Case Study Chapter 3 (8^{th} US Edition)

CASE STUDY—What Happened to Kmart?

On January 22, 2002, Kmart filed for Chapter 11 bankruptcy protection. It was the largest retailer ever to do so and shocked many people. Kmart had made retail h istory when its founder, the Kresge “five and dime store” chain, invented the concept of the discount store. The first Kmart was established in Detroit in 1962, the same year Wal-Mart opened its first store in Rogers, Arkansas. By the end of 1963 Kmart had 63 stores converted from Kresge’s.

In the following years, however, WaI-Mart expanded quickly by following a strategy of everyday low prices. Wal-Mart used information technology (IT) to track sales in all its stores and to replenish its fastest selling products. Wal-Mart demonstrated its willingness to spend needed funds on IT by installing registers with bar-code scanners in each store during the late 1 970s and early 1 980s, which fed the sales data into the back-end store computers. The result was Wal-Mart sales data were always current and store managers knew what was selling well and what was not. In time many orders were routed straight from the Wal-Mart store to the appropriate supplier, and the delivery went from that supplier directly to the store. Wal-Mart recently developed an extranet to work closely with key suppliers on problems such as how to increase sales on specific products. Many analysts believe Wal-Mart has the most sophisticated supply chain systems in the industry.

By 1983, with its cutting edge information systems, Wal-Mart was already spending only two cents per dollar getting goods to its stores while Kmart was spending five cents. From that differential alone, Wal-Mart could sell the same product at a price 3 percent lower than Kmart, an important saving to many shoppers. In 1990 Wal-Mart passed Kmart as the largest discount chain with annual sales of $32.6 billion for Kmart’s $32.3 billion. Wal-Mart was well on its way to becoming the world’s largest retailer. In December 2001, Target, Kmart’s other major competitor, passed Kmart as the second largest discount chain. Target had prospered by emphasizing its merchandising, distinguishing itself as a low-cost source of quality and style.

Kmart, in contrast, used a promotions-driven business model, drumming up business by advertising “blue-light” specials using circulars inserted into local newspapers. In an attempt to stay ahead of Wal-Mart, Kmart started investing $1 billion to modernize its information systems in 1987. According to David Carlson, then Kmart’s CIO, the company developed capabilities to collect the necessary data, but it did not use them to forecast demand, relying instead on management’s judgments. Carlson notes that Kmart’s suppliers promoted as many of their products as they could sell rather than helping Kmart to focus on the better selling items, as was Wal-Mart’s approach. Beginning in 1984, Kmart began diversifying its businesses by acquiring Waldenbooks, Payless Drugstores, Sports Authority and OfficeMax. It also opened its first Super Kmart Center, a much larger store that now included groceries.

Kmart continued to lose ground to competitors while it gained the image of being old-fashioned, outdated, and frumpy. It had a reputation of being a run-down place to shop with an inferior selection of products. Many of its shelves were empty while its prices were too high. It was even considered to offer poor customer service and to not care about competition. By 1994, Kmart was on the verge of bankruptcy. It sold off its newer businesses to concentrate on its discount stores, and, in 1997, it inaugurated the very popular Martha Stewart product lines for the home. In 1999, Kmart began developing BlueLight.com, a Web site designed to sell a few items in order to draw customers to physical stores and to polish its image. In May 2000, watching its hemorrhaging continue, the company hired Charles Conaway, the former CVS drugstore chain president, as Kmart's chairman and CEO.

Conaway pledged to turn the company around within two years, and said his goal was to make Kmart the primary destination for mothers looking for low-priced clothing, housewares, and packaged food for their families. He announced plans to restructure Kmart to increase the productivity of Kmart stores, inventories, and information systems. He closed 72 stores, reducing staff by 5,000. He even announced Kmart would spend about $1.4 billion for IT over two years versus only $263 million during the previous two years. However, in August 2001, Kmart announced a second quarter loss of $22 million, and Conaway blamed pricing pressure, particularly from Wal-Mart. Kmart reduced prices on 30,000 of its 70,000 items and cut down on advertising circulars. Consumer habits are hard to change and Kmart sales took a big hit.

