

WHARTON ON Marketing



Approaches for Retailers

WITH INTERNET SALES RISING and virtual storefronts expanding into consumers' homes, how should retailers plan for—and promote—online shopping? And, are the ground rules the same as bricks-and-mortar shopping, or would it be smart to adjust pricing according to who is shopping online and when? These are some of the newer issues that retail marketing executives are facing, along with an increasing awareness of the importance of maintaining customer satisfaction in the virtual and nonvirtual storefront and the value of customer loyalty programs. Meanwhile, bargain retailers like Wal-Mart, facing saturation in their target market, are looking for ways to grow by appealing to upscale shoppers. The following articles from *Knowledge@Wharton* take a look at what's in store for retail marketing.

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According to a recent study, 64 percent of consumers who shop on the Internet do not know that “it is legal for an online store to charge different people different prices at the same time of day.” Yet dynamic pricing is not new. Retailers have been using it for years in ways that benefit not just themselves but also their customers. The challenge is to establish dynamic pricing in ways that lead to profitability rather than price wars.

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When consumers have a bad shopping experience, they are likely to spread the word—not to the store manager or salesperson, but to friends, family, and colleagues. Overall, if 100 people have a bad experience, a retailer stands to lose between 32 and 36 current or potential customers. These are some of the conclusions of *The Retail Customer Dissatisfaction Study 2006*, conducted by The Jay H. Baker Retailing Initiative at Wharton and The Verde Group, a Toronto consulting firm. The biggest source of consumer dissatisfaction? Parking lots.

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After saturating its target market of bargain-hunting consumers, Wal-Mart is ratcheting up its low-price strategy to appeal to more upscale shoppers by expanding its merchandise lines to include organic foods, better wines, high-end consumer electronics, and new fashion-oriented apparel. It's an approach that carries some risk—including new challenges for its legendary supply-chain system—say Wharton faculty and analysts, but the move is dictated by intense competition and the lack of other opportunities for growth.

Can't Find That Dress on the Rack? Retailers Are Pushing More Shoppers to the Web

SHOPPERS WITH TASTES, or sizes, that fall outside the mainstream may have more trouble finding what they want in stores as retailers attempt to shift low-volume items to Internet sales.

According to Wharton faculty and industry analysts, retailers are paring back in-store selections of odd sizes or offbeat colors in order to save inventory handling costs as well as precious floor space. At the same time, stores are trying to coax shoppers looking for low-selling merchandise to special order those items or buy them through the retailers' web sites. The merchandise is then shipped directly to customers' homes.

Retailers have always feared operational problems leading to stockouts (items and/or sizes that are out of stock) and lost sales. Now, stores are generating intentional stockouts because they have the opportunity to capture lost sales through the Internet. "Slow-moving items can be efficiently sold using the web site, but not the stores. So when the customer comes into the store and wants an item that is a slow-seller, he or she can get redirected," says Gérard Cachon, Wharton professor of operations and information management.

Items with few takers can clog a retail supply chain, add cost to the distribution system, waste expensive retail square footage, and, ultimately, lead to costly markdowns.

As retail operations have expanded into mega-stores across the country and the world, a handful of losers in the merchandise mix at each location can grow into a big problem, says Cachon. "When there's so much variety and you have an item that sells maybe four or five times a year, millions of those items can add up to substantial amount of sales. You can effectively sell those items through a consolidated warehouse, but you can't put them in hundreds of Best Buys."

Wharton Marketing Professor Barbara Kahn says retailers who intentionally don't stock some



items still run the risk of turning off individual shoppers. She notes also that because retailers can offer a better assortment of merchandise through the Internet, consumers benefit overall. "From the single consumer point of view, the one who wants the odd size, this is not the best approach: It would obviously be preferable to have the item right there," says Kahn. "But if you think of the portfolio of consumers, then it's a different story. I would imagine the savvy retailers are maximizing their floor space to appeal to their best, high-value, loyal customers rather than catering to every taste, but at the same time they are servicing those one-off transactions by facilitating the online purchase."

Getting the Tangible Experience

Daniel Corsten, a former visiting professor at Wharton who now teaches at the London Business School, says he's not convinced the new strategy of pushing in-store customers to the Internet will work. "What happens is the store turns an impulse buy into rational buying. You come into the store and you want to buy something, but it is not there. You realize you were intrigued about buying [the item], but now you have to rationalize it. You ask, 'Do I really

want it?’ This breaks the purchasing process. All of a sudden you think twice.”

The new strategy stems from retailers’ desire to consolidate in-store operations with Internet sales, which now account for 10 percent to 15 percent of revenue, says Corsten. He warns that while retailers are wise to give the Internet more attention, the two channels do not necessarily appeal to all customers. “People go to a store because they like going to a store. They already chose not to go to the Internet,” says Corsten. “If I go to the Internet and make a purchase, I’m happy. If I go to the shop and make a purchase, I’m happy. But if I’m being shifted from the store to the Internet, then my purchasing process changes. Yes, I get the full assortment virtually, but I wanted the tangible experience.”

According to Corsten, retailers that do not stock a full assortment of items risk losing direct sales, but also sales of complementary items. A retailer choosing to pass on carrying certain sizes of jeans will also lose sales of belts and tops to the customers who wear those sizes.

Strategically, he says, if all stores sold only the best sellers, all retailers would begin to look alike. Retailers would lose their competitive advantage, and customers would then shop only for the cheapest price or at the closest store.

In order to identify customers who have not found what they are looking for—because it’s not there—and then convince those shoppers to special order or buy over the Internet, requires sophisticated, well-trained salespeople, he adds. “Finding great staff is always critical,” he says. “And a knowledgeable staff is expensive.”

Serguei Netessine, Wharton operations and information management professor, says Wharton research has found that out-of-stocks are more of a problem than retailers think. Computer records often indicate an item is in the store, but if the customer can’t find it, or it’s in a storage area or was shoplifted, the shopper leaves with the impression the store is out of stock.

According to Netessine, retailers typically believe their in-stock rate is 95 percent to 98 percent, but when customers are surveyed, they report the rate to be 75 percent to 80 percent. “It’s only half the story to have the item in stock,” he says. “The other half is to

make sure the customer is able to find it.” Research indicates the most important factor in determining whether customers are able to find an item is having knowledgeable employees on the shop floor that can locate it, he adds.

