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Kmart: Predicting Bankruptcy, Fresh Start Reporting, and Valuation of Distressed Securities

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ABSTRACT: On January 22, 2002, Kmart Corporation filed voluntary petitions for reorganization under Chapter 11 of the federal bankruptcy laws. While under Chapter 11 protection, Kmart renegotiated its debt, shed some of its non-performing assets, and issued new equity. Financier Eddie Lampert of ESL Investments bought much of Kmart's debt for less than $1 billion while it was in bankruptcy. As part of the reorganization plan, virtually all of Kmart's debt was converted into shares, and ESL Investments emerged as Kmart's largest shareholder. Subsequent to its emergence from bankruptcy on May 6, 2003, Kmart's stock has gone up from around $15/share to nearly $80/share over a period of one year. The case requires students to analyze Kmart's financial performance prior to the bankruptcy, identify the circumstances leading to the bankruptcy, use projected financial statements to derive Kmart's value post-bankruptcy, and explore issues related to Kmart's adoption of Fresh Start reporting upon its emergence from bankruptcy. The case questions fall into five categories: (1) pre-bankruptcy evaluation, (2) reorganization plan and Kmart in bankruptcy, (3) Fresh Start reporting, (4) bankruptcy valuation analysis, and (5) post-bankruptcy performance. The questions are largely independent, allowing instructors the flexibility to adopt only the sections relevant to their courses.

Keywords: bankruptcy; valuation; Kmart; Chapter 11; corporate distress; financial distress; prediction; Fresh Start reporting.

COMPANY HISTORY

Kmart was incorporated under the laws of the State of Michigan on March 9, 1916, as the successor to the business developed by its founder, Sebastian S. Kresge. Mr. Kresge opened his first store in 1893 where he sold everything for five or ten cents. By 1912, he had expanded to 85 stores with annual sales of more than $10 million. After operating the Kresge department stores for more than 45 years, the company opened its first Kmart discount department store in 1962. By 1977, nearly 95 percent of the Kresge company sales were generated by Kmart stores. To reflect this new thrust, the company officially changed its name to Kmart Corporation.

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In 1962, the same year Kmart opened its first discount department store; Wal-Mart opened its first, no-frills, discount store in Roger, Arkansas. In less than 30 years, Wal-Mart had become the number-one retailer in the country. As of 2001, Wal-Mart was operating 2,732 stores, with sales per square foot of $446, total sales of $217 billion, and net income of $6.7 billion. In contrast, as of 2001, Kmart was operating 2,113 stores, with sales per square foot of $227, total sales of $36 billion, and a net loss of $1.3 billion.

In response to severe competition from Wal-Mart in the discount retail space, between 1984 and 1992 Kmart attempted to diversify and expand its business by acquiring several specialty stores, including Walden Book Company, Home Centers of America (later renamed Builder's Square), the Sports Authority, Office Max, and Borders. In 1996, in an effort to compete with Wal-Mart Supercenters, Kmart unveiled a five-year, $35 billion new-store opening plan, and an enlargement and modernization program. These actions significantly increased the amount of debt on Kmart's balance sheet. By 1997 Kmart had divested its interests in all of its specialty stores to focus on its core business as a discount merchandise retailer.

By 1997, however, Wal-Mart had gained an almost insurmountable advantage over Kmart in the discount merchandise space by investing heavily in its core competencies—logistics, store management, and information technologies. Kmart, on the other hand, was, at best, lukewarm in its adoption of information technology. Lack of integration in its supply chain frequently led to stock-outs, inventory pile-ups and resulting write-offs, and low margins.

In August 2000, the new Chairman and CEO, Charles Conway, outlined three strategic imperatives and ''Big 5'' initiatives to improve the financial performance and competitive position of Kmart. The three strategic initiatives were: (1) achieve world-class execution by making end-to-end improvements and investments in the supply chain; to this end, Kmart announced a massive $1.4 billion investment in technology; (2) create a customer-centric culture to link day-to-day activities to better serve Kmart customers; and (3) become a marketing- and sales-driven organization with a defined and differentiated market position. The ''Big 5'' initiatives included: (1) fix the flow of goods and streamline supply chain management, (2) increase marketing effectiveness with less advertising costs, (3) fix the food department and grow the SuperKmart concept, (4) reduce SG&A expenses through process engineering, and (5) give assistance to develop and increase profitability of the bottom 250 stores.

In spite of these initiatives and investments, Kmart's supply chain troubles continued, and it struggled to keep pace with its rival discount chains, Target Corporation and Wal-Mart. See Appendix A for Kmart, Target, and Wal-Mart's condensed financial statements for the fiscal years 1997–2002. In addition, Kmart made a fateful decision for the holiday season of 2001 to compete head-to-head with Wal-Mart's ''Always Low Prices'' with its own version of everyday low prices called ''BlueLight Specials.'' In preparation for the 2001 fourth-quarter holiday season, Kmart had significantly increased its inventories, financed by cash flow from operations, bank lines of credit, and trade credit from vendors. Like all retailers, Kmart's financial performance depended heavily on the sales volume generated in the fourth-quarter holiday season. Wal-Mart responded to the ''BlueLight Specials'' by further slashing its prices. Kmart's fourth-quarter sales and earnings performance were disappointing.

Due to the deterioration in Kmart's financial health, Moody's Investor Services downgraded Kmart's unsecured debt to junk status in December 2001 by lowering its rating from Baa3 to Ba2. Standard & Poor's had downgraded its debt from ''BB-plus'' to ''BB'' in November 2001. On January 2, 2002, Prudential analyst Wayne Hood lowered his rating for the company to ''sell'' from ''hold'' and cut earnings per share estimates for the fourth quarter as well as the fiscal year, citing disappointing fourth-quarter sales and earnings. In addition, Hood noted that the company might choose to file for Chapter 11 protection within the next six months if its sales and profits don't get better (Patsuris 2002).

Kmart's precarious credit situation drove it to rely on special, surety bonds to guarantee payments to its creditors and employees. A surety bond is a contract in which the surety agrees to pay the debts or guarantee the contract performance of a principal to a third party, if the principal fails to pay its debt or perform on a contract. Kmart used surety bonds to guarantee payments of its self-insured worker's compensation claims and other liabilities, and to comply with government regulations requiring merchants who sell alcohol and firearms to post bonds. Enron also significantly relied on surety bonds, using them to back an estimated $2.5 billion of its fuel delivery and other contracts. Following Enron's bankruptcy, sureties became more cautious and reportedly required Kmart to put between $300 million and $600 million in supplemental security to back its bonds. Given its disappointing sales during the 2001 holiday season, Kmart was unable to come up with the money (Goodwin 2002). Further, on January 21, 2002, Kmart failed to make its weekly payment of $78 million to Fleming, a major food distributor and grocery wholesaler, and Fleming stopped its shipments to Kmart.

Consequently, on January 22, 2002, Kmart Corporation filed a voluntary petition for reorganization under Chapter 11 of the federal bankruptcy laws in the United States Bankruptcy Court for the Northern District of Illinois (*in re. Kmart Corporation, et al*. 2003). On January 24, 2003, Kmart (called debtor-in-possession while in bankruptcy) filed a Plan of Reorganization with the Court, and on February 25, 2003, filed an amended Joint Plan of Reorganization with the Court. The Joint Plan of Reorganization received the formal endorsement of the statutory creditors' committees and was confirmed by the Court on April 23, 2003. On May 6, 2003, Kmart emerged from reorganization and became a wholly owned subsidiary of a newly created holding company, Kmart Holding Corporation (ticker: KMRT).

AN OVERVIEW OF CHAPTER 11 REORGANIZATION

Under Chapter 11, a firm is allowed to continue its operations under the supervision of the bankruptcy court while a plan of reorganization is prepared and negotiated with its creditors. The firm has an exclusive right to propose a plan of reorganization for a period of 120 days after the initial filing of bankruptcy. Another advantage of filing for Chapter 11 is that an automatic stay is imposed: all payments of interest and principal on debt ceases, and creditors are prevented from taking any action against the firm to collect claims or seize assets. The reorganization plan assigns claimholders into classes according to the characteristics of their claims (broadly based on seniority) and proposes a distribution to these claimholders. After the reorganization plan is submitted to the Court, the firm and the creditors enter into negotiations on the specific terms of the plan.

The Bankruptcy Code requires the bankruptcy court to determine that the plan is in the ''best interests'' of all holders of claims that are impaired by the Plan and that have not accepted the plan. The ''best interests'' test, as set forth in Section 1129(a)(7) of the Bankruptcy Code, requires the bankruptcy court to find either that (1) all members of an impaired class of claims have accepted the plan, or (2) the plan will provide a member that has not accepted the plan with a recovery that is no less than the amount that such holder would recover if the firm were liquidated under Chapter 7 of the Bankruptcy Code (called ''liquidation analysis'').

Further, under Section 1129(a)(11) of the Bankruptcy Code, the firm must demonstrate to the bankruptcy court (typically by submitting projected financial statements and value estimates of the reorganized entity) the feasibility of the plan to ensure that the confirmation of the plan will not be followed by liquidation or a need for further financial reorganization.

