THE SCRATCH REPORT

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Is Cash Flow Better Than Growth?

Company	Kmart Holding Corporation
Ticker	NASDAQ: KMRT
Price (6/14/04) mid-day	$63.16
52 - week range	$14.72 - $67.65
Shares outstanding (in millions)	100
Market capitalization (in millions)	$6,316
Dividend yield	n/a
Price/earnings (consensus)	18.9x
Total debt (in millions)	$102
Debt/capital	4%
Recommendation	**Buy**

Overview

- *Kmart, in less than one year after emerging from bankruptcy, has recently turned profitable over the last two quarters. As a result, excess cash flow now permits a considerable amount of earnings expansion, should these funds be used merely for share retirement. Under this scenario, and absent any valuation expansion, prospective returns would be on the order of 15% per annum.*

- *The current valuation of Kmart suggests that it will continue to operate as a distressed retail firm that is under repeated pressure from Wal-Mart. Although the present recommendation is not predicated upon a growth scenario, there does however exist the possibility that Kmart's product differentiation strategy and urban location advantage might prove successful. If this is the case, and Kmart were to trade at a valuation of roughly similar firms, the shares could be worth $74.85.*

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Investment Thesis

Kmart was the subject of the largest retail bankruptcy in US history, or, more specifically, it was a direct casualty of Wal-Mart. With an unprecedented retail economy of scale, Wal-Mart unrelentingly lowered its prices to the degree that Kmart could no longer compete, or even generate a profit. Currently, in its post-bankruptcy operating state, Kmart faces the exact same retail competition that was previously present and one could argue that in the two years since its insolvency, competition has intensified.

There are nevertheless certain variables that must now be taken into consideration. Kmart was resurrected from bankruptcy by two prominent investors, Eddie Lampert of ESL Investments and Marty Whitman of Third Avenue Management. In exchange for their much needed capital commitment and financial advise, these two entities now own over 50% of the newly issued common shares through various share issuances and convertible notes. In a matter of approximately nine months, Kmart is once again profitable on a quarterly basis. Kmart quickly shed undesirable store locations, eliminated unnecessary expenditures such as corporate jets, and vastly improved the management of its inventory. At least from an ongoing operational viewpoint, Kmart is the most efficient it has been in several years and shareholders have been rewarded with a return of over 250% since the newly listed Kmart shares began trading in May of 2003.

Now that the operating margin has been restored to a pre-bankruptcy level, the investment community is most concerned with the growth opportunities that may reside within the retail industry. This is to say, how can Kmart possibly grow despite the ubiquitous Wal-Mart? The answer, quite simply, is that Kmart might not expand its retail sales any further. Yet, Kmart need not be viewed from the analysis of its anticipated growth, as is customary with most equity investments. Rather, Kmart can be viewed purely from its ability to generate cash from the existing level of sales, which were last recorded as a decline of 12.9% on a same store sales basis. It is therefore this unique attribute that requires examination.

In its most recent fiscal quarter, Kmart earned $0.94 per share on a fully diluted basis. With minimal assistance from the prepared sale of assets, this translated into $140 million of excess cash that was retained on the balance sheet. Total cash balances now constitute 42% of the market capitalization and 98% of shareholders' equity, or $22.21 per share. Future cash retention rates could be calculated in two ways. First, at an undiminished rate of current growth, which could effectively be calculated as 0%, the mere maintenance of the most recent quarter's performance would result in annualized cash accumulation of $560 million. Relative to its market value, this equates to a cash build rate of 8.8% per annum.

Alternatively, one might wish to account for cash flow during the entirety of Kmart's post-bankruptcy stated results. This estimation, indeed, might not be of a repeatable character, but only because an operating loss resulted in two of these four quarters, and, therefore, assuming some degree of ongoing profitability is present, cash flow could actually be higher. In any case, since the 2nd quarter of 2003 (the first complete reporting period), Kmart has expanded its cash reserves from $1.2 billion to $2.2 billion, which is at a rate of $257 million per quarter. Therefore, on an annualized basis, Kmart would retain roughly $1 billion of cash liquidity, or at a rate of 16.2% relative to its market value.