Finding the Size 13 Shoe

Kevin Freeland, president of Optimal Advantage, a Minneapolis retail consulting firm and a Wharton guest lecturer in operations and information management, agrees that the trend toward shifting marginal sales to the Internet increases overall consumer selection.

Earlier in his career, he worked in inventory management at Payless Shoe Source, where the average store was just 2,400 square feet. Even in the late 1980s and early 1990s, the chain’s inventory was undergoing triage as managers eliminated low-selling size 12s and 13s from their assortment. Back then, he says, the customer had no alternative. “The salesperson would have said, ‘We don’t carry size 13,’ and the person would have gone home disappointed. There has always been rationalization in the retail store. The significant difference is that today there’s an alternative way to purchase those items.”

Michael Zisman, a Wharton guest lecturer and managing director of operations at Internet Capital Group, says this emerging retail strategy would never have been possible without the rise of FedEx and UPS to carry out the final phase of the distribution process. He notes that stores have different policies about shipping payments. Many offer free shipping if the customer orders the item while they are still in the store. Internet shoppers usually must pay.

Zisman says shipping costs are no longer a barrier to consumers who are willing to spend some money in order to save time. Consumers are also now comfortable with ordering over the Internet, he adds. “People are acclimated to using the Internet now. If a store doesn’t have what you want in stock, you’re not insulted, whereas 10 years ago you would have said, ‘I’ll go somewhere else.’”

To make distribution more efficient, new companies are springing up to carry the inventory and ship it, according to Zisman, who is a director of Vcommerce, an Arizona firm that handles logistics for retailers. These companies,

he says, can take on the responsibility for carrying inventory and reduce the time it sits on retailers' books.

He argues that the shift toward more-efficient inventory handling could invigorate the overall economy, citing February 2006 U.S. Census figures showing that retail sales make up about a third of the nation's \$12 trillion economy. Retail goods inventory is about \$472 billion. At a carrying cost of 30 percent, this represents a real cost of \$150 billion, or 3.75 percent of sales. "The economy can't run with that sort of inefficiency.... If the whole economy can reduce its investment in inventory, everybody wins."

Beyond the logistics implications of shifting in-stores sales to the Internet, there are some marketing boons to planned scarcity. Zisman says he recently skipped a trip to his local computer store on a Saturday to purchase a Linksys router from Dell online. The delivery was shipped by Dell on Monday and was installed and working on Tuesday, leaving Dell with very little cost of carrying the inventory.

On top of that, 2 days later, Zisman received an e-mail advertising a sale on PCs from Dell, which had now acquired his e-mail address and other marketing information. Zisman points out that Dell took no brand or credit risk in the transaction and faced only a slight risk that he would return the item.

Pushing the Quick Buy

According to Netessine, some retailers, like the Spanish retail chain Zara, keep inventory low to make the most of scant retail space but also as a marketing strategy. Quick inventory turns encourage shoppers who might be waffling on a purchase to buy or risk losing out completely. "If you have low inventory and update fashions very quickly, then the customers know that when they come into the store, whatever they see is not going to be there tomorrow," says Netessine.

The strategy helps the retailer in two ways, he suggests. First, it prevents consumers from waiting for an end-of-season sale to buy the item—at a lower profit margin for the store. Second, it encourages more frequent store visits by customers who don't want to miss out on new merchandise. Once they are in the store, there's a chance they will buy.

William Cody, managing director of Wharton's Jay H. Baker Retailing Initiative, says some retailers are attempting to pare down in-store inventory to maintain a clean, boutique look. Stores that are crammed with merchandise send a signal to consumers that clearance sales are soon to follow. "The old retail adage was, 'Pack it high and let it fly,'" says Cody. "But that's a discount mentality."

Many clothing stores, he adds, are following Zara's lead and trimming back what they carry on the floor. "Apparel retailers are moving away from racks and racks of clothing to a cleaner presentation of the merchandise. It moves the store away from a discounter image. That's important to give more price credibility."

Retailers' Internet sales now account for 10 percent to 15 percent of revenue.

The approach may work for Zara or other fashion-oriented retailers with the technological capability to turn merchandise quickly, Netessine says. The strategy might not work so well with a grocery chain selling a basic item, like detergent. "If you go to the store and just want to buy detergent, you are more interested in the detergent being in stock than some new and improved version," he says. "With clothing, often you don't go in with a specific product in mind. So it will be easier to substitute." Cody adds that grocery stock-outs could also damage the retailers' relationship with its partnering vendors.

Corsten agrees that shifting low-volume sales to the Internet may be more effective for some items, such as electronics, which are standard brands, or appliances, which would be delivered days later anyway. But for apparel and more impulse-driven decisions, the push to limit inventory might backfire. He says research on consumer reactions to items that are out of stock shows that people are willing to switch stores or come back for planned purchases for "high-involvement items" such as cosmetics or hygiene products. For "low-involvement" products and impulse purchases, they may simply not make the extra effort—and the sale is lost for good.

Coaxing shoppers from store aisles to the Internet might work for many items, he adds, "but it will definitely take the magic out of the shopping experience." ■

What Consumers—and Retailers—Should Know About Dynamic Pricing

A STUDY RELEASED IN 2005 by the Annenberg Public Policy Center of the University of Pennsylvania was provocatively entitled “Open to Exploitation: American Shoppers Online and Offline.” It concluded that American consumers are “vulnerable to subtle forms of exploitation” by marketers.

Much of the study, which was based on a telephone survey of 1,500 adults, focused on privacy issues dealing with the collection of information about consumers. But it also examined people’s knowledge of pricing. It found, for example, that 64 percent of respondents who had recently used the Internet did not know that it is legal “for an online store to charge different people different prices at the same time of day.” In addition, 71 percent did not know that it is legal for bricks-and-mortar stores to do the same thing.

Is this type of pricing, known as dynamic pricing, underhanded or unethical? No, according to faculty members in Wharton’s Marketing department. They say such pricing—also called targeted pricing, flexible pricing, tailored pricing, or, to use the phrase employed in the Annenberg study, discriminatory pricing—is customary, an essential tool for companies, and often beneficial to individual customers and society as a whole. Does dynamic pricing sometimes upset consumers? Research shows that people do get disturbed if they learn that they paid more than someone else for the same item. But that happens because they often do not know much about the factors that go into a company’s decision to set prices, are reluctant to ask for a lower price, or find bargaining distasteful. And, of course, the people who get bargains are not at all likely to be disappointed or feel exploited.