Clearly, the estimated value of a reorganized firm is critical for the different classes of claimants, especially the classes that are impaired in the reorganization. Since the value of the reorganized firm affects the recoveries of the different classes of claimants, it is a contentious issue. All interested parties understand that the value of the firm is estimated based on unaudited projections of operations, cash flow, and related balance sheets. These projections reflect numerous

assumptions and estimates about the future performance of the firm and the industry, as well as general business and economic conditions. Furthermore, one needs to choose from a range of possible valuation models and make subjective judgments about the weights to be attached to the various competing models. In Chapter 11 reorganizations, a claimant's return depends on two key values: the ''true'' value of the firm's net assets and the estimated value used in the reorganization plan to decide on payouts to various claimholders (called ''Plan Value'').

The bankruptcy court will confirm the reorganization if the following three requirements are met:

(1) A two-thirds majority of each class of impaired claimants accepts the plan (unimpaired classes are not allowed to vote on the plan).
(2) Each dissenting claimant receives at least the amount it would have received in a liquidation (called the Best Interests test).
(3) The plan is feasible; that is, the confirmation of the plan is not followed by a liquidation or another request for further restructuring.

Once the bankruptcy court confirms the plan and sets the date for emergence from Chapter 11, it is binding on all claimants, even those that did not accept the plan or were impaired under the plan.

KMART'S REORGANIZATION

Appendix F provides a summary of the treatment of selected classes of Kmart's claimholders under the Joint Plan of Reorganization that was confirmed by the Court on April 23, 2003. As noted earlier, the estimated value of a reorganized Kmart affects the recoveries of the different classes of claimants, especially the classes that are impaired in the Reorganization Plan.

Kmart retained the services of Miller, Buckfire, Lewis & Co. to do formal valuations of reorganized Kmart as of the effective date of April 30, 2003. Miller, Buckfire, Lewis & Co. used the following valuation methodologies (source: Kmart's Reorganization Plan):

(a) Comparable Public Company Analysis

In a comparable public company analysis, a subject company is valued by comparing it to publicly held companies in reasonably similar lines of business. The comparable public companies are chosen based on, among other attributes, their similarity to the subject company's business, presence in the market, and size. The price that an investor is willing to pay in the public markets for each company's publicly traded securities represents that company's current and future prospects as well as the rate of return required on the investment. Numerous financial multiples and ratios were developed to measure each company's valuation and relative performance. Some of the specific analyses entailed comparing the enterprise value (defined as market value of equity plus debt minus excess cash) for each of the comparable public companies to their sales, EBITDA, and EBIT, as well as comparing their equity values to net income and book value. Where appropriate, the Financial Advisors applied these multiples to the projected financials of the Reorganized Debtors to determine an implied range of enterprise and equity values for the Reorganized Debtors.

(b) Discounted Cash Flow Analysis

The discounted cash flow method relates the value of an asset or business to the present value of expected future cash flows to be generated by that asset or business. Reorganized Kmart's' projected cash flows after debt service (as set forth in the Business Plan [see Appendix E]) were discounted to a present value as of the Effective Date using a discount rate equal to the weighted average cost of capital for Reorganized Kmart. For purposes of the valuation

> analysis, the Financial Advisors used a range of discount rates between 20 percent and 25 percent, which reflects a number of company- and market-specific factors, including business execution risk and the nature and derivation of the projections set forth in the Business Plan as well as the cost of equity for companies that the Financial Advisors deemed comparable.

Using the above methodologies, Miller, Buckfire, Lewis & Co. estimated the value of Kmart on April 30, 2003, to range from approximately $2,250 million to $3,000 million, The value does not include excess cash, if any, remaining after cash distributions under the plan. The excess cash, if any, is assumed to be necessary to run the business and not viewed as free cash flow for valuation purposes.

The equity value of reorganized Kmart was estimated to range from approximately $753 million to $1,503 million or from approximately $8.74/share to $17.43/share assuming a total of 86,236,453 common shares issued and outstanding as of April 30, 2003.

Under existing accounting rules, Kmart is required to adopt Fresh Start Reporting upon its emergence from bankruptcy. Fresh Start Reporting requires firms in Chapter 11 bankruptcy to estimate and report assets and liabilities at their reorganization value, which approximates fair value at the date of emergence from Chapter 11. The Fresh Start Accounting adjustments (see Appendix B) for Kmart are based in part on the enterprise valuation analysis prepared by Miller, Buckfire, Lewis & Co. Application of Fresh Start Accounting adjustments to reflect the fair value of assets and liabilities and the write-off of the Predecessor Company's equity resulted in a charge of $5.6 billion. The restructuring of Kmart's capital structure and resulting discharge of prepetition debt resulted in a gain of $5.1 billion. The charge for the revaluation of the assets and liabilities and the gain on the discharge of prepetition debt are recorded in Reorganization Items, not in the Consolidated Statement of Operations.

As noted in Lehavy (2002), these Fresh Start Accounting adjustments are important for two reasons. One, management's reported estimate of the Fresh Start value of assets and liabilities plays a vital role during bankruptcy negotiations because it determines the allocation among various bankruptcy claimants. Second, the management of the firm under bankruptcy has significant discretion in the determination of the estimates, and their choices reveal their biases and objectives.

Since in Chapter 11 reorganization debt held by claimants is frequently exchanged for equity, claimants who hold sufficient percentages of various classes of outstanding debt can have a strong bargaining position to influence the terms of reorganization, including the determination of the Fresh Start values. This motivates investors, often referred to as vulture investors in the popular press, to strategically buy debt of a firm in Chapter 11 reorganization in order to obtain majority ownership in the reorganized firm.

VULTURE INVESTING

Vulture investing is essentially investing in distressed securities, which are securities of companies that are in financial trouble and in the process of restructuring, reorganization, or liquidation under local bankruptcy laws. The basic strategy is to buy securities, usually debt, at a significant discount to its intrinsic value and then exit in one of two ways. Investors can simply trade out of their positions and sell their securities when the prices are higher. This is possible because with the increase in the number of large public companies in financial distress, an active market for trading claims of distressed companies has developed (Hotchkiss and Mooradian 1997). Alternatively, investors can swap their debt claims for cash or equity during reorganization. Vulture investors strategically purchase a sufficient percentage of various classes of outstanding debt, so that they have a strong bargaining position to influence the terms of the reorganization. In Chapter 11 reorganizations, where debt held by vulture investors is exchanged for a majority of the equity of the company, vulture investors can significantly influence management and/or gain control. By

pushing the firm to run more profitably, they can increase the value of their holdings as the firm emerges from bankruptcy.

Gilson (2001) outlines the simple strategy vulture investors use to purchase securities of firms in bankruptcy. Purchasing equity is generally an ineffective way to acquire or exercise control of a financially distressed firm, since typically equity holders do not enjoy high recovery rates during bankruptcy. With regard to purchasing debt claims, typically senior claims in the capital structure receive new senior claims (new debt or cash) in exchange for their pre-bankruptcy debt, whereas more junior claims receive common stock. Thus, with a view to gaining control of the distressed firm as it emerges from bankruptcy, investors prefer to purchase junior claims to senior secured claims. However, the most junior claims may have very low recovery rates because the firm's assets may not be worth enough to pay all the claims.

Bankruptcy rules influence the amount of different claims an investor will need to hold during reorganization. Before the bankruptcy court will approve a reorganization plan, each claimant class votes for or against the plan. The required percentage of votes required varies with the types of claims within the class. Typically, a class is deemed to have accepted the plan if at least a majority (in number) of claimholders in that class and at least two-thirds (in value) vote for the plan. Thus, an investor needs to hold slightly more than one-third of the claims in a particular class to threaten to hold up the firm's reorganization plan unless that claim class is given a higher recovery rate. However, an investor's ability to secure a higher recovery rate is limited by the ''cram down provision'' of the bankruptcy code. The ''cram down provision'' allows the Court to confirm the reorganization plan over the objections of the claimholders of a particular class, if it finds that the plan is fair and equitable to each impaired class, and does not unfairly discriminate with respect to each claim that has not accepted the plan.

VULTURE INVESTING IN KMART AND POST-BANKRUPTCY PERFORMANCE

ESL Investments purchased approximately $382 million principal amount of Prepetition Lender Claims, approximately $1,777 million principal amount of Prepetition Note Claims, and $61 million in Trade Vendor/Lease Rejection Claims and Trust Preferred Obligations. Furthermore, Third Avenue Trust purchased approximately $99 million principal amount of Prepetition Note Claims and approximately $79 million in Trade Vendor/Lease Rejection Claims.

Under the Reorganization Plan, the prepetition lenders would be entitled to cash and shares in reorganized Kmart in satisfaction of the Prepetition Lender Claims (Class 3 Claims). However, under the settlement agreed to by the parties, the Prepetition Lenders (other than ESL Investments and Third Avenue Trust) received only cash instead of cash and shares in an amount equal to 45 percent of the amount of their claims. ESL Investments and Third Avenue Trust received only shares in the reorganized Kmart instead of cash and shares in satisfaction of their Prepetition Lender Claims. In addition, they received shares for the other claims they held in Kmart as per the Reorganization Plan. Based on the above transactions and settlements, ESL Investments and Third Avenue collectively held slightly in excess of 50 percent of all shares of the newly reorganized Kmart.

