Strategic Report for Circuit City Stores, Inc.

Harkness Consulting
Innovation through Collaboration

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April 14, 2007

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Executive Summary

Originally founded as a Southern television store called the Wards Company, modern-day Circuit City Stores, Inc. (NYSE: CC) has experienced extensive growth and product diversification over its history. At present, the variety of product lines consists of electronic equipment, entertainment software, home office products, and related services. Circuit City, as a specialty retailer of consumer electronics, serves as a distribution channel for brand name electronic goods through retail stores, websites: www.circuitcity.com, www.thesource.ca, and www.firedog.com, and call centers. Currently, Circuit City's domestic market includes 642 Superstores and 12 other locations in 159 U.S. markets. The international market is comprised of 806 retail stores and dealer outlets in Canada as of February 28, 2007. The corporation employs over 46,000 people as it strives to achieve "Simplicity Guaranteed" for customers.

Circuit City is undergoing a transition period. As strategic restructuring efforts have not provided relief to its problematic situation, additional measures must be taken in the short-term horizon to alleviate pressures. The corporation's greatest challenge continues to be the complications surrounding its poor business model, which is exacerbated by the mature market characterized by intense competition. With Best Buy capturing a larger segment of the market share in addition to rivals such as Wal-Mart and Costco augmenting their electronic departments, Circuit City faces increased strain on profit margins and image.

Market uncertainty regarding the future of Circuit City has manifested itself through a stock price that has declined 78.7% in the last 52 weeks.[i] Many analysts have placed blame upon CEO Philip Schoonover for the falling stock price, which reached a 52-Week low of $3.44 on March 17, 2008. These results only parallel the declining financial health of Circuit City as seen throughout the 2008 fiscal year quarterly reports. Most recently, Circuit City announced a revenue decrease of 8% and same-stores sales decrease of 10.4% during its fourth quarter holiday season (in comparison to the 2007 fiscal fourth quarter).[ii]

Contributing factors to the deterioration of the company include a poor business model lacking modernization to adequately vie with rivals, industry-wide decreasing profit margins due to the aggressive competitive landscape, and a controversial cost-cutting program.

I. Initiatives to augment competitive edge:

Circuit City has never been the first to innovate within the industry. In fact, each of the corporation's moves –entering the Canadian market, launching Firedog, and initiating the new turnaround plan– has been in response to similar actions taken by their top rival Best Buy. Therefore, Circuit City has lagged behind the market leader and the latest trends in retailing for well over a decade.

In order to improve the corporation's business model, Circuit City is currently engaged in a turnaround plan focusing on its four growth pillars: win in home entertainment, services, multi-channel and real estate. Therefore, Circuit City is focusing on investing in operations and cleaning up its business structure to improve the corporation's competitive position within the industry. Across the nation, Circuit City is still in the process of closing, relocating, and remodeling poor performing stores in order to improve traffic flow and productivity. Circuit City discontinued the sale of appliances in August of 2000 leaving the corporation with larger 'big-box' stores around 30,000 square feet. Now in trial, the new store format of only 20,000 square feet is less costly and more appealing to customers. The new model featuring a more attractive floor arrangement is located in urban areas with plenty of interactive display counters. However, only 25 of the 654 domestically operating stores have been revamped to this new format re-banded "THE CITY." Therefore, the problem still exists regarding poor sales at the remaining 629 stores, especially as remodeling and relocating efforts greatly disrupt retail operations. For this reason, Circuit City has also engaged in investments in training and information systems to improve customer service and streamline supply processes.

While the turnaround plan continues, the initial phase of changes was implemented during the first half of the 2007-year to be in place for the greatly anticipated holiday season. However, financial information recently announced does not indicate that these efforts significantly improved the depressing conditions.

II. Effects of the competitive landscape:

The cutthroat and competitive nature of the consumer electronics industry has only intensified. However, one significant event disrupted sales and is in part to blame for the decrease in stock price and profit performance. During the 2006 holiday sales, the hot selling flat-panel televisions were in the midst of a pricing war. Specifically, Wal-Mart broke the $1,000 price floor for 43-inch televisions, an unanticipated low that surged through the market and affected every retailer.[iii] Additionally, Wal-Mart expanded their services to offer extended warrantees, driving down prices on this high margin item as well.

Consequently, the nature of the market was greatly altered. Electronics retailers use every means possible, including ruthless price-cutting, special discounts, exclusive offers, price matching guarantees, etc., in order to secure sales and increase revenues. As wholesale retailers and discount stores have augmented their selection of electronics goods in their modern and conveniently located stores, Circuit City has not been able to maintain sales.

III. Restructuring costs through a nationwide program:

In order to aid profit margins, Circuit City aggressively focused on its cost and expense structure. In March 2007 the corporation cut 7% of 'overpaid' sales associates, roughly 3,400 employees, and replaced the personnel with lower paid new employees. While this action greatly reduced costs of wages, it also hurt the level of customer service the company was striving to achieve. The decline in sales throughout 2007 can be attributed in part to this corporate act as loss of morale and expertise lead to a decline in service. Thus, it was the wrong move for the already deteriorating corporation.

In conclusion, Circuit City is conscious of its current predicament. The pressures of declining profit margins and stock prices only necessitate a hastened response, something in addition to the turnaround plan the corporation has constructed and initiated. As Circuit City struggles in every facet, it is hard to predict how management will stimulate the revitalization the corporation needs by solely emulating Best Buy's business model. Therefore, Harkness Consulting strongly recommends that Circuit City re-evaluate its core strengths within the current market landscape. Upon such an analysis, we suggest the corporation engages in an accelerated turnaround plan focusing on downsizing as well as concentrating more efforts on promoting and maintaining the online website and Firedog services. Harnessing the strength of their phenomenal website and brand name recognition, such a strategic maneuver will allow Circuit City to reorganize in a more productive manner.

Company Background

I. Building an Idea: 1949-1983[iv]

Modern-day Circuit City began in 1949 when Sam Wurtzel founded Wards Company in Richmond, Virginia to sell televisions. Wurtzel was inspired when he observed the construction of the first television station in the South while getting a haircut.

With humble origins, Wards Company's first storeroom location was lodged in a tire-recapping depot and displayed six 'TV's broadcasting the new television station. Over the next decade, the firm expanded by acquiring businesses ranging from warehouse showrooms, discount stores, and audio retailers. By 1959, Wards Company had four stores in Richmond, and quickly gained new footholds across the country in the following locations: Mobile, Alabama, Washington DC, Albany, New York, and Costa Mesa, California.

