

Financial Evaluation Strategy: Sears and Kmart Merger

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Firm restructuring in the form of mergers, acquisitions and divestitures are always the focus of attention of financial strategists and theorists. Strategic decisions made in these transactions change their size, culture and profitability and require a thorough process from the generation of the idea, the identification of the target partner, integration and achievement of synergy (Berkovitch & Narayanan, 1993; Lindenberg and Ross, 2001).

Sears, Roebuck and Co. and Kmart decided to merge and become Sears Holding Inc. closed the merger in March 2005, in an operation of \$621 million by which Sears purchased up to 54 K-mart stores. The operation sought to strengthen the presence of Sears in off-mall locations and increased liquidity and revitalized financial position to K-mart. Sears Holdings Corporation became the parent company and has become the fourth largest broad line retailer with operations in the United States and Canada.

This paper will present in the first section will provide background about both firms. A general approach to the life-cycle model (Chanmugan et al, 2005); evaluation of the motives for the merger (Berkovitch and Narayanan, 1993) in the second section. An analysis of the factors that explains returns (Delcoure and Hulsander, 2006) integration and synergy (DiGiorgio, 2002) will cover the third section. Finally, an ex-post assessment of the financial ramifications of the transaction will be included.

General Information about the Companies

Kmart Holding Corporation

Kmart corporation, founded in 1899 in Detroit had been one of the largest discount retailers in the United States. The operations of Kmart expanded to a total of 1,840 locations in 49 states and Puerto Rico, the U.S. Virgin Islands and Guam, and online presence (Marketline,

2007). Kmart structure included discount stores and super centers, usually located as stand-alone units that sell both general merchandise and branded products and services such as *Martha Stewart Everyday*®, *Jaelyn Smith*® and *Joe Boxer*®. Kmart stores also operate in-store pharmacies and groceries sections in their super center locations (Marketline, 2007).

Kmart had maintained consistent revenues in the past years but in January 2002, Kmart corporation and its 37 subsidiaries filed for Chapter 11 reorganization to solve financial problems that comprised operations, leverage and liquidity issues: Drop in liquidity due to declining sales and earnings since the first quarter of 2001 generated by difficulties in the bond market, vulnerable relations with suppliers, increased competition, general economic recessionary conditions and volatility in “decrease of supplier confidence, intense competition, unsuccessful sales and volatility in the capital markets. Through Chapter 11 reorganization, Kmart worked on a plan that would turn around the detrimental financial position by increasing sales, reducing debts and achieving efficiency in lower costs. Kmart was back in shape after 14 months under the ownership of Kmart Management Corporation, subsidiary of Kmart Holding Corporation (SEC, 2007).

Sears, Roebuck and Co.

Sears is recognized as a multi-line retailer with an extensive variety of products and services, distributed by the Sears brand and affiliates in United States and Canada in 861 full-line stores, 74 Sears Grand Stores and 1095 specialty stores including 47 outlet stores, and 111 hardware stores. Having started as a catalogue-order business, they expanded to physical presence across the nation. Traditionally located in shopping malls, they also offer related services or product repair in stand-alone stores located in off-mall sites. More than 10,000 technicians are part of the network of services in 50 states, added to the presence of Sears as an

online retailer. Sears owns 70.2% of Sears Canada, with similar business objectives as the domestic Sears.

Their myriad of products include: home appliances, merchandise, consumer electronic, tools, fitness and garden equipment, hardware, automotive services, tires and batteries, apparel, footwear, accessories, home products, health and beauty, pantry and toys. They carry brands such as Kenmore, Craftman, DieHard (Datamonitor, 2007).

Sears Holdings Corporation

The parent company resulting from the merger of Kmart and Sears Roebuck and Co, is a holding incorporated in Delaware and with headquarters in Michigan, relocated to Hoffman Estates, Illinois after the merger. At this time they are a broad line retailer with 2300 full line and 1,100 specialty retail stores owner of the operations of Kmart, Sears domestic and 370 full-line and specialty stores in Sears Canada. The latest report of revenues for 2007 (January) was \$53.0 million, with an increase of 7.9% over the same period of 2006. The net profit of \$1.5 million represented an increase of 73.7% compared to 2006, which shows the significant positive changes achieved in the financial segment of the income statement.

