OPTIONS FOR EXIT: THE END OF SEARS

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For decades Sears, once the nation's largest retailer, has been struggling. As early as 2004, people questioned if Sears could survive. Today, its demise seems nearly certain. But Sears still has hundreds of stores, billions in assets, major investors, and valuable consumer brands. The sinking may be inevitable, but slow. Sears is facing what could be the most difficult strategic decision of its life: how to die.

INTRODUCTION

"If you want a happy ending, that depends, of course, on where you stop your story."
– Orson Welles

Over the last two decades, James Rowe had made some serious money with Eddie Lampert's hedge fund: ESL Investments (ESL). ESL had been consistently posted 20+% gains year after year. Few other funds could match that kind of performance and James was glad he joined up when he did. But something seemed different now. Since the acquisition of Kmart and then Sears, ESL had been struggling. Kmart-Sears had become ESL's largest single holding. As the struggling retailers dragged on ESL, the fund had been doubling-down on its investments, loaning billions to the retailers. As it was becoming increasingly clear that Kmart-Sears would never recover, James started to seriously consider if he needed to get out of ESL before things got any worse.

Abigail Spencer prepared for her first meeting as a vice president at Sears. She had heard these meetings could be a little contentious, but Abigail had worked in high-pressure environments before. What she needed to do now was build allies among the other executives. As she strolled into the videoconference room she tried to introduce herself around the room but found everyone hunched over their laptops. Whenever she tried to make small talk, people would respond with looks like "What are you doing?" The only advice she got was "keep your head down". The lack of morale was palatable. "This can't last", Abigail thought.

As Alejandro Martinez sat on his porch, sipping his coffee and reading the paper, he noticed another article about Sears. There was a new one almost every week.

This wasn't good. Alejandro had worked in advertising for Sears for over 30 years before he finally was able to retire just a few years ago. If Sears finally crumbled, what would happen to his pension?

THE RISE OF SEARS

When it was founded, Sears revolutionized shopping. As the industrial revolution made the mass production of inexpensive consumer goods possible, average people did not know how to access these goods. Richard Sears and Alvah Roebuck came upon an idea: a mail-order catalog. Sears & Roebuck started with watches and jewelry, but they quickly grew to include almost everything under the sun. If customers wanted to mail order house, Sears could do that too! By the early 1900's Americans could order a "Modern Home" from the catalog for around $750 (Stevenson & Jandl, 1986). By 1895, the Sears catalog had grown to 532 pages its widespread popularity credited Sears, Roebuck and Company with playing a role in the history of linguistic change in rural areas (Kimball, 1963).

In 1906, Sears, Roebuck, & Co. opened a 40-acre logistics center that Henry Ford called the "seventh wonder of the business world". However, Ford's mass production of the automobile almost threatened to make the convenience of mail order catalogs obsolete. As stores became easier and easier to access, Sears's catalog sales began to decline. But Sears embraced the changing landscape. If consumers were becoming used to driving to a store, Sears would simply open their own stores.

Over the 1920s and 1930s, Sears opened large "anchor" stores that would eventually drive the proliferation of malls and shopping culture across America. As consumer culture and brand recognition grew, Sears joined the trend by introducing several of its own iconic brands: Craftsman tools, DieHard batteries, Kenmore appliances, Dean Witter Reynolds brokerage, Allstate insurance, Coldwell Banker real estate, the Discover credit card, and others. Despite the growing trend in suburbanization and car-centric shopping culture, Sears continued to emphasize its catalog. The costs of running a physical retail store were high compared to the costs of a centralized mail-order distribution center. The mail-order business model continued more efficient at low customer densities and with products that can be easily described (Michael, 1994), which had long been a stronghold for Sears.

Through the mid 1900's, Sears continued to grow into the largest retailer in America. In a very fitting fashion, Sears built what was then the tallest building in the world, the 110-story Sears Tower (opened in 1973) on the Magnificent Mile in Chicago – just as Sears was at its peak (Delventhal, 2018).