While the retention of cash at a double digit rate is certainly commendable, it might not be acceptable in the sense that there is an associated time value risk of this asset in the absence of utilization. Towards this end, if Kmart were to deploy the entirety of this cash flow towards the retirement of outstanding shares at the current valuation, the anti-dilutive effect on earnings relative to net market capitalization would be in the range of 18% to 33%. This type of prospective return requires no additional growth or store expansion.

One of the more important virtues of Kmart is that it can be examined from several different perspectives, or prospective future courses of action. If one takes the position that Kmart will once again become a viable retail firm and attempts to estimate earnings from an operational basis, the application of the current 3.8% operating margin to the consensus sales estimate results in earnings per share of $5.54, after accounting for the applicable $3.8 billion of net operating loss carryforwards. Alternatively, there exists a goodly amount of value in Kmart's real estate. Although its stores are leased rather than owned outright, the prospective subletting of these urban properties could generate earnings per share of $4.23 if Kmart operated as a quasi-REIT investment vehicle. This succeeding discussion is found later in the text of this paper.

As to valuation, the shares trade at a conventional p/e ratio of 18.9x the sole consensus earnings estimate of $3.35. When adjusted for cash reserves, the underlying retail business is valued at 12.2x. The alternative earnings estimation method would be to annualize the $0.94 per share earned last quarter, which results in full year earnings of $3.76 by which Kmart would trade at a net p/e ratio of 10.9x the retail operations. If sustained sales growth proceeds, or at least one quarter of positive sales growth is accomplished, then the shares might be accorded a valuation multiple that is roughly similar to other disfavored retailers of 14x. The resultant share price, inclusive of cash would then be $74.85, or one that is 18.5% higher. Of course, if Kmart were to merely expand earnings through share retirement amid no valuation expansion, returns would still be nearly 15%. It is this rather unique set of valuation and return characteristics afforded to the potential investor that warrants consideration, and, accordingly, purchase of these shares is recommended.

The Present State of Kmart

The bankruptcy of Kmart in 2002 was not due to extraordinary circumstances, at least in the traditional sense, although one might consider Wal-Mart an extraordinary enterprise. It was the result of a retail economy of scale that exists, and this scale was successfully exploited by Wal-Mart. Kmart had adopted a high/low pricing strategy to counter the Wal-Mart expansion, but Wal-Mart continued to price its products well below even the lowest Kmart price. Consumers, then, abandoned the Kmart stores in a predictable manner and its sales and profitability precipitously declined, in the absence of debt interest relief, to the point of insolvency. The table below demonstrates the rapid erosion of profitability that occurred between 2000 and 2002. It is also shown that the pressure applied by Wal-Mart had been occurring for nearly 10 years, as Kmart's financial performance was exceedingly unstable.

Table 1: Kmart Pre-Bankruptcy Operating Results

	Sales	SG&A as % of sales	Gross Margin	Operating margin	Net margin
1994	$33,589	22.5%	25.7%	0.1%	-2.9%
1995	$32,800	21.7%	23.3%	1.7%	1.0%
1996	$34,654	20.0%	22.1%	-0.9%	-1.6%
1997	$32,183	19.1%	21.8%	2.4%	0.8%
1998	$33,674	18.5%	21.8%	3.2%	1.5%
1999	$35,925	18.2%	21.8%	3.6%	1.1%
2000	$37,028	19.9%	19.7%	-0.2%	-0.7%
2001	$36,151	21.0%	17.4%	-6.6%	-6.8%
2002	$30,762	21.3%	14.6%	-8.9%	-10.5%

($ in millions)

The one advantage that Kmart has held over Wal-Mart is the location of its stores. Wal-Mart is primarily a rural retailer, while Kmart has placed the majority of its stores in urban settings. It is quite possible that the potential real estate value of Kmart was the determinant factor that led two money management firms, ESL Investments and Third Avenue Management to assist, and ultimately resurrect the troubled firm from bankruptcy.

These investment firms, which are collectively referred to as the "Plan Investors" in the Kmart SEC filings contributed a significant amount of capital to Kmart, assisted the company in the sale of several assets and negotiated repayments to Kmart creditors in exchange for 32 million shares of the newly issued equity. Kmart also issued 14 million additional shares to these investors in exchange for $127 million as well as a $60 million convertible note with a 9% coupon convertible into equity, which will be distributed to ESL. Both investors were also awarded an option to purchase 6.6 million shares at a strike price of $13 prior to May 2005. For his efforts to restructure the company, Eddie Lampert was also named as the Chairman of the new Kmart Board of Directors.

