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101: How to Survive Bankruptcy

Introduction

In late January, K-Mart filed for bankruptcy protection. To recover from bankruptcy, K-Mart needs a long-term strategy; something that it has lacked in recent years. Most people can name what K-Mart's main rivals, Wal-Mart and Target, stand for. Almost no one can say what K-Mart stands for. In fact, "Wal-Mart, hewing to a relentless focus on low price, is the category guerrilla. And then there's Target, smaller but coming on strong, for reasons generally attributed to its hip trendy image. A big part of K-Mart's problem is that, in contrast to its rivals, the chain never really seemed to settle on a definitive strategy or image[1]." Having a long-term strategy and image is absolutely essential for K-Mart to recover from bankruptcy.

Industry Analysis

K-Mart operates in the discount good retail market, which resembles the textbook definition of a tight oligopoly. Its main competitors are Wal-Mart (we view Sam's as a subset of Wal-

[1] Walker, Robert; Reporter; March 18, 2002; "Ad Report"; www.msn.com

Mart) and Target, although other stores compete within the market on specific goods. Consequently, rivalry in the industry is pretty intense. There is some product and brand differentiation, but a lot of the stores deal in commodities. A pack of Duracell batteries, for example, is the same at both K-Mart and Target. The differentiation that exists include, difference in the product lines, customer service, and extent of overall selection for each company. Substitutes for the market include stores that compete with the K-Marts and Targets within certain departments. For instance, the local hardware store competes with K-Mart and Target's hardware section. Entry into the market is difficult because entry must be on a large scale, in order to have any semblance of profitability. There are economies of scale in distribution and buying. In fact, Wal-Mart sometimes has suppliers drive trucks straight to their stores because they buy in such bulk.

Supplier bargaining power in the industry is minimal in most cases, but quite large in a few cases. An example of one of the caveats is Martha Stewart's relationship with K-Mart. Martha Stewart Omni Media Inc. has a large amount of supplier bargaining power over K-Mart because the Martha Stewart line is one of the ways that K-Mart differentiates itself from its rivals. "For Kmart, Beemer said, a good start would be the chain's Martha Stewart line of home and gardening products. That could distinguish it from the apparel-heavy Target, and the home- and food-focused Wal-Mart.[2]" In the market, buyer bargaining power is almost non-existent; consumers cannot extort profits from the companies. The threat of any one buyer not buying from one of the stores is not a big deal. Buyers do have the ability to switch to other substitutes or other rivaling companies in the market. Other complements for the industry include the overall economic conditions. For instance, with the recession at the

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[2] Nesbitt, Sarah; The Gazette; "On Top of Bankruptcy, K-Mart Faces Task of Overhauling Poor Image"; January 24, 2002

end of last year, the overall market demand increased. The more cost consciousness consumers are, the more that demand increases.

