THE KMART SAGA RE-VISITED

It has been more than a year since Kmart filed for Chapter 11 bankruptcy protection. Has anything changed?

BY STAN POHMER

In this column one year ago, March 2002, I reviewed the January 2002 Chapter 11 bankruptcy protection filing by Kmart, the largest retail bankruptcy in U.S. history. I reviewed what I believed were the causes leading to its financial demise and loss of customer franchise and some of the challenges the company faced — and some of the things our industry could learn from the Kmart debacle.

Well, it's now a year later. What's changed at Kmart in the past year? What does its future look like? What new lessons can we learn?

REVIEWING THE CHANGES

What's changed? A lot and a little. Here are a few of the key changes:

• Closed (or in the process of closing) 600 stores (almost one-third of its pre-bankruptcy store count) and at least one distribution center.

• More than 60,000 store, headquarters and distribution center employees were laid off.

• Kmart recently severed its 10-year supply contract with Fleming, its major food supplier.

• The Martha Stewart, Kathy Ireland and Jacqueline Smith exclusive brand programs and the recently introduced Joe Boxer brand will be the major merchandise points of differentiation.

My concern is that I haven't yet seen the strategic moves necessary to position Kmart for long-term survival — and some of the tactical moves already made will limit its ability to make the necessary strategic changes now and in the future.

• More than 30 percent of Kmart's sales come from the Hispanic and African-American customer base. It has recently announced monthly publications that will be sent into these ethnic markets with its weekly circulars (*Urban Direct* and *La Vida*) and have signed merchandise contracts with Thalia (a Hispanic celebrity) and a street-smart rapper to develop merchandise programs tailored to these markets.

• Cleaned up its balance sheet, primarily by getting out from beneath unfavorable leases for existing stores and voiding the leases from "dark" stores, those closed stores left over from previous failed strategic initiatives such as Builder's Square and The Sports Authority.

• Continued the historic revolving door of senior management. Most of the pre-bankruptcy management has been sacked, some under charges of poor "stewardship" and possible legal action from the Security Exchange Commission (SEC), the FBI/Justice Department and even Kmart itself. The senior management re-structuring team (CEO, CFO and chief restructuring officer) was made up of temporary outside consultants; the day Kmart exits bankruptcy protection, this team is gone and a new team needs to be hired.

• Announced a reorganization plan that, if accepted by the various creditor committees and the court judge, will pay secured lenders $0.40 on the dollar for pre-petition debt and trade vendors $0.12 on the dollar in new Kmart stock (the existing common stock will be cancelled, leaving all current investors and employees/retirees who have their 401ks in Kmart stock in the lurch). In addition, the current Board of Directors would be replaced with a new board made up of lending bank representatives, private investor groups (ESL and Third Avenue have bought a huge amount of the Kmart debt) and major trade vendors who were owed large amounts of money before the January 2002 filing. The new Board would have a strong focus on improving the value of the stock since a rising stock valuation will be their mechanism to become financially whole again.

DISTURBING DECISIONS

Here are a few of the areas where, in my opinion, not enough work has been done or the decisions made are disturbing:

• Kmart's "new" vision is essentially more of the same program that got it into its present predicament: becoming a smaller "store of the neighborhood" with more local control; further testing of a "store of the future" with wider aisles, improved lighting, fixturing, layout and adjacencies to help improve the shopping experience; reliance on exclusive brands. Besides being expensive to implement, none of this is significant enough to differentiate it from Wal-Mart and Target, who haven't been asleep at the switch during Kmart's troubles and have been taking significant market share in a tough economic period.

• Store closing decisions were made tactically, rather than strategically, based on financial performance, cost of operation, lease expense and ability to compete with the other major retailers in each market. For instance, Kmart states that it wants to cultivate and grow sales in the Hispanic market, yet decided to close a significant number of stores in strong Hispanic markets such as Texas, Southern California and South Florida. Another example is the decision to close only half of its supercenters, yet at the same time severing its relationship with Fleming, its primary food supplier. Rumor has it that Kmart plans to replenish this category itself, but it doesn't have the facilities to do so, and its track record on corporate replenishment programs of non-perishable products isn't good.

• The financial projections cited in the reorganization plan are aggressive, assuming a major improvement in the economy and retail industry and almost flawless implementation and performance of the turnaround plan. And Kmart isn't projecting profitability until the 2004 fiscal year; there's little indication that same-store sales are improving at the rate needed to regain market share and sustain the plan.

• The plan also assumes a return to normal in its trade partner relationships and confidence. The jury is still out on whether this can be accomplished; it will come down to how Kmart performs and stays current on its future payables.

WHAT TO EXPECT

Bottom line, from my vantage point as an interested observer, Kmart has made tactical decisions to temporarily save the company by fixing the balance sheet and allowing the company to exit bankruptcy protection. My concern is that I haven't yet seen the strategic moves necessary to position Kmart for long-term survival — and some of the tactical moves already made will limit its ability to make the necessary strategic changes now and in the future. Also, you can only manage profitability so long by generating operational and balance sheet component savings; at some point, sales growth, market share and the ability to effectively compete in the marketplace will dictate failure or success.

So what do I see as Kmart's future? I believe it will come out of bankruptcy, pretty much as proposed in its reorganization plan. I believe the new stockholders and owners of the company will give it some time to implement the plan. I believe the vendor community will give it the benefit of the doubt and support its efforts, at least for now.

But I also believe the competition will continue to be aggressive as Kmart works to reposition itself and restore lost customer confidence. And I believe the investors, creditors and suppliers do not have the patience of Job; they will be watching the performance and progress very closely and will not tolerate continued poor financial or operational results.

What happens if Kmart loses the support it needs? Chapter 22 — that's a company that files for Chapter 11 protection twice. And there aren't many companies still existing that have gone Chapter 22.

Can Kmart make it long-term? With a lot of luck and a sound strategic plan, the answer is yes. But the clock is ticking…

What can we learn from the saga of Kmart over the past few years? Tactical decisions need to be made in the context of a sound, logical and rational strategic plan that's committed to and supported by the stakeholders and shareholders. And this requires clear and shared vision and goals, the ability to execute, credibility and the courage to make the hard decisions.

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