Case study Write-Up #1

MET AD 731 A1: Corporate Finance

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Sears, Roebuck and Co. vs. Wal-Mart Stores, Inc.

The retail sector stands as a vital industry that delivers essential goods and services to consumers, forming the ultimate link in the supply chain. This sector encompasses diverse product and service categories such as cosmetics, electronics, and furniture. Notable entities like Walmart, Ikea, Alibaba, Costco, and Amazon have carved their presence in the retail space, and in this analysis, we focus on two giants in the American retail landscape - Sears, Roebuck and Co., and Walmart which operate as departments stores, grocery stores, supermarkets, and discount centers in the global market. Both sell a wide range of products starting from groceries to clothing and home appliances. These companies created a harbor where one can find anything for basic needs and more.

In this research, we delve into the qualitative and quantitative aspects of the financial performance of these two retail giants, with the aim of providing recommendations for a long-term, rational investor. The analysis commences with an overview of both companies and their business operations, followed by an exploration of their retailing strategies. Subsequently, we dive into their financial performances and outstanding ROE results are explored in detail. Finally, certain recommendations and conclusions are drawn based on the qualitative and quantitative analysis of the financial statements. Thorough calculations are explained.

General information about companies and their businesses

Wal-Mart Stores Inc. was opened in 1962 by Sam Walton in Bentonville, Arkansas. It all started with franchise variety store in Arkansas in 1945 and further expanded from Walmart stores to Sam's Club membership warehouses and Wal-Mart supercenters. Claimed to be the world's largest retail company in 1991 with net sales of $43.9 billion, shortly after it hit $100 billion annual sales in 1996. A comparative advantage of Wal-Mart stores was their attractive pricing on every product they sold. Starting from 1996, Wal-Mart started offering its clients credit cards in which loans were secured by Chase Manhattan Bank. In 1992 Walmart joined a joint venture with the international Cifra company with a 50% interest and by 1998 the retailer was conducting business in six different countries as well as Puerto Rico. Walmart's store and supercenters' location maps from the study of Basker about Walmart's growth (Figure 1) give us vivid representation of Walmart's rapid expansion from 1965 to 2005[1].

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[1] Emek Basker, The Causes and Consequences of Wal-Mart's Growth, Journal of Economic Perspectives—Volume 21, Number 3—Summer 2007—Pages 177–198