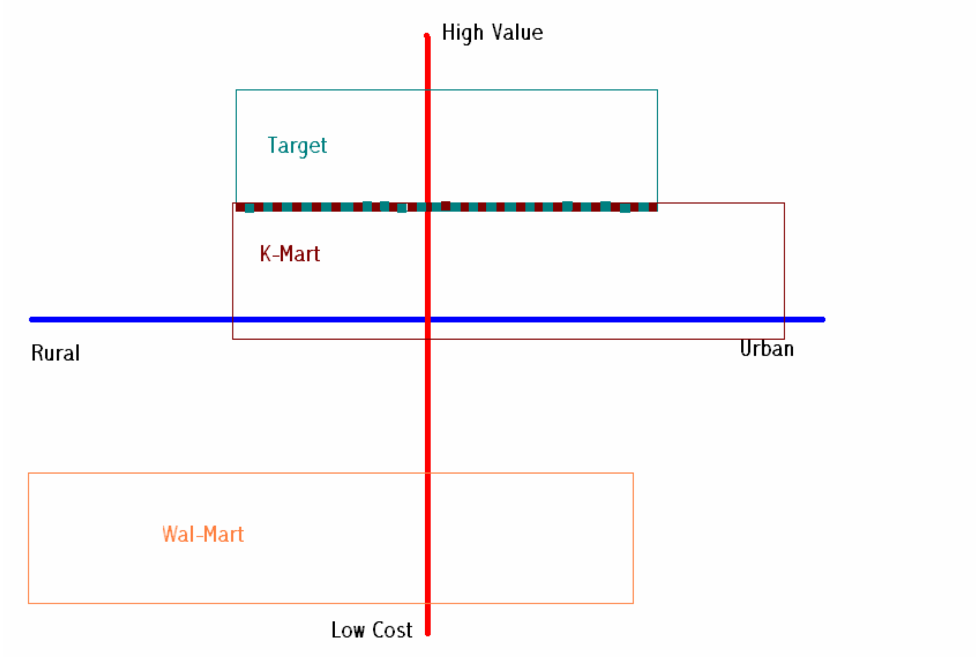
Option Values and Market Entry/Exit

The nature of the market, especially with respect to how hard entry is and the small number of firms, leads us to recommend that K-Mart should stay in the market. Even though K-Mart is currently performing rather poorly, there is a huge option value to staying in the industry. It would be imprudent to not try to revamp and reinvent K-Mart and see if profitability can be increased. Should K-Mart exit the industry, it would find itself in a position from which it would be all but impossible to reenter. In addition, K-Mart's current losses make it a bit of a wildcard in terms dealing with Wal-Mart and Target. It is hard for Wal-Mart and Target to deter K-Mart from doing rash things when K-Mart is doing so poorly. This makes it the perfect time for K-Mart to change strategy. There are large risks in changing its strategy, especially in relation to positioning, because Target and Wal-Mart might just try to force K-Mart to go out of business. Yet, these risks are inevitable if K-Mart chooses to stay in the market. If they do not change strategy or positioning, they will continue to lose money. The choice is simple – K-Mart must change strategy or exit the market. We believe that K-Mart can make money if they change their strategy, and even if they do not the option value is high enough for them to go ahead and try.

Also, contrary to most markets, the discount good retail market seems to have the most sustainable position at the bottom of the market. The majority of markets have their most sustainable positions in the high quality market niche. It seems that the economies of scale allow the cost strategy to be the most sustainable given that the company that has the lowest cost continually invests in supply chain management.

Targeting and Positioning

One key aspect that those turning around K-Mart should realize is that they made some very basic mistakes in the past and that now is the time to learn from them. The most fundamental of those mistakes were made *vis a vis* targeting a customer base and positioning K-Mart within the discount retail industry. In the past, K-Mart has strived, with disastrous results, to offer the hip and trendy products of the like carried by Target (or, as a hip and trendy person would say it – "Tar-zhay") as well as the super cheap prices of the kind offered by Wal-Mart. Their market strategy has often been confused and over ambitious, leading some to speculate that K-Mart's ultimate goal was that of world domination (within the retail industry).



We propose that K-Mart have a more structured and targeted approach to its future operations (see new market positioning above). "If the company is going to save itself, it must radically alter its turnaround strategy. Instead of attacking main competitor Wal-Mart Stores Inc. head-on, Kmart must carve out a less competitive niche for itself.[3]" K-Mart must do away with notions of world domination and target a specific customer base – we propose that K-Mart target the young urban families who have young children. This is their best bet given the (currently profitable) product lines that they already carry. The Martha Stewart line of house wares would ideally appeal to the young, urban families. The Martha Stewart line has worked very well at attracting the urban family and has laid the groundwork for the new strategy[4]. This strategy is also most likely to prove profitable in the long run, as it poses tremendous opportunities for creating long term lock-in by allowing K-Mart to differentiate itself from Target and Wal-Mart, thus allowing K-Mart to have high value customers.

Also, by having product lines that appeal to young kids and their parents, K-Mart can further differentiate itself from its rivals. Mothers will be able to stop at K-Mart for quality house wares and for products that appeal to their kids. This seems like a viable niche, especially since mothers are the chief spenders in the industry. K-Mart already carries the Disney line of clothing – it is a powerful name with tremendous appeal to kids. More importantly, it is a powerful name with tremendous recognition and goodwill amongst parents – this would make the parents more willing to part with their money. K-Mart should try to continue acquiring product lines that complement this niche.

