Kmart's Ten Deadly Sins

How Incompetence Tainted An American Icon

Marcia Layton Turner

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data

Turner, Marcia Layton.
Kmart's ten deadly sins: how incompetence tainted an American icon / Marcia Layton Turner.
p. cm.
Includes bibliographical references.
ISBN 0-471-43593-7 (Cloth)
1. K-Mart Corporation—Management. 2. Business failures—United States—Case studies. I. Title.
HF5429.215.U6T87 2003
381′.141′0973—dc21 2003006632

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

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Acknowledgments

Without the help of retail experts, industry veterans, knowledgeable insiders, business analysts and specialists, this book would have been far less interesting. A heartfelt thanks goes to Theo Addo of San Diego State University; Dennis Altman of the University of Kentucky; Will Ander of McMillan Doolittle LLP; Paul Argenti of the Tuck School of Business at Dartmouth; Kurt Barnard, publisher of Barnard's Retail Trend Report; Britt Beemer of America's Research Group; Don B. Bradley III of the University of Central Arkansas; Tony Camilletti of JGA, Inc.; Peter Fader of the University of Pennsylvania; Lynda Falkenstein "the Niche Doctor" of the Falkenstein Learning Corporation; Eugene Fram of the Rochester Institute of Technology; Rob Gelphman of Gelphman Associates; Mark Goldstein; Steven Greenberg of The Greenberg Group; Cathy Halligan of Prophet; Jim Harris of Seneca Financial Group; Stephen Hoch of the University of Pennsylvania; Barbara Kahn of the University of Pennsylvania; Don Longo of Retail Merchandiser; Al Napier of Rice University; John Parham of Parham Santana; Lars Perner of the University of California-Riverside; Mike Porter of Morningstar; Al Ries of

Ries & Ries; George Rosenbaum of Leo J. Shapiro & Associates, LLC; Biff Ruttenberg of Atlas Partners, LLC; Mark Scheinbaum; Mark Shinderman of Munger, Tolles & Olson LLP; Sandra J. Skrovan of Retail Forward, Inc.; Roger Valdez of Kmartsucks.net; Bart Weitz of the University of Florida; George Whalin of Retail Management Consultants; Ulysses Yannas of Buckman, Buckman & Reid; and the top notch local reporting teams at the Associated Press, *Detroit Free Press, Detroit News, New York Times,* and *Wall Street Journal.*

Thanks also to my group of long-time women business owner friends, Dana Abramson, Betty Andelman, Sandy Beckwith, Mary Anne Brugnoni, Elaine Lotto, and Mary Anne Shew, who cheered me on and encouraged me to write this book.

Likewise, my sincere appreciation goes to my agents Susan Barry and Lisa Swayne who helped create the opportunity for this book's existence, and to my editor, Jeanne Glasser, who shepherded the book along, despite numerous twists and turns in the plot along the way.

Finally, I will always be indebted to my husband, Charlie, for taking over many of the day-to-day responsibilities within our family so that I could bring this story to light.

Preface

Where did Kmart go wrong? That is the central question I try to answer in *Kmart's Ten Deadly Sins,* for myself and others seeking to understand how an industry pioneer became a laggard.

The answers I found are varied. Some reasons for the company's poor financial health are due to troubles decades ago, while others are very recent. Some can be traced to a particular CEO's misstep, while others appear to be related more to miscommunication throughout the organization. Some reasons are due to pure stupidity, while others might have made perfect sense at the time.

In the end, Kmart went wrong in a number of areas. I've identified ten that I believe account for a large portion of the company's challenges, but those ten are not all-encompassing. They are a framework, however, for evaluating other decisions, initiatives, and moves the company has made.

Through interviews with industry veterans, retail gurus, financial analysts, thought leaders, professors, former employees, supplemented with thousands of pages of reports from newspaper articles, magazine articles, books, websites, news-

letters, case studies, and reports, I've tried to dig for the real answers—the real reasons Kmart is struggling for its survival.

By reading Kmart's story, you'll learn about greed and corruption, as well as the dangers of empire-building, arrogance, and poor decision-making. You'll hear about the major players throughout Kmart's history, as well as the minor ones that could have had an even bigger impact if given the chance. It's an interesting tale that I hope you'll both enjoy and find instructive.