The existing Circuit City concept took hold in 1977 with knowledgeable staff, top-quality audio and video products, and in-store service help. In 1979, the company launched its first 32,000 square-foot Superstore. This format became the "big box" template now used for all Circuit City stores.

II. Growth and Expansion: 1984-2001

After a strong history as a private firm, the company officially changed its name to Circuit City and was listed on the New York Stock Exchange on September 14, 1984. The stock opened with a price of $1.68. After going public, Circuit City began to dramatically expand its marketing to reach new consumers. In 1990, Circuit City established the First North American National Bank to operate a private-label credit card.

In 1991, Circuit City began what is now known as CarMax in order to try to expand business beyond electronics. Since both electronics and cars are big-ticket items that require highly-knowledgeable employees and tight inventory control, Circuit City saw this as a logical business expansion. The first CarMax store opened in 1993 less than two miles from the Circuit City headquarters in Richmond, Virginia. In February 1997, Circuit City sold a chunk of CarMax to the public to raise funds, listing the stock was a tracking stock sold under the Circuit City umbrella.

On May 5, 2000, Circuit City stock reached its highest price to date at $57.125.[v]

III. Increased Competition and Challenges: 2002-present

Facing increased competition from other big box rivals, Circuit City expanded its credit holdings in 2002 by offering another credit card co-branded with Visa in an effort to increase customer loyalty. This card gave customers access to benefits such as zero percent financing, an online account, access to special promotions, and a 60-day guaranteed low-price program. Circuit City sold both the Visa card and the initial credit card option in 2004 to Bank One Corporation (now Chase Bank) with the agreement that Bank One will continue to provide both credit cards to new and existing customers.

In 2002, Circuit City spun off CarMax from a wholly owned subsidiary into a stand-alone company. Circuit City reported that management ought to be separated to focus on increasingly diverse goals. The new CarMax, Inc. became a separately traded company no longer attached to Circuit City. Since the spin off, CarMax has consistently outperformed the market.

Facing increasing competition from low-cost competitors, Circuit City eliminated all commissioned sales and converted their compensation structure to hourly pay in 2003. This transition was followed in 2007 by terminating 3,400 sales associates and moving previously commissioned sales associates to hourly positions entitled “product specialists.” Circuit City reported the restructuring saved the company about $130 million on an annual basis. Additionally, all sales personnel were retrained to sell the entire spectrum of product offerings instead of solely focusing on one department within the store.

In and effort to expand to new markets, Circuit City purchased a number of stores in Canada by acquiring InterTAN as a subsidiary in 2004. InterTAN, headquartered in Barrie, Ontario, was a leading consumer electronics retailer whose stores were branded as RadioShack. In February 2007, Circuit City closed 62 underperforming stores, citing decreasing margins on flat panel televisions as the primary cause. In an effort to boost sales, all Canadian stores were re-branded "THE SOURCE BY CIRCUIT CITY."

Closing underperforming stores was not confined to Canada. In early 2005, Circuit City closed 19 underperforming superstores in the United States. On February 11, 2005, Circuit City faced a possible takeover from Highfields Capital, as Boston-based hedge fund. Highfields Capital argued that management was not maximizing existing shareholder value, and offered Circuit City $17 a share, a $2.74 premium over the trading price. Circuit City rejected this bid, which spurred the Board of Directors to authorize an additional $400 million in stock repurchase, increasing Circuit City's total repurchase capacity to $800 million. In 2006, the repurchase capacity was raised again by the Board of Directors to $1.2 billion.

Due to the pressure from competitors' service centers, Circuit City launched FiredogSM in October 2006. Firedog is designed to be a customer service-focused group specializing in quick and easy PC services, home theater installation, and integrated services.

Beginning in summer 2006, Circuit City shuffled management in an effort to turnaround performance with fresh perspectives. In June of 2006, Philip J. Schoonover replaced W. Alan McCollough as Chief Executive Officer and Chairman of Circuit City's Board. In April 2007, Chief Financial Officer Michael Foss left Circuit City for a position at PetCo and has still not been replaced. In January 2008, John Harlow joined the management team as the Chief Operating Officer, a position that has been vacant since 2005.

In order to combat inadequate inventory movement and product offerings, Circuit City improved its supply chain organization through several initiatives in 2007. Circuit City Global Sourcing, Ltd., a Circuit City subsidiary with offices in Asia, focuses on obtaining products and maintaining relationships with suppliers. Merchandise secured at 'the best value for the cost' is shipped directly from manufacturers to the nine distribution centers located in North America. In-store point-of-sale systems record inventory movement and assist in automatic inventory replenishing for the domestic segment.

On March 17, 2008, Circuit City stock reached its lowest price to date at $3.44.[vi]

Due to shareholder concern and continuing poor financial performance, Wattles Capital Management LLC, which owns 6.5% of Circuit City's outstanding shares, nominated five directors to replace the twelve-member board in a letter sent April of 2008. Currently, the companies are scheduling 'a conversation' to discuss the matter.

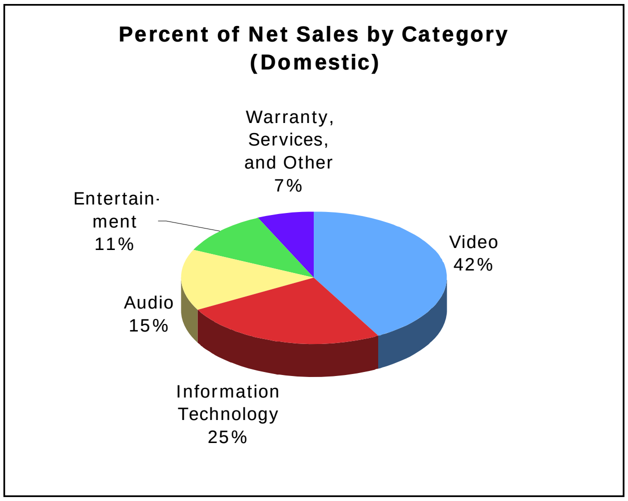
Competitive Analysis

Porter's Five Forces Summary for Circuit City.

