städtler* (2002).

<sup>27</sup> See *Wenzel* (2002a).

<sup>28</sup> See *Greipl/Täger* (2001: 27).

<sup>29</sup> See *Täger* (2000: 9).

<sup>30</sup> This trend has prompted some retailers, notably *Rewe*, to follow changing consumption patterns by diversifying into tourism. Today, the group owns one of Germany's leading package-tour operators.

<sup>31</sup> See *ver.di* (2002: 3).

<sup>32</sup> See *Monopolkommission* (1994); *KPMG/EHI* (2001: 18ff.); *A.C. Nielsen* (2002).

<sup>33</sup> In France the Top 5 (*Carrefour/Promedès*, *Leclerc*, *Casino*, *Intermarché*, *Auchan*) control 88 per cent of the market, compared with 70.4 per cent in the UK (*Tesco*, *Sainsbury*, *Wal-Mart/ASDA*, *Safeway* and *Somerfield*). On the smaller Dutch market (15 million inhabitants) the Top 2 *Ahold* and *Laurus* achieve 63 per cent (*KPMG/EHI* 2001, p. 21). For other countries see *The Economist* (2001).

ing, however, is dominated by a Germany-specific format that was pioneered by *Aldi* in 1962 (see box below) and later successfully imitated by the likes of *Lidl* (part of the *Schwarz Group*), *Norma* and *Penny* (part of the *Rewe Group*): hard discounters, typically offering a range of 600 to 700 products, with a high share of own-brands, at rock-bottom price and ultra-low margins. At the moment these “pile-‘em-high, sell-‘em-cheap”-merchants, control around a third of the food market – as opposed to only 10 per cent in the UK and 8 per cent in France –, with a share of 40 per cent forecast for 2007.<sup>34</sup>

Increasingly, however, the hard discounters are competing fiercely with the traditional retailers in the non-food segment, too. *Aldi*, for example, which has been selling high-quality own-brand computers at very attractive prices around twice a year for around half a decade, has become Germany’s biggest PC-retailer with a market share of 21.5 per cent ahead of *Fujitsu Siemens* (16,9 per cent),<sup>35</sup> and is also one of the country’s major distributors of clothing; in fact, in almost all product categories it has on offer, *Aldi* ranks amongst the country’s Top 3 to Top 5 sellers by sales volume.

#### **Box: The Aldi Group**

In 1946, *Theo* and *Karl Albrecht* took over their parents’ convenience store in Essen. Until 1960, they had managed to increase the number of *Albrecht Discount* stores – by then colloquially known as *Aldi* – to roughly 300. In 1961, the brothers invented the hard discount format combining ultra-low prices (and hence margins) with high product quality, a very narrow assortment of around 600 to 700 products, and a no-frills shopping environment, all of which have translated into the industry’s highest labor and area productivity. *Aldi* is debt-free and pays above-average wages. In 1962, the brothers split the company into two independent operations: *Aldi Nord* (*Aldi North*), headed by *Theo Albrecht*, and *Karl Albrecht’s Aldi Süd* (*Aldi South*). Although being generally referred to as the *Aldi Group* ever since, they by and large operate independently, with coordination taking place only with respect to some major decisions such as supplier choice and important pricing decisions. The reason behind the split – which also resulted in a demarcation line being drawn across Germany, clearly separating the two *Aldis’* economic interest spheres ever since, and international markets later on – was *Karl Albrecht’s* refusal to sell cigarettes, not on health grounds but with the aim to discourage theft. Today the *Aldi Group*, aside from some ancillary activities (real estate, coffee roastery etc.), operates 3.741 stores in Germany and 2.643 abroad. *Aldi Nord* is present in France (516 outlets), the Netherlands (384), Belgium (359), Denmark (200), Spain (18) and Luxemburg (10), while *Aldi Süd* has activities in the USA (578), Austria (267), the UK (with 230 stores in England, 20 in Wales and 17 in Scotland), Australia (34) and Ireland (10).<sup>36</sup>

<sup>34</sup> See *The Economist Online Edition* (2000); *M+M Planet Retail* (2002).