Discount Retail Timeline*

1879	F.W. Woolworth opens its first five-and-dime.
1899	S.S. Kresge Company founded by Sebastian S. Kresge.
1912	S.S. Kresge incorporates with 85 stores and sales of more than $10 million.
1918	S.S. Kresge Company becomes a publicly traded company on the NYSE.
1962	The first Kmart discount department store opens in a Detroit suburb, followed by 17 more that same year; Sam Walton opens first Wal-Mart store in Rogers, Arkansas.
1966	Sebastian Kresge dies at age 99; Kmart has 162 stores.
1968	Wal-Mart begins opening stores outside of Arkansas.
1970	Wal-Mart opens first distribution center and headquarters in Bentonville, Arkansas; chain has 38 stores.

*Adapted from Kmart corporate web site, Wal-Mart corporate web site, CNN/Money timeline from January 22, 2002.

1972	Robert Dewar named chairman and CEO, following Harry Cunningham, Kmart's chief architect; Wal-Mart added to NYSE.
1975	Wal-Mart has 125 stores in operation generating $340 million in sales.
1976	271 Kmart stores opened this year alone; total stores = 1,206.
1977	Company name changed from S.S. Kresge Company to Kmart Corporation to reflect that 94.5 percent of sales from the company in 1976 came from Kmart units; Wal-Mart acquires 16 Mohr-Value stores.
1978	Wal-Mart acquires Hutcheson Shoe Company and introduces its pharmacy, auto service, and jewelry divisions.
1979	Wal-Mart has 276 stores with more than $1 billion in sales.
1980	Bernard Fauber elected chairman and CEO.
1981	By year end, there were 2,055 Kmart stores in the U.S., Canada, and Puerto Rico; Wal-Mart buys 92 Kuhn's Big K stores.
1983	Wal-Mart acquires Woolco stores in U.S.; opens first Sam's Club.
1984	Kmart buys Walden Book Company and Builders Square; David Glass named president at Wal-Mart.
1985	Jaclyn Smith apparel collection debuts at Kmart; Wal-Mart has 882 stores with sales of $8.4 billion.
1986	Joseph Antonini succeeds Fauber as chairman, president, and CEO; Martha Stewart brand introduced.
1987	Wal-Mart has 1,198 stores with $15.9 billion; completes satellite network linking all of company's operating units.
1988	David Glass named CEO of Wal-Mart; first Wal-Mart Supercenter opened; 90 percent of Wal-Mart stores use bar-code scanning.

1990	Kmart purchases The Sports Authority; Kmart's logo changed from red and turquoise to red and white; company buys 22 percent interest in OfficeMax; Wal-Mart becomes nation's top retailer; Wal-Mart acquires McLane Company.
1991	Kmart raises $1 billion in equity through convertible preferred stock offering; company raises its stake in OfficeMax to 90 percent; Wal-Mart's Sam's American Choice brand products introduced.
1992	Kmart acquires Borders, Inc., a chain of bookstores; Kmart enters the European market; Sam Walton passes away.
1993	Kathy Ireland apparel line introduced; Wal-Mart acquires 91 Pace Warehouse Clubs.
1994	Kmart opens stores in Mexico and Singapore; a portion of The Sports Authority and OfficeMax sold off; Wal-Mart acquires 122 Canadian Woolco stores.
1995	Floyd Hall named chairman, president, and CEO; spins off Borders and sells remaining stake in The Sports Authority and OfficeMax; Wal-Mart has 1,995 Wal-Mart stores, 239 Supercenters, 433 Sam's Clubs, and 276 international stores with sales of $93.6 billion.
1996	Kmart completes $4.7 billion in new financing; Route 66 brand introduced.
1997	Big Kmart store format introduced; Martha Stewart Everyday line introduced; Builders Square and Kmart Canada sold off; Sesame Street brand introduced; Wal-Mart acquires OneSource nutrition centers.
1999	Martha Stewart brand expands into garden and patio products and Martha Stewart Baby Baby for infants; BlueLight.com web site debuts; Wal-Mart has 1,140,000 associates, becoming the largest private employer in the world.