Eddie Lampert's experience in distressed retail investing is an interesting story. He gained widespread attention during a similar investment into the then troubled AutoZone. Through rigorous cost control measures, store repositioning and a board seat, Mr. Lampert created a tremendous amount of wealth for the Autozone shareholders throughout the last several years. Recently, he also has taken a large position in Sears and has initiated a turnaround strategy for that firm, which began with the sale of its credit card operations. By reference to SEC filings, ESL Investments has also been accumulating the shares of food retailer Safeway. Needless to say, it appears that Mr. Lampert has taken a keen interest in the recent retail casualties of Wal-Mart. It remains to be seen whether these other endeavors will ultimately prove successful.

Nonetheless, Kmart now has a renewed strategy, and one that is focused on a smaller and more profitable base of stores. During its bankruptcy and the year and a half following its re-emergence, Kmart disposed of over 650 store locations. It now operates 1,505 stores in 286 of the 331 Metropolitan Statistical Areas in the United States. The stores range in size from 40,000 to 194,000 square feet, with an average size of 95,000 square feet. Of the 1,505 existing stores, 60 are Supercenters which combine discount retail items with grocery, or food related goods.

Kmart has publicly stated that it does not intend to compete with Wal-Mart on pricing. Rather, it will attempt to differentiate itself by offering store-specific or quality brands such as Martha Stewart Everyday, JOE BOXER, Jaclyn Smith, Sesame Street and Thalia Sodi.

Does Kmart Need To Grow?

The path to Kmart's profitability thus far has been through traditional means such as swift cost reduction and inventory control procedures. Management has also sought to reduce seemingly unnecessary expenses such as by the sale of its corporate jets, which subsequently resulted a gain of $12 million. To improve cash flow, merchandise inventories have been reduced from $4.4 billion in first quarter of 2003 to $3.4 billion in the same period in 2004. Similarly, accounts receivable have been worked down to $237 million in the first quarter of 2004 from $382 million during the same period in 2003. Since it is in the midst of downsizing rather than growing, capital expenditures have also been dramatically reduced. In the fiscal year 2001, Kmart expended $1.4 billion into the reinvestment of its business. If one were to annualize the recent figure of $55 million, capital expenditures might reach $220 million this year.

The combination of these measures has resulted in two successive quarters of profitability, which is demonstrated in the accompanying table below.

Table 2: Kmart Recent Quarterly Summary

	Second quarter FY2003	Third quarter FY2003	Fourth quarter FY2003	First quarter FY2004
Sales	$5,652	$5,092	$6,328	$4,615
Cost of goods sold	$4,418	$3,925	$4,740	$3,478
Gross margin	21.8%	22.9%	25.1%	24.6%
SG&A	$1,228	$1,178	$1,173	$1,004
SG&A as % of sales	21.7%	23.1%	18.5%	21.8%
EBIT	$8	($10)	$503	$165
EBIT margin	0.1%	-0.2%	7.9%	3.6%
Net profit margin	-0.1%	-0.5%	4.4%	2.0%
Same store sales	-5.4%	-8.6%	-13.5%	-12.9%
Cash	$1,200	$941	$2,088	$2,228
Shareholders' equity	$1,708	$1,707	$2,192	$2,285
Book value per share	$19.04	$19.05	$22.01	$22.78
Net Income	($5)	($23)	$276	$93
Add: depreciation & amortization	$5	$5	$21	$7
Less: capital expenditures	$27	$34	$47	$55
Free cash flow	($27)	($52)	$250	$45
Proceeds from sale of assets	$44	$49	$89	$66
Gains on sale of assets	-	-	$89	$32

($ in millions)

If profitability is in fact sustainable, then the most recent quarter might serve, at the minimum, as a proxy for future earnings. Net income was not egregiously exaggerated by gains from asset sales, as the $32 million recorded accounted for 19% of operating income. Further, one should expect that Kmart will continue to slowly discard unwanted assets such that income from this activity might well be recurring. Let us assume that 2% is the highest profit margin Kmart will ever achieve. Let us further assume that sales never exceed their current level. Stated differently, same store sales will never be higher than 0.0% on a normalized basis.

