

You do what you can to alleviate their suffering during their addled and bewildered state(s) as they discover how to reposition their wings post solo flight. You even hope that they will learn the process that they might teach their own hatchlings one day. Ah, the similarities of parenthood, whether we be barn swallows or humans.

Sometimes you may even have to resurrect the dead or know what to do about an acute case of tobacco poisoning. Thanks to Daddy, Mother, and the memories of childhood, I am prepared for the job.

I'll end with one of my favorite Henry David Thoreau quotes: "The natural world is but a canvas for our imaginations."

As always,  
Linda~

P. S. Did I tell you that I can "resurrect the dead"... L~

### **Biographical Sketch**

Linda G. (Brown) English is a native of Prescott, Arkansas. She taught for twelve years within the public schools of southwest Arkansas before running away from home to pursue her doctorate and return to her alma mater, Henderson State University, to teach. Currently, Linda is an Associate Professor of Counselor Education in the Teachers College of her beloved Henderson.

### **Kmart: A Capstone Case**

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*Kmart's collapse into bankruptcy in early 2002 provides useful discussion for a capstone course. Kmart had a host of problems that cover many business topics. It had marketing issues, supply chain problems, issues with productivity, information technology gaffs, staffing and ethical issues. Although these issues are interrelated, we have attempted to separate and summarize them here. Many of these problems can be found in the financial ratios and financial statements from that period, making it an interesting case for financial discussion as well.*

### **INTRODUCTION**

The year 1962 saw the beginnings of Target, Wal-Mart, Woolco, and Kmart. Since Kmart started from a pre-existing retail establishment, it had advantages of corporate backing and experience that Sam Walton of Wal-Mart did not have [Belsie, 2002]. Given this competitive advantage, one would expect to find that Kmart had excelled. Instead, Kmart stockholders endured decades of dismal results which found

their depths in the weeks following September 11, 2001, and ultimately resulted in bankruptcy in 2002.

## MARKETING

### Target Market

From the beginning, Kmart chose primarily urban locations, similar to Target, while Wal-Mart's strategy was to go primarily where the competition wasn't: small towns. Target, meanwhile, chose to aim for the middle-class, while Wal-Mart marketed towards blue-collar customers, "and Kmart has focused on a clientele between Wal-Mart and Target income segments." This "competitive equation" was shattered, however, when Wal-Mart adopted the "supercenter format." [Graff, 2006]

### Positioning

After the bankruptcy filing in 2002, D. Howell stated that one of Kmart's major problems has been positioning. According to Howell, Kmart has been in "perpetual turnaround" for years. It lost its focus when it expanded into specialty retailing. It attempted low everyday pricing and that failed. It attempted to differentiate itself through its exclusive brands, such as Martha Stewart, and didn't fare any better. Its attempt at life style positioning, "The Stuff of Life," didn't work either. It had no stability or consistency. It couldn't find its niche. Other researchers agreed. For example, Charan, Useem and Harrington [2002] comment that Kmart suffered from "see no evil," a dysfunctional board, and strategy du jour problems.

### Product

Kmart started out offering discounted national brands but shifted to its own brands in the 1970s. It then in the 1980s and 90s contracted with some well known people and firms to offer their brands as well: Jaelyn Smith for clothes and Martha Stewart for house wares. It added others, such as Joe Boxer and Disney much later. After the 2002 bankruptcy, Howard Davidowitz, a national retail consultant, "stated that Kmart's only key marketing asset was one with liabilities. The only reason they're in the game is because of Martha [Stewart], said Mr. Davidowitz. [Cuneo, 2002]

### Price

Unlike Wal-Mart's "everyday low prices," Kmart used promotional pricing, and relied heavily on weekly mailers. The problem with print promotion is that it is not as cost effective as Wal-Mart's slogan, which does not require such large purchases of weekly advertising. Kmart does not have the low price position in consumers' minds.