Sales at Wal-Mart and Target grew in 2001, while those at Kmart continued to decline. Conaway said he had not found a formula to distinguish his company from his competitors. Since Conaway had taken over, Kmart had increased the percentage of items in stock to 86 percent, compared to 73 percent two to three years earlier. In a conference with Wall Street analysts, Conaway said Kmart was "doing a phenomenal job of reinventing" its supply chain, which would be visible to all in a year's time.

Despite Kmart's continuing falling sales and rising losses Conaway again mandated price cuts, this time on 50,000 products. When Fleming Companies, now Kmart's sole grocery supplier, suspended shipments to Kmart because of Kmart's failure to meet its weekly payment of $78 million, the company realized it could no longer meet all of its financial obligations. Kmart had to declare Chapter 11 bankruptcy.

Kmart had clearly exhibited many problems. For instance, former Kmart CIO Dave Carlson said he had tried to unify Kmart's two separate computers in its distribution system, but he was turned down because the project was considered to be too expensive. When Conaway was first hired, he wanted to find new ways to bring customers into the stores, and so he cut back on Kmart's primary method of Sunday circulars but offered no clear alternative strategy. In 2000, central planners were still allocating 60 percent of Kmart's goods to specific stores. Conaway tried to address this problem, but by December 2001, 40 percent of its goods were still being allocated by central planning rather than by local stores. Also, Kmart continued to expand the variety of its products rather than focusing on fast selling items, as did Wal-Mart. Shipping was such a problem that in December 2000, being limited to only 900 trucks per day, Kmart was forced to choose between shipping toothpaste or Christmas trees. Warehousing was also an obvious problem since 15,000 truck-trailers were parked behind its stores holding excess inventory because they had no more storage space. Conaway did successfully eliminate this problem within a few months, thereby also reducing the "shrink" (stolen product) rate. Many analysts and observers, including Conaway, believed supply chain management was Kmart's most serious problem, particularly when compared to Wal-Mart. Kmart's promotions-driven business model created sharp spikes and drops in demand for products and has been much more difficult to support with supply chain management systems than everyday low pricing models such as Wal-Mart's. Indications of supply chain troubles were everywhere. Outdated technology at the distribution centers resulted in supplies often sitting on pallets for 24 or more hours until they were recorded in the central tracking system. The shelves displaying popular products were often empty, and to reorder them from regional distribution centers, store merchandisers first had to hand sift through previous purchasing receipts. Kmart's inventory turnover rate was very low. In the year 2000, Kmart's was an anemic 3.6; while Wal-Mart's was 7.3, and Target's was 6.3. Gary Buzek, the president of JHL Consulting Group, estimated that Kmart could add $1.9 billion in profit just by matching its competitors' turnover rates.

Conaway moved ahead quickly. In July, he selected i2 Technologies of Dallas, Texas, to work with Kmart in a project to rebuild its supply-chain systems. 12 had been a highly successful vendor of supply-chain software, although principally for manufacturers, while Kmart's new software had to be designed for its retail business. The project was to improve Kmart's management of sales forecasting, inventory sourcing, logistics, and reporting. 12 planned to use the Kmart project to create templates for sale to the retail industry in general and then customize them specifically for Kmart. The project would also connect these new systems to appropriate in-store technology such as bar-code scanners at cash registers. It would also include micro-merchandising, which enables individual stores to select their own merchandise according to the needs and demands of their local community. 12 claimed its software would track the ability of key suppliers to supply their products. It would also analyze Kmart's needs, and execute the required orders, schedule shipments, and record the delivery of products. 12 claimed its software would reduce excess inventory in stores and distribution centers, thus lowering costs, and enabling Kmart to lower prices. Sales would then grow and profits increase. Conaway stated Kmart's supply chain would become the best in the retail business, although Lora Cecere, a Gartner analyst, did question the ability of the project to succeed in such a giant, complex project.