When Kmart and Sears Roebuck and Co merged in 2005, the stockholders of Kmart and Sears who received common stock from this holding became stockholders of the holding and therefore governed by the laws that pertain to the parent.

Exploring Sears and Kmart's Merger Motives

A Merger and Acquisition is always lead for certain motives (Berkovitch and Narayanan, 1993) which are basically of three types: synergy, agency and Hubris. The Synergy motive is expected in most cases as this suggests that takeovers occur because of the incremental gains to be obtained. Agency motives are selfish as they prioritize the acquirer's interest over the

acquired firm. The Hubris hypothesis suggests that takeovers occur because of an error in valuation of the potential merger. In the following section, this paper will address what was the prevailing motive of merger between Sears and Kmart.

The relationship between Sears and Kmart existed years before the actual merger agreement. Actually, the emergence of Kmart from reorganization under Chapter 11 of the federal bankruptcy law in 2003 was not only the result of their own plan execution but was also the result of the active participation of investors from ESL companies, a strong shareholder in Sears Roebuck. Both Kmart and Sears' management teams have claimed to pursue goals of increasing shareholders' value through strategies of profitability, responding to the most basic finance theory of valuation (Miller & Modigliani, 1956).

Kmart Motives

In 2003, Kmart started working on a new financial plan to generate funds through sales, cost reduction, overhead management and increased productivity and customer service. This goal is consistent with the majority of theories that relate quality management to financial performance (Fokker, 1996). Two major elements stand out as the core of the plan: *Attractive pricing* and enhanced *service culture* (SEC, 2007).

Considering the competitive retail industry in the United States, Kmart needed a differentiation strategy that would set it apart from *mass retailers*. The opportunity to do it came with the merger. Therefore the motives of Kmart to merge were: Expansion, diversification, and quality. The brain behind this new plan was Edward S. Lampert who controlled ESL companies and ESL Investment Management LLC in the past and who soon would become Chairman of Sears Holding.

Sears Motives

For Sears, substantially larger than K-mart, the growth strategy was not too different even though Sears did not have the financial difficulties Kmart had at the time of the merger. In this context of economic stability, Sears financial strategy aimed also at differentiating , but in a different industry: multi-line retailers industry ; and for different reasons: Increasing shareholders’ value and reinforcing their full-line approach (SEC, 2007).

In February 2004, Alan Lacey former Vice Chairman of Sears approached Edward Lampert from Kmart to discuss a potential merger and signed an agreement to create Sears Holding Corporation, where Kmart would be the acquirer of Sears for \$11 billion. This proposal would change later in June 2004 when the announcement of the transaction was officially made.

Based on the discussion above, it is evident that the M&A operation between Sears and Kmart responds to Berkovitch & Narayanan’s Synergy Motives (1993).

Sears and Kmart Merger as Life-Cycle Process

This section will address the pre-merger phase between Kmart and Sears to align the life-cycle approach (Chanmugan et al, 2005) to the actions taken by top management and shareholders of both organizations. Bidders who enter the merger process overestimating synergies and underestimating the difficulties of the post-merger reduce their likelihood of success. Chanmugan et al define success in the merger process in financial and non-financial

Illustration 1 terms; in both cases, the ultimate goal is to increase the value for

Life-cycle Approach for Successful Mergers shareholders. Illustration 1 shows the life-

cycle

Life-cycle approach		
Bids, Pre-deal strategy Goals, target identification, valuation is connected to processes thereafter	→	Deal execution Synergy targets are aligned with required premium
	→	Post-merger integration Focused on key drivers that made the deal attractive

approach:

Source: Chanmugam, R., Shill, W., Mann, D., Ficery, K. & Pursche, B. (2005). The intelligent clean room: ensuring value capture in mergers and acquisitions.

Bids, Pre-deal strategy

In 2004 when the conversations started, the main topics of discussion were real estate and co-licensing of Sears brands -Craftsman and Kenmore- and were gradually taking the shape of pre-merger formal conversations when addressing business combinations. This stage is what DiGiorgio (2003) calls the target identification phase. The transfer of confidential information between both firms started in March 2004, after they signed a confidentiality agreement that protected sensitive information about financial position, loss and profits, and the conditions of the transaction itself.

