Attention Kmart shoppers? Into and out of bankruptcy

Erika Matulich
The University of Tampa

Karen Squires
The University of Tampa

Lisa Bostick
The University of Tampa

Ron Kuntze
The University of Tampa

Tom Barrett
The University of Tampa

Chip Myrick
The University of Tampa

ABSTRACT

This case investigates Kmart and the effects that growing competition, an inferior distribution network, and poor store execution had on the one time market leading retail chain. In the early 1990s Kmart dominated 30% of the retail market, but was beginning to experience fierce competition from other discount retail stores such as Wal-Mart and Target. Positioned as a low-priced discount store that offers a wide variety of products, Kmart began to lose significant market share. The retailer found it could no longer compete against Wal-Mart's highly advanced distribution network and Target's trendiness and higher perceived quality brands, products and service. Wal-Mart's distribution network significantly cut costs across all levels, which allowed it to charge every day lower prices and move away from weekly specials. Concomitant to the Wal-Mart threat, Target's trendiness, wider aisles, and updated stores were attracting customers away from Kmart. Saddled with a poor distribution network, unappealing stores, and a lack of differentiation from the discount competition, Kmart began hemorrhaging market share. Kmart first declared bankruptcy on January 22, 2002; at the time, the biggest chapter 11 filing in retail history. The case then asks, coming out of bankruptcy in May 2003, what should Kmart have done to once again become a profitable, significant retail power player? A post-mortem indicates that Kmart did not choose successful alternatives.

Keywords**:** bankruptcy, Kmart, retailing, marketing strategy, competition

INTRODUCTION

This case illustrates the importance of adapting to a changing market and how not keeping up with current technologies and consumer demands can have disastrous effects for a firm. It also underscores the need have key differentiating factors that set a brand apart from competition; as well as the importance of customer satisfaction. Students should also see that even well-established giants can fall if they fail to adapt to meet the challenges of a changing marketplace. This case can be used in any undergraduate and graduate business strategy course, marketing and management course, and any classes teaching financial statement analysis. Learning objectives include students being able to:

- Conduct a situation analysis (SWOT or Porter's 5 Ps) and understand the importance of such analysis in strategic decision making
- Perform a competitor analysis of both direct and indirect competitors
- Define competitive advantages and distinctive competencies of retailers
- Recommend a target market based upon market opportunity analysis
- Evaluate the elements of a marketing mix for retailers
- Prescribe evaluation and control measures based on financial performance

ATTENTION KMART SHOPPERS?

Former Kmart CEO, Charles C. Conaway, failed in his 19-month effort to revive the iconic firm, resulting in the largest retailing bankruptcy filing in history on January 22, 2002 (Davies, et al., 2002). On March 11, 2002, bankrupt Kmart named James B. Adamson as its fifth CEO in seven years. Adamson was a Kmart insider who began his retail career at both Gap and Target. Adamson was picked for his experience in engineering turn-arounds at companies such as Advantica Restaurant Group (parent of the Denny's chain), Burger King, and Revco drugstores. The situation for Adamson looked dire. Many analysts speculated that Kmart should simply shore up financials enough for a sale (Schoenberger, 2002).

Kmart was positioned as a low-price retail store offering a wide range of products and was one of the very founding 'discount store' chains that now dominated the retail landscape (Discounting, 1992). However, by 2002 it was no longer the leading discounter in the world, a position it had held for decades. Kmart was experiencing tough price pressure from the competing discounter Wal-Mart. Wal-Mart's superior logistics, identical retail strategy to Kmart, perceived same or better pricing, and a significantly superior in-stock position all effectively neutralized Kmart's national discount chain first-mover advantage (Zook, 2006). Further, Wal-Mart's "Everyday Low Pricing" (EDLP) was seen as a game changer in that customers perceived it as the uncontested price leader. EDLP resulted in significantly smaller marketing budgets and inventory costs for Wal-Mart as well as more evenly flowing sales reducing stock-outs (Ellickson, et al. 2012). Kmart's weekly price specials created spikes and surges in category volume that were hard to operationally facilitate, more costly to the bottom line, and left Kmart shelves bare in key merchandise areas. Combined, the results of heavy weekly price promotions made the Kmart stores look less inviting and contributed to poor customer service perceptions (Schoenberger, 2002). By 2000, Wal-Mart boasted almost three times the sales of Kmart and had become the world's largest retailer.