“Dynamic pricing has always been with us,” says Wharton Marketing Professor Peter Fader. “Think of the classic hagglers in the market of a Middle East bazaar. People will pay very different prices for the same bolt of fabric. This is more the norm in transactions than fixed pricing. Fixed pricing is a much

later phenomenon, and it’s an artificial one. Companies must engage in flexible pricing practices in order to honor their responsibilities to their shareholders. If retailers charge a flat, low price to make everyone happy, they’re leaving a lot of money on the table.”

“There is nothing really new here,” agrees Wharton Marketing Professor Z. John Zhang. “The only thing new is that the Internet has given companies so many different ways to set prices and adjust prices.” Notes Stephen J. Hoch, chairman of Wharton’s Marketing department: “People are exposed to dynamic pricing all the time. Do they understand [everything about it]? No. But they understand senior citizen discounts and student discounts.”

Sixty-four percent of surveyed Internet users did not know that it is legal for an online store to charge different people different prices at the same time of day.

To be sure, not all pricing strategies are permissible. Collusion by competitors in an industry to fix prices violates the law, as does the use of race or gender to target customers for different prices or other discriminatory treatment. In addition, if retailers use dynamic pricing in such a way that it angers customers, they can erode customer loyalty, spark a backlash, and lose business. But dynamic pricing is common. Different customers in an automobile showroom at the same moment can end up purchasing the same vehicle with the same extras for wildly divergent prices, depending on their knowledge of the car business and their negotiating skills. People with poor credit histories may pay higher interest rates to the same credit card company than people with stellar credit scores. If you are a highly profitable customer, a telephone company may offer you \$50 to switch to their services, but it may offer only \$20 to your less profitable

neighbor for switching. And who has not sat on an airplane wondering whether the passenger in the next seat paid a lot less for her ticket, even though she bought it on the same day?

Or consider the vacationer who, on a hot day at the beach, decides that he wants a cold beer. He can walk one block north to the luxury hotel along the boardwalk and pay \$5 for a bottle. Or he can head one block south to a corner bar and pay \$2. "It's the same beer, but people wouldn't be at all offended to pay \$5 at one place and \$2 at the other," Fader says. "People understand this. These are business issues more than legal or ethical ones."

The Internet has given online retailers tremendous opportunities to collect data on customer behavior and target people for different prices for the same merchandise. Website operators not only know what items customers put into their shopping baskets but what items they remove before checking out. Retailers can monitor behavior for long periods of time and figure out what web pages customers visit, which items they look at, and which products make particular customers happy. Online merchants also can tell if someone is a serious or casual shopper. Nonpurchase visits to a site may tell the retailer as much about customers as those visits when they fill up their shopping carts.

But precisely how retailers should tailor their prices based on customer behavior is not always readily apparent or predictable. For example, should frequent customers always be offered better prices or more frequent discounts than those customers who are not as loyal?

"There's not an obvious answer," Fader explains. "You can make two good arguments. If you're a frequent customer, maybe retailers should charge you more because they have you locked in and can rely on you for your business. Or maybe they reward your loyalty and charge you less. If a retailer makes the wrong decision, they can lose a good customer and leave money on the table. Retailers have to look at not just how often any given customer has been to the website but when they visited, what they bought, and whether their transactions were high margin. There are no simple rules of thumb. Retailers might be better off picking a few customers and giving them a 'special price' today. Companies tend to be uncreative in the way they approach

these questions. They look for black-and-white answers rather than nibbling at the edges."

Indeed, says Fader, there will be times when companies "make bad decisions and charge too much, tick people off, and lose them as customers." But that, he says, is the beauty of a free market. "If a company does dynamic pricing badly, they're going to lose customers and get beaten to a pulp."

Forget Big Brother

It also is important for consumers not to conjure up images of Big Brother-style retailers doing all in their power to take advantage of them, according to Hoch. Even though retailers have the ability to collect tons of information, many do not bother to gather it at all, and others are inept at using it effectively. "There's a lot of data you can collect about online clicking behavior," he explains. "Most online merchants don't collect that information and don't analyze it. The assumption is that these companies actually are very effective at all of these different practices. They're not."

There are occasions, too, when flexible pricing does not work in the best interests of the firm. "If you are the only firm in the marketplace and have a near-monopoly, or if your competitors are slow in reacting to what you do, you have pricing power," notes Zhang. "You know some customers are willing to pay more for your product, and some will pay less. So it's good for you to charge different prices to different people based on their willingness to pay. This has been shown in many studies."

If, on the other hand, a marketplace is crowded with many competitors, dynamic pricing may be a mistake because it can lead to a price war and erode profit margins, Zhang says. "If everybody has pricing flexibility and uses that flexibility, they're all going to bid for every customer in the marketplace, and competition is going to intensify. This is not necessarily good for the firm." In such an environment, the company that stands the best chance of emerging the victor will be one with "a large loyal following, good quality products, and a good brand image."

There are occasions when flexible pricing can benefit society, Zhang adds. Pharmaceutical companies can sell drugs at lower prices to poorer people who need them because they

charge higher prices to those with the means to pay more. If a drug company can set only one price for every customer in the market, that price will be low relative to those who are price insensitive and can afford to pay more and too high for those who cannot afford to pay much at all. But if a drug company engages in discounting, it can charge less to those who cannot afford to pay much. As a result, the company can expand its market, and society can benefit in a number of ways. More people are going to use the drugs, and the profitability of the firm is going to increase, allowing the company to conduct more research and development and turn out more drugs. “That’s why no economist will ever say that we should ban price discrimination,” Zhang states.

Transparent Price Discrimination

Marketing Professor Lisa Bolton has conducted research examining perceptions of price fairness and found that people use three “reference points” to determine what price they feel is fair for any given product: what the product cost in the past, what competitors charge for the product, and the costs associated with a product.

Bolton found that most people simply misunderstand the many factors that companies consider in setting prices. Consumers underestimate, for instance, the impact that inflation has on companies’ costs. When they compare prices across competitors, consumers often feel that all merchants should simply charge the same price for the same item, not taking into account the possibility that the department store across the street may charge higher prices because its costs of doing business are higher. Moreover, consumers too often focus on the cost of the physical materials required to make a product and neglect other manufacturing costs.