This analysis could be performed based upon two different operating periods. Firstly, regarding the most recent quarter, one should calculate the net market value (less cash) of Kmart, which amounts to $4.1 billion. Kmart earned $0.94 last quarter, which subsequently generated $140 in excess cash that was retained on the balance sheet. The most straightforward way to estimate future cash flow in this particular case would be to annualize the aforementioned figure. One could argue that this would underestimate the positive impact of holiday season sales. For example, Kmart earned $2.78 per share in the latest fiscal 4th quarter. If the gain of $89 million from asset sales were excluded, earnings would still have been $2.23 per share if the applicable tax rate remained unchanged.

In any case, let us assume that annualized cash added to the balance sheet will total $560 million, or at a rate of 8.8% relative to the market capitalization. If Kmart deploys this cash for the sole purpose of buying in shares, which would effectively reduce its net market value by $560 million, the accretive effect on its earnings would be roughly 13.6%. On an adjusted basis, the Kmart retail business then trades at a p/e ratio of 10.9x.

Table 3: Kmart Earnings / Cash Analysis

Scenario #1: Annualization of cash flow based on most recent quarterly retention rate			*Scenario #2: Annualization of cash flow based on entire post-bankruptcy reported results*		
Market capitalization	$6,335	million	Market capitalization	$6,335	million
Less: cash	$2,228		Less: cash	$2,228	
Net market capitalization	$4,107		Net market capitalization	$4,107	
Annualized earnings	$377		Annualized earnings	$377	
Earnings per share	$3.76		Earnings per share	$3.76	
Adjusted net share price	$40.95		Adjusted net share price	$40.95	
Net market value/earnings	10.9x		Net market value/earnings	10.9x	
Quarterly cash retention	$140		Quarterly cash retention	$257	
Annualized	$560		Annualized	$1,028	
Accretion to earnings =	$560 / $4,107		Accretion to earnings =	$1,028 / $4,107	
Potential appreciation:	13.6%		Potential appreciation:	25.0%	

If the above analysis is accepted and it is further applied to the next fiscal year, Kmart would still generate the same $377 million of net income, yet its net market value would be reduced again by $560 million. Thus, the attendant market value would be $3.5 billion, which results in an adjusted p/e ratio of 9.4x. If the Kmart earnings were repeatedly revalued at the current multiple of 10.9x, the effective annual return, or anti-dilutive effect on earnings would be 15.9%.

Likewise, it may be more appropriate to view cash flow in the context of Kmart's entire post-bankruptcy operating period. This would include two instances of operating losses and average proceeds of $62 million booked from asset dispositions. Since asset sale proceeds were recorded at a roughly similar $66 million most recently, one could argue that this approach is more indicative of future cash flow.

In the preceding four quarters, Kmart expanded its cash liquidity from $1.2 billion to $2.2 billion. This results in an accumulation rate of $257 million per quarter. Employing the same methodology as above, Kmart could theoretically expand its earnings this year by 16.2%, and 25% relative to net market value simply by using excess cash flow proceeds to retire shares.

What Could Kmart Earn If It Begins To Grow?

There exists the possibility that Kmart could in fact grow, as other retailers such as Target have successfully employed a differentiated product strategy that allows for co-existence with Wal-Mart. Towards this end, let us assume that the current 3.6% operating margin is the appropriate level of profitability to estimate future earnings. Readers are referred to the table on page 4, which demonstrates that this was the same operating margin that Kmart achieved in 1999 before the descent towards insolvency occurred. By way of reference, the operating margins of Wal-Mart and Target are provided below. If 3.6% is an acceptable estimation, then Kmart would still operate at a noticeably smaller margin than these two firms.

