

>: How to destroy a company and make a billion

Monday, February 4, 2008 / Dylan Jovine

TODAY I'M GOING TO ACCOMPLISH A GOAL I'VE ONLY DARED TO DREAM ABOUT ACCOMPLISHING IN MY LIFETIME.

No, I haven't developed the cure for cancer or unlocked the secret to world peace.

Nor have I decided to throw my hat into the ring and declare myself for President of both the Red and the Blue States.

Nope, today I plan to accomplish something much more... well, special then that.

Today, in one fell swoop, I plan to piss off 50,000 and 1 employees working at one of America's corporate icons, Sears Holding Corp, parent company to both Sears and K-Mart (SYM: SHLD).

That's right. By the end of this article I'll likely piss off all 50,000 employees who work at the iconic company because I'm gonna tell them, Ayn Ryand style, that they're not people at all - they're numbers.

And of course lets not forget the "1" I'm gonna piss off also. He'll be upset for an entirely different reason: he'll be upset because I'm gonna pull the curtain away from the great and omnipotent OZ himself. Yes, I'm pulling his card. Calling him out. Letting the cat out of the bag.

Yup, by the end of the day, if I have my way, "Mr. 1" is going to have hundreds, maybe even thousands, of people, I mean "numbers" coming into his office and asking - no better yet demanding - an explanation to the rumors and innuendos.

Who am I talking about? Who is "Mr. 1"?

Well, ladies and gentleman, if you haven't figured it out yet, "Mr. 1" is none other then the Chairman, CEO and majority shareholder of the company: billionaire hedge-fund manager Ed Lampert of ESL Investments.

(I think I'm gonna take a page from lunatic manic-depressive financial cry baby Jim Cramer and refer to the notoriously secretive and controlling hedge-fund manager henceforth as "Eddie." Makes him sound more like the boy next door, Eddie Haskell.)

Now if you're a person who works at Sears Holding Corp., or have a friend, relative or neighbor who works at Sears Holding Corp., get your straws ready. By the end of this article you'll have every right to load the straw with a spitball and shoot it right at your computer screen.

(Those of you with no connection with Sears Holding Corp. who find yourself angry at me after reading this article who (a) are Giants fans or (b) have the Monday morning blues or (c) work for a newspaper company or (d) are just miserable about life feel free to get your spit balls ready as well. Today, I will be - no I want to be - the manifestation of everything wrong in your life too!)

Observers of Eddie would be forgiven for saying that these days he's had somewhat of an image problem.

Hailed as the next "Warren Buffett" after bringing K-Mart out of bankruptcy (by buying its bonds for pennies on the dollar) and merging it with Sears, the stock of the combined company peaked at \$193 per share in April of last year. That's up a gazillion percent from the "coming out of bankruptcy" price of \$12 - \$14 per share (I couldn't see the writing on the chart system I used).

But during the past few weeks, the Buffett comparisons have faded as Lampert has seemingly scrambled to correct what some people call a sinking ship.

"We just can't avoid the cliché 'rearranging the deck chairs on the Titanic' when considering the proposed new operating structure for Sears," Carol Levenson, a credit analyst at Gimme Credit wrote in a note to clients. "The goal of making the merged Kmart and Sears into a retailing success has become increasingly less achievable, as same-store sales plunge and excuses abound."

You see, most of the folks "in the know" about retail act shocked that a financier like Eddie has the gall to not only run the company, but, according to many sources, micromanage it. They believe that its been nothing more then his ego that makes him believe he could run a retail company, especially one like Sears/Kmart.

And it's nothing more then his ego that caused him to make the following mistakes: First, he started raising prices on items he didn't want to sell any more for a loss (or didn't believe there was enough profit). Then, he had the incredible audacity to stop spending money to keep all of its stores in tip-top shape (have you been in one lately? I don't know about where you live but the one around here is "Argh!"). And finally, observers are stunned that he can't attract or retain high quality people with retail experience!

But what if Wall Street (and Carol from Gimme Shelter) doesn't get it? What if they never really got it at all, really?

adjectives - not mine).

Indeed, he may be all of these things and more. But one thing he isn't is a fool. And based on all of the talking heads out there it seems they never - for a second - contemplated the idea that maybe, just maybe, Eddie is making these decisions on purpose.

That's right. Maybe, just maybe, Eddie decided that slowly bleeding the company was the best the best use of the company's capital.