The Internet has given online retailers tremendous opportunities to collect data on customer behavior and target people for different prices for the same merchandise.

According to Bolton: “People will say, ‘It’s just a cotton T-shirt, how can you charge that much?’ Or they say of a drug, ‘It’s just a little pill, why does it cost so much?’”

By and large, consumers also feel that promotional costs for products and services are unfair and that the salaries of senior executives are unfair too. “The bottom line,” says Bolton, “is there is a general perception that prices are unfair. Researchers don’t understand well enough how consumers perceive the marketplace, what we call ‘marketplace metacognition.’ People live in a capitalistic society and believe in the free-market system, and yet they don’t seem to be knowledgeable about it.”

Marketing Professor Jagmohan S. Raju says companies can engage in flexible pricing in a way that minimizes customers’ potential antagonism: They can be more open about what they are doing. “Companies are recognizing it’s important to be fair, and customers are becoming more knowledgeable about what is going on with pricing. They want things to be more transparent. Transparency does not mean not charging different prices; it means companies being open about their strategies. Companies want to make sure their existing customers are happy, and their prices have to be in line with that goal. There is a recognition that customers are more knowledgeable about prices and can talk to each other about prices.... This does not mean that companies cannot charge different prices, however. I think they can still do that.”

Most observers agree that consumers will have to become accustomed to flexible pricing because it is here to stay. Fader says the companies, offline and online, that will benefit most from dynamic pricing will be those that conduct frequent experiments with pricing strategies—continually charging higher and lower prices to different people, offering coupons, discounts, and other incentives—to see which work best at improving the consumer’s shopping experience and increasing revenue and profit.

“A lot of learning comes by experimenting,” Fader notes. “Companies that know what experiments to run and read and act on the results are going to get richly rewarded. I’m looking for the time when we have electronic price tags on shelves in stores instead of bits of paper so that retailers can change prices during the course of the day or even as customer X is walking down the aisle. Companies will try it, and some will do it stupidly. But some will do it well and find ways to keep customers locked in and keep revenue flowing in.” ■

The Lowdown on Customer Loyalty Programs: Which Are the Most Effective and Why

WHEN MAKING A PURCHASE, a consumer has a choice between using frequent-flier miles, cash, or some combination thereof. Which will he or she choose? Another consumer has an opportunity to participate in a special program to get a free car wash after paying for a certain number of washes. What's the best way for the car-wash owner to motivate the customer to participate?

Such questions are serious business for airlines, hotel chains, credit-card companies, and other corporations that offer loyalty programs to customers. Wharton Marketing Professor Xavier Drèze and Joseph C. Nunes of the University of Southern California's Marshall School of Business have spent several years studying these programs and have reached a number of conclusions as to how they can be structured to generate the most revenue for companies that offer them.

Loyalty programs have been around for more than 100 years and are experiencing an enormous resurgence, according to Nunes. Frequent-flier programs are among the best known—American Airlines is credited with launching the first in 1981—but companies began trying to win the hearts and minds of customers long before that. One of the early efforts to encourage customer loyalty was the S&H Green Stamps program, which began in the 1930s. Consumers received tiny stamps when they made purchases from participating merchants, glued them onto pages of booklets, and redeemed them for products when the accumulated stamps—a form of “alternative currency”—had attained a certain value.

“Trading stamps of all kinds are often seen as the first alternative currency to be awarded to encourage repeat purchases,” Nunes notes. “They were initially awarded to customers who paid with cash instead of credit in the 1800s but evolved into something given out with purchases. After World War II, dozens of companies began trying to outdo each other, offering double, triple, and ultimately quadruple



stamps. The escalation ultimately led to the stamps' demise. By the mid-'60s, supermarkets started offering straight discounts instead to cut out the middleman.”

According to Jupiter Research, more than 75 percent of consumers today have at least one loyalty card, and the number of people with two or more is estimated to be one-third of the shopping population. Surveys by information-technology analysts Gartner, Forrester Research, and META Group suggest the data-for-dollars explosion is showing no signs of letting up anytime soon. According to Gartner analyst Adam Sarner, U.S. companies spent more than \$1.2 billion on customer loyalty programs in 2003.

Drèze and Nunes became interested in loyalty programs after suspecting that many of them were not performing as well as they could for the corporations promoting them. “There are a lot of ineffective programs out there,” Drèze says. “To distinguish a good one from a bad one you have to understand how they motivate people. There hasn't been that much research on the underlying principles that make a loyalty

program work or not work for a firm. We felt that was a significant gap that needed to be filled.”

Dollars and Miles

In a paper entitled “Using Combined-Currency Prices to Lower Consumers’ Perceived Cost,” Drèze and Nunes examine the different kinds of currencies that consumers can accumulate and spend, such as frequent-flyer miles and hotel and credit-card rewards points. As consumers are increasingly able to pay for a variety of goods and services using a combination of reward currencies and real money, how they respond to what Drèze and Nunes call “combined-currency” transactions has become important to marketers.

Loyalty programs have been around for more than 100 years and are experiencing an enormous resurgence.

In their paper, Drèze and Nunes present a mathematical proof that outlines the conditions under which a price delineated in multiple currencies (for instance, \$39 plus 16,000 miles) can be superior to a standard, single-currency price (where a person pays either \$189 or 25,000 miles but not a combination of the two).

In the paper, published in 2004 in the *Journal of Marketing Research*, Drèze and Nunes say there are two ways that combined-currency pricing can bring in more revenue for a company: such pricing can either lower the psychological or perceived cost associated with the pricing scheme or raise the amount of revenue collected given a perceived cost.

For example, a consumer may be indifferent as to whether he spends \$500 or 25,000 miles on an airline ticket, but prefers paying \$400 plus 5,000 miles rather than paying either of the single-currency alternatives. “At \$0.02 per mile, the combined-currency price brings in the equivalent revenue to the airline, yet inflicts a smaller psychological cost to the consumer,” the researchers write.