Table 4: Comparative Retail Operating Margins

	WMT	TGT
Calendar year	Operating margin	Operating margin
2003	5.9%	7.3%
2002	5.8%	7.4%
2001	5.7%	6.7%
2000	6.0%	6.7%
1999	6.1%	6.9%
Average	5.9%	7.0%

Since there is only one revenue estimate provided for this year, and the company does not offer guidance of its own, which may explain the scarce analytical coverage, one could apply this figure of $20,030 million to the operating margin of 3.6%. This would result in operating income of $721 million. In the most recent quarter, Kmart recorded net interest expense of $26 million, which is largely due to lease obligations. On an annualized basis, interest might require $104 million of income. Therefore, Kmart could earn $617 million of pre-tax earnings. It was mentioned previously that Kmart also has $3.8 billion of net operating loss carryovers. Since there is often an alternative minimum tax that applies to these situations, Kmart might wish to pay taxes at a corporate rate of 10%. It is worth noting that Kmart could extend this tax advantage for

24.7 years if it earns $617 of pre-tax income in those years. Nonetheless, net income in this circumstance would be $555 million, or $5.54 per share.

Table 5: Kmart Earnings Simulation

Sales	$20,030	million
Operating margin	3.6%	
Operating income	$721	
Less: interest expense	$104	
Pre-tax income	$617	
Net income (10% tax rate)	$555	
Earnings per share	$5.54	

Separately, and assuming that the true operating leverage of Kmart has not yet been achieved, as the elimination of redundant expenses is still occurring, earnings per share might well be considerably higher. For example, the renewed Kmart business strategy is to differentiate itself from Wal-Mart by selling store-specific items such as the Martha Stewart line, which also carry higher profit margins. The disparity between the Wal-Mart and Target operating margin is largely attributable to the fact that Target shelves higher priced, or fashionable products. Wal-Mart may extract unprecedented savings from its suppliers, but being the extreme low cost provider entails a great deal of potential margin compression.

Therefore, let us reasonably assume that Kmart can replicate the Wal-Mart operating margin of 5.9%. If this is the case, then operating income would be $1.2 billion using the aforementioned revenue estimate. Less interest expense and taxation, earnings per share could be $9.67. This is not to conclusively assert that earnings will be this high. Rather, it demonstrates that a combination of few debt obligations, corporate tax advantages and a relatively small outstanding share count can disproportionately expand earnings through small improvements in the operating margin.

Adjoining Discussion of Kmart As a Quasi-REIT Investment Vehicle

The media has widely portrayed Mr. Lampert's investment in Kmart as merely a maneuver to unlock the underlying value that resides in its real estate portfolio. There is good reason to believe that such value certainly does exist, yet Kmart already generates a large amount of cash flow from its rather distressed store locations, so it appears unlikely that this virtue would be forgone for a less profitable real estate alternative strategy. Nonetheless, let us examine this issue in greater detail.

Kmart does not own most of its stores, but rather holds long term leases on these properties that were entered into several years ago. One might conclude that it secured these leases at rates far below the current market average. It owns just 135 stores, or 9% of the total 1,505 locations. In the aggregate, it owns or leases roughly 143 million square feet of retail space. Most notably, a large percentage of these properties are located in urban areas where retail space is limited and leasing rates are quite high. During its bankruptcy proceedings, Kmart sold several then owned locations to competing retailers, obviously at distressed prices (the agreed upon terms of such transactions are not made available to the public). Incidentally, several of these locations were sold to Wal-Mart. Since Wal-Mart has had great difficulties developing urban areas, and convincing local authorities to allow the construction of 200,000 sq. ft. buildings for that matter, the most logical solution has been to purchase existing retail space. The table below illustrates recent purchases made by Wal-Mart as well as other parties.

Table 6: Recent Kmart Store Transactions

(Recent Wal-Mart store purchases)

City	State	Purchaser / Assignee
Chicago	Illinois	Wal-Mart
St. Paul	Minnesota	Wal-Mart
New Berwin	Wisconsin	Wal-Mart
New Haven	Connecticut	Wal-Mart
Wallingford	Connecticut	Wal-Mart
Pasadena	California	Wal-Mart
Wilmington	Delaware	Wal-Mart

(Other retail examples)

City	State	Purchaser / Assignee
Oakland	California	Home Depot
Syosset	New York	Home Depot
Lincoln	Nebraska	Home Depot
Tucson	Arizona	Lowe's
Mesa	Arizona	Kohl's
Houston	Texas	Target

If Kmart chose to systematically close down a portion of its attractively located stores and sublet this vacant space, it is quite possible that Wal-Mart would be a likely buyer. Although it is customary for Wal-Mart to own its real estate, recent expansion limitations might force the company to pursue other alternatives. In this rather perverse manner, Wal-Mart could actually fund the future cash flow of the same competitor it is attempting to displace once again.

