Kmart:
A Strategy for Survival

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Introduction

Discount retail has evolved into a highly competitive industry. As a result, discount retail pioneer Kmart, has faltered and fallen into Chapter 11 reorganization. This paper provides analysis of the industry, and a discussion of the firm-specific strategy that Kmart should undertake in order to reestablish itself as a player in the market.

Relevant Industry Forces

Entry Barriers

Entry barriers in the discount retailer industry are high. In order to compete with the likes of Wal-Mart and Target, a company would need a minimum efficient scale to compete on cost. To Kmart's advantage, it does benefit from a certain amount of economies of scale. The company is still the third largest retailer in the U.S. Once the restructuring plan has been implemented, Kmart plans to have 1,500 stores remaining. But Kmart has to realize, "Everybody today lives under the shadow of Wal-Mart."[1] Kmart should not fool itself into thinking that its economies of scale in purchasing or its distribution system can compete with Wal-Mart's. Wal-Mart is known for its expansive, powerful, and efficient inventory and distribution capabilities. It's also known for its low-cost structure from real estate to labor (non-union). Wal-Mart is now one of the leading buyers of consumer products in the world. Wal-Mart claims it has the biggest private satellite communications network in the U.S. The system links stores to headquarters in Arkansas by voice, data and video. Suppliers can tap directly into Wal-Mart's computers, where its system tracks sales of every item - improving inventory controls and cutting costs. Kmart has tried to copy Wal-Mart's technology prowess in the past, but have failed to implement properly.[2] Wal-Mart is not the only behemoth Kmart has to contend with – Target, as well as Wal-Mart has been growing even larger, partially thanks to Kmart's bankruptcy. "Kmart's loss is Wal-Mart's and Target's gain."[3]

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[11] Katz, Rachael. 24 April 2003. *Financial Analysts: Kmart will need appealing items, low prices.* Bloomberg News. Quote from Richard Hastings, chief economist at Bernard Sands.

[2] Hopkins, Jim. 29 January 2003. *Wal-Mart's influence grows; Retailer's power touches everything from prices to wages.* Money.

[3] Howell, Debbie. 24 February 2003. *Wal-Mart, Target gain supercenter share: distribution issues gain attention. (Special Report).* Discount Store News. Quote from Emme Kozloff of Bernstein Research.

Another problem for Kmart emerging out of bankruptcy is the loss of many of its customers to other discount retailers such as Wal-Mart, Target and Kohl's. Kmart has failed its customers, and those customers may consider switching costs too high to return to Kmart. The store will have to offer something that differentiates itself from the other retailers in order to lure customers back.

Buyer Power

Normally, "when buyers individually are very small relative to total firm sales, buyers can threaten to switch, but such threats are not devastating to the firm."[4] However, Kmart buyers have switched – en masse. As mentioned earlier, Kmart has alienated many of its customers. Along with bad publicity regarding investigations of top executives and Martha Stewart, many Kmart customers believed that Kmart was leaving the business entirely. As a result, store closings affected traffic in open stores as well.

Supplier Power

Even after bankruptcy, the size of Kmart's operation will give it extensive power over its suppliers. Kmart is susceptible to buyer power in areas where Kmart is trying to build its differentiation (i.e. – Joe Boxer™, Martha Stewart Everyday™), and in areas where Kmart is negotiating with a powerhouse such as Procter & Gamble (P&G). It's highly unlikely that Kmart or a company like P&G would want to end their relationship, therefore they will always find a way to work together. Kmart's power is not only in volume of purchasing but also in its use of shelf space. For example, should P&G try to raise prices, Kmart can give competing brands larger shelf space. (Wal-Mart has used this tactic successfully in the past.)

Rivalry

Rivalry in the discount retailer market is very intense. By the very definition of the industry (discount), price competition is fierce. The industry borders on being a loose oligopoly, dominated by Wal-Mart, Kmart, and Target. Recently, up and coming Kohl's has gained considerable attention for its aggressive expansion. (This analysis does not include wholesale or dollar stores.) Each retailer has survived by differentiating itself in different ways and through cooperation. Wal-Mart is the low-price leader, and Target and Kohl's use a value proposition. Kmart, on the other hand, has never quite been

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[4] Mcafee, R. Preston (2002), page 17. *Competitive Solutions*. Princeton, NJ: Princeton University Press.

successful at projecting a consistent image. While it has brands such as Disney™ and Martha Stewart Everyday™ (fitting more in the value strategy), it has also tried, and failed, to compete with Wal-Mart on price. Cooperation works in this market because Wal-Mart allows the others to exist so long as they don't try to directly compete with Wal-Mart's low-cost strategy.