Acting Force:	**Level of Threat to Profits:**
Internal Rivalry	Extremely High
Entry	Low
Substitutes and Complements	Low-Mid
Supplier Power	Mid
Buyer Power	Low

Internal Rivalry

Circuit City Stores, Inc. is primarily classified in the NAICS as belonging to Radio, Television, and Other Electronics Stores. It competes with other specialty consumer electronics retailers (Best Buy, RadioShack, and Game Stop), discount retailers (Wal-Mart and Target), warehouse clubs (Costco and Sam's Club), home office retailers (Home Depot), Internet-based retailers (Amazon) and direct-to-consumer alternatives (Dell, Apple, Hewlett Packard, etc) in wide range product categories. The chart below illustrates the diversity of product lines Circuit City sells in its stores:



Products Sold by Category:

Video	Televisions, imaging products, DVD hardware, camcorders, digital cameras, furniture, and accessories
Information Technology	PC hardware, telecommunications products, and accessories
Audio	Home audio, mobile audio, portable audio, and navigation products
Entertainment	Movie, music, personal computer and game software, game hardware, and accessories
Warranty, Services, and Other	Extended warranty, PC services, mobile installations, home theater installations, product repairs, and third party relations

Circuit City's direct competitor is Best Buy, which captures the largest market share in the industry with 25%. The second largest consumer electronics retailer is Wal-Mart, with 15% of the market share, followed by Circuit City with 9%.[vii] Firms in this industry can remain competitive through aggressive pricing practices, superior customer service, complete product and service assortments, and name recognition.

Due to the myriad of sellers in the market, and the uniformity of product lines available at these retail stores brands, sales in the consumer electronics industry are principally driven by price. The emergence of online shopping has especially intensified this result as the Internet allows customers easy access to information resulting in quick price comparison capabilities. For these reasons, the discount retailers and warehouse clubs, such as Wal-Mart and Costco, have been able to capture a larger market share, even though their product assortment is more limited than that of Circuit City. As these discount retailers increase their consumer electronics offerings, particularly with simpler products requiring less sales assistance, they further acquire Circuit City's market share. In addition, many of the corporation's vendors and suppliers have forwardly integrated, opening retail store locations of their own. Increased direct sales to consumers, and at lower prices, consequently reduce the need for a third party such as Circuit City.

For retailers that cannot compete on prices alone, offering superior customer service helps retain customers. For example, Circuit City's Firedog brand is a service that assists customers with home theatre installations, consumer PC services, and the convergence and integration of multiple technology products. Best Buy currently offers similar services through Geek Squad. This offering gives retailers the opportunity to capture higher profit margins since they are easily differentiated from smaller companies offering similar assistance to consumers. The Circuit City brand name, and increasing recognition of Firedog, as a consumer electronics provider assures customers of its product and service quality. Therefore, customers who shop at Circuit City for electronic goods simply hire Firedog for installation and repair needs. Furthermore, Circuit City offers other services that may cause consumers to prefer buying from its stores rather than other retailers. For example, under the 24/24 Pickup Guarantee, qualifying purchases are ready for customers to pick up at a specified store within 24 minutes of purchase confirmation; otherwise, the customer receives a $24 Circuit City gift card. Management believes this will become increasingly effective, as most customers who shop online prefer to pick up their purchase in a store. During fiscal 2007, approximately 54% of online sales were picked up from the store.

A major advantage of offering complete product and service assortments is that it greatly increases convenience for customers. For example, if a consumer shops at an Apple store, he is not able to compare the features and prices of different brands of computers, which is possible in a Circuit City or Best Buy store. Also, Circuit City is able to make sales on accessories and other services related to a customer's core product purchase, which have higher profit margins. However, the Internet has also mitigated some of these effects. For example, an online shopper can buy a television set at Circuit City and, within a few more mouse clicks, purchase a DVD player from a competitor.

Finally, although Circuit City may be in many consumers' evoked set of potential retailers when purchasing consumer electronics, the first name on the list is usually Best Buy. Regaining such brand recognition will be a major hurdle for Circuit City in the future. This may especially be important as the company enters new markets, such as with its Firedog service.

Another concern for retailers in the consumer electronics industry includes the seasonality of the business. Revenues for many retailers are typically greatest during the fiscal year's fourth quarter because it includes a majority of the sales from the holiday season. This means that the stores require more employees during that time of year as well as increased inventories. This might present a problem if the temporary staff lacks adequate training or morale. The quality of the service of the company will be the component that is most affected, which for Circuit City is also one of their major selling points. For Circuit City, the need for increased inventories should present less of a problem due to its efficient supply chain organization and processes.

Entry

The threat of entry to existing retailers in the consumer electronics industry is rather low. The major hurdles for entry include significant investment in real estate, building a well-trained work force, establishing relationships with suppliers, and the ability post-entry to compete on prices. Circuit City benefits from economies of scale in distribution and purchasing. Management believes that the use of the distribution centers enables the company to efficiently distribute a broad selection of merchandise to its stores, reduce inventory levels at individual stores, benefit from volume purchasing and maintain inventory control. Due to the large amount of capital required to surpass these hurdles and benefit from economies of scale, the only companies that are poised to enter the industry are those that already have significant land and labor, as well as the ability to compete on price. Companies such as Wal-Mart and Costco fit this description, and they all have already entered the industry.

Furthermore, a potential entrant must spend a significant amount in advertising and marketing costs. It will be difficult for such a firm to overcome the brand loyalty enjoyed by Best Buy, which is usually the first store visited by customers who are in need specifically of consumer electronics, followed by Circuit City. Therefore, even if an entrant is able to compete on prices, it may have trouble getting customers into its stores.

Despite these high barriers to entry, a possible threat of entry may come from a company that invented a new consumer electronics product and kept the distribution rights for itself. However, this scenario seems unlikely as such a company could increase the amount of volume it sells by distributing through other retailers, which would not hurt its ability to control prices. Therefore, due to these factors, as well as the expectations about post entry competition stemming from the internal rivalry within the market, the entry of a significant player in the consumer electronics industry is unlikely.

Substitutes and Complements

Substitutes for the consumer electronics products sold at Circuit City do not pose a serious threat to its profits. The company sells the entire array of consumer electronics products within its stores and other substitutes such as books, attending the cinema or theatre, or other forms of entertainment do not seriously restrict the growth of the industry. Substitutes for the retail service that Circuit City offers, on the other hand, may be a much larger problem. For example, as opposed to buying from a retailer, consumers may buy direct from the suppliers of this merchandise. During fiscal 2007, the five largest suppliers for Circuit City's stores in the United States were Sony, Hewlett-Packard, Samsung, Toshiba and Apple, which accounted for approximately 42 percent of merchandise purchased. All of these companies, except for Samsung, have their products available for sale direct to the consumer. One of the greatest threats to Circuit City is the possibility that consumers increase their purchases from these suppliers and reduce demand for the convenience and service provided by the retailers.

There are many consumer electronics products that serve as complements to each other and do not cannibalize profit margins. For example, DVDs complement DVD players, which complement television sets. As sales of one of these products go up, they all tend to increase;

therefore, it is beneficial to offer a broad spectrum of products at store locations. Additionally, services such as technical support and warranties, which produce higher profit margins, are well complemented by the lower profit margin merchandise the retailer sells. Other complements not sold in Circuit City stores also boost demand for their products. For example, popular television broadcasts with large audiences, such as the Super Bowl, greatly increase television sales. Similarly, popular movies or television shows help increase DVD sales and popular recording artists increase CD sales. As a result, complements greatly aid in increasing revenues for consumer electronic retailers.