THE SLIPPERY SLOPE DOWN

The altitude of Sears's success made it difficult to convey any sense of urgency or danger, after all, Sears occupied the spot at the top of the retail world, both literally and figuratively. But rather quietly, during the 1970's and 1980's, another discount retailer by the name of Wal-Mart was steadily growing. By the 1980s and early 1990s, the most eye-catching graphic in the Wal-Mart annual report was the "measles map" of the United States, in which each dot represented a company store or distribution center. At first, they were all clustered in Arkansas, Missouri, Oklahoma, and Texas, Wal-Mart's home turf, but then, year by year, the map charted a seemingly disease-like spread as state after state became densely covered with scores of little black dots marking a new Wal-Mart. Even the Midwest and South were largely dot-filled by the end of the 1980s (Lichtenstein, 2011).

Despite the steady climb as Wal-Mart grew and eclipsed smaller retailers, Sears continued to think of themselves as invincible. After all, they mused, Wal-Mart competed on price in strip-mall "big-box" locations; Sears competed on quality and anchored many of the shopping malls. However, with the suburbanization of America came a rise in the convenience of off-mall big-box stores. Even when Wal-Mart eclipsed Sears as the nation's largest retailer by sales in 1991, Sears's management continued to say that it was just a temporary fluke and that Wal-Mart's success couldn't last (Colvin, 2016).

However, as Wal-Mart continued to grow – and Sears continued to shrink – it became harder to deny that there were problems. Shareholders began to express irritation. One activist shareholder, Robert Monks fought, and lost, a proxy battle for control of the company. He did not succeed in unseating the current directors, but he did win himself a meeting with then-CEO Ed Brennan. Reportedly on his way to the meeting, he was told in the elevator that "this is the first time bad news has made it above the 78th floor." And yet, for all of the issues, managers at Sears made some minor adjustments but otherwise continued to act as if Sears were the most successful company in America (Colvin, 2016). Throughout the 1990's Wal-Mart continued to erode at the market share of retailers everywhere, Sears included. Consumers continued to fade from the malls and their anchor stores in favor of strip malls and big-box stores like Wal-Mart and Target. In 1992-1993, Sears made some adjustments by spinning off its Allstate insurance and its Dean Witter Reynolds / Discover business unit into independent companies to get Sears "returned to its retailing roots" (Delventhal, 2018).

MERGING WITH KMART

Still, as Sears tried to retrench, it could not get away from the problems it was facing and the decline continued. Around the same time, another retailer was having similar problems: Kmart. Kmart had been one of the early big-box, discount retailers and just as quickly as it had risen with the rise of strip-mall shopping, it had fallen to Wal-Mart's relentless expansion. By 2002, Kmart itself had declared bankruptcy. However, in bankruptcy, Kmart had found itself a bailout. A hedge fund by the name of ESL Investments (ESL) purchased Kmart during its bankruptcy proceedings in 2003. ESL was one of the most successful hedge funds on Wall Street. Over 20 years, it had consistently posted returns in excess of 20%. ESL was started, and principally managed, by Eddie Lampert, a Yale-grad who had worked on Wall Street and started the fund at the young age of 26. But with his record of successful investments, it appeared that if anyone could turn around struggling Kmart, it was him.

Shortly after acquiring Kmart, Mr. Lampert orchestrated a merger of Sears and Kmart into Sears Holdings in 2005. The merger between Kmart and Sears was supposed to beneficial to both sides. Sears could get away from failing American malls and into Kmart's more convenient locations while Kmart could leverage the Sears name and brands to supplement the failing Kmart stores (Peterson, 2017). Not all were convinced of the success of the merger. The business press frequently questioned if the deal could pan out. In 2004 and 2005, The Wall Street Journal published articles entitled "Can Sears and Kmart Take On a Goliath Named Wal-Mart?" (Merrick & Zimmerman, 2004) and "Long & Short: Lampert Faces a Long Shot in Reviving Sears" (Eisenger, 2005). Furthermore, some analysts argued that ESL's deal to acquire Sears for $11 billion undervalued Sears's real estate holdings, since they owned their own stores and were not held to leasing company agreements. Analysts at Smith Barney argued that Sears could have been worth upwards of $15 billion, mostly on the value of this real estate (Zuckerman, Merrick, & Smith, 2005), while others argued how that acquisition contained a reasonable margin-of safety, or price discount to estimated value, even though it occurred at a multiple of 1.8x Sears' book value at the time (Calandro, 2008). Nonetheless, with no rival bidders, the deal went through and Sears and Kmart merged into Sears Holdings.

NEARING THE END

Many of the synergies from the merger were never realized. Sears-branded products made their way into Kmart stores. The combined company sold some of its excess real estate holdings. But, as can be seen below, the combined company continued to lose money. From 2010 to 2017, Sears Holdings's sales have fallen by half and its operating income from a slim profit to a massive annual loss.