Katrina Roche, i2's chief marketing officer, stated that "i2 excels at sales but its execution isn't always flawless." Supply-chain management software for manufacturing still accounted for 90 percent of i2's business, and it had only recent and limited experience in the retail sector. One major roadblock was that manufacturers use a relatively small number of stock-keeping units (SKUs) that must be handled by supply chain management software. Unfortunately, Kmart had over 70,000 SKUs in its 2,100 stores, meaning the system must deal with 147 million possible pairings, and this number is increased by inserting many distribution centers and time periods involved. The i2 software was simply not designed to handle such huge data sets. Yet advanced planning software is fundamental to supply chain management, and the problem could only be solved by Kmart purchasing more hardware; an expensive solution for a company facing Kmart's financial problems.

The i2 project was organized with a team of 500 working in an isolated location. It included over 100 personnel from Deloitte Consulting who were to customize i2's existing software, making it able to track the movement of goods to Kmart's more than 2,100 stores. Conaway announced that the first applications would go live in early 2001, followed by a "rapid, methodical rollout" of several dozen business releases with a total of 93 distinct improvements, all by August 2002.

In February 2001, several suppliers, including Pharmavite Corp. of Northridge, California, and Bell Sports Corp. of Irving, Texas, said they were seeing improved inventory management in the last three months. Also, Kmart announced a $200 million program to purchase and install new point-of-sale terminal cash registers from IBM to improve customer service with faster checkout technologies.

In June 2001, Kmart began installing new warehouse management software called PkMS, from Manhattan Associates. Its goal was to move products more quickly through Kmart's distribution centers to the stores, thereby cutting costs while getting the product on the shelves before it has been sold out. The software was installed at corporate headquarters and in all distribution centers. Using it, workers who pick, pack, and ship products to the stores use bar-code scanners to locate each item and to track the flow of the goods. A spokesperson said Kmart would save $15 million a year by increasing productivity and lowering labor costs. Management hoped it might also increase sales. The result was that Kmart could track 30 SKUs at the beginning of the third quarter (2001), 119,000 in late November, and 500,000 three months later. However, Buzek believed the information would be useless because management just didn't believe in the system. In September, the company announced a $148 million write-off of its previous warehouse management system because it was so extensively modified that it no longer could work well and cost too much to maintain. Observers and analysts claim the write-off included abandoning some of i2's software. Kmart also wrote off $65 million for two outdated distribution centers, replacing them with two newer ones purchased from Toys 'R' Us.

In December 2001, word came out that the i2 project had fallen way behind. John West, i2's chief technology officer until late in 2001, said the software worked, but the project had stalled because of Kmart's "operational issues." One member of the i2 users group said, "If the data's not right, it's not that it doesn't work; it's just that you won't get the answer you want. Interestingly, when i2 had problems with Nike, it also blamed its customer and not itself. According to Karen Peterson, a Gartner analyst, Kmart originally did not understand the complex difficulties of the project. Another observer, Jim Dion, president of Chicago retail consulting firm Dionco Inc., said that with the project's difficulty in connecting its point-of-sale and inventory systems to its distribution systems, Kmart was still sending many of its orders on paper. Also in December, Kmart indicated it was now trying to modernize 800 of its stores at a cost of around $1 billion, and that money was competing with funds needed to modernize its supply chain. During the Christmas 2001 selling period Kmart moved less product off its shelves than it had in 2000.

When Kmart was forced to declare bankruptcy, it did indicate some plans for survival. Conaway announced that the company would use Chapter 11 bankruptcy protection to break store leases in 284 stores in 40 states and then close them. In June 2002, Kmart changed the name of its Web site from BlueLight.com to Kmart.com to attract a younger audience and help focus on Kmart stores and sales promotions. (BlueLight had never become a profitable Web business.) Kmart.com will also see an expanded variety of name brand products such as Pentax cameras and Disney apparel. Management believes Kmart.com also meshes better than BlueLight.com with the company's current "Stuff of Life" campaign, which is trying to position the chain as a family-friendly budget-minded store. Emphasizing exclusive brands such as Martha Stewart Everyday and Joe Boxer may help Kmart distinguish itself from its rivals. Conaway believes Kmart should be able to emerge from Chapter 11 in 2003.