Meanwhile, Target Corporation, another discount competitor putting pressure on Kmart, found a niche to lure buyers with relatively inexpensive but trendy, higher-image branded products, newer stores, and perceived superior customer service. With these competitors establishing positions in the market, Kmart's "middle ground" and lack of unique positioning found it being squeezed out of the retail marketplace.

The question posed to Kmart at the time was "What is the Kmart brand?" and what steps should Adamson take to revitalize and differentiate Kmart to regain lost market share and earnings? Are linear attributes such as size or price a feasible positioning strategy for Kmart? Should Kmart compete against Wal-Mart on an everyday low price strategy? Should Kmart compete against Target on a superior trend/brand/service strategy? Is there a third and unique strategy that Kmart should explore? What strategies would you recommend for Kmart to lure customers back to its retail stores?

Kmart Corporation

In 1897 Sebastian S. Kresge founded S.S. Kresge Company as a modest "five and dime" store in downtown Detroit, Michigan; selling most items in the store for ten cents or less. As time progressed, the prices changed but the business philosophy remained relatively consistent- offering products at low prices. Today this strategy is comparable to "Dollar Stores," and is typified by Dollar General/Family Dollar (Levy & Weitz, 2012).

In the 1950s, it was clear that the company needed to change to remain the leader in a growing competitive retail environment. Other discount retailers were studied and the Kresge organization opened the first Kmart discount department store in 1962, the same year that Sam Walton founded Wal-Mart. Four years later, sales in 753 Kresge stores and 162 Kmart stores topped the $1 billion mark. In 1977, the Kmart stores generated 95% of S.S. Kresge company sales (Discount Store News, 1992). Kmart diversified in 1984 with its purchase of Walden Book Co. and Home Centers of America (Kmart, 1992).

In 1987, Kmart started a line of merchandise under the Martha Stewart name, who served as a spokeswoman and consultant. Kmart continued diversifying, purchasing the Sports Authority in 1990 and acquired a 90% stake of OfficeMax in 1991. In 1991, Kmart also opened the first Kmart Supercenter, which offered a full-service grocery store in conjunction with the traditional retail products. Finally, in 1992, Kmart purchased Borders' bookstore as part of their diversification strategy. Then in 1994, Kmart realized their diversification strategy was not working and spun off Borders in 1995 along with The Sports Authority and OfficeMax. With trouble lingering, Kmart purchased its BlueLight.com Internet in service in 2001 in an attempt to generate some customer excitement and lure customers back to the retail store. But, even with all of Kmart's efforts, they were not generating the sales and had to file for bankruptcy protection in January 2002 (Davies, et al., 2002.)

GROWING COMPETITION

Wal-Mart

By 2002, Wal-Mart, was the largest retailer in the United States playing on a strategy of price and convenience, both tethered to EDLP (Zook, 2006). The EDLP pricing philosophy disallowed promotional pricing; however, Wal-Mart offered "Special Buys" and "Rollback" pricing. Special buys were items carried for a limited time or achieved through exceptional purchases from suppliers. Rollback prices were a nod to Wal-Mart's 'country past and values' and perceived as 'rolling back prices to the good ole days' (Barbaro, 2006). Wal-Mart's motto in 2002 is "Always Low Prices…Always." Sam Walton, founder of Wal-Mart, stated that "by cutting your price, you can boost your sales to a point where you earn far more at the cheaper retail than you would have by selling the item at the higher price. In retailer language, you can lower your markup but earn more because of the increased volume" ("Every Day Low Prices," nd).

By the early 2000s Wal-Mart enjoyed a significant cost advantage for many reasons. Wal-Mart was the largest retailer in the U.S., equating to an enormous buying power position with its suppliers. Wal-Mart's large purchase volume created economies of scale and its diversification created economies of scope. Add in the technological logistics superiority Wal-Mart boasted, and the more even inventory ebbs and flows of EDLP and the retailer led the way in ordering, shipping, and delivery of every item it sold. Wal-Mart systems and logistics became renowned, and its CPFR (collaborative planning, forecasting, and replenishment) changed retailing distribution worldwide (Seifert, 2003).

Wal-Mart was the first retailer to retain its own data of sold goods from the time the products begin at the factories to the time the end-user buys the good at a register. Other technologies that enabled Wal-Mart to gain a competitive edge over Kmart included early use of hand-held scanners, greater sophistication in cash registers, and advanced satellite and computer systems. Wal-Mart's advanced systems enabled the company to identify bottlenecks within the supply chain, tailor assorted goods to different markets, minimize inventory, and reorder goods more quickly and efficiently. Customers rarely found products out-of-stock or back-ordered at Wal-Mart -- a common occurrence at competitor Kmart.

