A Question of Business

Kroger, Wal-Mart, and Supermarket Competition

How and Why Do Companies Provide Goods and Services for Customers?

Suppose you walk into one of your local supermarkets such as Kroger, the largest supermarket chain in the United States in 2005 (www.kroger.com). You are walking into a business enterprise or company that is there to sell you an assortment of food, drinks, and consumer products selected to appeal to you and to satisfy your needs. What makes you want to shop or trade with Kroger rather than with, say, Albertson's or Wal-Mart? And why has Kroger spent billions of dollars to build and stock its store to attract you to shop there? Moreover, what factors determine the kinds of goods and services Kroger's chooses to offer you and the prices that it charges for its products?

Kroger is in *business* to make money for its stockholders, the people who have used their savings or capital to buy shares of its company stock. Kroger's stockholders' goal is to increase the value or "get a return" on their investment in the company's business. This will happen if (1) Kroger's managers select the right mix of products and attract more customers, then (2) can sell these products at a price high enough to generate sales revenues (the money it receives from selling the products) that (3) more than exceed the costs of operating the business (including payroll costs, the cost of purchasing the many products it sells, and the cost of leasing store space).

When Kroger's sales revenues exceed its operating costs, it is said to make a *profit*, the difference between its total revenues and total



costs. If Kroger can show its profit is likely to increase over time, more people will want to buy its stock. Then Kroger's stock price goes up, and so does the value of its stockholders' investment. The increase in stock price is its stockholders' reward for the *risk* they have taken in investing their money in its business: If a company ultimately performs poorly and its profits start to fall, the value of its stock falls; if it goes out of business entirely, stockholders lose all of their money.

Because the grocery business is competitive, finding ways to increase profit is not easy. Many of Kroger's rivals are trying to lure its customers away by offering them lower-priced or higher-quality products. Wal-Mart has become Kroger's major rival. Wal-Mart is rapidly expanding its

chain of superstores and grocery stores throughout the United States and offering customers lower prices than Kroger's. To fight back, Kroger has had to reduce the prices of it products. Whereas in the past, Kroger might have made a five-cent profit by selling a can of soup it now makes only three cents. Although this difference might seem trivial, it is not. The supermarket business has low profit margins, meaning the difference between the price at which Kroger buys products from manufacturers and sells them to customers is very small. Thus, a small drop in profit on every product it sells, such as a two-cent drop in profit on each can of soup, adds up to a major problem.

Kroger's managers have responded to Wal-Mart's competitive challenge in two ways. First, they have found ways to reduce Kroger's operating costs by using new information technology such as scanners and automated, self-service checkout lanes. So, even though Kroger must sell its products at lower prices, because it's managed to lower its other costs, it has been able to maintain its profit margins. Second, Kroger has tried to attract customers by offering them a much wider selection of superior quality meats and vegetables than Wal-Mart. Third, it has built attractive new stores to make Kroger a more enjoyable place to shop. The catch is that these latter tactics have *raised* Kroger's operating costs because buying higher-quality products and building new stores is expensive. But this strategy will not be a problem if Kroger manages to attract *more* customers willing to pay *higher prices* to obtain better-quality food and enjoy surroundings that are more attractive. If customers are willing to pay prices that are higher, Kroger will be able to increase its profit margins, and its profit will increase over time.

Recently, the battle with Wal-Mart has reduced Kroger's profit margins, although it is still making a substantial profit. But finding new ways to keep customers happy is its managers' major priority: If Kroger's customers continue to leave to shop at competitors like Wal-Mart, its sales revenues and profit margins will fall further. Stockholders will begin to sell their shares, and Kroger's future will be in jeopardy.[1] •

Overview

So far Kroger has met the challenge posed by Wal-Mart because its managers were aware of the changes taking place in the supermarket business; in June 2005 Kroger reported a much bigger than expected increase in profit. Many of its managers have risen through the ranks; many more have business degrees, and they all have wide experience of the supermarket business. This made them alert to the threat posed by Wal-Mart's fast growth and low prices. They also knew it was necessary to build attractive new supermarkets, offer a better shopping experience and superior produce. Many people, however, have not had much contact with the world of business and are not familiar with the way it operates.

Take the "business" of babysitting, for example. What do potential babysitters think about when they are deciding how much to charge a new family for their services? Do they think about the number of children involved or their ages when setting the price? Do they consider the kinds of activities they will be expected to perform such as preparing food or doing laundry? What about the time and gas it takes to drive to and from the family's house? Does a babysitter include these costs in deciding upon the price to charge? Suppose the parents guarantee they will be home by 10:30 p.m., and then don't get back at 11:00 p.m. Should they pay a higher "overtime" charge? Plumbers or electricians would factor all these kinds of things into the price they charge for their services, but do babysitters?

One reason that people may not understand what being "in business" means is that they often don't appreciate the way business operates around them. At a supermarket, for example, we take for granted that there will be a wide selection of fresh meat and produce and plenty of checkers and baggers to get us through the checkout process quickly. Often, it is only when supermarkets don't work as we expect—when there are too few checkers so we have to wait in line, or when we find that the food we bought is old or stale, that we wonder why the business is not working properly.