The magnitude of the potential deal comprised 54 real estate properties (stores) for which a determination of price, timeline for purchasing and financial performance information was necessary. In June 30, 2004 the transaction was announced and Sears and Kmart signed an agreement by which Sears would purchase these stores for a maximum price of \$621 million (SEC, 2007).

Deal Execution

The phase of deal execution is one of the most critical as here is where all the issues of valuation and strategic decisions of future lay-offs are defined, to align the premium that the acquirer will pay to the value added provided by the acquired firm (Chanmugan et al, 2005).

Sears and Kmart transaction could be categorized as *absorption* from the point of view of cultural change; but as *acquisition* from the point of view of ownership and economic results (Marks and Mirvis, 1998; Aluko & Amidu, 2005). Absorptions are characterized by a high degree of culture change in the acquired firms and low from the acquire (Marks and Mirvis, 1998). Acquisition implies one firm taking over the assets or ownership and management of other without a combination of their entities (Aluko & Amidu, 2005). There is a fuzzy line

between these two concepts, given that both Kmart and Sears created Sears Holding, but they continued operating as individual brands. In fact, the Board of directors of both firms refer to it as *business combination* (SEC, 2007).

Identified Synergies

The deal execution phase (Chanmugan et al, 2005) included assessments of the potential structure of the transaction, the consideration to be paid to the stockholders, the composition of key members of the board and top management. The definition of synergies was critical (Chanmugan et al, 2005; Berkovitch & Narayanan, 2003) to prompt a strategic plan post-merger.

The most notable synergies identified by the Kmart Board are reflected in incremental operating income and cost reduction. The incremental operating income is derived from operating profit synergies resulting from converting off-mall Kmart stores to Sears stores, and cross-selling Sears and Kmart products in each other's stores. The cost reduction is derived from scale synergies in purchasing costs, given the enhanced volume of purchases. Other costs reductions will result from consolidation synergies, that reduce the cost of corporate services such as: transportation logistics, integration of networks, consolidated services (SEC, 2007).

Other synergies result from the consolidation of management teams. The selection of key positions in the new organization would ensure continuity in the integration and post-merger, as recommended by DiGiorgio (2002). Table 2 shows a summary of the synergies identified by both Board of Directors in 2004 (SEC, 2007).

Sears entertained other alternatives in case of an unsuccessful agreement with Kmart: Acquisitions, leveraged buyout and leveraged recapitalization, but after evaluation were disregarded as they implied higher risk and would not provide the potential growth of a *business combination*.

Table 2

Summary of Identified Synergies in the Kmart – Sears Roebuck and Co. Merger

Identified Synergy	Metric	Finance Theory
1. Enhanced position in retail market	Annual revenue: \$55 billion Broader retail presence: 3800 full-line and specialty retail store Presence in Canada and U.S. Increase from 4th largest retailer to 3rd. largest retailer	Aluko & Amidu (2005) Berkovitch & Narayanan (1993)
2. Winning Real Estate Strategy	Expansion of points of distribution: Urban and high-density suburban locations Name recognition Diverse Customer base Growth in stand-alone, off-mall stores (given Kmart real estate addition) Potential sales of real estate assets Capitalizations of proceeds	Aluko & Amidu (2005)
3. Differentiation of stores through wealth combination of proprietary brands	Differentiated products Craftsman, Kenmore, Lands' End, DieHard, Covington and Apostrophe (Sears) Martha Stewart Everyday, Joe Boxer, Jaclyn Smith , Sesame Street, Route 66, Thalia Sodi (Kmart)	DiGiorgio (2002) Delcour and Hulsander (2006).
4. Strengthened Financial Position	Increased earnings Increased cash flow resulting from combined retail sales Better negotiation terms with vendors	Aluko & Amidu (2005) DiGiorgio (2002) Delcour and Hulsander (2006) Chanmugan et al (2005) Marks & Mirvis (1998) Lindenberg and Ross (2001) Berkovitch & Narayanan (1993)
5. Significant synergies	Incremental operating income in 2007: \$500 million \$200 million, operating profit synergies \$200 reduction of purchasing costs \$100 reduction of other costs	Berkovitch & Narayanan (1993) DiGiorgio (2002) Delcour and Hulsander (2006) Chanmugan et al (2005)
6. Stronger management team	Capable managers Positive and winning culture Disciplined investment strategy Operational excellence Governance and Board composition Senior Management teams	DiGiorgio (2002) Chanmugan et al (2005) Marks & Mirvis (1998) Berkovitch & Narayanan (1993)
7. Support from controlling stockholders	Agreement over stock by stock replacement Option for Sears to elect cash or stock consideration	DiGiorgio (2002) Chanmugan et al (2005)