Supplier Power

Demand for consumer electronics is very price elastic; consumers generally buy the lowest priced product regardless of retailer brand name due to the lack of switching costs. Consequently, Circuit City has very little supplier power. This is especially the case for consumers who are making more expensive purchases, such as computers and televisions. These consumers research their options, which the Internet has simplified and made costless. Therefore, if any given retailer were to raise prices on a product, it would lose a substantial amount of its sales, thus lowering profits.

Furthermore, after a customer has made one purchase with Circuit City, there is nothing that locks that person into a relationship the corporation. For example, if a customer buys a Samsung television at Circuit City, there is nothing stopping him from purchasing a Sony Blu-Ray Disc Player from Best Buy. Even the Firedog services can be hired to work on merchandise purchased from other retailers. The single exception is that a customer can only buy a warranty on a product purchased from Circuit City. However, almost all other consumer electronic retailers offer extended warranties, leveling the playing field and intensifying the competitive landscape in the market. In conclusion, consumers have many options and can buy electronic goods anywhere they so choose.

Buyer Power

Since Circuit City is the third-largest retailer in the consumer electronics industry and represents a significant portion of its suppliers’ sales, it has a good amount of buyer power.

Even though many of its suppliers have begun to sell their products directly to consumers, a majority of their products are still sold through relationships with third parties. If the market ever evolves so that manufacturer-distributor relationships are no longer necessary to maintain sales, then Circuit City will be in trouble. Currently, management has received no indication that any of its major suppliers will discontinue selling their merchandise to the company and expects that adequate sources of supply will continue to exist in the future for all products.

A major limiting factor of a retailer's buyer power in this industry is the lack of substitute inputs. Although there are many different brands of consumer electronics to choose from, it is in the retailer's interest to provide as many options as possible for its customers. Circuit City already has fewer brand options than some of its competitors, which reduces the value it passes on to consumers. In the competitive industry, the corporation must sustain a broad range of relationships and continually search for new opportunities.

SWOT Analysis

Strengths

- Established, multi-channel model: retail stores, website, and telephone services
- Brand recognition
- Diversified product line and variety of brand options
- Strong industry due to modern status of electronics as general commodities
- 3rd largest market share in the consumer electronics industry
- Restoring customer service: guided sales through the use of tablet personal computers and intensifying training for all sales personnel
- Firedog services aid customers with installation and repair needs
- Roughly 40% of domestic stores have been constructed, relocated or remodeled since 2001

Weaknesses

- Out-dated business model: did not modernize forcing them to engage in a restructuring plan in order to combat current market conditions (old stores are too large in size, no interactive displays, poor lighting, etc.)
- Harsh competitive landscape with numerous rivals: must compete on price and quality

- Price elasticity of demand is extremely high: the lack of switching costs results in no customer loyalty
- Market faces extremely low margins: all retailers engages in cutthroat price wars to capture sales from rivals
- Poor real estate locations
- Poorly listed on evoke set: customers consider competitors first due to reputation
- Customer service: low morale, experience, and productivity among employees after mass firing in 2007
- Few growth opportunities
- Five consecutive quarters of negative net income. Though the latest quarter, 4th quarter of the 2008 fiscal year, experienced a profit.

Opportunities

- Government-mandated conversion to a digital-TV standard by Feb. 17, 2009; thus, households must either buy a digital television or a converter box in order to continue to receive free television
- Focus on website as a primary channel for retail growth
- Exit the market before the situation becomes dire: search for merger possibilities or if conditions worsen, file for bankruptcy

Threats

- Competitive landscape continues to intensify and reduce Circuit City's market share: rivals such as Best Buy, Wal-Mart, Costco, etc. may take over market
- Vendors forwardly integrating creating their own direct channel to customers
- Past performance with negative net income may result in grim financial situation limiting longevity
- Economic conditions may lead to a decrease in consumer spending due to low disposable income
- Sensitive to housing market trend, which may not improve
- Unanticipated increases in costs: labor wages, advertising and marketing costs, etc.

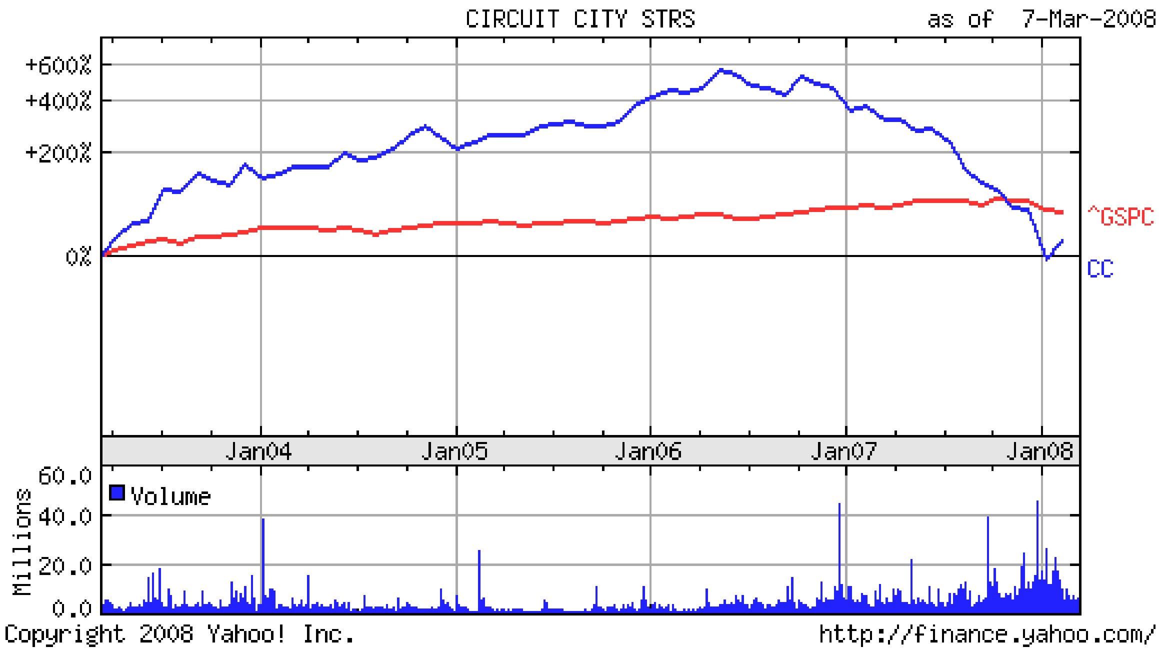
- Inaccurately forecasting customer interests and/or demands resulting in either an inventory excess or shortage
- Failure of restructuring efforts to improve financial situation
- Visibility of price discrepancies over the internet allow customers to compare retailers, which may mitigate revenues and profits if Circuit City does not constantly adjust for market pricing trends
- Seasonal fluctuations could negatively affect financial status
- Dependence upon international suppliers and their economic and political stability including policies, taxation, and the like
- Increase in transportation costs (including oil prices) may adversely affect cost structure
- Transportation interruptions, international or domestic, distressing inventory supply