In 2001, Kmart shifted strategies once again, with a new strategy to compete with less advertising and lower daily prices to compete head to head with Wal-Mart. Wal-Mart responded to the Kmart challenge with still lower prices. These newer initiatives further weakened the financial position of Kmart Corporation. The strategy failed, and Kmart ended up with enormous amounts of unsold inventory. [Graff, 2006] The strategy was in fact such a failure that "Kmart lost a whopping \$2.4 billion in fiscal 2001." [Schwartz et al., 2002] Perhaps the failure of head to head daily price competition is the reason that Kmart was, in 2003, "still the leading print promotional retailer." [Kwong, 2003, p. 445]

Competing on price can be a problem. Wal-Mart treats products as commodities and can afford to sell at low prices and still make healthy margins because of its efficient distribution system. Its distribution and inventory management are built on technology that Kmart was late to adopt. Kmart has not been able to compete with Wal-Mart on the basis of price. It cannot compete with Target on the basis of appearance, style or shopping experience. Price is the easiest variable to copy, at least in the short run. Price is a risky variable on which to compete unless a firm has sustainable cost advantages over its competitors. [Murane, 2002]

#### Promotion

In 2001 Kmart brought back the BlueLight Special, the closest thing that Kmart has to being its own brand, which it had discontinued ten years before. Its revived use is for first run goods rather than the dumping ground it had become in its first incarnation. [Stankevich, 2001; Kmart Turns on the Blue Light, 2001] Notice that this occurred at the same time it was slashing daily prices and reducing mailings.

It also sponsored Championship Auto Racing Teams (CART) and National Association for Stock Car Auto Racing (NASCAR) teams. Even though it was trying to get out from under these obligations--it was able to after the bankruptcy filing-- it planned to continue carrying NASCAR merchandise. [Kmart wants to sell..., 2000].

While Kmart gave lip service to reducing mailings, it did continue to use them for price promotion only. According to Guyette [2002] Kmart failed to aggressively advertise to create top-of-the-mind awareness and focused too much on price oriented sales pitches via newspaper inserts. These efforts mainly attracted non-loyal “cherry pickers” to whom Kmart had to sell at low margin prices. When it reduced its ad spending, switched from newspaper inserts to television to promote the BlueLight, and challenged Wal-Mart on pricing, it lost many of its price shoppers without attracting others, and margins and revenues fell. [Cuneo, Fine, et.al 2002]

#### SUPPLY CHAIN/DISTRIBUTION

Kmart from the beginning did not dominate many of its markets and so was not able to effectively develop its own distribution system. In its stores, many shelves were bare, or contained merchandise that wasn't selling.

In 2000, Jennifer Bott described some of the evolution of the supply chain problems at Kmart, explained how chronically empty shelves or shelves with the wrong stuff on them didn't result from lack of inventory but from inadequate or untimely information and the lack of a way to transfer stock from one store to another.

She described Kmart Corporation Chairman Chuck Conaway's belief that a just-in-time delivery system to stores was just what Kmart needed, especially for apparel. Investments in IT, scanners, and registers were attempts to improve customer service. [2000, July 26]

The very next day, Bott again reported on Kmart, quoting retail analyst Jeffery Edelman, saying “he liked Conaway's changes, even if they don't translate into lots of new faces. ‘Leadership was really the issue,’ Edelman said, adding that he was critical of Hall, not his management team. ‘I don't think’ (Floyd Hall, the prior CEO) ‘was focusing on the customer,’ he said. ‘The stores were ugly and always out of stock.’” [2000, July 27]

In 2001 Kmart turned to an alliance with distributor Fleming to help with the attempt to fix the supply chain muddle. At the time, it was believed that the alliance (with Fleming) would yield combined savings of about \$400 million by the third year. “By combining their volumes and buying power, the two organizations” hoped to “reduce supply-chain costs and leverage their procurement programs...” [Cottrill, 2001] This was a recurring theme for those reporting on Kmart in 2001, for example: Ferraro wrote that “Kmart has had some major operational (issues), poor information systems and out-of-stocks as a continual problem. The stores weren’t always pleasant...” [2001]

## PRODUCTIVITY

Productivity is a management issue, since much depends on efficient management of assets and people. Here too, Kmart lagged behind its rivals.