In this chapter, we start the process of building an appreciation of what business is and how it affects us in so many ways. First, we identify the three main meanings of the term: business as commerce, business as an occupation, and business as an organization. We describe the nature of business commerce and trade, along with how the forces of supply and demand determine the price of a product. We then discuss the way business occupations develop because of the process of specialization and the division of labor. Then, the way business organizations emerge to provide a stable platform on which people can engage in business commerce is described.

Finally, the relationship between the chapters in this book and the way they work together to provide an overview of how business creates value for people or the "value-creation process" is outlined. By the end of this chapter, you will understand what business is about and why business has always been a crucial factor in determining the occupations, wealth, morality, and culture of people and society.

What Is Business?

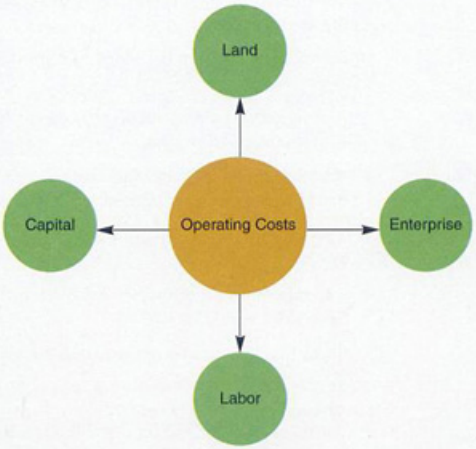
"The great game of business," "the world of business," "monkey business," "I'm going into business for myself," "big business," "the business of America is business," even "mind your own business," are some of the many sayings, or adages, connected to the word *business*. Business is a complicated word to define and understand because it has several different, but related, meanings. Let's pull apart these meanings to understand what business is about.



"Monkey business" is one of many sayings, or adages, connected with the word *business*.

Business is goal-directed behavior aimed at getting and using productive resources to buy, make, trade, and sell goods and services that can be sold at a profit. **Productive resources**–*land, labor, capital,* and *enterprise*–are the four crucial ingredients that make this possible. Typically, a business (1) operates from a specific location and facility (*land*); (2) employs one or more people (*labor*); (3) needs money (*capital*) to buy raw materials, inputs, machinery and computers, land, and labor; and (4) requires the foresight, drive, knowledge, ability, and ingenuity (*enterprise*) of one or more people–its owners or managers. Together, the cost of acquiring and using these four resources to make and sell goods and services determines a company's **operating costs.** This is illustrated in Figure 1.1.

Figure 1.1
Productive Resources and Operating Costs





Business in Action

A Blockbuster Adventure

In the early 1980s, the number of VCRs in peoples' homes was expanding rapidly, and thousands of small video stores were opening up to rent the videotapes that people wanted. Many of these "mom and pop" stores were small, offered only a limited selection of titles, and were often located in hard-to-find locations in remote shopping centers. Many of the stores also rented X-rated movies. Of course, parents and their children–the biggest segment of the video market–were reluctant to visit these stores.

David Cook, who was searching for a new business opportunity at this time, realized that there was a market for a new kind of video store: one that would appeal to families and satisfy their needs in a way that no other store could. In 1985, Cook opened his first Blockbuster Video Store.



David Cook, the founder of Blockbuster, set out to change the focus of the adult-oriented, video rental business to one that focused on the needs of families.

What were the elements of Cook's business model? To encourage families to come in and browse, Blockbuster stores were free standing, brightly decorated and lit, and in good locations with lots of parking. Cook made sure the stores were full of titles that appealed to children, and no X-rated movies were offered. He also pioneered the practice of renting out tapes for three-day periods and adopted a marketing campaign aimed at attracting the family viewing audience. Finally, he took advantage of new technology such as bar codes and scanners to speed up the checkout process and improve the shopping experience. As a result, Blockbuster became a smash hit. Every store Cook opened was immediately successful, grossing $70,000-$80,000 a month in revenues. Because each store's operating costs were only $20,000-$30,000 a month, profit margins were enormous. Cook soon **franchised** his video superstore concept–that is, he sold investors the right to own and operate their own Blockbuster stores using his business name and model. He later took the company "public," meaning shares of stock were issued and sold to investors. The chain's high profits caused the price of Blockbuster's shares to skyrocket, and it became one of the 100 fastest growing companies in the Fortune 500. Today, Blockbuster is the largest video rental chain in the world with over 5,000 stores. Cook had clearly found an opportunity to create a company that offered customers more value than they had previously been getting.[2]

franchising
A business practice whereby investors are allowed to purchase the right to own and operate a business using a company's name and business model.

Before we go on, we should recognize that while *for-profit* companies need competitive business models so do *nonprofit* organizations, such as government and state agencies and charities. By definition, **nonprofit organizations** are those that are not in business to make profit for stockholders but to provide value to the people and groups they serve. Nevertheless, nonprofits still need a business model that allows them to control their operating costs and to find ways to use their resources to create the most value they can. Charities, for example, compete to obtain donations. Suppose you have to decide which charity to give your money to. Would you give it to the charity that is able to send 85% of your money to needy people after it pays its operating expenses or just 45%? If a particular charity is known for paying its managers high salaries and having high operating costs, people will give less to this charity. Just like for-profit companies then, nonprofits must have a business model to guide their decision making.

nonprofit organization
An organization that is not in business to make profit but to provide value to the people and groups it serves.