



# TELEOS

THE INTELLIGENT WAY TO U.S. MARKETS

## AN INTRODUCTION TO THE WAL-MART EFFECT

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# AN INTRODUCTION TO THE WAL-MART EFFECT

*HOW DOING BUSINESS WITH THE NORTH AMERICAN RETAIL GIANT IS  
SHAPING AND CHANGING THE CHINESE MANUFACTURING  
COMMUNITY – PART 1*

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## INTRODUCTION

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China's secondary education facilities graduate more than one million engineers and skilled technicians every year – people whose education will be put to work in the business sector in the form of increasingly competitive and innovative entrepreneurial businesses. Paralleling this, as the existing standard of living for the average Chinese worker improves, it will offer many opportunities for companies operating within China to continue developing their businesses within China as captive producers increasingly become domestic customers. The development of a meaningful middle class in China will be dependant on China's ability to do more than just serve as a global dumping ground for low cost manufactured goods. Even if foreign direct investment (FDI) in China were to cease or significantly diminish, it is doubtful whether anything can restrain the development of the Chinese economy into an autonomous global power.

Granted, rates of growth may change, but the previously shielded Chinese economy has discovered the global stage and it is unlikely to regress from its position of a uniquely blended form of socialist and capitalist systems. China has already navigated two potentially devastating events which held the potential to destroy its early efforts at modernization: the collapse of the Soviet Union and its command-based economy, and the Asian currency destabilization in the 1990s. China's history suggests that when the Chinese dragon wakes, its ability to execute long term goals is unheralded. That the Chinese effort to modernize has survived two significant events that had the potential to destabilize them should be a sign that whatever its future challenges may be, the country has the foresight and fortitude to weather storms, whether of their or someone else's making.

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## A CHANGING RETAIL ENVIRONMENT

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The foundation of many Chinese OEM successes has been built on the basis of providing large U.S. retailers with inexpensive products. Much of this productive capacity has been built to parallel the production capacities of similar companies in North America. What was a smart move for U.S. retailers - developing lower cost Chinese manufacturing alternative vendors - has become broadly accepted both as a reality America manufacturers must face, and a benefit Chinese manufacturers are able to use to their distinct advantage. As the relationship between U.S. retailers has grown increasingly dependant on Chinese manufacturing capacity and the related cost advantages it affords their North American retail clients, many Chinese OEMs are beginning to become sensitive to the nature of their changing relationship with companies like Wal-Mart, Home Depot, Lowes, Best Buy and others. When these retailers originally approached many of their Chinese vendors, enormous latitude was given to bring the manufacturers up to specification because of the potential market share gains at stake if the retailer could obtain access to the lower priced products. The initial nature of this relationship was one of gratitude and partnering – an approach uniquely designed to positively build the affectations of the Chinese business environment at the same time it accomplished the retailer’s goal of low priced products. Nothing is wrong with this type of relationship; but as with most relationships, it is prone to change.

### NO LONGER PARTNERS?

The change many Chinese companies are beginning to experience is the alteration in how their retail customers view partnering with them now. Early on in their relationship, the idea of partnering was very much a shared reality. But as the vendor grew, the retail customer began to recognize that its interests were most ideally served if the vendor was kept at an arm’s length from the U.S. consumer. Many Chinese companies have seen their retail customers develop alternative Chinese vendors in the same fashion as they were once originally courted. This is an essential strategic move

on the part of the retailer as it affords the retailer the opportunity to keep his vendors playing off of one-another's price point. Allowed to go un-checked, this dynamic leads to a deflationary spiral as one manufacturer undercuts another's price in an attempt to increase market share. This relationship evolves over time; the actual inflection point when it becomes destructive is difficult to define because of the unique nature of each market. Factors such as product complexity, the necessary investment in a manufacturing infrastructure to provide an acceptable product, and technology adaptation on the part of the manufacturers all contribute to different points in time when the partnership relationship between a retailer and its vendor change.

Typically, the first sign that a Chinese vendor's relationship with their North American customer is changing is when they begin to be pitted against other OEM price points. As simple as this may seem, for many Chinese companies they have historically enjoyed the role of the hunter and not that of the hunted. The first sign their market is changing is when they no longer represent the price leader in the market – a signal given to them by their retail customer. This has already been experienced with many Chinese manufacturers who are separated from the retail customer by an additional layer. An excellent example of this is the power tool market. The Chinese power tool market is structured with a number of competitors from developed economies; these include companies like Black & Decker, Skil-Bosch and Makita. Serving this segment of the market are sub-contractors who manufacture sub-assemblies such as the motor for the power tool OEMs. It is within the sub-assembly segment of the market that deflationary price pressure is taking on extreme forms, necessitating the first push back in pricing between sub-contracted vendors who make motors and their selling price to the power tool manufacturers. A number of people within the sub-assembly sector of the market have been forced to consolidate, go out of business entirely, or attempt and integrate from the motor to the finished product.