Source: SEC (2007)

DiGiorgio (2003) contends that processes of change of culture that might take 7 to 10 years, must happen in a shorter period of time when acquisitions or mergers occur. This was

what happened with the merger process after Vornado's announcement. Since the share price of Sears increased 21% as a result, both Boards had to immediately assess the impact over their negotiation, trading prices, volatility of both common stock structure, and even over other retailers.

Consequently, both boards decided to speed up the timeline for the integration to reduce the window for speculation and volatility, that could alter the financial agreement, an aspect addressed in finance theory by Ball (2001), Stewart (2001), Fama and French (1956) and Jensen (2001) and in the literature about mergers (DiGiorgio, 2003; Chanmugan et al, 2005).

Valuation Strategies in Sears and Kmart Merger

Mergers and acquisitions are strategic decisions that blend financing decisions, investment decisions and dividend decisions (Slater and Zwirlein, 1996). Most theorists seem to agree that the value of a firm is given by the Expected value of the cash generation and not by earnings (Lindenberg & Ross, 2001). An ideal situation the *acquirer* should expect an incremental amount of cash flow from the *target*, and this is what Sears and Kmart expected: An increment of \$200 million in profits by the end of 2007.

Currency or Form of Consideration

The *form of consideration* is the currency of a merger transaction (Lindenberg and Ross, 2001). Kmart stockholders would receive stock of the Holdings in a one-on-one basis (stock consideration). Whereas, Sears stockholders had the possibility of choosing cash or stock consideration. This strategy was suggested by Sears as a protection measure in case of a potential decline in share prices of Kmart common stock.

From the Sears Board perspective, this would increase shareholder value, as it would give them the option of obtaining immediate cash or capitalize their ownership in the Holdings.

Multiple attempts were done to increase the consideration for Sears stockholders until the finally formula was agreed (SEC, 2007)

Each share of Sears common stock would be converted into the right to receive, at the election of the holder, either (1) 0.50 of a share of Holdings common stock or (2) \$50 in cash. The stockholder elections would be subject to proration to ensure that 55% of the shares of Sears common stock would be converted into stock and 45% into cash.

For reference, the table below shows the pro forma equivalent per share value for both firms in two different dates (SEC, 2007).

Table 3

Pro forma equivalent per share value

Date	Kmart Closing Price	Sears Closing Price	Kmart Pro Forma Equivalent	Sears Pro Forma Equivalent
November 16, 2004	\$ 101.22	45.20	\$ 101.22	\$ 50.61
February 18, 2005	100.21	50.89	100.21	50.11

Source: SEC (2007)

The pro forma equivalents were based on Kmart common stock closing price, making the implied value of the merger volatile upon changes in Kmart common stock market prices:

Kmart pro forma equivalent = Kmart closing price * 1.0

Sears pro forma equivalent = Kmart closing price * 0.50

As a result of the merger process, Holdings would issue approximately 156 million shares of Holdings common stock, with a final participation of 37% for Sears' stockholders and 63% for Kmart stockholders. The new stock was approved to be traded on the Nasdaq National Market using the symbol "SHLD".

Premium

The premium assessed for the consideration of shares of Sears common stock is equivalent to the trading price of Sears common stock prior to the announcement of the transaction (June 30, 2004) and 36.5% premium to the trading price on the trading day prior to the announcement from Vornado Realty Trust about the acquisition of 4.3% economic interest in Sears (November 5, 2004).