Wal-Mart, even in 2002 was not without its problems and flaws. Lower wages and minimal employee benefits compared to other retailers dogged the retailer, coming to a head in the early 2000s. Accusation of using sweatshop labor overseas to produce goods labeled "Made in America," along with violating international child labor standards overseas, and often "dingy looking" stores compared to seemingly more upscale Target -- often the same criticism levied at Kmart (Sozzi, 2013) were often cited criticism at the beginning of the 21st century.

Target

Target, with its bulls-eye trademark, positioned itself as the high-end mass merchandiser. Its registered trademark of "Expect More. Pay Less," combined with more pleasantly appearing, brightly lit, modern-looking locations appealed to middle-class, slightly higher-educated shoppers (Discount Store News, April 20, 1992). Wider aisles, easy navigation, department store origins (Target evolved out of Dayton-Hudson department stores in the 1960s—the first discounter without an extreme value/low price pedigree), and a culture of identifying shoppers as "guests" particularly resonated with suburbanites.

While still a discounter, designer products, higher-end brands, and a superior understanding of fashion and trends anchored to Dayton-Hudson allowed the retailer to maintain higher, yet competitive prices. Even in 2002 the Target in-house stylish "department store light" brands such as Michael Graves home accessories, Philippe Starck home furnishings along with traditional department store brands unavailable to Kmart and Wal-Mart, like Martex bed linens, and Calphalon cookware were a huge success. Target's higher quality versions of less expensive brands, such as Hanes Premium underwear also distinguished the retailer from its more downscale discounter competition.

In the early 2000s, Patty Morris, a Target spokeswoman, said the store had the "youngest, wealthiest, and most educated customer of the three. No merchandise is out of arm's reach, aisles are wide, and items are not stacked as high as at Wal-Mart and Kmart. We feel our competition is Old Navy, Pier 1 Imports, Pottery Barn, and Banana Republic" (Powell, 2001). This positioning allowed Target to significantly increase the average category price across almost all of its merchandise lines relative to Wal-Mart and Kmart, as well as increase average transaction, and most importantly, profit margins.

What Is the Kmart Brand (2002)?

In the early 2000s Kmart, with its signature K logo and no motto, sees itself as the mass merchandiser for America-- home to a broad range of products, from gardening supplies to celebrity-named fashions. Its most prized signature line to date, has been Martha Stewart home fashions, paint, kitchen, garden, and outdoor dining merchandise. However, with Martha Stewart's recent legal problems, the image of this brand has been tainted. Other successful brands include Sesame Street for kids, Route 66, Jaclyn Smith clothing, and Kathy Ireland women's clothing, plus sizes, and maternity items. Kmart's garden center competes against lawn and garden specialty shops. Plants, dining sets, grills, fertilizers, lawn maintenance supplies, and other garden specialties sell well. On average, Kmart prices are higher than Wal-Mart and somewhat competitive with Target. Its past and current strategy is that of a "high-low" retailer that cuts prices on some items and promotes the sales in weekly circulars.

Kmart gained notoriety for its "blue light specials." Developed by store managers in the 1960s, blue light specials were unadvertised promotional items that were announced over the store public address system and offered to shoppers for just 30 minutes. By the 1990s, the promotion was associated with unwanted clearance merchandise and inventory overstocks in lieu of true values. Blue light specials were dropped in 1991 despite having a 65% brand recognition, according to former CEO, Charles Conaway (Schultz, 2012). In 2001, Kmart implemented a “Dare to Compare” advertising campaign, where managers could hand write signs citing price comparisons with Wal-Mart and Target. A former Kmart employee stated, “Our employees would walk across the street to Wal-Mart and write down competitor prices on basic items. We would come back to Kmart and change our prices on these items and advertise accordingly” (Myrick, 2004). Wal-Mart and Target responded with price cuts, resulting in sales. Among strong criticisms that the claims were false, and with the filing of a Target lawsuit, the “Dare to Compare” advertising campaign was withdrawn (“Target Sues,” 2001).

By 2002, Kmart’s deteriorating stores did not compare favorably with rival Target or Wal-mart. Kmart stores were roundly criticized by customers as unappealing, frequently out of stock due to an antiquated and costly distribution system, and lacking necessary personnel because of labor cutbacks in response to lagging store sales and profits (Schultz, 2012). All of these issues ultimately led to bankruptcy proceedings. Selected financial information at the end of 2001 and selected ratio calculations are provided, to illustrate the need for Kmart to file bankruptcy in January, 2002 (Exhibits 1 and 2).

