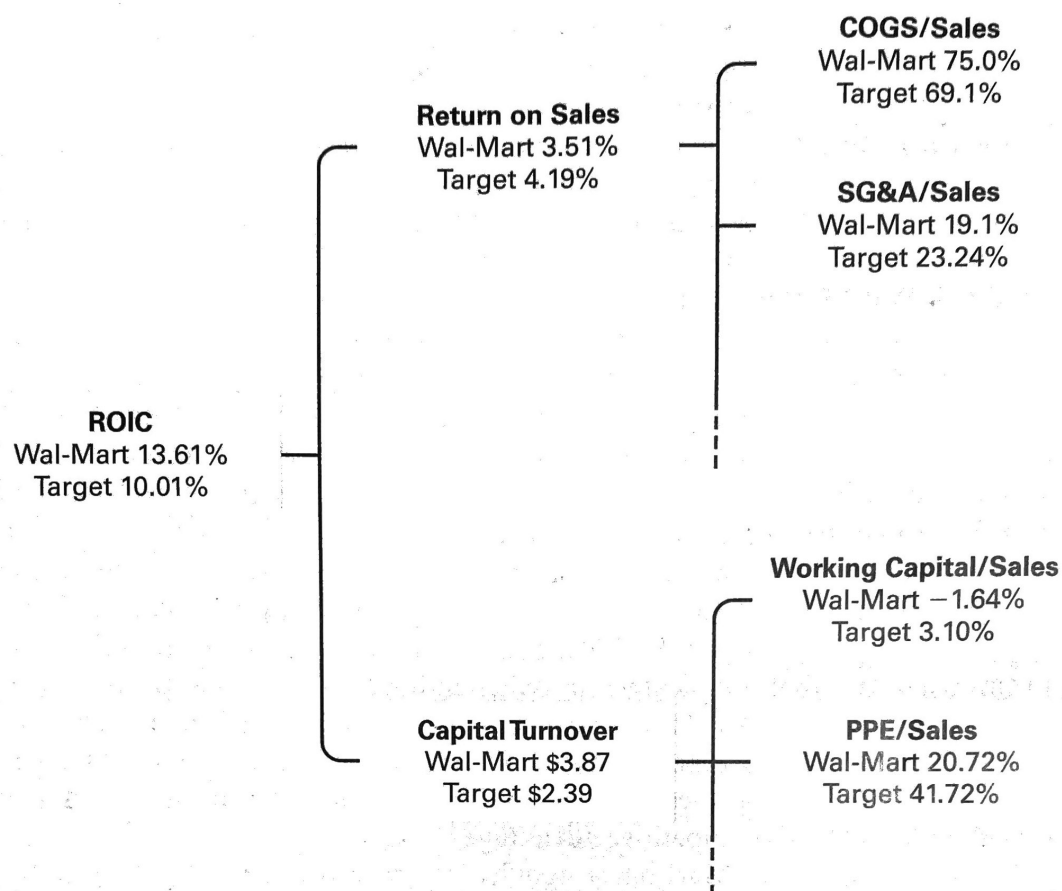


Figure 3.9 Comparing Wal-Mart and Target, 2012



First, note that Wal-Mart has a *lower* return on sales than Target. The main reason for this is that Wal-Mart's cost of goods sold (COGS) as a percentage of sales is higher than Target's (75% versus 69.1%). For a retailer, the COGS reflects the price that Wal-Mart pays to its suppliers for merchandise. The lower COGS/sales ratio implies that Wal-Mart does not mark up prices much as Target—its profit margin on each item sold is lower. Consistent with its long-time strategic goal, Wal-Mart passes on the low prices it gets from suppliers to customers. Wal-Mart's higher COGS/sales ratio reflects its strategy of being the lowest-price retailer.

