DAVID P. STOWELL

Kmart, Sears, and ESL:
How a Hedge Fund Became One of the World's Largest Retailers

The Unusual Weekend

January 11, 2003, was the weirdest Saturday that Eddie Lampert could remember. Most Greenwich billionaires do not spend their weekends lying in bathtubs in cheap motels eating cold chicken. Unfortunately, the setting was not only odd; it was quite ominous. Lampert was fully clothed, blindfolded, and handcuffed.

The previous day, Lampert, 42, had sat in his office at ESL Investments, the multibillion-dollar hedge fund he controlled. The fund's clients included savvy institutions and famous names such as Michael Dell and David Geffen, but Lampert himself was the single largest investor. He had spent much of his time that Friday poring over documents related to Kmart's Chapter 11 bankruptcy. Lampert had access to experienced attorneys, bankers, and accountants who specialized in restructurings, but he insisted on personally understanding every detail of the complicated swap of defaulted debt for new equity. On first glance, Lampert thought he smelled a great opportunity that rival retailers and private equity shops were missing. He had already accumulated a sizeable amount of Kmart's defaulted debt for less than half of its face value. But before he really took the plunge and started buying larger amounts in the biggest trade of his career, he wanted to study the upside potential and downside protection in excruciating detail. After all, it was his reputation, and largely his money, on the line.

Lampert discovered within hours that money and reputation are not the most serious assets that one can have on the line, as he took an unexpected plunge of a different sort. When he left his low-rise Greenwich office building and walked to his car in the parking garage around 7:30 p.m., four men unknown to Lampert approached, and one suddenly drew a pistol. Lampert soon found himself locked in the trunk of a car that had been parked near his. Presumably, Kmart's bankruptcy was the last thing on his mind as he tried to determine which direction the vehicle was headed on Interstate 95. He would soon have to apply his considerable intelligence to negotiations of a different kind.

Flash Forward: November 2004

Lampert had always been somewhat secretive and tried to avoid much press coverage for ESL Investments, but since talking his kidnappers into letting him go free in exchange for a small amount of money, he had become extremely tight-lipped. (Lampert never actually turned over the

©2005 by the Kellogg School of Management, Northwestern University. This case was prepared by Research Associate Paul Stowell under the direction of Professor David Stowell. Cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management. To order copies or request permission to reproduce materials, call 800-545-7685 (or 617-783-7600 outside the United States or Canada) or e-mail custserv@hbsp.harvard.edu. No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of the Kellogg School of Management.

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.

Do Not Copy or Post

money, and his inept kidnappers later found themselves in police custody after using Lampert's credit card to order pizza.)

Despite Lampert's desire to stay out of the limelight, he was not the sort of person to turn down a compelling investment, even if it meant an explosion of press coverage. Since his kidnapping, Lampert had gone from being a talented manager of a hedge fund to also serving as chairman of Kmart Holdings, the new company that emerged from the bankruptcy of the venerable retailer. Then, on November 17, 2004, Lampert announced that he had reached an agreement with the board of Sears to acquire the famous company for approximately $11 billion in cash or Kmart stock. The financial community was surprised, and research reports from Wall Street analysts revealed a wide divergence of opinion on the wisdom of the combination. Lampert's preference for a low profile became hopeless as it became clear that, despite his day job managing a hedge fund that did not even have a Web site, he would soon be the chairman of the nation's third largest retailer. *BusinessWeek* featured Lampert in several major articles, following a cover story whose copy deadline apparently pre-dated the announcement of the acquisition by days if not hours. The title posed the flattering question: "The Next Warren Buffett?"[1]

Case Focus

The idea of a hedge fund manager becoming chairman of Kmart and Sears was laughable just a decade ago. This case examines some of the notable and rapid changes in the capital markets over the last twenty years that have made such an idea a reality. In particular, the case explores the emergence of financial buyers (principally private equity funds and hedge funds) as strong competitors to strategic buyers (companies buying other companies in the same industry) in the mergers and acquisitions market. The case presents two key questions: First, as a strictly financial buyer, should ESL have acquired a controlling stake in Kmart's defaulted debt in 2002? Second, as a largely strategic buyer, should Kmart under ESL's control have acquired Sears (announced in November 2004 and consummated in March 2005)?

The Rise and Fall of Kmart

Kmart was founded in 1899 as S. S. Kresge Company, and at various times in the last twenty years had owned Borders Books, Walden Book, The Sports Authority, and OfficeMax. After mismanaging its Internet efforts and finding itself unable to keep its supply chain as low-cost as rivals Wal-Mart and Target, Kmart by mid-2000 was suffering from stagnant same-store sales, comparatively low sales per square foot, and complaints from customers that the stores were disorganized and run-down. Wal-Mart and Kmart each had $32 billion in sales in 1990; since that time Kmart's sales had been essentially flat, while Wal-Mart's had grown to over $250 billion.[2] (See **Exhibit 1** for sales comparisons.) One of the *Wall Street Journal*'s epitaphs for Kmart remarked on the decades-long role played by Wal-Mart in the demise:

> *In the late 1970s, Wal-Mart's sales were 5 percent of Kmart's; it had 150 stores to Kmart's 1,000 or so, mostly in urban locations. Wal-Mart, meanwhile, invaded rural America, where it quietly perfected a format of using technology to reduce inventory, keep shelves stocked and offer the lowest prices. By the time it began meeting Kmart head*

[1] *BusinessWeek*, November 22, 2004.
[2] COMPUSTAT database.

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

on, Wal-Mart enjoyed a significant price advantage that a series of Kmart executives failed to overcome.[3]

The recession of 2001, especially following the 9/11 attacks, hit Kmart very hard. CEO Charles Conaway instituted price cuts to match Wal-Mart on selected goods in early 2001 and then decided on a bold holiday season strategy: Kmart would dramatically cut its advertising budget and use the savings to match Wal-Mart's low prices on almost everything. The plan was executed; the results were disastrous. With reduced marketing, Kmart did not draw many new customers. Those that did come were surprised and gleeful at the reduced prices. In December 2001, with the stock trading below $5 per share (see **Exhibit 2**), Kmart sold millions of items below cost, and below the already marked-down value recorded as inventory on its balance sheet. As details on the scope of the holiday season losses were still emerging, Kmart faced a cash crunch, and after a vendor announced Kmart had fallen behind on payments, the 103-year-old company filed for Chapter 11 bankruptcy on January 22, 2002. In early March, the company fired Conaway and set ambitious plans to emerge from bankruptcy by July 2003.

Not long afterwards, hedge funds specializing in trading distressed debt started studying Kmart's assets, but none of them had the capital or the confidence to amass a controlling stake in the defaulted bonds. With the company in bankruptcy, shareholders had lost all of their investment. The question that remained was the value of Kmart's assets now belonging exclusively to its creditors, including bond holders. Clearly, the bonds would never be paid off at their face value, but holders would have a clear legal claim on assets, with each creditor's share depending on the number of bonds held and the level of seniority of the bond covenants.