Exhibit 1: Selected Financial Information

Source: Mergent Online	**Kmart**	**Target**	**Wal-Mart**
	1/31/2001	**2/3/2001**	**1/31/2001**
Currency	**USD**	**USD**	**USD**
Auditor Status	**Not Qualified**	**Not Qualified**	**Not Qualified**
Scale	**Millions**	**Millions**	**Millions**
Total current assets	7,624	7,304	26,555
Total assets	14,630	19,490	78,130
Total current liabilities	3,799	6,301	28,949
Long Term Debt	4,748	6,670	17,774
Retained earnings (accumulated deficit)	4,018	5,542	30,169
Total shareholders' equity	6,083	6,519	31,407
Total revenue	37,028	36,310	193,295
Net Income	(268))	1,264	6,235
Cont income (loss) before interest, tax, reorganization & trust (EBIT)	(83)	2,479	10,975

Exhibit 2: Selected Ratio Calculations

Source: Mergent Online	**Kmart**	**Target**	**Wal-Mart**
	1/31/2001	**2/3/2001**	**1/31/2001**
Currency	**USD**	**USD**	**USD**
Market value of equity	2,461,735,540	33,704,883,540	253,896,000,000

Working Capital (in millions)	3,825	1,003	-2,394
Working Capital/Total Assets	0.261449077	0.051462288	-0.030641239
Retained Earnings/Total Assets	0.274641148	0.284350949	0.386138487
EBIT/Total Assets	-0.005673274	0.127193433	0.14047101
Shareholders' equity/Total Liabilities	0.711711712	0.502582684	0.672195707
Sales/Total Assets	2.530963773	1.86300667	2.474017663
Z Score	3.380761513	4.299816041	6.699363697
Current Ratio	2.006843906	1.159181082	0.917302843
Debt/Total Assets	0.584210526	0.66552078	0.598016127
Net income/Shareholders' Equity	-0.044057209	0.193894769	0.198522622
Net income/Sales	-0.007237766	0.034811347	0.032256396

Emerging from bankruptcy, Kmart and Adamson must find a way to turn around Kmart to ensure survival in the highly competitive retail industry. Kmart has many problems it has to address, including distribution problems, lack of customer service, unappealing stores and most of all a lack of clear differentiation from discount competition. Where does Kmart stand in the retail market and can they survive?

DISCUSSION QUESTIONS

1. With Kmart just coming out of bankruptcy, if you were James B. Adamson, what would you do to reorganize Kmart to help them compete in the market?
2. What could Adamson do to stop customers fleeing to Target and Wal-Mart while they are restructuring?
3. Is there anything Kmart could have done to prevent Wal-Mart's advanced distribution network and Target's trendiness from taking market share from them? If so when should Kmart have evaluated and implemented their strategies?
4. What should Kmart do, from a promotional point of view, to attempt to retain and attract back customers at that time? Who should they target?
5. Should Kmart continue doing business or shut down and sell off their valuable real estate? This discussion can include a focus of Kmart's current financial performance and market reactions (See Exhibits 3 and 4).
6. Perform a SWOT analysis on Kmart then and now.
7. What is Kmart's current position in the retail market? Why is it effective? Why is it not effective?
8. How should Kmart position itself in the market in 2003? Now? Price, trendiness, other strategies?
9. What can Kmart do to re-establish customer satisfaction in 2003? How can they attract customers back to their stores?
10. How did Kmart's financial position compare to their competitors immediately prior to filing for bankruptcy (See Exhibits 3 and 4)?
11. How does Kmart's financial position compare to their competitors today?
12. What challenges might Kmart face in the future?