During the bankruptcy proceedings, Eddie Lampert, Chairman, Chief Executive Officer, and principal owner of ESL Investments, was appointed Chairman and Director of Kmart. Crucially, Mr. Lampert sat on the Financial Institutions Committee (FIC), the committee overseeing the bankruptcy on behalf of the claimholders. Because of his position on the FIC, Mr. Lampert was able to significantly affect the bankruptcy proceedings in addition to being able to appoint six of the nine Kmart board members. Upon Kmart's emergence from bankruptcy on May 6, 2003, Mr. Lampert became Chairman of the company.

Kmart's performance since emerging from bankruptcy has been remarkable. For the fourth quarter ended January 2004, Kmart reported net income of $276 million compared to an $834 million loss a

year earlier, although total sales for the 39 weeks fell 23 percent to $17.07 billion, with same-store sales sliding 9.5 percent. Commenting on the quarter's results, Julian Day, president and chief executive officer, said, "By giving careful thought to the processes of sourcing, logistics, pricing, inventory management, and in-store presentation, we have significantly improved the profitability of our market basket. Our improved inventory management, along with cash flow from operations and receipts from sales of surplus real estate, has significantly strengthened our cash position."

The primary reason for Kmart's stellar performance since emerging from bankruptcy has been its real estate transactions. Kmart owned and leased thousands of store locations with extremely favorable terms with very low fixed lease rates for periods that exceeded 50 years. Although these lease terms were very valuable, Kmart, using Fresh Start Reporting rules, reported its Property and Equipment as having a total value of just $10 million (Appendix B). Beginning in mid-2004, Kmart began selling its valuable real estate holdings. On June 4, 2004, Kmart sold 24 stores to Home Depot for up to $365 million, or roughly $15 million per store. On June 30, 2004, Kmart announced the sale of 54 stores for $621 million cash to Sears Roebuck & Co., with each store fetching an average price of $11.5 million. Again, on September 29, 2004, Kmart announced it had finalized the sale of another 50 stores to Sears Roebuck & Co., for $575 million in cash. Based on these store sales, analysts began to project the value of Kmart's entire real estate portfolio in excess of $18 billion. Kmart stock price closed on September 29, 2004 at $88.06/share or a market capitalization of $7.81 billion.

On November 16, 2004, Kmart and Sears Roebuck announced a $12.3 billion cash-and-stock deal creating the new company, Sears Holding Corporation. The CEOs of Kmart and Sears Roebuck justified their decision to merge by asserting that the combined $55 billion retail giant would produce stronger brands, greater efficiencies in operations, and higher returns than either company could achieve standing alone.

However, the retailing experts and the market offered mixed reviews on the deal. Many questioned how combining two retailers that were struggling would produce an entity that would compete with the likes of Wal-Mart and Target. Both Kmart and Sears had impressive strengths and brands. Kmart was strong in home furnishings and apparel, including such lines as Thalia Sodi, Jacklyn Smith, Joe Boxer, Martha Stewart Everyday, Route 66, and Sesame Street. Sears was well known for its appliances and tools, lawn and garden products, and had such key brands as Kenmore, Craftsman, and DieHard. However, retailing experts noted that while operational synergies would certainly reduce costs, lack of a merchandise strategy that resonated with consumers would hinder the merged company from recapturing the power of either brand (Knowledge@Wharton 2005).

Many observers speculated that Eddie Lampert may have plans to break apart the merged company and sell the assets. Land's End, the clothing label that Sears bought for $2 billion and that had turned out to be a disappointing acquisition, was the obvious choice. Others in the market had the opposite view and conjectured that Eddie Lampert was using the Sears Holding Company as a publicly traded vehicle to house a portfolio of private and public companies, much like Warren Buffet created Berkshire Hathaway to buy lower-valued companies and turn them around (Cramer 2005).

REQUIRED

Part I: Kmart's Financial Performance Prior to Bankruptcy

(a) Using the information in Appendix A, evaluate Kmart's critical growth, profitability, and efficiency (turnover) ratios for the years 1998–2002 and compare Kmart's performance to that of Wal-Mart and Target. How do the different business strategies of these retailers manifest themselves in the ratios?

(b) Using the information in Appendix A, analyze Kmart's credit risk and its ability to pay its bills using common solvency and liquidity ratios for the period of 1998 to 2002. Do these ratios indicate that debt-rating agencies are likely to downgrade Kmart's debt? Explain.

(c) Based on your overall evaluation of Kmart's financial performance, what would have been the best predictor of Kmart's deteriorating financial health (if any)?

Part II: In Bankruptcy

Based on the information provided in the case, what are the primary factors that led Kmart to file for bankruptcy on January 22, 2002? Was the bankruptcy caused by short-term market effects, management shortcomings, or simply bad luck? Are there components of Kmart's operations that might have value in the future?

Part III: Fresh Start Reporting

Appendix B provides information regarding the adoption of Fresh Start reporting by Kmart. Using this information, provide the necessary journal entries used to record the following Fresh Start Reporting Adjustments:

- Record the discharge of debt; eliminate the existing liabilities subject to compromise, record the payment of liabilities, and the issue of new debt.
- Cancel the old equity and establish the issue of new equity.
- Record the asset value adjustments so as to adjust the assets to the fair values as determined in the allocation of the reorganization value. Record the amount of goodwill, if any, for the reorganization value in excess of the value assigned to the specific assets.

Part IV: Kmart's Bankruptcy Valuation Analysis

(a) Appendix C provides details of the liquidation analysis including the estimated recovery rates for Accounts Receivables, Inventories, Prepaid Expenses, and Net Property and Equipment. The company does not provide details on how the estimated recovery rates were derived. However, given your knowledge of Kmart and the retail industry, answer the following questions: (1) What factors would you consider in evaluating the reasonability of the Estimated Recovery Rates? (2) What assumptions could be challenged by the claimants and on what grounds? (3) What other information would you request from management in order to evaluate the plausibility of the Estimated Recovery Rates?

(b) One of the bankruptcy valuation methodologies described in the case is the ''Comparable Public Company Analysis.'' Based on the information in the case as well as the data in Appendix D (which provides information on Kmart's relative valuation) derive the set of multiples used by the valuation experts and approximate the range of Kmart's reorganized value as of April 30, 2003, by using the Comparable Public Company methodology. Given your analysis, comment on the reasonability of this valuation.

(c) Another methodology used by Kmart's consultants is the Discounted Cash Flow (DCF) Analysis method. Based on the information in the case as well as the financial projections provided as part of the reorganization plan and used as the basis for the DCF Analysis (Appendix E), approximate the range of Kmart's reorganized value as of April 30, 2003, using the DCF Analysis method. Make necessary assumptions and clearly state them. Given your analysis, comment on the reasonability of this valuation.

(d) Based on the information in the case and your analysis in Part IV of the case, do you believe that the Fresh Start Accounting equity value provided by Kmart while in Chapter 11 bankruptcy is understated or overstated? Given that Kmart's management has

discretion in the determination of Fresh Start values, what does it suggest about Kmart management's biases and objectives during and after reorganization? While you can rely on the calculations in questions (a)–(c) of Part IV of this case, this question asks for your opinion and does not require new computations.

Part V: Post-Bankruptcy Performance

Subsequent to its emergence from bankruptcy, Kmart's stock price (traded as Kmart Holding Corp: KMRT) had soared from $15 to $25 in a month, and to $65 (or a market cap of $5.8B) a year after the bankruptcy. Given this stellar post-bankruptcy stock performance, why was the bankruptcy valuation so grossly understated? What explains this amazing turnaround? Did one group of bankruptcy claimants gain wealth at the expense of other groups?

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APPENDIX A

Historical Financial Statements—Kmart, Target, and Wal-Mart (in millions)

Panel A: Kmart (Condensed Financial Statements)

Fiscal Year-End	1/30/1997	1/27/1998	1/27/1999	1/26/2000	1/31/2001	1/30/2002
Income Statement						
Sales (Net)	31,437	32,183	33,674	35,925	37,028	36,151
Cost of Goods Sold	(23,736)	(24,492)	(25,648)	(28,111)	(29,658)	(29,936)
Gross Profit	7,701	7,691	8,026	7,814	7,370	6,215
SG&A Expense	(6,274)	(6,136)	(6,245)	(5,788)	(6,625)	(6,764)
EBITDA	1,427	1,555	1,781	2,026	745	(549)
Depreciation and Amortization	(654)	(660)	(671)	(770)	(777)	(824)
EBIT	773	895	1,110	1,256	(32)	(1,373)
Interest Expense	(538)	(412)	(343)	(330)	(333)	(414)
Non-Operating Income (Loss)	64	(114)	(19)	44	(13)	(915)

