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Kmart and ESL Investments (A)

I admire Mr. Lampert for his bravery, but I really doubt Kmart is going to succeed.[1]

—James Harris, Seneca Financial Group

In February 2003, Kmart Corporation filed its amended reorganization plan with the United States Bankruptcy Court for the Northern District of Illinois in preparation for its planned exit from bankruptcy. After filing for bankruptcy in January 2002, the company had spent the past thirteen months restructuring its operations, its management team and its balance sheet. The company had closed 600 of its 2,100 stores, and rejected or renegotiated hundreds of unprofitable vendor contracts and leases. It had launched numerous initiatives designed to grow sales and improve profitability, and re-signed exclusive licensing deals with key merchandising partners (e.g., Martha Stewart Everyday). Despite these achievements, the press coverage of Kmart's imminent emergence from chapter 11 focused more on the tasks that lay ahead. Many retail industry analysts questioned whether Kmart was ready to come out of bankruptcy and whether management had made the changes necessary for Kmart to succeed going forward. They pointed to continued weak sales trends and negative operating cash flow as evidence that these changes had not yet been made.

One man was betting heavily that they had. Edward S. Lampert, through his hedge fund ESL Investments, had purchased significant stakes in Kmart's discounted pre-petition bonds, loans and trade claims while Kmart was in chapter 11. Lampert had also committed to invest additional capital in Kmart upon its emergence from chapter 11, at which point Lampert and his investment partner, Third Avenue Management, would own an estimated 51% of Kmart's common stock

Kmart's reorganization plan still had to be voted on by its claim holders. These votes were due by April 4, and a hearing to approve the plan was scheduled for April 22.

[1] Amy Merrick, "Kmart Emerges from Chapter 11, Sees 2004 Profit," *The Wall Street Journal*, May 7, 2003, p. B6, via Factiva, accessed January 2008.

Professor Stuart C. Gilson and Research Associate Sarah L. Abbott prepared this case. This case was developed from published sources. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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Background

The Origins of Kmart

In 1889, Sebastian S. Kresge opened the first Kresge store, a 'five-and-dime' general merchandise retailer. Over the years, Kresge expanded his store base, and by 1912, there were 85 Kresge stores generating over $10 million in annual sales.

In 1962, the first Kmart branded store was opened. By 1966, the retail chain had 162 Kmart-branded stores, 73 Kresge stores, and generated over $1 billion in annual sales. Kmart was a leader in the use of advertising, and was the first retailer to sponsor newspaper advertisements.

In the mid-1980s, Kmart's management expanded beyond discount general merchandising, acquiring other types of retail operations, including OfficeMax, an office supply retailer; Sports Authority, a sporting goods retailer; and two book retailers, Walden Books and Borders. However, this experiment in alternative retailing formats was relatively short-lived, and by the mid-1990s Kmart had divested itself of all of these businesses.

Kmart opened its first 'supercenter' in 1991. Supercenters were significantly larger than traditional Kmart stores and carried food and groceries in addition to general merchandise. While grocery items tended to have lower gross margins, they were important in driving store traffic as customers tended to purchase these goods more frequently. Kmart supercenters were open seven days a week, 24 hours a day, and included full-service bakeries and video stores. Supercenter-type shopping centers had been popular in Europe for years. In the United States, the concept was introduced in 1988 by Kmart's competitor, Wal-Mart. Following the initial concept launch, both Wal-Mart and Kmart aggressively rolled out supercenters nationwide.

By 2001, Kmart was the third-largest discount retailer and the fourth-largest general merchandise retailer in the United States. It operated 2,114 stores, including 136 supercenters, located in all 50 states, Puerto Rico, U.S. Virgin Islands, and Guam. In a 2003 court filing the company noted: "Approximately 75% of the U.S. population shops at Kmart each year, and about 85% of the U.S. population lives within 15 miles of a Kmart store."[2] Kmart stores were mostly free-standing, one-story units, ranging in size from 40,000 to 190,000 square feet, with an average size of 98,000 square feet. The stores tended to be located in more urban areas, with locations in 300 of the U.S.'s 324 metropolitan statistical areas.[3]

The Discount Retailing Industry

In 1960, discount retail stores in the United States generated $2 billion in annual sales. By 2000, industry annual sales had grown to $200 billion, reflecting a wide range of discount retail formats including discount department stores, discount specialty stores, membership/warehouse clubs, and traditional discount stores.[4]

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[2] Kmart Corp, February 25, 2003. Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and Its Affiliated Debtors and Debtors-in-Possession (Chicago: United States Bankruptcy Court for the Northern District of Illinois, Eastern Division, 2003), p. iv.

[3] A metropolitan statistical area, as defined by the U.S. Office of Management and Budget, "contains a core urban area of 50,000 or more population." (Source: http://www.census.gov/population/www/estimates/metroarea.html, accessed January 2008.)

[4] Standard & Poor's, "Retailing General. Industry Profile. How the Industry Operates" (Industry Survey), November 29, 2001, p. 16 (accessed through NetAdvantage, February 2008).

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The discount store segment in the United States was dominated by Wal-Mart, Target, and Kmart, generating 2002 sales of $157 billion, $37 billion and $31 billion, respectively.[5] Each company pursued a distinct sales strategy. Wal-Mart was the low-price leader. Sophisticated use of technology and strong buying muscle helped to keep inventory costs down. In 1991, Wal-Mart launched Retail Link, which provided 3,200 vendors with detailed inventory information allowing them to monitor in-stock levels, and re-stock merchandise as necessary. Wal-Mart relied primarily on an Every Day Low Pricing (EDLP) pricing strategy, keeping prices consistently low rather than running weekly promotions. This allowed for lower advertising expenditure. However, "rollbacks" – price cuts on high volume items – were used selectively to generate customer excitement and increase store traffic. In addition to low prices, Wal-Mart management focused on delivering a positive customer experience, with clean, bright stores and "greeters" employed to welcome customers upon entering stores. In 2002, Wal-Mart operated 2,875 stores, including 1,258 supercenters, in the United States, with the highest concentration of store locations in suburban and rural areas. The median household income of a typical Wal-Mart customer was approximately $25,000.

Target, on the other hand, focused on a more upscale customer segment. In 2002, its customer base had a median household income of $43,000, and more than 75% had attended college. Target's advertising tagline was "Expect more. Pay less." Its merchandise assortment was considered more up-market and more fashion-forward than Wal-Mart or Kmart. Target operated 1,147 stores, including 94 SuperTargets. Target utilized a promotional pricing strategy, and also relied heavily on brand-building television and print ads.