Bankruptcy and Inefficient Financial Markets

In most bankruptcy cases, bond holders receive either cash from sale of assets in the event of liquidation or equity in the new company that successfully emerges from bankruptcy. In either case, each step of the process generally requires both court approval and broad agreement among the bondholders. The complexities that arise from these procedures make it very difficult for mainstream investment managers who focus on traditional equity valuation and credit spread analysis to understand the risks and rewards sufficiently well to include defaulted debt in their portfolios. Furthermore, many pension fund and mutual fund managers are prohibited by the guidelines of their funds to own bankrupt assets, or in some cases to own any "junk" or "high-yield" securities, those bonds for which the ratings agencies Standard & Poor's and Moody's have signified the issuer has a higher probability of bankruptcy.

The difficulty of analyzing competing claims on assets, forging agreements with other bondholders, and satisfying a bankruptcy court gave rise to a small industry of bankruptcy specialists. Twenty years ago, such specialists were largely attorneys who found themselves in high demand when corporations considered snapping up assets at cheap prices following the bankruptcy of a competitor or a company that had a strong position in an adjacent market. Acquiring assets during a bankruptcy was seen as just one piece of a corporation's mergers and acquisitions strategy. Bankruptcy was considered an opportunistic time to acquire businesses that had strong synergies with existing, healthy lines. Since most companies in the same industry experienced the same business cycle, however, the timing of a rival's bankruptcy often found the

[3] "Kmart to Buy Sears for $11.5 Billion," *Wall Street Journal*, November 18, 2004.

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

industry's survivors in a weak position and unable or unwilling to commit cash to an acquisition. This timing mismatch encouraged financial buyer interest in bankruptcy-related activity.

Financial Buyers vs. Strategic Buyers

Among Warren Buffett's many skills evident in the 1960s and 1970s was the ability to "keep his powder dry" and build up cash for deployment in a counter-cyclical manner in several different industries. Thus, when companies were either bankrupt or distressed, Buffett was often the only player who could commit cash on short notice to acquire cheap assets. In many cases, these assets did not have any synergies with Buffett's other holdings. In these instances, Buffett was a pure *financial* buyer, as opposed to a *strategic* buyer. Despite the fact that strategic buyers should theoretically have been willing to offer a higher price for the assets because of the synergies that would come from merging them with similar operations, those bidders found themselves without the ability to acquire at the moment when the assets were available at the most attractive price. On the other hand, pension funds, endowments, and mutual fund managers always had cash to deploy and theoretically should have been able to match Buffett on price, but these managers had neither the expertise, nor in many cases the flexibility, to acquire large, illiquid, and complex assets.

Eddie Lampert's transition from a hedge fund manager to the chairman of Kmart and acquirer of Sears was an example of a financial buyer who had also become a strategic buyer. In 2002, with cash positions under pressure and risk appetites very low, potential corporate buyers of Kmart's assets preferred to stay away from the bankruptcy proceedings, despite the many synergies that might have been available in combining Kmart with another big box retailer. ESL had large holdings in several public companies, but Lampert also had lots of cash on hand that could be deployed opportunistically, regardless of what part of the cycle the macro economy or the retail industry was in.

Private Equity

Private equity is usually defined to include venture capital (VC) funds, leveraged buy-out (LBO) funds, and mezzanine funds. VC funds seek out small, early-stage companies that are generally several years away from having the size and track record to launch a successful public equity offering. VC funds thus pursue a portfolio of high-risk, high-reward investments, with the full understanding that the majority of their individual investments may fail. Mezzanine funds, a very small portion of the private equity market, typically provide subordinated debt financing to growth companies that require relatively small amounts of debt that is junior to senior debt.

LBO funds have a very different profile from VC funds in that they seek to acquire mature businesses that they can use as vehicles to produce an attractive medium-term return on investment. LBO shops have been able to produce attractive returns because of two market inefficiencies. First, despite many attempts to bring them together, the incentives of managers and shareholders have never been perfectly aligned in public companies. Shareholder activism takes an immense amount of energy and organization, and the more widely dispersed a company's ownership is, the more difficult it is for shareholders to make sure that managers are always acting in the best interest of the owners. Thus, publicly owned companies may in some cases not be managed as effectively as private companies. Or, to put it differently, managers may be

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

maximizing something other than profit. For instance, managers may be maximizing employment, executive compensation and perks, or perhaps even political clout. By taking a public company private and either directly managing it or closely supervising its management, LBO funds believe they can return a company to its *raison d'être* by cutting costs and running the business for cash.

The second inefficiency that LBOs claim to address is that certain types of companies, even when well-managed, are perennially undervalued by the public equity markets. There are certain fixed costs associated with being a public company, including ongoing required reports to shareholders and disclosures to the Securities and Exchange Commission (SEC), National Association of Securities Dealers (NASD), New York Stock Exchange (NYSE), and other regulatory bodies. Such costs have increased dramatically due to more aggressive regulators and stock exchanges on top of new accounting demands following passage of the Sarbanes-Oxley bill in 2002. These costs are borne disproportionately by shareholders in smaller companies. In addition, one LBO manager argues, "Many mid-cap companies have begun to feel orphaned by the public equity markets and have a difficult time attracting research coverage and investor interest."[4]

LBO funds have been notably active in the market for mergers and acquisitions (M&A) in recent years. During the recession of 2001 and its aftermath, traditional corporate strategic acquirers to a large degree shunned M&A as a potential avenue for growth and efficiency, and their shareholders for the most part seemed to approve of this newfound caution after the obvious excesses that characterized some of the acquisitions of the late 1990s. LBO funds, on the other hand, found themselves flush with cash during this period due to their increasing acceptance among institutional investors. The private equity industry had still not deployed the large amount of cash that had been raised during the period 1997–2000, and the decline in new LBO funds during 2001–2002 was much less dramatic than the overall slowdown in the M&A market. Overall, the amount of funds raised by private equity sponsors from 1999–2004 was comparable to the total amount raised by the industry in its entire history up to 1998. (See **Exhibit 3**.)

When an LBO fund seeks to take a public company private, or to acquire a large division of a public company that seeks a divestiture, the "buy-out" of the entity is generally done with an infusion of some equity from the fund's cash reserves, but that thin equity slice is stretched over a large asset with borrowed funds. By tapping the high-yield bond market, LBO funds are often able to leverage their equity infusion many times in order to complete large transactions with mostly borrowed money. By setting up separate legal entities, the LBO funds ensure that they cannot be held liable (beyond the loss of their equity investment) if companies under their control ultimately fail. High-yield bond investors are willing to lend money to these entities because they earn a high interest rate, the LBO funds have a good track record of managing businesses for cash, and in the event of business failure and default the bondholders will at least recognize some value as they will become the new owners of the company's assets.