2000	Martha Stewart line extended into kitchenware and plants; Charles Conaway takes over as chairman and CEO; H. Lee Scott named president and CEO of Wal-Mart.
2001	BlueLight Special reintroduced after 10 years; Martha Stewart introduces organizing and home decorating lines; Kmart signs $4.5 billion exclusive agreement with Fleming to distribute food and consumables to its stores; BlueLight.com acquired by Kmart from SOFTBANK, its partner; Wal-Mart has biggest sales day ever—earning $1.25 billion on the day after Thanksgiving.
1/22/02	**Kmart files for Chapter 11 bankruptcy protection.**
3/08/02	Kmart announces that 284 underperforming stores will be closed.
3/11/02	James Adamson is appointed CEO, Julian Day, president and chief operating officer, as former CEO Chuck Conaway leaves the company.
4/18/02	Karen Austin is promoted to senior vice president and chief information officer.
6/19/02	Kmart relaunches its Internet site, renaming it Kmart.com.
1/14/03	Kmart announces that it intends to close 323 more stores.
1/19/03	Julian Day is promoted to CEO as James Adamson continues to serve as non-executive chairman during the reorganization process.
1/24/03	Kmart files its plan of reorganization with the bankruptcy court, setting its target exit date as 4/30/03.
2/04/03	Kmart and Fleming end their supplier relationship.
4/22/03	The U.S. Bankruptcy Court approves the company's reorganization plan, allowing Kmart to proceed.
5/06/03	Kmart emerges from Chapter 11 bankruptcy with a new chairman, Edward Lampert, a major shareholder in the new Kmart, and new stock.

Introduction

"How did you go bankrupt? Gradually, then suddenly."
—*The Sun Also Rises,* Ernest Hemingway

For years, Kmart's financials had been lackluster, but until 2002, the company had never filed for bankruptcy. Sure, there had been rumors, but it had never actually happened. Why now? What caused the company's prospects to become so bleak that bankruptcy protection was the only answer? Some say the answer is Chuck Conaway, who began his tenure as CEO in 2000, and his "frat boy" management team.

Out of what looks like pure greed, former managers pushed Kmart into bankruptcy by draining the corporate coffers, in the process giving themselves extensive compensation packages and embarking on ill-advised price wars. The extent to which executives and managers went to conceal their ill-gotten financial gains is impressive. One newspaper report called it a "two-year program of deceit, intimidation and unauthorized spending,"[1] in which "former Kmart managers altered information submitted to the board of directors about a controversial $24 million loan program for key executives in December 2001,"[1] This indicates that their minds definitely were not on helping Kmart improve its market position. If they had been, Kmart would be better off for their leadership, not worse.

Finally, employee whistleblowers could stay quiet no longer and began sending anonymous letters on Kmart letterhead

about accounting irregularities and wrongdoing within the company to local media and government investigators. Those letters prompted the FBI, the U.S. Attorney's office, and other government agencies, as well as Kmart itself, to cull through its corporate records for answers.

According to the stewardship review that the company performed and reported in its bankruptcy reorganization plan in 2003, it appears that Kmart was financially stable, although not immensely profitable, when Chuck Conaway took over. But it was under his leadership that executives began exploiting the company for all that it was worth.

Many of the executives were new to the company, hired during Conaway's massive push for more staffers. However, Conaway didn't feel it necessary to follow the company's hiring guidelines or requirements. No formal applications were requested of many new management hires, no background checks were completed, nor were any interviews conducted with the new hires, according to Kmart's review.[1] Instead of consulting the company's human resources department for salary guidelines, certain former executives doing the hiring determined the compensation packages offered all on their own. Reports *The Detroit News,* the executives "set contract terms of these new hires, authorizing excessive compensation packages. Not only did these hiring packages go beyond what Kmart would normally have given its employees, they also were far larger than what the new hires had received from their previous employers."[1]

Comments Kmart retiree Nathan Menoian regarding employee salaries, "When I was there, they made a valid point that you had to pay good salaries to attract and keep talented people. But somewhere along the line, it just became outrageous. They (executives) just wanted to take as much as they could get."[2]

Jeffrey Boyer, a Conaway pick and Sears veteran, was CFO for just seven months, but pocketed more than $1 million in cash, bonuses, and severance on his departure. Mark Schwartz, the brash president Conaway instated, earned more than $2 million in fiscal 2000, of which he only worked about five months,[2] and received more than $1.2 million just for housing in 2001. Conaway earned millions in salary and bonuses on top of the perks that

included more than $500,000 for housing and other personal expenses in 2000 and 2001, plus another $122,000 for personal use of the company jet.[2] Buying corporate airplanes was another Conaway initiative, and with other managers he spent $12 million of Kmart's money on them without getting proper authorization. The planes then were used for both business and personal trips by management, with Kmart footing the bill.