The salient issue is the determination of the actual value of Kmart's real estate portfolio. It has recently hired Kimco Realty (NYSE: KIM) to assist in the ongoing sale of certain assets. Most recently, it was reported in the *San Jose Business Journal* (1/19/04) that Kmart sold four California store locations to Kohl's for an estimated $100 million. Since neither company discloses the value of this transaction and the source of this information was reportedly a Kmart insider, the information is essentially unsubstantiated and readers may wish to disregard the following analysis. Moreover, it is not a critical variable in the overall valuation of Kmart. Nonetheless, let us assume it is somewhat accurate. Since the average Kmart store averages 95,000 square feet, this places the value of these stores at $263 per sq. ft. However, the average retail lease typically extends for 25 years. It is common practice to apply a cap rate to such transactions to account for the present value of the future cash flows. If an 8% cap rate were applied, the California stores could have been purchased for $21.05 per sq. ft, as reported by the aforementioned media publication.

Kmart also has stores in less lucrative markets other than California such as the Midwest and South. By reference to the SEC filings of three of Kmart's present landlords, one could reasonably estimate the average lease value of the Kmart stores. These firms are Agree Realty (NYSE: ADC), Malan Realty Investors (NYSE: MAL), and Vornado Realty (NYSE: VNO). Agree and Malan rent space to Kmart primarily in the Midwest and in both urban and rural areas. The extrapolation of data provided in these filings indicates that Kmart has presumably secured relatively low lease rates. Its average rate with Agree is roughly $3.84 per sq. ft. and $2.56 with Malan. The agreements with Vornado involve locations primarily in the Northeast, which typically carry higher lease prices. According to Vornado's recent Form 10-K filing, Kmart currently pays $8.24 per sq. ft.

It has been estimated that the average Kmart lease rate is $4 per sq. ft. It is also estimated that the average current market rate for these properties is $7 per sq. ft. Given the information just provided, this appears reasonable. At least in theory, Kmart could book a profit of $3 per sq. ft. by merely subletting this space to other tenants. Or, if these properties are worth $7 per sq. ft., then Kmart currently has roughly $10 per share of leased real estate value.

A possible course of action, although the returns of which would be suboptimal with respect to the preceding return proposition, would be for Kmart to operate largely as a REIT. One might assume that since Kmart still generates positive cash flow from a number of stores, these locations would be retained for further operation. If 50% of these stores are desirable, then Kmart would operate 71.5 million sq. ft. of retail stores. Additionally, Kmart would generate roughly $140 of retail sales per sq. ft. This would result in sales of $10 billion and, at the current 3.6% operating margin, pre-tax income of $360 million.

If the Kmart real estate is in fact worth $7 per sq. ft., the remaining retail space could be rented for a profit of $3 per sq. ft. This amounts to $215 of operating income. The application of previous interest expense and taxation calculations would result in total net income of $424 million, or $4.23 per share. If Kmart chose to distribute 90% of its income to shareholders, as is customary practice with REIT's, then it would yield a 6% dividend, or 9.3% based on its net share price.

Table 7: Kmart Real Estate Analysis

Estimated 2004 sales:	$20,030
Total sq. ft. (mil):	143
Sales per sq. ft.:	$140

1.) Sub-leasing calculation:	
71.5m sq. ft. x $3 per sq. ft. sublease profit =	$214.5m, or $2.14 per share
2.) Operation of existing stores calculation:	
71.5m sq. ft. x $140 of sales per sq. ft. =	$10,010m total sales
At a 3.6% operating margin =	$360.4m operating profit, or $3.59 per share
Normalized Earnings Per Share	
$574.9m combined pre-tax income	
Less interest expense ($104m)	
and taxation at 10% ($47m) =	$423.8m net income, or $4.23 per share
REIT Alternative	
90% of $423.8 million distributed to	
shareholders in the form of dividends =	$381.4m, or $3.80 per share in distributions
	$3.80 / $63.16 = 6% dividend yield
	$3.80 / $40.95 = 9.3% return on net share value