Lehman Brothers prepared an analysis of historical share prices for the stock of Kmart and Sears between May 2003 and November 2004, in addition to performance indicators for Kmart and Sears, S&P 500 index, a portfolio of equities of four large department stores (e.g. Dillards and JcPenney), a portfolio of equities of the two largest home improvement retailers in the U.S (Home Depot and Lowe's) and a composite of three discount stores equities (Target, Wal-Mart and Costco). At the end of the analysis Lehman Brothers gave a *fair* opinion of the impact of the merger on Kmart.

Leverage and Financing Options

After payment of merger considerations and other adjustments derived from the merger, the free cash flow of the Holdings was expected in \$700 million, \$5.1 billion in indebtedness (capital leases and short term and long-term borrowings) leaving the new organization with requirements of additional financing, which would be covered with a five-year revolving credit facility for \$4 billion before the merger is completed.

Holdings was assigned a "BB-plus" corporate credit rating by Standard and Poor, and a "Ba1" rating by Moody's Investor Service, which were not satisfactory ratings as they are usually related to low grade ratings or "junk" ratings. Therefore the financial performance of Holdings would determine the cost of capital to be obtained from the market. With the ratings

assigned to the Holding, the efforts for funding would be extraordinary, implying a risk to the optimal outcome of the merger and the future growth of the entity (SEC, 2007)

At this point it is important to point out that the purchase transaction of 50 Kmart stores, was conceived as a Sears-Kmart transaction, that would go ahead regardless the success in completing the merger. Sears paid \$172 million from the total agreed of \$575.9 million and did not take possession of the stores until months later, when the remaining cash of the transaction was due. If the merger would not take place, the purchase would still stand; if it did, it would have neutral effect in the consolidated situation of Holdings (SEC, 2007). On November 17, 2004, both firms announced the execution of the merger agreement.

Evaluation of the Risk Analysis and Risk Response Systems

In the American economy mergers and acquisitions appear to have become a “mature” utility” (Chanmugan et al, 2005). Firms can mirror the experiences of others and walk through the pre-merger process with relative comfort; however it is the creativity in the post-merger integration what will determine the capture of value and synergy. Sears and Kmart performed a thorough risk analysis of factors that could slow down the integration process or hinder the entire merger process, summarized below:

1. Risk of not receiving the consideration (cash or stock) chosen by Sears stockholders or risk of receiving considerations with lower value
2. Differences in the market value of the Holdings common stock in comparison to the existing Kmart and Sears common stock, given the timeline of the merger process.
3. Failure to realize the projected synergies and other benefits of the business combination.
4. Cannibalization of sales of Sears of Kmart

5. Failure to realize the expected value of the combined real estate portfolio
6. Failure to differentiate products and services
7. Failure to meet the timeline for integration
8. Challenges in the consolidation of operations, retention of key personnel
9. Conflicts of interest of Directors of Kmart and Sears
10. Conflicts of interest between Chairman of the Holdings that could discourage potential new investments
11. Risk of relatively less free cash flow in the Holdings than Kmart and Sears before the merger, that could limit the potential for growth and performance
12. Rated as *below-investment grade debt* by some agencies, limiting access to reasonable financing
13. Dividends will not be paid by Holdings; stock returns depend on trading prices
14. Risk of losing key personnel
15. Pending lawsuits connected to the merger

Sears and Kmart prepared evaluations of more than 30 other risks related to the market and the conditions of the retail and services industry, consumers' preference, volatility of the markets, international trade restrictions, public debt restrictions, seasonality among others, which were stated in the forward-looking statement part of the merger process (SEC, 2007).

Assessment of Alignment of financial Strategy and Financial Theory

The financial strategy put in place by Holdings was based on the model of DiGiorgio (2003) about key elements of a merger, the assessment of the process performed by Sears and Kmart is positive. DiGiorgio (2003) defines success by an appropriate selection of target and

integration of processes. Table 4 shows a summary of factors based on DiGiorgio (2003) assessed on the Kmart and Sears merger process.