Complements

In terms of complements, Kmart's best bet is to continue partnering with brand-name designers, particularly those who appeal to Kmarts new target customers (Latinos and Afro-Americans). Kmart's branded product lines drive sales. This is beneficial for designers as it provides them with a very wide audience, substantial distribution and fits well with the overall consumer trend of using mass merchandising channels to meet shopping needs.

Substitutes

Substitutes might include, to a certain degree, club stores, grocery stores, "dollar" stores and other discount retailers. However, because of the wide variety of merchandise available, there are very few actually true substitutes.

Differentiation

Players in the discount retail industry compete stringently on price. However, as new players emerged (namely Wal-Mart and Target), differentiating factors evolved that allowed those new entrants to win market share from Kmart, the original discount-retail behemoth. Wal-Mart placed itself in rural and suburban America, and became a technological leader in inventory management. Target adapted by creating a hybrid low-price, solid-quality experience in terms of its product lines and the stores themselves. Kmart has not been able to clearly define itself in terms of customer expectations. The addition of brand-name house ware and apparel lines has helped keep Kmart in the game. However, in order to survive, Kmart must clearly define itself, its target customer and stick to its strategy. From the standpoint of differentiations, once Kmart has identified its target market, it should increase emphasis on designer-branded lines targeted to that audience and de-emphasize commodity-type offerings.

Pricing and The Discount Retail War of Attrition

By its very nature, the central factor in the discount retail industry is price. Unfortunately, there are very few options available to K-Mart in developing a pricing strategy to compete with Target or Wal-Mart. Because it has so many customers with essentially one defining characteristic—price sensitivity—K-Mart cannot segment its customers and offer different prices based on individual characteristics, such as time sensitivity (as with airlines). Likewise, K-Mart's variable cost structure precludes any dynamic pricing scheme such as yield management (movie theaters) or peak-load pricing (utilities). In fact, the nature of its business effectively confines K-Mart to a few indirect price discrimination strategies:

- Coupons: price-sensitive customers value money more than time, and will be willing to sift through newspapers to save a few cents
- Bulk Discounts: those customers are also willing to buy larger quantities of various items—such as two-for-one deals—in order to get a lower aggregate price

None of these strategies, however, is exclusive to K-Mart—indeed Wal-Mart already has an edge in the bulk discount strategy. In fact, employing indirect pricing discrimination schemes typically leads to *increased* price competition, and the inevitable result is a war of attrition. With its extensive vertical integration and efficient management, Wal-Mart has far lower costs—as a result, it has a lower daily cost of fighting this war and can undoubtedly last longer. The best play for K-Mart in this instance is to recognize that the cost leadership market can support only one firm and concede defeat—in *this* market.

Segmentation

This is perhaps K-Mart's key failure over the last few years: the inability to decide which market it is in. While Wal-Mart is *the* provider of everyday low prices—on everything from bicycles to groceries—to low-income rural families, and Target peddles affordable clothes and housewares to the trendy young urban market, K-Mart has no real identity and has attempted to straddle both. As a result, it has been forced to fight *both* Wal-Mart and Target on their own turf at the same time, with disastrous results. Even on the verge of emerging from bankruptcy, K-Mart is still searching wildly for an identity: while it recently announced extensions of its exclusive Martha Stewart Everyday™ and

Joe Boxer™ lines, it also launched two multi-cultural magazines, *La Vida* and *Urban Living,* targeted towards inner-city minorities. Martha Stewart's fans have little in common with Snoop Dogg's—this is hardly a cohesive strategy.

In simplest terms, K-Mart needs to be able to say unequivocally "we are *the* low-price retailer for the ______________ market." In order to accomplish that, K-Mart must:

- Simplify and strip down to basics: K-Mart needs not only to shut down its most unprofitable stores, but also streamline its range of products in order to simplify and improve inventory management—one primary reason shoppers have left the company. K-Mart CEO Julian commented, "It is sad to say, but true that we disappointed a number of customers, and many as yet have not resumed shopping in our stores" (Covert, Dow Jones Newswire).
- Get out of Wal-Mart's way: Wal-Mart has proven that they are the only successful everything-but-the-kitchen-sink low-price retailer. In particular, K-Mart should get out of groceries: it is a logistical nightmare with razor thin margins.
- Copy—but not compete with—Target: Target's genius was in moving slightly upscale from Wal-Mart and focusing on a targeted audience.