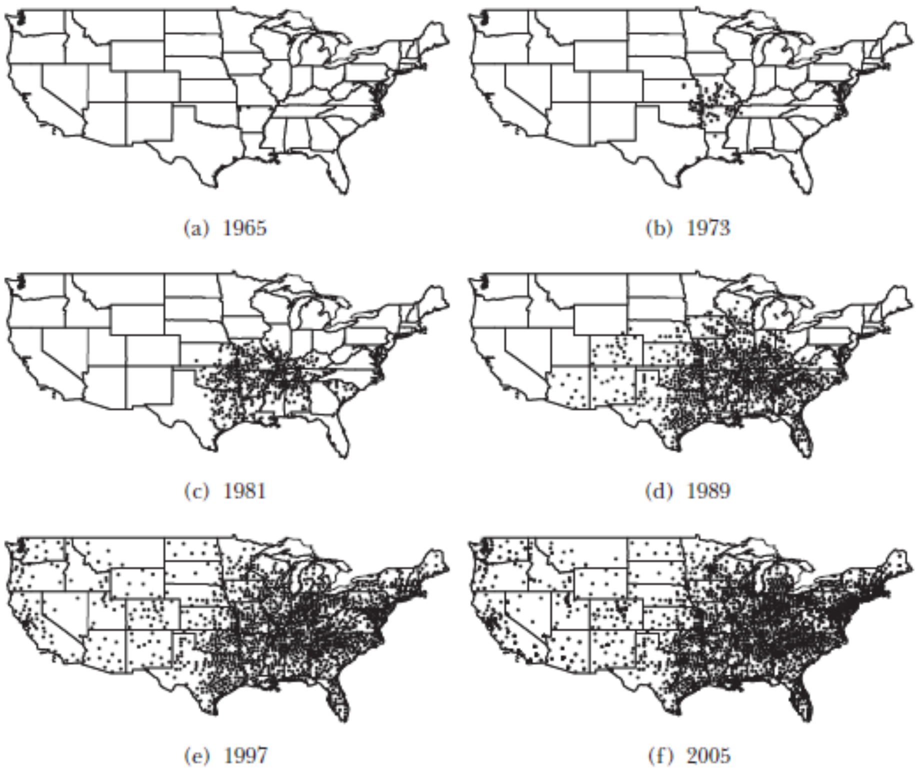

Figure 1: Walmart Store locations, 1965-2005

Sears, Roebuck and Co. was founded much earlier in 1891. Initially a catalog business, Sears expanded into retail business in 1924. The history of the company is deep so that getting introduced to some of the historical figures might be interesting. In late 19th century as well as for the larger part of 20th century Sears company dominated the retail industry not only of the United States but of the world. In 1906 it performed the first major retail IPO in American consumer industry with market capitalization at $40 million. From 1924 to 1999, Sear's stock was part of the Dow Jones Industrial Average[2]. Also, it had been one of the leaders of the world's retail industry until in the 1980s the company confronted an increased number of competitors in the market and digitalization. It led Sears company to come up with different profit maximization strategies which included new targeting of audience, revised product offerings and the most innovative for its time was the issuance of company's proprietary credit cards. To illustrate, the company created new 24 million credit accounts between 1993 and 1996, and at the end of 1997 there were 27 million active credit card users with an average balance above $1000[3]. Provided data in the case study shows that credit card sales comprised roughly 90% of the overall receivables. Focusing on increasing sales through proprietary credit sales the Sears, Roebuck and Co. had to compete in financial sector with existing credit cards like

2 https://en.wikipedia.org/wiki/Sears

3 Miller et al, Sears, Roebuck and Co. vs. Wal- Mart Stores, Inc., January 19, 2006

MasterCard or Visa, as well as it had to operate a securitization program with which it could secure its credits.

Comparative Analysis of Retailing Strategies: Sears vs. Walmart

Retailing strategies encompass comprehensive plans and approaches that businesses use to accomplish their objectives. It includes a wide range of activities and decisions related to product offerings, pricing, marketing, store operations as well as customer service. While Sears and Walmart followed different trajectories in the retail industry, there were moments in their histories when they shared comparable retailing tactics.

Discussing the similarities of companies' retail strategies, both companies offered competitive pricing for the wide range of products that they offered. The value provided by the companies was that a customer could find any necessary item of basic or regular use in one place – a large department store with affordable prices. Two companies had operated or still operating not only in United States but also in other countries. While Sears had department stores in Mexico and Puerto Rico, Walmart has operating 10,500 stores in 20 countries[4]. Maintenance of stores and operations throughout the world and providing affordable prices to their clients indicate the efficient supply chain management by Walmart and Sears.

There are distinct differences in the retailing strategies that companies use. The first and major difference comes from the target audience of each company. According to the article by Insider Inc., average Walmart customer in US is a 59-year-old white, married woman with $80,000 annual income who wants a low-cost, one-stop-shop experience[5] while Sears' average purchaser is statistically described as a 30 – 60 years old female who earns around $40,000 a year[6]. We notice that both companies target low to middle class suburban shoppers – people who live in rural areas and don't have access to stores and aim to solve their problems by providing "all in one place at affordable price" opportunities however Walmart seems to have better earning clients. It's also important to note that even if both companies targeted the public, Sears had warehouses which allowed them to target broader range of customers as they could sell their wholesale and bulk products to wholesalers.

Next difference in given companies' retail strategies is in their retail format. Sears functioned as a department store, mostly situated within shopping malls. In contrast, Walmart adopted different store formats like Walmart Supercenters, discount stores, and neighborhood markets. While Sears

[4] https://corporate.walmart.com/askwalmart/in-which-countries-does-walmart-operate#:~:text=Today%2C%20Walmart%20operates%20approximately%2010%2C500,20%20countries%20and%20eCommerce%20websites.