The BlueLight Always program that Conaway and Schwartz devised, however, was what really broke the bank. In the summer of 2001, to gear up for Kmart's planned price war against Wal-Mart, executives bought $850 million in new merchandise for its stores without talking to Kmart's treasury officials about whether the company could afford such a buying spree, without consulting its suppliers about the practicality of such a program, and without any kind of internal analysis to verify that such a strategy was one Kmart could adequately support. When the program failed, as most observers—including Kmart's board—fully expected, the company lost millions and quickly ran into liquidity problems.[1]

To try and cover up the cash flow shortage, managers began shuffling vendor payments—"allowances"—Kmart receives from suppliers for premium shelf space, attributing $92 million in payments to different time periods to improve its accounting records. Two Kmart executives were also later charged with fraudulent reporting of revenue, arising from a secret arrangement with American Greetings Corp in 2001. The execs agreed to make American Greetings its sole source of greeting cards and received a $42.3 million payment from the company at a time when it was struggling to meet Wall Street earnings expectations. Although American Greetings indicated to auditors that there were "no strings attached" to the payment, there was actually a side agreement with Kmart that if their exclusive contract was rescinded, the payment had to be returned. That fact made it improper for Kmart to include the payment as revenue when it did.[3] Kmart's financial statements from the first three quarters of 2001 were impacted by these maneuvers, which made the company's financial health seem stable when it clearly was not.

In addition to covering up the company's current cash flow shortage, executives also sought to continue the charade by fal-

sifying projections. *The Detroit News* reported that "Executives began to force Kmart's merchandising personnel to use outrageous and unattainable goals in Kmart's forecasts and financial reports. When these staffers resisted, they were demoted or transferred."[1] And in September 2001 executives initiated a payment slowdown to make up for the cash shortfalls, dubbed "Project Slow It Down," or "Project SID,"[4] reducing or stopping payments to vendors and then avoiding explanations for the slowdown when questioned.[1]

Despite the obvious financial problems executives knew the company was having, they took the opportunity to request additional financial compensation from the board. And the board, seeing the strong forecasts for the future that the executives had prepared, approved nearly $29 million worth of "retention loans" for 25 top-level executives[5] in December 2001. However, unbeknownst to the board, loans then were doled out to two additional, lower layers of employees, far beyond the scope of the agreement.[4] To cover up that additional loan activity, "management created purported committee documents that varied materially from the loan program documents submitted for approval, and these documents were inserted in the company's official board files after the fact," according to the stewardship review.[1]

When the company's 2001 holiday sales failed to materialize and the company suffered a catastrophic $2.42 billion loss, suppliers stopped shipping product due to nonpayment, its bonds were downgraded to junk status,[6] and a Prudential Securities financial analyst predicted a bankruptcy filing,[1] Kmart's future was sealed. With suppliers unwilling to provide product on credit and a growing cash shortfall making prepayment for product impossible, the company had few options.

The Announcement

Kmart's bankruptcy filing was the largest-ever for a retailer. Most industry analysts weren't caught off guard by Kmart's bankruptcy announcement on January 22, 2002, a situation that was reversed in May 2003. In fact, many had expected it. But what had forced Kmart to take such steps at that particular time?

Few outside Kmart knew of the treachery and greed that had brought the company down, but over the next year, with the help of the Justice Department and the Securities and Exchange Commission, the company and its customers finally started to get some answers. Then-CEO Jim Adamson conceded the stark reality of the situation in a statement issued about Kmart's bankruptcy: "These results reconfirm the significant difficulties Kmart experienced last year, including unsuccessful sales and marketing initiatives, an erosion in supplier confidence, and below-plan sales and earnings performance in the fourth quarter—all of which were factors in the decision to file for Chapter 11 bankruptcy protection."[7]

This statement is interesting given Adamson's cushy compensation package. During his stint as CEO, Kmart was contractually bound to provide him with similar luxuries, such as access to weekly private plane service from his residences in Detroit, New York, and Florida, a car and driver in Michigan and New York, and temporary accommodations near Kmart's headquarters,[2] while the company claimed bankrupt status. That's on top of the $2.5 million "inducement payment" to convince him to take the job *and* his $1.5 million salary.[2] Meanwhile, laid-off Kmart employees received a severance package consisting of a wave goodbye.

Comments Patrick McGurn, special counsel for Institutional Shareholder Services, which advises big investors on corporate governance and CEO pay, "Kmart boggles the mind. At least Tyco (another company hit by corporate scandal) still has some value for shareholders. You can't say that for Kmart. It's really a pay-for-failure situation."[2]

To get past its troubled times and get the company back on track, Kmart's new leadership let go most of the executives in place prebankruptcy and terminated any managers who had received retention loans. Fearful of any continuing questions about its compensation processes, Kmart elected to start over.