In addition to experiencing only a limited slowdown in new commitments of capital, LBO funds over the period 2001–2004 benefited from historically low interest rates. While the reduction of short-term and long-term rates from 2001–2003 was symptomatic of the general economic malaise that caused potential strategic buyers to retreat from M&A activity, it was beneficial for LBO shops because of their reliance on borrowing to fund acquisitions that cost

[4] Paul Finnegan presentation at Kellogg Private Equity Conference, March 2005.

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

many times their available cash. (See **Exhibit 4** and **Exhibit 5**.) In effect, lowered interest rates meant that LBO funds operated in the M&A market with a much higher leverage multiplier.

Hedge Funds

The line between some types of hedge funds and LBO funds blurred in the last few years, but most hedge fund strategies remained quite distinct from the LBO investing model. Many hedge funds could be thought of as unrestricted mutual funds. Regulators allowed hedge funds to operate outside the limitations of the Investment Company Act of 1940 as long as they did not market their services to, or accept money from, small or unsophisticated investors. In 2005 the SEC was planning new regulations for the industry (the scope of which remained unclear), but for many years hedge funds had been completely unregulated, except that they could accept funds only from large institutions or accredited individual investors who met a high standard of net worth. The regulatory philosophy regarding the hedge fund industry in the United States had essentially been that rich and sophisticated investors were free to have their money managed by whomever they wished and to choose any level of risk that suited their appetite. Small investors, on the other hand, were protected and well-served by the myriad of regulations that covered mutual fund managers.

The freedom of hedge fund managers from "long-only" decisions that face traditional managers has given rise to many different investing strategies that are unavailable to mutual funds. The most basic variation on an equity mutual fund is a "long-short" equity hedge fund, in which managers take long positions in stocks that they like and also take short positions in stocks that they feel will decline over the short- or medium-term. Most such funds hope to be market-neutral, which is to say that since they hold long and short exposures in roughly equal amounts, their returns over time will have limited correlation to the stock market at large. This suits the goals of many of such funds' investors since one of the reasons investors shift assets to hedge funds is because of their preference for absolute return rather than relative return. Long-short managers are expected to deliver a positive return every year, regardless of whether the stock market goes up or down.

The early years of the hedge fund industry, before institutional money starting pouring in since the early 1990s, was dominated by long-short and other hedging strategies, so the name "hedge fund" stuck even as it became a misnomer for many funds carrying that classification. It is important to note that the main distinction between hedge funds and mutual funds is not that all hedge funds are hedged, or that mutual funds cannot hedge any of their investments. In fact, some mutual funds are allowed to buy put options to protect (hedge) against some of their downside risk, or to sell covered call options to generate income in return for giving up some of the potential upside in their investments. The distinction between the two types of funds is simply whether or not they are open to the general public, and therefore whether they are subject to large amounts of regulation. Hedge funds' investing styles range from completely hedged, low-risk strategies that seek simply to generate returns of 6 to 8 percent in any market condition to unhedged, highly leveraged speculation on currencies, commodities, or even weather and natural disasters.

Hedge funds on average do not carry any more risk (as measured by standard deviation of returns over time) than the average equity mutual fund, but no mutual fund manager would be allowed to take the risks undertaken by the small minority of hedge funds that carry very high risk but offer very high potential rewards. For instance, in 1992 George Soros, head of the

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

Quantum Fund, became known as "the man who broke the Bank of England" when he borrowed at least $10 billion to short the British pound while buying German marks, betting that Great Britain would eventually be forced to remove itself from the European Monetary System. When the size of his bets forced British officials to admit that their stated policies were unsustainable, the Quantum Fund made a quick profit of more than $1 billion. While such hedge fund trades capture headlines, they are not the norm for an industry in which most funds market themselves by pointing out that their historical returns exhibit less volatility than the stock market.

Hedge fund strategies that bear limited correlation to the broad stock and bond markets include convertible arbitrage, risk arbitrage, and distressed debt trading. Convertible arbitrage involves investing in corporate debt that is convertible into a company's stock and usually selling short common stock in the same company, trying to find an arbitrage between the value of two different securities issued by the same corporation, or else trying through constant readjustment of the position to realize the "volatility" or "optionality" value embedded in the convertible security. Risk arbitrage involves betting on whether announced mergers or acquisitions will be consummated as planned. By taking long positions in a target company and short positions in a would-be acquirer, a trader is taking the view that an acquisition will go ahead, because the spread in the price of the two company's common stock will reflect some possibility of the deal falling apart until it actually happens and the spread narrows to the exact terms laid out in the acquisition agreement. Traders realize that they cannot know for sure what will happen in the future, but they translate the spread in prices into the market's opinion of the implied probability of the deal going through. Then they can do their own estimation of the probability of deal success based on all of the available facts and potential complications such as shareholder proxy votes, anti-trust concerns, or even volatile personalities in the executive suites of the acquirer or the target. If, for example, the market believes there is a 70 percent chance of success, but the trader believes it is closer to 50 percent or to 90 percent, the trader will take a position to exploit the difference.

For many years, hedge funds active in the distressed arena tried to buy defaulted or near-default bonds and then resell them weeks or months later at a profit. While managers of such funds felt they had the expertise sufficient to risk capital in the complicated and esoteric world of bankruptcy, they were generally looking for exit strategies by reselling distressed bonds at a profit as a company moved to the later stages of restructuring. This stands in contrast to some current hedge fund investors who are attracted to restructurings because of the potential to acquire longer-term control over attractive assets. The blurring of the line between LBO and hedge funds began when hedge funds specializing in bankruptcy started hanging onto their distressed investments through the entire restructuring process, leaving them with substantial, and sometimes controlling, stakes in companies when upon emergence from bankruptcy bondholders' claims are transformed into equity in the new entity.

ESL: The Hedge Fund That Could Not Be Categorized

ESL Investments, so named after the initials of its manager, Edward S. Lampert, had always been an atypical hedge fund in that it tended to buy big chunks of companies' common stock and then stick with its investments for a few years at a time. ESL for the most part did not pursue short-term trading strategies, and it also did not specialize in distressed debt. Instead, Lampert hewed closer to the line of Warren Buffett in acquiring substantial but noncontrolling stakes in public companies that he perceived could provide an attractive return. In some important respects, however, he differed from Buffett. First, Lampert tended to buy stakes in companies that were in

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

worse shape than those Buffett favored. Buffett acquired unhealthy companies only if he was going to take full control and use the assets as springboards for other investments. As far as minority stakes in public companies went, Buffett bought stakes in such companies as Coca Cola and Gillette because he believed they had great management and excellent long-term prospects.

Two of Warren Buffett's most famous quotes show Lampert's deviation from the Buffett model. Buffett wrote that "it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price." Buffett also said many times over the years that his "favorite holding period is forever." Lampert, since leaving a plum job working for Robert Rubin in risk arbitrage at Goldman Sachs, had shown himself very willing to take minority positions in fair companies selling at a discount in order to benefit from potential improvements in operating businesses. While certainly having a much longer holding period than most of his hedge fund peers, he had also shown no indication of preferring unlimited holding periods. Many of his investments had been in companies that were limping along, neither near death nor extremely successful, where management was able to respond with energy and action to his recommendations.