EBT	299	369	748	970	(378)	(2,702)
Income Taxes	(68)	(120)	(230)	(337)	134	115
Net Income Before Ext. Items	231	249	518	633	(244)	(2,587)
Ext. Items and Disc. Ops.	(451)	—	—	(230)	—	169
Net Income (available to common)	(220)	249	518	403	(244)	(2,418)
Balance Sheet						
Operating Cash and Market. Sec.	406	498	710	344	401	1,245
Inventories	6,354	6,367	6,536	7,101	6,412	5,822
Other Current Assets	973	611	584	715	939	817
Total Current Assets	7,733	7,476	7,830	8,160	7,752	7,884
PP&E (Net)	5,740	5,472	5,914	6,410	6,557	6,161
Other Assets	813	610	422	534	523	253
Total Assets	14,286	13,558	14,166	15,104	14,832	14,298
Current Debt	156	165	77	66	68	—
Accounts Payable	2,009	1,923	2,047	2,204	2,159	103
Income Taxes Payable	—	—	—	249	187	143
Other Current Liabilities	1,437	1,186	1,567	1,557	1,587	378
Total Current Liabilities	3,602	3,274	3,691	4,076	4,001	624
Long-Term Debt	3,599	2,904	2,629	2,773	3,027	1,187
Other Liabilities*	1,013	965	883	965	834	8,139
Total Liabilities	8,214	7,143	7,203	7,814	7,862	9,950
Preferred Stock	—	—	—	—	—	—
Paid In Common Capital (Net)	3,037	3,075	3,144	3,022	2,952	3,087
Retained Earnings	3,035	3,340	3,819	4,268	4,018	1,261
Total Common Equity	6,072	6,415	6,963	7,290	6,970	4,348
Total Liabilities and Equity	14,286	13,558	14,166	15,104	14,832	14,298
Statement of Cash Flows						
Operating:						
Net Income		249	518	403	(244)	(2,418)
+ Depreciation and Amortization		660	671	770	777	824
Working Capital Adjustments		(36)	281	(218)	257	4,708
= Cash From Operations		873	1,470	955	790	3,114
Investing:						
− Capital Expenditures		(392)	(1,113)	(1,266)	(924)	(428)
− Increase in Other Assets		203	188	(112)	11	270
= Cash From Investing		(189)	(925)	(1,378)	(913)	(158)
Financing:						
+ Increase in Debt		295	(363)	133	256	(1,908)
− Dividends Paid on Common		—	—	(80)	(73)	—
+/− Net Issuance of Common Stock		(887)	30	4	(3)	(204)
= Cash From Financing		(592)	(333)	57	180	(2,112)
Net Change in Cash		92	212	(366)	57	844
+ Beginning Cash Balance		406	498	710	344	401
= Ending Cash Balance		498	710	344	401	1,245

* Other liabilities in 1/30/2002 comprise of ''liabilities subject to compromise'' in Chapter 11 as follows:

Accounts payable	$3,058
Short-term debt	$84
Long-term debt	$3,262
Other liabilities	$1,735
	$8,139

Panel B: Target Corp (Condensed Financial Statements)

Fiscal Year-End	1/31/1997	1/31/1998	1/31/1999	1/31/2000	1/31/2001	1/31/2002
Income Statement						
Sales (Net)	25,092	27,487	30,662	33,702	36,851	39,826
Cost of Goods Sold	(17,128)	(18,944)	(21,085)	(23,029)	(25,504)	(27,606)
Gross Profit	7,964	8,543	9,577	10,673	11,347	12,220
SG&A Expense	(6,089)	(6,108)	(6,843)	(7,490)	(7,928)	(8,924)
EBITDA	1,875	2,435	2,734	3,183	3,419	3,296
Depreciation and Amortization	(650)	(693)	(780)	(854)	(940)	(1,079)
EBIT	1,225	1,742	1,954	2,329	2,479	2,217
Interest Expense	(442)	(416)	(398)	(393)	(426)	(473)
Non-Operating Income (Loss)	—	—	—	—	—	463
EBT	783	1,326	1,556	1,936	2,053	2,207
Income Taxes	(309)	(524)	(594)	(751)	(789)	(839)
Net Income Before Ext. Items	474	802	962	1,185	1,264	1,368
Ext. Items and Disc. Ops.	(11)	(51)	(27)	(41)	—	—
Net Income (available to common)	463	751	935	1,144	1,264	1,368
Balance Sheet						
Operating Cash and Market. Sec.	201	211	255	220	356	499
Receivables	1,720	1,555	1,656	1,724	1,941	3,831
Inventories	3,031	3,251	3,475	3,798	4,248	4,449
Other Current Assets	488	544	619	741	759	869
Total Current Assets	5,440	5,561	6,005	6,483	7,304	9,648
PP&E (Net)	7,467	8,125	8,969	9,899	11,418	13,533
Intangibles	—	—	—	—	—	250
Other Assets	482	505	692	761	768	723
Total Assets	13,389	14,191	15,666	17,143	19,490	24,154
Current Debt	233	273	256	498	857	905
Accounts Payable	2,528	2,727	3,150	3,514	3,576	4,160
Income Taxes Payable	182	210	207	318	361	423
Other Current Liabilities	1,168	1,346	1,444	1,520	1,507	1,566
Total Current Liabilities	4,111	4,556	5,057	5,850	6,301	7,054
Long-Term Debt	4,808	4,425	4,452	4,521	5,634	8,088
Deferred Taxes	630	720	822	910	1,036	1,152
Total Liabilities	9,549	9,701	10,331	11,281	12,971	16,294
Preferred Stock	321	310	292	—	—	—
Paid In Common Capital (Net)	171	250	360	806	977	1,173
Retained Earnings	3,348	3,930	4,683	5,056	5,542	6,687
Total Common Equity	3,519	4,180	5,043	5,862	6,519	7,860
Total Liabilities and Equity	13,389	14,191	15,666	17,143	19,490	24,154
Statement of Cash Flows						
Operating:						
Net Income		751	935	1,144	1,264	1,368
+ Depreciation and Amortization		693	780	854	940	1,079
Working Capital Adjustments		384	220	126	(467)	(1,380)
= Cash From Operations		1,828	1,935	2,124	1,737	1,067
Investing:						
− Capital Expenditures		(1,351)	(1,624)	(1,784)	(2,459)	(3,194)
− Purchases of Intangibles		—	—	—	—	(250)
− Increase in Other Assets		(23)	(187)	(69)	(7)	45

= Cash From Investing	(1,374)	(1,811)	(1,853)	(2,466)	(3,399)
Financing:					
+ Increase in Debt	(343)	10	311	1,472	2,502
+ Increase in Pref. Stock	(11)	(18)	(292)	—	—
− Dividends Paid on Common	—	(195)	(190)	(203)	(203)
+/− Net Issuance of Common Stock	(90)	123	(135)	(404)	176
= Cash From Financing	(444)	(80)	(306)	865	2,475
Net Change in Cash	10	44	(35)	136	143
+ Beginning Cash Balance	201	211	255	220	356
= Ending Cash Balance	211	255	220	356	499

Panel C: Wal-Mart Stores Inc (Condensed Financial Statements)

Fiscal Year-End	1/31/1997	1/31/1998	1/31/1999	1/31/2000	1/31/2001	1/31/2002
Income Statement						
Sales (Net)	104,859	117,958	137,634	165,013	191,329	217,799
Cost of Goods Sold	(83,510)	(93,438)	(108,725)	(129,664)	(150,255)	(171,562)
Gross Profit	21,349	24,520	28,909	35,349	41,074	46,237
SG&A Expense	(15,483)	(17,724)	(20,491)	(24,665)	(28,682)	(32,883)
EBITDA	5,866	6,796	8,418	10,684	12,392	13,354
Depreciation and Amortization	(1,463)	(1,634)	(1,872)	(2,375)	(2,868)	(3,290)
EBIT	4,403	5,162	6,546	8,309	9,524	10,064
Interest Expense	(845)	(784)	(797)	(1,022)	(1,383)	(1,357)
Non-Operating Income (Loss)	1,319	1,341	1,574	1,796	1,975	2,044
EBT	4,877	5,719	7,323	9,083	10,116	10,751
Income Taxes	(1,794)	(2,115)	(2,740)	(3,338)	(3,692)	(3,897)
Minority Interest in Earnings	(27)	(78)	(153)	(170)	(129)	(183)
Net Income Before Ext. Items	3,056	3,526	4,430	5,575	6,295	6,671
Ext. Items and Disc. Ops.	—	—	—	(198)	—	—
Net Income (available to common)	3,056	3,526	4,430	5,377	6,295	6,671
Balance Sheet						
Operating Cash and Market. Sec.	883	1,447	1,879	1,856	2,054	2,161
Receivables	845	976	1,118	1,341	1,768	2,000
Inventories	15,897	16,497	17,076	19,793	21,442	22,614
Other Current Assets	368	432	1,059	1,366	1,291	1,103
Total Current Assets	17,993	19,352	21,132	24,356	26,555	27,878
PP&E (Net)	20,324	23,606	25,973	35,969	40,934	45,750
Intangibles	1,037	2,126	2,538	9,392	9,059	8,566
Other Assets	250	300	353	632	1,582	1,333
Total Assets	39,604	45,384	49,996	70,349	78,130	83,527
Current Debt	618	1,141	1,006	5,408	6,661	3,148
Accounts Payable	7,628	9,126	10,257	13,105	15,092	15,617
Income Taxes Payable	298	565	501	1,129	841	1,343
Other Current Liabilities	2,413	3,628	4,998	6,161	6,355	7,174
Total Current Liabilities	10,957	14,460	16,762	25,803	28,949	27,282
Long-Term Debt	10,016	9,674	9,607	16,674	15,655	18,732
Deferred Taxes	463	809	716	759	1,043	1,204
Minority Interest	1,025	1,938	1,799	1,279	1,140	1,207
Total Liabilities	22,461	26,881	28,884	44,515	46,787	48,425
Paid In Common Capital (Net)	375	336	371	705	1,174	661
Retained Earnings	16,768	18,167	20,741	25,129	30,169	34,441