Financial Analysis

Stock Price

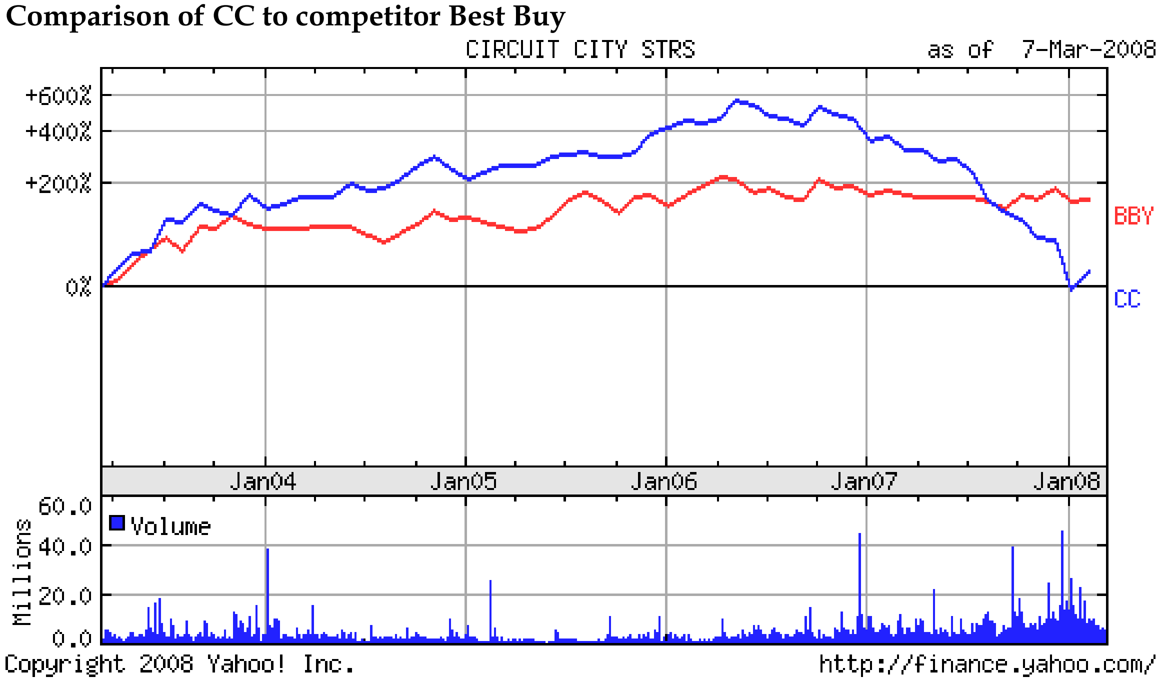
Currently trading at $3.84 per share, Circuit City has a market capitalization of $646.7 million with 168.4 million shares outstanding. As the stock price continues to plummet, the 52-Week High occurred a year ago on March 28, 2007 at $19.60 leaving a -78.7% 52-Week Change. The downfall began after closing at $28.81 the week of October 9, 2006. The chart below illustrates Circuit City's stellar past performance over the last five years, outperforming the S&P 500 until the week of September 17, 2007.

Comparison of CC to S&P 500 Index, from which it was dropped on March 28, 2008.



In a cross-industry analysis with its direct competitor Best Buy, we note that economic and industry related influences affect both similarly until the first three quarters of the 2008 fiscal year, when Circuit City's stock experienced a steady downfall.

Comparison of CC to competitor Best Buy



Several events took place around the beginning of 2007 that aided to market speculation regarding the company and stimulated the stock price downfall: management turnaround, employee restructure, launch of Firedog, acceleration of price competition, greater-than-expected use of Circuit City's Unbeatable Price Guarantee program,[1] and increase of store closings. These issues coupled with the rise of competition with new store layouts and modern displays decreased the value of Circuit City in many investors' eyes. Thus, the company's stock price has now bottomed around $4 a share. The tools used to value stocks further illustrate how far Circuit City now deviates from the industry and its own past performance level:[viii]

Valuation Measure:	CC	BBY	Industry
Price/Earnings Ratio	-2.2	14.2	18.87
Price/Book Ratio	.56	4.8	4.26
Price/Sales Ratio	.07	.5	.73
Price/Cash Flow Ratio	-76.9	7.6	15.68

First, the industry P/E ratio suggests that investor sentiments are optimistic as they expect higher earnings growth, which is also reflect by the healthy P/E ratio for Best Buy. Circuit City's negative ratio exemplifies its troubled state and is truly useless to analyze. Similarly, the less than 1 P/B ratio illustrates the corporation is earning a poor return on assets, -2.19% to be exact while Best Buy is earning 10.83%. Reflecting the current situation and market opinion, either Circuit City will see positive results from their turnaround efforts or the company will have to dissolve in some form. Third, while a low P/S ratio is desirable, Circuit City may contribute the exaggerated ratio of .07 due to their discounted market capitalization. Thus the ratio does not display how much an investor is paying for a dollar of the company's sales, as it should. Instead it presents the problem Circuit City is in as it attempts to recover. Lastly, the P/CF ratio indicates the market's poor expectations of Circuit City's future financial health. In fact, Circuit City was pulled from the Standard & Poor's 500 Index March 28, 2008 due to its extended poor performance within the last two years.