Like Wal-Mart, Kmart's customer base had a median household income of approximately $25,000. Kmart used a promotional pricing strategy; in 2001, advertised items accounted for 30% of sales. Kmart's systems and inventory management capabilities were generally thought to be inferior to those of its peers. However, industry analysts did give Kmart credit for its successful private label strategy. As one analyst commented, "…Kmart has distilled its private brand strategy from hundreds of labels with little customer acceptance to a few focused products that offer value to its customers."[6] Most notably, Kmart's Martha Stewart line launched in 1997 had expanded to more than $1 billion in sales by 2001.[7]

Despite this, Kmart was struggling to compete, and lagged its peers on key operating metrics such as gross margin, sales per square foot, and sales growth.[8] (See **Exhibit 1**.)

The Road to Chapter 11

Events surrounding the 2001 holiday season brought this struggle to a critical juncture.

In mid-2000, Charles Conaway was hired as the new CEO of Kmart. Conaway had previously served as CEO of CVS, the nationwide chain of drug stores. Upon joining Kmart, Conaway launched a comprehensive review of the retailer's operations, and within two months announced plans to close

[5] For Wal-Mart and Target, those sales statistics were for their U.S. discount store divisions only, excluding warehouse clubs and department stores.

[6] Standard & Poor's, *op. cit.*, p. 17.

[7] "Kmart files for bankruptcy protection," *The Cambridge Reporter*, January 23, 2002, p. A7, via Factiva, accessed March 2008.

[8] A popular sales growth metric in the retail industry is year-over-year growth in same store sales. This ratio measures annual sales growth in those stores which have been open for more than one year.

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72 stores and overhaul Kmart's information systems. In August 2001, Conaway launched his most aggressive initiative, dubbed 'BlueLight Always,' lowering prices on over 30,000 products and effectively starting a price-war with Wal-Mart. The goal was to cut the average premium of Kmart's prices over Wal-Mart's prices from 9% currently, to between 1% and 2%.[9] To help fund the price cuts, Conaway slashed Kmart's advertising expenditures. He also aggressively ordered inventory in preparation for the 2001 holiday season.[10]

However, holiday sales proved disappointing for Kmart. Year-over-year 2001 December same store sales declined 1%, versus same store sales growth of 8% and 10% for Wal-Mart and Target, respectively. On January 10, 2002, Kmart's management informed the market that Kmart would miss analysts' quarterly earnings estimates.

The pressure on Kmart's earnings and cash flow was further exacerbated by turmoil in the surety bond market.[11] Kmart had historically been self-insured for certain liabilities (e.g., related to workers' compensation and gun sales), and management had backstopped this with surety bonds, as required by state regulators. Following the Enron scandal, however, liquidity in the surety bond market had dried up, forcing Kmart to purchase alternative insurance coverage at significantly higher premiums.

While management did not share the details of Kmart's liquidity issues publicly, it became evident that there was a problem. There were rumors that Kmart was scrambling to secure additional financing, and vendors started delaying shipments to the company, fearing they would not get paid. A poll of Kmart vendors in mid-January showed that only a third were still shipping merchandise to the company on normal terms, while the rest had either delayed or stopped shipping. A spokesperson for Scotts Company, a manufacturer of garden products, told the *Wall Street Journal*, "We thought it would be most prudent to hold back in the event they [Kmart] choose to file chapter 11…There's no reason to incur risk without visibility."[12]

A number of leading factoring firms also stopped lending to Kmart vendors.[13] Century Business Credit, one of the five-largest U.S. factoring firms, acknowledged that it was no longer extending credit to manufacturers who shipped to Kmart. Tyco Capital was also rumored to be unwilling to increase its already sizable exposure to Kmart. But a spokesperson for Capital Factors Inc. expressed a more optimistic view of Kmart's situation: "Obviously, we're all keeping our fingers crossed … But they have the liquidity and my gut feeling is, the bank facility will be put in place."[14]

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[9] Ann Zimmerman and Amy Merrick, "Kmart Rivals Appear to Benefit from BlueLight," *The Wall Street Journal*, September 7, 2001, p. B1, via Factiva, accessed February 2008.

[10] The holiday season is critical for retailers. In fiscal year 2001, Kmart generated 30% of total net sales it its fourth quarter (the three months ended January 30, 2002). $5.5 billion in revenues, or 15% of total annual revenues, were generated in December alone.

[11] A surety bond (in some situations known as a "performance bond") is a contract among a principal, an agent, and a third party who guarantees the performance of the principal under the contract. In return for guaranteeing the principal's performance, this third party (the "surety") is typically paid an annual fee by the principal. In most commercial situations surety guarantees are provided by regulated insurance companies.

[12] Amy Merrick, "Kmart Suppliers Limit Risk in Case of Chapter 11 Filing," *The Wall Street Journal*, January 21, 2002, p. A4, via Factiva, accessed January 2008.

[13] Factoring firms purchase receivables, at a discount and on a non-recourse basis, from their manufacturing customers. By selling their receivables, manufacturers/vendors receive cash up-front and limit their credit exposure to their retail customers.

[14] James Covert, "Suppliers Await News from Kmart Amid Bankruptcy Fears," *Dow Jones News Service*, January 16, 2002, via Factiva, accessed March 2008

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On January 17, Charles Conaway was replaced by Jim Adamson, a Kmart director who had steered the restaurant company Advantica through the bankruptcy process earlier in his career. Mark Schwartz, Kmart's president and a Conaway hire, also resigned.

On January 21, Fleming Companies, the exclusive supplier of all of Kmart's food products and other consumables, announced that it had ceased shipping goods to Kmart following a missed payment the previous week. An emergency meeting of Kmart's board of directors was called for later that day, and on January 22, Kmart and 37 of its U.S. subsidiaries filed for protection under chapter 11 of the U.S. Bankruptcy Code in the United States Bankruptcy Court for the Northern District of Illinois, Eastern Division. The Honorable Susan Pierson Sonderby was appointed to preside over the bankruptcy.

Over the preceding year, Kmart's common stock price had fallen from a high of $13.55 to just 66 cents on the day it filed for bankruptcy. At the time of filing, Kmart had assets of $14 billion and shareholders' equity of $4 billion. With 2001 fiscal year sales of $36 billion, it was the largest U.S. retailer ever to file chapter 11. (See **Exhibit 2** for Kmart's historical financial statements.)

Debtor-in-Possession

> *After considering a wide range of alternatives, it became clear that this course of action was the only way to truly resolve the company's most challenging problems.*[15]
>
> — Charles Conaway

Kmart's board of directors announced that it planned to "fast-track" the chapter 11 process and to emerge from bankruptcy by July 2003. While operating under court protection, the company planned to undertake a host of operating and financial restructuring initiatives, including "the elimination of unprofitable stores and leases, improvement of store operations and inventory management, and the restructuring of its balance sheet through the conversion of all debt into equity."[16] Various provisions in the Bankruptcy Code made it easier to pursue these initiatives. One such provision was the "automatic stay," which prevented secured creditors from seizing collateral while a company was in chapter 11.[17]

In conjunction with the filing, Kmart filed several "First Day Motions."[18] Through these motions, Kmart sought approval to pay employees, hire bankruptcy advisors, pay the pre-petition claims of "critical" vendors, and reject leases on closed stores, among other actions.