[5] https://www.businessinsider.com/typical-walmart-shopper-demographic-white-woman-earning-middle-income-2021-7#:~:text=The%20retail%20giant%20has%20the,and%20earning%20%2480%2C000%20per%20year.

[6] Chloe et.al, March 5, 2014, https://chloebhalley.wordpress.com/tag/sears-analysis/

introduced Sam's club which granted fee-based membership to its customers and thus access to wholesale products, Walmart did not have a membership requirement.

It's foundational to pay attention to the companies' management and leadership performance as well. Sam Walton – now known as a father of retail – was the one who laid the foundation of Walmart and successfully run the business up until his death. He and his team made the company go public, smoothly adapt new technologies to meet modern needs and achieved successful operating international business. On the other hand, Sears as a retail business has a deep history of overcoming two great depressions – one in the early 1920s and World War II – during and after both of which it greatly benefited. However consecutive change of leadership among which there were presidents who never showed up in a board meeting had different impact on company's performance and not always positively.

Customer experience is another way to compare Walmart and Sears' retail strategies. Google search shows that current Walmart stores in MA, USA are open from 6 am to 11 pm while Sears stores open 10 am and work till 7 pm. As the reporter Norman says before coronavirus pandemic Walmart stores were operating 24/7. These numbers can tell us a lot about the experience that customers get from each company and the conclusion that a Walmart store is more available for an average customer than Sears store can be drawn. Surely, we can't say a lot about customer experience in the early 2000s neither can't refer to reliable customer experience source, but I think that if we ask from a random person walking in the street there is a higher likelihood that this person has heard about Walmart but hasn't heard about Sears. Based on the available information and through extrapolation, we can conclude that the public was more aware of Walmart stores than Sears and that Walmart stores were more accessible to the public.

Qualitative analysis of Sears and Walmart's financial performance

A qualitative assessment of companies' financial performance includes the descriptive analysis of ratios on liquidity, assets, and market value. Then we dive deep into the DuPont equation to study what the calculated ROE ratios speak about in more detail. We answer the question if the higher ROE ratio necessarily suggests buying that stock and discuss the uses and limitations of using ratios to evaluate the companies' financial statements.

Ratios (1997)	**Formula**	**Sears**	**Walmart**	**Industry average 2017** [7]
Liquidity				
Current	$\frac{Current\ assets}{Current\ liability}$	=30682/15790 = 1,94	=17993/10957 = 1,62	=1,24

[7] https://www.readyratios.com/sec/industry/G/

Quick	$\frac{Cash\&cash\ eq + Receiv}{Current\ liability}$	=(358+3316+20956-1113+335)/15790=1,5	=(883+845)/10957=0,158	=0,49
Asset management				
Inventory turnover	$\frac{Sales}{Inventories}$	=36371/5044=7,21	=104859/16193=6,48	=2,91
Days sales outstanding	$\frac{Receivables}{\frac{Annual\ sales}{365}}$	=(3316+19843+335)/ 36371*365=235,77	=845/104859*365=2,94	
Market value				
Price/Earnings	$\frac{Price\ per\ share}{EPS} = $ $= \frac{Market\ cap}{Earnings}$	=323/1188=0,272	=228/3056=0,075	

Table 1: Summary of Financial ratios for Walmart & Sears

Current and quick ratios play an important role in assessing a company's liquidity. The current ratio measures a company's ability to cover short-term liabilities with short-term assets, while the quick ratio (acid-test ratio) does the same but excludes inventory. By calculating liquidity ratios for Walmart and Sears with financial statements for the year 1997 in hand we can see that both current and quick ratio is higher for Sears than for Walmart. As I couldn't find average values for the calculated ratios for retail industry in 1997, anyways I provided available values for year 2017. Current and quick ratios for Sears are 1,94 and 1,5 and for Walmart 1,62 and 0,16 respectively. Higher ratios for Sears indicate stronger financial health, that is, in case of liquidation the company will be able to provide enough liquidity (cash) to cover its debts to creditors. Higher current assets and higher cash and cash equivalents with receivables for Sears resulted in stronger ratio than Walmart. However, if we pay closer attention, we notice that a significantly large amount of credit card receivables is making Sears' liquidity stronger. With deli considered, heavy reliance on credit sales and receivables for a non-financial retail firm should raise doubts about the short-term collectability of receivables and their trustworthiness.