<sup>35</sup> See *Süddeutsche Zeitung Online Edition* (2003).

<sup>36</sup> See *Schlitt* (2001); *Lebensmittelzeitung (Internet Edition)* (2002c); *Stern Online Edition* (2002); *Brandes* (2003).

## Ultra-Low Profitability

With average profits reaching only 0.8 per cent of sales in West Germany – down from 3.4 per cent in 1970 – and 0.5 per cent in the poorer Eastern part of the country,<sup>37</sup> Germany's retail industry is probably the least profitable all over the industrialized world. These figures are well below Germany's manufacturing sector's average of 3 per cent (USA: 8 per cent).<sup>38</sup> Returns are particularly meager in the food segment – at 0.5 per cent of earnings,<sup>39,40</sup> compared to 5 per cent in the UK and 3.5 per cent in France<sup>41,42</sup> – and in the super-, hypermarket and DIY-formats. By contrast, they are quite healthy – by German standards at least – in the hard discount business, with *Aldi* again leading the pack. With earnings estimated at around 2 per cent of sales, the group is not only Germany's most successful and most consistently profitable retailer. It even managed to double its return to almost 4 per cent in the crisis years 2001 and 2002.<sup>43</sup>

However, the hard discounter's strong and entrenched position and their enormous influence on prices is only one, although important, explanation for the extremely low profit margins in Germany's retail sector:

- The vast majority of German retailers are not listed,<sup>44</sup> but family-owned – by some of the richest families in the country or even the world,<sup>45</sup> to be sure – or organized as co-operatives. Not only does this imply relatively higher barriers to exit compared to countries where public-stock companies are dominant (UK, USA, France). It also means that the maximization of shareholder value may not be their single most important principle of doing business.
- Although zoning regulations do impose severe restrictions on the construction of large-scale stores (>2.500 sq. meters, i.e. ≈27.500 sq. ft.) and greenfield shopping centres,<sup>46</sup> they are noticeably less stringent, especially for the smaller units (<700 sq. meters or ≈ 7.700 sq. ft.) required by the hard discounters, than France's or the UK's building codes. As a result, retail space has grown by the factor 10 in the past fifty years, with another 10 per cent increase imminent until

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<sup>37</sup> See *Greipl/Täger* (2001: 32).

<sup>38</sup> See *Jacobsen* (2001: 50).

<sup>39</sup> See *Spiegel Online* (2002).

<sup>40</sup> Since 1991, food prices have risen at a pace below the inflation rate (*The Economist* 2002).

<sup>41</sup> See *Manager Magazin* (1999a: 74).

<sup>42</sup> In other words: On a yearly basis, German consumers have to spend around €6.5 billion less on food than British consumers as a result (*Manager Magazin* 1999, p. 74).

<sup>43</sup> See *Wolfskeil* (2002).

<sup>44</sup> In Germany, only 12 per cent of all food retailers are listed, versus 40 per cent in France and 97 per cent in the UK (*Rehm/Syre* 2003, p. 20).

<sup>45</sup> *Theo* and *Karl Albrecht*, the brother founders and owners of the *Aldi* group this year rank third – behind *Bill Gates* and *Warren Buffet* – in *Forbes* magazine's annual list of the world's richest people.

<sup>46</sup> Approximately only 300 shopping centers are in operation throughout Germany.

2007.<sup>47</sup> Currently, Germany's selling space amounts to 293 sq. meters per 1.000 inhabitants, compared with France's 160 and the UK's paltry 133.<sup>48</sup>