Kmart's management also worked with a consortium of lenders to put together "debtor-in-possession" (DIP) financing. DIP financing provided a debtor with funding to continue its business operations. Under the priority of claims specified in the Bankruptcy Code, obligations such as DIP financing that arose while the firm was in chapter 11 ("post-petition claims") had priority over the

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[15] Amy Merrick, "Kmart Lays Out Plans to Trim its Size, Increase Efficiency in Bankruptcy Filing," *The Wall Street Journal*, January 23, 2002, p. A3, via Factiva, accessed January 2008.

[16] Disclosure Statement, p. v.

[17] The automatic stay is an "injunction that automatically stops lawsuits, foreclosures, garnishments, and all collection activity against the debtor the moment a bankruptcy petition is filed." (Source: http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/glossary.html, accessed March 2008.)

[18] First Day Motions are customarily filed with the court on the same day a Debtor files for chapter 11. These motions are filed to ensure that the Debtor can continue to operate its business while in chapter 11. Areas frequently covered by First Day Motions include payment of vendors and employee compensation.

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firm's unsecured pre-petition claims, and had to be paid as they came due. Pre-petition claims, in contrast, could not be paid while the debtor was in chapter 11, unless the bankruptcy court authorized such payment. The court approved $1.15 billion of a proposed $2 billion DIP loan facility in late January, and approved the balance of the facility in March. The loan had a floating interest rate equal to the prime rate plus 250 basis points or LIBOR plus 350 basis points, at Kmart's option. Covenants in the facility restricted capital expenditures and required Kmart to report a minimum level of EBITDA, among other things.

Days after the bankruptcy filing, in accordance with Section 1102 of the Bankruptcy Code, an unsecured creditors' committee was appointed to represent Kmart's trade vendors and other general unsecured creditors. In addition, the judge approved the formation of a financial institutions' committee and an equity committee. These committees could hire financial and legal professionals to advise them during the case, and charge any resulting expenses to the company.

In September 2002, representatives of ESL Investments and Third Avenue Management, two investment funds that specialized in purchasing the claims of financially distressed companies and that had acquired significant stakes in Kmart's debt, were added to the financial institutions' committee.

Senior Management Changes

In the first half of 2002, most of Kmart's senior managers were replaced. Ronald Hutchinson joined Kmart as chief restructuring officer; Julian Day was hired from Sears Roebuck to serve as Kmart's COO and president; and Albert Koch, chairman of turnaround specialist Jay Alix & Associates, became CFO.

In January 2003, Julian Day replaced Adamson as CEO. This personnel change was rumored to be the work of Edward Lampert of ESL Investments, who was perceived to be frustrated with the pace with which Adamson was taking the company through chapter 11.[19]

Kmart's board also fired five other senior executives who had been beneficiaries of a controversial forgivable loan program. The program, which had been authorized in late 2001 by then-CEO Chuck Conaway, awarded 25 Kmart executives $28 million in forgivable loans shortly before Kmart filed for bankruptcy. The loans were purported to be a retention tool, but a subsequent internal investigation concluded that Kmart's board of directors had been deliberately misled about the details of the program.

Store Closings

At the time it filed for chapter 11, Kmart had 2,114 stores and employed 234,000 people. Two months later, in March 2002, Kmart received court approval to close 283 stores located in 40 states and Puerto Rico. In connection with these closings, Kmart eliminated 32,000 jobs, and raised $633 million from the sale of inventory. In January 2003, the company obtained court approval to close an additional 317 stores in 44 states. This second round of store closings was expected to generate 35,000 additional layoffs and raise $500 million from the sale of inventory and selected store leaseholds.

In determining which stores to close, management considered a range of factors, including historical and projected operating results, the local competitive environment, store age and size,

[19] Mitchell Pacelle and Amy Merrick, "Salvage Operation: Behind Kmart Exit From Chapter 11: Investor's Big Bet—As Debt He Held Lost Value, Mr. Lampert Forced Out CEO, Pushed Up Timetable— Still Facing Wal-Mart, Target," *The Wall Street Journal*, May 6, 2003, p. A1, via Factiva, accessed January 2008.

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capital expenditure requirements, and the lease-to-value ratio. Of the 600 stores that were closed or targeted for closure, 246 were considered 'low volume' locations (below $12 million in annual sales).

These store closings were facilitated by Section 365 of the Bankruptcy Code, which addressed how a debtor should deal with claims arising from store leases and other so-called "executory contracts."[20] In January 2002, Kmart was party to more than 5,000 leases or subleases with 3,240 separate landlords and sub-tenants. All but 133 of its U.S. stores were leased. These leases generally had an initial term of 25 years, with subsequent five year extension options. A standard "going-dark" provision in the leases stipulated that the leased property had to be continuously operated or Kmart would be in default and subject to eviction. Many of Kmart's leases were thought to be at rates well above current market levels.[21]

Under Section 365, Kmart could choose to assume or reject each store lease as it saw fit.[22] The Bankruptcy Code gave a debtor 60 days from the time it filed for Chapter 11 to make this decision, although management could ask the judge to extend this window. Extensions could be substantial. In February 2003, in connection with the second round of 317 proposed store closings, Kmart asked the court to extend the window to assume or reject store leases to 270 days *after* the date on which its reorganization plan became effective.

To more effectively manage the daunting process of closing hundreds of stores in a relatively short time period, in mid-2002 Kmart elected to sell "designation rights" in certain of these properties to a group of purchasers led by Kimco Realty Corporation, Schottenstein Stores Corporation, and Klaff Realty, LP. Under the designation rights sale agreement, the purchasers paid Kmart $46 million for the exclusive right to determine how each of 56 leased stores targeted for possible closure would be treated under Section 365, and whether each store lease would be assumed or rejected. If a given store lease was assumed, the purchasers could also require Kmart to assign the lease to a third party of the purchasers' choosing. In a lease assignment, this third party (the "assignee") would take over servicing the original lease and be able to occupy the property. The right to take over a below-market lease was therefore a valuable asset that an assignee would be willing to pay for. Although lease contracts generally contained restrictions on assignment, some bankruptcy courts had invalidated these restrictions on the grounds that doing so would benefit all creditors.[23]

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[20] An executory contract is a formal agreement in which each party to the agreement has an ongoing obligation to the other. Leases, supply contracts, and licensing agreements are all examples of executory contracts.

[21] For example, with respect to 13 stores that Kmart closed that were owned by Kimco Realty Corporation, the largest shopping center company in the United States, a CIBC analyst estimated that the properties were worth about $5-7 per square foot (annual rent expense) versus the $10 that Kmart was paying. (Source: Dean Starkman, "Kimco Trims Earnings Estimates Due to Woes of its Tenant, Kmart," *The Wall Street Journal*, January 23, 2002, p. A6, via Factiva, accessed January 2008.)