2002–2003 Decision: Should ESL Seek to Gain Control of Kmart during Bankruptcy?

ESL, as a hedge fund investing on behalf of its clients, should pursue a single goal: to maximize return on investments in any market condition without unacceptable levels of volatility. In 2002, ESL was a financial buyer seeking to earn high returns from a Kmart acquisition despite having no synergies with other investments.

For years before its bankruptcy filing, Kmart had been consistently beaten by competitors with much more advanced supply chain technologies (Wal-Mart) and superior marketing and store design (Target, Old Navy, and others). Attempts to compete despite a clearly inferior cost structure led to increasing leverage over time. Kmart's balance sheet was ill-equipped to handle the recession of 2001, and the problem was exacerbated by poor decisions on the part of management.

As Lampert and his associates at ESL pondered the risks and rewards of a big infusion of cash into such a troubled entity, they pored over its balance sheet. (See **Exhibit 6**.) The operating business was in shambles, but could a large reduction in debt and a new, energized management team make Kmart a viable operation? No one had delusions that Kmart could take Wal-Mart on head to head, but Kmart retained many assets, including one that was becoming increasingly difficult for Wal-Mart to find: real estate.

In studying the potential downside of an investment, the ESL team likely took comfort from the fact that if the operating business just could not be salvaged after an all-out effort, Kmart would still retain value even in liquidation because of its real estate holdings. Kmart owned some of its big-box retail locations, but most of them were on long-term below-market leases that could have considerable present value in the event that Kmart wanted to (or had to) sell the leases to other businesses. Later, in response to considerable speculation among Wall Street analysts that ESL just wanted to realize the inherent real estate value of Kmart or Sears and then look for an

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

exit strategy, Lampert would remark that no "retailer should aspire to have its real estate be worth more than its operating business"[5] and emphatically declare his commitment to making Kmart's retail operations strong and viable. But at the time of the decision to plunge into Kmart's defaulted debt, Lampert must have considered the effective "put option" that the real estate represented if things did not work out. In fact, some analysts later decided that the real estate holdings of Kmart alone were worth several times what ESL had paid to acquire control of the company in 2002–2003. For instance, in July 2004, Deutsche Bank released a twenty-five-page study of retailers' real estate holdings, which showed that Kmart's shares at that time, despite having already quadrupled since emergence from bankruptcy, were still trading at a minimum 24 percent, and perhaps as high as 133 percent, discount to the net asset value of Kmart's real estate holdings including favorable long-term leases.[6] In other words, the analysts believed that even if Kmart were to send all its employees home and shut its doors to business, the company would still be worth much more than the equity market value of the company.

Lampert's Kmart Play

Based on ESL's analysis of the situation, Lampert decided to plunge into the Kmart restructuring despite ESL's lack of experience in both bankruptcy proceedings and running businesses with majority control of a company's common stock. During the spring of 2002, ESL began quietly accumulating Kmart's defaulted bonds. Trading in distressed debt occurs through private, unpublished transactions, so the exact timing and size of Lampert's trades are unknown. Sometime during the summer of 2002, ESL informed Kmart, then operating under a bankruptcy trustee and a new CEO, that the fund had accumulated more than $1 billion in face value of the company's defaulted debt.[7] In September 2002 ESL was able to gain a voice in the restructuring process through a seat on the Financial Institutions Committee, a statutory body appointed by the bankruptcy court. Lampert pushed for the restructuring to move more quickly than it had been up to that time and argued that the company could emerge from Chapter 11 within a shorter time frame than the management team thought. UBS Investment Bank provided the following commentary:

> *In early November, Mr. Lampert met with Kmart's then Chairman and CEO Jim Adamson to emphasize the importance of early emergence and to make clear his opinion that the process was moving too slowly; he specifically pressed Mr. Adamson to file a plan of reorganization by Thanksgiving. When the Company did not meet such a timetable, Mr. Lampert's attorney demanded Mr. Adamson's resignation.*

With Lampert's support, Julian Day was appointed the new CEO of Kmart in January 2003, and the bankruptcy process starting moving at a faster pace. ESL continued to buy Kmart debt in privately negotiated transactions throughout the period. During final preparations for emergence from bankruptcy in March and April of 2003, many of Kmart's creditors, both banks and bond investors, made it clear that they would prefer to receive cash and end their involvement with Kmart, as opposed to receiving equity in the new company. ESL took advantage of the bank lenders' preference to cut their losses, buying many of their claims for approximately 40 percent

[5] News conference, November 17, 2004. Transcript available in company's SEC filings at http://www.sec.gov.

[6] *Gold in Them Thar Retailers*, Deutsche Bank, July 26, 2004.

[7] ESL's role during restructuring in 2002–2003 was largely out of the public eye. This account is consistent with recently published articles and also relies on a timeline created by UBS Investment Bank.

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

of their face value. Holders of Kmart bonds likely received an even lower recovery value on sales to Lampert's fund. Ultimately, ESL controlled 51 percent of the new Kmart's equity when it emerged from bankruptcy, after debt was transformed into equity. Lampert became the company's chairman and was also able to nominate three additional directors to the board of directors of Kmart Holdings, whose new stock soon began trading on the NASDAQ National Market. As Lampert made several small sales of Kmart real estate leases to other retailers and managed the retail business for cash, the market realized that Kmart could be a viable business now that it was stripped of almost all of its debt. As a result, the stock started trading up dramatically. (See **Exhibit 7**.)

November 2004 Decision: Should Kmart (under ESL's Control) Acquire Sears?

The Sears chain had been almost entirely based in malls for decades, but after seeing its sales growth eroded by stand-alone "big box" retailers during the 1990s, management in the last few years started experimenting with an "off-mall" concept called Sears Grand. After good results from the early phases of testing, Sears was ready in 2004 to expand the idea at a rapid clip. The chain found that much of the demographic that once constituted reliable consumers at its urban and close suburban mall locations had moved farther away from cities to far suburbs and rural areas. Lampert's desire to sell fifty Kmart locations coincided exactly with Sears management's desire to roll out the off-mall Sears Grand concept nationwide at a fast pace.

During 2002 Lampert had built a substantial minority position in Sears stock, in keeping with his history of acquiring minority stakes in underperforming companies. Owning nearly 10 percent of the company, he was familiar with its challenges, but also with the opportunities available if the chain could re-establish relationships with its traditional customer base by following them out to neighborhoods and communities without any large malls. After Kmart and Sears closed the deal for the transfer of fifty stores in September 2004, wheels must have begun turning in the heads of each chain's management. The deal seemed to create significant value for each counterparty, and Kmart, a struggling chain, still had 1,400 stores left, hundreds of them in the exact types of locations Sears hoped to target with Sears Grand. Sears's sales per square foot were $80 higher than Kmart's, so converting dozens of stores at a time in the right neighborhoods could provide tens of millions of dollars in additional value.