## THE HOME-DEPOT – TTI – RYOBI CASE STUDY

The power tool community was stunned in 2003 to hear the announcement of a relationship between TTI and Home Depot. Companies the likes of Black & Decker, Skil-Bosch, Porter Cable and Milwaukee Electric had some of their worst fears realized when Home Depot announced that TTI would manufacture a line of proprietary power tools under the Rigid trade name; solely for Home Depot's use at what most agreed were particularly distressed prices. Seen by some industry insiders as a sign of weakness for those involved in the Home Depot deal, the consequences of this deal are still being felt within the power tool community.

Unraveling the TTI-Home Depot deal takes insight into the various players participating in the deal. Rigid was a relatively unknown brand name owned by Emerson Electric, a company primarily known for its line of industrial vacuums marketed under the Rigid name. Emerson was getting little of value from the Rigid brand, and realized that its position within Home Depot was susceptible to competitive pressure because of their limited number of products. To Emerson, it was only a matter of time before Black & Decker or Skil-Bosch moved into their vacuum product line with competitive products. In an unrelated deal, TTI (a Hong Kong firm with 2004 sales of 16,304,140,000 [HK\$] originally specializing in motor manufacturing and electronic sub-assemblies) had negotiated the rights outside of Japan for the Japanese-owned Ryobi power tool line. TTI's investment in the power tool community had historically been poorly timed as they found themselves repeatedly competing for sub-contracted motor assembly with much smaller firms in China who could service power tool OEMs with lower overhead and significantly lower costs.

For strategic reasons not explicitly known to the market place, but probably having to do with TTI's recognition that they could not compete with Johnson Electric (another much larger and more profitable Hong Kong motor company), TTI moved to vertically integrate from motor manufacturing to the finished power tool. Doing so irreversibly alienated their power tool customers

from TTI, but fundamentally repositioned TTI within the U.S. retail market. TTI's move took place at a time when Home Depot's power tool suppliers were beginning to gain an upper hand in their ongoing negotiations with their retail clients in large part due to the emphasis North American power tool companies had been placing on product innovation and direct-to-the-consumer marketing. Seeing an opportunity to shake the confidence of their suppliers, Home Depot struck a deal with a somewhat distressed TTI power tool business unit, establishing prices over a multi-year contract that would not have been possible with a power tool OEM in a stronger financial and market position. The deal allowed TTI to accomplish its goal of vertically integrating into the power tool market, but at a cost to the power tool market's profitability given the concessions in its Home Depot contract. Some industry analysts have suggested that the TTI deal may prove to be the example people use for the next decade as to Chinese businesses mortgaging their futures for short term gains.

The motivation from Home Depot's side is more difficult to draw out, and relies on a heavy interpretive function on the part of those who observed the deal take place. Seen most simply, the TTI-Rigid deal provides Home Depot with a long term supply contract at price points existing North American, Japanese, European and even other Chinese power tool OEMs would not match. This provides the most basic motivation for Home Depot's relationship with TTI. But the TTI move is much more strategic for Home Depot than this cursory analysis suggests: for Home Depot, the TTI deal represents their assertion that, just like Wal-Mart, the Home Depot name, logistical expertise and consumer loyalty lies with the retailer, not the power tool manufacturer. Believing this, Home Depot and others like it, are moving to brand increasingly sophisticated products as their own proprietary in-house product. Retailers like Home Depot, Lowes or Wal-Mart will initially ask that a product line such as a complete power tool SKU somehow be differentiated if only on the basis of color or label. But as retailers have grown more sophisticated, they have begun to ask why they can not demand more than proprietary colors and stickers; why can they not also command proprietary designs, brands and pricing?

This change in the position of North American retailers has been met with dismay on the part of established power tool OEMs like Black & Decker and Skil-Bosch. Interestingly, one of the short term effects of the Home Depot contract with TTI was an intense market consolidation within the North American power tool community: Black & Decker bought Porter Cable and TTI purchased Milwaukee Electric. Both of these moves were designed to protect the higher-end of the power tool market which Porter Cable and Milwaukee had historically had to themselves. This market consolidation left North America with only one domestically owned power tool OEM – Black & Decker. What remains to be seen in the power tool market are questions that are inherently going to have ripple effects and parallel applications in many other consumer products' companies whose success is intimately tied to their relationship with the retailer. Among these questions is whether Home Depot's move with TTI forces the balance of the power tool community into a pure price cutting phase, or whether the manufacturers begin to rely on increasingly innovative products whose commercial success relies on more than one retail outlet, making the proprietary TTI-Home Depot relationship implicitly inefficient and unstable. On the other hand, if the additional opportunities for product development are somehow incremental and do not allow the consumer to really differentiate between brands, the likelihood that the consumer power tool segment will come under increasingly intense deflationary pressure may prove accurate, with the long term results being additional market consolidation, fewer competitors, and stagnant market development activities.