Total Common Equity	17,143	18,503	21,112	25,834	31,343	35,102
Total Liabilities and Equity	39,604	45,384	49,996	70,349	78,130	83,527
Statement of Cash Flows						
Operating:						
Net Income		3,526	4,430	5,377	6,295	6,671
+ Depreciation and Amortization		1,634	1,872	2,375	2,868	3,290
Working Capital Adjustments		3,444	857	915	37	858
= Cash From Operations		8,604	7,159	8,667	9,200	10,819
Investing:						
− Capital Expenditures		(4,916)	(4,239)	(12,371)	(7,833)	(8,106)
−Purchases of Intangibles		(1,089)	(412)	(6,854)	333	493
− Increase in Other Assets		(50)	(53)	(279)	(950)	249
= Cash From Investing		(6,055)	(4,704)	(19,504)	(8,450)	(7,364)
Financing:						
+ Increase in Debt		181	(202)	11,469	234	(436)
− Dividends Paid on Common		—	(693)	(890)	(1,070)	(1,249)
+/− Net Issuance of Common Stock		(2,166)	(1,128)	235	284	(1,663)
= Cash From Financing		(1,985)	(2,023)	10,814	(552)	(3,348)
Net Change in Cash		564	432	(23)	198	107
+ Beginning Cash Balance		883	1,447	1,879	1,856	2,054
= Ending Cash Balance		1,447	1,879	1,856	2,054	2,161

APPENDIX B
Fresh Start Reporting

Kmart Holding Corp
Form 10-Q (Partial)
April 30, 2003
(Filed: June 16, 2003)

2. Basis of Presentation

The unaudited Condensed Consolidated Balance Sheet distinguishes pre-petition liabilities subject to compromise from both those pre-petition liabilities that are not subject to compromise and from post-petition liabilities. Liabilities subject to compromise are reported at the amounts expected to be allowed, even if they may be settled for lesser amounts. In accordance with SOP 90–7, we adopted Fresh Start accounting as of the Confirmation Date. However, in light of the proximity of such date to our quarter end, for accounting purposes, the effects of Fresh Start accounting and the Plan of Reorganization, including the cancellation of the existing common stock and the issuance of the new common stock, have been reported ''as if'' they occurred on April 30, 2003.

3. Fresh-Start Accounting

Fresh-Start Adjustments

In accordance with Fresh Start accounting, all assets and liabilities are recorded at their respective fair market values. Such fair values represent our best estimates based on independent appraisals and valuations. To facilitate the calculation of the enterprise value of the Successor Company, we developed a set of financial projections. Based on these financial projections, the enterprise value was determined by the Company, with assistance of a financial advisor, using various valuation methods, including (i) a comparison of the Company and its projected

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TABLE B1

Kmart Reorganization Adjustments

	Predecessor Company April 30, 2003	Fresh Start Adjustments	Recapitalization	Successor Company April 30, 2003
Assets				
Current assets				
Cash and cash equivalents	$1,232	$—	$—	$1,232
Merchandise inventories	4,446	(15)	—	4,431
Other current assets	528	168[a]	195[b]	891
Total current assets	$6,206	$153	$195	$6,554
Property and equipment, net	4,623	(4,613)[a]	—	10
Other assets and deferred charges	212	(154)[a]	38[b]	96
Total assets	$11,041	$(4,614)	$233	$6,660
Liabilities and Shareholders' Equity (Deficit)				
Current Liabilities				
Long-term debt due within one year	$—	$—	$8[b]	$8
Accounts payable	1,151	—	9[b]	1,160
Other current liabilities	915	117[a]	563[b]	1,595
Total Current Liabilities	$2,066	$117	$580	$2,763
Long-term debt	—	—	108[b]	108
Capital lease obligations	415	—	—	415
Other long-term liabilities	174	279[a]	1,208[b]	1,661
Total Liabilities Not Subject to Compromise	2,655	396	1,896	4,947
Liabilities Subject to Compromise	8,896	114[a]	(9,010)[b]	—
Trust convertible securities	387	(387)[a]	—	—
Other comprehensive income	(908)	908[a]	—	—
Common stock	537	(537)[a]	1[c]	1
Other equity	(526)	(5,108)[a]	7,346[d]	1,712
Total Liabilities and Shareholders' Equity (Deficit)	$11,041	$(4,614)	$233	$6,660

[a] To adjust assets and liabilities to fair market value (''FMV''), and reflect the write-off of Predecessor Company's equity and the application of negative goodwill to long-lived assets.
[b] To record assumption or discharge of Liabilities subject to compromise and cash to be received from the Plan Investors.
[c] To record par value of new common stock for the Successor Company.
[d] To record gain on discharge of liabilities subject to compromise and additional paid-in-capital of new common stock for the Successor Company.

performance to the market values of comparable companies, (ii) a review and analysis of several recent transactions of companies in similar industries to the Company, and (iii) a calculation of the present value of the future cash flows under the projections. Table B1 reflects the reorganization adjustments to Kmart's unaudited Condensed Consolidated Balance Sheet as of April 30, 2003.

APPENDIX C
Liquidation Analysis (Source: Kmart's Plan of Reorganization)
Liquidation Analysis
($ in 000s)

V. Selected Notes to Liquidation Analysis

Note 1 Overview and Liquidation Period

This Best Interests Analysis was prepared as if the Debtors were substantively consolidated. The Analysis is based on the Company's projected balance sheet as of April 30, 2003 (except as indicated), and the actual amount of assets available to the estates as of the date of liquidation may differ from the amount of assets used in this Analysis (see Table C1).

TABLE C1

I. Calculation of Net Estimated Proceeds Available for Allocation

	Projected Balances @ 4/30/03	Estimated Recovery Rate Range		Impact on Unsecured Creditor Recoveries		See Note
		Low	High	Low	High	
A. Statement of Assets						
Cash and Equivalents	$820,550[a]	100%	100%	$820,550	$820,550	
Accounts Receivable	414,894	25%	40%	104,512	164,185	2
Inventories	4,581,433[b]	53%	62%	2,447,229	2,845,873	3
Prepaid Expenses and Other Current Assets	166,223	45%	53%	74,032	88,465	4
Net P&E	4,633,995	13%	19%	593,359	878,996	5
Other Assets and Deferrals	182,989	19%	37%	53,607	70,462	6
Total Assets	10,800,084	38%	45%	4,093,290	4,868,531	
B. Recoveries from Exercise of Avoiding Powers				240,000	405,000	7
C. Recoveries from Claims Against Certain Directors, Officers, and Advisors of Debtors				—	—	
D. Other Proceeds—Sale of Pharmacy Lists				152,000	192,000	
E. Gross Proceeds				4,485,290	5,465,531	
F. Creditor Recovery Expenses						
Corporate Expenses				(400,000)	(450,000)	8
Six months' store rent and occupancy following completion of GOB sale				(498,668)	(498,668)	
Employee retention and severance				(92,624)	(92,624)	
Chapter 7 Trustee fees (3% of gross proceeds)				(134,559)	(163,966)	
Other professional fees				(80,000)	(100,000)	
				(1,205,852)	(1,305,259)	
Net Estimated Proceeds Available for Allocation				**$3,279,438**	**$4,160,272**	

[a] Cash and Equivalents is projected balance of cash (net of checks outstanding) and marketable securities at 4/30/03 reduced for payment of estimated professional fees of approximately $37.3 million.
[b] Inventories is projected balance of inventories at 4/30/03 increased for estimated inventories secured by Trade Letters of Credit outstanding as of the projected filing date (See Note 3—Inventories).

Management of the Company, with the assistance of AlixPartners LLC, prepared the Analysis. The Analysis presents management's estimated net value of the Company's assets if the Debtors were to be liquidated under the provisions of Chapter 7 of the United States Bankruptcy Code (the ''Code''), and the net proceeds of the liquidation were to be applied in strict priority to satisfy claims against the debtors.

The Analysis is limited to presenting information that was the representation of management and does not include an evaluation of the support for the underlying assumptions. The Analysis has not been examined or reviewed by independent accountants in accordance with standards promulgated by the American Institute of Certified Public Accountants. The estimates and assumptions, although considered reasonable by management, are inherently subject to significant uncertainties and contingencies beyond the control of management. Accordingly, there can be no assurance that the results shown would be realized if the Company were liquidated and actual results in such case could vary materially from those presented.

For purposes of this Analysis, management assumes a liquidation would require three phases and would take place over 18 months. Phase I would comprise a three-month period during which inventories would be sold in a going-out-of-business sale (''GOB Sale'') conducted by a third-party. By the end of the GOB Sale substantially all store, distribution center, and field associates would be terminated. During Phase I, certain headquarters associates would be terminated including, for instance, staff of merchandising, merchandise finance, advertising, stores organization, loss prevention, maintenance, accounts payable, training, communications, and purchasing.

