Checkout

Eddie Lampert's Next Play: Inside the Hedge Fund War at Sears

By Davide Scigliuzzo, Eliza Ronalds-Hannon, Josh Saul, and Lauren Coleman-Lochner

November 30, 2018, 5:00 AM EST
Updated on November 30 2018 10 57 AM EST

- Hedge fund titan weighs a long shot bid for the bankrupt chain
- CDS maneuvers pit their new alliance against Omega, Och-Ziff

Sears Files for Bankruptcy After 134 Years in Business

Edward Lampert isn't done with Sears yet. Neither are Sears's enemies on Wall Street.

Six weeks after the storied department store chain filed for bankruptcy, Lampert is maneuvering to salvage what he can from the worst investment of his life.

Edward Lampert *Source: Sears Holdings Corp.*

Having presided over Sears's collapse, the hedge-fund titan is now preparing a takeover bid for the chain with another private investment firm, Cyrus Capital Partners, people with knowledge of the matter told Bloomberg News this week.

They're having to maneuver around other prominent hedge funds that bet against them -- as well as a long list of lenders who'd rather shut down the retailer and get whatever money they can now.

The machinations have sent the 125 year old Sears tumbling down a financial rabbit hole and into a Wall Street Wonderland where, to the uninitiated, up might seem like down.

Swaponomics

Key to the story are credit-default swaps and other arcane investments that hedge funds can wield in ways that might appear to defy common sense or, according to some investors involved, even border on manipulation. For many of the players in this drama, whether Sears survives as a going business is beside the point.

The retailer "is just burning money," said Aldon Taylor, the chief executive officer of Deep Roots Capital, which isn't an investor. "It's a joke."

The potential takeover bid is the latest twist in Lampert's decade-long attempt to engineer profits out of Sears Holdings Corp. Behind him now is Cyrus's Stephen C. Freidheim, who has made his own play for Sears with a series of complex -- and sometimes controversial -- investments.

Read more about the ties that bind Lampert and Cyrus's Freidheim

Cyrus became deeply entwined in Sears's fate in the months leading up to the company's collapse. It amassed positions in its stock and bonds. And it lent money to the retailer alongside affiliates of Lampert's hedge fund, ESL Investments Ltd.

Then Cyrus doubled down -- some would say even tripled down -- with a massive credit-default swaps trade that effectively insured other investors against a potential Sears default.

That's when things began to get weird.

At one point, for instance, rival CDS factions battled over an unlikely prize: obscure Sears notes that are virtually worthless on their own. But those notes, it turns out, could hold the key to the insurance-like wagers in the CDS market. So Cyrus ended up paying $82.5 million to Sears to keep the debt from falling into the hands of funds on the other side of its trade.

Then, this week, Cyrus unexpectedly showed up in court with an offer to lend $350 million to the bankrupt retailer at terms that undercut a previously announced loan. The deal was hastily cut in the hallway of the bankruptcy court. Once again, the move could strengthen Cyrus's hand when it comes to Sears's investments, including its CDS bets.

The CDS tail, in other words, keeps wagging the Sears dog.

Hard Sell

Representatives for Sears, ESL and Cyrus declined to comment for this story, which has been pieced together from interviews with market participants and other people with knowledge of the behind-the-scenes dealings. Representatives for key rivals on the Sears trade, including Omega Advisors, Och-Ziff Capital Management and Brigade Capital Management, also declined to comment.

For most of the investing world, Sears has been a hard sell. The retailer, along with its Kmart chain, has bled more than $11 billion since 2012.

That would have been the end of it for many other companies. But Lampert, who served as Sears CEO, its largest shareholder and ultimately its biggest creditor, engineered spinoffs and asset sales to keep the chain going. By the time Sears filed for Chapter 11, Lampert and his ESL held more than $2.6 billion of loans to entities within the retailer's sprawling capital structure.