It failed to compete with its rivals when it came to efficient usage of store space. Kmart’s productivity lagged Wal-Mart and Target with sales per square foot of \$236 to their \$506 and \$320 respectively. [Howell, 2002] Bott concurs, stating “while Kmart boasted Monday that its sales per square foot reached a record \$233 during 1999, the figure is still far behind Wal-Mart’s and Target’s estimated sales per square foot of \$494 and \$362 respectively.” [Bott, 2000, March 7] These problems continued even after the 2002 bankruptcy. In a 2008 article, much the same story was still being told, “The average sales per square foot at a Big K was \$116 last year, compared with \$308 at Target and \$443 at Wal-Mart and \$137 at Sears....” [Kmart tests concepts]

In inventory management, Kmart also dropped the ball. In the year 2000, Kmart turned over inventory 3.6 times compared to 6.3 for Target and 7.3 for Wal-Mart. [Carr & Cone, 2001, 33]

Additionally, it failed to get sales results from personnel. According to Johnson, during the period from the mid to the late 1990s, Kmart earned 73 cents in sales per employee compared to every dollar of sales per employee at Wal-Mart. “IT wasn’t the only advantage Wal-Mart had; cross-training and other store management efficiencies combined to create significant advantages.” [2002]

## INFORMATION TECHNOLOGY

“When a large company such as Kmart fails, the causes can often be traced to IT.” [Dodge, 2002] There was a vast difference between the approach taken by K-mart and by rival Wal-Mart with respect to acquisition of appropriate information technology. While Kmart “had the tendency to be penny-wise and pound-foolish,” Wal-Mart, on the other hand, “used [information technology](#) to keep track of what sold,” to “replenish the products that were selling the fastest, and keep inventory costs down. Even more important in the long run: Wal-Mart's systems have been used to support a coherent and consistent strategy of everyday low prices and customer service, while Kmart has lurched all over the map.” [How Kmart fell..., 2001]

Kmart didn’t completely ignore information technology. But despite some large investments in information technology, “Kmart never used the technology it had to its full potential.” There was information available to forecast, but executives believed that their judgment was more reliable than data, and instead of dropping unprofitable products they just kept adding new ones. [How Kmart fell..., 2001]

## STAFFING ISSUES

Given the fact that Kmart was failing to compete with its rivals in the sales per employee category, it would appear that it was overstaffed. Yet tales of customer service employee shortages abound. One such example comes from Muller and Brady:

Getting a grip on inventory snafus should lead to happier customers, since employees freed up from bureaucratic tasks can spend more time on the store floor. It's a critical problem for Kmart where, all too often, customers walk out grumbling. 'When you're looking for help, you can't find anyone in certain areas,' says Loraine Scudder, a 53-year-old retired bookkeeper from Dexter, Mich. 'You have to walk the store or go all the way to the service desk.' Scudder and others complain that once they do get help, advertised items are often not in stock. [2000]

In 2001 things got worse. In an effort to deal with long checkout lines, Kmart installed self-serve checkers. This move was both a blessing and a curse. It was a blessing because "the self-serve registers...cut down on labor costs; machines that don't require checkers mean less need to hire clerks." With this move, Kmart was "the first mass merchant to employ self-checkout units on such a massive scale." The curse was the fact that after installing the self-check registers Kmart had fewer clerks to serve customers. Long lines were a problem that irritated customers, but so was lack of customer service. [Ferraro, 2001]

Lack of staffing (as well as supply chain issues) also led to empty shelves even though Kmart had huge inventories.

