



JAMES SEBENIUS

ELLEN KNEBEL

Bill Nichol Negotiates with Walmart: Hard Bargains over Soft Goods (A)

The Bentonville meeting started routinely enough, with Walmart's buyer soon moving to a 2005 review of the Little Ones-branded infant sox supplied by Kentucky Derby Hosiery (KDH). Under an exclusivity agreement with Little Ones Products, KDH had produced and sold this popular line to Walmart for six years.¹ During this period, KDH had met all sales, growth, and margin targets set by the giant retailer for this line of infant sox, and had conformed to Walmart's exacting quality and logistical requirements. Sales to Walmart of infant sox, predominantly the Little Ones brand, were vital to the Kentucky firm, accounting for about 20% of its total annual revenues. And KDH's margins on this line of infant sox were roughly double its margins on other sox and hosiery, which had been under relentless downward pressure.

These meetings were never easy, but Bill Nichol, Jr., Chairman and CEO of KDH for ten years, felt relatively comfortable in Walmart's plain offices, given his firm's history since the early 1970s with Walmart and its virtually perfect Walmart "scorecard" with this fast-growing product line. Then came a "bolt from the blue." Nichol remarked

We'd built an enormous sales base with Walmart, approaching 18 percent U.S. market share, with that brand. It had been cultivated over a six-year period. One day in a meeting in Bentonville, my Walmart counterpart said simply, "We don't want that brand anymore."

Looking back, Nichol recalled the essence of the conversation that followed:

Nichol: "Haven't we met all our agreed growth numbers and conditions for the last several years?"

Buyer: "Yes. But it has been decided at top levels that Walmart is going to drop that brand. Sorry."

Nichol: "Can you please explain why this decision is being taken? Is it final?"

¹ "Little Ones Products" is a fictitious name used to disguise the actual company involved in the situation described in the case.

Professor James Sebenius and independent researcher Ellen Knebel prepared this case. This case draws on an earlier case series, "William Nichol, Jr. and Kentucky Derby Hosiery: Negotiating with Wal-Mart" (A) and (B), HBS Nos. 907-001 and 907-002. Certain details have been disguised. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

Copyright © 2010 President and Fellows of Harvard College. To order copies or request permission to reproduce materials, call 1-800-545-7685, write Harvard Business School Publishing, Boston, MA 02163, or go to www.hbsp.harvard.edu/educators. This publication may not be digitized, photocopied, or otherwise reproduced, posted, or transmitted, without the permission of Harvard Business School.

Buyer: "The reasons involve overall brand policy, competitive factors, and other considerations. But what is important for you to understand that, whatever the reasons, this now a closed issue."

Stunned, Nichol had taken a deep breath. His first thought was brutally simple:

We had an enormous amount of capital deployed in the Little Ones Products brand, in machinery, equipment, and marketing, and all manner of investment dependent on that volume. There is nowhere else to go to replace such volumes, so when you operate at the volume of Walmart and you have the long-term debt obligations that it takes to support that level of volume, it is very important that those numbers do not move down very much, or else you face disastrous financial consequences. Chapter 11 would not be out of the question.

In fact, about 25% of KDH's modern, high-speed production machinery was devoted to the Little Ones-branded line. This relatively new capital equipment was secured by long-term loans from J.P. Morgan, KDH's banker, that were ultimately a general obligation of the firm. And, to make matters even worse, although Walmart did not sign contracts longer than one year with most suppliers like KDH, negotiating exclusivity had required KDH to guarantee five years of minimum sales volumes and significant forward financial obligations to Little Ones Products.

Over his long business career, Nichol had faced plenty of tough negotiations. But this one promised to be among the most challenging. He took another deep breath and began to formulate a negotiating strategy to turn this disastrous decision around.

Kentucky Derby Hosiery

William Nichol, Sr. founded hosiery wholesaler, Kentucky Derby Hosiery (KDH) in 1948. Headquartered in Hopkinsville, Kentucky, KDH supplied socks and hosiery for adults and children. Son William (Bill) Nichol, Jr., ("Nichol"), followed his father into the business in 1971. By holding various positions within the then one-plant company, Nichol came to understand the intricacies of the hosiery business. He took over from his father as Chairman and CEO in 1985.

By 2005, KDH's seven manufacturing plants supplied hosiery, socks, accessories, and leg wear to a number of major retailers such as Kmart, Target, Dollar General, and Family Dollar. Its national market share in the overall sock category had risen to about 6%, making KDH one of the top five U.S. producers. However, Walmart, which had dealt with KDH since the early 1970s, had grown spectacularly. The retail giant was now KDH's largest single customer, accounting for about 35% of KDH's overall sales volume of about \$150 million annually.

Times were increasingly tough, however, for the North American-based sock manufacturing industry. Production was rapidly moving offshore. Retail selling prices for socks and hosiery, under intense global pressure, were registering recent declines of 5-10% per year. Since the late 1990s, the aggregate profit margin of this industry had been relentlessly shrinking, by perhaps three percentage points annually. Major banks that had traditionally supported domestic textile firms were sharply reducing the exposure of their loan portfolios to this sector. Domestic industry appeals to the U.S. government for protection had bought some time, but the future looked bleak.