[22] If a contract was assumed, both contracting parties were obligated to continue performing under the contract, provided any arrearages or defaults under the contract were cured. They were also free to renegotiate the contract terms. If a contract was rejected, on the other hand, the debtor could in effect "walk away" from its obligation under the contract, and the other party would be entitled to assert a claim in bankruptcy court for any resulting economic damages. This claim would be treated as an unsecured pre-petition claim, *pari passu* with the debtor's other pre-petition unsecured claims. In the case of non-residential property leases, the damages that could be claimed by landlords for non-payment of past and future rents could be capped at a level that was significantly less than the payments contractually owed under the lease.

[23] See William F. Taylor, Jr. and James A. Tiemstra, "'Designation Rights' Sales: Triumph of Expedience Over the Code?," *American Bankruptcy Institute Journal*, September 2001.

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By February 2003, Kmart had rejected over 340 leases on closed stores. Kmart had also renegotiated 80 leases, resulting in $12 million in annual rental expense savings. Overall, Kmart's average rent expense per square foot declined from $4.40 to $3.99.[24]

Vendor Relationships

As Kmart went into chapter 11, it had relationships with approximately 4,000 vendors. Kmart's primary short-term objective with respect to its vendors was to make sure they had incentives to continue shipping merchandise to its stores. To this end, Kmart sought a First Day Motion from the bankruptcy court authorizing it to pay the pre-petition claims of certain "critical vendors." Among others, these vendors included Fleming Companies, the exclusive supplier of Kmart's groceries (owed $76 million by Kmart when it filed for bankruptcy); Handleman, the exclusive supplier of music to Kmart (owed $65 million); egg and dairy vendors (owed $13.5 million); and liquor vendors. On January 24 and February 13, this motion to pay critical vendors was granted. However, one of Kmart's creditors, Capital Factors Inc., challenged the validity of this order in the U.S. District Court of Chicago, arguing that payments made under the critical vendors order (approximately $367 million in aggregate) were in violation of the Bankruptcy Code.[25] (See **Exhibit 3** for detail on this and other Kmart vendor programs.)

Kmart also used the chapter 11 process to renegotiate several key vendor contracts. Its contract with Cardinal Health, Inc., which supplied Kmart with most of its prescription drugs and accounted for $3 billion in sales in 2002, was renegotiated to provide more favorable pricing and terms. A number of Kmart's exclusive licensing deals were also renegotiated. Most of these contracts gave the licensee the right to terminate as a result of Kmart going into chapter 11. However, given the importance of the Kmart contract to these parties, most of them opted to work with Kmart.[26]

In early 2003, after a year operating in Chapter 11, Kmart also decided to reject its supply contract with Fleming Companies, after intensive negotiations to restructure the contract had failed. Contract rejection was again achieved through use of Section 365 of the Bankruptcy Code. Under the 10-year contract, originally signed in February 2001, Fleming was to supply Kmart with "substantially all (of its) food, consumables and core pantry products."[27] In the year prior to Kmart's chapter 11 filing, Fleming products had accounted for $4.2 billion (11%) of Kmart's annual revenues. In lieu of this relationship, Kmart chose to self-distribute its groceries, using distribution center capacity freed up by it store closings. Management estimated this would generate cumulative cost savings of $450 million through 2006.[28] (See **Exhibit 4** for selected data on Fleming Companies.)

Sales growth initiatives

In an effort to improve lackluster sales trends, Kmart also rolled out or tested a number of marketing initiatives. It eliminated its BlueLight Always program, emphasizing its "roots as a

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[24] Disclosure Statement, p. 65.

[25] Vicki M. Young, "Kmart's Rocky Road—$1BN Creditors Reject Bankruptcy Exit Plan," *Women's Wear Daily*, April 15, 2003, p. 1, via Factiva, accessed March 2008.

[26] For example, Kmart accounted for 29% of Martha Stewart Everyday's 2001 operating income (excluding losses from its internet business). Source: Amy Merrick and Matthew Rose, "Martha Stewart's Kmart Alliance: A 'Good Thing?'," *The Wall Street Journal*, January 16, 2002, p. B1, via Factiva, accessed January 2008.

[27] Kmart Corporation, March 24, 2003 10-K , p. 7.

[28] Disclosure Statement, p. vi.

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high/low retailer."[29] It shifted its focus from predominantly price-based strategies towards exclusive product offerings. It targeted more marketing expenditures and product offerings directly at Hispanics and African-Americans, the two fastest growing population segments. It gave store managers greater discretion to buy inventory in order to better tailor store offerings to local tastes. And it experimented with new store layouts, featuring wider aisles, new signage, and better lighting.

The Equity Investment

On January 24, 2003, Kmart signed an equity investment agreement with ESL Investments ("ESL") and Third Avenue Management ("Third Avenue"). This agreement would provide Kmart with cash that it needed to settle its pre-petition debt and recapitalize the company.

ESL Investments was a hedge fund based in Greenwich, Connecticut, bearing the initials of its founder Edward S. Lampert. Prior to starting ESL in 1988, Lampert had worked in risk arbitrage at Goldman Sachs, and then with Texas-based investor Richard Rainwater. In 2003 ESL had more than $5 billion in assets under management, including large holdings in AutoZone, Footstar, Inc., and Sears, Roebuck & Company (in which ESL held an 8.9% equity stake).[30]

Headquartered in New York, Third Avenue was led by Martin Whitman, a 77 year-old Wall Street veteran and former adjunct professor at Columbia University. Third Avenue managed $5.6 billion in assets, including its $2 billion flagship Third Avenue Value Fund.

Both ESL and Third Avenue had purchased significant amounts of Kmart's public bond, bank and other debt in the secondary market at significant discounts to face value. At the beginning of 2003, ESL and Third Avenue respectively held $1.6 billion and $178 million (in face value) of Kmart's unsecured debt. (See **Exhibit 5** for more detail on these holdings.) Investors who purchased the debt of financially distressed companies were sometimes known as "vulture investors." They pursued a variety of strategies, often attempting to profit through participation in a bankruptcy reorganization or liquidation.

The equity investment agreement called for ESL and Third Avenue to invest $140 million in cash in Kmart as part of its chapter 11 plan of reorganization. In exchange, the investors would receive 14 million common shares in the newly reorganized company. Both investors would receive additional common stock in exchange for their holdings of Kmart pre-petition bond and trade claims. And ESL had agreed to swap its holdings of Kmart bank debt for new Kmart stock in lieu of the cash that the other members in that class were due to receive. Giving full effect to Kmart's reorganization plan, ESL would hold approximately a 46% of Kmart's equity, and Third Avenue would own 5%.[31]

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[29] Kmart Corporation, March 24, 2003 10-K (Troy: Kmart Corporation, 2003), p. 6, via http://www.sec.gov/, accessed February 2008.

[30] Sandra Jones, "Stealth Investor is taking a big bite of Big Store," *Crain's Chicago Business*, April 7, 2003, p. 3, accessed via Factiva, March 2008.