However, in making these new outlays of cash to acquire locations, Sears would clearly be taking a risk as it increased its leverage. (See **Exhibit 8** and **Exhibit 9**.) It would also for the first time be entering the off-mall arena, thus exposing itself to Wal-Mart and Target. Kmart's bankruptcy had come about largely due to being overleveraged and competing with Wal-Mart during a recession, so the additional risk Sears was taking on even with just fifty new locations could not be taken lightly. To acquire additional Kmarts that would have higher operating value as Sears Grands would mean more borrowing.

With Lampert as chairman of Kmart and the second largest shareholder in Sears, and also having recently completed a real estate deal that both sides found to be highly advantageous, it is reasonable to suspect that Lampert stayed in close contact with the top management of Sears throughout September and October of 2004. When the question of combining the two companies was first raised is not known, but it is hard to imagine that Lampert himself was not considering

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

the idea. Then, in the first week of November, a sudden and unexpected flurry of news provided a catalyst.

On November 5, 2004, to Lampert's and Sears's surprise, Vornado Realty Trust announced in a regulatory filing that it had acquired a 4.3 percent stake in Sears common stock. Vornado was a large real estate investor that had a reputation for buying cheap real estate assets. Sears stock jumped 23 percent on the news, as speculation swirled that Vornado might purchase the rest of the company at a premium in order to acquire its real estate. (Unlike Kmart, Sears actually owned most of it store locations.) (See **Exhibit 10**.)

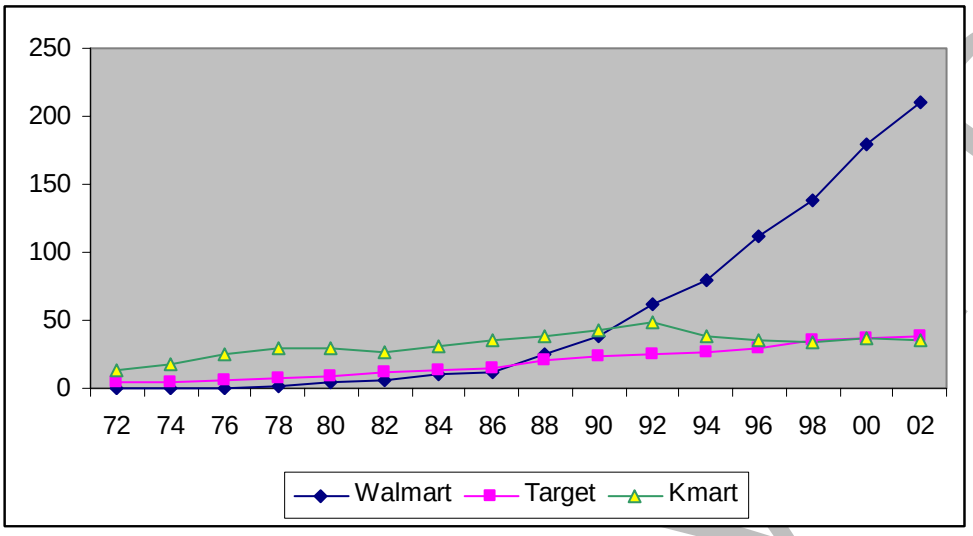
Now came the moment of decision for Lampert and the Sears board of directors. Both controlled retailers that had struggled against Wal-Mart and whose real estate had been undervalued by the market for several years. But now the market had woken up rather suddenly to the real estate argument, and a decision had to be made. How would Sears respond if Vornado or other "vulture investors" made a bid for the company? Could either of the chains, each at one time the nation's largest retailer, succeed against competitors with lower cost structures and higher sales per square foot?

As a financial buyer, Lampert had not previously been interested in acquiring more than 10 to 15 percent of Sears. But now he found himself as a potential strategic buyer, and the timing of his decision was being forced by the emergence of a financial buyer (Vornado) that had much more experience than ESL did in real estate investments. (See **Exhibit 11** and **Exhibit 12**.)

Do Not Copy or Post

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.

Exhibit 1: Kmart, Target, and Walmart Sales, 1972–2001 ($ in 2001 billions)



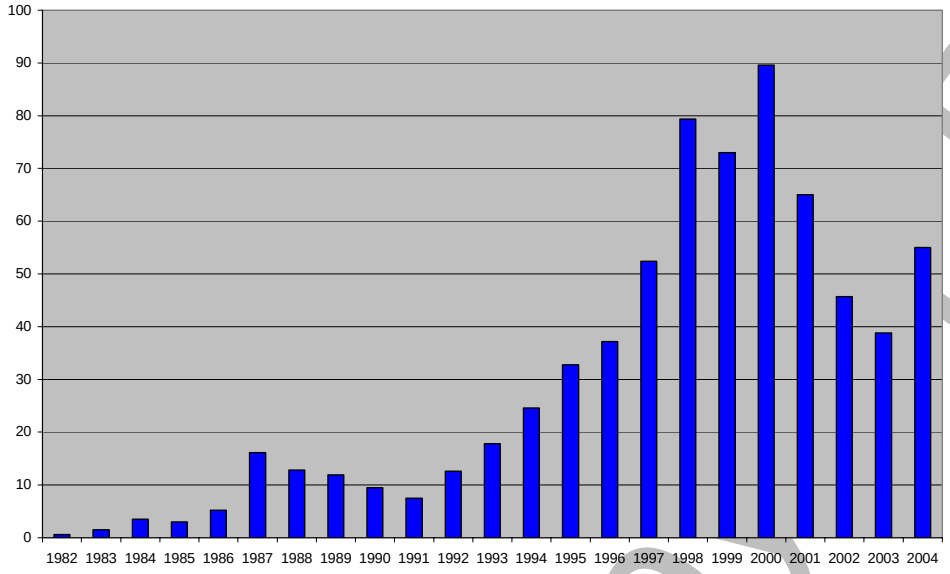
Sources: COMPUSTAT database; Bureau of Labor Statistics; author's calculations.

Exhibit 2: Kmart Daily Closing Prices, January 2001–July 2002

Source: Bloomberg.