Despite this general industry gloom, or perhaps because of it, Montreal-based Gildan Activewear, a world leader in t-shirts and branded basic clothing, had made serious overtures earlier in 2005 to acquire KDH, though the negotiations proved inconclusive. As the majority shareholders of KDH, Nichol and three family members had a strong attachment to KDH. By this point, they also turned

down another legitimate offer from a venture capital firm and had had discussions with another potential acquirer.

Indeed, to prosper under these challenging conditions, KDH had made several defensive moves. First, it had established a low-cost, tax-advantaged production facility in Ghana under the African Growth and Opportunity Act. The firm had also opened importing offices in China and Korea and was planning a joint venture production facility in China. By 2005, about half of KDH's production had been moved offshore. Second, by extremely conservative financial practices, Nichol had steadily reduced KDH's debt-equity ratio from a high of 3.5:1 in 1999 to a far more manageable 1:1, with its debt composed about equally of short and long-term obligations.

Among KDH's most important strategic choices was the exclusivity arrangement it had negotiated with Little Ones Products (LOP) to produce and sell a line of LOP-branded infant sox. LOP was a Fortune 500 company with a strong brand of "hard goods." (Indeed, attracted primarily by these branded hard goods, Walmart had grown to become LOP's largest customer.) LOP's appealing brand helped protect KDH's line of infant sox against the margin-eroding pressures from the global commoditization of most of its products. As a result, KDH's margins on this LOP-branded infant sox were almost double those on the rest of its products. Based on this exclusivity, KDH had invested heavily in equipment and marketing to support its LOP-branded line. But exclusivity had come at a high price: multi-year fixed minimum sales requirements to Walmart and five years of forward financial obligations (royalties on gross sales), of which three years remained. To LOP, this provided an attractive revenue stream from one of its few brand extensions to "soft goods" like sox.

Emergence of the Mega-retailers

Nichol recalled the supplier-retailer negotiation environment prior to Walmart's explosive growth in the 1990s.

If you go back in time, the power of the mega-retailers was far less than it is today. The bargaining power we originally encountered at Walmart was that they were just another relatively small retailer. We have grown with them and worked with them over a long period of time—since the early 1970s. A similar growth pattern was occurring with our other customers during that time period. Until the mid-1980s, Walmart was not really that big. The growth rates we experienced in the 80s and continuing through the early 90s were exciting and challenging to manage. . . . From the earlier years, the ability to service Walmart from a supplier point of view was a very simple process.

The quality specifications Walmart requires have changed radically since the early times. The extremely demanding and challenging distribution requirements were not as controlled of a process as they are today. More recent requirements of Walmart include meeting a very high quality standard that is continuously monitored, and meeting delivery schedules that are difficult to execute. Being able to change product mixture, being able to adapt to their fast-paced way of doing business, is not for everybody This has eliminated a large number of supplier competitors from the industry. This has allowed Walmart to aggressively go forward with companies that have proven they can deliver the products desired by Walmart customers.

While some see Walmart in highly adversarial terms toward its suppliers, especially on price, Nichol stresses KDH's very different experience with the retail giant

Walmart has continuously improved the quality of their supplier performance. It is often perceived to be all about price. But it is much deeper than price. If you are willing to work in a

collaborative relationship, then your profitability with Walmart can be very good. Most people don't understand how that could be true.

In the 1990s, Walmart began to engage suppliers in store "re-planning" events during which it would communicate its goals and invite the suppliers to pitch new products. The discussions generated by the goal setting and product demonstrations could greatly influence business decisions in the coming year for suppliers like KDH. These annual or semi-annual events became an important part of the supplier-retailer negotiation process for KDH. Explained Nichol:

So that's the stage that's set—the goals that Walmart lays down, in this instance, a specified percentage sales increase in hosiery products for the upcoming calendar year. That is the challenge; we know our baseline numbers, and that means a certain percent improvement in sales and profit within the same retail footage. Everything that we talk about is relative to the retail footage that products occupy. This is another quantitative measurement that Walmart has mastered and many of their competitors have not. The negotiation process starts with a buyer communicating their goals. Our sales and marketing people must understand those goals at the start of the process. This includes their ability to translate these goals to actions our company can take to ensure the direction is correct.

Although there was latitude for discussion, the goals explained and communicated by Walmart to its suppliers were tied to overall corporate strategy and set at the highest levels of the organization. Observed Nichol:

Senior management sets the goals and then the goals are communicated to the suppliers. The goals are related to Walmart's corporate master plan and corporate financial requirements—and then it kind of rolls down to the departments and buyers and is interpreted in a few different ways. The big picture is a consistent interpretation, and their buyers and merchants understand that that's the challenge for the upcoming period. Those goals take the form, from our point of view, of what the product changes will be and what the retail pricing strategy will be, what the quality levels will be, what the branding strategies will be. So we have to take those quantitative measurements and make them an actionable event that ends up with a modified set of products. ... To out-perform a prior period is an ever-present state of mind that does not exist in all of our retail customers.