[31] ESL's equity ownership could increase still further following Kmart's exit from bankruptcy, as it had agreed to invest up to an additional $60 million in cash, as needed by Kmart, in return for a convertible note. ESL was also given a two-year call option to purchase up to $86 million in common stock at $13 per share. (Source: Kmart Corporation, February 25, 2003. First Amended Joint Plan of Reorganization of Kmart Corporation and Its Affiliated Debtors and Debtors-in-Possession, p. 132).

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Plan of Reorganization

On February 25, 2003, Kmart submitted its amended disclosure statement detailing its plan of reorganization. The disclosure statement was sent to all of Kmart's claimholders who were entitled to vote on the plan.

Under the proposed plan, pre-petition claims would largely be settled with new stock in the reorganized company. Kmart's financial advisors estimated that the company's post-reorganization equity value was approximately $1,128 million, or $13.09 per newly issued share. (**Exhibit 6** presents Kmart's financial projections underlying its reorganization plan, and **Exhibit 7** summarizes the valuation analyses done by Kmart's advisors.)

Secured creditors, representing largely real estate mortgages and other priority claims, were the only claimholders who would be paid in full. The plan called for the remaining classes of creditors to be paid an amount significantly less than their allowed claims.

Kmart's pre-petition bank loans (with a face value of approximately $1.1 billion) presented one of the biggest challenges to reaching a settlement. These loans had been guaranteed by certain subsidiaries of Kmart. These subsidiaries had substantial assets, and the pre-petition bank debt holders asserted they had first claim on these assets. Other parties, most notably members of the general unsecured creditors' committee, challenged this argument. They claimed that the subsidiaries were not truly separate entities (so that their assets should be available to all creditors) and that, moreover, the subsidiaries had acquired the assets through "fraudulent transfers."[32] Eventually, it was agreed that bank claim holders would receive a cash payment equal to 40% of their allowed claims.

Unsecured bondholders, holding approximately $2,277 million of debt in face value, would receive $327 million in Kmart shares, for a 14% recovery rate. Trade claims, aggregating approximately $4.3 billion, would receive $430 million worth of Kmart shares, for a 10% recovery. Trust preferred and common shares were cancelled and would receive nothing under the reorganization plan.

Finally, a "creditor trust" was established to administer any proceeds from litigation pursued by Kmart. These proceeds were to be distributed to its creditors, trust preferred holders, and common equity holders.[33] (See **Exhibit 8** for a detailed summary of Kmart's reorganization plan.)

Augmenting the equity investment by ESL and Third Avenue, Kmart would raise additional cash to fund the reorganization through a $2 billion "exit financing" facility that it had arranged with a consortium of investors including Bank of America, FleetBoston, and GE Capital. The financing would be structured as a three-year term loan, secured by inventory, and would become available to Kmart once it emerged from chapter 11.

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[32] Under Sections 344 and 348 of the Bankruptcy Code, if assets were initially transferred from the parent company to a subsidiary in exchange for consideration that was less than the assets' "fair value," the transfer could be deemed fraudulent and be nullified.

[33] On January 21, 2203, Kmart filed with the court the results of an internal investigation into the alleged misconduct of a number of former executives. According to the investigation, several former executives had been "grossly negligent" in carrying out their duties, and at least ten had breached their employment contracts. In addition to participation in the forgivable loan program, charges included over-purchasing inventory and underpaying vendors. Kmart's board planned to pursue legal action against some of these executives with any monetary proceeds from these actions to be contributed to the creditor trust.

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Claimholders who were "impaired" under the reorganization plan would be entitled to vote on the plan. Voting would take place by classes of claims. A given class would be deemed to accept the plan if at least two-thirds of the face value of claims represented in the class, and at least one-half of the number of holders in the class, voted for the plan. A prerequisite for confirming the plan was that all impaired classes of claims had to accept the plan. If one of more classes rejected the plan, the judge could still confirm the plan over the objections of the dissenting classes, but this would require a special hearing to determine whether such a "cram down" was warranted.

Looking Forward

In explaining the rationale for emerging from bankruptcy at this time, Kmart's management stated:

> Although Kmart has accomplished many important goals through the tools afforded by Chapter 11, Kmart believes that the prospects for further operational improvement will be best achieved outside of Chapter 11. There are continued costs of remaining in Chapter 11 that Kmart believes warrants emergence at this time, including the administrative costs of the Chapter 11 process and the continued diversion of management time by the Chapter 11 proceedings.[34]

Whether the significant actions taken in chapter 11 would be enough to return the retailer to profitability remained to be seen.

[34] Disclosure Statement, p. v.

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Exhibit 1a Peer Analysis—Selected Financial and Market Data ($ in millions)

Company	Market Value	Enterprise Value[a]	Enterprise Value to: Sales	Enterprise Value to: EBITDA[b]	Price/ Earnings	Gross Margin	SG&A/ Sales	EBITDA Margin
Wal-Mart	$217,409	$239,776	0.98x	14.1x	27.0x	21.5%	16.8%	7.0%
Target	26,031	36,434	0.83	8.1	15.7	33.4	21.4	10.2
Kmart						18.8%	21.3%	0.1%

Note: Market data is as of February 21, 2003. Financial information is as of, or for the fiscal year ended, January 29, 2003.

Source: Company financials. Historical equity pricing data supplied by FT.com, via Capital IQ, accessed March 2008.

[a]Equity market value plus net debt.

[b]Earnings before interest, tax, depreciation and amortization expense.

Exhibit 1b Peer Analysis—2002 Sales Productivity and Growth Statistics

	Wal-Mart	Kmart	Target
Total Division Sales ($millions)	$157,121	$30,762	$36,917
Total Stores (year-end)	2,875	1,514	1,147
Total Square Footage (000's)	388,685	139,000	140,255
Average Sales Per Square Foot	$422	$212	$278
Same Store Sales Growth (year-to-year):			
2001			
Q1	3.5%	1.7%	2.8%
Q2	5.6%	1.0%	3.4%
Q3	6.7%	(1.5%)	3.0%
Q4	7.2%	2.1%	6.2%
2002			
Q1	8.6%	(8.8%)	6.8%
Q2	7.1%	(11.0%)	4.4%
Q3	4.2%	(7.6%)	1.0%
Q4	3.3%	(9.8%)	(1.1%)

Note: Wal-Mart's statistics are for its U.S. Wal-Mart stores division. Target's statistics are for its Target stores operating segment.

Source: Company financials.