Although Eddie's made a killing investing in retailers, he's no Sam Walton and he knows it. He's an investor. A financier. And a very successful one at that. And being a successful investor means one thing and one thing only - you are good at allocating capital.

What does "allocating capital" mean? It means that as an investor you invest money into the ideas/businesses/stocks/whatever that offer you the highest return on your invested capital. For every \$1,000 you invest you want to get back \$300, \$400, \$500 and more, not \$50 bucks.

And anybody who is in the business of allocating capital who has studied competitive strategy already knows that in the long-term, Wal-Mart (SYM: WMT), Target (SYM: TGT) and Best-Buy (SYM: BBY) have already won the war. Best-Buy has got you covered on electronics and ovens, Target's got you covered fashionable designs at a cheap price, Martha's bolting to Macy's (SYM: M) and if you're just gonna compete on price, you're never gonna beat Wal-Mart

So you can keep remembering the glory days of both companies but you'd be wasting your time. You could keep looking for great managers but you'd be wasting your time. That's because, over the long-term, one financial inch at a time, the stronger companies get stronger and the weaker ones get weaker until one day you're blown into oblivion (Does anybody remember Alexanders?)

Sure, you could string a few good quarters here and there. But even if you pull around a remarkable "turnaround" like Macy's or JC Penny (SYM: JCP), the truth is that you're never really getting ahead financially. Your stock will float between \$20 and \$30 bucks a share but your return-on-capital will really never get above 10% (for every \$1,000 you spend on the business you'll only get \$100 back).

In short, you'd be wasting your financial time. Especially when you could get better returns by pulling money out of the company then you can by leaving it in.

And that's what most people who are covering this whole drama don't seem to understand. Eddie isn't thinking about the people at Sears/K-Mart or whatever it's called these days. And to be perfectly honest, he's really not thinking about the customers of the company either.

What Eddie is thinking about is how to squeeze the most money out of this company so that he - or better yet his fund - could invest the company in other companies that have higher returns on capital.

In other words Eddie is thinking about Eddie. And rightfully so. Why? Because helping the people at Sears may help in the short run but it's not a good strategy in the long run. The best long-term strategy is to take the money out of companies with low returns and invest into companies that offer higher returns. Companies that offer higher returns create more jobs in the long-term than companies that don't. It's that simple.

So keep bleeding Sears, Eddie. It's better to honestly kill something off in five years than it is to drag it on for a lifetime.

And don't listen to these people who say you're not like Warren Buffett. Forget them - they're just playa haters. They don't remember that Buffett did the exact same thing at Berkshire Hathaway (SYM: BRK) when he bought the company. He started bleeding the textile business and used all the excess cash he generated he put into insurance, etc.

They might not get it now but what Buffett did was in the long-term interest of the country at large because his ability to allocate capital insured that more jobs were created in the long-term. Sure, the thousands of people who made textiles for a living were out of work. But in their place came tens of thousands of people in other companies that you own that grew fast and created jobs (not to mention all the Buffett-billionaires, etc).

But Eddie did make one key public relations mistake. A mistake that any man who is nicknamed "Eddie" should have known not to make from years of watching Eddie Haskell on Leave it to Beaver. Whereas Buffett smiled and communicated like Haskell when bleeding Berkshire dry, Lampert is like more like Barry Bonds - he's too high profile and he's about as cuddly as a crocodile.

What he should have done is put a puppet CEO in charge, given the person a limited budget, stayed behind the scenes and let the CEO take all of the arrows for him while he smiled every time a camera snapped a photo. That's what Eddie Haskell would have done.

(And that's the difference between making huge money (a couple billion) and stupid money (tens of billions) and I guess Eddie knows that also. Making stupid money is all about appearances Eddie. Now everyone's out to get you for real).

And another last point for all you "Eddie-Lovers" out there: Contrary to what some manic-depressive financial commentators may believe, Sears is NOT the next Berkshire. Indeed, I think it's foolish to almost convince yourself of that. And dangerous. Very dangerous.

You see with Berkshire, Buffett would take all his excess capital money and buy stocks. But first he had to buy an insurance company or two to

make sure he didn't violate the Investment Company Act of 1940 which states that no more than 40% of your assets can be in stocks.

And it doesn't seem likely that Eddie is going into insurance. So unless he changes his mind and acquires an insurance company, look for Eddie to pull as much money out of the company as possible. Special dividends. Big payouts. Huge bonuses.