On the other hand, you will notice that Wal-Mart spends less on sales, general, and administrative (SG&A) expenses as a percentage of sales than Target (19.1% versus 22.24%). There are three reasons for this. First, Wal-Mart's early strategy was to focus on small towns that could only support one discounter. In small towns, the company does not have to advertise heavily because it is not competing against other discounters. Second, Wal-Mart has become such a powerful brand that the company does not need to advertise as heavily as its competitors, even when its stores are located close to them in suburban areas. Third, because Wal-Mart sticks to its low-price philosophy, and because the company manages its inventory so well, it does not usually have an overstocking problem. Thus, the company does not need to hold periodic sales—and nor bear the costs of promoting those sales (e.g., sending out advertisements and coupons in local newspapers). Reducing spending on sales promotions reduces Wal-Mart's SG&A/sales ratio.

In addition, Wal-Mart operates with a flat organizational structure that has very few layers of management between the head office and store managers. This reduces administrative expenses (which are a component of SG&A) and hence the SG&A/sales ratio. Wal-Mart can operate with such a flat structure because its information systems allow its top managers to monitor and control individual stores directly, rather than rely upon intervening layers of subordinates to do that for them.

It is when we turn to consider the capital turnover side of the ROIC equation, however, that the financial impact of Wal-Mart's competitive advantage in information systems and logistics becomes apparent. Wal-Mart generates \$3.87 for every dollar of capital invested in the business, whereas Target generates \$2.39 for every dollar of capital invested. Wal-Mart is much more efficient in its use of capital than Target.

One reason is that Wal-Mart has a lower working capital/sales ratio than Target. In fact, Wal-Mart has a *negative* ratio (-1.64%), whereas Target has a positive ratio (3.10%). The negative working capital ratio implies that Wal-Mart does not need any capital to finance its day-to-day operations—in fact, Wal-Mart is using its *suppliers'* capital to finance its day-to-day operations. This is very unusual, but Wal-Mart is able to do this for two reasons. First, Wal-Mart is so powerful that it can demand and get very favorable payment terms from its suppliers. It does not take ownership of inventory until it is scanned at the checkout, and it does not pay for merchandise until 60 days after it is sold. Second, Wal-Mart turns over its inventory so rapidly—around eight times a year—that it typically sells merchandise *before* it has to pay its suppliers. Thus, suppliers finance Wal-Mart's inventory and the company's short-term capital needs. Wal-Mart's high inventory turnover is the result of strategic investments in information systems and logistics. It is these value-chain activities more than any other that explain Wal-Mart's competitive advantage.

Finally, note that Wal-Mart has a significantly lower PPE/sales ratio than Target: 20.72% versus 41.72% . There are several explanations for this. First, many of Wal-Mart's stores are still located in small towns where land is cheap, whereas most Target stores are located in more expensive, suburban locations. Thus, on average, Wal-Mart spends less on a store than Target—again, strategy has a clear impact on financial performance. Second, because Wal-Mart turns its inventory over so rapidly, it does not need to devote as much space in stores to holding inventory. This means that more floor space can be devoted to selling merchandise. Other things being equal, this will result in a higher PPE/sales ratio. By the same token, efficient inventory management means that it needs less space at a distribution center to support a store, which again reduces total capital spending on property, plant, and equipment. Third, the higher PPE/sales ratio may also reflect the fact that Wal-Mart's brand is so powerful, and its commitment to low pricing so strong, that store traffic is higher than at comparable discounters such as Target. The stores are simply busier and the PPE/sales ratio is higher.

In sum, Wal-Mart's high profitability is a function of its strategy, and the resources and distinctive competencies that its strategic investments have built over the years, particularly in the area of information systems and logistics. As in the Wal-Mart example, the methodology described in this section can be very useful for analyzing why and how well a company is achieving and sustaining a competitive advantage. It highlights a company's strengths and weaknesses, showing where there is room for improvement and where a company is excelling. As such, it can drive strategy formulation. Moreover, the same methodology can be used to analyze the performance of competitors and gain a greater understanding of their strengths and weakness, which in turn can inform strategy.

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