- The EURO-conversion on January 1<sup>st</sup>, 2002, and the ensuing confusion amongst consumers, was (mis)used by some retailers to raise prices dramatically – increases by 10 or 20 per cents were not exceptional –, with equally dramatic consequences not only for their turnover and profits, but also for the sector as a whole. *Aldi*, however, exploiting its reputation for great value (high quality products at very low prices), reacted with the biggest overall price reduction of its corporate history. As a result, it was able to increase its sales by more than 10 per cent in 2001 and, as mentioned above, and to double its profits.
- Finally, German consumers apparently hold price and value in much higher esteem than service and quality. According to a recent survey conducted by *McKinsey*, a consultancy, the share of so-called price/value customers is 42 per cent (France: 48 per cent, UK: 32 per cent), whereas only 13 per cent (France: 48; UK: 13) consider themselves of the service/quality variety. Affinity consumers, i.e. brand-conscious and peer group-oriented customers, account for 45 per cent (France: 25; UK: 55).<sup>49</sup> The very high elasticity of demand demonstrated by German consumers has also been confirmed by a number of other studies.<sup>50</sup>

### **Retail-Specific Legislation**

As mentioned above, planning laws and zoning regulations hinder large-scale new entry by any big-box operator. Some other sector-specific regulations, however, also impact significantly upon corporate strategies, and hence retail competition:

- At a legal maximum of 80 hours/week store opening hours<sup>51</sup> in Germany are among the shortest in Europe (Table 5). Sunday and holiday openings are not permitted at all. This contrasts markedly with the 168 hours/week in the UK, 96 hours/week in the Netherlands, and a minimum of 144 hours/week in France.<sup>52</sup>
- Germany's fair trading and antitrust laws contain some important restrictions for retailers' pricing policies. To summarize briefly – ignoring the (few) exceptions to this rule –, they forbid merchants to sell goods below cost on a permanent basis.<sup>53</sup> A pricing strategy centered around some loss-leaders is therefore very

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<sup>47</sup> See *Städtler* (2000); *Greipl/Täger* (2001: 34f.).

<sup>48</sup> See *The Economist* (2002).

<sup>49</sup> See *Child/Heywood/Kliger* (2002).

<sup>50</sup> E.g. by *Herrmann/Möser/Werner* (2002).

<sup>51</sup> More generous store hours apply for supermarkets and other retail outlets which are located on the premises of airports and major railway stations – and gas stations, many of which have been transformed in 24/7 convenience stores as a result. In addition, the German government has recently passed legislation extending store opening hours on Saturdays which will take effect on June 1<sup>st</sup>, 2003. Stores will then be allowed to close at 8 p.m. instead of 4 p.m.

<sup>52</sup> See *KPMG/EHI* (2001: 10).

<sup>53</sup> For details see *Wirtschaft und Wettbewerb* (2002).

likely illegal under German law (but more often than not perfectly legal in the US and the UK).

**Table 5: Store Opening Hours in Select EU Countries**

Country	Mon - Fri	Sat	Sun/Holidays	Hours/Week
UK	00.00 – 24.00	00.00 – 24.00	00.00 – 24.00	168
Netherlands	06.00 – 22.00	06.00 – 22.00	Closed	96
Spain	00.00 – 24.00	00.00 – 24.00	Closed	144
France	00.00 – 24.00	00.00 – 24.00	Open*	144 (Minimum)
Germany	06.00 – 20.00	06.00 – 16.00 [From June 1 <sup>st</sup> , 2003: 06.00 – 20.00]	Closed	80 [From June 1 <sup>st</sup> , 2003: 84]

(\* Note: Only store-owners and their family-members, but no employees are permitted to work on Sundays and holidays)

Source: KPMG/EHI (2001, p.10)

### **Wal-Mart’s Strategy in Germany – and Why It Failed**

Lee Scott, Wal-Mart Inc.’s current CEO recently admitted in the German business weekly *Wirtschaftswoche* (2001) that the company had messed more things up in Germany than it had managed to do right. Indeed, an endless string of amazing management blunders have plagued Wal-Mart’s German operation from the very start. Even worse, we hold that the company has so far not succeeded to fully remedy any of them. Wal-Mart’s principal mistakes on the German market may be summarized as follows:

- A fundamentally flawed entry-by-acquisition strategy,
- a management by “hubris and clash of cultures”-approach to labor relations,
- a blatant failure to deliver on its legendary “we sell for less – always“, “every-day low prices” and “excellent service” value proposition, and
- bad publicity due to its repeated infringement of some important German laws and regulations.