Exhibit 3: Financial Highlights

	Kmart 1/28/2004	Target 1/31/2004	Wal-Mart 1/31/2004
Financial Summary			
Total Revenue	17,072,000,000	48,163,000,000	258,681,000,000
EBITDA	505,000,000	4,280,000,000	15,168,000,000
Net Income	248,000,000	1,841,000,000	9,054,000,000
Total Assets	6,084,000,000	31,392,000,000	104,912,000,000
Current Assets	5,811,000,000	12,928,000,000	34,421,000,000
Total Liabilities	3,892,000,000	20,327,000,000	61,289,000,000
Current Liabilities	1,776,000,000	8,314,000,000	37,418,000,000
Long Term Debt	477,000,000	10,217,000,000	20,099,000,000
Stockholders' Equity	2,192,000,000	11,065,000,000	43,623,000,000
Profitability Ratios			
Return on Equity (%)	15.83	16.64	20.31
Return on Assets (%)	5.70	5.86	8.45
Return on Investment	106.77	28.76	63.74
EBITDA of Revenue (%)	3.69	10.05	7.30
Operating Margin (%)	3.51	7.31	5.81
Pre-Tax Margin	1.79	10.63	22.85
Net Profit Margin (%)	3.81	8.47	7.38
Effective Tax Rate (%)	30.77	37.80	36.06
Liquidity Indicators			
Quick Ratio	1.35	0.78	0.17
Current Ratio	3.27	1.55	0.92
Working Capital/Total Assets	0.66	0.15	-0.03

Source: Mergent Online on September 20, 2004

Exhibit 4: Additional Financial Highlights

	Kmart 1/28/2004	Target 1/31/2004	Wal-Mart 1/31/2004
Debt Management			
Current Liabilities/Equity	0.81	0.75	0.86
Total Debt to Equity	0.22	1.00	0.53
Long Term Debt to Assets	0.08	0.33	0.19
Asset Management			
Revenues/Total Assets	2.81	1.53	2.47
Revenues/Working Capital	4.23	10.44	-86.31
Interest Coverage	5.7		15.25

Stock Price and Valuation (Data as of 09/17/2004)			
Market Cap (mil)	7,865	41,307	227,122
Shares Outstanding (000's)	89,629	911,462	4,327,781
52-Week Range	23.31 – 89.00	37.05 - 46.43	50.74 - 61.05
7-Day Average Closing Price	86.02	45.67	52.96
30-Day Average Closing Price	77.42	44.27	53.23
200-Day Average Closing Price	50.40	41.61	55.15
Dividend Per Share (TTM)	0	0.27	-
PE Ratio	34.82	21.48	-
Earnings Per Share (TTM)	2.52	2.11	-
Last Price	87.75	45.32	52.48
Last Day Range	87.22 - 89.20	44.84 -45.43	52.14 - 52.94

Source: Mergent Online on September 20, 2004

EPILOGUE

Kmart came out of bankruptcy in May 2003, closing 599 stores and laying off more than 67,000 employees in an attempt to lower cost structure. At this time, Kmart made a $1 billion investment in IT to enhance its distribution network and to help keep shelves stocked, reducing operating costs by 21.4% and reducing inventories by 22.3% (Reed Elsevier, 2003). Executive upheavals followed (Dixon, 2003), but personnel changes were just the beginning of Kmart's problems and ultimate continued decline.

After the Kmart bankruptcy and store closures described in the case, Kmart continued to stall and was purchased by hedge fund CEO Edward Lampert. Little was done to change the image of the once leading discounter and number two retailer in the world; analysts accused Lampert of selling off upside down Kmart leases and less profitable Sears stores (Wahba, 2013) to ultimately reduce the company to a now purported less than $12 billion in sales in 2014 (from a one-time high of $35 billion). Kmart merged with the long-time largest retailer in the world, but now struggling Sears in late 2004. Martha Stewart left Kmart in 2009, and store closings of both Sears and Kmart escalated from 2010 until the present day (Bloomberg, 2009). Kmart/Sears continues to find itself on pundits and analysts lists of "the next major company to go bankrupt" (Higgs, 2015). Lampert has been strongly criticized by dozens of analysts, including Robin Lewis, CEO of popular retail strategy newsletter *Robin Report*: "What he's done brilliantly is manage these brands into oblivion while squeezing billions of dollars of cash into his elusive businesses," further characterizing the Sears/Kmart decline to the "sinking of the Titanic" (Lewis, 2014). Ex-CEO of Sears Canada, Mark Cohen, adds: "It's an asset strip -- he's run it into the ground" (Egan, 2015).

Meanwhile, Wal-Mart is expected next year to be the first company in mankind's history to reach the half-trillion dollar mark in world-wide sales; already leading the globe in revenues and number of employees (Snyder, 2015). Wal-Mart's web business alone (which was started only a couple years ago) is expected to eclipse Kmart's entire sales in 2015, and Target boasts stronger margins than both retailers with sales of $72 billion in 2014 (Target, 2014), twice that ever claimed by once behemoth Kmart.

"Attention Kmart Shoppers" and the "Bluelight Special" appear to be relegated to historical business trivia.

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