We propose that K-Mart position itself as the low-price retailer for urban ethnic communities, following on the strength of its *La Vida* and *Urban Living* marketing efforts. K-Mart should get out of its rural markets where it is threatened by Wal-Mart, and leverage its significant urban presence to provide clothing, cosmetics, housewares, and entertainment products *specifically tailored* to the ethnic communities in those areas. As it did with Martha Stewart, K-Mart needs to partner with African-American and Latino celebrities to develop branded product lines. Just as importantly, in order to engender a strong attachment to and identification with K-Mart within this market segment, the company needs to rid itself not only of extraneous inventory offerings, but also of any incongruous product lines (i.e., Martha Stewart, herself). This strategy presents several advantages:

- By focusing its efforts on a specific audience, K-Mart can carve out a niche for itself and serve a community that is largely neglected by its discount retail competition.

- Since its product offerings will differ significantly from either Target or Wal-Mart, K-Mart will be able to raise prices slightly not only on its “ethno-centric” offerings, but on other “everyday” items as well, such as cleaning products.

By positioning itself in this way—slightly upscale from Wal-Mart and in a different market from Target—K-Mart can find a new basis of competition and avoid direct retaliation from either Target or Wal-Mart.

The Martha Stewart Everyday™ line, as incongruous as it is with this proposed strategy, is too valuable to simply discard, however. K-Mart has two options here: it can either allow one of its competitors—or even a higher-end department store such as Dillard’s—to “buy out” the Martha Stewart contract, and use the capital to restructure along ethno-centric lines, or it can spin off the line into a new series of stores, perhaps not branded under the K-Mart name, focusing on home furnishings for the upscale young family market. In keeping with its new, more-targeted strategy, however, we recommend selling off the line in order to focus its energy on revamping the K-Mart image.

First Mover Advantages and Disadvantages

Kmart is actually an innovator of new concepts in the mass merchandising industry. They were the first to develop the low-price merchandising concept, with operations beginning in 1937 -- approximately thirty years before both Wal-Mart and Target ever entered the market. Kmart was also the first to attempt entry into a niche market by selling branded, low-priced products like Martha Stewart Everyday ™, Disney™ and Sesame Street™ branded items. Unfortunately, each of Kmart’s innovations have failed to be sustainable. Not only have these new concepts been easily imitated, they have also been successfully executed by Kmart’s competitors – Wal-Mart and Target.

Location, Location, Location…

The key to sustaining a competitive advantage in retail lies in location. As the first to market, Kmart had its luxury of choosing where to locate. Unfortunately, management made a tactical error by choosing to operate in large urban areas with concentrated populations. While advantages exist for high volume and profit, there are several disadvantages with choosing to locate primarily in urban areas. First, high profits and volume practically scream 'opportunity' for competitors. Kmart's product offering is not unique leaving few, if any, barriers to entry. Second, it costs more to operate in urban areas. Real estate and wage rates are *significantly* higher in say, New York City, than they are in Wichita, Kansas.

In contrast to Kmart's strategy, Wal-Mart strategically chose to locate operations in rural areas with populations of less than 50,000. This essentially created a monopolistic opportunity for Wal-Mart as the first mover in those locations[5]. Populations that low cannot generate enough volume to support two mass merchandisers, preventing entry from competitors. This is supported by the fact that Wal-Mart has more stores that operate without direct competition. Approximately 22% of Wal-Mart's stores operate without any direct competition from either Kmart or Target. Meanwhile, Kmart and Target had only 18% and 15% of their stores operating in monopolistic markets. This results in both higher prices and better margins. Wal-Mart prices its products approximately 6% higher in these types of unique markets, which contributed to over 1.3% of their profits in 1987.[6]

Execution, Execution, Execution…

Realizing its inability to compete with the low-cost leader (i.e. Wal-Mart), Kmart creatively tried to differentiate itself by offering premium branded products. Management had limited success with its apparel division by offering "brand" names such as Jaclyn Smith™ and Kathy Ireland Exclusive™, which communicated little fashion appeal and value in the consumer's eyes during the late 1980's and early 1990's. However, management hit the jackpot launching Martha Stewart Everyday™ in 1997, which successfully offered linens, paint and home decorating products that communicated both style and quality and economy to consumers. Martha's line of products have contributed over $5 billion in sales revenue to Kmart since its introduction.[7]

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[5] "Top Discount Merchandisers Analyzed via the Value Framework" by Mitchell Levy and Paul Losch. http://ecmgt.com/Jun2002/feature.article.htm
[6] http://instruction.bus.wisc.edu/mcarpenter/inbox/EvMBA/23
[7] http://www.forbes.com/2001/06/21/0621facesPM.html

While these products were extremely successful in generating store traffic and improving profits through modest price increases over the short term, the long term effects have proven disasterous. This is due to Kmart's inability to execute properly. First, Kmart dropped the ball by failing to secure other licensing agreements. This opened the door for Target, who responded in 2000, by signing a licensing agreement with design house Mossimo. Offering branded products at prices lower than what can be found in department stores has proven appealing to consumers, which can be reflected in Target's expansion into other categories including cosmetics (Sonia Kashuk™) and electronics (Michael Graves™). Second, Kmart failed to execute the strategy change by improving the store image. New customers venturing into Kmart for Martha Stewart products were reminded of the poor service, uncleanliness and the same low quality product selection outside the home décor department. The result has been complete customer confusion.