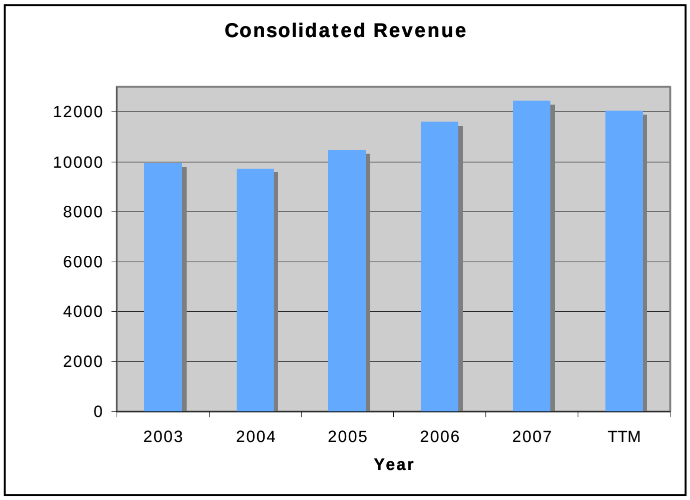
[1] If the customer returned within 30 days from the date of offer with a currently advertised lower price from a local store, Circuit City refunded 110% of the difference between their price and the advertised price.

Profitability

Circuit City's downward trajectory within the stock market only reveals the financial trouble the corporation is in with their disappointing profitability margins. The company's financial struggles are captured through a comparable analysis with Best Buy. Best Buy and Circuit City retail identical products at comparable price points and cost of goods sold in the same cities. However, Best Buy reaped $39.5 billion in revenues with net profit margins of 3.7%[ix] while Circuit City had $12.5 billion in revenues with a negative net profit margin in the 2007 fiscal year. Regardless of their size differences (with 868 domestic and 304 international Best Buy stores, and 654 domestic and 806 international Circuit City stores), average store sales reached $30.7 million per store for Best Buy while Circuit City only saw $8.6 million per store. Taking square footage into consideration (with average domestic square footage for Best Buy being 39,123 square feet and Circuit City being 20,250 square feet), domestic segments for Best Buy earned $914 in revenue per retail square foot and Circuit City stores earned $895 in revenue per selling square foot. Last, Best Buy earned $7.5 million in gross profit per store and $1.1 million in net income per store. On the other hand, Circuit City earned $2 million in gross profit per store and negative $5,671 in net income per store. However, both retailers experienced a decrease in net income due to the poor performance with their international segments. A more in depth analysis of the financial statements will provide us with further information regarding where and how Circuit City is failing.

Revenue

In the 2006 fiscal year, Circuit City experienced a company high of 10.8% growth in revenue. However, that decreased by 360 basis points to 7.2% in 2007, though sales totaled $12.43 billion. For the latest quarter in the 2008 fiscal year, Circuit City has seen a distressing negative 8% growth in revenue.[x] The decline is primarily due to the difficult conditions and the less than desirable 2007 holiday sales. Additionally, comparable sales are down as well. In the 2007 fiscal year, they fell 240 basis points to 5.8%. Below is a graph depicting total consolidated revenue for the past five years, including a value for the trailing twelve months:



Costs and Margins

With timid revenue weakening profitability potential, costs play a crucial role in Circuit City's financial health. Below are key financial statistics for a selection of corporations within Circuit City's peer group.

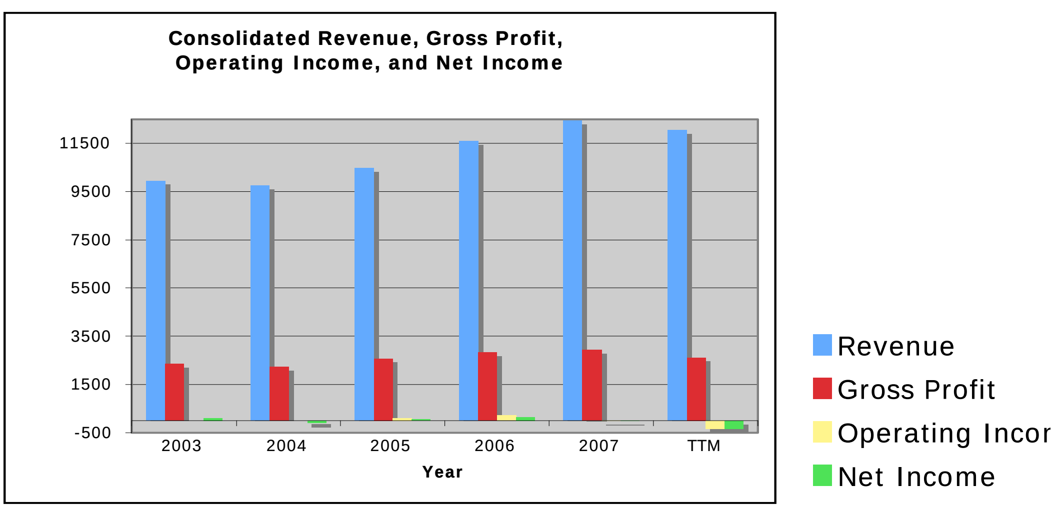
Competitive Landscape[xi]

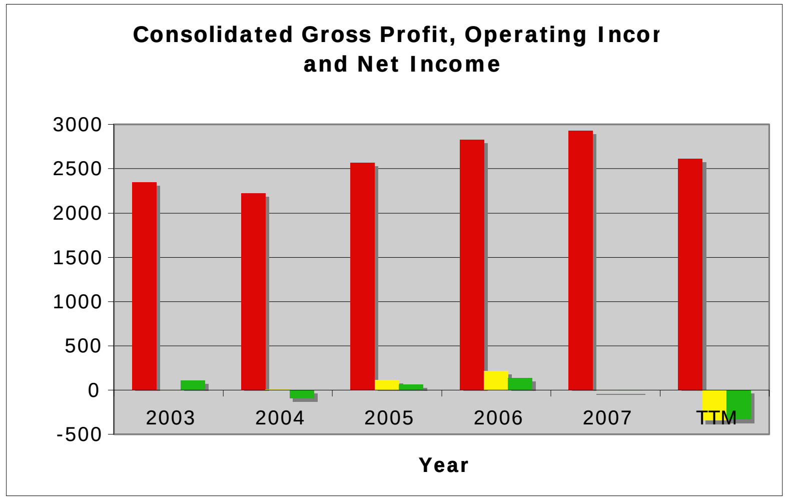
	CC	BBY	DELL	WMT	Industry
Key Statistics					
Revenue (ttm $ bil.)	12.05	40.02	59.61	378.80	4.35
Market Cap ($ bil.)	.647	19.27	45.56	193.43	.849
Employees	46,082	140,000	83,300	1,900,000	3,004,000
Profitability					
Net Income ($ bil.)	-.329	1.41	2.95	12.88	.040
Qrtly Rev Growth (yoy)	-4.50%	4.00%	10.50%	8.40%	7.20%
Gross Margin (ttm)	20.60%	23.85%	19.09%	24.21%	29.45%
Operating Margin (ttm)	-1.50%*	5.53%	5.97%	5.84%	8.52%
Return on Assets	-2.19%	10.83%	10.60%	7.80%	
Return on Equity	-19.85%	24.04%	61.09%	19.67%	
EPS (ttm)	-1.978	3.078	1.325	3.058	1.40

Costs of goods sold are relatively identical across the industry as seen through a vertical common size analysis; however, they still create a problem in the low margin electronic industry. Gross margins for Circuit City (20.6%) are well below its main rival Best Buy (23.85%) and the industry average (29.45%). Therefore, Circuit City is already at a disadvantage being

325 basis points behind its direct competitor. Adding to the profitability strain, operating costs for Circuit City have been historically higher than Best Buy. In the 2007 fiscal year, Circuit City's selling, general, and administrative costs were 23.6% of sales while those for Best Buy were only 18.8%. As a result, operating margins for Circuit City have never been high as the 2007 fiscal year resulted in 0%, 2006 saw 1.9%, and 2005 experienced .8%.