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Exhibit 2a Kmart Corporation, Consolidated Statements of Earnings ($ in millions, except per share data)

	2001	2000	1999
Sales	$36,151	$37,028	$35,925
Cost Of Sales	29,853	29,732	28,161
Gross Margin	6,298	7,296	7,764
Selling, general and administrative expenses	7,588	7,366	6,569
Equity income (loss) in unconsolidated subsidiaries	0	(13)	44
Restructuring, impairment and other charges	1,091	0	0
Continuing (loss) income before interest, reorganization items, taxes and dividends on convertible preferred securities	(2,381)	(83)	1,239
Interest Expense, net	344	287	280
Reorganization items	(183)	0	0
(Benefit from) provision for income taxes	0	(148)	315
Dividends on convertible preferred securities, net of income tax	70	46	50
Net (loss) income from continuing operations	($2,612)	($268)	$594
Discontinued operations, net	166	0	(230)
Net (loss) income	($2,446)	($268)	$364
BASIC EARNINGS (LOSS) PER COMMON SHARE			
Net (loss) income from continuing operations	($5.29)	($0.53)	$1.21
Discontinued operations	0.34	0.00	(0.47)
Net (loss) income	($4.95)	($0.53)	$0.74
DILUTED EARNINGS (LOSS) PER COMMON SHARE			
Net (loss) income from continuing operations	($5.29)	($0.53)	$1.15
Discontinued operations	0.34	0.00	(0.41)
Net (loss) income	($4.95)	($0.53)	$0.74
Basic weighted average shares (millions)	494.1	482.8	491.7
Diluted weighted average shares (millions)	494.1	482.8	561.7

Note: Years ended January 30, 2002, January 31, 2001 and January 26, 2000.

Source: Disclosure Statement.

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Exhibit 2b Kmart Corporation, Consolidated Balance Sheets ($ in millions)

	2001	2000
TOTAL ASSETS:		
Cash and Cash Equivalents	$1,245	$401
Merchandise inventories	5,796	6,350
Other current assets	800	925
Total Current Assets	$7,841	$7,676
Property and equipment, net	6,093	6,522
Other assets and deferred charges	249	617
Total Assets	$14,183	$14,815
TOTAL LIABILITIES & EQUITY:		
Long-term debt due within one year	$0	$68
Accounts payable	89	2,190
Accrued payroll and other liabilities	420	1,691
Taxes other than income taxes	143	187
Total Current Liabilities	$652	$4,136
Long-term debt and notes payable	$330	$2,084
Capital lease obligations	857	943
Other long-term liabilities	132	883
Total Liabilities not subject to compromise	$1,971	$8,046
Liabilities subject to compromise	$8,093	0
Company obligated mandatorily redeemable convertible preferred securities	$889	$887
Common stock	503	487
Capital in excess of par value	1,695	1,578
Retained earnings	1,032	3,817
Total Liabilities and Equity	$14,183	$14,815

Note: Data as of January 30, 2002 and January 31, 2001. As of fiscal year end 2001, Kmart had a net operating loss (NOL) carry forward of $369 million and total deferred assets of $1,369 million. By fiscal year end 2002, these amounts had increased to $1,143 million and $2,466 million, respectively. In both years, Kmart recorded a full valuation allowance against these assets to reflect the uncertainty of its future earnings.

Source: Disclosure Statement and other Company filings.

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Exhibit 2c Kmart Corporation, Consolidated Statements of Cash Flows ($ in millions)

	2001	2000	1999
Cash Flows from Operating Activities:			
Net (loss) income	($2,446)	($268)	$364
Discontinued Operations	(166)	0	230
Restructuring, impairment and other charges	1,254	728	0
Reorganization items, net	(183)	0	0
Depreciation and amortization	824	777	770
Equity loss (income) in unconsolidated subsidiaries	0	13	(44)
Dividends received from Meldisco	51	44	38
Decrease (increase) in inventories	560	335	(544)
Increase (decrease) in accounts payable	1,046	(137)	169
Deferred income taxes and taxes payable	(55)	(204)	258
Changes in other assets	295	29	(127)
Changes in other liabilities	(23)	14	133
Cash used for store closings	(128)	(102)	(80)
Net Cash Provided by Continuing Operations	$1,029	$1,229	$1,167
Net Cash Used for Discontinued Operations	(102)	(115)	(83)
Net Cash Provided by Operating Activities	$927	$1,114	$1,084
Net Cash used for Reorganization Items	($6)	$0	$0
Cash Flows from Investing Activities:			
Capital Expenditures	($1,385)	($1,089)	($1,277)
Investment in BlueLight.com	(45)	(55)	0
Acquisition of Caldor leases	0	0	(86)
Net Cash Used for Investing Activities	($1,430)	($1,144)	($1,363)
Cash Flows from Financing Activities:			
Proceeds from Issuance of Debt	$1,824	$400	$300
Payments on Debt	(320)	(73)	(90)
Debt issuance costs	(49)	(3)	(3)
Payments on capital lease obligations	(86)	(78)	(77)
Payments on dividends of preferred securities	(72)	(73)	(80)
Purchase of convertible securities	0	(84)	0
Issuance of common shares	56	53	63
Purchase of common shares	0	(55)	(200)
Net Cash used for Financing Activities	$1,353	$87	($87)
Net Change in Cash and Cash Equivalents	**$844**	**$57**	**($366)**
Cash and Cash Equivalents, Beginning of Year	$401	$344	$710
Cash and Cash Equivalents, End of Year	**$1,245**	**$401**	**$344**

Note: Years ended January 30, 2002, January 31, 2001 and January 26, 2000.

Source: Disclosure Statement.

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Exhibit 3 Selected Kmart Chapter 11 Vendor Programs

1. ***Reclamation Claims Program.*** Outside of bankruptcy, under the Uniform Commercial Code, a vendor was entitled to reclaim merchandise shipped to a customer on credit if the shipment was made while the customer was "insolvent." The vendor had to assert its reclamation right within 10 days of the shipment date. If the customer filed for chapter 11, Section 546(c) of the Bankruptcy Code preserved the vendor's reclamation right, and extended the 10-day window to 20 days. As of its chapter 11 filing date, Kmart faced reclamation claims of $275 million from 693 vendors. Under a program approved by the bankruptcy court on September 25, 2002, vendors who asserted reclamation claims against Kmart could voluntarily elect to be paid either: (1) 75% of their allowed claims during the 2002 holiday season provided they continued to ship to Kmart on customary terms, or (2) 100% of their allowed claims when Kmart emerged from chapter 11.

2. ***Return to Vendor Program.*** At the time it filed for chapter 11, Kmart was in possession of unsold seasonal holiday merchandise as well as certain damaged or defective merchandise. Within a month, Kmart sought court approval for a voluntary program, pursuant to Section 546(g) of the Bankruptcy Code, to return to its vendors certain "seasonal, slow-moving, unsaleable or defective" merchandise in exchange for a full credit against the vendors' prepetition claims. (Outside of bankruptcy, it was standard industry practice for retailers to be able to return damaged or defective merchandise to vendors in exchange for a full refund.) Vendors would have 20 days decide it they wanted to participate in the program. If they did participate, they would have to agree to provide post-petition trade credit to Kmart. The agreement would only apply to merchandise that had been acquired on credit that was still unpaid.