The government's investigation is not over, however, and it has been suggested that past executives could end up facing criminal charges or being sued by creditors. In February 2003, two former senior executives were indicted by a federal grand

jury on charges that they inflated Kmart's revenue by misrepresenting vendor payments and a third has been subpoenaed to give testimony about former management. If there is evidence against Conaway and he ends up being sued, it is likely that his director's and officer's liability insurance policy, paid for by Kmart, will cover any required payout although that issue has not yet been decided.[2] It appears that Kmart continues to foot the bill for the past misdeeds of its executives, but can it afford to?

The Aftershocks

In marked contrast to Kmart's 2002 losses, Wal-Mart reported first quarter 2002 results showing nearly 20 percent earnings growth and sales increases of more than 14 percent, despite increasing inventory only 3 percent.[7] As Kmart's sales have slid, Wal-Mart and Target are picking up the slack, gaining market share. But since the three discount retail powerhouses account for 88 percent of the $206 billion U.S. market,[8] any major gains will likely be at Kmart's expense. However, according to Cathy Halligan, a director at Prophet, a strategic brand and marketing consulting firm, "Three players can survive in a market. Three players can do well if each company has a distinctive, relevant, and compelling brand and marketing strategy. The problem is that Kmart has nothing that differentiates it from the other two major competitors in the same space." Its identity overlaps with both Target and, to a greater degree, Wal-Mart. The result is that the company is getting squeezed out of the industry, and its financials show it.

Proof that three players can survive and thrive in the discount mass merchandise category is the emergence of Kohl's, a strong competitor, points out Halligan. "Kohl's is coming on strong, is expanding rapidly, and has posted excellent financials," she says. Three-some Wal-Mart, Target, and Kohl's are evidence that three companies can do well in a competitive category.

Both Wal-Mart and Target have higher sales per square foot, with Wal-Mart achieving $440-per-square-foot and Target $275, while Kmart earns just $245. Its 2.0 to 3.0 percent gross margins are also at the bottom of the barrel, while Wal-Mart achieves 5.5

to 6.5 percent and Target hits 5.5 to 7.5 percent.[9] Kmart, however, is determined to regroup and recapture its lost customers.

Kmart's Roots

Many of Kmart's troubles are rooted in its former life as the S.S. Kresge chain of five-and-dimes. Kresge was the powerhouse of its day but recognized a cultural shift in the 1960s away from variety stores, as they were also known, toward discount shopping. To remain ahead of the pack, in 1962 Kresge introduced the Kmart discount store, which later eclipsed the Kresge stores in terms of growth and sales. Over the next 25 years, all of the Kresge stores were sold or converted into Kmart-format stores.

With the financial resources of the well-established Kresge Corporation and the expertise of its employees, Kmart was well positioned to own the discount retailing industry. For almost 20 years it did. And then came 1980, a pivotal year for Kmart. Around 1980, Kmart's always-rising sales started to fall. It was the year the company's past strategies began to catch up with it. It was the year that then-CEO Robert Dewar recognized that the company's growth through expansion had to change; more than 800 new stores had been opened in the past four years, with little positive impact on the company's bottom line.[10] Although new store openings had fueled the company's growth for many years, that strategy was not working anymore and Kmart had to devise a new plan. Dewar stepped down and was replaced by Bernard Fauber. This also was the year Wal-Mart really started gaining steam, following record sales of $1 billion in 1979.

Never having faced declining sales, Kmart's management was not equipped to respond. Over the next two decades, Kmart tried a variety of strategies to reverse its downhill course, few of which seemed to work. Some boosted sales, others worked in the short term but damaged the company's long-term prospects, and others drained the company's resources altogether. Meanwhile, Kmart's board and shareholders grew impatient for the turnaround. That turnaround came thanks to Floyd Hall, who essentially saved the company from the threat of bankruptcy. So when Hall was ready to step down, in came fair-haired Chuck

Conaway to take the reins and leverage Kmart's strengths even further. As it turns out, he leveraged more than its strengths. He leveraged its future.

Kmart Today

The Kmart of 2003 looks little like the Kmart of 1962, or of 20 or even 10 years ago. Decimated by nearly 600 store closings in 2002 and 2003, close to 67,000 job cuts, and financial losses in the billions, Kmart is down for the count. What's left is approximately 1,500 stores, 180,000 employees, and an unknown quantity of die-hard Kmart customers. How much more the customers are willing to endure on behalf of the retailer also is a big unknown.