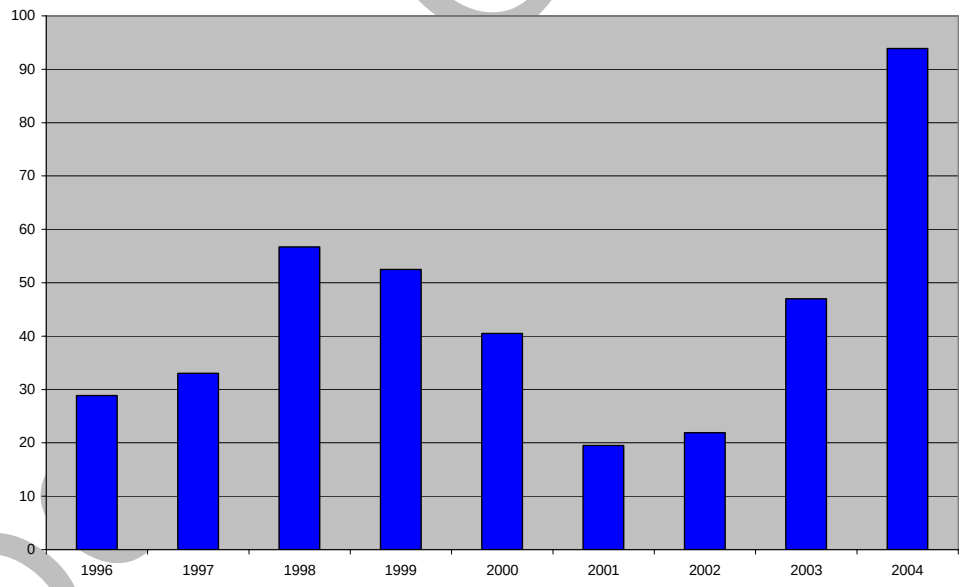
Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.

Exhibit 3: U.S. Private Equity Annual Inflow of New Funds ($ in billions)



Source: Venture Economics and *The Private Equity Analyst*, cited in Finnegan presentation.

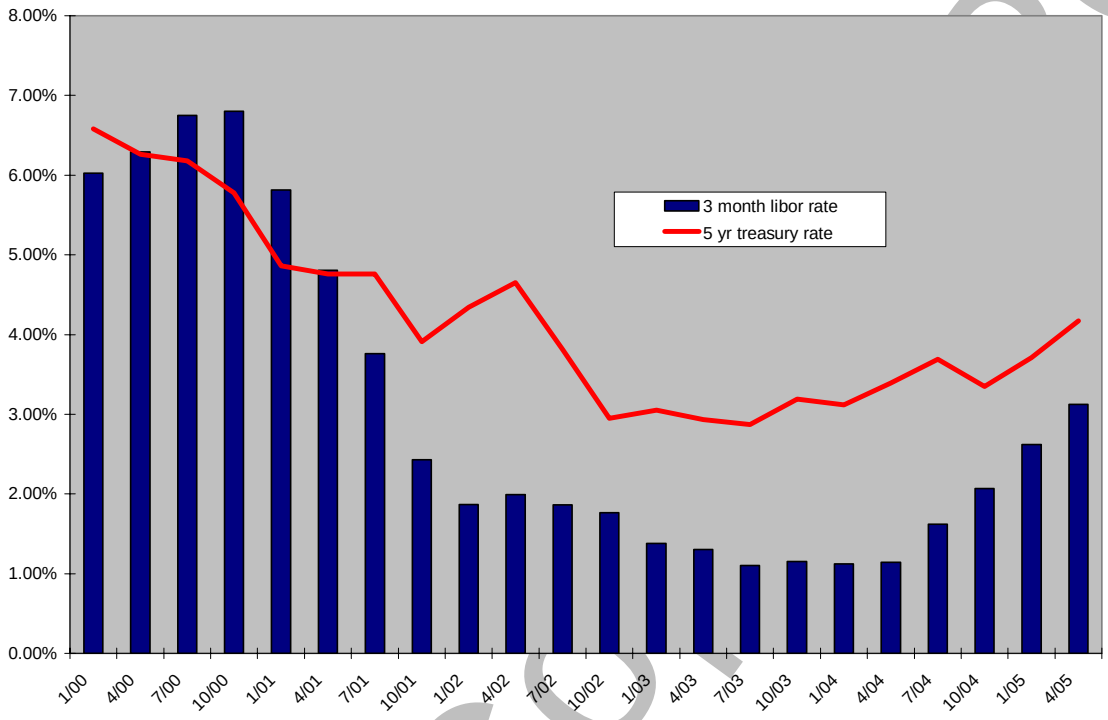
Exhibit 4: Value of Completed LBO Transactions ($ in billions)



Source: Standard & Poor's, cited in Finnegan presentation.

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.

Exhibit 5: Libor and Treasury Rates, 2000–2005



Source: Bloomberg

Do Not Copy or Post

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.

Exhibit 6: Kmart Balance Sheet, January 1999–January 2003 ($ in millions)

	JAN 2003		JAN 2002		JAN 2001		JAN 2000	JAN 1999
ASSETS								
Cash and short-term investments	2,088.00		613.00		1,245.00		401.00	344.0
Receivables	301.00		473.00		0.00		0.00	0.00
Inventories—total	3,238.00		4,825.00		5,822.00		6,412.00	7,101.00
Prepaid expense	27.00		191.00		0.00		0.00	0.00
Other current assets	157.00		0.00		817.00		811.00	715.00
Total current assets	5,811.00		6,102.00		7,884.00		7,624.00	8,160.00
Property, plant, and equipment—total (gross)	159.00		10,896.00		12,309.00		11,942.00	11,554.00
Depreciation, depletion, and amortization (accumulated)	6.00		6,004.00		6,148.00		5,385.00	5,144.00
Property, plant, and equipment—total (net)	153.00		4,892.00		6,161.00		6,557.00	6,410.00
Other assets	120.00		244.00		253.00		449.00	534.00
TOTAL ASSETS	6,084.00		11,238.00		14,298.00		14,630.00	15,104.00
LIABILITIES								
Debt—due in one year	51.00		68.00		84.00		68.00	66.00
Accounts payable	820.00		1,287.00		103.00		2,288.00	2,204.00
Income taxes payable	37.00		42.00		40.00		73.00	249.00
Accrued expense	778.00		504.00		138.00		265.00	337.00
Other current liabilities	90.00		219.00		259.00		1,105.00	1,220.00
Total current liabilities	1,776.00		2,120.00		624.00		3,799.00	4,076.00
Long-term debt—total	477.00		1,269.00		2,076.00		3,914.00	3,759.00
Deferred taxes	0.00		0.00		0.00		0.00	0.00
Investment tax credit	0.00		0.00		0.00		0.00	0.00
Other liabilities	1,639.00		8,150.00		8,139.00		834.00	965.00
EQUITY								
Common stock	1.00		519.00		503.00		487.00	481.00
Capital surplus	1,943.00		1,922.00		1,695.00		1,578.00	1,555.00
Retained earnings	249.00		(2,742.00)		1,261.00		4,018.00	4,268.00
Less: Treasury stock—total dollar amount	1.00		0.00		0.00		0.00	0.00
Total common equity	2,192.00		(301.00)		3,459.00		6,083.00	6,304.00
Total stockholders' equity	2,192.00		(301.00)		3,459.00		6,083.00	6,304.00
Total liabilities and stockholders' equity	6,084.00	AG	11,238.00	TL	14,298.00	TL	14,630.00	15,104.00
Common shares outstanding	89.59		519.12		503.30		486.51	481.38

Source: COMPUSTAT

Do Not Copy or Post

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.