3. ***Consignment Vendor Program.*** A significant percentage of Kmart's inventory was provided to Kmart on consignment. This included such merchandise as jewelry, CDs, DVDs, vacuum cleaners, and prescription pharmaceuticals. On January 22, 2002, Kmart asked the court for permission to continue to accept merchandise from consignment vendors, and to pay for such merchandise "in the ordinary course of business." The company also sought permission to pay for consigned goods that had been ordered and delivered, but not yet paid for, prior to the chapter 11 filing. Following court approval of this request, Kmart paid over $25 million to several consignment vendors. Subsequently Kmart announced that it might seek to treat certain other consignment agreements as executory contracts. Some of the vendors who would be affected by this, however, argued that because they had filed financing statements under the Uniform Commercial Code prior to Kmart's chapter 11 filing, their claims should be treated as secured claims, which were fully payable in bankruptcy. $70 million of consignment vendor claims were affected by this dispute.

4. ***Vendor Lien Program.*** On March 6, 2002 the bankruptcy court approved Kmart's request that it be allowed to grant certain "approved trade creditors" liens on Kmart's merchandise. These liens would only be granted to vendors who continued to do business with Kmart on normal business terms, and would be junior to the lien of the DIP facility lenders. Vendors had approximately two weeks to decide if they wanted to participate in this program.

5. ***Critical Vendor Program.*** Immediately upon filing for chapter 11, Kmart sought court approval to pay the outstanding pre-petition claims of certain vendors whose merchandise it viewed as especially critical for the continuation of its operations. These vendors were responsible for supplying Kmart with groceries, recorded music products, liquor, and

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advertising, among other things. Vendors who were not deemed "critical" would not receive such early payment.

Source: Disclosure Statement, pp. 19–25.

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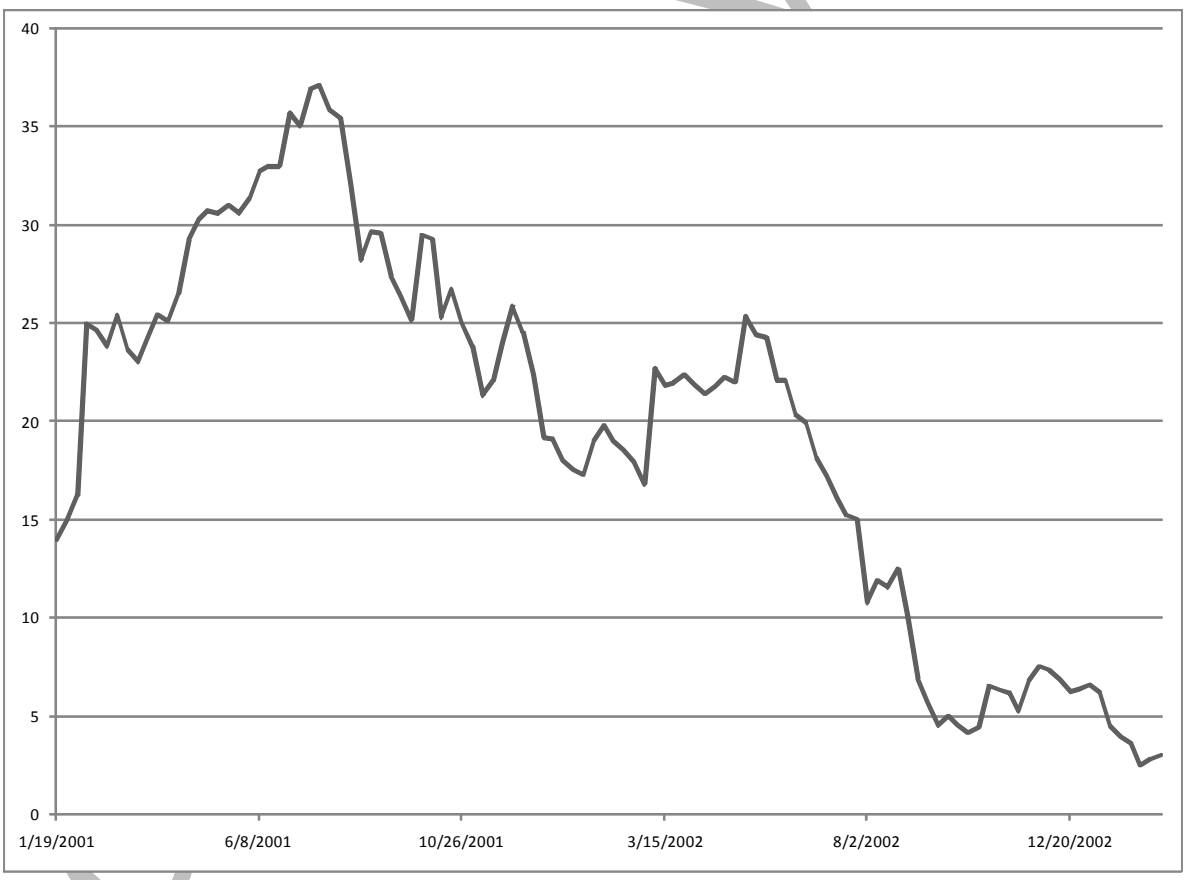
Exhibit 4a Fleming Companies—Selected Historic Financial Data ($ in millions)

	2001	2000	1999
Sales	$15,628	$14,446	$14,646
Operating Income	280	258	197
Net Income	27	(122)	(45)
EBITDA	396	156	275
Total Assets	$3,655	$3,263	$3,518
Total Liabilities	3,156	2,836	2,958

Source: Worldscope, via Thomson One Banker, accessed February 2008.

Exhibit 4b Fleming Companies Common Stock Price



Source: Thomson One Banker, accessed February 2008.

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Exhibit 5 Pre-petition Claims Held by the Investor Group ($ in millions)

Creditor Class	Total Face Value	Investor Group Holdings: ESL	Third Avenue	% of Class Owned by Investor Group
Class 3. Pre-petition Lender Claims	$1,076	$ 382	$0	35.5%
Class 4. Pre-petition Note Claims	$2,277	$1,177	$99	56.0%
Class 5. Trade vendor/ Lease rejection Claims	$4,300	$61	$79	3.3%
	$7,654	$1,620	$178	

Source: Disclosure Statement.

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Exhibit 6a Kmart Corporation, Projected Income Statements ($ in millions)

	2004	2005	2006	2007
Net Sales	$25,614	$26,981	$28,478	$30,170
Cost of sales, buying and occupancy	20,423	21,308	22,407	23,669
Gross Margin	$5,191	$5,673	$6,071	$6,501
Selling, general and administrative expenses	4,814	5,066	5,258	5,409
Earnings before interest and income taxes	377	607	813	1,092
Interest Expense, net	86	73	61	51
Earnings before income taxes	$291	$534	$752	$1,041
Income taxes	110	202	287	397
Net earnings	$181	$332	$465	$644
Depreciation and amortization	47	93	142	192
EBITDA	$424	$700	$955	$1,284
Year/year Same Store Sales Growth	3.8%	4.5%	4.3%	4.0%

Source: Disclosure Statement.