Valuation

The valuation of Kmart is partially impeded in the traditional manner by which the investment community values equities because it receives coverage by only one analyst. Therefore, and not to diminish these analytical capabilities, one cannot be reasonably sure that the "consensus" estimate is in fact accurate, or at least representative, as a consensus should be. This, incidentally, could induce a discussion as to the reliability of consensus estimates and the vagaries associated with this phenomenon. However, and quite refreshingly, Kmart is in no such position to be manipulated by earnings estimates. In fact, the media has recently scrutinized Kmart for a lack of disclosure and the unwillingness to present a complete future business plan to investors. While this has certainly caused great anxiety among the analytical community, it has been presented herein that any number of strategies could result in a successful Kmart investment.

As a result of this circumstance, the Kmart earnings were calculated from a variety of scenarios, and, accordingly, the potential valuation of Kmart will vary as well. However, there is one common theme that re-emerges, which is a deeply discounted Kmart p/e ratio.

If one accepts the premise that Kmart will not grow above its current rate, which is a declining one, then the current net valuation of 10.9x the previously calculated earnings of $3.76 should not expand with great conviction. This circumstance, coupled with earnings expansion facilitated by share count reduction would result in returns on the order of 15% per annum.

There is the possibility that Kmart will amend the current sales decline and restore some level of growth. The return potential of which is in reference to the consensus sales estimate of $20 billion this year. If Kmart merely maintains the present operating margin, then a reasonable estimate of earnings would be $5.54 per share. If this is the case, and Kmart is once again viewed as a growth enterprise, then the resultant 7.4x net p/e ratio will no longer be appropriate.

Both Target and Wal-Mart trade at valuation multiples of 19.4x and 23.7x, respectively. Yet one should not assume that Kmart would benefit from such a valuation, at least not in its current state. However, JC Penney and Sears, both of which are similarly disfavored retailers might allow for a more accurate comparable company comparison. JC Penney trades at 18x this year's earnings estimates and Sears is accorded a valuation of 10.2x. The average valuation of these two companies is 14.1x earnings. Let us assume that Kmart should be valued at a p/e ratio of 14x. If Kmart earns $3.76 per share this year, the application of this multiple would result in a share price (inclusive of the $22.21 per share of cash) of $74.85, which is a profit of 18.5%. Alternatively, Kmart in a full success mode could generate $5.54 per share of earnings. At 14x this estimation, the shares would be worth $99.77, for a return of 58%.

Investment Summary

It must be considered a rarity that a firm which was terribly beaten by competition to the point of insolvency could re-emerge from those proceedings, exhibit zero future growth from its most recent financial reporting period, yet be in a position to expand its earnings at nearly a double digit rate. Kmart is such an example. Upon its post-bankruptcy reconfiguration, Kmart ridded itself of prior indebtedness, rapidly sold unprofitable store locations, and began the tedious task of reducing operating expenses and capital expenditures, which has now permitted a sufficiently large amount of recurring cash flow. It was presented within the text of this paper that the utilization of these funds to merely retire outstanding shares could increase earnings on the order of 15% per annum.

While returns of this character are certainly acceptable, Kmart could also be examined as a prospective retail growth investment. The challenges are copious, yet it has been demonstrated that firms can co-exist alongside the relentless growth of Wal-Mart. Even at the current operating margin, which is quite modest in relation to competing firms, and the assignment of a comparable valuation, the Kmart shares could ultimately be worth $74.85, or 19% higher. With these types of returns available irrespective of what growth conditions may exist, the shares are therefore recommended for purchase.