Inventory turnover is slightly higher for Sears 7,21 compared to Walmart's 6,48. This ratio tells us about how efficiently a company manages its inventory by assessing how many times it sells and replaces its inventory in a specific period. A higher turnover ratio for Sears may indicate that Sears achieved higher efficiency in using its inventory than Walmart or that Walmart had excess inventory given that Walmart had three times as both sales and inventories than Sears company.

Days sales outstanding in asset management is another interesting marker to discuss. We notice a huge difference in the DSO ratio between companies. While it took 236 days on average to collect payment from its customers after a sale for Sears, Walmart's was only 3 days. It says that Walmart was collecting receivables faster than Sears thus has more efficient accounts receivables.

Coming to market value, we see the P/E ratio for Sears was 27,2% while for Walmart it was 7,5%. It indicates investors were willing to pay for each dollar of Sears' earnings 27,2 cents while for Walmart investors were willing to pay only 7,5. This might suggest that Sears had higher growth expectations or was overvalued, while Walmart's lower ratio may indicate undervaluation or lower growth expectations.

ROE	$= ROA \times Equity\ multiplier$ $= Profit\ margin \times Total\ assets\ turnover\ \times Equity\ multiplier$ $= \frac{Net\ Income}{Sales} \times \frac{Sales}{Total\ assets} \times \frac{Total\ assets}{Total\ common\ equity}$
Sears	$= \frac{1188}{36371} \times \frac{36371}{38700} \times \frac{38700}{5862} =$ $= 0,0327\ \times 0,94\ \times 6,602 =$ $= 0,0307\ \times 6,602\ = 0{,}203$
Walmart	$= \frac{3056}{104859} \times \frac{104859}{39604} \times \frac{39604}{17543} =$ $= 0,0291\ \times 2,648\ \times 2,258 =$ $= 0,077\ \times 2,258 =\ 0{,}178$
Industry average	Industry average on ROA for retail industry in 2017 was 3,3%[8] while average ROE for retail sector in 2023 accounts for 18,29%[9].

Table 2: ROE – the DuPont Equation

Both the calculations of Don Edwards and the in-assignment calculations of ROE for year 1997 give higher ROE values for Sears compared to Walmart, 20,3% and 17,8% respectively. The question is whether a higher return on equity is a true indicator of a company's financial health and efficient performance. In this case, the DuPont equation helps us to break down return on equity (ROE) into its components and gives a deeper understanding of what drives companies' financial performance. Walmart has an ROA of 7,7%, which means it generates 7,7 cents of profit for every dollar of assets. This suggests that Walmart is using its assets efficiently to generate profits. Sears has an ROA of

[8] https://www.readyratios.com/sec/industry/G/

[9] https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/roe.html

3,1%, indicating it generates 3,1 cents of profit for every dollar of assets. While this is a positive return, it's lower than Walmart's ROA, suggesting that Walmart is more efficient in utilizing its assets to generate profits. It's important to compare ROA to industry benchmarks to draw meaningful conclusions about two companies' financial performance. Compared to the available average ROA value for retail sector 2017 (3,3%), 20 years later, we see Walmart's ROA in 1997 was still outperforming the industry average of 2017.