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Exhibit 6b Kmart Corporation, Projected Balance Sheets ($ in millions)

	2004	2005	2006	2007
TOTAL ASSETS:				
Current Assets				
Cash and Cash Equivalents	$300	$366	$566	$951
Merchandise inventories	3,995	3,925	3,910	3,872
Other current assets	658	681	708	739
Total Current Assets	$4,953	$4,972	$5,184	$5,562
Property and equipment, net	676	1,083	1,491	1,899
Other assets and deferred charges	12	14	16	17
Total Assets	$5,641	$6,069	$6,691	$7,478
TOTAL LIABILITIES & EQUITY:				
Current Liabilities				
Long-term debt due within one year	$0	$0	$0	$0
Accounts payable	1,357	1,505	1,570	1,684
Other current liabilities	962	1,187	1,538	1,828
Total Current Liabilities	$2,319	$2,692	$3,108	$3,512
Long-term debt	19	0	0	0
Other long-term liabilities	1,797	1,539	1,279	1,019
Total Liabilities	$4,135	$4,231	$4,387	$4,531
Shareholders' equity	1,506	1,838	2,304	2,947
Total Liabilities and Equity	$5,641	$6,069	$6,691	$7,478

Source: Disclosure Statement.

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Exhibit 6c Kmart Corporation, Projected Cash Flow Statements ($ in millions)

	2004	2005	2006	2007
Cash Flows from Operating Activities:				
Net (loss) income	$181	$332	$465	$644
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Depreciation and amortization	47	93	142	192
Equity income in unconsolidated subsidiaries	(47)	(48)	(49)	(50)
Dividends received from Meldisco	46	47	48	49
Change in Operating Assets and Liabilities				
Inventories	52	71	15	38
Accounts Payable	331	148	65	114
Deferred income taxes and taxes payable	110	202	287	271
Other assets	82	(24)	(27)	(31)
Other liabilities	(205)	(184)	(144)	(190)
Net Cash Provided by Continuing Operations	$597	$637	$802	$1,037
Cash Flows from Investing Activities:				
Capital Expenditures	($450)	($500)	($550)	($600)
Net Cash Used for Investing Activities	($450)	($500)	($550)	($600)
Cash Flows from Financing Activities:				
Payments on Debt, net	($95)	($19)	$0	$0
Payments on capital lease obligations	(52)	(52)	(52)	(52)
Net Cash Provided by (Used for) Financing Activities	($147)	($71)	($52)	($52)
Net Change in Cash and Cash Equivalents	**$0**	**$66**	**$200**	**$385**
Cash and Cash Equivalents, Beginning of Year	$300	$300	$366	$566
Cash and Cash Equivalents, End of Year	**$300**	**$366**	**$566**	**$951**

Source: Disclosure Statement.

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Exhibit 7 Valuation Data ($ in millions except per-share data)

	Low	High	Median
Aggregate Firm Value	$2,250	$3,000	$2,625
Aggregate Equity Value	$753	$1,503	$1,128
Shares outstanding (MM)	86.24	86.24	86.24
Equity Value Per Share	$8.74	$17.43	$13.08

Source: Disclosure Statement.

Note: Valuation methodologies employed:

1) Public Company Analysis. The market multiples of publicly traded companies with similar businesses were applied to Kmart's operating statistics. Multiples analyzed included: enterprise value (market value of equity plus debt less excess cash) / sales, enterprise value/ EBITDA, enterprise value/EBIT, equity value/earnings, and equity value /book value.

2) Discounted Cash Flow Analysis. Cash flows projected to be generated under Kmart's Business Plan were discounted at Kmart's estimated weighted average cost of capital (WACC). In conducting this analysis, Kmart's advisors assumed a WACC of between 20% and 25%.

3) Comparable Acquisition Analysis. Multiples paid in mergers and acquisitions involving companies with a similar business profile to Kmart were applied to Kmart's operating statistics. Multiples analyzed included purchase price / sales, purchase price / earnings, and purchase price/book value.

Note: On February 21, 2003, the 20 year Treasury bond yielded 4.88%.

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Exhibit 8 Claimholder Recoveries under Kmart's Reorganization Plan

Class	Description	Estimated Claim	Estimated Recovery[a]	Comments
Class 1. Secured Claims	Primarily real estate mortgage holders but also tax liens and set-off claims	$61,000,000	100%	• Claims to survive emergence from bankruptcy until paid-in-full or to be paid-in-full upon exit
Class 3. Pre-petition Lender Claims	Unsecured creditors	$1,076,156,647	40%	• To be settled in cash • Resolution process was complex as lenders had guarantees from Kmart subsidiaries and claimed, as a result, that they had a priority claim on the assets of those subsidiaries • ESL to exchange its cash settlement for common stock in the reorganized Kmart
Class 4. Pre-petition Note Claims	Unsecured bondholders	$2,277,384,987	14%	• Bondholders to receive pro-rated share of 25,008,573 shares of newly reorganized Kmart (approximately 29% of total shares issued)[a] • Also to receive a share of any proceeds from Kmart's creditor trust
Class 5. Trade vendor/ Lease rejection Claims	Includes claims greater than $30,000.	$4,300,000,000	10%	• To receive pro-rated share of 31,945,161 shares of newly reorganized Kmart (approximately 37% of total shares issued) [a] • Also to receive a share of any proceeds from Kmart's creditor trust
Class 6. Other unsecured claims	Personal injury and other litigants; government claims ex taxes. Includes claims greater than $30,000.	$200,000,000	10%	• May elect to receive cash or stock • Cash payment, if elected, will be received on the three year anniversary following emergence from Chapter 11
Class 7. General Unsecured Convenience Claims	Class 5 and 6 claimants where the claim is less than $30,000	$5,000,000	6%	• Will receive cash • Class 7 claimants may elect to join Class 5
Class 8. Trust Preferred Obligations	Mandatorily Redeemable Convertible Preferred Securities issued by Kmart Financing I	$648,043,500	N/A	• Per instrument terms, no settlement until lenders are paid in full
Class 10. Subordinated Securities Claims	Litigation claims by stockholders	N/A	N/A	• Claim given same priority as common stockholders • To receive a pro rated 2.5% share of any proceeds from Kmart's claim against former employees and others for alleged mismanagement (Kmart's creditor trust)
Class 11. Existing Common Stock		N/A	N/A	• Old shares to be cancelled • To receive a pro rated 2.5% share of any proceeds from Kmart's claim against former employees and others for alleged mismanagement (Kmart's creditor trust)

Source: Disclosure Statement.

[a]Estimated recovery based on the estimated aggregate equity value for Kmart of $1.128BN, the midpoint of the range supplied by Kmart's advisors.

Note: Class 2 ("Other Priority Claims"), Class 9 ("Intercompany Claims"), and Class 12 ("Other Interest") have been excluded from the table because they were not applicable.

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