Kmart Holding Corporation
Consolidated Statements of Operations
(Dollars in Millions, Except Share Data)

	SUCCESSOR COMPANY	PREDECESSOR COMPANY		
	39-WEEKS ENDED JANUARY 28, 2004	13-WEEKS ENDED APRIL 30, 2003	FISCAL YEAR 2002	FISCAL YEAR 2001
Sales	$ 17,072	$ 6,181	$ 29,352	$ 34,180
Cost of sales, buying and occupancy	13,084	4,762	24,842	28,193
Gross margin	3,988	1,419	4,510	5,987
Selling, general and administrative expenses	3,577	1,421	6,242	7,177
Restructuring, impairment and other charges	-	37	574	947
Net (gains) losses on sales of assets	(89)	-	5	9
Equity income in unconsolidated subsidiaries	(5)	(7)	(34)	-
Income (loss) before interest expense, reorganization items, income taxes and discontinued operations	505	(32)	(2,277)	(2,146)
Interest expense, net	105	57	155	344
Reorganization items, net	-	769	363	(183)
Income (loss) before income taxes and discontinued operations	400	(858)	(2,795)	(2,307)
Provision for (benefit from) income taxes	152	(6)	(24)	-
Dividends on convertible preferred securities of subsidiary trust	-	-	-	70
Income (loss) before discontinued operations	248	(852)	(2,771)	(2,377)
Discontinued operations (net of income taxes of $0)	-	(10)	(448)	(69)
Net income (loss)	$ 248	$ (862)	$ (3,219)	$ (2,446)
Basic income (loss) per common share before discontinued operations	2.77	(1.63)	(5.47)	(4.81)
discontinued operations	-	(0.02)	(0.89)	(0.14)
Basic net income (loss) per common share	2.77	(1.65)	(6.36)	(4.95)
Diluted income (loss) per common share before discontinued operations	2.52	(1.63)	(5.47)	(4.81)
discontinued operations	-	(0.02)	(0.89)	(0.14)
Diluted net income (loss) per common share	2.52	(1.65)	(6.36)	(4.95)
Basic weighted average shares (millions)	89.6	522.7	506.4	494.1
Diluted weighted average shares (millions)	99.3	522.7	506.4	494.1

KMART HOLDING CORPORATION
CONSOLIDATED BALANCE SHEETS
(DOLLARS IN MILLIONS, EXCEPT SHARE DATA)

	SUCCESSOR COMPANY		PREDECESSOR COMPANY
	JANUARY 28, 2004	APRIL 30, 2003	JANUARY 29, 2003
ASSETS			
CURRENT ASSETS			
Cash and cash equivalents	$ 2,088	$ 1,232	$ 613
Merchandise inventories	3,238	4,431	4,825
Accounts receivable	301	382	473
Other current assets	184	509	191
TOTAL CURRENT ASSETS	5,811	6,554	6,102
Property and equipment, net	153	10	4,892
Other assets and deferred charges	120	96	244
TOTAL ASSETS	$ 6,084	$ 6,660	$ 11,238
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)			
CURRENT LIABILITIES			
Mortgages payable due within one year	$4	$8	$ -
Accounts payable	820	1,160	1,248
Accrued payroll and other liabilities	671	1,321	710
Taxes other than income taxes	281	274	162
TOTAL CURRENT LIABILITIES	1,776	2,763	2,120
LONG-TERM LIABILITIES			
Long-term debt and mortgages payable	103	108	-
Capital lease obligations	374	415	623
Pension obligation	873	854	-
Unfavorable operating leases	342	344	-
Other long-term liabilities	424	463	181
TOTAL LONG-TERM LIABILITIES	2,116	2,184	804
TOTAL LIABILITIES NOT SUBJECT TO COMPROMISE	3,892	4,947	2,924
LIABILITIES SUBJECT TO COMPROMISE	-	-	7,969
Predecessor Company obligated mandatorily redeemable convertible preferred securities	-	-	646
SHAREHOLDERS' EQUITY (DEFICIT)			
Successor Company preferred stock 20,000,000 shares authorized; no shares outstanding	-	-	-
Predecessor Company common stock $1 par value, 1,500,000,000 shares authorized; 519,123,988 shares issued and outstanding	-	-	519
Successor Company common stock $0.01 par value, 500,000,000 shares authorized; 89,633,760 and 89,677,509 shares issued, respectively	1	1	-
Treasury stock, at cost	(1)	-	-
Capital in excess of par value	1,943	1,712	1,922
Retained earnings (Accumulated deficit)	248	-	(1,835)
Accumulated other comprehensive income (loss)	1	-	(907)
TOTAL SHAREHOLDERS' EQUITY (DEFICIT)	2,192	1,713	(301)
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)	$ 6,084	$ 6,660	$ 11,238