TABLE 13.14 Decision to Join Consortium

		Firm 2	
		Work alone	Enter consortium
Firm 1	Work alone	10, 10	10, 20
	Enter consortium	20, 10	40, 40

price above $180,000 but would like to receive the highest price she can. If I am the only bidder for the house, how can I make the seller think that I will walk away rather than pay more than $200,000?

I might declare that I will never, ever pay more than $200,000 for the house. But is such a promise credible? It may be if the seller knows that I have a reputation for toughness and that I have never reneged on a promise of this sort. But suppose I have no such reputation. Then the seller knows that I have every incentive to make the promise (making it costs nothing) but little incentive to keep it. (This will probably be our only business transaction together.) As a result, this promise by itself is not likely to improve my bargaining position.

The promise can work, however, if it is combined with an action that gives it credibility. Such an action must reduce my flexibility—limit my options—so that I have no choice but to keep the promise. One possibility would be to make an enforceable bet with a third party—for example, "If I pay more than $200,000 for that house, I'll pay you $60,000." Alternatively, if I am buying the house on behalf of my company, the company might insist on authorization by the Board of Directors for a price above $200,000, and announce that the board will not meet again for several months. In both cases, my promise becomes credible because I have destroyed my ability to break it. The result is less flexibility—and more bargaining power.

EXAMPLE 13.4 Wal-Mart Stores' Preemptive Investment Strategy

Wal-Mart Stores, Inc., is an enormously successful chain of discount retail stores started by Sam Walton in 1969.[12] Its success was unusual in the industry. During the 1960s and 1970s, rapid expansion by existing firms and the entry and expansion of new firms made discount retailing increasingly competitive. During the 1970s and 1980s, industry-wide profits fell, and large discount chains—including such giants as King's, Korvette's, Mammoth Mart, W. T. Grant, and Woolco—went bankrupt. Wal-Mart Stores, however, kept on growing and became even more profitable. By the end of 1985, Sam Walton was one of the richest people in the United States.

[12] This example is based in part on information in Pankaj Ghemawat, "Wal-Mart Stores' Discount Operations," Harvard Business School, 1986.

How did Wal-Mart Stores succeed where others failed? The key was Wal-Mart's expansion strategy. To charge less than ordinary department stores and small retail stores, discount stores rely on size, no frills, and high inventory turnover. Through the 1960s, the conventional wisdom held that a discount store could succeed only in a city with a population of 100,000 or more. Sam Walton disagreed and decided to open his stores in small Southwestern towns; by 1970, there were 30 Wal-Mart stores in small towns in Arkansas, Missouri, and Oklahoma. The stores succeeded because Wal-Mart had created 30 "local monopolies." Discount stores that had opened in larger towns and cities were competing with other discount stores, which drove down prices and profit margins. These small towns, however, had room for only one discount operation. Wal-Mart could undercut the nondiscount retailers and never had to worry that another discount store would open and compete with it.

By the mid-1970s, other discount chains realized that Wal-Mart had a profitable strategy: Open a store in a small town that could support only one discount store and enjoy a local monopoly. There are a lot of small towns in the United States, so the issue became who would get to each town first. Wal-Mart now found itself in a *preemption game* of the sort illustrated by the payoff matrix in Table 13.15. As the matrix shows, if Wal-Mart enters a town but Company *X* does not, Wal-Mart will make 20 and Company *X* will make 0. Similarly, if Wal-Mart doesn't enter but Company *X* does, Wal-Mart makes 0 and Company *X* makes 20. But if Wal-Mart and Company *X* *both* enter, *they both lose 10*.

This game has two Nash equilibria—the lower left-hand corner and the upper right-hand corner. Which equilibrium results depends on *who moves first*. If Wal-Mart moves first, it can enter, knowing that the rational response of Company *X* will be not to enter, so that Wal-Mart will be assured of earning 20. *The trick, therefore, is to preempt*—to set up stores in other small towns quickly, before Company *X* (or Company *Y* or *Z*) can do so. That is exactly what Wal-Mart did. By 1986, it had 1009 stores in operation and was earning an annual profit of $450 million. And while other discount chains were going under, Wal-Mart continued to grow. By 1999, Wal-Mart had become the world's largest retailer, with 2454 stores in the United States and another 729 stores in the rest of the world, and had annual sales of $138 billion.

In recent years, Wal-Mart has continued to preempt other retailers by opening new discount stores, warehouse stores (such as Sam's Club), and combination discount and grocery stores (Wal-Mart Supercenters) all over the world. Wal-Mart has been especially aggressive in applying its preemption strategy in other countries. As of 2007, Wal-Mart had about 3800 stores in the United States and about 2800 stores throughout Europe, Latin America, and Asia. Wal-Mart had also become the world's largest private employer, employing more than 1.6 million people worldwide.

TABLE 13.15 The Discount Store Preemption Game

		Company X	
		Enter	Don't enter
Wal-Mart	Enter	−10, −10	20, 0
	Don't enter	0, 20	0, 0