A necessary prerequisite for both the above measures is for a sustained advertising campaign that gets the word out to the target customer base. The adds should probably be centered on television advertising to attract the new customer segment that K-Mart is

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[3] Muller, Joann; Journalist; Business Week; "Kmart: The Flood Waters are Rising"; January 28, 2002
[4] D'Innocenzio, Anne; AP Journalist; The Times-Picayune; "Martha Stewart label's checking out options"; February 10, 2002

targeting, although it should not completely ignore the historically successful newspaper inserts. K-Mart needs to send the message to the public that they are going to be around for the long run with quality products that appeal to the young family (mothers). If asked what K-Mart stands for and offers, the targeted customers should be able tell you post the new round of advertising. It is crucial that the new advertising communicate the new image that K-Mart hopes to instill.

Having dealt with positioning itself within the retailing industry, K-Mart still faces the prospect of geographic positioning. Currently, K-Mart has a clear first mover advantage with their location in the urban areas. Target and Wal-Mart both list little, if any assets in the urban markets compared to a sizeable portion of the K-Mart stores. K-Mart should use the urban areas that they have effectively in order to attract their targeted customer base. The first mover advantage can help K-Mart make a quick profit and create brand recognition before one of its rivals decides to enter the market.

K-Mart should also try to get out of locations that have a Wal-Mart within a two-mile radius. Directly competing with Wal-Mart is a bad idea – there is a high probability that the competition will eventually whittle down to price competition; a strategy that Wal-Mart has cultivated into an art form. K-mart will have trouble with Wal-Mart in such close proximity, so much so that K-Mart should pull out. Also, K-Mart should shut down any stores that are unprofitable, and in the medium term get out of the non-discount retailing activity (Office Max) in order to concentrate on your core business model (discount retailing). We suggest that the last recommendation be implemented over the medium term because these "non-core" operations still offer valuable cash flow to K-Mart and have a high option value in the short term should the new strategy fails to deliver the expected results.

This sequence of moves will almost definitely be met with a wave of retaliation from Target. However, we contend that in the long run, the discount retailing industry will be composed of three primary operators (Wal-Mart, K-Mart and Target) with Wal-Mart controlling a majority of the industry and the others fighting it out over the remainder of the pie. When viewed in this context, competition with Target is highly preferable to competition with Wal-Mart. The more that K-Mart is able to differentiate itself from Target with unique product lines and differing locations, the less of a risk of a severe reaction from Target. Therefore, the better that K-Mart does at following its new strategy, the less that it has to worry about Target. Whatever competition and retaliation K-Mart does face, it will definitely be preferable to K-Mart's current situation, where K-Mart has to worry about retaliation from Target and Wal-Mart.

Structural Changes

In retrospect, it seems as if somewhere down the road, K-Mart lost sense of what it was and what it was striving to be. In its drive to become the all-encompassing discount retailer, K-Mart has suffered a loss of corporate identity as well as failing to incorporate some key measures that would have resulted in better yield management and higher profitability. Concerning both these measures, we propose that K-Mart focus on its employees and its supply chain management.

Ask an employee at Wal-Mart about what the store stands for and you are likely to get a response like "We are here to provide any thing a person could want at the best possible price." The same question posed to an employee of Target is likely to elicit a response pertaining to the trendy products stocked on the shelves. A K-Mart employee is, however, unable to answer the same questions largely because K-Mart itself does not know what it is and what it stands for. K-Mart employees need to be made aware of what they are representing and a corporate culture needs to be ingrained into them. Additionally, in order to boost efficiency within stores we recommend that incentive based bonuses and pay schemes be implemented. Furthermore, we also recommend that branches within an area (say a district) be pitted against one another in much the same way Enterprise does with its car rental locations. This will result in higher performances on a wide scale. It will also go a long way to helping K-Mart provide the same level of customer service that both Target and Wal-Mart offer.