Phase II would comprise the next six-month period (and would actually have started during Phase I). During Phase II, the Company's real estate and most of the Company's non-real estate fixed assets would be marketed. In addition, headquarters operations would continue to wind down, and most remaining headquarters associates would be terminated. Certain headquarters personnel, such as staff in legal, finance and accounting, and information technology would be retained as necessary to support Phase III. Phase III would comprise a nine-month period after completion of the real estate marketing efforts during which any remaining litigation would be pursued, final tax returns filed, bankruptcy court reports and schedules filed, and remaining assets disposed.

While the Analysis assumes an 18-month liquidation time frame, final resolution of all preference actions is expected to extend 12 months beyond the 18-month liquidation time frame. All professional fees associated with resolution of such matters are contemplated in the estimated net recoveries from preferences actions.

Note 2 Accounts Receivable

Accounts receivable comprises a variety of accounts, the most sizeable being Pharmacy Receivables, Store Receivables, and Merchandise Allowance Receivables.

Pharmacy Receivables are receivables from third-party insurance companies in connection with the filling of prescriptions. All accounts aged past 60 days are fully reserved. Historical experience indicates that the Company's reserve policy has been sufficient in estimating losses incurred with this account.

Store Receivables are a combination of layaway receivables and credit extended at the store level by store management to customers. For purposes of the Analysis, the account is assumed to be primarily comprised of credit extended to customers and would be, in all likelihood, uncollectable.

Merchandise Allowance Receivables are allowances generated in connection with food products purchased through Fleming.

Other Receivables are comprised of a number of miscellaneous accounts such as rent due from subtenants and former subsidiaries, amounts due from landlords for repairs and maintenance, and amounts due from bad checks, etc. and have varying degrees of estimated collectability (see Table C2).

TABLE C2

Accounts Receivable	Projected Balance @ 4/30/03	Recovery Rate Range		Estimated Proceeds Range	
		Low	High	Low	High
Pharmacy Receivables (net)	$100,000	90%	100%	$90,000	$100,000
Store Receivables	86,000	0%	0%	—	—
Merchandise Allowance Receivables (net)	61,353	10%	35%	6,135	30,677
Other Receivables	167,540	5%	20%	8,377	33,508
Total Accounts Receivable	$414,894	25%	40%	$104,512	$164,185
				25%	40%

Note 3 Inventories

Merchandise inventories are assumed to be disposed of through a lawful ''going-out-of-business sale'' commencing May 1, 2003, with no restrictions on the Company's ability to aggressively advertise the sale as a ''going-out-of-business sale'' (''GOB Sale''). The GOB Sale assumptions reflect the Company's experience in 2002 when it closed 283 stores over a ten-week time period and are adjusted where considered appropriate for the scale and timing of a mass liquidation, as well as for the projected composition of Company inventory at the commencement of a mass liquidation. The Low Recovery scenario assumes that the sale takes 13 weeks and reflects a lowered net recovery resulting from deeper discounts and increased direct expense. The High Recovery scenario assumes a ten-week sale period and is more reflective of the results achieved in the 2002 store closings. For purposes of the Analysis, GOB Sale Merchandise Inventory is the sum of perpetual inventories, imports paid not received, and merchandise letters of credit outstanding under the Company's projections as of April 30, 2003 (see Table C3).

Note 5 Net P&E—Owned and Leased

Net P&E includes owned land, buildings, furniture, fixtures, and equipment at the stores, distribution center, and corporate resource center, net of depreciation. Certain P&E is recorded as capitalized lease assets. Proceeds from the disposition of owned real estate and real estate leasehold interests were established using estimates provided by Rockwood Gemini Advisors.

Proceeds from the sale of furniture, fixtures, and equipment are estimated based on management's experience with store closings (see Table C4).

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TABLE C3

Projected Merchandise Inventories at Cost @ 4/30/03	$4,322,229
Add: Inventory Received after 4/30/03	259,204[a]
GOB Sale Merchandise Inventories at Cost	4,581,433
Assumed Selling Value of Merchandise Inventories	$6,737,402
Assumed Selling Value Gross Margin	32%

	2002 GOB Sale	Percentage	Low Recovery	Percentage	High Recovery	Percentage
Merchandise Inventory @ Retail	$1,415,469		$6,737,402		$6,737,402	
Sales (Gross Recovery)	890,303	62.9%	4,042,312	60.0%	4,237,696	62.9%
Store Direct Expenses						
Total Employment Expense	118,479	8.4%	777,183	11.5%	603,774	9.0%
Rent & Occupancy	47,132	3.3%	320,279	4.8%	320,279	4.8%
Advertising	31,100	2.2%	204,005	3.0%	158,486	2.4%
Other SG&A	4,435	0.3%	82,667	1.2%	64,222	1.0%
Total Store Direct Expenses	201,146	14.2%	1,384,134	20.5%	1,146,761	17.0%
Royalty Expense[b]	NA		8,826	0.1%	9,252	0.1%
Liquidation Fees	58,423	4.1%	202,122	3.0%	235,809	3.5%
Total GOB Expenses	259,569	18.3%	1,595,082	23.7%	1,391,823	20.7%
Estimated Cash Proceeds from Sale	$630,734	44.6%	$2,447,229	36.3%	$2,845,873	42.2%

[a] Projected Trade Letters of Credit at 4/30/03 ($216 million) are grossed-up by 20 percent for insurance, freight, and import fees and are assumed, for purposes of this Analysis, to be issued to foreign vendors and that all goods secured by Letters of Credit are shipped and paid in the normal course. Additionally, it is assumed that all purchase orders for goods not secured by Trade Letters of Credit would be cancelled as of the hypothetical filing date. While it may be possible to cancel certain Trade Letters of Credit, it is assumed that any potential cancellation would be offset by any goods on a non-secured purchase order that are FOB. Accordingly, the estimated Trade Letter of Credit balance is considered a reasonable estimate of the value of goods that would flow into a GOB sale subsequent to the sale commencement date.

[b] Royalty Expense on Licensed Inventory is estimated using projected balances of licensed inventories as of 4/30/03. Expense is calculated on those lines where royalties are determined by sales. Royalty expense calculated on purchases or receipts are assumed to have been booked prior to commencement of the GOB Sale. Results of the 2002 GOB Sale were tracked only on a direct store expense basis. Consequently, comparable information for royalty expense is not available.

TABLE C4

Proceeds from the Sale of Furniture, Fixtures, and Equipment

Real Estate Assets	Projected NBV @ 4/30/03	Recovery Rate Range Low	Recovery Rate Range High	Estimated Proceeds Range Low	Estimated Proceeds Range High
Owned[a]:					
Stores				$193,529	$234,546
Distribution Centers (DC)				933	11,803
Kmart Resource Centers (KRC)				9,625	19,250
Other				57,020	65,569
	1,208,392	22%	27%	261,107	331,168
Leased:					
Capitalized Assets and LHI[a,b]	1,703,830	17%	27%	293,238	461,536
Non-Real Estate Fixed Assets					
Furniture and Fixtures—Stores	1,229,244	3%	5%	36,877	61,462
Furniture and Fixtures—DCs	282,944	0%	5%	—	14,147
Furniture and Fixtures—KRC	213,659	1%	5%	2,137	10,683
Other	(4,074)	0%	0%	—	—
Totals	$4,633,995	13%	19%	$593,359	$878,996

[a] Per discussions with the Company's real estate advisor, Rockwood Gemini Advisors, appraised values have been reduced by 50 percent to reflect the liquidation assumptions contemplated by this Analysis.
[b] For purposed of the Analysis, Capitalized Assets are considered to be principally real estate assets and Leasehold Improvements are considered as part of those assets. Anticipated recoveries on Capitalized Assets and Leasehold Improvements are assumed to be through the sale of designation rights.

APPENDIX D

Data for Relative Valuation

Kmart Corporation
Relative Valuation
(Dollars in Millions, Except Per Share Data)

	Kmart[a]		Wal-Mart[b]		Target[c]	
Filing Date	**Jan 2003**	**Jan 2004**	**Jan 2003**	**Jan 2004**	**Jan 2003**	**Jan 2004**
Fiscal Year	**2002**	**2003**	**2002**	**2003**	**2002**	**2003**
Number of Outstanding Shares (millions)	519.12	89.59	4,395.00	4,311.00	909.80	911.81
Price/Share[d]	0.24	25.31	51.68	52.68	31.04	37.95
Market Value of Equity	126	2,267	227,123	227,099	28,237	34,599
Book Value of Debt	4825	501	37,055	40,322	10,186	10,217
Cash	613	2088	2,736	5,199	758	716
Enterprise Value	4,338	680	261,442	262,222	37,665	44,100
Book Value of Equity	−301	2,209	39,461	43,623	9,443	11,065

Revenue	30,762	23,253	229,616	256,329	42,722	46,781
EBITDA	−12	639	13,295	15,025	4,476	4,839
Square Feet of Stores (millions)[e]		154		454		193

[a] Kmart financial data was taken from Compustat.
[b] Wal-Mart financial data was taken from Bloomberg.
[c] Target financial data was taken from Bloomberg.
[d] Price per share data was taken from Bloomberg.
[e] Kmart's square feet of stores data was taken from http://www.bizstats.com/whyspf.htm.
Wal Mart's square feet of store data were taken from http://www.buildings.com/Articles/detail.asp?ArticleID=1525
Target's square feet of stores data were taken from http://pressroom.target.com/pr/news/target-stores/fastfacts.aspx