In the end, the only people that will get big benefit from his bleeding of Sears will be the investors in his hedge-fund.

Now that's smart business. Business that in the long-term will create the most amount of jobs possible. But in the short-term it's gonna be very painful if you're an employee of the company. Or if you're an investor who believes in make believe.

Let the spitballs begin!



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Chief Investment Officer

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Economic Calendar for the Week of February 04 - February 08

Tuesday, February 05

10:00 AM - ISM Services

Release Details

formerly: Non-Manufacturing NAPM (National Association of Purchasing Managers)

Importance (A-F): This release merits an improved B-.

Source: Institute for Supply Management

Release Time: 10:00 ET on the third business day of the month for the prior month.

Raw Data Available At: <http://www.napm.org>.

The non-manufacturing ISM report is a national survey of purchasing managers which covers new orders, employment, inventories, supplier delivery times, prices, backlog orders, export orders, and import orders. Diffusion indexes are produced for each of these categories, with a reading over 50% indicating expansion relative to the prior month, and a sub-50% reading indicating contraction.

The index should be far more indicative of the broader economy given its inclusion of service-producing as well as good-producing sectors outside of manufacturing. However, the short history of the index dates to only July 1997 and doesn't provide the insight of a longer period inclusive of varied economic climates. The seasonal adjustment of the index didn't begin until January 2001 with only 3 of the 9 components seasonally

adjusted as of April 2001. The lack of historical data and lack of a tight correlation to the non-manufacturing economy leaves the relatively poor "B-" rating compared to the "A-" rating of the well-respected manufacturing ISM index.

Highlights

Actual: 53.9 (-0.2 pts from Nov)

Key Factors

The services sector softened up a bit in Dec as the 3-month trailing average suggests the index is trending lower in line with weaker home prices and consumer confidence.

New orders poked back up to the 3-month average at 53.5 after having visited the worst levels for 07 in Nov.

Inventories continue to bubble around the contractionary/growth 50 level.

Prices paid can be summed in one word: Ouch!. Remain lofty.

Employment (seasonally adjusted) perked up off a weak Nov.

Exports were drained to 50.5 despite the cheaper buck while imports near 50 as both now suggest slower growth may be going global

Index is volatile and independent of its components. Can cause confusion in interpretation.

Thursday, February 07

8:30 AM - Initial Claims

Release Details

Importance (A-F): This release merits a C .

Source: The Employment and Training Administration of the Department of Labor.

Release Time: 8:30 ET each Thursday (data for week ended prior Saturday).

Raw Data Available At: <http://www.dol.gov/opa/media/press/eta/main.htm>.

Initial jobless claims measure the number of filings for state jobless benefits. This report provides a timely, but often misleading, indicator of the direction of the economy, with increases (decreases) in claims potential signalling slowing (accelerating) job growth. On a week-to-week basis, claims are quite volatile, and many analysts therefore track a four week moving average to get a better sense of the underlying trend. It typically takes a sustained move of at least 30K in claims to signal a meaningful change in job growth.

There are two other statistics in this report -- the number of people receiving state benefits and the insured unemployment rate; neither is watched closely by the market. Some analysts track the number of people receiving state benefits from month to month as a guide for job growth, though this series has a poor track record in predicting the monthly employment report. The insured unemployment rate changes little on a weekly basis and is never a factor for the market.

Highlights

Initial claims surge 69K to 375K in the week of January 26.

Continued claims rose 47K to 2.716 mln in the week of January 19.

Key Factors

Poor seasonal adjustment helps explain the volatile January levels -- strong adjustment early in month but absent in this latest week.

Pulls 4-week average back to 326K Should find a more accurate weekly level in the coming weeks.

The 4-week average of continued claims fell for a second week (after thirteen weekly gains).

Some increased clarity after the unbelievably low early year initial claims levels.

Big Picture

Seasonal adjustment provided some volatility early in the year as the over-adjustment for post holiday workers left a 300K level and under-adjustment (we hope) in the latest week left a surge to 375K. The 326K 4-week average provides a better read but may also be low given the 340Ks seen in December. Continued claims (a better read on hiring) ended a string of gains in the four week average with two declines which may prove to be just an interruption. Claims provide a nearly real time read on layoffs and the labor market as the employment report reflects the broader combined read of layoffs and hiring. A 360 K level for the 4 week average has been consistent with recession -- 362K in 1990 and 373K in 2001.