There was no integrated plan in the business process to take orders from the merchants and their planning organization all the way through to the people who had to pick and ship the products. As a result, warehouse capacities were exceeded and shipments arrived late. [Andel, 2002]

Another problem at least partly related to staffing issues was the unkempt condition of many of the stores. [Bott, July 27; Ferraro, 2001]. A vicious cycle began, where declining sales led to more cuts in staff:

'Kmart brought in a lot of Wal-Mart people as field and store managers,' the former Kmart executive says. 'But those people failed miserably because Kmart didn't give them the people they needed to improve the stores. Kmart corporate was sending out memos telling managers to cut employee hours to a certain level: period. Floors went unmopped and merchandise wasn't put out. Cutting store level labor costs to make numbers was a vicious cycle that caused sales to plummet further. [Nannery, 2002]

Kmart apparently focused on new stores to the detriment of existing stores. In a telling report in early 2002, just prior to the bankruptcy filing, NPR's Robert Siegel describes a seriously struggling Kmart, saying

...the BlueLight biggie is in trouble up to its Nerf balls, seemingly being squeezed to death by Wal-Mart and Target, Wal-Mart being huge and cheap, Target being chic and cheap, Kmart being sloppy, spotty, understocked, over the hill and cheap, not to mention boasting checkout lines longer than most parades. [2002]

## ETHICAL ISSUES

In addition to all of the operational issues, Kmart had a number of ethical issues/lapses. For example, it awarded retention bonuses to managers while thousands of workers were laid off with no severance packages.

Just before Kmart filed for bankruptcy, CEO Chuck Conaway walked away with a golden parachute worth at least \$9.5 million that included a severance package worth three times his \$1.5 million base salary, and forgiveness of a \$5 million loan. [LeClaire, 2002].

In addition, it appears that the books were not reflective of the company's financial position even though a stockholder case was dismissed.

Apparently, the problems in proper financial accounting at Kmart were longstanding. A software programming flaw in Kmart's accounts-payable system involving one of the company's vendors led to an understatement of the company's cost of sales from 1999 through 2001. The error was one reason given by the company for a December 2002 restatement that boosted its net loss for that period by not quite \$100 million. (At the time, the company also restated its results for the first two quarters of 2002, lowering its net loss for that period by roughly the same amount.)

Another reason Kmart gave for that restatement was the premature recording of vendor allowances, also called slotting fees, paid to Kmart (and many other retailers) by suppliers to keep their products on store shelves. Indeed, alleged improper reporting of vendor allowances have been the source of an accounting scandal at the company. [Katz, 2003]

It isn't just old management that deserves criticism here, because

Even if Adamson were the right person to fix the company, such perquisites might seem over the top.... But what's especially galling to critics is that Adamson has been a member of Kmart's board of directors since 1996--yup, the same board that okayed those tens of millions in bonuses and loans to other top executives even as Kmart slid toward the precipice. And that's not all: Adamson also headed up the board's audit committee in 2000 and 2001, which happens to be the period now being examined by the SEC and the local U.S. Attorney's office for accounting irregularities.

Meanwhile, the company has set up its own internal "stewardship review" to probe the payouts to ex-executives and alleged accounting hanky-panky. That puts Adamson in the incredibly awkward, deeply conflicted position of heading up Kmart even as his own role in its collapse is being scrutinized by underlings.... Already Kmart has restated 2001's results because of an

accounting error that masked \$500 million in additional losses. [Schwartz, Burke & Schuerman 2002]

In addition, some question whether Kmart donated to political parties in hopes of escaping scrutiny. Kmart contributed \$136,000 and \$244,942 to the Democrats and Republicans. This information is cited in Cook's [2002] article in a list of contributions to political parties by companies whose activities had been questioned. His source is Center for Responsive Politics.

## FINANCIAL ISSUES

The problems described above came to a crisis point with the terrorist attacks of September 11, 2001. The financial crisis had been looming and imminent, but the attacks and the subsequent lack of shopping by consumers in that week were too much for the shaky financial position of the company. According to Rios, "...The Sept. 11 terrorist attacks hit Kmart harder than other retailers because the company was in the midst of making significant changes to its operations." It was also apparently counting on sales to generate the funds necessary to pay its suppliers. While November sales at Wal-Mart and Target rose..."Kmart's net fell 1.9 percent to \$3.3 billion and comps declined 2.6 percent" [Wolf, 2001].