Exhibit 7: Kmart Daily Closing Prices, May 2003–March 2005

Source: Bloomberg

Do Not Copy/Post

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.

Exhibit 8: Sears Income Statement ($ in millions)

	Dec 2003	Dec 2002	Dec 2001
Sales	41,124	41,366	40,990
Cost of goods sold	26,202	25,646	26,234
Selling, general, and administrative expense	10,951	11,510	10,758
Operating income before depreciation	3,971	4,210	3,998
Depreciation and amortization	909	875	863
Interest expense	1,027	1,148	1,426
Nonoperating income (expense) and special items	3,414	266	–486
Pretax income	5,449	2,453	1,223
Income taxes—total	2,007	858	467
Minority interest	45	11	21
Income before extraordinary items	3,397	1,584	735
Extraordinary items and discontinued operations	0	–208	0
Net income (loss)	3,397	1,376	735
Earnings per share (primary)—excluding extraordinary items	11.95	4.99	2.25
Earnings per share (primary)—including extraordinary items	11.95	4.34	2.25
Common shares used to calculate primary EPS	284.30	317.40	326.40
Earnings per share (fully diluted)—excluding extraordinary items	11.86	4.94	2.24
Earnings per share (fully diluted)—including extraordinary Items	11.86	4.29	2.24

Source: COMPUSTAT

Do Not Copy or Post

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.

Exhibit 9: Sears Balance Sheet ($ in millions)

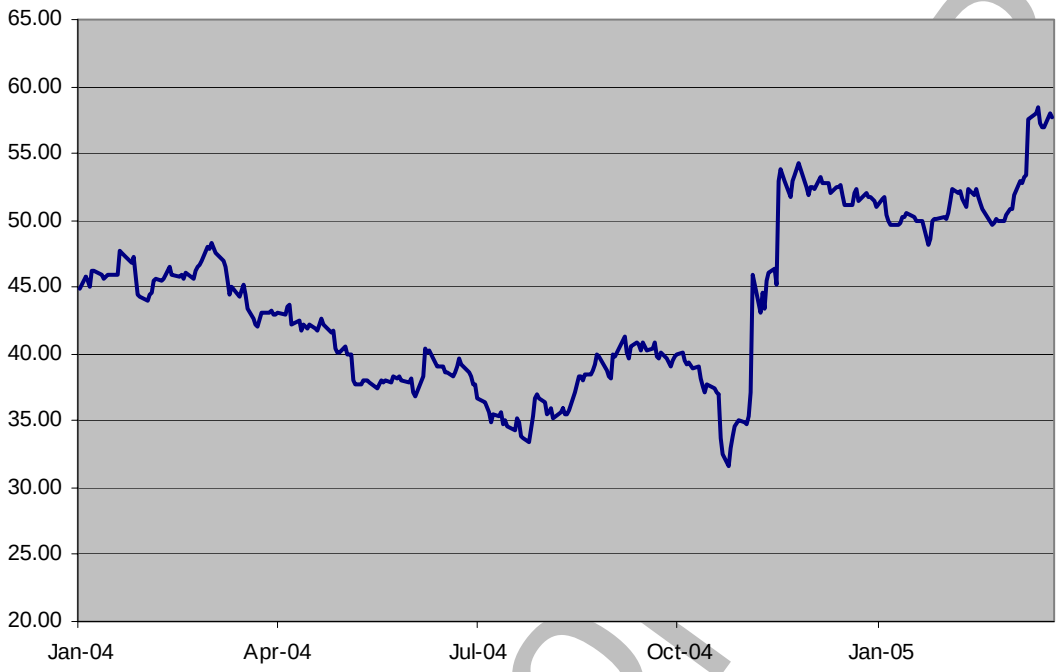
	Dec 2003	Dec 2002	Dec 2001
Assets			
Cash and short-term investments	9,057	1,962	1,064
Receivables	2,689	31,622	28,813
Inventories—total	5,335	5,115	4,912
Other current assets	1,115	1,284	1,316
Total current assets	18,196	39,983	36,105
Property, plant, and equipment—total (gross)	13,124	12,979	13,137
Depreciation, depletion, and amortization (accumulated)	6,336	6,069	6,313
Property, plant, and equipment—total (net)	6,788	6,910	6,824
Intangibles	1,653	1,648	C
Deferred charges	24	277	C
Other assets	1,062	1,591	1,388
Total assets	27,723	50,409	44,317
Liabilities			
Debt—due in one year	2,950	4,808	3,157
Notes payable	1,033	4,525	3,557
Accounts payable	3,106	7,485	7,176
Income taxes payable	1,867	0	0
Accrued expense	609	C	C
Other current liabilities	4,194	1,779	1,694
Total current liabilities	13,759	18,597	15,584
Long-term debt—total	4,218	21,304	18,921
Deferred taxes	0	0	0
Investment tax credit	0	0	0
Other liabilities	3,345	3,755	3,693
Equity			
Common stock	323	323	323
Capital surplus	3,493	3,463	3,437
Retained earnings	10,530	7,441	6,582
Less: Treasury stock—total dollar amount	7,945	4,474	4,223
Total common equity	6,401	6,753	6,119
Total stockholders' equity	6,401	6,753	6,119
Total liabilities and stockholders' equity	27,723	50,409	44,317
Common shares outstanding	230.38	316.73	320.4

Source: COMPUSTAT

Do Not Copy or Post

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.

Exhibit 10: Sears Daily Closing Prices, January 2004–March 2005



Source: Bloomberg

Do Not Copy/Post

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.

Exhibit 11: Selected Quotes from Edward S. Lampert, Chairman of Kmart Holdings, at Kmart-Sears Joint News Conference, November 17, 2004 (Emphasis Added)

"This truly is a historic day and something that we've been working on very diligently to make happen. *The combination of Kmart and Sears, as you can see, will jointly have roughly $55 billion in revenues, nearly 3,500 store locations consisting of roughly 1,500 Kmart locations and 870 or so Sears locations on the mall . . .* The terms of the deal are that Kmart shares are going to be converted to 1 share of Sears Holdings Corporation, and the Sears shares will receive for 55 percent of the Sears a half a share of the combined company, and for 45 percent of the Sears share $50 in stock. There will be an election. Shareholders will have an opportunity to elect either stock or cash, and the stock portion of the merger will be tax-free to shareholders. *As part of the merger agreement, ESL and its affiliates, our affiliates, have elected to receive all stock in the merger, and we think that is something that is a very important sign of our confidence in the combined company . . .*

"We are going to need really the best of us, but the best of both the Kmart team as well as the Sears team. I think that *there is going to be a lot of work to do in converting Kmart stores into Sears stores where appropriate, bringing Sears products into Kmart stores . . .*

"Given the large ownership that we will have on the Board, we will be able, *similar to what Kmart has been able to do for the last couple of years, we will be able to manage the business strategically and for the long term without having to worry about figuring out how to make monthly same-store sales, hit a specific target, and without giving any type of quarterly earnings guidance* and then trying to manage the business to that guidance.