The question is, will Kmart truly be able to bounce back? What will it take to keep going? The company still doesn't have a low enough cost structure to compete with Wal-Mart's low prices, nor does it have the trendy image of Target. What can Kmart do to become the shopping destination of choice?

Sources: Mitchell Pacelle and Amy Merrick, "Kmart Gets Pressure from Two Investors to Hurry a Rebound," Wall Street Journal, September 12, 2002; Jenny Strasburg, "Kmart Turns Off <BlucLight.Com>," San Francisco Chronicle, June 20, 2002; Amy Merrick, "Kmart Renames Its Web Site, Turned Off by BlueLight.com," Wall Street Journal, June 20, 2002; Michael Levy and Dhruv Grewal, "So Long, Kmart Shoppers," Wall Street Journal, January 28, 2002; Constance L. Hays, "Kmart to Close 284 Stores; 22,000 Jobs will be Cut," New York Times, March 9, 2002; Kim Gi rard, "Kmart: SCM Gone Wrong," Baseline, January 23, 2002, <www.basclinernag.com >; "Kmart Corporation to Close 284 Under-Performing Stores Based on Financial Objectives Review," Kmart Corporation, March 8, 2002; Carol Sliwa, "IT No Bargain for Troubled Kmart," itworld.ca, March 1, 2002; Carol Sliwa, "IT Difficulties Help Take Kmart Down," Computer World, January 28, 2002; Steve Konicki, "Now in Bankruptcy, Kmart Struggled with Supply Chain," Information Week, January 28, 2002, <www.inf~rma-ttonweek.com>; Carol Sliwa, "Beyond IT: Business Strategy Was a Problem, Too," ComputerWorld, January 25, 2002; Peter Abell, "Kmart Declares Chapter 11," AMR Research, January 23, 2002, <www.amrrcsearch.com >; Edward Cone, "Commentary: Blame Enough to Go Around at Kmart," Baseline, January 23, 2002, <www.basc-linemag.com>; "Kmart Files Chapter 11," ABCNEWS.com, November 22, 2002, <www.abcncws.go.com >; Stephanie Strom and Leslie Kaufman, "Kmart is on Verge of Filing a Claim for Bankruptcy," New York Times, January 22, 2002; David F. Carr and Edward Cone, "Code Blue," Baseline, December 10, 2001, <www.baselinernag.com>; Ted Kemp, "Kmart Calls Supply Chain to Rescue," Internet Week, December 7, 2001, <www.internetweck.com >; Constance L. Hays, "Slow Lane to Kmart's Recovery; Consumers Turn Frugal and Many Suppliers Discontent," New York Times, November 8, 2001; Constance L. Hays and Leslie Kaufman, "Some Suppliers Say Kmart Has Pressed for Deals," New York Times, October 25, 2001; Alone Gilbert, "12 Forecasts Slow Growth, Losses," Information Week, April 19, 2001; "Dog of the Day: 12 Technologies," Forbes, February 27, 200 1~ Jack McCarthy, "Managing through Reorganization," InfoWorld, July 20, 2001; Todd R. Weiss, "Kmart to Spend $270 Million on New Technology for its Stores," Computer World, February 15, 2001; Marc
L. Songini, "Pharmavite to Launch Collaborative System with Kmart," Computer World, February 5, 2001; Chris Nolan, "Attention Kmart Shoppers," Smart Business, February 1, 2001.

CASE STUDY QUESTIONS:

Evaluate Kmart using the value chain and competitive forces models. What was Kmart's business model and business strategy?

1. What was the relationship of information systems to Kmart's business processes and business strategy? How well did its systems support its strategy?
2. What management, organization, and technology factors contributed to Kmart's problems?
3. How important was supply chain management in contributing to Kmart's

problems? Evaluate Conaway’s decision to use i2 software to improve Kmart’s supply chain management.

4. Were those blaming software for the collapse of Kmart correct? Explain your answer.
5. It has been said that “Wal-Mart uses their IT strategically, and they fully integrate it into their operating model.” Does this statement apply to Kmart? Explain your response.
6. List the problems Conaway faced when he took over Kmart, and then describe the short-and long-range policies you would have followed had you been in his place.