It is important to note, they add, that this consumer’s preference for the combined-currency price indicates that each mile or dollar spent is not valued equally. The perceived cost

of paying more dollars and/or miles increases as the payment in that currency increases. As a result, it will be best for a company to charge a combined-currency price for, say, an airline ticket when two conditions exist: the consumer does not value each unit within a currency equally, and the perceived cost function for one of the currencies is said to be “convex.” Convexity means, for example, that 25,000 miles appears to be worth more to the consumer than twice as much as 12,500. Why? “Twenty-five thousand miles will get you a free round-trip ticket within the United States, while 12,500 miles might only get you an upgrade,” says Drèze.

The authors reached their conclusions after surveying three groups of travelers and having them evaluate and make choices among prices issued in single and combined currencies. The authors say their research is the first to explore how consumers evaluate transactions involving combined-currency prices.

“You would think that if people were offered money and miles, they would always take the money, but a lot of people want the miles instead,” Drèze says. “Their feeling is, ‘Money is only money; and if I take money instead of miles, I’ll just use the money to pay a bill.’ There’s nothing special about paying a bill. But when they take frequent-flier miles as a reward instead of cash, they will use them to take trips and that gives them memories. That makes the miles special. The airlines consider their programs ‘aspirational’ as fliers earmark their miles for special trips. There’s a lot going on psychologically when it comes to taking miles or some other kind of rewards points. People don’t consider miles or points to be the same thing as money.”

“Artificial Advancement”

In another paper, “The Endowed Progress Effect: How Artificial Advancement Increases Effort,” Nunes and Drèze outline how companies can structure certain rewards programs to make them more attractive to customers and, hence, more profitable. Endowed progress means that people who are provided with artificial advancement toward a goal show greater persistence towards reaching the goal than they otherwise would. By artificial advancement, a company advances a customer

toward a goal while simultaneously moving the goal further away, so that the task requirements and the reward remain unchanged.

For example, a company could improve a rewards program that requires eight purchases in order to earn a specific reward by revamping it so that the program requires 10 purchases, but with two awarded upon enrollment. Both programs require eight purchases and provide the same reward, but customers are more apt to complete the program—and complete it sooner—if they are given a head start, according to the paper, which was published in the *Journal of Consumer Research*. The authors demonstrated this through an experiment involving 300 customers of a car wash who received loyalty cards and whose subsequent visits to the car wash were tracked.

As consumers are increasingly able to pay for a variety of goods and services using a combination of reward currencies and real money, how they respond has become important to marketers.

“By converting a task requiring eight steps into a task requiring 10 steps, but with two already complete, the task is reframed as one that has been undertaken and incomplete rather than not yet begun,” according to the study. “This increases the likelihood of task completion and decreases completion time.”

In addition to the study of the behavior of the car wash customers, Drèze and Nunes conducted four other studies of consumers for their paper on the endowed progress effect. They found, first, that as people progress toward a goal, their effort will increase and thus completion time will decrease. Endowed progress, which provides artificial advancement towards the goal, exacerbates this effect. Second, the researchers learned that persistence depends on relative progress made by a person, not on the amount of reward points or miles that would be lost by failing to continue.

Third, when the endowed progress is issued in points rather than purchases, both the endowment and the return that customers obtain for their efforts appear more significant;

and, thus, customers will exert more effort. Finally, Nunes and Drèze learned that the endowed progress effect is more likely to operate when consumers are provided with a reason for the endowment, even if that reason is specious—such as, “Our company is considering a rewards program; would you like to participate?”

Programs on the Increase

Loyalty programs continue to grow. “Even Neutrogena is planning to roll one out, and the NBA [National Basketball Association] is looking at starting one, too,” says Nunes. “Loyalty programs used to be used chiefly in service businesses like credit cards, hotels, and airlines. Those businesses with inventories of perishable products or services, like hotel rooms and seats on planes, had little costs and lots to gain from getting into this. Credit cards just used miles as a payback: you collect 3 percent from vendors and give 1 percent back. But now, to remain competitive, all kinds of companies are doing it. Heck, Maxwell House coffee has its own program where consumers earn ‘House Points’ with each can they buy.”

Nunes says some consumers get excited about amassing points even if the points have no currency value. “Yahoo Answers, a question-and-answer site run by Yahoo, gives points to users who answer questions and rate the questions and answers of others,” he says. “You can’t exchange these points for real-world goods and services, yet people still spend enormous amounts of time accumulating them just to beat others in a list of top point-getters or simply to compete with themselves.”

Loyalty programs can be quite effective. In a study, “Exploiting the Installed Base Using Cross-Merchandising and Category Destination Programs,” that Drèze conducted with Wharton Marketing Professor Stephen Hoch, a “baby club” loyalty program increased sales of baby products by 25 percent on average over a 6-month period. It did that by increasing the number of transactions with baby products. It also increased the amounts purchased in each transaction and boosted store traffic by 5 percent.

But Nunes points out that the long-term impact of loyalty programs is not yet completely understood. For instance, an online study by Maritz, a market research and consumer

loyalty program consulting and implementation company, found that members of programs spend more. But it was unknown whether the program drives spending or whether big spenders are just more prone to join programs and get rewards for their spending. Nunes suspects the latter and worries that “some firms are simply bidding for the best customers by offering them bigger and better rewards.”

Loyalty programs, he adds, “need to be designed to offer differentiated products and services to customers based on their purchasing patterns and profitability. If these programs are simply based on quantity discounts or paying for patronage, they will not endure.”

Drèze and Nunes are continuing their research into loyalty programs. Among other issues, they are currently exploring the use and effectiveness of “status”—gold cards, platinum cards, and the like—in loyalty programs. “A lot of loyalty programs endow customers with status, which they earn through purchases or other actions,” Nunes explains. “Our research is looking into how stratifying customers and endowing some with status makes them feel different and thus behave differently.”

The researchers have just begun investigating the topic. But from what they have discovered so far, it appears that assigning a customer to a category—such as gold status—may put them in the top 5 percent of all customers, but it does not necessarily make the customer feel special. It turns out that gold customers feel much more distinctive and apt to spend more if they know that there is another class of people—those endowed with “silver” status, for instance—below them. This paper is tentatively entitled “A Cut Above: Exclusivity and Status in Consumer Loyalty Programs.”