Store closures were expected to generate approximately $500 million in cash flow for the company in 2003, but the cost of bankruptcy has been heavy, with Kmart recording about $1.7 billion in restructuring charges[11] in connection with its filing. Although many bankruptcies drag on for more than a year, Kmart emerged in little more than 15 months. Due to the high cost of remaining in bankruptcy, from attorneys fees, consultant fees, court fees (estimated at about $145,000 in billable hours a day, or more than $114 million in professional fees and expenses since its bankruptcy filing[12]), and the negative impact bankruptcy presumably has on sales, Kmart pushed aggressively to exit at the first opportunity.

Summarizing management's feelings on the subject, former CEO James Adamson stated, "We do not want to remain in bankruptcy a day longer than necessary."[11] Of course, he has the added incentive of several million dollars in bonus compensation if the company exits before July 30, 2003, that also nudged the company's progress. Adamson led Kmart for little more than a year—from 2002 to 2003.

After regrouping under Chapter 11 bankruptcy protection, which eliminated most, if not all, of its obligations to continue operating underperforming stores, the company emerged with a stronger balance sheet (eliminating $7.8 billion in debt), improved cash position, and a head start toward profitability, which it anticipates as soon as 2004. But is its plan to position the

company as “the store of the neighborhood” a smart one? And can it really become “the authority for moms?” Will Hispanic and African-American consumers be its ticket to profitability?

Perhaps of more immediate concern, will customers be willing to venture back into Kmart stores now that the company’s survival looks more assured? And will they come back a second time after seeing that not much has changed at the store level? Although these are critical present-day issues for Kmart, some of its biggest problems lay in its past, and continue to haunt the company today.

The Ten Deadly Sins

Depending on whom you talk to, Kmart’s fall from grace could be due to any number of factors. Some analysts believe Kmart has been focusing on the wrong demographic group, targeting younger blue-collar workers making less than $40,000 when it’s the middle-income customer with kids who is doing all the buying. Focus has been a weakness for the company and its leaders, who have shifted the company’s objectives and brand strategy time and again. Others argue that throughout its history, Kmart’s strategy has been to grow by opening new stores, rather than keeping its existing stores looking fresh and inviting.

The truth is that Kmart has made a number of errors throughout its 40-year history, some that seemed like good decisions at the time, and others that were obviously off-base even then. By taking a look back at Kmart since its establishment in 1962, you begin to see patterns.

Yes, the names of CEOs change every few years, but in some cases, the decisions they make are often course reversals from previous leaders—almost a cycle that all Kmart policies face. Its approach to information technology management is a case in point; successive CEOs vow to overhaul the system and end up just throwing out portions developed by former leaders. Other strategies are just flawed, plain and simple, such as its decision to engage in a pricing war with Wal-Mart. Some realities are mind-boggling, such as how Kmart virtually could have ignored Wal-Mart as it made serious inroads into its market. Instead of

making great strides forward, Kmart often has found itself playing catch-up, with some CEOs undoing the damage done by prior leaders and others simply making the situation worse. Its poor supply chain management system is an area where the company has consistently been weak, but why it is still today is more puzzling.

The point of this book isn't simply to point fingers, it's to identify how such a retail pioneer could have fallen so far behind its upstart competitors. By studying its inconsistent past, readers will get a sense of where Kmart went wrong, as well as what it needs to do now to succeed in the postbankruptcy future.

The recent scandal involving past Kmart executives is a very small part of the story. It explains a little of why a relatively stable company could fall so far so fast, but it doesn't account for all of the company's problems. Although greedy managers ultimately caused the cash crunch that precipitated Kmart's bankruptcy filing, Kmart was already at a disadvantage. It had no clear market position, no niche, no inviting stores, no state-of-the-art technology, and no focus. It did have a tendency to switch strategies with the wind. On the positive side, it did have—and continues to have—a remarkably loyal group of customers. Those customers want a better Kmart. Management now has a chance to give it to them. Will they? That's the big unknown.

Through phone interviews with dozens of financial analysts, retail consultants, former employees, former suppliers, researchers, strategists, professors, and industry observers and leaders, a picture of Kmart management's thinking emerged. When coupled with the review of thousands of pages of articles, SEC filings, news reports, and background data, a clearer image emerged of what exactly went on—and why.

Let's hope there's a lesson in there for each of us.

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