The maintained elevated selling, general, and administrative costs, primarily due to the turnaround plan and price discounting practices, exacerbate the problem Circuit City faces dealing with low product margins. The necessity of the turnaround plan because of low same-store sales growth not only incurs further costs from remodeling and the like, but also interrupts business operations forcing customers to use local competitors while changes are underway. Both of these results have negative impacts upon the financial statements. Additionally, costs have also remained high for Circuit City due to two recent strategic investments in information technology and multi-channel activities, as the corporation seeks to increase revenue streams through new initiatives. The graphs below depict how these expenses combined with decreasing sales erode profits for Circuit City, leaving them with net income of negative $8.3 million for the 2007 fiscal year and negative $329 million ttm.





Due to the highly competitive nature of the existing market resulting in decreasing markup possibility and poor sales, profitability continues to be an issue for Circuit City. Even though the fourth quarter of the 2008 fiscal year resulted in a positive net income, the five preceding quarters were all losses.[xii] For this reason, the operating margin and net income figures are alarmingly negative in the trailing twelve months. These profit issues, especially if not corrected by management in the short-term horizon through drastic measures, will greatly impair Circuit City's ability to pay its maturing obligations in the future.

Liquidity Measures

Consequently, Circuit City must be wary of its potential financial health since cash flows into the corporation simply do not exist as of late. Below are two liquidity measures, the working capital ratio and quick ratio, to try to clarify Circuit City's position. The working capital ratio describes the amount of current assets available to settle each dollar of a current liability. Therefore if the ratio is above one, as it is, the corporation is able to meet maturing obligations. However, the ratio has significantly decreased within the last three years: a bad sign. The quick ratio, on the other hand, does not include non-cash accounts such as inventory and pre-paid expenses; therefore, it is a better indicator for retail stores in Circuit City's position. As we can see below, the quick ratio is less than one signifying that without the sale of inventory, Circuit City cannot pay its current liabilities.

Liquidity Ratios for Circuit City

	2006	2007	2008 ending November 30, 2007
Working Capital Ratio	1.78	1.65	1.27
Quick Ratio	.705	.70	.372

The low quick ratio is primarily due to large stock of inventory Circuit City holds as a percentage of assets (table below). Therefore, the low liquidity measurement in itself is not too alarming. What is distressing, however, is the negative net income Circuit City has been experiencing, as previously discussed. Even though all retail companies depend highly on selling their inventory, Circuit City is in trouble because it isn't selling its inventory, and that will affect its ability to meet its future obligations. The chart below shows how Circuit City is unable to move their merchandise off their shelves and out of their distribution centers in comparison to Best Buy:

Percentage of Inventory Asset

	2005	2006	2007
CC	38.5%	41.7%	40.8%
BBY	27.7%	28.1%	29.7%

Inactive merchandise is the principle cause of the resulting elevated merchandise volume. Thus, as previously discussed, management has embarked on several initiatives to combat the inadequate inventory movement.

Furthermore, the liquidity position represented by the cash conversion cycle, indicates the inefficiency of Circuit City's cash flows as money is tied up in business operations and therefore unavailable for other activities. The length of time between merchandise purchasing payables and receivables for selling those goods to customers is relatively high compared to its direct rival:

Cash Conversion Cycle

	2005	2006	2007
CC	29	30.1	29.7
BBY	5.5	6.3	6.7

The largest factor causing the discrepancy is the difference in inventory turnover rates, as it takes Circuit City about two weeks longer than Best Buy to sell their goods:

Days Inventory

	2005	2006	2007
CC	67.4	65.7	64.1
BBY	49.7	48.9	49.5

Last, cash and cash equivalents have been quickly decreasing on Circuit City's balance sheet. In the 2005 fiscal year, Circuit City held almost $880 million in cash. This decreased by $563.7 million to $316 million in the 2006 fiscal year. Again, cash and cash equivalents fell $174.8 million to $141 million in the 2007 fiscal year. The corporation has primarily been utilizing its cash on purchases of property and equipment, dividend payments, and current investing activities. However, the present low level of cash on hand hurts liquidity, especially as net earnings face negative $329 million ttm.

Evidently, Circuit City management must stimulate a change in the company's performance, if not only for the shareholders but for the future of the company as well.

Strategic Issues and Recommendations

Restructuring efforts have not resulted in the positive outcomes management hoped they would. In fact, considerable losses in the first three quarters of the 2008 fiscal year only indicate that the downward trajectory for Circuit City is approaching a dismal situation in which drastic choices must be made. As CEO Schoonover now seeks to 'rebuild the selling culture' after his aggressive attempts to restructure costs and expenses, such rejuvenation actions are simply not going to improve longevity as an ubiquitous big-box consumer electronics store.

In the competitive market, Circuit City truly does not have many options or opportunities. The corporation cannot reduce costs or expenses any more than it has. Consolidated selling, general, and administrative cost margins fell 90 basis points to 20.2% in the fourth quarter of the 2008 fiscal year from the prior year period.[xiii] If Circuit City halts all turnaround plans, the old store formats in poor locations will not attract customers. Additionally, the corporation cannot capture revenues from its competitors as rivals have done a better job adapting and modernizing to the tastes of the consumer. Circuit City cannot even mold its business to find a special niche within the industry as all stores carry warrantees, offer installation/repair services, and sell the full offerings of brands and products available. The corporation's out-dated business model in the competitive landscape of the electronics industry has put it at an extreme disadvantage.