Throughout the document and particularly in Table 2 of synergies, this researcher presents an assessment of the theories used to evaluate the synergies in the transaction. In the valuation process of the stock to be considered in the merger, the firms use an approach of stock by stock suggested by Lindenberg and Ross (2002). In the financing options to complete the transaction, the firms used an approach of Pecking Order Theory (Myers, 2001) using internal funding before requesting for financing.

Table 4

DiGiorgio key factors in target identification

An application to Kmart- Sears Roebuck and Co.

Action	Done
1. Define the degree of compatibility with the target	Yes
2. Assess potential disconnects on cultural fit	Yes
3. Use competence models to define characteristics of the future integration manager	No
4. Plan to implement a separate transition structure lead by the future leaders of the new organization	Yes
5. Plan to face public scrutiny over the process and to respond to questionings about layoffs and other effects	Yes
6. Plan to communicate effectively between managers and employees regarding: key roles, management structure, layoffs and changes in careers.	yes

Source: DiGiorgio (2003)

Based on the application of financial theories, the firms would have benefited from using a simulation approach to determine the return of the operation and other non-financial issues that affect the post-merger process, such as an analysis of culture change (DiGiorgio, 2002; Chanmugan et al, 2005). However the firms compensated it with the thorough risk analysis performed.

After the merger, both shareholders and management team applied a method of report that relied in a Pro Forma Adjusted Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Through this method, comparison and performance measurement are more accurate, as it excludes the effects of the merger and gains from asset sales and restructuring.

EBITDA

In the annual report for 2005 Lampert pointed out earning per share (EPS) substantially lower than 2004 (\$5.59 vs \$11.00) but highlighted that the net income was substantially above 2004 (\$858 million vs. \$648 million). In his statement, Lampert acknowledged the magnitude of the revenue of \$55 billion in the consolidated P&L and the responsibility of leading 350,000 employees.

He remarked the importance of measuring success through profitable growth reflected on EBITDA and discard sales of sales growth as the aim of their business. By using EBITDA it was possible to show the real impact of the merger transaction on earnings, showing \$2,969 million for the fiscal year 2005 and \$1,488 million for the fourth quarter of 2005 (Marketline, 2007).

According to the public reports filed by Holdings, the target synergies were exceeded, with an improvement of \$488 million between 2004 and 2005 in the domestic Pro Forma Adjusted EBITDA, whereas for Kmart it was a decrease of \$74 million compared to 2004, explained by the lower number of stores, the increased costs of conversion (clearance and other off-prices) of Kmart stores to Sears stores. By the end of 2005, Holdings had converted 48 Kmart stores. The goal for Kmart in 2005 was to bring it to a stabilized figure that allowed for growth thereafter (Marketline, 2007). The Adjusted EBITDA is used by management to evaluate

performance, but it is not recommended for investors or other third parties. The reconciliation between EBITDA and GAPP financial measures is a requirement to assess the transaction correctly.

In the most current report of 2007, Lampert describes Sears Holdings as a *start-up* to exemplify the vulnerability to changes, challenges and opportunities of the merger (Sears Holdings, 2007). The role of top management in the creation of value in the organization was the outstanding point of this annual report. In a philosophy that reduces agency costs (Jensen, 1976), Lampert urges managers to be accountable, responsible and aligned with the goals and missions of Holdings, ensuring that a consistent compensation package is put in place (Sears Holdings, 2007).

The assessment for fiscal year 2006 seems to show a stable Holdings with sales at the same level of most of their important competitors, however it also seems clear that the strategy for expansion does not include a propagation of stores in the proportions of their competitors, which imposes a strong restriction to the generation of revenue, which would have to originate from sales that yield additional profits (Market Line, 2007).

One of the major restrictions to the growth was the dead weight of Kmart stores that operated with low levels of profits and sometimes losses. The re-direction from the focus on sales to profits, reduces the inventory costs, marketing expenses and labor costs formerly allocated to sales as an ultimate purpose.

The focus on customer satisfaction as a generator of profitability is anchored to an optimal customer experience that does not end with the sale of a product but continues until the customer accrues value (Marketline, 2007). This philosophy yielded incremental results in

operating income, a better expense management in all the three properties of Holdings and improved EPS. (See table 5).