APPENDIX E

Projected Financial Statements (Source: Kmart's Plan of Reorganization)

Panel A: Projected Consolidated Statements of Operations

Kmart Corporation
(Debtors-in-Possession)
(Dollars in millions)

	Fiscal Year			
	2004 (Ending Jan. 2005)	**2005 (Ending Jan. 2006)**	**2006 (Ending Jan. 2007)**	**2007 (Ending Jan. 2008)**
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	89	73	61	51
Earnings before income taxes	288	534	752	1,041
Income taxes	109	202	287	397
Net earnings	179	332	465	644
Depreciation and amortization	47	93	142	192
EBITDA	424	700	955	1,284

Panel B: Projected Consolidated Balance Sheets

Kmart Corporation
(Debtors-in-Possession)
(Dollars in millions)

	Fiscal Year				
	2003 (Ending Jan. 2004)	**2004 (Ending Jan. 2005)**	**2005 (Ending Jan. 2006)**	**2006 (Ending Jan. 2007)**	**2007 (Ending Jan. 2008)**
Assets					
Current Assets					
Cash and cash equivalents	300	300	312	468	807
Merchandise inventories	4,048	3,995	3,925	3,910	3,872
Other current assets	739	657	681	708	740
Total current assets	5,087	4,952	4,918	5,086	5,419
Property and equipment, net	273	676	1,083	1,491	1,899
Other assets and deferred charges	14	13	14	15	16
Total Assets	5,374	5,641	6,015	6,592	7,334
Liabilities and Shareholders' Equity					
Current Liabilities					
Long-term debt due within one year	8	8	8	8	8
Accounts payable	1,026	1,357	1,505	1,570	1,684
Other current liabilities	828	966	1,159	1,470	1,720
Total Current Liabilities	1,862	2,331	2,672	3,048	3,412
Long-term debt	251	115	73	68	63
Other long-term liabilities*	1,993	1,750	1,492	1,233	972
Total liabilities not subject to compromise	4,106	4,196	4,237	4,349	4,447
Shareholders' equity	1,268	1,445	1,778	2,243	2,887
Total Liabilities and Equity	5,374	5,641	6,015	6,592	7,334

* ''Other long-term liabilities'' include capital lease obligations as can be inferred from the payment of $52 in the statement of cash flows on the next page.

Panel C: Projected Consolidated Statements of Cash Flow

Kmart Corporation
(Debtors-in-Possession)
(Dollars in millions)

	Fiscal Year			
	2004 (Ending Jan. 2005)	**2005 (Ending Jan. 2006)**	**2006 (Ending Jan. 2007)**	**2007 (Ending Jan. 2008)**
Operating Activities				
Net Earnings	$179	$332	$465	$644
Adjustments to reconcile net earnings to net cash used for operating activities:				
Depreciation and amortization	50	93	142	191
Equity income in unconsolidated subsidiaries	(47)	(48)	(49)	(50)
Dividends received from Meldisco	46	47	48	49
Changes 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	(164)	(215)	(183)	(230)
Net cash provided by operating activities	639	606	763	996
Investing Activities				
Capital expenditures	(450)	(500)	(550)	(600)
Net cash used for investing activities	(450)	(500)	(550)	(600)
Financing Activities				
Payments on debt, net	(137)	(42)	(5)	(5)
Payments on capital lease obligations	(52)	(52)	(52)	(52)
Net cash used for financing activities	(189)	(94)	(57)	(57)
Net change in cash and cash equivalents	—	12	156	339
Cash and cash equivalents, beginning of year	300	300	312	468
Cash and cash equivalents, end of year	$300	$312	$468	$807

Summary of Significant Assumptions

The financial projections included in this Disclosure Statement are dependent on successful implementation of the business plan of Kmart Corporation and its subsidiaries and the accuracy of the assumptions contained therein. The Projections have not been prepared to comply with the guidelines established by the American Institute of Certified Public Accountants (AICPA).

Fresh Start Accounting and Enterprise Value

The Projections assume that Kmart will emerge from Chapter 11 on or about April 30, 2003, and as required, adopt the principles of Fresh Start Accounting prior thereto. Adoption of Fresh Start Accounting requires that assets and liabilities be stated at their reorganization value, which approximates fair value at the date of emergence from Chapter 11. Adjustments to reflect the fair value of assets and liabilities, on a net basis, result in an excess of fair value of net assets over reorganization value (''negative goodwill'') of approximately $4.2 billion. This negative goodwill will be allocated on

a *pro rata* basis and serve to reduce the basis of our non-current assets. The remaining negative goodwill of $0.1 billion will be recorded in the income statement as an extraordinary gain.

Net Sales

Net sales for 2003 as compared to 2002 are projected to decrease by 17.5 percent due to the closure of 283 stores in May 2002 and additional stores by March 2003. Net sales are expected to increase 0.7 percent in 2004, 5.3 percent in 2005, 5.5 percent in 2006, and 5.9 percent in 2007. The increases in net sales for 2004 through 2007 are partially the result of 70 new store openings, which are planned as follows: 10 each in 2004 and 2005, 20 in 2006, and 30 in 2007. On a same-store basis, the Projections assume that same-store sales will increase over prior years by 1.1 percent, 3.8 percent, 4.5 percent, 4.3 percent, and 4.0 percent for 2003 through 2007, respectively. The primary drivers of the same-store sales increases include the continued improvement in operational execution, increased promotional productivity and improved product flow. As a result of improved product flow and allocation, inventory turns are expected to improve from 4.0 in 2002 to 4.2 in 2003. Inventory turnover is expected to further improve to 5.0 by 2007 as a result of right-size purchasing and flow path optimization.

Gross Margin

Gross margin as a percentage of net sales is projected to improve from 18.0 percent in 2002 to 21.5 percent in 2007. This improvement is driven by improved promotional productivity and favorable product mix. In addition, the Projections assume lower depreciation of buildings and leasehold improvements as a result of the write-down of assets for Fresh Start Accounting.

SG&A

Selling, general, and administrative expenses (‘‘SG&A’’), as a percentage of net sales, are projected to remain relatively flat at approximately 20 percent from 2002 to 2003 as lower depreciation expense generated by Fresh Start Accounting adjustments is mostly offset by the effects of store closings and the resulting lower sales base. Thereafter, SG&A is expected to improve to 17.9 percent of net sales by 2007. This improvement is primarily due to improved operating procedures and cost control initiatives at Kmart’s headquarters.

Income Taxes

The Projections assume that Kmart will substantially offset its unused net loss carryforwards against the Company’s cancellation of debt income at emergence. The effective tax rate going forward is estimated at 38.0 percent. Tax benefits will be fully reserved until utilization.

Capital Expenditures

The Projections assume that annual capital expenditures build from $350 million in 2003 to $600 million in 2007. The increase is primarily related to new store openings (a total of 70 through 2007) and updating the existing stores.

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APPENDIX F
Treatment of Selected Classes of Kmart's Claimholders
(Source: Kmart's Plan of Reorganization)

Below is the summary of the treatment of selected classes of Kmart's claimholders under the Reorganization Plan:

Class Description	**Treatment**
Class 3: Prepetition Lender Claims	
These are unsecured creditors of Kmart	Issued 18,723,735 shares of new common stock of Kmart Corporation and cash recovery of $243 million[a]

Estimated Amount of Claim: $1,076,156,647.02
Estimated Percentage Recovery: 45.0 percent

[a] According to the valuation analysis prepared by Kmart's investment bankers and financial advisors, the estimated mid-range value of Kmart's equity is approximately $1.128 billion (average of $753 million and $1,503 million) or $13.09/share (average of $8.75/share and $17.43/share) assuming a total of 86,236,453 shares. A cash recovery of $243 million and the 18,723,775 shares at an average of $13.09/share totals a recovery of $488 million, which is approximately 45 percent of total estimated amount of claims of $1,076,156,647.

Class 4: Prepetition Note Claims

These are comprised of unsecured debentures and notes issued by Kmart over the course of several years	Issued 25,008,573 shares of new common stock of Kmart Corporation

Allowed Amount of Claims: $2,277,384,986.97
Estimated Percentage Recovery: 14.4 percent

Class 5: Trade Vendor/Lease Rejection Claims (amounts over $30,000)

These are claims arising as a result of retail merchandise or services provided by trade vendors or service providers, rejection of executory contracts and unexpired leases, guarantees with respect to industrial revenue bonds, and unsecured deficiency claims	Issued 31,945,161 shares of new common stock of Kmart Corporation

Estimated Amount of Claims: $4,300,000,000
Estimated Percentage of Recovery: 9.7 percent

Class 6: Other Unsecured Claims (claims greater than $30,000)

These comprise personal injury and other litigation claimants and claims by government entities on account of anything other than taxes. Note that a large percentage of these claims are of unknown amounts and disputed.

Estimated Amount of Claim: $200,000,000
Estimated Percentage of Recovery: NA

Claimholders will receive their *pro rata* share of common stock on the third anniversary of the effective date of the Plan of Reorganization

Class 7: General Unsecured Convenience Claims

These are claims held by persons who would otherwise qualify for treatment as Class 5 or Class 6 creditors, but whose claims are in amounts equal to or less than $30,000

Estimated Amount of Claim: $5,000,000
Estimated Percentage Recovery: 6.25 percent

Under the Plan, these claimants will receive cash in an amount equal to 6.25 percent of the amount of their claim.