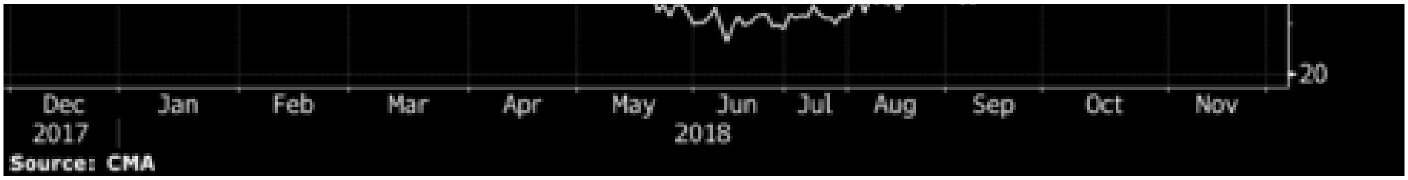
Enter Cyrus. Its bet isn't so much a wager on Sears's survival as it is a bet that it can recoup a lot more money on the company's assets than the rest of the market expects.

Swaps Goldmine

Other hedge funds have taken the opposite view. Seeing bankruptcy and default as all but certain, they were paying almost 50 percent premiums -- $5 million for every $10 million insured, in upfront cash -- for Sears CDS.

To Cyrus, it became a potential goldmine. The swaps are linked to a unit of Sears that, in the wake of Lampert's financial maneuvering, has little remaining debt itself. Which means that when buyers of the swaps came to collect on their insurance, sellers of the swaps like Cyrus could dodge a big payout because there wouldn't be enough bonds outstanding to cover all the trades. Cyrus would, in turn, pocket the juicy premiums.

Around the time of Sears's Oct. 15 bankruptcy filing, there were more than $400 million of swaps wagers linked to less than $300 million of the Sears unit's unsecured bonds.



To boot, rumors swirled that Cyrus was snapping up whatever of the Sears entity's bonds were left. And Lampert at one point proposed a complicated refinancing, which drove speculation that he would take out the remaining debt. The market chatter caused prices on the swaps to nosedive, which would have caused Cyrus's profits on the trade to swell.

That's where the obscure Sears notes came into play. Hedge funds including Omega, Och-Ziff and Brigade, which had bet against Sears by buying CDS protection, sought to acquire the debt from Sears this month in order to boost their payout from the swaps, people familiar with the matter said.

Ultimately, after about a week of legal wrangling -- and accusations from both sides that the process was being manipulated -- Cyrus outbid them. The deal handed Sears $82.5 million of cash just as the crucial holiday shopping season was getting underway. As part of the sale to Cyrus, Sears agreed not to auction any more of the notes that are so crucial to the CDS trades, people with knowledge of the matter said.

Then, this week, Cyrus representatives turned up in the federal bankruptcy court in White Plains, New York, and made Sears another offer it couldn't refuse. Cyrus agreed to shave 1.5 percentage points off the 11.5 percent that another lender, Great American Capital, was charging Sears for financing.

Blindsided

The president of Great American Capital, John Ahn, was blindsided. He said Cyrus was offering terms that weren't attractive for an ordinary lender. But then he acknowledged that the hedge fund has many fingers in the Sears pie.

"Cyrus is invested in a lot of different pieces of Sears's capital structure in a big way, so it's unclear what their overall motivations are," Ahn said.

Outside of the Wall Street rabbit hole, many retail experts doubt that Sears can survive.

Consider that holiday staple, the poinsettia. While Sears is selling them for $6.99, competitors like Home Depot and Aldi have priced the plants for 99 cents, according to Burt Flickinger, managing director of Strategic Resource Group, a retail-advisory firm.

That's just one example of how Sears merchandise is overpriced -- which, in turn, explains why sales keep falling, he said.

"There's no way to stop the bleeding and bring the proverbial patient back to life," said Flickinger. "Sears has already gotten a death sentence."

Meanwhile, the retailer's workers are getting nervous that they'll be left in the cold. A group of them sent a letter to Lampert this week asking for guarantees that the company will fight for their jobs, pensions and severance pay.

"While we understand that Sears and Kmart must make changes to survive, we do not believe it is fair that financial firms stand to profit from Sears's bankruptcy while employees like us are asked to sacrifice," they said in the letter, which was signed by 62 current and former employees.

– With assistance by Claire Boston

(Updates with letter from workers in final two paragraphs.)

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