Organizational Design and Incentives

It's Lonely At the Top…

Unfortunately, Kmart has another disadvantage -- specifically, regarding its organizational structure and required incentives. Kmart's current bankruptcy proceedings are wrecking havoc on the organization. As of February 2003, Kmart lacks both a management team and a board of directors. CEO Julian Day is looking to hire a president, human resources, a financial team **and** a chief merchant prior to its expected emergence from Chapter 11 bankruptcy on April 30th, 2003. Day is in the process of hiring an executive search firm to look outside for his management team. In addition, Kmart needs 9 new board members, to be selected by its creditors. While a new executive team and board may provide a fresh perspective, there are going to be some setbacks, such as providing incentives for proper motivation.

So Show Them The Money…

It is expensive for Kmart to hire skilled managers. Burt Flickinger, a retail consultant and managing director of Strategic Resources Group, stated that "a lot of the best people in the industry don't want to interview for [these] jobs."[8] This explains the need to provide more incentive in the form of higher salaries, cash bonuses, stock, options and even personal loans. For example, Kmart's former CEO, James Adamson has a compensation package worth more than $5.87 million this year, not including an unspecified "success bonus" if the company emerges from bankruptcy. Meanwhile, Target's CEO, Robert Ulrich, received a salary of $1.4 million and a $3.7 million bonus in 2002.[3]

In addition, Kmart suffers from low employee and management moral. The company has terminated 22,000 employees and closed 283 stores since declaring Chapter 11[9]. The result has been distracted senior managers, (who fail to focus on revamping Kmart's operating strategy), and vacant, unmotivated store employees (who fail to provide adequate customer service). As one angry Kmart customer from Texas so eloquently stated, "Kmart needs more than bankruptcy protection – it needs manager and employees who give a damn."[10]

Cooperation

Cooperation in this industry is tenuous at best. When announcing its plans to emerge from bankruptcy, Kmart stated its intentions in terms of targeting the Latino and Afro-American urban markets. In doing so, the weakened retailer signaled to its rivals Wal-Mart and Target, its intentions to focus on a market segment that lay outside the competition's direct scope of emphasis. Armed with Kmart's battle plan, rivals are in a position to take measures to reduce Kmart's chances of success in its stated target market, or leave well enough alone (in a sense cooperating with the weakened retailer). However, Both Wal-Mart and Target would gain to varying degrees by Kmart's total demise. In fact, Target has already moved to acquire some locations that Kmart has abandoned as a result of restructuring. In addition, Kmart has demonstrated a willingness

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[8] "Kmart's Challenge: Finding Willing Execs" by Brent Snavely, Crain's Detroit Business dated Feb. 3, 2003, Vol. 19 Issue 5, p 6, 1 p

[9] "Kmart's Challenge: Finding Willing Execs" by Brent Snavely, Crain's Detroit Business dated Feb. 3, 2003, Vol. 19 Issue 5, p 6, 1 p

[10] Customer Testimonials for Kmart Shopping, http://www.morningnewsbeat.com/archives/2002/02/025.html

to relinquish its presence in some markets, such as Texas, where Wal-Mart clearly dominates.

Conclusion

In order to survive, Kmart must clearly define its customer and define itself in terms of its customer. Kmart's strength is that many of its locations are located in urban areas where competitors do not have locations. Kmart needs to leverage this strength, defining itself in terms of those markets. Most urban markets have higher concentrations of minorities, and Kmart can differentiate itself by developing products lines specifically tailored and branded to these groups. If Kmart is to survive in the discount retail market, it must differentiate itself and leverage its strengths. . In order to achieve this, Kmart needs to make some key tactical decisions:

- Hire senior managers who have both merchandising and marketing experience, (particularly with ethnic and urban consumers), as well as a history of successful execution in the retail channel.
- Invest in re-positioning the Kmart brand by modifying store locations, hiring and motivating staff employees, and promoting the brand through advertising to their target segment.
- Develop licensing agreements to provide stylish and branded products that specifically appeal to ethnic and urban consumers.

Focusing Kmart's strategy on this target market may force management to make extremely difficult decisions, such as releasing the lucrative Martha Stewart Everyday™ brand. However, in the end, the mass merchandising industry cannot feasibly support two national firms going after the same customer segment. It's either pick a niche, or say goodbye to the days of the bluelight special.