#### **Flawed entry-by-acquisition strategy**

As mentioned above, Wal-Mart entered the German market through two consecutive acquisitions. While its first move – the 1997 takeover of the 21 *Wertkauf* stores – was indeed a shrewd one, given that company’s excellent earnings (3 per cent of sales), its competitive locations, and its very capable management, Wal-Mart’s 1998 follow-up deal with *Spar* for 74 hypermarkets was widely judged an ill-informed, ill-advised act, for several reasons:

- *Spar* is considered to be the weakest player on the German market due to its mostly run-down stores, very heterogeneous in size and format, with the majority of them located in less well-off inner-city residential areas. Not only did this result – for *Spar* before and *Wal-Mart* after the acquisition – in one of the industries’ lowest turnover per sq. meter of floor area (Table 6), higher logistics costs and lower returns. Even worse, *Wal-Mart* has been unable until today to upgrade most of these stores and to implement a uniform design to build brand recognition.
- Nevertheless *Wal-Mart* was willing to pay *Spar* €560 million for the transaction – which was maybe the best deal throughout *Spar*’s troubled history as, two years earlier, *Spar* had acquired 36 of these stores for as little as €85 million.<sup>54</sup> Worst of it all, through the extremely costly transaction *Wal-Mart* did not even purchase real estate but has only bought itself subtenant status at most of these locations. It is very likely then that the company will be forced to give up a number of them as soon as the leases will expire.
- Ever since, *Wal-Mart* has been in fruitless talks with competitors *Metro* and *Globus* in order to expand its far-flung store network substantially (around 80 per cent of the German population have no *Wal-Mart* store in their vicinity).<sup>55</sup> With organic growth close to being a mission impossible for hypermarket operators due to stringent planning and zoning regulations, the company, as a result, still lacks the size necessary to extract significant price concessions from suppliers and to reduce its currently very high logistics costs. According to German retail experts, for a company to fully exploit economies of scale in food retailing a minimum annual turnover of around €7.7 billion is de rigueur – a critical mass which is 2.5 times higher than *Wal-Mart Germany*’s actual sales.<sup>56</sup>

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<sup>54</sup> See O’Brian (2000).

<sup>55</sup> *Metro*’s owners even sacked the company’s year-long CEO, *Erich Conradi*, who was rumored to have prepared a deal, to signal their unwillingness to sell out to *Wal-Mart*. Nevertheless *Metro*’s *Real* and *Extra* divisions would nicely fit in with *Wal-Mart*’s Supercenter format, while *Metro*’s Cash+Carry outfits would perfectly complement *Wal-Mart*’s Sam’s Club membership warehouses. However, *Metro* reacted to *Wal-Mart*’s entry not only by streamlining its (then) loss-making *Extra* and *Real* subsidiaries. In addition, it acquired German rivals *Allkauf* and *Kriegbaum*, thereby significantly limiting *Wal-Mart*’s scope for future expansion in attractive locations.

<sup>56</sup> See *Bergmann* (2000).

**Table 6: Productivity Per Unit of Sales Floor**

Rank	Company	Sales in € / sq. meter
1	Aldi Group	7.500
2	Rewe Group	5.850
3	Globus	5.250
4	Schwarz Group	4.900
5	Metro	4.000
6	Edeka Group	3.600
7	Tengelmann Group	3.600
8	Wal-Mart	3.500
9	Spar Group	3.000

Source: KPMG/EHI (2001, p.15)

### **Management by “hubris and clash of cultures”**

Many companies’ ambitions to position themselves (profitably) in foreign markets or to establish themselves as “global players” have been thwarted by their inability to fully understand and to adapt to the specific conditions of doing business in other countries, exposing their profound lack of intercultural competence and management skills. This observation is even more true if foreign markets had been entered through mergers or acquisitions. The difficulties of making mergers work are well-known to corporate leaders, the affected staff, management theorists and management consultancies.<sup>57</sup> The formidable challenge of post-merger integration is further complicated significantly if it must be taken up in an international environment, with all issues frequently being compounded by a lack of language and culture bridging skills. Failure to accomplish this task satisfactorily, however, inevitably results in mutual distrust, disillusionment, demotivation and the exodus of high potentials as well as of “old hand” staff – with the well-documented negative impact on the merged companies' competitiveness, profits and shareholder value.