Table 5

Adjusted EBITDA for Performance Valuation

Adjusted EBITDA	Quarters Ended		Fiscal Year Ended	
	February	January	February	January
	2007	2006	2007	2006 Proforma
Operating income per statement of income	1,399	1,500	2,523	2,073
Plus depreciation and amortization	299	282	1,142	1,108
Less gain on sale of assets/businesses	(50)	(331)	(82)	(357)
Before excluded items	1,648	1,481	3,583	2,824
Vice chairman separation expense			8	
Visa/MasterCard settlement			(36)	
Merger transaction costs				34
Legal reserve - AIG Annuity Insurance Co., et al. v. Sears Roebuck	74		74	
Restructuring charges	1	7	28	111
Adjusted EBITDA as defined	1,723	1,488	3,657	2,969
% to revenues	10.6%	9.3%	6.9%	5.5%

Source: Sears Holdings Reports Fourth Quarter and Full Year 2006

Operating Income

The total operating income by February 2007 was \$1.4 billion which was below the \$1.5 billion reported in January 2006. The explanation of this decrease comes from \$317 million pre-

tax gain obtained in the sale of the credit portfolio of Sears Canada (2005), which was offset by additional minority interest expense. When comparing 2006 and 2005 an improvement does appear despite the restructuring charges over Sears Canada and Kmart.

Value Generators

Integration

The integration process implied the relocation of 520 Kmart associates from their former headquarters to the new ones in Hoffman Estates. The integration of the Supply Chain, IT, Finance, Legal and Human Resources was also accomplished within 2005, with special attention to the Marketing department and customers relations. The efforts of Lampert to maintain the morale of shareholders were clear in the annual report where he encouraged to continue with the post-merger activities and strive for concrete outcomes.

In the case of Sears Holding statements made by their Chairperson suggest that the transformation of Kmart locations into Sears stores would be an immediate action. Other type of transformations were also performed such as name changes: Sears Essentials to Sears Grand, offering Sears products in K-mart locations and testing product lines in clustered locations nationwide. All these transformations were expected to influence the perception of quality and variety that was the motive of the transaction in the first place (Sears Holdings, 2007).

Compensation

Lampert (Marketline, 2007) addresses compensation of employees and top management and explains that the pay-for-performance approach to compensate managers is an option that Holdings has used with care, especially because of the linkage with stock options and its volatility. According to Lampert the use of employee's stock options seems a good idea when the stock is up but he acknowledges that this is an artificial way of perceiving gains for short term

fluctuations that do not pertain to the company itself. This position is consistent with the views about theory of the firm expressed by Jensen (1976).

Capitalization and Shareholders' Value

The new strategy in Holdings has been to use capital for investment only when they are reflected in improved customer experience; therefore the misspending of resources is avoided. This requires a discipline that would lead to a long-term value for the organization. Lampert remarks the practice of fiscal discipline in operating and capital expenses. These statements are consistent with the recommendations of Slater and Zwirlein (1996) about the relationship between the financing, investing and dividends strategies as Lampert suggests that any return on investment that yields free cash flow will not be used to aggressive capital expenditure. Lampert also suggests the allocation of free cash flow to repurchases or acquisitions as an alternative target for the resources. This is also partially consistent with the reduction of agency costs of free cash flow (Jensen and Meckling, 1976).

Based on the statements made in the annual report by Lampert it is clear that the strategy of growth and the strategy to generate value is really focused on the shareholders and the customers. Lampert states: “in the near term we believe the greatest value will come not from increasing our store base, but primarily from better utilizing our existing assets to deliver more value to our customers and ultimately our shareholders” (Sears Holdings, 2007)

Free Cash Flow

At the end of fiscal year 2006 the cash balance of Sears domestic was \$3.3 billion, which was under the projections for the year, explained by additional federal and state tax payments and a decrease in January sales. The free cash flow of the fiscal year was \$816 million that was

allocated to Share repurchases, capital expenditures, pension contribution and acquisition of new interests in Sears Canada.

The ability to generate cash flow is one of the enhanced characteristics of Holdings, which ultimately increases long-term shareholder value (Berkovitch & Narayanan, 1993). The figures for 2006 showed \$1.69 billion of after-tax cash flow in 2006.