Before outlining the plan proposed by Harkness, we would like to mention that exit strategies were taken into consideration. Circuit City has recently experienced or is experiencing many indicators that signal future bankruptcy for a corporation: poor inventory control, declining sales, earning losses (even worse, operating losses widening from one period to another), top management turnover in 2006 and potential changes in 2008, employee layoffs in 2007, expense cutbacks through current restructuring efforts, and possible cash flow inadequacy. For this reason, Harkness pondered the cost-benefit analysis of bankruptcy as an exit strategy for Circuit City. The positive effects for filing bankruptcy are the following: petitions filed under Chapter 11 consequently appeal to the Automatic Stay of 362, which states creditors must stop collecting payments and payments are void post-petition. Therefore, bankruptcy protection frees up cash, as the corporation does not need to make debt repayments. Circuit City may then utilize this cash to reorganize its business and aggressively continue the turnaround plan. Additionally, if Circuit City were to file for bankruptcy now and conditions worsened, the corporation would then be able to liquidate assets and pay secured creditors, unsecured creditors, preferred stockholders, and then common stock holders more readily. As a result, bankruptcy would be preferable to all debt holders, especially stockholders who are at the end of the collection line and would receive the remaining cash. However, the current financial situation is not disastrous enough to file for bankruptcy protection; Circuit City can still afford to pay off current obligations and long-term debt coming to maturity. Even though liquidity ratios showed the corporation does not have much flexibility from that perspective, Circuit City holds only $56 million in debt. We at Harkness Consulting believe that once Circuit City enters bankruptcy, the probability of successfully exiting is extremely low. Without comprehensive information on the particularly painful 2008 fiscal year and clarifications on the ambiguities found in the 2007 10-K, Harkness believes it may be premature to file for bankruptcy at this time.

Another possible strategy facing Circuit City is a merger or buyout from another corporation. Due to the low stock price and investor discontent, a large corporation with cash on hand would be able to buy Circuit City at a rather low price. Such a move would be favorable in the market's eye as current shareholders call for a change. At present, Harkness has no suggestions as to what company would find Circuit City to be a profitable acquisition. Therefore, we recommend that Circuit City hire an investment bank to further research this option in addition to executing the accelerated turnaround plan we put forth.

Harkness Consulting finds Circuit City has a chance at survival due to its website as a channel of distribution and its services offered through Firedog. First, the Circuit City website has proven to be a valuable resource for the corporation. Circuit City's eCommerce website received the Future Now Inc.'s 2004 Online Retail Study for Customer Focused Excellence.[xiv] The corporation currently posses a larger online market share comparable to general revenue market share, due to the well-designed and easily manageable online option for customers. In fact, web-oriented sales grew roughly 50% to reach $1 billion during the 2007 fiscal year.[xv] By focusing their efforts on improving this channel of distribution, it could become a main stop for electronics consumers. Second, Circuit City has experienced excellent results, and an increase in net income because of the higher margin obtained with its Firedog brand. In specific, revenues reached $283.2 million in the 2007 fiscal year, as sales grew 29%.[xvi] Moreover, through the services offered by Firedog, Circuit City is able to take advantage of "solution sales" which consist of the cables, batteries, and other accessories needed to carry out the services. As consumers continue to upgrade and enhance their electronics, the assistance provided by Firedog will always be in demand. Thus, Circuit City should focus efforts on promoting and maintaining quality service on these two fronts; additional marketing and training must be done in order to fully take advantage of their profitability potential.

Last, we advise that Circuit City starts the accelerated process of re-evaluating store performance and closing underperforming locations with its stores abroad in Canada. A segmented view of company earnings illustrates how downsizing these locations first may improve financial health:

Segment Performance, Year Ending February 28, 2007						
	Domestic $ in mil.	% of sales	**International** $ in mil.	% of sales	**Consolidated** $ in mil.	% of sales
Net Sales	11,859.6		570.2		12,429.8	
Gross Profit	2,740	23.1%	188.4	33.0%	2,928.3	23.6%
SG&A	2,632.8	22.2%	208.8	36.6%	2,841.6	22.9%
Impairment of goodwill	-	-	92.0	16.1%	92.0	0.7%
Net earnings	97.1	.8%	(107.3)	(18.8%)	(10.2)	(0.1%)

Segment Performance, Nine Months Ending November 30, 2007						
	Domestic $ in mil.	% of sales	**International** $ in mil.	% of sales	**Consolidated** $ in mil.	% of sales
Net Sales	7,692.9		400.3		8,093.2	
Gross Profit	1,527.8	19.9%	144.1	36.0%	1,671.9	20.7%
SG&A	1,898.4	24.7%	136.0	34.0%	2,034.3	25.1%
Impairment of goodwill	-	-	TBD	TBD	-	-
Net earnings	(368.1)	(4.8)%	42.2	10.6%	(325.9)	(4.0)%

Even though the international segment accounts for roughly 5% of Circuit City's revenue, the stores abroad increase financial strain upon the corporation. Impairment of goodwill expenses as well as current costs of restructuring efforts simply erode profits. For example, Circuit City earned $1.4 million in net earnings per domestic store while it suffered a loss of $133,126 per international store in the 2007 fiscal year. Due to poor performance, total international segment stores have decreased by 160 since the 2005 fiscal year. Circuit City acquired the services of Goldman Sachs to explore alternatives and opportunities for InterTAN in the beginning of 2007. Reports indicated the search of a possible sale of this segment. Harkness would like to support the research and analyses of Goldman Sachs and encourage Circuit City to take action upon any of their recommendations.

The accelerated restructuring plan must continue within the domestic segment as well. Therefore, Circuit City ought to increase underperforming store closings, limit remodeling of outdated store formats to reduce costs, relocate to smaller and cheaper site locations once lease agreements mature, and halt expansion plans. One of the greatest expenses Circuit City currently faces is the lease agreements on poorly located, oversized stores. About 94% of the corporation's contractual obligations (about $4.7 billion) are in the form of rent expenses, as Circuit City leases all but five of its domestic stores. Therefore, Circuit City may want to engage in negotiations buying out strategic leases at a cheaper price. Landlords will want to do this as opposed to seeing Circuit City file under bankruptcy protection. Obviously, the means to do so are limited as cash and cash equivalents have been reasonably exhausted as of late.

As outlined by Harkness Consulting, these auxiliary steps must be taken in addition to those CEO Schonoover is proposing. Such measures may significantly improve the health status of Circuit City and help secure longevity as a consumer electronics corporation. Moreover, the accelerated restructuring plan is a step in the right direction for Circuit City as it also readies the corporation for potential bankruptcy. Thus, Circuit City will be able to exit early, if indicators continue to worsen, before the corporation finds itself in a truly desperate situation.

Unless otherwise noted, facts and information obtained from 2007 Circuit City 10-K Report
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information regarding corporate origins in Company History section, unless otherwise noted, obtained from http://investor.circuitcity.com/history.cfm
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[vi] http://finance.yahoo.com/q/hp?s=CC
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