Walmart will tolerate errors (i.e., missing Walmart's defined supplier goals) up to a point, if the supplier is not taking a complacent approach. The worst thing you can do is be complacent. Walmart goes to many extremes to give their suppliers the opportunity to be profitable. They want them to be profitable; they want them to have a good return on investment. They want them to be hungry for new business, so that they will bring to market innovative, value-driven products for their customers. They don't want to be abusive in a way that would jeopardize a good supplier and therefore eliminate future opportunities.

As email became more common, the means of negotiating and communicating changed. KDH experienced a marked shift from face-to-face to electronic interaction. "Not too many years ago," recalled Nichol, "it would have been totally face-to-face meetings, followed up by telephone calls. I would say now that 80 percent is e-mail. So the communication dynamics with Walmart are ever changing. We may get six phone calls a week from Walmart and probably hundreds of e-mails in a week."

Looking to the Past for Clues

As Bill Nichol tried to think through a negotiating strategy to salvage KDH's LOP-branded infant sox, he thought back over other difficult dealings with Walmart for clues about the best approach. During one annual planning session, Nichol recalled, Walmart had announced annual hosiery sales goals that he knew KDH simply could not meet. Clearly, KDH would be better taking the initiative to challenge these targets up front, rather than inevitably explaining why it could not perform.

Walmart makes it very clear that they want the relationship to be on the corporate-to-corporate relationship level. If for any reason you don't feel comfortable with your business, for whatever reason—a buyer's personality, not being treated fairly, not being communicated with in the normal expected manner, whatever your problems are—then the open door policy demands that you go up a level in their corporate structure to pursue resolution of the problems. In this process, the burden is on the vendor. They make it very clear that if you don't step forward and explain why you disagree with changes in the business plan, and tell them why you don't think this will work, then you haven't fulfilled your obligation as a supplier. Their mode of operation is, "Tell us what your difficulties are. Communicate with us." If the buyer won't respond to that, it is your obligation to go up a level. Needless to say, there is no guarantee that the plan will change.

Taking advantage of this open door policy, Nichol arranged a series of meetings and calls up the corporate ladder. These meetings confirmed that the aggressive sales goals had been set at a very high level in Walmart. However, drawing on a detailed fact base, Nichol challenged his counterparts by saying, "You know, that's a great goal, but I don't think that it's possible." They're not going to get upset if I say that, as long as I can explain why I think that it is not possible. That opens a whole new level of dialogue. They said, "You know the sock business. Why do you think we can't do this?" And I gave them a lot of different reasons why I didn't think it was reasonable. Beyond explaining why the goals were unattainable, Nichol went further

I tried to avoid being purely negative by saying if you would do this, this, and this, then maybe we can get there (e.g., we need more shelf space, we need for your [Walmart's] performance in your order management to improve by some percent, we need to work together to improve inventory management). And I said, "we'll split this percent goal up and, say, with merchandising, we can carry about half of it. But, you're going to have to improve these (previously mentioned) issues. If we work together and take action on these suggestions, then we can get the overall performance back on track." I discussed all of this openly with my Walmart counterparts; Walmart encourages such open discussion; it is welcome constructive criticism.

By working with Walmart on all these fronts, substantial improvements could be made, though sales increases were smaller than Walmart's initial goals. And KDH's positive relationship with Walmart was maintained, at least through this challenging episode.

That "goal negotiation" was in the past. Now, however, Nichol faced the buyer's ultimatum on dropping Little Ones-branded sox. Drawing on his years of experience dealing with the retailer, he needed to learn more about this decision and urgently seek to reverse it before Walmart replaced his line and/or irrevocably reduced the shelf space devoted to infant sox.

We had little time and had to move rapidly. As CEO, I began to go upstream at Walmart to ensure that the direction coming from the buyer was consistent with their management strategy. Using Walmart's "open door policy," we determined that, indeed, Walmart had made a branding decision at a higher level that was not favorable to us. As we communicated

up the chain of command, it became apparent that the decision to drop the Little Ones Products brand from the store was going to happen. The precise rationale for this action was hard to figure out from these conversations, though we knew that Walmart was seeking to get greater control of the brands it carried and reduce brand fragmentation. Yet the blunt message we heard at all levels was clear: 'this decision is irreversible.'

Nichol wondered how to negotiate KDH's way out of this rapidly closing, 3-sided vise: Walmart's decision to drop his most profitable line, ruinous forward financial obligations to LOP, and long-term bank debt that was unsustainable without the volumes and profits from the LOP line. For no apparent reason, a wry thought flashed into Nichol's mind: "Those previous offers to buy KDH--made well before this conflict with our largest customer—might not have been such bad ideas, after all. Too bad!"