These problems, however, could have been detected by financial analysts during the summer of 2001. Financial ratios were computed from financial statements retrieved from Securities and Exchange Commission 10Q filings and are presented in Table 1.

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Place Table 1 about here

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### Assignments and questions:

1. Do a SWOT analysis of Kmart prior to its bankruptcy.
2. Why did it not just close unprofitable stores? What did bankruptcy allow Kmart to do that it could not have done otherwise?
3. Why was it not able to fix its supply, inventory and IT problems?
4. Why was it not able to fix its marketing, productivity and personnel problems?
5. Describe a coherent strategy for Kmart.
6. Look at the Financials in Exhibit One. What do they tell you? Could a financial analyst in August, 2001 have foreseen the difficulties looming in September and later?

**Table 1: Selected Financials for Kmart and Competitors**

Financial Ratios--Summer 2001

Based on quarterly revenues and costs.

	8/2001 10q	7/2001 10q	5/2001 10q	7/2001 10q	6/2001 10q
	Kmart	Wal-Mart	Target	JCPenney	Sears
Current	2.12	1.02	1.16	1.79	2.38
Quick	0.34	0.18	0.49	0.58	2.00
Cash Flows from Operations to CL [MRQ]	-0.04	0.05	-0.02	0.01	0.08
Average Inventory [in millions]	6640.50	22238.00	4271.00	5341.00	5607.00
Inventory Turnover [MRQ]	1.06	1.86	1.32	0.97	1.16
Avg Days in Stock [MRQ]	85.62	48.87	69.13	93.94	78.72
Average Receivables [in millions]	0.00	1759.50	1844.50	815.00	22468.50
Receivable Turnover [MRQ]	NA	30.01	4.44	8.85	0.46
Average Collection Period [MRQ]	NA	3.03	20.48	10.28	199.94
Quarterly Purchases	7515.00	42208.00	5668.00	5318.00	6460.00
Average Payables [in millions]	2291.00	15257.00	3430.50	3649.50	6912.00
Payables Turnover [MRQ]	3.28	2.77	1.65	1.46	0.93
Average Days Payable [MRQ]	23.42	32.89	55.08	62.45	97.37
Cash Conversion Cycle [MRQ]	62.20	19.01	34.53	41.77	181.29
Fixed Asset Turnover [MRQ]	1.30	1.32	0.68	1.45	1.55
Total Asset Turnover [MRQ]	0.58	0.65	0.40	0.42	0.24
Debt	0.49	0.59	0.67	0.65	0.86
Debt to Total Equity	1.02	1.47	2.02	1.84	6.09
Debt to Common Equity	1.24	1.47	2.02	1.84	6.09

Notes:

...Sears charges interest on its receivables and makes revenue from it, so the cash conversion cycle is not reliable for this company.

...MRQ=Most recent quarter, 91 days.

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### **Biographical Sketch for Glenna Sumner**

She received her BS in Finance from Southeast Missouri State University in 1984. She earned her MBA with an emphasis in Finance in 1987. She completed her Ph.D. in 1993 in the field of Economics. Although she began teaching in 1988, she began her academic teaching career as a Ph.D. at Birmingham-Southern College in 1993. She also taught at Missouri Baptist University and Ouachita Baptist University before coming to Henderson State University in 2000. She has written numerous journal articles and presented research at many conferences both in the United States and around the world. She teaches Economics, Finance and Business Ethics in both the graduate and undergraduate programs here at Henderson.

### **Biographical Sketch for Anita B. Williams**

She received her BA in history with a minor in accounting from the University of Arkansas at Little Rock in 1976, an MBA with emphasis in marketing in 1979 and the Ph.D. in Business with a major in marketing from the University of Arkansas in 1985. Although she began teaching in 1979, she began her academic career at Tennessee Technological University. She came to Henderson in 1988 and currently teaches marketing and management communications at the undergraduate level and marketing at the graduate level. Her practical experience is in retail having worked with a family business for a number of years.