This is exactly what happened to *Wal-Mart Germany*. To begin with, it appointed four CEOs during its first four years of operation. The first was *Rob Tiarks*, a US citizen and a *Wal-Mart, Inc.* senior vice president who had previously supervised around 200 US Supercenters from the company headquarters in Bentonville, Arkansas. Not only did he not speak any German. Due to his unwillingness to learn the language – a view shared by most of the other US managers that were redeployed to Germany to assist him –, English was soon decreed as the official company language at the management level. What is more, he displayed an astounding degree of ignorance with regard to the manifold complexities and the legal and institutional framework of the German retail market (see below), ignoring any strategic advice presented to him by former *Wertkauf* executives – thereby encouraging the top three of them to leave within six months.<sup>58</sup> After *Wal-Mart's* 1998 acquisition of UK retailer *ASDA*, *Tiarks* was replaced by Englishman

<sup>57</sup> See *Hofstede/Neuijen/Ohavy/Sanders* (1990); *Kay/Shelton* (2000); *Bekier/Bogardus/Oldham* (2001).

<sup>58</sup> See *O'Brian* (2000); *Baumann/Gorgs* (2001).

*Allan Leighton*. In terms of his specific market knowledge as well as linguistically as inexperienced as *Tiarks*, he preferred to head the company from his Leeds, UK, office and was replaced as little as six months later by *Volker Barth*.<sup>59</sup> The first German ever to be entrusted with the top job, and one of the few remaining ex-*Wertkauf* managers still aboard, he too failed to integrate *Spar* – a rather loose organization of largely independent regional units – into *Wertkauf* – formerly a highly centralized owner-controlled firm – and to blend their vastly different corporate cultures with *Wal-Mart's*.

Since May 1<sup>st</sup>, 2001, *Kay Hafner*, supported by a group of native Germans, has been at the company's helm. However, the jury is still out as to whether he is indeed the badly needed integrator.<sup>60</sup> According to headhunters *Wal-Mart Germany's* is widely considered to be a very unattractive employer, with around one third of its executives – from store managers upwards – actively seeking job offers from other companies. The underlying causes are said to include widespread dissatisfaction with their relatively low pay, *Wal-Mart's* practice to transfer store managers after one or two years, and the (allegedly) “low American quality standards” of most merchandise currently in store.<sup>61</sup> Others complained about the company's frugal internal regulations for business trips, in particular the decree that executives have to share rooms – a rule unheard of in any other major German or European company (and, in our view, unenforceable were it ever imposed).

In the US, *Wal-Mart* is a strictly non-union employer; only 12 of its more than one million US employees – workers in the meat department of its Jacksonville, Texas, store – are known to be union members.<sup>62</sup> In Germany, like in most other parts of Continental Europe however, unions, despite decreasing membership, still wield enormous influence – both in the political sphere and on the shop floor. The unions' enthusiasm, prompted by *Wal-Mart's* decision to hire more staff immediately after its entry in Germany to provide “excellent customer service”, quickly faded away. Soon faced with rapidly mounting losses, *Wal-Mart's* management resorted to staff cuts and closures to reduce its above-average personnel costs. Due to strict worker protection regulations, however, making surplus workers redundant can be a complicated, lengthy and costly affair in Germany – a cumbersome fact of life for its German competitors, but, obviously, *terra incognita* for *Wal-Mart Germany's* (mostly) American executives. What is more, the company refused to formally acknowledge the outcome of the sector-specific centralized wage-bargaining process (which is the standard procedure for determining wages in Germany) *ver.di*, the relevant union, and the retailers' employers' association had agreed upon. Although it voluntarily paid its staff 0.5 per cent on top of the general raise, to the company's management complete surprise, *ver.di* retaliated by organizing walkouts at 30 stores throughout the country – resulting not only in lost sales but in bad publicity for “union-bashing” *Wal-Mart*.<sup>63</sup> As will be discussed in more detail below, the *ver.di*–*Wal-Mart* controversy is escalating after the union sued the company for breaching Germany's financial information disclosure regulations.