“If you go back 10 or 15 years, a gold card was really special,” Drèze says. “Today, if you don’t have a platinum card, which confers greater status than gold, you’re nobody. The interesting thing is that what has evolved over time is that more and more customers need status. Marketers need to find ways to separate one class of customer from another.” ■

Beware of Dissatisfied Consumers: They Like to Blab

IT'S COLD AND RAINY, and the parking lot outside the store is packed, except for a spot way out in the corner. The shopper pulls up, only to find a shopping cart blocking the space. Inside, the store is jammed. The digital cameras are hard to find, and it's impossible to know why one costs \$150 and another \$300. The two models that are on sale are out of stock, and it takes a clerk 5 minutes to bring another one from the back of the store. At checkout, the line is stalled while those on either side are flowing smoothly. Finally, when the customer reaches the cashier, he is told his \$25-off coupon is not valid until the next day.

Wharton Marketing Professor Stephen J. Hoch, who suffered through this scenario first hand during a recent shopping trip, says customers are bound to talk about these kinds of experiences. And, according to new Wharton research, such word-of-mouth communication should be a big cause of concern to retailers.

Results of *The Retail Customer Dissatisfaction Study 2006*—conducted by The Jay H. Baker Retailing Initiative at Wharton and The Verde Group, a Toronto consulting firm, in the weeks before and after Christmas 2005—show that only 6 percent of shoppers who experienced a problem with a retailer contacted the company, but 31 percent went on to tell friends, family, or colleagues what happened. Of those, 8 percent told one person, another 8 percent told two people, but 6 percent told six or more people. “Even though these shoppers don’t share their pain with the store, they do share their pain with other people, apparently quite a few other people,” says Hoch.

Overall, if 100 people have a bad experience, a retailer stands to lose between 32 and 36 current or potential customers, according to the study.

The complaints have an even greater impact on shoppers who were not directly involved as the story spreads and is embellished, researchers found. Almost half of those surveyed, 48 percent, reported that they have avoided a store



in the past because of someone else’s negative experience. For those who had encountered a problem themselves, 33 percent said they would “definitely not” or “probably not” return. “This storytelling has even more impact on the people the story is told to than the people who told the story,” says Hoch. The data is based on a survey of 1,186 shoppers.

Those surveyed were asked to discuss their most recent shopping experience. Half said they had at least one problem. On average, survey respondents reported experiencing three problems on the shopping trip, during which they spent an average of \$163. The top three categories of merchandise purchased were clothing, 23 percent; groceries, 16 percent; and electronics, 12 percent.

Paula Courtney, president of The Verde Group, says the exponential power of negative word-of-mouth lies in the nature of storytelling. “As people tell the story, the negativity is embellished and grows,” she says. For example, the first time the story is told, it might be about a customer service representative who was rude. By the time the third or fourth person hears the story, the customer service representative becomes verbally abusive. “To make a story worth

telling, there has to be some entertainment value, a shock value," says Courtney. "Story-telling hurts retailers and entertains consumers."

Why don't shoppers confront the retailer directly? "If they were boiling mad, they would complain to the management during the store visit or maybe after, but they don't do that very often," says Hoch. "Some people figure it's going to happen again, and they can't do anything about it. They are resigned to it. But the main reason they don't complain is it's too difficult to go out of their way to deal with every service slight."

Indeed, the survey showed that 46 percent of those who had a problem expect they would definitely or probably experience the same problem in the future.

Jammed Parking Lots, Crammed Merchandise Racks

Parking was a major source of aggravation for shoppers, according to the survey. It topped the list of problems, with 40 percent of those surveyed reporting dissatisfaction in the parking lot.

According to William Cody, managing director of the Baker Initiative, parking problems set the stage for customers to "arrive angry," which can make them more likely to have a troubled shopping experience. Most retailers, he says, don't consider the parking lot to be part of their operations, but he advises them to take a closer look at their landlord's management of parking problems and try to come up with creative solutions.

Customers' time has become an important part of the retail value equation, along with price, merchandising, and other traditional components of the industry.

He notes that during the Christmas selling season, one mall in New Jersey hired people to wave flags—indicating available parking spots—at shoppers circling to find space. Even if this doesn't speed up the parking process, Cody says the presence of the flag wavers might provide some psychological comfort to

shoppers by signaling that the stores were at least attempting to address their concerns.

In addition to parking problems, shoppers surveyed complained that it took a long time for them to be waited on (24 percent) or to pay (33 percent). Shoppers who had to wait for service complained about it to 2.1 other people, on average, and those who had to wait a long time to pay told an average of 1.4 people.

Customers' time has become an important part of the retail value equation, along with price, merchandising, and other traditional components of the industry, according to Courtney. "Retailers haven't caught up to the phenomenon that consumers have no time. Time is a rare and precious thing." Yet because the Internet allows shoppers to buy around the clock, there is more pressure on retailers to respect their customers' time. "The Internet has erased all the boundaries that existed with shopping in terms of when you can shop."

Courtney told about her own experience buying a briefcase in an airport shop in Philadelphia. She used her mobile phone to call her husband in Toronto and ask him to go online to research the brand. He discovered that the same model, which was on sale for \$475 in the airport, was available online for \$230. Courtney used the information to negotiate a 50-percent reduction in price at the airport store. "We are much savvier shoppers," she says. "We have no time, and we don't want to overpay—all the more reason retailers have to worry."

Meanwhile, she adds, retailers continue to focus on merchandise, jamming stores with inventory that overwhelms customers and cuts into the time they have to shop. According to the survey, shoppers are likely to tell 2.5 people, on average, about their inability to find an item because the store was cluttered with merchandise. "Retailers are putting as many jeans and shirts out as they can get on the racks." In the end, she points out, retailers will wind up reducing the price on merchandise to make up for the negative experience, eroding their profit margins.

Gatherers vs. Grazers

According to Hoch, the survey shows some slight differences in attitudes among shoppers who were reporting their experiences at a mass

merchant versus a specialty store. “People who are in a specialty store are more in the pleasure-seeking experience, while people going to a mass merchant are on a mission.”

He notes the study did not find huge differences in the attitudes of male and female shoppers, although men were more likely to complain. “It’s clear that males are hunters and gatherers and females are grazers and gleaners. When the male is frustrated in his attempt to get the task accomplished, he is more likely to be irritated. Females are more interested in the customer service interaction.”