"In terms of the *strategic perspective* behind the merger, I think it is pretty obvious that *scale is very important to compete effectively . . . we need to have a very low-cost structure in order to compete with our biggest competitors.* And I think that while we need to have a low-cost structure, it needs to be consistent with the reputation and quality of service that Sears has always provided and the type of service that we at Kmart aspire to achieve.

"Clearly, the Kmart locations are very significant, 1,500 off-the-mall locations in high-traffic areas. Sears has the best offerings . . . in hard lines, with Craftsman, Kenmore, DieHard. . . . The issue for Sears, however, has been with competitors opening hundreds of stores a year; the ability to actually be closer to the customer is something that Sears has started to move towards with the launching of the Sears Grand stores. But the time—the time and capital required to get there quickly—is both prohibitive and risky, and I think that the ability to take the Kmart store base and determine whether we want to convert those Kmart stores over to the Sears nameplate and to bring Sears products into the Kmart stores is a great opportunity.

"The other factor with competitors opening so many stores and Sears not having been opening stores off the mall is *Sears has had to spend a significant amount of money, both in marketing and capital expenditures, just to stay even.* That same capital which has been running roughly, call it $900 million or $1 billion a year can now be really directed at very, very high return on investment opportunities, both in the conversion process as well as helping to upgrade, whether it is the fixtures or the appearance of the existing Kmart stores.

"From a Kmart perspective, in addition to the products, which is something that we've aspired to and we've been working towards and we did this really with the relaunch of our apparel brands; *we clearly need to find at Kmart points of differentiation with our major*

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

Exhibit 11 *(continued)*

competitors. This has been something that has been talked about. It has been talked about before the Company went into bankruptcy, when it was in bankruptcy and since it has emerged . . .

"*The combined cost of goods sold of the two companies is roughly $40 billion*. We purchase roughly $40 billion of merchandise from around the world. And I think that the ability to sort of work together to really get best practices from both organizations and work with our supplier base to really help drive their business and help them save money, so that we can save money for our customers, is a big opportunity. In terms of SG&A of the two companies, *the combined SG&A is roughly $12 billion. And as you will see when we discuss the synergy opportunity, the opportunity both on the purchase of merchandise as well as the SG&A is fairly significant* when you think of those numbers . . .

"*Sears stores in general are roughly $80 per square foot more productive than Kmart stores. And if you talk about roughly 100 million square feet of real estate that Kmart has, if we could ever achieve that level of productivity in the Kmart stores, either as Sears or as Kmart, you're talking about an $8 billion opportunity. So I think that the financial dimensions are very, very significant and they blend very well with the strategic dimensions.*

"Finally, I think that as a board and a management team, *we're going to have an ability and a willingness to monetize noncore and nonproductive assets.* We want to make sure that the businesses that we run are going to be able to produce real economic value for the shareholders over time, and at the same time I think we want to make sure that we stay focused on the biggest opportunities . . .

"I think finally before I turn the podium over, *I don't think any retailer should aspire to have its real estate be worth more than its operating business. There's been a lot of speculation about real estate strategy, real estate value, and I think that there is some truth to the notion that there are certain retailers whose real estate is worth more than its operating business. I think while that may have been true at Kmart at one point in time, we've worked very, very hard to improve the profitability of each of our stores and to make those stores worth a lot more as an operating business than as real estate. The more money the store makes, the more valuable they are as operating businesses, and that's something that I think the combined company can do very, very well.*

"To the extent that we have stores that can't produce the type of profit that we're looking for, we would have to consider other alternatives. I think *well-run retailers over time should be able to earn a 10 percent EBITDA to sales ratio*. I think when you look at Home Depot, you look at Target, you look at The Gap, they all achieve that metric. And again, *that's not something we think that we're going to be able to do anytime soon, but that's something that we're going to work towards. We're going to work towards best-in-class financial metrics and best-in-class customer metrics.*"

Source: Press conference transcript, available in SEC filings at http://www.sec.gov.

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.
Do Not Copy or Post

Exhibit 12: Selected Quotes on Kmart Acquisition of Sears, November 17–19, 2004

Tom Peters, management author: "If you think they'll be able to take on Wal-Mart, I've got a nice bridge." (*Wall Street Journal, 11/18/04*)

Burt Flickinger, retail consultant: "This is cause for celebration for competitors." (*WSJ*)

Emme P. Kozloff, Sanford Bernstein retail analyst: "Wal-Mart is in a good position. It could take advantage of the inevitable disarray at Kmart over the next year to take market share. And it's always harder to get customers back that have defected." (*WSJ*)

Michael B. Exstein and Shirley Lee, Credit Suisse First Boston retail analysts: "In the near term, we do believe that the opportunities for cost savings and improvements are real, not to mention significant opportunities for the combined entity to monetize some of its real estate (i.e., overlapping/'nonstrategic' store locations). As a result, we believe Sears shares will continue to rally on today's news given these two points. In the longer term, however, we believe that the integration (such as systems and logistics) and execution challenges before the combined entity is [sic] enormous and far more complex than any combination attempted in the retail industry to date. Prior to today's announcement, many would consider Sears and Kmart to be the industry laggards with uncertain business models. It is not clear to us how the combination of such two [sic] retailers could work long term." (*CSFB Retail Industry Flash, 11/17/04*)

Kozloff, McGranahan et al., Sanford Bernstein retail research team: "The merger of Sears and Kmart has strong strategic rationale for two beleaguered retailers: real estate for Sears, brands for Kmart. Sears is currently trapped in a capital-consuming but obsolete on-mall real estate footprint. Kmart real estate helps level the playing field with other hard line players. However, the integration promises to be complex, difficult and lengthy; near-term risk is substantial and probability of success is mixed. Execution will be the key to making the merger work, and the track records of the two companies are not encouraging. The task of integrating supply chains, systems and two disparate cultures is enormous. We expect existing Kmart locations that have appropriate demographic trade areas to be candidates for conversion to the Sears 'mini-grand' format. Management sees 'several hundred' candidates over time, although the pace is likely to be measured and returns carefully monitored. Our demographic analysis suggests roughly 300 potential conversions over time. Potential synergies—revenue, purchasing and cost—are powerful (pegged by company at $500 million) and, if realized, will create value." (*Bernstein Research Weekly Notes, 11/19/04*)

Source: http://www.sec.gov/Archives/edgar/data/319256/000095012304013859/y68947fe425.htm (accessed January 15, 2005).

Do Not Copy or Post

Copying or posting is an infringement of copyright. Permissions@hbsp.harvard.edu or 617-783-7860.