Table 1
Sears Holding Corp. Financial Performance

	2010	2011	2012	2013	2014	2015	2016	2017
Revenues	$44,043	$43,326	$41,567	$39,854	$36,188	$31,198	$25,146	$22,138
Operating Expenses	43,330	42,852	43,068	40,692	37,115	32,706	26,146	24,116
Operating Profit	713	474	-1,501	-838	-927	-1,508	-1,000	-1,978
Interest, Taxes, & Other Expenses	416	324	1,646	216	189	302	128	243
Net Income	297	150	-3,147	-1,054	-1,116	-1,810	-1,128	-2,221
Assets								
Current Assets	11,438	11,535	10,244	9,265	8,959	5,863	6,045	4,996
Fixed Assets	13,370	12,733	11,137	10,075	9,302	7,346	5,292	4,366
Total Assets	24,808	24,268	21,381	19,340	18,261	13,209	11,337	9,362
Liabilities	15,373	15,654	17,040	16,168	16,078	14,154	13,293	13,186
Equity	9,435	8,614	4,341	3,172	2,183	-945	-1,956	-3,824
Total Liability & Equity	24,808	24,268	21,381	19,340	18,261	13,209	11,337	9,362

*All figures in millions of U.S. Dollars
(Mergent Online, 2018)

The continued declines forced the new owners to take an increasingly active role in the management of the company. Through ESL's 55% controlling stake, ESL directed Sears to begin a stock buy-back program. Since 2005, Sears spent over $6 billion buying back its own shares to boost its stock price (Isidore, 2018). Lampert split the company into 30 divisions in an attempt to create a culture of competition in 2008. Each division operated nearly independently, reported independent results, and competed with each other for resources (Delventhal, 2018).

In 2013, Lampert formally took over as CEO. Through the hedge fund, ESL Investments has loaned Sears Holdings over $1.12 billion backed by collateral in the form of several stores' real estate. He also pushed a new "Shop Your Way" program where customer loyalty points could be exchanged for coupons and discounts. In addition to building customer loyalty, "Shop Your Way" was also tied into social media and was supposed to drive in-store customers into online customers. Unfortunately, as one executive put it "The reality is, when your top line falls as significantly as it has and your customer base doesn't buy all online — they are middle-aged to older, and they shop the store — as much as you try to shift channels to online, it's just not happening."

As if a failed online program were not bad enough, the loyalty program was hurting in-store sales. Employees are instructed to push the Shop Your Way program. So much time was spent on pushing the program that cashiers that used to scan eighteen items a minute had fallen to just five a minute. Stores are chronically understaffed as in-store resources were diverted to supporting online operations or other competing divisions. As a result, in-store shoppers would get frustrated and sometimes left without checking out (Peterson, 2017).

With fewer customers, there has been an effort to "downsize" the stores. In 2015, Lampert created a real estate trust called Seritage Growth Properties. Sears immediately sold 235 stores to Seritage in exchange for $2.7 billion, but then Sears rents back a portion of the square footage from Seritage. Seritage rents the remaining square footage to other clients and pay substantial dividends back to Lambert and ESL, who own 43% of Seritage. While the sales have given Sears Holdings a much-needed cash infusion and prevented bankruptcy, the sad irony of renting your own stores back is not lost on managers.

Internally, morale is low. Managers continue to flee the failing retailer. According to Business Insider, at least 67 VP-level executives have left in 2015 and 2016 alone. Lampert is now considering selling off nearly all the remaining real estate holdings, about 200 stores, to continue to stave off bankruptcy (With divisions competing against each other, there is constant internal fighting. At one point the appliances division ditched Sears's own Kenmore brand in favor of LG because it felt it was being price gouged. Top-level meetings with the CEO are almost always through teleconferences and executives often fear falling afoul of what the CEO wants to hear. Many suppliers are becoming increasingly concerned that Sears will be unable to pay and are quietly ending their relationships with Sears. There is a general feeling that the company cannot be saved.

But if Sears is failing, where does that leave James, Abigail, and Alejandro? Is it better to just get it over with and end the company now while there is still some value or to continue to drag out this demise as long as possible? Who else would be affected by the end of a retail giant? What is Sears most likely to do?

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