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<sup>59</sup> See *Hirn* (2002).

<sup>60</sup> It is being rumored that *Wal-Mart Inc.*, helped by headhunters, is actively seeking a successor for him due to *Wal-Mart Germany's* continuously unsatisfactory performance (*Schlitt* 2002, p. 29).

<sup>61</sup> See *Wenzel* (2002b).

<sup>62</sup> See *Bergmann* (2000).

<sup>63</sup> See *Gehrmann* (2001).

A final anecdote proves *Wal-Mart's* initial hubris with respect to its suppliers: Its minor role and lack of buyer's power on the German market notwithstanding – or simply being unaware of it –, the company's chief executives demanded unlimited access without prior announcement to the factory floors of their suppliers, including most of Germany's best-known and most valuable consumer brands, for on-site quality inspections. To nobody's surprise – *Wal-Mart's* leaders' obviously expected –, however, the vast majority of them did not feel the (commercial) need to oblige.<sup>64</sup>

### ***Neither "everyday low prices" nor "excellent service"***

Traditionally, *Wal-Mart* has inflicted a full-scale price war on incumbents on every single market it has so far entered in order to credibly communicate its legendary “every day low price”-pledge to local consumers. While extremely successful almost everywhere else, this strategy badly backfired in Germany – largely due to the afore-mentioned ignorance, lack of experience, and hubris of *Wal-Mart Germany's* original top management team led by *Rob Tiarks*:

- To his complete surprise, all affected German competitors, first and foremost *Aldi* – which throughout its existence successfully defended its position as Germany's undisputed cost and price leader –, *Lidl*, *Rewe* and *Edeka*, not only matched all of *Wal-Mart's* price cuts.<sup>65</sup> Even worse, the results of several independent surveys, commissioned by newspapers or conducted by *Stiftung Waren-test*, a highly influential government-sponsored consumer protection agency, and the *Gesellschaft für Konsumforschung* (GfK), Germany's biggest market-research institute, demystified *Wal-Mart's* fundamental value proposition “everyday low prices” as a (largely) empty promise: They showed that *Wal-Mart* had not been able to systematically undercut *Aldi* and the other hard discounters, and that, by contrast, its assortment was not even substantially cheaper than the traditional retailers' (*Rewe*, *Edeka* etc.) offerings.<sup>66</sup>
- So far *Wal-Mart Germany* has not succeeded in delivering on the second part of its value proposition – “excellent customer service” – either. By contrast the company has repeatedly been rated as only just or even slightly below average in terms of overall consumer satisfaction (Table 7).<sup>67</sup> In our view, this is because *Wal-Mart's* traditional US-centered view of customer service, enshrined in some of its famous/notorious basic beliefs and rules, is only partly compatible with the expectations of German consumers. This is in particular true of the famous “ten-foot-rule” (“three-meter-rule” in metric Germany) and the institution of the “greeter” (which, in the meantime, have been largely abolished after shoppers unaware of its key role in *Wal-Mart's* service concept had repeatedly complained that they had been harassed by strangers on store premises). While yielding

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<sup>64</sup> See *Bergmann* (2000).

<sup>65</sup> See *Manager Magazin* (1999b: 42).

<sup>66</sup> See *Lebensmittelzeitung Internet edition* (2002b).

<sup>67</sup> For a more recent survey – with an equally disillusioning outcome for *Wal-Mart* – see *Wirtschaftswoche* (2002).

little tangible economic benefits – German consumers have been accustomed for decades to shopping at self-service formats without any staff assistance –, the additional personnel required to perform these services efficiently, are the cause why *Wal-Mart's* labor costs (as a percentage of total costs) continue to remain above the industry's average.