In fact, most of the customers who abandoned K-Mart over the past few years have cited the lack of cleanliness at the stores as a key factor in their choice to shop elsewhere. Consumer accounts of why they left largely included the lack of customer service and the dirty K-Mart stores that they shopped in.

On the side of managing supplies effectively, K-Mart has been guilty of under-investing in the necessary infrastructure. While its customers have spent huge amounts of money fine tuning their software to keep track of customers' tastes, preferences and spending patterns (Wal-Mart's customer information database is second largest database in the world), K-Mart has done little to upgrade its software since it was installed in the early eighties. As a result, cases of Easter candy appearing on the shelves two weeks after Easter (with highly unprofitable results) and advertised products not being in stores on time are not unheard of.

We propose that K-Mart tackle this problem in a two pronged manner. Firstly, K-Mart should invest heavily in software that will enable it to manage its supply chain effectively; we additionally recommend that CRM solutions provider Siebel be hired on a full time basis (for installation as well as to provide continuous support for the software). Secondly, K-Mart needs to rediscover for itself what kind of products it needs to be selling and what kind of products it would be better of discarding from its shelves. Questions like

"Do I really need to be selling groceries if I am no longer trying to compete with the Wal-Mart superstores" need to be asked (Answer: No, you should not be selling groceries).

K-Mart should move quickly and lock in lucrative suppliers and high value brand names like Martha Stewart; additionally, these suppliers should be locked in for the long term. This kind of lock-in proves valuable to K-Mart in two manners. Firstly, it creates a safety net with the profitable lines that K-Mart has been carrying over the years. Secondly, and perhaps more importantly, it sends out a signal to other retailers – and the public – that this is a company that in it for the long haul. By announcing that it will have quality product lines for the long-term, it can also attract further quality lines. Suppliers will not be scared of putting their products in K-Mart.

Some may argue that it would be difficult to woo back such lucrative suppliers given the volumes of red ink on K-Mart's balance sheet. We contend the exact opposite – that it should be easier to woo them back now, given that K-Mart has already filed for chapter 11 protections, than it would have been at the beginning of the year. Because of the way the law is written, contracts established after an entity has filed for Chapter 11 protection receive priority (when it comes to getting compensated) over those that were written prior to the filing. K-Mart should constantly remind its suppliers about this when negotiating new contracts with them.

Finally, K-Mart also needs to restructure the manner in which it finances its operations. Currently, a good proportion of its loans are tied to its inventory (which is being used as collateral). We propose that these loans be paid off first so that the inventory (which already generates high overhead costs) can be disposed off in order to generate some much-needed cash flows. We also suggest that K-Mart dispose of some of its most profitable locations in the mid to long term. The way things stand right now, K-Mart's most profitable locations are the ones in the middle of nowhere – the ones in areas where K-Mart has a virtual monopoly. It may at first seem like total nonsense for K-Mart to dispose off these locations, but one needs to bear in mind that K-Mart desperately needs to refocus on its core business model (a discount retailer targeting the urban young family). At the same time, these locatio ns are the very ones that K-Mart can dispose for a tidy profit (read: Wal-Mart would give an arm and a leg and maybe a little bit more to step into an area where America cannot go to shop). Yet, an immediate disposal of these locations hurts K-Mart's ability to change strategy if the new policy fails, thus killing the option value of K-Mart's existing assets. That is why K-Mart should wait until their new strategy works before taking such brash moves.

Conclusions

Much of K-Mart's current predicament is a result of its own doing. They have failed to keep pace with the times inside their market. In fact, this past Christmas season, when the rest of the market was not picking up customers because of the economic downturn, K-Mart could not hold its own. They are in need of a serious overhaul if they are to remain in the marketplace. They need to slim down their number of stores, introduce employee incentive, update their delivery systems, expand their product lines, and focus on a specific population and geographical segment. If they implement these changes, K-Mart should be able to carve out a sustainable niche inside the discount retail goods industry. The response of K-Mart's rivals will help shape whether K-Mart's shift in strategy is successful or not. Given the fact that such a radical change in policy is needed for K-Mart and market entry is difficult, there are large benefits to keeping options open if the policy fails.