Calculated ROEs for Sears and Walmart are 20,3 and 17,8% respectively. Comparatively high equity multiplier for Sears is contributing to a higher ROE level. We should denote the fact that more than 68% of current assets of Sears were comprised of credit card receivables which in turn was contributing to higher total assets. According to Sears, Roebuck and Co. 1997 annual report Sears card as percentage of sales accounted for 55,1% of sales which again guides us to the conclusion that particular ratios are higher for Sears and however most of them could had been driven by credit receivables. The case highlights an ongoing trend of increased delinquencies and charge-offs, accompanied by an increase in the allocation for uncollectible domestic accounts[10]. Even if the ROE or equity multiplier comes out higher indicating that it would be more profitable to buy Sears' stock, its credit operation driven financial performance should serve as a cautionary signal to a prudent investor.

Furthermore, according to the information provided in the case, as of 1998 Walmart had entered into lease agreements for 38 future locations each of which commits for minimum rentals for 20 to 25 years. It communicates about the company's extensive expansion plans and serves as a confident indication for long-term investment.

Recommendations

As a prospective investor, it would be important for me to consider several critical factors in decision-making. First and foremost, understanding a company's core values and mission would be essential. This provides insight into its fundamental principles and long-term objectives. Equally important is assessing the company's commitment to ecological sustainability and social responsibility, as it speaks to its ethical stance and broader impact on society.

Furthermore, corporate culture, fairness, and integrity are crucial considerations. These elements contribute to a company's ethical framework and overall reputation. It's also vital to evaluate a company's legal standing, ensuring strict adherence to federal and state laws, as well as regulations set forth by the United States Securities and Exchange Commission (US SEC). The legal profiles of both

[10] Miller et al, Sears, Roebuck and Co. vs. Wal- Mart Stores, Inc., January 19, 2006

current and former leaders significantly influence a company's stock valuation, reflecting the level of trust and credibility in its management.

In the case of Sears and Walmart, both companies have historically committed to providing cost-effective products and services while aiming to enhance customers' lives. However, allegations against former Sears presidents, involving alleged misappropriation of company funds and violations of legal regulations, raise concerns about the management's commitment to investor interests. This prompts questions about the effectiveness and prudence of Sears' decision-making.

Moreover, in the years leading up to 1998, Walmart initiated steps toward social and ecological sustainability. Notable efforts included the reduction of excess packaging in their products to minimize waste and environmental impact. Additionally, Walmart began sourcing products locally, thereby mitigating transportation-related emissions and supporting local economies. The company demonstrated philanthropic commitments through contributions to diverse social causes via its charitable foundation, encompassing donations to educational programs, disaster relief efforts, and community initiatives.

In conclusion, Walmart emerges as a robust investment option based on both qualitative and quantitative analysis. Its steady historical growth, efficient asset utilization, superior liquidity and more favorable customer experience position it as a strong contender for long-term investors. Moreover, Walmart's efforts in social and ecological sustainability further enhance its appeal. Hence, we recommend that a rational investor consider buying stock in Walmart for a promising and enduring investment venture in the dynamic retail sector.

The successful execution of innovative strategies and the agile response to evolving consumer demands position Walmart with significant growth opportunities, making it a wise choice for long-term investors who look beyond the horizon. While the ongoing pattern of rising delinquencies and charge-offs, along with an augmentation in the provision for uncollectible accounts and the breach of legal regulations, coupled with suboptimal management performance, renders Sears an unappealing investment choice. Although an examination of financial performance yields more favorable results in favor of Sears over Walmart, critical qualitative factors are speaking louder than the raw ratio outcomes. More specifically, Sears' proprietary card operations and the ensuing burdensome activities, such as compliance with and regulation of securitization programs, are diverting the company's attention away from its core retail sector, causing an inefficient allocation of focus and resources.

Limitations and conclusion

There exist several constraints when employing ratios as a means of assessing a company's financial performance. Defining a specific ratio as unequivocally "good" or "bad" is challenging, and it underscores the importance of delving deeper than mere numerical assessments. Various factors may underlie the performance of a particular ratio, necessitating a comprehensive examination that encompasses not only the quantitative aspects of a company but also its qualitative dimensions when making investment decisions. A more comprehensive quantitative analysis would benefit from historical trend assessments (for 5 or more years), along with comparisons to industry averages for the retail sector preceding the 2000s.