Cultural Change

In terms of the cultural impact, Lampert (Sears, 2007) acknowledged that the “goal is to see Sears Holdings become a great company whose greatness is sustainable for generations to come” based on a culture of openness to change and adaptation. Considering that both Kmart and Sears were founded in the 19th century, this statement seems proper to describe the similarities between these two firms.

Grade Rating

One of the major frustrations of the Sears Holdings Board has been the grade rating assigned by some rating agencies. Lampert is confident that the firm should have an investment-grade rating, given the disciplined behavior in investment and the efforts for inventory management. Lampert recognizes that the levels of inventory at the end of 2006 are still above the target but disregards it as a reason for a bad rating (Marketline, 2007).

To prepare a final evaluation of the impact of the merger of Sears and Kmart, the model of DiGiorgio of End-state goals is presented below. The indicators of this disciplined growth are given by the increased profitability at the end of 2005, the new strategy of focusing on profit and not sales and reducing the expense structure (Sears Holdings, 2007). The foundation of this growth is linked to a change of culture, more innovation, and more customer service. Lampert

urges the stockholders in his annual report of 2007 to listen to the customers in a more efficient way that they had before in order to achieve those goals.

Table 6

End-state goals of a successful M&A

End-state Goal	Achieved
1. Talent retained	Yes
2. Speed to market new products	Yes
3. Measures of customer retained, lost or gained	Yes
4. Synergy capture	Yes
5. Employee satisfaction	Yes
6. Identification of service and product problems	Yes

DiGiorgio, R. (2002). Making mergers and acquisitions work: What we know and don't know – Part I

Evaluation of the use (or misuse) of financial theory and risk analysis

Sears Holdings and its Chairman acknowledge that there is always room for accounting abuses, especially in business combinations operations. Some potential sources of misuse of financial theory are noted in the section above but were not detected in the Sears Holding operation. The use of free cash flow from stock returns was not misused by top management; compensation packages based on stock options was not used either; use of short-term gains in the stock market to increase rewards or bonuses to managers was not done either. In this regard, the firm understood the theory of agency costs of free cash flow (Jensen & Meckling, 1976) and the theory of the firm (Jensen, 1976).

Lampert also addresses the risk of *myopic focus* on earnings, something that is cautioned in the finance literature by Stewart (2001). Sears Holding top management maintains a policy of not discussing investment opportunities with analysts of Wall Street and not playing with the stock market for pure speculation (Sears Holdings, 2007).

Finally, Lampert uses a holistic approach to evaluate the results of the merger, in a format very similar to Chanmugan et al (2005), where the most important subjects are the

shareholders and the customers. The well-being of the employees and top executives seems to be a priority for Sears Holding and therefore they work on the retention of key personnel, increase of satisfaction in the workplace and the alignment of the human capital to the mission of the organization (DiGiorgio, 2003).

Myers (2001) suggested that most of the financial strategies had an inability to comprehend theoretical models. In the evaluation of Sears Holdings combination, it appears clear that Lampert clearly understands the reality of the financial markets, the reality of the real market (retail industry) and supports all his statements with finance theory. The steps taken by Sears Holding since the merger in 2005, are conservative and cautionary, but if the long-term goals are designed with this basis, it would be expected that the growth of Sears Holdings be achieved sooner than later.

Conclusions

The discussion about the business combination of Sears and Kmart covered not only the financial aspects of a merger but reached out to the consideration of other non-financial factors that influence the decision of selecting a target, making the pre-merger phase work and integrate the organizational culture as a value-added of the process (Chanmugan et al, 2005; DiGiorgio, 2002).

This paper has combined the use of models of motives for take-overs (Berkovitch and Narayanan, 1993), model of bidder returns (Delcoure & Hunsander, 2006) and applications of the concept of EBITDA to value the financial results of the merger. The research has also revisited germinal theories such as Agency Theory (Jensen, 1976) or EMH (Modigliani and Miller, 1958) as the springboard to understand the contemporary approaches to returns, value, and the interactions in the market.

Sears Holdings performed an efficient identification of the target, has followed up each step of the transformation, and is focused on the generation of value for shareholders and customers. A combination that would reap fruits in the near future.

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