Situations like the TTI-Rigid-Home Depot deal present a unique opportunity to help a Chinese firm navigate potential pitfalls that could decimate years of profitability, and possibly the viability of the client itself. Chinese businesses may initially experience some success on the basis of a cost disparity; however, this is not a sustainable competitive advantage as domestic competitors can easily match its price point and export customers are likely to integrate into China in order to take advantage of the low-cost labor while keeping a portion of the margin for them. What may at first

seem to be a savvy short term move like that of the TTI-Home Depot deal may in fact turn out to be a move which destabilizes the entire market and their business in the short term.

#### **RETAILER'S MOTIVES ARE NOT IN DISPUTE**

The retailers' motives in pitting competitors against themselves are clear: they believe that if they can continue pushing prices lower they will be able to forever keep levels of consumption at their current position. As with most arguments, this also has an inflection point, which is by necessity an economic argument whose place to explain does not belong in this business plan. Suffice it to say that the underlying belief that retailers can forever sustain their growth models on the basis of ongoing lower prices overlooks questions of market saturation and the need for consumers to see innovation if they are to maintain their engagement and continued purchase of a particular product or technology.

Allowed to go un-checked, the competitive price pressure U.S. retailers place their vendors under will lead to broad consolidations within the manufacturing marketplace. Some will argue that this process merely reduces a larger group of inefficient businesses into a smaller group of much more efficient businesses. At some level this is accurate; however, if a market is allowed to engage itself in a fully deflationary spiral such that the only companies left standing are those who met the increasing demands of the market at the cost of product innovation, brand name building activities and customer service, then the likelihood that the product itself will remain viable is small. This is the unforeseen danger in the dynamic evolving between Chinese manufacturers, their North American competitors who are also attempting to utilize Chinese labor as a cure-all for their cost woes and the retailer who believes by setting this all in motion they, and in turn the consumer, will benefit with no detriment.

The way out of this spiral is not immediately clear to many, and it is as simple to say as it is complex to escape. To take seriously the possibility for a cruel deflationary spiral is to go back to the idea of innovation as absolutely essential for saving all involved – the manufacturers, the retailers,

and the consumers – from ultimately unsatisfying market consolidations and economic stagnation. Many businesses coming to grips with these realizations are the prototypical Chinese success story, and they should be proud of their success. It is without doubt that their success is one they have earned, one they have fought for, and one they have had to innovate and stretch themselves to achieve; however, as with any form of success, the very nature of being successful means that others notice your success and attempt to copy it. The initial success these companies have enjoyed will only be perpetuated if they can anticipate the next stage in their relationship with their retail customers.

The next stage requires that the business learn to navigate into a position where it has some modicum of leverage over its retail customer. This is a dynamic evolution fraught with peril and will ultimately be successful if two things are a part of its business plan: a continued emphasis on being a cost competitive producer and second, an ability to create new products that the retail customer feels they need for their own reasons. As this balancing act finds equilibrium, the manufacturer can then begin to focus on additional intangibles that will further enhance its leverage over the retailer such as marketing activities and building a domestic brand in the North American market.

In a recent edition of *DNS Retailing Today: the Connection to America's Leading Retailers*, an article introduced the idea that Wal-Mart's business model is reaching a point of limited returns for it, which has weighty implications to the Chinese manufacturing economy: "Marketing is intent on letting customers know about the quality and fashionability of products sold at Wal-Mart and plans to more than double the frequency of a circular that was previously distributed monthly." (*Source: DNS Retailing Today*, "War of words continuing over Wal-Mart's salaries, benefits", by Mike Troy, page 4.

Most importantly and potentially a significant momentum halting event for the Chinese economy would be to for Wal-Mart to be forced to look less closely at low price sources and more

closely at OEMs that can innovate and manufacture a product consumers are involved with. In some unanticipated ways, this type of change could allow North American manufacturing to gain a breath from the last decade of deflationary pricing schemes and again focus on consumers whose needs they know much better than their Chinese competitor. Seen most advantageously for the entire global economy, a mass change of perspective by Wal-Mart could very well be one of the important and key factors in stabilizing incestuous manufacturing environments who have built duplicitous capacity with improperly secured credit to chase markets whose viability is soon to require more than only a cost advantage. Only the future will tell if this change is one that benefits only a select group of manufacturers, or presents a transition for both the Chinese and European economies.