- Finally, suffice it to say that Germany's restrictive shopping hour regulations prevent *Wal-Mart* (as well as any other Germany-based retailer, to be sure) from offering its customers the additional convenience and superior shopping comfort associated with 24/7 operations.

**Table 7: German Retailers: Overall Customer Satisfaction**

Rank	Company	Satisfaction Index (Maximum: 100)
1	Aldi Group	73.45
2	Globus	71.42
3	Kaufland	71.01
4	Lidl	69.09
5	Norma	68.52
6	Marktkauf	66.96
7	Wal-Mart	64.39
8	Metro	63.97
9	Penny	63.32
10	Real	62.50

Source: KPMG/EHI (2001, p.15)

### ***Repeated Infringements of German Laws and Regulations***

With the ensuing negative publicity, *Wal-Mart* stands accused of, or has already been tried and fined for breaching several important German laws and regulations, in particular

- Section 20(4) of the "Act Against Restraints of Competition" (*Gesetz gegen Wettbewerbsbeschränkungen* or *GWB*). This centerpiece of German antitrust legislation bans all "undertakings with superior market power"<sup>68</sup> from selling a range of goods "not merely occasionally below its cost price, unless there is an objective justification for this",
- Section 335a of the "Commercial Act" (*Handelsgesetzbuch* or *HGB*). It requires all corporations to disclose basic financial information including a balance sheet and an annual profit or loss statement and,

<sup>68</sup> Based upon section 19 of the act both the German *Federal Cartel Office* and the courts defined *Wal-Mart Germany* as an undertaking with superior market power – despite its tiny share of the German retail market but because of the huge financial resources of *Wal-Mart Inc.*

- in early January 2003, the recently amended "Obligatory Deposit Regulation". It stipulates that retailers must provide a deposit-refund-system for certain types of plastic and metal beverage containers or, alternatively, to refrain from selling any product bottled or canned in containers which are covered by this piece of legislation.

*Wal-Mart's* failure to comply with the provisions of the German antitrust act may simply be considered a further proof of its initial hubris with regard to the workings and intricacies of the German retail market.<sup>69</sup> Its unwillingness to publish key financial data – despite increasingly hefty fines levied against the company, and more recently, also against *Dave Ferguson*, head of *Wal-Mart's* European operations, *Kay Hafner* (CEO Germany), and *Gottfried Haug* (CFO Germany) personally – is now widely perceived by analysts and the media as a blunt attempt to prevent outsiders – including shareholders – from taking a true and fair view of the dire state of *Wal-Mart's* German business activities.<sup>70,71</sup>

## Conclusion and Outlook

*Wal-Mart's* difficulties on the highly competitive German market can, after five years of extremely disappointing results, no longer be discarded as mere teething problems. Widely perceived now as a mediocre retailer with no particular strengths and weaknesses, let alone any particularly attractive and credible value proposition, *Wal-Mart Germany* seems light-years away from meeting the internal financial benchmarks set by *Wal-Mart Inc.'s* Bentonville headquarters: a return on equity of 17 per cent (10 per cent after tax) and the requirement that any investment must have been completely refinanced by means of the cash flow it generates after a maximum period of 15 years. As we have tried to demonstrate, *Wal-Mart's* failure on the German market has been the inevitable result of its inability – caused by an astounding degree of ignorance of key principles of internationalization strategies and intercultural management – to select and implement an adequate entry and business strategy. Instead of shaking up the extremely competitive German retailing sector with an innovative approach to doing business, as it has so convincingly done in the USA, in Germany the company seems to be the prey rather than the hunter. *Wal-Mart Germany's* future looks bleak indeed.

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<sup>69</sup> As for the "Obligatory Deposit Regulation", almost all retailers reported transition problems.

<sup>70</sup> See *Financial Times Deutschland Online Edition* (2002); *Manager Magazin Online Edition* (2002).

<sup>71</sup> After suffering a series of defeats before lower courts, in mid-March *Wal-Mart Germany* took the case to the *Bundesverfassungsgericht*, the German *Supreme Court* (Ronke/de Paoli 2003).

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