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Cody says retailers historically have paid a great deal of attention to how to satisfy the customer but have not been too interested in finding out what makes them dissatisfied. “In retail, it’s hard to focus on the dissatisfied because your customers are anonymous, unlike a direct sales or business-to-business model. Wal-Mart has 100 million shoppers a week, so it’s hard to do. Historically it has focused more on product and experience as a way to create satisfaction.”

And despite the value in learning about consumer gripes, retailers have resisted asking their customers what they do wrong for fear of stirring up negative thoughts, Courtney adds. “They have been reluctant to present consumers with a laundry list of things they may have experienced because it would turn people off.”

Retailers, Cody suggests, need to find ways to get customers to share complaints with management, not friends and family. One way is for retailers to ask customers to check a box on their credit card slip indicating they had a problem at the store. Retailers could then attempt to follow up or give the customer a phone number or web address to make their complaints directly. If nothing else, he says, it would give the customer a chance to blow off steam. That could prevent them from spouting off to others who might then embellish the experience and make matters that much worse for the retailer.

Courtney recommends that retailers pay closer attention to recruitment and hiring of front-line sales people and other workers with direct customer contact. “The least-trained, lowest-paid people are the ones you put in front of your customers, particularly during the Christmas season.”

As for Hoch, good cheer goes a long way for retailers at any time of year, he says. “Retailers that are responsive and friendly are more likely to smooth over issues than those that don’t try to be as friendly as possible. Maybe something as simple as a greeter at the beginning of the store or at the end would help. Some people say the personal touch doesn’t matter, but I disagree.”

Consumers, too, can take steps to head off dissatisfying shopping trips, adds Courtney. First, they should take their complaints directly to the retailer. “Don’t we all, as consumers, benefit from telling the company?” she asks. “We recommend that the first thing is to complain to the person closest to the problem. If someone is rude, confront that person. Or if you don’t want to do that, take it to the store manager.”

Customers should never escalate the problem, she cautions. “We encourage complaining, not yelling. It never pays to be abusive as a customer. You might just be escorted to the door if there is an emotional experience. If something has made you very upset, don’t do anything about it until you can let your emotions pass.”

She suggests consumers go back the next day or make contact by telephone or in writing. “Be as factual as possible. It lends credibility to your story and makes you not sound like a crazy lunatic.” In addition, consumers should shop around and not return to stores where they had a bad experience. “The erosion of business is the only way to wake up retailers, to get them focused on the customer’s experience.”

Finally, if a retailer refuses to respond to dissatisfied customers, shoppers should feel free to spread the word. “If all else fails, we do encourage you to tell all your friends and family. Don’t tell five people, tell 35 people,” says Courtney. “Retailers need to know that if they don’t listen, it will hurt their bottom line.” ■

Wal-Mart: Is There a Downside to Going Upscale?

AFTER SATURATING ITS TARGET MARKET of working class, bargain-hunting consumers, Wal-Mart is ratcheting up its low-price strategy to appeal to more upscale shoppers by expanding its merchandise lines to include organic foods, better wines, high-end consumer electronics, and new fashion-oriented apparel. It's an approach that carries some risk, say Wharton faculty and analysts, but that is dictated by intense competition and the lack of other opportunities for growth.

The changes come as Wal-Mart—the world's largest retailer with annual sales of more than \$300 billion—has struggled with slowing growth and rocky transitions internationally as well as into urban areas of the northeastern United States. In a speech at the company's annual meeting this month, Wal-Mart chief executive Lee Scott outlined elements of the strategy and quoted Wal-Mart founder Sam Walton: "You can't just keep doing what works one time. Everything around you is always changing. To succeed, stay out in front of that change."

Wooing the Baby Boomers

According to Wharton Marketing Professor Xavier Drèze, now that Wal-Mart has conquered the value end of retailing, its options are limited. "They are going upscale. It's the only choice available," he says. "They have expanded to the point where they can't expand in the U.S. anymore. If you can't grow by reaching more people, you have to grow by selling more—and more expensive—[merchandise]."

Approximately 80 percent of American shoppers now visit a Wal-Mart store at least once a year, and more than 170 million consumers around the world shop at a Wal-Mart store each week. In addition, the company has expanded to 6,100 stores in 70 countries. "Wal-Mart is sending a signal that they are about more than price," says Wharton Marketing Professor David Bell. "They have played price. Now they want to play quality and broaden their image. It will be interesting to see whether people believe it."

The new strategy will help Wal-Mart compete against Target, its chief discount-chain rival, adds Wharton Marketing Professor John Zhang. "Target is doing well. Customers perceive it as more trendy and higher-end. Wal-Mart now is forced to move to the high end to look more like Target instead of just looking cheap." Demographics are also driving the changes at Wal-Mart, which traditionally has had the most appeal to young families. The chain is making an effort to woo the nation's 70 million aging baby boomers, according to Zhang. "These are the customers with more spending power. You have to figure out a way to follow them and satisfy their needs."

The new higher-end products will be sprinkled throughout Wal-Mart's core offerings and are not likely to alienate the company's established base, suggests Wharton Marketing Professor Stephen Hoch, who says he sees no reason for the initiative to fail. "Target has been successful at going slightly above where Wal-Mart is. Wal-Mart may not be perfectly associated with a trading-up image, but my guess is they can buy brands that have that panache as well as anybody else, or even better."

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Of course there is always a chance Wal-Mart could jeopardize its current position by aspiring to move up the customer ladder, Drèze notes, comparing the situation to regional airlines that do well in their niche, then expand nationally, but ultimately fail because they have lost their competitive edge. "The question for Wal-Mart is, if they sell high-end [goods], is there a competitive edge to that? Or will it make them just another retailer? That's the risk."

In March, Wal-Mart opened an experimental store in Plano, TX, an affluent area where the average income of \$140,000 is triple that of the typical Wal-Mart shopper, according to market research firm Information Resources, Inc., (IRI). The store carries 2,000 premium items, including meat, cheese, wine, and fresh produce, not available in typical Wal-Mart supercenters.

In a report to clients, Bank of America analyst David Strasser says Wal-Mart's shift up the price continuum is already showing results. For several years, the chain's sales growth was led by food and consumables, while general merchandise was weak. Strasser analyzed sales of consumer electronics at 1,300 stores where higher-end merchandise, particularly flat-panel televisions, was introduced last year. For the first time in 4 years, consumer electronics became a nongrocery category to contribute growth to the overall sales mix at U.S. Wal-Mart stores.