Class 1: Secured Claims and Class 2: Priority Claims were not impaired and are not listed. Class 8: Trust Preferred Obligations, Class 10: Subordinated Securities, Class 11: Existing Common Stock, and Class 12: Other Interests were cancelled and not entitled to any distribution. Class 9: Intercompany Claims are purely accounting transactions and are eliminated.

CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

Overview

This is a comprehensive case that requires students to analyze Kmart Corporation's financial information, investigate the circumstances leading to its bankruptcy, and analyze accounting and valuation issues as it emerged from its Chapter 11 reorganization. The case has been prepared from publicly available information, including Kmart's 10-K and 10-Q filings, Joint Plan of Reorganization filed with the United States Bankruptcy Court for the Northern District of Illinois, and news items in the business press. This case is targeted primarily at graduate-level courses in Financial Statement Analysis as well as Forecasting and Valuation.

Incremental Contribution of the Case

This teaching case provides several opportunities for the instructor to contribute to the students' learning experience in a typical financial statement analysis and/or forecasting and valuation courses. First, the case demonstrates the ability of a detailed financial ratio analysis (over time and compared to other firms) to predict bankruptcy. Second, the case introduces and demonstrates the implementation of Fresh Start Reporting for firms emerging from bankruptcy. Third, the case familiarizes the students with the institutional background of a Chapter 11 bankruptcy, and, in particular, the requirements for a liquidation analysis that demonstrates the value of the firm if it were to liquidate instead of reorganize. This is a fascinating part of the case because it illustrates possible methods to compute assets' liquidation values as well as a discussion of the effect of management incentives on the determination of these figures. Fourth, while there are many teaching cases whose objective is to derive equity values based on various valuation models, this case requires students to derive equity values based on the firm's own release of projected financial statements during bankruptcy, and discusses the potential for these forecasted statements and the resulting valuation to be biased. Finally, the case discusses the incentives of the various groups that are a part of a typical bankruptcy (e.g., management, creditors, and vulture investors) and demonstrates the effect of these incentives on the reported financial numbers (both on the projections provided during the bankruptcy and on the fresh start numbers). This provides students with a unique and clear-cut example of the use of reporting discretion in financial reporting.

There are a number of existing cases (primarily Harvard Business School cases) relating to bankruptcy and Chapter 11 reorganization. Some of these cases, such as Bankruptcy and Restructuring at Marvel Entertainment Group (Esty and Auerbach 2007) and Flagstar Companies Inc. (Gilson 2007) focus on the valuation of a company in a corporate restructuring. Other cases deal with the details of the restructuring process. For instance, Scott Paper Company (Gilson and Cott 1997) requires students to evaluate the optimal level of layoffs in a corporate downsizing program.

Two other cases deal with topics similar to the issues discussed in the Kmart case. In ''TWA: The Second Bankruptcy'' (Barth and Yildiz 2001) students are required to act as the holders of TWA's 8 percent secured notes and to analyze the information in the proxy statement in order to decide how to cast the vote on the firm's reorganization proposal. The second is ''Eddie Bauer'' (Healy et al. 2009), which is a comprehensive valuation case in a setting in which the firm is emerging from bankruptcy protection and later plans to go private. While both the TWA and the Eddie Bauer cases rely on details that are similar to those provided in the Kmart case, they primarily address valuation issues and do not focus on the same set of issues as the ones in the Kmart case (e.g., understanding the mechanics of the Fresh Start adjustments, the analysis of the financial performance of the firm prior to bankruptcy, and the assessment of the reasonableness of the

Estimated Recovery rates *vis-à-vis* Kmart's post-bankruptcy performance). As such, we believe that the Kmart case provides incremental contribution over and above existing published cases.

Case Learning Objectives

Following are the specific learning objectives of the case:

i. Analyze the financial statements of Kmart Corporation through the computation of appropriate ratios with a view to ascertaining its potential bankruptcy. In addition to assessing the financial position and performance of the firm, students have to understand and evaluate the business risks that confronted Kmart and its management actions prior to its bankruptcy.
ii. Understand Kmart's Reorganization Plan, specifically, the treatment of its various claimholders and the details of the liquidation analysis as set forth in the Bankruptcy Code.
iii. Learn to value Kmart as it emerges from reorganization using appropriate valuation methodologies and based on the unaudited projections that Kmart's management provided in the Reorganization Plan.
iv. Understand the use of Fresh Start Reporting by Kmart and examine the consequences of Kmart's management discretion in the determination of Fresh Start values.
v. Understand the reasons and consequences of Kmart's stellar stock performance after it emerged from bankruptcy.

Implementation Guidance

The case is most suitable for a graduate-level course in Financial Statement Analysis as well as a Forecasting and Valuation course. In Financial Statement Analysis, the case can be used concurrently with lectures on Credit Analysis and Distress Prediction—for instance, Chapter 10 of *Business Analysis and Valuation*, Palepu and Healy (2007). In a Forecasting and Valuation course the case can be used to demonstrate the forecasting process (using the Kmart-provided financial projections) as well as the various valuation techniques used by bankruptcy valuation experts. The categories of case questions are largely independent allowing instructors the flexibility to adopt only sections that are relevant to their courses. For a Financial Statement Analysis course, the instructor could assign questions in Part I, II, and III. For a Forecasting and Valuation course, Parts IV and V would be appropriate.

The case is challenging and broad in scope, but manageable if the instructor reviews the underlying topics prior to assigning the case to allow students with limited knowledge and background to tackle the case. For instance, prior to assigning Part III questions, the instructor should provide an overview of Fresh Start Reporting, including the allocation of reorganization value to identifiable assets, reporting of liabilities, and required disclosures in financial statements of the new entity. The main body of the case provides an overview of Chapter 11 reorganizations and a description of the various approaches for valuing firms in financial distress. In addition, the instructor could provide supplemental handouts on various valuation methodologies and Fresh Start Reporting.

The case is computationally intensive. However, instructors can obtain electronic spreadsheets of the condensed financial statements of Kmart, Target, and Wal-Mart and the projected financial statements of Kmart from the journal's website. This will significantly reduce students' preparation time, allowing them to focus on analysis and interpretation. Also, the case is best used as a collaborative project in which groups of three to four students submit written analyses of the case. A lead time of at least two weeks is suggested before the case analyses are required.

Instructors should schedule a class discussion after students submit their projects. For optimal class discussion, two class sessions of 1.5 hours each should be devoted to the case. The first class

TABLE 1
Student Feedback

	Mean Response
1. The case content was realistic.	4.38
2. The Kmart case and class discussion enhanced my understanding of how to analyze the financial performance of a firm prior to bankruptcy.	4.10
3. The Kmart case and class discussion helped me understand the accounting rules for companies emerging from a Chapter 11 bankruptcy (Fresh Start Reporting).	4.14
4. The case incorporated many of the analysis techniques (strategy analysis, accounting analysis, etc.) taught in the course.	4.10
5. Overall, the Kmart case and class discussion enhanced my understanding of the Chapter 11 reorganization process.	4.21
5. Overall, I found the Kmart case and class discussion interesting and useful.	4.22
6. I would recommend that the Kmart case be used as part of this course in the future.	4.47

session would cover the company history leading to its bankruptcy filing on January 22, 2002; comparative ratio analysis of Kmart, Wal-Mart, and Target's growth, profitability, efficiency, and credit risk; Kmart's Reorganization Plan; and an introduction to Fresh Start Reporting (Requirements in Parts I, II, and III). The second session would cover the valuation methodologies in detail, liquidation analysis, post-bankruptcy performance, and vulture investing in Kmart (Requirements in Parts IV and V). The valuation spreadsheets and PowerPoint slides for the two class sessions described above are available on the journal's website.

Student Feedback

The authors have used the case in a graduate financial statement analysis course. It was assigned as a collaborative project with a group size of between 3–4 students accounting for 10–15 percent of the course grade. Students were asked to provide feedback on the following questions, using a five-point scale with the following response categories: (1) Strongly Disagree, (2) Disagree, (3) Neither agree or disagree, (4) Agree, and (5) Strongly Agree. Mean response for the 58 students (or 45 percent) completing the survey are reported in Table 1.

Responses to the ''Other Comments'' section of the student feedback forms indicate that the students found the case very interesting and a useful tool to discuss Chapter 11 reorganization.

On average, the students spent between 1–2 hours on each part with the instructors spending between 2–3 hours preparing for each part of the case. The case generated considerable discussion and interest among the students on the topics of Fresh Start Reporting, valuation, and the strategies for investing in distressed securities. The case has significant real-life relevance because many graduate students had heard about Mr. Eddie Lampert and the returns he generated for ESL Investments from his investment in the distressed bonds of Kmart.

TEACHING NOTES

Teaching Notes are available only to full-member subscribers to Issues in Accounting Education through the American Accounting Association's electronic publications system at http://aaapubs.org/. Full-member subscribers should use their usernames and passwords for entry into the system where the Teaching Notes can be reviewed and printed. Please do not make the Teaching Notes available to students or post them on websites.

If you are a full member of AAA with a subscription to Issues in Accounting Education and have any trouble accessing this material, then please contact the AAA headquarters office at info@aaahq.org or (941) 921-7747.

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