Strasser also points to sales of the chain's new, more upscale private-label clothing line, Metro 7—which have been so strong that the company has had trouble keeping items in stock—and its line of 400-thread-count sheets, which have recently been selling out and are another symbol of Wal-Mart's move up the luxury continuum.

Even within the food and beverage category, Wal-Mart is changing its menu, most notably with new lines of organic foods, fresh produce, and top-shelf wines and liquor. William Cody, managing director of Wharton's Jay H. Baker Retailing Initiative, says Wal-Mart's expansion in wine represents a departure from the chain's cultural roots in Bentonville, AR, where founder Walton shied away from selling alcohol. According to Cody, changing federal regulations over the distribution of alcohol may open up new opportunities for Wal-Mart, Costco, and other national retailers. Recent federal court cases have overturned statutes written at the end of Prohibition that gives states control over alcohol distribution.

Adjusting to Organics and Other Innovations

Organics represent a new, growing category of demand for all retailers and is expected to experience double-digit growth through 2010, according to an IRI report issued in May that

states: "Wal-Mart has been relatively slow to enter the fray, given a potential disconnect with its core lower-income consumer."

The \$15 billion organic foods market represents just 2 percent of overall U.S. food and beverage sales but is growing at a rate of 20 percent a year, compared to 2 percent to 4 percent for nonorganic groceries, according to the Organic Trade Association. "The opportunity for the consumer is that Wal-Mart can hypothetically offer organics at a lower price, but that's assuming unlimited access to the supply," says Cody. "Can they position themselves as the low-price leader in organics? Possibly, but it's more a way to bring in new customers who buy organics."

Moving into organic foods will create new challenges for Wal-Mart's legendary supply-chain system, adds Serguei Netessine, Wharton professor of operations and information management. "Coming into organic foods is somewhat tricky, especially for someone as big as Wal-Mart. While Wal-Mart's typical supply model is to push vendors into a centralized distribution system, the wholesale organic foods market is made up of many small suppliers selling perishable goods that require complicated handling. "It's essentially hopeless and meaningless to try to centralize distribution. You have to change the distribution system somehow to go back to the model in which suppliers supplied directly to the nearest store."

Without major industrial-scale supply operations, Netessine says he doubts Wal-Mart's claim that it can substantially reduce the price of organic foods. Still, he's not counting Wal-Mart out just yet. "They will have to adjust," he says. "People incorrectly think of Wal-Mart as only supplying cheap goods to people on a budget. If you look at Wal-Mart merchandise, the list includes gold and diamonds and expensive electronics. Wherever there is some demand for something, even expensive items, Wal-Mart tries to come in. Every time, they have to adjust the supply chain for different merchandise, but for organic food [this adjustment] seems especially tricky."

Another new innovation Wal-Mart executives are promoting is walk-in medical clinics, operated by outside firms like RediClinic, a healthcare startup created by America Online founder Steve Case. Wal-Mart leases space at 11 stores

to pilot clinics and has said it may increase that number to 50 by the end of this year.

According to Cody, the clinics fall more in line with Wal-Mart's traditional consumer base, and while they may not be profit centers themselves, the clinics could help boost pharmacy sales or simply draw more shoppers into Wal-Mart stores.

Morris Cohen, Wharton professor of operations and information management, suggests the healthcare clinics will get leverage from Wal-Mart's real estate clout. However, they pose new issues of supply-chain management specific to services, as opposed to product inventory, where Wal-Mart is viewed as the master. "It makes a lot of sense that Wal-Mart should be providing services in carefully selected convenient locations where you can share some of the overhead of the store," he says, noting that the chain already has optical and pharmacy services. "Why not manicures?"

Moving into organic foods will create new challenges for Wal-Mart's legendary supply-chain system.

Cohen explains the challenges of operating a service supply chain center around consistency and quality. "A service is consumed as it is produced, unlike a product that can sit on a shelf and come out of a box when the customer wants it. So often the quality rests on the dependability of the front-line people delivering the service." Consistent service, for example, requires companies to maintain excess capacity for times when they are not busy in order to meet customer needs when they arise, says Cohen. "It's still matching supply and demand, but the knobs you have to turn are different."

The clinics may also fit into Wal-Mart's push to present itself as a kinder company, particularly after unions generated reports showing that Wal-Mart employees lacking health insurance coverage are among the top users of state and federal-financed Medicaid programs. CEO Scott has said that 30 percent to 40 percent of those visiting the Wal-Mart clinics are uninsured, while surveys indicate that if those people had not been able to come to the clinic, 20 to 40 percent would have sought expensive emergency room

care. Another 10 percent to 20 percent would have gone without treatment.

Hoch points out that Wal-Mart is taking other steps to improve its appeal to shoppers, including new image-oriented advertising and a major initiative to operate with greater sensitivity to the environment. "I do think they are engaged in more outward-reaching public relations efforts to burnish their image, such as feel-good ads," he says. "They need to constantly evolve."

Successes and Setbacks Abroad

Meanwhile, Wal-Mart's international expansion, which is an earlier attempt at generating growth beyond the company's well-established base, continues to have both successes and setbacks. In March, Wal-Mart raised its stake to a controlling 51 percent share in Central American Retail Holding Co., with 375 supermarkets in Guatemala, El Salvador, Honduras, Nicaragua, and Costa Rica. In May, it pulled out of South Korea, where it had 16 stores.

Wal-Mart officials have indicated that India, where government reforms lifting restrictions on foreign ownership of retail operations are underway, could be a major target market for the company. Meanwhile, Wal-Mart is expanding rapidly in China, where, Zhang says, there "are a large number of value-conscious customers and where infrastructure and logistics will play an important role. Wal-Mart has the advantage [in this area]. I sense the company probably will do well."

Wal-Mart has had some success in Britain after stumbling in Germany, says Hoch. In Japan, after struggling for years, Wal-Mart several months ago took a controlling stake in the country's fifth-largest retailer, Seiyu Group. The company operates more than 400 supermarket and general merchandise stores in that country. "You win some and you lose some," Hoch says. "Each individual global market has its own set of issues. Wal-Mart has been successful in North America, including Canada and Mexico, and will continue to look for opportunities. The company is designed to grow. If it can't grow, it's in trouble." ■